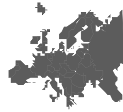

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THE CHOICE OF THE APPROPRIATE EXCHANGE RATE POLICY FOR THE POST-SOCIALIST EUROPEAN COUNTRIES: A THEORETICAL APPROACH

Abstract

Most of the former socialist countries have already made already a serious progress in transforming their economies to the free market system. As opposed to the old E.U. members, who have had the necessary time to adjust their economies to the needs of the monetary union, the post-socialist countries are forced to follow the strict path of the Maastricht criteria. To that end, exchange rate policy plays a very central and important role since, on the one hand, these countries are allowed to participate in the globalized economy throughout a credible exchange rate regime and, on the other hand, able to tackle the many problems which arise from the international financial instability. In this article, we argue that conclusions about the appropriate exchange rate policy of these countries can be made only in the realm of the theories of financial integration.

Key words:

Monetary Policy, Exchange Rate Policy, Maastricht Treaty.

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1. Introduction

The choice of the appropriate exchange rate regime was always a very puzzling exercise for the politicians and for the theoreticians too. Historically, as Bordo states, using a currency internationally as medium of exchange, of accounting and store of value, was always a matter of credibility, and of credible commitment (Bordo, 2004). This was evident in the area of the golden rule and the convertibility of national currencies with the gold, and after the First World War, when the golden rule commitment did not exist and the countries experienced many problems. Things seem not to have changed much in the modern area of intensive trade and free capital movement. This can be seen this today in many small countries using the dollar as a medium of international exchange as in Panama that uses dollar, and countries like Argentina, which tray to impose a strange commitment, the so called currency board. We saw this in the case of the European countries that created an international new currency, the euro. We still see it now in the case of the New European Countries (NECs), that tray to become members of the euro zone and to replace their own currencies with the Euro.

In the economic theory, the choice of the exchange rate regime has been studied intensively since Hume. There have been developed many theories and models about this matter. For the purpose of this article theories may be separated in two broad categories. The fists one includes the models, which tray to calculate the level of the exchange rate and their changes, like the Purchasing Power Parity, the Covered and Uncovered Interest Rate Parity, the Overshooting Model of Dornbush, the Sticky Price Model, the Flexible Price Model or the Portofolio Balance Model (Sarno, 2002), and the second to deal directly with the choice of the exchange rate regimes and includes three group of theories[1] and specially the theories of Optimal Currency Areas, the theories of Political Economy and the theories of Financial Integration[2]. The first group, the OCA theories, focuses on the adaptability of the exchange rate mechanisms and trays to conclude about the merits of the different regimes (mostly flexible versus fixed and

[1] We use the term group about these theories because they are not narrow defined models, but more methodological approaches, which contains many others theories. For example the first from Mundell developed theory of OCA is accomplished through the theories of Kenen and McKinnon, (De Grauwe, 2003), (Mongelli, April 2002), (Ashinger, 2002) and (Bordo, 2004)

[2] We can add to this groups a fourth one, the group of the New Open Macroeconomic, which tray to solve the problem of the choice of the exchange rate regimes through formal mathematical models of dynamic optimizations in an open economy (Sarno and Taylor, 2002).

currency union) with the help of the nature of the economic disturbances and their geographical characteristics. The group of the Political Economy theories focuses on the possibility to impose credibility in the area of the economic policy throughout the exchange rate regime choice and lastly the group of the Financial Integrations points on the destabilizing role of the free capital movement and the consequences for the choice of the exchange rate regime.

What it matters for the NEC[3], even though they have expressed a clear commitment in adopting the euro, is the road to the adoption. While the Old European Countries (OECs) have adopted the euro after a long standing procedure, that is to say the participation in the Free Trade Zone, the Custom Union, the Single Market, the Monetary Union and most of all the participation in the European Exchange Rate Mechanism (ERM I), which enabled them to adapt their economies to the condition of the monetary union, the NECs have to adapt in a short run to the conditions which are imposed by the Treaty of Maastricht. At a first glance, the road to the euro seems clear and predominant. The monetary discipline, which is imposed by the Maastricht criteria, should help to integrate them in the euro zone. At second glance, these same criteria seem to impose many constrains, which hamper the road to the real convergence of the NECs to the level of the old ones. The criteria about the stability of the exchange rate and the participation of the countries in the waiting room of the ERM II in order to adopt the euro leave the countries with many options, regarding the timing and the concrete regime to choose.

