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Consequences of EU Accession: Economic Effects on CEECs

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Abstract

This paper discusses the economic effects of EU enlargement for the group of Central and East European accession countries (ACs). It consists of three parts: In Part A the financial aspects of accession to the EU are explained. It deals firstly with the outcome of the negotiations at the December 2002 European Council Summit in Copenhagen in relation to the expected flows of net transfers over the period 2004-2006. The most uncertain component of these transfers are related to the project-related funds, their disbursement and fiscal implications because of co-financing requirements. Secondly, we discuss the issue of the longer-run negotiations with respect to the Financial Framework to be decided for the period 2007-2013; here the issue of the formation of likely new coalitions within the enlarged European Union is dealt with and possible winners and losers in such negotiations are identified. In Part B we discuss the difficulties the new members will face upon accession in the conduct of macroeconomic policy. In particular, the crucial issue of fast vs. delayed entry to the European Monetary Union (EMU) will shape the constraints within which the conduct of fiscal and monetary policy will have to take place. It is quite likely that it is this issue which will dominate the medium-run growth prospects of the new members upon accession. Part C explores the longer-run growth and convergence scenarios for the new member states. It describes the relative growth performance of the ACs in relation to the EU so far and discusses the reasons why the growth performances might remain more volatile compared to those of the current EU member countries. It also refers to the promising patterns of structural catching-up and convergence which have already taken place, it evaluates the impact of accession upon strengthening trade and production networks, on easing market entry and on speeding up the process of institutional and behavioural convergence. All these issues are important in shaping the long-term growth and catching-up paths of the new EU members.

Keywords: EU enlargement, accession to the EU, fiscal transfers, macroeconomic implications, EMU membership, growth and convergence

JEL classification: E52, E61, E63, F14, F15, F36

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Consequences of EU accession: economic effects on CEECs*

A Fiscal and financial aspects of the accession to the EU: the issue of transfers

1 Introduction

The Copenhagen European Summit in December 2002 was one of the most important milestones in the long process of EU enlargement. Accession negotiations with the candidate countries (Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia) were concluded. This opened the door for the next and final legal steps towards enlargement: first, the signing of the Accession Treaty, followed by its ratification by the legislative bodies of the 15 present EU member countries, the European Parliament and the legislative bodies in the accession candidate countries, subject to the results of the referenda to be held in each of these applicant countries.

By the beginning of the Copenhagen summit, only the chapters *agriculture* and *finance and budget* remained open out of the total of 30 negotiated chapters. This was no coincidence: these two chapters have the most far-reaching financial implications for both the present and future members of the European Union. It was clear that the room for manoeuvre was rather limited and the financial framework for the new members laid out in 1999 in Berlin could not be enlarged. The stakes were high for the candidate countries. Would they be able to secure the maximum resources permitted under the 1999 Berlin framework in the first three years of membership? Would they return from the summit with results that they could present to their constituents without loss of face? Would solutions be found whereby none of the new members would become net contributors to the EU budget in the first three years of membership? Would agreement be reached on direct payments to farmers in the new member states that guaranteed fair competition with farmers in old member states, once agricultural trade had been liberalized and the Common Agricultural Policy introduced in the new member countries?

2 Transfers: the amounts

The outcome of the long and hard negotiations in Copenhagen was that the total financial commitments for the ten new members for the three-year period 2004-2006 amounted to EUR 40.85 billion. This is less than the sum cited in the 1999 Berlin resolution, EUR 42.59 billion, yet somewhat more than the one stipulated in the Commission's Information Note of January 2002, EUR 40.16 billion (European Commission, 2002a). Interestingly, that fact remained more or less unnoticed, as the immediate target of the

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candidate countries was to increase the financial commitments that were accepted at the Brussels summit in October 2002. There, as a result of a German initiative, appropriations for structural actions in the new member states were cut by two and a half billion euro. As a consequence, the total financial package offered by the Union dropped to EUR 40 billion. In Copenhagen the prospective new members' position improved considerably (by EUR 800 million) as compared to this last EU offer. This helped the EU to 'sell' the

Table 1

Net budgetary positions of the new members after enlargement

(Payment appropriations)

	CY	CZ	EE	HU	PL	SI	LT	LV	SK	MT	TOTAL
2003											
pre-accession aid	**16**	**170**	**55**	**197**	**844**	**45**	**115**	**84**	**123**	**11**	**1,661**
2004											
pre-accession aid	11	181	67	235	970	51	127	99	120	7	1,869
agriculture	12	100	29	125	426	43	73	42	57	3	911
structural actions	6	169	39	209	859	27	94	66	118	7	1,594
internal actions	5	44	5	42	154	12	11	10	19	2	305
additional expenditure	0	7	25	58	131	38	84	28	21	0	392
cash flow lump sum	28	175	16	155	443	65	35	19	63	12	1,011
budgetary compensation	69	125	0	0	0	30	0	0	0	38	262
total allocated expenditure	**131**	**801**	**181**	**824**	**2,983**	**267**	**423**	**264**	**398**	**70**	**6,343**
trad. Own resources	-27	-66	-8	-97	-123	-18	-22	-7	-33	-14	-415
VAT resource	-10	-74	-6	-61	-194	-22	-14	-8	-26	-4	-420
GNP resource	-60	-426	-37	-349	-1,114	-129	-78	-48	-148	-23	-2,412
UK rebate	-8	-56	-5	-46	-148	-17	-10	-6	-20	-3	-320
total own resources	**-105**	**-623**	**-56**	**-554**	**-1,579**	**-187**	**-124**	**-70**	**-225**	**-43**	**-3,566**
Net balance	**27**	**178**	**125**	**270**	**1,404**	**80**	**299**	**195**	**173**	**26**	**2,777**
2005											
pre-accession aid	6	153	57	199	823	43	110	86	102	2	1,581
agriculture	37	392	82	544	1,512	125	228	116	205	8	3,248
structural actions	14	355	88	438	1,776	59	203	151	244	13	3,343
internal actions	9	76	9	72	266	21	18	17	33	4	524
additional expenditure	1	9	26	61	141	38	109	29	52	0	466
cash flow lump sum	5	92	3	28	550	18	6	3	11	27	744
budgetary compensation	119	178	0	0	0	66	0	0	0	66	429
total allocated expenditure	**191**	**1,255**	**266**	**1,342**	**5,068**	**370**	**674**	**402**	**647**	**119**	**10,334**
trad. Own resources	-40	-105	-12	-150	-213	-29	-33	-11	-54	-21	-667
VAT resource	-16	-116	-10	-95	-304	-35	-21	-13	-40	-6	-657
GNP resource	-91	-653	-57	-535	-1,707	-198	-120	-74	-226	-35	-3,697
UK rebate	-12	-88	-8	-72	-230	-27	-16	-10	-30	-5	-497
total own resources	**-160**	**-963**	**-86**	**-853**	**-2,454**	**-288**	**-191**	**-107**	**-350**	**-66**	**-5,518**
Net balance	**31**	**293**	**179**	**490**	**2,614**	**82**	**483**	**295**	**297**	**53**	**4,816**

(Table 1 continued)

Table 1 (continued)

	CY	CZ	EE	HU	PL	SI	LT	LV	SK	MT	TOTAL
2006											
pre-accession aid	1	98	35	124	509	27	66	52	64	0	976
agriculture	46	483	102	653	1,934	158	294	156	260	10	4,095
structural actions	18	427	110	524	2,107	73	248	189	289	15	3,998
internal actions	12	102	12	97	359	28	25	22	45	5	708
additional expenditure	1	9	26	61	140	38	127	28	52	0	481
cash flow lump sum	5	92	3	28	450	18	6	3	11	27	644
budgetary compensation	112	85	0	0	0	36	0	0	0	63	296
total allocated expenditure	**194**	**1,294**	**288**	**1,487**	**5,498**	**378**	**766**	**451**	**720**	**121**	**11,198**
trad. Own resources	-40	-105	-12	-150	-213	-29	-33	-11	-54	-21	-667
VAT resource	-17	-119	-10	-97	-310	-36	-22	-13	-41	-6	-671
GNP resource	-94	-670	-58	-549	-1,752	-203	-123	-76	-232	-36	-3,793
UK rebate	-13	-93	-8	-77	-244	-28	-17	-11	-32	-5	-529
total own resources	**-163**	**-988**	**-89**	**-873**	**-2,519**	**-296**	**-196**	**-110**	**-359**	**-68**	**-5,660**
Net balance	**31**	**307**	**200**	**614**	**2,979**	**82**	**570**	**341**	**361**	**53**	**5,538**

Note: In case of political settlement for Cyprus, an additional amount of EUR 127 million in payments should be foreseen for the three years 2004/2005/2006.

Source: European Commission (2002).

outcome as a success, even if the final result was less favourable than that envisaged in the Berlin financial framework of 1999.

For the EU candidate countries, it was an issue of vital importance to ensure that they avoid a possible net payer position in the first years of membership. The notion that new members, who are at a substantially lower level of economic development than incumbents, should contribute more to the common budget than they receive was unacceptable. Any negotiating government which agrees to accession conditions leading to such an outcome could be regarded as a sure loser at the next elections.

Although the Commission declared several times that it would not allow the new members to become net contributors to the EU budget, the candidate countries' concerns have been justified (see Richter, 2002). Contributions to the EU budget, termed 'own resources', can be predicted quite accurately (customs duties and agricultural levies; VAT-based resource and GNP-based revenue component – see European Commission, 1998, Annex 3, p. 5). Transfers from the EU budget, however, are much more uncertain. It is very important to distinguish between planned and actual transfers. Commitment appropriations and payment appropriations are both planning categories. The first category, commitment appropriations, represents resources available in a given year to support EU co-financed projects. Actual expenditures on individual projects need not necessarily start or end in that year. The second category, payment appropriations, stands for expenditures earmarked in the given year for ongoing EU co-financed projects. This sum, however, is still a far cry from actually disbursed resources that are, to a large extent, dependent on the success/failure rate of applications for EU co-financed projects.

Transfers from the EU budget reach the target countries through a variety of channels. One group of transfers is not project-related and, in that context, payment appropriations can be taken as real future disbursements. This group consists of direct payments in a simplified version for new members, market interventions in agriculture, internal actions and additional expenditures. The other group consists of project-related transfers where the sum to be disbursed in a given year is determined by the amount of EU co-financing successfully secured for individual projects. This group includes transfers from the *Structural* and the *Cohesion Funds, rural development*, as well as the residuals from p*re-accession aid*. Project-related transfers require national co-financing. The typical amounts are 25% for transfers from the Structural Funds, 15% from the Cohesion Fund and 20% for rural development. Project-related transfers are, in this sense, 'expensive' compared to the first group of transfers which do not call for national co-financing.

At the 2002 Copenhagen summit one of the candidate countries' main targets was to maximize those transfers that will be really disbursed, first by increasing the total sum of commitments, and second, by increasing the share of non-project-related transfers within total transfers. The first attempt failed to yield any real success. The second attempt was successful, as neither the additional expenditures budgeted at the Copenhagen Summit for strengthening the prospective new Schengen borders, nor the lump-sum transfers to be disbursed so as to avoid the net payer position, are project-related items. The opportunity for partially redirecting rural development resources to 'top up' direct payments to farmers was a further change that augmented the share of non-project-related, hence less risky and expensive, transfers. Poland's special deal was the reallocation of EUR 1 billion from structural actions, partly to (a) unconditional lump-sum payments and partly to (b) project-related payments, without national co-financing. The purpose of the deal was to reduce the national budget deficit that would have come about as a result of having to top up direct payments to Polish farmers. The Czech Republic managed to secure a similar deal for EUR 100 million.

Will all these changes suffice to keep the new member nations from ending up as net payers? In order to answer this question, we need an assessment of the new members' prospective success rate where project-related resources are concerned. The Commission's Second Cohesion Report (2001a) provides helpful guidance in this assessment. According to Table A.35 of that report, 72% of the resources available in the period 1994-1999 were in fact paid from the Structural Funds (Objectives 1, 2, 3, and 4) for the average of the 15 EU members. As for the Cohesion Funds, the project implementation rate in the last year of the financial framework (1999) ranged from 85% (Portugal, the best performer) to 65% (Greece, the weakest performer). Another factor should also be considered: for incumbent countries, extensions from a previous financial framework create a financial buffer for the first two years of the subsequent financial framework – an opportunity that the new members will not be able to avail themselves of. These figures may serve as one of the possible points of reference to assess the success rate of the prospective new members.

However, one could arrive at a more pessimistic assessment using the same source. Between 1994 and 1999 some EU members performed disappointingly with their failure/success rate in receiving transfers from Structural Funds (Objective 2 and 4, respectively). Italy and Belgium had a record of 51% and the UK of only 46%. These figures may also serve as a reference for the prospective members when considering a more pessimistic scenario.

