Eastward Enlargement of the Euro Zone

At the beginning of May 2004 ten new member states joined the European Community. The next major step for each of them will be when they become full-fledged members of EMU, which they are obliged to join as soon as they fulfil the Maastricht convergence critieria. What problems can be expected along the way, and how can a smooth EMU accession be achieved?

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Euro Adoption and Growth in Central Europe: Managing a Political Process

EMU enlargement is the next big thing. In May 2004, eight countries in Central Europe[1] as well as Cyprus and Malta have joined the European Union (EU) and also the European Monetary Union (EMU) with a derogation on adopting the euro as legal tender. Joining the eurozone will be a question of time rather than intention. Moreover, with Bulgaria and Romania, two additional candidates are awaiting admission to the EU and eventually EMU. Monetary unions have been assessed along the criteria of optimum currency areas (OCA) as introduced by Robert Mundell,[2] Peter Kenen[3] and Ronald McKinnon.[4] According to these criteria, those countries qualify for monetary union, which are less susceptible to asymmetric shocks, or have mechanisms in place to offset these shocks without recurring to monetary policy. Such mechanisms are wage and price flexibility, labour migration and fiscal transfers. The case for an independent monetary policy is also based on diverging business cycles because a booming economy requires a restrictive monetary stance to prevent it from overheating, while an economy in recession would appreciate some monetary stimulus. How should the monetary authority react if both are in the same currency union?

Most observers have rightly concluded that Europe is not an optimum currency area, because business cycles are not well synchronised, wage and price flexibility is low, and fiscal transfers and labour migration are not welcome. However, in our view many observers have wrongly concluded that Europe should therefore not form a monetary union, because they have underestimated people's ability to adapt to new environments. People respond to the incentives and constraints set by monetary union and create what is needed to form an optimal currency area (OCA). The idea of an endogenous optimum currency union has been developed in parallel by a number of authors.[5] In 2001 we initiated a research project, kindly supported by the European Union's Fifth Framework Programme, which thrives on the questions of how the euro will shape European economies. As we now know, the introduction of the euro has fostered substantial changes in Western European markets from increased competition, trade expansion, an integrating financial market, fiscal coordination, up to changes in the way wages and prices are set. The euro will be a catalyst of change in the Central European economies, too.[6] This is the presumption of our project on the eastward

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[1] The new members from Central Europe are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

[2] Robert Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, 1961, pp. 657-665.

[3] Peter B. Kenen: The Theory of Optimum Currency Areas: An Eclectic View, in: R. A. Mundell and A. K. Swoboda (eds.): Monetary Problems of the International Economy, Chicago 1969, University of Chicago Press.

[4] Ronald McKinnon: Optimum Currency Areas, in: American Economic Review, Vol. 53, 1963, pp. 207-222.

[5] See for instance Jeffey A. Frankel and Andrew K. Rose: The Endogenity of the Optimum Currency Area Criteria, in: The Economic Journal, Vol. 108, 1998, pp. 1009-1025; as well as Michael Bolle and Michael Neugart: How will the Euro shape European Economies, paper presented at the 4th Conference on Macroeconomic Analysis, University of Crete, 2000.

Table 1
Characteristics of New and
Prospective EU Members

Country	GDP per capita (PPP, USD)	Unemp-loyment rate	School enrolment (1996)	ICRG	I/Y	Current account balance (%GDP)
Bulgaria	7,130	19.4	76.8	71.8	19.9	-4.4
Czech Republic	15,780	8.1	91.4	76.8	28.1	-6.5
Estonia	12,260	12.6	103.8	73.5	31.4	-12.3
Hungary	13,400	5.7	100.6	76.3	24.0	-4.0
Latvia	9,210	12.8	83.7	76.5	27.3	-7.7
Lithuania	10,320	17	86.3	76.3	22.5	-5.2
Poland	10,560	18.2	96.3	75.8	19.1	-2.6
Romania	6,560	6.6	78.4	69.8	23.1	-3.3
Slovakia	12,840	19.3	94.0	74.5	31.2	—
Slovenia	18,540	5.9	91.7	79.8	23.5	1.7
Germany	27,100	7.8	103.7	82	18.0	2.3

S o u r c e s : GDP per capita at PPP (current international USD) for 2002, unemployment rate (% of labour force) as of 2001, secondary school enrolment (% gross) as of 1996, by World Development Indicators, World Bank 2004; ICRG composite Indicator of 2003 by PRS Group (2003); I/Y is gross capital formation (% GDP) for 2002, current account balance (% GDP) by World Development Indicators, World Bank 2004.

enlargement of the eurozone.[7] This article is based on its findings.

Adjusting to a monetary union is not always a smooth and frictionless process. People have to learn and accept the new rules of the game. This is a political challenge as much as an economic one. Take the German experience as an example. Nominal wage cuts would have been unthinkable only a few years ago, but now more and more employees are prepared to accept them as recent wage deals suggest.[8] Since Germany has lost monetary autonomy, real wage adjustments by monetary or exchange-rate means are ruled out. Employees responded to this loss of flexibility by allowing nominal wage flexibility. However, before German workers accepted the new rules of the game, it took some time and credible threats to move jobs abroad. The speed of learning and adjustment therefore determines the putative output loss of lost monetary autonomy. In this respect, politics are crucial for they moderate between winners and losers, as well as determine the credibility of the economic stance.

The Stability Pact, for instance, has conveyed little confidence in future fiscal consolidation, because its credibility is damaged by weak enforcement. Therefore, people have not adjusted accordingly.

Characteristics of Central European Member States

In the terminology of the World Bank, the new members from Central Europe are upper-middle-income economies (except Slovenia, which is a high-income economy), that is, they are in the same group as Argentina, Botswana or Saudi Arabia. Although they have come a long way since transition started, most of them can still be considered poor by Western European standards (cf. Table 1). These income disparities create a number of problems for European (economic) integration in general and EMU enlargement in particular.

The most important point is, that low incomes relative to the West make people unhappy, because the living standards of Western Europe serve as a benchmark for the own well-being. This will be reinforced by the introduction of the euro. In as much as the euro increases price transparency and enhances competition, which boosts efficiency and growth, it also increases the visibility of income differentials. People will demand a faster catch-up. The example of German unification has illustrated that people may not persistently accept different standards of living in what they consider a joint economic area. The unhappiness can translate into political instability or excess migration, both not well embraced by current members.

Macroeconomic policy coordination is much more difficult when countries are so heterogeneous in economic strength. This is in particular true with regard to monetary policy – poor but fast growing countries tend to create inflationary pressures[9] - but also in other policy fields, such as corporate taxes or social standards. Western European employees may not feel too comfortable with low cost workers just across the border. Especially those who wish a stronger political integration of the EU should look forward to real convergence, for that would create more aligned interests and thus make political integration easier.

Growth accounting segregates the impact of capital accumulation from gains in total factor productivity (TFP) on growth. Development economics tends to

[6] A recent report by the Polish National Bank states that euro adoption should impose wage discipline and enhance wage flexibility: National Bank of Poland: A Report on the Costs and Benefits of Poland's Adoption of the Euro, Drukarnia NBP, Warsaw 2004, edited by Jakub Borowski.

[7] The Eastward Enlargement of the Eurozone is supported in FP5: Human potential (HPSE-CT-2001-00084). Please visit the website www.ezoneplus.org for a full description and findings.

[8] Recent wage deals at Siemens and DaimlerChrysler disguised nominal wage cuts as longer working hours without higher pay.

[9] This is due to the Balassa-Samuelson effect, which is estimated to add 1-2 points to consumer-price inflation in Central Europe: Mihály A. K o v á c s et al.: On the Estimated Size of the Balassa-Samuelson Effect in Five Central and Eastern European Countries, NBH Working Paper, No. 5, 2002.

regard TFP as the main source of growth in output per capita.[10] Human capital – i.e. a healthy and well-educated workforce – and good institutions – i.e. low transaction costs and protection from expropriation – are leading indicators of TFP.

However, EU members in Central Europe score well on both accounts. Table 1 lists a lagged indicator for secondary school enrolment, which suggests that the workforce today in Central Europe is in general not much less educated than in the West, partly thanks to the higher importance given to schooling and education in socialist countries. Only Bulgaria and Romania exhibit a greater distance. Institutional quality is proxied by the ICRG (International Country Risk Guide) indicator, which has an average value of 75.1 in the Central European members plus Romania and Bulgaria.[11] That is below Germany's figure of 82.0 but above that of the United States (73.8).[12] The reasons behind the institutional upgrade are on the one hand compliance with the *acquis communautaire*, and on the other hand increasing economic integration with the West, which has improved enforcement of laws and property rights. An investor who feels mistreated by a local government in Central Europe can now sue all the way up to the European Court of Justice.

With human capital and institutional quality at levels close to Germany, differences in capital/labour-ratios explain a larger part of differences in output per capita than usual with comparisons between rich and poor countries. The differences in capital/labour-ratios are an important source of current capital flows because capital should yield higher returns where it is scarce, given that other things – human capital and institutions – have similar levels. Some authors have calculated that the median country in Central Europe might need capital inflows of as much as 370 per cent of GDP to level capital/labour-ratios.[13] Future growth will be fuelled strongly by investments. The political management of investments will therefore be decisive.

