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**Ezoneplus: Research project, European Commission, Fifth Framework Programme**

## Editor's Note

Welcome to the latest issue of the Ezoneplus newsletter. Apart from our usual reports on conferences and relevant literature, this time you may find a very brief piece of research controversy itself. Michael Bolle and Thomas Meyer start with putting the focus on a **political economy interplay between prospective EU-candidates and the European Union**. Christian Fahrholz' comment confirms the possibility to (re-)pass some of the convergence efforts inherent to a prospective EMU-membership, in terms of **"political risk"** onto the current EU(Eurozone). However, the two points of view differ completely regarding the possible channels how this risk transfer might occur. Despite that both presume aggregated costs of EU- and subsequently EMU-enlargement to amount higher than commonly anticipated, since .

In sum, if CEEC should be able to gain extra clout as political and financial stability becomes their "offer" in the bargaining play with the EU, they may feel tempted to conduct economic policies oscillating between either too rigid or too lax.

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**Slovenia**

## Bargaining on Enlargement

**Michael Bolle, Thomas Meyer (Free University Berlin)**

The EU redistributes substantial amounts of money, mainly toward the agricultural sector and to foster the economic convergence of its members. The applicant states in central and eastern Europe may want to receive a big chunk of these funds. And indeed, they would be major beneficiaries if the rules were left unchanged, because they are poor and agrarian. However, the current EU does not seem to be too generous with the newcomers since it set aside only a minor amount of roughly € 41bn during the last October Copenhagen summit. The applicants are up to take or leave it. Could they renegotiate on that deal?

Possibly. But they need something to offer that the EU appreciates, and hence, is willing to pay for. This asset could be financial and political stability – a major goal of the whole accession process. If any of the applicant states were to experience a severe economic crisis, suited to undermine political stability, an European bailout seems unquestionable. This unspoken promise of a bailout may lead to moral hazard - a well known phenomenon in economics. Since economic restructuring will have to be pursued inevitably, applicant states might pursue a more risky economic policy (shock therapy). A shock therapy might reduce the total

**The EU as lender of last resort – a safe strategy for candidate countries?**

adjustment burden, but runs the risk of economic crisis and vanishing political support. If ever, at the advent of failure, they receive the bailout. **Hence, they do actually transfer some of their risk onto the EU.**

Some newcomers might find it worthwhile to opt for a very rigid adjustment policy which includes rapid liberalisation, low welfare expenditures, fiscal and monetary austerity, and so forth. If it works, fine; if it fails, the EU pays. In a way candidate countries have to put their stability at risk, otherwise they can't bargain additional funds from Brussels.

Comment: **Christian Fahrholz (Free University Berlin)**

Certainly right, it can be presumed that the EU appreciates political stability in central eastern Europe. Accordingly, applicant states can probably elicit the EU's willingness to pay for political stability by putting the same deliberately at risk. However, contrary to such an austerity policy being too rigid to be sustained, candidate countries might be tempted to consider the opposite strategy in the first place.

Indeed, we may think not only of the described revaluation scenario as in the Hungarian forint-crisis this January, but also with respect to a possible devaluation scenario. In particular, required soft pegs in accordance with ERM II provide the respective incentives for an exceedingly risky economic policy stance. At the outset of ERM II, i.e. after admittance to the EU, applicant states might slacken the reins and thus endanger the stability of the exchange rate regime. **Such policy might run into a classical severe currency crisis eventually undermining political stability.** Thus, again incidence of moral hazard but this time probably at lower political costs, presuming that austerity policies involve higher losses to vote-maximizing decision-makers.

A key issue in this context is the credibility of the external constraints set by Maastricht criteria. If political stability is a major goal of the whole accession process, it is doubtful whether these criteria provide really effective constraints: Why should the EU point a finger at the fine prints, if applicant states are on the brink of disaster? Accordingly, there should be a considerable leeway for political manoeuvre. This might result in a broadening of the currently negotiated basic guidelines for financial matters in upcoming years and probably exceed the agreed 3%-limit (funds p.a. in terms of national GDP).

**ERM II could provide a mismatch of incentives**

## Ezoneplus' Conferences

### **(1) Brussels/Belgium: May 9, 2003**

The Ezoneplus Consortium organises a high-level meeting of representatives of the European Commission and academia in Brussels coming May. The aim of **Eurozone Enlargement: Exchange-rate Choices and Adjusting Markets** is to present our research and outcomes of the first year of Ezoneplus (see Ezoneplus Summary Report, December 2002 - [Introduction](#)). Divided into a keynote lecture and three topical panels, the workshop will cover capital & labour markets, trade & FDI, as well as exchange-rate policies. Reflecting the reshaping effects on these markets, we will try to expand our view towards more policy-oriented questions.