Of the EUR 40.85 billion available for enlargement over the period 2004-2006 as commitment appropriations, EUR 27.88 billion will be budgeted as payment appropriations. Of this latter sum about 50-60% will be project-related and 40-50% non-project related. In financial terms, this is equivalent to some EUR 13.9 to 16.7 billion in project-related transfers and EUR 11.2 to 13.9 billion in non-project-related transfers. Own resources, i.e. the new members' contribution to the EU budget, will amount to approximately EUR 14.7 billion. The sum of these figures, as well as an estimated success/failure rate for the project-related transfers, provide a basis for the calculation of the net financial position that the ten new members can expect as a group. (The net position of individual members within the group may vary considerably.)

For the next step an assessment of the prospective success rate of the new members in relation to project-related resources is needed. Assuming a success rate of 50% (pessimistic scenario) or 70% (optimistic scenario)[1] in the receipt of project-related transfers, overall net flows disbursed to new members in the period 2004-2006 will range between EUR 5 and 10 billion.[2] This sum amounts to EUR 1.7 to 3.3 billion annually, with a lower value in the first year (2004) and higher values in the third year (2006). This accounts for 0.4% to 0.8% of the new members' annual GDP or, expressed in other terms, 0.02% to 0.04% of the annual aggregate EU-15 GDP in the period 2004-2006.

The expected net financial position for the new members can be interpreted as the real costs of enlargement (in terms of budgetary transfers) accruing to the 15 incumbent

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1 70% corresponds to a (rounded) average success rate of the EU-15, 50% stands for the (rounded) average of the worst EU-15 performers in their worst years, both in the period 1994-1999. For an explanation for choosing these two rates see Richter (2002). For detailed statistics on the success rates of the EU-15 see European Commission (2001b), Statistical Annex, Table A.35.

2 For some countries the success rate may even be worse than 50%, as illustrated by the discouraging examples of pre-accession aid.

members of the European Union in the first three years after enlargement. Contrary to widespread perceptions, the above figures testify to the negligible costs involved.

Three remarks are due here. First, advantages from membership are not equivalent to the net financial position of the new member states. Gains from a new wave of foreign direct investment, decreasing transaction costs of trade, transport and industrial co-operation, and the opportunities offered by the completely free access to the European market, are much more important than net gains from transfers. Second, the balance of transfers improves as time passes; the balance of the third year will be substantially better than that of the first or the second year. By the beginning of the new financial framework, 2007, the phasing-in process will have been completed in the structural actions and will have progressed considerably in the field of direct payments. Third, decisions about the next financial framework 2007-2013 will already be made with the participation of the new members; as a consequence, their ability to influence the redistribution of expenditure will be much better than it was in the accession negotiations. It there is cause for concern for the present members about the costs of enlargement, then it relates to the period 2007-2013, not to 2004-2006.

Copenhagen brought about an important breakthrough in the long-discussed issue of direct payments. Farmers in the new member countries will be the main beneficiaries of the Copenhagen decisions. The pre-Copenhagen offer of the EU to the candidate countries was a 'phasing-in' of direct payments, starting with 25% of the level that farmers of the acceding countries would be entitled to receive in the case of full implementation of the CAP from the day of accession. This would rise to 30% and 35% in the second and third year of membership, respectively. The candidate countries considered this proposal unacceptable and made serious efforts to raise the initial rates of phasing-in, referring to the distorted competition between farmers in the old member countries, who have enjoyed full support, and farmers in the prospective new member countries, with just one quarter of that level in the first year of membership. The candidate countries were also dissatisfied with the production quotas offered by the EU.

Behind-the-scenes negotiations prior to the Copenhagen summit and intense talks at the summit resulted in substantially improved conditions for the candidate countries. In the field of direct payments, the initial rates for 'phasing-in' were not raised but the new members will have the opportunity for a 30% top-up from national resources on the 25%, 30% and 35% from Brussels. Part of this top-up may be reallocated from the resources earmarked for rural development, on condition that the redirected resources may not exceed 20% of the total sum for rural development. That solution improves the competitive production of farmers in the prospective new member countries to a considerable extent.

A special solution was offered principally to all candidates, but practically to Slovenia only. Any candidate country with a system of agricultural subsidy comparable to the CAP may opt for starting its membership with the 25% rate of support from the EU and with a top-up from the national budget that corresponds to its 2003 level of national subsidies plus 10%, provided that the 25% from Brussels and the national top-up combined do not surpass the 100% offered in the framework of the CAP after completing the phasing-in for direct payments. For Slovenia, where subsidies (and prices of factors of production) have been similar to those in the EU, this provides a fair and easy transition to the CAP. As subsidies are much lower in other candidate countries, it is not likely that they will use this option. In the final round of negotiations before Copenhagen, the production quotas allocated to the prospective new members increased to some extent. As a result, the current production level will not have to be cut back upon accession; in some areas there will even be room for increasing output as compared to the present level.

3 Transfers: the impact

Before addressing the issue of the economic impact that transfers will have on the new member countries' economies, it is important to deal with the political implications. The agreement on transfers reached in Copenhagen was the outcome of a very difficult bargaining process. It was a compromise, something far from satisfactory for the prospective new member states as it could not be presented as a great success in the domestic political arena. Nevertheless, it is not an unacceptable outcome and in the short run this outweighs other considerations. If the outcome of the negotiations had been a possibly negative net financial position, or if the idea of national top-ups for direct payments had not been invented, the governments would in all likelihood not have been able to 'sell' accession either to their legislative bodies or to the voters in the upcoming referenda. These two issues could have developed into crucially important arguments for the opponents to EU accession in the applicant countries.

What will the economic impact of the transfers be? At first glance, the impact would appear negligible. Additional resources of EUR 5 to 10 billion for the ten new members over a period of three years can well bear comparison, though with some reservations, with a probable FDI inflow of EUR 52 billion, forecast by the Vienna Institute for International Economic Studies (wiiw) for the prospective new EU members (without Cyprus and Malta) in the final three pre-accession years, 2001-2003. The reservations refer to the difference in prices (transfers: 1999 prices, FDI: current prices) and to the fact that the prospective new members are also sources of outward FDI. Subtracting this sum, EUR 3 billion for the three years concerned[3], we arrive at a *net* FDI inflow of EUR 49 billion. Even this sum is five to ten times greater than the estimated net inflow of EU transfers in the years concerned. Compared in another way,

3 Estimation by Gábor Hunya, Vienna Institute for International Economic Studies (wiiw).

the cumulative current account deficit of the central European applicant countries (excluding the Baltic states) is estimated to amount to about EUR 45 billion over the same three final pre-accession years.

Although calculating the balance of transfers to and from the EU budget provides valuable information about the magnitude of additional financial resources available to the new member states' economies as a result of accession to the EU, the 'net position' approach is unsuitable for assessing the impact of the EU transfers on their economies. Both the transfers to and from the EU budget will appear in different segments of the economy, thus causing significant variations in individual, distinctly separate fields.

Cohesion Fund transfers make up about one third of the total structural actions (transfers from the Structural Funds and the Cohesion Fund) and 11% of total payment appropriations for the period 2004-2006. An important feature of these transfers is that they are absorbed by the national budgets. Depending on the success rate with the projects involved, Cohesion Fund transfers create an additional revenue of 0.11% to 0.15% of the applicants' GDP (after deducing 15% national co- financing.) This is a modest impact in macroeconomic terms; however, at the level of public investment in the *environment* and *transport infrastructure* the impact will be considerable.

Structural Funds transfers will contribute to financing projects in *education and training*, *infrastructure* and the *enterprise sector*. In this case, the revenue side is much less concentrated than in the case of Cohesion Fund transfers, as the main recipients will be regions and regional projects, respectively. Here again, overall additional financing may be negligible in a countrywide comparison, yet the impact will be significant at the regional, sub-regional or local levels, or in a limited group of activities (e.g. a new centre for higher education in a certain discipline, etc.). All this refers to transfers for rural development and the residual from pre-accession aid.

For the sake of comparison, we recall that transfers from the Structural Funds to the four cohesion countries made up 5.5% of their total fixed capital formation in 1989-1993, 8.9% in 1994-1999 and will probably reach about 7% in 2000-2006. The respective shares have been especially high (between 11.4% and 14.6%) in Greece and Portugal (see Lolos, 2001). Due to the 'phasing in', and likely difficulties with absorption in the first years of membership, these shares will probably be below 5% of fixed capital formation in the new member countries.

All project-related transfers require national co-financing. Whether co-financing requires additional expenditures from the national budget, whether already budgeted items will obtain additional external financing through EU transfers or whether existing national structural expenditures can be replaced by EU resources, are questions that cannot be answered in general terms as the answer may differ from country to country and item to item. It is permitted to use Cohesion Fund transfers to finance ongoing programmes, while the *additionality principle* applies to Structural Fund transfers and requires that the level of public investment in the recipient country must at least be maintained, compared to a past reference period. This means that national structural spending cannot diminish, but can be restructured to cover co-financing needs (see Backé, 2002, p. 153). Restructuring expenditures along these lines may lead to serious problems in areas that lose out in the process: those receiving less support than before, owing to the co-financing requirements of projects in preferred areas supported by transfers from the EU. This issue is unlikely to be that important given the low initial level of transfers, but as 'phasing in' progresses and the transfers increase, it may become a significant source of conflict.

Direct payments to farmers are a specific form of transfers. They replace national agricultural subsidy systems and thus reduce overall national budget expenditures. For the new members this will not be so simple. In an important last-minute concession at the Copenhagen summit, the prospective new members were offered the option of paying national top-ups to their farmers from the national budget. This will have a dual impact. First, the competitive position of the farmers in the new member countries will improve to a considerable extent during the first years of membership; second, national budgets will have to cope with a serious additional burden. New member states will have to contribute to the EU budget 'to pay for the direct payments', but the expenditure side of their national budget will know no relief as the respective expenditures will remain more or less at pre-accession levels as a result of the top-ups. In conclusion, it is quite obvious that the new members' national budgets will feel the impact of the transfers to and from the EU most.

It is a relatively simple matter where 'own resources' are concerned: an item of expenditure equivalent to about 1.1% of the GDP can be safely assessed. On the revenue side, however, the impact is much more difficult to assess owing to the unpredictable value of inflows to project-related items. It is also difficult to estimate the expenditures required to cover co-financing requirements for reasons mentioned earlier. Peter Backé attempted (even before the Copenhagen Summit) to assess the budgetary effects of structural actions: the impact of the transfers from the Structural Funds and the Cohesion Fund. He found that the fiscal impact may range between -0.9 and +1.3% of the new members' GDP (Backé, 2002, p. 155). The message of this result may be as follows: the overall impact may be either negative or positive, but it will definitely be moderate. That notwithstanding, this moderate overall impact may mask quite substantial partial changes, as well as radical restructuring in individual sections of the budget, and the work involved in managing these significant changes should not be underestimated.

It is important to point out that transfers are only one aspect of the multiple implications of EU accession for the new members' budgets. The costs of complying with the acquis (especially in environmental protection), phasing out production subsidies, tax harmonization, reduced risk premia in financing and, finally, the positive growth effects deriving from EU membership will have significant repercussions for the prospective new members' national budgets.[4]

4 Transfers in the enlarged European Union after 2006

The forthcoming EU enlargement creates an entirely new situation with the composition of the Union in relation to its members' economic strength. The original six members (France, Germany, Italy and the Benelux countries) were rather homogenous in their average level of economic development; that situation changed after the first enlargement, when Ireland entered the Union with its economy lagging substantially behind the average. The number of laggards increased to two when Greece joined the European Community in 1981, and to four when Spain and Portugal became members in 1986. The 8 to 4 ratio of 'rich' and 'poor' members in the EC-12 was next modified in the course of the latest wave of enlargement in 1995 when Austria, Finland and Sweden joined. This time the shift took place in favour of the highly developed group within the Union, changing the proportions to 11 to 4. Due to Ireland's exceptionally rapid economic growth in the past decade, this country has caught up with the highly developed group and now even exceeds the EU-15 average per capita GDP on the eve of the forthcoming enlargement. By 2007 the proportions within the pool of the present 15 members would be 12 to 3, with Greece, Portugal and Spain still clearly below the average level of development.

