

STRATEGY OF EMU

ENLARGEMENT

BACKGROUND, OPTIMAL CHOICES, CONSEQUENCES

Edited by

Katarzyna Żukrowska

Dominik Sobczak

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The publication was edited by:

Katarzyna Żukrowska
Dominik Sobczak

Reviewers:

Prof. dr hab. Bazyli Samojlik
Prof. dr hab. Kazimierz Starzyk

Text editor:

Dominik Sobczak

Cover design:

Dominik Sobczak

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Introduction

The volume, which you hold in your hands embraces papers that were presented in the course of conference on “Strategy on EMU enlargement” organised at Warsaw School of Economics on 12 December 2003 within the schedule of meetings planned within EUROZONE PLUS program, financed from 5th Framework Program of the EU. Published papers do not give the whole scope of information that was offered during the meeting, as not all participants had written their papers, and the course of discussion is not covered by the publication. Nevertheless, the core philosophy presented during the conference can be easily found in the publication, which is divided into three parts:

- first deals with fiscal and monetary strategies of CEEC accession to the EMU;
- second, with economic and political background for EMU enlargement;
- third covers strategy of EMU enlargement – standpoints given in the course of the discussion.

In first part Ryszard Michalski, undersecretary of state at the Polish Ministry of Finance, gives the guidelines of the Polish strategy of accession to EMU, Renzo Orsi and Fabrizio Iacone (Bologne University) discuss the monetary policy strategies in accession countries, showing the differences and advancement of individual countries in this specific field. Karel Zeman from Czech Republic covers the topic of social problems arising in economies of accession countries as a result of social and monetary restrictions. Vit Barta from Czech National Bank throws light on strategy of accession to the EMU with special stress put on difficulties in fulfilling the Maastricht inflation criterion. Jan Iša and Ivana Sikulova (Slovak Academy of Sciences) talk about fulfilment of the convergence criteria in Slovak Republic, while Eva Muchová discusses the scenarios of Slovakia’s entry into the EMU.

In part two, I am covering the problem of fiscal policy after 1989 considered as background for growth stimulation in transforming and EU economies. Practice in this field is used as an environment that helps to formulate certain generalizations. Carlos Vieira and Sofia Costa discuss the problem of sustainability of fiscal policies in the EU and the CEEC. Ryszard Wilczyński comments the effects of euro after a half of decade, pointing out at changes of the exchange rate of the common currency towards the American dollar. Team from Estonia consisting of Tiiu Paas, Jaan Masso, Marit Room-Hinnosaar and Christopher Schumann give a deep overview over income differences, poverty and unemployment as main consequences of transformation in Baltic States. Dominik Sobczak (Warsaw School of

Economics) comments preparation of the Polish capital markets to participation in single financial market of the EU. Joanna Stryjek (Warsaw School of Economics) reveals the pros and cons of three countries that stayed outside the Eurozone. Information on this topic gives the complete picture of those 'in' and those 'out'. Małgorzata Grącik (International Security Department at Warsaw School of Economics) informs about institutional bases for transatlantic relations, what completes information on the 'bi-currency' world financial system.

Third part gives an overview of three papers, which are presented as voices in discussion. Jan Krzysztof Bielecki (former Polish Prime Minister) talks about European debate on fiscal discipline and the Polish path towards EMU membership. Andrzej Sławiński (National Bank of Poland) gives his comments to Massimiliano Marzo paper on monetary policy, while Jakub Borowski (National Bank of Poland) gives an overview of costs and benefits of EMU accession.

All in all, lecture of all papers gives a view on both challenges and merits of the accession countries as well as tackles some problems that are faced by the EMU members. In both groups of countries smooth functioning of EMU and stimulation of growth is possible but this cannot be achieved unconditionally. Methodical reader will find explanations to some questions he can ask himself, seeing the differences in results of applied transformation and accession strategies in individual accessing countries. They also point at some paradoxes of transformation and accession that can be found in the group of 10 post-communist states which are to enter the EU in May 2004 and 2007. Membership in EMU seems to be a difficult task for the accession countries although performance in fulfilment of convergence criteria is much better than in the so called Southern economies, when they were going through a process of selection to EMU in May 1998. This is an optimistic message as well as the prospects of accelerated growth that is offered by EMU and enlargement of EU under certain conditions. The publication is worth reading and it reveals a big dose of information, often contradictive towards well established opinions and sometimes even theories. This is the effect of progress in the sciences, this is the effect of changes in international relations, this can be considered as result of globalisation, liberalization and changes in individual economies.

This volume is a second one, published at Warsaw School of Economics, dealing with the subject of Eurozone enlargement. The first one was published in 2003, as a result of conference held in Cracow in November 2002. The title of the first book edited by K. Żukrowska and D. Sobczak is "Eastward Enlargement of the Eurozone. Impact on Trade, FDI and Capital Markets".

Katarzyna Żukrowska

Acknowledgements

I would like to thank my closest associates from International Security Department of Warsaw School of Economics who helped me to organize the conference and were engaged in preparation of the papers presented within its course. Namely I would like to express my gratitude to: Małgorzata Grącik, Joanna Stryjek, Dominik Sobczak and Piotr Bańbuła. Their engagement in preparation, organisation and, finally, in participation in the conference, made the whole event possible. They have also worked on preparation of this volume for publication.

I owe also warmest words of gratitude to all who have kept the deadline and wrote in very short time their papers, which are collected in this publication. I am not enumerating their names here as the list can be found in the contents of this volume. This remark refers to all Authors of the texts. The quality of the texts says for itself.

Special gratitude is due to Hanns-Dieter Jacobsen and Michael Bolle from Free University of Berlin, who stimulated organization of this conference.

Katarzyna Żukrowska

Part 1:

Fiscal and monetary strategies of CEEC accession to the EMU

Remarks on the Polish strategy of accession to the EMU

1. After some fifteen years of intense transformation of its economic, political and social life Poland joins the European Union what can be regarded as an important milestone of a long process of full integration with the united Europe. It must be stressed that what we have achieved in Poland during last years in this respect could not have been possible without a close cooperation with our European partners. We have managed to benefit from their experience and will be able to continue this process as expeditiously as possible with their long term assistance and support.

2. Since the early 90-ties the accession to the European Union has always been the strategic goal of all Polish governments. After signing the Europe Agreement considerable efforts have been undertaken aiming at adjusting the domestic economy to the economies of EU member states. This included growing openness and competition on the internal market, creating new institutions (especially in the financial sphere), privatisation, restructuring and increasing efficiency of Polish enterprises, liberalization of capital movements as well as substantial changes in the volumes and structure of the foreign trade. At the same time consequent anti-inflationary policy reduced its rate to the level typical for stable economies. The high GDP growth rates diminished the difference in living standards between Poland and the UE, measured by GDP per capita based on PPP. The process of changing the real economy was accompanied by the approximation of Polish legal system to *acquis communautaire*, enabling us to participate in the mechanism of the single market soon.

The forthcoming EU enlargement is of historical importance for all accession countries and – we hope – for the whole Europe. We have always been aware that acceding the EU will be a unique durance of joining the west European political and economic structures as well as constituting historical step forward in the process of modernizing our economic and social structures.

3. The primary objective of the Polish government is to conduct the economic policy which will guarantee keeping the economy on the path of a fast and self-sustainable economic growth that is necessary for the

* The author is the Undersecretary of State at the Polish Ministry of Finance.

acceleration of the catching-up process and at the same time ensuring the fulfilment of nominate convergence criteria of the Maastricht Treaty.

At the certain stage, rather sooner than later, Poland will join the Economic and Monetary Union (EMU) what will be tantamount to the acceptance of common monetary policy and adoption of the euro. We are still discussing the optimal timing of this process and related benefits and costs. The issues of not only technical importance to be decided within next years are following:

- the choice of the exchange rate policy,
- the establishment of an appropriate central rate (parity),
- the choice of the optimum date for the exchange rate fixing.

4. Steadily growing strength of intra-industry linkages between the economies of Poland and the EU, reflects the considerable progress of integration. What is even more relevant, it constitutes an important factor in the convergence of business cycles, making Poland's economy more immune to asymmetric external shocks.

A relatively high correlation of business cycles together with advanced growth of intra-industry trade imply relatively small risk of major bad consequences of the external asymmetric shocks or cycle divergences which would have to be absorbed by higher exchange rate volatility. It thus seems that Poland more and more meets the criteria of an optimal currency area with the EMU countries. As a consequence, the floating exchange rate seems to have limited significance as an absorber of both external asymmetric shocks and negative effects of business cycle divergences.

5. From the date of the accession Poland will participate in the 3rd stage of the EMU with the status of a country with derogation what formally means that introduction of the euro will be possible with fulfilling all the conditions described in the Maastricht Treaty.

The participation in the EMU is in the strategic interest of our country, meaning better interactions with the EU structures and institutions, guaranteeing low inflation and interest rates. Joining the euro area can bring measurable benefits resulting from the elimination of currency risk, increased transparency, reduction of transaction costs, further development of foreign trade, broader inflow of foreign investments and financial stabilization. The elimination of the exchange rate risk will help benefit from the single market activities, especially from financial and capital operations.

6. The willingness for fast membership in the EMU stems from a deep belief that replacing the zloty by the euro will have a predominantly beneficial impact on the Polish economy, supporting the sustainable economic growth and accelerating the convergence processes. It is connected with a widely spread belief that the benefits of the euro introduction will be higher than the costs. This can be quite justified when we take into account the fact that the benefits will have rather long-term effects while the costs will be usually born once.

At the same time one cannot forget quite poor economic performance of Euroland during last two, three years. On the other hand, the inclusion of the accession countries to the European structures will result in the considerable benefits for the old member states – especially in the context of overcoming the economic slow-down and structural problems in many European economies.

7. When anticipating the benefits of the membership in the euro area, it is worth mentioning all the challenges for the economic policy and necessary adjustments contributing to a flexibility increase of the existing system. Inevitable resignation from an independent monetary policy implies the loss of basic instruments by monetary authorities, allowing them to limit the influence of the negative internal and external factors on the competitiveness of the Polish economy. The lack of possibility to use freely the exchange rate and interest rates as tools of national monetary policy will cause a situation under which the fiscal policy will have to absorb the shocks which may occur in everyday practice. The speed of the fiscal policy reactions to the asymmetric shocks will depend on its flexibility and limitations related, for example, to the debt servicing needs and level of the budget deficit.

The main challenge the Polish public finances face is to create conditions for fast, self-sustainable growth, taking advantage of the financial resources from the EU in the most effective way, fulfilling the nominal convergence criteria in a reasonable period of time to become a fully fledged participant of the EMU around years 2008 - 2009.

8. On September 23rd, 2003 the Polish government accepted the "*Medium-term strategy of the public finances*", which aims to protect Poland from exceeding a threshold of 60% of the GDP for public debt, stipulated by the Polish Constitution, and to ensure membership in the EMU in due time. On October 8th, 2003 the government approved the plan of reforming and limiting the public expenditures, which will have an obvious impact on two areas:

- fiscal actions within the central administration and economy,

- budgetary actions within the field of social expenditures.

The mentioned actions within the fiscal policy are to alleviate the tensions inside the State budget connected with a need to improve the scale and structure of expenditures. A special emphasis must be put on curtailing the share of the fixed expenditures in the State budget. One can notice the occurring difficulties in the fiscal policy are to a great extent tied with the accession process. Poland will benefit from the absorption of the Cohesion Fund and structural funds in the long run, while the immediate costs of joining the EU will have to be incurred before May 1st, 2004. Undertaking those steps will allow to fulfil the fiscal convergence criteria and will assure Poland's adequate adjustment to the asymmetric shocks in the future. The reform of the public finances by no means will be an easy task to carry out. However, expected acceleration of the economy growth in years to come will hopefully allow to minimize the reform's socially painful side effects.

9. It should be stressed that the challenges connected with the accession to the EU and to the EMU do not touch only the fiscal policy, but also the structure of the whole economy. For example, one of the conditions of membership in the EMU is the capacity of a participating economy to absorb potential disturbances by the economic policy tools. It means that also in the period before the membership in the EMU the economic policy in Poland should focus not only on achieving nominal convergence, but also on improving the capacity of the Polish economy to absorb asymmetric shocks in such a way which limits the risk of slowing down the growth rate. That is why it is so urgent and necessary to improve the resilience of the national economy, especially the flexibility of prices and wages, as well as of the labour market. To liberalize the latter, the government has already undertaken significant institutional and legislative steps.

From the theoretical point of view, when assessing the impact of asymmetric shocks on a currency area, beside the labour market flexibility, it is also very important to know the extent of mobility of all production factors (including labour). At this juncture, it is worth stressing that the labour market liberalisation in Poland (increasing labour mobility and wage flexibility) seems to be vital for the prospects of adopting a fast lane approach to the euro.

10. For Poland, as well as for other accession countries, prospects for our future progress in the EU are of particular importance. Without further redirecting our trade and strengthening investment links, it would be very difficult for Poland and other accession countries to achieve a strong and sustainable growth. To a great extent it will depend on the future development of the whole Union. From this perspective the recent progress

in unifying the financial markets and in advancing labour and pension reforms in several EU countries should be welcomed. On the other hand we have to realise that the reform agenda is still not completed. The difficulties with striking the right balance between short-term growth concerns and long-term fiscal sustainability are here the best example (the Stability and Growth Pact syndrome). However, if credible and comprehensive structural reform and fiscal consolidation plans were in place, one could support an opinion, that some additional flexibility regarding the timing of fiscal consolidation might be justified. This is particularly true for the countries implementing pension and other reforms with obvious long-term fiscal benefits.

Nevertheless, such a solution requires a reasonable amendment of commonly applicable rules which must be then strictly obeyed.

11. Formally speaking, the EU, on basis of the nominal convergence criteria described in the Maastricht Treaty¹, will evaluate the level of the convergence of the Polish economy from the membership eligibility point of view. Poland has already fulfilled the inflation and the public debt criteria, and is close to observe the long-term interest rate criterion. Unfortunately we have not managed to fulfil the criterion of the general government deficit so far. We expect that the acceleration of the economy and successful implementation of the public finances reform will lead to the fulfilment of this criterion soon.

Taking into consideration the fundamentals, current situation and prospects for the Polish economy as well as forecasts of the general government deficits in the forthcoming years, one can expect that Poland will meet all nominal convergence criteria in year 2007 to become a full member of the EMU in 2008 or 2009. To make it true, we consider entering the ERM II at the beginning of 2006 at the latest.

As it was already mentioned, one of the main problems before including the Polish currency to the ERM II is to set up a central exchange rate of the zloty to the euro – the choice of the best exchange rate strategy to join the Eurozone. Considering the floating exchange rate system we have in Poland, setting up the central exchange rate encounters a number of difficulties. The intention of the government and the National Bank of Poland is to negotiate the central exchange rate of tying the zloty with the euro within the ERM II at the level that would

¹ Here I assume that there will be no change in existing nominal criteria nor an extension of them by additional ones, e.g. from a real convergence domain. This seems to be a quite strong assumption.

provide conditions for an export-driven, stable economic growth, and enable to avoid tensions on the currency market.

12. Taking on the euro as the Polish legal tender is not only the intention of the government, monetary authorities or the private sector. It is supported by a huge majority of ordinary people, as 73% of the Poles are eager to accept a quick replacement of the zloty by the single European currency.

Monetary policy strategies for accession countries³

1. Introduction

According to the Statute of the European System of Central Banks (ESCB) “the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community” (Art. 2).

Yet price stability is a general statement, the European Central Bank (ECB) interpreted it as a commitment to stabilise inflation around a precise value: price increase up to 2% over the medium term, adopting then a formal inflation targeting.

The Statute also requires the ECB to “act in accordance with the principle of an open market economy with free competition” (Art. 2) to reach the target. The link between monetary instruments and target then can only be indirect, and the transmission of the policy impulses is left to the markets. In the interest rate channel, the monetary authority operates supplying liquidity to the market of reserves, those funds held by the commercial banks to make inter-bank payments and to satisfy the legal minimum reserve requirement.

Transmission to inflation takes several stages: expectations and arbitrage communicate the monetary stance from the overnight deposit market to inter-bank deposits with longer maturity and to other contracts, including bonds and interest rate swaps, thus determining the term structure of the interest rates, the cost of financing investment through other sources (bank loans and other financial market instruments) and the opportunity cost for current consumption. These factors define the condition of the aggregate demand and determine the quantity of broader measures of money in the system. Assuming for the short run a less than perfectly elastic supply, there is a trade off between output production and inflation and the monetary authority may try to exploit it and choose the desired combination of the two; in the long run on the other hand real income is essentially determined by supply side developments, and inflation is then a monetary phenomenon (ECB (2001)).

¹ University of Bologna.

² University of Bologna; contact at orsi@economia.unibo.it.

³ Paper presented for the conference “Strategy of EMU enlargement” held in Warsaw 12-13 December 2003. We thank all the participants. We are particularly grateful to Vít Bárta, Jakub Borowski and Vladimir Lavrac for helpful comments.

Price stability also requires monitoring the external value of the currency, because domestic production uses inputs purchased in the international markets too, especially in the case of energy and raw materials the domestic demand is rather inelastic and fluctuations of those prices may transfer into local inflation. It is also possible that temporary swings of international relative prices trigger inflation over the medium term, if the indexation in the economy is high: in that case a quick reaction of the central bank may reduce or prevent the undesired effect. The external value of the euro is then watched over too, and the potential influence of the international prices is not neglected.

The exchange rate can also be used to stabilise inflation, at least for the component originated within the country – producers that may be relatively big for the domestic market, and then have a certain ability to set prices, can be forced to higher discipline exposing them to international competition.

Under a fixed exchange rate, in fact, domestic entrepreneurs know that the attempt to increase local prices, for given level of the international ones, will induce consumers to switch the demand to foreign production. Arbitrage anyway may take time and, in practise, not all the consumers move at the same moment – local producers can then initially adopt a combination of reductions of both prices (those exceeding the international ones) and quantities, or even fail to perceive the demand shift or be unable to react to it, and involuntarily increase the inventories. In the short run then it is possible to observe a certain discrepancy between domestic and international prices, and a certain trade off between inflation and output. Yet, under the assumption that prices of internationally traded goods must converge in the long run, local producers will eventually have to set theirs in line with the foreign ones, if they do not want to be driven out of the market so the trade off between inflation and output does not extend beyond a certain horizon in this case either.

Active management of the exchange rate then constitutes a second channel of monetary transmission. This can be realised with direct intervention on the foreign exchange market, but may also be more indirect: the increase of the interest rate differential between financial assets priced in the local and foreign currency may prompt an inflow of financial capital and a larger demand for the local currency, and then an appreciation of the exchange rate.

If inflation has a strong inertial component, the ability of local producers to quickly set prices in line with the international ones is limited, so fixing the exchange rate entails a progressive loss of competitiveness. This loss may be reduced committing to a crawling peg instead, as long as

the planned devaluation is small enough to keep the economy under the pressure of exchange rate.

Since indexation is more likely to be included in the contracts if the country experienced a long period of high inflation, an active crawling peg is often adopted in the early stage of a disinflation plan. In fact the alternative policy of floating the exchange rate may reduce the anti-inflationary discipline, because local producers know that higher prices could be followed by a depreciation of the exchange rate before arbitrage shifts too much demand to the foreigner producers; indeed an exchange rate policy aiming at the *ex post* stabilisation of the real exchange rate may even prevent a successful reduction of inflation.

In the example of ECB we identified several elements that characterise a monetary policy framework: the monetary authority, the ultimate goal of its action (with a clear, quantitative interpretation of it), and an introductory description of the mechanisms linking the instruments of monetary policy to the final objective.

One reason to begin with the ECB is that the identification of these characteristics is particularly simple: it is in fact a supranational institution created *ad hoc* by the members of the European Union (EU) and these features are either carefully defined in the international agreements or in specific documents issued by the ECB itself to satisfy the requirements of transparency and accountability. But, more importantly, the European model is the natural reference for the eight Central and Eastern European Countries (CEECs) invited to join the EU in May 2004 because they will also be expected to adopt the euro as their currency and to transfer the responsibility of monetary policy to the ECB in the near future.

The CEECs already delegated the monetary policy to independent agencies, the local national central banks, formally committing them to price stability or to preservation of the value and integrity of the local currency. The interpretation of the objective of monetary policy seems anyway to be different across them. Poland and the Czech Republic run an inflation targeting commitment, while Estonia, Latvia and Lithuania pursue price stability and preservation of the value of the currency with a very strict peg of the exchange rate, either as a formal currency board or with a regime that can be assimilated to it (the reference currency is the euro, except for Latvia which still keeps the SDR). Finally Hungary is in an intermediate position, having a weak exchange rate commitment (with 15% oscillation bands) but also an explicit inflation target.

Slovenia and Slovakia are on the other side of the spectrum, not being currently committed to any explicit quantitative goal. Slovakia in particular follows an implicit inflation target in which forecasts are announced in advance, making the regime similar to a standard inflation target (National

Bank of Slovakia (2002)). Slovenia followed a more intermediate approach, in which the anti-inflationary stance was coupled with a certain attention to the external equilibrium. Capriolo and Lavrač (2003) anyway noticed that a more aggressive strategy has been pursued since 2001, with an active, albeit informal, crawling peg.

Upon accession to the EU, the CEECs will be also expected to join the euro area in the future, which means that they accept for the long run the interpretation of price stability given by the ECB. Moreover, perspective accession to the euro area sets the targets for monetary policy already for the medium term: the Maastricht criteria in fact include two conditions that in practise impose a rather tight exchange rate commitment and an inflation targeting. The targets announced by the CEECs should then be read as guidance for the current monetary policy at most up to the beginning of the evaluation period, when the Maastricht criteria take over.

2. Exchange rate and inflation stabilisation

As we already discussed in the Exchange rate report (Orsi and Iacone (2003)), the current variety of monetary regimes in the CEECs is partially due to historical and institutional reasons. Since here we are only interested in the exchange rate for its function as monetary instrument (and possibly as a monetary target), we present the developments of the last decade only very quickly.

At the beginning of the transformation from centrally planned economies, the first task for the CEECs was to introduce a structure for the choice and the allocation of production based on the conditions of demand and supply: by opening to the international market and fixing the exchange rate, they were able to expose the local economic agents to the price structure of the internationally traded goods, also signalling that such a structure would have remained stable in the foreseeable future. The exchange rate commitment then played a crucial role in the early stages of the transition, providing a nominal anchor to a system that had none. Only Slovenia followed a different approach to disinflation, targeting the growth of a relatively narrow monetary aggregate (M1) and operating on the foreign exchange market in order to prevent an excessive real rate appreciation (Capriolo and Lavrač). Contrary to the strategy of the Bundesbank and of the Eurosystem, the control of M1 was also enforced with non-market instruments and procedures.

In the second phase of the transition, Poland and Hungary switched to a crawling peg meanwhile widening the oscillation bands, and the Czech Republic and Slovakia abandoned the commitment at all; finally, Poland too reverted to a complete free float.

Considering the CEECs as a group, then, we observe a progressive reduction of the exchange rate commitment. The effective implementation of monetary policy, anyway, is still more geared towards the exchange rate than in the euro area. Even countries not subject to explicit exchange rate commitments operate on the foreign exchange market: Poland is currently the only member of the CEECs whose currency is really floating freely.

The higher emphasis on the exchange rate as a monetary policy instrument depended on several factors. First, the interest rate mechanism of transmission of monetary policy envisaged by the Eurosystem requires the efficient functioning of markets that at the beginning of the transition did not even exist in the CEECs, so the exchange rate proved to be the only feasible instrument for monetary policy at the time. Alternative, non-market based instruments such as the administrative allocation of credit may have been allowed in the early stages of the transition, but they too were less efficient with respect to inflation stabilisation, needing a certain development of market institutions. Second, at the beginning of the transition the local central banks did not have a record history: the fixed exchange rate was then also useful to establish credibility, because the monetary authority was committed to continuously keep it in line with the announced reference, and a failure would have been spotted immediately, whereas the inflation targeting is referred to the medium term, allowing for possible short run deviations and thus making the *ex-post* assessment of the credibility more difficult. These two elements may well be different at the moment: with the progress of the integration in the EU, the CEECs were required to abandon non-market instruments as a part of the implementation of the *acquis communautaire*, and to rely only on the market for the transmission of monetary impulses; besides, the monetary authorities in the CEECs successfully drove inflation to one-digit figures, obviously gaining credibility in the process.

Finally, even assuming a functioning interest rate channel at the moment, the exchange rate channel of monetary transmission should be more important in the CEECs, due to the higher openness to the international trade of candidate EU members with respect to the euro area.

The three Baltic States, being the smallest countries and the ones having to face the longest transition (they were even part of the Soviet Union, and experienced the largest disruption of the productive structure) were then more likely to keep a strong emphasis on the exchange rate. This in fact is what happened: they maintained the tight exchange rate

commitment, despite a sensible real appreciation of the local currencies in the last years, and Estonia even resisted the probe of a speculative attack. The other countries, having probably less incentive to resist speculative pressures, eventually gave up the commitment or weakened it sensibly.

There is no doubt about the importance of the exchange rate with respect to inflation stabilisation: broadly speaking, and ignoring the issues related to the alternative specifications, all the empirical analysis found that an appreciation of the real exchange rate significantly reduced the growth rate of prices.

More details of the link from the exchange rate to the inflation are in Darvas (2001) and Coricelli, Jazbec and Masten (2003), who focussed the analysis on the particular issue of estimating the measure of the impact of an exchange rate variation on domestic inflation for the Czech Republic, Poland, Hungary and Slovenia. Despite the different methodologies, they both found that the pass through of exchange rate fluctuations on the domestic inflation is higher in Slovenia and in Hungary rather than in Poland and in the Czech Republic. It is difficult to say if this ranking depends on the degree of openness, Hungary and Slovenia being smaller than Poland and the Czech Republic, or on the exchange rate regime chosen by these countries, with the first two managing the exchange rate more directly. Yet at least the second hypothesis does not seem consistent with the data: the rationale should be that by floating the exchange rate the volatility is larger, so if the additional noise is not incorporated into inflation, the pass-through is lower, but the volatility vs. USD and vs. DEM of the Slovenian tolar was higher than for the Polish zloty and for Czech koruna.

Point estimates are of course sensitive to the model, and with this respect both the approaches may be open to some criticism. Darvas allowed for time varying parameter but imposed a random walk structure to them, implying a high degree of instability. More importantly, he constrained the long run real exchange rate to follow a purchasing power parity (PPP) type of relation, in practise imposing a one-to-one pass-through for countries pegging the exchange rate: this is strongly at odds with the fact that the real effective exchange rate appreciated in all the CEECs, and even more so in those having a fixed peg. Coricelli *et al.*, adopting a I(2) specification for prices, implicitly denied the possibility that inflation was stable around a mean or a trend in the long term, as if the central bank failed in its stabilisation policy. In any case, the estimated pass-through are so different that the researcher should be careful in drawing sharper conclusions: Coricelli *et al.* proposed a value of nearly 1 for Slovenia and Hungary, of 0,8 for Poland and of 0,5 for the Czech Republic, while Darvas estimated approximately a value of 0,4 for the first two countries, of a bit more than

0,2 for Poland and even less for the Czech Republic. Rather than for their face value, then, we think that these unstable estimates are important because they support the careful approach of the monetary authorities of Poland and of the Czech Republic, that acknowledge the difficulty in proposing a precise model for the evaluation of a policy and advise that a certain discrepancy between inflation and its target may be anticipated in the short run, and also allow for some sensible interpretation of the forecasts from the central bankers.

3. The interest rate channel of transmission of monetary policy

Since the transmission of interest rate impulses through the aggregate demand follows a much more indirect channel, it is generally acknowledged that it could not play a role in the early stage of the transition. Yet in a functioning market economy the financial structure should be in the condition to carry the monetary innovations along the term structure of interest rates up to the aggregate demand, and then to affect the output / inflation mix. This in fact is assumed by the inflation targeting central banks, and in the inflation reports the conditions of supply and demand are extensively discussed.

The empirical evidence supporting the existence of a standard interest rate channel is still controversial; results seem to depend strongly on the econometric approach adopted by the researcher and on the sampling period considered.

It is anyway encouraging that the number of studies devoted to the topic increased quickly in the last years, also prompted by the effort of the local monetary authorities. The main problem that the researchers faced is the lack of data: the empirical analysis are usually based on less than ten years, and this is even an optimistic approach because the nature of the changes undergone by the CEECs during the last ten years is so deep that one can not really expect that the parameters were stable throughout the whole sample period. Interpretation of the results and comparison of different researches is made even more difficult by the variety of approaches to the econometric analysis, which include, among other things, the choice of modelling variables in level or in first differences, the presence of trends and of *ad hoc* explanatory variables, and the choice of a VAR opposed to a more parsimonious structural model.

Early works were mainly dedicated to Poland, the largest of the CEECs: Christoffersen, Sløk and Wescott (2001) studied the period 1992-1998, Gottschalk and Moore (2001) the years 1992-1999 and Horská (2001) the phase 1993-2000. Despite several methodological differences, they all

confirmed that the exchange rate can indeed be used to control inflation, but did not find evidence of the alternative interest rate channel.

In a more recent contribution covering the period 1992-2003, Elbourne, de Haan and Kiviet (2003) found that the economic activity falls quickly after an interest rate shock, but the reaction of inflation is weak and remains at the border of the significance region.

A more pronounced effect is presented in Maliszewski (2002), who used a Bayesian VAR and also allowed for some time switching coefficients in the policy reaction function in correspondence to the change of monetary regime realized with the introduction of the inflation targeting. Yet, to analyse the interest rate channel properly, we should observe the impact of that monetary policy instrument on the economic activity, and then the one of economic activity on inflation: since these impulse response functions were omitted, it is not possible to say if the significant effect of the interest rate on inflation was due to the interest rate channel or it was a reaction to the appreciation of the exchange rate induced by the same shock.

A similar limitation is present in the VAR analysis of Wróbel and Pawłowska (2002), where the impact of the economic activity on inflation was not presented. Their findings are also weakened by the fact that the reactions of inflation and output to the interest rate, albeit pointing to the right directions, were never significant.

It is possible that the weak support provided by these analyses is at least partially due to the methodology adopted: VAR models have the advantage of requiring a minimal structural specification, but, in return, they need the estimation of many parameters. Considering the short length of the sample period and the extreme instability of the parameters due to the transition, large standard errors and non significant estimates seem to be the unavoidable consequence.

A structural model, such as the one proposed by Svensson (2000), can provide a more parsimonious approach. Applying it to Poland, Iacone and Orsi (2002) and Łyziak (2002) found that indeed the (real) interest rate has an impact on the economic activity, and that the effect increased in the last few years; the evidence of a second step taking from the economic activity to inflation is less convincing: Iacone and Orsi found only a weak effect (and limited to the last part of the sample), while Łyziak claimed that this link too is operational.

Empirical evidence for the other CEECs is in general less extensive, but results are not basically different: the analysis of Elbourne *et al.* is of particular interest because they covered all the candidate CEECs. A convincing link from the interest rate to output only appeared for Hungary and possibly for the Czech Republic, and a weak evidence supporting the case in this country was also presented by Maliszewski; a statistically

significant effect of interest rate on inflation was only present for Latvia and Lithuania, and it constitutes a very puzzling result because this link can not be explained neither via the interest rate channel, because the intermediate effect on output was clearly missing, nor via the exchange rate channel, given that the nominal exchange rate was fixed.

The negative impact of a real interest rate shock on the economic activity in Hungary and in the Czech Republic was confirmed by the structural estimates in Iacone and Orsi, who also found evidence in favour of the successive step in the transmission mechanism at least in the case of Hungary (evidence for the Czech Republic is more dubious, and only for the last part of the sample).

Finally, neither Elbourne *et al.* nor Iacone and Orsi found significant evidence in favour of the efficacy of the interest rate channel in Slovenia: a possible effect was only limited to the step from real interest rate to economic activity, and for the last part of the sample, thus supporting the argument of Capriolo and Lavrač that, until recently, the interference of the central bank on the financial markets made the interest rates not informative about the policy stance.

4. Inflation differentials between the CEECs and the EU

According to the principle of one price and to the purchasing power parity theory, the domestic prices of internationally traded goods should be equal to the foreign prices converted in the local currency. This relation is often generalized to the inflation rates, implying a stable real exchange rate over time. Pegging the exchange rate, the domestic central bank could then reduce inflation to the level of the foreign country.

Yet the level of prices in the CEECs was much lower than in the EU, so a strong real appreciation was to be expected. Čihák and Holub (2001) analysed the validity of the principle of one price, finding that the gap in the level of prices is narrowing and the structure of relative prices is getting more similar with respect to the EU standard, but the evolution is necessarily slow. On a purely empirical basis Roger (2001) evaluated that at the beginning of the transition the absolute prices in Prague, Warsaw and Budapest ranged from 30 to 40% of the corresponding prices in the major European cities, reaching a level of 60 to 70% in 1999.

A second factor likely to cause a stable inflation differential is the Balassa-Samuelson effect. The idea behind it is that the international prices and the technology conditions fix the capital/labour ratio in the sector of traded goods, and that the same wage is passed to the sector of non-traded goods and services due to the factor input mobility within the country. As a

consequence, if the productivity grows at a lower speed in the sector of non-traded goods than in the other one, than the difference is compensated with more inflation in the non-traded goods. Since the catching up of the less developed economies is likely to take place in form of import of more efficient technology and increased productivity in the sector competing on the international markets, we may expect that the productivity gap between the sector exposed to the international competition and the one operating only locally, without external interference, can be very large. As a consequence the CEECs may experience higher inflation during the catching up, and the real exchange rate could tend to appreciate on a Consumer Price Index (CPI) basis.

Quantitative studies vary both for the approach (country specific vs. general for all the CEECs) and for the methodology, but they mainly converge on the idea that the estimates can be placed in the 1-2 percentage points of additional inflation per year or more. Surveys are in Borowski, Brzoza-Brzezina and Szpunar (2002), where 1,5% per year was suggested for Poland, and in Coricelli (2002), where the range for the CEECs was 2-4%, implying approximately a 1% appreciation of the real exchange rate per year; Coricelli also remarked that the catch up of productivity to the levels of the least developed EU countries will still take a considerable time (he suggested 15 years).

Pegging the exchange rate should then result in real appreciation, as in fact it happened: the Baltic States, that never depreciated the central parity, recorded the largest real appreciation, but the one-to-one relation between domestic and foreign inflation did not hold for any CEEC, and they all appreciated their currency in real terms to a certain extent.

5. Anchoring inflationary expectation

Even if the initial difference in price levels, the additional inflationary inertia in the CEECs and the Balassa-Samuelson effect caused higher inflation in the CEECs, the link between exchange rate and inflation is still strong enough to make it a valid intermediate target, and in fact this is explicitly acknowledged by some central banks (Hungary, Latvia). The fixed exchange rate served the purpose of providing a nominal anchor for the inflation expectation and of offering the public a reference that is clearly visible and on which the commitment of the central bank could be tested every day.

The fixed peg anyway has drawbacks too. First, by committing its actions to the stabilisation of the exchange rate, the central bank abandons any room for autonomous policy: this is one of the reasons for which the

peg is accepted at all, because it implies that discretionary policies are ruled out, but it also prevents anti-inflationary policies in case of conflict between stabilisation of the exchange rate and of inflation. Committing to a single intermediate target means, in fact, renouncing to use of many other leading indicators that may be well useful to predict the dynamics of the final objective of monetary policy.

More importantly, it may be the case that the exchange rate is not a sustainable commitment at all: the foreign exchange reserves that a central bank may use to defend the currency are limited and much smaller than the funds that may be raised on the international financial market to run a speculative attack against it. The exchange rate commitment can be defended if some forms of capital controls are in place, but this cannot be the case between the EU and the CEECs. The central bank cannot count on the interest rate either, to defend the exchange rate: the speculative attacks in the past showed that not even three digit short term interest rates can put the attack off.

If these drawbacks are perceived, the credibility of the central bank is undermined and the attempt to influence the inflationary expectations fails.

Given that the ultimate task of monetary policy is price stability, the central banks may commit to a reference target for inflation without intermediate targets. This in fact has been done by Poland and the Czech Republic, while Hungary tried to complement the two commitments. Accountability is realised primarily announcing a target for inflation in the following year, and then discussing monetary policy decisions and inflation developments in inflation reports and in additional specific communications.

Since the target is referred to the medium term (one year), deviations are possible and were indeed frequent: even allowing for a tolerance band, the target was not hit in 3 cases out of 5 in Poland and in 4 out of 5 for the Czech Republic; Hungary on the other hand successfully reached the target in the last two years (see Table 1 for details). Admittedly the task is more difficult for the CEECs than for the Eurosystem, as local inflation is more subject to external factors (international and administrative prices above all) and because the macroeconomic models, having been estimated with a much smaller dataset, can provide less precise information. Maliszewski and Iacone and Orsi analysed the problem allowing for a structural break in the inflation dynamics in correspondence to the year in which the main commitment passed from the exchange rate to the inflation targeting: from both papers we gather that, if there had been a change at all, then it was in the direction of a better control of the growth rate of prices.

It is possible that the discrepancies between the target and the observed value of *ex post* inflation and the shift of the emphasis from the daily base to the medium term are perceived by the economic agents as a

weakening of the anti-inflationary commitment, with an adverse impact on the formation of the expectations, ultimately making price stabilisation more difficult and socially expensive.

Hungary faced the risk of the erosion of the central bank credibility maintaining a weak exchange rate commitment with the inflation target, but with this approach it is possible that the intervention of the monetary authority to achieve one target prevents reaching the other one. In that case one must give in, and the Hungarian decision to update the central parity in June 2003 seems to prove that in that case inflation stabilization has the priority. Committing to both targets then could contribute to confusion in the formation of expectations rather than helping it.

Floating their currency freely and lacking a formal inflation targeting commitment, Slovenia and Slovakia do not have an explicit mechanism to anchor the expectations.

Capriolo and Lavrač and Coricelli *et al.* argued that the relatively high inflation of Slovenia in the last years, compared to the other CEECs was due to the fact that the *ex post* adjustment of the central bank to stabilise the real exchange rate was a discretionary policy, and that the agents internalised it, not feeling then enough pressure to revise their expected inflation to a lower level. The current monetary stance, in which the central bank operates with an active crawling peg, is then still exposed to the same risks, in particular for the possibility of the monetary authority to accommodate shocks using the exchange rate and for the lack of an anchor for the expectation of inflation: not announcing a target may make the final stabilisation of prices more difficult or even jeopardize it.

The situation in Slovakia is slightly different, but here too the lack of an explicit commitment prevents the full accountability of the central bank. According to the monetary authority, the main difficulty that prevented the passage to an explicit inflation targeting so far is the wide range of administrated prices still present in the economy (this was also acknowledged as the cause of higher than expected recent CPI inflation). The central bank could, anyway, introduce an alternative commitment, for example excluding administrated prices from the targeted inflation, and maybe supplementing the target with a forecast of the CPI inflation. Admittedly even this measure may be indirectly subject to the effect of the decisions of the fiscal authority on those prices, but it may still help to sustain the expectation of lower future inflation.

6. Monetary policy on the way to euro

6.1. Exchange rate regimes in the EU

Once into the EU, the CEECs will have the chance to peg their currency to the euro in the ERM 2 exchange rate mechanism, adopting in that case a fluctuation band that may be as wide as up to $\pm 15\%$. The central parity is decided jointly with the ECB and changes are possible as long as they are in line with the macroeconomic fundamentals. The ERM 2 can be a rather flexible regime, but stronger commitments can be undertaken towards the euro by the other currencies: even a currency board may be feasible, as long as the euro constitutes the only reference and the parity is agreed jointly with the ECB.

Participation to the ERM 2 then does not imply any modification to the policies of Hungary, Lithuania and Estonia, apart from a potential change in the actual parity. The CEECs anyway are not required to join the ERM 2 upon EU accession, also having the option to postpone the application.

They will have to stay in the exchange rate agreement in the course of the evaluation period during which the performance of the country is monitored under the Maastricht criteria. These impose two years of exchange rate stability towards the euro, during which any devaluation is obviously ruled out: in the past a short preliminary period of stable exchange rate even without formal participation in the ERM 2 has been taken into account for Italy, Finland and Greece, but in any case the commitment to a fixed exchange rate is part of the route to the accession in the euro area.

Borowski *et al.* noticed that depreciation above the 2,25% with respect to the central parity may appear as evidence of tension on the exchange rate, and that the role played by interventions in support of the exchange rate will be considered too. If their interpretation of the documents of the ECB discussed therein is correct, as it seems, the depreciation during the run up into euro cannot exceed 2,25%, so Borowski *et al.* suggested setting an informal intervention rate at 2%. They also noticed that for that 2% informal threshold there is no commitment from the ECB to the intervention to sustain the exchange rate of the CEECs currency, so the burden of the adjustment is all on the CEECs central banks: to the point that this is perceived from the markets too, the exchange rate regime is also weakened by this different reference.

6.2. On the way to the euro

The candidate country can only choose when to enter the ERM 2, when to access the euro area and what to do in the period preceding the final two years in which the exchange rate stability is monitored.

With this respect, participation in the euro area should only take place when the advantages exceed the costs. It is often remarked in the literature about optimal currency area that many features are endogenous (for example, trade is expected to be fostered by monetary integration) but there are some factors that still remain as prerequisite for the run up into euro: these should include at least a sound fiscal consolidation and a certain degree of flexibility of the labour market.

They are in fact extensively discussed by the CEECs central banks, often in statements joint with members of the governments, and, on the base of these factors, provisional timetables have been laid down. We summarise them in Table 2: euro adoption is planned for the years 2006-2010, so while some countries, Estonia and Lithuania above all, are planning to join the euro at the fastest possible speed, some others, including the largest ones, have a slower approach and must then decide how to run monetary policy in the period preceding the last two years of the run up of the Maastricht criteria.

The opportunity of the fixed exchange rate approach for the CEECs was extensively debated in the last few years. Bofinger and Wollmershäuser (2000) argued that a perfect float is not desirable for countries still in the process of catching up with the most developed ones, because the local foreign exchange markets are typically very thin and sudden flows of funds may then trigger excessive swings of the nominal rate. They also thought that a fixed exchange rate can be maintained by countries that are very small because they can afford concentrating their effort on that only, leaving the interest rate endogenous and making in this way monetary policy dominated by the exchange rate, and for countries having very close macroeconomic fundamentals (an argument that possibly could be extended to countries with different fundamentals, if the exchange rate is regularly crawling). Corker, Beaumont, van Elkan and Iakova (2000) too accepted a fixed exchange rate (in the form of the currency board) for Estonia, and the same argument could have been extended to the other Baltic States; Gulde, Kahkonen and Keller (2000) reached the same conclusion for Estonia and Lithuania (but again the argument seems appropriate for Latvia as well). For countries of the size of Hungary or larger, Szapáry (2001) proposed a “narrow band, backed by adequate supportive policies”.

Masson (1999) and Corker *et al.* suggested for the majority of the CEECs the opposite policy, as Buiter and Grafe (2002) did too, under the

assumption that a fixed exchange rate without restrictions to the movement of capitals is exposed to speculative attacks.

Considering the pressure undergone by France, which in the 1992 ERM 1 crisis did not have worse macroeconomic fundamentals than Germany, we are actually sceptical about the stability of fixed pegs as exchange rate regimes unless both, the countries explicitly commit and actively intervene in defence of the attacked currency. Narrow bands in general could make the defence of the exchange rate more difficult and then increase the risk of a speculative attack: please notice here that the arrangement chosen by the current ERM2 participants, with the 15% oscillation bands per side, seems to acknowledge that.

Since the supply of international reserves is limited, even a currency board is not a fully credible exchange rate agreement and can be subject to a speculative attack or exchange rate pressures (as it already happened in Estonia) or bank runs.

Factors reducing the risk of attacks are the availability of foreign currency reserves to defend a fixed exchange rate, along with the consistency of macroeconomic policies. Sustainable public finances represent a fundamental requirement in this respect. Another important support to a fixed exchange rate policy in a context of capital mobility is the endorsement of the central bank of the anchor currency: speculative attacks are often triggered by the fact that the reserves that a central bank can mobilise to defend the exchange rate are limited, and very little when compared to the volume of funds that can be raised on the market. If anyway the monetary authority of the anchor currency is credibly oriented to support the exchange rate agreement, the chance of success much reduced, to the point that the expected gain from a speculative attack in such a case can even be negative.

We think that fixed exchange rate commitments cannot be managed for an indefinite time without capital controls, and indeed the failure of several of these arrangements had been a relevant source of instability on the international financial markets in the last few years.

The catching up of the productivity of the CEECs with the euro area countries is far from concluded, and it will last for several other years. Meanwhile, the Balassa-Samuelson effect and the principle of one price will continue to push inflation in the accession countries: keeping the exchange rate fixed the risk is that the inflation in the accession countries will overshoot the threshold, unless a restrictive policy is implemented. *Coeteris paribus*, then, they should be less inclined to keep the exchange rate fixed with a hard peg in the ERM 2 but this of course does not rule out participation to the agreement and occasional, mutually agreed devaluations.

Floating the exchange rate without formal commitment does not mean neglecting it as a policy instrument and as a potential source of disruption: on the contrary we think that its effect on inflation is faster and more reliable, so we expect the monetary authority to use it in conjunction with the interest rate to achieve the target.

Since there is enough evidence that inflation targeting provided in Poland and in the Czech Republic a valid reference for monetary policy and an anchor to the expectations not inferior to the exchange rate commitment, we think that these two countries should maintain the current monetary arrangement. We think that Slovakia too should introduce this policy regime in the explicit form in order to help the formation of expectations in line with the inflation stabilisation programme.

We also think that Hungary may drop the exchange rate commitment and remain with the inflation target only, especially if a situation of potential conflict between the two targets is feared. Failing that, or should Poland, Slovakia or Czech Republic join the ERM 2 before the monitoring period, we think the widest possible bands should be chosen and the occasional devaluations to follow the macroeconomic fundamentals should not be opposed.

In any case we think that the situation of the currencies joining the ERM 2 in the process of accession to the euro area may be eased because it is well known that the fixed exchange rate arrangement has to remain in place for only a relatively short time, and because it can count on some sort of support from the target currency (the euro) at least under some conditions.

We already noticed that Slovenia should explicitly introduce a target for monetary policy to help the formation of expectations favourable to the final disinflation to the euro area level: with this respect the detailed plan described in the accession programme, subscribed both by the central bank and by the government may serve to that purpose too.

Finally, Estonia and Lithuania plan to join the euro as soon as possible, thus having to enter the ERM 2 with the hard peg immediately. Latvia is planning a slower approach, converting the peg from the SRD to the euro only in 2005, upon accession to the ERM 2, and introducing narrower fluctuation bands. They could conceivably try and exploit the credibility acquired so far and enter the ERM 2 with the hard peg, but remembering that their goal is not the hard peg itself but the euro accession, and that this purpose is also served by a wide oscillation band before the evaluation period, so they can consider resorting to that in the wake of a speculative attack rather than waiting for it and opposing it putting at risk the internal stability.

7. Concluding remarks

To summarize, CEECs should only access the euro area if they are able to forfeit the exchange rate as a tool to counter asymmetric shocks to the real economy. This includes fiscal stabilisation and flexibility of the labour market.

The Maastricht criteria require two years of stable exchange rate in the ERM 2. Since fixed exchange rate are exposed to speculative attacks, countries that are currently floating their currency could minimize the risk staying out of the ERM 2 until the beginning of the evaluation period or adopting the 15% oscillation band; the central parity should be defended only for the duration of the assessment of the Maastricht criteria.

Meanwhile, the role of anchoring the expectations should be left to an explicit inflation targeting; a formal and detailed programme of euro accession strategy may constitute a valid alternative especially for those countries where inflation targeting has not been implemented yet.

Despite the exposition to speculative attacks, it is encouraging to notice that in the run up to the monetary union of Italy or Greece the “convergence play” helped these countries, increasing their credibility and leading them to a smooth accession to the euro.

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Annex 1. Tables and figures

Table 1. Targets and results in the inflation targeting CEECs

	Poland		Czech Republic		Hungary	
	Target	Result	Target	Result	Target	Result
2002	4%-6%	0,8%	3%-5%	0,6%	6%-8%	6,8%
2001	6%-8%	3,6%	2%-4%	2,4%	3,5%-5,5%	4,8%
2000	5,4%-6,8%	8,5%	3,5%-5,5%	3%		
1999	8%-8,5%	9,8%	4%-5%	1,5%		
1998	<9,5%	8,6%	5,5%-6,5%	1,7%		

Notes: the target for Poland in 2002, was revised to 2%–4% in June; the target for Poland in 1999 was adjusted to 6,6%-7,8%; inflation targeted for the Czech Republic is net inflation up to 2001 and headline inflation afterwards; the Czech National Bank does not limit its commitment to a certain month of the year, but has a target range for any day of the year.

Table 2. Provisional timetable of accession to the euro area proposed by the CEECs central banks

Estonia	2006
Lithuania	2006/2007
Slovenia	2007
Poland	2007
Latvia	2008
Hungary	2008
Slovakia	2008/2009
Czech Republic	2009/2010

Sources:

- notes, press releases or statements from the web pages of the central banks of the CEECs.
- On the Prospects of Introducing the Euro in Lithuania.
- Programme for ERM 2 entry and euro adoption (joint programme of the Slovenian government and of the bank of Slovenia).
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- Joint press release of the Ministry of Finance and the Magyar Nemzeti Bank.
- Monetary policy of the bank of Latvia.
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- *The Czech Republic's euro-area accession strategy*, Joint document of the Czech government and the Czech national bank.

Annex 2. Updated Tables and Figures from the Exchange rate report

Figure 1. Real exchange rates

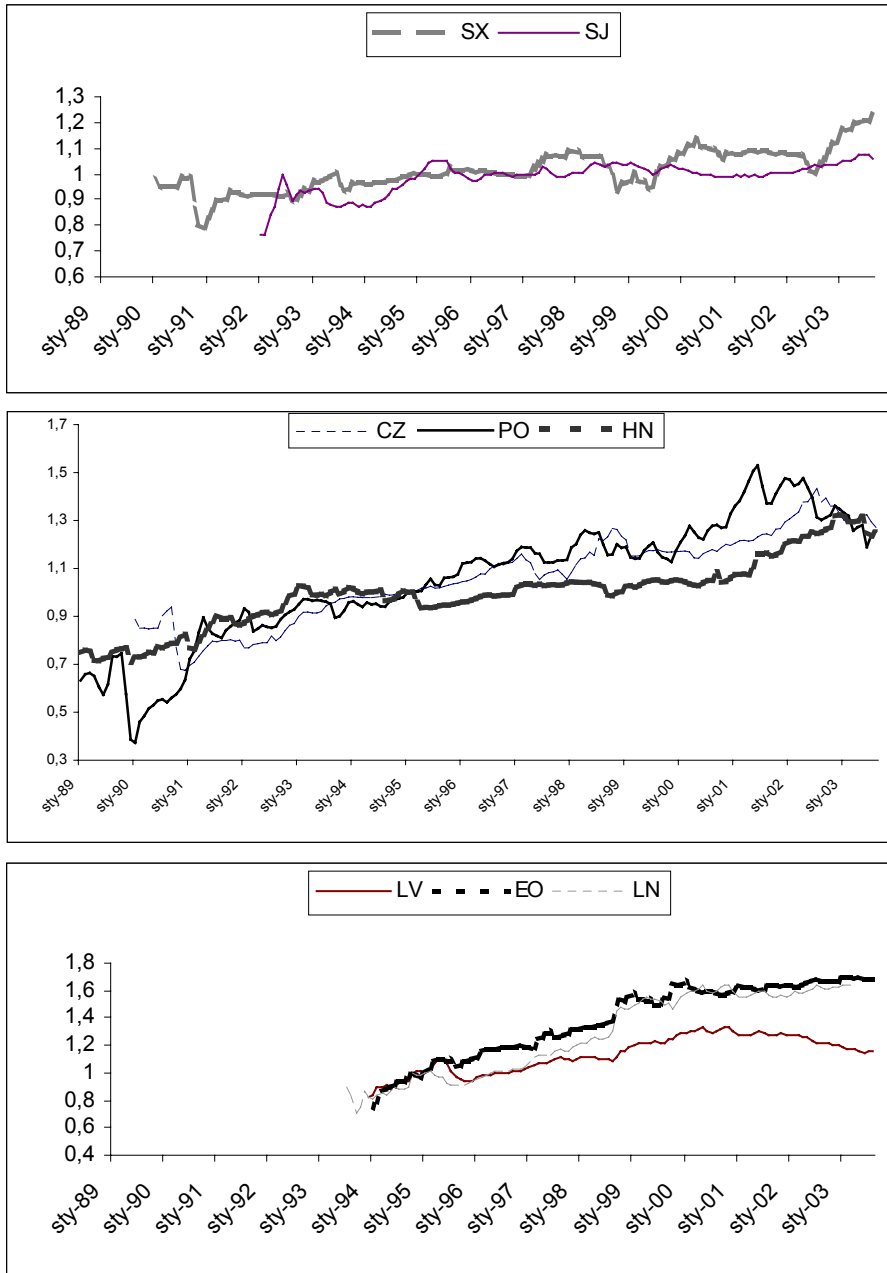


Table 1. Real exchange rates

	CZ	SX	PO	HN	SJ	LV	EO	LN
1989	...	...	0.631	0.742	...	...	...	...
1990	0.836	0.928	0.531	0.769	...	...	...	...
1991	0.772	0.901	0.831	0.850	...	...	...	...
1992	0.808	0.917	0.884	0.924	0.896	...	...	...
1993	0.939	0.967	0.949	1.005	0.895	...	...	...
1994	0.987	0.976	0.957	0.994	0.927	0.930	0.909	0.893
1995	1.020	1.004	1.035	0.954	1.023	1.010	1.071	0.947
1996	1.088	1.001	1.126	0.981	0.993	1.000	1.174	1.007
1997	1.097	1.050	1.153	1.031	1.000	1.082	1.266	1.144
1998	1.187	1.028	1.211	1.024	1.031	1.121	1.408	1.322
1999	1.171	1.003	1.162	1.040	1.022	1.234	1.557	1.517
2000	1.172	1.094	1.259	1.047	0.998	1.310	1.596	1.610
2001	1.237	1.082	1.432	1.131	0.996	1.281	1.627	1.567
2002	1.365	1.062	1.386	1.253	1.025	1.230	1.658	1.605
2003	1.303	1.192	1.268	1.283	1.063	1.165	1.689	1.638
1995/1992	1.263	1.095	1.171	1.033	1.142	...	...	...
2003/1992	1.613	1.300	1.434	1.388	1.187	...	...	...

