Ezoneplus Newsletter

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The Eastward Enlargement of the Eurozone

Contents of this Issue

EZONEPLUS Partners: Estonia, Finland, Germany, Italy, Poland, Portugal, and Slovenia

Editor's Note

Welcome to our new issue of the Ezoneplus newsletter. Below you may find latest information about activities, publications, Ezoneplus conferences and those of our partners or which are generally related to our research. Additionally, the literature section will provide you with information on current and important working papers and more general publications.

Ezoneplus' Conferences

(1) Krakow/Poland: 21-24/11/2002

As a joint initiative with the Institute for Strategic Studies in Krakow/Poland, the Polish Ezoneplus team from the Warsaw School of Economics held an academic workshop on "EMU enlargement's impact on capital markets, trade and FDI in the CEE countries". In order to improve academic and policy co-operation between Poland and the Czech Republic, several representatives from the respective National Banks were invited to present their countries' approaches.

The Czech Republic - public finances worse than in other candidates

Mr. Vít Bárta (advisor to the Czech National Bank) first explained in his presentation "Czech National Bank and euro: major options and issues" why to date, the CNB abstained from issuing an official Euro entry strategy: Apart from some leading officials in the CNB, there is still reservation in the Bank and the Ministry of Finance about the timing to adopt the Euro. However, a "fast-track"-solution, an earliest possible adoption in 2007 seems to be possible, if three sources of risks can be eliminated: Business cycles, public deficit, and labour market developments.

To Mr. Bárta, economic transformation in terms of shadowing the business cycles of industrialised countries (mainly Germany) is far from complete as the correlation of business cycles is insufficient. Second, public finances have to carry a heavy burden in terms of high mandatory expenditures and a structurally driven deficit. Because of the mostly expansionary fiscal policy in recent years, the fiscal performance today is probably much worse than in other accession countries and for Mr. Bárta the biggest macroeconomic risk. Third, persistent rigidities in the labour markets could justify some reservations towards an early Euro entry. At last, as long as the current real appreciation is not fully understood, Mr. Bárta argues for a slightly more reserved approach towards an early entry into the euro zone.

Mr. Jakub Borowski (National Bank of Poland) stressed "The Impact of Poland's EMU Accession on Foreign Trade" and tried to assess the positive welfare effect on trade stemming from the Euro adoption.

Gravity models to estimate Euro's impact on trade

First of all, the unified currency will bring about dynamic efficiency gains, leading to an increased capital stock and expansion of trade, thus, resulting in potential output rise. However, it is difficult to assess the impact of current exchange-rate volatility on trade, but since only three per cent of all Polish firms do some sort of exchange-rate hedging, the majority will profit from the volatility abolition due to monetary integration. The results of empirical studies do not provide an unequivocal answer to the question about the direction and scale of this impact. Still, expanding a gravity model from Andrew Rose, Mr. Borowski estimates trade to possibly rise threefold (!) in a long-term perspective.

Prof. Dr. Karel Zeman (Institute of Integration of the Czech Republic into the European and World Economy): "The Basic Features of the Proceeding Discussion about the Czech Republic Preparation for Joining the Eurozone". First, Professor Zeman described the growing understanding between the Czech Government and the National Bank, which should raise the possibility of entering the euro zone between 2006-10. Although broadly advocating a fast-track solution, he confirmed Mr. Bártas' comments on the lack of fiscal prudence in the Czech Republic. Not only a bunch of non-performing assets, but lasting problems of the health care and pension system should continue to keep the share of mandatory state expenditures worryingly high.

National Banks in Poland and the Czech Republic: diverging strategies?

Hereafter, a lively discussion emerged in response to a remark from Mr. Borowski claiming that there should not be significant differences between the two countries' monetary and exchange-rate policies. To him, of course fiscal consolidation appeared crucial before entering the Exchange-rate mechanism II, however, one should use the positive pressure stemming from an "as-fast-as-possible" entry strategy. This pressure could enable a country to encourage and promote still necessary adjustment processes, e.g. in the labour market. Mr. Bárta in contrast, highlighted the fear of unexpected real exchange-rate movements and evoked the image that entering ERM II too early would be similar to entering the subway albeit with the train still moving! Despite that the Polish experts **Mr. Marcin Żogala** and **Mr. Marek Rozkrut** (both NBP) claimed in line with Mr. Borowski that waiting for compliance with the so-called OCA-criteria may prove to become an infinite venture.

