# Economic, Political, Institutional as well as Social Risks and Opportunities of EMU Enlargement

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The Eastward Enlargement of the Eurozone

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The inclusion on May 1st, 2004 of eight Central and Eastern European Countries (CEEC) into the European Union (EU), and subsequently into the European Monetary Union (EMU) some years later, will cause deep changes within the political, economic, and social settings of the Union as well as in those of the new member countries. This paper's underlying idea is that the new EU members in Central and Eastern Europe should continue to pursue an economic strategy of real convergence to the economic levels of the "old" member countries as rapidly as possible by securing sustained growth, e.g. by increasing private savings and by reducing the current account deficit. This report will discuss the implications of a "catch-up" strategy and have a look at the economic, political, social and institutional consequences for EMU enlargement.

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# Economic, Political, Institutional as well as Social Risks and Opportunities of EMU Enlargement

## 1. Introduction

The inclusion on May 1st, 2004 of eight Central and Eastern European Countries (CEEC) into the European Union (EU), and subsequently into the European Monetary Union (EMU) some years later, will cause deep changes within the political, economic, and social settings of the Union as well as in those of the new member countries. The enlargement forces the EU not only to reform its institutions to accommodate a much larger number of member countries. Enlargement also means deeper economic integration. The new members will get full access to the European single market that allows for free movement of goods, services, labour and capital with their western neighbours. Over the next years, participation in the monetary union will be a further step in including CEEC in the EU's integration process.

The project's underlying idea is that the new EU members in Central and Eastern Europe should continue to pursue an economic strategy of real convergence to the economic levels of the "old" member countries as rapidly as possible by securing sustained growth, e.g. by increasing private savings and by reducing the current account deficit. The attempt to catch up to EU levels has produced considerable progress indeed over the recent years because the new Member States have grown faster than the EU 15 since the mid-1990s (European Commission 2004: 11) by 1.5 per cent above the EU average. The GDP per capita gap, however, still remains considerable: In 2002, only Slovenia and the Czech Republic had a GDP per capita in PPP terms above 60 per cent of the EU average, Hungary above 50 per cent, Poland, Estonia and Lithuania around 40 per cent, and Lithuania just 35 per cent.

This report will discuss the implications of a "catch-up" strategy and have a look at the economic, political, social and institutional consequences for EMU enlargement. A process of CEEC joining the eurozone, implying the reshaping of economic determinants that may lead to efficiency gains, has thus to consider economic adjustment and social costs as well because real convergence, based on sustainable increased growth, can only be a long-term process, lasting for decades. It comes at a time when all the EU members, old and new, have to adapt to a world experiencing rapid economic and social change and restructuring, as well as trade

globalisation. They will also have to come to terms with the particular challenges that derive from an ageing population, growing immigration, labour shortages in key sectors and social inclusion problems. Failure to attain real convergence[1] may jeopardize the benefits arising from EU accession and could even be a source of destabilisation for current members. It will be shown that monetary integration may fail if the CEEC do not succeed in providing rigorous and comprehensive changes in their respective economic, political and institutional environments and provide for appropriate social acceptance.

## 2. Exchange-rate policies

The project *Ezoneplus* has investigated the exchange-rate policies of CEEC. A concluding examination focuses on the time period from CEEC' attainment of the EU status of 'members with a derogation' until the ultimate decision on their final conversion rates at the dawn of EMU. Exchange-rate policies deal primarily with the choice of exchange-rate regimes and their timing. In addition, exchange-rate policies are linked to fiscal and financial policy issues. Because of the prescribed fixed exchange-rate regimes in ERM II, the choice of central parities and fluctuation bands as well as the choice of final conversion rates vis-à-vis the euro are addressed below.

The starting point of our considerations is that CEEC' economies have to rely on sizable capital influx in order to stimulate growth and real convergence towards current members of EMU. The track of EU-enlargement has to be politically stabilized and the social acceptance of the course taken be maintained. Hence, the general trend towards real exchange-rate appreciation in CEEC fostering their catching-up is desirable and has to be maintained for a prolonged period. However, trend real appreciation through leaps in productivity as well as possibly due to erroneous economic policies risks undermining the stability of the convergence process. The particular problem is that Maastricht criteria and especially ERM II stipulate the adoption of those kinds of fixed exchange-rate regimes—i.e. so-called soft pegs—which are particularly prone to speculative attacks impeding the process of sustainable convergence. Accordingly, exchange-rate policies should be organized in a way that the risk of disordered devaluations and currency crises is at least reduced.

[1] At this point it should be noted that real convergence is connected with other costly kinds of convergence CEEC have to strive for, e.g., nominal convergence that calls for meeting the Maastricht criteria when entering EMU, or institutional convergence aimed, e.g., at the implementation of EU legislation.

At the outset of EU-membership in May 2004 CEEC lose to a considerable degree their monetary sovereignty and exchange-rate issues become a matter of common concern according to Article 124 (ex Article 109m) of the Treaty establishing the European Community. Decisions regarding exchange-rate policies are shaped within specific areas of European governance. The agreements lay the foundations for success or failure of CEEC' sustainable convergence towards current EMU-members. In this report, we examine the range of decision-making processes within this particular European sphere. The aim is to reveal imponderables and gaps in institutional precautions of EU exchange-rate policy coordination.

