Warsaw Workshop, 12 December 2003

Eurozone Enlargement – Reshaping Policies and Social Conflicts

Minutes

I. Joanna Stryjek (WSE): Minutes on Jan Krzysztof Bielecki "Keynote Lecture"

The Keynote Lecture was delivered by **Jan Krzysztof Bielecki**, Chief Executive Officer, Pekao S.A. and former Polish Prime Minister, on "**European Debate on Fiscal Discipline and Poland's Path towards Membership in the EMU**". These are his main findings:

"During the recent economic slowdown, fiscal positions have sharply deteriorated in many EMU member states, especially in France and Germany. Violating the rules of the Stability and Growth Pact (SGP) by these countries ignited a discussion on the future of this Pact. Proposals concerning that problem range from keeping the SGP intact to abolishing it completely. Interesting studies on the matter were made by two researchers – Lorenzo Codogno and Antonio Fatás.

Lorenzo Codogno has stressed 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. Hence, financial markets can still reward or punish fiscal policies. In order to avoid such a situation further convergence in fundamentals, especially in debt-to-GDP ratios, would be required.

Antonio Fatás has developed a concept of non political and independent national fiscal policy councils. In his opinion, 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; they should constitute a source of implicit constraints that would provide the benefits of restricting fiscal policy, leaving enough flexibility to accommodate counter-cyclical measures at the same time.

To sum up, the recent suggestions for revising of the GSP constitute a 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."

II. Dominik Sobczak, Malgorzata Gracik (WSE): Minutes on Session I "Conflict of fiscal and monetary restraints with social demands"

1. Presentation of Jakub Borowski, National Bank of Poland: "Costs and benefits of Euro adoption"

Notwithstanding obvious benefits, the membership in the common currency area, as was pointed out by **Jakub Borowski**, 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 are to be taken into account. Those will be possibly reinforced by labor market rigidities.

However, when assessing these costs the following factors cannot be overlooked.

- Well synchronized business cycles between Poland and the eurozone countries show that asymmetric shock exposure is low. One may expect that it will be even lower following the euro area entry.
- Moreover, it must be born in mind that the role of the floating exchange rate stabilization tool is in fact limited because 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).
- 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 a low structural deficit.

2. Presentation of Karel Zeman, Institute of Integration of the Czech Republic into European and World Economy: "Social issues of EMU accession strategy: The Czech example"

Professor **Karel Zeman** from the Institute of Integration of the Czech Republic into European and World Economy contributed with a paper about basic potential restriction and risks of the preparation for EMU accession on social demands in the Czech Republic. Professor **Zeman** said that according to the recommendation of the joint and co-ordinated 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. Therefore the timing depends to a large extent on the speed of the real convergence process achieved by means of structural reforms and on the nominal convergence process, especially on a rigorous fiscal consolidation.

Conformably, the assessment done by MF, MIT and CNB, the Czech Republic's euro area accession strategy is oriented at the expected date of its joining the euro area around 2009-2010. Czech authorities foresee that the state will be able to fulfil the criteria for euro area accession with successful achievement of the Maastricht criteria, including consolidation of public finances, sufficient level of real convergence and adequate progress in structural reform guaranteeing sufficient economic alignment with the EU Member States. Nevertheless, the EMU accession strategy of the Czech Republic is accompanied by many basic social issues and risks which are associated with the following elements:

- social issues of fiscal consolidation,
- labour market adjustment.

The first factor - *social issues of fiscal consolidation* is connected with the effect of adverse demographic pressure, which will constitute a significant burden for the public budget in the foreseeable future. Therefore, there is a need to establish a sufficient room for maneuver in the Czech fiscal system. Despite the most favourable current demographic structure for the Czech Republic, the state witness a beginning of acceleration of population ageing, reflecting both falling birth rate of the past decade and the rise in the numbers of seniors, which will escalate in the end of this decade. That situation can bring about two kinds of resolutions. 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. However, increasing of expenditure for pension and health care stemming from changes in demographic developments are substantial sources for conflicts with social demands and of fiscal risk.

