Key findings of *Ezoneplus*

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by Prof. Dr. Hanns-D. Jacobsen, Managing Director

The admittance of eight CEECs into the EU, and the subsequent enlargement of the EMU, will cause deep changes within the political, economic, and social settings of both old and new EU-members. The hallmark of the current enlargement process is that it has been a political decision to include new members into the EU. The enlargement process has originated from the realization that post-communist countries required political stabilization. The marked difference between the sizes of the population and of the economies is the prime source of underlying tensions of the enlargement process. The research project *Ezoneplus* focuses on the ensued reshaping of politics and markets. In particular, *Ezoneplus* ascertains how to overcome imponderables in organizing the process of leading new EU-members toward the eurozone. In this regard, *Ezoneplus* tries to get the bottom of ensuring sustainable growth and convergence in respect of new members' run-up to EMU. The simultaneous deepening of the EU *acquis communautaire* and, in particular, the adoption of a common currency entail new challenges for both old and new EU-member states.

Key results of this project may be summarized as follows: First, a common currency induces the reshaping of markets – i.e. markets adopt to new circumstances, thereby pushing the Euro-area closer to an 'optimum currency area'. Nevertheless, reshaping will remain incomplete due to political reasons. National policy-makers cannot sacrifice their own electoral survival by implementing efficient economic and social policies. Second, as a consequence, there is an ongoing tug-of-war on the distribution of costs of social and economic adjustment between old and new member states. The political bargaining on these costs affects the prospects of stabilizing the capital influx towards CEECs and their ability to catch up to living standards in the old EU-member countries.

The stability of the CEECs' convergence process is the main goal of both current and new EU-members. *Ezoneplus* discusses the implications of a particular catch-up strategy and has a look at the economic, political, social and institutional consequences involved. A process of new EU-members joining the eurozone, implying the reshaping of economic determinants that may lead to efficiency gains, has thus to consider economic adjustment and social costs as well because real convergence, based on sustainable increased growth, can only be a long-term process. In addition, both new and old EU-members have to cope with particular challenges that derive from an ageing population, growing immigration, labour shortages in key sectors and social inclusion problems. Failure to attain sustainable convergence may jeopardize the benefits arising from EU accession and may even be a source of destabilisation for old EU-members. On the one hand, *Ezoneplus* explores these uncharted waters along the lines of capital markets, labour markets, as well as goods and services markets with regard to trade and FDI. On the other hand, the project puts emphasis on policies related to fiscal and exchange-rate issues as well as to the social dimension of new EU-members' convergence towards the eurozone.

The starting point of our considerations is that economies in new EU-member countries have to rely on sizable capital influx in order to stimulate growth and real convergence towards current members of EMU. The track of EU-enlargement has to be politically stabilized and the social acceptance of the course taken be maintained. Hence, the general trend towards real exchange-rate appreciation in new EU-member countries fostering their catching-up is desirable and has to be maintained for a prolonged period.

Capital markets

As regards capital market integration risks are predominantly to be found in the lacking institutional quality of financial markets in new EU-member countries. National and foreign investments will only lead to more growth if the institutional environment guarantees high and safe returns. The trend real appreciation, ensuing sizable current account deficits, is partly due to a convergence play. The current high valuation is certainly a fair bet reflecting highly profitable investment opportunities. However, any doubts regarding the sustainability of convergence trigger a revaluation of assets that may lead to a reversal of capital flows. Institutional strengthening allows for linking capital markets in CEECs to mature financial markets in the eurozone. Eventually, efficient financial markets are the best preventive measure against overinvestment delivering a fair price signal of risk and chances involved in steady stream of capital influx to new EU-member countries.

Foreign exchange markets

In addition, capital movements are determined in the foreign exchange market. The exchange rate mirrors macroeconomic fundamentals, microeconomic risks – i.e. particularly capital market imperfections –, and in particular expectations about future economic policies. Exchange rate risk in sustainable growth regimes will eventually vanish at the onset of EMU-membership. But there is still a long way to go for new EU-members. According to Maastricht criteria and in order to achieve the entry conditions of EMU, CEECS have to rely on 'soft pegs' exchange-rate regimes in ERM-II. Correspondingly, to most observers, the period between entering ERM-II and entering EMU is hence the time when risks will be concentrated. Exchange-rate regimes with wide bands and only moderately overvalued conversion rates – probably achieved by a final devaluation at the outset of admittance to ERM-II – will best serve sustainable growth regimes in CEECS. Though, pursuing false economic policies, will particularly lead to the well-known problems of speculative attacks and currency crises in ERM-II. In this respect, unsustainably high current account deficits may tilt the balance heavily against a successful enlargement of EMU. Guaranteeing, in turn, sustainable capital movements implies heavy burdens for national policy makers, in terms of prudent, most notably restrictive, economic policies. However, whether vote-maximising governments in new EU-member countries achieve to comply with the Maastricht criteria remains doubtful from a perspective of political economy.