Resources from the EU budget to diminish differences in the level of economic development of the member countries (that is, fostering cohesion) may make up 0.45% of the EU's GDP up until 2006 as approved by the Berlin Council in 1999. The respective resources are delimited by another instrument as well: structural actions' transfers may not exceed 4% of the GDP of any recipient country in any year. Throughout three successive financial planning periods (1989-1993, 1994-1999 and 2000-2006) per capita transfers increased, from EUR 143 to EUR 187 and to EUR 217 (see European Commission, 2002c, p. 6). Despite this tendency for increasing transfers, with the hard bargaining during the accession negotiations in mind, it is difficult to imagine that in the next planning period (2007-2013) either limit will be raised (0.45% of the EU GDP for fostering cohesion and 4% of GDP as the upper limit for available EU transfers for any recipient country, respectively).

This means that the bargaining for the redistributed resources will be more difficult than ever. The accession of the new members will increase the EU's aggregate GDP by about

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4 See Kopits and Székely (2002), Breuss (2001), Havlik (2002), Fidrmuc et al. (2002).

5%[5], with an accordingly modest contribution to the EU budget. Thus available resources for redistributing will hardly increase, while claims on transfers by potential recipients will be substantially higher: the gap between the economic development levels of the member states above EU average and those below EU average will be much wider in the EU-25 than it was in the EU-15.

In the new, enlarged Union of 25 member states the situation of the highly developed core will change, inasmuch as most of those regions that were eligible for structural support will no longer be eligible in the wake of the emerging disparities – if the present rules of the game prevail. The 'genuine' losers among the present member states will be Greece, Portugal and Spain, i.e., those cohesion countries which would further enjoy structural support if the enlargement did not take place. In order to minimize the shock caused by ceasing structural support in the respective EU-15 regions involved, the Second Cohesion Report recommends alternative solutions (European Commission, 2001a, p. xxxiv):

- Keeping the threshold of 75% of the EU average as the criterion for eligibility for support in the enlarged EU, but making support available for regions outside the least developed areas through a separate set of priorities and criteria.
- Keeping the 75% threshold, but making available temporary support (phasing out), (a) for regions that, from 2006 onwards, would no longer be considered laggards in a EU-15, and (b) a higher level of support for regions that would have remained below 75% of the EU average without enlargement.
- Setting the threshold higher than 75% to eliminate the automatic excluding effect caused by the lower EU average after enlargement.
- Fixing two thresholds of eligibility, one for the regions in the present EU-15 and one for the new members.

While each of the four solutions, except the last one[6], would be technically suitable to face the challenge, the fundamental problem remains unsolved. With the given volume of resources available for redistribution, old and new members will compete for the same stakes. The two different aims will also compete: first, the need to avoid a drastic decrease of structural support in present member states whose gap with the EU average has not closed in real economic terms, but will close in statistical terms after the enlargement; and second, that the essence of cohesion policy is to focus structural support on the least developed regions of the European Union as a whole.

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[5] This calculation done at current exchange rates however underestimates the contribution of the accession countries to output of the Enlarged European Union. Valuing their GDP at purchasing power parities roughly doubles their share in EU(25) GDP.

[6] This would mean the application of double standards for old and new members, contradicting the basic principles of the European Union.

Table 2

GDP per capita in selected countries at current PPPs (EUR/ECU), from 2003 at constant PPPs

	1995	2004	2007	2013
			projection assuming 4% p.a. GDP growth and zero population growth p.a.	
Czech Republic	11281	15628	17580	22244
Hungary	8236	13634	15336	19406
Poland	6302	10302	11588	14663
Slovak Republic	8235	13426	15102	19109
Slovenia	11607	18441	20744	26247
Estonia	5927	11774	13245	16759
Latvia	4407	9127	10267	12990
Lithuania	5235	10393	11691	14792
Cyprus	14150	22980	25850	32708
Malta	9330	14406	16205	20505
Bulgaria	5004	8463	9520	12046
Romania	5768	6603	7427	9398
Greece	11924	17906	20142	25486
Portugal	12840	18937	21301	26953
			projection assuming 2% p.a. GDP growth and zero population growth p.a.	
Austria	19937	27420	29098	32769
Germany	19890	25869	27452	30916
EU(15) average	18182	25204	26812	30355
EU(25) average	16382	23038	24630	28183
EU(27) average	15677	22037	23584	27046

European Union (15) average = 100

	1995	2004	2007	2013
Czech Republic	62	62	66	73
Hungary	45	54	57	64
Poland	35	41	43	48
Slovak Republic	45	53	56	63
Slovenia	64	73	77	86
Estonia	33	47	49	55
Latvia	24	36	38	43
Lithuania	29	41	44	49
Cyprus	78	91	96	108
Malta	51	57	60	68
Bulgaria	28	34	36	40
Romania	32	26	28	31
Greece	66	71	75	84
Portugal	71	75	79	89
Austria	110	109	109	108
Germany	109	103	102	102
EU(15) average	100	100	100	100

(Table 2 continued)

Table 2 (continued)

European Union (25) average = 100

	1995	2004	2007	2013
Czech Republic	69	68	71	79
Hungary	50	59	62	69
Poland	38	45	47	52
Slovak Republic	50	58	61	68
Slovenia	71	80	84	93
Estonia	36	51	54	59
Latvia	27	40	42	46
Lithuania	32	45	47	52
Cyprus	86	100	105	116
Malta	57	63	66	73
Bulgaria	31	37	39	43
Romania	35	29	30	33
Greece	73	78	82	90
Portugal	78	82	86	96
Austria	122	119	118	116
Germany	121	112	111	110
EU(25) average	100	100	100	100

European Union (27) average = 100

	1995	2004	2007	2013
Czech Republic	72	71	75	82
Hungary	53	62	65	72
Poland	40	47	49	54
Slovak Republic	53	61	64	71
Slovenia	74	84	88	97
Estonia	38	53	56	62
Latvia	28	41	44	48
Lithuania	33	47	50	55
Cyprus	90	104	110	121
Malta	60	65	69	76
Bulgaria	32	38	40	45
Romania	37	30	31	35
Greece	76	81	85	94
Portugal	82	86	90	100
Austria	127	124	123	121
Germany	127	117	116	114
EU(27) average	100	100	100	100

Sources: Benchmark Results of the 1996 Eurostat-OECD Comparison by Analytical Categories, OECD, 1999; Purchasing Power Parities and Real Expenditures, 1999 Benchmark Year, OECD, 2002; national statistics; WIFO; **wiiw** estimates.

Benchmark PPPs for 1996 and 1999 extrapolated with GDP price deflators. GDP per capita for accession countries according to **wiiw** Annual Database, for OECD countries according to OECD Economic Outlook statistics converted to EUR.

But the problems of redistribution will not be confined to the present EU members. The disparities in the level of economic development among the ten new members are also considerable and will even grow when Bulgaria and Romania join the Union, perhaps as soon as 2007. In the *First progress report on economic and social cohesion*, the Commission operates with three groups of countries in a European Union of 27 member countries (see European Commission, 2002c, p. A-13). The first group consists of 12 'rich' members of the present EU-15 with an average level of development about 20% above the average of the EU-27 (at PPS, year 2000). The second group has three members from the present EU -15 (Greece, Portugal and Spain) and the three most developed accession countries (the Czech Republic, Cyprus and Slovenia) with a group average of 87% of the EU-27 average level of economic development. The third group includes all other present applicant countries at about 41% (group average) of the EU-27 average (see European Commission, 2002c, p. 9).

If the concept of solidarity were taken very strictly, structural support should be concentrated in the least developed regions. Table 3 illustrates the consequences in 2007. Working with the assumptions that, (i) 0.45% of EU GDP will continue to be available for financing structural actions, (ii) no member may receive more transfers than 4% of its GDP in the framework of structural actions, and (iii) the allocation starts with 'full satisfaction' of the least developed EU members (only after they have reached their ceiling for transfers will resources be allocated to the next least developed members), the results are as follows.

Table 3

Hypothetical share of groups of new EU members in transfers from the Structural Funds and the Cohesion Fund in 2007

in %

	Group A= 3 Baltic states and Poland	Group B= Group A + Hungary and Slovakia	Group C= Group B + Czech Rep. and Malta	Group D= Group C + Cyprus and Slovenia
Maximum share in total available resources for structural actions in the **EU-25** in 2007	41	60	75	79

	Group A= 3 Baltic states, Poland, Bulgaria and Romania	Group B= Group A + Hungary and Slovakia	Group C = Group B + Czech Rep. and Malta	Group D= Group C + Cyprus and Slovenia
Maximum share in total available resources for structural actions in the **EU-27** in 2007	59	77	91	96

Note: The basic assumptions used are as follows: 0.45% of the EU GDP is available for structural actions, transfers in the framework of structural actions reach the maximum level permitted (4% of GDP).

Source: Data of Table 2.

In a EU-25, the group of least developed new members, the Baltic states and Poland, would absorb 41% of total available resources for structural actions. If all new members were added (except for Slovenia and Cyprus, which are more or less at the same level as the three remaining cohesion countries of the EU-15) they would absorb 75%.

The picture differs substantially in a EU-27 in the year 2007, assuming that the bloc of the least developed countries – Bulgaria, Romania, the Baltic countries and Poland – receive, under the same conditions, 59% of the available sources. This exercise shows that relatively more developed new members, in particular Hungary and Slovakia, but also the Czech Republic and Malta, will have a substantially worse position in the bargaining process in a EU-27 as compared to a EU-25. Quite obviously it is not feasible that the new members get nearly all available resources, and the maximum assistance for the least developed new members already consumes nearly two thirds of total available resources. The Czech Republic, Hungary and Slovakia will probably have to share the remaining one third with the 'rich' new members Slovenia and Cyprus, the former cohesion countries and some highly developed members with a few underdeveloped regions.

Strong concentration of transfers from the Structural Funds and the Cohesion Fund as illustrated above would most probably reduce the motivation to participate in the European integration of those countries which are not beneficiaries, or only to a marginal extent, of the intra-EU redistribution in the enlarged Union. It must be recalled that structural actions have always had a dual function in the EU: first, to reduce disparities in the development at national and regional levels, and second, to facilitate the integration process, strengthening sectoral policies and institutional development. 'Broadly speaking this is because the structural and cohesion funds have functioned as a pool of money that could be deployed in order to remove political obstacles on the road to integration. Expressed in a cruder fashion: to buy out countries that otherwise would refuse to participate in the one or other reform process.' (Tarschys, 2000)[7] In 1999, out of the 11 rich EU member states (i.e., the EU-15 minus the cohesion countries) 7 had at least one, but typically more Objective 1 regions with a development level below 75% of the EU average.[8] Karlsson points out that the availability of EU transfers for local projects contributed to diminishing the archetypal prejudice against 'the bureaucracy in Brussels' in the member countries (Karlsson, 2002, p. 63).

The main issue of the new financial framework will be to find a balance between the two functions of structural actions: to diminish regional disparities by focusing resources in the least developed countries/regions and to facilitate cohesion in the whole integration bloc.

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7 As cited by Karlsson (2002), p. 63.

8 Belgium 1, Germany 6, France 5, Italy 8, Netherlands 1, Austria 1, UK 3 regions. Sweden and Finland had special support for their northern territories. The only countries left out are Luxemburg and Denmark (See European Commission, 2002c, p. A-19.)

To make the solution of this problem even more difficult, the own resources ceiling must be observed, i.e. the extent of redistribution may not increase. More resources for structural actions could be made available through a radical reform of CAP, but this is an option of minor probability.

A further question is whether the tools invented to diminish relatively small disparities, as in the present EU-15, are really suitable to treat problems in countries/regions with a wide income gap relative to the EU average, or the whole set of instruments should be reconsidered. Reforms along this line could lead to a complete restructuring and a new philosophy of structural actions in the enlarged Union, although the divergence of interests of various country groups would not disappear. It would, however, become easier to address the related problems in the framework of an overall reform instead of trying to adjust the existing distribution schemes to a situation undergoing fundamental changes.

In the course of discussions on enlargement it has often been stated that at the level of important economic processes (trade and FDI) the accession has already taken place. Concerning the redistributive aspects of European integration, we can stand this statement on its head and point out that enlargement can only be considered successfully completed once the new financial framework has been signed by all members in 2006.

B Macroeconomic implications of EU membership for CEECs

In this section we shall discuss the implications of EU membership for the conduct of macroeconomic policy. An extensive amount of research has been undertaken on the macroeconomic policy challenges that the CEECs will encounter in the wake of EU accession. Much of the discussion has focussed on the implications of choosing exchange rate regimes and, in particular, on the issue of the time horizon of EMU membership and on the situation the new members will face prior to full EMU membership. We shall, in the following, discuss the monetary and exchange rate policy challenges of the new member countries[9] and also return to some fiscal policy challenges. In section C we shall then discuss the longer-run growth and catching-up perspectives of the new member countries.

Figs. 1-4 present some graphs concerning recent macroeconomic developments in the accession countries (ACs).

