POLICY ADVICE: MARKETS AND POLICIES

Renzo Orsi,
Katarzyna Zukrowska et al.

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Jean Monnet Centre of Excellence

Freie Universität Berlin
Ihnestr. 22, 14195 Berlin, Germany
Phone: +49 (30) 838 – 54966
Fax: +49 (30) 838 – 52357
Email: info@ezoneplus.org

The Eastward Enlargement of the Eurozone

Berlin Evora Helsinki Ljubljana Bologna Tartu Warsaw

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Policy Advice: Markets and Policies

Abstract

This paper aims at the provision of applicable recommendations for institutions and actors involved regarding the EMU accession process both in CEE and in the euro-zone. In order to provide topical advice, the first part, on markets, will concentrate on theory and empirics of labour markets, financial markets and foreign direct investment, whereas the second part, dealing with policies, will put emphasis on exchange rates, FDI, labour markets, and the social dimension. It turns out that benefits and losses of EMU accession may differ with regard to the different issue areas. To get to clear-cut recommendations, diverging impacts and their balance have been taken into consideration. Special regard has been given to divergent groups of winners and losers during accession, its impact on the political decision-making process, and ways to compensate for them.

JEL-Classification: E0, E5, E6, D6, F0, F1, F2, F4, H5, G1, J2, J3, J6

Keywords: EU enlargement, monetary integration, economic integration, EMU, ERM 2, trade and FDI, financial markets, fiscal and monetary policy, labour markets, social policies, exchange rate regimes for CEE

Affiliations:

Katarzyna Zukrowska
International Security Department
Warsaw School of Economics
Poland
Email: zukrowsk@warszawa.home.pl

Renzo Orsi
Department of Economics
University of Bologna
Italy
Email: orsi@economia.unibo.it

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Katarzyna Żukrowska, Dominik Sobczak, Joanna Stryjek, Piotr Bańbuła

I. 1. Introduction

Discussion on the strategy of entering the Economic and Monetary Union (EMU) and introducing the common currency in Accession Countries is often centred on fulfilling the convergence criteria set out in Maastricht. However, as it is often underlined in recent months by the Commission, researchers, as well as fiscal and monetary authorities of these countries, high degree of real convergence is also crucial in order to benefit from the euro and prevent destabilisation in the whole Eurozone.

Real convergence means, that real spheres of the economy, such as labour markets, financial markets and regulations for foreign investments, should also be well prepared for operating in the single currency area. This report is devoted to this very subject. The authors try to answer the question to what extent the real spheres of economy are prepared for euro adoption and what should be done in order to prepare them better. What adjustments should be made? What reforms implemented? What pattern are there to be followed? The report tries to identify best practices in various spheres. Practices which are derived from the experiences of current EMU members.

The report focuses on three main segments of economy, segments which will be very significantly influenced by the euro adoption. They are, as mentioned above, labour markets, financial markets and foreign direct investments (FDI). The report also tries to give some insights into the answer to a key question of time: when accession countries should enter the EMU?; what are the arguments from the point of view of the discussed segments of economy?

I. 2. Financial Markets

2.1 Introduction

Effective and developed financial markets are certainly very important in current market economies. Since the implementation of the common currency in the European Union this became even more true, as a gradual shift from the continental to the Anglo-Saxon model of business financing is observed. In young market economies of accession countries, financial markets are still very much underdeveloped, but they are soon about to face the challenge of introducing the euro. In this context it is important to answer two general questions: "What is more beneficial for these markets – quicker or slower euro adoption?" and "How to prepare these young financial market to stand up to this challenge?". This text elaborates mainly on these two issues.