During a section devoted to the evolution of CEEC' capital markets, **Mr. Pjotr Banbula** focussed on ways of opening markets for capital flows and **Mr. Dominik Sobczak** (both Warsaw School of Economics) examined the development of eastern European stock exchanges.

Mr. Rafał Wielądek (Warsaw School of Economics) discussed the linkage between exchange rates and capital flows, whereas **Mr. Thomas Meyer** (Freie Universität Berlin) looked at "The shaping of capital markets", revealing the impact the Euro already had on western financial markets and how he is about to influence the financial sphere in the applicant states. Both researchers pointed at the importance of complete liberalisation of capital flows prior to EU-membership. Being a source of future efficiency gains, such liberalisation may imply costs if inflows would overshoot a sustainable level. Eventually, this money may be withdrawn all of a sudden undershooting the long-run level and depriving the applicant states of financial resources leading to crisis.

Further presentations dealt with "Interest rates and capital flows", "FDI flows and Trade with East" both **Prof. Dr. Katarzyna Żukrowska** (Warsaw School of Economics); "FDI and Eurozone enlargement – the Czech View" **doc. Ing. Ingeborg Němcová** (University of Economics, Prague) and "Social support for the integration of Poland with the EU" **Prof. Dr. Stanisław Swadzba** (University of Economics in Katowice). The complete minutes of the workshop and some of the papers presented are available at http://www.ezoneplus.org

(2) Brussels/Belgium: April 2003
The Ezoneplus Consortium will arrange for a high-level meeting of representatives of the European Commission and academia in Brussels next April. The aim of the two-day workshop is to present our research and outcomes of the first year of Ezoneplus (see Ezoneplus Summary Report, December 2002). Divided into an "open" forum and a closed part, the workshop will cover capital, labour markets, trade & FDI, and exchange-rate policies. Reflecting the reshaping effects on these markets, we will try to expand our view towards more policy-oriented questions.

In most cases participants are related to European institutions, however, experts in international finance and government representatives are equally welcomed. Contact address: a.stuchlik@ezoneplus.org (Andrej Stuchlík)

Brussels workshop – April 2003

Other Conferences/Events

(1) Tartu/Estonia: 3-4/9/2002
PhD course "Computational general equilibrium modelling". From 3-4 September, the representative of the Finnish group Risto Vaittinen with Juha Honkatukia (both VATT) organised a course on the usage of computable equilibrium models for economic policy modelling. The lectures were arranged in order to promote further research co-operation between the Helsinki and Tartu institutions in the field of using CGE models for simulating the impact of different shocks.

(2) Ljubljana/Slovenia, 19-21/9/2002
EADI conference "EU enlargement in a changing world - Challenges for development cooperation in the 21 century" Together with co-author Tina Žumer, Vladimir Lavrač from the Ezoneplus research team in Slovenia presented the paper "Accession of CEE countries to the EMU: Nominal convergence, real convergence and optimum currency area criteria". Contact address: Lavračv@ier.si (Dr. Vladimir Lavrač)

Events in Estonia and Slovenia

(3) Malta, 17-19/10/2002
At the conference "The EMU and its implications for applicant countries", University of Malta, Dr. Lavrač presented the paper "Institutional arrangements towards the European single currency: Implications for pre-accession countries".

(4) Ljubljana/Slowenia, 21-24/10/2002
Slovenia's banking association prepared an educational programme "Banking school" for leading banking personnel. Dr. Lavrač contributed with a lecture on "EMU and the euro".

(5) Tallinn/Estonia: 27-28/11/2002
"Integration and EU Enlargement"
A joint seminar was organised in Tallinn with participating institutions from both Finland (ETLA, Bank of Finland, Yrjö Jahnsssoni Foundation) and Estonia (University of Tartu, Tallinn Technical University and Bank of Estonia). The event was aimed at enhancing regional co-operation, thus additionally, a doctoral tutorial was initiated as part of the seminar. Contact address: Tpaas@mtk.ut.ee (Prof. Dr. Tiiu Paas)

Publications

(1) Ezoneplus Summary Report out now
Bolle, Michael (Ed.). *Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets.* Berlin: Berliner Wissenschaftsverlag, 2002.
(ISBN-3-8305-0350-4, € 15,-)

Ezoneplus Summary Report - First year's results

Eastward enlargement will eventually induce the adoption of the euro by the then new member states. This will be a major event, quite distinct from mere accession to the European Union, and markets will be re-shaped.