Notes to Figure 1 and Table 1: CZ – Czech Republic; SX – Slovakia; PO – Poland; HN – Hungary; SJ – Slovenia; LV – Latvia; EO – Estonia; LN – Lithuania.

Sources:

- Datastream (quoted sources: OECD, IMF or National Central Banks);
- National Central Banks;
- the entries in Table 1 are averages over the whole year (except 2003, which is up to March or less according to the data availability); base: 1995, January =1.

Table 2. Inflation rates

	EA	CZ	SX	PO	HN	SJ	LV	EO	LN
1990	...	...	...	224.24	33.21	...	...	...	...
1991	4.39	...	...	60.28	32.09	...	...	...	...
1992	3.30	12.51	8.86	44.61	25.60	89.77	...	...	1160.67
1993	3.19	18.25	25.15	37.70	21.07	22.80	34.76	37.91	188.61
1994	2.67	10.26	11.61	29.43	21.26	19.45	26.22	41.65	45.09
1995	2.49	7.86	7.18	21.83	28.24	8.93	23.17	26.53	35.70
1996	2.13	8.53	5.34	18.76	19.91	9.06	13.16	14.81	13.07
1997	1.49	10.09	6.36	13.21	18.36	8.75	6.96	11.88	8.36
1998	0.88	6.74	5.63	8.43	10.28	6.50	2.76	4.28	2.42
1999	1.75	2.59	14.19	9.81	11.20	8.02	3.20	3.88	0.29
2000	2.48	3.93	8.41	8.64	10.07	8.90	1.81	5.05	1.41
2001	2.05	4.20	6.56	3.63	6.85	7.01	1.91	4.20	1.97
2002	2.37	0.55	3.23	0.72	4.84	7.28	1.39	2.68	-0.95
2003	2.20	0.37	9.62	1.23	4.88	4.83	3.34	1.01	-1.43

Notes: EA – Euro Area (12 partners).

Sources: Datastream; the entries in Table 2 are the inflation rates over the whole year (December vs. December of the previous month) (except 2003, which is referred to November or less according to the data availability).

Table 3. Exchange Rates vs. US \$

	CZ	SX	HN	PO	SJ	LN	LV	EO
1992	27.65	...	77.77	1.29	...	...	...	...
1993	28.59	...	90.41	1.74	113.34	...	...	13.22
1994	28.76	32.07	105.05	2.27	127.90	3.97	0.56	12.97
1995	26.51	29.89	125.65	2.41	119.30	4.00	0.53	11.49
1996	27.14	30.56	152.65	2.70	134.89	4.00	0.55	12.02
1997	31.75	33.27	186.96	3.28	159.85	4.00	0.58	13.86
1998	32.24	35.21	214.38	3.49	166.20	4.00	0.59	14.07
1999	34.64	41.42	237.42	3.97	182.83	4.00	0.59	14.70
2000	38.65	46.28	282.51	4.35	224.57	4.00	0.61	16.99
2001	38.02	48.37	286.63	4.10	243.66	4.00	0.63	17.49
2002	32.69	45.24	257.56	4.08	239.54	3.67	0.62	16.60
2003	28.27	36.88	224.63	3.89	207.65	3.07	0.57	13.90

Exchange rates vs. DEM

	CZ	SX	HN	PO	SJ	LN	LV	EO
1992	17.73	...	49.90	0.83	...	...	...	...
1993	17.29	...	54.65	1.05	68.47	...	...	7.99
1994	17.76	19.81	65.03	1.41	78.93	2.46	0.35	8.00
1995	18.52	20.88	87.89	1.68	83.31	2.80	0.37	8.03
1996	18.04	20.31	101.41	1.79	89.63	2.66	0.36	7.99
1997	18.29	19.19	107.73	1.89	92.12	2.31	0.33	7.99
1998	18.31	20.05	122.09	1.99	94.51	2.28	0.33	8.00
1999	18.86	22.54	129.23	2.16	99.47	2.18	0.32	8.00
2000	18.21	21.78	132.97	2.05	105.67	1.89	0.29	8.00
2001	17.41	22.15	131.28	1.88	111.53	1.83	0.29	8.01
2002	15.75	21.82	124.17	1.97	115.58	1.77	0.30	8.00
2003	16.27	21.21	129.47	2.24	119.51	1.77	0.33	8.00

Note: 2003 up to 15 December; entries are averages of daily exchange rates.

Source: Datastream.

Table 4. Volatility (st. dev.) vs. US \$

	CZ	SX	HN	PO	SJ	LN	LV	EO
1992	0.76	...	2.08	0.12	...	...	...	...
1993	0.48	...	5.42	0.17	9.22	...	...	0.36
1994	0.87	0.86	3.51	0.08	5.94	0.05	0.02	0.62
1995	0.60	0.63	8.97	0.05	5.74	0.03	0.01	0.39
1996	0.43	0.55	6.37	0.11	2.91	0.02	0.00	0.23
1997	2.41	1.16	11.06	0.20	8.02	0.02	0.01	0.52
1998	1.98	0.80	5.00	0.07	5.06	0.00	0.01	0.53
1999	1.35	1.99	9.43	0.18	9.25	0.00	0.01	0.54
2000	1.81	3.04	18.21	0.18	15.80	0.00	0.01	0.92
2001	1.09	1.09	7.76	0.10	8.10	0.00	0.01	0.51
2002	2.35	2.55	16.06	0.10	11.07	0.22	0.02	0.95
2003	1.15	1.69	6.67	0.09	7.34	0.13	0.01	0.57

Volatility (st. dev.) vs DEM

	CZ	SX	HN	PO	SJ	LN	LV	EO
1992	0.46	...	2.07	0.09	...	...	...	...
1993	0.23	...	2.58	0.09	4.37	...	...	0.11
1994	0.35	0.45	4.77	0.11	1.29	0.14	0.01	0.05
1995	0.23	0.44	7.39	0.05	3.02	0.09	0.01	0.09
1996	0.34	0.29	2.99	0.05	0.97	0.06	0.01	0.06
1997	0.87	0.26	3.48	0.07	1.76	0.09	0.01	0.04
1998	0.57	1.07	6.44	0.09	1.07	0.09	0.01	0.03
1999	0.42	0.58	1.41	0.06	1.66	0.08	0.01	0.03
2000	0.30	0.35	1.55	0.05	2.01	0.10	0.01	0.03
2001	0.37	0.23	4.01	0.08	1.07	0.05	0.01	0.03
2002	0.36	0.54	1.58	0.10	1.59	0.01	0.01	0.02
2003	0.37	0.38	8.60	0.17	1.87	0.01	0.01	0.01

Note: data for 2003 up to 15 December; entries are standard deviations.

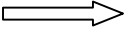
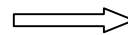
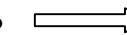
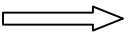
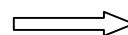
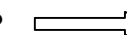
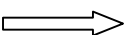
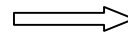
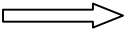
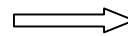
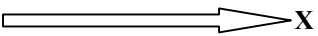
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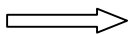
Table 5. Overview of the current exchange rate regimes

	Exchange rate regime	Inflation Targeting
Czech Rep.	Free float + interventions	Net of indirect taxes and regulated prices
Slovakia	Free float + interventions	
Hungary	Fixed exchange rate; ±15% oscillation bands	CPI inflation
Poland	Free float	CPI inflation
Slovenia	Free float + interventions	
Latvia	Fixed exchange rate: 1 SDR = 0.7997 LVL	
Lithuania	Currency Board: 1 EUR = 3.4528 Litass	
Estonia	Currency Board: 1 EUR = 15.6466EEK	

Source: National Central Banks.

Figure 2. Changes Occurred in the Exchange Rate Regimes

	Currency Board /Fixed peg no band	Fixed peg narrow bands	Fixed peg wide bands	Managed float	Managed float
Czech Rep.	• 	• 	• 	X	
Slovakia	• 	• 	• 	X	
Hungary	• 	• 	X		
Poland	• 	• 	• 		X
Slovenia				X	
Latvia	X				
Lithuania	X				
Estonia	X				

Note: Regimes are ordered in terms of flexibility of the exchange rate. An X indicates the current exchange regime, a • denotes a previous regime, and an  indicates a regime change.

Karel Zeman*

Social issues of EMU accession strategy – conflict of fiscal and monetary restrictions with social demands in the Czech Republic

Abstract

Paper sums up basic potential restriction and risks of the preparation for EMU accession on social demands in the Czech Republic.

According to the recommendation of the joint and coordinated approach of the Ministry of Finance (MF), the Ministry of Industry and Trade (MIT) and the Czech National Bank (CNB) the Czech Republic will join the euro area as soon as economic conditions allow for doing so (/1/).

The timing depends to a large extent on the speed:

- of the real convergence process achieved by means of structural reforms and
- of the nominal convergence process, especially on a rigorous fiscal consolidation.

According to the assessment in the mentioned joint and coordinated approach (of MF, MIT and CNB) the Czech Republic's Euro-area accession strategy (provided that the Maastricht criteria are fulfilled, including a successful consolidation of public finances, sufficient level of real convergence is achieved and adequate progress is made with structural reform guaranteeing sufficient economic alignment with the EU Member States) is oriented to the expected date of its joining the euro area around 2009-2010. The Czech authorities foresee that the Czech Republic will be able to fulfil the criteria for euro area accession at this time.

Basic social issues and risks of EMU accession strategy of the Czech Republic's and its entry into the euro area are associated with:

- social issues of fiscal consolidation and
- with labour market adjustment.

* The author is a professor at the Institute of Integration of the Czech Republic into European and World Economy; Štěpánská 18, 110 00, Prague 1; Phone/fax: 00420 222233141; Email: baloun@vse.cz; Internet: nb.vse.cz/icre.

1. Social issues of fiscal consolidation

The launch of the fiscal balance renewal process¹ will help the Czech economy to move towards a position in which it will be able to aspire to adopt the euro. But fulfilling the Maastricht budget criteria alone is not enough. This is clearly documented by the economic difficulties currently being experienced by certain EU Member States who in the past failed to take full advantage of the opportunity to achieve fiscal balance.

The need to establish sufficient room for manoeuvre in the Czech Republic's fiscal system is underlined by the fact that as early as in the second half of this decade, the public budget will start feeling **the effects of adverse demographic pressure**.

From the static point of view, **the current demographic structure** is probably the most favourable over the entire history backed up with demographic data. Share of population in the group of age between 20 and 59 reached record levels in 2000 as this group includes strong age-groups born during the World War 2. At the same time strong generation born in the end of seventies and in the eighties enters its productive ages. Nevertheless, we witness a **beginning of acceleration of population ageing**, reflecting both falling birth rate over the past decade and the rise in the number of seniors, which will escalate at the end of this decade. Growth in the number of seniors to 2007 is covered appropriately by the law on extending the retirement age (see figures in Table 1).

Table 1. Age distribution of the population in the Czech Republic in per cent of total (end of year)

Age groups	1985	2000	Medium variant of Projection		
			2010	2020	2030
0 – 19	30,0	22,9	19,3	18,3	17,2
20 – 59	52,6	58,7	57,3	53,2	52,2
60 +	17,4	18,4	23,4	28,8	30,6

Source: *Statistical yearbook of the Czech Republic 2000*, Czech Statistical Office, Prague 2000.

¹ The Czech government has prepared and approved a three year consolidation programme in the course of 2003 aimed at reducing the public budgets deficit to no more than 4 per cent of GDP by 2006 (/1/; /2/).

In the short run, the resolution of the problem can be helped by increasing the economy's ability to create sufficient number of jobs and financial resources as well as by increasing the motivation to work. In the longer run, the development generates necessity to give the pension reform such a shape so as to ensure long-term stability of the system.

Future expenditure for pension and health care stemming from changes in demographic developments are the important sources of conflicts with social demands and of fiscal risk.

Current calculations indicate that, in the medium term, the unfavourable trends stemming from the ageing population will, for the time being, only show up to a limited degree. This concerns the delayed effects of the high birth rate from the 1970s and beginning of the 1980s.

The increase in the number of senior citizens as a result of the decline in the mortality rate and the rapidly increasing life expectancy up to 2007 is covered to a certain extent by the extension in the retirement age. The imbalance on the pension account of the state budget has not been caused by demographic factors, but by the situation on the labour market, especially early retirement. A sharp rise in the ratio of the number of pensioners to the number of employees presents a risk to the sustainability of the constant ratio of average pension to the average wage.

The current unfavourable development of the budgetary system then has been caused by factors other than demographic. For stabilizing the mandatory expenditures of the general government budgets, it is important to carry out measures to increasingly motivate the population to join the labour process and not to draw on social benefits.

Nevertheless, the situation will dramatically change in the longer term (especially after 2010 – after the Czech Republic's expected entry into the euro area). The ageing population process will substantially destabilize the economy's production capabilities and the general government budgets. **Fundamental reform of the pension system is an essential supposition for this period**, considering that the current system is not compatible with the unfavourable demographic situation.

The increasing share of **mandatory expenditure**, forming the structural part of the budget in total budget expenditure which is one of the most serious risks to future development of the Czech economy, is related to an ageing population. It is also coupled with the fact that the employment rate for older employees is declining. The low employment rate for this group, which was made even more problematic by possible early retirement, will cause serious problems in the future and will require modernization of the pension system in the Czech Republic.

Main problems of the current state of the pension system are in the following areas:

- The level of pensions from the basic (mandatory) pension system is low and in real terms lower than 1989 levels.
- The degree of solidarity in the system is high, particularly as a result of the high degree of income redistribution and also group redistribution (advantage for self-employed persons). By contrast, intergenerational solidarity as part of the financing of the system will be retained and support for mandatory individual pension saving is not being considered.
- Differentiation of pensions is low due to the significant income solidarity.
- The ratio of pensioners to insured persons paying insurance premiums is rising constantly. The increase in old-age pensions makes up the largest part of this growth. The number of old-age pensioners has recently been rising as a result of both demographic change and the relatively good possibilities for taking early retirement.

Linked to the resolving of these problems is a need to reassess the current legislation enabling concurrence of earning and pension. As long as the target is to strengthen insurance principles in the pension system, concurrence of pension and earning should not be much restricted. Until such time, however, compromise solutions will have to be found that will be administratively feasible and will gradually move towards the target state.

From 1993 to 1996 pension insurance incomes exceeded expenditure. From 1997 to 1999 a deficit arose, and this deficit will evidently get worse unless the system is fundamentally altered. One of the causes of this deficit is the advantage given to persons in self-employment in payment of their insurance premiums. Yet the successfulness of the collection of insurance premium is rated as very good compared to other transforming states and is around 95 per cent.

Target solution of the pension system will continue to be based on two pillars:

- mandatory pension insurance (financed on pay-as-you-go principle)
- and voluntary supplementary pension insurance (based on capital financing).

In the basic **mandatory pension insurance** the rate between the average old-age pension and net wages should range from 55 per cent to 60 per cent, and around 45 per cent relative to gross wages. As other sources of finance for security in old age are developed, it is reasonable to expect that the incomes from these sources should reach 10-15 per cent of net pre-retirement incomes after the critical 10-15 years. The entire pension system

should provide an adequate compensation for low, medium and upper income groups.

The system should continue to be uniform, without major variations between groups of insured. The insurance principle will be strengthened, i.e. closer link between the insurance premiums paid and the size of pension. Adequate compensation in the basic system will be provided chiefly for low and middle-income groups. At the same time it is necessary to take into account the fact that present-day pensioners and people of pre-retirement age did not have the chance to create for themselves other sources of security during old age or in the event of invalidity status.

As part of the regularly financed system (pay as you go), the amount of the pension will depend only on the total volume of insurance premiums paid (registered in a personal record of the insured persons) and the total age reached after entering retirement. Such a construction makes it possible to valorise pensions in a way that corresponds to the development of the national economy and eliminates the problems associated with the age limit. This change naturally makes it necessary to improve the administrative aspect of the system substantially so that fully automatic acquiring and updating of insured persons records is possible.

- The new system will include a guarantee of the minimum income of pensioners.
- The system is made financially more stable by the restricting measures both on the side of incomes and on the side of expenditure. In order directly to maintain the system's financial stability certain corrections are being considered; these affect early retirement (actuarial reduction of pensions), substitute periods (scrapping or reducing them) and tightening the conditions for the self-employed persons. In the medium term it is probable that the age of retirement will be raised further.
- In order to strengthen the participation of the payers of insurance premiums (employees and employers) in the administration of the system and to make financial flows more transparent, it will be made separate from the state budget in terms of finances and institutions through the transformation of the current insurer (the Czech Social Security Administration) into a public-service, democratically run Social Insurance Company.
- The target solution for mandatory pension insurance will have to be conceived in accordance with the tax system.

In the immediate future the range of possibilities offered for **voluntary pension insurance** will be expanded, but not at the cost of reducing the significance of the existing system:

- In any case the motivation to participate in the supplementary pension

insurance system and to make larger contributions will increase, particularly in the case of employees with medium and higher rates of remuneration for whom the compensation for incomes in old age cannot be sufficiently covered by the basic mandatory system.

- At the same time, new forms will be developed, chiefly the possibility of creating occupational systems of supplementary pension insurance that are usual in developed countries.
- Other forms may also be established on a commercial principle, i.e. commercial life assurance.

It is expected that the pension system will continue to contain two pillars: mandatory pension insurance financed on pay as you go basis and voluntary supplementary pension insurance run on fund principles.

The reform steps will necessarily have impact on the Czech Republic's fiscal system. In the mandatory part of pension insurance transformation costs will have to be dealt with. In the voluntary part of the system tax relief should work as a motivational tool, whether on the side of the insured or their employers as contributors.

The reform being prepared therefore requires extensive legislative adjustments in all parts of the system (substantive, financial and organizational management).

According to the experiences of OECD member states (/8/) the first step towards a pension reform would be a readjustment of key PAYG parameters. For example, the contemplated switch to inflation indexing might return the system to current balance by 2006 and result in slowly rising surpluses in subsequent years that would peak at 2 per cent of GDP in the mid-2020s. But, by itself, the corresponding decrease of replacement rates would not be socially sustainable for very long unless other forms retirement income became available rapidly. The logic of this approach, therefore, would be to establish a second pension pillar to provide additional retirement income over time as the PAYG system shrinks. Other approaches may also be considered, drawing on the range of reform models implemented in other OECD member countries.

The key feature of any sustainable system is that it provides appropriate incentives for older workers to remain in employment longer as their life expectancy increases. The Czech Republic has some margin of flexibility in ensuing pension reform insofar as privatisation receipts in the next few years would provide a financial buffer. But the essential point is that such margin be used to underpin a genuine reform, and not to finance temporarily a system that is unsustainable in the longer run.

2. Labour market adjustment

Potential risks and possible conflicts with social demands connected with the Czech Republics preparation for entry into the euro area are crated by relatively low degree of labour market adjustment.

For strengthening the adjustment mechanisms of the labour market the Ministry of Labour and Social Affairs of CR has identified the following as the key labour market issues (/4/):

- Limited offer of vacant jobs across the most of the Czech territory, with the most critical gaps existing within the Moravian-Silesian and Ústí Region that have been most seriously hit by the consequence of restructuring and scale-downs of the current core industries;
- Skills mismatch of the released labour force offer and demand (the structural unemployment);
- Set-up of the social benefit systems requirements, motivating people who prefer the social security income to the work income and providing insufficient incentives that would drive the people to change their life circumstances and adopt active solutions in seeking a new job and preventing their social exclusion;
- Insufficient resources of labour offices to handle the current scope and structure of unemployment and to implement the European Employment Strategy.

In coincidence with the EU Member Countries, the Czech employment policy is carried out following to the below key principles.

- Integration and co-ordination of the labour market policy (active employment policy) with policies of other types;
- Unemployment prevention and timely activation of all citizen;
- Employment policy implementation management and use of set targets;
- Progress and results monitoring and evaluation; and
- Reinforcing the roles of the other labour market actors and co-operation with them (social partners, regional and local partners and non-profit organisations).

From the labour market situation and the Czech accession to the EU a necessity follows to **write the mid-term objectives and long-term conception of the national employment policy** that shall:

- Recognise the principles and aims of the European Employment Strategy as expressed in the new generation of the Broad Employment Policy Guidelines, as well as the Lisbon process objectives;
- Set the national concept of the substantive and time scales to achieve the Lisbon process objective, while reflecting the Czech labour market situation and needs, until 2010; and

- Set the Government goals relating to the unemployment solution over its term in office, as its mid-term objective.
- In accordance with a decision of the European Council, the Ministry of Labour and Social Affairs of CR prepared **National Action Plan of Employment (2003) (/4/)** oriented to four pillars: improving employability, developing entrepreneurship and job creation, encouraging adaptability of business and their employees, strengthening equal opportunities policies for women and men.

The Government will continue its efforts **to improve employability of the labour force** through giving priority to active preventative measures on provision of social benefits that, without application of activation impulses, keep their recipients passive in many cases. The best approach to reducing long-term unemployment and young people unemployment is to provide support to the development of individual skills, knowledge and motivation for work and learning. The Government will further pursue modernisation of the Czech education system so that each school leaver attain such education as providing her or him with the best possible competencies to enter successfully the world of work.

The existence and creation of jobs is subject to competitiveness and success of businesses. The Government, in its proposed measures, has emphasised creation of conditions enabling setting up new enterprises, while providing conditions for the existent businesses to achieve continued growth and prosperity. The Government, in according with its Programme Declaration, will carry on the necessary structural reforms, including the public finance and tax policy reform. The Government expects that the income tax rate will be reduced, and harmonisation of the tax system with the EU regulation completed.

The employment policy focus on **the long-term unemployed** means, however, that the labour offices would reduce the scope of quality of their services for other clients. Efficient direct labour force procurement for employers (concerning the short-term unemployed for a larger part) promotes their prosperity and is also a prerequisite of the subsequent creation of new jobs for the long-term unemployed.

The business and finance policy priorities have been focused on enhancing performance and competitiveness of the economy. The Government has undertaken both in its Programme Declaration and agreements with the EU to continue implementation of structural reforms and privatisation, as a prerequisite to achieving an accelerated and long-term economic growth. The Czech accession to the EU is likely to increase the foreign investment inflow, and emergence of new competitive export capacities may be expected. However, following the EU accession, there

will be a still keener corporate-level pressure on increased performance, competitiveness and growing productivity of work, that will in fact result in a certain number of businesses going bankrupt or in terminated operation of some individual businesses.

Impacts of the above processes will translate, not just on a short time scale, into continuation of the current declining trend in employment. Hence, the emphasis of the employment policy will need to shift towards promoting improved employability as a prerequisite to "an efficient cleanup" of the labour market, while at the same time reducing high levels of long-term unemployment and focusing on prevention of social exclusion. **The fundamental requirement for the employment policy during the forthcoming period will be to seek politically acceptable solutions of consequences of the above structural changes.** The size of the envisaged drop in employment that will translate into the growth of unemployment will to a considerable degree depend on the steps adopted.

The capacity and willingness of both, employers and employees, **to respond to changes in the demand for goods and services are a prerequisite to the successful economy and, therefore, to a sufficient number of jobs.** This applies on the levels of the whole economy, separate industries and, most importantly, separate businesses. Strengthened co-operation on the business level is deemed a key driver to promote innovation and permanent adjustment process in each workplace. It is important at the same time to bring closer to the real life also legislative requirements that will ensure the space for bargaining between the social partners in addressing specific problems.

3. Concluding remarks

Public finances in the Czech Republic are the most critical part and a potential barrier to the entry into the euro area. Social and health care expenditures not only constitute the main share in general government expenditure, they also have the highest dynamics. The focus on fiscal consolidation according to the medium-term fiscal framework is on expenditure side. The envisaged expenditure savings should reach 70-80 per cent of total consolidation, 20-30 per cent should be reached by increased revenues. The development in the years 2004-2006 is marked by public finance reform which aims at reducing the general government deficit to 4 per cent of GDP in 2006 and to comply with the Maastricht fiscal criteria in 2008 at the latest (/2/).

The three major expenditure-side measures include cuts in wage expenses in public sector, cuts in discretionary spending of individual ministries, and reductions in sickness benefits. Those three measures constitute more than $\frac{3}{4}$ of all expenditure cuts. Savings in the public sectors' wage spendings are planned to be reached mostly through the reduction of the number of employees (annually by 2 per cent over the period 2004-2006). Cuts in discretionary spendings will concern mostly military expenditures, the state subsidy for housing savings programmes, subsidies to business and the operating costs of individual ministries.

Some additional savings should come from parametric changes in the pension system, including reductions in early-retirement pensions, minimal indexation of pension benefits and a further increase of the statutory retirement age. In a longer perspective, the negative impact of the Czech pension scheme on public finances should be avoided by the transformation of the currently defined-benefit to a defined-contribution system. The new (so called notional defined-contribution, NDC) system is preliminarily planned to be introduced in 2010. The reform also foresees cuts in social assistance and social care. Whereas cuts in discretionary expenditures will be more pronounced at the beginning of reform, from 2005 onwards, the focus should shift towards systematic measures.

Apart from fiscal policy, **labour market adjustment** seems to be the major issue of the Czech Republic's EMU accession strategy. To strengthen the adjustment mechanisms of the labour market, steps must be taken to increase the flexibility of the labour market and real wages not only in the institutional area but also in area such as transport infrastructure and the housing market.

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Vít Bárta*

Strategy of Accession to the EMU and Possible Difficulty with Fulfilling the Maastricht Inflation Criterion: the Czech View

In this paper we deal with two topics. Within the first (a descriptive) one, we present briefly the strategy of the Czech Republic towards euro. Within the second, we deal with a potential difficulty which accession countries might possibly face when attempting to meet the Maastricht inflation criterion. We suggest that if the Czech Republic (and also other accession countries) displays a similar inflation pattern as current EMU incumbents, the fulfilment of Maastricht convergence criteria (especially if they are strictly interpreted) might become quite costly. Should this represent an economic policy issue it may be worthwhile to start studying available policy options right now. As the second part of the paper does not provide a full-fledged answer to a given problem, it presents the issue in a structured way and indicates the ways in which the answer could be outlined.

1. Czech strategy towards euro

In October 2003 the Czech Government and CNB approved the joint document called „*The Czech Republic's Euro-area Accession Strategy*“. This document declares the intention of the Czech Republic to adopt euro possibly in 2009 or 2010, if some general economic conditions are reasonably fulfilled. These refer to an achievement of sufficient structural flexibility of the economy in general and of flexibility of labour market in particular and to a completion of fiscal consolidation respectively. These tasks are considered to be crucial because in both areas the Czech Republic seems to lag behind the majority of EU countries.

In addition, the Strategy declares that the inflation targeting is an appropriate monetary regime for current and future period and that it will be practised until very adoption of euro. It admits, however, that due to the necessity of fulfilling the Maastricht exchange rate criterion the inflation targeting regime will have to be adjusted accordingly. The Strategy also

* The author is an Advisor to the Bank Board Member in the Czech National Bank. The views expressed in Section 2 of this article are those of the author and should no be attributed to the CNB. All errors and omissions are exclusively the author's responsibility.

explains why an early entry to ERM II is not advisable. It suggests that the timing of the entry to the ERM II should be such as to minimise the length of stay in ERM II. The attitude of Czech policy-makers towards ERM II deserves a bit more detailed elaboration.

Although European Commission and European Central Bank consider the participation in ERM II as beneficial for the candidate country, Czech National Bank (CNB) like several other Central European banks is more doubtful. There are several reasons for this scepticism. First, with respect to the ability of ERM II to stabilise the exchange rate doubts arise due to the fact that the band $\pm 15\%$ does not seem to have any significant stabilisation potential. In addition, intra-marginal interventions by ECB will be unlikely and marginal interventions will not be guaranteed. Second, it is suggested that the ERM II may be beneficial for the stabilisation of inflation. But the combination of inflation targeting with ERM II framework may imply an emergence of a systemic conflict between two targets (inflation target vs. exchange rate target). The consequences of such conflict may thus resemble those recently witnessed in Hungary. It seems obvious that shadowing of the ERM II has had quite detrimental impacts on both policy-making (namely for its credibility) and on economic performance. Third, participation in ERM II is sometimes presented as a factor possibly accelerating a fiscal consolidation and structural reforms. However, if a government fails to implement necessary measures (while being in ERM II) this hesitation could provoke sudden reversals in capital flows or even speculative attacks against the commitment to maintain the exchange rate within the band. Instead of stabilising the exchange rate the ERM II may become clearly a destabilising factor.

All these arguments lead Czech policy-makers to believe that ERM II should be considered only as a gateway (or “waiting room”) to euro and that the length of stay in ERM II should confine to the shortest possible period (2 years). As mentioned above, entry to ERM II should be considered only when conditions for a smooth fulfilment of all Maastricht convergence criteria are met or, in other words, when the economy displays a sufficient flexibility in all crucial areas.

2. Could the fulfilment of the Maastricht inflation criterion be costly?

2.1. Is here any problem?

As compared to the majority of transition countries, inflation in the Czech Republic was relatively low throughout the most of transformation period. Consequently, a fulfilment of the Maastricht inflation criterion

(MIC) at some more or less distant future has never been considered as an issue both domestically and internationally. Concerns about the compliance with the Maastricht inflation criterion seem to be even less justified when looking at the inflation record during the most of 2003 when the economy happened to be at the verge of deflation. In such an “inflation-free” environment any attempt to analyse the circumstances of meeting the inflation criterion may seem to be somewhat perverse.

However, we are convinced that recent very low inflation is only a temporary phenomenon and is far from being sustainable over the medium run. The motivation for this statement is provided by existing inflation patterns among EMU countries. A brief inspection of the data shows that inflation differentials within EMU are relatively large and persistent and that countries with the highest inflation refer typically to catching up (“peripheral”) countries. As these less advanced EU incumbents still display some features that cause a relatively higher inflation it might be disputable to suppose that the EU accession countries, including the Czech Republic, will converge to the EU average inflation in a foreseeable future. It can be therefore assumed, that recently observed very low inflation in the Czech economy is only a temporary phenomenon and that the inflation pattern will converge to that which prevails in less advanced EMU economies. This implies that the fulfilment of the MIC by transition economies may not be so easy as it is often argued especially if Maastricht exchange rate criterion is applied strictly. A more detailed knowledge of potential costs would thus allow for a better understanding of policy options which policy-makers are likely going to face when attempting to meet Maastricht monetary criteria.

2.2. Inflation performance in EU countries during 1998-2003: stylised facts

Below (Table 1.) we present several facts about the inflation development in the EU in recent years. We focus on those features that are relevant for the level and the volatility of MIC. Thus we obtain a benchmark for assessing the assumed pattern of inflation in the Czech Republic in the period before adoption of euro.

The inspection of the data leads to the following observations. First, with a bit of simplification we can identify three groups of countries within Europe, low inflation countries (such as Germany, France, Great Britain), high inflation countries (such as Greece, Ireland, Portugal and possibly Spain) and the average inflation countries (Belgium, Italy, Luxembourg, Netherlands, Austria, Finland, Sweden, Denmark). While in low inflation countries, yearly inflation was never above 2% during 1998-2002, in high inflation countries the inflation was never below 2% (the only exception is Spain in 1998). In the group of average inflation countries, their inflation

was sometimes below sometimes above 2%. This implies a relatively narrow (and stable) set of countries whose inflation performance constituted a basis for a computation of MIC¹.

Table 1. Inflation in the EU countries during 1998-2003 (HICP, y-o-y changes)

	1998	1999	2000	2001	2002	2003f
EU-15	1,3	1,2	1,9	2,2	2,1	2,1
EU-12	1,2	1,1	2,1	2,4	2,3	
Belgium	0,9	1,1	2,7	2,4	1,6	1,5
Germany	0,6	0,6	1,4	1,9	1,3	1,1
Greece	4,5	2,1	2,9	3,7	3,9	3,4
Spain	1,8	2,2	3,5	2,8	3,6	3,1
France	0,7	0,6	1,8	1,8	1,9	2,0
Ireland	2,1	2,5	5,3	4,0	4,7	3,9
Italy	2,0	1,7	2,6	2,3	2,6	2,7
Luxemburg	1,0	1,0	3,8	2,4	2,1	
Netherlands	1,8	2,0	2,3	5,1	3,9	2,2
Austria	0,8	0,5	2,0	2,3	1,7	1,4
Portugal	2,2	2,2	2,8	4,4	3,7	3,1
Finnland	1,4	1,3	3,0	2,7	2,0	1,1
non-EMU countries						
Sweeden	1,0	0,6	1,3	2,7	2,0	3,1
Great Britain	1,6	1,3	0,8	1,2	1,3	2,8
Denmark	1,3	2,1	2,7	2,3	2,4	2,2
average of 3 countries with lowest inflation	0,7	0,6	1,2	1,6	1,4	1,2
Maastricht inflation criterion	2,2	2,1	2,7	3,1	2,9	2,7
EU-15 minus average 3 countries with lowest inflation	0,6	0,6	0,7	0,6	0,7	0,9

Source: Eurostat and own calculations.

¹ We are aware of the fact, that the precise definition of the MIC is based on 12 months averages recorded just before the examination rather than on yearly values as we suggest above. We have opted for our simplified approach in order to make the whole exposition more tractable. A more precise approach is unlikely to alter our conclusion.

German inflation served for this purpose in all 5 years, French and British inflation three times and Swedish and Austrian inflation two times. The level of MIC was thus typically determined by large economies through quite stable inflation performance.

Second, the basis for a computation of the MIC is so low that the difference between the average of three best performing countries and the average of the whole EU-15 “consumes” almost a half of the margin of 1,5 percentage points. This indicates that the Maastricht criterion is relatively demanding and that the margin of 1,5 percentage point is not particularly benevolent. This is confirmed by the fact, that even several current EU members would fail to comply with the MIC in recent years. Among the biggest “culprits” are Greece, Ireland and Portugal which would not pass the test for four times in last five years. Spain would miss the MIC three times as well as Netherlands. A similar result we obtain if we look at the average inflation of each individual country. The average inflation over the period 1998-2002 was higher than average MIC in Greece, Spain, Ireland, Netherlands and Portugal. This indicates an existence of some common features shared by less advanced economies which drives their inflation persistently above the level consistent with MIC.

Third, although the MIC is not a stable value its volatility is lower than the volatility of inflation of majority EU countries. This is far from being surprising as it is given by a very definition of MIC. However, this arithmetic may be quite unpleasant for accession countries. While the MIC has been varying between 2,1% in 1999 and 3,1% in 2001 (by 1 p.p.), in all accession countries the volatility was much higher. This was not only the case during the period under consideration but also between 2001 and 2002 when strong disinflation occurred.

To sum up, should the features which still characterise the inflation patterns in less advanced EU countries persist in the Czech Republic in next four or five years, the fulfilment of the MIC may become quite challenging. This is due to the level effect that tends to keep the inflation above the level required by MIC. Another difficulty may arise due to higher volatility of inflation in the Czech economy either due to the business cycle effects or due to a higher vulnerability of inflation to external shocks as is again suggested by the experience of less advanced EU countries. The MIC thus may seem to be more demanding than it is generally believed.

2.3. Factors of future inflation in the EMU accession countries

There are basically three groups of factors that could potentially cause the failure of EMU applicants to pass the test of MIC. We call these factors as level factors, business cycle factors and shocks respectively. The classification is intuitive and should be self-explanatory. The level factors

refer to those which are expected to persist over the long run, i.e. until the real convergence is basically achieved. On the other side, business cycle factors refer to those that evolve during the medium run: while inflationary pressures are expected to threaten during booms, they are expected to retrieve during recessions. Finally, inflationary shocks occur randomly and cannot be predicted. However, their impact on inflation may be crucial and could do a lot of harm to the real economy and complicate a policy-making focused on the elimination of the inflationary repercussions.

Level factors and Balassa-Samuelson effect

As indicated above, level factors are supposed to persist over the long run implying higher inflation (real exchange rate appreciation) in accession country as compared to EU (core) countries. In the economic literature the following factors were typically discussed:

- income and price level catch-up,
- Balassa-Samuelson effect,
- reduction in the difference in the cost of capital between transition countries vis-a-vis EU,
- wage and price rigidities (nominal downward wage stickiness),
- fiscal expansion,
- degree of competition in key domestic market.

Among those factors the prominent attention was directed towards Balassa-Samuelson effect (BSE) and its quantification. Although the theoretical framework of the BSE is relatively simple, its operationalisation is far more difficult. Therefore, different authors arrive to dramatically diverging results. This is largely due to poor quality of statistical data, differences in methodologies applied (a distinction between tradable and non-tradable goods and the evolution of this distinction over time) and also due to analysing different samples of countries.

It is interesting to note, that while earlier studies indicated a scope of the effect typically between 3-4%, more recent studies suggest more modest impact of productivity differentials on real appreciation (inflation differentials) typically in the range 1-2% for central European transition economies. Among these the BSE seems to be generally lower for the Czech Republic, Slovakia and Slovenia and relatively higher for Hungary and Poland.² Unfortunately, the empirical evidence remains largely indecisive.³

² Flek et al. (2002) suggests that the impact of Balassa-Samuelson effect on inflation (real exchange rate appreciation) in the Czech Republic is very small if not negligible.

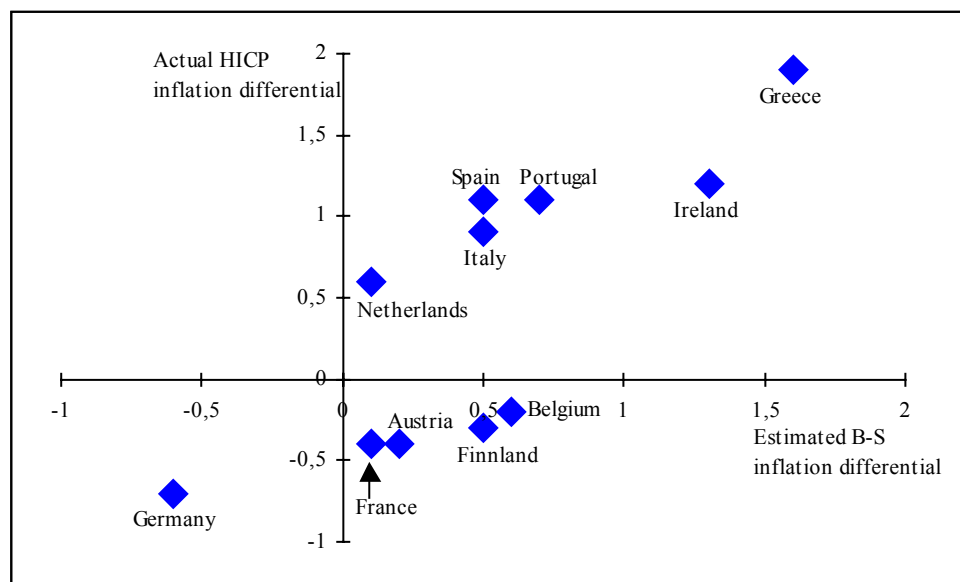
³ While the finding that the BSE may be relatively small for the Czech Republic is *per se* not especially encouraging, in one respect it is rather challenging. The smaller the scope of

Although the relative productivity performance of the Czech Republic since 1990 has been (according to several authors) quite disappointing, we assume that it will improve somewhat in the future and that catching-up process will become more rapid. This will be driven not only by entering the EU but also by an ongoing microeconomic restructuring fostered by constant inflow of FDI. This assumption is justified by the experience of Mediterranean countries which display the catching up in the long run.

Empirical evidence from EU

Recent study by ECB (2003) analysing the size, persistence and sources of inflation differentials in the Euro area also presents some results with respect to the Balassa-Samuelson effect in the EMU. It summarises the findings of several empirical studies that quantify the size of BSE and compares the implied inflation differentials due to the BSE with actual HICP inflation differentials between 1995-2002 (see Graph 1.).

Graph 1. Implied inflation differentials in the euro area average due to BSE compared with actual inflation differentials during 1995-2002



The study concludes that the actual inflation development is broadly consistent with estimates of BSE although the gap between actual inflation in a group of countries with relatively higher inflation (as compared with a

BSE can be identified, the higher proportion of relatively high real exchange rate appreciation thus remains unexplained in satisfactory manner.

group of countries with relatively lower inflation) is higher than what the BS estimates would imply. Indeed, BSE cannot be the only explanatory variable for inflation differentials as the examples of Belgium and Finland show. Similarly, the actual inflation in Netherlands requires another explanation than that offered by a Balassa-Samuleson framework.

The evidence supports the hypothesis that less advanced EU countries do converge towards the euro area average and that an important part of this catching up can be associated with the BSE. There is no reason to believe that Czech Republic (and accession countries) cannot replicate the same process. There are at least two reasons why the Czech economy might witness a better performance in a productivity area:

- Inflow of FDI to the Czech economy recorded since the end of last decade reached such a high level (in per capita terms) that justifies an assumption that supply side has been profoundly boosted recently. This can be indicated by an improving export performance and also by rapid growth in industry in last several months. While it would be a bit premature to judge (on the basis of this sketchy evidence) that we witness something like a “structural break”, we believe, that these developments indicate at least a possible improvement in productivity growth in the future.
- A forthcoming membership in the EU is likely to provide a boost for the economy. Although the impact will be less direct its basis will be of long run nature.

Business cycle factors

Recent experience with a volatility of inflation over the business cycle in the Czech economy is not particularly encouraging. Most of our inflation targets were “undershot” and the CNB spent a lot of time on careful explanation why it has happened and what factors were behind the development. We believe that the central bank played only a secondary role in the development of inflation and that mostly exogenous (external) factors accounted for the missing of the targets. The CNB thus provided the public with a plenty of evidence that its monetary policy is not really a powerful instrument for dealing with the inflation.

If the Czech inflation is more excessive on both sides than the MIC (which is certainly the case) the ability of the Czech monetary policy to curb this volatility will necessarily be constrained. Especially, an increase of inflation during the boom may require rather high nominal interest rates which may imply excessive appreciation of currency, loss of competitiveness of export oriented sector, high current account deficit and generally an emergence of macroeconomic imbalances. The very openness

of the economy thus constitutes a limited autonomy for monetary policy and namely an upper limit for the movements of nominal interest rates.

Would the monetary policy be strong enough to cope with inflation volatility over the business cycle? The above mentioned study by ECB (2003) about the inflation differentials in euro area finds out a positive relationship between measures of the relative cyclical positions of euro area countries and their relative inflation rates. It concludes that since the start of Stage Three of EMU in 1999, countries with above average inflation rates have experienced higher cumulative output growth than the euro area average and vice versa. However, the pattern is not universal. While a very high inflation in Ireland was predominantly driven by GDP growth and the output gap, the inflation in Greece seemed to be driven mainly by convergence effects rather than by business cycle effects. Nevertheless, above average inflation is typically accompanied by high wage growth and decline in unemployment although in some countries the low level of unemployment reflects the progress of structural reforms on the labour market.

To conclude, in addition to level factors (which operate on a sustained basis) the business cycle factors may further complicate the fulfilment of the Maastricht inflation criterion due to a higher volatility of inflation over the business cycle as compared to the very criterion. We suggest that coping with the inflation challenges might impose quite high costs in terms of lost output. The quantitative answer to this question could be obtained only through a set of model simulations of a given economy. This ambition is, however, beyond the intention of this paper.

2.4. Strategies of adopting the euro and policy options

We can basically discern two strategies towards the euro: fixed strategy and flexible strategy. In the case of fixed strategy the date of adoption would be stipulated (possibly long) in advance and all economic policies will be tuned accordingly (most likely irrespectively to costs incurred). On the other hand, under flexible strategy the conditions for meeting the Maastricht would be assessed on a continuous basis and the decision about the entry to EMU would be made when conditions are found to be favourable.⁴ The risks of a fixed strategy are that the costs of fulfilling the Maastricht criteria may unexpectedly become very high, especially if level- and business cycle factors coincide. By the same token, the loss of credibility could be rather painful if the country decides to retrieve from the commitment given to markets earlier and fails to adopt euro in a pre-

⁴ From reading the strategy of the Czech Republic towards euro, one is tempted to conclude that Czechs represent an in-between approach.

announced time. On the other hand, risks of flexible strategy consist in a fact that the commitment to adopt euro may seem to be somewhat loose. The strategy may lack the credibility and may not anchor expectations properly. This may be the case especially when dealing with exchange rate expectations.

A lot has been said in the literature about the content of the Maastricht convergence criteria and about the controversy they imply. We are not going to elaborate on that topic here. Rather we draw the attention to the ways in which these criteria could be fulfilled. We have two basic possibilities – either policy-makers would consider Maastricht criteria in their strict version and adjust policies accordingly, or they would attempt to “adjust” the very criteria. The strict interpretation of criteria leads to the following option. Either targeted values of Maastricht criteria are taken seriously and corresponding economic variables become a real focus of economic policies (we could call this as a “hard fulfilment”). Or, Maastricht criteria are still taken as granted but their fulfilment would be based on some kind of “cheating” (we could label such an approach as a “cheap fulfilment”).⁵ The adjustment of the very Maastricht criteria (possibly through a political process) would be driven by an intention to soften a possibly adverse impact on the real economy, should criteria be taken strictly (we could label this approach as a “soft fulfilment”). Again, two versions of “soft fulfilment” are possible. The first possibility would refer to a re-negotiation of some of the criteria (e.g. instead of 1,5 percentage point margin 2 percentage point margin could be allowed for). This version would be an explicit one and would require a derogation granted for in an *ex ante* manner. The second possibility might be based on a looser interpretation of criteria (e.g. a wider tolerance of the fluctuation band for the exchange rate). Such a version would be probably more implicit (less rule-oriented), more on an *ad hoc* basis and the tolerance would be gained in an *ex post* manner.⁶

Let us look at the available policy options if costs of “hard fulfilment” would appear to be “excessively” high. Indeed, a search for reasons would be required. Should the level factors be identified as a major reason of inflation, implementation of robust policies does not seem to be very wise.

⁵ „Cheap fulfilment“ could be attained in a number of ways. One of the methods of reaching the sufficiently low inflation could consist (for example) in a purposeful manipulation with indirect taxes just during the reference period.

⁶ A “flexible” assessment of the eligibility of a given country could take into account (for example) a “non-representative inflation performance” of some incumbent country (should this one be among those three countries whose inflation performance would be used for the calculation of the Maastricht inflation criterion). Another example of “creative accounting” might be an exclusion of “non-member” country from calculation of Maastricht inflation criterion.

As the level factors of inflation are likely to persist over the medium- and long run, attempts to diminish inflation by tighter policies would imply economic losses which could be politically rather costly. Any keen effort to comply with the Maastricht criterion during the reference period only must be considered as a bit futile if there are no obvious reason for keeping the “domestic” inflation on lower level even after entry to the EMU. A more reasonable and economy friendly option would contain an explicit softening of an existing Maastricht inflation reference value if the negotiation power of accession country proves to be sufficiently high. If, on the other side, business cycle factors are identified as major reason of “excessively” high costs of fulfilling the Maastricht, an advisable option would be a postponement of adoption of euro (“waiting for a better time”). Such an option would require that the country has a flexible strategy towards euro (see above) or, in other words, that it does not make any fixed commitment long before the actual adoption. If, however, the commitment exists it might be advisable to negotiate an explicit softening of inflation criterion. The justification could then be based on an unpleasant fact of a higher volatility of inflation in a candidate country as compared to MIC and also on a concern not to undermine the real convergence. In all cases, the option of “cheap fulfilment” is available but it would be a matter of taste of policy-makers (both in the EU and in the accession countries) whether they would prefer this approach. But there is probably not much what could be discussed about “cheap fulfilment” from the economic point of view.

3. Summary

If inflation patterns in new member countries of the EU follow those witnessed in less advanced EMU members, the fulfilment of the Maastricht monetary criteria may become more challenging than was perceived until recently. This could be even more the case if convergence criteria are interpreted strictly and “enforced” vigorously. Should the level factors of inflation persist over the medium- and long-run, the compliance with Maastricht criterion may be costly. The basic option is either an implementation of tight policies with negative implications for growth and real convergence (“hard fulfilment”) or negotiation with EU about softening of the criteria (“soft fulfilment”). Should the business cycle factors of inflation prevail, the postponement of adoption of euro should be considered. In any case, a flexible strategy towards adoption of euro would be advisable. Although such a strategy may fail to anchor (exchange rate) expectations properly, it may be useful for avoiding unnecessary (and unanticipated) costs related to the fulfilment of criteria. Fixed strategy

towards euro may become too binding under some circumstances. There are, however, the risks that a retreat from fixed commitments would have negative impact of the credibility of a given country. The latest development in Central European economies seems to indicate that their governments are generally aware of potential costs and risks related to the adoption of euro and embark on relatively conservative strategies. The Czech strategy towards euro is in line with this conservative approach.

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Fulfilment of the convergence criteria in the Slovak Republic

1. Introduction

The accession process of the Slovak Republic (SR) into the EU comes to the final stage. The negotiations on the financial conditions for the entry into the EU were closed on the summit in Copenhagen in December 2002. In April 2003, the treaty of the SR accession to the EU was signed in Athens, the integration of the SR into the EU was approved in referendum in May, and in the Slovak parliament in July of this year. The accession process will be completed by the ratification of the accession treaty in the parliaments of the EU member states.

Slovakia is joining the EU in May 2004, together with other nine countries. The current legislation of the EU does not include provision that would enable an opt-out statute towards the monetary union as is the case of Denmark and the United Kingdom. After the signature of the Maastricht Treaty (1992), every accession country has to accept all commitments resulting from this treaty including the future membership in the EMU as well, and obtains derogation for adopting the euro. For this reason, the question is not „whether“ but „when“ the SR will join the monetary union.

In order to join the EMU, realisation of an economic strategy aimed at the fulfilment of the Maastricht criteria is expected. In this way, the EMU becomes a subject with a share on determining the economic policy of the SR. Adopting the euro will probably be one of the basic objectives of the monetary policy of the National Bank of Slovakia (NBS). However, joining the Eurozone should come after the completion of reforms that have significant influence on meeting the Maastricht criteria and fulfilling consequent commitments of the Stability and Growth Pact.

In its programme declaration, the government of the SR has presented resolution to establish preconditions for meeting the nominal (Maastricht) convergence criteria by 2006. The NBS promotes the earliest possible accession to the EMU. This position results from the assessment of the actual state and perspective of the development in real and nominal convergence of the Slovak economy towards the EU economy, and from the

* Ass. Prof. dr. Jan Isa and Ivana Sikulova work at the Institute of Slovak and World Economy, Slovak Academy of Sciences, Bratislava.

assessment of various aspects of the EMU membership. A joint document of the Ministry of Finance of the SR and the NBS named *Strategy of the SR for Adoption of the Euro* was presented to be discussed in the public in May of this year. Today, it is considered as approved government strategy.

2. Convergence of the economies

While judging a readiness of the SR for entry into the EMU, it is necessary to consider not only nominal convergence represented by the Maastricht criteria, but also real and structural convergence. Real convergence means assessment of the economic performance and competitiveness of the economy and structural convergence involves assessment based on the criteria of the theories of optimal currency areas (OCA).

2.1. Interaction between the real, structural and nominal convergence

Although the Maastricht macroeconomic criteria and not the microeconomic criteria defined by the theories of OCA, are officially obligatory for joining the EMU (the only exception is the criterion on inflation accepted by both approaches), the OCA criteria are crucial. They are essential for a well operating monetary union and represent features of sound advanced market economies.

The scenario for forming the EMU has not included real convergence as a condition for entry into the Eurozone either. However, exactly real convergence is one of the main economic priorities of the candidate countries and a condition for a successful operating within the EU and EMU. The key problem of the accession countries is not the obligation to fulfil the Maastricht criteria, but growth of their economic performance within the Eurozone.

The EU economics and finance commissioner Pedro Solbes appeals to the candidate countries not to aim their economic policies at rapid entry (after the EU accession) into the Eurozone. On the contrary, continuing structural and economic reforms and strengthening competitiveness of their market economies should be the high priority for them. In addition, the governor of the ECB Jean Claude Trichet points out the need for a sustainable fulfilment of the nominal convergence criteria. The sustainability of nominal convergence itself presumes that sufficient preliminary progress was made towards real and structural convergence.