Real Effects of EMU Enlargement

EMU adds to the dynamics of the Single Market because it increases price transparency and helps forge a European capital market, which makes cross-border financing in Europe much easier. In a widely cited article, Jeffrey Frankel and Andrew Rose[14] argue that belonging to a currency union triples trade, and that each additional percentage in trade boosts output by 1/3 per cent over 20 years: They conclude that "Poland could raise its income by as much as 20 percent by joining the euro zone".[15] Moreover, the trade creation can be attributed to lower transaction costs, stronger competition and transparency of prices because most models control for free trade agreements when assessing the benefits of currency union.[16]

Besides trade, EMU will reduce risk premiums on engagements in Central Europe which in turn gives a boost to capital flows and investments. Table 1 shows that the accession countries have been importing substantial amounts of capital and experienced high investment rates in the past (Slovenia is again the exception), which is reflected by concomitant current account deficits and real trend appreciation of the exchange rates.

The ability to absorb capital will also rise because European financial integration will enhance the quality of capital allocation. Please note that in all Central European countries foreign banks own the majority of assets and form a crucial part of the domestic financial system. And foreign banks typically bring superior risk management and access to international capital markets.[17] Moreover, increased real economic integration can reduce the risks of new investments because it may be easier to find complementary production – supply and demand linkages – in a larger market.

Loss of Monetary Autonomy

The costs of a currency union are usually seen as the loss of monetary instruments to cope with

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[10] Cf William Easterly and Ross Levine: It's Not Factor Accumulation: Stylized Facts and Growth Models, in: World Bank Economic Review, 2004 (forthcoming).

[11] On a scale between zero and 100, where 100 is the best possible score. The ICRG (Institutional Country Risk Guide) composite indicator is compiled by the PRS Group. Figures are for 2003. Zimbabwe scores lowest with 37.0; while Switzerland has the highest institutional quality with 91.3.

[12] The levels of human capital and institutional quality are still somewhat below Western European levels, but since these are to some degree endogenous, they can be expected to rise with incomes.

[13] Leslie Lipschitz, Timothy Lane and Alex Mourmouras: Capital Flows to Transition Countries: Master or Servant?, IMF Working Paper, WP/02/11, 2002.

[14] Jeffey A. Frankel and Andrew K. Rose: Estimating the Effect of Currency Unions on Trade and Output, NBER Working Paper, No. 7857, 2000.

[15] Ibid., p. 22. In a comment on this article, Dani Rodrik supports the view that joining a currency union may boost incomes, but questions whether trade is the operative channel. Quality of institutions and geographical variables usually trump trade. Cf. Dani Rodrik: Comments on Frankel and Rose, "Estimating the Effects of Currency Unions on Trade and Output", at: http://ksghome.harvard.edu/~drodrik/comments%20on%20Frankel-Rose.PDF, 2000.

[16] See also Susan Schadler: Charting a Course Toward Successful Euro Adoption, in: Finance & Development, June 2004, pp. 29-33.

[17] Cf George Clarke, Robert Cull, Maria Soledad Martinez Peria and Susana M. Sánchez: Foreign Bank Entry: Experience, Implications for Developing Countries, and Agenda for further Research, in: Background Paper for the World Development Report 2002.

economic shocks – based on the OCA criteria. EMU brings additional requirements in the form of the Maastricht criteria and the Stability Pact, which demand a certain level of nominal convergence prior to joining the eurozone. This nominal convergence, low inflation and modest budget deficits, among other things, may be expensive for prospective members. To achieve nominal convergence, they may have to cut discretionary fiscal spending – e.g. investments on infrastructure and institutions. Since these public goods are important inputs to production, reductions in their provision may cost growth.[18] In our view, these fears are overstated, if only because the task of nominal convergence should be seen in perspective: the Maastricht criteria have to be matched only once, the year prior to euro adoption; and the Stability Pact is about to receive a more flexible interpretation because of France's and Germany's economic woes and a more compassionate EU Commission. Therefore, nominal convergence might not impede long-term growth too much. Moreover, the link between public spending and productivity enhancing public goods should not be taken at face value because public investment programmes always entail agency costs, which are visible *inter alia* by the poor performance of structural funds in Europe's periphery.[19]

Another point is that the OCA criteria have a very benign view of exchange rates as a shock absorber, but they ignore the volatility and instability that is caused by erratic exchange-rate movements.[20] Moreover, the mere fact that already four out of ten central European economies (the Baltic States and Bulgaria) have introduced currency boards suggests that monetary autonomy is not regarded as too precious.[21]

The more serious threat is that during the transition from present regimes to EMU enlargement imbalances arise which destabilise exchange rates and financial systems. The way towards the euro passes through the European Exchange Rate Mechanism 2 (ERM2). ERM2 is a soft peg, because the currencies are allowed to fluctuate in a band of +/-15 per cent around a parity rate with the euro.[22] Soft pegs have become unpopular among many economists, for they lack the credibility of fixed regimes and the shock-absorption capabilities of fully flexible regimes. In particular after the Asian crisis of 1997, corner solutions – i.e. either fully flexible or fixed exchange-rate regimes – have become fashionable. In fact, exchange-rate regimes in Central Europe have followed this notion and applied either managed floats or currency boards.[23] However, during ERM2 the managed floats at least will have to be transferred into the soft peg. And the Hungarian experience illustrates what a bumpy ride this may become: in 2003, the Hungarian National Bank defended an appreciation of its currency by monetary expansion and subsequently had to fight depreciation pressures (as consequence of the monetary overhang), which eventually led to a downward realignment of the forint.

Managing Euro Adoption

The timing and management of EMU enlargement are the interesting issues, because in the long run the benefits of euro adoption will outstrip the alleged disadvantages. Unfortunately there is no unambiguously safe strategy towards the euro; hence, policies always have to strike a balance between diverging interests and goals.

EMU requires substantial adjustments for instance in the form of increased wage and price flexibility or fiscal restraint. In particular fiscal restraint is often regarded as the bell-wether of the seriousness of economic adjustment[24] because it will be the only remaining macroeconomic instrument. However, one should not underestimate the hardship economic adjustment may put on many people in Central Europe and the political pressure which may arise. Unemployment is rampant from Estonia to Bulgaria (cf. Table 1) which may reduce the willingness to accept cuts in public spending or to embrace international competition. Large agricultural sectors in some countries, e.g. Poland, will have to be downsized, which means that potentially millions of workers will have to switch jobs and change their lifestyle. Such large swings have never been easy.

It is conceptually useful to look at the trade-off with respect to risk premiums. Ideally, risk premiums on

[18] Helmut W a g n e r: Pitfalls in the European Enlargement Process. Financial Instability and Real Divergence, in: Deutsche Bundesbank Economic Research Centre: Discussion Paper No. 6, 2002, pp. 18-24.

[19] Cf Sjef E d e r v e e n, Henri L. F. de G r o o t and Richard N a h u i s: Fertile Soil for Structural Funds?, in: Tinbergen Institute Discussion Paper, 2002, No. 096/3.

[20] In a later article, Robert Mundell picks up this argument. Cf. Robert M u n d e l l: Uncommon Arguments for Common Currencies", in: H. J o h n s o n, A. S w o b o d a (eds.): The Economics of Common Currencies, London 1973, pp. 114-132.

[21] The Baltic States, but not Bulgaria, are small open economies, and hence, come closest to fulfilling the OCA-criterion.

[22] Perhaps exchange rates will have to stay within a narrow band of say +/-2¼ per cent to be considered stable, and thus to fulfil the Maastricht criterion on exchange-rate stability. A binding interpretation has yet to emerge.

[23] Hungary and Slovenia have already adopted ERM2-style exchange-rate regimes.

[24] See for instance Susan S c h a d l e r, op. cit.

investments in Central Europe are an increasing function of current account deficits, starting from a certain base set by economic fundamentals such as the capital/labour-ratio. At some equilibrium amount of capital inflows, risk premiums are such that marginal returns on capital are equalised between poor and rich EU members.[25] A lower risk premium – for instance, by eliminating exchange-rate risk via EMU – thus translates into higher equilibrium capital flows.

In reality, the risk premium is determined by an array of different variables, developments, and shocks; and it is not necessarily a smooth function of the current account. Economic and political variables may affect risk premiums at different speeds, causing whiplash effects and imbalances. Fiscal consolidation, for instance, may signal sound economic policies to investors, thus boosting foreign investments. These investments, though, will be unlikely to create jobs in those sectors which suffer most from spending cuts, such as agriculture. Angry peasants may take to the streets and cause political instability, hence pushing up risk premiums. On the other hand, a too generous policy that scares off investors might similarly create unrest because the desired growth would not be accomplished. The political skills show in bringing about the necessary adjustment and maintaining social acceptance at the same time.