This collection covers the underlying mechanisms for the most important markets – i.e., labour markets, capital markets, as well as trade and foreign direct investments. It turns out that market adaptation is a key to the success of enlargement. Moreover, the role of exchange rates will be of crucial importance, and may leave room for bargaining between old and new members. The introduction of the Report is available at the ezone-plus-website. Below we list the main findings of *Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets*.

Exchange-rate policies

EMU and CEEC - different interests?

Independent of the actual exchange-rate regime adopted, the run-up period will force CEE policy-makers to combine low inflation, financial stability, and continuing structural change in increasingly opening economies – and, thus, to maintain a tight fiscal policy stance. However, the political incentives generated by pegged rates often fail to provide sufficient fiscal restraints to help governments avoid possible currency crises. It goes without saying that current members of EMU run such risks as well, but **Mr. Christian Fahrholz** (Freie Universität Berlin) suggests that CEEC are tempted to exploit those risks to increase their political leverage in financial matters with current members of EMU. Based on these considerations which indicate a variety of trade-offs as a result of different preferences and restrictions, both the CEEC and the EU have to take into account a still-to-be-determined set of transmission mechanisms affecting the markets in question.

Prof. Renzo Orsi (University of Bologna) finds with regards to an early inclusion of the CEE countries into the euro zone that they might experience more inflation and output volatility than they would if they were to retain their monetary independence, while the management of monetary policy and inflation stabilisation could become marginally more difficult in the broader euro-area. The empirical evidence so far indicates that exchange-rate regime choices are largely consistent with the information provided by the macroeconomic fundamentals of the economies. These results also suggest a number of common answers:

First, among the variables related to macroeconomic stabilisation, current inflation plays an important role in the regime choice. High current inflation rates make fixed exchange-rate regimes more difficult to sustain. As expected, they increase the possibility of adopting more flexible regimes.

Corner solutions or variety of exchange-rate regimes?

Second, overall, the exchange rate is the main long-term factor influencing domestic prices, and can be seen to be the common inflation-adjusting mechanism (e.g. in the Czech Republic, Poland, and Hungary).

Third, the idea that for the CEEC there is only transition toward the two-corner solution can be generally rejected by evidence. The findings suggest that a range of exchange-rate regimes can be justified due to specific characteristics of each country, its objectives, and the timing planned for the transition.

Forth, following progressive market liberalisation, demand-side pressures, measured in terms of output gap, are seen to be a significant cause of (mainly CPI) inflation.

Labour Market Adjustment

EMU-enlargement is primarily a nominal change but it may also have real consequences on the functioning of the economies and especially on labour markets. Experience from monetary shocks and unemployment fluctuations show that monetary disturbances, interest rate and price level shocks can cause employment shocks at least in the medium term. **Prof. Jaakko Kiander, Dr. Risto Vaittinen** (both VATT, Helsinki), and **Prof. Tiiu Paas** (University of Tartu) examine the risk if the beneficial effects of EMU membership might cause a positive overshooting in the accession countries, which can be followed by recessions and increased unemployment.

Certain sectors of the EU15 economies and certain regions (e.g. Germany and Austria) are going to experience bigger effects from migration than others. The overall migration from the CEE countries over a time span of 10 years may be only about one percent of the EU15 population. However, it is likely that the migration will not be evenly distributed over the whole EU15. If the majority of migrants move to regions close to CEE countries, the population increase in these regions may be 2-4 percent over 10 years. Such an increase would no longer be an unobservable and insignificant change, although neither does it pose an unmanageable challenge.

The migration of labour from the future member states to the current EU area will reduce economic growth as measured by GDP in the new member states. But at the same time, the contraction in the labour force will increase the salary level and per capita incomes. Thus migration will help to narrow the differential in living standards between the then new and the old EU countries.