First, we outline the general interests of current and new members of the EMU. Second, the institutional setting of European exchange-rate affairs is delineated. Although we refer to the ERM II, the insights can be generalized. Finally, we explain why CEEC have the upper hand regarding exchange-rate regime choice. This applies to their exchange-rate policies prior to the Maastricht qualification process as well as with regard to their passing through the ERM II.

The stability of the convergence process is the main goal of both current and new members of EMU. This is a prerequisite for successfully completing the enlargement project in all its political, economic and social facets. The most obvious measures to ensure sustainable convergence are, first, to keep CEEC as long as necessary at a remove until their economies mature. This is to say, that CEEC should slow down their rush to EMU. Second, fluctuation bands should be as wide as possible in order to allow catching-up economies equilibrium real exchange-rate appreciations. This applies, third, also to the choice of central parities and in a similar manner to that of conversion rates. A final devaluation before entering ERM II would counteract the negative impact of trend real appreciation on the stability of fixed exchange-rate regimes. This is also valid with regard to rather undervalued central parities[2] which may allow for absorbing devaluation pressure stemming, for instance, from exogenous shocks (Babetski et al. 2003:13).

However, preparing for the EMU club is not a 'free lunch' as nominal and real convergence can turn out to be conflicting objectives in the run-up to the EMU (see Gáspár 2001:17-21). The policy mix required particularly for achieving compliance with Maastricht criteria

[2] Generally, from an economic point of view, equilibrium exchange rates would be most favourable. They would neither distort purchasing powers, competitiveness, nor contribute to a redistribution of wealth, i.e. no effects on stocks of debts and claims. Yet it can be said that undervalued central parities favour agents accounting for debts denominated in domestic currency, but makes agents having obligations denominated in foreign currency worse off. The opposite holds for the case of overvalued central parities.

qualifying for EMU membership is likely to slow down output activity and employment. The nature of the arising conflict between current and new EMU members originates from both parties admitted inclination to complete the enlargement process but disinclination to bear the costs. Because the 'ins' are also interested in CEEC' sustainable convergence, CEEC will have leeway in passing some of these costs on to current members. Exchange-rate policy choice during the CEEC' run-up to the EMU reflects the hard bout of haggling over sharing the burden of the costs involved.

Current EMU-members' general interest is evident: According to the Maastricht provisions applicant countries bear all arising costs. CEEC shall stick to Maastricht and bear the costs entirely themselves. The current members' position regarding the exchange-rate policy choice of CEEC is as follows: The legal provisions of ERM II allow for the time being only a few alternative exchange-rate regimes. Currency boards are not considered to be a substitute for participation in ERM II (ECB 2002: 59-60). However, accession countries that are currently operating with a currency board might not necessarily be required to, first, float their currency within ERM II before they later re-peg it to the euro. Currency boards would offer accession countries an opportunity to draw on the ECB credit facilities directly and, thus, possibly impair the ECB's price stability objective. Moreover, an early accession, even unilateral euroisation, will provoke too much heterogeneity inside the EMU. This will seriously impair control of monetary policy, for instance, because the transmission mechanisms of monetary policy and the functioning of automatic stabilisers in CEEC are still unclear. Therefore, a premature inclusion of CEEC will result in a mark-up of the euro's risk premium.[3] Most notably, however, the Council of Ministers would have no influence in determining the final conversion rates at which the accession countries enter the eurozone (Buiter and Grafe 2002:5-6).

If both 'outs' and particularly 'ins' are interest in completing the present enlargement process, then CEEC will have leeway in passing some of the costs incurred on to current members. From the viewpoint of political economy, governments strive to remain in office. In this sense, CEEC will be unlikely to bear the entire costs. They will attempt to reduce the detrimental social effects of their run-up to EMU. In doing so, they constantly weigh the costs of maintaining policies necessary for Maastricht compliance against the risks of voter

[3] In this respect, ERM II can be regarded as a measure to continue testing the operation of automatic stabilisers and channels of monetary policy in new member countries.

alienation. This holds all the more so, as current members are interested in sustainable convergence of CEEC.

The latter will not hesitate to give in to the accompanying moral hazard. Basically, the most appropriate means of ruling out exchange-rate turmoil impeding CEEC' sustainable convergence is (unilateral) euroisation. In addition, there are also some microeconomic advantages, for instance, the lowering of transaction costs and the transparency of prices. These would foster economic integration, both through increased trade and FDI. Euroisation may be advisable for extremely small, open economies where trade is a considerable share of national income such as in case of the Baltic countries (Natalucci and Ravenna 2002:29). In such countries a relatively erratic exchange-rate performance would hamper any stabilisation efforts (Eichengreen and Masson 1998:3).[4]

Above all, however, the most striking difference to the prescribed soft pegs with respect to policy-makers' incentive structures is that unilateral euroisation can be very unpleasant to national voters because of the social and economic drawbacks that cannot be offset. The opposite holds true for soft pegs. Exchange-rate pegging provides front-loaded benefits and delayed costs. Fiscal laxity would undermine a peg only after some time, forcing a discrete devaluation in the future. Assuming that the time-horizon of politicians is sufficiently short, a government may be tempted to act with fiscal laxity (Tornell and Velasco 1995:4). When exchange-rate policy affects private citizens' welfare and accordingly their level of support for the government, the latter will favour relaxed budgetary spending. As a consequence, austerity policies necessary to strengthen the stability of a fixed-exchange-rate regime and, thus, sustainable convergence will be delayed too long (cf. Marini and Piersanti 2001).