In order to fully understand the challenge the NECs face, in the first part of this article we will introduce the economic theories of the choice of exchange rate regimes. Here we put emphasis on understanding the relevance of all three groups of theories for the case of the complex project of the euro zone in a modern area of financial integration. Therefore, we use the notion of the impossible trinity and their variants of the blessed and unblessed trinity. In the second part we will introduce the Maastricht criteria and their underpinnings in order to fully explain the situation of the NECs and to judge the constraints imposed by the Maastricht Treaty. In the third part we will introduce the situation and the characteristics of these countries from the point of view of the financial integration of these countries in E.U. and the challenge, which impose such integration to their exchange rate policy.

[3] The group of the NECs includes the countries of Central and Eastern Europe as well as the Baltic Countries also all the post-socialist countries (countries in transition) which are already members of E.U. or candidate countries, while the group of OECs includes the first members countries of the euro zone, the Great Britain, Denmark and Sweden.

2. Economic Theories and the Choice of the Exchange Rate Regimes

As we have already stated, we separate the plethora of the economic theories regarding the matter of the exchange rate in two broad categories: those which deals with the factors determining the value of the exchange rate and those which deal directly with the choice of the appropriate exchange rate regimes. In the next, because of shortage of space, we will not review the many models in the first category and procedure with the second one. This however, does not mean that the category of theories is irrelevant to the problem of choice of the exchange rate regimes[4, 5].

2.1. Theories of Optimum Currency Areas

At the beginning of the 60's Mundell developed his open economy model under free capital movement. Under the assumption of price rigidities he introduced an income – flow mechanism and showed how an open economy tens to short run equilibrium. With the help of this model Mundell investigated the effectiveness of monetary and fiscal policies under flexible and fixed exchange rate regimes and showed how a policy mix can lead to internal (fiscal policy) and external equilibrium (monetary policy) (Obstfeld, 2001). A later work from Pool and others showed that the effectiveness of exchange rate regimes depends on the nature of external shocks. Especially they showed that the free floating is effective in the case of external real shocks while a regime of fix system is effective in the case of external monetary shocks (De Grauwe, 2006).

As such rules are impractical because of the difficulty to disentangle between monetary and real shocks and because a mix of policies is a matter of the concrete situation of each country, Mundell continued in developing the theory of Optimal Currency Area (OCA), where he tried to solve the problem of optimal choice of exchange rate regime concentrating on geographical characteristics. In this case Mundell looked at alternatives to exchange rate adjustment mechanisms, like the flexibility of prices and wages, the mobility of labor, the fiscal transfers and defined an optimal currency area as an area, which can abrogate

[4] In similar vein the IMF differentiate between exchange arrangements and exchange rate policies (IMF, 2006).

[5] In practice, very often the authorities even when they choose a stable regime they adjust the exchange rate when they see that the fundamentals have changed or even when they choose a flexible regime they intervene in the market when they feel that the fluctuation of the exchange rate is very high and disturbing. Here were we need the analysis of such models and theories which state the factors determining the value and the change of the exchange rate.

on the adjustment mechanism of the exchange rate because there are alternative adjustment mechanisms and can function under a single currency (fix exchange rate mechanism, fixed peg or a monetary union) (De Grauwe, 2003). Later, works from Kenen and McKinnon completed the theory of Mundell introducing the importance of openness and the amplitude of the differentiation of the economy as criteria for an OCA (Ashinger, 2002). In general the economic analysis concludes that the effectiveness of the monetary policy in a monetary union depends on the symmetry of the shocks. As monetary union operates under a single monetary policy, it cannot respond to shocks which have different effects on the countries (De Grauwe, 2003).

New developments in the economic analysis however shows that theoretically there is no need of the ex ante existence of the necessary adjustment mechanisms for the realization of a monetary union as they can be imposed ex post through an endogenous process of integration and of convergence. In other words, there is no need of ex ante fulfilling of the OCA criteria as they can be accrue ex post (Mongelli, 2002) and (De Grauwe, 2003)[6, 7].

2.2. Political Economy Theories Or Theories of Credible Exchange Rate Regimes

A great deal of the economic analysis relates the choice of the exchange rate regime with the level of the institutional development of a country. It is often believed that countries with weak institutional framework, with a weak government, a government, which succumb to the pressure groups and follows inflationary policies, can often impose a discipline by pegging their currency to a currency of a country with a disciplined government. The best example to that are the first years of the functioning of the European Monetary System, where countries like France and Italy, with a history of high inflation and of unstable currencies imposed the stability and the credibility of their policies and currencies by pegging them with the very stable Deutsche Mark, a policy which contributed so to the convergence with E.U. (De Grauwe, 2003). On the other hand it must be admitted that this reasoning is not unquestionable as far as it is possible to argue that even those weak countries cannot hold on the commitment because weak government reneges on the pressure of the different groups (De la Tore, 2002).