Capital flows are driven by expectations of future performance. Fast growing economies are susceptible to overheating and asset-price bubbles because some investors react pro-cyclically, and expect that past performance will last, albeit some *mean-reversion* would be more realistic. Consider the average price/earning (P/E) ratio of shares at the Warsaw Stock Exchange. From 1998 to 2003 it increased from 16.3 to 284.9, i.e. in 2003 shareholders needed more than 284 years of current profits to redeem the share price.[26] Obviously, they expect company profits to soar in the future, which would bring down the P/E to more modest levels. Most observers regard a P/E ratio of around 15 as healthy. Booms in housing prices in Central European cities are another likely target. There are two problems connected with asset-price frenzies. First, they do not create jobs (quickly) and hence contribute little to social acceptance. Second, they are most likely unsustainable and increase economic volatility. Economic policies should therefore mitigate purely asset-price

driven investments, and be prepared for asset-price booms and busts to occur. The challenge is preventing them from endangering financial and exchange-rate stability (during ERM2). Such policies would include foremost a prudent banking supervision: banking positions should be stress-tested whether they withstand even substantial swings in asset prices. Assessing collateral according to expected asset prices – usually a projected price hike – should be discouraged, for instance by requiring higher minimum reserves for such loans. The most important measure would be to prepare markets for larger swings, for that would prevent a panic among investors once they appear. The governments should resist any temptation to give explicit or implicit guarantees or promises of bail-out. A lack of clarity on this issue may cause speculation, and in the end a problem that may be too big to refuse a bail-out.

Conclusions

Euro adoption will be a question of time. And it is a political process because ultimately politicians have to decide how fast adjustment to the new rules of the game shall be. Real convergence to EMU's rich members will be necessary to ensure social acceptance and the ability of macroeconomic coordination in Europe, as well as to foster political integration if desired. EMU enlargement improves growth prospects through trade creation and financial integration, i.e. substantial capital flows from West to East. However, the same mechanisms which increase price transparency will also increase the visibility of income differentials, and push the pressure for converging standards of living.

The governments may find themselves between a rock and a hard place because economic reforms which boost growth – for instance, by liberalisation and fiscal moderation – may put hardship on those sectors of the economy where adjustment is most painful, such as in agriculture or with elderly workers. Without such reforms, growth may slow down and real convergence may take too long to satisfy people. Political instability caused by an unhappy electorate can backfire on risk premiums and capricious financial markets potentially amplify minor shocks to a full-blown crisis. This will be a particular problem during ERM2, when financial markets will test whether parities are well chosen and sustainable.

Since EU members in Central Europe already have good institutions and a well-educated workforce, future growth will rely on investments and capital imports, which increase the capital/labour-ratio. However, some imbalances and frictions will be unavoidable

[25] Cf Leslie Lipschitz, Timothy Lane and Alex Mourmouras: Real Convergence, Capital Flows, and Monetary Policy: Notes on the European Transition Countries, IMF, mimeo 2004.

[26] Figures are published by the Warsaw Stock Exchange at: www.wse.com.pl/zrodla/gpw/spws/ang/wskaz_rok_akcji.html.

during the catch-up process. Hikes in asset prices and volatile capital flows can destabilise economies if they are not properly managed. Such a management would include a prudent banking and financial supervision as well as the preparation of markets and people for the fact that some friction may occur, and thus the avoidance of bad surprises. No policy should lull investors into false security.

It is easy to overestimate the ability of national monetary policies in Central Europe to absorb shocks; and hence the loss if they are transferred to the European level and passed to a supranational body, such as the European Central Bank. However, some increase in economic volatility should be expected in particular during ERM2. Structural and fiscal policies can accelerate the adjustment process, but it will be important to maintain social acceptance, otherwise political instability may add to economic volatility. Reckless cuts

in fiscal spending therefore appear unrealistic. Passing through ERM2 can be a bumpy ride because the exchange rates will, on the one hand, smooth some economic volatility, but on the other hand, may also be a source of volatility. Unlike in ERM1, the ECB is not obliged to defend parities once it deems euro price stability in danger. When the going gets tough, the burden will be on accession countries' central banks. This may encourage speculation because they cannot draw infinitely on euro reserves as the ECB could.

Ultimately, it is a matter of judgement when to adopt the euro. Decision-makers have to balance long-term benefits with political adjustment costs, and should proceed once they consider the process manageable. A frictionless euro adoption may be elusive, but voters and investors will be a source of stability as long as they believe in the long-term stability of the economic and political process.

Paul De Grauwe* and Gunther Schnabl**

EMU Entry Strategies for the New Member States

The recent enlargement of the European Union by ten mostly Central and Eastern European (CEE) countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, Slovenia, as well as Cyprus and Malta) heralds the enlargement of the European Monetary Union (EMU). With the adoption of the EU Treaty the ten new member states have already become members of the EMU – although still with derogation. In contrast to Denmark and the UK, which had the possibility of opting against EMU membership, the new member states are obliged to join the EMU as soon as they fulfil the Maastricht criteria for monetary, fiscal and exchange-rate convergence.

In addition, while the new member states can postpone full-fledged EMU membership by not meeting the Maastricht criteria (as presently Sweden does), all new member states seem to have a strong

intention to join EMU as soon as possible. The recent accession of Estonia, Lithuania and Slovenia to the Exchange Rate Mechanism II heralds a new round of EMU enlargement by 2006/07. Why do the new member states want to join EMU as soon as possible and how can a smooth EMU accession be achieved? These are the questions analysed in this paper.

The Costs and Benefits of an Early EMU Membership

The costs and benefits of an early EMU membership have been widely discussed within the theoretical framework of optimum currency areas (OCA) as put forward by Mundell[1] and McKinnon.[2] In their seminal papers the two authors relied on three main criteria to make an assessment of the pros and cons of joining a monetary union: asymmetry, flexibility and openness.

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[1] Robert Mundell: A Theory of Optimal Currency Areas, in: American Economic Review, Vol. 51, 1961, pp. 657-665.

[2] Ronald McKinnon: Optimum Currency Areas, in: American Economic Review, Vol. 53, 1963, pp. 207-222.

The seminal paper by Mundell on optimum currency areas focused on asymmetric shocks and the flexibility of labour markets. Assuming stable prices and wages, Mundell scrutinised the macroeconomic adjustment mechanisms of demand shifts between two regions. Within this Keynesian framework, he found that asymmetric shocks were most easily adjusted by monetary policy and (thereby) exchange-rate changes. Wage flexibility and labour mobility could compensate for the lack of independence in monetary policy-making.

The analysis presented by Mundell leads to scepticism about the desirability of forming a monetary union among the present EMU members and the accession countries. Because the EU25 have become more heterogeneous, the probability of asymmetric shocks is high.[3] As in addition labour market flexibility is widely perceived to be low, one size in monetary policy for the EMU25 is unlikely to fit all.

Yet, there are other factors that have to be considered. McKinnon[4] argued that in small open economies Mundell's assumption of stable prices and wages does not hold. As world market prices can be regarded as fixed for small countries, domestic price volatility is high if the exchange rate floats freely. To stabilise the level and the volatility of prices McKinnon recommended fixed exchange rates. As openness affects exchange-rate stabilisation, small open economies have considerable gains from a monetary union in terms of price stability and low transaction costs for international trade. These may well exceed the costs of lost monetary policy independence.

The empirical evidence for openness is quite clear cut. Figure 1 shows the exports to the EU15 as a percentage of GDP for four groups of countries: the twelve present EMU members, the three EMU "outs", the eight CEE potential EMU member states as well as Cyprus and Malta. In the year 2002 exports to the EU15 as a percentage of GDP averaged 29.6% for the CEE new member states in comparison with 20.9% for the EMU members. Trade integration with the EU15 is considerably stronger for the CEE countries than for the "outs", Denmark, Sweden and the UK (13.3% on average). Based on McKinnon's openness criterion the Central and Eastern European countries pass the OCA-test.

Figure 1
Exports to EU15 as a Percentage of GDP (2002)
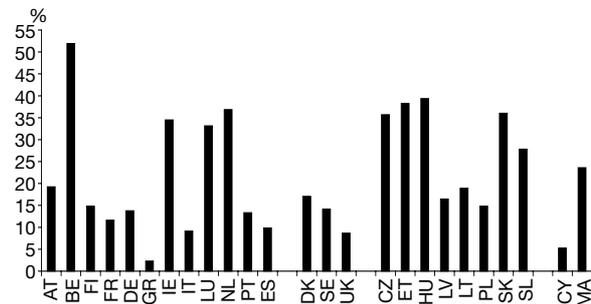
Source: IMF: Direction of Trade Statistics.

Nevertheless the traditional theory of optimal currency areas leaves one sceptical of the advantages of an early EMU membership. The high probability of asymmetric shocks is unlikely to be compensated by labour market flexibility and by the gains from additional trade. This explains the position of the Deutsche Bundesbank,[5] which has suggested a later date for accession because of the considerable structural divergence between the present Euro Area and the new member states. A similar thinking prevails in the United Kingdom where it is widely argued that one monetary policy cannot be optimal for both the UK and continental Europe.