[9] In the following we shall use 'new member countries', 'accession countries (ACs)', and 'candidate countries' interchangeably. It refers to the eight Central and Eastern European countries which are going to join the European Union in May 2004, i.e. the Czech Republic, Hungary, Poland, Slovakia, Slovenia and the three Baltic states. At times we shall also refer explicitly for comparative purposes to Bulgaria and Romania. When these two countries are included – as in Figure 7 – we refer to the CEEC-10 as compared to the group of Central and Eastern European accession countries, also referred to as CEEC-8.

Figure 1a

GDP deflator

change in % against preceding year

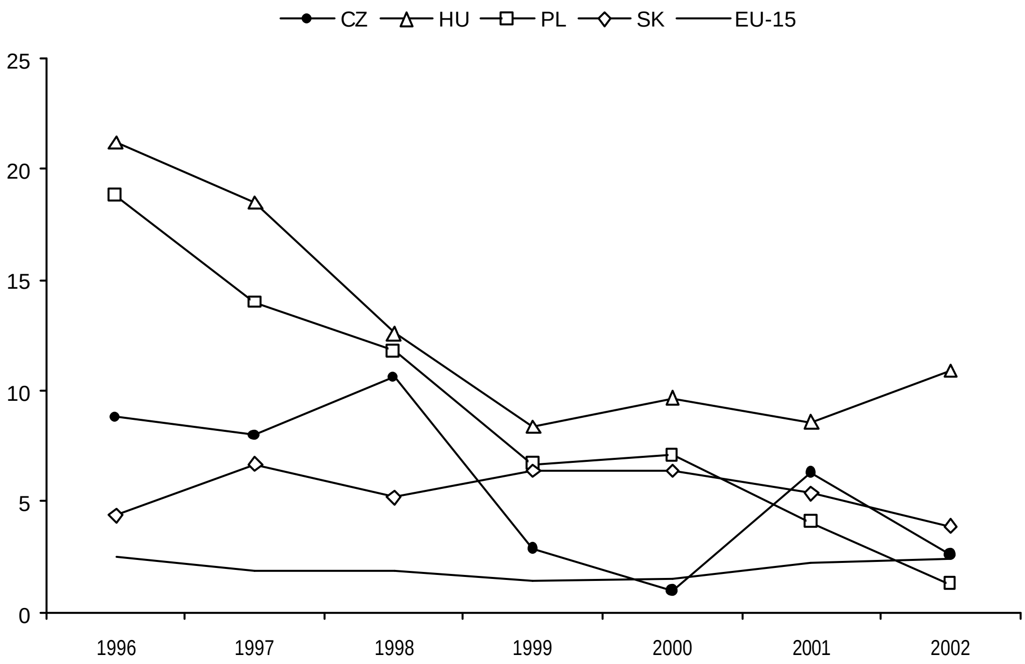
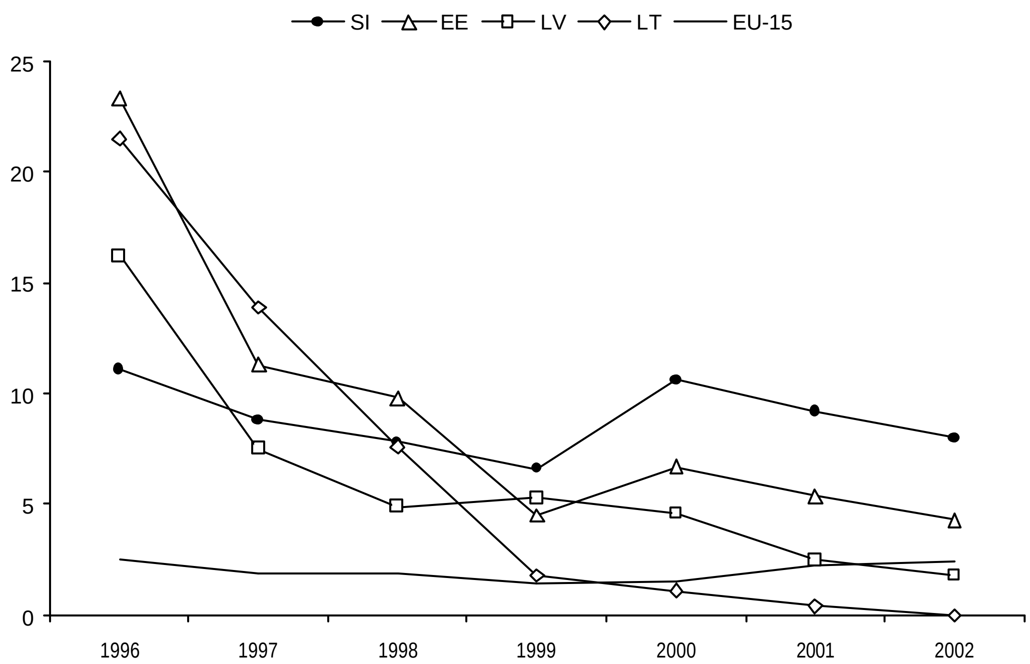


Figure 1b

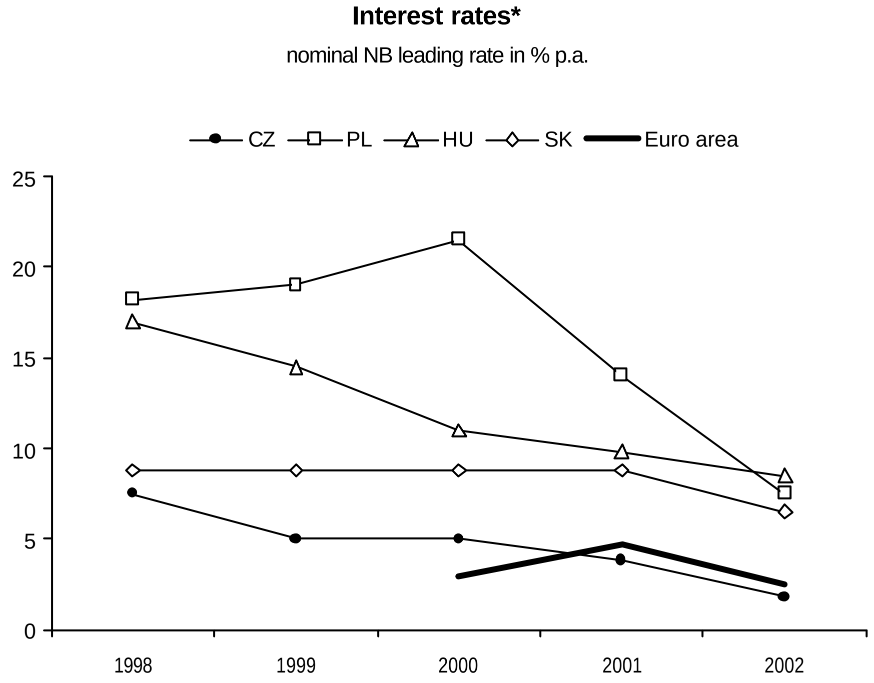
GDP deflator

change in % against preceding year



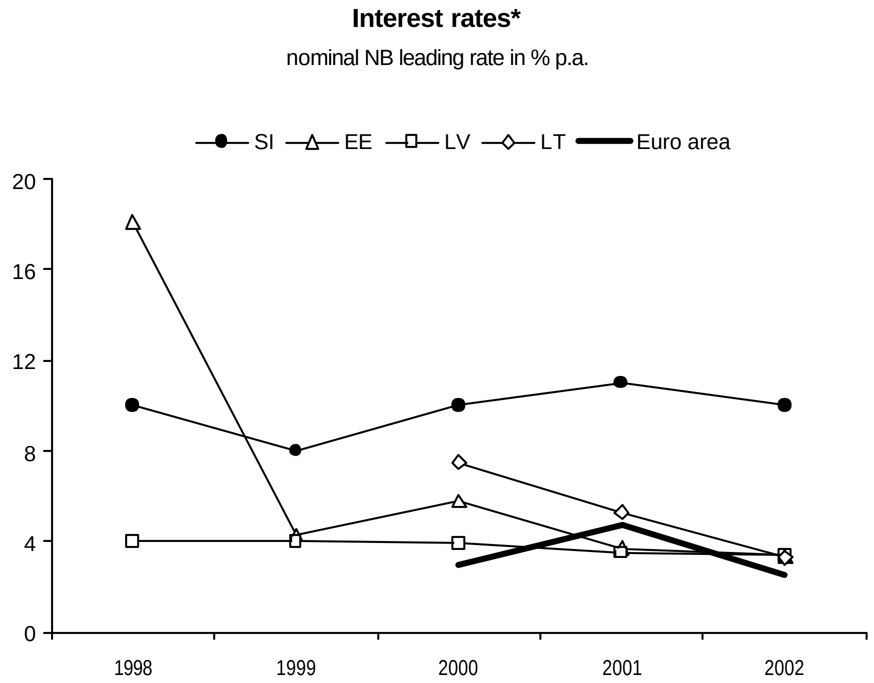
Source: **wiiw** Database incorporating national statistics; OECD.

Figure 2a



Note: Euro area; interest rate for main financing operations.

Figure 2b



Note: EE, 1-month TALIBOR interbank rate. LT, 1-month VILIBOR interbank rate. Euro area; interest rate for main financing operations.

Source: **wiiw** Database incorporating national statistics; ECB.

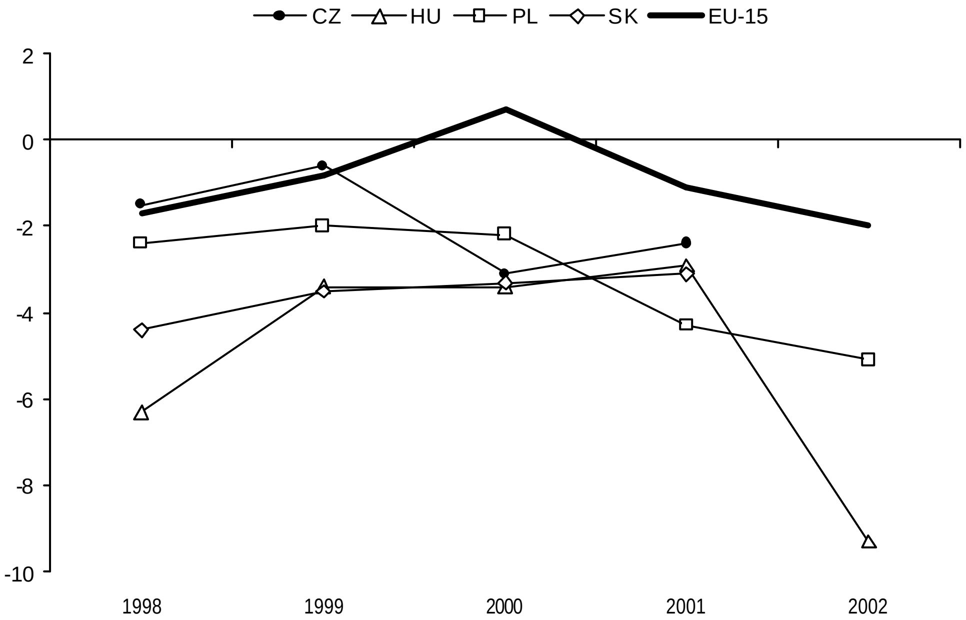
We can see that there was in general an impressive decline in inflation rates in the candidate countries, as well as in nominal interest rates (Figs. 1 and 2 respectively); however, with some exceptions they still hover above the EU rates. We shall return to the issue of nominal convergence later on. As regards an assessment of the fragility of the system of financial intermediation, let us just shortly mention that most of the transition economies have gone at different points through dramatic processes of bank restructuring. Conditions in the banking systems (linked mostly to stalemates in the process of corporate restructuring) had previously led to serious interruptions in the growth processes or outright recessions. By the late 1990s/early 2000s the conditions in the banking systems have much improved and in all the first round accession countries (Slovenia was a laggard in this respect until very recently) a substantial segment of the banking system is owned by foreign banks. This implies that from the balance-sheet point of view, the banking system in the ACs is in much better shape than it was in the 1990s. There is still an assessment that the degree of financial intermediation in ACs is much lower than in EU member countries and that some of the features of thin and imperfect capital markets persist (such as the difficulty for SMEs to get access to credit); in these respects substantial further progress should still occur.