Fixed-exchange-rate regimes are attractive to office-seeking policy-makers in CEEC particularly when these countries are already credibly committed to joining the EMU for political reasons. Some bigger CEEC will make use of the prescribed soft pegs during their passing through the ERM II. Threatening to put their sustainable convergence towards the EMU and the entire enlargement process at risk would enable CEEC to pass on to current members a portion of the aforementioned costs. Accordingly, such a policy stance is hereafter denoted as a *'threaten-thy-neighbour'*-policy (Fahrholz 2003). Whether CEEC can carry out such a policy hinges upon the specific European governance structure.

[4] Certainly, there are also some costs in replacing the national currency with the euro such as the necessity of accumulating large-scale currency reserves, the loss of instruments cushioning exogenous shocks, the loss of seignorage, the loss of a lender of last resort etc. Whether a country should opt for unilateral euroisation is in the end an empirical question about whether net benefits will be positive (Nuti 2000:3).

The conflicting interests of current and new members regarding the distribution of the incurred costs are resolved in European intergovernmental bargaining. There will be a fierce bargaining over redistributing these costs. This dispute will be settled in the context of the European governance for exchange-rate policy coordination.

The basics of ERM II's institutional design are as follows: According to the Resolution, decisions on central parities and the fluctuation band are taken by mutual agreement of the euroyone ministers, the ECB and the minister and central bank governor of a respective accession country intending to participate in ERM II. The Commission and the Economic and Financial Committee (EFC) are only consulted within this procedure.[5]

Decisions concerning ERM II and exchange-rate issues in general are taken within this specific realm of European governance. On request of an accession country the above-mentioned parties can agree on narrower fluctuations bands than the standard one—as has been the case with Denmark, presently running a fluctuation band of +/– 2,25% margins. Interestingly and in contrast to the provisions of the former EMS, all parties have the right to initiate a confidential procedure if central rates are to be realigned. Ideally, this procedure enables central rates to be reconsidered before they deviate too much from real equilibrium exchange rates and currency crises become inevitable. Though realignments in terms of devaluation would infringe on the provisions of the Treaty, revaluations of central parities are compatible with ERM II (Article 121, ex Article 109j).

While we can simply assume that the ECB and central bank governors are in general guided by price-stability objectives, the other decision-makers might strive for entirely different goals. The new EMU-member country and the ministers of the eurozone—i.e. the 'eurogroup', so to speak, an ECOFIN without the 'members with a derogation'—act as a forum for intergovernmental bargaining allowing for political compromise in terms of issue-linkages, side-payments etc. For that reason the resulting outcome regarding the determination of central parities in ERM II will most probably fall short of economic first-best solutions as regards the stability of the convergence process.

Countermeasures against CEEC' *'threaten-thy-neighbour'*-policy have to be deliberated within this institutional setting. Countermeasures include the above-mentioned broad fluctuation bands and devalued central parities as well as keeping CEEC at a remove.

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5 The EFC comprises two representatives of each the European Commission, the ECB, and the current EMU-member countries. It is an advisory board submitting opinions to and contributing to the work of the Council of Ministers (ECOFIN) and the European Commission.

As regards the choice of broad bands, the problem is that sovereign CEEC can introduce small bands before entering ERM II. A subsequent widening of the fluctuation bands, though, will signal that both parties cannot agree on an appropriate exchange-rate regime. Accordingly, market sentiments might shift and cause a destabilising process putting sustainable convergence at stake.

In addition, it is doubtful that CEEC will accept devaluation. On the contrary, rather overvalued central parities and conversion rates respectively will allow these countries to import and consume more resources. If consumption possibilities positively affect CEEC' governments' levels of support, they will push for rather overvalued exchange rates.

Apart from central parities and fluctuation bands the timing of entrance to ERM II might be another area of potential countermeasures. However, CEEC being sovereign countries can like 'members with a derogation' choose exchange-rate policies according to their interests.

In summary, there are no institutional constraints within governance structures of exchange-rate policy affairs in ERM II to curb CEEC' moral-hazard behaviour. There are effectively no countermeasures that would enable current members of the EMU to keep new members in check; unless, the 'ins' can set up issue-linkages allowing for specific political compromises or change the rules of the game. The latter would require a revision of the Treaty Establishing the European Community, an undertaking very far beyond any plausibility.

Therefore, the only feasible option left to keep CEEC in check is to pay them for conducting prudent exchange-rate policies. Two solutions are conceivable: First, current members agree to (slightly) overvalued central parities in ERM II allowing CEEC access to more resources. Second, both current and new members agree on additional funds for CEEC. The latter would easily enable them to offset the costs of their run-up to EMU in terms of detrimental social and economic effects. In that way, the stability of sustainable convergence and a successful completion of the enlargement process would be ensured.

## 3. Sustainable capital flows?

Most observers agree that substantial capital flows towards the new member states are beneficial, because they allow a rapid catch-up without immediate sacrifices in consumption. Moreover, they follow basic economic logic which suggests that poorer countries with a lower capital density should offer numerous investment opportunities and be thus attractive to foreign money. Too often, however, such enthusiasm towards a region or market has

turned sour, which calls for some caution with the current development. The Asian crisis of 1997 and the burst of the new economy bubble are among the most vivid reminders of possible dangers. The question is, are current capital flows a sign of overinvestment in new members' assets, or do they reflect genuine profit opportunities? Whatever the answer might be, it seems clear that most new members must steer through troubled waters on their way towards the euro.