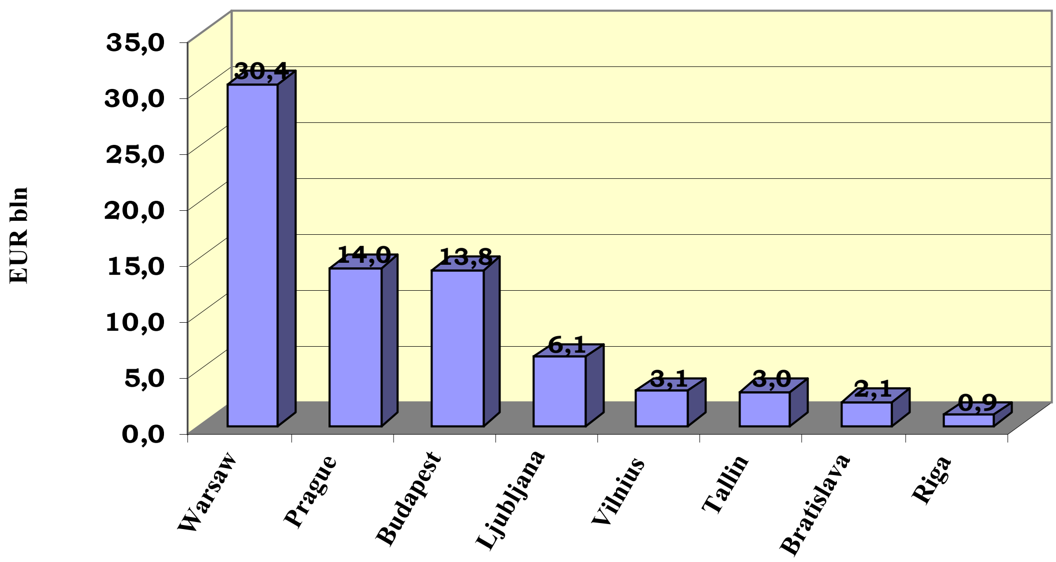
2.2 Financial markets in accession countries

Since the system change at the beginning of the 90s only fifteen years have passed, yet the financial markets and their institutions in Accession countries went through a dramatic change. It must be noticed that centrally planned economies did not include the majority of activities normally existing in market economies, thus almost everything had to be created from scratch. Financial markets were shaped by two fundamental processes – transition to market economy and EU accession negotiations. During this time much has changed in the legal and institutional environment of Accession Countries.

2.2.2 Capital markets

First exchanges were opened at the beginning of the 90s (Budapest Stock Exchange and Ljubljana Stock Exchange – 1990, Warsaw Stock Exchange – 1991, Prague Stock Exchange, Bratislava Stock Exchange and National Stock Exchange of Lithuania – 1993) and some in the later period (Budapest Stock Exchange and Riga Stock Exchange – 1995, Tallinn Stock Exchange and Cyprus Stock Exchange – 1996). The emergence of stock markets was closely associated with the privatisation process, yet the direct approach of specific countries was different. In some of them, like the Czech Republic, the Slovak Republic and Lithuania, capital markets were only supportive to massive voucher privatisations and were established even before sound and competent frameworks and regulations were in place. Countries that followed more traditional approach, with trading practices being established in the first place, were Estonia, Hungary, Latvia, Poland and Slovenia. In these markets number of shares listed was gradually increasing over time. These two approaches were not without consequences for future shape of the stock exchanges, as liberal attitude proved to create numerous shortcomings of the existent market participants. Still, the capitalization of most of the stock exchanges in Accession Counties is negligible when compared with their western counterparts. Only Warsaw Stock Exchange, as far as capitalization is concerned, is comparable with exchanges in the EU, but still only with the smallest ones, namely Luxemburg (USD 31,5 bln market capitalization) and Vienna (USD 49,2 bln market capitalization)[1]. Noticeable exceptions to the overall trait for national exchanges are Prague (USD 14 bln market capitalization) and Budapest (USD 13,8 bln market capitalization). Apart from Cyprus and Ljubljana exchanges in other Accession Countries are still highly undeveloped, even compared only to their neighbours, leaving alone western markets. However, concerning the growth of capitalization, many of these stock markets have outperformed European and US markets, e.g. Tallinn Stock Exchange rose by about 90% (January 2000 till December 2003) and National Stock Exchange of Lithuania by 44% (January 2002 till December 2003).