On the fiscal side, the situation remains problematic. The fiscal position in some of the economies is still out of line with EU macroeconomic guidelines which aim at fiscal balance over a full cycle; the fiscal deficits in quite a few of the ACs still exceed the 3% deficit limit (Fig. 3). There are strong arguments (see Buiter and Grafe, 2003) that the application of these guidelines to the candidate countries is misplaced. The reasons for this are twofold: firstly, from the point of view of 'fiscal sustainability', it would be inappropriate to neglect differences in structural characteristics and in the expected trend growth rates of the respective economies. In this respect, it is clear from the analysis of what constitutes a sustainable debt/GDP situation that economies with either different initial debt levels (which are relatively low in ACs) or with different prospective trend growth rates (in principle, also with different demographic profiles) would be able to carry different public deficit/GDP ratios over the medium-run. Secondly, there is still a legacy from the transition process which is to be completed, as well as the tasks of developmental catching-up and de facto integration with the EU: there is a need in transition economies to shoulder substantial burdens of ex-ante investments to overhaul an outdated capital stock, to achieve environmental levels somewhat in line with current EU members, to finance the reorientation of educational and training institutions to match the dynamic requirements of a catching-up market economy, to build up infrastructure facilities, to support the institutional changes which still have to be completed to comply with the acquis, etc. In all these respects, there is an argument in favour of inter-generational equity, which is that not only the current generation should carry the burdens of these investments, but that these should also partly be shared by future generations which are going to be the beneficiaries

Figure 3a

General government budget balance 1)

in % of GDP

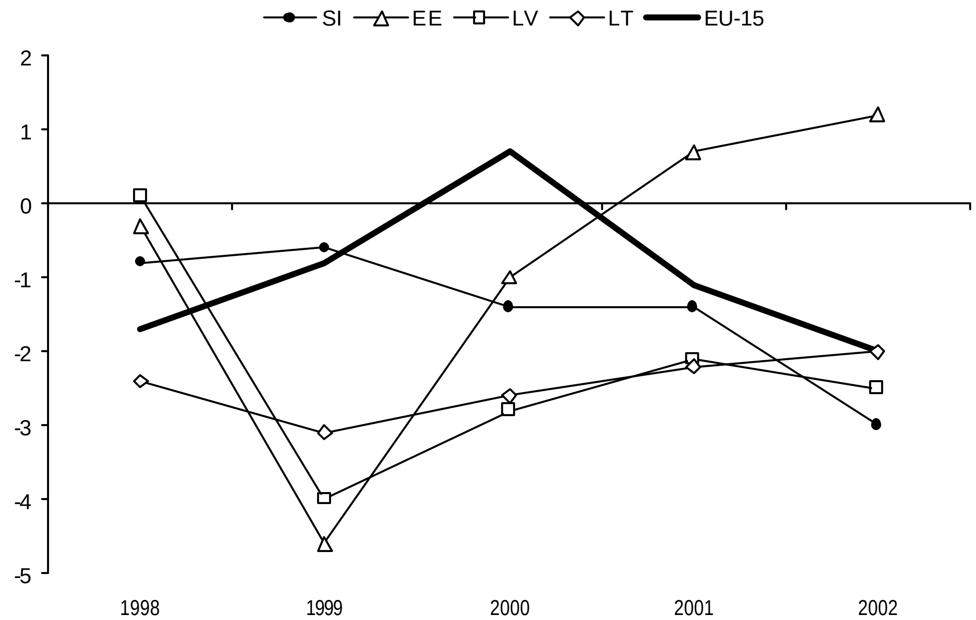


1) Poland: Central government budget balance.

Figure 3b

General government budget balance

in % of GDP



Source: **wiiw** Database incorporating national statistics; OECD.

of the increases in productivity and income levels which such investments will entail. This would imply the build-up of some degree of public debt, as long as this is within the bounds of 'fiscal sustainability' and does not give rise to crisis situations. As the strict adherence to the zero deficit criterion over the business cycle is linked to EMU membership, it is clear that a decision in favour of early EMU membership will also impose this criterion on the use of fiscal policy. This would, however, be inconsistent with the views set out above.

All the above are medium- to long-run arguments to adjust the deficit and debt criteria in the light of the specific circumstances of the new member countries, but one should not forget that the fiscal position also poses problems of macroeconomic stability in the short term. In the short term there is a danger of ACs suffering more than the more mature EU economies from volatile movements in public deficit/GDP levels with ensuing impacts upon interest rates and upon the situation in financial markets more generally. Measurements of the volatility of growth rates of catching-up economies in general, or of transition economies in particular, show that cyclical volatility is more pronounced in these economies (see Azariadis, forthcoming). This brings with it the danger that the deficit/GDP ratio moves outside the corridors either indicated by the Maastricht criteria or potential threshold levels beyond which international financial markets react detrimentally. This can, in turn, affect the public and private sectors negatively in terms of higher interest rates and bring about a deterioration in credit ratings.

The greater volatility of the business cycle and the possibility that structurally the ACs are more prone to react to (internal or external) shocks[10] also establishes a greater need for counter-cyclical policy. To make room for such a policy, there is in turn a justification for a longer-term fiscal-deficit target, which allows stronger reactions in a downturn without moving into danger zones in which the above-mentioned negative reactions in financial markets would take place. In general, ACs will continue to undergo extensive structural adjustment processes also after joining the EU, often contributing to macroeconomic volatility; hence they will continue to be in a vulnerable position.

It follows that while the longer-run sustainability of the fiscal situation should be the basic guideline for setting the rules for fiscal planning, the shorter-term concern for public deficits will also require detailed monitoring. A use of rigid fiscal policy guidelines that ignores the specific situations the ACs will find themselves in will not be conducive to their catching-up process. Fiscal policy should be mostly designed to facilitate a smooth growth process. While this target is shared amongst most economists, there remains quite a lot of disagreement over the type of fiscal policy arrangement which will most likely attain this target. Independently of the positions of the new member countries, there has been a growing debate amongst economists and policy-makers about possible reforms of the

[10] There is evidence for somewhat higher degrees of concentration and specialization of industrial structures compared to the advanced EU incumbents (see wiiw, 2003).

Growth and Stability Pact (see e.g. Wyplosz, 2002); some of the suggestions have gone in the direction of focussing more strongly on economically justifiable criteria of fiscal sustainability rather than simply on flow criteria (the year-by-year deficit to GDP target), giving special treatment to those forms of public expenditure which strengthen an economy's long-run productive potential (and hence trend growth path), as compared to those that are purely consumptive expenditures. The debates concerning reform considerations of the Growth and Stability Pact will no doubt increase with the accession of the new members as the range of countries with different structural characteristics, inter-temporal and inter-generational trade-offs and trend growth rates widens.

As it stands now, upon EU accession, the new member countries will participate in the EU's economic and fiscal policy coordination and surveillance framework (Broad Economic Policy Guidelines, BEPG, and Stability and Growth Pact, GSP). In essence this amounts to being guided by the targets set in the Stability and Growth Pact which oblige member countries to obey the 3% fiscal deficit limit even in times of 'normal' economic downturns; for outright recessions, the GSP rules include escape clauses. The accession countries will, prior to EMU membership, have to present annual Convergence Programmes to the Commission and the Council of Ministers and they will be expected to follow the annual recommendations of the Council in relation to the BEPGs. However, prior to EMU membership, there are no sanctioning mechanisms applied in the case of failure to follow the recommendations in the BEPGs. The pressure to conform is nonetheless judged to be quite substantial.

Given the complications of reaching any agreements at the EU level on reforms of the existing policy frameworks, it can thus be expected, and this has partly already taken place in the pre-accession phase, that the new member countries will have to comply with existing policy frameworks and will thus face much stronger pressures to conform to tighter fiscal policy guidelines than they are used to in current practice. While this will no doubt lead to a stronger determination to make serious attempts to tackle issues which endanger longer-run fiscal sustainability (such as social security reforms), analysts also believe that the shift to obeying the fiscal criteria, which get applied much more tightly when early entry to the EMU is targeted, might shift the emphasis too much from a growth and catching-up perspective towards fulfilling the pre-set criteria of macroeconomic stability in the short term. We now turn to the debates over the timing of the entry to EMU.

The exchange rate issue and the debate on the timing of EMU entry is extremely complex and so far economists have not converged towards a common position. Quite a few of the arguments discussed above with respect to fiscal policy also apply here in relation to appropriate exchange rate policy. The overall aim is to enter a framework in which sustainable and 'smooth' growth can best be achieved. The question is how to achieve this target.

It is well known that the traditional approach to the question of when a country should join a monetary union depends on whether its own, and the structures within the union, allow it to fulfil the so-called OCA ('optimum currency area') criteria. These are the criteria which have been set up to judge whether the costs of losing the flexibility to maintain sovereignty over certain policy instruments (independent exchange rate and monetary policy) are outweighed by the benefits of a joint currency union (lower transaction costs, lower volatility in an important set of prices, in particular the stability of exchange rates with the main trading partners, potentially lower interest rates due to a greater credibility of a centralized monetary policy, potentially lower trend inflation rates, less danger of destabilizing capital flows, etc.). The application of OCA criteria include the analysis of the degree to which a particular country is prone to asymmetric shocks in relation to the other member countries of the monetary union. This can be judged by looking retrospectively at the track record of synchronicity of business cycles and prospectively by judging whether production structures have become sufficiently diversified and have converged. Furthermore, whether there are strong inter-country transmission mechanisms of shocks through trade, FDI and other linkages and the manner in which a country responds to such shocks by relative adjustments in product and labour markets (through prices or quantities, the latter including the inter-regional and inter-country mobility of factors of production). The analysis of the relative fulfilment of these criteria in relation to particular countries has always been the core element in judging whether a country (and the other members) would net-benefit from joining a currency union or whether a currency union should be formed in the first place.

Many of the studies have shown that when currency unions are formed they often include countries which – at the time of joining such a union – do not fulfil the OCA criteria. One reason for such an outcome could be that political considerations simply override the narrow economic criteria considered by OCA analysis. Apart from this, another approach has recently gained popularity which has focussed attention on the potential 'endogeneity' of OCA criteria fulfilment (see Frankel and Rose, 2002). This endogeneity refers to a situation in which OCA criteria are not fulfilled by countries as long as they are outside the currency union, but that certain processes are set into motion through currency union membership which imply that the criteria are more likely to be fulfilled ex post. From an a priori theoretical analysis, there are strong grounds for believing in this endogeneity: by lowering transaction costs and removing exchange rate volatility with the main trading partners, a currency union will intensify trade links and also intensify further production integration. This, in itself, will lead to a strengthening of transmission mechanisms of shocks and hence to a stronger synchronicity of business cycles. On the other hand, some authors have argued, based on traditional trade theory (Krugman, 1993), that trade intensification can also lead to more pronounced patterns of specialization, thus increasing the likelihood of asymmetric shocks. More recent analysis has come out less in favour of Krugman's hypothesis, as tighter integration does indeed lead – over time – to developmental convergence, to more intra-industry trade and more horizontal rather than vertical production differentiation and integration. In the particular case of EU and EMU integration, there is the additional, very important fact, that we are dealing here with a union characterized by 'deep integration' (a term coined by Lawrence, 1996). Such a union is more than a customs and currency union, as it has unified a number of other central areas of policy making (such as competition policy, regional policy, parts of social policy, strong coordination of fiscal policy, etc.) and has moved very far in the integration of product markets, capital markets and – though somewhat less successfully – labour markets. In such a context the above mentioned processes leading to increasingly integrated structures get intensified, which leads to the faster transmission of shocks, the synchronization of business cycles and of policy responses to such cycles.

As against this picture, we must acknowledge that the ACs are a group of countries which are still at substantially lower levels of economic development (as measured by income per capita and productivity levels), and still in a process of fundamental structural adjustment (partly remnants of transition processes, partly adjustments in structural and institutional terms related to developmental and catching-up processes). Thus, while membership of a union where 'deep integration' is a very important feature, and granting that this will no doubt speed up the convergence and integration processes more than if one remained outside the union, such processes still take time. Furthermore, economic integration is itself the cause of (sometimes dramatic) adjustment processes which require a policy framework which deals with such pressures in a (welfare) efficient manner. Hence the question still arises of the point at which the (practically) irreversible step towards full currency union should be taken, with all the obligations this involves in a wide range of areas of policy-making. Here the views of economists, both in the ACs as well as in the current EU, are still not unified.

There are two additional considerations which are brought into the picture in the current debates on the timing of EMU membership of the ACs: one has to do with the nature of full capital market integration and the scope for destabilizing movements of capital, the other refers to the well-know Balassa-Samuelson (B-S) hypothesis with respect to price level convergence between economies as a catching-up process unfolds.