The Warsaw Stock Exchange (WSE 2004) reports rocketing price/earning (P/E) ratios: In 1998 the average P/E ratio was at 16.3 which was in line with what most observers regard as healthy. In 2002, the average P/E ratio reached 101.5; and in 2003 it was a breathtaking 284.9. This means that the average company at WSE needs nearly 300 years of current profits to earn its valuation. Those who hold these shares obviously believe that profits will soar in the near future, and there are many reasons to support this. If, however, such a belief fails to materialise, share prices will have to fall substantially to realign P/E ratios with sustainable levels. Plummeting asset prices may then trigger a vicious spiral where banks amass bad loans, refuse further financing, and send prices down the drain. In the course of such a spiral it is very likely that prices will undershoot reasonable levels and only gradually improve after the dust settles. Since early sellers reap highest prices, every investor would be fast at selling if he fears the beginning of a downward spiral. This explains why prices move violently as soon as they appear hollow. Even a wrong suspicion of overvaluation may become self-fulfilling in the end. If asset prices tumble and cause financial crisis the effect on the domestic economy may be devastating.

A high valuation, such as at WSE, may not necessarily be an overvaluation. It rather reflects investors' confidence in future profits. Nor need it be devastating if stock markets in the new members crash, because their importance is limited, with a market capitalisation of 15 to 22 percent of GDP in the three biggest economies, Poland, Hungary, and the Czech Republic, compared to more than 67 percent in Germany and even 153 percent in the US. However, these figures may blur the relative importance of stock markets, because the capitalisations have to be related to other indicators of financial development. For instance, the ratio of domestic credit to market capitalisation is a little more than one in the US and a little more than two in Germany, indicating the higher importance of equity financing in the US. In Poland this ratio is 2.4; in Hungary 2.6, and in the Czech Republic it is 2.0—i.e., close or below the German level. Hence, stock markets, though small, are still an important source of financing in the new members. Moreover, they might reflect a general trend that goes beyond publicly

listed companies. If overvaluation takes place in regular stock markets then why not in other parts of the economy?

A high valuation may turn into overvaluation for basically two reasons: (i) Exogenous events compromise the initial profit expectations, and the adjusted calculations lead to substantially lower prices. (ii) Initial profit expectations have been hollow in the first place, but over-enthusiasm and speculation has driven investments further. Low yields in mature markets may also induce investors to take higher risks in emerging economies.

With regard to EU and eurozone enlargement, most investors attach a high probability to a by-and-large smooth integration—the so-called convergence play—which explains the currently high valuation and the steady stream of capital. Although, this seems to be a fair bet, there is still a chance that things may not work out that way. The recent row over the EU constitution may give a taste of what may lie ahead. If convergence fails to materialise as successfully as predicted by most market participants, than a revaluation of assets may lead to a reversal of capital flows. True, the affluent EU members would jump to assist those in trouble, but it may become prohibitively expensive even for the wealthy countries to reverse downward market sentiment. The crisis of the first ERM system is a telling example. Moreover, if political tensions arise between old and new members, such as the row over Iraq, the appetite to help may be severely reduced.

The best insurance against overinvestment is efficient financial markets which deliver fair price signals on risks and chances. The new members from Eastern Europe have experienced modern financial systems for 15 years or less, which indicates that there is still some room for improvement. In Table 1 we have attempted to create a composite indicator of relative financial development in the new member states by aggregating several normative measures which are usually deemed important in that respect. The division in quantity and quality reflects the notion that both are necessary to create sustained growth: Big financial markets facilitate capital provision and contribute to investments and growth, but may fall prey to over-enthusiasm and asset-overvaluation, unless intermediaries are sophisticated enough to assess risks appropriately.

The Ezoneplus composite indicator (ECI) gives an impression of the relative performance of a country's financial sector vis-à-vis its peers. The average is zero. It cannot say whether new members are generally vulnerable to financial crisis, but illustrates where problems may be more acute.

The three top performers in the quantity division, Czech Republic, Estonia, and Hungary, have nevertheless different reasons for their success. The Czech Republic has a strong money- and quasi-money-base M2 as well as a liquid stock market. Estonia boasts a high market capitalisation of listed companies, albeit little turnover, and high volumes of domestic credit. Hungary, too, has substantial domestic credit and a liquid stock market. On the quality side, again the Czech Republic and Estonia stand out, in particular because foreign activities have been strong: both indicators, FDI and foreign ownership in banks, are considerably above the average. Slovenia suffers from its sluggish opening towards foreign capital, which is reflected in low foreign ownership and low FDI, mitigated only by a top rating for institutional quality. A similar pattern holds on the quantity side: Slovenia is a net exporter of capital which depresses its ECI, but it boasts the highest GDP per capita as a balance. Since Slovenia recently started to embrace foreign capital, its ratings will surely improve in the future. Poland, the most populous new member, has FDI and capital formation far below average and high interest-rate spreads, which lead to the low scores in both divisions of the ECI. Unsurprisingly, Romania and Bulgaria, the latecomers not expected to join the EU before 2007, score lowest with a slight advantage to Bulgaria.

Sustainability of capital flows may be in question whenever quantity outpaces quality; but fortunately substantial differences appear only with Hungary and Slovenia, and to a smaller extent with Latvia and the Czech Republic. The reasons for Slovenia's results have been laid out above. Hungary receives a high quantity ECI because of strong domestic credit and high stock market turnover, however, it loses ground on the quality side in particular because of high interest-rate spreads and low foreign ownership.