Table 1. Market Capitalization of stock exchanges (end of 2003, USD bln.)



Source: www.fese.be, national stock exchanges websites.

What is important for further process of European integration, securities exchange commissions (SECs) of candidate countries established, on May 2001, Supervisory

[1] www.fese.be.

Consultancy Group, which was to coordinate integration related activities. Main objectives of this new body were:

- Exchanging information on the experience of regulators about introduction and implementation of EU directives
- Establishing forum for consultations to the effect of full harmonization with EU standards.

Bond market in candidate countries is dominated by government securities. The issuance of government debt securities proved to be a convenient way of financing budget deficits and ongoing process of restructuring will probably sustain these tendencies. Government bonds constitute over 90 % of overall value of the debt securities market in Cyprus, Latvia, Lithuania, Malta and Poland. The Czech Republic, Hungary and Slovenia also have high share of bonds issued by Financial Institutions. The situation on national bond market is different only in Estonia where non-financial and non-monetary corporations took over 50% of the market[2].

2.2.3 Banking sector

Looking at capitalization and situation on debt securities market, it comes as no surprise that financial system in candidate states is strongly dominated by banks. At first, when countries had to fight with high inflation, nominal interest rates were significantly higher than in the Western Europe. The only exceptions were the Czech Republic and, to smaller extent, Slovakia. Generally two disinflation strategies have been pursued. The first one consisted of mixture of exchange rate targeting and inflation targeting and it was used in case of Hungary, Poland and Slovenia. The second one was the currency board applied in Baltic states. Both strategies let to reasonably low level of real interest rates, yet nominal interest rates and spreads are generally above those in the EU. The importance of particular types of credits in bank's portfolios has also changed over time. While corporate credits still dominate, part of their share has been taken by household housing credits. This increase was possible thanks to growing stability of mortgage regulations and gradual fall in interest rates.

[2] *Bond Markets and Long-Term Interest rates in European Union Accession* Countries, European Central Bank, October 2003.

Table 2. Nominal credit interest rates in the commercial banks, mid 2003

Country	Average level of the nominal credit interest rates, mid-2003	Interest rate margins (lending rate minus deposit rate) percentage points
Lithuania	5,7	4,4
Latvia	7	-
Estonia	5,6	5,1
Czech Republic	3,8	2,3
Hungary	9,5*	2,8
Slovenia	13*	-
Poland	10,3	5,9
Slovakia	8,7*	-

Source: National central banks websites. * data for the enterprise sector

The ownership structure has also gone through profound change, as the vast majority of banks were state-owned. Even though transition countries lured potential investors with tax and licensing incentives, foreign financial institutions were reluctant to enter their markets. The situation started to change in the second half of the 90s when foreign banks took part in privatisation in the Czech Republic, Hungary and Poland, while purchases in the Baltic states begun after the Russian crisis. It must be noted that foreign financial institutions strongly imprinted their presence in candidates counties' banking sector.

Table 3. Percentage share of foreign capital in the commercial banks assets

Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia	Slovenia
85,8	**85**	**90,7**	**68**	**86**	**70,9**	**95,6**	**16,9**

Source: K. Mérő, M. Endrész Valentinyi, ***The Role of Foreign Banks in Five Central and Eastern European Countries*****, National Bank of Hungary, November 2003; C. Thimann,** ***Financial Sectors in EU Accession Countries*****, European Central Bank, July 2002.**

The idea behind such wide opening was creating efficient system in the absence of domestic capital and expertise. Foreign involvement was to import new technologies, know-how and best practices in banking business, as well as higher level of credibility of the countries themselves. Yet, such a significant share of foreign capital is not without consequences for financial authorities and stability of the system. Moreover, it may result in threat of withdrawal from the local market and closing down the bank just as a result of the change of the owner's strategy. This may have little to do with the performance of the local bank nor its market position. Such a move may prove profitable for a parent institution but at the same time it may be fatal for the local banking sector and its stability[3].

