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Conference Services

Please find attached the presentation by Mr. Willem Buiter, Cheif Economist, EBRD to the Special Session on Integration Process in the OSCE Region of the 12th OSCE Economic Forum, Prague, 31 May – 4 June 2004.

European Bank
for Reconstruction and Development

Enlargement of the EU: Expected Benefits and Inherent Risks

Willem Buiter

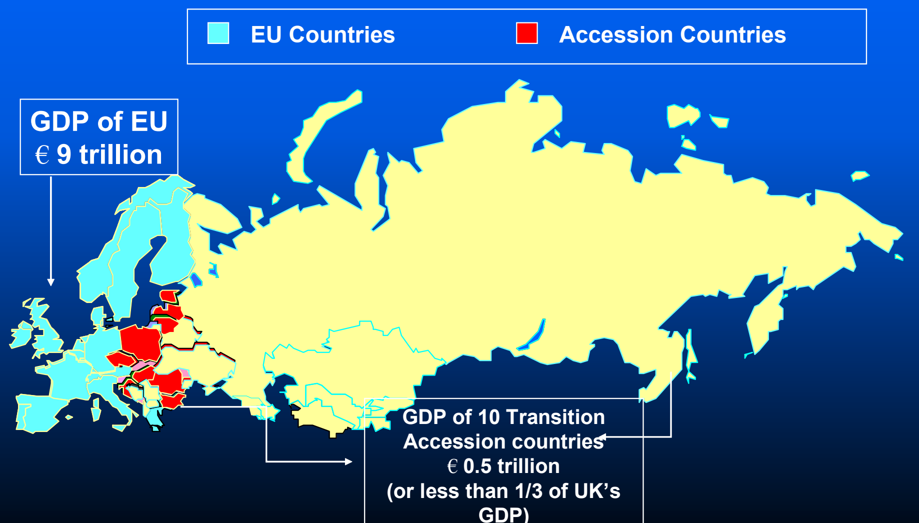
Prague, 3 June 2004

Timeframe

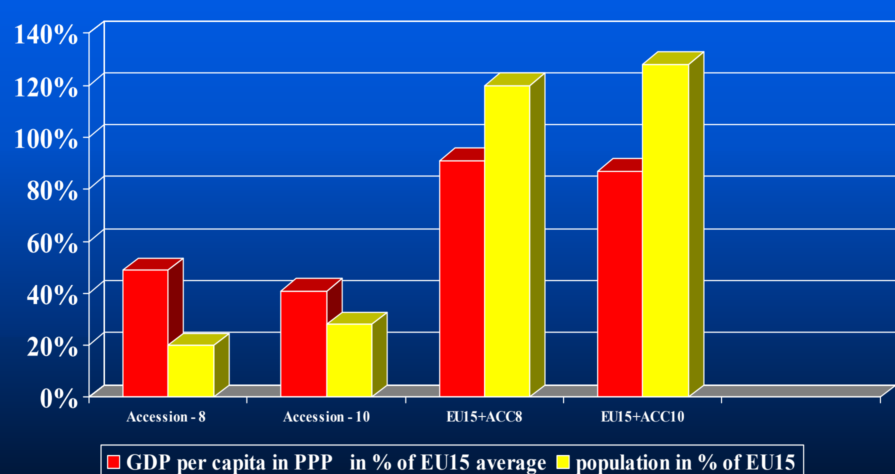
- Ten new members, 8 of which transition countries (Baltics, Czech & Slovak Republic, Hungary, Poland, Slovenia), have joined the EU on 1 May 2004.
- Bulgaria and Romania hope to do so by 2007 and so does Croatia
- Turkey, while a candidate, has not yet been given a date for the start of membership negotiations.