Lithuania is the only country where quantity severely lacks behind quality, which is good news as regards sustainability, but may also indicate forgone possibilities. Lithuania scores low in almost every aspect of ECI quantity, but in particular has a low volume of domestic credit. Since there is an obvious trade-off between size and security of the financial sector, Lithuania may have opted too starkly for security.

**Table 1**

*Ezoneplus* composite indicator on relative financial development[6]

| **Country** | ***Quantity*** | ***Quality*** |
|---|---|---|
| Bulgaria | -5.2 | -3.1 |
| Czech Republic | 5.6 | 4.7 |
| Estonia | 3.6 | 3.6 |
| Hungary | 3.7 | 0.8 |
| Latvia | -0.4 | -1.3 |
| Lithuania | -4.5 | 0.9 |
| Poland | -2.6 | -1.9 |
| Romania | -6.2 | -3.9 |
| Slovakia | 2.2 | 2.0 |
| Slovenia | 1.0 | -1.8 |

Data: World Development indicators (2003),
European Commission (2002), PRS Group (2004).

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The ECI, again, only provides a picture of relative performance among the new members and those, Romania and Bulgaria, which are expected to arrive soon. However, if we pretended that the Asian-5 countries, South Korea, the Philippines, Thailand, Malaysia, and Indonesia, were in Eastern Europe and the year were 1997, the start of the Asian-crisis, what would they

[6] The quantity measure includes the following seven indicators: (i) Market capitalisation of listed companies (% GDP); (ii) stock market turnover (% GDP); (iii) domestic credit provided by the banking sector (% GDP); (iv) M2 (% GDP); (v) capital-account surplus (% GDP); (vi) gross capital formation (% GDP); and (vii) GDP per capita (at constant 1995 US$). These indicators are casually used to proxy the size of a financial sector. The quality measure consists of (i) net FDI inflows (% GDP); (ii) interest-rate spread in the banking sector; (iii) bank liquid reserves to asset ratio; (iv) the share of majority foreign-owned banks in total assets (%); (v) inflation (CPI); and (vi) the ICRG indicator on institutional quality. The Ezoneplus-composite indicator (ECI) is the sum of the Z-standardised values for each country. The ECI uses generally 2002 data where available, otherwise data of 2001. There were no comparable data available for a Romanian interest-rate spreads, thus we left it aside. Slovakia's current-account deficit is taken from 2000. The ICRG is generally from 2003. Bulgaria's share of foreign ownership in banking dates back to 1998.

look like?[7] Indonesia for instance would have scored an ECI quantity of 8, but an ECI quality of only -1.3; the Philippines had an ECI quantity of 10.8 and ECI quality of -2.2. Only Malaysia and Thailand had above-Eastern-Europe quality but by far higher volumes (68.5 and 17.3, respectively). Though this comparison serves just as a quick illustration it shows that, while far from perfect, financial development in the new members is on much more solid ground.

[7] We could not find comparable data on foreign ownership, thus, we left it aside. Since ownership was generally lower in East Asia, thanks partly to legal restrictions, this overestimates ECI quality.

## Financing Real Convergence in CEEC – Three scenarios

The case for investments as a leading indicator for growth in the long run remains strong for it is theoretically compelling and empirically robust (Levine and Renelt 1992). To catch up to the EU15 living standards, the new member states have to invest more than they can currently save. The savings gap could be filled with foreign savings (net capital imports) or increased domestic private savings. Whereas it is assumed that foreign savings could compensate for the lack in domestic savings only in the short run, long-run sustainable growth requires the CEE countries to provide their own savings to finance domestic investments, i.e. to attain an external balance in the economy. Net capital imports from the EU15 to finance growth could be interpreted as opportunity costs of the Enlargement for the "old" member countries as they represent savings not available for investments in the EU15. The following three scenarios present these costs when it is assumed that 80% of capital is imported from EU15 countries. Scenario I extrapolates the status quo. Scenario II calculates accumulated costs for the EU15 if real convergence if financed – ceteris paribus – with increased capital imports. Scenario III reflects the idea, that sustainable growth is attainable only by a balanced current account in the new member countries and hence increased private savings.

The assumptions are as follows: EU15 GDP growth is kept constant at 1.5%. The sample of CEEC should catch-up to 75% of EU15 GDP in 2015 (Poland: 60%), the start year is 2000. We impose a linear relationship between investments and output change. Absolute values are expressed in ppp international US$.