2.3 Impact of the common currency on financial markets

Introduction of the common currency brings several benefits for financial market. The most important of them is the elimination of exchange rate risk, as there are no more exchange rates. Lack of this risk significantly decreases the risk of investing and operating abroad, therefore, it stimulates internationalisation. Moreover, it reduces the costs of cross-border transactions, as there is no asymmetry of information, no need to hedge and much better comparability of prices. All this considerably enhances transparency of the market. In addition, banks, pension funds and insurance companies as institutions of public trust, which must reduce risk to minimum, have imposed limits on their engagement in assets denominated in foreign currencies. With a single currency, these limits exist no more. As a result, these institutions have much more possibilities to increase their return on invested assets, bringing bigger profits to their customers.

Apart from elimination of exchange rate risk, common currency contributes to the decrease of country-specific risk by unification of monetary policy, which means equal nominal interest rates in all member states. As a result, there is a common base for all interest rate securities, thus the market interest rate of a security depends mostly on its risk premium. This also strongly contributes to transparency of the market.

However, reaping maximal benefits from the common currency by national financial markets is only possible if a single financial market within the whole single currency area exists. Only then it is possible to take advantage of the synergy effect and significantly improve depth and liquidity of capital markets.

As the single financial market is not necessary for the introduction of the common currency, although it is strongly beneficial, the process of its creation was not concurrent with monetary integration in the European Union. Establishing the single financial market is scheduled to be completed by 2005, while the euro exists since 1999.

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[3] *For more details concerning banking system in candidate states see: A. Kot,* Accession countries over the last decade: credits to non-financial sector and the role of foreign ownership in the banking sector, *Warsaw, January 2004.*

Accession countries will in an opposite situation. Due to their preparations for joining the European Union, they are currently implementing all regulations necessary for participation in the EU single financial market. As a result, they will jump into the final stages of its creation on 1st May 2004, and will participate in its completion. Eventually, they will participate in the EU single financial market without sharing the common currency. Due to this, they will not be able to gain full benefits of this process, despite being very well prepared, from the regulatory as well as organisational point of view.

2.4 Technical aspects of introducing the euro – Giovannini Report

Introduction of the single currency is a very important and challenging process for financial markets, as it is necessary to convert all securities, as well as other assets, from domestic currency to euro denomination. There are several questions, for example: How to do it? When to do it?, and much more. Accession countries entering the EMU will face the same problems, as the EMU countries on the day of its creation. Therefore, it is strongly advisable to follow the solutions implemented by the euro pioneers.

In the second half of the 1990s, the European Commission, as well as Member States preparing for the euro introduction, were very well aware of the challenges facing financial markets. Thus, in order to ensure smooth conversion process, a group of experts was set up, chaired by Alberto Giovannini. The Group, formed in 1996, was to identify consequences of the introduction of the common currency on financial markets and put forward practical solutions that would improve market integration. The solutions were proposed in the first of four reports which have been prepared. Its main aim was to identify technical solutions which have to be adopted by markets and provide guidance for both public authorities and markets.