As the nominal and real criteria condition each other, they should be pursued in parallel, and are not antagonistic. They are desirable in term of a stable operating of the whole monetary union and in term of a smooth

operating of the individual members within the integration bloc as well. It is appropriate for the participants to perform the substantial part of the convergence process prior to entry into the monetary union. Thus, it is possible to solve their specific problems by means of the whole national policy framework. The Slovak economy has made progress regarding all three types of convergence mentioned above.

2.2. Real convergence of the SR economy to the EU economy

Real convergence of the SR to the EU may be understood as the approximation of the real parameters and conditions of the Slovak economy to those of the EU. Primarily, the differences in GDP per capita at purchasing power parity, in price levels and in labour productivity are monitored.

As for approximation of the level of GDP per capita at PPP and of the price level in the SR to the average level in the EU, the convergence process has not been balanced. During the period 1996-1998, the approximation was accomplished in an unsustainable way, namely by an excessive indebtedness abroad. It resulted in a short term divergence of both indicators. However, since 2000, the process of convergence reappeared and it is supposed to be the case in the next years as well. GDP per capita at PPP reached about 48% of the EU in 2002. On the basis of this indicator expressed in EUR the SR economy's performance in comparison with the EU economy has grown by one quarter over the past eight years, even despite stagnation in the years 1999 and 2000 connected primarily with slow GDP growth in Slovakia.

Catching up process in performance of the SR towards the EU can take place in two different ways, either through a faster real growth of the economy, mostly due to labour productivity growth, or through appreciation of the exchange rate of the SKK against EUR. Catching up in the labour productivity that equalled only about 50% of the EU average has been achieved by investments, including FDI, and by reducing overemployment. The real GDP growth in the SR exceeded the level of this indicator in the EU by more than 3% in 2002. Estimates for 2004 rank Slovakia in terms of growth rate (3,9%) in the fourth place among all candidate countries. A faster rate of growth is expected only in the Baltic States.

The second way of catching up in performance of the economy means appreciation of the real exchange rate and equalizing price levels. Approximation of price levels has been based first of all on a faster growth of prices in the SR in comparison with the EU over the past years. Despite the increasing inflation differential between the SR and the EU, Slovakia still enjoys the lowest price level in comparison with other candidate countries. One of the reasons is backwardness in price deregulation in

previous years. The convergence of price levels seems to be most appropriate prior to entry into the EMU. Additional adjustments of the administratively regulated prices after joining the Eurozone could have proinflationary effects.

While equalising price level in Slovakia reached about 41% of the EU level at present, it is necessary to consider the wage growth as well. This should not be faster than the labour productivity growth. If it were not the case, creating inflation pressures due to cost growth would take place.

2.3. Structural convergence

The evaluation of the structural convergence is based on the criteria of the OCA theories. Their basic idea is that for countries or areas exposed to symmetric shocks or having a mechanism for absorption of the asymmetric shocks, the adoption of a single currency is an optimal solution. The OCA theory defines such criteria as degree of openness of the economy, similarity of the shocks and business cycles, product diversification, labour force mobility, fiscal transfers. The stronger are the ties between countries within a single currency area, the higher profit their participation in a monetary union will bring.

In contrast with the EU and/or the EMU, the SR is a small open economy. On the ground of the territorial structure of its foreign trade, Slovakia would even fall into the Eurozone much more than some present EU members, including some EMU members. In 2002, about 60,5% of the Slovak exports was addressed to the EU and another more than 28% to the CEFTA members, thus to the future EU members. The share of the EU on the SR imports reached 50,3% and the share of CEFTA equalled about 23%.

Concerning convergence of business cycles, higher convergence of the SR to the EU and/or the EMU was achieved during the period 1993-1997. Between 1998-1999, a moderate divergence of the business cycles, caused mostly by structural transition of the Slovak economy, started. A high volume of reciprocal trade is able to accelerate synchronisation of the SR business cycle with that of the Eurozone as a whole, but only providing a prevailing share of intra-sector trade. On the other side, a higher specialisation of economies could lead to divergence of business cycles.

The similarity in the structure of the foreign trade by commodity indicates structural convergence of the SR to the EU and EMU. However, labour force mobility is not sufficient. In addition, it will be restricted by Germany and Austria during a transition period after the accession to the EU. To conclude, in respect to the overall structure of the economy, the SR has advanced towards the Western Europe over the recent period, and despite some differences, the expectancy of asymmetric shocks has fallen slightly.

3. Nominal convergence

In the last year, Slovakia met three out of five Maastricht criteria, namely the criterion on public debt, long-term interest rates and criterion on exchange rate stability. On the other hand, the criteria on inflation and budget deficit were not fulfilled. As for this year, the overall fulfilment of the nominal convergence criteria is not going to change. However, the governor of the NBS, Marian Jusko, finds the development in 2003 positive, as it brings favourable trends towards the future.

3.1. Fiscal criteria and consolidation of public finances

Meeting the fiscal criteria (budget deficit and state debt) is likely to be the most demanding task of the convergence process (as well as in the most EU member countries before establishing the monetary union). These two parameters had never been so high in the past but decrease of their ratio to GDP is expected.

Budget deficit

It is difficult to assess the fulfilment of the budget deficit criterion. The main reason is that the „fiscal processes“ over the last years were considerably influenced by extensive extraordinary (occasionally) expenditures and revenues. The most important fiscal items of this type include privatisation revenues, payment of privatisation bonds, cost of industry and bank restructuring, payments for government guarantees and transfers into state funds. With respect to the huge volume of these operations, using various accounting methods leads to significantly different results.

Government Financial Statistics (GFS) of the International Monetary Fund used in Slovakia in the past showed out lower deficit than ESA 95 (European System of National Accounts) – approach based on the national accounts – in the years 1999 and 2000. Despite the inaccuracies of data and considerable differences between the GFS and the ESA 95 approach, both methodologies show out similar development trends of fiscal deficit over the last years. The fiscal deficit reached 7,2% in 2002 what calls for fast fundamental reforms. The deficit is expected to fall to 5% in this year and to 3,9% in 2004.

The planned decrease of the fiscal deficit to 3% by 2006 will be an extraordinarily demanding task for Slovakia. It should be stressed, that the most EU member states needed longer period to meet the fiscal criteria. In addition, they have done it under much more favourable internal conditions (well operating market economies) and during more favourable phase of the world business cycle.

It needs to be highlighted, that the main problem of the fiscal policy does not subsist in fulfilling the fiscal criteria prior to the EMU accession, but in creating conditions for sustainable development of the public finances with respect to the strict requirements of the Stability and Growth Pact. Decreasing of the budget deficit to the level required by the Maastricht criteria not endangering real convergence will be obviously a decisive factor determining the time horizon of the entry of Slovakia into the EMU. It should be reminded, that the privatisation, one-shot and non-recurring revenues oriented on the reduction of the budget deficit and government debt have only a supporting, not systematic character.

Public debt

One of the Maastricht criteria presently met by Slovakia is the ratio of the public debt to GDP. However, it is mainly a merit of a very low level of the state debt prior to beginning of the transition process. But this state has worsened relatively quickly. The ratio of the gross public debt to GDP increased from 32% in 1999 to 43% in the end of 2001 and it has reached 44,3% at present. This level of public debt does not allow its further growth. If it were the case, the condition of sustainability of indebtedness would be broken.

Consolidation of public finances

The consolidation process of the public finances represents a key issue in the accession process towards the EMU. The high fiscal deficits are caused by the costs of structural reforms on one hand and in particular by their slow and inconsistent realisation on the other hand. The improvement in fulfilling the fiscal criteria is conditioned by completion of the reforms needed for a sustainability of the public finances and by a sound assessment of the reform's costs. These are likely to have a backward impact on meeting the convergence criteria. For example, the reform of the public finances system connected with the pension reform, tax reform, health service reform and education system reform can create a pressure on the budget deficit and endanger the meeting of the criterion on the public debt and the interest rates criterion as well. While implementing reforms, it is necessary to consider, whether it is possible to cover the relevant costs by privatisation gains, savings, indebtedness or by higher taxes.

The International Monetary Fund (IMF) finds the three key reforms of the Slovak government – the tax reform, the pension reform and the health service reform - to be proper steps towards supporting the Slovak economy in a medium term. The IMF considers the pension reform to be essential and the current pension system to be unsustainable. However, according to the IMF, implementation of the capitalisation pillar may endanger the budget

stability. A too large transfer of the allowances from the Social Insurance Office to the second pillar will almost definitely hinder meeting the Maastricht criteria as early as in 2006.

The Ministry of Finance of the SR insist on its position, that the costs of the pension reform should not exceed 1% of GDP (approximately 11 bln. SKK). To the contrary, exceeding this level would imply a postponement of the entry into the Eurozone. For this reason, the transfer of the disability insurance and annuity assurance into the private sector for the contributors into the second pillar has been delayed. The new law on pension savings should enter into force early in 2004 and the new way of saving pensions should come into operation on 1st January 2005.

At present, it is also very difficult to assess the impact of the tax reform on the state budget. This reform includes more transparent and simpler tax laws, removal of the tax burden from the direct taxes to the indirect ones (value added tax, consumer taxes) and a single tax rate amounting to 19% (individual income tax, legal entity income tax, value added tax). The tax reform will result in the reduction of the direct taxes balance. Considering the intention of the government to satisfy the Maastricht criterion on the budget deficit in 2006, the fiscal neutrality of the tax reform is of an elementary condition. The designed adjustments of the various taxes are conditional with each other. The revenue gap resulting from the implementation of the single individual income tax and legal entity income tax has to be compensated by increase of the revenues from other taxes, mainly from the value added tax and consumer taxes. Although the tax reform is fiscally neutral, the new structure of the tax framework will be much more efficient for the economy. It will have a beneficial impact on the business environment, investments and on the economic growth.

With reference to the tax reform, the IMF draws attention to the too high speed of introducing amendments, which can bring unpredictable effects. According to the IMF, it is not possible to predict exactly neither the impact of the reform on the level of the tax revenues nor the response of the taxpayers. It is necessary to warn of the individual income tax revenues. While forecasting the impact of the tax reform on the revenues from this tax, several significant factors are used, that are difficult to evaluate with a sufficient certainty. In consequence, there is a risk that the gap in the revenues caused by the tax reform can be much bigger than expected. However, this uncertainty can be resolved only during 2004.

3.2. Monetary criteria and adaptation of the monetary policy of the NBS

The are several factors taken into account in the process of shaping the monetary policy.

Inflation

Inflation is one of the criteria Slovakia does not currently fulfil. Although the average inflation rate had been decreasing until 1996 after the price explosion during the first years of the transition process (mainly in 1991 and 1993), it came to a reverse movement and the consumer price index began to move off the reference value.

Difference between the growth of consumer prices in Slovakia and reference value in the EU had risen during the period 1997 – 2000. Inflation rate fell considerably in the years 2001 and 2002. However, price of this decrease was deceleration of the deregulation process. It resulted in the need of correcting distortions by the new government. Consequently, a considerable growth of inflation is expected in the years 2003 and 2004 (according to the prognosis, in 2004, the average annual inflation rate should reach 7,5%). Thus, the inflation rate will be much higher than the reference value.

While assessing inflation development (and forecasting it as well), it should be taken into consideration, that the monetary policy of the NBS is able to influence only the core or net inflation. However, it is not able to influence development of the regulated prices and indirect taxes. Already for a long time, the inflation in Slovakia depends on the adjustments of the regulated prices and indirect taxes and on the development of the prices of strategic raw materials on the world market, especially on oil prices, rather than on the monetary policy of the NBS. Since the start of the transition process, the share of these factors has represented approximately four fifths of the price increase. The core inflation has imposed only one fifth of the price growth since 1990 and it reaches a level of the reference value for the inflation criterion at present. The difference between the total inflation and the core one is expected to start decreasing since 2005. Hence, the total inflation will approach the reference value in the EMU.

The NBS intends to fulfil the Maastricht criterion on inflation in 2006 or 2007. Obviously, the government and the NBS should synchronize their anti-inflation strategy, that should not be based on the postponement of the deregulation of the administrative prices (on the contrary, a definite schedule for deregulation should be negotiated) and on the restrictive monetary policy impeding the economic growth.

Long-term interest rates

By that time, it is difficult to evaluate the criterion on the long-term interest rates for the government bonds. The problem of assessing this criterion in Slovakia consists in the fact, that the SR emitted the ten year government bonds in 2000 for the very first time and than in 2001. The interest rates of these bonds (above 8%) exceeded the Maastricht criterion (7,4% in 2000).

But the long-term interest rates are falling gradually. This is due to the reduction of the risk premium, inflation and interest rates in the domestic and foreign market. A very important role is played by the long-term expectations associated with the assumed convergence (decrease) of inflation and interest rates in context of the integration process. According to the trend of the interest rates, this criterion can be considered as fulfilable.

Exchange rate

The exchange rate of the Slovak crown had been relatively stable for a long time. While operating the fixed exchange rate regime, it means till October 1998, the exchange rate fluctuations were only moderate, except for the short period prior to the conversion of the exchange rate regime. However, the stability had been maintained unnaturally and had imposed an adverse development of the balance of payments between 1996 and 1998 and also a substantial reduction of the foreign currency reserves in 1997 and 1998.

After the conversion from the fixed exchange rate regime to the flexible one (managed floating with no preannounced paths for the exchange rate), the fluctuations were higher, however, the exchange rate of the SKK against the EUR moved mainly within a band $\pm 3\%$. These relatively small fluctuations were ensured by the interventions of the NBS and by the changes of the interest rates as well. The real processes in the economy and the expectations have imposed appreciative pressures on the SKK since the end of 2002. In this case, an important role is played by the accession of the SR to the EU and to the EMU and by the expected growth of the foreign direct investments (FDI) that are likely to contribute to the growth of the labour productivity and of the competitiveness of the Slovak exports.

Regarding the relative stability of the exchange rate of the SKK over the last years, this criterion can be also considered as fulfilable. However, after the statement of Pedro Solbes, who admits a possible narrowing of the fluctuation band of the exchange rate deviation for the currencies participating in the ERM II to the level of $\pm 2,25\%$, meeting this criterion is under question. According to the governor of the NBS Marian Jusko, Solbes had in mind only the depreciation of the currency that could reach

a maximum of 2,25%. As regards appreciation, the primary range should remain unchanged.

It should be reminded, that a very tight fluctuation band considerably contributed to the crisis of the original EMS due to facilitating the speculative attacks on the currencies of the EMS members. This could be a danger for the present ERM II members as well. However, a bigger problem subsists in the possible complications connected with the searching for a balanced exchange rate for the conversion ratio of a currency when using the narrow fluctuation band.

Adaptation of the monetary policy of the National Bank of Slovakia

The monetary policy belongs to the key fields of the integration process of Slovakia into the EMU. It performs a stabilisation function within the economic policy and in coordination with other policies, it provides assistance in meeting the Maastricht criteria.

The monetary policy aimed at the price stability is not assumed to be exposed to shocks caused by the privatisation revenues in 2003 (as was the case in 2002), because it comes to a considerable slowdown or completion of the privatisation. However, the monetary policy can be highly exposed to the pressures on the appreciation of the currency due to the inflow of FDI. The inflation will be significantly influenced by increase of the regulated prices in 2003.

According to the monetary programme of the NBS for 2003, the year-end inflation within 7,7-9,7% interval is assumed. It corresponds to the average inflation between 8,2-9,3%. The core inflation should fluctuate within a band 2,7-5% and the net inflation should reach a level between 2,9-4,5%. The monetary policy is pursued in more favourable external conditions (improvement of the balance of trade) in 2003. The better coordination of the monetary policy and fiscal policy should also bring a positive effect. However, the pursuance of the monetary programme can be complicated by following risks:

- pressures on the exchange rate appreciation that would not respond to the performance of the real economy without the adequate corrections of the NBS,
- slower economic growth in our trade partners,
- volatile oil price development breaking outside the OPEC reference range.

As for the NBS, one can state that it has achieved a great advance in the institutional conversion and in the transformation of the monetary and exchange rate policy towards the monetary union as well, mainly after the acceptance of the new bill on the NBS. First of all, it regulates the monetary

policy instruments of the NBS, which include all key instruments used by the Eurosystem at present. The transition to the qualitative management based on the prime interest rates should be especially appreciated. The prime interest rates of the NBS stand at 6,25% at present, after they were reduced in the end of September of 2003 in order to prevent inflows of speculative capital. It is evident, that taking only the readiness of the NBS for the accession to the EMU into consideration, this could take place very fast. Unfortunately, the readiness in other fields is not so ideal at all.

Assessment of meeting the Maastricht criteria indicates Slovakia could, providing a successful completion of the necessary reforms, gradually approach the best performing candidate countries and thereby the EMU as well. The exchange rate of the SKK is developing clearly positive. The development of the public debt is so far positive as well, however, it can be endangered by the budget deficit. Fulfilment of the inflation criterion complicated by the necessary deregulation of the administratively regulated prices, by adjustments of the indirect taxes and by the need for a gradual approach of the price and wage level towards the EU will be difficult. Indeed, the most demanding task will be (as well as in other Visegrad countries) the reduction of the budget deficit reaching much higher level than is the reference Maastricht value at present.

4. Strategy of the accession to the EMU

Present discussions on possible strategies of the accession to the EMU concentrate on seeking for most favourable time for adopting the euro.

4.1. Views on timing of the entry into the EMU

Views on the speed of entry can be divided into two basic groups. Of course, within them, perception of various partial issues is different. The first group of economists and politicians prefers targeting for the earliest possible entry into the monetary union. This strategy should be opted when dominant opinion is that the benefits from early entry into the EMU will considerably exceed the costs. The second strategy, sometimes called “wait and see“ strategy (L. Balcerowicz) or slow lane variant, should be opted if the view prevails that emphasis on the earliest possible meeting the convergence criteria would be associated with exceedingly high adoption costs or even with the deceleration of real convergence.

Economists and politicians concentrating explicitly on the time horizon of the entry when analysing strategy of the accession process are characterized by certain apriority. For them, the speed of country's entry into the monetary union is the most important issue, while other points

(sustainability and stability of growth, real convergence, evaluating optimal conversion ratio and so on) go into background.

The strategy of a rapid or slow entry but not an optimal strategy is being often discussed. However, in reference to speed of the accession process, the term „optimal“ is relative. What is optimal for one country (for example the earliest possible entry) does not have to be optimal for another one for which a slower lane could be more suitable.

When discussing strategy of the accession process, it has been generally forgotten that we have two instructive (even though rather different) examples from recent past available. On the strength of them, effects of the fast and slow „lane“ can be evaluated. On one side, there is a negative example of the German monetary integration in the early nineties. The German monetary union was established during the shortest possible period regardless the state of real and nominal convergence. Obviously, one of the main mistakes was incorrect evaluation of conversion ratio that was indeed advantageous for citizens of the former East Germany. But for the East German economy, it was word for word a catastrophe. To these days, the German economy has not recovered from it.

Recent good timed process of establishing the Economic and monetary union is an opposed and rather successful example of monetary integration. It indeed has not taken place in an ideal way, but its effects are stimulant so far. (By the way, some economists consider just Germany to be a weak part of the EMU). According to the actual debates on strategy of the accession process, we do not find the strategy of the earliest possible entry of the SR into the EMU as optimal for several reasons. We consider following two factors to be crucial:

- huge risk associated with an accelerated fulfilment of the fiscal criteria that would not lead to the necessary macroeconomic stabilisation of the economy, and considering tightened requirements of the Stability and Growth Pact for the EMU members, it would imperil the process of real convergence. In such case, the monetary union would be a restraint for Slovakia rather than growth stabiliser and accelerator,
- need for a sufficient time interval for reaching necessary nominal convergence and seeking for a balanced exchange rate of the SKK that would be basis for an optimal conversion ratio when entering into the EMU.

Obviously, attention of the accession countries (including the SR) should aim at seeking for own optimal strategy that could differ in single countries in accordance with concrete conditions – it could be closer to the fast lane variant in some countries or to the slow lane variant in another ones.

4.2. Approved government strategy of adopting the euro in the SR

In accordance with the Programme Declaration of the Government of the SR, a joint document of the Ministry of Finance of the SR and the NBS named Strategy of the SR for Adoption of the Euro was presented at the government negotiation in summer of this year. A public discussion on this document was realised among experts and laymen as well. As regards the date of adopting the euro, the public is not uniform. Some people incline to the “sooner” strategy, and some prefer later accession to the monetary union.

After the public discussion, the strategy was discussed in the Slovak government as well. The joint declaration of the government of the SR and the NBS on accession process of Slovakia to the Eurozone comprises conclusion of this discussion. It is stated in the declaration that the SR should adopt the euro in the earliest possible term after fulfilling the Maastricht criteria in a sustainable way. At present, the government prepares and gradually approves reforms in several key fields. However, the final form of these reforms including their impacts on public finances will be known in the course of the next year.

The Slovak government has required the Minister of Finance to present, in cooperation with the NBS, a concretisation of the strategy at the government negotiation in the first half-year of 2004. It should include evaluation of the results of the realised reforms regarding the competence of the SR to meet the Maastricht criteria in a sustainable way. It is supposed that Slovakia will indicate its position on the entry date of the SR to the ERM II not before presentation of this document.

5. Conclusion

The preparation of the SR for joining the Eurozone requires realisation of substantial reforms that are essential regardless of the integration into the European structures. While the banking sector reform and important institutional changes have been successfully accomplished, the reforms of the enterprise sector, health service, education system and social welfare system lag behind. It results in an inefficient exploitation of resources from the tax revenues and in a permanent pressure on the public finance system.

The year 2003 means a beginning of the fundamental economic reforms for Slovakia. The realisation of the accession strategy to the EMU requires a close coordination of the government and NBS performance, mostly in regard to harmonisation of the fiscal and monetary policy. With respect to the fulfilment of the Maastricht criteria, the sustainable reduction of the budget deficit and decrease of inflation without its restraint is

required. The social consensus regarding the necessary reforms will be one of the preconditions for a successful realisation of the strategy. These reforms will result in qualitative changes in the Slovak economy.

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Slovakia on the road to EMU

1. Introduction

The process of integration of the Slovak Republic into the Economic and Monetary Union (EMU) has become a priority and it is not an option but a must, since the new member states, including Slovakia, have not been accepted for the, so-called, opt-out clause. The only question remaining is the time perspective of the entry into the EMU, which is not explicitly determined.

The National Bank of Slovakia repeatedly declared its support for entry into the euro area on the earliest possible date. The Slovak government expressed its determination to create the conditions for achieving the Maastricht criteria by 2006. The rationale behind it is that a full advantage of the benefits coming along with the integration process can only be taken at its final stage – inside the monetary union. On the other hand, there are some critical statements regarding risks and expected negative impact of monetary union in case of early entry into the EMU.

In the light of **the theory of optimum currency areas (OCA)** two countries form an optimum currency area if the costs (negative impacts) of a common currency are lower than the benefits of the common currency. The adoption of a single currency can eliminate the exchange rate risk, reduce the transaction costs, increase the market transparency in the terms of prices, protection against external shocks, having positive effect on the inflow of FDI. In general, there will be increased pressure for the standardisation of domestic economic policy measures and reforms. In addition, the stability of business conditions will be increased. As regards the costs, the most frequently mentioned disadvantages are the loss of the freedom to pursue an independent monetary policy.

The current approaches to the theory of OCA emphasize that if the economy exhibits a sufficient ability to adjust itself to respond to a negative impact of a common currency then a shock occurs. Then, the chances of a monetary union to become successful are greater. The costs of **asymmetric shocks** are lower if the flexibility of the economy and economic processes is higher.

* Dr. Eva Muchová is an Associated Professor at University of Economics in Bratislava.

The flexibility of response to asymmetric shocks in the economy of Slovakia is limited, whether it be the labour market responses or potential fiscal policy responses. It is expected that it may leave small room for manoeuvre. It is therefore important to reduce the occurrence of asymmetric shocks, or to promote processes for synchronising them. Naturally there are fears that a single monetary policy will not be able to respond to the specific needs of the Slovak economy and other candidate economies as well.

2. Real vs. nominal convergence

The process of convergence is defined as a phenomenon that has two complementary and interdependent sides – real and nominal one. **Real convergence** and integration with the EU and candidate countries' economies and higher flexibility of the economy are the two ways how to stabilise the Slovak economy in the event of asymmetric shocks after losing the possibility to use the exchange rate for stabilisation purposes. Preparation for Slovakia's entry into EMU is in fact a programme for the standardisation of economic parameters in line with the conditions of open international competition. It is important to compare the status and the dynamics of development of the Slovak economy with the economies of the current EMU members prior to their entry into the euro area, as well as of the present candidate countries.

The traditional approach to the mutual relationship between nominal and real convergence is based on the assumption that higher real growth may be achieved only at the cost of higher inflation and fiscal deficit. However, sometimes it is argued that this assumption is unfounded. Nominal convergence creates conditions for making a successful headway in real convergence provided it is based on thoroughly prepared and realised reforms, taking place at an appropriate rate. **Real convergence** is usually based on an evaluation of the approximation of the economy's performance to the EU economy's performance as GDP per capita at purchasing power parity, GDP growth rate in comparison with EU, rates of growth of real productivity and wages. **Nominal convergence** is assessed by five specific criteria included in the protocol to Maastricht Treaty.

One of the Slovak Republic's pre-accession economic programme agreed to with the European Commission is to boost its per capita income, measured on a purchasing power parity basis, to at least one-half of the EU average. Per capita income converged towards the EU average during the years immediately following independence, however the stabilization policies introduced in 1998 temporarily reversed the convergence trend.

The under-utilisation of labour and low labour productivity are major constraints to faster growth and a more rapid catch-up. Increasing labour productivity is also essential for higher wages. The level of GDP per capita in Slovakia (on a purchasing power parity basis) is 48% of the EU average, while labour productivity is 43%. In its medium-term economic programme, the government has targeted a per capita income of between 50 and 55 per cent of that in the EU by the time of accession. OECD calculations (Table 1.) suggest that, if the unemployment were reduced by about 2 percentage points per year over the period 2003 to 2010, with productivity growth remaining at that recorded in 2000, per capita income would reach 66% of that in the European Union by the end of decade.

Table 1. Convergence with the European Union* (in %)

Year	Unemployment rate		Labour productivity growth		Real GDP growth		Relative per capita GDP (Slovakia/EU)		Relative labour productivity (Slovakia/EU)	
	A	B	A	B	A	B	A	B	A	B
2000	19	19	4	4	2	2	48	48	43	43
2001	19	19	3	3	3	3	49	49	43	43
2002	19	19	3	3	4	4	49	49	44	44
2004	19	15	3	4	4	7	50	54	45	46
2006	19	12	3	4	4	6	51	58	45	48
2008	19	10	3	4	4	6	51	61	46	50
2010	19	6	3	4	4	7	52	66	47	52

Source: OECD

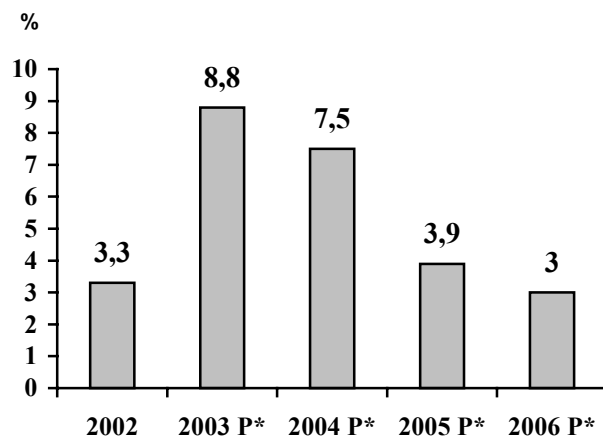
* Calculations are based on steady state assumptions for all variables other than the ones examined. In Slovakia, total population growth is assumed to be 0,2 and working-age population growth to be 0.9. In the EU, total population is assumed to be constant. Column A assumes an unchanged unemployment rate and productivity growth. Column B assumes a declining unemployment rate and higher productivity growth.

3. Nominal Maastricht criteria

Slovakia, as a country seeking the accession to the EMU, is first required to join the European Monetary System (ERM II). As a member of ERM II, it must meet the convergence criteria established in the Maastricht Treaty. It is necessary to bear them in mind as definite indicators of healthy macro-economic bases of an economy. At present, the distance between the inflation of the transition economies and the EU average is still large and difficult to reduce. The analysts agree that new candidates need to achieve

price stability prior to pegging their currencies to the euro. For this reason, they are advised to rely on internal means of achieving price stability through autonomous monetary policies with relatively flexible exchange rates rather than by rushing to the euro-peg. The switch to euro-peg has to be gradual, and only after achieving price stability.

Figure 1. Inflation

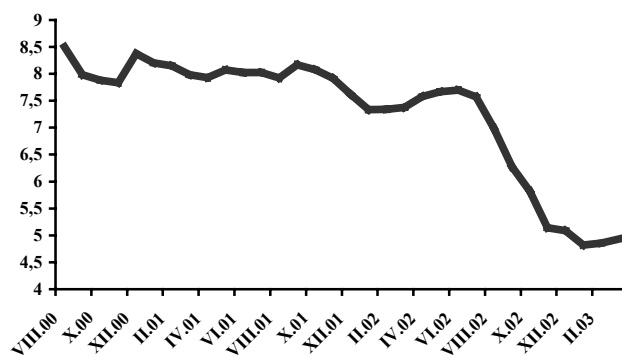


* Average for the interval

** January 2003

The lowering of inflation in the Slovak Republic depends on the extent of administrative price adjustments and the scale of changes in indirect taxes. These measures are considered to play a dominant role in the price development. Since the beginning of transformation, they accounted for about 80% of price growth.

Figure 2. Long term interest rates*



* Yield to maturity on 10-year government bonds (issue no. 133).

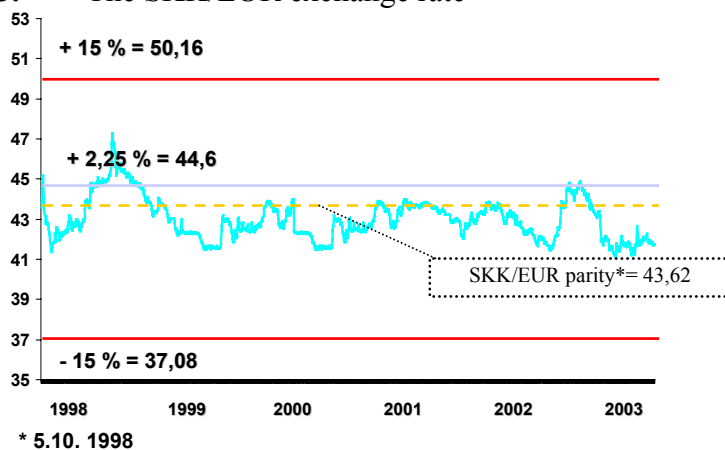
Long term interest rates on government bonds decrease gradually due to decline in risk premium, falling inflation and interest rates on domestic and foreign markets. It is obvious that the long-term expectations of future convergence in inflation and interest rates in connection with EMU are vital.

4. Exchange rate

In the immediate future, the intention of monetary policy in Slovakia is to eliminate adequately the spreading of inflationary impulses from the deregulation of prices. In the medium-term, monetary policy will be increasingly supported by inflation targeting, qualitative performance of monetary policy (management by means of interest rates) reduction of interest rates and gradual stabilisation of the nominal exchange rate against the euro. The long-term goal of monetary policy is stabilisation of the nominal exchange rate against the euro and gradual reduction of interest rates.¹

Participation in the European Exchange Rate Mechanism means approaching a long-term sustainable level of the real exchange rate. In the conditions of Slovakia this means completing the reform of relative prices and approaching the price and wage levels of the countries of the EU, and so a higher level of inflation in the medium-term period. In addition, the transition economies rank among the small open economies, so that they cannot lose sight of the importance of competitiveness, which they can correct with the help of the exchange rate.

Figure 3. The SKK/EUR exchange rate



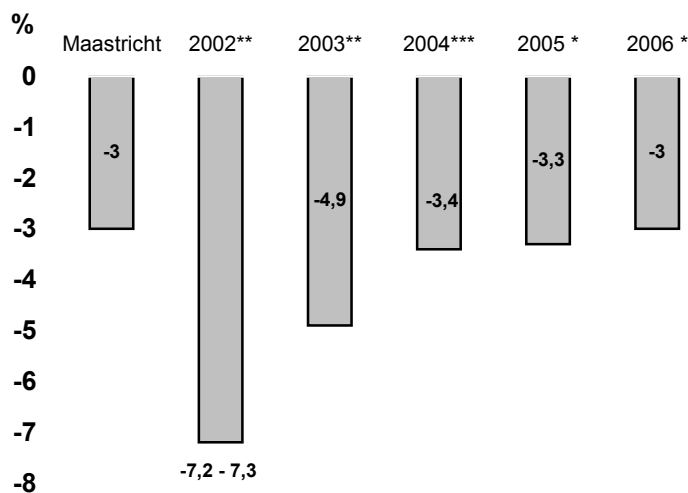
¹ Introduction of the euro was firstly reflected in a decision of the Bank Board of the NBS from May 1998, which announced that in the currency basket of the SKK, the DEM would be replaced by the EUR since 1st January 1999.

Compliance with the monetary convergence criteria involves a certain conflict with the need for real convergence. On the one hand, it is necessary to reduce the inflation rate to the level of the EU countries (price stability criterion), which will enable reduction of the interest rate differential and convergence of long-term interest rates. On the other hand, entry to the ERM II requires that a country reach a level of real exchange rate close to its equilibrium level, so that it will be able to fix the nominal exchange rate and maintain it (within the fluctuation band) without generating macro-economic imbalances. This stipulates correction of relative prices, approximation to the level of prices and wages in the EU countries, which will bring a higher inflation.

5. Fiscal deficit and debt

The current situation indicates that fiscal deficit and public debt are in a downward trend. To fulfil the objective to reduce the fiscal deficit below 3% of GDP by 2006 will require public finance consolidation and reform, effective reform of education and health care systems as well.

Figure 4. Fiscal deficit



* according to the State budget for 2003 (ESA 95)

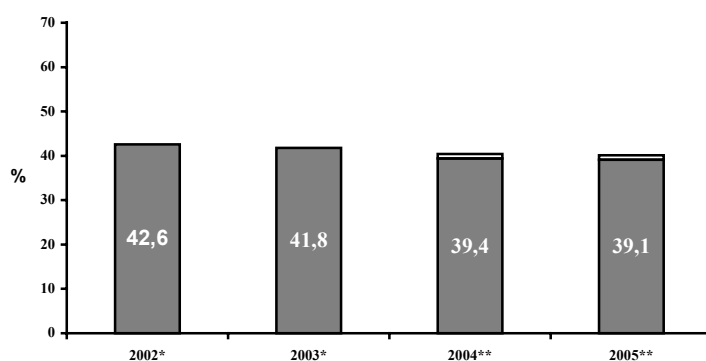
** preliminary data

*** draft assumptions for the State budget for 2004

The process of budget consolidation should be concentrated into the shortest possible period of time (four years at most). On the other hand, public spending cuts can increase unemployment and retard economic growth. So, maintaining fiscal convergence is a relatively difficult task and can constrain growth.

The General Government Debt situation is not specially alarming in the transition economies. None of the countries (leaving aside Bulgaria) has government debt higher than 70% of GDP and some countries show a lower ratio (Czech Republic, Poland, Slovakia, Slovenia and Lithuania) than the target of 60% of GDP established by the Maastricht criteria.

Figure 5. Consolidated public debt as a share of GDP



* Notification tables of the MF SR (ESA95)

** Medium-term financial outlook for 2002-2005 (MMF)

6. The strategy of the Slovak Republic for joining EMU

Preparation for entry into EMU is in fact a programme for the standardisation of economic parameters of the country concerned with the requirements of international competition. EMU membership should be reached after the completion of reforms that might enormously influence the fulfilment of the Maastricht criteria. The reduction of public finance deficit and reduction of inflation without its suppression, play the key role in this process.

There are three alternatives of time schedule of joining to EMU. The fulfilment of the Maastricht criteria in 2005 is considered as only a theoretical possibility due to the current state. A time schedule for an entry into EMU in 2007 is problematic, mainly owing to administrative delays and processes postponed.

The second alternative of the EMU accession assumes that the Maastricht criteria will be fulfilled in 2006, then the assessment to be made during the course of 2007 and the admission to the EMU to take place in 2008. The fact which plays against this variant is political cycle, a parliamentary election should be held in 2006. This could complicate the fulfilment of the Maastricht criteria.

The third alternative is based on the assumption that the Maastricht criteria will be fulfilled in the year 2007. Then it is enough for Slovakia to file an application for membership in the ERM II during the course of 2005. That means that Slovakia's entry may be expected roughly in 2008-2010. The earliest realistic target for the entry can be 2008 if the required reforms are implemented and the assumptions about the performance of the nominal criteria materialise. (It is obvious that Slovak economy should operate under ERM II for the shortest possible time.) There are several issues that should be mentioned in this context. Before the ERM II application is filed it should be clarified, negotiated and agreed at what exchange rate parity Slovakia will join the ERM II. The rate should correspond with an equilibrium rate for the period of Slovakia functioning in the ERM II and in the period immediately following the entry into the EMU as well.

Regarding EMU joining deadline, it is important to coordinate the procedure with the neighbouring candidate countries, especially with the Czech Republic, Hungary and Poland. It is expected that any lagging behind on our part would send a negative signal to financial markets and investors.

There is a need for a consistent strategy for accession to EMU, the steps of Government and National Bank of Slovakia should be closely coordinated, mainly in connection with harmonisation of monetary and fiscal policy. The Slovak economy will have to go through systemic changes to increase its ability to flexibly respond to eventual asymmetrical shocks.

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Part 2:

Economic and political background for EMU enlargement

Fiscal policy in Poland after 1989 – background for growth stimulation in transforming and EU economies. Practice and some generalizations

1. Introduction

The paper is aimed at showing how important predictable and balanced fiscal policy is in liberalizing and globalising economy. It gives an overview of policies that can be applied within the framework of reducing budget deficit and how fiscal policy is changed in a post-communist economy that transforms into market democracy with changed revenues and restructured expenditures in the state budget, as well as increasing wealth of the state measured by increased incomes. Practices in Poland after 1989 are used as background for presenting fiscal coordination in EMU.

2. Role of fiscal policy in current economic policy

Fiscal policy plays an important role in current conditions in each economy. Its purpose is traditionally to collect funds for¹:

- functioning of the state with its internal and external obligations (allocation),
- covering distributive functions,
- stabilization function.

The state budget revenues cover a number of sources, which generally can be divided into domestic and foreign revenues. **Domestic revenues include:**

- **Tax revenue:**
 - **indirect taxes**, i.e.: value added tax (VAT) as well as excise tax, what means that sale of goods and paid rendering of services on territory of a country as well as exports and imports of goods and services are subject to value added tax (VAT). Revenue from the excise tax includes receipts from taxation on goods of domestic production and imported goods;

* Prof. dr. Katarzyna Żukrowska is the Dean at Social and Economic College at Warsaw School of Economics.

¹ S. Owskiak, *Finanse publiczne. Teoria i praktyka*, PWN 1999 pg. 56.

- the tax on games of chance and mutual betting;
- **income tax**: corporate income tax (CIT) and personal income tax (PIT);
- other tax revenues, which include receipts from abolished taxes, i.a. the tax on wages and salaries (earnings), the equalization tax, the import tax, the sales tax;
- **Non-tax revenue**:
 - revenue of budgetary entities;
 - dividends – the term dividend is understood as both payments from profit by sole share-holder companies of the State Treasury and state owned enterprises, as well as income from State Treasury holdings in commercial law companies, banks and other financial institutions;
 - payments from profit of the National Bank of Poland originate mainly from income obtained from trading State Treasury securities;
 - receipts from custom duties;
 - other non-tax revenues – receipts with a penalty character, including interest on overdue liabilities to the state budget.

Foreign revenue includes receipts from interest on foreign credits and foreign loans granted by the government of the Republic of Poland as well as fees from government guarantees (letters of support) on foreign credits received. **State public debt** – includes: debt of State Treasury, other debt of government sector, debt of local government sector. Debt of State Treasury is understood as the nominal indebtedness of State Treasury. **Domestic debt of the State Treasury includes:**

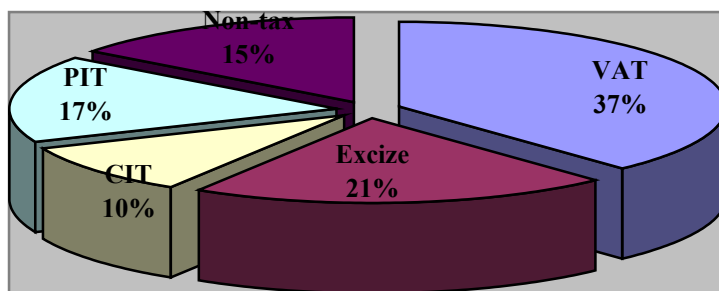
- liabilities of the State Treasury due to treasury securities issued on the domestic market,
- other domestic debt of the State Treasury i.a. liabilities of budgetary entities, current settlements with banks, liabilities from non-implemented wage increases in the budget sphere, prepayments for passenger vehicles.

Foreign debt of State Treasury includes:

- **liabilities of the State Treasury** due to treasury securities issued on the international capital market, i.a.:
 - Brady bonds – bonds issued in October 1994 within framework of a reduction and restructuring of debt to commercial banks associated in the London Club;
 - foreign bonds;
 - bonds denominated in foreign currencies, sold to foreign investors, outside of the country in which currency are denominated (Eurobonds);

- bonds issued in foreign markets, denominated in the currency of the country where they are sold;
- **credits received;**
- **liquidation of clearing balances;**
- Debt guaranteed by the government of the Republic of Poland is a potential debt of the State Treasury.

Chart 1. Structure of budget revenues in Poland (2002)



Source: own arrangement, based on data from Statistical Yearbook 2002, pg. 501.

The majority of revenues in Poland are domestic, making up to 99,2 % of the total revenues². Tax revenues amount to 84,8%, while non-tax form 14,4%, of which revenues of budgetary entities make 4,6%, dividends from state owned enterprises and from State Treasury Holdings in commercial companies make 0,6%, dividends from banks are estimated at 0%, payments from profit of the National Bank of Poland make 3,5%, foreign revenues come to 0,8%. Tax revenues in Poland are structured in the following way: indirect taxes form 58,7%; what is made by VAT (37,6%) and excise tax (20,6%). The excise tax embraces: spirits (3%), motor fuels (9,4%), tobacco products (5,2%) and tax on games of chance (lotteries) and mutual betting (0,5%). Income tax is 26,1% of revenues, while corporate tax makes 9,4% of revenues. Corporate tax includes also taxes paid by banks and other financial institutions (1,6%). Personal income tax makes 16,7% of revenues.

3. Methods to reduce budget deficit

The budget deficit can be reduced in three ways: (1) by restructuring and reducing expenditures; (2) by increasing budgetary revenues³; (3) by applying both mentioned methods, in a policy-mix⁴.

² *Rocznik statystyczny GUS 2002*, Warszawa, pg. 501.

³ Traditional approach to reduction of one of the taxes required increase in others, while new approach gives other opportunities. It creates conditions to reduce all direct taxes and

Increase of revenues can be obtained generally in two ways: by diminishing taxes and increasing turnover, which means increasing total revenues with reduced unit taxation, and by increasing taxes. Increased taxes (direct and indirect) result in diminishment of investments and in longer term bring about tensions to the budget revenues. In short term they fulfil their task of increasing revenues. Increase of taxes can result in acceleration of disinvestment process, especially in conditions when a number of countries apply different fiscal policy and liberalize flow of capital internationally. This is the case with most developed economies, which have liberalized capital flows (long-, medium-, and short-term) in different economic grouping and, too, different degree. Enough to mention:

- deepest liberalization within Single European Market,
- rather complex liberalization within OECD,
- medium liberalization within WTO,
- some economies have made the decision to liberalize capital flows individually, what means that no reciprocity is expected in such arrangement, but the country expects advantages from capital flows.

Disinvestment process can be considered as an effect of consciously undertaken decisions, aiming at increase of service sector share in the economy or stimulating revenues from foreign investments, increasing wealth of citizens. Third possibility is explained by mistakes made by politicians who being experts in public affairs (budgetary estimations) overlooked the international effects of increased taxation policy. Such mistakes are quickly being punished by outflow of investors (old and lack of new ones). Difficulties in most of the EU Member States to keep the fiscal requirement of Maastricht criteria derive from the fact that in preparations to EMU decisions were taken to increase the tax burdens in order to reduce the budget deficit. This has worked but the effect was rather short-sighted. With time passing the budget revenues started to shrink as business was sluggish. The slowdown in economy was not resulted by shape of the cycle (which was flatten by increase of international division of labour, mainly move from inter-branch to intra-branch specialization). It was resulted by deregulation of the economy, caused by increase of taxes (no matter which type: direct or indirect) each of the tax burden works in the same direction: it collects money from investors or consumers reducing demand or savings

in longer run also indirect taxes, which will be compensated by increase of turnover and cumulated value of revenues, while the economy flourishes, loosened by reduction of tax corset.

⁴ K. Żukrowska, D. Sobczak, *Fiscal Policy*, in: M. Bolle (ed.), *Eurozone Enlargement. Reshaping Policies and Social Conflicts*, Ezoneplus Summary Report Volume two, Berlin 2003, pg. 22.

and both have their impact on decisions of buying goods and services or financing investments. They influence also availability of capital on the money market (savings).

Decisions in this field (leading to increase of taxes) should be evaluated as done on purpose. They accelerate processes, which otherwise would be difficult from political point of view to undertake. As they have a direct impact on:

- stimulation of disinvestment and acceleration of structural changes of the economies, in which increase of services is expected,
- they stimulate outflow of capital to economies which are in chronic need of money (transforming economies, catching-up economies, developing economies),
- they stimulate decisions in EU, leading to further deepening of economic integration by introducing some coordination in the field of taxation policy.

The general decision is to push forward desired decisions by bringing out problems which otherwise, being small scale issues, are put aside in light of more important ones that have to be solved as priorities.

4. Why policy of deficit reduction is applied?

The reasons of application of deficit reduction policy are multifold. First and most known reason is linked with stabilization policy⁵. Budget deficit was accumulated into high burdens over the economy in form of growing public debt. State was borrowing money to pay its debts what was bringing tensions on the capital market, pushing up the interest rate. At the same time, higher interest rate in addition to fiscal burdens were slowing down the economy, increasing both inflation and unemployment. Despite believes that increased state expenditures can effectively stimulate growth, the economy found itself on a steep down-turning slope with no perspective to climb up. Increased unemployment was demanding higher expenditures from the budget to support the most needing. This, in turn was increasing expenditures, and the whole story repeated. Increased inflation was additionally reducing the incomes of companies and households. Only state could profit from this by reducing obligations from postponed payments⁶.

⁵ R. Musgrave, P. Musgrave, *Public Finance in Theory and Practice*, New York, 1989, pg. 7.

⁶ *The Macroeconomic policy Framework for EU Membership and Euro Area Participation – the Role of Budgetary Policy*, Directorate General, Economic and Financial Affairs, European Commission, Brussels, May 2002.

The second reason is linked with policies conducted within the high deficit policy. Easy access to money was used for covering costs of intervention, which stimulated, in short time, competitiveness of production, saving temporary some jobs and some companies from restructuring. Other countries in the neighbourhood followed such policy, stimulating actively and in costly manner competitiveness of their products and production. The policy applied here resembled a type of contest in which the state supported producers in order to make their production competitive on the international market. The competitors, in turn, required support from their states and this could go on pushing the state's demand for money. This had an impact on productivity, interest rates and inflation.

Third reason can be ascribed to international effects of such false competitiveness, which was, in the long run, prohibiting development in less developed economies, especially when development was stimulated by aid money transfers, which were spend on imports from the donor countries, creating dependencies in developing countries, increasing their indebtedness and increasing burdens put on donor economies and their budgets. In other words, applied policy had its national (internal) and international dimension.

With growing liberalization and globalisation, such a procedure could not have been continued. There was a need to departure from applied policies and replace them by new ones, liberal and more internationally oriented. As formula, a thick layer of middle class bringing peace and stabilization to the region was no longer true. Stabilization of rich became more often undermined by their own policies applied internally in which share of unemployed reached it's post-war pick. Moreover, a big share of unemployed was long-term unemployment. Stabilization became also undermined by international dimension of the applied policies as poverty in underdeveloped countries became a bigger threat than possibility of military attack from the side of one of the neighbouring states or a state located somewhere further from the borders but within the same region.

Decisions to depart from old polices were not easy and had a strong political component. Introduction of common currency, deepening integration, and stimulating further moves in that direction (deepening) were considered to be a perfect explanation of certain decisions that had to be taken. Convergence of economies and models of their functioning within the Member States was a good reason to apply policy of difficult money⁷.

It should be stated here that J.M. Keynes (and other economists in the same period) had invented several solutions to overcome economic problems of cycles and their fluctuations. The remedy consisted of two main stages: first was addressed to national economy, with parallel preparation on

⁷ H-W Sinn, *The Systems Competition*, Oxford 2003, pg. 74.

international level for further moves. This was creating jobs in national economies by spendings from the state budget. This measure can be considered as a short-term policy measure; the second, was linked with creation of international organizations, which were aimed at mutual liberalization of relations starting with trade and ending with capital, labour and service movements. This measure can be considered as long-perspective policy plan. It was invited together by B. White and J.M. Keynes.

5. Can a post-Washington consensus policy be effective in stimulating economy?

Washington Consensus was introduced in 1970 by John Williamson from Institute for International Economics, located in Washington. It embraced:

- financial discipline (control of budget deficit),
- giving priority to public expenditures reorienting them from publicly sensitive to neglected fields, with high return and high fiscal abilities,
- introducing a tax reform (lowering levels and increasing base),
- introducing financial liberalization aimed at market decision on level of interest rates,
- launching a single exchange rate,
- supporting liberalization of trade,
- announcing the need to liberalize capital transfers,
- supporting privatisation,
- advising deregulation (eliminating solutions limiting competition),
- favouring protection of intellectual property.

Washington Consensus was a remedy for tensions brought into the economy by strong deregulation impulses caused by energy shock of the beginning of 1970's. Traditionally in such occasions a prescription given by scientists was not put into action immediately. Time was needed to make the idea ripe enough to be used. This has happened in late 1970's and early 1980' with application of *reaganomics* in US, after *thatcheromics* in UK and further in macro-stabilization policies in transforming economies and convergence of economy in preparation to EMU. Results of Washington Consensus differ and continue to be different until now. Still in the first part of the previous decade, EU economy was catching up with the US benchmark, while in second part of the decade it slowed down. The reason was simple. Economy of single market went under strong pressure of deregulation. Nevertheless, it was announced that cycles were asymmetric, that economy is in a down turn. Such explanation was a powerful tool for

economists and politicians. Within departure from Keynesian model of stimulating growth, internal and external liberalization – the economy has received stimuli to deregulate adjusting to new conditions of functioning. The effects of those deregulations and adjustments were similar to the down-turn of business cycle. Some economists advocated in such circumstances that the period of Washington Consensus is over, it does not prove to be conducive to growth in all economies and, as a result, there is a need to approach growth problems or wider economic policy stimulation in other manner. Advocates of departure from Washington Consensus supported the idea of so called Revised Consensus of the 1990's. Policy mix prepared in this school of thinking embraced following moves and advices:

- increase savings by tax discipline,
- reorient state expenditures on correctly defined social goals,
- reform tax system including environment protection,
- increase control over banks,
- keep exchange rate on level corresponding with competitiveness (elimination fluctuations & fixing),
- interregional liberalization of trade,
- building competitive markets (privatisation, deregulation),
- right to ownership for all,
- independent central bank, fiscal apparatus, independent courts, agencies promoting development,
- increase funds on education.

Revision of the Consensus can be considered in light of adjusting some of the fiscal and monetary requirements alongside with the changing economic conditions. This means exactly the opposite than proposed loosening of the fiscal and monetary requirements, as it calls for adjustments to lowered inflation, followed by lowered interest rates and finally resulting in lower size of the budgetary deficit and in consequence in reduced public debt. Two criteria in the set of convergence requirements are fixed, while remaining two move according to best performance of the three countries of the EC. The two fixed criteria were fiscal: budget deficit and public debt. The two moving criteria concern monetary policy what embraces interest rate and inflation rate. Generally inflation rate was reduced considerably, although it went up a little in the last years. Defining fiscal criteria was subordinated to fact that inflation was high and this resulted in reduction of public debt when budget deficit was maximum 3%. While with reduction of inflation below 3%, what was followed by reduction of interest rate to about 2%, there is need to adjust the fixed criteria on lower level, i.e. budget deficit ≥ 0 . Otherwise changed conditions in monetary field will result in return to an increase of public debt. Not

saying that budget deficit, that occurred recently in France and Germany, is also partly resulted by the fact that with low inflation and low interest rate, the state has incentive to borrow, what is argued by launching a policy that stimulates growth. In sum, revised consensus means revision in fiscal criteria not loosening the fiscal policy but making it more strict.

Revised consensus – without explaining what it means in practice – can be considered as guideline, turning policy in a wrong direction and it was just advanced stage of the same notion, just deepened and more focused internationally, going beyond national borders of most advanced economies. Some smaller or bigger experiments proved that the whole assumption of transmitting growth works in relations between rich and poor but not unconditionally. This was first proved within European Community (Rich North and Poor South); within NAFTA (USA, Canada and Mexico), within relations of European Community and Post-Communist States (Central and Eastern Europe as well as Commonwealth of Independent States).