### Scenario I: Extrapolating the status quo

If the status quo is extrapolated into the future, i.e. the net capital imports and domestic private saving quotas remain constant, only the Czech Republic and Slovenia will reach the imposed convergence target. The EU15 will face accumulated costs of 618 billion ppp international US$ which represents 0.47% of the accumulated EU15 2000-2015 GDP.

| | GDP 2000 | Current account 2000 (% GDP) | GDP 2015 | % of conver-gence target | Accumu-lated costs for the EU15 2000-2015 in billions | % of accumu-lated EU15 2000-2015 GDP |
|---|---|---|---|---|---|---|
| Czech Republic | 13868 | - 5.23 | 22545 | 99.15 | 122,96 | 0.09 |
| Estonia | 10183 | - 5.72 | 18690 | 82.20 | 14,08 | 0.01 |
| Hungary | 12228 | - 2.85 | 17589 | 77.36 | 54,49 | 0.04 |
| Poland | 9844 | - 6.34 | 16982 | 93.36 | 411,22 | 0.31 |
| Slovenia | 16486 | - 3.02 | 23599 | 103.79 | 15,3 | 0.01 |
| **All countries** | | | | | **618,01** | **0.47** |

**Scenario II**: **Financing real convergence through net capital inflows**

If the countries are supposed to reach the convergence target in 2015, implying an external balance, the costs for the EU15 nearly double to 1135 billion representing 0.86% of accumulated EU15 GDP. Current account deficits would rise substantially by 1 to 18,4 % per year except for the case of Slovenia.

| | Current account 2000 (% GDP) | Current account 2015 (% GDP). Growth rate of capital imports in () | Accumulated costs for the EU15 2000-2015 in billions | % of accumulated EU15 2000-2015 GDP |
|---|---|---|---|---|
| Czech Republic | - 5.23 | -6.07 (1 %) | 133,99 | 0.10 |
| Estonia | - 5.72 | -24.55 (10.2 %) | 38,39 | 0.03 |
| Hungary | - 2.85 | -35.90 (18.4%) | 319,01 | 0.24 |
| Poland | - 6.34 | -12.63 (4.7%) | 634,91 | 0.48 |
| Slovenia | - 3.02 | -0.84 (-8.2%) | 8,2 | 0.01 |
| **All countries** | | | **1134,54** | **0.86** |

**Scenario III: Sustainable growth – Substituting foreign capital with domestic savings**

When it is assumed that current account deficits are not sustainable in the long run, transition economies are to finance the catch-up bit by bit by themselves. Then savings by households have to fill the financing gap released by lowering capital imports to zero in 2015 implying reduced consumption. Substituting foreign savings with domestic private savings implies the private saving quotas to rise from below 21% to more than 30% of disposable income. This policy would reduce the associated accumulated costs for the EU15 to 80 billion which represents 0.06% of accumulated EU15 GDP and 7% of the costs associated with scenario II.

| | Savings quota of households (% of disposable income) 2000 in % GDP | Savings quota of households (% of disposable income) 2015 in % GDP. Growth rate of household savings in () | Accumu-lated costs for the EU15 2000-2015 in billions | % of accu-mulated EU15 2000-2015 GDP | % of costs of scenario 2 |
|---|---|---|---|---|---|
| Czech Republic | 20.5 | 31.9 (3.0 %) | 15,63 | 0.01 | 11.6 |
| Estonia | 14.5 | 44.8 (7.8%) | 1,80 | 0.001 | 4.7 |
| Hungary | 13.3 | 44.5 (8.4%) | 8,48 | 0.01 | 2.7 |
| Poland | 14.6 | 34.0 (5.8%) | 53,82 | 0.04 | 8.5 |
| Slovenia | 12.7 | 15.4 (1.3%) | 2,36 | 0.002 | 29.0 |
| **All countries** | | | **80,02** | **0.06** | **6.97** |

## 4. The Social Dimension

In the short history of eastward enlargement, migration stands out as the prime concern of those national governments most affected, Germany and Austria (Kemmerling 2003b). Public opinion is still tilted against an immediate integration of labour markets between East and West. Rather ironically, however, policy-makers should be more concerned about too little migration than too much. With low international mobility, costs of adjustment will be heavily concentrated in Eastern Europe, and asymmetric shocks will cause an enlarged monetary union to deviate from its path of becoming an OCA. So far, it seems, migration cannot function as a primary mechanism of adjustment for CEEC.

One major reason, why migration is so low, concerns politics. In the negotiations on enlargement, Germany and Austria insisted on the postponement of a fundamental principle of the internal market: the freedom of settlement.[8] Free movement of East European workers will not be allowed before (max.) 2011. By that time, however, ambitious CEEC may have already entered ERM-II. The lack of freely adjusting labour markets between East and West may be a serious problem if CEEC are hit by financial crises. Even more importantly, if, say, increasing unemployment, is itself a trigger for currency crises as some argue (Obstfeld 1994), lifting barriers to migration would not only reduce the actual pressure from national governments, but would also signal to markets that tightness of national labour markets will not spill over into capital markets.

Public sentiment is but one reason for the imposition of these legal barriers. Interest groups in Western Europe have also played a role in the enlargement negotiations (Kemmerling 2003c). In fact, CEEC have had to implement the full acquis communautaire of the EU, whereas the old member states have not. As a consequence and contrary to traditional fears of social dumping, which on an anecdotal basis may be valid on their own[9], so far enlargement has been rather a burden for Eastern European labour markets than a source of alleviation via competitive advantages (Burda 1999). Hence, for reasons of both economic efficiency and redistributive fairness, Western European governments should seriously consider whether it is wise to postpone freedom of settlement for the full seven years.

Far more intricate is the problem of non-clearing labour markets in Western Europe. With unemployment rates lingering around 10 per cent in continental Europe, incentives to migrate

8 Only recently, other EU-15 governments seemed to have joined the band-wagon by implementing similar legal provisions against Eastern European workers.