Dimensions

Data for 2002, current values

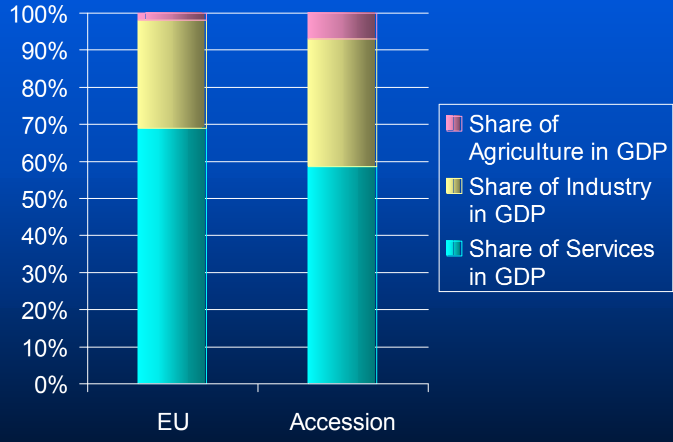


GDP per capita in PPP terms and Population in EU15 and new member countries, 2002

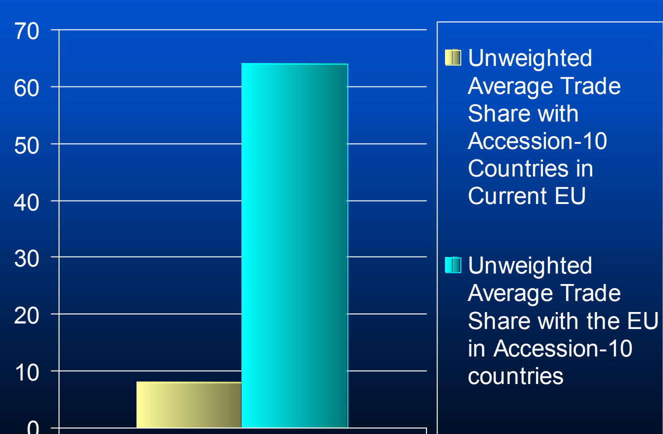


Structure of GDP (2002):

Accession-10 countries have larger agricultural and industrial sectors



Trade integration between the regions, 2002



CEE 10 Trade with E(M)U in 2002

Group 1	Trade w. EU+group 1 % of total trade	Trade with EU % of total trade	Trade with EMU % of total trade
Czech Rep.	86	72	64
Estonia	64	59	39
Hungary	73	66	58
Latvia	75	59	37
Lithuania	67	52	38
Poland	79	70	59
Slovenia	77	69	63
Slovak Rep.	87	58	50
Group 2			
Bulgaria	56	52	35
Romania	59	52	54
Average	71	60	48

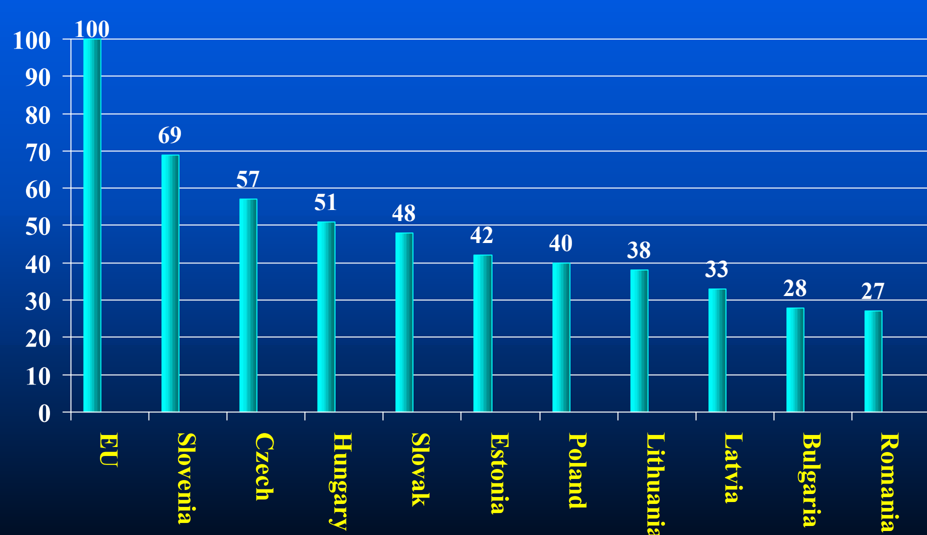
Opportunities for candidate countries

- Accession has been main driving force behind structural reforms in the CEECs; Reform fatigue & fiscal restraint aversion.
- Perception in region of greater political stability and future economic prosperity. Real prospects for catch up with west.