On the other hand, 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. On that basis Professor **Zeman** predicted that the situation would dramatically change in the longer term, especially after 2010 – when the Czech Republic is expected entry into the euro area. In order to avoid this substantial destabilization of the economy's production capabilities and the general government budgets, it is required a fundamental reform of the pension system. To resolve these problems, there is a need to reassess the current legislation enabling concurrence of earning and pension. As professor Zeman said, there should be found such compromise solutions that would be administratively feasible and gradually would move towards the target state. Thus, the target solution of the pension system will continue to be based on two pillars:

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

The second factor - *labour market adjustment* carries potential risks and possible conflicts with social demands in the Czech Republics. Professor **Zeman** forecasted that the indispensable process of labour market adjustment might be increasingly intensified with the Czech Republic's preparation for entry into the euro-area. Hence, to strengthen the course the Ministry of Labour and Social Affairs of the CR has identified relevant provisions to create more sufficient labour market policy including active employment policy in the advent of entering the EU. For that reason, the Ministry, in accordance with provisions supplied by the European Council or European Commission, prepared a National Action Plan of Employment (2003) based on four pillars:

- improving employability,
- developing entrepreneurship and job creation,
- encouraging adaptability of business and their employees,
- strengthening equal opportunities policies for women and men.

Apart from the Plan, the Czech government will continue its efforts to improve employability of labour force through creation of conditions enabling setting up new enterprises, while providing conditions for the existent businesses. All the activities will be additionally supported by the necessary structural reforms, including the public finance and tax policy reform. Professor **Zeman** underlined, that the government expected the reduction of income tax rate and harmonization of the tax system with the EU regulation completed. In turn, the business and finance policy priorities have been focused on enhancing performance and competitiveness of the economy. For that reason, continuation of structural reforms and privatization became a prerequisite for 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. The fundamental requirement for the employment policy during the forthcoming period, as said by Professor **Zeman**, will be to seek politically acceptable solutions of results of the above structural changes. Consequently, 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, thereby, to a sufficient number of jobs.

3. Presentation of Ivana Sikulova, Institute of Slovak and World Economy, Slovak Academy of Sciences: "Fulfillment of the convergence criteria in the Slovak Republic"

Adopting the euro, **Ivana Sikulova** emphasised, will be one of the basic monetary policy objectives of the National Bank of Slovakia (NBS), as the Bank promotes the earliest possible accession to the EMU.

The government of the Slovak Republic takes the same stand on this matter – in its programme declaration it has presented a resolution to establish preconditions for meeting the nominal convergence criteria by 2006.

In 2002, Slovakia met the criteria on public debt, long-term interest rates and exchange rate stability. The criteria on inflation and budget deficit were not fulfilled. As for this year (2003), the overall fulfilment of the nominal convergence criteria is not going to change. The inflation criterion will be difficult to meet because of the following reasons:

- the necessary deregulation of the administratively regulated prices;
- adjustments of the indirect taxes;
- the need for a gradual approach of price and wage levels towards the EU.

However, the most demanding task will be the reduction of the budget deficit, as it reaches much higher level (7.2 per cent in 2002) than is the reference Maastricht value at present.

Nevertheless, the governor of the NBS Marian Jusko finds the developments in the above field in 2003 positive, and he claims that they bring favourable trends towards the future.

III. Pjotr Banbula, Dominik Sobczak, Malgorzata Gracik (WSE): Minutes on Session "Ezoneplus Research Results"

1. Monetary Policy

The panel was chaired by Prof. **Vladimir Lavrac** from the Institute for Economic Research, Ljubljana, and consisted of three presentations elaborating on the findings of Ezoneplus reports.

The first presentation was delivered by Prof. **Renzo Orsi** from the University of Bologna and it covered monetary policies in Accession Countries, both in historical and future perspective. The exchange rate was found essential with respect to inflation stabilization, although the influence of exchange rate fluctuations on the domestic inflation is weaker in Poland and in the Czech Republic. The interest rate channel of transmission of monetary policy is significantly less visible. It has been argued that the variety of monetary regimes can be attributed to historical and institutional reasons and the path towards euro will differ from country to country. The fixed exchange rate seems suitable for small economies (Baltic countries), whereas countries currently having a floating rate may find the narrow band too restrictive, also because of the clash with the inflation criterion. **Iacone and Orsi** have also underlined the need of sound fiscal policy and increased flexibility of the labour market.

The second presentation was delivered by Prof. **Andzej Slawinski** from the National Bank of Poland. Prof. **Slawinski** commented on the work of Massimiliano **Marzo** (cf. Ezoneplus Working Paper 17) and confirmed findings of his paper which analyzed the inflation targeting policy in Czech Republic, Hungary and Poland. The factors responsible for undershooting of inflation rate by CNB were business cycle fluctuations and technical difficulties in targeting inflation. Polish troubles with undershooting the inflation target can be attributed to lack of clear set of exceptions that have to be taken into account if the target is not satisfied. Hungary has been successful in meeting monetary targets, although the policy of inflation targeting needs further specification. Prof. **Slawinski** also discussed the significance and impact of the turbulences in financial markets on Polish and Hungarian economies.

