Eurozone Enlargement
Reshaping Policies and Social Conflicts

EZONEPLUS Summary Report

Michael Bolle (Ed.)

Editor’s note

The closer the date for the eastward enlargement of the European Union the more fundamental questions about the economic policy implications of this extraordinary step arise, not just for the accession countries but also for the “old” members and for the European Union (EU). The subsequent participation and eventual membership of most of the Central and Eastern European Countries (CEEC) in the European Monetary Union (EMU), starting in 2006 or 2007, pose varying challenges to macroeconomic issues areas and, above all, to the social systems of the countries concerned.

This Summary Report reflects outcomes of the research project "The Eastward Enlargement of the Eurozone (Ezoneplus)" that has analysed these challenges with particular emphasis on monetary and fiscal policies, on exchange-rate regimes and on the social dimension of the EMU enlargement process. It will be shown that structural asymmetries in an enlarged currency union will only slowly proceed towards a convergence of welfare states across EU-25. The pace of this process depends largely on the willingness and capability of political decision-makers at all levels to coordinate the policies in question.

The research consortium, supported by the EU's 5th Framework Programme, consists of leading economic and political research institutions from Estonia, Finland, Italy, Poland, Portugal and Slovenia, coordinated by the Berlin group of the Freie Universität Berlin's Jean Monnet Centre of Excellence. Under the direction of Hanns-D. Jacobsen, Christian Fahrholz, Achim Kemmerling, Thomas Meyer and Andrej Stuchlik have put together this report by developing a set of focal questions and by extracting some policy advice questions that induce further discussion. Additional thanks go to our students, Philip Mohl, Oliver Pamp and Algara Stenzel, who helped prepare the print version.

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Introduction

Ezoneplus started with two cardinal assumptions: (1) Although EMU may not be an optimal currency area, it may become one as a common currency sets in motion endogenous processes of enhancing intra-EU trade and capital flows. The prime empirical task for the first stage of *Ezoneplus* was therefore to show to what extent the reshaping of markets has already taken place when current and new EMU member states are compared. (2) Reshaping does not take place instantaneously and is not evenly balanced across all types of markets. Moreover, it has to be accommodated by the social and political sphere in all countries. Since reshaping entails a heavy burden of structural adjustment, it is likely to produce societal unrest and political bargaining over the costs of adjustment. The second major task of this project is to track these social and political conflicts and to relate them to the pivotal policy area for *Ezoneplus*: exchange-rate policies.

Correspondingly, the first stage of *Ezoneplus* investigated both problems, and our findings are summarised in the first summary report (*Ezoneplus* 2002). In the following, second, report we aim at extending our previous discussions on the question of how policies have been reshaped in the wake of enlarging the currency union. The following three sections show the evolution of three major policy areas: (1) fiscal and monetary policy, (2) exchange-rate regimes, and (3) the discussion of what we call the social dimension, i.e. social, labour and transfer policies. Assessing these three policy areas will allow us to be prepared for the final step of *Ezoneplus*, giving adequate policy responses that combine economic efficiency with the issue of how to achieve social and political acceptance of such policy measures.

The first part of the summary report deals with the question to what extent fiscal and monetary policies have already been reshaped by the prospect of an enlarged EMU. In the introduction to this part, Meyer sketches some of the basic trade-offs fiscal and monetary policies face these days. The adoption of a common currency means for new entrants that they have to shoulder the burden of additional reforms, but that these, at least in the short run, will not be implemented on a one-to-one basis, since social and political costs would be too high. Lavraè shows in more detail the kinds of trade-offs involved in meeting the Maastricht criteria and the related debate on the Stability and Growth Pact (SGP). Contrary to monetary policies in CEEC, that already exhibit reshaping and preparation for

EMU to a great extent, fiscal policies are much more difficult to adapt to the needs of ERM2, let alone EMU. Żukrowska and Sobczak show the trajectories of budgetary positions of current EMU member states. They argue for a certain policy reversal before and after EMU accession and show why CEEC may face similar problems.

The second part takes up these lines of reasoning, but from a different perspective: the choice of exchange-rate regimes. Orsi and Iacone focus on the temporal and cross-country variation of exchange-rate regimes in the last decade. Reshaping is visible for all countries: monetary and exchange rate policies have clearly shifted from the needs of early transition to the problem of integrating CEEC into a common European economic area. Due to historical and economic factors, however, CEEC exhibit a marked diversity in the choice of exchange-rate regimes. Obviously, there does not exist a unique policy optimal for all countries. More importantly, most countries – apart from the small Baltic economies – did not opt for one of the two famous corner solutions: fixed or float. To the contrary, CEEC have aimed at paving the way to a monetary policy by the use of (some form) of pegged exchange rates as nominal anchors. The Maastricht criteria will remain the 'route' to be taken by these countries. This section concludes with two major recommendations: (1) Entry to EMU should happen as soon as possible, (2) before entering ERM2 countries should prefer to float rather than to fix their exchange rate prematurely.

The third part discusses both the reshaping of certain policy areas and the socio-political repercussions of an eastward enlargement of EMU. The focus lies on the potential for social conflict enhanced by the enlargement process and the consequences for national policy-making. Kemmerling addresses the political economy of major issues concerning national welfare states. He argues that there is substantive political resistance against the flexibilisation of labour markets and social policies. This has implications for both national wage bargaining systems and national net contributions to the EU public budget. He projects that the SGP will be put under increasing pressure, since politicians will fear the negative consequences of fiscal retrenchment, and that CEEC could manage to double their share of EU transfers once they join EU and EMU. In his last section, the author discusses so-called 'soft issues' such as public opinion on the adoption of the Euro. The analysis of micro-data shows that although support is primarily driven by national legacies, welfare state institutions may well play a role in cushioning the short-term costs of *Ezoneplus*.