Short term

- **Resilience in 2001-2003**
  - fall in export growth to 5-10 per cent in constant prices
  - but domestic demand strong (Polish recession in 2001-2 ended in 2003)
  - net FDI inflows increased by 11% between 2000 and 2002 but fell more than 50% in 2003
  - record portfolio inflows in 2003, but large fluctuations since the start of negotiations

Per capita GDP in PPP as % of EU GDP, 2002



How long will it take for CEEC to converge to EU if growth differential is 3% pa? (2001)

	50%	75%	100%
Czech Rep	na	9	19
Estonia	6	20	30
Hungary	na	13	23
Latvia	14	28	38
Lithuania	10	24	34
Poland	8	22	32
Slovak Rep	2	16	26
Slovenia	na	3	13
Romania	24	37	43
Bulgaria	20	34	41

Macro-outlook

Main Forecasts

	Growth		Inflation (avg.)	
	2003	2004	2003	2004
Bulgaria	4.3	4.8	2.3	7.2
Czech Republic	2.9	4.0	0.2	1.4
Estonia	4.7	5.5	1.3	2.1
Hungary	2.9	5.0	4.7	8.2
Latvia	7.5	6.0	3.0	3.4
Lithuania	9.0	6.5	-1.2	1.5
Poland	3.7	4.5	0.7	2.2
Romania	4.9	5.0	15.4	11.5
Slovak	4.2	4.4	8.5	8.1
Slovenia	2.3	3.1	5.6	5.2

Fiscal deficits are still large and partially related to EU accession

- One-off expenditures are done now rather than later (to beat Convergence Reports?). (Czech Rep., Hungary)
- Structural fiscal deficits are partially driven by 'acquis'-related public investments.

General Government balance in per cent of GDP

	2002	2003	2004
Czech Republic	-6.7	-5.8	-6.2
Hungary	-9.3	-5.6	-4.5
Poland	-6.7	-6.9	-7.6
Slovakia	-7.2	-3.6	-3.9

Pitfalls (1): Enlargement costs higher than budgeted for

- **Budgeted transfers (EU budget framework until 2006) from the EU for structural operations should cover about 3% of accession countries' GDP until 2006 (incl).**
- **Equivalent to less than 10% of total EU budget. Euro 67bn allocated to candidate countries in current EU budget is about one tenth of funds given to east Germany after unification. Vast majority of EU budgetary funds will go to old members even after enlargement.**
- **Funding after 2006 less clear, since rules for structural operations might be adjusted.**

Pitfalls (2): EU not ready for enlargement

- Voting mechanism in the EU: Reforms in Nice did not go far enough; agreement on new constitutional proposals uncertain.
- CAP reform (beyond the current Fischler proposals) necessary in the long run when accession countries are granted equal treatment, unless the EU total budget is increased.
- Rules for allocation of structural funds might change as well, allowing poorer existing member countries to keep more of their current transfers.

Pitfall (3): EMU membership path

- Inflation (no more than 1.5% above average of 3 lowest inflation countries)
- Nominal interest rate (10 year rate no more than 2.0% above average of 3 lowest inflation countries)
- Nominal exchange rate
  - Respect normal fluctuation margins for ERM without severe tensions for at least 2 years before the examination. No devaluation 'on own initiative'. [Question: can one 'respect normal fluctuation margins for ERM' without being an ERM and therefore an EMU member? If not, at least 2 years of ERMII plus unrestricted financial capital mobility: risk of speculative attacks and crises]. Italy and Finland precedents 1998/9; Greece precedent 2000/1.
  - Council of Ministers decides conversion rate
- Financial
  - Deficit < 3 % of GDP
  - Debt < 60 % of annual GDP
- Central Bank independence

Pitfall (3 ctd.) EU and EMU membership

- EU membership implies EMU membership – part of 'Acquis'; no more indefinite opt-outs (Denmark, UK).
- However, duration of derogation for euro adoption is open-ended : no requirement to enter ERMII ; once in ERMII, exchange rate & other EMU criteria may not be met (intentionally or accidentally).

Pitfall (3 ctd.) The macroeconomic challenges

- For sustained growth, it will be necessary to get the fiscal/monetary policy mix right (also in order to meet the Maastricht criteria). Data for 2003.