[6] This is of course the main aim of the draftsmen's of the Maastricht Treaty as we will see in the follows parts of this article.

[7] Proponents of the above thesis see this coming through the abolishment of the exchange rate and the positive effect of this abolishment on trade volume, the so called Rose-effect, while others like Krugman claim that an abolishment of the exchange rate will lead to a specialization and to the increase in the intra-industrial trade and not to the inter-industrial trade and in this way to asymmetrical structures in the monetary union and so to the above mentioned asymmetries (Mongelli, April 2002).

At the ground of such theories lies the very important problem of time consistency (or inconsistency)[8] and the problem of discretionary policy, brought out by writers like Kydland and Prescot (Pentecost, 2000), Barro and Gordon (De Grauwe, 2003) and Calvo (Mendoza, 2005). For the case of an open economy the works of Barro and Gordon proved that the effectiveness of an anchor depends on the cost of reneging on the commitment. In general terms this theory concludes that the best way to respond to the problem of time inconsistency is a rule based policy, which is often realized throughout inflation targeting by using a Taylor-type monetary policy combined with a free floating regime (Bordo, 2004).

2.3. Theories of Financial Intergration

The advantages of the financial integration are not only theoretical. Mature economies, countries with a developed institutional framework, a developed financial market and stable and credible government seem to enjoy the advantage of a financial integration and financial globalization. These countries seem to have solved the problem of a credible currency in a global level and therefore use mostly floating.

The financial integration seems to impose more problems in the case of developing or emerging economies, as well as in the case of transition economies. These economies which partly participate in the global financial market, seem do not be able to fully enjoy the advantage of the mobility of capital[9]. In these countries the mobility of capital seems to show its hard face in form of capital runs, sudden stops and currency and bank crises like those of Mexico (1984), East Asia (1997–1998), Russia (1998), Brazil (1998–1999), Turkey (2000) and Argentina (2001). The countries of this group, which have chosen a fix exchange rate or a peg they seem to end up with a currency or bank crises, while those that have chosen a floating regime seem to face problems with ex-

[8] The problem of time consistency (or inconsistency) is one of the most important puzzles of the economic policy analysis and as we will see in the next sections lies at the heart of the problem of the Maastricht Treaty. In reality, the problem of time inconsistency concerns the application of economic policy measures at a discretionary basis or on the basis of rules. The mathematical analysis of the problem of the time inconsistency showed the even those discretionary applications of measures which are based on an optimal mathematical solution are going to be suboptimal as far as the facts changes (Pentecost, 2000), as already stated Lucas in his famous critic. Finally, this theory concludes that the best solution for the application of these measures is a rule based application, which is for the case of monetary policy a Friedman-type or a Taylor-type rule, applied strictly or with flexibility (at least the last one) and therefore they are characterized as rules with the constrained or enlightened discretion (Arestis, 2003).

[9] For a comprehensible presentation of the empirical results of the financial integration, not only for developed countries but also for the emerging market economies, where there it is shown that the advantage is more indirect than direct, look at Kose et al. 2006).

tended exchange rate volatility. Basically, the problems these countries face with the choosing and using of an exchange rate are related to the credibility of their currencies and this in turn is related firstly with the constrained ability to borrow in their own currencies and therefore the necessity to borrow from abroad in foreign currencies, a fact which was coined by Eichengreen and Panizza as the «original sin» (Eichengreen, 2005)[10], and secondly with the consequences which can have such a borrowing in foreign currencies and thirdly a fear of floating (Calvo, 2005). Countries which borrow in foreign currencies show a currency mix, where the debt is denominated in foreign currency and the earnings devoted to repay the debt in their own currency. In such cases a deprecation or devaluation of their own currencies can have devastating results as far as it raises the burden of the debt in foreign currencies. In such cases these countries express a fear of floating, which in turn force them to use the interest rate as a shock absorber[11].