Economy which tries to catch-up has to stabilize as catching-up is resulted by growth and growth is stimulated by investments (national and international). Investments require stabilization of prices as with high inflation rates each value of invested capital diminishes, bringing losses to its owner. Most catching-up economies are heavily dependent on foreign capital inflow as flows of capital can reduce or even close the gap between demand and supply for capital on domestic market. This requires not only stabilization but also liberalization. Moreover, investments need specific guarantees showing that economy of capital location is predictable. All mentioned arguments show that Washington Consensus is spreading wider to new group of countries and continents and in economies were the idea was born it is going through a „lifting process”, which means deepening.

In other words, politicians should not depart from the guidelines given by Washington Consensus, strongly linked with fiscal policy. Changes in the sphere of fiscal policy – in order to be efficient – have to be, on the one hand, decisive; while on the other, slow and gentle. Otherwise they create dangerous shocks for the economy in question. People who take policy decisions have to react and often withdraw from abrupt decisions thus creating additional shocks for the economy. Such decisions can concern level of taxes, value of exchange rate, pegging of exchange rate, level of interest rate. Polish exemplification in the just mentioned fields is a good example of wise policy, which not only did not cause tensions on capital markets in the Polish economy but also did not lead to withdrawing from once taken decisions.

In other words both abrupt or gradual changes in different spheres were undertaken correctly and with deep knowledge of the results. Mistakes would always demand withdrawal, causing thus additional shocks to which the economy had to adjust adversely after formerly taken decisions.

6. Overview of the Polish fiscal policy

Fiscal policy applied in Poland is a good example of gentle changes, adjusted to rate of growth of the economy, what was followed by rate of growth of incomes of households and companies. The correctness of such policy proves that some moves have to be abrupt, others gentle. Introduction of VAT was abrupt but adjustments in its level in different spheres were slow. Same can be said about shock liberalization of the economy (trade) and gradual adjustments in capital flows liberalization. Type of applied policy mix is subordinated to the effects that are expected to be born in an economy, where the policy is introduced. This was true with the exchange rate policy and pegs used which were focused on achieving:

- stabilization of the economy,
- stimulation of competition on home market – forcing reduction of costs,
- gradual marketization of the policy what was univocal with depoliticization of it.

In case of tax policies the purpose was different. The whole idea is to achieve several goals at a time:

- stimulate economy,
- attract foreign capital,
- cumulate needed money for allocation,
- reduce the burdens of fiscal policy, forming a straightjacket around the economy.

Table 1. Tax structure according to income of personal tax-payers

Qualification of tax brackets	1999	2000	2001	2003
Taxpayers in first brackets	95,0	94,59	95,18	95,09
Taxpayers in second bracket	4	4,09	3,83	3,78
Taxpayers in third bracket	1	1,32	0,99	1,13

Source: Ministry of Finance.

The topic of fiscal policy in Poland is interesting per se. In light of limited space of the paper it will concentrate on one of the taxes applied in Poland, namely PIT. Choice of this tax for analyses is well argued. Lowered

level of PIT reflects increased incomes and reduced burdens, which leave money in disposal of the consumers and thus stimulate economy. PIT reductions are possible during economic up-turn and are not recommended in down-turns as they can bring additional turbulences in the economy reducing revenues and thus reducing abilities to finance incomes of the budgetary sphere.

The share of taxpayers in first brackets is the biggest one as it is estimated at 95% average over the period 1999-2003. This could be interpreted without additional information that wealth in Poland did not increase. But in reality this was not the case if we look at the PIT rates in 1996-2003. The PIT rates were changing in 1996-2001 and in 2002-2003 they were kept frozen. This is illustrated by below table.

Table 2. Tax rates in three brackets in 1995-2003

1995			
Tax assessments basis (PLN)		Tax rates	
Above	Up to	%	Computation
-	12 400	21	21% of the tax assessments basis less 165,60 PLN
12 400	24 800	33	2 438,40 PLN + 33% of the surplus over 12 400 PLN
24 800	-	45	6 530,40 PLN + 45% of the surplus over 24 800 PLN
1996			
Tax assessments basis (PLN)		Tax rates	
Above	Up to	%	Tax rates
-	16 380	21	21% of the tax assessment basis less 218,40 PLN
16 380	32 760	33	3 221,40 PLN + 33% of the surplus over 16 380 PLN
32 760	-	45	8 286,80 PLN + 45% of the surplus over 32 760 PLN
1997			
Tax assessments basis (PLN)		Tax rates	Tax assessments basis (PLN)
Above	Up to	%	Tax rates

-	20 868	20	20% of the tax assessment basis less 278,20 PLN
20 868	41 736	32	3 895,40 PLN +32% of the surplus over 20 868 PLN
41 736	-	44	10 573,16 PLN + 44% of the surplus over 41 736 PLN
1998			
Tax assessments basis (PLN)		Tax rates	Tax assessments basis (PLN)
above	Up to	%	Tax rates
-	25 252	19	19% of the tax assessment basis less 336,60 PLN
25 252	50 504	30	4 461,28 PLN + 30% of the surplus over 25 252 PLN
50 504	-	40	12 036,88 PLN + 40% of the surplus over 50 504 PLN
1999			
Tax assessments basis (PLN)		Tax rates	
above	Up to	above	Up to
-	29 624	19	19% of the tax assessment basis less 394,80 PLN
29 624	59 248	30	5 233,76 PLN + 30% of the surplus over 29 624 PLN
59 248	-	40	14 120,96 + 40% of the surplus over 59 248 PLN
2000			
Tax assessments basis (PLN)		Tax rates	
above	Up to	above	Up to
-	37 024	19	19% of the tax assessment basis less 493,12 PLN
37 024	74 048	30	6 541,24 PLN + 30% of the surplus over 37 024 PLN
74 048	-	40	17 648,44 PLN + 40% of the surplus over 74 048 PLN

2001			
Tax assessments basis (PLN)		Tax rates	
above	Up to	above	Up to
-	37 024	19	19% of the tax assessment basis less 493,12 PLN
37 024	74 048	30	6 541,24 PLN + 30% of the surplus over 37 024 PLN
74 048	-	40	17 648,44 PLN + 40% of the surplus over 74 048 PLN
2002			
Tax assessments basis (PLN)		Tax rates	
above	Up to	above	Up to
-	37 024	19	19% of the tax assessment basis less 530,08 PLN
37 024	74 048	30	6 516,40 PLN + 30% of the surplus over 37 024 PLN
74 048	-	40	17 648,44 PLN + 40% of the surplus over 74 048 PLN
2003			
Tax assessments basis (PLN)		Tax rates	
above	Up to	above	Up to
-	37 024	19	19% of the tax assessment basis less 530,08 PLN
37 024	74 048	30	6 516,40 PLN + 30% of the surplus over 37 024 PLN
74 048	-	40	17 648,44 PLN + 40% of the surplus over 74 048 PLN

Source: Ministry of Finance, Direct Taxes Department.

Until 2001 there was regression in tax burdens illustrated by brackets levelling as well as tax burdens reductions applied. This means that the first given statistics on stabilizing of the groups covered by different brackets was not univocal with lack of wealth increase in the society. Since 2001 the brackets were frozen, what was univocal with slow-down of the economy as

less money was left in possession of the consumers. This fact was univocal with smaller demand on the market. Lowering taxation means that more money is left for consumption purposes what naturally stimulates economy, without middleman participating in distribution and adding additional costs, reducing demand on consumption. Similar effect can be achieved by reduction of tax for companies (CIT). Nevertheless, stimulation of such move for the economy is relatively smaller in comparison with PIT. This finding is proved by tax policies applied in all transforming economies as well as in case of developed market democracies.

Table 3. Economic indicators for individual acceding and candidate countries and EU-15

Country	GDP growth in 1995-2002, %	Employment growth in 1995-2002, %	Labour productivity growth in 1995-2000 %	Population in 2002 (EU-25=100) (EU-25:456 mln)	Employment rate in 2001 % of 15-64 year old population	GDP per capita (at PPP) in 2001 (EU-15=100)	GDP (at PPS) in 2002 (EU-25=100)
Czech Rep.	1,7	-0,5	2,2	2,2	65,1	60	1,4
Estonia	5,0	-1,1	6,2	0,3	61,3	41	0,1
Hungary	3,9	0,7	3,1	2,2	56,5	57	1,4
Latvia	5,2	0,2	5,0	0,5	58,7	35	0,2
Lithuania	4,0	-2,2	6,4	0,8	60,1	39	0,3
Poland	4,0	0,2	3,8	8,5	55,0	39	3,6
Slovak Rep.	3,8	-0,1	3,9	1,2	56,8	47	0,6
Slovenia	3,9	0,7	3,2	0,4	63,8	74	0,3
CEEC-8	3,6	0,0	3,6	16,1	-	-	7,9
Cyprus	3,6	1,2	2,4	0,2	65,9	74	0,1
Malta	3,3	0,6	2,7	0,1	54,2	55	0,1
AC-10	3,6	0,6	2,7	0,1	54,2	55	0,1
Bulgaria	0,6	-1,3	1,9	1,7	49,6	25	0,5
Romania	0,4	-1,8	2,2	4,9	62,4	25	1,3
AC-10, BG and RO	3,0	-0,5	3,6	23,0	57,4	40	9,9
EU-15	2,2	1,2	1,0	83,6	64,1	100	90,1

Note: Labour productivity refers to GDP per employed person (at purchasing power parties, or PPP). PPS: purchasing power standards (Eurostat). Employment rates for Cyprus, Lithuania and Poland are for 2000. GDP levels for Malta in comparison to the EU are for 1999.

Source: WIIW database incorporating national statistics; WIFO and WIIW calculations using AMECO; Eurostat. Quoted after Competitiveness Report 2003, Benchmarking. EU. Brussels, 2003 pg. 133.

Lowering of corporate taxes makes sense when it is directed at attracting foreign capital flows, which in turn creates jobs and stimulates consumption. There are additional attractions for foreign investors in addition to low CIT, so CIT could be reduced as last move, helping to finance the budget. Those additional sources of income for foreign investors derive from accelerated growth of labour effectiveness, incomes made on difference of interest rate between home market (where the credit is drawn) and location market where the credit is invested, differences in labour costs, etc.

The above data indicates that Poland has numerous advantages in comparison to remaining accession countries. Those are: biggest and youngest population, relatively high productivity rates of growth, positive employment growth records and relatively low GDP per capita what can be considered in such circumstances as a driving force. In such circumstances reduction of PIT is more important than reduction of CIT, although the latter can not be left on relatively high level in comparison to neighbours. Remaining accession countries have also better results in numerous mentioned fields, which decide about effectiveness of foreign investments, measured by rate of return.

7. PIT in selected EU Member-States

Tax rates and brackets in EU member states are still high, although they are subject of reduction. Progressive rates are implemented in all EU Member-States. Flat taxation is not applied and it seems a distance solution if attempts are made to apply. Moreover, tax free amounts of income are lower than income considered as poverty line setting. This can be exemplified by practice in UK, Holland, Germany, France, Greece and Ireland. Despite level of development similar policies are applied. Tax systems in member states of the EU are complicated, they include long lists of exceptions and relieves. Short overview of the tax systems in selected EU member-states allows to draw conclusions about the credibility of the applied system, its effectiveness and prospects to change.

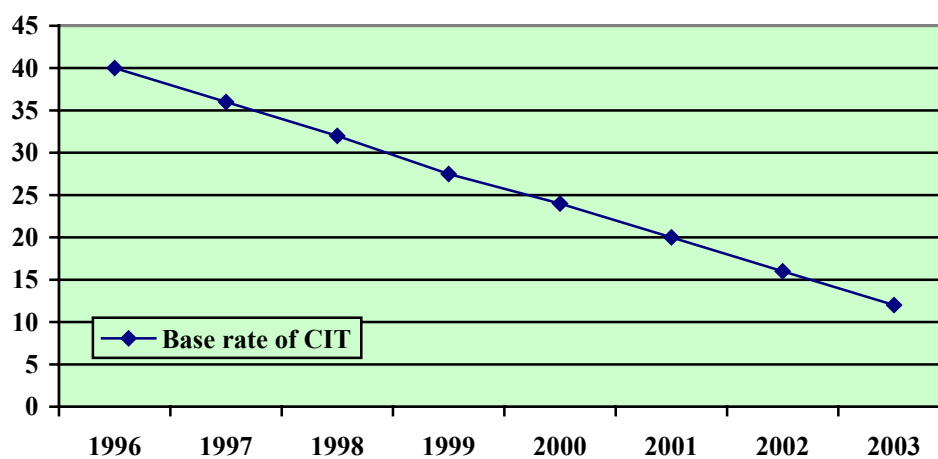
7.1. Ireland

The maximum qualifying interest in respect to eligible loans is the lower of the interest actually paid and the given above thresholds. Personal taxes in Ireland are higher than corporate. Low corporate taxes in Ireland of 10-12% were stimulating investments and led the economy to highest rate of growth in last decade. Ireland was a leader among EU member states in reducing her CIT.

Table 4. PIT in Ireland in 2003

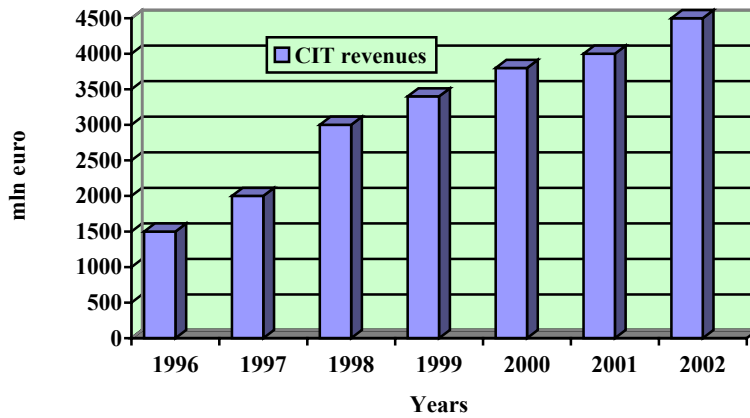
Amount in euro	Rate (in %)	Cumulative tax in euro
Single		
Up to 28 000	20	3 256
Over 28 000	42	-
Widowed/single with dependent children		
Up to 32 000	20	3 769
Over 32 000	42	--
Married		
Up to 37 000	20	4 721
Over 37 000 ^a	42	-

^a Increased by the lower of euro 1900 and income of the lower-earning spouse in case of two-income house-hold (couple).

Chart 2. Level of CIT in Ireland (1996-2003)

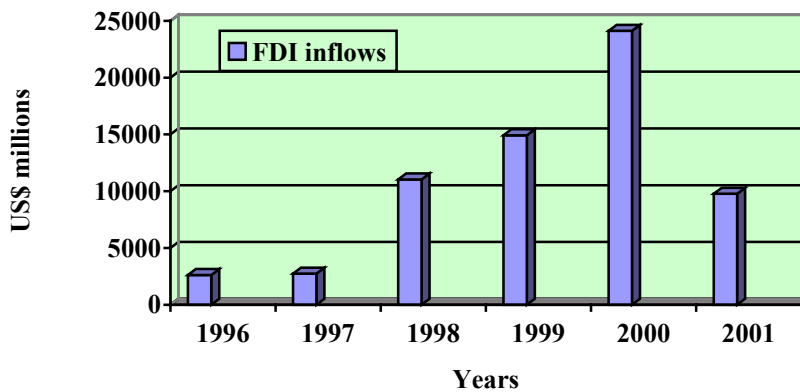
Source: Statistical Report 1996-2002, <http://www.revenue.ie>

However, reduction of taxes does not result in reduction of budget revenues.

Chart 3. Net revenues from CIT

Source: World Investment Report 2002. pg. 303.

At the same time reduced taxes stimulated inflow of foreign direct investments. According to World Investment Report (2002) average annual flow in 1990-1995 was estimated at US\$ 1 139 millions. After 2000, when FDI halved to all developed economies, similar tendency was observed in Ireland but still the inflow was relatively high in comparison with remaining economies. In the same decade FDI outward stock from this country doubled from US\$ 2 948 million in 1990 to US\$ 5 137 million in 2001.

Chart 4. FDI inflows to Ireland, in millions US\$

Source: Central Statistical Office, International Investment Position 31 December 2002, October 2003.

The personal taxes have two brackets and double after passing the threshold of 37 000 million. A credit may be given in respect of interest on credits drawn in case of purchase, improve or reconstruction of main residence owned by taxpayer or his former (separated spouse) or dependent relative (other than child) occupying the residence (free of rent)⁸. The most popular form of allowances is a credit against an individual's tax liability. This is applied in case of virtually all personal allowances as well as in case of home loan interests relief⁹. Following occurrences can be subject to deduction from the total income:

- business losses,
- capital allowances on leased assets,
- expenses on medical care and health insurance,
- certain gifts.

In case of joint assessment of the couple incomes, the income of wife is often considered as additional income of the husband and as such a subject to tax deduction. In certain conditions wife's incomes can be considered as primary subject of tax deduction. In case of individual assessment of husband and a wife, each of their incomes are cumulated and in both cases deduction of individual relives is applied according to the rules applied in case of single. The allowances in Ireland embrace:

- basic personal tax credit (Euro 1 520) or married man's tax credit (doubled amount),
- two types of credits used for widowed souses (Euro 2 600, gradually decreased in following three years, or Euro 3 040 when widower was not treated as primary taxpayer in the jointly assessed couple),
- tax credit of Euro 205 is given to person over 65,
- credit of Euro 1 520 applies in case of single parents with a resident child,
- Euro 800 credit for blind person (doubled in case of blind husband and wife),
- Euro 770 applies when one spouse in jointly assessed couple stays at home and care for kids,
- maximum Euro 30 000 as allowance for handicapped,
- Euro 60 for certain dependent relatives, living on low incomes,
- 20% tax relief is automatically deducted to those, who went true a medical treatment.

⁸ http://www.taxireland.ie/ir_tax/income.asp (10/12/03).

⁹ *Tax credits, Relieves and Rates for Income Tax Years 2002 and 2003*, Office of the Chief Inspector of Taxes, February 2003.

7.2. Greece

Taxes in Greece have four brackets and are progressive as in other countries but the progression is gradual not steep like in Ireland. Mortgage interest paid for taxpayers first dwelling is deductible in full, when deducted before 31 December 2002. From 1 January 2003 a credit equal to 15% of the annual mortgage interest on taxpayer's principle home is granted. Deduction cannot be granted if taxpayer (dependents) own a house with area of minimum 70 m², increased by 20 m² for each of the first two children and 25 m² for each additional child. Next restrictions of allowances concern total area which may not exceed 120 m² (introduced as upper limit). Final restrictions state, that the credit can be claimed in respect of part of the loan not exceeding Euro 200 000.

Table 5. PIT in Greece

Taxable income in euro	Rate (in %)	Wider, non taxable brackets for individuals with dependent children	Number of dependent children
Up to 10 000	0	Euro 11 000	1
10 001-13 400	15	Euro 12 000	2
13 401-23 400	30	Euro 20 000	3
over 23 400	40	Incr. By euro 1 000	4 and more

Rates and brackets for individuals are:

Taxable income in euro	Rate (in %)	Wider, non taxable brackets for individuals with dependent children	Number of dependent children
Up to 8400	0	Euro 11 000	1
8401-13 400	15	Euro 12 000	2
13 401-23 400	30	Euro 20 000	3
over 23 400	40	Incr. by euro 1 000	4 and more

Source: K. Costas, *Taxation of individuals in Greece*, IBFD, Amsterdam 2003, section 7.

In case of Greece it is possible to set losses in one category against income in any of the remaining six categories in order to arrive at the accumulated amount of the net deducted income. Most of the deductions were replaced by tax credits. Social security contributions are deductible in full.

Since 1 January 2003 the following credits have been available:

- credit equal to 15% of the home rent¹⁰,
- credit equal 15% of annual educational expenses¹¹,
- tax credit of Euro 30 for each child of the taxpayer with employment income of minimum 9 months.

7.3. France

In case of France the mortgage interest is, as a rule, not deductible for houses occupied by owners. For mortgage loans concluded before 1 January 1998, interest incurred solely in respect of the taxpayer's main residence, is partly creditable against income tax for the initial 5-year period. The amount of tax reduction depends on the date on which the loan was concluded and on the size of the fiscal household¹². Tax credit is calculated as 25% of deductible interest for loan draw between 1st January 1996 and 31st December 1997 for acquisition of existing accommodation or serious repairs. Interest charged in 2002 is deductible up to Euro 2 287, to which Euro 305 is added for each dependent person. Subject to certain conditions, costs relating to qualifying major equipment (sanitary appliances, heating systems, elevators) incurred between 15 September 1999 and 31 December 2005, relating to taxpayer's owner-occupied main residence, give rise to a tax credit, which may be spread over several years. The amount should be equal to 15% of the deductible expenses which are limited. The amount can be increased by adding credits for each dependent child. The tax reduction is not deducted when the taxpayer already enjoys the benefit of the tax credit on interest for major repairs.

Table 6. PIT in France

Taxable income (per share) in euro	Rate (in %)
Not exceeding or equal to 4 191	0
4 191 – 8 242	7,05
8 242 – 4 506	19,74
14 506- 23 489	29,14
23 489 – 38 218	38,54
38 218 – 47 131	43,94
over 47 131	49,58

Source: http://www.taxinfrance.com/framest_ent_uk.htm?url,
http://www.taxinfrance.com/uk/enterprises/vie_tva.htm.

¹⁰ Cannot exceed Euro 75 for both single and married person.

¹¹ Cannot exceed Euro 1000 per annum.

¹² M. Henderson, *Taxation of Individuals in France*, IBFD Amsterdam 2000, section 4.3.

In France allowances and deductions are not applied as a general principle. In some cases they are income related and vary with its level while in other cases incentives are used, which give certain groups of taxpayers defined advantages. These are either deductible from overall income or give rise to tax reduction in form of tax credit¹³. Personal allowances depend on type of income and are defined in following manner:

- employment income and pensions – a 10% deduction limited for 2002 income to euro 12 437 (3 240 for pensions) is applied to each recipient of employment income or pension within the fiscal household, to cover employment; additional deduction of current expenses may also be applied;
- income from qualifying securities. An allowance up to euro 2 440 for a married couple whose net taxable income does not exceed euro 94 262 (euro 1 220 for single taxpayer, whose net taxable income does not exceed euro 47 131) is available with regard to dividends distributed by French companies and interest on debenture notes that are issued in France¹⁴;
- real property income – state earlier allowances of 14% of property income (15% for certain rural estates) are available to cover management expenses, insurance costs and depreciation of currency;
- non-professional income, trading income and agricultural income. A special allowance up to 20% of the net profit (no higher than 113 900 euro) can be applied but should not exceed euro 22 780. Special deductions are applied for newly established enterprises;
- non-commercial activities (a 37% allowance with minimum Euro 305 is available in income is lower than euro 113 900);
- remuneration paid to company managers (*gérants*) and shareholders. A 20% allowance on the part of remuneration below 113 900 is available if income is lower than euro 113 900;
- child-care expenses give reductions, which can equal 25% of the total expenses made in this category;
- in case of grown up child, having own family, but referring to his family on his parents income tax return. A tax deduction is applied here

¹³ J. Kesti, *European Tax Handbook*, IBFD, Amsterdam, 2003, section 1.6.

¹⁴ The allowance is reduced by half when the taxpayer's net taxable income exceeds the above thresholds. The allowance is also available in case of other investment revenues (ie. bonds, negotiable bonds, loan notes and capital gains) all made before 1 January 1996 according to OPCVM – organismes de placement collectif en valeurs mobilières. (An investment fund with variable capital, which issues new shares continuously and is obliged to redeem them on demand, according to their asset value.

- up to euro 4 137 for a single child, or euro 8 274 for married couple, whatever the number of children in the household is;
- the income derived from the letting of dwellings to low income tenants enjoys a deduction of 60% (instead of 14%) for period of 3 years, when lease was validated after 1st January 2002 for minimum of three years and income of tenant and rent are lower than revised limit;
 - schooling expenses – taxpayer is entitled to tax credit of euro 61 153 or 183 per child attending secondary school or university, the amount of tax credits is deducted according to the undertaken establishment.

7.4. Germany

Income law in Germany is complex, which means that it differs for single taxpayers and jointly assessed couples. This also concerns computation methods, which seem to be sophisticated. This is illustrated in table above. In Germany the mortgage interest is not deductible in case of houses, which are occupied by their owners. In case when the property is rented, the mortgage interest is deductible in the calculation of the rental income, which the taxpayer obtains. The system of personal allowances, deducted and credits is one of the most complex in EU member-states. It leaves considerable margin for different interpretations and thus taxpayers often resort to professional advice offered by tax consultants. Their fees are deductible, what creates additional incentive for taxpayers. Individual taxpayers are in position to deduct all expenses directly incurred in acquiring or maintaining their income in computing for the various categories.

The deduction is limited to 50% of related costs, provided the net aggregated income of a taxpayer is not negative. Deductions applied here are made from total income. Those deductions include:

- deductions for special expenses¹⁵,
- exceptional expenditure deduction.

In addition to special deductions the taxpayers in Germany are allowed to deduct tax relieves in case of exceptional expenditures, which were in the tax-year unavoidable. Such expenses embrace:

- medical costs,
- limited maintenance,

¹⁵ Those include: mandatory contributions to health, nursing, accident and liability insurance, premiums of private insurance, contributions to statutory pension scheme and to unemployment insurance; contributions by employees to certified private pension plans; expenses for taxpayers professional education for a profession, which he does; tax consultant's honorary; expenses for gifts and different types of donations. 30% of contributions to private schools.

- limited training expenses,
- expenses for child care,
- expenses for domestic help (up to euro 624); expenses for living in a nursing home.

Table 7. PIT in Germany

For single taxpayers in 2003 Rate will change as follows:

Taxable income	Marginal rate	2004 personal allowance	Rate in (%)
Up to 7 236	0		
7 237-9 251	19,96-23,02	7 426 euro	Minimum rate: 17%
9 252-55 007	23,02-48,50	14 853 euro	Top marginal rate: 47%
over 55 007	48,50		

Tax rates in 2003, jointly assessed spouse taxpayers

Taxable income (euro)	Marginal rate (%)	2005 personal allowance	Rate in (%)
Up to 14 471	0		
14 472-18 503	19,96-23,02	7 664 euro	15%
18 504-110 015	23,02-48,50	15 339 euro	42%
over 110 015	48,50		

Source: Income Tax Law (Einkommensteuergesetz), notified of 19 October 2002, BGB 1 2002 at 4210, Sections 10, 10a, 10b and 34F.

Moreover, there is a personal or basic allowance granted to each taxpayer (doubled if married couple fills jointly the form). There is a monthly child relief in form of tax credit (refunded on any access). This relief is granted in case of all resident children under 18. Such credit is also applied to children between 18-27, when they are full-time students, serve military duty, or are unemployed¹⁶. Mentioned deductions are not applied if child's tax credit exceeds or equals the benefit of lump-sum deductions. Single parents are entitled to additional deductions.

Taxpayers over 64, living on income other than pension (from statutory pension scheme), are granted a tax free allowance of 40% gross salary (excluding the pension taxed as income from employment) plus 40% of aggregate income of other categories (excluding statutory pension

¹⁶ Tax credit is in such case euro 154 per child (increased from fourth kid in family). There are additional deductions available for each child of the taxpayer: (1) euro 1 824 (or 3 648 for jointly assessed spouses) per child per year; (2) euro 1 080 (euro 2 160 in case of a couple jointly deducting taxes) per child per year for child care.

scheme payments). Tax credits are available for owner-occupied dwellings, subject to conditions, donations to political parties and domestic help and are granted to individuals or partners running a business.

7.5. The United Kingdom

The rate structure of taxes in the UK consists of two elements: personal allowances and tax rate. The first GBP 1 920 of taxable income is the income above any personal allowances. In practice there are three rates, rating from 10% to 40%. Income is subject to different tax rates, charged according to different income groups.

Table 8. PIT in UK in 2003

Type of rate	Taxable income	Rate (%)
Starting rate	First 1 920	10
Basic rate	Next 1 921-29 900	22
Higher rate	Over 29 900	40

Source: <http://www.inlandrevenue.gov.uk/Rates/it.htm>.

In Britain there is an income relief – tax is applied under MIRAS (mortgage interest rate relief at source). This is available for people over 65 or in case of loans up to £ 35 000 drawn on security of their land or main residence. 90% of this is applied to purchase of a life annuity. No other deductions or relieves are available. In UK a wide variety of personal deductions are available, alongside with credits¹⁷. Firstly, loan interest (excluding interest on a bank overdraft) for a qualifying purpose paid by an individual is allowable as a general deduction from income. The notion of qualifying purpose includes:

- acquisition of minimum 5% of the share of capital of a close trading company,
- acquisition of shares in employee controlled company,
- acquisition of machinery or plant (ex. a car) for use in a partnership or employment.

Other interest paid can qualify for relief in computing taxes from incomes. This concerns trading income. In some specific cases losses are permitted to be subject of deduction from incomes, practically deriving from different sources. The amount of basic allowance depends on age of the taxpayer (thresholds embrace 65 and 74) and his marital status. A married couple is due to pay taxes of £ 2 110, if husbands income exceeds:

- £ 24 330 and he is aged under 65,

¹⁷ J. Kesti, *European Tax Handbook*, IBFD, Amsterdam, 2003, section 1.6.

- £ 27 240 aged 65-74,
- £ 27 780 aged 75 and more.

Particular cases offer additional allowances to the taxpayers. This can be granted in case of:

- registered blind,
- a woman in tax year, when she becomes a widow, and
- an individual, who has a qualifying child resident with him and is not entitled to the married couple tax credit, or whose spouse is totally incapacitated by physical or mental infirmity for the whole of the tax year.

7.6. Holland

Taxes in this country are divided into three categories. The personal allowance can be divided into three types:

- Maintenance,
- exceptional expenses,
- gifts/donations.

Table 9. Tax rates in Holland in 2003

Up to taxable income (Euro)	Rate on excess (%)	Social security premium	For tax payers of 65 and older (including social security)
Up to 15 883	32,9	31,2	15,0
15 883-28 850	38,4	31,2	20,5
28 850-49 464	42,0	-	42,0
over 49 464	52,0	-	52,0

Source: taxation in Netherlands 2003, Ministry of finance, Hague 2003 pg.29-30.

Other categories of incomes (i.e. capital gains) are taxed in different rates depending on income levels to which they are applied. Box two indicates other incomes, which embrace shares, capital gains, share holdings, towards which 25% of tax is applied. In Box three deemed income from savings and investments is taxed at rate of 30%. Levy rebates are subtracted from total amount of tax. Losses from other years are set off and the tax dues are calculated and reduced by the tax credits. Personal allowances are given in form of levy rebates, similar to tax credits as they reduce the tax payable by taxpayer. The rebates here include:

- employment levy rebate – for all employed and self-employed,
- children levy rebate (adjusted to number of children),
- single parents levy rebate, and senior citizen levy (over 65),
- young disabled,

- rebate for social investments and venture capital; rebates applied usually differ for separate age groups.

To sum up, the tax would be much more transparent after simplification. Countries creating a single internal market should not compete with the use of taxes. Moreover, level of taxes and complicated (established) system of deductions, allowances and credits make the applied tax system ineffective, what easily discourages investors. In addition, the commonly applied tax systems are brought to a threshold in which increase in taxes reduces the budget revenues, what illustrates in practice the Laffer's curve. Taking into account that reduction of direct taxes (PIT and CIT) stimulates both consumption and investments, revenues from indirect taxes can replace the gap between revenues to states budget and expenditures. There is no simple dependency that reduction of one direct tax has to be replaced by increase of another one. Reduction of tax rates can result in economic relaxation and rate of growth recovery, stimulated by investments and consumption. The results in this field are better in case of wide layer of income group with higher revenues. This is the case with developed EU member states more than in the case of catching up economies. Nevertheless, the two types of economies integrated together and forming a single internal market can both lower the taxes. This was experienced by Ireland and it has proved to be a good stimulus for the economy. Ireland in last 6 years was the quickest growing economy in Europe. Additional impulses in this economy can be obtained by simplification and reduction of PIT (personal taxes). Reduction of PIT gives strong push in the economy in case when the population was living in austerity conditions, rejecting all consumption temptations. In case of advanced market economies, reduction of PIT can give also good results in periods of deep revolutionary changes in consumer durables, creating demand for goods despite the fact that old durables did not fully amortize.

Increase of 1% of taxes increases by 4% outflows of investments¹⁸. This is important as the leading role in estimations of profitability of investments done by Trans National Corporations, while small and medium investors follow the decisions of the big players on the market. In case of increase in taxes, the opposite is true. The process of disinvestment was accelerated additionally with increased comparability of the investments conditions after introduction of euro and integration (liberalization of relations) with economies representing lower level of development. Preparation for fulfilment of the convergence criteria in 1997 and 1998 was accomplished by either reduction of expenditures or increase of taxes.

¹⁸ J. Gorter, A. Parikh, *How Sensitive is FDI to Difference in Corporate Income Taxation within the EU?*, *De Economist*, 151, No.: 2, 2003.

Expenditure based consolidation was introduced in Austria, Finland, Ireland, Netherlands and Spain. Revenue based consolidation was applied in Belgium, Greece, Portugal. Mixed strategies featuring one of measures and, in some cases, creative accounting was used in France, Germany and Italy.

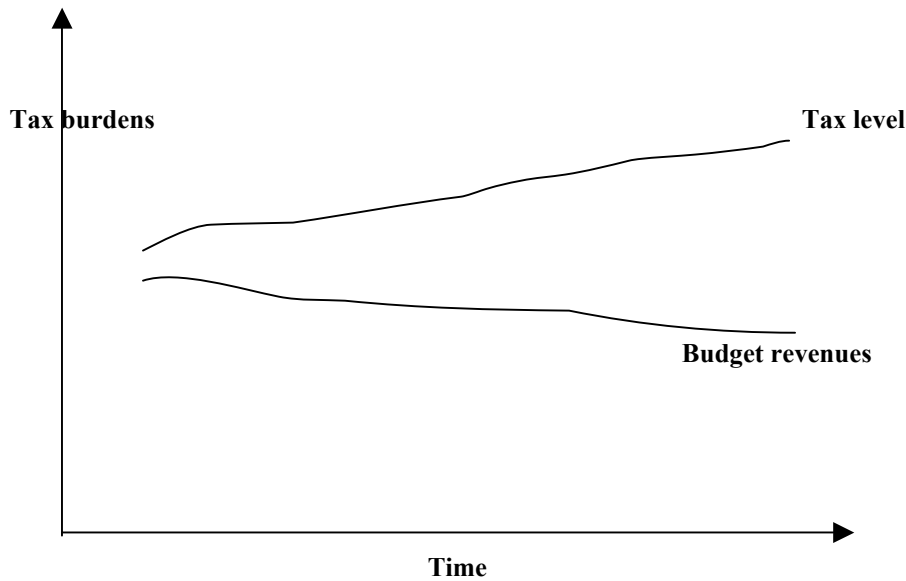
Table 10. Budget balances (in % of GDP) of EMU countries in the 1990's

Country/year	1993	1994	1995	1996	1997	1998	2003
Austria	-4,2	-4,8	-5,1	-3,8	-1,7	-2,3	-1,3
Belgium	-7,3	-5,0	-4,3	-3,8	-1,9	-0,9	0,2
Finland	-7,3	-5,7	-3,7	-3,2	-1,5	1,3	0,5
France	-6,0	-5,5	-5,5	-4,1	-3,0	-2,7	-4,0
Germany	-3,1	-2,4	-3,3	-3,4	-2,7	-2,1	-4,1
Greece	-13,8	-10,0	-10,02	-7,4	-4,0	-2,5	-2,6
Ireland	-2,3	-1,7	-2,2	-0,2	0,7	2,1	1,3
Italy	-9,4	-9,1	-7,6	-7,1	-2,7	-2,8	-2,7
Netherlands	-3,1	-3,6	-4,2	-1,8	-1,1	-0,7	-2,4
Portugal	-6,1	-6,0	-4,6	-4,0	-2,6	-1,9	-3,7
Spain	-6,7	-6,1	-7,0	-4,9	-3,2	-2,6	0,1
Average	-6,3	-5,5	-5,2	-4,0	-2,13	-1,7	-1,7

Source: *IMF World Economic Outlook 2001*, For 2003 – The European Survey 2003.

Methods of budget deficit reduction applied by different countries were reducing the budget very gently at beginning of 1990's and more rapidly in late 1990's. Countries which introduced revenue based consolidation do not have problems recently in their macroeconomic policies currently, while remaining face more or less serious constraints in the deficit freezing. The source of this problem is indicated below. In some case increased tax burdens were too high. Increased burdens of taxes caused disinvestment, with deregulation and catching-up conditions. In 1993 the average budget debt in EMU candidate countries was -6,3% of GDP, and in 1997 and 1998 all EMU candidate countries were already able to meet the convergence criteria¹⁹.

¹⁹ R. Perotti, R. Strauch, J.v.Hagen, Sustainability of Public Finances, 1998, CEPR, London.

Chart 5.

Source: own arrangement.

Higher tax burdens (direct and indirect) reduce the capacities to invest²⁰. Doing so, they give a snow ball effect, what finally causes reduction of revenues.

Table 11. Different approaches to cover the budget deficit gap

Field in which changes were introduced	Reaction in the sphere of budget
1. Approach: reduction of one of the revenues, while the other is raised	Budget deficit increase
2. Approach: reduction of one of the revenues	Budget revenues increase (this is so in case of customs tariffs, PIT, CIT, access duties)
3. Approach: reduction of CIT	Attraction of FDI – revenues increase
4. Approach: reduction of PIT	Stimulation of consumption – revenues increase (VAT)
5. Approach: introduction of a flat tax	Revenues increase (investments and consumption grows)

Source: own arrangement.

²⁰ O.Blanchard, R. Perotti, *An Empirical Characterisation of the Dynamic Effect of Changes in Government Spendings and Taxes on Output*, NBER Working Paper 1999, 7269.

Different solutions can be applied on different phases of international relations development. In other words the advice of CIT reduction was sufficient to attract investments in case of Ireland. The country did not lower PIT and has big margin to manoeuvre with its reduction, giving an opportunity to do so today, what will additionally stimulate the Irish economy, enabling it to keep high rates also in current decade. This shows that earlier finding of MacDougall²¹ and Richman²² find support in current economy if policy of replacement of one tax burden by another one is made. According to MacDougall and Richman small open economies can have limited interest, if any, in putting a source tax on internationally mobile capital, as capital will always be able to shift the tax burden. In other words, the source tax draws mobile capital away and in result the domestic product and marginal productivity of the complementary immobile factors both fall. This results in decline of income from both mobile factors, and the decline is bigger than in conditions when factors were to pay tax themselves. In other words tax shifts to immobile factor (i.e. labour). With movement of labour ability to move taxes from CIT to PIT vanish. If in EU a Member-State economy still looks for possibilities to lower taxes this will lead to tax competition²³. When such a method occurs within a group of countries, which form internal market and have common currency, than disintegrating tendencies will arise, increasing tensions among members of the integrated group. Solution to this is coordination of taxes or introduction of double level system: one bringing revenues to national budget, other to central: EU budget. If countries do not come to an agreement on common tax levels, than it would be necessary to introduce a flat tax, equal for companies and individuals²⁴.

8. Arguments in favour of coordination of fiscal policy in EMU / EU

Generally the attitude of economists towards fiscal policy is divided, some say that such move is crucial, others consider it as unnecessary. In some cases discussion on this problem reminds the phase of deepening integration, in which political integration was considered as crucial before EMU was set. Recently, it occurred that EMU functions without political

²¹ G. D. MacDougall, *The benefits and Costs of Private Investments from Abroad: A Theoretical Approach*, Economic Record 36, 1960, pg. 13-35.

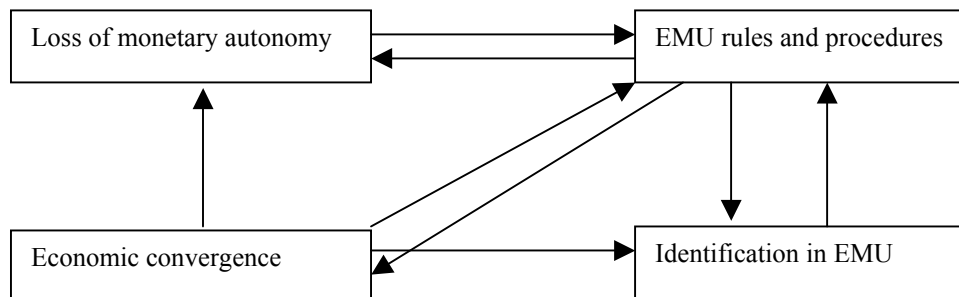
²² P.B. Richman, *Taxation of Foreign Investment Income*, John Hopkins Press, Baltimore 1963.

²³ A. Alesina, R. Perotti, *Fiscal Adjustments in OECD Countries: Composition and Macroeconomic Effects*, International Monetary Fund Staff Papers 1997, 44(2),pg. 210-48.

²⁴ H-W. Sinn, *The New Systems Competition*, Blackwell Publishing 2003, pg. 35.

integration²⁵. Nevertheless, deepening, when conducted in a specific manner, enforces further deepening and it seems that it is so in current circumstances, when fiscal and monetary criteria, strongly dependent on each other, are separated. Fiscal criteria are decided on national level, while monetary on international, EU level. From the economic point of view several arguments can be found, which support the need of fiscal coordination.

Chart 6. EMU self-deepening mechanism of integration



Source: K. Dyson (ed.), *European States and the euro. Europeization. Variation, and Convergence*, Oxford University Press, 2002, pg. 10.

According to R. Prodi²⁶ “euro is a currency without state” but more accurate is saying that “euro is a single currency with many states”. In such circumstances tensions arise between single authority management of monetary policy and decentralized fiscal policies. “This inclines need to coordinate fiscal policies” as well as high and increasing degree of trade and fiscal interdependence in the euro area has increased fiscal spill-overs between countries. The effect of this is multiplied by the fact that “common currency has produced a number of collective goods”. In EMU this is: average inflation rate, exchange rate and external balance are all collective goods, what means that they are shared by and affect all euro-area countries. Until now the coordination between monetary and fiscal policy in the EU or between national fiscal authorities is relatively low in EMU. This is so as

²⁵ One year of EMU. OECD. Paris, 2001.

²⁶ Quotations in this paragraph are made from R. Prodi’s introduction to Second meeting of Group of Economic Analysis embracing Policy Advisers which was held on 16 of April 2002. Those experts help the Commission to make best and most informed possible decisions in economic matters. The Group brings together ca. 25 independent economists from all corners of the Union and a number of Commission Officials. The model for the Group is the Council of Economic Analysis, set by the French Prime Minister in 1997. It reports directly to the President of the European Commission.

emphasis was put on automatic, instead of discretionary stabilization. R. Prodi states that he “approves discretionary fiscal policy, which is confined to critical situations and large shocks”. Nevertheless, according to him “...coordination should not be limited to exceptional circumstances²⁷”. He argues that occasional coordination is ill-suited for implementing a consistent macroeconomic strategy in both normal and exceptional situations. In other words “such a system should be regular not occasional”. His statement led to discussion of experts on:

- first, the need of fiscal discipline and methods that should be effective to conduct it,
- and most effective model of coordination.

The discussion on coordination of fiscal policies in the EU led to several conclusions. Most important is that in EMU fiscal discipline should be kept but at the same time critical remarks were addressed to Stability and Growth Pact (SGP) which was evaluated as model, which is far from optimal²⁸. Its shortcomings are the following:

- lack of incentive to maintain discipline in good times,
- insufficient attention to public debt,
- excessive uniformity of targets.

Experts formed several proposals, which could gear some of the problems. The most important concerned:

- complementing the deficit targets with spending rules covering central and local governments, putting more emphasis on debts, focusing on cyclically adjusted variables – it could be accommodated within current institutional framework,
- idea of creating independent fiscal policy committees at national level, what would require a shift of paradigm.

As far as fiscal policy coordination is concerned – there is a question of principle and question of design²⁹. Opinions vary on concept and benefits of coordination. Nevertheless, there is a general agreement on coordination for aggregate demand management (ideas were to decide on size of correct

²⁷ Look for more into: G. O’Donnel, *UK policy coordination: The Importance of Institutional Design*, 2001.

²⁸ A. Brunila, M. Buti, D. Franco, *Introduction*, in: A. Brunila, M. Buti, D. Franco (ed.), *The Stability and Growth Pact*, Basingstoke, Palgrave 2001.

²⁹ A. Italianer, *Maastering Maastricht: EMU issues and how they were settled*, in K. Gretschmann (ed.), *Economic and Monetary union: implication for national policy makers*, European Institute for Public Administration, Maastricht 1993.

deficit and further on appropriation of Member States). The opinions on this issue were presented by³⁰:

- Klas Eklund – impossible to set an international Committee responsible for setting the fiscal stance;
- Mathias Dewatripont – stressed different starting points of Member States – which means that coordination makes sense if it would help to avoid pro-cyclical budgetary stances;
- Horst Siebert – deficit is a flow variable, while debt – a stock variable, and in such circumstances deficits are variables which must be kept;
- Giampaolo Galli – idea of independent Committee is good idea;
- Harry Huizinga – stressed that much of sensitivity of the budget over business cycle came from variations in tax revenues, what means that the policy should be addressed towards stabilization of the revenues; this expert was against automatic stabilizers on tax side, what was supported by an argument showing that stabilization of income over business cycle comes at a cost of fewer incentives for work and investment; it seems that his opinion was not shared by others and his ideas were solitary;
- Judit Nemenyi – fiscal policy is a long-run policy instrument and should not be used to pursue short- or medium policy goals; she was referring to Hungarian experience in which setting deficit goal helped to reduce the debt and deficit; she forgot that stabilization policy in Hungary was applied in specific circumstances, created by accession, what in the end led to increase of the budget deficit twice above the required level, which is obligatory until now;
- John Llewellyn – was pointing at debt not at the deficit, stressing that sustainability as the capacity of country to sustain the tax pressure;
- John FitzGerald – shared the view that there is no need for EU to be involved in ensuring sustainability of debt and avoid inappropriate fiscal stances; he stressed that differences in demographic developments and needs linked with this are different in each country and thus should be reflected in SGP;
- John Dolado – was in favour of simple and logical rules, what should be considered as a correct approach if we look back at all solutions that were applied in the European Communities in order to achieve certain goals.

³⁰ A. Sapir, M. Nava (ed), *Economic policy making in the European Union. Proceedings of the first four meetings of the Group of economic Analysis*, European Commission. Group of Policy Advisers, Luxembourg 2003, pg. 129-132.

Commissioner Solbes put forward an idea that the role of each policy actor and their responsibility should be clear. They include: budgetary discipline, measures to increase growth potential, reactions to economic shocks, etc. He stressed that the problem of SGP stems from the fact that goal of close-to-balance position was not met. He concluded his statement that Commission will put forward proposals for behavioural rules, which can improve current system by exploiting possibilities within the current Treaty framework. In case of policy coordination opinions of experts were also dispersed³¹:

- Horst Siebert was in position that until now coordination was limited to mutual information; he was in favour of automatic stabilizers and creation of conditions in which they are allowed to work;
- Peter Birch Sørensen agreed that automatic stabilizers should be allowed but this was univocal with seeing SGP as cyclically-adjusted measure, what as practiced until now has proved to be a bit of wishful thinking;
- Maria Jose Rodrigues stated that macrostabilization policy should be build upon three pillars: (1) stability and discipline; (2) enhancing the growth potential; (3) convergence and catching up; she said that it is useful to clarify rules and work on monitoring improvement of interface between BEPGs and national budgets; in case of convergence – she said – it is less important to deal with country specific features as spending is different across countries; her opinion was correct but a remark is needed concerning tax policy that also varies (in case of CIT and PIT).
- Giampaolo Galli was pointing out that a move towards cyclically adjusted balances would not help, as we are not equipped with instruments that can be used to measure them;
- John FitzGerald underlined that bad behaviour of one or two countries can damage the entire euro area; he was suggesting that a clear definition should be given what appropriate and actual fiscal stance should be;
- John Sutton said that coordination is supported as the fear increases that lack of discipline will undermine stability; his suggestion was to introduce three levels of coordination: (1) cyclical policy; (2) response to big shocks; (3) response to secular trends;
- Tryphos Kollintzas made a remark that coordination of dealing with spill-overs will be needed but this has to be done differently than today;

³¹ Ibidem, pg. 132-134.

- John Llewellyn pointed out that discretionary policy worked, which is proved by reduction of fluctuations in output; in his opinion cyclically adjusted budget balances are useful information;
- Michael Landesmann was in favour of debt sustainability concept but was sceptical about ability to define its optimal level;
- Harry Huizinga remarked that macroeconomic spill-overs of fiscal policy were far from clear and this is one of the strongest arguments against using national fiscal policy, discretionary or not, affecting output in other countries;
- Klas Eklund informed that coordination of fiscal policy has to be funded on credibility; according to his view a set of rules for debt sustainability could decrease the need for coordination;
- Dariusz Rosati called for fiscal discipline, at the same time undermining the need of coordination of fiscal policy on EU level;
- Mathias Dewatripont stressed the need of preparing the debt targets operational; His position was to introduce rule-based coordination, as a measure ensuring policy of the ECB;

The Commission in its Communication to the Council and European Parliament dated 27.11.2002 has given an overview of budgetary policies³². This document consists of following points:

- the SGP: an appropriate framework for conducting budgetary policies with valid short- and long-term objectives³³,
- mixed budgetary performance since 1999,
- difficulties in implementation of the SGP³⁴,
- proposals to improve the interpretation of Stability and Growth Pact,
- a four point program to improve the implementation of the Stability and Growth Pact.

The document stressed all the well known facts that SGP was not implemented in several member states, what undermines the whole stability policy conducted in EU and can have an impact on monetary parameters. This can be dangerous especially in the light of budget deficits that occurred in two biggest European economies: France and Germany. Smaller economies in this circumstances do not have such big impact on European economy (i.e. Portugal).

³² *Strengthening the Coordination of Budgetary Policies*, Communication of the Commission to the Council and European Parliament [COM(2002) 668 of 27.11.2002].

³³ M. Buti, *The Stability and Growth Pact three years on. An Assessment*, Paper presented at seminar on fiscal policy in EMU, Stockholm, 3 May 2001.

³⁴ P. Jacquet, J. Pisani-Ferry, *Economic Policy Coordination in the Euro-zone: what has been achieved? What should be done?*, London January 2001, CER, London.

The program points out that fiscal rules to be effective need to be accomplished with:

- firm political commitment of all parties concerned to adhere their budgetary commitments at EU level and to exercise their role in process peer review and enforcement,
- timely and high-quality analysis of the economic and budgetary conditions so that policy conclusions are based on reliable data and firm analytical underpinnings,
- effective enforcement procedures that address slippage from agreed budgetary targets in a timely and robust manner,
- measures to improve communication so as to enhance the external pressure on Member States to run round fiscal policies.

The four point program requires from the Members States:

- reaffirmation of their political commitment to the SGP in a “Resolution to reinforce the coordination of budgetary policies” (explicit defining criteria of main SGP provisions, ex.: that the “close to balance or in surplus” requirement would only be envisaged if strict conditions and safeguards are met; defining also behavioural norms in coordination of budgetary policies at EU level);
- upgrading the analysis of economic and budgetary policies (The quality and timeliness of government finance and statistics need to be improved as they are a foundation on which budgetary surveillance is built. It is essential to follow an effective, timely and transparent action in its role as statistical authority in domain. Quality of public finances should be given more attention; Stability and convergence program has to meet the requirements of SGP; Commission will reinforce its surveillance of MS economies and in particular concentrating on specific countries);
- more effective enforcement procedures (specification will create conditions in which Commission can activate early warning mechanism; inappropriate loosening the budget in good times should be viewed as violation of budgetary requirements; precision what is understood by the notion “country on satisfactory pace”);
- better communication through openness and transparency (reliable and timely information must be given on budgetary commitments of MS and how SGP is being implemented)³⁵.

The proposed four points on stabilization are correct but do not seem to produce sufficient remedy, which can be found in either introduction of flat taxes individually by states or in a group of countries. Moving towards

³⁵ B. Eichengreen, Ch. Wyplosz, *The Stability Pact: More than a minor nuisance?* 1993, Economic Policy 26, pg. 65-104.

such goal in stages (taking similar period of time as preparation for EMU, starting from Werner's Report in 1970 till introduction of EMU in 1999 took about 30 years) postpones immediate solution of difficulties on the markets and thus can be strongly opposed politically. Solution here can be found either in introducing flat taxes in smaller group of countries (within the framework of enhanced cooperation). Those remaining outside, shortly, will become sensitive towards this move, joining the group.

9. Conclusions

Concentrated so much on European affairs, which are presented as competing and contradictive with solutions applied in the American economy, economist, who were looking for remedies, in majority did not find proper solutions that could bring release to tensions created by current fiscal and monetary system in EMU and, wider, in the EU. Solutions are simple: if decisions to coordinate fiscal policy in all Member States of the EU are not taken (including newcomers from East Central Europe) than possibilities are at least four:

- enhanced integration of group of eight (minimum) within the scope given by enhanced cooperation,
- crises caused by budget imbalances of Germany and France, enlarged by strong capital outflows of European economy as corporate rate in US is higher than in EU, while everyone watches nominal interest rate, lower in EU countries, which will force political decisions,
- individual approach country by country, what will increase tensions between them, while they continue to compete with level of taxes,
- leaving things as they are will lead to similar situation as the one mentioned in the second point above.