	Growth	Inflation	Fiscal deficit	Gross Public debt/GDP	Current Account
Bulgaria	4.3	2.3	0.0	46.1	-8.3
Czech R	2.9	0.2	-5.8	23.0	-6.5
Estonia	4.7	1.3	2.6	5.1	-13.7
Hungary	2.9	4.7	-5.6	58.2	-9.1
Latvia	7.5	3.0	-2.0	17.5	-9.3
Lithuania	9.0	-1.2	-1.9	24.4	-6.6
Poland	3.7	0.7	-6.9	50.6	-1.9
Romania	4.9	15.4	-2.4	26.1	-6.0
Slovakia	4.2	8.5	-3.6	42.8	-0.6
Slovenia	2.3	5.6	-1.4	26.0	0.0

Pitfall (3 ctd.) Current Monetary Regimes

Country	Nominal Target/Exchange Rage Regime
Czech Rep.	Managed float against Euro, inflation target
Hungary	± 15 & band; central parity fixed ito Euro, inflation target
Poland	Floating, inflation target
Romania	Managed float, inflation target to be introduced in 2004/5
Slovak Rep.	Managed float, inflation target
Slovenia	Managed float, inflation target
Latvia	Fixed against a composite (SDR)
Bulgaria	Currency board (fixed at Lev 1.95583 per Euro)
Estonia	Currency board (fixed at EEK 15.69664 per Euro)
Lithuania	Currency board (fixed at Litai 3.4528 per Euro).

Pitfall (3 ctd.): What exchange rate regime?

- All new member countries should aim to become full EMU members ASP (but no sooner). Countries too small, open & financially vulnerable to have their own currencies. No real benefits from exchange rate flexibility. Full benefits of international financial integration only reaped after candidate countries adopt the euro.
- Fiscal sustainability necessary and sufficient condition for euro adoption.
- Nominal convergence (inflation rate) nice but not essential. ERMII dangerous.
- Real convergence (productivity, composition of output, financial sector development) highly desirable intrinsically, but irrelevant for enjoying benefits of EMU.

Pitfall (3 ctd.): What exchange rate regime?

On economic grounds, externally imposed EMU admission criteria make sense if and only if there are *either*

- externalities
  - Fiscal sustainability externalities
    - Contagion effects of debt default
    - Inflation externalities through response of ECB to fiscal unsustainability
    - Demand spill-overs from inability to use automatic fiscal stabilisers automatic stabilisers
- Paternalism

Re Externalities: if they exist, are they too small to matter?

Re: Paternalism: a no-no because of principle of subsidiarity (≈ myob).

Pitfall (4): Safeguard Clauses

- For first 3 years of membership new members are "guilty until proven innocent"
- Three types of safeguard clauses:
  - Economic Developments
  - Internal Market
  - Justice and Home Affairs (mutual recognition of judgements)
- EC will decide sanction for new member not fulfilling obligations; then the member can take the EC to court.

Conclusions

- Main risks to EU enlargement:
  - Costs might be higher than budgeted for. Financing might become a problem after 2006 (Finland-Germany Presidency swap).
  - Inadequate internal EU reform; political and administrative paralysis.
  - Abuse of safeguard clauses by protectionist old EU members.
  - Problems on the path to EMU membership: ERM purgatory, risk of speculative attacks, volatility, misalignment

Conclusions, ctd.

- Incomplete transition in many new member countries (incl. governance and public administration). Much serious restructuring and reform remains to be done.

Conclusions

- After the Iron Curtain the Schengen Curtain or the Brussels Lace Curtain?
  - Romania, Bulgaria
  - Turkey
  - Croatia, FYR Macedonia, Serbia & Montenegro, Albania, Bosnia & Herzegovina
  - Wider Europe: Belarus, Moldova, Ukraine, Russia
  - Not even Wider Europe: Georgia, Armenia, Azerbaijan
  - Not even Europe: Central Asia

Conclusions

- Good neighbour instincts and self-interest dictate:
  - market access;
  - generous visa and work permit arrangements
  - capacity building assistance
  - promotion of cross-border infrastructure
  - prospects of eventual EU membership for those who are interested