Basically the problem of a workable combination of the exchange rate regime and a regime of free capital movement was already stated in the works of Mundell. Nowadays this approach is reintroduced in economic theory in the form of the «impossible trinity» or the «trinity of macroeconomic policies» according to, where it is not possible to realize all three combination: fixed exchange rates, free capital movement and autonomous monetary policy, but only two of them either a combination of fixed exchange rate and a autonomous monetary policy by imposing measures of capital control or a combination of free capital movement and fixed exchange rate regimes by giving up the autonomous monetary police or, at lastly, a combination of free capital movement with autonomous monetary policy by giving up the fixed exchange rate and using a flexible exchange rate regime[12]. At the heart of such a thinking lies the tradition of the old quantitative theory of money and the impossible combinations which spring out are the result of the effort to realize two goals with one tool, the monetary circulation of an economy. In line with that thinking a country which wishes to fix the exchange rate can do it by intervening in the currency market through open market operations and by changing the monetary basis, which can have impact on the price level, which in turn constrains the monetary policy. In line with this thinking, new theories like the above mentioned enhance the destabilizing role of the free capital movement and they conclude by introducing the bipolar view, eliminating the combination of the middle by introducing hard pegs, like those of

[10] Eichengreen and Panizza include to the original sin the constrained ability of a country to issue long term debts in their own currency (Eichengreen et al., 2005).
[11] Calvo marked up the discussion of a choice of exchange rate regime for the case of emerging markets and made the fear of floating one of his central arguments, in which he included not only the problems which resulted from financial sector and the free movement of capital but also those which resulted from the real sector, for example those they resulted from high transmission mechanism of a depreciation of the currency in the tradable sector (Calvo, 2005).
[12] For an historical retrospective of the different combinations that have used different countries since the 18ht century, look at Obstfeld and Taylor (2005).

dollarization, currency board or even monetary union on the one side or free floating regime on the other, as the only viable combinations.

De la Torre, Levy Yeyati and Schmukler, in order to adapt this line of reasoning to the new environment of free capital movement and financial integration developed different variations of the trinity, combining the credibility of a currency, the credibility of money especially the store of value (which includes the flexibility of prices of the products as well as that of the assets), the contractual and regulatory institutional level of the country and the flexible exchange rate regime. Two of the variations developed by the above writers are the «blessed» and the «unblessed trinity» (De la Tore, 2002) which seem to fit very well to the purpose of this work, therefore we continue by introducing them.

2.3.1. The «Blessed» and the «Unblessed Trinity»

The blessed trinity is a combination of credible money, a sound contractual and institutional level and a workable flexible exchange rate. In such a blessed trinity the country has an international credible currency, which is used in the country but as well abroad as a medium of exchange and of value. The countries can issue debt in their own currencies and there is little need to borrow in a foreign currency. In such a situation the households and the firms can borrow in the long term and in their own currency resulting in low level of currency and maturity mismatch for the country. On the side of the institutional level there exist an effective contractual framework, which protect the rights of borrowers and lenders, does not disoriented the households and the firms in risk taking activities. In such a situation the exchange rate is allowed to fluctuate without having disturbing effects on the product sector or the asset side. This type of country does not need to have high foreign currency reserves because it does not need to intervene in the currency market or it intervenes very little and seldom. In a blessed trinity situation the country can follow an autonomous countercyclical monetary policy without considering the policies of other countries. In such a situation the adjustability of the real exchange rate may be effective without negative effects in the production sector as well in the labor market.

The unblessed trinity maps mostly the situation of the emerging market economies and introduces a combination of a currency without having a status of global currency (hard currency), a situation where the contractual and regulatory framework is not working very well and the floating of the exchange rate is not a welcome option because of fear of floating. In this situation the country uses its own currency but this currency does not gain international recognition and international credibility, so that it can be used from the international investors as medium of store. The country is not able to issue debt in its own currency and therefore it borrows very often in foreign currency. Similarly, the households and the firms cannot borrow very often in foreign currency with the result to expose themselves to an exchange rate risk. Equally, the non tradable sector borrows in terms of the tradable sector (in foreign currency) without having the necessary earnings in foreign currencies. In the institutional level exist a contractual

and a regulatory level, which is not enforced very strictly, the rights of borrowers and lenders are enforced, the accounting and the steering framework are not effective and there exist fraudulent activities. On the exchange rate side, the countries of this group express fear of floating because of the high proportion of the debt in foreign currency. In such a situation a depreciation or devaluation of the domestic currency can have devastating effect on the state, the households and on the firms which have borrowed in foreign currency. In such a situation a country trays to avoid fluctuation of the exchange rate and therefore keep a high amount of external reserves, a fact that imposes additional cost. The central bank on the other side cannot fulfill its mandate of lender of last resort among others, because it does not posses enough foreign reserves. Such features expose this country to capital flows, to sudden stops, to bunk runs, to crises and decreases the possibility of realizing autonomous monetary policy.