Most participants are related to European institutions, however, experts in international finance and government representatives are equally welcome. For more information contact: Andrej Stuchlík, Free University Berlin. [a.stuchlik@ezoneplus.org](mailto:a.stuchlik@ezoneplus.org)

**Brussels workshop – May 9, 2003**

## Other Conferences/Events

*- Upcoming -*

### **(1) Tartu/Estonia: 9/4/2003**

A seminar dealing with micro simulation models will be organized at the University of Tartu, Estonia. The seminar will be given by Professor N.

Anders Klevmarcken from Department of Economics of the Uppsala University (Sweden). The topics will include general introduction to the microsimulation models and overview of some of applications based on the own work of Anders Klevmarcken. Those applications based on household survey data, microeconomic of time use data, direct and behavioural effect of income tax changes, the economics of the old baby-boomers (withdrawal from the labour market, housing, health accumulation and the demand for health services). Please notice that the exact time of the seminar is still subject to changes. For more information, please contact: Prof. Tiiu Paas, [Tpaas@mtk.ut.ee](mailto:Tpaas@mtk.ut.ee) or PhD student Andres Võrk, [avork@ut.ee](mailto:avork@ut.ee)

### **(2) Évora/Portugal: 11/4/2003**

The European Documentation Center of Évora University will host the conference: “The Enlargement of the European Union: social and economic impacts”. Together with leading academics from University of Extremadura (Spain), Freie Universität Berlin (Germany), University of Tartu (Estonia), Institute for Economic Research (Slovenia) and some portuguese Universities (Évora, Algarve, Porto and Lisbon), the conference will focus on “impacts on Iberian countries” and “Policy and Market impacts in EU and accession countries”, which involves different research areas such as Trade, FDI, Labour markets, social dimension, Structural European Funds and monetary and fiscal policies. For more information please contact: Prof. Jose Caetano, [jcaetano@uevora.pt](mailto:jcaetano@uevora.pt)

### **(3) Tartu/Estonia: 17/4/2003**

The University of Tartu, Estonia, hosts a seminar on macroeconomic modelling. In particular it will focus on the advantages of econometric macroeconomic models over the computable general equilibrium models. The seminar will be given by Grassini Maurizio. He is the professor of Econometrics and Economics of European Integration at the University of Florence, Italy. The purpose of this workshop is also to start scientific cooperation between Estonian and Italian partners in order to develop an extensive macroeconomic model for Estonia that could be used for analysing the economic costs and benefits of EU enlargement. Please notice that the exact time of the seminar is still subject to changes. For more information, please contact: Prof. Tiiu Paas, [Tpaas@mtk.ut.ee](mailto:Tpaas@mtk.ut.ee)

**Micro- and Macro-modelling in Estonia**

### **(4) Värsja/Estonia: 26-28/6/2003**

11th scientific and training conference “Estonian Economic Policy on the Way Towards the European Union”. The conference is organised in cooperation of University of Tartu, Tallinn Technical University, University of Leipzig and Fachhochschule Kiel. The main topics will be: national and regional aspects of economic policy, problems of local governments, industrial relations, and economic policy and entrepreneurship. For more information, please contact: Mrs. Ülle Maidla, Secretary of the chair of economic policy at University of Tartu, [mylle@mtk.ut.ee](mailto:mylle@mtk.ut.ee)

*- Past -*

### **(1) Budapest/Hungary: 27-30/11/2002**

Lavrač, Vladimir. 2002. “Exchange rate arrangements of accession countries: recent lessons and challenges for the future” presented at Exchange rate strategies during the EU enlargement: EU high level scientific conference, Budapest: International Center for Economic Growth. [Link to the presentation](#)

**CEECs’ institutional arrangements on the way to EMU**

### **(2) Lahti/Finland: 23/11/2002**

Kiander, Jaakko: "EU Eastern enlargement and the future of the Finnish welfare state", presentation during a seminar on EU enlargement organised by the Finnish Social Democratic members of the European Parliament, Lahti, Finland.