As regards the first issue, the potential danger of destabilizing capital flows in the context of a very high degree of capital market integration, there is an influential study by Begg et al (2002). As this study discusses the issue in great detail, with an extensive evaluation of international experiences with different exchange rate regimes, we shall be brief on this topic. Within the context of EU accession, full capital market liberalization is part of the acquis, and no exemptions were requested by the ACs in the context of entry negotiations (except for transition regulations regarding the acquisition of agricultural land). Hence the conditions of full capital market liberalization have to be taken for granted and the conduct of economic policy has to adjust to this fact. In our opinion, however, the further regime switch involved in this respect, compared to the situation of ACs just prior to accession, will not be that far-reaching as some commentators seem to suggest. ACs have already largely liberalized their capital transactions with the EU. Hence, the pressures under which the fiscal and monetary authorities already had to operate over the past few years, and which they have mastered with varying degrees of success, are a good indication of what is to be expected immediately after accession. Nonetheless, one must acknowledge that the financial systems in the ACs remain more fragile than in the EU member countries and imperfections, as well as remaining interest rate differentials, increase the attractiveness of borrowing from abroad. However, the dangers of unduly large capital inflows and outflows would increase with a policy which adopts very ambitious targets with respect to complete convergence of inflation rates with EU core members at a very rapid rate (see the discussion on the B-S process below) and which attempts to achieve a fixed exchange rate regime which then turns out to be unsustainable. This was the lesson learnt from numerous experiences both in Central and Eastern Europe as well as internationally over the last decade and a half. Thus a concerted effort to utilize the available degrees of freedom under the ERM regime (in which most of the ACs will find themselves upon EU accession) rather sensitively in relation to targets which can be realistically attained and sustained will also project the right signals to international financial markets. The mix of policy instruments (inflation targeting, fiscal policy and growth enhancing policies) should be employed in such a way that individual new member states are seen as working in harmony rather than in conflict with achieving smooth growth. Full EMU entry should follow a period in which structural adjustment pressures are coped with within a policy framework which still maintains some degree of flexibility. The intention of the design of the Maastricht criteria for EMU entry was after all to show that candidate countries are able to fulfil the criteria of nominal convergence and of fiscal stability on a sustained basis rather than as a temporary blip.

Tests of the Balassa-Samuelson (B-S) hypothesis have come to the forefront of the analysis of price convergence processes and the way in which these might conflict with the criteria set as conditions for joining EMU. The B-S insight into the reasons for price level differences (and relative exchange rate under-valuation) across countries which are at different levels of economic development has turned out to be an important tool for analysing the processes by which price level convergence would take place between countries such as the ACs and the member states of the EU. The analysis is based on monitoring differences in relative productivity levels in tradable and non-tradable sectors between more advanced and less advanced economies. Given the assumptions that small open economies are price takers in the tradable sector, that workers obtain their marginal products and that the labour force is mobile across sectors, a differential catching-up process in productivity in the tradable goods sector (where initial productivity gaps are assumed to be higher) pushes up the relative price of the non-tradable sector and hence

Figure 4a

Real appreciation*, 2000-2002 (base month January 2000)

(national currency vis-à-vis EUR, PPI-deflated)

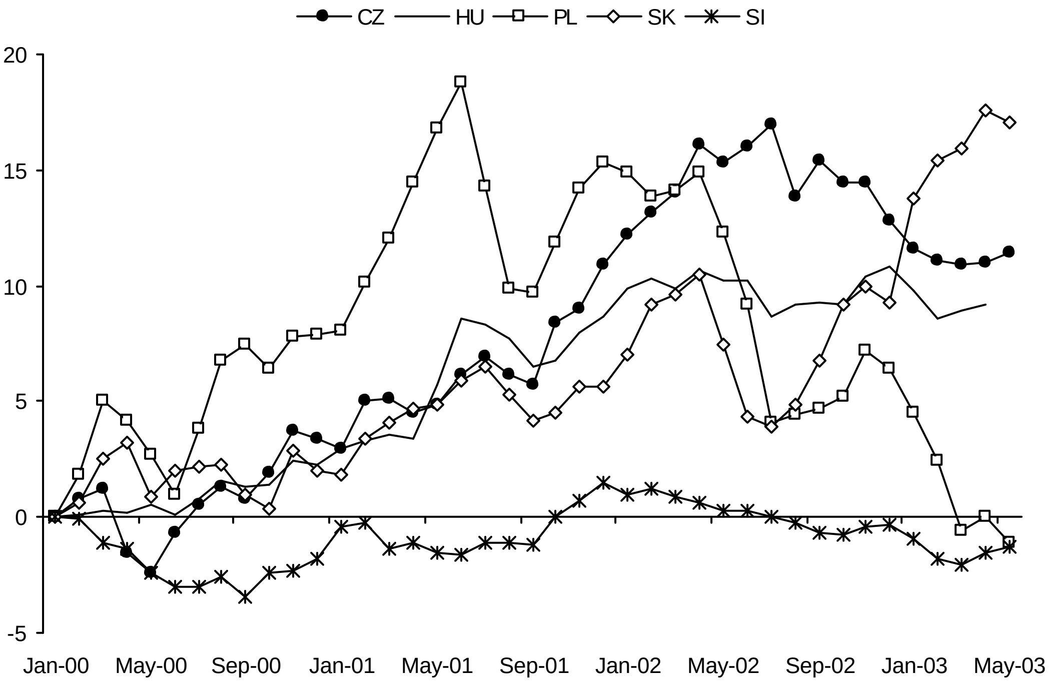
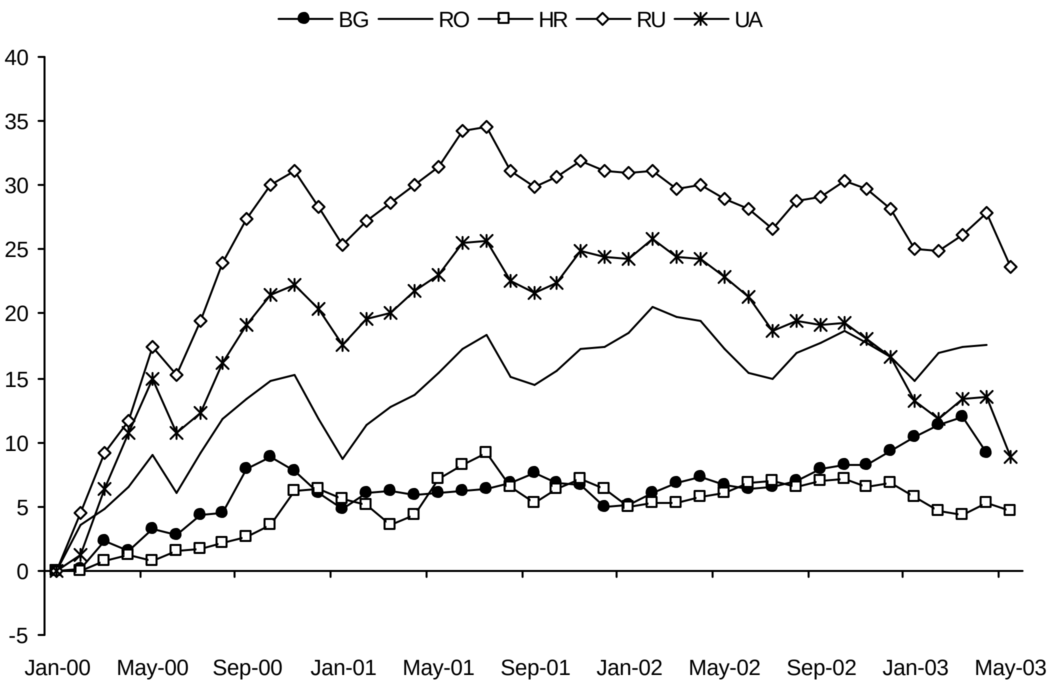


Figure 4b

Real appreciation*, 2000-2002 (base month January 2000)

(national currency vis-à-vis EUR, PPI-deflated)



*

An increasing line means a real appreciation.

Source: **wiiw** Monthly Database incorporating national statistics.

the overall price level in the catching-up economy. It thus leads to a real appreciation of the currency and this can be achieved either through a higher inflation rate in the catching-up economy and/or the appreciation of the nominal exchange rate. Fig. 4 shows that we are indeed witnessing a substantial real appreciation of the currencies of most of the ACs in relation to the Euro zone. Estimates of the Balassa-Samuelson process (of real exchange rate appreciation) between the CEECs and the EU have been made by a number of authors (see particularly Halpern and Wyplosz, 1997 and 2001; for an overview of available studies, see European Commission, 2002e, Ch. 5) and have been found to be quite substantial. These authors have generally suggested that there will be substantial scope for real exchange rate appreciation by the new members also after accession. This has generally been a strong argument against early membership of the EMU. The reason is that by the existing rules for EMU membership, a country has to show a sustained period in which there is nominal exchange rate stability in relation to the Euro and in which inflation rates – again over a sustained period – remain close to those of the low inflation members of the EMU. These requirements are in obvious conflict with a significant B-S process. Hence, as long as the EMU accession rules are not changed, a significant B-S process would not allow EMU entry.

More recently some authors have argued – based on careful econometric analysis – that some of the existing studies overestimate the scope for a further B-S process for accession countries in the future (see particularly the estimates by Coricelli and Jazbeg, 2001, also presented in European Commission, 2002e, Ch. 5). They argue that using past time series of ACs as a predictor for future trend changes in relative price structures, overestimates the scope for the B-S process in future, as the relative price changes in the past include an initial period in which strongly distorted price structures inherited from a planned economy still had to adjust (think of the many highly subsidized areas, especially in the non-tradable sector such as rents, public transport, etc.). If one decomposes the relative price structure changes into a component which reflects the adjustment of relative prices from a 'distorted' planned economy to a market environment and a pure B-S adjustment, one obtains much lower, although still substantial estimates of a B-S adjustment process. Our own view is that the adjustment process in relative price structures due to past 'distortions' is still not completed (there are substantial adjustments still to be expected in many CEECs in rental markets, in public transport, in health, etc.) and this adjustment will continue to play a role in the future; secondly, productivity level comparisons (see e.g. wiiw, 2003) still show very substantial productivity gaps in the tradable sectors of the ACs in relation to the EU members and, furthermore, that productivity catching-up is very uneven across the different sectors of the economy (see also Landesmann, 2000, and Landesmann and Stehrer, 2002). There remains thus a substantial scope for the B-S process to take place. This amounts to a strong structural argument for either delaying EMU accession or to change the rules for such an accession as the existing ones would prevent the effects of such a structural adjustment process. ERM entry, however, is feasible, as it allows adjustments to the central parity rates by common agreement.

We now return to the issue of whether early EMU entry will positively or negatively affect macroeconomic stability in the ACs (for a careful discussion of these issues, see Begg et al., 2002). There is no agreement on this issue. The authors who plead for early entry to EMU base their argument upon the belief that such an entry would provide a safeguard against the potentially destabilizing inflows and outflows of capital which were discussed above and which – even when the fundamental policies pursued were sound – would lead to destabilizing exchange rate crises. In conditions of fully liberalized capital movements (the takeover of the acquis does not allow any restrictions in this respect) such destabilizing capital movements could not be prevented and in fact, it is argued, will almost by necessity take place as we move towards the 'end-game' when the markets test the final phase before an irreversible rate with the Euro is being fixed.

The other perspective related to macroeconomic stability is whether the ACs can afford to give up the safety valve of exchange rate adjustments when they move into unsustainable current account positions. We have seen in the past that CEECs have not been able to sustain a fixed-peg situation (with the exception of those economies which have adopted a strict currency board regime, i.e. Bulgaria and Estonia). Such arrangements have led to major exchange rate crises which entailed exchange rate realignments (Czech Republic 1997, Slovak Republic 1999; see also the realignment in Poland 2002, etc.) While opinions differ in this respect, many economists argue (as would the European Commission and the ECB) that it would be premature, given the experience over the past few years, to be confident that a period with a quasi-fixed exchange rate regime could be adopted in order to achieve EMU entry in two years' time after accession. Given the arguments stated above, the critics of early EMU entry would emphasize that, one, such a regime would have a high probability of breaking down; two, if the regime were to be sustained it would do so at the cost of subjecting all other goals in macro-policy making to this target which might entail significant welfare costs; three, the regime might be sustained just in order to achieve EMU entry, after which the above-mentioned structural problems would re-emerge as they could only be tackled temporarily (see the recent experiences with EMU member countries, such as Portugal and Italy).

A last point to be mentioned in this context is the inconsistency between the goal of early EMU entry and the transitory stipulations imposed on labour flows between the current EU members and the ACs. These transitory restrictions which leave it open to EU incumbent members to impose restrictions on labour flows for a period of up to seven years after accession are, of course, contrary to one of the crucial OCA criteria which demands high degrees of labour mobility across regions to accommodate asymmetric shocks. While such mobility does not necessarily require international mobility of labour, but could be partly dealt with by high intra-country inter-regional mobility, there are clearly problems with increasing the rather low inter-regional mobility rates in ACs in the short run, as they are themselves caused by deep-seated structural barriers (particularly in the housing market, by high transport costs and infra-structural bottlenecks) which cannot be removed quickly.