One should agree that solutions introduced here should be simple and logical. This means that first, fiscal convergence criteria (unadjustable until now, and fixed to the formerly defined level), should be changed (i.e. lowered: budget deficit to ≥ 0 as in current conditions of very low inflation as well as interest rate they result in increase of the public debt and thus in increase of budget deficit). Second, reductions of all allowances, credits and privileges should be eliminated, what ought to be accompanied by tax burden reduction in phases, leading to a flat tax in each country equalizing CIT and PIT. Reduction of direct taxes should not be compensated by the indirect ones. Just the opposite it should be followed by reduction of the indirect tax burdens as well, what stimulates consumption. This should be done in stages, that could be agreed by all Member States or just a group.

There is no doubt that the rest will follow as their sensitivity will increase with time passing and changes introduced. As a follow-up (or maybe a precondition) the reduction of tax burdens should be accompanied by restructuring of the budget expenditures. This will raise real competitiveness and intensified competition, elements important in a strategy that points at creating from the EU the most competitive market in the world.

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Sustainability of Fiscal Policies in the EU and the CEEC

1. Introduction

The persistently large government deficits, and the resulting accumulation of debt in most developed countries since the mid seventies, raised significant concerns over the existence of long-run constraints on public borrowing, and the economic consequences of fiscal indiscipline. This has been one of the most controversial and discussed economic issues among academics and policymakers during the process towards EMU, and has now been revived with the plans for EU enlargement and, especially, with the recent controversy over the excessive deficit procedure in Germany and France.

The discussion over these questions is particularly important in a monetary union for several reasons. On the one hand, a deeper degree of economic and financial integration increases the probability that the effects of unsustainable fiscal policies in one country may spill over to other member states, eventually threatening the stability of the whole union. On the other hand, the complete liberalisation of financial markets, and the elimination of exchange rate risk, increases the internal mobility of goods, services and production factors, raising spending and tax competition and hence restricting national fiscal flexibility. This may be particularly problematic for a highly indebted country, where a significant fraction of public revenues is permanently reserved to debt service, restricting considerably its capacity to implement stabilisation policies and provide sufficient public goods. This could further deteriorate the fiscal situation, by jeopardising growth prospects and diverting the tax base.

Despite recent efforts towards fiscal consolidation in most EU and Central and Eastern European countries (CEEC), complying with the Maastricht's convergence criteria and the Amsterdam's Stability and Growth Pact, expensive welfare programs and unfunded social security systems, together with an ageing population, can exert considerable strain on public finances over the next generations.

The main objective of this section is to investigate whether current fiscal policies are sustainable, that is, able to guarantee the government's solvency. This question is tested, for those countries where data is available, by examining the long-run univariate and multivariate stochastic properties

* The authors are researchers at Universidade de Évora in Portugal.

of the fiscal variables, as implied by the intertemporal budget constraint. For the other countries, most CEEC, data restrictions do not allow the application of such methodology, but a careful observation of recent trends may give some insights on the state and prospects for public finances.

2. Literature Review

“There is wide agreement on the need for fiscal discipline in a monetary union, but there are several problems with our current definition of it. [...] (i) a focus on actual rather than cyclically adjusted deficits, which results in insufficient constraints on lax fiscal policies in good times and excessively tight constraints on responsible fiscal policies in bad times (this shortcoming is however being addressed, as the assessment of the budgetary situation is increasingly based on cyclically-adjusted data); (ii) a focus on the deficit rather than on the debt situation, i.e. on short term constraints rather than on long term sustainability. [...]”

Pisani-Ferry (2002)

The governments' ability to cope with fiscal deficits has been analysed in a considerable number of studies. In order to depict whether a country may experience fiscal sustainability problems in the future, several theoretical approaches have been considered. The Intertemporal Budget Constraint (IBC) appears as a common starting point to all of them but the underlying assumptions assume particular features across the different approaches. One perspective is to consider a “collateral constraint”: the stabilization of the debt-to-GDP ratio at its current level. The other is to focus on the long-term viability of the current fiscal policy and macroeconomic environment while assuming that the present statistical properties of the time series will not change in the future. In the first approach, a limit over the level of debt relative to GDP is imposed. In the second, it is the debt-to-GDP growth rate the relevant variable to be restricted.

Regarding the first approach, empirical analysis may assume several forms. A simple examination of whether the current net-of-interest surplus is enough to guarantee the instant stabilization of the current level of public debt, by comparing the actual with the necessary net-of-interest surplus to achieve stability, may be performed. This is often mentioned as the “permanent primary gap” evaluation proposed by Buitert (1983 and 1985). But the goal of the authorities may as well be to stabilize the debt-to-GDP ratio, not immediately at its current level, but at a certain optimal level in a specific future date. In this case, an evaluation of whether it is possible to converge to the established target, and whether the current economic policy will allow us to get there in time, is particularly relevant.

Blanchard (1990), however, states that those simple measures of sustainability founded on the stabilization of the debt-to-GDP ratio at its current level or at a certain value in the steady state show important limitations: first, because they assume that present fiscal conditions will prevail in the future; second, because, even though they indicate whether the government should continue with the current fiscal policy, they do not provide any quantitative indication about the magnitude of the necessary policy change. By considering current projections for the relevant variables and estimating the precise value of the fiscal adjustment required to achieve sustainability, Blanchard (1990) suggests a different set of fiscal indicators aiming to examine the sustainability issue such as, for instance, the difference between the constant average tax rate necessary to stabilise the debt-to-GDP ratio during a certain time period and the actual implicit tax rate. This tax gap may be calculated for an infinite set of time horizons, bearing in mind however that, as the time horizon becomes longer, the probability of misreckoning the future path of the variables becomes higher. This is, in fact, the main problem with this kind of indicators: the availability and quality of the projections.

A less restrictive approach is to test the IBC in an infinite horizon, which brings us to the second approach, mentioned a few paragraphs above. Basically, here we focus on the long-run relationships and on the long-term properties of the relevant variables. Differently from the first approach, the debt ratio is no longer “required to stabilize but its growth rate should not exceed the interest rate” (Vieira, 1999). In order to test the sustainability condition empirically, this approach uses extensively the methodologies proceeding from the unit root and cointegration literature. Most empirical studies examine the time series of debt and deficit, first analysing their order of integration (econometric methods to the ones put forward by Trehan and Walsh, 1991) and then testing for cointegration (econometric methods like the ones used by Hakkio and Rush, 1991). According to Vieira (1999) “among others, the tests can be divided according to a chronological order, testing conditions, econometric techniques, variables used, or assumptions on the interest rate”.

In fact, among the considerably large set of empirical studies using this kind of approach, several particular procedures may be identified. Sometimes, a constant interest rate is assumed like in Hamilton and Flavin (1986), where stationarity tests are used to analyse long-run limitations on debt financing, or in Hakkio and Rush (1986), where the stationarity of the net-of-interest deficit is tested; Trehan and Walsh (1988, 1991), where the focus lies on the stationarity of the total deficit, or Hansen et al. (1991), where an analysis of the stochastic properties of the series of debt and net-of-interest surplus is put forward. As for avoiding the assumptions on the

expected interest rate, allowing for stochastic variations in the interest rate like Wilcox (1989), Hakkio and Rush (1991) or McCallum (1994) suggest, may be a solution.

US data is widely used in the literature concerning the sustainability of fiscal policies. Analyses have focused mainly on the univariate properties of debt (Hamilton and Flavin, 1986; Wilcox, 1989) or on cointegration between government revenue and expenditure (Trehan and Walsh, 1988, 1991; Hakkio and Rush, 1991; Martin 2000). Likewise, several empirical studies focusing on EU countries use simple measures of fiscal sustainability or the above-mentioned approaches when testing for sustainability.

Von Hagen and Harden (1994), for instance, compute the difference between the debt ratio and the discounted debt ratio for a fixed time horizon, using actual data instead of the expected debt ratio and *ex-post* real interest rates. Policies are considered to be non-sustainable if, for a given period, this difference assumes negative values. Results point to the following: France, Germany, the U.K., Luxembourg and the Netherlands show evidence of fiscal practices that are close to sustainable for the whole sample period (1971-1984). As for Denmark, Belgium and Ireland, they start the sample period with unsustainable practices but improve their performance in the 1980s. The authors point to the existence of unsustainable practices in Italy, Greece, Spain and Portugal. Artis and Marcelino (1998) find that, with few exceptions, EU governments are insolvent, even though debt/GDP ratios show signs of stabilizing. Following the Blanchard et al. (1990) approach, Gang et al. (2001) examine sustainability for seven EU Member States (Belgium, France, Germany, Italy, Netherlands, Spain and Sweden) and conclude that, except for Spain and Sweden, none of the countries under consideration show evidence of sustainable policies in the mid-nineties.

On the other hand, Afonso (2000) only finds evidence of stationarity of the first difference of the stock of public debt in Germany, Austria and the Netherlands and, after a process of cointegration tests between public revenues and public expenditures, the author concludes that fiscal policy may not be sustainable for most countries with the possible exceptions of those three. Uctum and Wickens (2000) extend the results of Wilcox (1989) and consider the case where the discount rate is stochastic and time-varying and the discounted primary deficit can be strongly or weakly exogenous. The authors analyse the fiscal stance of the United States and the European Union since the 1970's and conclude that there is some evidence of sustainable fiscal practices in Denmark, the Netherlands and Ireland, while Belgium, the United States, Italy, Spain and Portugal show signs of unsustainability in their fiscal policy. Considering not only the European

countries and the United States but also Canada, Leachman et al. (2001) employ a multicointegration procedure and find evidence that Finland, Norway, the U.K. and Switzerland display government budgeting behaviour consistent with sustainable fiscal practices and that, on the contrary, in Belgium, Denmark, France, Greece, Italy, the Netherlands, Portugal, Spain and Sweden government budgeting behaviour is inconsistent with sustainable fiscal policies. Over the sample period (which varies according to the country being analysed) the governments of these last countries may have been trying to exploit low rates of interest relative to growth or carry out a Ponzi scheme. Yet, if growth declines, sustainability of the fiscal processes may become problematic, demanding structural adjustments.

More recently, the European Commission (2003) summarizes the status of public finances in the European Union and infers some interesting conclusions from the results of the tax gap indicator. Even assuming that the Stability and Growth Pact compliance scenario is accomplished and all member states achieve their budget targets for 2006, there is a risk of unsustainable public finances emerging in about half of the EU Member States.

Overall, empirical evidence reveals diverse results, according to the different methods employed and periods considered. Besides, this diversity of results may arise as a consequence of the specificity of national experiences or different definitions of sustainability (Fève and Henin, 2000). Nevertheless, all the references mentioned above argue that some EMU countries will face, sooner or later, substantial tax increases or expenditure cuts unless other mechanisms are brought into play in order to improve the structural government balance, such as promoting labour market flexibility and improving economic performance.

3. Methodology and Data

Sustainable fiscal policies are here defined as those that can remain unchanged into the future without violating the government's intertemporal budget constraint. This long-run constraint is basically an accounting identity requiring the outstanding stock of debt to be completely offset by the expected, in present value, sum of all future primary surpluses and money creation.

This requires the complementary restriction that the discounted value of the debt-GDP ratio must equal zero in the limit. With the variables represented as ratios to GDP:

$$(1) \quad d_t = \sum_{j=1}^{\infty} \frac{1}{(1+\rho)^j} \left\{ t_{t+j} + \Delta m_{t+j} + m_{t+j-1} \left[1 - \frac{1}{(1+\pi_{t+j})(1+\psi_{t+j})} \right] - g_{t+j}^* \right\},$$

$$(2) \quad \text{and} \quad \lim_{n \rightarrow \infty} \left[\frac{d_{t+n}}{(1+\rho)^n} \right] = 0$$

where ρ_t is the real interest rate net of output growth ψ_t , with mean ρ , and d_t is the interest bearing real public debt outstanding at the end of the period. The variables g_t and t_t represent, respectively, real primary government expenditures, *i.e.*, excluding interest payments on the public debt and real primary government revenues, excluding seigniorage. The variable g_t^* is computed as $g_t + (\rho_t - \rho)d_{t-1}$, and m_t is the monetary base. This presentation in ratios to GDP is consistent with the usual indicators employed to evaluate the performance of fiscal policies, and removes from the tests potential effects of nonstationarity in inflation and real GDP growth.

As referred in the previous section, several distinctive testing procedures have been proposed to investigate this long-term notion of fiscal policy sustainability with a transversality condition. Since the sustainability condition is interpreted as a long run relationship, it suggests the use of methodologies derived from the unit root and cointegration literature to test it empirically. The methodology adopted below follows the approach suggested in Hakkio and Rush (1991).

After some mathematical manipulation of equation (1), the following expression can be obtained:

$$(3) \quad tg_t - tt_t = \sum_{j=1}^{\infty} \frac{1}{(1+\rho)^j} (\Delta tt_{t+j} - \Delta g_{t+j}^*),$$

where tg_t represents total government expenditures ($g_t + \rho d_{t-1}$) and tt_t stands for total government revenues $\{t_t \text{ and } m_t + m_{t-1} / [(1+\pi)(1+\psi_t)]\}$, as ratios of GDP.

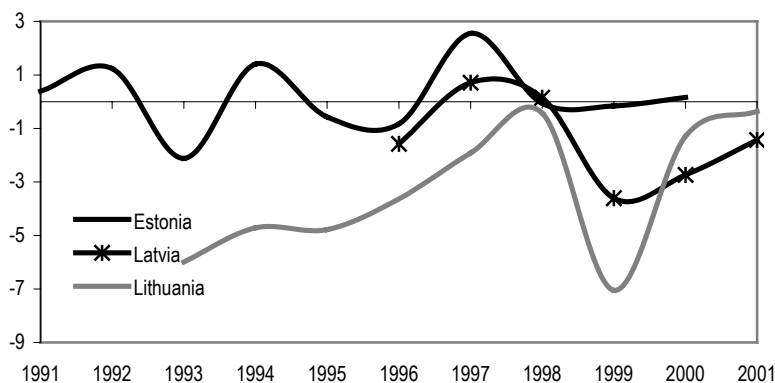
All the variables on the right-hand side of equation (3) are expressed in first differences. If all these series in first differences are stationary, *i.e.*, if all the variables in levels are I(1), the right-hand side of (3) is stationary. This implies that the left-hand side, the global deficit, must also be stationary. Since tg_t and tt_t are, by the previous assumption, integrated of order one, they must therefore be cointegrated.

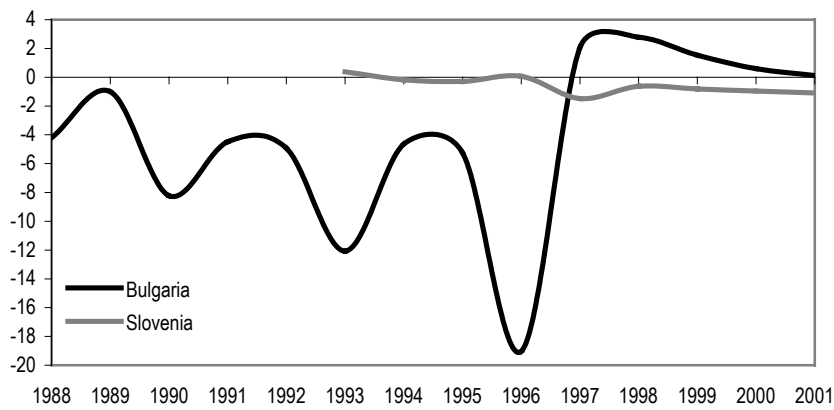
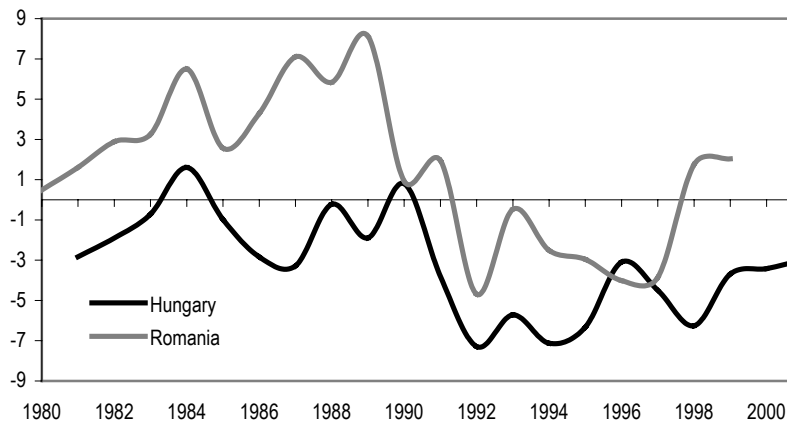
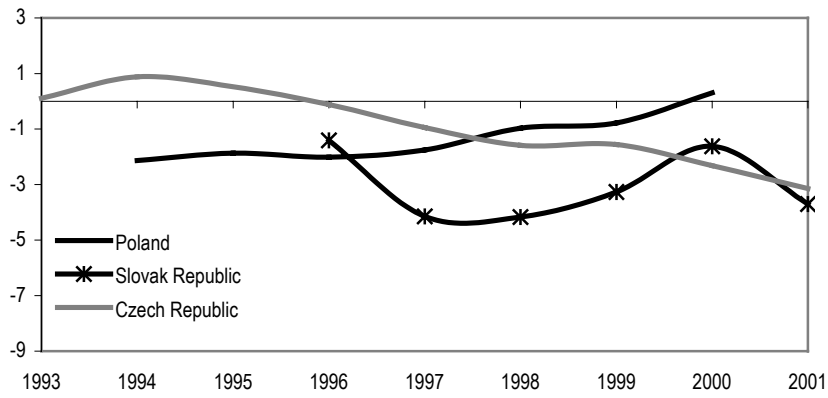
The unit root tests will employ the widely used augmented Dickey-Fuller (ADF) methodology, with the lag length chosen by the Schwarz Bayesian Criterion (SBC). The hypothesis of cointegration will be tested using the procedure developed by Johansen (1988) and applied in Johansen and Juselius (1990) of maximum likelihood tests, which are based on the multivariate general representation of the vector error-correction model. Both alternative test statistics, known as the 'Trace' and the 'Maximum-eigenvalue' statistics, will be computed. The latter tests the null hypothesis of, at most, r cointegrating vectors against the alternative of exactly $r+1$, while the former tests for, at most, r cointegrating vectors against an alternative of, at least, $r+1$ vectors.

The choice of which and how the deterministic terms are included in the model is a nontrivial issue, and may have considerable influence on the final conclusions of the tests (Johansen and Juselius, 1990). Given the characteristics of the variables involved, the tests will be predominantly performed in a model with a constant term in the cointegrating vector and no other deterministic elements.

The tests will be performed on all countries for which a sufficient period can be analysed. The data set is taken from the IMF's *International Financial Statistics*, and considers annual data for the central government. Annual data allows the use of a longer time span, more powerful tests, and avoids problems of seasonality.

Figure 1. Fiscal deficits in the CEEC

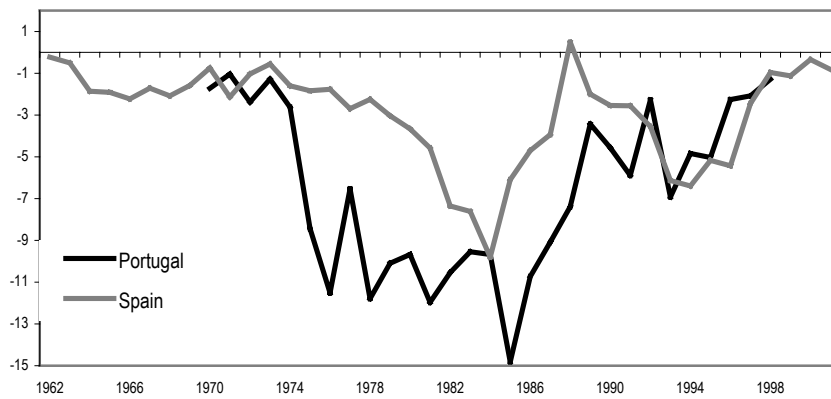
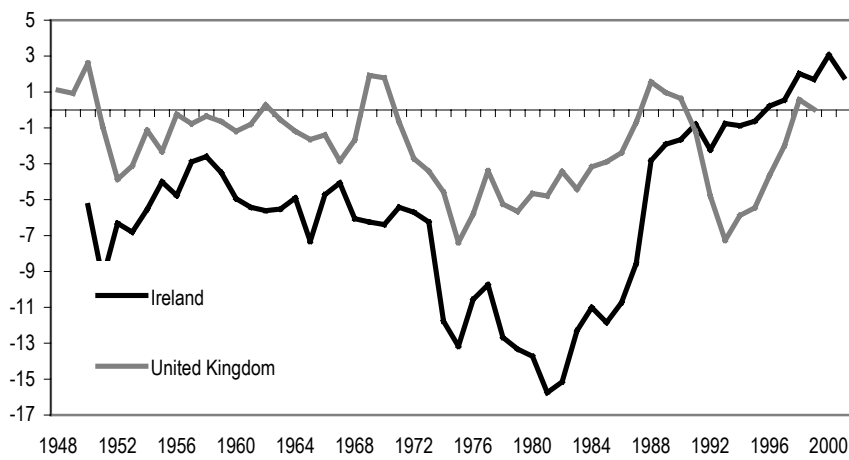
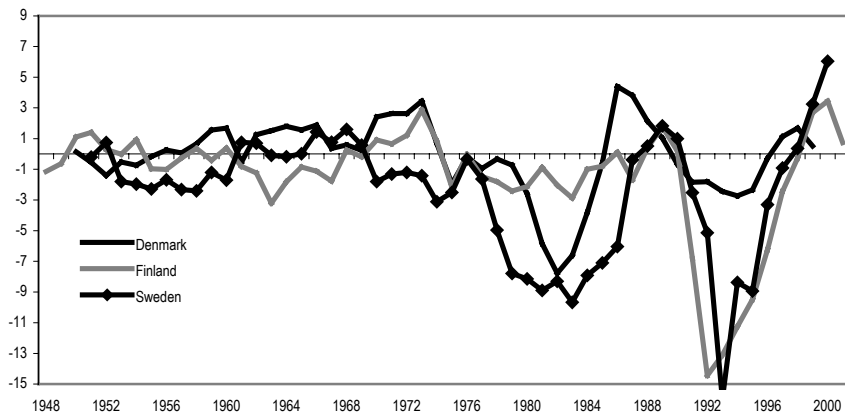




Source: International Financial Statistics, IMF.

Figure 2. Fiscal deficits in the EU





Source: International Financial Statistics, IMF.

Observing the data, we find clear signs of fiscal retrenchment in the last few years (Figures 1 and 2). The problem is that some of these fiscal adjustments may involve only temporary effects on the measures of the deficit and debt. An improvement of the budget accounts just before EMU through a wave of privatisations as in France, or a cut in public investment as in Germany, for example, has an immediate effect of fiscal retrenchment, without the potential political costs of a tax increase or a reduction of public current expenditures. However, these decisions may yield merely a temporary effect on the deficit, if the expected net returns from those privatised assets or from the curtailed investments exceed, respectively, their sale-value and initial cost.

4. Testing long-run sustainability

Table 1. displays the univariate stochastic properties of the main budget variables, with a special emphasis on the total surplus. The unit root tests on the series of total revenues and expenditures may provide earlier indications of the fiscal situation in some countries, but are intended mainly as a pre-test for the cointegration analysis. The test on the total surplus, however, provides a more direct indication of sustainability and stability of the debt ratio.

The empirical evidence on Table 1. suggests that all series of total revenues and total expenditures are integrated of first order.¹ Before proceeding to the cointegration analysis, a first direct test of sustainability can be performed. A sufficient, but not strictly necessary condition is the stationarity of the series of total surplus. Besides testing sustainability, this condition also examines whether the ratio of debt-to-GDP will grow without bound. The results are shown on the last column of the above table.

The unit root tests more or less strongly reject the null hypothesis of nonstationarity of the total surplus in Austria, Denmark, Finland, France, Germany, Luxembourg, the Netherlands (at the 10% level) and the UK. In the particular case of the Iberian countries, although the time period available is relatively smaller, the results clearly suggest unsustainability. This is certainly due to the very large imbalances incurred by both countries during the 1970s and 1980s. The situation has gradually improved, although the Council of the EU has recently (November 2002) issued a Recommendation against Portugal in the framework of the Excessive Deficit Procedure (article 104.7 of the Treaty).

¹ The tests on the first-differenced series, not shown, unanimously rejected the null of nonstationarity, excluding the hypothesis of higher orders of integration.

Table 1. Unit root tests

Country	sample period	Augmented Dickey-Fuller test statistic		
		total revenues	total expenditures	budget balance
Austria	1948-1998	-1.0773 (0)	-1.3054 (0)	-3.039** (0)
Belgium	1948-1998	-0.7234 (0)	-0.9932 (0)	-1.5672 (0)
Denmark	1950-1999	-1.4974 (0)	-1.4958 (0)	-3.7352** (1)
Finland	1948-2001	-1.1885 (0)	-2.1194 (1)	-3.4548** (1)
France	1948-1997	-1.0280 (0)	-0.4081 (0)	-3.0073** (0)
Germany	1949-1998	-2.5270 (0)	-2.5235 (0)	-4.2987** (0)
Greece	1951-1999	-1.3579 (0)	-1.2611 (0)	-1.9161 (0)
Hungary	1981-2001	-3.1506 (0)	-0.6711 (0)	-2.1257 (0)
Ireland	1950-2001	-1.6659 (0)	-1.4073 (0)	-0.9107 (0)
Italy	1948-2001	-0.9442 (0)	-0.9983 (0)	-1.0505 (1)
Luxembourg	1973-1997	-2.3661 (0)	-1.9857 (0)	-4.0759** (0)
Netherlands	1948-2001	-1.4874 (0)	-1.2085 (0)	-2.7306* (0)
Portugal	1970-1998	-1.4446 (0)	-2.1163 (0)	-1.9582 (0)
Romania	1980-1999	-1.7834 (0)	-2.9845 (0)	-1.9586 (0)
Spain	1962-2001	-0.7096 (0)	-1.5122 (0)	-2.1646 (0)
Sweden	1951-2000	-1.7706 (0)	-1.8835 (0)	-1.9813 (0)
United Kingdom	1948-1999	-1.5255 (0)	-1.6280 (0)	-3.4677** (1)

Notes: The lag length is chosen according to the 'Schwarz Bayesian Criterion'. In parenthesis is the number of lagged differenced terms used in the regression (in all ADF tests the maximum lag length considered was four). The asterisks ** (*) indicate rejection of the null of nonstationarity at the 5 (10) per cent significance level.

In January 2003, a Recommendation has also been issued to Germany and an *Early Warning* to France². The fact that both countries have been found in the tests above to follow sustainable fiscal policies suggests that the European authorities are more concerned with short-term values than with long-run trends.

² More recently, new recommendations have been issued by the European Commission, which has opted for granting an extra year for the correction of the excessive deficit in Germany, as it has been proposed for France. Efforts are required from these two countries in order to avoid risks of persistence of the excessive deficit situation in 2005 (roughly two thirds of the required overall fiscal consolidation of 1,3% over two years (2004-2005) should take place in the first year – 2004).

Table 2. Cointegration tests

	λ_{\max}		Trace	
	r=0	r<=1	r=0	r<=1
Austria	17,0844** (1)	2,1116 (1)	19,1960* (1)	2,1116 (1)
Belgium	5,4005 (1)	2,8826 (1)	8,2831 (1)	2,8826 (1)
Denmark	15,7881* (2)	6,1452 (2)	21,9333** (2)	6,1452 (2)
Finland	13,4806 (2)	1,5562 (2)	15,0368 (2)	1,5562 (2)
France	10,6394 (1)	4,1475 (1)	14,7869 (1)	4,1475 (1)
Germany	19,6508** (1)	9,4210 (1)	29,0718** (1)	9,4210 (1)
Greece	11,8436 (1)	2,6677 (1)	14,5112 (1)	2,6677 (1)
Hungary	6,8596 (1)	1,8632 (1)	8,7228 (1)	1,8632 (1)
Ireland	6,6257 (1)	2,7869 (1)	9,4126 (1)	2,7869 (1)
Italy	10,7304 (1)	1,4950 (1)	12,2254 (1)	1,4950 (1)
Luxembourg	19,3684** (1)	3,7413 (1)	23,1096** (1)	3,7413 (1)
Netherlands	17,3428** (1)	1,3833 (1)	18,7261* (1)	1,3833 (1)
Portugal	5,9909 (1)	3,3013 (1)	9,2922 (1)	3,3013 (1)
Romania	11,5664 (1)	2,1166 (1)	13,6830 (1)	2,1166 (1)
Spain	6,6434 (1)	3,1209 (1)	9,7643 (1)	3,1209 (1)
Sweden	10,3099 (1)	3,6817 (1)	13,9916 (1)	3,6817 (1)
United Kingdom	8,9430 (1)	2,1975 (1)	11,1405 (1)	2,1975 (1)

In parenthesis is the order of the VAR. The asterisks ** (*) indicate rejection of the null hypothesis of no cointegration at the 5 (10) per cent level of significance. Critical values (Pesaran, Shin and Smith, 1997): 15.87/20.18 (5%) and 13.81/17.88 (10%) for the λ_{\max} /Trace tests and the null hypothesis of r=0, and 9.16 (5%) and 7.53 (10%) for both tests of r \leq 1.

The robustness of the above conclusions derived from the unit root tests on the budget surplus may be evaluated with a cointegration test between total revenues and expenditures. Table 2 presents the results of the

Johansen testing procedure. The model employed in the tests includes a constant in the cointegrating vector and no other deterministic terms. The order of the VAR (in parenthesis) has been chosen according to the indication of the Schwarz Bayesian Criterion (SBC).

The null hypothesis of no cointegration is rejected for Austria, Denmark, Germany, Luxembourg and the Netherlands, reinforcing the results obtained above. For Finland, France and the United Kingdom no evidence of cointegration was found and therefore the final results are not conclusive, requiring further econometric and data analysis. For all other countries, the evidence strongly suggests unsustainable fiscal policies and therefore the need for further fiscal corrections. This is the case of Portugal and Spain for example, which have recently followed similar paths in terms of deficits and debt (Figure 2.).

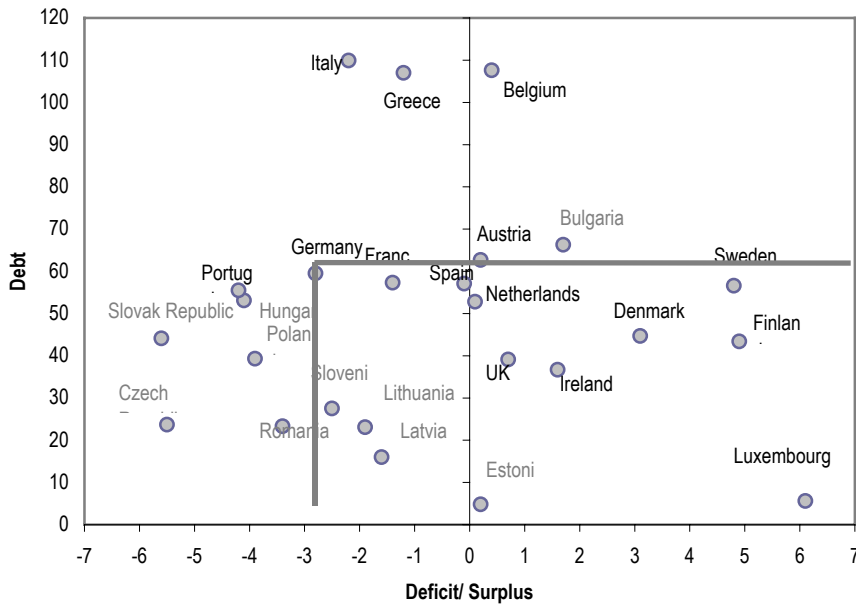
5. The CEEC's fiscal situation

Except for Hungary and Romania, data is not available for a long-run analysis in all other CEEC. Besides lacking a sufficiently long data series, fiscal variables in these countries reveal large fluctuations and significant structural breaks, especially in Bulgaria.

Observing the evolution of the deficit/surplus as a ratio to GDP (Figure 1.), it appears that the series seem to converge to equilibrium in the last years of the sample. The prospects of accession and the conditions of fiscal consolidation seem to have significantly reduced budget deficits. A more careful analysis, however, suggests different patterns. The Czech Republic, for example, has been presenting progressively higher deficits since the mid 1990s, the Slovak Republic displays the largest deficit at the end of the period considered (3,7% of GDP), and Hungary also presents a relatively high deficit in 2001 (2,9%), but improving from 6,3% of GDP in 1998. On the other extreme, Bulgaria, Romania, Estonia and Poland display fiscal surpluses in the last year for which data is available.

Figure 3. displays the positions of the current and incoming member countries in a debt/deficit chart for 2001, the latest year for which data is available for all these countries. The values are not directly comparable with the previous data set since they refer to the general government and therefore include for example the social security accounts, an important element in many countries.

Figure 3. General Government Consolidated Gross Debt and Deficit/Surplus (% of GDP) in 2001



Source: European Commission (2002a and 2002b) Eurostat (2002 and 2003).

Most CEEC are concentrated in the lower left part of the chart, presenting higher deficits but lower debt ratios. The lower the debt ratio, the lower the share of the budget allocated to the debt service and therefore the less difficult it is to reduce the deficit. Current EU members appear mostly in the top half of the chart, burdened with high public debts, and some in the lower right, a clear sign of fiscal discipline.

6. Final remarks

Although a long-term analysis reveals some unsustainability issues, the Stability and Growth Pact's extremely restrictive provisions may be sufficient to prevent major future fiscal problems both in the current and in the prospective EU members. Even the deteriorating fiscal conditions in recent years in some EU countries, such as Portugal, seem to be mainly due to the economic recession, and have raised doubts, even from the European Commission's presidency, on the desirability of maintaining the strong restrictions of the Pact in these declining economic conditions.

For those CEEC for which data restrictions do not allow a long-run analysis, no major problems can be identified from a visual inspection of the fiscal variables. One factor benefiting these countries is the fact that they do not hold a very high debt to GDP ratio, comparatively to some EU countries, where public debts above GDP have been observed in Italy, Greece and Belgium. Within the CEEC, only Bulgaria presented a debt ratio above 60 per cent in 2001 (Figure 1.). A very high debt ratio implies that a large share of the public revenues must be reserved for debt service, reducing the autonomy of the fiscal policy to react to the business cycle.

The most serious threat to fiscal stability in all the European countries is the predicted changes in their demographic structures. A rapidly ageing population will increase the fiscal burden, through the welfare and health systems. Dependency ratios will, on average, double in the next fifty years (Table 3.). The situation will be particularly problematic in the Southern European countries, notably in Spain where the dependency ratio is expected to reach 73,8 in 2050.

The population in the CEEC is, on average, relatively younger than the EU's average, which could postpone all the fiscal problems related to the social security funds and welfare programs. However, according to the United Nations' projections, population in the CEEC is ageing faster. By 2050, the median age will be above that of the current EU members (Table 3.).

Recognizing that "long-term fiscal sustainability is a major issue in many EU Member States" (Commission of the European Communities, 2003, pg. 7), the European Commission recently issued a report addressing the problem faced by pension systems. According to the report, public expenditures on pensions will increase, on average in the EU members, from 10,4% of GDP in 2000 to 13,3% by 2050, with the effects starting within the next decade.

EU governments are now facing the important challenge of ensuring the sustainability of their welfare systems. Fiscal policies must be implemented to reduce the current debt burden and to modernise the pension systems. At the same time, economic policies aimed at increasing productivity and employment are also required.

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The euro after a half of a decade

Five years ago the European Monetary Union (EMU) was launched and the euro was implemented in order for European Union (EU) member countries to more appropriately benefit by from their economic potential. The increasingly complex external environment has tested the efficiency of macroeconomic policy mix inside the EMU, as well as the strength and sustainability of the euro.

1. The Launch of the EMU

The establishment of the currency union on January 1st, 1999 was a milestone towards the long process of the European integration. On the formal side, prior to 1999, all regulations, principles, systems and institutions necessary for the EMU were being established. Specifically, the Maastricht Treaty, which laid foundations for the euro, became effective in 1993. On the economic side, beginning with 1999, 11 EU members¹ transferred their sovereignty over monetary and exchange rate policies to the community level. While other areas of the policy making, such as the budgetary and structural policy or wage developments, have been kept at national level, they were subjected to closer surveillance and coordination by the EMU and EU.

1.1. Economic Objectives of the EMU

The basic intention behind the EMU and the euro was to materialize benefits from the optimal currency area which is designed to cover with the single currency a group of economies with high level of convergence. These potential benefits can be classified into several groups.

On the most **aggregate** level, the primary objective of the EMU was to make a contribution to economic growth, employment and prosperity of the member countries. Within the EMU, the elimination of exchange rate risks, as well as a strong commitment towards lower inflation and interest rates, were designed to promote strengthened macroeconomic stability,

* Ryszard Wilczyński is a professor at Warsaw School of Economics, Socio-Economic College and works in Ministry of Finances.

¹ Austria, Belgium, Finland, France, Germany, Iceland, Italy, Luxembourg, Netherlands, Portugal and Spain. On January 1st, 2001 Greece joined the EMU.

investment decisions, trade and overall economic activity. The opportunity to speed up growth was particularly needed as for more than two decades the economies of EU had visibly underutilized their capital and labor resources and, consequently, have lagged behind the US in terms of economic growth.

The introduction of the euro was also designed to promote the development of **financial markets**. The evolution of those markets, from national fragmentation to gradual, deeper integration, stimulates competition as well as liquidity and efficiency of the financial sector, thereby leading towards better allocation of capital. EMU was also supposed to contribute to a switch from borrowing funds by corporations from banks to borrowing directly on the capital market, i.e. to move away from commercial to investment banking.

Both equity and bond markets considerably expanded. It was particularly significant as in the area of financial markets Europe trailed well behind the US. In 1998 the combined equity capitalization of France and Germany amounted to 1,5 trillion dollars, i.e. to 37% of their combined GDP whereas in the US the equity capitalization was 10 trillion dollars, i.e. 125% of GDP. The value of outstanding corporate bonds in Europe represented 20% of bonds in the US.² The implementation of the currency union meant also the development of new financial instruments, high-level financial analysis and services as well as the acceleration of a trend to cross-border investment, as well as mergers and acquisitions.

The **companies** felt benefits deriving from the elimination of costs of exchanging currencies and of hedging against foreign currency risks. Expanded financial markets offered to companies lower financing costs while strengthened transparency helped to improve purchasing decisions of companies, as well as of **consumers**. The latter group benefited also from the increased competition within the currency union as the union exerted downward pressure on prices while enhanced economic growth was expected to increase employment opportunities for consumers.

The extent to which the existing monetary union allows to benefit from those opportunities depends on how close it resembles the model of optimum currency area (OCA). The concept, originally proposed by R. Mundell and extended by others (e.g. R. McKinnon, P. Kenen), was designed as one of the solutions to the tensions in the Bretton-Woods system which started to appear during the 1960's (the parallel solution – by M. Friedman – was to use flexible exchange rates). The model of OCA is based on the idea of giving up exchange rate flexibility as a tool of dealing with balance of payment shocks by an individual country and transferring it

² J.D. Tordjman, *Better than Viagra*, International Economy July/August 1998, pg. 29.

to the region or the group of countries with similar level of development, full mobility of factors of production, homogenous monetary policy and – finally – single currency.

The efficiency of OCA depends on several factors and processes inside the union, such as diversification of output, an openness of the economies, factors' mobility, wage and price flexibility, trade integration or fiscal federalism. The more advanced those processes are the lower possibility of asymmetric shocks as well as the need to use exchange rate as an instrument of dealing with these shocks.

1.2. Will the EMU Achieve Expected Benefits?

Already within the few years period prior to the start of the EMU there was a developing debate on how the union will fit the requirements of the efficient OCA and – consequently – whether and to what extent the euro will be a success or a failure?

The euro advocates (with R. Mundell among the most prominent in that group) suggested that when facing asymmetric shocks European countries would be better off using single currency which would cushion disturbances in the adversely hit countries thanks to capital movements. They also maintained that in the late 1980's, after the full liberalization of capital flows within the EU, the European Monetary System became unsustainable as stable exchange rates, independent monetary policy and capital mobility could not be achieved at the same time. Given the close integration of European markets large exchange rate fluctuations were not acceptable. In that context a common monetary policy and a single currency were strongly recommended.

High openness as well as trade integration of European economies provided another support for the euro. Optimists recognized the fact that the fulfilling of Maastricht criteria was the remarkable step towards convergence among European economies and towards improvement of their economic fundamentals (it was particularly important for generally weak economies, such as Greece, Portugal or Spain).

The critics of the EMU (including M. Friedman and M. Feldstein) focused on structural asymmetries, asymmetric shocks and the lack of instruments to respond to such shocks. In the monetary union, such as the US, those instruments include primarily labour mobility with wage flexibility related to it, and fiscal federalism. Labour mobility within the monetary union helps to prevent the unemployment rate from spreading. Fiscal federalism provides higher public transfer payments throughout the union to regions hit by adverse shocks. Both labour mobility and fiscal

federalism are low in the EMU as compared with the US.³ M. Friedman maintained that the monetary union should follow the political union and not precede it as it is in the case of EMU (“putting the cart before the horse”).

After five years of the EMU, evaluating several issues is still open. The euro avoided turbulent fluctuations and the EMU weathered a number of external shocks. However, the relative stability was mostly accompanied by weak growth or stagnation while macroeconomic policy was becoming increasingly controversial.

2. Monetary Policy in the EMU

Monetary policies gained priority with overcoming problems of inflation and wider macrostabilization.

2.1. Basic Principles of Monetary Policy

Within the EMU, monetary as well as exchange rate policy have been transferred from the national to the community level. Decoding on that the EU members have taken the largest step in relinquishing their sovereignty.

According to articles 105 to 109a of the Maastricht Treaty the European System of Central Banks with the crucial role of the European Central Bank (ECB) has been set up to conduct the monetary policy. The strong objective of the EMU was to ensure the kind of monetary stability seen in Germany and therefore the ECB was equipped with the Bundesbank-like qualities: a mandate to deliver price stability and the independence necessary to stay clear of political pressures.

The principle and single objective of the ECB is to maintain price stability for the euro area as a whole. This objective was defined as keeping an average area-wide CPI below 2% over the medium term. The tasks of the ECB are:

- to define and implement the EMU monetary policy,
- to conduct foreign exchange operations (currency policy vis-a-vis other currencies),
- to hold and manage the member states' official foreign reserves,
- to promote the smooth operation of payment systems.

³ E.g. B. Connolly, *The Case for a Euro Catastrophe*, International Economy, July/August 1998, pg. 24-27.

The ECB activities should be based on some basic **principles** of:

- accountability, with an appropriate communication so that actions can be held accountable to the public,
- transparency – processes of setting targets and making decisions must be clear to the public,
- medium term orientation – ECB has some discretion in response to short term deviations from targets.

To pursue its objectives, the ECB decided to choose mixed **operation strategy** which incorporates two pillars: monetary and inflation targeting. Under the first pillar the ECB monitors three month moving average growth rate of money supply (M3) relative to a reference value established in consistency with price stability. Relying on monetary targeting means developments which are easily observable and under direct control of the bank and therefore can be interpreted by the public in a transparent manner. The second pillar – inflation targeting – encompasses all other “economic and financial indicators which affect price developments”. The ECB inflation forecasts are compared with inflation objectives and divergences serve as the basis for adjusting policy rates and for explaining these decisions to the public.

2.2. Some Controversies on Monetary Policy

Since the start of the EMU in 1999, the ECB conduct of the monetary policy has brought about discussions on the need of its **revision** in both areas of operational actions as well as of target setting. During 2003 discussions have been intensifying and some revisions were implemented.

First, money supply (M3) growth in relation to the reference value set by the ECB was not always a reliable signal of future inflation and, therefore, it often failed to be a good guide to interest rate decisions. Cross-country comparisons show that inflation matches money growth reasonably well in the long run for countries with very high rates of inflation and money growth while this relationship works less for low levels of inflation.⁴

In these circumstances the ECB decided to downgrade the importance of the monetary pillar. The pillar has been retained to reflect the monetary origin of inflation over the medium and long term but is now used as more of a cross-check on the results of the economic analysis made under the second pillar.

Secondly, the ECB has become more accommodative of inflation slightly in excess of 2%. Since 2001, in a recessionary global environment, many economists and policy makers have complained that the ECB inflation

⁴ P. De Grauwe, M. Polan, *Is Inflation Always and Everywhere a Monetary Phenomenon?*, Discussion Papers No 2841/2001, Center for Economic Policy Research, London 2001.

target below 2% was too low for a one-size-fits all monetary policy that forces low growth in EMU economies close to deflation, e.g. they argued that ECB monetary policy was too tight for Germany. Some ECB critics suggested that the bank should be more flexible and allow inflation to fluctuate as much as a percentage point above and below that target.⁵ They also stressed that the ECB should be more concerned about such objectives as financial stability or stabilization of the business cycle – as long as these objectives do not interfere with price stability.

Since the start of the EMU, the ECB pursued building its credibility with a clearly anti-inflationary monetary policy. When several EMU members recorded low inflation and negligible growth this policy was criticized as too conservative. The bank responded that poor growth should be attributed to insufficient structural reforms rather than to the tight monetary policy. Finally, the ECB revised the definition of price stability from “below 2%” to “close to 2%” recognizing also that it is undesirable to allow the EMU inflation to fall below 2%.

3. Fiscal Policy in the EMU

Current requirements concerning fiscal policy gained momentum in parallel to monetary policies. In Europe the framework for both was formulated in Maastricht criteria. Nevertheless, macropolicies similar to those applied in Europe in 1990’s were also applied in US within the framework of Reaganomics, which in turn had impact on forming the guidelines for Washington Consensus.

3.1. Basic Principles of Fiscal Policy

Within the EMU and EU individual countries are free to choose the extent as well as the composition of government expenditures and revenues. Fiscal policy provides the scope for domestic priorities, regarding e.g. how to balance public expenditure against private purchasing power or how to respond to demand fluctuations. These individual priorities are absent in the area of the EMU monetary policy. However, there is an orderly **surveillance of fiscal policies** at the union level, regarding the significance of sound public finances for price stability and stable economic growth. This budgetary surveillance is governed in various ways.

⁵ This opinion was expressed by Sir Edward George, the Governor of the Bank of England. See: *ECB Must Be More Growth-Oriented in Policymaking*, Financial Times, March 5, 2003.

First, EU members are required to avoid excessive government deficits, i.e. actual or planned deficits over the reference value of 3% of GDP (unless the deficit is exceptional and temporary and close to 3%) and to avoid public debt ratio over 60% of GDP (unless the ratio is satisfactorily declining and approaching 60%). Governments breaching the 3% reference value trigger the excessive deficit procedure.

Second, Broad Economic Policy Guidelines (BEPG) issued each year by the ECOFIN Council include fiscal policy recommendations to be taken into account by member states preparing their budgets and drafting stability and convergence programs. The Commission reviews compliance with BEPG.

Third, Stability and Growth Pact (SGP) commits member states, particularly those inside the EMU, to aim for a medium term budgetary position of close to balance or in surplus. It also threatens with financial sanctions against countries running excessive budget deficits.

In particular, SGP requires that EMU members submit stability programs. The programs cover the current, the preceding as well as following three years and include: a medium term objective for the budgetary position of close to balance or in surplus and the path of a general government debt ratio; the main assumptions about expected economic developments and their impact on budgetary and debt positions; a description of policy measures being taken to achieve program's objectives.

When the general government deficit exceeds 3% of GDP, SGP threatens with sanctions which first take the form of a non-interest-bearing deposit comprising a fixed component (equal to 0,2% of GDP) and a variable component (equal to one tenth of the percentage point excess over the reference value of 3%). A deposit is converted into a non-payable fine if, in the opinion of the ECOFIN, the excessive deficit has not been corrected after two years. However, when excessive deficits result from unusual events or severe economic downturns, sanctions can be avoided.

There are two main **principles** of SGP. First, the Pact should ensure public finances discipline and sustainability in each country so as not to undermine the EMU. Higher deficits and debts in one country could exercise upward pressure on interest rates in the entire EMU. This country could, therefore, free ride on other EMU members as a result of the ECB anti-inflationary policy. In a single currency area looser fiscal policy has advantages for a country so long as others remain prudent. Higher government borrowing on the capital markets means also "crowding out" private investments. The Pact is supposed to prevent moral hazard as a country may be encouraged to borrow too much by the belief that its partners (or the ECB) would never permit it to default.

Secondly, the Pact should allow fiscal policy to help smooth business cycle fluctuations in each country, provided this does not compromise public finance discipline. To achieve this the Pact fully relies on the operation of automatic fiscal stabilizers (as e.g. tax receipts) which are highly sensitive to business cycle, helping to slow activity during upswings and to speed it up during downswings.

3.2. Some Controversies on Fiscal Policy

For the last two years tensions and controversies over SGP have been intensively developing. Behind these tensions are the poor growth of the Eurozone economy and the divergent performance within it. During 2002-2003, the EMU economy has recorded a very weak growth rate below 1%. Some significant economies (Germany, France, Netherlands) experienced even the recession whereas others (as e.g. Ireland, Greece, Spain) recorded relatively strong growth. Germany and France will breach SGP in 2004 for the third consecutive year whereas e.g. Finland, Ireland or Luxembourg have strong budgetary surpluses.

It is also argued that while between 2000-2003 the structural balance in the US has gone, according to OECD, from 0,9% surplus to 4% deficit and in the UK from 1,3% surplus to 1,2% deficit, in the EMU the deficit has remained very little changed at about 1,6% of GDP. Both the US and the UK are clearly outperforming the Eurozone in terms of economic growth.

Among **shortcomings of SGP** some are often hinted at by its critics. The Pact is a one-size-fits all policy, i.e. it does not distinguish between economies with low levels of debt (e.g. Ireland, Luxembourg) and those with serious concerns about debt sustainability (e.g. Italy, Belgium). It places too much emphasis on deficits and not enough on debt. The automatic stabilizers may not provide the appropriate degree of stabilization. In fact, pro-cyclical – instead of anti-cyclical – fiscal policies are induced: the pressure for the structural deficit reduction falls during economic upswings but increases during downswings. In the context of 2002-2003 downswing and conservative ECB monetary policy critics saw in SGP the deflationary bias which could send growth in Germany, Italy, France or Netherlands even lower.

The advocates of SGP in its current shape (such as the ECB) argue that the short run fiscal and monetary discipline promotes long run fiscal balance, stimulates rates of national savings, structural reforms and economic growth while excessive fiscal deficits reduce the scope for loosening the monetary policy.

Economists as well as policy makers point at several elements of SGP that need to be **reformed**. They argue that, first, a country's prudent level of borrowing depends on its initial level of debt. Therefore countries with good

debt positions should be allowed bigger structural deficits. Secondly, future government liabilities, particularly from pension promises, need to be included in the assessment of the budgetary solvency. Third, the government's borrowing to fund investments should be taken into account ("the golden rule"). Fourth, in the final evaluation of the budget, the extent to which reforms are advanced and their implications for public finances should be included. Fifth, the outsiders must be convinced that EMU members' budgetary accounts are the true and fair view of their obligations.

At the end of 2003 ECOFIN Council didn't implement financial sanctions against Germany and France which breach the budget deficit limit three years in a row. This decision shows that existing fiscal rules – whatever they are – may be strongly interpreted in favor of big member economies.

4. The International Position of the euro

The EMU policymaking and its outcomes have a significant impact on attracting the international market participants to the euro. This is reflected in the role of the single currency in the international turnover as well as in the euro's strength vis-a-vis other currencies.

4.1. The euro in the International Turnover

The EMU started as the economic area comparable to that of the US in terms of GDP, foreign trade and population with the only visible gap in the field of development of financial markets. The annual ECB report on the international role of the euro⁶ shows that both, in private as well as in official turnover, the euro has been gradually decreasing its distance towards the US dollar as an international currency.

On international **debt markets** the share of euro-denominated debt securities issued by non-residents of the Eurozone increased in 2003 to more than 30% while prior to the start of the EMU the corresponding figure for the legacy currencies was below 20%. In December 1999, funds denominated in euro under management in non-EMU Europe amounted to 15,9% of the total. In June 2003 their share increased to 36,4% (the corresponding figures for the dollar were, respectively, 26,8% and 20,4%).

The issuers of euro-denominated bonds outside the euro area came mostly from the UK and the US. Among buyers, the European investors accounted for the bulk of demand for those bonds in the primary market

⁶ *Review of the International Role of the Euro*, European Central Bank, Frankfurt am Main, December 2003, pg. 9-32.

while recently the rising level of demand from Asian investors was recorded.

On international **loan markets** the euro became the main currency of denomination for loans made by non-area banks to non-bank borrowers in the EMU and accounts for half of such loans, far more than prior to 1999.

On **foreign exchange markets** the euro was – from 2002 to the first half of 2003 – the second most widely settled currency accounting for about one quarter of all settlements.