2.4. The Philosophy of the «Blessed Trinity» in the E.U. and Practical Issues Concerning the Maastrict Criteria

What is of course unquestionable is the intention of the NECs to participate in the euro zone[13]. But questionable is the road to that end. As opposed to the OECs, which followed, to some extend, an evolutionary road to the euro zone, initially participating to the European Free Trade Zone, after to the European Custom Union, then to the European Single Market and lastly to the European Monetary Union, using for a long time the European Exchange Rate Mechanism I (ERM I)[14], which have enabled them to make considerable progress to the end goal of the euro zone and converge their economies, the NECs, coming from a short process of transformation are asked to participate in the E.U and the euro zone by adopting the preconditions which are stated in the Maastricht Treaty, a kind of top-down process of transformation and of economic integration.

The nature of such an implementation can be understood using the political trinity, which has be developed by Dani Rodrik, who investigated the combination of the financial integration, the development of national rules and the development of global federal rules. Like the impossible trinity in the economic theory, the political trinity of Rodrik underlines the impossibility of combining all three goals and by showing the realization of two of them. Especially, Rodrik

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[13] While Great Britain and Denmark are not obliged to participate in euro zone all other countries as soon as become members of the E.U are obliged to participate to the euro zone and as far they have not adopted the euro, they are characterized as deviationists (Convergence Report 2010, p. 5).

[14] The ERM I is the pre-existed mechanism of ERM II, and which ceased to exist, when the euro zone become reality in the year 1999.

states that the financial integration can be realized by transferring competences from the national level to the global federal level or by keeping the competences in the national level and allowing the free movement of production factors and the capital by abolishing every barrier which can constrain the free movement of the production factors and the capital (Rodrik, 2000). As far as of today the E.U has not chosen a solution of a kind of federation. The only way remaining to the integration is the maintenance of national rules and the abolishment of barriers, giving emphasis on national particularities, a fact that seems to contradict the intention of the Maastricht Treaty.

Looking at Maastricht Treaty and the criteria with the «eyes» of the intitutionalists or neo-intitutionalists, it can been seen, that the Treaty gives emphasis on rules than on discretion, on what the neo-intitutionalists call optimal economic constitution than on optimal reform path (Screpanti-Zamagni, 2004) and neglects the possibility of adjustments of a single country in the macroeconomic field.

The Maastricht Treaty concentrating on criteria like the inflation, the long term interest rate, the fiscal deficit, the external debt and the stability of the exchange rate, gives emphasis on monetary stability. The rule base behavior is hoped to lead to the integration of the member states. In order to judge how far to integration this can lead let as look at the single criteria more carefully.

The inflation criterion prescribes that a candidate country should not have inflation higher than 1,5% to the weighted average of the three best performer countries in E.U. during the year of the judgment. This criterion contradicts clearly the inflation criterion of the ECB as far as the ECB follows a level of inflation lower but near to 2% because it is possible that the best performer countries have inflation lower than 2%, resulting in the paradoxical situation where the candidates countries aim at a lower level of inflation that the ECB. Even thought the ECB, depending on the situation, can change the targeted inflation, the problem of the Maastricht criterion remains as far as the best performer countries can belong to E.U but not to euro zone, and so the candidate countries may orientate their policies to goals different of that of the euro zone (Jonas, 2004) and (Darvas, 2010).

In the last Convergence Report of 2010, for example, the ECB judging the inflation criterion of the candidate countries took in account the inflation level of Portugal (-0,8%), Estonia (-0,7%) and Belgium (-0,1%), letting out the best performer country, which was Ireland with -2,3% (Darvas, 2010), using a kind of constrained or enlightened discretion, which can be very easily stigmatized as judgment, which is of course made ex post and not ex ante and offers not too much help to the candidate countries (Jonas, 2004).

The same questions can be expressed regarding the criterion of long term interest rate, as far as this criterion states that the long term interest rate of the candidate countries should not be higher than 2% of the weighted average of the three best inflation performer countries.

Concerning the fiscal criteria (fiscal deficit and debt) the Treaty states that the fiscal deficit should not be higher than 3% and the debt of a country should not be higher than 60%. Independently form the critique that can be expressed concerning the concrete fiscal and debt levels, it can be emphasized that these fiscal criteria together with the others (inflation, long term interest rate) and the Stability and Growth Pact point out to an approach, which is similar to what in the economic theory and economic analyses is called as a «New Macroeconomic Consensus» characterized as an approach (Arestis, 2003) which:

- Discredit any active role to the fiscal policy because such a policy needs long standing regulatory changes and because such a policy is viewed as ineffective.
- Sees the monetary stability and a low and stable inflation rate as the main objective and considers inflation as monetary phenomenon.
- Does not take any active action to bust employment and development because it believes that in the long run employment / unemployment are solely determined through the level of the production factors and technology, the so called NAIRU, reintroducing so the Say's law.