C Growth implications of EU membership for CEECs

In this section we shall discuss the possible growth trajectories of the new member countries, review some of the research that has taken place in this area and also discuss the various factors which are directly related to EU accession and which might affect these growth trajectories.

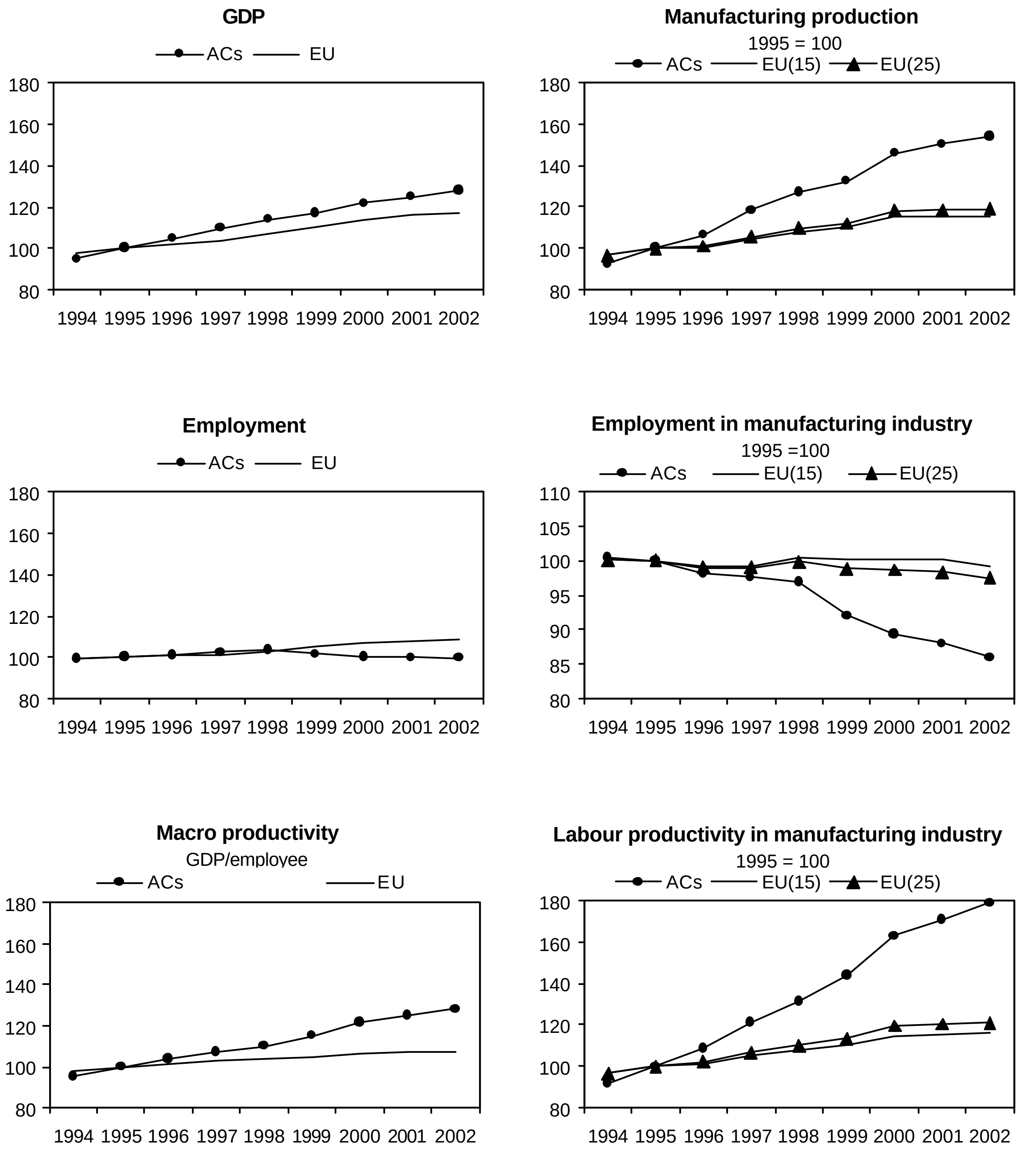
Research on growth has been buoyant over the past two decades. There was both a dramatic increase in the theoretical literature on growth as well as in empirical and econometric studies. Growth analysis has dealt with most areas which could be relevant for the assessment of longer-term performances of ACs: it dealt with issues such as openness and growth, regional integration and convergence, institutional and political-economic determinants of growth, growth and income distribution, development traps and regional economic growth, growth and factor mobility, the role of technology transfer, of infrastructure, of human capital, of FDI, etc. In all these areas there was extensive theoretical and empirical research and, in addition, to cross-country regression analysis, there were also large numbers of in-depth country studies (see Rodrik, forthcoming; GDN, 2002) which are increasingly considered to be important complements to cross-country analysis.

Relevant results are that regional integration does support convergence, although there might be phases in which this impact becomes weak; that regional integration particularly benefits countries below a certain 'threshold' level of income (for a recent interesting contribution which provides estimates directly applicable to ACs, see Crespo et al., 2002); that investment rates and stocks of human capital are very important for growth and catching-up; furthermore, there is evidence for the impact of international technology transfer, that institutions matter, that regional convergence processes within countries can come to a halt, that there may be development traps, etc. There is also some analysis of the impact of EU transfers on economic growth and catching-up, based largely on the experience of cohesion countries, and here researchers have relied mostly upon model simulations (see e.g. European Commission, 2001b, Moucque, 2000).

In assessing the growth implications of EU accession we start with a quick review of the recent growth experiences of the ACs. Fig. 5 shows the growth trajectories of the aggregate of the ACs in relation to the EU-15 over the 1994-2002 period for GDP,

Figure 5

Growth of GDP, manufacturing production, employment and labour productivity in the ACs and the EU



Source :**wiiw** Database incorporating national statistics, Wifo and **wiiw** calculations using AMECO.

employment and GDP per employee (the latter is a variable which we shall call 'macro-productivity'). Over this period, which followed the initial phase associated with the 'transformational recession', we can detect a clear growth differential between the ACs and the EU-15. The differential amounts to 1.3% p.a. for GDP growth and to 2.6% p.a. for macro-productivity (the difference between the two is due to the worse employment growth experience for the ACs over this period). These differential productivity trend growth rates fall within the range of measures which were estimated in the recent growth literature for 'convergence'. They fall significantly short of the growth performances which characterized the catching-up experiences of some of the South-East Asian economies over the 1970s to the 1990s and we shall discuss below whether there is any likelihood for ACs to replicate this experience. The adjoining graphs for manufacturing show that the differences in the growth trajectories in output and (labour) productivity in this sector between the EU-15 and the AC-8 was more pronounced than for GDP as a whole: the growth differential for output amounted here over the period 1994-2002 to 4.3% and for productivity 6.5% per annum. This also confirms the productivity growth (catching-up) differential between the tradable and non-tradable sectors underlying the Balassa-Samuelson hypothesis, as manufacturing accounts for a large share of the tradable sector.

The aggregate trends in growth for the group of ACs shown in Fig. 5 hide differences in growth performances of the individual countries and hence a look at individual country series is useful, as shown in Fig. 6. We can see that, at the individual country level, there is quite a lot of volatility (as there is, of course, also amongst the EU-15). The volatility over the period 1995 to 2002 depicted in the graphs relate to external accounts and exchange rate crises (Czech Republic 1997/98, Slovakia 1999/2000, Poland 2001/02), often combined with banking and corporate restructuring problems, or the impact of external shocks such as the Russian crisis in the case of the Baltic states. Looking forward, it is likely that some of the factors which make the growth processes of the ACs more volatile than those of the more established market economies of Western Europe will continue to persist: the persistent need for longer-term capital inflows combined with the natural tendency of catching-up economies to operate under structural current account deficits provides a continuous basis for volatility in external economic relations, as economic policy has to steer the economy along a path which aims at both nominal stability and the medium-run requirements of a catching-up process. Furthermore, there is evidence that the transition/catching-up economies undergo more pronounced political swings than the more matured Western European states which translate into more accentuated political business cycles. The underlying causes are partly the less consolidated structure of political representation by political actors/parties, but also the result of the deep processes of transformation and painful structural reforms which are still in process, such as social security reforms, the deep structural impacts of the transformation on labour markets, on regions, on different demographic and professional groups etc. On top of that comes the

Figure 6a

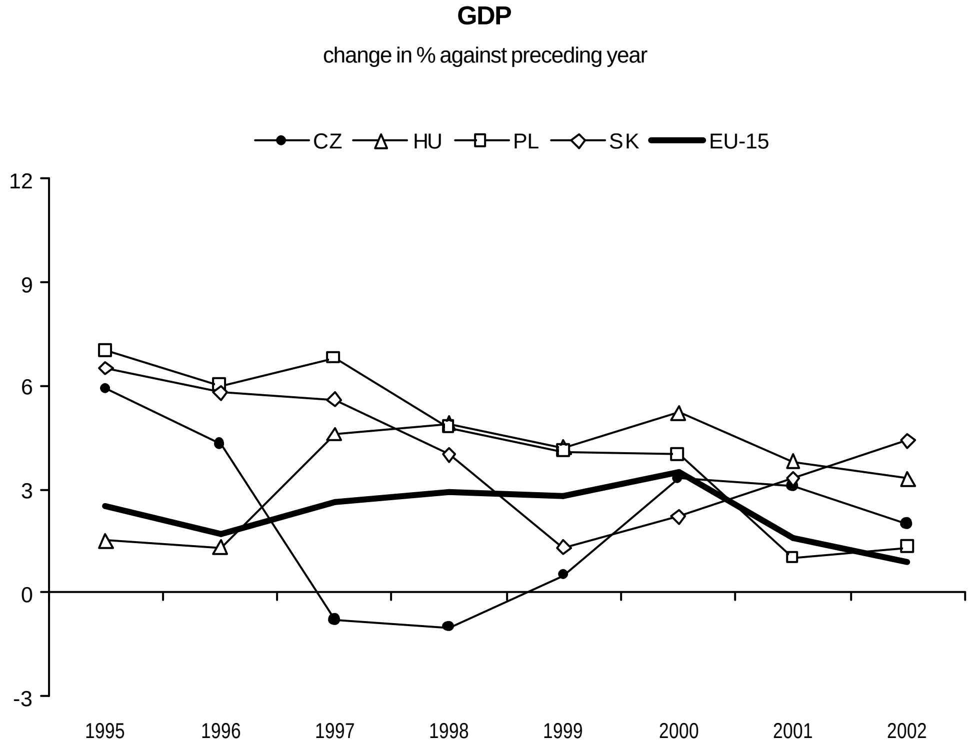
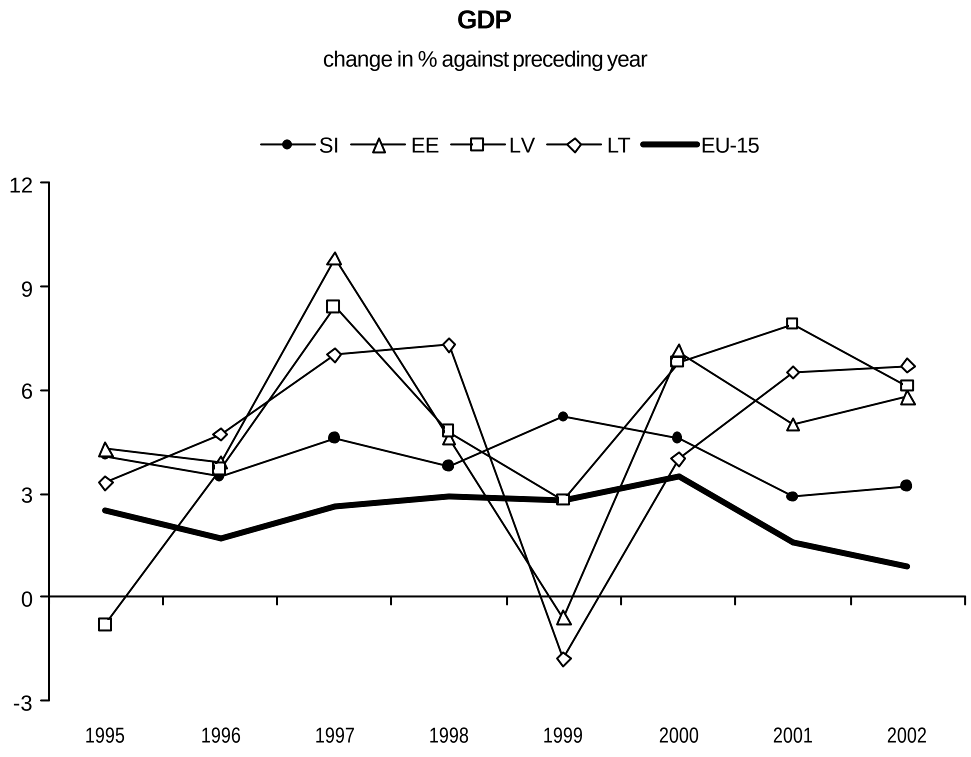


Figure 6b



Source: **wiiw** Database incorporating national statistics; OECD.

more strained fiscal situation which makes stop-go policies more likely, as well as the more meagre system of financial intermediation, providing a weaker domestic base in capital market transactions and thus less scope for inter-temporal smoothing. All these factors contribute to the likelihood, for some time, of stronger volatility in growth trajectories in ACs than in the advanced market economies of the EU (for some general evidence that growth is more volatile in lower income countries, see Azariadis, forthcoming).