This judgement may change however, if later works by Mundell are considered. As outlined by McKinnon,[6] Mundell himself later questioned his original Keynesian framework in which monetary policy serves as a tool for macroeconomic stabilisation,[7] and advocated a monetary union for the then EC members.[8]

Indeed, in developing countries and emerging markets monetary policy is usually a source of volatility, rather than an instrument of macroeconomic stabilisation in the case of exogenous (asymmetric) shocks. As public expenditure is quite commonly financed through inflation, and as exports are quite often supported by devaluations, exchange rates tend

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[3] Jarko Fidrmuc, Iikka Korhonen: Similarity of Supply and Demand Shocks between the Euro Area and the CEECs, Bank of Finland Institute for Economies in Transition Discussion Paper No. 14, 2001.

[4] Ronald McKinnon, op. cit.

[5] Deutsche Bundesbank: Wirtschafts- und währungspolitische Zusammenarbeit der EU mit den beitretenden Ländern nach Unterzeichnung des Beitrittsvertrages, Monthly Report July 2003, pp. 15-38.

[6] Ronald McKinnon: Optimum Currency Areas and Key Currencies: Mundell I versus Mundell II, in: Journal of Common Market Studies, Vol. 42, 2004, forthcoming.

[7] Robert Mundell: Uncommon Arguments for Common Currencies, in: Harry Johnson, Alexander Swoboda (eds.): The Economics of Common Currencies, London 1973, pp. 114-132.

[8] Robert Mundell: A Plan for a European Currency, in: Harry Johnson, Alexander Swoboda, op. cit., pp. 143-172.

to be rather volatile. This economic instability causes losses in terms of real growth.

The upshot is that if membership in the monetary union incorporates a significant degree of macroeconomic stabilisation the gains from joining the monetary union will be large. Indeed in many CEE countries high inflation and depreciation could be observed during most of the 1990s, until the adoption of the EU treaty forced them to stabilise their macroeconomic fundamentals. Since the danger of macroeconomic instability is even greater for small and open economies with international capital mobility, the benefits of EMU accession in terms of macroeconomic stability seem to be significant.

Econometric estimations by De Grauwe and Schnabl[9] show that exchange-rate stability in Central and Eastern Europe has led to less inflation and more growth. The positive effect of stable exchange rates on growth comes from two transmission channels. First, exchange-rate stability toward the euro stimulates trade with the European Union. This process can be expected to continue after EMU accession as the OCA criteria are likely to be endogenous.[10] Econometric estimations by Micco, Stein and Ordoñez[11] find that EMU membership has increased bilateral trade between the present members considerably compared with trade with the non-EMU countries.

Second, because capital markets in the new member states remain underdeveloped – as is the case in most emerging markets and developing countries – there are high risk premiums on their interest rates, which hamper investment, consumption and growth. These can further increase in the wake of financial and currency crisis. If the CEE countries import the reputation of the European Central Bank irrevocably they achieve an interest-rate level that is exceptionally low for the standards of emerging markets.

With the negotiations on entry to the EU and the macroeconomic convergence associated with them, deeper capital markets have already emerged and interest rates in all new member states have declined considerably. The entry into the monetary union

would secure this advantage irrevocably. The CEE countries have the unique opportunity to complete the catch-up process of an emerging market with the interest rate of a highly developed economy.

An insurance mechanism against asymmetric shocks would emerge if the CEE countries are integrated into the Euro Area capital markets. If individual stocks and bonds of Central and Eastern European companies were listed in Frankfurt or London and held by citizens of the whole Euro Area, the risk of asymmetric shocks would be shared by all Euro Area countries.[12]

ERM II Membership

Considering the considerable advantages of an early EMU membership, the new member states currently plan accession by 2006 at the earliest (Estonia) and by 2010 at the latest (Czech Republic). The path into the monetary union leads first to the Exchange Rate Mechanism II (ERM II), which regulates the exchange-rate relationships between the present Euro Area and the future EMU members ("pre-ins"). There are no explicit regulations for the timing of ERM II entry, but the Maastricht criteria require a minimum waiting period of two years before examination to enter EMU.

For countries that want to enter the monetary union as soon as possible a speedy ERM II entry was necessary. Given that Estonia, Lithuania and Slovenia joined the ERM II in June 2004, EMU entry can take place in late 2006 or early 2007 – if all the Maastricht criteria are met. The other new member states can choose between an early or late ERM II entry.

There are two perspectives on the timing. The European Commission stresses the disciplinary function of ERM II: since the smooth participation in the exchange-rate mechanism requires a high degree of macroeconomic convergence, the consolidation of public deficits and structural reforms must be pushed ahead. The exchange-rate mechanism serves as an "internship" for macroeconomic discipline. The early entrance to ERM II is even reasonable if EMU ascension is not aimed for immediately after two years.

On the other hand, the candidates stress the risks for macroeconomic stability which originate in volatile international capital flows. Since the capital controls of the new member states had to be dismantled before joining the EU, sudden reversals of short-term

[9] Paul De Grauwe, Gunther Schnabl: Exchange Rate Regime and Macroeconomic Stability in Central and Eastern Europe, CESIfo Working Paper No. 1182, 2004.

[10] Jeffrey Frankel, Andrew Rose: An Estimate of the Effect of Common Currencies on Trade and Income, in: Quarterly Journal of Economics, Vol. 117, 2002, pp. 437-466.

[11] Alejandro Micco, Ernesto Stein, Guillermo Ordoñez: The Currency Union Effect on Trade: Early Evidence from EMU, in: Economic Policy, Vol. 37, 2003, pp. 315-356.

[12] Robert Mundell: Uncommon Arguments ... , op. cit.

international capital flows could endanger the ERM II exchange-rate targets and thereby postpone EMU membership.[13]

In order to minimise this risk, most countries want to keep their time in ERM II as short as possible. If entry into the exchange-rate mechanism announces entry into the monetary union after little more than two years, as was the case with Greece, expectations will stabilise towards the ERM II parity, which is – according to the fixed rate rule – seen as the Euro conversion rate. Speculative attacks and crises are unlikely. The exchange-rate mechanism is seen as a waiting-room for monetary union.

For countries that aim for a later EMU entry, it can therefore make sense first to secure the nominal and – in particular – the fiscal convergence provided for in the Maastricht criteria, and then enter the ERM II. While clear progress in nominal convergence has been achieved already, in many countries the budget deficits remain a problem. All of the new CEE members have debt levels below the Maastricht benchmark of 60% of GDP, but the annual budget deficits have increased markedly in many countries. Poland, the Czech Republic, Slovakia and Hungary were all far above the Maastricht 3% limit in 2003.

In the wake of ERM II entry, a parity against the euro has to be decided upon in multilateral negotiations. For the new ERM II members Estonia, Lithuania and Slovenia the central rates were set close to the prevailing market rates. Given the comparatively wide band of ±15% around the central rate, a relatively broad range of exchange-rate arrangements is possible. The European Council has only excluded three options: a fully flexible rate without commonly agreed parity (such as currently in Poland), exchange-rate pegs on currencies other than the euro (such as the currency basket in Latvia),[14] and continuous but controlled devaluation (the crawling peg, such as practised by Slovenia before its ERM II entry).

Entry into the monetary union is possible after two years at the earliest, provided there are no severe tensions or devaluations of the parity and as long as the other criteria for inflation, long-term interest rates and public debt are fulfilled. Whether member-ship in the exchange-rate mechanism will remain free of severe tensions will not depend solely on capital markets, but also on the Balassa-Samuelson effect, which is related to the economic catch-up process of the new member states.[15]

The Balassa-Samuelson effect originates in the high productivity growth of the traded (industrial) goods sector. The increasing productivity in industry is reflected in increasing wages for industrial workers. Wages also increase in the non-traded goods sector (services) due to labour mobility. Since productivity remains fairly constant in the non-traded goods sector the prices for services increase. The upshot is that the industrial catch-up process leads to more inflation.

Although the Balassa-Samuelson effect is a side-effect of the desired real convergence process, it can be in conflict with the nominal convergence process as required by the Maastricht Treaty. The Maastricht criteria for inflation and nominal long-term interest rates were conceptualised for countries with about the same level of development, but not for the fast-growing CEE economies. If a country pegs its exchange rate tightly to the euro, and thus fulfils the exchange-rate criterion, that country can count on higher inflation than in the Euro Area.[16]

There are very different estimations of the scope of the Balassa-Samuelson effect and other factors, such as increasing capital inflows before the EMU entry, which may reinforce it. Additional inflation could be in the range from 1% up to 4%. This increases the probability that – given hard pegs to the euro – inflation in the EMU accession candidates will be higher than the allowed 1.5 percentage points above that of the three best-performing members. The CEE new member states face the dilemma of real versus nominal convergence.

The Path to Monetary Union

How can the aspiring members achieve EMU membership despite this Maastricht bottleneck? The simplest solution would be to adapt the Maastricht

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[13] Robert C o r k e r, Craig B e a u m o n t, Rachel van E l k a n, Dora I a k o v a: Exchange Rate Regimes in Selected Advanced Transition Economies — Coping with Transition, Capital Inflows, and EU Accession, IMF Policy Discussion Paper No. 00/03, 2000.

[14] Latvia plans to shift to a unilateral euro peg in January 2005 targeting EMU membership by January 2008.