EMU-enlargement poses challenges to the labour markets of the accession countries. They have to face the requirement of fiscal and financial stability without the help of independent monetary policy or exchange-rate movements. Thus, labour market flexibility - though in general little appreciated - is badly needed.

Capital Markets

Capital markets in Europe are changing towards a more open-market approach, and so are the capital markets in the CEE applicant states, albeit they are still in process of transition. According to **Mr. Thomas Meyer** (Freie Universität Berlin) an open-market solution is generally regarded as the more efficient solution in terms of allocation and corporate governance, but might also increase financial volatility. Institutional maturity, such as effective property rights, sufficient competition, and so forth, plus macroeconomic stability are necessary to mitigate volatility. The adoption of the euro then promises monetary stability and an institutional upgrade to Western European levels.

Euro introduction - beneficent but higher risk of overshooting

The downside might be that any deviations from this train would become more costly. A very early reliance on markets and deregulated banking might not suit the transition economies that, due to their volatile economic development, might prefer a more interventionist stance. However, exuberances and downward spirals are sometimes part of financial markets and seemingly small causes might trigger destabilising capital flows that again increase economic volatility.

A financial crisis would hurt the CEEC in any case, but the euro somehow raises the stakes: Increasing expectations in form of macroeconomic monetary and institutional stability, the Euro will fuel optimism and thus capital inflows. The common currency improves access to international capital at lower cost and facilitates integration into the European financial markets; however, failure to keep pace with this development might also incur much higher cost.

Trade and FDI

Professors from Portugal's University of Évora, **José Caetano, Aurora Galego, E. Vaz, Carlos** and **Isabel Vieira** reveal that there is an increasing divergence of trade patterns between CEEC and the EU, which suggests different factor endowments as well as distinct dynamics of integration into the international process of production.

CEEC on the way to new "southern" EU members

Those CEE countries sharing a border with the EU have increasingly engaged in sectors where competitiveness is based on the production scale and on product differentiation. As a consequence, there is an increasing approximation to the situation in the central rather than that in the southern EU countries. Regarding possible negative diversion effects of FDI flows; the researchers find no such evidence. Instead their results imply that the trends observed in FDI flows to these countries in the last few years merely reflect the expected upsurge of FDI inflows in the run-up to and immediately after accession, and the gradual downturn some years later, when FDI stocks reach a certain equilibrium level.

Nevertheless, the empirical analysis on FDI determinants suggests that these are the regions where more attention should be paid to the issue of attracting and maintaining foreign investments. Efforts should be focused on the implementation of structural reforms capable of generating the necessary conditions to attract market-seeking FDI.

So far, the high volume of FDI appears to have contributed to the transformation of these countries' specialisation patterns, leading to the gradual consolidation of export structures based upon products that are intensive in technology and in qualified labour. Moreover, in almost all CEEC, the structural changes in trade composition were consolidated by an increase of Intra-Industry-Trade in total trade. Such a situation is particularly noticeable in the countries receiving the highest amounts of FDI, thus suggesting a positive link between the two flows.

(2) Ezoneplus Working Paper No. 5A, August 2002:
Meyer, T. et al.: The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets. Regional Inputs on Data and Statistic
Link to the paper

Empirical Input on Capital and Labour Markets

(3) Ezoneplus Working Paper No. 6A, August 2002:
Kemmerling, A. et al.: Regional Input: Labour Markets
Link to the paper

(4) Ezoneplus Working Paper No. 7A, August 2002:
Żukrowska, K. et al. FDI and Trade. Exemplification of Poland and other Post-communist States
Link to the paper

(5) Ezoneplus Working Paper No. 11, September 2002:
Paas, T. et al.: Labour Flexibility and Migration in the EU Eastward Enlargement Context: The Case of the Baltic States.
Link to the paper

Case Study: The Baltics

Literature

(1) Swedish Economic Policy Review, August 2001
Baldwin, R. et al.: "Eastern enlargement and ECB reform", pp 15-50.