9 cf. Vaughan-Whitehead (2003).

from CEEC to EU-15 countries are moderate at best (Kemmerling 2003b). In combination with legal barriers to migration unemployment leads to skyrocketing numbers of informal and illegal East European workers in Western Europe, some of whose jobs are highly precarious. It goes without saying that unemployment has numerous causes. From a policy-maker perspective, however, an enlarged EMU will only become an OCA once Western European labour markets overcome structural deficits. Since public opposition towards such policies still remains fierce in most of EU-15, this will be feasible only in the long run.

In the short run, CEEC labour markets will be burdened with the costs of adjustment. Some studies claim an initial job loss of up to 1 Mio. for all CEEC-10 in the first few years of EU accession (Kiander et al. 2002). Costs of EMU accession will arguably be higher in the beginning. Moreover, people most likely to lose in the early stages of enlargement are usually also those who are most sceptical towards enlargement and the euro (Kemmerling 2003a). As a consequence, CEEC governments will be put under additional pressure as demand for compensation will increase. Hence, the likelihood of implementing sound fiscal policies, as required by Maastricht criteria, may be reduced once the burden of structural adjustment kicks in.

A first-best solution to costs of structural adjustment is, of course, reforming national labour markets in Eastern Europe. The question, however, remains how big the actual room for manoeuvre of Eastern governments will be. Some Eastern European labour market institutions, such as unemployment benefits for example, have helped to spur growth and productivity in these countries (Boeri and Terrell 2002). In the light of ezoneplus, the scope of reform seems to be, grosso modo, limited,[10] and should be concentrated on those institutions that have a visible impact on national inflation rates. A prime channel to be investigated here is the so-called Balassa-Samuelson effect. Simply put, countries experiencing phases of high growth also see inflation on the rise, since there are spill-overs between economic sectors with different productivities. The degree to which these spill-overs occur, however, crucially depends on national labour market and social policies (Kemmerling 2003c). In brief, East European policy-makers would better consider the inflationary impact of these policies at the eve of EMU enlargement.

[10] This does not deny the fact that for some countries labour market institutions need an overhaul. For country specific topics see e.g. current EU reports (Commission 2002).

Some Eastern European countries will readily embark on further reforms of the tax and social security systems as recent evidence shows. There is some evidence that the euro has sped up will to reform in Western Europe, but that this has been, so far, of limited consequence. Political opposition towards reforms exerted by the use of numerous political institutions such as parliaments, referenda or constitutional courts has halted these reforms in many countries (Kemmerling 2003b). Similar actions can be expected in Eastern Europe, where only some of the smaller countries such as Estonia or recently the Slovak Republic seem to implement strategies that, ultimately would also challenge traditionally strong welfare states in, say, France or Germany (cf. Sinn 2001). Since the likelihood for such social dumping across the whole of Eastern Europe seems to be small, even in an enlarged currency union the problem is of limited significance in the short run.[11]

This all lends support to the idea that at least some new members will demand more compensation, once they are members of EU/EMU. There are politico-economic reasons to believe that the pleas of CEEC will be, at least partially, fulfilled on the level of EU cash transfers (Baldwin et al. 1997; Kemmerling 2003c). A stylised model in which Eastern European countries merely exert their voting power in the Council of Minister shows that these countries could almost double their share of EU transfers (up to 20 billion p. a.) by the use of crude political power (Kemmerling 2003c). Moreover, some Western European governments, being under considerable pressure from national interest groups[12] themselves, might eventually agree to increases in their own contributions, as long as the strictness of SGP rules is loosened (cf. Soskice and Iversen 1998). Given the barriers to cross-national migration, there may be even good efficiency-based arguments for such international redistribution (Casella 2002). It is, finally, in the tradition of European integration to create new funds for deeper stages of integration; cf. the example of the Cohesion fund created in the Maastricht negotiations (Moravcsik 1999: 446).

If such fiscal transfers from West to East are necessary for guaranteeing the political legitimacy of an enlarged E(M)U, an enlargement of the currency union nevertheless increases the need for further reforming the ways these transfers are allocated. EMU enlargement amplifies the need for efficient, i.e. least-cost solutions, and numerous studies have shown that

11 But see Boeri et al. (2002: 21) for a bleaker long-term outlook on externalities between different welfare states.

12 Among these 'interest groups' are also subnational regions that are recipients of sizeable transfers form Brussels either in the form of Common Agricultural Policy or Structural Funds. These regions have been seen to lobby heavily for the maintenance of their cash flows, even if this would mean higher overall net contributions for the country as a whole.

transfers should be focussed on genuinely poor regions and on fostering human capital investments rather than structural change per se (Boeri et al. 2002). Moreover, EU cash should be made conditional on the implementation of structural reforms in social and labour market policies, such as strict administration of unemployment benefits or activisation of labour market policies (Boeri et al. 2002: 20). Another example would be in-work benefits that not only reduce fiscal costs relative to other measures, but arguably stimulate national inflation rates less than institutions that enhance general wage compression.

Welfare states of different types and sizes will lead to externalities which are difficult to handle for national governments in the long run. This problem will be enhanced dramatically by enlarging the currency union: whereas the heterogeneity of social policy preferences will increase through the entry of new member countries, the constraints for financing these preferences converge in a currency union. It is therefore not only politically, but also economically reasonable to think about how to reduce these externalities in the long run. The introduction of a pan-European safety net guaranteeing a social minimum is an important policy proposal to be pondered in the near future. The crucial task will lie in stimulating mobility of factors of production where lack of coordination between welfare states stifles it, while containing mobility that is exclusively due to differences in the benevolence of national systems.