[15] Paul De G r a u w e, Gunther S c h n a b l: Nominal versus Real Convergence with Respect to EMU Accession: Entry Strategies for the New Member States, Tübinger Diskussionsbeitrag No. 287, 2004.

[16] Within an environment of high inflation and depreciation there seems to be no conflict between nominal and real convergence (cf. Sabine H e r r m a n n, Axel J o c h e m: Real and Nominal Convergence in the CEE Accession Countries, in: Intereconomics, Vol. 38, No. 6, 2004, pp. 323-327). Yet, the Balassa-Samuelson effect is likely to become "visible" as macroeconomic convergence with the Euro Area increases (cf. Paul De G r a u w e, Gunther S c h n a b l: Exchange Rate Regime ... , op. cit.)

criteria to the countries in a catch-up stage of economic development. Such changes in the convergence criteria would find broad approval in Central and Eastern Europe, but the European Central Bank and the ECOFIN council have stressed that the principle of equal treatment should be applied.

A late EMU membership, as suggested by the Deutsche Bundesbank,[17] could – due to the large income differences between the centre and the eastern periphery – delay entrance into monetary union for decades.

Thus, in order to fulfil the Maastricht inflation and exchange-rate criteria simultaneously in the year of examination, there are mainly two options. Hard pegs to the euro – which require a high degree of fiscal and wage flexibility – or nominal appreciation within the ERM II limits – which allows for a more flexible adjustment to asymmetric shocks in the periphery via exchange rates.

Hard Pegs to the Euro

Countries such as Estonia or Lithuania that have pegged their currencies tightly to the euro in the past will sustain these pegs. Provided that there is a mutual agreement about the central rate the new member states can maintain the euro-based currency boards as a unilateral commitment within ERM II. Although the band width for the Estonian krona and the Lithuanian lita has been set to ±15%, they are likely to remain (unilaterally) committed to a narrow band width close to ±0%.

Slovenia, which let the tolar depreciate gradually against the euro before its ERM II entry in June 2004 is likely to allow for some more exchange-rate flexibility. Nevertheless the Slovenian monetary authorities seem to target a close band around the ERM II central rate. Depreciations have abated since the ERM II entry.

For such hard pegs to the euro the Balassa-Samuelson effect would most likely lead to higher inflation that could exceed the Maastricht benchmark. This is even more likely as economic growth in the Euro Area is recovering and demand for CEE goods will increase. To dampen the inflationary pressure in the year of examination, the EMU accession country whose monetary policy is committed to exchange-rate stability can keep a lid on inflation through a restrictive fiscal policy.

The cost of entrance into the monetary union would be a considerable output loss. This would seem acceptable only if fiscal consolidation were necessary to meet the Maastricht budget criterion. Fiscal contraction to curb inflation may be supported by a "non-inflationary wage policy" and structural reforms to ensure fiscal flexibility.

All in all, a hard peg to the euro will require a high degree of macroeconomic flexibility to ensure a safe EMU entry. If failures in implementation, timing and dosage of the fiscal contraction occur, expectations regarding the EMU entrance could be destabilised.

Nominal Appreciation within the ERM II Band

While the small currency board countries Estonia and Lithuania have already achieved enough macroeconomic flexibility to sustain a hard euro peg over a long time-period, this may be less the case for the larger accession countries such as Poland, Hungary or the Czech Republic. For these countries nominal appreciation within the ERM II ±15% band may be the better choice.
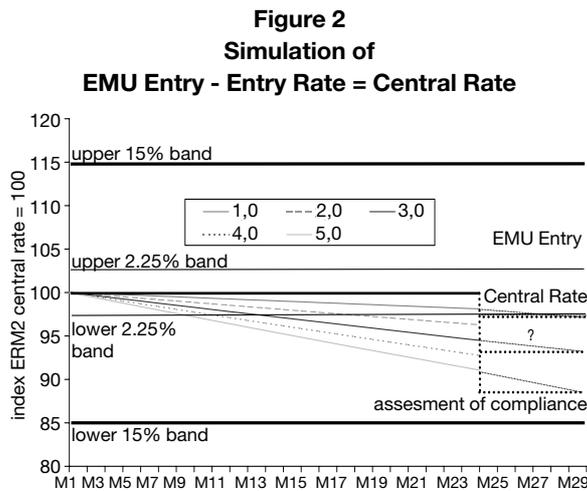
If a country fulfils the Maastricht inflation criterion by bringing inflation (close) to the EMU level, the Balassa-Samuelson effect will cause a nominal appreciation of the currency.[18] In comparison to fiscal contraction this has two advantages. First, adjustment will be "automatic" and therefore not subject to discretionary policy decisions. Second, although appreciation implies a restrictive effect on exports, output losses are likely to be limited.

This gradual adjustment process is simulated in Figure 2 for different degrees of yearly nominal (and real) appreciation (1% - 5%).[19] We assume that – as in the case of Ireland before its EMU entry in 1999 – the ERM II entry rate is equal to the ERM II central rate. This would provide a high degree of flexibility for nominal exchange-rate movements. The exchange rate can move above and below the central rate but is likely to appreciate below the central rate due to the Balassa-Samuelson effect.

Further, we assume that the assessment of compliance with the Maastricht criteria takes place after 24

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[17] Deutsche Bundesbank, op. cit.

[18] Paul De Grauwe, Gunther Schnabl: Nominal versus Real Convergence ... , op. cit.

[19] Taking the Balassa-Samuelson effect into account Buiter and Grafe (Willem Buiter, Clemens Grafe: Anchor, Float or Abandon Ship: Exchange Rate Regimes for Accession Countries, CEPR Discussion Paper No. 3184, 2002, p. 40) estimate that the annual equilibrium (real) appreciations do not exceed 3.5% to 4.0%.

Figure 2
Simulation of
EMU Entry - Entry Rate = Central Rate

Figure 3
Simulation of
**EMU Entry - Entry Rate > Central Rate**

months ERM II membership (waiting-room approach) and that at the same time the final EMU conversion rate, say, six months after assessment is announced. At this time the CEE currencies have probably appreciated as shown in Figure 2. If the prevalent central rate were announced to be the conversion rate, the respective currencies would gradually depreciate towards the conversion rate starting from – or even prior to – the day of the announcement of the EMU membership.

To dampen the resulting inflationary pressure the revaluation of the central rate has to be considered. Revaluation of the central parity is explicitly allowed by the Treaty. The degree of revaluation will be subject to negotiations between the EMU and the accession country. In Figure 2 we assume that a further appreciation is projected and the Balassa-Samuelson effect is fully incorporated in the determination of the final conversion rate. Nevertheless, a mixed strategy as pursued in Ireland which allows for some depreciation prior to EMU entry is possible.

While Figure 2 assumes a gradual adjustment to the Balassa-Samuelson effect, in practice exchange-rate movements are likely to be more erratic if the entry rate is equal to the central rate. This may change if the ERM II entry rate is above the ERM II central rate thereby projecting a clear appreciation path towards the EMU entry rate (Figure 3).

Setting the ERM II central rate above the entry rate is based on the idea that the currencies will appreciate towards the projected EMU entry rate. This approach would require exact information about the degree of expected appreciation and the duration of
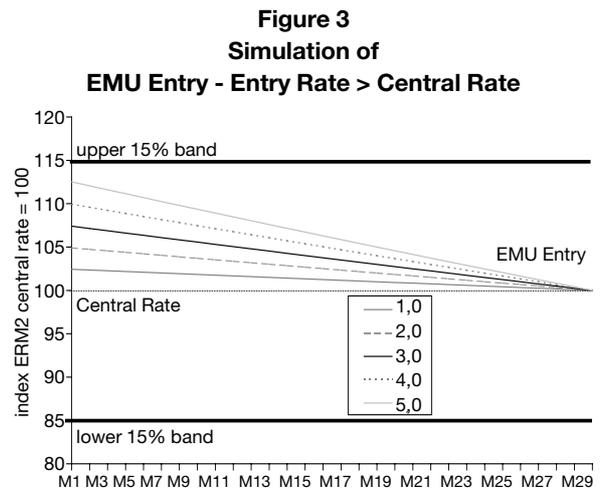
ERM II membership. If this commitment is credible, EMU entry would be safe.

Outlook

The entrance of the new member states into the European Monetary Union remains clouded in uncertainties. The new candidates, whose membership will be decided on a case-by-case basis, face substantial challenges to achieve EMU membership. Yet the fact that the advantages such as macroeconomic stability, more trade and low interest rates seem substantial makes it very likely that a political consensus in the countries for the necessary fiscal and structural adjustments will be achieved. The ERM II accession of Estonia, Lithuania and Slovenia already heralds an early EMU enlargement.

In Frankfurt and Brussels a speedy EMU enlargement seems to be taken for granted. The future voting procedure in the expanded European Central Bank has already been decided.[20] Whether monetary policy-making will be easier within the enlarged monetary union is still unknown. The divergence of inflation rates will continue to grow and the economic and political weight of the periphery will increase. Low real interest rates at the periphery may increase the risk of overheating and thereby increase the need for fiscal flexibility and structural reforms. These will be new challenges for the enlarged monetary union.