The authors consider the decision-making process within the European Central Bank (ECB) in course of the prospective eastward enlargement. They stress that high-growth, high-inflation „Irelands" might then outvote the „core" countries. Of particular interest is their delineation of the accession countries' pass-through of Exchange Rate Mechanism II (ERM II) and the overall examination process. Following to the letter, access to Council voting takes no less than 33 months after admittance to European Union (EU). However, due to political economy considerations and previous experiences Central Eastern European Countries might be eligible for Council voting very soon. This highly demands reform of ECB's decision-making process.

(2) Deutsche Bundesbank, Monthly Bulletin, October 2002
"Fundamental determinants of real exchange rate movements in the central and east European accession countries" pp. 47-59.

Balassa-Samuelson and beyond

This article first provides a brief overview of the real exchange rate movements in the central and east European accession countries and then, on the strength of this, reports on the results of an analysis of the underlying determinants. This reveals that the relatively large productivity increases which characterise the catching-up and development processes are the prime, but by no means the sole, cause of the real currency appre-

ciation in those countries. The transmission mechanisms that lie behind this are, nevertheless, more complex than is sometimes assumed.
Link to the paper

(3) DIW-Wochenbericht 48/02
Brücker, H.; Weise, C.: "Die EU vor der Osterweiterung: Reformchancen im Europäischen Konvent nutzen"

On December 12 and 13 the EU is to conclude its accession negotiations with eight east and central European countries as well as with Malta and Cyprus. Moreover, a positive signal concerning the accession of Bulgaria and Rumania is expected. The recent agreement on the medium-term financing on the Common Agricultural Policy (CAP) has paved the way but demonstrated at the same time that the discussion on enlargement has been dominated by financing considerations.

The Union is still ill prepared for the accession of less affluent and mostly agrarian countries because a comprehensive reform of budget relevant policies is still to be decided upon. Furthermore, the accession of a large number of new members requires a fundamental reform of the EU's decision mechanisms. The responsibility for such kind of reform is with the European Convention, which has to deal with the proposals for a change of the Union's contractual basis.
Link to the paper (in German)

(4) DIW Discussion Papers No. 287, June 2002
Weise, C.: How to finance Eastern Enlargement of the EU

Some Costs of Enlargement

This paper analyses the consequences of the planned enlargement on the EU budget for the years 2007 and 2013. It concentrates on the EU's Common Agricultural Policy and Structural Policy and calculates the possible fiscal consequences of enlarging the EU for various policy scenarios. Enlarging the EU could be financed without overstepping the current upper limit for the EU budget, but it increases the pressure for EU policy reform. The main aim of such reforms is to reduce income support in agricultural policy and to concentrate structural policy on needy member states. These reforms would lead to a distribution of net burdens, which was more strongly orientated according to the relative income of EU members. The burden for net contributors would remain under control; financial support for needy member states in the present EU would continue and new members would receive equal treatment from expenditure-related programmes.
Keywords Enlargement, EU Budget, reform scenarios
JEL- Classification D78, F02; H11, H87, P16
Link to the paper

(5) European Commission (DG Employment and Social Affairs). Employment in Europe 2002, September 2002

The new report "Employment in Europe 2002" states a considerable reduction of average unemployment rates in the EU. An elaborate analysis of NAIRU across member states, complemented by a discussion of latest trends in employment, suggests an increase in flexibility in European labour markets. Chapter 5 focusses on the labour market situation in CEECs as well as how a European employment strategy faces new challenges because of enlargement.
Link to the paper

DG ECFIN on CEEC' economic programmes

(6) European Commission (DG ECFIN). Enlargement Papers. No. 14., November 2002. Evaluation of the 2002 pre-accession economic programmes of candidate countries.

This Enlargement Paper brings together into a single document the Directorate General for Economic and Financial Affairs evaluation of the second Pre-Accession Economic Programmes (PEPs) of the candidate

countries. Chapters include macroeconomic framework, monetary and exchange-rate policies, fiscal policy, structural reform, and institutional and analytical capacity.
Link to the paper

(7) European Commission (DG Enlargement). October 2002
Towards the Enlarged Union. Strategy Paper and Report of the European Commission on the progress towards accession by each of the candidate countries.
Link to the paper

The Commission's Strategy Paper

Miscellaneous

All Ezoneplus Working papers are now also available via the RePec-network of economic papers. See http://www.econpapers.hhs.se

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