The role of the euro in **international trade** of both EMU and third countries is also increasing. About half of the total outside trade of EMU countries is priced in euro; e.g. in case of exports of goods this share increased from 2000 to 2002: in Belgium and Luxembourg from 42% to 53,4%; in France from 48% to 55,3%; in Portugal from 40% to 48,5%, in Spain from 49% to 57,6%. On the import side the share of euro remains lower as it reflects the substantial imports of commodities (e.g. raw materials) usually priced in dollars. The share of the euro as an invoicing currency in the UK exports to the EU increased from 19% in 1999 to 36% in 2002. The share of the euro in international trade of the Central and Eastern European acceding countries ranges from approximately 60% to 80%.

The role of the euro as a **reserve currency** has been relatively stable as historical evidence shows that the currency composition of reserves changes only gradually. Within 2000-2002 the share of the single currency in global foreign exchange reserves slightly increased, from 15,9% to 18,7%. As foreign exchange reserves' composition is often bound to reflect trade and financial links, substantial amounts of the euro are kept as reserves by EU neighbouring countries.

Numerous countries in Europe and Africa apply exchange rate regimes linked to the euro, i.e. they use the euro as the **anchor currency**. In the middle of 2003 this list included such types of links as ERM II (in Denmark); euro-based currency boards (in Bulgaria, Estonia, Lithuania, Bosnia and Herzegovina); unilateral shadowing of ERM II (in Cyprus, Hungary); peg arrangements based on the euro (e.g. in CFA Franc Zone) or on the basket containing the euro (in Malta, Latvia); as well as managed floating with the euro as a reference currency (e.g. in Czech Republic, Slovak Republic, Slovenia, Tunisia).

4.2. The Exchange Rate of the euro

Sustainable and strong currency remains the crucial component of the currency union as well as the significant instrument needed to achieve the objectives of the union. Fluctuations in the exchange rates depend heavily on the dominating international capital flows. Current exchange rates are influenced by internal and external factors. Among internal factors

macroeconomic policy mix and political stability are significant underpinnings of the currency as they affect investors' perception of returns and risks associated with the allocation of funds to assets denominated in the common currency. External factors include the strength of other major currencies as well as the situation on the global financial markets.

The fluctuations of the euro exchange rate towards the US dollar are illustrated by the data below.

Table 1. Euro exchange rate, 1999-2003 (annual data, end of period)

the rate/year	1999	2000	2001	2002	2003
dollar per euro	1,00	0,93	0,88	1,05	1,26

Source: *International Financial Statistics*, International Monetary Fund, Washington DC 2003, pg. 1006,1007.

Table 2. Euro exchange rate, 2002-2003 (quarterly data, end of period)

the rate/quarter	2002				2003			
	I	II	III	IV	I	II	III	IV
dollar per euro	0,87	1,00	0,99	1,05	1,09	1,14	1,17	1,26

Source: as in Table 1.

During five years of the EMU the euro exchange rate towards the dollar has shown a **gradual** rather than sudden or dramatic fluctuations, although in quite a broad corridor, between the minimum rate close to 0,80 dollar per euro in October 2000 to 1,26 at the end of December 2003.

In January 1999, at the launch of the euro its exchange rate to the dollar was close to 1,20 dollar per euro. During the first half of the hitherto functioning of the EMU this rate has been decreasing although the macroeconomic policy mix inside the EMU was deemed as appropriate for providing monetary and fiscal discipline which strongly supported the euro. However, it was not enough to compensate for the buoyant growth of the US economy and the rapid increase of US financial markets which attracted investors, also those from the Eurozone, to the dollar. Investments in US assets, particularly the Treasuries, were also considered as the "safe heaven" in the context of the uncertainty on international markets after a series of financial crises in several important emerging economies.

Despite some warnings, e.g. from the Fed Chairman A. Greenspan, who during 2000 warned against “irrational exuberance” of financial markets, investors kept believing in the sustainability of the IT-based economic expansion in the US, where the labour market was visibly more liberalized and flexible than in Europe. International capital flows have been supporting US dollar against the euro.

In the second half of the hitherto functioning of the EMU the exchange rate of the euro to the dollar has been gradually reversing. Despite the increasing debate on the macroeconomic policy mix inside the EMU, the euro has been appreciating, again under the major impact of external factors. During 2001 the US economy turned into recession which – this time – followed an asset inflation (or even asset bubble), while CPI has been consistently low. The recessionary impact was aggravated by terrorist attacks of September 11th, 2001 as well as by wrong corporate governance and financial collapse of several big firms, such as Enron.

The impulses of the US recession were spread also to the EMU economy; however, the monetary and fiscal policy response to economic slowdown was much less aggressive here than in the US. E.g., since the beginning of 2001 till the end of 2003 the ECB has cumulatively cut short term rates by 2,75 percentage points to the level of 2% whereas the Fed has cut by 5,5 percentage points to 1%. This difference in interest rates together with the mounting uncertainty on consequences of the increasing fiscal and current account deficits in the US have caused the euro to appreciate against the dollar, particularly strongly during 2003 with the single currency attaining its lifetime highs at the end of the year (see Table 2.).

Regarding the **short run perspectives** for the euro, despite its record high level of the exchange rate, further appreciation of the single currency towards the dollar cannot be ruled out.

On the internal front, the EMU exporters and policy makers who complain about the strong euro hitting exports and GDP growth are recently joined even by some central bankers. However, current global recovery stimulates also the recovery in the Eurozone. For 2004 most analysts project that GDP growth rate in the EMU economy will increase to about 1,8% from 0,4% in 2003. That makes less likely the possibility that the ECB will cut interest rates soon and thus help weaken the euro. First, the bank keeps claiming that weak economic growth is the structural, not monetary, problem. Secondly, current interest rates in the EMU hardly compensate for inflation.

Strong factors of the likely, further appreciation of the euro are on the external, dollar side. The global economy remains unbalanced with the US growth far ahead of other economies (such as Europe or Japan). This growth pattern (global economy “flying on one engine”) is increasingly

unsustainable. In the US, fast GDP growth stimulates current account deficit which currently is very high as it accounts for 5% of GDP. Fiscal expansion has brought about almost equally high budget deficit. Those structural imbalances (“twin deficits”) tend to undermine investors’ confidence. Adding the record low interest rates to it results in the fact that the US economy does not attract – so strongly as in the past – foreign private investments to dollar denominated assets. Fiscal and monetary expansion will probably remain in place during 2004 till the presidential election.

Further weakening of the dollar is the most likely instrument not only of mitigating the current account problem and maintaining growth in the US but also of addressing global imbalances. Asian governments and central banks will continue their efforts (by investing their huge foreign exchange reserves in US Treasuries) to prevent the appreciation of their currencies to the dollar in order to maintain their strong export-led growth. Strong growth remains the primary objective in Asia where enormous excess labour is waiting to enter modern economy.

In these circumstances the rebalancing of current account balance in the US and of the global economy may occur via appreciation of other currencies of countries that post a trade surplus with the US: this group includes Mexico, Canada but also the Eurozone which is strongly targeting internal monetary stability while letting private capital flows set exchange rates. Thus the US domestic problems (such as low savings and twin deficits) will be transferred to and absorbed by the EMU economies.

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Tiiu Paas, Marit Rõõm-Hinnosaar,
Jaan Masso, Christopher Schumann*

Income Inequality, Poverty and Unemployment as Main Social Consequences of Transition Processes in the Baltic States

1. Introduction

The evolution performance of the European post-socialist economies consists of the following main features that have had significant impact on the social consequences of transition: 1) quick reallocation of labour from public to private sector, 2) rapid changes in international trade patterns, reorientation of trade flows from East to West, 3) significant FDI inflows and their impact on economic restructuring, 4) profound institutional reforms and 5) high social costs of transition that have reduced social cohesion. The main reasons of declining social cohesion of the post-socialist societies are the failure of institutions to integrate individuals and weakness of labour markets and social welfare systems in promoting economic and social integration. Weak social cohesion and increasing social exclusion cause unstable development of the society and may threaten economic growth in the long run.

The Baltic States, as the only former Soviet republics among the EU accession countries, are considered to be successful in their economic and political transition. At the same time quick transition from the centrally planned to liberal form of market economy has led to serious social problems. The speed of transition processes has been often quicker than expected and the absorptive power of people to cope with quick economic, social and political changes is limited.

The paper aims at analysing social consequences of transition and European integration processes in the Baltic States during the recent decade, emphasizing the issues that are the new phenomenon for the societies in transition. These new phenomena include unemployment, increasing inequality, poverty and, in aftermath, also the feeling of social exclusion. Overcoming the social consequences of transition and integration processes needs development of social protection systems and implementing new social protection measures for the most vulnerable groups of population.

* The authors are researchers at University of Tartu in Estonia. Christopher Schumann was involved in the BaltSeaNet (5th Framework Programme, Contract HPRN-CT-2000-00073) doctoral programme at the University of Tartu Institute of Economics in 2001-2002.

The European Union social protection system is not universal. It does not offer clear positive experience for the new member countries of how to develop the social protection system that supports population's adjustment processes to the new economic and political systems and improves stabilization processes in the labour markets. Therefore, by developing social protection systems and elaborating national strategies to promote sustainable and competitive development of the accession countries using support of EU structural funds the analysis of social consequences of transition is unavoidable.

The paper consists of three main parts. The first part of the paper stresses the increasing income inequality problems. Also theoretical questions of origins and consequences of inequality are considered in this part of the paper. High level of income inequality is a remarkable reason of subjective poverty; due to high level of income inequality people have a feeling of social exclusion. The second part of the paper describes the poverty situation in the Baltic States putting pressure on the relationships between poverty and social exclusion. The third part analyses unemployment issues. The empirical part of the paper mainly bases on the data of the international organizations and national statistical agencies.

2. Income inequality

2.1. Origins and consequences of inequality

Inequality is a topic that obtains rising attention in the context of European integration and transition processes. Newly introduced freedoms of capital and labour movements as well as open trade, create opportunities for many, but the development leaves some population groups behind. It is not only the domestic distribution of incomes that is of concern. While nations, cultures and economies move closer towards each other, people are getting more aware of differences across borders and distribution of the total income in the enlarged Europe. Widening gaps between poor and rich may not only hamper social cohesion within the countries but can also keep people from supporting further integration. In addition, inequality may have negative consequences for economic growth.

Inequality is a social and economic phenomenon that every society is confronted with. The degree of inequality does differ widely across and within countries and there are a variety of explanations. Most of the theoretical discussions on inequality have been undertaken in the field of development theory and, among others, inspired by Kuznets and by the neoclassical growth theorists in the 1950s (e.g. Solow 1956, Kaldor 1957). Kuznets (1955) observed a regular connection between development and

inequality. The famous Kuznets hypothesis claims that in the course of early development, economies show rising degrees of inequality, while in later stages, inequality declines. This relation described by an inverse U-shaped curve can be explained by shifts in the production and employment structures. The Kuznets' hypothesis has been the object of much empirical research in the last decade. There are still some doubts about the validity of the hypothesis (eg. Anand and Kanbur 1993). In some papers the hypothesis has also been verified (eg. Barro 1999).

In neoclassical growth and distribution theory, people are paid according to their marginal products. The original framework, based on the concept of perfect competition, has been elaborated for other market form and the theory of human capital has been included in recent models (for an overview, see Aghion and Howitt 1998). It is undoubtable that an individual's human capital is decisive for placement on the labour market and for income potentials.

While these theories state a relation between general development and inequality and cross-country convergence of income levels, other approaches revealed other determinants of inequality and do not predict declining dispersion of income levels but persistent or even growing inequality. A group of researchers identified capital market imperfection to be responsible for persistent inequality (eg. Banerjee and Newman 1993, Lindh and Ohlsson 1998, Stiglitz and Weiss 1981). They argue that lacks of information lead to a biased allocation of capital. Groups within a society that are initially poorly endowed with capital goods tend to have restricted access to credits and therefore make relatively few investments in physical or human capital. As this affects their success on the labour market and their occupation choice, groups with low initial wealth will, in the long run, have fewer opportunities to break into the sphere of jobs with high earnings potential. Inequality will be persistent as long as credit rationing works against the relatively poor.

Inequality is ordinarily considered as a phenomenon that has negative consequences for countries. First of all, it leads to dissatisfaction in the society and to social tensions. Of course, it depends on the cultural norms, preferences and traditions of every society to which degree inequality is perceived negatively and when this makes people change their behaviour. In cases where the income distribution is considered to be unjust, people's reaction may range from a change in voting behaviour up to riot, unrest or even revolution. While in the case of social unrest, where fights and casualties may occur, the negative effect is obvious, slight changes in the legislation or the public atmosphere can have negative impacts on economic growth as well. It is argued that the insecurity of property right and low investment incentives are key factors in this context. If the disposal of

properties is possibly subject to changes in the future, incentives for investment are low because the expected returns are tainted with question marks. Low investment propensities hamper business activities and further economic growth. (eg. Benhabib and Rustichini 1996, Alesina and Perotti 1996, Benabou 1996)

Rodrik (1997) underlined that countries with a high degree of internal division (inequality, ethnic separation) and weak institutions of conflict management (government institutions, democratic rights and social safety nets) have been in the past decades more vulnerable to macroeconomic shocks and experienced sharper drops in the growth patterns than countries with more equal distributions. In a society with high inequality, the potential for dissatisfaction and social tensions are high.

2.2. Measurement of inequality

Inequality is by its nature a relative phenomenon. Obviously, the question of inequality only arises in a group of people where its members have different amounts of wealth to their disposal. The starting point for any inequality considerations is a comparison of these amounts or – in other words – the distribution of income. Inequality can be conceptualized "as the dispersion of a distribution, whether that be income, consumption or some other welfare indicator or attribute of a population" (World Bank 2002).

In general, income is a good proxy for the welfare of different members of a society since it represents the power to satisfy the own needs. The more diverse the distribution of the income, the higher the range of different sets of goods that the individuals or households can choose to have to their disposal. Since most of the survey data on income are gathered on the household level, it does make a difference how different structures of households are taken into account. Since there are synergy effects within households and since children do in general need less food than adults, different weights are attributed to different members of the households. The distribution of "equivalent" household income might lead to different results than the distribution of per capita or per household member distributions. In this analysis, income per household member is chosen as the dimension in which inequality is measured.

There are many different analytical tools that can be used in order to discuss the problem of inequality. The most common tool used to display inequality graphically is the "Lorenz curve" and numerically the inequality is expressed by the Gini index¹. In reality, we can observe Gini values

¹ The Lorenz curve plots the distribution of income on two relative scales each in the range from 0 to 1 ranking the individuals according to their income. The curve has a concave form. The numerical Gini index is closely related to the Lorenz curve. It ranges between 0

between 0,2 (20) representing very equal and 0,6 (60) very unequal societies. Cornia and Court (2001) found that inequality is perceived to be very high, if the Gini index exceeds 0,4 (40). In addition to the Gini index, comparing the mean income of different quintiles (e.g. deciles or quintiles) in the society and calculating the ratios between them allows a closer look at the characteristics of the distribution.

2.3. Income distribution in the Baltic States

Data on income distributions in the Baltic States can be taken from household budget surveys (HBS) that have been carried out by the national statistical offices. The national institutions themselves have published most of the data, but additional data can be found in the publications of the World Bank, the United Nations and in the WIID database.² If not indicated otherwise, the numbers refer to disposable income per household member. It must be stated, that in different publications, the data for the same years and countries may differ widely. Especially for the observations in the early 1990's many inconsistencies can be found which is partly due to changing definitions of income and partly to biases in the samples. For 1990 and 1991, there is no reliable data available. The surveys undertaken in recent years improved in their methodology and deliver more comparable data. For Lithuania, since 1997 the deciles have been reported on the base of expenditure on consumption instead of income. But because income and expenditures are closely related in every household, the correlation of the distribution of disposable income and of expenditure on consumption is high and comparability is maintained. Though with respect to the decile and quintile ratios, expenditure data may bias the results downwards since the share of the expenditure on consumptions is higher among the poorest households than among the richest.

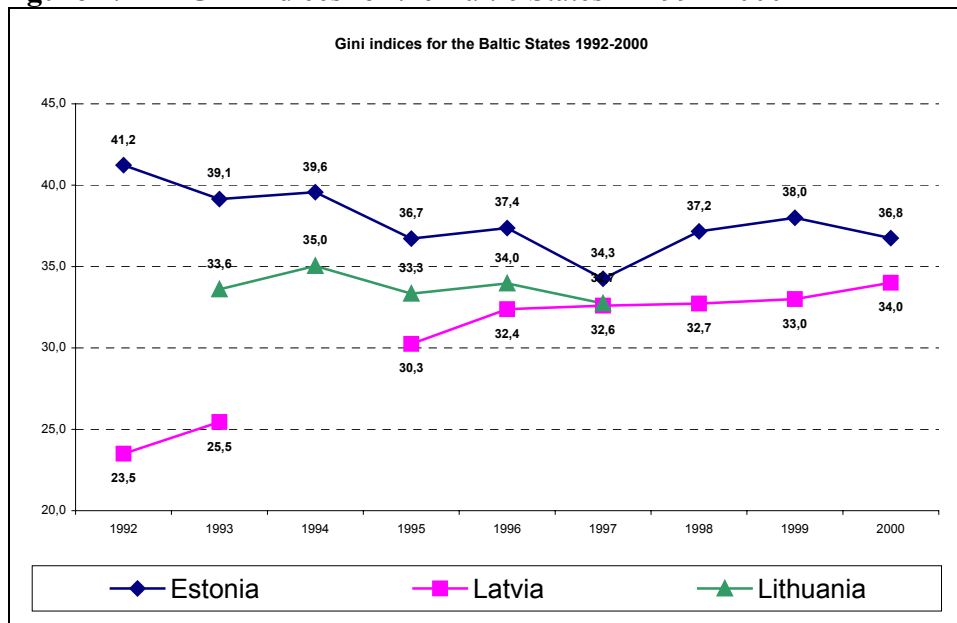
In the course of the 1990's, the Baltic States have experienced a huge increase in inequality. In a study by Milanovic (1999), all transition countries in the sample reported in 1989 a Gini between 20 and 26, which identifies them as relatively egalitarian societies. Because of the major role of the state in employment and the little extent of wage differentiation in this sector in all Soviet republics the Gini index of 22.6 (0.226) for Latvia in 1989 appears to be reasonably representative for all Baltic States before independence. Estonia, Latvia and Lithuania were all on the same low level of inequality.

and 1 (or 0 to 100) and indicates how far away the distribution is from the state in which all individuals have exactly the same income.

² WIID: World Income Inequality Database. Joint Programme of the World Institute for Development Economics Research (WIDER) and the United Nations Development Programme (UNDP). Link: <http://www.wider.unu.edu/wiid/wiid.htm>.

In the following years, enormous changes in the Gini index have taken place. The Gini index for Latvia rose continuously to 32 in 1996. Lithuania reached a level well beyond 30 already in 1993 and the Gini in Estonia jumped even up to 40. In the years 1992-1994, the difference between the Baltic States was tremendous. But as shown in Figure 1., this difference became less drastic during the recent years. The Gini of Lithuania remained more or less constant at about 33 and Latvia has reached the same level in 1997 and displays rising index up to 34 in 2000. In Estonia, it has declined slightly in the course of the decade down to 37, but it still exceeds the inequality of the two other Baltic States.

Figure 1. Gini indices for the Baltic States in 1992-2000



Source: National Statistical Offices, WIID, Milanovic (1999), UNDP, World Bank.

The differences in inequality between the countries are reflected in the distribution among the population quintiles as well (Table 1.). In 1996, the average income of the poorest 20% was relatively higher in Latvia than in Lithuania and Estonia where it was in the range of 7%. In the centre quintiles (II, III and IV) the income shares of Estonians was significantly lower than those of Latvians and Estonians. In each of the countries, the poorer half of the population earned little more than a quarter of the total income while the richest quintile accounted for more than 40%. In the share of the richest, the biggest differences among the countries can be observed. In Latvia, they earn 40,4% of the total income, in Lithuania 41,4% and in Estonia 44,8%. The relatively higher extent of inequality in Estonia is not so

much a result of the drawback of the poor but rather due to the higher wealth of the rich. In Latvia, the span between the richest and the lowest quintile is the smallest, which corresponds to the lowest Gini in Figure 1.

Table 1. Distribution of income by quintiles

Country	Year	I.	II.	III.	IV.	V.	Total
Estonia	1996	6,9	11,7	15,1	21,5	44,8	100,0
Latvia	1996	7,7	13,0	16,9	22,0	40,4	100,0
Lithuania	1996	6,7	12,6	16,8	22,6	41,4	100,0
Estonia	2000	6,6	12,3	15,5	21,6	44,1	100,0
Latvia	2000	6,4	13,2	16,7	21,3	42,4	100,0
Lithuania ¹	2000	7,7	12,4	16,6	22,1	41,1	100,0

¹ based on consumption expenditure data

Source: National Statistical Offices, UNDP, WIID.

A comparison of the quintile distribution of 1996 and 2000 shows few changes. It should be noted, that in 2000, the poorest population in Lithuania is relatively better off than in the other countries. In Latvia, the poorest have lost a considerable share of the total income. On the other end of the distribution scale, the income share of the richest quintile increased by 2%. In Estonia, we observe a slight rise in the income shares of the “middle classes”, while the share of the richest (but as well of the poorest) has dropped.

2.4. Explaining inequality in the Baltic States

In order to interpret the numbers presented, comparisons to other countries should be made. Appendix 1 show the Gini, the decile and quintile shares and ratios for the present European Union members and the Central and Eastern European candidate countries as reported in the Human Development Report 2001.

In the Baltic States, the level of inequality is quite high in comparison to the other transition countries that intend to join the European Union. In Hungary, the Czech Republic and Bulgaria, inequality has not risen so drastically in the course of transition. Their Gini indices show values around 25, the Slovak Republic had an initial jump that was even lower. Romania and Slovenia have a little higher Gini, but the only country among the

Central and South-Eastern European candidate countries, that reached a Gini above 30 is Poland, a country that was exposed to a certain extend of inequality more than other socialist countries even before the changes (Milanovic 1999). Poland is the only Central European transition country that comes close to Latvia and Lithuania in terms of inequality. In Estonia, the gap between rich and poor is still higher. The figures for the decile and the quintile ratios draw a similar picture. The decile ratios of the other candidate economies are far from having two digits. Most of the quintile ratios lie between 3,5 and 4,5.

The group of the present EU member countries is more diverse. Not surprisingly, countries with a traditionally high level of taxes and substantial redistribution like the Scandinavian countries have low levels of inequality. Their Gini, as well as the ones for Belgium and Austria, is around 25. Germany after reunification reported a Gini of 30 while the Netherlands and all Mediterranean countries, except for Italy, are above this level. The highest extent of inequality among the European Union members can be observed in the countries with liberal economies – in the United Kingdom and in Ireland. Their Gini is as high as 36. These are as well the only two countries with a double-digit decile ratio. With respect to the quintile ratios, only the UK, Ireland, the Netherlands and the Mediterranean countries are in the range of the level of Latvia, Lithuania and Estonia.

The following discussion and possible explanations of the development of inequality in the Baltic states bases on the observations described in the previous part as well as additional information provided by the national statistical offices and the national UNDP Development reports.

The first obvious observation is the initial rise in inequality in the course of early transition. Milanovic (1999) proposed that the rise in inequality in the course of transition is a result of a “hollowing out” of the middle class.

Despite of the rising differences among the wage earners in the public sector, which is one source of rising inequality, shifts in employment from the state sector towards the private sector on one side and unemployment on the other side contributed to inequality. Income levels in the agricultural as well as in the industrial sector have not kept track with the development in the third sector. Although there is a connection between restructuring the labour markets and the production processes, the case of the Baltic States cannot be taken as an approval of the Kuznets hypothesis. The predicted rise of the Kuznets curve refers rather to countries with an initially dominant agricultural sector. In the Baltic States, agriculture is of minor importance, it contributes only between 5 and 10 % to the gross value added in the economies.

There are two more aspects that should be mentioned when explaining the initial rise of inequality. All three Baltic States have privatised their economies rapidly after gaining independence. This process started during a period in which the capital markets were themselves in a process of stabilization. In the beginning, there was not much transparency in the capital markets and we can refer to the argument of capital market imperfections and information asymmetries. During the early 1990's the number of persons that had access to capital via financial institutions was limited and since the privatisation procedures favoured those in possession of capital, groups with an initial advantage in wealth or information could use the opportunity to get control of profitable assets. At the same time, the Baltic States experienced hyperinflation. A large share of population that depended on wages and transfers suffered from a real depreciation of their income, while those being able to invest in real estate or build up a new firm as entrepreneurs were able to set a base for future high income potential.

Estonia had higher degrees of inequality throughout the decade while Lithuania's inequality remained on the same level that Latvia reached only in the late 1990's. On the one hand this may be explained by differences in social policies of these countries in the first years after independence. Up to 1995, Estonia's social policy was based on a link of transfers to the minimum wage. During these years the minimum wage was lower than in Latvia and Lithuania. The latter countries tied their social policy to additional indicators, which put poor people in these countries in a position that was better than in Estonia in relation to the richer population groups. When explaining differences in inequality, the tax systems should be mentioned in this context. Estonia introduced a system that taxes income by a flat rate of 26%. That is the reason, why the redistribution in Estonia became lower than in the other Baltic States.

In general, we can state that among the poor, the share of old-aged pensioners as well as of unemployed is rather high. These groups suffered most from the transition since they have not been able to adapt to the new situations as the others. Education is another important determinant of wages as well. The educational level is in average higher in the upper deciles and especially young people that graduated from universities receive high earnings. People with low education naturally earn less and are therefore strongly represented in the lower deciles. In addition, people with low education are more strongly threatened by unemployment and in case of losing their job, they have fewer chances to get a new one. Among the poor, we can also observe a higher share of families with a high number of children.

Another factor that is decisive for the relative income position is the geographic location. In all countries, regional differences in the wage levels can be observed. Income potentials in urban centres are much higher than in rural areas or in those characterized by mono-industrial structures left over from the Soviet times. In Estonia, Tallinn, Tartu, Pärnu and their hinterland have a stronger economic position than other areas. In Latvia, the strongest areas are Riga and Ventspils, while in Lithuania the income levels in Vilnius, Kaunas and Klaipeda are above the others. Urban centres have higher share of the 25-44 year-old that often show high entrepreneurial activities. On the other hand, regions with high shares of farm households and regions with high unemployment contribute to the bottom part of distribution. This is especially the case for north-eastern and south-eastern municipalities in Estonia and for the region Latgale in Latvia. At the same time, in these areas the share of the Russian speaking minorities is higher than in the other regions. Thus, there is an ethnic dimension of wage distribution as well.

The observations with respect to regional differences in income seem to confirm the theory of local spillovers to be important for the emergence of inequalities. The potential for positive spillovers is much higher in urban centres and can be expected to be low in rural areas. As long as deprived regions cannot improve their human capital endowment and attract investments, regional disparities will remain and the spatial dimension of inequality will persist.

In conclusion, it should be said that inequality has risen quite drastically in the Baltic States in the past decade. Starting from a relatively "egalitarian" distribution in Soviet times, Latvia and Lithuania have reached dimensions of inequality similar to those in the UK, Ireland and the Mediterranean countries. In Estonia, the level is even higher. Societies in the Baltic States are also exposed to unequal distributions more than all other Central and Eastern Europe candidate countries. When they will join the European Union and later the Eurozone, they will form a group among the countries with the highest inequality. At the same time the results of the study developed on the basis International Social Survey Program (ISSP) data of 1999 show that the people from the post-socialist countries are less willing to tolerate existing income inequalities than the people from the countries with developed market economies, even after the actual level of income inequality and other determinants of attitudes are taken into account (see Marc Suhrecke, 2001). Thus, additionally to increasing inequality people seriously suffer from the feeling of social exclusion.

3. Poverty

3.1. The concepts of poverty and social exclusion

Poverty and inequality are closely linked to a given mean income. Poverty is a narrower concept than inequality. It is defined through the censored distribution of individuals or households below a certain low level of income (the poverty line) not through the whole distribution of income. The more unequal is the income distribution, the larger is the share of population living in poverty.

In general the concept of poverty is defined as inability of people to afford an adequate standard of consumption. At the same time the answer to the question, what is the adequate standard of consumption, is very much a subject of discussions and it has significant variation between countries and over time. Thus, the concept of poverty consists of objective and subjective aspects.

Economists ordinarily consider poverty in both absolute and relative terms. According to the absolute approach, the poverty line is determined as the sum of minimum needs in respect to nutritious food, clothing, household, transport, communication, etc, and respectively the income required in order to cover all these minimal needs. Thus, poverty in absolute terms means that consumption is falling below the fixed level of minimum consumption.

The relative approach interprets poverty in relation to the prevailing living standards of the society, recognizing the interdependence between the poverty line and the entire income distribution. Two approaches are used for definition of the relative poverty line (Anand, 1997; pg.242-279):

- The poverty line is defined as the income level, which cuts off the lowest p percent of population in the national income. The choice of p is arbitrary. This indicator of the relative poverty line quantifies the extent of poverty;
- Poverty is defined in relation to contemporary living standards like half of average (mean, median) income level of the society. Poverty in relative terms means inability to afford the average consumption level that people have.

Poverty in relative terms will never disappear. John Black in Oxford Economic Dictionary (Black, 1997, pg. 360) stated that if an absolute standard of poverty is accepted it is at least conceivable that technical progress will eventually lift everybody above the poverty line, but if poverty is relative, the poor will be always with us.

If poverty line is defined, the percentage of population in poverty refers the incidence of poverty or level of poverty. The poverty gap indicates the total income needed to bring all poor to absolute poverty line.

Dealing with the stated concepts of absolute and relative poverty is not sufficient for exploring all poverty issues. Poverty is generally regarded as being a multidimensional concept. It is a situation where an individual or a group of people finds itself with extremely limited material and social resources. Such people find it difficult to obtain necessary means for nutritious food, shelter, clothing, medical care, education; they cannot afford to meet cultural and intellectual needs; they feel insecure about future and do not see any prospects for improvement. That is concept of subjective poverty. Multidimensional approach to the concept of poverty has plenty of disputable questions, which are also discussed by defining the poverty concept and elaborating the poverty reduction strategies for the Baltic States. There is still confusion over the question whether the statement that “poverty is multidimensional” means that 1) poverty itself relates to income but the causes of poverty are multidimensional or 2) the concept of poverty is multidimensional and relates to more than just income (Poverty Reduction..., pg. 38). As result of debates about poverty as a complex issue, the responsible authorities³ of the Baltic States in collaboration with representatives from the international organizations elaborated the national approaches to definition of the poverty concept (Table 2.).

The definitions include elements of absolute, relative and subjective poverty and emphasize the limitation of resources considered to be necessary for socio-economic participation of all people in normal society life. These definitions are used as starting points for assessment of poverty and elaborating national poverty reduction strategies of the Baltic States.

Sometimes the terms “poverty” and “social exclusion” have been used synonymously with reference to the multidimensional concept of poverty. The concept “social exclusion” was taken up in 1985 by Jacques Delors, the former president of the European Commission. In the same year, the European Poverty Programme was extended to include the issue of social exclusion. It was recognized that the concept “social exclusion” is more appropriate to analyse the multitude of current societal problems like unemployment, instability of families, shortage of welfare benefits and international migration in a common framework (Rodgers, et al, 1995). Social exclusion is ordinarily used as a broader and more comprehensive concept than poverty.

³ The main national organizations dealing with poverty issues are the Ministry of Social Affairs in Estonia, Ministry of Welfare in Latvia and Ministry of Social Security and Labour and National Social Committee in Lithuania.

Table 2. Definition of poverty concept in the Baltic States

Country	National approach to definition of poverty
Estonia	From a societal point of view, poverty is a social problem. Certain population groups lack material resources, and are deprived of a standard of living which is considered necessary for socio-economic participation in society. From an individual (household, social group) viewpoint, poverty is a socio-economic condition in which the primary physiological and social needs of the subject are not met.
Latvia	Poverty is a condition where people are unable to satisfy their basic needs due to insufficient material, cultural and social resources.
Lithuania	Poverty limits a person's chance to live a free, long, healthy and creative life in an adequate environment, that is, to live a respectable life.

Source: Poverty Reduction in Estonia, Latvia, and Lithuania, Riga UNDP, 2000, pg. 36-38.

The causes of social exclusion result from the failure of institutions to integrate individuals into society. But these causes are not limited to the failure of institutions. The analyses of various research studies and approaches (Gaudier 1993, Silver 1994, Berghman 1998) allow us to agree with the suggestion presented by Regina Berger-Schmitt and Heinz-Herbert Noll (2000, pg. 18), that social exclusion should be conceptualized as the failure of one or more of the following four systems:

- the democratic and legal system promoting civil integration,
- the labour market promoting economic integration,
- the welfare state system promoting social integration,
- family and community system promoting interpersonal integration.

In the case of the Baltic States, like other transitional countries, the causes of social exclusion and poverty are interrelated. People have strong feeling of social exclusion due to increasing inequality and unemployment as the new phenomenon for the post-socialist societies, which emphasises both, objective and subjective aspects of poverty.

3.2. Poverty assessment in the Baltic States

Due to some differences in defining the poverty concept (see Table 2.), there is also a lack of unified methodology for assessment of poverty despite numerous empirical studies about poverty issues in the Baltic States (Keune 1998, Kutsar and Trumm (ed.) 1999, Sileika and Blaziene 2000, Trapenciere *et al* 2000, Kuddo *et al* 2002) and in other post-socialist countries (Klugman *et al* 2002, Milanivic 1997).

The basic indicator for assessing poverty is the poverty line, which states the income level supposed to be enough to avoid the inadequately low level of consumption. The border between the adequate and inadequate level of consumption is very difficult to settle. Various indicators have been elaborated in order to define this border, and methods for calculation and implementation of these indicators have significant variations between the countries depending on the level of economic development, geographical location, culture, habits, norms of consumption, etc.

Thus, the poverty line indicators are subjects of discussion and these indicators depend first of all on the countries' economic and demographic situation. Some poverty line indicators settled by the international organizations are presented in the Table 3. According to the European Union approach, people are living below the poverty line if their annual per capita income after social transfers is below the 60% of the national median income. This income does not include irregular income and income from selling assets.

Table 3. International indicators of poverty line

International organization	Poverty line indicators
World Bank	2,15 or 4,30 USD (PPP) per capita per day (depending on the level of development of a country, it's geographical location, etc)
European Union (Social Protection Committee, 2001)	60% of the national median income
UNICEF (United Nations Children's Fund)	35-40% of average salary

Source: Own arrangement based on: EU, Social Protection Committee, 2001; World Bank, 2000; Kuddo, *et al*, 2002.

The main information about the poverty line indicators, risk groups and some results of assessment of the poverty situation in the Baltic States is resumed in the Appendix 2.

In calculating Estonia's absolute poverty line, the levels of minimal expenditure by household members were taken as a starting point. The minimal expenditure consists of:

- costs of a minimal food basket,
- housing costs, and
- basic clothing, education and transport expenditures.

The absolute poverty line is a dynamic indicator, which is adjusted annually according to changes in the cost of living. In Estonia the settled level of minimum expenditure was 78,6 euros (1 226 EEK) per household member (per month) in 2000. The costs of a minimal food basket were at

the same time 38 euros (593 EEK). This absolute poverty line makes up 70,3% of national median per capita income. According to the European Union standard this relative poverty line indicator is comparatively high in Estonia.

The share of population living below the poverty line has been rather stable in Estonia during the period 1996-2001. The most drastic change in poverty situation was in the years 1999 and 2000 when the after-effects of Russian crisis on Estonian economy appeared. The poverty level rose by almost 2 percentage points mostly due to increase of unemployment. In 2001 the situation stabilized and the share of Estonian population living below the relative poverty line stated by the European Union was 17% (about 230 000 persons) (Household Living Niveau, Statistical Office of Estonia, 2002, pg. 34-37 and pg. 60). There are several poverty layers in Estonia:

- direct poverty (the incomes are 80% or less of the poverty line),
- endangering subsistence (the incomes are 81-100% of the poverty line),
- poverty risk: the households and individuals remain in the poverty risk area if their incomes per household member are 101-120% of the poverty line (Poverty Reduction ..., UNDP, Riga, 2000).

A person is considered to be poor in Latvia if his or her income is less than 75% of the average income at the disposal of an individual Latvian resident and 50% of the value of Latvia's full subsistence goods and services basket. People with extremely low income have a monthly income that is less than the nationally set minimum level. The consumption patterns of the Latvian households indicate that the largest share of the limited resources accessible to Latvia's poor is spent on food and housing. Poverty is more widespread and entrenched in rural areas. In rural areas more than 70% of the population live below the crisis subsistence minimum, while in urban area this indicator is about 50%. Although the highest risk group for falling into poverty is families with three or more children, age remains a factor that can increase a person's risk of falling into poverty. Discrimination in the labour market based on age can be a serious obstacle for people in forties and fifties seeking employment (Poverty Reduction..., UNDP, Riga, 2000, pg. 31-32). A study on the relationship between ethnicity and poverty has concluded that ethnicity is not of major relevance regarding the distribution of poverty in Latvia. Other personal characteristics, such as education, and rural/urban settlement, are much more important in explaining differences in poverty level in Latvia (Aasland, 2000).

In calculation of Lithuania's absolute poverty line indices of a Minimal Subsistence Level (MSL) and State-Supported income (SSI) have been in use since the beginning of 1990s. The SSI is approximately 10%

higher than the MSL. Despite of its progressive loss of value in relation to the initial consumption basket, the MSL is still applied in developing social policy in Lithuania and it is also referred as political and social poverty line. It represents the minimal income guaranteed by the government and the state-supported income (SSI). The absolute poverty line is about two MLS. The Lithuania's Statistical Office calculates also relative poverty line, which forms an amount equivalent to 50% of average consumption expenditure. The relative poverty line in Lithuania is almost equal to the average social insurance pension and it constitutes 40% of the Lithuanian average wage (after taxes). Poverty tends to be more widespread among certain segments of the Lithuanian population and it is more likely appearing among those who are only marginally participating in the labour market, or those who have dependent family members. Pensioners have higher poverty rates than the average, with almost 21% living in poverty. 30% of farmers and 40% of the unemployed or people who, for other reasons, did not work were also poor. The lack of good education is also a serious risk factor of poverty in Lithuania. The distribution of poverty among people with university education, and those with only basic or secondary education differs by as much as six or seven times (Poverty Reduction..., UNDP, Riga, 2000, pg. 17-18).

There is no doubt that the level of economic development of the Baltic economies has had a major impact on the scale of poverty in these countries. During the first period of reforms (1991-1995) the Baltic States' economies experienced a significant downturn. On the basis of relative poverty, the levels of inequality significantly increased during this period. In 1996, 21,4% of Latvians had per capita income below the 50% of the average per capita income, 18% of the Lithuanians lived below the relative consumption poverty line (50% of average expenditures), and 12% of Estonians lived below the 50% of per capita median income (18% below the 60% median income – the officially stated income poverty line in EU) (Lantz-de Bernardis, 2002; Household Living Niveau..., 2002). In the EU member states the average share of population living below the poverty line was 17% in 1996.⁴

In conclusion, despite some cross-country differences in methodological approaches used for exploring poverty and social exclusion in the Baltic States the concept of poverty and indicators used for assessment of poverty in all three Baltic States are close to those used in EU

⁴ When comparing the corresponding indicators with the EU it should be born in mind that the data collected for the EU countries were collected by surveys which in some sense have a different methodology (the equivalence scales 1 : 0,5 : 0,3 were used in the EU, 1: 0,8: 0,8 in Estonia). The poverty line was the same – 60% of national median.

and OECD countries. At the same time differences in applying methodological approaches and statistical indicators for assessing poverty in the Baltic States complicate direct comparison of poverty situation between these countries. Using additionally also the self-assessment information expressed by the households (Gassmann, 2000; Paas and Vörk, 2003), it is possible to suggest, that the share of population that suffers from poverty is the biggest in Latvia. The main risk groups for poverty and also strong feeling of social exclusion are unemployed, low educated people, people from rural areas, families with small children and elderly people.

4. Unemployment

4.1. General trends in unemployment in the Baltic States

As mentioned in previous sections when loosing a job, a person faces a great risk of poverty and social exclusion. Unemployment can also be considered as one of the main reasons of increasing inequality and poverty and, as can be seen in the following, the distribution of unemployment is partly correlated with the distribution of inequality (if we look for example at regional differences, as well as age-groups and professions).

Unemployment in the Baltic States⁵ has been increasing in the 90s due to the restructuring process of the economies and in 2001 was at rather high level even compared to the European Union average (Figure 2.). Under the communist system unemployment did not officially exist and in practice everyone was provided a job and obliged to have one. In the beginning of transition unemployment started to increase when the privatisation process began and the Baltic States lost their close connection to the Russian market, whose supplier they had been.

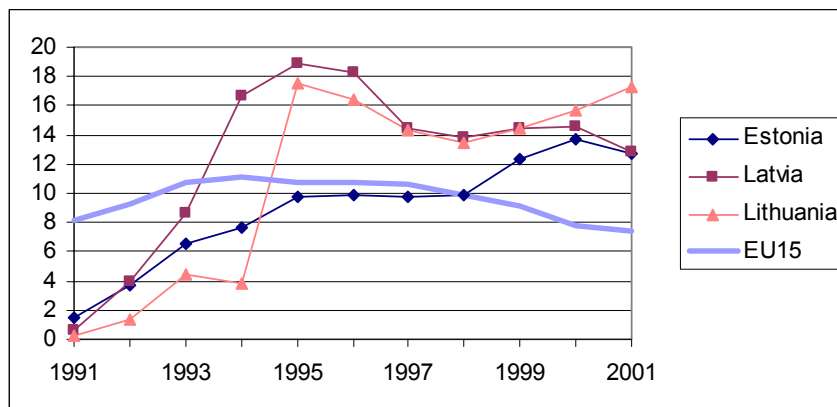
Compared to the stable economies, high unemployment in the Baltic States was an expected result of the transition process. The general decrease in production, which was initiated mainly by the fall in the product demand, led to the decrease in labour demand and formed the pool of unemployed. The following changes in the structure of production caused the need for reallocation of labour, which in two ways increased unemployment. First, reallocation of people from so-called old sectors (the less productive ones, the ones with the decreasing product demand) to the new, emerging ones,

⁵ The Baltic States are described by significant differences in the registered and labour force survey based unemployment rates. The registered unemployment is about half of the labour force survey based unemployment rate. As it is generally agreed that the labour force survey based unemployment provides the most adequate information about the general picture of unemployment in the country, the survey based data is used in the following analysis.

took time. Secondly labour force was not as mobile as could have been expected. It has been argued that due to the nature of Soviet education system, characterised by narrow specialisation, people in the post-Soviet countries find it more difficult to change profession and sector of employment. So that opposite to the expectations from the beginning of transition, unemployment rate in the Baltic States has by now, when reallocation between the old and new sectors should be more or less finished, remained still at a high level.

It should be noted that the development of unemployment has not followed exactly the same trend in all three Baltic States. While Latvia and Lithuania experienced the highest unemployment rates in the mid 1990s, then in Estonia the unemployment rate has been gradually rising peaking in the year 2000. After 1995 unemployment rates in Latvia and Lithuania were falling until the Russian crises. Due to the effects of the Russian crises the unemployment rates started to increase again in all the Baltic States, in 2000 they were at the range of 14-16%. In Estonia and Latvia unemployment has decreased from the year 2000, while in Lithuania it has shown the upward trend.

Figure 2. Unemployment rates in the Baltic States and EU15



Source: ILO and local statistical offices for the Baltic States, Eurostat for the EU15.

What were the reasons for the different development of unemployment in Estonia? It has been argued that the sharp increase in unemployment in Estonia in the middle of 90s was prevented by a decrease in labour supply due to emigration to the other former Soviet countries (the development which was to some extent observed in the other Baltic States also) and leaving to the retirement (Eamets, Philips, Annus 1999). The other possible reasons for the small unemployment in Estonia have been found in the successful privatisation of state enterprises. The privatisation technique

chosen in Estonia was direct sales (often to foreign owners), which ensured investments to the companies and therefore lead to the stable employment. While in Lithuania privatisation took place by distributing vouchers to the people, which lead to no investments in the enterprises and large rent-seeking activities by the managers and workers trying to cash the profits and receive high wages, which ended in financial collapse of the enterprises (Nesporova 2002).

4.2. Structural unemployment

It is usually argued that unemployment in the Baltic States is mainly structural, i.e. there are available vacant jobs, which cannot be filled because of lack of workers with suitable qualifications. The main reasons for this are found in the education system, which gives “wrong type of education”, and low regional mobility.

The Baltic States can be described by a rather large share of long term unemployment (unemployed more than one year), which supports the idea of structural unemployment. The share of long-term unemployment was steadily increasing in the Baltic States during the first half of 90s. From then on, about 50 percent of the unemployed had been without a job for more than one year. In 2001 the share of long-term unemployment was lowest in Estonia (48,1%), which is a little higher than the EU15 average (44,0%), and higher in Latvia (59,1%) and Lithuania (56,2%). Generally, the share of long-term unemployed is larger in regions where unemployment rate has persistently been high. Besides the regional characteristics, the persons experiencing long unemployment spells can usually be characterised by low skills and qualifications.

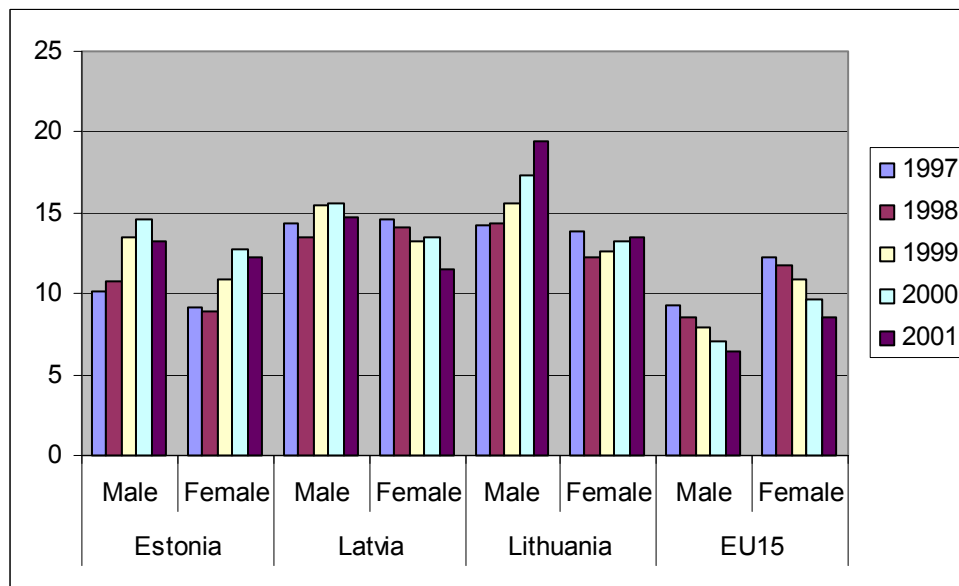
Unemployment by gender

Compared to the EU, the Baltic States are remarkably different in terms of the male/female labour market performance. The male unemployment rate in the year 2001 was much higher compared to the female unemployment rate in all three Baltic States. Still it should be noted that this describes the overall trend only in Estonia, where female unemployment rate has been lower almost throughout the transition period since 1995. The other two Baltic States have earlier experienced different developments (Figure 3.).

The lower unemployment rate among female workers can mostly be explained by the decrease of women participation rate. The other factors leading to lower women unemployment rate are sector specific (female employment in the public sector and service sectors, which have not experienced employment decrease).

It has also been argued that the willingness of women to take up lower paying jobs have helped women to stay out of unemployment (Nesporova 2002).

Figure 3. Unemployment rate by gender



Source: ILO and Eurostat.

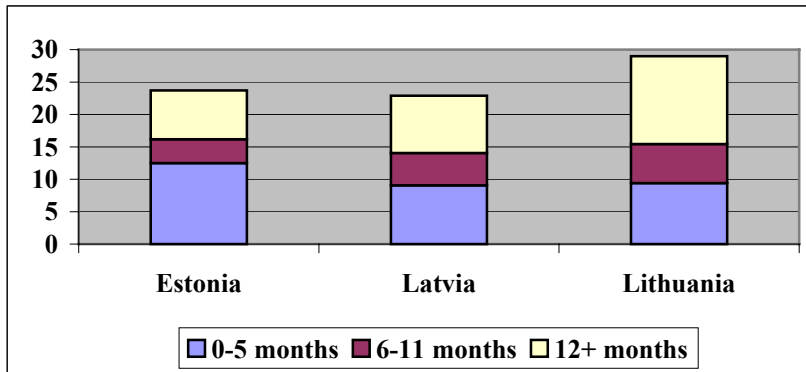
Youth unemployment

Youth unemployment rate was in the Baltic States, as well as in EU in 2001, about 1,7 times higher compared to the age group older than 25. Although the youth unemployment is a problem in EU, it seems to be even a more severe problem in the Baltic States as the youth unemployment rate was in 2001 more than 20 percent in all the Baltic States compared to 14,0% in EU (Figure 4.). The share of long term unemployment among youth is also extremely high: in 2000 being highest in Lithuania where 46,8% of the young unemployed have been looking for a job for more than a year, while in Latvia the share was 38,7% and in Estonia only 24,8%. Generally the main reasons for the high youth unemployment rate are found in the shortcomings of education system, which has not yet been fully reformed in line with the market needs.

Still the high unemployment among youth in the Baltic States is somewhat surprising and should be noted that it has not been the case throughout the whole transition period. As the transition process changed the structure of production and therefore the existing human capital depreciated, the young people having modern education and being more

open to innovations were often preferred to the prime aged workers. But as the initial restructuring was finished, work experience regained its value. On top of that, the decreasing labour demand and increasing unemployment put young into unfavourable position as the employers are usually looking for workers with some experience. So due to the absence of practical working skills, the school graduates, who lack professional training, find it hard to find work. As there is an otherwise redundant but qualified workforce available, youths with little experience are unable to compete.

Figure 4. Youth unemployment rate by the duration of unemployment spells in 2000



Source: Eurostat.

It should be noted, that educational attainment is an important factor affecting unemployment among youth, and as we shall shortly see the general unemployment rate too. In Estonia the youth unemployment rate among the less than upper secondary educational group was 41,8 % in 2000, while being 17,6% among tertiary education group. The similar trends characterise Latvia and Lithuania. The positive effect of higher education is especially strong in Latvia where the unemployment rate among the young people with tertiary education level was 5,4%.

Unemployment by qualifications

The previous sector of employment and profession of the unemployed describes the structure and changes in employment. Compared to Germany as the biggest EU country, for example the structure of the pool of unemployed by the previous work experience is not substantially different (see Appendix 3.). It can be noted that the share of people with work experience in the primary sector is lower in Germany compared to the Baltic States. There are minor differences among the Baltic States in terms of the sector composition of the unemployed. For example in Lithuania where the

production and employment in industry decreased most sharply, the share of unemployed with previous work experience in industry is the highest. While when looking at the composition of the pool of unemployed by profession, it can be seen that in Germany the share of clerks, technicians and associate professionals is much larger compared to the Baltic States and share of less skilled workers generally lower.

As mentioned, educational attainment is an important factor determining unemployment. Unemployment rate is lower among more educated people in the Baltic States, which is the result similar to EU countries. The differences in unemployment among educational attainment are most pronounced in Estonia, where it has been argued that the vocational education is one of the main problems causing youth unemployment. While in Lithuania there are no large differences among persons with upper secondary education and the ones without it.

Unemployment by ethnic group

The ethnical issues determining unemployment are important in the Baltic States. The two Baltic States, Estonia and Latvia, have a very large Russian minority, 28% and 32% respectively. The share of non-Latvians and non-Estonians is even higher 45% and 35%. In Lithuania Russians form only 6% and the non-natives altogether 17% of the population. Most of the non-natives are Russian speaking and their knowledge of the official language is usually poor, which is one reason for the higher unemployment rate of the non-natives in the Baltic States. The other reasons for the higher unemployment rate of non-natives are their qualifications, which are usually specific to the decreasing industries.

In Estonia, Russian speaking population in some regions, for instance in the industrial cities in Ida-Viru county, forms the majority of the inhabitants. The unemployment in these regions is high mainly due to the decrease in production, which was concentrated on the mining and energy production. So the regional disparities of unemployment are partly connected with the ethnical issues.

In May 2000, the unemployment rate of Lithuanians was 13,6%, which is much lower when compared to the Russians 22,1%, Poles 17,1%, and representatives of other nationalities 22,9%. In the second quarter of 2000 the rate of unemployment among the non-Estonians was 16,3% compared to the 11,3% of the Estonians. In Latvia unemployment rate of Latvians in 1998 was 10,8% while Russians had unemployment rate of 21,0%.

Unemployment by region

Although the Baltic States are small, there is substantial variation in unemployment rate at the county level. Generally unemployment tends to be lowest in big cities and the regions with diversified industrial economy, regions offering good opportunities for tourism and recreation and areas bordering more developed countries. The regions with the highest unemployment are usually the ones with mono-industry and rural areas (Eamets 2001).

It can be said that the regional differences in unemployment are caused by the traditional structure of production and low regional labour mobility. The last one is also influenced by the socio-psychological reasons and by the poor performance of housing market and infrastructure. According to the survey results from Estonia, only 10% of the respondents in the region with high unemployment were ready to move if they were unemployed (Estonian Human Development Report 1996). In general, people with higher education were more willing to move from one region to another.