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[20] The voting system in the enlarged Eurosystem is discussed by Michael F r e n k e l, Ralf F e n d e l: The New ECB Voting System: Some Room for Improvement, in: Intereconomics, Vol. 38, No. 6, 2003, pp. 334-338.

Miklós Losoncz*

Fiscal Consolidation in the New EU Member States and their Accession to EMU

As is well known, 10 Central, Eastern and Southern European countries have joined the European Union with the obligation of becoming members of the Economic and Monetary Union without the need of specifying any definite deadline. Until the formal accession to the euro area, they receive derogation from the rules of the EMU. However, they are supposed to elaborate their convergence programmes, aiming at achieving the criteria of financial stability as defined in the Maastricht Treaty (and in the Stability and Growth Pact), the accomplishment of which is carefully monitored by the European Commission.

The objective of this article is the analysis of the fulfilment of the budgetary requirements concerning the accession of the 10 new member states (AC-10) to the EMU. The set of convergence criteria was defined in such a way that there is a strong interrelationship among its individual elements, and because of the various externalities and synergies it is impossible to meet one or two of them at the expense of the others. Nevertheless, the most crucial criterion is the fiscal one. Public finances form the major bottleneck to joining EMU. Fiscal consolidation, too, determines to a large extent the fulfilment of the other convergence criteria. The extraordinary importance of fiscal consolidation is indicated by the fact that accession to EMU is possible only two years after the accomplishment of the requirements related to the general government deficit and debt.

General Government Deficits and Debt: the Present Situation

According to the budgetary criteria of the Maastricht Treaty, the candidate countries have to keep the general government deficit relative to GDP below 3 per cent and the gross general government debt below 60 per cent in the reference period before joining EMU. At present, it is the Baltic States (Estonia, Latvia and Lithuania) and Slovenia, which meet the budgetary requirement of the Maastricht Treaty, since their

general government deficits relative to GDP are less than 3 per cent (see Table 1). These small countries have followed rather conservative fiscal policies in the 1990s and 2000s. With their newly gained independence, it seems to be most probable that their fiscal policies were not challenged and constrained by the commitments of the former Soviet Union and Yugoslavia, respectively.

On the other hand, Cyprus, Malta and the Visegrad countries (comprising Poland, the Czech Republic, Slovakia and Hungary; the category serves purely analytical purposes) lag significantly behind the Baltic states and Slovenia in the size of their general government deficits. In order to meet the budgetary requirement of EMU accession, the general government deficit relative to GDP has to be lowered by 9.9 percentage points in the Czech Republic, 6.7 percentage points in Malta, 3.3 percentage points in Cyprus, 2.9 percentage points in Hungary, 1.1 percentage points in Poland and 0.6 percentage points in Slovakia compared to 2003. Nevertheless, in 2004, the general government deficit is expected to increase to 6 per cent of GDP in Poland and 4.1 per cent in Slovakia, making the task of cutting the deficit more difficult. It will be pointed out below that the reduction of the general government deficit by 2-3 percentage points of GDP in the short term was a tedious business even in the more developed old EU member states and frequently faced social resistance.

Rather paradoxically, the 10 accession countries have to fulfil criteria which are not met by several EU-15 members either. In 2004, Germany and France are going to break the budgetary rule in the third consecutive year. In addition, the projections of the European Commission show that this year the general government deficit is likely to exceed the 3 per cent reference limit of GDP in Italy, the Netherlands, Portugal and Greece. Consequently, half of the 12 euro zone countries will post budget deficits above 3 per cent of GDP in 2004. The European Commission sees only slight improvements for 2005.

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Table 1
Net Lending (+) or Net Borrowing (-),
General Government
(percentage of GDP)

	2000	2001	2002	2003	2004	2005
Cyprus	-2.4	-2.4	-4.6	-6.3	-4.6	-4.1
Czech Republic	-4.5	-6.4	-6.4	-12.9	-5.9	-5.1
Estonia	-0.3	0.3	1.8	2.6	0.7	0.0
Hungary	-3.0	-4.4	-9.3	-5.9	-4.9	-4.3
Latvia	-2.7	-1.6	-2.7	-1.8	-2.2	-2.0
Lithuania	-2.6	-2.1	-1.4	-1.7	-2.8	-2.6
Malta	-6.5	-6.4	-5.7	-9.7	-5.9	-4.5
Poland	-1.8	-3.5	-3.6	-4.1	-6.0	-4.5
Slovakia	-12.3	-6.0	-5.7	-3.6	-4.1	-3.9
Slovenia	-3.0	-2.7	-1.9	-1.8	-1.7	-1.8
AC-10	-3.2	-4.1	-4.9	-5.7	-5.0	-4.2
EU-15	1.0	-1.0	-2.0	-2.6	-2.6	-2.4
EU-25	0.9	-1.1	-2.1	-2.7	-2.7	-2.5

S o u r c e : European Commission: Economic Forecasts, Spring 2004, p. 131.

Table 2
Gross Debt,
General Government
(percentage of GDP)

	2000	2001	2002	2003	2004	2005
Cyprus	61.7	64.4	67.1	72.2	74.6	76.9
Czech Republic	18.2	25.2	28.9	37.6	40.6	42.4
Estonia	5.0	4.7	5.7	5.8	5.4	5.3
Hungary	55.4	53.5	57.1	59.0	58.7	58.0
Latvia	13.9	16.2	15.5	15.6	16.0	16.1
Lithuania	24.3	23.4	22.8	21.9	22.8	23.2
Malta	57.1	61.8	61.7	72.0	73.9	75.9
Poland	36.6	36.7	41.2	45.4	49.1	50.3
Slovakia	49.9	48.7	43.3	42.8	45.1	46.1
Slovenia	26.7	26.9	27.8	27.1	28.3	28.2
AC-10	36.4	38.5	39.4	42.2	44.4	45.2
EU-15	64.0	63.2	62.5	64.0	64.2	64.2
EU-25	62.9	62.1	61.5	63.1	63.4	63.4

S o u r c e : European Commission: Economic Forecasts, Spring 2004, p. 134.

The fulfilment of the other criterion relating to the government debt is much easier for the new member countries (see Table 2). The gross debt of the general government is above 60 per cent of GDP only in Malta and Cyprus. The state of affairs in this specific field is much better in the new member states than in the EU-15. In 2003, gross general government debt was less than 60 per cent of GDP in merely 5 out of 12 old member countries (Spain, Ireland, Luxembourg, the Netherlands and Finland). With the exception of Spain, they are small countries with a high degree of exposure to foreign influences and adjustment pressures. Since the meeting of this criterion will not constitute any major problem for the majority of the new EU member states, no details of this issue are discussed. Instead, the focus is directed to general government expenditures, revenues and their balance in the Visegrad countries.

The statistical figures on general government deficits and gross debt are rather distorted in the new member states because of the fairly large size of the black or grey or unobserved economy (see Table 3). With the inclusion of the unobserved economy, the actual volume of GDP in the new member countries is some 10-20 per cent higher than that presented by official statistics. The revenues produced in the unobserved economy are transferred to legitimate consumption or to financing sources of business investments. The general government deficit relative to GDP is therefore lower than is indicated by the official statistics. The tax burden is allocated in the economy rather unevenly, since those involved in the unobserved economy do not pay taxes. The "whitening"

of the unobserved economy may help push down the present fairly high taxes and the general government deficit as a percentage of GDP.

In addition, the size of the general government deficit relative to GDP is lower than that registered by the official statistics if the contributions to private pension funds (instead of to the pay-as-you-go social security system) are included in public finances in countries which have implemented a reform of the pension system. They equal some 0.7 to 1 per cent of GDP annually in the new member countries under survey (with the higher figures in Poland and Hungary). They should be deducted from the general government deficit, since they represent a revenue loss in the budget and they do not generate additional demand in the economy. The disbursements come from the public sector. However, with the decision approved of lately by Eurostat, this deduction is not allowed. A second revision is possible, but even in case of a positive approach, its impact will not be apparent before 2006.

According to the provisions of the Stability and Growth Pact as well as other Community legal rules, sanctions can be applied against those countries which fail to meet the general government deficit requirement. In November 2003 Ecofin (the finance ministers of the EMU member states) did not approve of the application of the excessive deficit procedure as proposed by the European Commission, which was in line with the effective legal rules of the Community, against Germany and France for their violation of the Stability and Growth Pact by allowing budgetary deficits above 3 per cent of their GDP. The legal dispute

Table 3
The Share of the Black Economy in the GDP of some European Countries

Country	Year	Estimation Per cent of GDP
Bulgaria	2002	22.0-30.0
Romania	2001	21.0
Greece	1998	Above 20.0
Latvia	2000	18.0
Hungary	1998	18.0
Lithuania	2003	15.0-19.0
Slovenia	2003	17.0
Italy	2002	16.0-17.0
Slovakia	2000	13.0-15.0
Poland	2003	14.0
Czech Republic	1998	9.0-10.0
Estonia	2001	8.0-9.0
Germany	2001	6.0
Denmark	2001	5.5
France	1998	4.0-6.5
Portugal	1996	5.0
Finland	1992	4.2
Belgium	1995	3.0-4.0
Sweden	1997	3.0
Netherlands	1995	2.0
United Kingdom	2000	2.0
Austria	1995	1.5

S o u r c e : European Commission.

was settled by the Court of Justice of the European Community which annulled the Ecofin decision.