Regarding the bond market, the recommendations proposed by the Group were the following[4]:

- Redenomination of existing debt, as it would increase liquidity and the credibility of the process by demonstrating governments' commitment. This would also remove the risk of investor's holding securities denominated in national currency and emerging differentials in rates. In order to deal with the problem of new nominal amount of

[4] *Impact of the introduction of the euro on capital markets*, Communication from the Commission, Brussels, 1997, p. 2-5.

bonds individual member states should introduce appropriate renominalisation measures that would have minimum influence on financial rights and obligations;

- "Bottom-up" technique for redenomination was proposed as an optimal method, with rounding to the nearest cent; the number of approaches to redenomination was also to be kept as low as possible;
- Harmonised market rules would be desirable, as they provide transparency and greater clarity as to the format of the future market. Actual/Actual system should be implemented for day counts for bond markets. On coupon frequency, the choice should be left open (semi – annual or annual). Introduction of standard definition for business days is also desirable (i.e. TARGET business days);
- Price continuity has to be ensured and prices may be calculated on national basis or on European ones, however introduction of Eurozone-wide indicator rates is desirable;
- Informal co-ordination of government debt issuing could prove to be beneficial, both for issuing institutions and buyers.

As for the equity market, the main conclusions were the following:

- Exchanges will trade and quote in euro from first January 1999 and intermediaries will have to make the necessary conversion;
- Redenomination should be carried along with the same change in the accounting unit and its exact date should be a company's decision;
- Non par value (NPV) shares solution was recommended, as it excludes need for physical exchange of share certificates. The share prices can be adjusted by simple splitting and there is no need for capital adjustment. However, the implementation of the NPV share solution would require national legislation to be adopted in most of the Member States[5].

It is worth underlining that the importance of harmonization and implementation of common rules differs between bond markets and equity markets. This fact mirrors other phenomena, namely the direct impact of the introduction of the common currency on both markets. While government bond market has recorded rather qualitative increase, the situation on corporate bond market was substantially different. The reasons behind its growth were: wave of merges and acquisitions, relatively low interest rates, poorer performance on part of the companies and unfavourable situation on equity markets. The

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[5] Ibidem, p.3-5.

influence of these factors was further amplified by the introduction of the euro. As for the equity markets, issuers tend to rather concentrate on national markets and currency of denomination plays only minor role. Moreover, organized markets are, by definition, mostly affected by macroeconomic changes and global events. The inequality of indispensable changes on both markets recommended by the Giovannini Group reflected this fact. While the immediate effect brought along with euro has strongly affected bond market and means of financing in Western Europe (shift towards Anglo-Saxon model to the detriment of intermediaries), the currency itself could not eliminate persisting differences between countries. Differences that have direct impact on creating truly single, transparent and liquid financial market.

2.5 Financial markets in accession countries on their way to euro

First of all, it must be noted that introduction of the common currency in candidate countries is a part of much wider and complex process and it should be treated as such. All Accession Countries will have to adopt euro as none of them has the privilege of opt-out, yet their path towards Eurozone may differ in time and applied strategies.

Bearing in mind that euro is only a part of single financial market in Europe, accession countries must apply strategy that would cover the whole process of integration. Thus, at first it is essential to participate in the process of creating the EU single financial market and become a part of it, even though without euro reaping full benefits will not be possible.

The remaining tasks, directly related to euro adoption, will be easier due to the experience of current EMU countries. In preparation for the introduction of common currency, accession countries should try to implement strategy that would include:

- close cooperation with legal and institutional authorities of the EU and Eurozone, namely European Central Bank (ECB), European Securities Committee (ESC), Committee of European Securities Regulators (CESR) and the European Commission;
- careful and thorough analysis of all steps taken by Member States on their way to euro, with special attention to fundamental reports: Giovannini reports, Lamfalussy Committee reports, advice of the European Commission, as well as directives and regulations; each state should also prepare a list of country-specific and most ailing problems;

- analysis of aftermath of the steps taken by Member States and adopted solutions should be done; possible drawbacks should be identified and alternative solutions should be elaborated;
- each country should prepare a list of the tasks that are to be undertaken by public sector and those falling on the private one; to smooth the process, cooperation of the two should be established as fast as possible;
- strategy of each country should include clear objective, sequence of indispensable actions, clear allocation of responsibility, appropriate deadlines and adequate methods of control;
- strategies leading to euro and adopted solutions should be adjusted to country-specific features and problems;
- national capital markets should follow the general tendencies observed in the EU, such as increasing consolidation and privatisation of capital market institutions; joining this process will ensure proper preparation for the introduction of euro, as well as participation in the slowly emerging pan-European capital market; abstaining from internationalisation may result in isolation, and eventual disappearance of national capital market.