In conclusion, it should be said that high unemployment in the Baltic States has been a problem since the middle of 90s. The reasons of unemployment have been argued to be mainly structural due to the changes in the production structure, education system and low regional mobility. Therefore unemployment is not equally distributed among labour groups and regions.

5. Concluding remarks

Increasing income inequality, poverty and high level of unemployment as significant social consequences of transition processes are serious social issues that should be considered during elaboration and implementation of the national development strategies and improving the social protection systems in the Baltic States. The real value of social protection costs has been declining in all three Baltic States since regaining independence in 1991. As a consequence, people are not receiving fully acceptable social support in order to adjust to rapid changes and to increase social cohesion of the societies. At the same time people from the post-socialist countries are often less willing to tolerate existing income inequalities than the people from the countries with developed market economies. Thus, additionally to increasing inequality, people seriously suffer from the feeling of social exclusion and high subjective poverty.

The general decrease of employment and changes in the production structure have led some groups of population to poverty and social

exclusion. That has put pressure on policy makers to address seriously the issues of poverty, inequality and unemployment. The main risk groups for poverty are unemployed, low educated people, people from rural areas, families with small children and elderly people. In recent years the links between poverty and unemployment have been strengthening. People without a job have a serious threat to fall into poverty. But due to high number of low paid jobs also many employed people and their family members have the threat to fall into poverty. In the aftermath, severe policy debates have started in the Baltic States. While there is a pressure to increase social protection of people, there also exists a growing concern that wage developments, which sometimes exceed the productivity growth, may decrease labour demand. As a consequence, employment will decrease and the burden on national budgets will increase inducing growth of inequality and poverty. Thus, there are evidences of a vicious circle.

The development of the Baltic States' social protection systems has to base on good information system about real economic situation of all population groups. Social protection system has to be more targeted on supporting the most vulnerable groups of population and offering proper instruments in order to encourage people to be active on the labour market and to improve their own and family members' human capital (education, training and health). It is important to ensure higher levels of employment that at the micro level could reduce social exclusion, and at the macro level improve the ability to finance social expenditure.

Achievement of sustainable and competitive development as the main target stated by the national development strategies of the Baltic countries means that the needs of current generations are met without impeding future generations in meeting theirs to the same extent. The enrichment of current generations is acceptable only if it strengthens welfare resources and improves the factors of development by investing in infrastructure, technological development and human resources. The role of the human factor increases in line with the role played by know-how, innovation, organization and management, and other quality factors that improve competitiveness of the nations. The content of the human factor is changing: individual characteristics such as level of education and health are accompanied by the growing importance of social relations shaped by interaction between people.

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Appendix 1. Inequality in CEE candidate countries and EU members

Country	Year	Gini	I st decile	X th decile	I st quintile	V th quintile	highest to lowest decile	highest to lowest quintile
Slovak Rep.	1992	19,5	5,1	18,2	11,9	31,4	3,6	2,6
Hungary ¹	1998	24,4	4,1	20,5	10,0	34,4	5,0	3,5
Czech Rep.	1996	25,4	4,3	22,4	10,3	35,9	5,2	3,5
Bulgaria	1997	26,4	4,5	22,8	10,1	36,8	5,0	3,6
Romania	1994	28,2	3,7	22,7	8,9	37,3	6,1	4,2
Slovenia	1998	28,4	3,9	23,0	9,1	37,7	5,8	4,1
Poland ¹	1998	31,6	3,2	24,7	7,8	39,7	7,8	5,1
Austria	1987	23,1	4,4	19,3	10,4	33,3	4,4	3,2
Denmark	1992	24,7	3,6	20,5	9,6	34,5	5,7	3,6
Sweden	1992	25,0	3,7	20,1	9,6	34,5	5,4	3,6
Belgium	1992	25,0	3,7	20,2	9,5	34,5	5,5	3,6
Finland	1991	25,6	4,2	21,6	10,0	35,8	5,1	3,6
Luxembourg	1994	26,9	4,0	22,0	9,4	36,5	5,4	3,9
Italy	1995	27,3	3,5	21,8	8,7	36,3	6,2	4,2
Germany	1994	30,0	3,3	23,7	8,2	38,5	7,1	4,7
Spain	1990	32,5	2,8	25,2	7,5	40,3	9,0	5,4
Netherlands	1994	32,6	2,8	25,1	7,3	40,1	9,0	5,5
France	1995	32,7	2,8	25,1	7,2	40,2	9,1	5,6
Greece	1993	32,7	3,0	25,3	7,5	40,3	8,5	5,3
Portugal	1995	35,6	3,1	28,4	7,3	43,4	9,3	5,9
Ireland	1987	35,9	2,5	27,4	6,7	42,9	11,0	6,4
UK	1991	36,1	2,6	27,3	6,6	43,0	10,4	6,5

¹ based on consumption expenditure data

Source: UNDP Human Development Report 2001.

Appendix 2. Assessment of poverty in the Baltic States

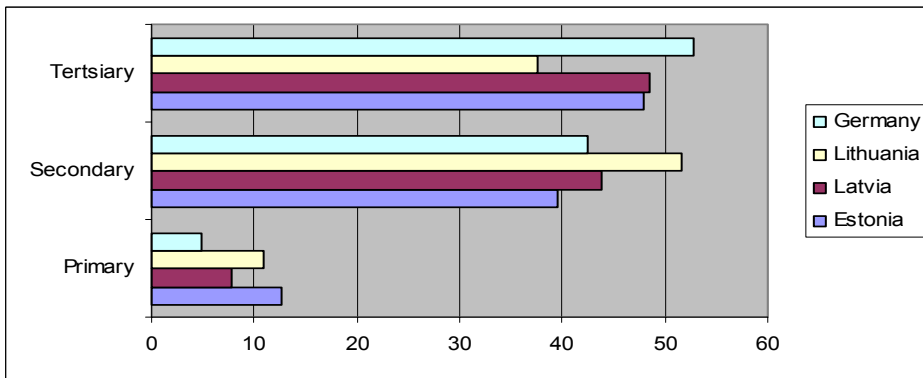
Means and approaches for exploring poverty	Estonia	Latvia	Lithuania
1. The main data source.	Estonia's Household Income and Expenditure Survey conducted by the Statistical Office of Estonia	Household Budget Survey conducted by the Central Statistical Bureau of Latvia; Labour Force Sample Survey	Household Surveys conducted by the Statistical Office of Lithuania
2. The main national organizations dealing with poverty.	Ministry of Social Affairs	Ministry of Welfare	Ministry of Social Security and Labour; National Social Committee
3. Poverty line	Absolute poverty line: minimal expenditure by household members which consist of a) costs of a minimal food basket; b) housing costs, and c) basic clothing, education and transport expenditures. Relative poverty line: 60% of national median per capita income.	Absolute poverty line: the nationally set minimum monthly per capita income level. Relative poverty line: 75% of the average per capita income at the disposal of a Latvian resident.	Absolute poverty line: about two minimal subsistence level (MSL). Relative poverty line: 50% of average per capita consumption expenditure.
4. Poverty layers	1) direct poverty (the incomes per household member are 80% or even less of the absolute poverty line); 2) endangering subsistence (the incomes are 81-100% of poverty line); 3) poverty risk (the incomes are 101-120% of poverty line).	1) people with low income (the nationally set minimum monthly income), 2) 50% or less of the value of Latvia's full subsistence goods and services basket. 3) people with 75% of the average per capita income at the disposal.	1) by relative poverty line; 2) by absolute poverty line; 3) by extreme poverty line (MSL).
Poverty distribution (1999)	Direct poverty – 14% of households; Poverty endangering subsistence – 10% of households;	Persons with low income (49 USD) – 15,8%; 50% of the full subsistence basket	By the relative poverty line (68,7 USD) – 15,8%; By the absolute poverty line (65,3

	Poverty risk – 19% of households (Absolute poverty line was 89 USD in 1999).	per person (70 USD) – 31,2%; 75% of the average income per capita (79 USD) – 39,3%.	USD) – 13,1%; By the extreme poverty line (MSL= 31,3 USD) – 0,9%.
Risk groups	Young families with children; households with unemployed family members; persons with disabilities; elderly people.	Families with three and more children; single-parent households with children; unemployed, elderly people, families, which depend on incomes from agriculture.	Families with children; households with unemployed family members; farmers, pensioners, people with low education.

Sources: National Statistical Offices of the Baltic States; National Poverty Reduction Strategies of the Baltic States, Poverty Reduction in Estonia, Latvia, and Lithuania, Riga: UNDP, 2000.

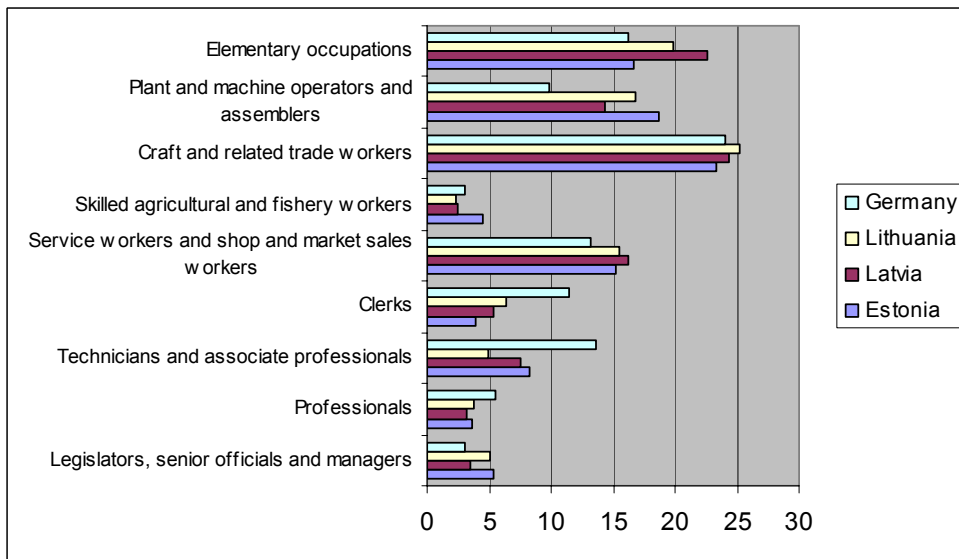
Appendix 3. Unemployment by education, sector and profession

Figure 1. Share of unemployed by sector of the previous job in year 2000



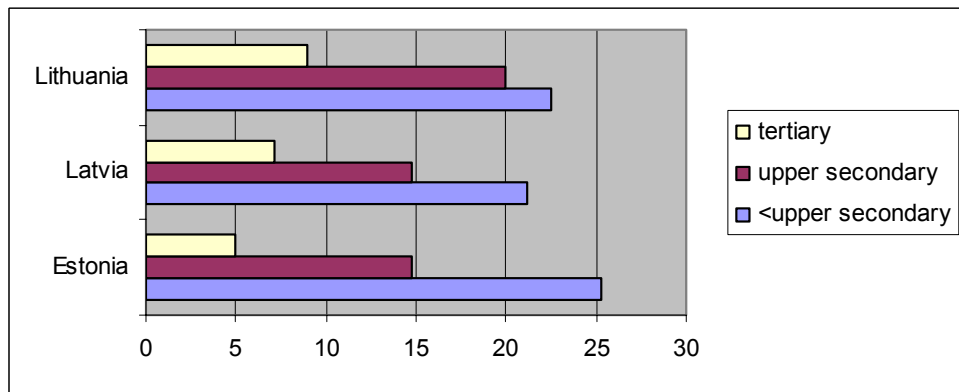
Source: ILO.

Figure 2. The distribution of unemployed by their profession in year 2000



Source: ILO.

Figure 3. Unemployment rates in the Baltic States by educational levels in year 2000



Source: Eurostat.

Polish capital market in the light of participation in the EU single financial market

1. Introduction

“Efficient and transparent financial markets foster growth and employment by better allocation of capital and reducing its cost. They therefore play an essential role in fuelling new ideas, supporting entrepreneurial culture and promoting access to and use of new technologies. It is essential to exploit the potential of the euro to push forward the integration of EU financial markets. Furthermore, efficient risk capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs.”

Lisbon European Council Conclusions, March 2000

The statement made by the European Council in Lisbon appeared in the document which set the new strategic goal for the European Union for the next decade: *“to become the most competitive and dynamic knowledge-based economy in the world capable of sustainable economic growth with more and better jobs and greater social cohesion”*¹. This fact stresses the importance which the European Union attaches to the creation of effective financial market. This is however, a fairly new approach, especially as the capital market is concerned. The Single Internal Market, including free movement of capital, was established in the beginning of the 1990s. The common currency, euro, was introduced in three stages, between 1992 and 1999, but a definite path, a clear-cut strategy to foster the creation of pan-European capital market, was undertaken by the European Union only in May 1999, when the European Commission adopted the Action Plan for creating a single financial market.

Why this issue was set aside for such a long time, leaving in fact the Single Internal Market incomplete, since already the report of the Delors Committee² called for full integration of financial markets as one of the

¹ Presidency conclusions – Lisbon European Council: 23 and 24 March 2000, www.europa.eu.int.

² The Delors Committee (the name taken after the surname of the then President of the European Commission, Jacques Delors) was established in June 1988 and consisted of central banks' governors of all Member States, as well as independent experts. Its task was

prerequisites for effective operation of the Economic and Monetary Union (EMU)? It was due to the fact, that the creation of the single financial market was not a *sine qua non* condition of introducing the common currency (nevertheless, in theory, being one of the prerequisites for a monetary union).

Consequently, the need for a common capital market among the EMU members was not very strong. It was also due to the characteristics of the traditional continental European financial system, in which dominant role as provider of financial resources for the economy is played by the banking sector, which was already well integrated.

The recent years have brought about changes in the *status quo*. Due to the continuing globalisation process, which resulted in liberalisation and deregulation of financial sector, a tendency of financial market unification appeared. In well developed European economies, the system started to evolve towards the Anglo-Saxon model, with capital markets significantly gaining in importance.

This has also been recognised by the European Commission, as the DG: Economic and Financial Affairs official, Delphine Sallard, stated in a report that “*The access to the deep and liquid capital markets is one of the United States’s greatest competitive advantages. (...) The need to address this competitive disadvantage (in the EU – author’s comment) is urgent. It is also critical. European entrepreneurs and job creators must have access to sort of deep and liquid risk capital markets that are available to their peers in the United States.*”³

Recognising the need for a single capital market, the European Union embarked on the process of its creation. The process is to be completed by 2005, with the aim to bring “*benefits in terms of greater market liquidity, more rational allocation of capital, and greater choice for investors and consumers*”⁴.

Taking all the above into account, in the light of Poland’s accession to the European Union in May 2004, it is crucial to prepare the national capital

to prepare the action plan which would lead to the creation of the Economic and Monetary Union. The Committee’s report was issued in April 1989. Read further in: *Report on Economic and Monetary Union in the European Community*. Committee for Study of Economic and Monetary Union (Delors Committee), 12 April 1989, “ECU Newsletter” no 28/1989 – Supplement.

³ D. Sallard, *Risk capital markets, a key to job creation in Europe. From fragmentation to integration.*, report presented on a conference organized by the European Commission, 24 November 1998, Brussels, pg. 20, www.europa.eu.int.

⁴ *Building a Single EU Financial Market*, in a speech delivered by Frits Bolkestein, Member of the European Commission in charge of the Internal Market and Taxation (SPEECH/03/348), to the EU Parliamentary Financial Services Forum, European Parliament, Brussels, 8th July 2003, pg. 2.

market for joining this process smoothly. Only then, Polish capital market will become an integral part of the European single market, with all benefits for the Polish economy.

2. Towards the single capital market in the EU

The need of creating a single financial market in the European Union was explicitly recognised at the Cardiff European Council in June 1998. In terms of capital markets, it was stated that its fragmentation should be eliminated in order to reduce the cost of capital raised on the market, and closer coordination of supervisory authorities should be encouraged. At the Vienna European Council in December 1998 the European Commission was asked to prepare an action plan which would include all steps which must be taken to create a single financial market.

The Commission, assisted by The Financial Services Policy Group⁵, prepared the Financial Services Action Plan (FSAP) to be implemented by 2005. The set objectives stipulated that the single EU capital market will:⁶

- enable corporate issuers to raise finance on competitive terms on an EU-wide basis,
- provide investors and intermediaries with access to all markets from single point-of-entry,
- allow investment service providers to offer their services on a cross-border basis without encountering unnecessary hindrances or administrative or legal barriers,
- establish a sound and well integrated prudential framework within which asset managers can put funds at their disposal to their most productive use,
- create a climate of legal certainty so that securities trade and settlement are safe from unnecessary counterparty risk.

With the aim of unifying capital markets in the Eurozone, several necessary groups of actions have been recognised⁷. Under each of them a number of directives was scheduled for implementation throughout the period 2000-2005⁸. These actions include:

⁵ The Financial Services Policy Group consisted of representatives of ECOFIN Ministers and European Central Bank. See: *Financial Services: Implementing the Framework for Financial Markets: Action Plan*, Communication of the Commission, COM(1999)232, 11.05.99, pg. 3.

⁶ Ibidem, pg. 22.

⁷ Ibidem, pg. 5-9, 13-14.

⁸ All directives already implemented and scheduled for implementation in the future can be found in progress reports on the realization of the Financial Services Action Plan, published

1) Establishing common rules for integrated securities and derivatives markets

A modern legal framework for competitive secondary markets should include common definitions of markets and exchanges to ensure clear allocation of responsibility for authorisation and supervision. Moreover, a common approach to authorisation and supervision of alternative trading systems is needed, as well as stringent safeguards to counter market manipulation.

2) Raising capital on an EU-wide basis

There are still considerable hindrances to the emergence of effective market for high risk companies, which include mainly sector of modern technologies and generally small and medium enterprises. Many of these impediments relate to fragmented approaches to the regulation of securities business. It is necessary to abolish these obstacles in order to allow this capital market segment to acquire a sufficient critical mass to represent a viable alternative to more costly and inflexible forms of financing for start-up companies. To achieve this, the Commission decided to integrate the Risk Capital Action Plan (RCAP), scheduled for realisation between 1998 and 2003, which was supposed to result in creation of a single market for high risk securities, into the FSAP. Moreover, integrated regulation at EU level will also stimulate further internationalisation of traditional capital market segments, which will result in deepening of European capital markets, providing more liquidity and thus increasing their attractiveness for both domestic and foreign issuers and investors.

3) Financial reporting

Cross-border investments are to some extent discouraged by uncertainty as regards credibility of financial statements, therefore there is a strong need to unify financial reporting requirements. Moreover, solutions introduced in the EU must mirror the developments in internationally accepted best practices in order for the European companies to have equal chances of raising capital on international markets. At present, International Accounting Standards (IAS) seem to be the best benchmark. Similarly, International Standards on Auditing should represent the minimal conditions for ensuring proper credibility control of financial statements.

4) Creating a single market framework for supplementary pension funds

The introduction of euro stipulated considerable changes in the operation of pension funds, especially in connection with engagement in financial instruments denominated in previous currencies of EMU member states. This situation allowed for replacing, to a certain extent, currency matching

by the European Commission approximately every half a year. Already nine such reports are available on the website www.europa.eu.int.

rules and stringent asset category rules by qualitative prudential rules. Keeping in mind, that pension funds are important players on capital markets, it becomes necessary to impose a rigorous prudential framework in order to ensure the security of pension funds beneficiaries, but also stimulate the flow of long-term capital which is available for private sector investment.

5) Introducing common rules for collateral

A single capital market, with equal costs and risks in domestic, as well as cross-border transactions, isn't possible without mutual acceptance and enforceability of cross-border collateral. When there is a higher risk of invalidation of cross-border than domestic collateral arrangements, as well as more uncertainty as regards enforceability, if provider becomes insolvent, cross-border transactions are subject to higher costs and risks. In such conditions, still existing after the introduction of euro, a cost effective and integrated securities settlement structure cannot exist.

6) Regulating mergers and acquisitions at community level

In recent years, we are witnesses of ongoing consolidation tendencies in various economic sectors. This often involves cross-border mergers and acquisitions of large public companies. Such transactions have always considerable influence on capital markets. For the single market it is therefore necessary to adopt common regulations governing such transactions. The adoption of Take-Over Bids Directive, which is currently being worked on, and the European Company Statute ensure protection of minority shareholders. They have also paved the way for commencing work on a directive on cross-border mergers and on transfer of company seat.

7) Establishing sound supervisory structures on the community level

Decisions on appropriate supervisory arrangements for capital markets are determined at national level. Due to this, mutual confidence in the effectiveness of partner country financial supervision and regulation is crucial for successful cross-border supervision. Closer cooperation among securities commissions in the EU has taken a step forward with the creation of Forum of European Securities Commissions, which, following the recommendations of the Lamfalussy Report⁹, was transformed into The Committee of European Securities Regulators (CESR) in June 2001. Supervisory authorities of all 15 Member States, Norway and Iceland are

⁹ This was the Report of the Committee of the Wise Men on the regulation of European Securities Markets. The report was issued on 15 February 2001 after a one year debate on the state and perspectives of capital markets in Europe. The report also put forward certain recommendations in relation to establishing the single capital market. See: *Initial Report of the Committee of the Wise Men on the Regulation of European Securities Markets*, Brussels, 9 November 2000 and *Final Report of the Committee of the Wise Men on the Regulation of European Securities Markets*, Brussels, 15 February 2001.

members of CESR, whose role is to improve coordination among European securities regulators and serve as an advisory group to the European Commission in preparing and implementing regulations connected with capital markets. Moreover, it works to ensure more consistent and timely day to day implementation of Community legislation in the Members States, and, in order to do so, CESR may issue guidelines, recommendations and standards¹⁰.

Legislative work, has been done by the Commission, together with the European Parliament, the Council, and advisory bodies, in all the above mentioned seven fields concurrently. At present elaboration of the remaining directives as well as their implementation entered the final stage. According to the Commission, the whole process is expected to be completed as it was scheduled in the Action Plan. There is also a strong determination to implement the measures of FSAP coherently in all 25 EU Member States¹¹, which means that all accession countries must be well prepared for the process.

3. Preparation of the Polish capital market for implementing FSAP

Since the year 2000, when the process of establishing the single financial market in the EU has started, Poland has done a lot to prepare the national capital market for integration with the European Union. The main difficulty was, and still is, the fact, that at the moment of accession, which is the 1st of May, all national legislation on capital markets must be in line with regulations introduced in the EU. However, at the same time, the Community has been carrying out the task of constructing a single capital market. The process which stipulated considerable changes in existing law, and regulating at community level the areas which were hitherto in competence of national authorities.

Polish institutions responsible for capital market regulation, designing particular bills had to take into account and monitor current developments in the EU, as well as the implementation process of Financial Services Action Plan. In order to stand up to this task and prepare well for accession, the Commission for Securities and Stock Exchanges (KPWiG), the Polish capital market supervisory authority, initiated at the beginning of 2001 the creation of Capital Market Regulatory and Supervisory Consultative Group, a body consisting of capital market supervisory authorities of all twelve

¹⁰ About CESR read further on www.europefesco.org.

¹¹ *Financial Services. The FSAP enters the Home Straight*, Ninth Report, European Commission, Brussels, 25 November 2003, pg. 7.

candidate countries. In May 2002 the observer status was granted to the Albanian authority, while in September 2002 the Turkish authority became a member, and Croatian authority joined in March 2003. Between June 2001 and March 2003, Mr. Jacek Socha, the President of Polish KPWiG, chaired the Consultative Group. Since then, Mr. Károly Szász, President of the Hungarian supervisory authority is the Chairman.

The main objectives of this initiative included exchanging experiences and best practices in implementation of Community regulations and directives, creating a forum for consultation on complete harmonisation of national legislation with EU standards, as well as joining the works on new regulation of capital markets in the EU. The latter objective was achieved by participation of the Group's chairman in meetings of CESR as an observer.

This initiative, together with a permanent dialogue with the European Commission, allowed for introducing the necessary regulations without greater delays. Already in the year 2000 significant changes in the regulation of Polish capital market have been implemented by amending the Bill on public trade in securities. They included the introduction of the rule of mutual recognition of prospectus and single passport for brokerage houses. Moreover, cooperation with Member States on exchange of information and market supervision has been enforced. In addition, rules of operation of the, so called, official market have been defined, which is the obligation of each Member State.¹²

In autumn 2003 another amendment of the mentioned Bill has been prepared. Its objective is to implement into Polish law the Community regulations on:

- the requirements related to preparation, auditing and dissemination of IPO¹³ prospectus,
- the protection of confidential information,
- requirements for admitting securities to public trade, especially in relation to publishing necessary information,
- investment services connected with trading securities, and
- insider trading and market manipulation practices.

The amendment takes into account all recent recommendations of the European Commission and is scheduled to enter into force before May 1st.

In addition to these two major amendments, several other Community solutions have been implemented into the Polish capital market regulations. One of them concerns preventing the use of financial system for money

¹² *Stan przygotowań polskiego rynku kapitałowego do integracji z Unią Europejską*, Komisja Papierów Wartościowych i Giełd, Warsaw, November 2003, pg. 5.

¹³ Initial Public Offering.

laundering, where some work still has to be done, according to the latest monitoring report prepared by the European Commission¹⁴. Another area is related with investor protection systems, where Poland was allowed a transition period for the guaranteed value of compensation in the situation when an investment company cannot fulfil its financial commitments¹⁵. Also, since 2001, the directive on finality of settlements in payment systems and securities settlements systems is entirely implemented in Poland.

As a result of the above mentioned work, from a regulatory point of view, the Polish capital market is fairly well prepared for accession to the European Union and for full-scale participation in the created single financial market. In the monitoring report the Commission still pointed out a few areas in which some legislative work ought to be done before May 1st, however no concern is expressed that there is a risk of lateness.

4. Conclusions

According to the Initial Report issued by the Committee of the Wise Men in November 2000, the single capital market should improve allocation of capital due to the creation of more efficient, deeper and broader security markets, improved market liquidity and lower transaction costs. Moreover, intermediation between savers and investors should also increase its effectiveness due to intensified competition among financial institutions, greater freedom of choice, and taking advantage of economies of scale and scope on a large market. In addition, the single financial market, contributing to the objectives set in the Lisbon Strategy, will have a positive impact on the European economy as a whole.¹⁶

The Polish Ministry of Finance as well as other institutions responsible for the functioning and development of capital market in Poland, are aware of the potential benefits of participating in the single EU capital market. As it was discussed above, as far as legislative work is concerned, the job to be done before accession is almost completed, and the Polish market will be able to participate in the final stages of putting the single EU capital market into life.

¹⁴ Read further in: *Comprehensive monitoring report on Poland's preparations for membership*, The European Commission, 2003, pg. 25, www.europa.eu.int.

¹⁵ *Stan przygotowań polskiego rynku kapitałowego do integracji z Unią Europejską*, Komisja Papierów Wartościowych i Giełd, Warsaw, November 2002, pg. 19.

¹⁶ *Creating a single European market for financial services*, A discussion paper produced by a working group in the City of London drawn from a broad range of international financial services interests, pg. 7, www.cityoflondon.gov.uk.

However, taking advantage of these benefits will not be automatic. It will require a clearly defined strategy of further capital market development. It is especially essential in the country, where this market is still very young and underdeveloped. The first attempt to come up with that kind of strategy has already been made at the very beginning of the year, when the Ministry of Finance presented the "Agenda Warsaw City 2010", which is the preliminary draft of further capital market development strategy in Poland. The Agenda does not include very concrete proposals and schedules, but it describes the main objectives, factors which may positively and negatively influence the Polish market in the nearest future, and generally says what should be done to make Poland the leading capital market in the region, and an important player in Europe.¹⁷

It is also important to stress, that a single financial market in the common currency area is an important precondition for proper functioning and taking full advantage of a monetary union. Despite the fact, that the funding members of the EMU live without it already for five years, participation in the single EU financial market will be very important for new member states from Central and Eastern Europe in the context of their future membership in the Eurozone. It is due to the fact, that fulfilling the convergence criteria will be more problematic and costly for them as a result of a young market economy, greater structural problems and little supply of domestic capital. Therefore, these countries will need to take advantage of all possible benefits offered by the common currency as fast as possible to overtake the costs of necessary reforms and adjustments.

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¹⁷ Read further in: *Strategia Rozwoju Rynku Kapitałowego „Agenda Warsaw City 2010”*, a project for consultation, Ministry of Finance, Warsaw, January 2004.

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Sweden's attitude to EMU and its influence on the policies of Denmark and the United Kingdom

1. Sweden

The issues concerning the Economic and Monetary Union (EMU) have been at the centre of the debate on European integration for close to two decades. Numerous advantages and disadvantages of the EMU project have been discussed in many contexts. However, the consensus on the future effects of establishing the monetary union has not been reached yet. This is, to a large extent, explained by the fact that the issue spans a lot of aspects, and almost each argument has many counter arguments. In addition, the monetary union is both an economic and a political project, and the whole discussion on it is heavily politicised. This fact makes the matter more complicated and hard to understand for the general public.

Sweden is a country where both democracy and independence are seen as issues of crucial importance. Unfortunately, the construction of the EMU ranks among the most extraordinary achievements in modern world politics, and there is no doubt that becoming a member of it limits both the above values. This fact seems to be hard to accept for the Swedish society.

In discussing Sweden's attitude to EMU, it is important to remember that Sweden did not become a member of the European Union until January 1995. The margin of victory in the national referendum of 1994 which led to membership was small. Afterwards, anti-EU sentiment kept running fairly high in this country. At present, it is still hard to say whether the Swedes consider themselves to be citizens of Europe.

The Riksdag (Swedish Parliament) decided in November 1997 that Sweden should not adopt the single currency from the start of the third stage of EMU on January 1999. The official reasons for this were the fact that Sweden did not meet the convergence criteria and the lack of popular support for the EMU project. Nevertheless, Swedish Parliament did not rule out future participation and underlined the need to preserve the greatest possible freedom of action for joining the euro at a later date.

Since then, Sweden was examined twice – in 2000 and 2002, as far as the fulfilment of the convergence criteria is concerned. However, the country has not made a conscious effort to fulfil the criterion of a stable

exchange rate. The Swedish krona is not participating in the ERM 2¹. Moreover, according to the *Convergence Report 2002*, it fluctuated quite markedly against the euro during the period 2000-2002.²

The decision to stay outside the EMU is pretty controversial, as Sweden has obtained no formal right to opt out from the monetary union. It may become the reason of accusing the country of not fulfilling its formal obligations, and in this way may lead to a significant loss of political credibility as an European Union partner. Because of that, first it is worth analysing the matter from the legal point of view. Unfortunately, this issue is not definitely clear. On one hand, the Swedish Parliament ratified the Maastricht Treaty without any reservations regarding the monetary union. According to that, the decision to remain definitely outside the EMU would not comply with Sweden's legal obligations. Moreover, Denmark and the United Kingdom have obtained such opt-out clauses in the Maastricht Treaty protocols, and the fact confirms the view that Sweden is not free to decide on the matter any more. If such a choice existed, Denmark and the United Kingdom needn't have negotiated the special conditions of the agreement.

On the other hand, the Swedish government declared at the opening of the membership negotiations on February 1, 1993 that "a final Swedish position relating to the transition from the second to the third stage will be taken in the light of future events and in accordance with the provisions of the Treaty", and repeated the declaration at the opening of the EMU negotiations on November 9, 1993.³ Furthermore, when informing the Swedish Parliament about the negotiations on November 10, the government declared that "as regards the transition from Stage Two to Stage Three of EMU, the ultimate decision rests with the Parliament".⁴ All that was officially registered by the member states and did not bring about any opposition from them.

The arguments which speak in favour of Sweden's unchangeable obligation to do its best in order to satisfy the requirements laid down by the Maastricht Treaty and join the monetary union seem to be stronger. Nevertheless, it is not likely that Sweden would be forced to join EMU against its will.

¹ *Convergence Report*, European Central Bank, 2002, www.ecb.int.

² *Convergence Report 2002 – Sweden*, Commission of the European Communities, 2002, http://europa.eu.int/comm/economy_finance/publications/convergence/report2002_en.htm, pg. 22.

³ L. Calmfors, *EMU, a Swedish perspective*, Kluwer Academic Publishers, The Netherlands, 1997, pg. 238.

⁴ *Ibidem*.

1.1. Public support for EMU project

The decision of the Riksdag on participation in the monetary union is closely related with the attitude of the society towards the project. Public support for EMU has been changing surprisingly in Sweden. Politicians have been between the devil and the deep blue sea for a long time, as – on one hand – they were obliged to keep to Maastricht Treaty conditions and fully participate in Stage Three of the EMU as soon as it was possible, and – on the other hand – there was no public support for such an action. In Autumn 1997, only about 23 per cent of Swedes supported joining the monetary union whereas more than 48 per cent were against (see table 1). The lack of public support became at that time one of the crucial arguments which made the Riksdag decide that Sweden would stay outside the Eurozone. Sweden seemed to need more time for a broad and encompassing public debate concerning the membership before a definite decision on whether or not to participate in the union was made. Otherwise, the decision may not have been perceived as legitimate by the electorate, which might have exposed the political system to considerable strains.

After some time, the number of EMU advocates slowly started to increase and from November 1998 to November 1999 it was close to the number of opponents (in May 1999 the advocates outnumbered even a little bit the opponents). Afterwards, we could observe a considerable increase of EMU opponents up to more than 40 per cent. The situation changed one more time at the end of the year 2001, when the euro was about to be put into circulation (40,9 per cent of advocates and 34,6 per cent of opponents). Finally, the successful introduction of euro notes and coins (1 January 2002) seemed to convince the Swedes that the EMU project was far from being a complete failure, and the support for the EMU reached 46% (May 2002). That was a perfect time for the government to fix a date of a referendum. Nevertheless, the politicians preferred to put off the decision and deal with the matter after general elections, which were to be held in Autumn 2002.

Finally, the referendum was agreed by the leaders of the parties in the Riksdag at the end of 2002 – it was decided to be held on 14 September 2003. Unfortunately, with every passing day, Swedes were less and less likely to be choosing the EMU when they vote in the referendum. In May 2003, public support for joining the monetary union decreased to 33 per cent whereas the number of opponents reached 43,5 per cent. Afterwards, various statistics usually showed that the EMU pessimists outnumbered the EMU enthusiasts. This was really strange, because – on the other hand – there was a massive 'yes' for the EMU project from most Swedish parties, trade unions and biggest newspapers. It was a kind of evidence that public opinion in Sweden cannot be so easily influenced by the media.

Table 1. EMU preferences (November 1997 – May 2003)⁵

	Total		
	Yes/ for	No/ against	Don't know
November 1997	22,9 %	48,5 %	28,6 %
May 1998	28,9 %	44,6 %	26,5 %
November 1998	34,4 %	36,6 %	29,0 %
May 1999	36,9 %	38,7 %	24,4 %
November 1999	38,5 %	34,8 %	26,7 %
May 2000	32,6 %	42,0 %	25,4 %
November 2000	27,8 %	47,2 %	25,0 %
May 2001	31,3 %	43,2 %	25,6 %
November 2001	40,9 %	34,6 %	24,5 %
May 2002	46,0 %	30,9 %	23,2 %
November 2002	39,9 %	34,7 %	25,4 %
May 2003	33,0 %	43,5 %	23,5 %
Referendum 14 September 2003	42,0%	55,9%	2,1% (blank)

Source : *EU and EMU preferences in Sweden May 1992 - May 2002*, Statistics Sweden (SCB), www.scb.se/statistik; *Result of the referendum 14 September 2003*, www.riksdagen.se/eu/teman/emu/en/kampanjer/.

Before the referendum it became hard to guess whether the Swedes would finally support the idea of introducing the euro in their country or not. The situation became even more unpredictable after the brutal murder

⁵ **Question November 1997 - November 2001:** "Many EU Member States have joined in establishing the European Monetary Union (EMU), which is to lead among other things to a common currency in these countries. If there were a referendum today about Sweden joining the EMU, how would you vote – for or against joining?"

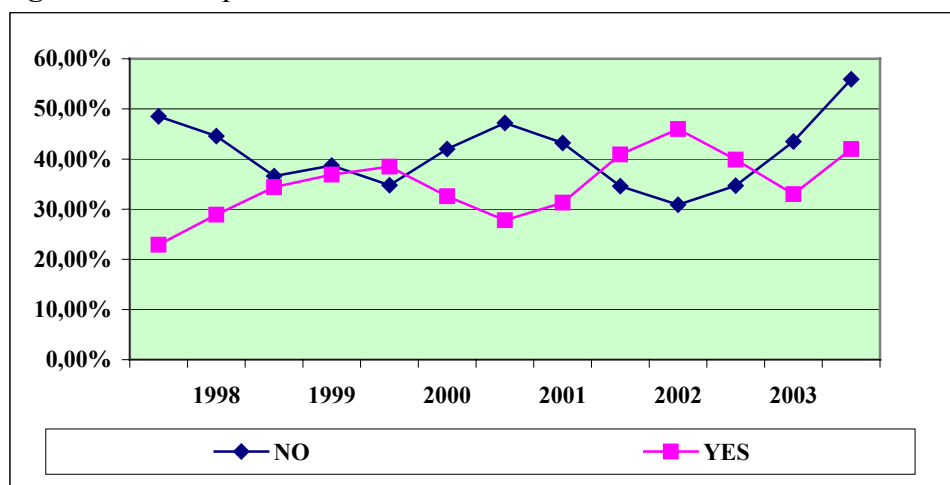
Question May 2002 - November 2002: "Many EU Member States have joined in establishing the European Monetary Union (EMU), which among other things means a common currency in these countries. If there were a referendum today about Sweden joining the EMU, how would you vote – for or against joining?"

Question May 2003: "This autumn a referendum will be held in Sweden. How would you vote if the referendum was held today? Would you vote YES or NO on the question 'Do you think Sweden should introduce the euro as its official currency?' ". [Statistics Sweden (SCB), www.scb.se/statistik].

Question 14 September 2003: "Do you think Sweden should introduce the euro as its currency?"

of Swedish Foreign Minister Anna Lindh, who was one of the main supporters of the idea of the EMU membership in Sweden. At that time, a few opinion polls showed that EMU advocates slightly outnumbered the opponents, and one could wonder if the psychological effect was likely to influence the result of the referendum or not.

Figure 1. EMU preferences in Sweden



Source : *EU and EMU preferences in Sweden May 1992 - May 2002*, Statistics Sweden (SCB), www.scb.se/statistik; *Result of the referendum 14 September 2003*, www.riksdagen.se/eu/teman/emu/en/kampanjer/.

Finally, the outcome of the referendum⁶ on whether or not Sweden should introduce the euro as its currency was that the No side won with 55,9 per cent of the votes with 42,0 per cent for the Yes side (blank papers made up 2,1 per cent of votes); the turnout was 82,6 per cent of those entitled to vote.⁷ As we can see, the Yes vote was beaten by almost 15 per cent – a far wider margin than opinion polls had predicted. In this way the Swedes broke somehow with a tradition according to which voters in this country tended to follow the advice of their political leaders. That was a result of the general growing tendency to increase distance between voters and politicians as well as reduce political-party commitment in Europe. It confirmed the fact that Sweden was not an exception from this rule. Swedish voters started to behave more and more as observers rather than as

⁶ Referendums in Sweden are consultative, which means that the Riksdag is not obliged to follow their outcome. However, the parties in the Riksdag can decide in advance that they intend to follow the outcome, thus making a consultative referendum decisive in principle. This was the case with the referendum on 14 September – the political parties undertaken to respect the No result of it.

⁷ *Result of the referendum 14 Sep. 2003*, www.riksdagen.se/eu/teman/emu/en/kampanjer/.

participants in the political process. In the aftermath of the economic crisis, they displayed growing doubts over how representative the authorities, the established political parties, and the traditional organisations actually are.

Table 2. Result of the referendum 14 September 2003

Men&Women (%)			
	Yes	No	Blank
Men	52,3	45,8	1,9
Women	40,2	57,7	2,1
Age groups (%)			
	Yes	No	Blank
18-21	29,1	66,3	4,6
22-30	45,5	51,5	3
31-64	48,8	49,9	1,3
65+	45,2	52,5	2,3
Political parties' sympathizers (%)			
	Yes	No	Blank
Social Democrats	49	49	2
Moderates	75	24	1
Liberal Party	71	26	3
Christian Democrats	45	53	2
Left-wing Party	11	88	1
Centre Party	21	77	2
Green Party	14	84	2

Source: *Folkomröstningen om EMU/Euro 2003*, <http://www.europaportalen.nu/folkomrostningen%202003.html>.

Before the referendum on the euro, the Yes parties of the Riksdag (The Social Democrats, The Moderates, The Liberal Party and The Christian Democrats) declared that a new referendum on whether or not Sweden should introduce the euro as its currency cannot come into question until the next decade (nevertheless, from a legal point of view there is nothing saying that the Riksdag cannot decide to hold a new referendum earlier).⁸

⁸ *The referendum*, www.riksdagen.se/eu/teman/emu/en/folkomrostning/.

Analysis of the anti-euro vote show that it included many women, young people (see Table 2.) and low-paid workers, just as in the 1994 referendum. Several parties were seriously split on the issue. However, it seems that it is the Social Democrats – the country's leading political movement – who have the greatest problem with their own voters, as much of their support traditionally comes from the less privileged section of Swedish society.

Election analysts claim that the No voters' main reason for rejecting the euro was a perceived lack of democracy and national sovereignty. However, this time there was also a powerful new argument concerning the economy, that is, the anti-euro lobby was able to point to high unemployment and heavy cutbacks in major EU countries, and this made a lot of sceptics convinced that Sweden would be better off managing its own economy. Moreover, there is still a strong believe that equity, justice, security and social welfare are best dealt with inside the country's borders.

1.2. Sweden's influence within the EU

There is no point of being a member of the EU if the chances to influence the decisions taken are highly limited. However, does staying outside the EMU lead to limited influence within the EU?

In general, we can distinguish two ways of exercising influence, so-called direct influence and indirect influence. The first one involves Sweden's ability to influence the processes and decisions linked to the monetary union, and the second one concerns Sweden's ability to generally influence the EU issues.

As far as direct influence is concerned, the ECB is supposed to run such an autonomous monetary policy that membership in the currency union does not change much from the influence possibilities viewpoint. Nevertheless, for those countries that belong to the monetary union, there are some points of contact with the central bank system. For example, the ECB is governed by the ECB Governing Council and the Executive Board; the Governing Council consists of the Executive Board and the heads of the national central banks in those countries that belong to the monetary union. Of course, neither the ECB nor the members of its decision-making bodies are allowed to take instructions from Community institutions, governments, or other bodies. But if we compare the Governing Council to the European Commission, whose members have to follow the same principle, that is, they also should not seek or take any instructions from outside, we can easily notice that even with such a restriction it is still worth having an own representative in this kind of institution.

For the EU countries that stay outside the monetary union, the opportunities to influence the ECB policies and practices are very limited, and in reality this influence cannot be expected to have any importance.

As far as indirect influence is concerned, EMU membership provides a number of opportunities to take part in the vital decision-making processes. Countries that decided to join the monetary union are more integrated and constitute so-called EU political core. Becoming a member of such a group would have for sure increased Sweden's capability to influence the perceptions of other parties, to raise issues for inclusion on the agenda, and to build powerful coalitions. On the other hand, the monetary union membership is not the only factor, which decides if Sweden has such a power or not. That depends also on the credibility the country enjoys. However, the decision to stay outside the EMU strengthens Sweden's image of so-called reluctant European, which leads to loss of political credibility. It can be seen as a refusal to accept responsibility for further European integration, and states that choose to reap the benefits of the European cooperation without really being prepared to pay the price for this cannot expect to be given much trust.

It is really hard to find any disadvantage of joining the EMU from the indirect influence possibilities point of view. In reality, a monetary union membership strengthen the negotiating power of a state and in that way the state can, more or less, influence almost all the issues of the EU cooperation.⁹

The negotiation process that involves many different parties requires formation of coalition in order to reduce complexity and reach compromises. For a small state like Sweden it is easier to join a coalition than to create one. So, if Sweden wishes to influence the agenda or initiate reforms in a specific area within the EU, it should join a group of major countries, which could provide the nucleus for an impelling coalition in the political process. The views of the major powers are often automatically considered in the EU decision-making process, regardless of the issue, whereas small states must develop a reputation, that is, they must have really good arguments and be known as serious partners in order to be listened to.

A state that remains outside even an informal but important decision-making group will find it more difficult to obtain vital information at crucial stages in the negotiating process, and we should remember that one of the main rules in the international negotiation is that a party should act early in the process to be successful in influencing the political agenda. This is a

⁹ P. O. Edin, *The euro – a pig already in the poke*, EMU: voices from without, Industri förbundet, Stockholm, 1998, pg. 81.

matter of crucial importance, as supranational political compromises normally develop slowly and are difficult to change later.

Participation in the monetary union would have also increased Sweden's opportunities of exercising influence in international negotiation on issues such as, for example, exchange rates and monetary arrangements at the global level, or issues within the International Monetary Fund (IMF), the Organisation for Economic Cooperation and Development (OECD), and the World Trade Organisation (WTO). During negotiations on this kind of matters, the monetary union will probably try to present common standpoints.

The last aspect of Swedish influence in the EU is bound up with the EU's Common Foreign and Security Policy (CFSP). The EMU and the CFSP are closely connected, as decisions on them were taken as a compromise between German aspirations to deepen a political co-operation and French desire to create a monetary union. Moreover, economic co-operation has been always treated as a step towards a political one. In this connection, it is important to consider the possibility that the monetary union members will deepen the integration and go towards a political union. The probability of such an event seems to be quite high. Of course, it may also happen that the group of countries eager to integrate more in the political area will differ from that one which participate in the monetary union, but this will not change much, as most of the countries would probably participate in both projects. So if the aim is to exercise influence in the EU, Sweden should participate at least in one of them.

2. Denmark

As far as the EMU membership is concerned, Denmark is treated as a "Member State with a derogation". The implications for Denmark were elaborated in a Decision taken by the heads of state or government at their Edinburgh summit meeting on 11 and 12 December 1992.¹⁰ This Decision states that Denmark retains its existing powers in the field of monetary policy according to its national laws and regulations, including the powers of Danmarks Nationalbank in the field of monetary policy.

Denmark is a country which – next to Belgium and Luxembourg – is perhaps the most integrated into the European Union, and the euro is one of the most important currencies for the Danes. Denmark's trade with the euro area is substantial – the euro area member states account for almost half of Denmark's exports. For this reason, although political support among the

¹⁰ *Convergence Report 2002*, op. cit., pg. 38.

populace in this country for the monetary union is weak, in economic terms the case for Denmark adopting the euro appears strong.

The lack of support for EMU project did not discourage the Danish government from holding a referendum (on 28 September 2000). Its result was not a surprise – a majority of Danish voters (53,1% against 46,9%) voted against adopting the euro in their country (the turnout at the referendum was 87,5%).¹¹

Denmark has maintained a fixed-exchange-rate policy since the beginning of the 1980s. Since the start of the third stage of EMU on 1 January 1999, Denmark has participated in the European Exchange Rate Mechanism, ERM 2. Due to its high degree of convergence, the country has entered into an agreement with the European Central Bank and the euro area member states on a narrower fluctuation band of +/- 2,25% (the standard width of the fluctuation band in ERM 2 is +/- 15%).

Table 3. Support for the euro in Denmark (1998-2003)

	For	Against
Spring 1998	34	57
Autumn 1998	41	53
Spring 1999	44	48
Autumn 1999	42	50
Spring 2000	41	51
Autumn 2000	41	55
Spring 2001	40	56
Autumn 2001	47	48
Spring 2002	52	43
Autumn 2002	55	40
Spring 2003	53	39
Autumn 2003	52	43

Source: *Eurobarometer*, Reports No. 49-60, European Commission, http://europa.eu.int/comm/public_opinion/standard_en.htm.

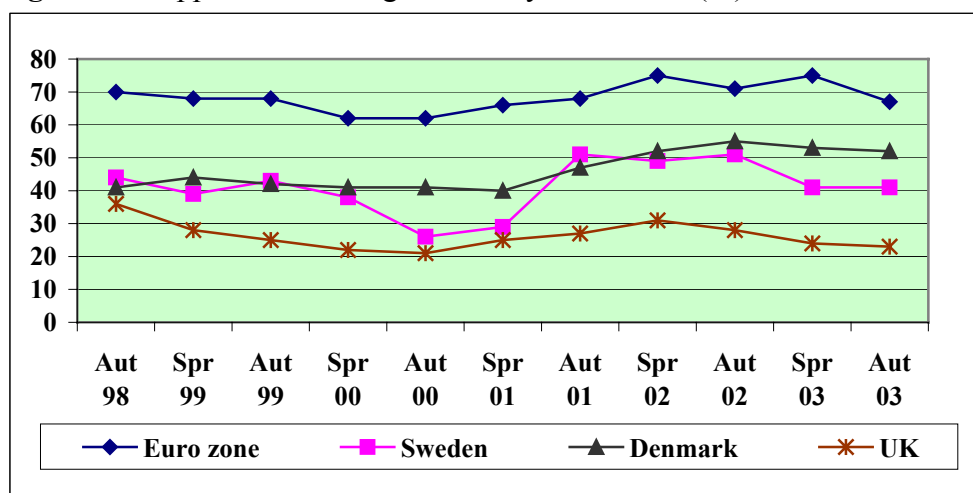
Denmark presently fulfils all the economic requirements laid down by the Maastricht Treaty. Moreover, Danish membership in the EMU would have very few financial market implications, because the exchange rate is

¹¹ *Euro referendum*, http://www.nationalbanken.dk/dnuk/eurohist.nsf/side/Euro_referendum.

already at the expected parity rate versus the euro and long-term interest rates in Denmark are essentially identical to those in most EMU countries. In fact, as far as monetary policy is concerned, Denmark gave up most of the freedom in this field long time ago. Hence, joining the Eurozone would just constitute a kind of confirmation of the policy which is already run by Denmark's authorities.

According to the opinion poll carried out in autumn 2003, 52% of the Danes supported the idea of joining the EMU whereas 43% were against¹² (see Table 3.). However, despite the fact that EMU advocates outnumber the opponents, the negative result of the referendum on euro in Sweden and the collapse of negotiations on the new EU constitution will probably postpone the date of a referendum in Denmark.

Figure 2. Support for the single currency 1998-2003 (%)



Source: *Eurobarometer 60*, http://europa.eu.int/comm/public_opinion/standard_en.htm.

The result of the Swedish referendum gave some more strength for Danish euro pessimists and it showed the country's government that the decision concerning the date of the referendum should be based on a strong and stable public support for the EMU project, as otherwise unpredictable changes in public opinion cannot be excluded (when the date of the Swedish referendum was set, the support for the EMU project was pretty high in Sweden).

Moreover, the prime minister – Anders Fogh Rasmussen – announced that the Danish EMU opt-out will not be sent to a referendum before the situation regarding the new EU constitution is resolved, that is, before

¹² *Eurobarometer 60*, http://europa.eu.int/comm/public_opinion/standard_en.htm.

signing a new treaty or an abandonment of the project. If there is a new treaty, the resolution of the issue would certainly not take place before the autumn of 2004, and the treaty could not be sent to a referendum before the spring of 2005.¹³

Apart from that, there will be parliamentary elections in Denmark by November 2005 at the latest, and it is very unlikely that a Danish referendum on the euro would take place just before such elections. In that case, the referendum would be affected by domestic politics, and it would be difficult to gather the Yes side.¹⁴ Taking all the above into consideration, it seems that the referendum will not be held before the spring of 2006.

3. The United Kingdom

The United Kingdom shall be under no obligation to move to the third stage of EMU unless it notifies the EU Council that it intends to do so. On 30 October 1997 the country informed the EU Council that it did not intend to adopt the single currency on 1 January 1999, and this situation has not changed.

If the UK decides to join the Eurozone, it will have to follow the same procedure as present EMU members, that is, fulfil all the requirements laid down by the Maastricht Treaty. However, British participation in the monetary union depends not only on meeting this condition – the Blair government has said that five additional criteria (tests) must be satisfied before it would call a referendum on the question of EMU membership. According to the government, the additional tests are necessary because of the distinctive nature of the UK economy – a large economy in the EU with a global outlook – and its history of economic instability, which shows sustained periods of clear divergence between the UK and the euro area.¹⁵

In general, the five tests define whether a clear and unambiguous case for entry can be made. They are:¹⁶

- 1) Sustainable convergence (compatibility of business cycles) between the UK and the Eurozone economies.
- 2) Sufficient flexibility to handle economic changes and shocks.
- 3) Impact on investments. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?

¹³ Christensen, J. B., *Focus: Denmark*, www.danskebank.com/research.

¹⁴ *Ibidem*.

¹⁵ *The five tests framework*, HM Treasury, <http://www.hm-treasury.gov.uk/>, pg.1.

¹⁶ *Ibidem*, pg. 2.

- 4) Upon Britain joining the EMU, would the financial sector feel both the initial and the strongest impact? Would the City benefit from euro participation?
- 5) Would British accession to the EMU promote higher growth, stability and create more jobs?