On the other hand, we must also be aware that there is evidence of rather dramatic upgrading of industrial structures (to varying degrees) in the various ACs (for details see Landesmann, 2000). Contrary to expectations by classic trade theory, we were able to detect a strong pattern of differential catching-up following a Gerschenkron pattern (for details on this, see Landesmann and Stehrer, 2001, 2002). In short, it meant that some of the ACs have been able to exploit the 'advantage of backwardness' most strongly in branches which are technologically more demanding and require skilled labour inputs. This has turned their 'comparative advantage' away from labour-, and low skill-intensive industrial branches and has considerably strengthened the ACs presence in medium-/high-tech branches, which exceeds that of some of the southern European Cohesion countries (for details see wiiw, 2003). In fact, if we look at the areas in which the strongest market share growth rates have taken place, it has been in the technology driven and medium-, high-skill areas (see Figs. 7).

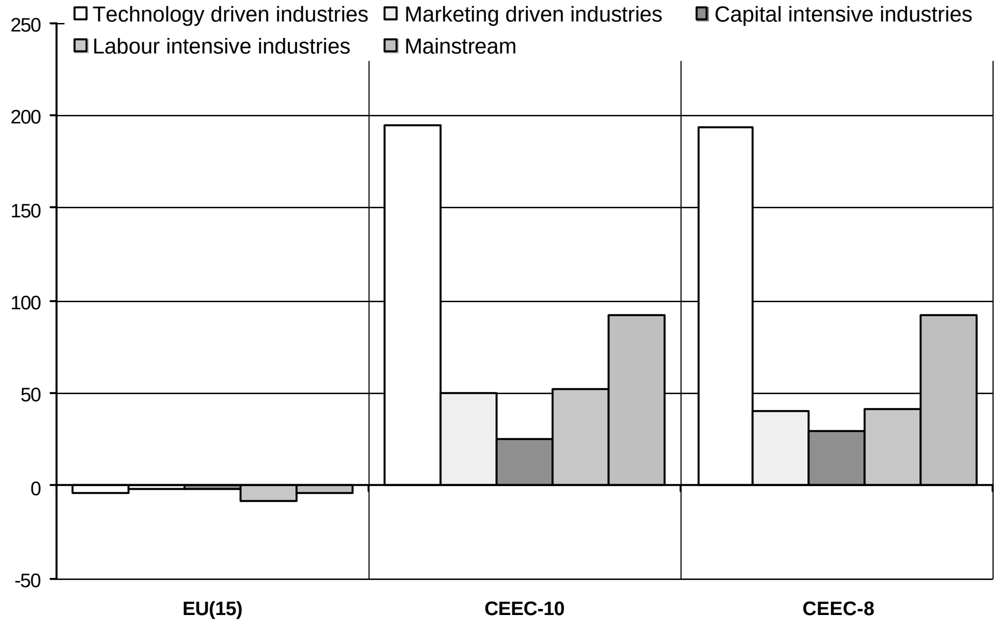
Thus from a structural change point-of-view there are very promising developments in ACs although the extent of the structural upgrading processes observed varies across the candidate countries. The qualitative catching-up process is not restricted to the manufacturing sector, but has also been taking place particularly in the market services sector. Developments in market services are an essential complement to upgrading in the industrial and other sectors of the economy by providing essential inputs for organizational change to those sectors. Just as in manufacturing, the role of foreign-owned companies is crucial in the upgrading process in the market services sector. This brings us to a discussion of the potential boost which accession might bring to foreign direct investment flows and, further, to the growth prospects of the accession countries.

In terms of aggregate effective demand analysis, the impact of FDI on growth is critically discussed by Laski and Römisch (2003). On the other hand, the other feature which is normally more prominently emphasised in the literature is the supply-side impact of intensified FDI flows and of cross-border production networks. We know from more global international evidence (see e.g. UNCTAD World Investment Reports) and the accumulated evidence on the experience in Central and Eastern Europe (see e.g. Hunya, 2002) that FDI is an important transmitter of technological and, more widely, organizational and market know-how for catching-up economies, that it facilitates access to the markets in which

Figure 7a

Change in export market shares, 1995-2001

by industry categories (%) in enlarged EU-25 trade

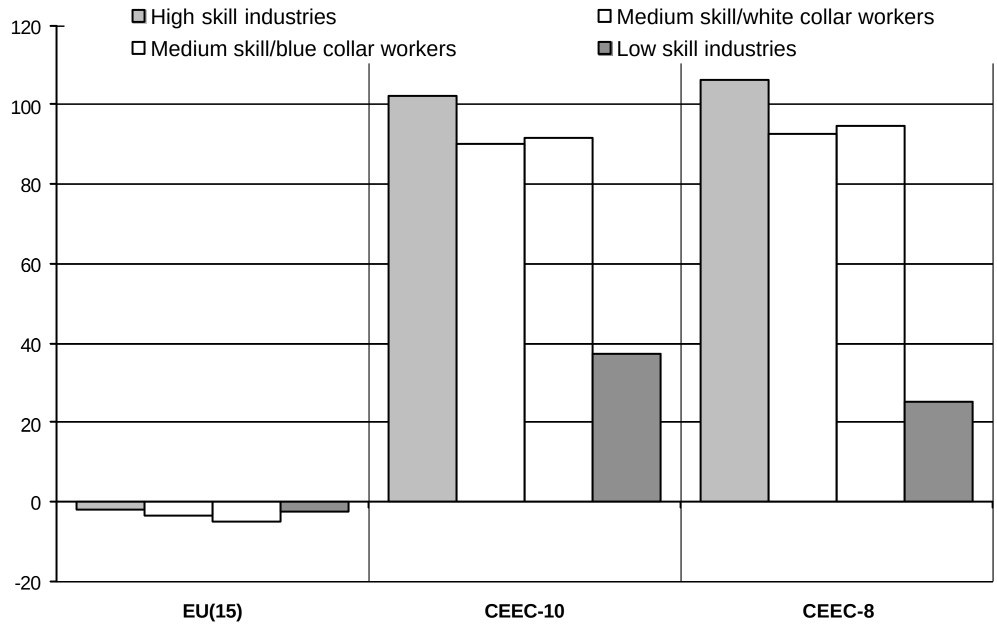


Source: **wiiw** estimates based on Eurostat COMEXT Database.

Figure 7b

Change in export market shares, 1995-2001

by skill categories (%) in enlarged EU-25 trade



Note: Enlarged EU-25 trade refers to intra-EU(15) trade flows plus trade flows between the EU-15 and the accession countries in both directions. Change in export market shares refers to the % change in the shares of the different country groups in the various industry types between 1995 and 2001 in enlarged EU-25 trade.

Source: **wiiw** estimates based on Eurostat COMEXT Database.

international firms operate, and that it also bundles together complementary assets (managerial, organizational, types of labour, capital, etc.) which reflect the firm assets and the relative factor endowment advantages of host and source countries. Thus FDI activities are generally recognized as carriers which allow the reaping of international location advantages, intra-firm division of labour as well as economies of scope and scale. All these components have been and will continue to be of significant importance for ACs upon entry to the EU as legal, institutional and behavioural convergence processes gain speed. The institutional, legal integration of the ACs into the structures of the EU is widely expected to provide an additional impetus to cross-border corporate activity between new and (especially neighbouring) old members. Given the asymmetry in relative economic weights, the impact will be asymmetrically felt much more in the new member countries (see the estimates reported by Breuss, 2003). Nonetheless, one should mention that FDI stocks have already reached very high levels in some of the accession countries and thus the increased corporate cross-border linkages might not show up in dramatically increased quantitative FDI flows but more in the deepening of cross-border corporate structures, in mechanisms of technological and organizational know-how transfer, and in the boost which cross-border labour movements might give to such linkages.

If one talks about growth in ACs, one should not leave out the fact that growth processes are very differentiated across regions. Two features stick out in particular: there is a big difference between growth in the regions bordering the EU and in the more peripheral regions further away from EU borders; secondly, capital cities emerge as major attractors of FDI and in the evolution of tertiary activities, which in turn translates into much better labour market and income performance (for detailed analysis of this, see Römisch, 2003). With accession we could initially envisage that this regional unevenness would possibly get even more pronounced. The reason would be that a further strengthening of production networks would proceed immediately in the regions where transport costs are low, where there is a high density of communication channels and where integration of transport and other infra-structural facilities across the borders could be done most easily. This tendency would be further strengthened through an intensification of trans-border bilateral policies and EU support for border regions. Over time, however, the natural processes of inter-regional spillovers, of tight labour and land market situations in the border regions and the capital cities might lead to some diffusion of these agglomeration tendencies and the gradual development of more peripheral regions. However, Western European experience shows that there can be very protracted 'lock in' of some regions into a peripheral status (see Italy's Mezzogiorno and the East German Länder) which is very difficult to overcome even with very substantial policy resources devoted to it.

There has recently been a lively and controversial discussion about the impact which the use of EU Structural and Cohesion Fund resources could have on the ACs (see e.g. the contributions by Boldrin and Canova, 2001 and 2003, and Hallett, 2002). Convincing proof that regional policy had, overall, growth-enhancing, or just simply redistributive effects, is not available and hence positions with regard to their effectiveness remain very controversial. Boldrin and Canova (2001) discuss critically the theoretical model on which an argument for growth-enhancing effects of regional policy must be based. Such a model must make a convincing case for threshold phenomena as well as other increasing returns to scale phenomena which provide the basis for analysing why market forces could lead to divergent growth processes and poverty traps (see also the survey by Azariadis, forthcoming). Hallett (2002), on the other hand, emphasizes the conditionality of the effectiveness of regional policies upon institutional developments, the effective use of other policy instruments, structural features of labour and product markets, etc. Just as with the experience of the Southern cohesion countries and of Ireland, we are likely to see a wide range of relative successes or failures in the effectiveness with which EU structural policies are going to affect the growth processes at the regional and national levels of the new member states. A simple growth model which expects uniform convergence or divergence processes across regions or countries is thus bound to be misleading.

Finally, on the question of whether we can expect 'growth miracles', such as those observed earlier in South-East Asia (or Ireland for that matter). In relation to these previous examples, the catching-up processes of the ACs are taking place in an historical context quite distinct from those earlier experiences. The important difference is the degree to which international economic relations have been liberalized (product markets, capital markets, much less so labour markets); this is true for the global situation in general but particularly for the Central and Eastern European countries in the context of their accession to the EU. Consequently, the range of policies which are available to ACs to intervene in the growth process are very different compared to those that were available to South East Asian countries (this refers to both macro and micro policies). Even in comparison to previous entrants to the EC – such as the Southern cohesion countries – the level of 'deep integration' which has been reached in the EU at this stage supersedes by far the level achieved in previous enlargements; consequently, the range of policy options available and the degree of institutional diversity are far more constrained in the current accession round. The other side of the coin is that the current ACs can potentially benefit from much quicker, and less costly channels of technology transfer, from much lower entry barriers into a large integrated market, from the benefit of much lower copying costs of institutional and legal designs and, of course, from a number of EU policy schemes which provide significant resources to overcome developmental gaps. There are other factors which account for powerful differences from the South East Asian growth experience, most important are probably the much lower saving and investment rates in the ACs. All in all, one should at this stage shy away from predicting whether the scenario of a much speedier catching-up process might be feasible in the ACs than is currently observed, but rather define very clearly the policy options available in the current context, analyse carefully the differentiated use which can be made of such policy options and focus on the design of policy packages (at regional, national and EU levels) which are internally consistent and are directed towards the sustainability of a smooth growth and catching-up process.

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