The new member states, too, can be sanctioned if they do not achieve their general government deficit targets included as commitments in their convergence programmes approved of by the European Commission. If the divergence of actual numbers from the projected figures fixed in the convergence programmes is significant, under certain well-defined conditions the access of the countries in question to the sources of the Cohesion Fund may be banned until the appropriate budgetary positions are restored. Otherwise the conditions of the enforcement of commitments are not so stringent as e.g. in the case of IMF loans, with which most of the Visegrad countries gained experience in the 1980s and 1990s.

The ongoing debates about the future and the interpretation of the Stability and Growth Pact create uncertainty over the objectives of the convergence programmes in the new EU member countries.[1] In other words, the question arises, why the acceding

countries should bring sacrifices to achieve objectives which are not achieved by half the present EMU member states and which may change over the adjustment period. Furthermore, the example of Germany and France demonstrated that legal enforcement is rather weak, or at least controversial, in the European Community, which creates doubts regarding credibility. An even worse assumption would be to conclude that there are different types of countries in the EU depending on their size, economic strength and bargaining power with different rights and obligations. In contrast to Germany and France, rather strong pressure was exerted on Portugal in similar situations.[2]

Before discussing the challenges the Visegrad countries have to face on their way to EMU, it could be instructive to take a look at the main features of fiscal consolidation accomplished by the 12 member countries of the Economic and Monetary Union after 1995. The analysis is based on the ESA (European Standard Accounting) 1995 figures of the European Commission.[3]

EU Experience with Fiscal Consolidation

Following the resolution of the European Council approved at the Madrid summit in December, 1995, on the modified sequencing of the introduction of the euro, the majority of the EU member states accomplished fiscal adjustments or fiscal stabilisation. As a result of the adjustment and stabilisation measures, the general government deficit relative to GDP was lowered below 3 per cent in all EMU candidates of that time.

The common feature of the adjustments was that the general government deficit was pushed down primarily by raising revenues rather than reducing expenditures. Governments attached primary importance to the promotion of job creation in increasing revenues, since growing employment generates additional revenues through various payroll taxes and social security contributions paid by both the employers and the employees. In addition, any drop in unemployment eases the expenditure side of the budget because less unemployment benefit is disbursed. In

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[1] The discussion of the various proposals would be beyond the scope of the conceptual framework of this report. For details see e.g. Gábor Orbán, György Szapáry: The Stability and Growth Pact from the Perspective of the New Member States, in: Working Papers of the National Bank of Hungary, No. 2004/4, Budapest, May 2004, pp. 33 ff.

[2] Some experts think that Portugal is a victim of the Stability and Growth Pact. The price of meeting the deficit targets is slow GDP growth or even recession.

[3] Statistical Annex of European Economy, Spring, 2004, ECFIN 174/2004-EN, Brussels, pp. 215. Judit Adler, László Akar, Miklós Losoncz, László Molnár: Az államháztartás kiadási oldalának felülvizsgálata (The revision of the expenditure side of the general government, in Hungarian), mimeo, GKI Economic Research Co., Budapest, August 2004, pp. 6-8.

some countries, targeted labour market expenditures were even lifted temporarily in order to encourage the increase in employment under the assumption that the resulting growth in general government revenues through taxes and social security contributions would outpace the original expenditures.

The conclusion to be drawn from this seems obvious: first, there is an interrelationship between general government expenditures and revenues, and it is not justified to separate the two sides rather rigidly. Second, the general government is part of a system defined more broadly, and revenues and expenditures as well as their balance depend to a large extent on the functioning and efficiency of other segments of the economy, in this particular case on the flexibility of the labour market. Any improvement in the resilience of the labour market may contribute to increasing general government revenues and decreasing expenditures.

Following the weakest resistance, the rationalisation of expenditures usually resulted in the streamlining of investments financed by the general government and to a smaller extent the fall of subsidies. As regards the major expenditure items, interest payments relative to GDP went down most significantly in Italy and Belgium, the two most indebted countries, from 11.5 per cent in 1995 to 5.3 per cent in 2003 in Italy and from 8.8 per cent to 5.6 per cent in Belgium. This proved to be a rather specific adjustment, since the drop in interest payments was not accompanied by the cutting of other items such as social transfers and collective consumption expenditures. It is assumed that interest payments were cut back indirectly, certain state-owned enterprises were privatised and other state-owned assets were sold and the accruing money was used for the reduction of general government debt with a subsequent easing of interest payments. In addition, with the preparation for accession to EMU, interest rates fell, simultaneously reducing interest payments. A remarkable conclusion is that if the revenues deriving from privatisation are used for the cutback of general government debt, this may contribute to sustainable deficits. On the other hand, the meeting of the convergence criteria of the Maastricht Treaty (inflation, interest rate) other than the budgetary ones makes the adjustment of the general government deficit easier.

The drop in interest payments relative to GDP was accompanied by a radical cutback of social transfers in Finland. The streamlining of social transfers was somewhat less pronounced in Sweden, Denmark, the United Kingdom and Ireland, and partly in Spain. In other words, the cutback of social transfers contributed to the improvement of the general government balance. It is remarkable that the consolidation of the expenditure side of the general government balance did not concern collective consumption; its share of GDP did not fall sharply. In certain countries like Spain and Sweden it even grew slightly between 1995 and 2003. In these countries, the major tool of successful budgetary consolidation was the restructuring of social transfers with the strengthening of individual performance and responsibility. The share of GDP of expenditure allocated to the financing of public institutions did not go down substantially; in some countries it even grew somewhat. The share of social transfers diminished more rapidly than that of collective consumption. The share of social transfers decreased more in highly developed countries than in more backward ones. However, the fact cannot be excluded that this trend has nothing to do with development levels, but is dependent on the specific features of the welfare state.

Within collective consumption, the streamlining of public administration was a rather regular practice, also following the weaker resistance. It was relatively easy to obtain political support for this kind of rationalisation. In order to decrease general government expenditure or at least its rate of growth, the largest items were frequently frozen or they were allowed to increase only rather modestly by built-in brakes. Structural reforms of general government are still on the agenda in nearly all old EU member countries. However, social resistance against more pronounced reforms seems to be rather strong. The measures taken so far are relatively modest in size expressed as a percentage of GDP.

Possibilities and Constraints of Fiscal Consolidation in the New Member Countries

The task of meeting the budgetary criterion is not identical to the simple mechanical reduction of the general government deficit relative to GDP. The European Commission is willing to approve the fulfilment of the budgetary requirement if the deficit lowered below 3 per cent of GDP is sustainable, i.e. it can be maintained below the reference value in the medium and long run. The formal fulfilment based on temporary cuts in expenditures and polished statistical figures is unacceptable. The necessity of achieving sustainability implies profound changes in the size and the structure of both expenditures and revenues. In other worlds, sustainability should be associated

with structural reforms. Nevertheless, there is a rather strong social resistance to reforms in the Visegrad countries as well.

The meeting of the budgetary requirements imposes limits only on the size of the general government deficit expressed as a percentage of GDP. The autonomy of the fiscal policy of the individual EU member countries is preserved as regards the internal proportions of general government expenditures and revenues. Therefore, it is not necessary and not instructive to compare the size of the revenues and expenditures relative to GDP of the new member states to the EU or EMU average.

As is well-known from the economic literature, there may be a trade-off between nominal and real convergence, particularly in the short term. According to this way of thinking, the fulfilment of the convergence criteria of the Maastricht Treaty in general, and those relating to balanced public finances in particular, may rather quickly impede or delay the catching up process in terms of GDP per capita and may have a negative impact on employment. In other words, meeting the convergence criteria of the Maastricht Treaty requires short-term sacrifices in order to realise long-term advantages in terms of sustainable economic growth. The major argument against rapid nominal convergence is that the less developed acceding countries with lower per capita GDP have to invest heavily in physical infrastructure from public sources in order to speed up the catching up process. They also have to reform their public administration as well as their social security, pension and education systems with additional costs and the subsequent increase of their budgetary deficits in the short term. Finally, with the requirement of co-financing, the access to EU transfers, too, raises general government expenditures.

In principle, the general government deficit relative to GDP can be reduced, inter alia, by pushing down interest rates, accelerating GDP growth, enhancing revenues and diminishing expenditures or the combination of these factors. As far as the individual elements are concerned, according to empirical evidence, fiscal policy does not work in an isolated environment; it may receive support from other policies promoting fiscal stabilisation. The individual convergence criteria of the Maastricht Treaty are closely interrelated to one another. Exchange-rate stability and the convergence of inflation rates and interest rates may have a significant impact on the outlays and the revenues of the general government. With declining

yield curves, the decrease of interest payments could contribute to diminishing the deficit. The degree of the drop in the yield curves depend to a large extent on trends in the rate of inflation, the growth path selected as well as the confidence of foreign investors. The fall in interest payments does not have any adverse impact on economic growth. At present, interest rates in the developed countries tend to increase in the near future which limits the room for manoeuvre of the central banks of the new member states. Apart from the Balassa-Samuelson effect, the elimination of the legacy of the socialist past, too, is reflected in the higher rates of inflation, again limiting the possibilities of reducing interest rates.