### **(3) Ljubljana/Slovenia: 19-21/09/2002**

Lavrač, Vladimir, and Tina Žumer. 2002. "Accession of CEE countries to the EMU: nominal convergence, real convergence and optimum currency area criteria", presented at [EU enlargement in a changing world: challenges for development co-operation in the 21st century](#): 10th General Conference of EADI, Ljubljana.

## **Publications**

### **(1) Ezoneplus Working Paper No. 12, February 2003**

Yilmaz, Bahri: "Turkey's competitiveness in the European Union: a Comparison with five candidate Countries – Bulgaria, the Czech Republic, Hungary, Poland, Romania and the EU 15"

The main purpose of this paper is to examine the international competitiveness of Turkish economy and structure of specialisation in foreign trade in comparison with the five- candidate country -Bulgaria, the Czech Republic, Hungary, Rumania, Poland and the EU/15. Thus, **this paper attempts to find out Turkey's ability to overcome difficulties and challenges that might arise from the hard competition with the enlarged EU**, mainly in the field of foreign trade.

The paper is divided into four main sections. In the first section we will focus on the importance of the EU countries for the Turkish economy. In this context, it will be given an overview of the economic relations between Turkey and the EU. The second part describes the methodology for assessing Turkey's competitiveness with the Five and the EU/15 as a whole. Then we will try to interpret the empirical results. This empirical analysis sheds light on the structural differences in trade sectors among the six countries and the extent to which such differences have increased or decreased between Turkey and the Five candidate countries. The concluding section draws some basic conclusions from the empirical results and considers the future position of Turkey within the enlarged EU.

[Link to the paper](#)

**Turkey and Eastern Europe: who is catching-up and why?**

### **(2) Ezoneplus Working Paper No. 13, March 2003 – Regional Input**

Paas, Tiiu; Marit Rõõm; Allan Sikk; Reilika Liiv; Christopher Schumann, and Orsolya Szirko: "Social and Political Dimensions of the Euro Zone Enlargement in the Case of the Baltic States"

The paper aims to analyse social and political dimensions of eurozone enlargement in the Baltic States emphasizing also negative consequences of transition and integration processes and their possible impact on EU accession. The paper consists of two main parts. The first part analyses social dimensions of EMU enlargement paying attention to common features and differences of social issues and policy implications in the Baltic States. The second part of the paper stresses the political dimension of transition and EU enlargement analysing institutional aspects of political systems, political values and attitudes together with assessments of regime change and the popular stance towards EU. [Link to the paper](#)

**The Baltics: Social and Political Aspects of EMU accession**

### **(3) Ezoneplus Working Paper No. 14, March 2003 – Regional Input**

Galego, Aurora, J. Caetano, and S. Costa. "The Eastward Enlargement of the Eurozone. Social and Policy Aspects in Portugal, Spain and Italy"

This preliminary report explores some features of the social dimension of enlargement regarding the Southern EU-Member countries, namely Portugal, Spain and Italy. Theory suggests that integration may affect wages, employment and income distribution through changes on trade, FDI and migration flows. By removing all barriers to the free movement of goods and services, capital and labour, Eastward Enlargement will affect the location of economic activities, innovation and technology. Subsequently, the need for economic readjustments will impose extra difficulties at national, regional and sector levels.

First we focus on the main characteristics of the labour market in Portugal, Spain and Italy, analysing in more detail recent developments concerning unemployment. Some aspects related to poverty and inequality will be analysed in order to outline the key social problems in those countries. Secondly, a brief review of labour market policies and institutions as well as pension systems and social and unemployment assistance will be made. [Link to the paper](#)

**(4) Ezoneplus Working Paper No. 15, March 2003 – Regional Input**  
Kemmerling, Achim: “Regional Input on the Social Dimension of Ezoneplus for Belgium, the Netherlands, France, Austria and Germany. Of reshaping policies, social conflicts and political consequences”

Within Ezoneplus the Social Dimension is a hybrid in the sense that it addresses both the reshaping of certain policies and the socio-political repercussions an Eastward enlargement of the eurozone may have. Correspondingly, key questions to be answered can be grouped under two headings: Firstly, **what kind of external shocks does the enlargement produce on national and EU policies?** The three policy areas here to be inspected are social security systems, labour market regulation, and EU structural and agricultural policy. Secondly, how do national societies and political systems respond to these new constraints? This implies both potential social conflicts possibly enhanced by the enlargement process, as well as their implications for national policy-making. In order to combine both topics, we suggest an analysis using insights of modern political economy. In brief, this is to say that rational political actors act in response to Ezoneplus in a way predictable once the socio-economic outcomes of the enlargement process have been analysed. [Link to the paper](#)