Taking into account that financial markets in Member States are far more developed and integrated, as they have already walked the path that is to be followed, the task before accession countries is relatively easier. One must also remember that strong presence of foreign financial institutions on national markets may be very beneficial. While majority of the banking system in CEE countries is in their hands, the implementation of technology, know-how and appropriate practices is going to be significantly easier. Thus, the private sector should not impede the integration, on contrary. The potential disadvantage of foreign ownership is its impact on the system stability, since even correct and reliable domestic regulation may be insufficient in this situation. The behaviour of foreign-owned banks depends very much on the stability of the parent institution. Thus, this becomes a potential channel for spreading the financial sector instability. The effective cooperation of regulatory institutions becomes crucial and it should become one of the parts of applied strategy.

The situation is somehow different with stock exchanges, as there is little certainty about their long term development. In most cases the strategy consists of increasing liquidity, capitalization, improving transparency and education. However, while it does not have to be clearly stated, consolidation with bigger European bourses is more than probable. It is worth underlining that possible dangers deriving from increased foreign involvement, already visible in the banking sector, will not affect this segment of the market. Even though many countries with relatively small capitalization are perhaps not going to pay to much attention to this segment of the market, they should take into consideration that alternatives to financing via the banking sector are desirable. It would provide them with better stability. Moreover, capital markets are more effective in financing innovations.

Along with the introduction of legal acts, some institutional changes should be implemented, with emphasis put on supervisory bodies. It is argued that, as long as different regulation will exist among each segment, there will be no reasons for integrated supervision. Moreover, the exact shape of supervisory model should match the shape of the market itself. However, properly applied integrated supervision would lead to increased coordination and coherence of regulations and efficiency deriving from economics of scale. Each country should decide what type of supervision is to be implemented[6]. The other question is supra-national supervision of financial segments all over the Europe. Taking into account increasing globalisation and presence of foreign investors on national markets such step would be desirable. Regulatory bodies of accession countries should definitely participate cooperation of European supervisory authorities. Moreover, the delegations and independence of supervisory agencies of accession countries should be enhanced, so that they match market and system requirements.

2.6 Conclusions

Accession countries will participate in the EU single financial market before introducing the common currency. This has several positive effects, among others, this will ensure proper preparation for joining the Eurozone, as far as institutional framework and legal adjustment is concerned. Therefore, the remaining tasks will have mainly technical character. Due to this, from financial markets point of view, the quickest possible euro adoption would be most advisable, as only with the single currency, accession countries

[6] *Stan przygotowań polskiego rynku kapitałowego do integracji z Unią Europejską*, Komisja Papierów Wartościowych i Giełd, November 2002, p. 34-38.

will be able to fully benefit from the single financial market. To some extent however, these benefits will be unequal among these countries. It is due to the fact, that states which have their national currency pegged against the euro, as in the currency board arrangement, do not experience exchange rate fluctuations, therefore, country specific risk is limited. These countries will be able to befit from the single financial market to a greater extent even without euro.

For financial markets there is only one drawback of quick euro adoption. It is related with the risk of improper entry exchange rate, as well with the fact that the parity will not be generally known by the public. Market participants, aware of the fact that speculation on the exchange parity between euro and national currency may prove very profitable, may destabilise the market for a short period of time. This could have considerable detrimental effects. Proper preparation for joining the Eurozone, as well as stable exchange rate would eliminate this risk, but it may require a little more time.