Rapid economic growth may broaden the room for manoeuvre of fiscal policy to dampen general government deficit expressed as a percentage of GDP. However, the rate of GDP growth largely depends on a great number of external and internal factors which cannot be influenced by economic policy-makers (particularly the external conditions in small and open economies). Although economic recovery is under way in the world economy, it is rather shaky because of high oil prices, terrorist threats, the weakening of the US dollar etc. Furthermore, import demand in the major external markets (EU-15) of the new EU member states is growing more slowly than the average of the world economy. Therefore, no additional significant impetus can be gained from the further improvement of the international environment. Under these circumstances, the lion's share of the adjustment accrues to economic policy in general and fiscal policy in particular.

Since interest payments depend on other factors, like interest rates etc., and they cannot be influenced by fiscal policies, the primary balance of the general government excluding interest payments deserves special attention. The general government deficit could be reduced in the near future by improvements in the primary balance (excluding interest payments).

The impact of the improvement of the primary balance on economic growth will depend partly on the magnitude of the change and partly on the effects of expenditure and revenue policies. The most favourable way of reducing the general government deficit is to combine cuts in expenditures with tax reductions. Tax reductions are assumed to generate additional growth in the economy. If this is not the case, and tax reductions are not implemented, or taxes are even raised, cuts in budgetary expenditures would lead to losses in economic growth through a decline

in demand. Another way of pushing down the general government deficit is to introduce changes in the structure of expenditures. The replacement of certain items in expenditures by others, like those financing the running of businesses by those serving public investments, e.g. in infrastructure, also generate growth through the expansion of demand. On the other hand, if expenditures financing infrastructural investments are shortened, the result could be a loss of economic growth.[4] Finally, structural reforms tend to increase the expenditures and increase the general government deficit in the short term, whereas they bear fruits with a significant time lag.

On the other hand, fiscal adjustment, too, is an important precondition for meeting the other criteria. According to past experience, fiscal restrictions may result in the improvement of the general government budget, but at the same time they may shift imbalances from the general government to other areas of social life with a declining quality and level of various social services etc.

An additional challenge is that it is questionable whether or not the general government will able to treat asymmetric shocks efficiently in the new member states. The main reason for this is that automatic stabilisers seem to be rather weak. Consequently, discretionary measures should play a great role in responding to asymmetric shocks.

As far as the revenue side is concerned, the fiscal policies of the Visegrad countries, too, have to face additional difficulties. With their accession to the European Union, the value added tax (VAT) system and the customs regime changed, with the adverse consequence of declining VAT revenues. (In the new regime, companies have to pay the VAT after they have sold the goods dispatched from another EU member, whereas before the accession they had to do so immediately after the accomplishment of the purchase. In the new regime, the risk of the avoidance of VAT payment obligations is higher than before, at least in the short run.) This was the case in the previous enlargement of the EU in 1995, too, when Sweden, Finland and Austria joined the European Union. Officials of the Visegrad countries drew the attention of the European Commission to the expected fallout of VAT revenues, but no specific measures were taken.

There is another contradiction or conflict between economic and fiscal policies. The shift in the structure of economic growth from the consumption-led pattern to the investment and export-driven one, which is very favourable in the long-run, too, reduces the revenues deriving from VAT which, in turn, may have an adverse impact on the general government deficit.

Summary and Conclusions

In this paper, it was attempted to analyse the major factors influencing fiscal consolidation aimed at meeting the general government deficit and debt criteria of the Maastricht Treaty. The analysis was focused on the Visegrad countries comprising Poland, the Czech Republic, Slovakia and Hungary. This group of countries faces the most severe difficulties in achieving the provisions of the Maastricht Treaty. The problems of the small acceding countries (the Baltic states, Slovenia, Malta and Cyprus) are rather specific and distinct from those of the Visegrad ones.

The argumentation comprised legal and institutional, empirical, theoretical and historical reasoning. As regards the legal and institutional factors, it would be unfair to impose budgetary requirements on the Visegrad countries which were not, or cannot be, fulfilled by a large number of EMU member states. The uncertainties concerning the future and the interpretation of the Stability and Growth Pact may question, or at least soften up, the rationale of making commitments to strict fiscal policies, since the rules of the game may change over time. Legal enforcement is controversial, the rules of the Stability and Growth Pact were not applied consequently against Germany and France late last year, whereas they had been deployed against Portugal more decisively earlier. The European Commission has the tools for enforcing the achievement of the commitments made in the convergence programmes concerning fiscal stabilisation by the Visegrad countries since under certain well-defined conditions the access of the new member states to the sources of the Cohesion Fund may be refused.

Theoretical and empirical arguments were produced, first, in favour of the inclusion of the unobserved economy in GDP. With this adjustment, the starting position of the Visegrad countries would be better. Second, the general government deficit should be adjusted for the contributions to private pension funds, again with a positive impact on the deficit.

The historical overview of fiscal consolidation in the EU-15 relating to the period preceding the creation of EMU revealed that the major element of successful

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[4] GKI Economic Research Co.: Az euróhoz vezető optimális út megtervezése. (The planning of the optimal road to euro)., mimeo, Budapest, April 2004, p. 17.

deficit reduction was the increase of general government revenues rather than cuts in expenditures. In fact, the significant decrease of general government expenditure relative to GDP was exceptional and temporary. The major source of the drop was the fall in interest payments which had a rather weak correlation with fiscal reforms. It is unfair to request structural reforms concerning the expenditure side of general government from the Visegrad countries which were not implemented by the old EU members.

In the Visegrad countries, the switch to the new VAT and customs regime as a consequence of their EU membership led to a drop in VAT revenues, adding another challenge to fiscal consolidation. In this case an institutional factor, namely accession to the EU, triggered a drop in general government revenues.

Nominal convergence may conflict with real convergence more significantly at a lower level of economic development than at a higher one. The Visegrad countries have to invest heavily in infrastructure in order to ensure the catching-up to the EU average. With the principle of additionality, the conditions of access to the sources of the Structural Funds and the Cohesion Fund, too, put a burden on general government expenditures which would not occur without EU membership.

One of the major conclusions of this paper is that a "systemic approach" is necessary for fiscal consolidation, taking into account the effects of other factors excluded from general government as well as externalities and synergies (the black economy, the contributions to private pension funds, GDP growth, falling inflation rate, diminishing interest rates, privatisation etc.) Economic policy should bolster the unfolding of the forces indirectly reducing the general government deficit as a percentage of GDP (the whitening of the economy by combating black market activities, disinflation, the strengthening of the credibility of foreign investors etc.)

The other conclusion is that both a rapid and a more extended scenario of EMU accession have their undesirable dangers and risks. The too rapid and too radical reduction of general government deficit through the cutback of expenditures could be counterproductive by constraining economic growth and transferring financial imbalance into social dis-

equilibria and tensions (as was the case recently in Slovakia). An extended scenario, too, would be disadvantageous and undesirable since it would not be tolerated by financial markets, and they would force the governments to take more radical measures with higher social costs than in the case of a more moderate strategy. Therefore, the optimal way leading to the EMU should be elaborated. Considering the rules of the games constant, the annual reduction of the general government deficit relative to GDP amounting to 0.5 - 0.8 percentage points could be feasible.[5] More radical cuts require stronger political support, let alone social consensus, which the fragile governments of the Visegrad countries do not enjoy.

Ecofin and the European Commission should interpret the convergence criteria and the Stability and Growth Pact more flexibly. The main argument behind this is the fact that the economic tools of the EMU were designed for developed economies with cycles fluctuating around an equilibrium (and moving at US frequencies), whereas the Visegrad group is made up of more backward countries which have left behind a painful transition to the market economy with the objective of catching up with the developed economies. More flexibility should imply the recognition of the difficulties of fiscal consolidation in general and structural reforms in particular. Nevertheless, there are signs indicating that the European Commission tends to agree to tolerate a higher general government deficit if it is related to profound structural reforms aimed at achieving sustainable general government balances.

Rather paradoxically, the adoption of the euro is de facto going on in some less developed countries of South-Eastern Europe, like Serbia and Montenegro and Macedonia. The process is rather spontaneous, neglecting the formal approval of the European Central Bank nor meeting any convergence criteria. On the other hand, the Baltic States which are, too, rather backward by Central and Eastern European standards are the most prepared states for accession to EMU, mainly due to their specific historical heritage. Quite surprisingly, the most developed Visegrad countries have to face the most difficulties and the most severe adjustment burdens in the preparation for accession to EMU. They may deserve more understanding and help from the European Commission and the old member states.

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[5] The Stability and Growth Programme of Portugal (Update for 2004-2007) envisages the reduction of the general government deficit relative to GDP by 0.6 percentage points between 2004 and 2006.