Labour markets

Smoothly functioning labour markets could be of great help in that respect. Flexibly adjusting wages and quantities – as for the latter this would imply high flows of migration between countries – could assure that, firstly, the fulfilment of Maastricht criteria gets easier and, secondly, that convergence of per-capita-income gains speed. But it is well-known that European levels of mobility and flexibility remain conspicuously below the economic efficient values. An additional problem are high social and labour standards of the old EU-members which are likely to increase labour market rigidities and tighten the problem of unemployment in the CEECS.

Goods and services markets

Goods and services markets, finally, also show some discomforting patterns so far. On the one hand, though rather small, the incidence of trade diversion between old and new member states is not a *quantité negliable*. This is all the more the case, since losses are unequally distributed across old member states. Next, the patterns of specialisation between Western and Eastern Europe do not show the kind of productivity-enhancing and growth-stimulating feature a sustainable growth strategy would imply. Thus, at least for some years, or even decades, down the road a division of labour could emerge that is characterised by an exchange of eastern agricultural and western industrialised goods, a structure difficult to change. Since many of the CEECS will be able to exploit their comparative advantages only by increased exports of agricultural and low-wage, low-tech products, staunch resistance by the respective lobbies in the "old" member states is to be expected. A more balanced division of labour, even developing intra-industry trade further, depends largely on the creation of an environment that favours foreign direct investment, the transfer of technology and the development of production structures which can master all-European or global competition. In addition, adjusting goods and services markets require the political readiness of old EU-members to accept an increasing influx of products and services from CEEC.

Socially acceptable and feasible policies

The prime 'social' risk of such a growth regime lies in the societal acceptance of economic changes. First of all, any integration process produces winners and losers. It is among those losers where we expect to find the greatest imponderables within the process of sustainable convergence. The successful implementation of reforms hinges upon the ability of national governments to compensate losers. The enlargement process affects different segments of the population differently, dividing the electorate into 'winners' and 'losers' of integration. Hence, the issues redistribution and compensation loom large into the task of implementing a sustainable growth regime.

Fiscal and exchange-rate policies

Appropriate fiscal and exchange-rate policies strengthening private sector's expectations thus ensuring a steady stream of capital influx are required, but hard to put through. From the viewpoint of political economy, governments strive for office retention. Therefore, incumbent governments may be forced to dampen the detrimental social effects of their run-up to the eurozone. In this respect, the prescribed soft pegs in ERM-II provide perverse incentives as additional fiscal spending gives front-loaded benefits and delayed costs. Governments in CEECs will constantly have to weigh the costs of maintaining necessary policies for Maastricht compliance against the hardship of voter alienation. This holds all the more so, as current members are interested in sustainable convergence of CEECs. The latter will not hesitate to give way to the according moral hazard.

Policies should be organized in a way that the risk of disordered devaluations provoking currency crises and a reversal of capital flows is at least reduced. Prudent fiscal and exchange-rate policies may have to be supported by the old EU-members.

With both sides being reluctant to 'pay the bill' it comes with little surprise that there has been and will be a prolonged tug-on-war between current and new EU member countries. Hence, we expect 'pork-barrelling' in crucial policy areas, ranging from the EU budget, to the modalities of EMU enlargement, and to the coordination between tax and transfer systems. This kind of genuine 'EU risk' could further endanger the sustainable flows of capital within an enlarged Europe.

Knowing all these forms of risks and potential conflicts, *Ezoneplus* establishes what to do about them. The answer is both amazingly simple and inherently complex: The kind of sustainable growth regime intended has to assure a switch from the short terms needs of guaranteeing stable capital flows to the long term need of raising national saving ratios in Eastern Europe. The point is that the EU will only come to terms with the political and economy tensions outlined so far, if the level of wealth transfer is eventually reduced to sustainable levels. The prime mechanism to do this is by enhancing national savings. Accordingly, policy advice relates to strengthening the capacities of both policies and political institutions on national and European levels to trigger increases of saving ratios in Europe. Such measures will buttress up a sustainable growth regime leading new EU-members towards the eurozone.