As far as technical aspects of euro adoption is concerned, it would be strongly advisable that candidates learn from the experience of current EMU members. Moreover, some accession countries will probably join earlier, while other later. Therefore some new experiences of relatively young market economies introducing the common currency will also be available to some countries. Learning from each other and taking advantage of the best practices can be achieved by close cooperation between legal authorities, both government and independent regulatory institutions. Careful analysis of both, preparatory process and its implementation should guarantee the success.

I. 3. Labour markets

3.1 Introduction

Accession to the Economic and Monetary Union (EMU) does not put any direct requirements on the labour market of candidate countries. However, sound and stable economic situation seems to be a necessary precondition as far as fulfilment of the criteria laid down by the Maastricht Treaty is concerned. Such a situation can be created only if the labour market is functioning properly – it is sufficiently effective and it ensures adequate balance between security and flexibility.

EMU member states have not, on average, carried out more reforms than EU countries staying outside the Eurozone and it is difficult to find any significant link between the initial unemployment level in these countries and the labour market reform indicators. Nevertheless, reforming the labour market before the macroeconomic environment becomes more unfavourable, that is, before joining the monetary union, seems to be a good solution. Becoming a member of the EMU means that it is not possible to use country-specific monetary and exchange rate policies to offset asymmetric economic shocks, hence improving the ability of accession countries' labour markets to adjust to such shocks in the future should be in their best interest.

There are two major labour market issues relevant from the EMU membership point of view: unemployment and labour market flexibility. In general, bringing down the relatively high unemployment rate is necessary in order to avoid a shift in the political preferences in EMU member states from price stability to employment-creating but inflationary monetary policy, and greater labour market flexibility enhances the capacity of this market to adapt to changing economic environment.

Unfortunately, labour markets of the EU accession countries do not seem to be as flexible as they should, bearing in mind the need to achieve high levels of employment in a near future, as well as necessary smooth adjustment to quickly changing demand and branch structure of the market. Therefore, any adverse shock over the labour market, as a result of unfavourable changes on trade flows (e.g. higher competition between imports and national production) or adjustments in the productive structure might have long-lasting effects and increase regional disparities. With limited options (or non-existence of such options, labour market takes up the role of the main shock absorber. This fact is a very important argument, stressed also in the optimal currency area theory, in favour of making labour markets more flexible, and thus able to cushion external shocks.

Over the past years, EMU member states have conducted a number of reforms of labour market institutions. The type and scope of the reforms differed significantly across countries and labour market outcomes have evolved differently. This is a kind of evidence that the problem requires an individual approach – it is not possible to create just one, common labour market policy advise for all the accession countries. Moreover, while working on the policy advice, one should avoid making comparisons with the situation which occurred in present EMU member states, as measures applied there cannot be simply transposed to the accession countries. However, the analysis of the reforms in EMU countries may indicate to some extent what has to be changed on the labour market as far as the process of preparation for EMU membership is concerned.

Apart from that, it must be noted that the labour market policy has only a limited impact on the labour market situation. In most cases, other policies have major influence on this market and the role of labour market policy is only to diminish the negative results of them.

3.2 Labour markets before the EMU – what to do?

While preparing to the EMU membership, the accession countries should keep in mind all the targets which the EMU countries are currently trying to meet, even though they are not directly tied with the common currency. In particular, the introduction of the quantitative targets for employment rates agreed by the European Council (in Lisbon, 2000 and in Stockholm, 2001) may introduce some peer pressure on those countries that have less employment-friendly policies. Under the Lisbon Agenda, an overall employment target of 70% by 2010 was established for the European Union, to which an intermediate target of 67% by 2005 was later added at the Stockholm Spring Council in 2001. The above target seems to be pretty ambitious even for the present member states, and the new member states may find it impossible to meet, at least in the given time perspective (in 2002, the average employment rate in accession countries was 55,9%, while in the euro area it reached the level of 64,3%).