Regarding the exchange rate, the Maastricht Treaty, prescribes that the exchange rate of the candidate countries should be stable and that the candidate countries in order to adopt the euro have to participate to the Exchange Rate Mechanism II (ERM II) and remain there for at least two years. While the conditions of participating and the regulatory frameworks of the ERM II are somehow given, a great uncertainty about the criterion of the stability of exchange rate exists. The article 121(1) in order to clarify this point states that an exchange rate is stable when fluctuates in normal way and does not depreciate deliberately, obviously in order to avoid competitive depreciations. While ERM II defines the fluctuation point in the range of +/-1,5% , officials of the ECB, in the name of an equal treatment of the new and old member, states that the stability of the exchange rate should be judged taking in account the range of +/-2,25%, the direction of the change (depreciation or appreciation), the level of changes, the lasting time and of course the causes of these changes, reintroducing in this way the concept of the constrained or enlightened discretion, which again is applied ex post and not ex ante (Jonas, 2004).

Looking back, it is clear, that the Maastricht criteria aim more to the monetary stability and in turn to the credibility of the policy and the currency[15]. OCA criteria are not considered at all in the Treaty (Bukowski, 2011), possibly in the hope that the monetary union is going to fulfill them ex post, and hope that the monetary stability is going to foster integration and real convergence. Financial stability criteria are not considered at all or considered only in the form of the «blessed trinity», in the form of «blessed functionality». Now is a time to turn to the unblessed trinity.

[15] In this regard, the Stability and Growth Pact, which completes the Maastricht criteria framework, plays a very important role.

3. The NECs, the Unblessed Trinity and the Financial Crisis

As already stated the Maastricht Treaty is very unspecific regarding the matters of the exchange rate and let open many options for the preparation phase as well the participation process in ERM II. The NECs, taking in account this possibility have chosen different exchange rate regimes and in general as far as they approached E.U there was a trend towards more flexible exchange rates. Today, the NECs-members of the E.U can be separated in two groups, the first one, the CEE4, which includes Estonia, Latvia Lithuania, and Bulgaria, and has chosen pegs, the second, CEE5, which includes Poland, The Czech Republic, Slovakia, Slovenia and Romania, that has chosen floating.

Obviously, the choice of the concrete exchange rate regime depends on the situation of the country, the fundamentals and the choice of the macroeconomic policy. For the NECs, the choice of the exchange rate regimes also mirrors the requirements, the constraints, the transition process and the progress of convergence. In the early phase of transition process these countries had to manage the fundamental problems like the privatization of the state firms, the deregulation of prices while at the same time care for the macroeconomic stability, the high inflation rates and the downturn of the production; thus, most of them choose a stable anchor and peg to SDR, the dollar or a basket and of course to euro. With the passage of time the situation changed. Most of these countries managed to belt the high inflation and the production started to recover. A good number of them were very successful in attracting foreign direct investments, covering in this way a great part of their reconstructions needs and the low savings rates (Makris, 2009b), (Demecas, 2007). More successful were the countries of Central Europe and the Baltic, as they were able to manage down inflation and the high fiscal deficits, to step down the long term interest rates and to achieve higher production rates experiencing at the same time higher balance of payment deficit and higher external debt and thus they have chosen pegs mostly in the form of currency boards. It must be noted that the of Central Europe and the Baltic experienced a higher appreciation of their real exchange rate (Martin et al., 2007), obviously mirroring their higher growth potential regarding the countries of Southeastern Europe, as stated by the Balassa-Samuelson effect but also the higher depreciations of the nominal exchange rates at the beginning of the transition process (Halpern-Wyplosz, 1997).

Concluding it can be stated that the NECs taking in account the logic of the unblessed trinity and the concrete macroeconomic situation have been relatively successful in managing their exchange rate policy and most of all managing a number of speculative attacks and thus gaining so credibility for their currencies. Unquestionable, to that point, is the contribution of the so called «hallo effect» and the perspective of participation in E.U. resulting to the lower appropriate interest rate.

The situation has changed dramatically since the outbreak of the financial crisis in 2008, which lasts until today. Explaining this crisis, Paul Krugman stated that it includes all we know about crises: at the same time it is a currency crisis, a bank crisis and sovereign crisis (Krugman, 2009). There are many explanations of the causes and the ways it propagated, and they can be separated in two broad categories. The first category concerns all the explanation which can be related to the financial sector and the way it works: the changing role of banks and financial institutions from simple intermediary institutions to institutions which create and distribute financial securities, the role of securization, of repos, of short selling, of derivatives and especially the role of credit default swaps and others. The second group includes macroeconomic explanations. These explanations concentrate mostly on the exorbitant privilege of dollar, the saving glut, the investment drought, the financial glut a.s.o. (Derrucci-McKay, 2011). Contrary to the above mentioned explanations, ours concentrates on the real sphere, because we believe that the above mentioned characteristics are more symptoms of deep macroeconomic disequilibria, which are related with the way the globalization is realized (Makris, 2009b).