## 5. Institutional implications

In order to overcome the obstacles addressed in the previous sections, the European Union has to deepen its institutional reforms. The draft design of the European Constitution is an important step into this direction. Other institutional changes, however, might still be improved in both scale and scope. The key challenge for the EU comes with its simultaneous enlargement of both political and economic structures. While the new member states have already adapted the *acquis communautaire*, their inclusion into European redistributive politics and regulatory decision-making necessitates the anticipation of likely consequences.

As regards labour markets, Europe experiences far-reaching structural change triggered by the euro. With the accession of new member countries which are socially and economically below the EU average, labour market institutions of the incumbent members come under increased pressure. This is especially true for established wage-bargaining systems and labour mobility. Within the next years, the EU has to address both topics. Especially in regard to established

wage bargaining systems in Western Europe, national players will demand some sort of compensation for being exposed to Eastern European competition. Therefore a tighter coordination across Europe in terms of income policies and wage-bargaining could be helpful, especially if it is backed by enhanced reforms in labour markets. In addition, quantitative adjustments of labour markets are also greatly fostered by the adoption of a common political stance concerning migrants from so-called third countries. This would also be a highly efficient step towards solving the problem of rising shadow economies in most Western European countries.

Fiscal policy still remains an important means for European governments to cope with social imbalances and labour market distortions. As discussed below, however, uncoordinated national fiscal policies might endanger exchange rate policies in the new member states, consequently, their accession strategy to the euro. The EU already provides for a certain degree of fiscal policy coordination through the Maastricht criteria. As recent examples show, however, the lack of compliance of member states increasingly undermines the Stability Pact's capacity for coordination. On the other hand, the EU is unlikely to get the institutional backing to enforce fiscal compliance. The European constitution does not foresee a strong constitutional role for the Commission in European fiscal policy. On the other hand, the economic circumstances of the member states may substantially vary, influencing national demands for fiscal policies.

The performance of exchange-rate policy stems most notably from the formation of fiscal policy. The latter probably puts the stability of transitional exchange-rate arrangements in CEEC at risk. A breakdown would leave all EU-/EMU-members worse off in terms of output and employment as well as in terms of a smooth functioning of European decision-making processes. Therefore, there are incentives for internalising such external effects even in advance. Possible institutional consequences are retracting fiscal competencies from CEEC, i.e. centralizing fiscal policy on the European level; alternative: modifying the SGP in terms of controlling investive and curtailing consumptive budget expenditures.

The enlargement of the ECB board by new members has a major impact on European monetary policy. Although the new member states will not immediately join the euro, their accession will alter the decision-making structures of the board. With economically more heterogeneous members the optimal fit of European monetary policy is more difficult to agree upon. Monetary decision-making risks suffering institutional deadlock. CEEC can be

suspected to opt for growth-promoting monetary policy in an enlarged eurozone fostering their real convergence towards the EU. In turn, a common monetary policy can be too restrictive, i.e. curtailing output and employment in CEEC. In this regard, ambiguous institutional changes within the decision-making process of the ECB can put the price stability of the euro at risk. This applies particularly when market sentiments expect the ECB to be too much inclined to cater to CEEC' concerns and to accept possibly higher inflation in the periphery, thus, forfeiting credibility. Again, there are possibly external effects which make all EMU members worse off. Possible institutional consequences are modification of existing transparency rules in the ECB. They may be designed to dampen volatile market expectations.

With enlargement and the adoption of the *acquis communautaire* the new member states are subject to the growing body of financial regulation in Europe. The present efforts to create a truly integrated financial market in the now-enlarged EU (take the Financial Service Action Plan on securities-market legislation as an example) offer substantial opportunities but might also pose some challenges. A single market in financial services is estimated to boost employment by half a percentage point plus have a one-off effect on EU growth of 1.1 percentage points (DG Internal Market 2002).

The benefits of a sophisticated and well-developed financial market are undisputed, and the efficiency gains associated with a single market look promising. However, the quality of regulation is often related to the degree of development of the regulated economy—i.e., some may fear that the new members, which are mostly poorer than the EU average, might become overstrained with the complexity and requirements. A more simple regulation might have been more appropriate but is no longer an option. The answer in most new members was to sell most domestic financial institutions abroad, banks in particular, in order to import financial experience, modern risk management, and fresh capital. The downside of this move might be the loss of local knowledge of traditional financial relations with potentially adverse effects on lending to entrepreneurs and small and medium sized companies (SME), notably the backbone of the economies and employment.

Despite the strong foreign entry, financial markets in the new members lag behind in terms of efficiency and integration with the rest of the EU (Bundesbank 2003). This is probably unsurprising, given the little time that has passed since the beginning of transition and the still lower income levels, albeit some discomfort remains. In particular the sustainability of capital

flows (see introduction) may be in question, because inefficient financial systems facilitate misallocations and over-investment. The latter may receive new momentum once EMU approaches and investors enthusiastically anticipate the reductions in currency, country and inflation risk. The institutional implications are straightforward: The new members must maintain the pace of financial modernisation and development. This may be accompanied with provisions for good corporate governance, following for instance the recent OECD initiative. However, it remains important not to throw out the baby with the bathwater: The creation of a European level-playing field may put too much emphasis on harmonisation and pay too little attention to the special needs of the new members from Central and Eastern Europe. Sustained growth may only be achieved if entrepreneurs and SME have sufficient access to external funding.

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