The third presentation was delivered by **Sofia Costa** from University of Evora. She commented on the monetary policy report and its findings, stressing answers for questions proposed by Professor **Lavrac** before the regional inputs were elaborated. In addition, she referred to the experiences of the southern members, particularly Portugal, during the 80's/ 90's and before entering the Eurozone. During the 80's Portugal was suffering from a severe macroeconomic imbalance, monetary policy was based on capital controls, credit ceilings, administratively fixed interested rates and financial markets were rather undeveloped. Still, the disinflation process was almost painless, mostly because of balanced monetary and fiscal mixed, flexibility of labour market and equilibrium real appreciation of escudo in the period following the accession to the community.

2. Fiscal Policy

The presentation of the main conclusions of the report on fiscal policy developments in the EMU and accession countries, prepared under the Ezoneplus project, was delivered by Professor **Katarzyna Żukrowska** from Warsaw School of Economics.

All countries entering the EMU must fulfill the budget deficit criterion set in Maastricht at 3% of GDP. This was equally true for countries that created the EMU as it will be for the new EU members which aim at introducing the common currency within the next few years. Most of the twelve EMU countries experienced significant fiscal instability in the 1990s and had to implement consolidation packages. Generally there were three models of fiscal consolidation – expenditure based (Austria, Finland, Ireland, Netherlands, Spain), revenue based (Belgium, Greece, Portugal) and mixed (including the one-off measures and creative accounting – France, Germany, Italy). Experience of the years following 1997, when the criterion had to be met, shows what types of reforms brought the best and most sustainable results in the longer run. All expenditure based consolidations proved effective and sustainable. The same is true for two sound revenue based reforms introduced in Belgium and Greece. On the other hand, inconsistent consolidation in Portugal, as well as problematic measures and accounting techniques used in France, Germany and Italy, brought only a temporary improvement. In particular, France and Germany in 2004, for the third consecutive year will breach the Growth and Stability Pact limit of 3% of GDP. Some of the accession countries have also significant problems with budgetary balance, namely Poland, Slovakia, Czech Republic and Hungary. All these countries have already embarked on fiscal reforms; however their results remain uncertain, especially in Poland.

Discussion

Dr. **Krzysztof Rybiński** – chief economist of the BPH PBK bank

The report draws important conclusions that present fiscal performance depends on the type of consolidation – the biggest problems are currently faced by countries who took up the least sound reforms (France and Germany). These countries, together with Italy, have put the Growth and Stability Pact under question. Poland is currently heading in the same direction, as it was also acknowledged in the report of the Commission, which may result in using problematic measures by the Polish government to fulfill the Maastricht criteria.

Dr. **Małgorzata Rutkowska** – National Bank of Poland

Budgetary consolidation in Poland should mainly involve reductions in expenditures, because the tax and non-wage burdens are already high and many companies already view them as an important obstacle in accelerating development and growth.

Prof. Dr. **Hanns-D. Jacobsen** – Freie Universität Berlin

It is necessary to distinguish two situations: a country entering the ERM II when more flexibility is possible, as monetary instruments are still available, and a country entering the EMU – there is a single monetary policy conducted by the European Central Bank.

At the moment some important questions come forward: will the Maastricht criteria remain so strict after France and Germany breached the Growth and Stability Pact? And what should be the institutional arrangements which would ensure policy sustainability?

3. Fiscal Policy

Achim Kemmerling, in his conference-paper entitled “The social dimension of Ezoneplus of reshaping policies and social conflicts”, performed a comprehensive analysis of socio-economic outcomes of the EU’s enlargement process. Scope and scale of different political conflicts on the enlargement, the issue of social acceptance of the EU enlargement, and the question about the reason why countries strive for political union, constituted a basis for his considerations. At the beginning, the author described the whole process of European integration as a puzzle consisted of variety of cultural and social degree of heterogeneity, accelerated by the liberalization of international goods and factor markets. He stated that political integration has more to offer than a mere abolition of traditional trade barriers to national product markets. For that reason, for old member states as well as for new ones, the enlargement process might become contingent on the enlargement of the eurozone. He noted that a high degree of trade liberalization will cause the situation when the enlargement of the currency turned up to be a necessary prerequisite to guarantee the mutually beneficial enlargement of the EU.