When the British Treasury reviewed the tests in October 1997, its assessment was that no. 1, 2, 3 and 5 had not been met, while no. 4 had been met.¹⁷ An interesting thing about these criteria is that they were created in such a way that they overlap to a certain extent – for example, it is difficult to envisage meeting the first four criteria without also fulfilling the fifth one.¹⁸

Table 4. Support for the euro in the United Kingdom (1998-2003)

	For	Against
Spring 1998	34	49
Autumn 1998	36	48
Spring 1999	28	55
Autumn 1999	25	59
Spring 2000	22	61
Autumn 2000	21	63
Spring 2001	25	57
Autumn 2001	27	58
Spring 2002	31	52
Autumn 2002	28	61
Spring 2003	24	63
Autumn 2003	23	65

Source: Eurobarometer, Reports No. 49-60, European Commission, http://europa.eu.int/comm/public_opinion/standard_en.htm.

The latest assessment of the above tests was presented by the Treasury department at the beginning of June 2003. The official answer to the question whether the criteria were met was “no, but we are getting closer”, which – theoretically – holds the door open to a referendum by the end of the present parliament's term in 2006¹⁹. However, referendum at that time is

¹⁷ J. B. Christensen, *Focus EMU*, www.danskebank.com/research, pg. 2.

¹⁸ Ibidem.

¹⁹ J. B. Christensen, *UK*, www.danskebank.com/research, pg. 2.

hardly probable, as there is still no public support for the EMU membership in the UK. In general terms, British public opinion on the EMU has not changed much over the past six years (see Table 4.): about 60% are against, about 30% are in favour, while one in ten voters remains to take a stand. The “Yes ” camp gained a little extra support in the wake of September 11 and in connection with the successful introduction of physical euro notes and coins on January 1st, 2002.²⁰ However, afterwards the number of EMU opponents increased once again.

These additional criteria seem to serve the interests of the government pretty well. They are rather vague and open to interpretation, so – on one hand – the government can easily explain the lack of rush in order to make a decision on EMU membership, and – on the other hand – it would be easy for the government to declare that the criteria are satisfied (and in this way open the door to a referendum) in case of a swing in the public’s opinion in favour of the euro. Of course, the greater the difference in growth and interest rates, the more difficult it will be to explain why the criteria are met. However, it seems that economic differences are unlikely to present an obstacle at the present time. Instead, public opinion will most likely play a decisive role, as far as the assessment of the five criteria is concerned. Nevertheless, it would be easier for the UK prime minister Tony Blair to convince voters about the advantages of adopting the euro if the UK economy underperformed that of Euroland. This could happen if the UK housing market, which is under a lot of pressure, plunges the economy into a tough recession while the continental economies start to recover.²¹

In general, there is no doubt that Tony Blair supports the EMU project and would be happy to see Britain join the Eurozone. However, with such opinion poll trends, it is hardly surprising that at present he remains reluctant to strongly advocate EMU entry. Affirmative votes in Sweden would have increased the probability, at least marginally, that voters in the UK also say ‘yes’. However, the British voters need more convincing arguments, as the hostility in the UK towards the EMU project seems to be more deep-seated than in the other ‘out’ countries.

²⁰ Christensen, *Focus EMU*, op. cit., pg. 4.

²¹ *Ibidem*, pg. 5.

4. Conclusion

For all the countries described above, the decision to stay outside the EMU appears to be more of a lack of public support to enter the Eurozone rather than a lack of political will or an inability to meet the convergence criteria (though the UK has advanced as one of the primary reasons for not joining the monetary union a lack of 'sustainable convergence'). It is why the countries run so-called 'wait and see' policy. From a political point of view, however, the possibility to observe the functioning of the EMU from outside seems to be risky, as – on one hand – it may persuade the population of these countries to become more positive towards the euro, but – on the other hand – it may also make public opinion swing against accepting the single currency. The policies of the 'out' countries both depend on the success of the euro and influence each other. All this makes the matter more unpredictable, and thus it is more difficult for the politicians to plan the strategy to join the Eurozone.

The negative result of the euro referendum in Sweden appeared to be a factor which gave more strength for the euro pessimists and thus it would not only postpone the Swedish membership but also make the politicians in Denmark and the UK put off making decisions on this matter.

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Institutional framework for Transatlantic relations

1. Introduction

Considering traditional EU-US relationship, there is often a question arising on institutional foundations of transatlantic ties. Each of us is fully aware of significant tensions on Brussels – Washington line; with the only difference once it refers to political or trade disputes. Nevertheless, despite these considerable numbers of “rifts”, one can not deny an unprecedented degree of the EU-US economic cooperation. Moreover, analyzing formal inter-governmental agreements tackling strong and everlasting cooperation there is always a dilemma appearing on how high a potential dissonance between formal documents and the practice occurs.

The aim of the paper is to present an institutional framework, which the EU-US political and economic binds are based on. Regarding the limited number of pages, only some of the topics, with regard to its present day interest, are unfolded and detailed. Particularly, the focus was put on transatlantic economic relations, for which a number of action-plans, agendas and reports should determine further development of cooperation. However, to which extent the declared resolutions and constituted rules will be met depends on internal institutional facilities, domestic consumer tolerance, administration constrains or political willingness.

2. Transatlantic Declaration

Diplomatic relations between European Community and the United States were established in 1953 where the first American observers were sent to the European Coal and Steel Community together with the newly established initiative – European Defense Community (1952). The Delegation of the European Commission to the US in Washington dates from 1954 and the American mission to the European Community began its activity in 1961. Over the past fifty years during the cold war, the EC-US relations had been based on the conviction of common threat from the Soviet Union on the one hand and the belief of common heritage, close historical, political, economic and cultural ties on the other one. These two factors created the situation, in which the USA and Western Europe constituted a united western block as a counterbalance of the eastern block

led by the Soviet Union. However, the Transatlantic Partnership forged by the Kennedy administration in the 1960s seemed to be an overestimated alliance-formula aimed at extending the range and scope of EC-US relations. The document was a political manifestation of western unity in the event of the Soviet Union's threat and did not envisage, in general opinion, the real partnership between two parties.

The topic of this paper is focused on shaping EU-US institutional framework after the end of the cold war with an emphasis on transatlantic economic cooperation. The overall conception for conducting Euro-American relations in new circumstances provided bilateral document called the Transatlantic Declaration adopted on 22 November 1990. The document envisaged a political will for upgrading the Euro-American post cold war political relations and constituted an institutional ground for further elaboration. Both sides reiterated their attachment to values and principles essential for the preservation of peace and freedom and for the development of free and prosperous economies. The European Community and the United States declared determination to help consolidate "the new Europe", undivided and democratic, based on a pattern of cooperation that would contribute to achievement of political and economic progress in the whole Europe and beyond¹. Bearing the conviction of shared responsibility to common interests and transnational challenges, the EC and the USA obliged themselves to endow their relationship with long-term goals and perspectives². Directed by the democratic rules of law, individual liberty, prosperity and social progress worldwide, the Europeans and the Americans have set common purposes to be met by joint cooperation. Within that mechanism, the parties have set up biannual regular consultation; ad hoc consultations and dialogue between their political bodies.

The cooperation initiated in the Transatlantic Declaration formulated a regular political dialogue in four main areas. The issue of **international security (1)** became the prior objective to be preserved by cooperating with other nations against aggression and coercion, contribution to the settlement of conflicts and reinforcing the role of the United Nations and other international organizations. Second, both partners declared to pursue policies aimed at achieving a sound world economy, marked by sustained economic growth with low inflation, a high level of employment and equitable social conditions. **Mutual economic cooperation (2)** was set up with the aim of strengthening the multilateral trading system by liberalization and implementation of GATT and OECD principles related to

¹ *Transatlantic Declaration* issued on 22 November 1990, <http://www.eurunion.org/partner/transatldec.htm>.

² *Transatlantic Declaration* issued on 22 November 1990, preface.

trade in goods, services and investment. Cooperation on matters such as technical and non-tariff barriers to industrial and agriculture trade, services, competition policy, transportation, telecommunication, high technology and standards – turned up to be a set of requisite areas, which should be deepened and enhanced on higher level of cooperation. Third, the EU and the US have set out cooperation in **education, scientific and cultural matters (3)**. This section embraced activities such as exchanges and joint project in science and technology, including research in medicine, environmental protection, pollution prevention, energy space, high energy physics and the safety of nuclear and other installations. As far as education and culture cooperation is concerned, this domain included academic and youth exchange and other relevant areas. The last, fourth field of mutual concern was called **transatlantic challenges (4)**. In this regard, the EC and the US addressed transnational challenges in the following areas: combating and preventing terrorism; illegal production, drugs trafficking, money laundering. Convinced that the cooperation and joint activities are the only ways to respond the cross-border challenges, the partners undertook collaboration in the issues of combating against international organized crime; protection of proliferation of nuclear armaments, chemical and biological weapons and missile technology³.

Consequently, carrying the EU-US cooperation forward, the Transatlantic Declaration became a foundation for next institutional framework – the New Transatlantic Agenda (NTA). This was the answer to the end of the cold war and the acceleration of globalization. The document turned up to be a new bedrock for the EU – US relationship in the light of significant changes in Europe, marked by the outcomes of Maastricht Treaty, which created the European Union and called up a Common Foreign and Security Policy (CFSP). The primary objective of the new transatlantic agreement was the forming an equal and global partnership covering all issues recognized by the Europeans and Americans.

3. New Transatlantic Agenda

Changes in international relations, since the 1990 Transatlantic Declaration affected considerably the policies of European Union and the United States. Therefore, it became the highest necessity to improve and

³ To be able to pursue the submitted range of issues, the parties agreed to establish a regular and intensive consultation based on procedures accepted by the President of the European Council and the President of the United States on 27 February 1990, *Transatlantic Declaration*, op. cit.

broaden the structure of mutual cooperation. The New Transatlantic Agenda launched at the Madrid summit in 1995 relied basically on the mechanisms arising out of the 1990 Transatlantic Declaration and embraced four major goals:

- 1) promoting peace and stability, democracy and development around the world,
- 2) responding to global challenges,
- 3) contribution to the expansion of world trade and closer economic relations,
- 4) building bridges across the Atlantic.

The four-shared tasks set up in the NTA were subsequently expanded and detailed within the Joint EU-US Action Plan. The latter document constituted a supportive guideline, which deepened various fields of cooperation, some of them only marked in the NTA. As an extension of the NTA efforts in economic sphere was an agreement called Transatlantic Economic Partnership (TEP) reached at the EU-US London summit in 1998. The new initiative – TEP intended to extend bilateral and multilateral cooperation and common actions in the field of trade, investment and related issues.

The contents of the NTA and the TEP, displayed in the further part of the paper, is completed with some additional notes and remarks enclosed in subsequent documents. Those are mainly reports or initiatives aimed at verification or reforming the previous EU-US agreements. Moreover, looking at these two arrangements (the NTA and the TEP) from the eight-year perspective, one can not avoid drawing up conclusions or evaluations having known the latest results. Hence, the original provisions taken from the NTA, the EU-US Action Plan or the TEP are accomplished with some other information and remarks on recent changes or new ideas in the respective topic. In this regard, the EU did its evaluation of the TEP in October 2000 and subsequently of the NTA in March 2001. At that time it had been passed five years since the NTA was established and the beginning of the Bush administration was good time to assess EU-US partnership through the prism of implementation of the NTA. Since that time, important events emerged, which influenced considerably the US and the EU policies, which were: the prospect of enlargement of the EU, the advent of the euro introduction or European Security and Defense Policy as well as intensified global threats such as proliferation of weapons of mass destruction, organized crime or infectious diseases brought new needs and challenges for

joint action⁴. Therefore, European officials proposed to make the transatlantic cooperation more action-oriented and more concentrated on clear defined priorities, already founded in the NTA, but requiring more political will to meet.

3.1. Promoting peace and stability, democracy and the development around the world

First major part of the NTA occupies the purpose formulated as “maintaining peaceful relations between the states, promoting democratic rules of law and sustainable development”. To achieve this outstanding purpose, both sides committed themselves to work together for a stable and prosperous Europe through the following activities: a) reconstruction in the former Yugoslavia; b) reinforcing existing cooperation on consolidating new democracies and their market economies in Central and Eastern Europe; c) supporting transitions to a market economies in Russia, Ukraine and other new independent states (NIS) to integrate them in the global economy; d) upholding the Turkish government’s efforts to strengthen democracy and advance economic reforms in order to enable it further integration to the transatlantic community; e) working towards the resolution of the Cyprus question and encouraging the dialogue between and with the Cypriot communities. Furthermore, the EU and the US declared to work staunchly to achieve a just, lasting and comprehensive peace in the Middle East, through making the most of benefits from the Peace Process and promoting conciliatory attitude between Israel, Lebanon and Syria. Both announced to attach the highest importance to resolving crisis, settling down conflicts and making peace in conflict-prone areas in Africa, Central and South America, Central and South and Eastern Asia⁵. Therefore, they pledged to strengthen their efforts in preventive diplomacy, attacking the root causes of crisis and conflicts and in the field of movement from relief to long-term development.

Deriving from the same overarching purpose of peace and stability, they agreed to coordinate, cooperate and act jointly in the areas of development and humanitarian assistance. To this end, the Europeans and the Americans identified the human rights and democracy as key pillars for promoting sustainable development and building democratic societies. They agreed to consult bilaterally and within the framework of relevant bodies of

⁴ *Reinforcing the Transatlantic Relationship: Focusing on Strategy and Delivering Results* Communication from the Commission to the Council, Brussels, 20.03.2001, COM(2001)154 final, pg. 2.

⁵ *Joint EU – US Action Plan, Goal I: Promoting peace and stability, democracy and development around the world*, <http://www.eurounion.org/partner/actplan.htm>.

the UN on the countries where there is a serious violation of human rights. Furthermore, both sides supported jointly a greater integration of the OSCE (Organization for Security and Cooperation in Europe), its human dimension into conflict prevention, as well as its other activities including conflict prevention/crisis management, confidence- and security-building measures and the economic dimension. For this reason, cooperation in international organizations became a primary objective in terms of exercising the EU-US common goals lay down in the NTA. Accordingly, the emphasis was put on better cooperation within the UN framework. Thus, the approach should have an impact on an overall cooperation within other international fora, namely in international economic organizations with an aim to reduce overlapping activities in institutions such as: UN economic bodies, WTO, Bretton Wood's institutions, OECD⁶.

3.2. Responding to global challenges

Second goal put down in the NTA concern the issues of global challenges. In this section, the partners revealed their common tasks that they wanted to fulfill on global reach. In this regard, joint EU –US approaches resulted from the assumption that neither of them can overcome new global challenges alone⁷. Therefore they pledged to undertake joint efforts to address the following challenges: international organized crime; terrorism and drug trafficking; money laundering; illicit trade in nuclear materials; mass migration; degradation of the environment; nuclear safety and the problem of infectious diseases. Bilateral cooperation and institutional dialogue presumed to be efficient measures to combat those dangerous phenomena. A necessary factor was to establish an information exchange mechanism on cooperation in law enforcement and criminal justice fields, especially regarding activities in providing training, technical assistance and equipment to other nations. An urgent issue turned up to be strengthening information exchanges on illegal immigration and on asylum through founding common responses to refugee crisis situations, notably by early-warning mechanisms and coordination activities. In order to deal better with legal and judicial issues, an institutional cooperation was established, which included extradition, deportation, mutual legal assistance and other cooperative actions.

The EU and the US addressed their interest in continuing work on biotechnology, including activities such as mutual acceptance of data for assessment and the release of genetically modified organisms (GMO). The issue of GMO trade focused a great attention of both partners and caused a

⁶ Ibidem, par. 7.

⁷ Ibidem, *Goal II: Responding to global challenges*.

significant transatlantic dilemma supported by overall world's discussion on food scares. It resulted from the situation when the EU put in place new regulations for GMO products in relation to the safety of products and the disposal of waste – requiring economic operators, including those from the USA, to adapt⁸. The Europeans recognized the GMO as a potentially risky for the health or environment and put the ban on genetically modified food. On the contrary, the US perceived these new product-regulations as significant trade barriers and worried about preserving the viability of the international standard-setting process. The long-lasting impasse in bilateral talks finally inclined the Americans to insert the GMO's problem under the WTO dispute panel. The initial judgment upheld the Americans statement, which claimed that the EU restrictions on importing GMF caused trade-distorting effects. At length, the USA seems to reach its objective on free exporting GMF to EU countries, but under certain conditions, namely labeling rules restriction on each GMO product. In turn, the EU has been working to develop comprehensive, transparent and science-based regulation⁹.

Nevertheless, the question of GMO is not ultimately resolved, while the problem of regulation of GM products affects many countries around the world. Furthermore, the topic of GM food-export affects another issue, namely food aid and assistance for developing countries. This time, the US put the allegations that through the EU objection to GM policy, most African governments refused to receive American GM food aid. The revealed explanation about the possible health risk of consuming modified corn and the environmental impact into the eco-systems in southern Africa did not convinced Americans, who reproached Europe with contributing to hunger in Africa¹⁰.

On the contrary, as far as the issue of world health protection is concerned both parties announced to establish an EU-US task force to develop and implement an effective global early warning system and response network for communicable diseases. They promised to start cooperating bilaterally or within the WHO and other international organizations on respective programs on health-related matters.

Next challenge that the EU and the US faced under the NTA provisions is environment protection. Both parties declared significant engagement in dialogue on ways and means to limit and reduce global

⁸ *WTO report on European Union*, Press release, PRESS/TPRB/198, 26 July 2002, http://www.wto.org/english/tratop_e/tpr_e?to198_e.htm.

⁹ P. Lamy, *Partnership of a Great Purpose: the European Union, the United States and the WTO*, Press Conference of the EU Trade Commissioner P. Lamy and USTR R. Zoellick at the Office of the US Trade Representative Washington, 25 June 2003, Speech/03/ 328.

¹⁰ *Ibidem*.

emissions of greenhouse gases, including CO₂. They devoted special attention to cooperatively developing and implementation safety and environmental protection, while recognizing the need to achieve, wherever possible, global regulatory uniformity. Nonetheless, simultaneously with coming into power the Bush administration, American environmental policy changed considerably. Previous obligations assumed by Clinton's officials have not been promised since the current administration withdrew from the former declarations claiming that the 1997 Kyoto Protocol did not constitute any interest for the Americans. President G.W. Bush announced that the US would no longer support the Kyoto Protocol or intend living up to the targets his country agreed upon four years ago¹¹. Under the Protocol, the US was supposed to cut its greenhouse gas emissions by 7 percent. With 4 percent of the world's population, the country accounts for about 25 percent of the Earth's greenhouse gas emissions. Consequently, on 13th March 2001 president G.W. Bush said that the legislate limitations on CO₂ emissions from US power plants would be too costly, in light of rising energy prices. The US approach caused some deadlock on talks conducted within the UN framework Convention on Climate Change (UNFCCC), which contributed to formation the Kyoto Protocol.

The Europeans under the Swedish presidency endeavored to rescue the climate change talks by narrowing differences between the EU and the US on how the Protocol targets should be met. However, an intransigent position of the Americans induced the EU states to ratify the Kyoto climate protocol by 2002 with or without the US participation. However, in long run perspective, the US input into the Kyoto Protocol seems to be necessary, taking into account the requirement to limit CO₂ emission in the industrialized countries by at least 55 percent. Despite the environmental "rift", the EU-US ecological cooperation embraced other issues such as: biodiversity, ozone layer depletion; persistent organic pollutants; desertification and erosion; water quality and quantity; land-based sources of marine pollution; hazardous wastes; contaminated soils and forest.

¹¹ Greenhouse gas emissions from fossil fuel burning in electricity generation and from agriculture and transportation are thought by many scientists to have reached levels that require precautionary and prompt action. Under the Kyoto Protocol, 39 industrialized nations must cut emissions of six greenhouse gases to an average of 5.2 percent below 1990 levels by the period 2008-2012. But the Protocol will not take effect until it is ratified by 55 percent of the nations emitting at least 55 percent of the greenhouse gases, above all carbon dioxide (CO₂). *UN Framework Convention on Climate Change*, <http://unfccc.int/>.

4. Transatlantic Economic Partnership

Third major point in the NTA and its supportive act - Joint EU-US Action Plan is devoted to economic issues under the title “Contributing to the expansion of world trade and closer economic relations”. But the main EU-US document tackling with transatlantic trade and investment is the Transatlantic Economic Partnership (TEP).

The chief objective scheduled by the both parties is to strengthen the multilateral trading system through supporting of WTO and leading the way in opening markets for trade and investment. The long run purpose is to create a New Transatlantic Marketplace (NTAM) by progressively reducing or eliminating barriers that hinder the flow of goods, services and capital. The areas for cooperation pointed out in the NTA have been subsequently shifted and much built-up in the TEP, together with a timetable for achieving specific results.

In conformity with the confidence-building measure recommended in the NTA, the TEP document is about to contribute to resolving trade disputes, which occur quite frequently in the EU-US relations. Provisions contained in the NTA were further elaborated within the new TEP agenda, which addresses trade issues in eight areas: services; agriculture; government procurement; intellectual property; technical barriers to trade, environmental issues; labour and competition policy. Cooperation between the EU and the US under the TEP was divided into two levels – multilateral, which is to be fulfilled mainly by the actions on the WTO forum and – bilateral, based on the TEP and other mutual agreements. Multilateral actions are to serve encouraging the multilateral trading system within the framework of WTO, in which the TEP has to play a key role as a useful instrument for more coordinated positions on individual subjects or joint proposals to be submitted in the WTO multilateral discussions and negotiations¹².

The key part in the EU-US cooperation within the WTO plays the instrument of dispute settlement, which in the TEP, is strictly combined with transparency and implementation. Transparency refers to the general public access to WTO documents to make the system more open to consultation, and the matter of implementation means full realization of WTO commitments by all its members. In the NTA the parties called for working on the completion of unfinished tasks, namely in goods and

¹² In pursuing the collective objectives, the EU and the US declared to involve other trading partners through admitting new members to the WTO, notably China and Russia. After years of endeavors WTO approved China's association in 2001 and Russia has been still striving for gaining the WTO membership.

services sectors. Therefore, the TEP foresees extension of negotiations on the basis of the General Agreement on Trade in Services (GATS) Article XIX, which gives provisions on setting out the new framework for services. The parties decided to achieve the highest possible level of liberalization in the framework of GATS process by encouraging sectoral dialogue between service industries¹³. In this respect, the activities included mutual recognition agreements on specific services sectors with an appropriate participation of relevant professional and regulatory bodies¹⁴. Moreover, the NTA foresees liberalization of financial services within the WTO members.

Under the TEP provisions, the EU and the US pledged their engagement in other areas requiring multilateral actions, such as: agriculture, trade facilitation, industrial tariffs, intellectual property rights (with the aim of establishing an agreement on improving the level of IPR protection throughout the world under the WTO auspices), investment, competition, procurement, trade and environment, “market access” (which means additional trading opportunities in conformity of their WTO commitments, including tariff reductions on industrial products developing countries), electronic commerce, labour standards, rule of law issues. All discussing issues pointed out above constitute a subject under WTO ongoing negotiations conducted within the last Doha Round aims at further trade liberalization¹⁵. In this respect, the most important purpose for the EU and the US was to set into motion the next WTO negotiations round, specially regarding the 1999 “Millennium Round” in Seattle finished with a damaging failure. The pending Doha Round negotiations, started in Qatar in November 2001, do not bid fair to conclude quickly, taking into account last results from the 2003 Cancun ministerial meeting in Mexico. The reasons lay in the vast scope of differences between the high-developed countries represented by the US and the EU on the one hand - and the developing or the least-developed states, on the other. Main problems concentrated around the agriculture issues embracing the reductions of export subsidies and those domestic supports that distort free trade in agriculture goods. In order to move forward, the 2001 WTO Doha declaration gave, with an significant support of the EU-US, a special and differential treatment for developing

¹³ *Transatlantic Economic Partnership*, section: *Multilateral action: detail for services*, <http://europa.eu.int/comm/trade/issues/bilateral/countries/usa/1109tep.htm>, pg. 14-15.

¹⁴ *Ibidem*, point 3: *Services*.

¹⁵ The EU and the US managed to narrow their difference on agriculture meeting, which showed their common statement raised at the last ministerial meeting in Cancun (Mexico), see: Ann M. Veneman, US Agriculture Secretary, *US-EU Framework for WTO Agriculture Negotiations* Washington DC, August 13, 2003: <http://www.state.gov/e/eb/rls/rm/2003/23336.htm>, and Robert B. Zoellick, the US Trade Representative, Washington DC, June 25, 2003.

countries enabling them to meet the standards in food security and rural development¹⁶. Next difficult chapter in the WTO negotiations constituted the liberalization of services. The so-called Singapore issues including investment, competition polities, transparency in government procurement and trade facilitation have become a serious dilemma within the ongoing negotiations. The Singapore four purposes divided the 148 members of the WTO into two groups - supporters – the EU and the US, and the opponents - developing countries, which the latter claimed to drop all of them from the post-Doha agenda. For that reason, the 2001 EU report on the implementation of the NTA informed that the services sector lacks a lot in comparison to the progress made in the areas such as technical barriers to trade, regulatory cooperation, consumer product safety, food safety, biotechnology or competition.

Parallel to multilateral actions undertaken on the WTO forum, the TEP Action Plan brought into the EU-US institutional framework a new range of bilateral arrangements. The reciprocal agreements under the TEP included the issues of regulatory cooperation in the field of technical barriers to trade and goods. In this regard, both parties pledged to improve existing bilateral mechanisms and internal procedures of regulatory authorities, while preserving independence of domestic management. The agreement anticipated mutual recognition, which meant removal or lowering of barriers resulting from different requirements to be met by goods. They announced to extend the current mutual recognition agreement to new sectors and further work in the field of international standardization and consumer product safety. Accordingly, the objective of mutual regulatory cooperation and recognition comprised the areas such as: services, procurement, intellectual property, agriculture, including food safety, plant and animal health, biotechnology.

In the field of food safety, plant and animal health, the TEP agreement implies a system of early warning to be able to set up special dialogue and consultation in the event of conflicts¹⁷. On that basis, the sides planned to open so called “contact points” to be able to keep officials informed of food safety development and facilitate the flow of relevant information. In order to fulfill this purpose, the EU and US citizens from respective scientific and technical agencies would participate in exchange programs to become more familiar with their counterparts food safety systems, regarding inspections and control procedures. In the sector of biotechnology, the parties declared to reduce all unnecessary barriers to trade, increase scientific and regulatory

¹⁶ *WTO Doha Declaration explained*, The Work Programme: www.wto.org/english/tratop_e/dda_e/dohaexplained_e.htm.

¹⁷ *TEP*, Section 3.5.1. *Food safety, plant and animal health*.

cooperation and information exchange, as well as promotion transparency and information of consumers. As far as environment issue is concerned, the TEP introduced some new solution to improve cooperation in this field, namely TEP Environment Group. The new forum was formed to focus on the interface between trade and environment, and became a main body for environmental dialogue, alongside other existing formations: the EU-US High Level Environmental Bilateral Consultation and Transatlantic Environmental Dialogue. On the contrary, dialogue on labour issues was set in such a way to be able to exchange views regarding the implementation of the worker rights provisions. The cooperation in that field would be developed with the aim to improve working conditions worldwide. Thus, it would be contributed by maintaining transatlantic communications between employers, workers and NGOs. To this end, the Transatlantic Labour Dialogue (TALD) was established to uphold talks between US business and labour advisory groups, and with the EU social partners. In this field a special role was assumed for the newly launched Transatlantic Consumer Dialogue (September 1998) intended to work on implementation of competition law procedures.

In order to manage the day-to-day trade and investment transatlantic relations, the EU and US established the TEP Steering Group. The mechanism was to operate within the institutional structure of the NTA and would assist where necessary by ad hoc or specialized working group fulfilling the respective tasks. Among number of duties, the most important task of the Steering Group was to monitor and report on the realization of TEP objectives and the scope of implementation of the agreements reached under TEP. The Steering Group was obliged to inform a group of senior officials (Senior Level Group, SLG) as well as ministers of its progress. In order to keep monitoring within the TEP framework at the highest level, the SLG prepares twice year summits between the presidents of the European Council and the European Commission and the president of the US.

In the 2001 EU report on evaluation of EU-US trade relations, the TEP was assessed as a useful instrument for further development of transatlantic cooperation in trade and investment, although there was underlined that the Plan can not resolve all difficulties and disputes that occur between the parties. Despite setbacks in ensuring the timely implementation of the TEP Action Plan, the conclusion was that the early warning mechanism for trade and investment matters is working satisfactory within the structured framework. As far as trade disputes are concerned, there was emphasized that it would always be some contentious issues, so typical for the world's two largest trading blocks. In practice, at the most 1-2% of the trade and investment flow, according to the European Commission, is affected by the trade disputes. Although such a number

seems to be a slight burden for transatlantic commercial relations, it can not be disregarded, specially taking into account publicity, which the disputes attract the media¹⁸.

4.1. New Transatlantic Marketplace

One of the visionary purposes constituted in the NTA is the initiative of a New Transatlantic Marketplace (NTAM). Building upon the provisions of Transatlantic Business Dialogue (TABD) the idea of NTAM aims at getting closer both economies by getting rid of barriers to the flow of goods, services and investment. The initiative gained support from consumer and environment communities on both sides of the Atlantic brought together in the transatlantic consumer dialogue (TACD) and the transatlantic environmental dialogue (TAED). In order to initiate the Transatlantic Market Place it is need to facilitate trade in goods and services and further reducing or eliminating tariff and non-tariff barriers. Both sides agreed that to resolve bilateral trade issues and disputes, there should be reinforcing a confidence-building process. Therefore, the institutional framework of business dialogue (TABD) should contribute to conclude an agreement on mutual recognition of conformity assessment (which includes certification and testing procedures) for certain sectors. These undertakings include cooperation in the international standard setting process aiming to achieve the greatest possible use of international standards, as well as the maximum practical transparency, participation and non-discrimination.

The transatlantic economic structure (NTAM) was to embrace cooperation on health food standards; veterinary and plant health procedures; government procurement agreement; intellectual property rights (IPR); financial services and customs cooperation. Critical topic for setting up the NTAM became a common building of information society. Understanding of global issues and implying access to information services through public institutions, regulatory reforms, and technological cooperation went into the making of creation of information society on both sides of the Atlantic. Advancing collaboration in science and technology areas is presumed to lead to better cooperation in information communication technology. Further areas of joint action within the transatlantic market embraced an agreement on deepening cooperation on competition matters, data protection, transportation, energy and biotechnology. As far as the transport issue is concerned, the partners agreed to design and implement global navigation satellite systems, improving mutual cooperation on air traffic management and maritime transport safety. In the 2001 EU report on the NTA progress, the Europeans underlined a

¹⁸ *Reinforcing the Transatlantic Relationship...*, op. cit., pg. 6-7.

need to strengthen cooperation, in particular by actions towards more liberalized air transport market¹⁹. In energy field they declared to intensify contacts and cooperation on energy-related issues, which would include environmental protection, technical assistance activities to third countries and energy technology.

By the forming of common transatlantic market, a grave importance is attached to the problem of job creation. Therefore, the EU and the US pledged to set up a joint working group on employment and labour-related issues in the follow-up to the G-7 jobs conferences, the OECD and the International Labour Organization. According to the given proposals, active labour market policies should be based, as recommended in the NTA, on technologies and encouraging entrepreneurship.

4.2. Building bridges across the Atlantic

Last major goal in the NTA entitled “Building bridges across the Atlantic” tackles about promoting a vibrant transatlantic community by deepening and broadening commercial, social, cultural, scientific, and educational ties. Under the principle “people to people links” the EU and the US resolved to fulfill the purpose on bringing nearer both societies, especially in commercial dimension. The mechanism of transatlantic dialogue (TABD) turned up to be a proper “vehicle” to meet that intent. The engine of development within the TABD is a private business sector from both side of the Atlantic, which contributed to embark that initiative in 1995. The TABS aims to promote mutual trade and investment by removing costly inefficiencies caused by duplication and differences in European or American regulatory systems²⁰. Thus, the idea was to advance and strengthen the whole work initiated by official–diplomatic side through regular business dialogue including non-governmental or private sectors.

Under the “people to people links” the EU and the US pledged to encourage their citizens to increase contacts in various fora, namely – youth, professionals, academics, think tanks etc. They expressed willingness to enhance cooperation in educational exchanges, including scholarships and intern programs. Both partners recognized a need to help to reform a higher education in the countries of Central and Eastern Europe, Russia, Ukraine, the remaining NIS and Mongolia by identifying and assessing those projects of the EU TEMPUS program, which already include US-partner universities.

On the contrary, the section “Information and culture” involved a number of artistic and cultural cooperation projects, such as exchanges in

¹⁹ Ibidem.

²⁰ More see at: <http://www.tabd.com/>.

the field of the visual arts; theatre; ballet; orchestras and musical groups; the co-production of films and TV programs. Furthermore, the EU and the US decided to develop cooperation in literary creativity; spreading knowledge of cultural and artistic heritage programs. Following the provisions undertaken in the earlier parts of the NTA, both sides announced to negotiate a new, comprehensive EU-US science and technology cooperation, which would enable to meet global challenges and foster economic growth.

5. Practical outcomes

The EU and the US enjoy the world's largest commercial relationship and are each other's largest trade and investment partners according to the latest reports undertaken at the EU-US summit of June 2003 in Washington. Officials from both sides of the Atlantic assured, that despite a pretty big number of trade and political disputes, the EU and the US still remain each other's most important strategic partners. As said by Pascal Lamy, the EU Trade Commissioner, this unique relationship is founded on the enormous trade and investment cooperation, which the latter considerably surpasses the foreign investment flows of any other groups of countries. In conformity of the European Commission information sources, revealed on the occasion of the EU-US 2003 meeting, the far-reaching objective of the creation of Transatlantic Marketplace is becoming more and more feasible²¹.

However, regarding the latest impact of trade disputes, which hit the headlines around the world, the participants of the transatlantic summit on 2 May 2002 decided to embark a bilateral initiative called Positive Economic Agenda (PEA). It is designed to promote transatlantic cooperation by focusing on areas where there is goodwill on both sides to achieve convergence or/and mutual recognition of rules, standards in areas where considerable gains can be sought²². The PEA project was to stimulate further cooperation and common action by well-identified and mutually beneficial bilateral undertakings to be reported to the EU-US summits in order to reach a high degree of accountability and transparency. The PAE roadmap was to serve to classify the most promising sectors of co-operation and to outline the way ahead towards joint objectives. Under the PAE provisions, the EU and US have managed lately to make a substantial progress, namely in the financial markets dialogue, in the launch of regulatory cooperation in the

²¹ *EU-US Bilateral Economic Relations*, European Union Factsheet published on the occasion of the EU-US Summit in Washington, 25 June 2003.

²² *The Positive Economic Agenda*, the EU Factsheet.

sectors of cosmetics, automobile safety, nutritional labeling and metrology. Furthermore, they enabled to conclude an agreement on marine safety equipment under the Mutual Recognition Agreement (MRA) and set out negotiations on establishing an Open Aviation Area (OAA)²³.

As far as the idea of the New Transatlantic Marketplace (NTAM) is concerned, both partners agreed to pursue that ambitious plan together with the parallel developing Western Hemisphere's economic formation, namely Free Trade Area of the Americans (FTAA). As stated in the 2001 EC evaluation report, business on both sides of the Atlantic invest and produce overseas much more than they export from their national borders. The following figures show that the EU and the US are the leading players in international trade and each other's single largest trading partner in goods and services. That indicates that there was paved a substantial basis for achieving the objective of the NTAM. Altogether, in 2002 the EU and the US world's trade in good accounted for 37 percent and in world's trade in services for about 45 percent²⁴. In the same period, two-way cross-border trade in goods and services amounted to more than 650 billion euro. The EU and the US each account for around 21 percent of each other's total trade in goods. Transatlantic trade represents 39 percent of the EU and 35 percent of the US total trade in services. In 2001, the EU-US trade in services accounted for 36 percent of total bilateral trade (goods and services).

The same intertwined and interdependent economic relations one can see in terms of foreign direct investment (FDI). The EU and the US companies invest more in each other's economies than in other parts of the world. In this respect, the EU and the US accounted in 2001 for 49 percent and 46 percent respectively of each other's outward FDI flows. The EU accounted for 54 percent of the US inward FDI and the US for 69 percent of the EU inward FDI. The importance of the EU-US investment relations shows the investment period 1998-2001, in which the US was the destination of 52 percent of the EU outward FDI flows while the source of 61 percent the EU inward FDI. In 2002, the EU FDI in the US amounted to 862,6 billions dollars out of 1 321 billion dollars of total foreign investment in the USA. At the same time, the US's FDI in the EU accounted for 700 billions dollars²⁵. Thus, the FDI indicator shows that the US and the EU economies' engagement remain overwhelmingly focused on each other.

Apart from these impressive data, the US-EU trade relations are not deprived of substantial crisis. On the WTO forum, the EU and the US

²³ *EU-US Economic Relationship*: <http://www.eurunion.org/partner/usstates/usstates.htm>.

²⁴ Eurostat sources.

²⁵ US Department of Commerce, European Commission External Relations Directorate General, EU Statistic Office-Eurostat.

conduct a number of trade disputes, which made up 16 of the total 54 completed cases that had been provided to dispute settlement panels²⁶. Nevertheless, that ongoing situation is, according to EU trade commissioner P. Lamy, a symptom of sound and well-developing relations, in particular when one considers the proportion of EU-US 40 percent of world's trade.

6. Conclusions

If the New Transatlantic Agenda would not have been established, the broad and intertwined relations between the EU and the US would be developing as such. Nevertheless, the institutional basis, which was reached by the introduction of NTA, brought more convergent and clearer priorities for both partners to cooperate. The institutional structure allowed them to prioritize the most urgent objectives and find a denominator for common interests. However, the first established framework (NTA) does not mean that it can not be further changed. Transatlantic relations characterizing of high dynamics prove that even the institutional structure should follow up fluctuating requirements. Hence, the formal EU-US construction, largely dominated by ad-hoc exchanges of information should be replaced, according to the 2001 EU' evaluation report, by much more action-oriented cooperation. The EU report noticed that despite choosing the short-term objectives, both sides got accustomed to ensuing on previous initiatives or setting long-term strategic themes²⁷. In this respect, the Europeans suggested that it should be newly identified strategic priorities, which would cover the most live issues and urgent problems.

The NTA framework has undoubtedly contributed to the creation of the broader-based and more structured relationship. According to the EU report from March 2001 "many of the objectives set in 1995 have been, or are in the process of being achieved". Nevertheless, despite some setback and delays, the NTA and its accompanying "action plans" helped to produce a number of concrete agreements. However, there are still prevailing many impediments, namely institutional limitation or political constrains, which do not allow to overcome all problems and tensions. Moreover, As far as the EU-US trade disputes are concerned, despite their slight impact on the whole EU-US economic cooperation, there is some risk of a negative spill-over effect from individual disputes into the overall political relationship, which nowadays is much broader and deeper than it was before 1995.

²⁶ Pascal Lamy, *op.cit.*

²⁷ Communication, *op.cit.*

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Part 3:

Strategy of EMU enlargement – voices in discussion

European Debate on Fiscal Discipline and Poland's Path towards Membership in the EMU

The Economic and Monetary Union (EMU) was to be established in three stages. On the basis of the Delors Report, the European Council decided in June 1989 that the first stage of the realisation of EMU should begin on 1st July 1990 – the date on which, in principle, all restrictions on the movement of capital between Member States were abolished. For the realisation of Stages Two and Three, it was necessary to revise the Treaty establishing the European Economic Community in order to establish the required institutional structure. Finally, the negotiations resulted in the Treaty on European Union which was agreed in December 1991 and signed in Maastricht on 7 February 1992.

Transition to the second stage of EMU took place on 1 January 1994. The coordination of monetary policies was institutionalised by the establishment of the European Monetary Institute (EMI), whose task was to strengthen cooperation between the national central banks and to carry out the necessary preparations for the introduction of the single currency.

Transition to the third stage, since it was supposed to mark the start of EMU, was subject to the achievement of a high degree of durable convergence measured against a number of objective criteria laid down by the Maastricht Treaty. In December 1995 the European Council confirmed that this stage would start on 1 January 1999. On this day responsibility for monetary policy in the Member States of EMU was transferred from their respective national central banks to the Governing Council of the European Central Bank (ECB). It means that monetary policy has been centralized and set uniformly for all the Member States of EMU. However, this rule does not concern fiscal policy, which has not been centralized and remains the realm of largely sovereign decisions of the member states. Sound and sustainable public finances – appropriate deficit and debt levels – depend on policies of national governments.

In order to support the monetary policy measures of the European Central Bank, the "Stability and Growth Pact" of 1997 (SGP) has been adopted. The essential element of the Pact is fiscal discipline defined as the obligation to pursue – over the medium term – a balanced budget or a surplus. However, the actual deficit may deviate from the medium-term target, depending on business cycle fluctuations. In periods of weak or negative economic growth, the deficit is allowed to increase, but not to

exceed the reference value of 3% of GDP. If the excessive deficit persists, sanctions might be applied on the member state concerned. Sanctions will consist of a non-interest bearing deposit with the upper limit of 0,5% of GDP.

During the recent economic slowdown, fiscal positions have sharply deteriorated in many EMU member states. Revenue declines were particularly abrupt in 2002. France and Germany, the two largest countries at the heart of Europe, are both violating the strictures of the SGP. Apart from that, Portugal and Italy are also facing severe fiscal deterioration. The events taking place in the above countries ignited a discussion on the future of the Pact.

There are many studies dealing with the subject and trying to find a solution to the above problems. Proposals range from keeping the SGP intact (and the numerical threshold especially) to abolishing it completely (as a straitjacket which arbitrarily constrains fiscal policy, without reason or cause). Interesting conclusions concerning this matter have been recently reached by two CEPR's experts – Lorenzo Codogno and Antonio Fatás. Codogno has strongly highlighted the role of financial markets as the guardian of fiscal discipline under EMU. He has noticed that EMU government bonds yields, despite their common euro denomination, have converged to a significant extent, but not fully. It means that EMU government bonds are still viewed as imperfect substitutes, and that the SGP is insufficient to ensure that all member states have the same creditworthiness. Therefore financial markets can still reward or punish fiscal policies. To reduce yield differentials further convergence in fundamentals, especially in debt-to-GDP ratios, would be required.

Another CEPR's expert – Antonio Fatás – has developed a concept of non political and independent national fiscal policy councils. According to Fatás, explicit constraints on fiscal policy have the advantage of simplicity and transparency, but they suffer from lack of flexibility and enforcement problems. Because of that, national fiscal policy councils (non political and independent) should be made referees of the budgetary process or agenda-setters. In the sense these councils could be the source of implicit constraints that would provide the benefits of restricting fiscal policy while, at the same time, leaving enough flexibility to accommodate counter-cyclical measures.

Between the two mentioned above radically opposite proposals there are several suggestions for revising the SGP:

- to place more emphasis on the public debt ratios and the pace of debt reduction in the budgetary surveillance process,
- to focus on reforms of fundamental fiscal institutions and replace the numerical reference value for deficit with some kind of index of

institutional reform; countries achieving good results in the realm of revenue sharing reform, pension reform and unemployment and disability insurance reform would be exempt from strict fiscal guidelines, since they should not be prone to chronic deficits,

- to exempt public investment from a deficit ceiling,
- to adjust a deficit ceiling cyclically (keying it to the constant employment budget balance),
- to establish an independent (non political) institution influencing fiscal policy (creation of national fiscal policy councils).

In general, the recent flurry of suggestions for revising of the GSP is the proof of two important facts:

- fiscal discipline is considered a central component of the macroeconomic policy framework of the EMU,
- measures to ensure fiscal discipline – fiscal rules and the parameters of the fiscal rules – are not designed forever and might be changed. The 3 per cent reference value for fiscal deficit is not set in stone.

The current discussion on the GSP is very important for accession economies, including Poland. The EU is a large and heterogeneous entity and it will become even more heterogeneous in 2004. The accession economies may differ from the "old" members of EMU in real interest rates (the result of common nominal interest rates and different inflation levels due to the *Balassa-Samuelson* effect) and in growth rates (the result of catch-up growth). Thus, after the EU enlargement and later, after euro area enlargement, the uniform reference values of the GSP could be even less suitable to the members as a whole than they are today. Because of that, it seems important for accession countries to make an effort in formulating their own position in the fiscal discipline debate.

Andrzej Sławiński*

Commentary on Massimiliano Marzo's paper "Monetary Policy"¹

My task is to comment the excellent paper prepared by Massimiliano Marzo. My task is difficult, because I agree with the author's way of reasoning and the conclusions. With some of them I could not agree more. Thus, what I would like to do is to add some additional comments and underline the role of external factors in shaping the monetary policy in Poland. The focus of Massimiliano Marzo's paper is on the assessment of the inflation targeting in the accession countries. Thus I will also focus on this issue and I will use some of the author's conclusions to point my comments.

I will start with the remark that the implementation of the inflation targeting in Poland was not to regain credibility of the central bank. In 1995-1996 the eclectic monetary policy of the National Bank of Poland was delivering disinflation in the context of economic growth. In 1997, the tightening of the monetary policy stopped the developing credit boom and enabled to narrow the widening trade deficit. In 1998, the disinflation was continued despite strong economic growth. Thus, the implementation of inflation targeting in 1999 aimed rather to strengthen than to regain central bank credibility, which had not been impaired. The goal was achieved, but at a price. The reason were the external shocks, which forced the NBP to tighten its monetary policy, which deepened the slowdown triggered by the recession in Europe.

In 1999, the rise in inflation came as a surprise produced by the rise in oil prices and the exceptionally poor harvest in Poland. The NBP reacted with an increase in interest rates. Was it possible to react in a different way? The answer we find in the Massimiliano Marzo's paper: "One of the main troubles of the NBP was represented by a lack of a clear set of exceptions that have to be taken into account if the target is not satisfied". The other external factor, which forced the NBP to tighten its monetary policy was the deterioration on the current account of the balance of payments resulting to a large extend from the Russian crisis in 1998 and the following 80% depreciation of the rouble.

* The author is a professor at Warsaw school of Economics and works as an advisor in National Bank of Poland.

¹ The report *Monetary Policy* by Massimiliano Marzo was prepared as a Working Paper under the project *Ezoneplus* financed within the 5th Framework Programme of the European Union. The report is available at the website: www.ezoneplus.org.

Despite the fact that there were reasons for the rise in interest rates in 1999 and 2000, the monetary policy of the NBP was perceived as controversial. The reason was that the NBP was not easing its policy in the second half of 2000 despite the growing output gap and the resulting weakening of the inflationary tensions in the economy. The controversies over the monetary policy were exacerbated by the sharp real appreciation of the zloty.

There were reasons for the appreciation of the zloty including Balassa-Samuelson effect and the convergence play instigated by the disinflation in the Polish economy producing expectations of interest rate cuts. Nonetheless, the factor which augmented the zloty appreciation was the NBP withdrawal from interventions in the foreign exchange market.

In the globalised foreign exchange market it is almost impossible for central banks to intervene against the trend. However, effective interventions are possible when a trend is weakening. Such was the case in Poland in May and June 2001 when the zloty was appreciating despite the outflow of portfolio capital. The situation reflected the conviction among investors that there would be a turnaround of the trend. The NBP did not use the opportunity allowing a further appreciation of the zloty.

Since January 2000 till July 2001 the zloty appreciated 30% in real terms. Massimiliano Marzo wrote in his paper that “if currency appreciation is too fast, it becomes largely advisable to manage a slow reduction of the nominal interest rate, together with a combined set of sterilized intervention in order to keep the exchange rate under control and minimize the impact on the corporate sector”.

In case of Poland the second element was lacking. In 2001 the NBP was reducing the nominal interest rates but it was not intervening in the foreign exchange market. The strong zloty appreciation put additional burden on the corporate sector of the economy, which was heading towards an economic slowdown.

The case of Poland provided an example of an opportunistic disinflation, which did not find much sympathy with politicians and might undermine the credibility of an inflation targeting as a medium-term target².

Summing up, there were some deficiencies of the monetary policy in Poland after the implementation of inflation targeting. Among them was the focus on short-term rather than medium-term targets, the benign neglect attitude towards the strong real appreciation of the zloty, and the opportunistic approach towards disinflation. Nonetheless, the adoption of the inflation targeting in Poland facilitated the reduction of the inflation to

² J. Jonas, F. S. Mishkin, *Inflation Targeting in Transition Economies: Experience and Prospects*, NBER working paper, 2003.

the level, at which the National Bank of Poland may aim its policy not on the disinflation but on the price stability. The NBP has accumulated also the experience, which may help to cope with potential reversals of inflation caused by the problems with the budget or external shocks.

Costs and benefits of entering the EMU

Notwithstanding obvious benefits, the membership in the common currency area entails some costs. First, the potential real costs stemming from the fulfillment of the inflation criterion should be taken into account. These costs are short-term only. Second, it is often stressed that the costs associated with the loss of autonomous monetary policy and attendant risk of higher output variability after the euro adoption shall be taken into account. Those will be possibly reinforced by labor market rigidities.

However, when assessing these costs the following factors cannot be overlooked:

1) Well synchronized business cycles between Poland and euro zone countries show that asymmetric shock exposure is low. One may expect that it will be even lower following the euro area entry. First, increasing trade integration between Poland and euro-zone countries will reduce the vulnerability of the Polish economy to asymmetric shocks. Enhanced trade integration leads to an enhanced convergence of business cycles. Second, after adopting the euro synchronisation of the business cycles between Poland and the euro area should also be reinforced by adjustments in monetary policy, since Poland's entry to the EMU will entail the elimination of the potential sources of asymmetrical shocks originating in the differences between interest rate policies conducted by the NBP and the ECB. Finally, euro adoption in Poland should contribute to increasing flexibility of real wages, translating into a more effective mitigation of asymmetric shocks. Summing up, it can be stated that the euro adoption itself will result in further integration and convergence between the economies of Poland and euro zone, thus facilitating the absorption of asymmetric shocks and lowering the cost of giving up autonomous monetary policy. This phenomenon is known as endogeneity of OCA criteria.

2) Moreover, it must be born in mind that the role of the floating exchange rate stabilization tool is in fact limited for variability of the exchange rate to a large extent results from factors other than economic fundamentals (expectations of the future interest rate path, risk parameter or the nature of financial markets itself).

* The author is the Head of the Monetary Policy Unit in the Department of Economic Analyses in the National Bank of Poland.

3) And finally, one may not disregard the role of automatic stabilizers. However, in order to allow them to operate freely without causing the deficit to increase above the reference level of 3%, Poland should aim at reaching low structural deficit.

The membership in the common currency area is associated with various benefits. These benefits by far exceed the costs. First, the elimination of the exchange rate excludes the possibility of a currency crisis, what in turn results in foreign currency debt rating upgrade. Second, giving up the domestic currency will contribute to the decline in domestic interest rates due to the elimination of exchange risk premium (estimated at 150-200 basis points). As a consequence, the cost of capital decreases, which leads to increasing domestic investment. Fourth, the elimination of the foreign exchange rate volatility results in exchange rate uncertainty reduction, hence in the international trade expansion. Third, transaction costs savings are estimated at 0,2% GDP. And finally, the economy will benefit from higher FDI inflow and increased competition in the goods and services market. Stronger competition induced by the monetary union fosters better allocation of labour and capital and increases pressure on a more efficient use of existing resources, which boosts factor productivity. To sum up, common currency offers prospects for higher output in the long run. Basing on the assumption that the long run effect of the euro can be channelled through either interest rates or international trade, they can be reckoned to be around 4-7%. All other factors adding to further output growth are not included in the estimation.

Delay in euro adoption, on the other hand, is associated with risks. Poland may miss the opportunity to achieve a sound macroeconomic policy sooner than later. Moreover, there is a chance of losing investment attractiveness to new euro area entrants.

Euro adoption as soon as possible implies following policy prescriptions:

- Public finances and structural reforms should be implemented prior to ERM II entry, since sound public finances condition the fulfilment of the convergence criteria. Thus, it is evident that Hausner plan needs support as a step towards faster euro adoption.
- Combination of disciplined fiscal policy and moderately tight monetary policy should be pursued, as more favourable to long-term economic growth than recent policy mix. In addition, such policy mix is vital for mitigating ERM II-related risks.
- Central parity in ERM II should be consistent with the long-term equilibrium exchange rate. Moreover, ERM II membership should be as

short as possible, therefore postponed until meeting convergence criteria during the second year of membership is guaranteed.

- Until ERM II entry floating exchange rate regime should be maintained. Such a regime leaves more space for anti-inflation monetary policy and minimises the risk of severe tensions on the foreign exchange market at the same time.

Fulfilment of Maastricht criteria is required for the euro adoption. To date, two monetary criteria are met. Poland fulfils the price stability criterion since September 2002. However, the fulfilment of the criterion at the moment of verification will be conditional upon the reference value at that time, set against NBP's permanent inflation target. Taking into account that after the EU enlargement in May 2004 the new members will be eligible to become reference value countries (some of them record inflation rates below the euro area average – Czech Republic, Lithuania), one may expect that the reference value will be lower than today.

The interest rate criterion is met in Poland since March 2003. However, maintaining the long-term interest rates on a required level is associated with implementation of Hausner plan. Its success will possibly reduce the currency risk premium and thus the long-term interest rates. In this respect, the importance of successful introduction of well-designed public finances reform shall be emphasised once again.

To sum up, it has to be stressed that euro is not an END in itself. It is a MEANS towards faster growth. Since the net benefits of the euro zone accession are clearly positive, fast euro adoption is strongly recommended. Every possible measure should be undertaken to take advantage of the opportunity for faster economic growth that we are being offered.