**(5) Ezoneplus Working Paper No. 16, March 2003 – Regional Input**  
Kiander, Jaakko: “The Nordic Welfare State in the 1990s: Consequences of disinflation and fiscal consolidation in the three Nordic EU Countries”

This paper reviews the current state of the so called Nordic welfare state, and the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors to fiscal consolidation. The economic crises and structural changes of the 1990s are viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. Even after these hardships the Nordic model remains clearly distinctive and in many respects successful. Although the Nordic welfare model has survived many difficulties, there lie further challenges in the future. The most important of them are possible tax competition which may threaten the financial basis of current welfare systems, especially in Denmark and Sweden, and expected demographic change, which will add excess burden to the public finances within the next 20 years. However, the all Nordic countries have currently healthy fiscal surpluses, which gives them a better position than for most other Western European countries. [Link to the paper](#)

#### ***Ezoneplus Estonia***

**(6)** Paas, Tiiu, Raul Eamets, Jaan Masso, and Marit Rõõm. 2003. “Labour Market Flexibility and Migration in the Baltic States: Macro Evidences” University of Tartu - Faculty of Economics and Business Administration Working Paper Series, No. 16.

#### **New Regional Inputs: Comparative studies on -**

**14) Italy, Portugal  
and Spain**

**15) Austria, Belgium,  
France, Germany and  
Netherlands**

**16) Denmark, Finland  
and Sweden**

**EU enlargement and  
the impact on labour  
market flexibility**

The Eastern enlargement of the European Union and the requirements of the European Monetary Union call for increased flexibility of labour markets in both the current EU members and candidate countries. If labour markets and institutions are rigid in the monetary union, market disequilibrium is likely to grow. The present paper aims to give a **macro-economic overview of the Baltic States' labour market** in the period 1995-2001, laying emphasis on the issues of labour market flexibility and labour migration in the context of EU eastward enlargement.

Free movement of labour as a natural consequence of EU enlargement will also exert pressure on the Baltic labour markets due to the possible migration of better-qualified and flexible labour force, and cross-border movement of labour within the Baltic Sea Region countries. Coupled with ageing of the population, it may increase shortage of skilled labour. Consequently, if labour mobility increases and labour market flexibility declines remarkably during the enlargement processes, market disequilibrium is likely to grow in the Baltic States as well. [Link to the paper](#)

(7) Paas, Tiiu. 2003. "Regional Integration and International Trade in the Context of EU Eastward Enlargement" Hamburg: HWWA Discussion Paper 218, January.

The paper aims to explore international trade flows of the countries involved in the EU eastward enlargement processes - the current EU members (EU15) and the candidate countries (CC12). The empirical results of the study allow us to conclude that the behaviour of bilateral trade flows within the countries involved in EU eastward enlargement accords to the normal rules of gravitation, having statistically significant spatial biases caused by the trade relations, between the Baltic Sea Region (BSR) countries (the BSR bias), the border countries (the border bias) and the EU member and candidate countries (the East-West bias). The East-West trade relations are still rather weakly developed and there is a statistically significant difference in international trade patterns between the two groups – the current EU members and the applicant countries. The lessons of the Baltic Sea Region in integrating countries with different economic and political backgrounds and developing bilateral trade relations are valuable in supporting EU eastward enlargement and the reintegration of new member countries into Europe. [Link to the paper](#)

**Mimikry of EU-Enlargement: Lessons on integration from the Baltic Sea Region**

#### ***Ezoneplus Finland***

(8) Kiander, Jaakko, and Henrik Lönnqvist. 2002. *Economic growth and the welfare state* (in Finnish) Helsinki: WSOY.

(9) Kiander, Jaakko. 2002. "Migration and the future labour shortages in Finland", (in Finnish) PTT Katsaus No. 4.

#### ***Ezoneplus Slovenia***

(10) Borak, Neven, and Vladimir Lavrač. 2002. "An outline of the banking regulatory and supervisory system in Slovenia", in *Banking and financial stability in Central Europe : integrating transition economies into the European Union*. Green, David and Karl Petrick, eds. Cheltenham: Edward Elgar, pp. 105-124.

## **Literature**

### **(1) Board of Governors of the Federal Reserve System. International Finance Discussion Papers, December 2002**

Natalucci, Fabio and Federico Ravenna: "The Road to Adopting the Euro: Monetary Policy and Exchange-rate Regimes in EU Candidate Countries", No 741.