The first part of the presentation was devoted to socio-economic changes to be expected from the enlargement of the eurozone. Short analysis of the impacts of the trade and FDI and on capital markets and macroeconomic policies preceded the part about the impact of labour markets. The latter could, according to A. Kemmerling, decline the other effects for Western Europe. The problems of negative shocks or initial structural adjustments the candidate countries face by joining the currency union may follow the outflow of workers to adjacent member states. Then he underlined, that an unequal distribution of labour flows might evoke political conflicts. This situation affects particularly two countries: Germany and Austria, which accumulate together about 80 per cent of the current

CEEC-10 population residing in Western Europe. However, there was noted, that the overall impact of migration on the risk of job loss and on wages was very low.

The labour market question given by the author entails different problems, which are: (1) unemployment and employment; (2) the degree of international inequality; and (3) the incidence of poverty. As regards the public opinion, unemployment (1) is considered to be the most serious predicament in the EU member states. In short run, it is predicted, that unemployment rate could rise due to Ezoneplus. Thus, the enlargement of the EU and EMU will have typical adjustments costs for both regions. The author presented the evolution of employment rates basing on his results on how high unemployment, immigration from CEEC –10 and the size of the shadow economy are correlated. The next factor represented the evolution of income differentials (2), which was the objective of many European welfare states to reduce inequality. For the CEEC, a fundamental prerequisite is to catch-p the levels in wealth of the EU member states to be able to form in the future a European Social Model. The author showed that inequality of income was assumed to be an important indicator for assessing the level of social conflicts within the societies. Subsequently, he noted that there has been some convergence in levels of incomes between Western and Eastern Europe. In fact, the intra-national income inequality has increased in most CEEC, although the level of this inequality is closer to the German or Danish level that to that of the UK. Last elaborated issue was the evolution of poverty rates (3). According to data gathered by the author, poverty in transition societies is concentrated among ethnic minorities, woman, and the low-skilled population. It is associated with the fact, that the urban poor and the members of ethnic minorities are the most dependent on social assistance and other instruments of social policy. Finally, the author came to conclusion that limiting the scope of welfare state policies, enlargement of EMU and its implications for national fiscal policy will likely increase the incidence of poverty in CEEC, whereas its impact on Western Europe will be marginal in most cases.

Basing on the Ezoneplus idea that markets and policy areas have already started to adapt to a future enlargement of the EU and the EMU, there appears a necessity to reshape policy areas related to the welfare states. First element concerns the reshaping of labour market policies and institutions including the analysis of the policies regulating the East – West migration (1); incidences of labour markets reform (2); and changes in wage-bargaining systems (3). The problem of migration is crucial in particular for Germany and Austria, who perceive current solution by limiting migration flows. Therefore during the negotiations on accession, Austria and Germany managed to achieve substantial temporary exemptions from the principle of free movement of labour. Justifying that step, the author presented two sorts of channels of political economy: public opinion or special interest groups lobbying. Using the method based on relevant interest groups, the author presented the bilateral bargaining rounds between the EU and Poland, in which the pivotal stance played the Western European trade unions which blocked the free flow of Eastern Europeans up to the seven years. This led the author to another conclusion, that the eastward enlargement would increase the competition between countries, and would therefore induce structural reforms with the aim of making the Western European labour markets more flexible. Hence, A. **Kemmerling** cited a number of theoretical approaches embracing pessimistic and optimistic views on the role of EMU for structural reforms in labour markets. Finally, he admitted that so far, the channels from monetary union to labour market reform are difficult to anticipate. However, the presented graph gave an empirical model of the political determinants of labour market reform in OECD countries. The table suggested that the EMU membership was not a good predictor for of the follow – through rate of labour market reforms.

Furthermore, the discussion on how to fight structural unemployment with the help of structural reforms was directly, according to A. **Kemmerling**, linked to the issue of national wage bargaining in enlarged currency union. Regarding the relevant theories – on the one hand increased price transparency and general market competition may exert disciplinary pressure on national wage bargaining, but on the other hand the external effect on each wage policy on the EU-15 or EU-27 price levels is markedly smaller.