The crisis seems to nest in Europe, questioning the same existence of euro and risking the long standing project of E.U. and the euro zone. The debt crisis of Greece, Portugal and Ireland and the difficulties of handling the debt of countries like Italy, Spain or Belgium make, at least, clear that the credibility of a currency cannot be simply imposed by adopting a hard currency like euro, but it demands much more than that. The NECs, and especially the Baltic countries, have been particularly hard hit though there are significant differences within the region. Their dependence on foreign trade and capital flows played a crucial role in the pre-crisis growth, but it became the main factor explaining the severity of the crisis. They experienced cuts in their trade and downturns of the production, the capital inflows ceased and they experienced great needs for capital and liquidity, which they covered by extending their debt and using the liquidity lines of IMF, the E.U and other international organizations. The extended debt, the cuts of the trade and downturns of the production led the CEE4 countries to readjustments of the real exchanges rates of their currencies, while the CEE5 countries using flexible exchange rate regimes was able to counter and to recover relatively soon (Babecky et al., 2010).

The crisis, apart from the problem that it has speeded overall in the world, demonstrated the key-role of the expanded financial sphere. The destabilizing role of the valuation of financial positions, securities and in general of balance positions, as well as their procyclicality came through clearly during the crisis. The increase in the prices of assets and securities extended the potential of the banks and the other financial institutions to offer new credit and additional liquidity (broad banking lending channel, banking lending channel or financial accelerator) on the one hand and on the other it enhanced the willingness of the household and firms to utilize the new liquidity. As far as this favorable situation lasted and prices of the assets continued to increase, the banks and the other financial institutions continued to expand their credit. Later, when this favorable

process turned off and the prices of the assets started to decrease, the capital of the banks and the other financial institutions shrinked and they turned off the tap of the credit, the hedgers and the speculators became ponzi players[16]. All this poses many challenges to the monetary policy. Setting the monetary policy the authorities now have to think not only about the relation of exchange rate and the interest rate via the channel of the production sector, but also about the relation of the exchange rate and the assets and, most of all, how the assets are connected with the interest rate and the inflation, which are the main objectives in the modern area of economic policy. To that point the contemporary consensus lies not to consider such facts, for example in the Taylor rule, as far they do not affect the expected inflation rate[17].

The countries, which for different reasons have chosen the currency board or a peg like the candidate countries when they enter in the ERM II, have to solve the relation between the interest rate and the exchange rate in a concrete way and they have to look carefully on the effects of their choices either in the interest rate or in the exchange rate. The concrete choice will depend on the given situation, for example, in a case where a country faces a tendency of appreciation of its currency, can act by decreasing its interest rate, that could foster in turn the inflation and that can lead this country away from the Maastricht inflation criterion The concrete choice also depends as well on the way the criteria are defined and the tolerance, with which the authorities of the E.U. handle the not fulfilling of these criteria. The Maastricht Treaty offers the same space for maneuver since it defines the inflation criterion as a cap, and the exchange rate criterion as floor. The direct effects of the monetary policy are very important and especially how far concrete monetary measures contradict with the different goals. The authorities should always be able to predict if a decrease in the interest rate leads to a depreciation or to an appreciation of the exchange rate. The operative view, which is based on the theory of the interest rate parity and on the rational expectations, states that a decrease in the interest rate will lead to an appreciation of the exchange rate, while the speculative view, which takes in account the returns of the securities, states that such a decrease in the interest rate will lead to a depreciation as far as a decrease in the interest rate means a decrease in the return of the assets and this in turn will lead the investor to invest abroad resulting a depreciation of the domestic currency.

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[16] Hedgers are those investors, whom earnings are secured throughout the investment and speculators are those investors whom earnings are not fully secured throughout the investment but there are gut changes to be full secured in the future, if the condition of the investment change favorably while the ponzi player are those whom earning are not at all secured and finance the investment mostly by rolling over credits as long as they can (Kregel, 2004).

[17] Today as far as the crisis is not yet settled down, these questions are very actual and interesting and they occupy the economic literature intensively. For a comprehensible introduction of the way monetary policy is conducted during the financial crisis, look at Borio (2009).