This paper examines the choice of exchange rate regime in EU candidate countries during the process of accession to the European Monetary Union (EMU). In the presence of real exchange rate appreciation due to the Balassa-Samuelson effect, candidate countries face a trade-off between trend appreciation of the nominal exchange rate and high inflation rates. In a general equilibrium model of an emerging market economy, we show that under a fixed or heavily managed exchange rate the Balassa-Samuelson effect might prevent compliance with the Maastricht inflation criterion, unless a contractionary policy is adopted. We then discuss how the **real exchange rate appreciation** shifts the output gap/inflation variance trade-off, increasing the cost of managing or fixing the exchange rate. As a consequence, the requirement of membership in the Exchange Rate Mechanism (ERM-II) and the Maastricht inflation criterion constrain the policy choice while providing no additional benefit to countries credibly committed to joining the Euro. [Link to the paper](#)

### (2) IMF Working Paper No. 02/222, December 2002

Frenkel, Michael, and Christine Nickel: "How Symmetric Are the Shocks and the Shock Adjustment Dynamics Between the Euro Area and Central and Eastern European Countries?"

The authors use a structural **vector autoregression model** to identify and compare demand and supply shocks between euro area countries and central- and eastern European countries (CEECs). The shocks and the shock adjustment dynamics of these countries are also compared to EU countries that currently do not participate in the EMU. Focussing on the period 1993-2001, they find that there are still differences in the shocks and in the adjustment process between the euro area and the CEECs. However, several individual CEECs exhibit shocks and shock adjustment processes that are fairly similar to some euro area countries.

[Link to the paper](#)

### (3) NBP - National Bank of Poland,

Borowski Jakub, Michal Brzoza-Brzezina, and Piotr Szpunar: "Exchange-Rate Regimes and Poland's Participation in ERM II"

In this paper we address some of the issues resulting from Poland's will to join the Economic and Monetary Union. Our attention focuses on topics related to the possibly soon entry into the European exchange rate mechanism (ERM II). We consider the possible paths of entering the system, providing a detailed analysis of the choice of fluctuation margins and the central parity. Further, we analyse the possible monetary policy strategies within the system. We describe the benefits and drawbacks of ERM II participation and consider the eventuality of parity revaluation. In this part estimates of the **Balassa-Samuelson effect** for Poland are provided. [Link to the paper](#)

**OCA theory: how likely are adverse shocks in Euroland and prospective EMU-members?**

## Miscellaneous

Members of the Ezoneplus Research Consortium together with a variety of institutions across Europe initiated **WellbeNet** (Quality of Life in Europe: Perceptions and Policies), a new research project dealing with all economic and political aspects of Well-being. All relevant information on this initiative composed for the European 6th Framework Programme can be obtained via Web: <http://www.ezoneplus.org/infowellbeing.php> or from Andreas Spannbaauer, Free University Berlin. [a.spannbauer@ezoneplus.org](mailto:a.spannbauer@ezoneplus.org)

### *Ezoneplus Estonia*

The Estonian researchers from Tartu University developed a new research project: "Structural changes in Estonian labour market: risks and sustainable development" financed by Estonian Ministry of Education for 2003-2008.

The purpose of the research project is to study the structural changes in labour markets that arise from the openness of the Estonian economy and integration with the European Union. The accompanying risks and their socio-economic consequences will be analysed. In the course of the research work we would like to develop both theoretical and empirical papers that are necessary for understanding the processes ongoing in the labour markets. Additionally, the aim is to propose alternative possibilities for the sustainable development of both Estonian economy and society. Research methodology is based on fundamental conceptions from both micro and macroeconomics, using a variety of different methods of econometric modelling (econometric models of cross section and panel data, general equilibrium models et cetera.). For more information, please contact: Prof. Tiiu Paas, [Tpaas@mtk.ut.ee](mailto:Tpaas@mtk.ut.ee)



Note: Content for the Ezoneplus newsletter is submitted by the Jean Monnet Centre of Excellence, Freie Universität Berlin. Although the Centre had editorial discretion, we will not accept any liability in respect of the information presented above. Contact: [newsletter@ezoneplus.org](mailto:newsletter@ezoneplus.org)

**Freie Universität Berlin**  
Department of Political and Social Sciences  
Jean Monnet Centre of Excellence  
Innestr. 22  
D-14195 Berlin  
<http://www.polwiss.fu-berlin.de/more/coe.htm>