Second major element of the chapter "Reshaping policy areas related to the welfare state" was the issue of the EU transfer policies and the EU budget. To elaborate this problem, the author used politico-economic model of fiscal federalism, with which are associated the following dilemmas: (1) anticipating of which regions, countries and individuals of current members states will lose transfers and how they will react to this problem; (2) looking at the set of policy alternatives, that national government has to respond to enlargement; and (3) approaching the political economy to anticipate reforms of the EU budget. Thus implicates, according to A. **Kemmerling**, a necessity to embark the reforms before the enlargement in the countries as Germany and the Netherlands, the biggest net contributors in the EU. Then, the author submitted a simulation of future budget position of current EU member states and compared the status quo in 2001 with a one-to-one extension of the budgetary rules to CEEC. Thus affected a budget position, which was due not only to increasing contributions. From this cause, the regional transfers (SFs) will be redistributed, since many regions of current member states will be pushed above certain thresholds. The problem of CAP seemed to be similar in nature as structural funds. The author concluded that the shifting the status quo of EU-15 to EU-25 is regarding SFs mainly a zero sum game, whereas CAP directly affects the absolute size of the EU budget. However, the structure of the EU budget and its two main components (CAP and SFs) are not likely to remain stable once enlargement will have taken place. The author presented then an analysis of modeling the effect of different bargaining rules and the distribution of EU transfers.

The last thing presented by A. **Kemmerling** referred to the issues of support, opposition and alienation of EMU politics among the population from the EU countries and accession states. The analyses was conducted in such a way to show whether support in driven by politico-economic considerations or depends on more general historic and cultural situation in these countries. Moreover the presented report aimed to reveal some light on the question whether and how these anti-enlargement attitudes may be transformed into the political position. The most important issue stated in that part was the question of people respond to the process of eastward enlargement and in particular the EMU membership. The presented graph showed the scale of support of public opinion in CEEC-10 on EMU membership. Next, the author singled out several factors aimed at explaining the voting behaviour of people in different countries with the help of individual and national characteristics. Finally, he revealed the findings of a lack of political support for to European integration and how the phenomenon of euroscepticism is transformed into party politics. The report was then concentrated on the issue of "soft" and "hard" euroscepticism and its further impact on social conflicts and consequences for EU and EMU enlargement.

Discussion

The presentation of A. **Kemmerling** evoked a grave discussion on social and labour policy. Main role fell to Professor **Mieczyslaw Kabaj** from Institute of Labour and Social Affairs who commented the delivered report on social dimension of Ezoneplus. According to his statement, labour policy as a part of social policy indicates that reduction of unemployment rate causes the reduction of social welfare and all protection expenditures. A proof gives the Amsterdam Treaty by showing that the EU recommends to treat social policy (labour policy) as an integral part of economic policy, equally to other policies: fiscal or trade. As said by professor **Kabaj**, the Lisbon Strategy assumed that by 2005 the EU employment rate would be achieved in 70 percent and by 2010 the EU member states would get a full employment. The aim of the Lisbon strategy is to promote employment, but on the other hand cutting off social expenditures. From that reason expending social assistance will follow enlarging of unemployment rate. The case applied to the Polish circumstances showed, according to professor **Kabaj**, that the social problems and economic policy would create substantial conflicts. The key challenge is to make the labour market policy including labour legislation much more flexible. Given the examples of Finland and Sweden he showed that these two countries managed to reduce their unemployment rate by half due to the programs of labour promotion.

Next, the floor was taken by professor **Renzo Orsi**, who questioned the graphs relate to gross social expenditures ratio from 1998 presented by Achim **Kemmerling**. On the contrary, Professor Jaakko **Kiander** from the University of Helsinki made subsequently his remarks on the Nordic experience in labour policy and its implications for European market.

At the end there was resumed a discussion between professor **Kabaj** and Dr. **Vit Barta** from the National Bank of the Czech Republic. The main argument concentrated around the problem of social expenditure reductions and their profound impact on the employment rate. In the opinion of Mr. Vit **Barta**, the key problem with the unemployment rate was due to labour legislation. Professor **Kabaj** presented a contrary standpoint proving that the crucial elements in the process of shaping the labour market belonged to macroeconomic factors. Mr **Barta** exeplified the case of Germany, where high unemployment rate was the fault of German goverment and trade unions. Therefore he opted for the solution – „let the market work". In turn Professor **Kabaj** argued that collection of macroeconomic elements are the most important facotors in unemployment question. Finally, the discussion was concluded with the closing speech of Professor **Katarzyna Zukrowska**, the host of the Warsaw conference and Professor **Hanns-D. Jacobsen**, who proposed to shift the deliberations for the dinner time.