The operative view focuses on the real sphere and according to this view the relation exchange rate – interest rate depends on the transmission mechanisms of the impact of the exchange rate variations on the prices of the production sector. It also depends on the wages and on the Balassa-Samuelson effect[18, 19]. Contrarily, the speculative view focuses on the monetary sphere and considers the exchange rate as an asset, which has its own price and therefore has much to do with stability of the financial sector. The real question that should be answered here is how far a change of the interest rate mirrors changes in the real sphere of the economy and in the fundamentals or than in the financial sector, in the valuations of investors concerning the country or the exchange rate risk. At this point, it must be taken in account the destabilizing role of the expectations and the speculation.

The financial crisis affirmed the views of Keynes about the role of expectations but most of all destabilized the «hallo effect» of the NECs and brought in light all the pains they striving to avoid problems like the level and the structure of the debts, the liquidity shortages, the international reserves, the valuation effects of balance sheet position a.s.o.

The need of an adjustment mechanism is even stronger for the NECs if taken in account that these countries are in a process of nominal and real convergence. The proponents of the monetary union claim that the adoption of the euro will eliminate the uncertainty of the exchange rate and this in turn will bust the internal trade in the union. Especially, they claim that risk averse investors will prefer a secure investment with lower risk than one with higher risk and pass over the situation, where higher risk and therefore changes in the exchange rate offer higher possibilities of gains (De Grauwe, 2003). The proponents of the monetary union also claim that the elimination of the exchange rate will lead to a better adjustment of the price levels of the member countries and so to a nominal and real convergence (De Grauwe, 2003).

Empirical studies of Rose (Mongelli, 2002) showed that the elimination of the exchange rate and the adoption of a single currency can lead to an increase in trade but it does not completely eliminate the border effect. Additionally, many studies showed that the volatility of an exchange rate must not contribute negatively to the trade. Taking in account the works of Krugman, who showed that the elimination of the exchange rate could lead to an increase in the interregional trade and so to specification and concentration and not to intraregional trade and differentiation, the choice of a flexible exchange rate mechanism seems to be more favorable.

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[18] Here we see all these theories, which are related with the switching role of the exchange rate, like those of the separation of the market, the pricing to market, local pricing models, pricing to production country, the relation of the traded and non traded sector, staggered prices a.s.o.

[19] The ineffective are these transmission mechanisms the lower is the role that can play an exchange rate adjustment, the effective can be a realization of fix exchange regime or a peg. For a first appraisal of such transmissions mechanism for the case of the NECs, look at Coricelli et al. (2006).

Regarding the second view, the speculative view, it must be emphasized that speculation cannot be countered simply by eliminating floating of the exchange rate through hard peg regimes, currency board or dollarization, or monetary union. As already mentioned, Mundell and Pool stated that in the case where the external shocks are real, a flexible regime is effective, while in the case where the external shocks are monetary a fix regime is effective, but this conclusion is not practical because of the impossibility to identify the shocks. Apart of that there seems to be another important reason why such a «freezing» of the exchange rate cannot be effective. The experience of countries that have used such solutions, like Argentina, shows that such a «freezing» solves the problem of the balance of payment crisis by transferring the crisis to the banking sector[20].

4. Conclusion

The credibility, which the NECs seek to reach, will be finally imposed with the participation in the E.U and the euro zone. Nevertheless, the road to that participation is questionable and seems to include many difficulties. The logic of Maastricht Treaty, the logic of an optimal path of an optimal economic constitution throughout the fulfilling of restrictive criteria does not let any space for the optimal perform paths, which can and should chose the NECs in their process to convergence to Europe. The inflation criterion and the criterion for the long term interest rate seem to destabilize the path to the convergence than to lead to macroeconomic equilibrium. The fiscal discipline seems to narrow the adjustments of these countries seriously. The exchange rate criterion and the waiting room of the ERM II seem not to fit very well to the new financial integrated environment and to the needs of an extended volatility of the financial flows. The transfer of the financial flows all over the world are not simply the complements of the transfers of the goods flows. The financial sector seems to follow its own rules which cannot be ignored, as proved by the crisis. In order to face these rules from the side of exchange rate policy, the «unblessed trinity» seems to be a very valuable instrument. It was shown that the countries which intents to participate in the E.U and euro zone should first of all take time to adjust their economies to the new environment, by using mostly a flexible exchange rate mechanism. Problems which may occur throughout the extended volatility of the financial sector should not be handled with the help of the exchange rate, but with other tools disposed the Central Bank and can be used in different ways in different cases.

[20] The same conclusion results from many studies, which examined the crises of S.E. Asia, as far they identified the extensive borrowing in foreign currencies as one of the most important reasons of the crises.

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