Spring European Council in 2003 admitted that the achievement of the Lisbon Strategy Goals is at risk in enlarged EU and it called up a special task force to write a report on the most immediate measures that should be undertaken in order to improve the situation on the labour market. The major proposals regarding accession countries given in the report and in *Joint Assessment Papers* are summarised in the Chart 1. (each activity which should be treated as a priority in a given country is crossed).

Chart 1. Proposals concerning labour market reforms

	Cyprus	Czech Republic	Estonia	Hungary	Lithuania	Latvia	Malta	Poland	Slovenia	Slovakia
Hold wage developments with productivity growth		X	X	X						
Reduce high tax wedge - built more employment tax system	X	X	X	X	X	X	X	X	X	X
Increase the level of R&D spending	X		X	X		X		X		X
Promote part time work and fixed term work	X	X	X	X	X	X	X	X	X	X
Reduce undeclared work	X	X	X	X	X	X	X	X	X	X
Increase spending on Active Labour Market Policies (ALMP's)	X	X	X	X	X	X	X	X	X	X
Modernise and develop Public Employment Services (PES)			X		X	X		X		
Tackle young people unemployment								X		X
Increase mobility	X	X	X	X	X	X	X	X	X	X
Increase female participation							X			
Better integration of minorities and immigrants in the labour market		X	X	X	X	X				X
Raise human capital and improve lifelong learning systems (e.g. facilitate access to a university degree)	X	X	X	X	X	X	X	X	X	X
Reduce the number of early school leavers						X	X			
Increase participation in training for the entire workforce	X			X	X			X		

The most important messages driven from the chart for the policy which should be run in all the accession countries are as follow:

- promote flexibility,
- reduce high tax wedge,
- increase spending on active labour market policies,
- invest in human capital and improve lifelong learning,
- increase mobility,
- reduce undeclared work.

Improved job mediation, more flexible wages and increased wage differentiation, improved education, training and life-long learning, reforms of tax and benefit systems, less restrictive employment protection regulation, working-time flexibility as well as measures to increase labour mobility all contribute to **increasing labour market flexibility**[7]. The more decentralised is the wage setting process, the lower the lay-off protection, the lower the unemployment benefits, the more open the social dialogue and the less directly

[7] *Labour market mismatches in Euro Area Countries,* European Central Bank, March 2002, http//:www.ecb.int/pub/pdf/labourmarket2002.pdf.

intervening active labour market policy, the bigger is this flexibility[8]. In other words, labour market flexibility requires a shift towards a model of employment that is less rigid and enhances the capacity of the labour market to adapt to any occurring changes.

It is desirable that the potential EMU member states should **reduce tax wedge**. However, this is not so easy to accomplish, as budgetary expenses tend to increase rather than decrease throughout the history in most of these countries. Hence, they should do their best at least not to generate additional budgetary burdens. New policies which are to be introduced should be financed through existing budgetary resources, as budgetary shifts are still possible. Only the resources destined to co-finance Structural Funds should be considered as expenses that can be created additionally, even by increasing budget deficit or public debt. Otherwise, additional budgetary expenses would bring more disadvantages than advantages. Moreover, it should be noted that excessive budgetary burdens directly endanger fulfilment of the convergence criteria, and consequently jeopardize rapid accession of a country to the EMU.

It is also important to introduce **active labour market policies** subsidising low-paid employment in order to increase the effective labour supply of low-skilled workers. In general, however, such measures are second-best to necessary **reforms of tax and benefit systems**. These systems affect the labour markets from the supply side to the extent that they influence both search intensity and incentives to invest in human capital. In particular, in the absence of strict job search requirements, generous unemployment benefits may lead to an insufficient job search intensity, and long benefit durations may tend to increase long-term unemployment. Moreover, generous unemployment benefits can adversely affect matching processes in the event of cyclical downswings, as workers who become unemployed have weaker incentives to take up work when real wages decrease.

The next crucial issue for the accession countries to focus on, while preparing for EMU membership, concerns **wage-setting systems** and the related degree of centralization of wage bargaining, which affect labour markets through their impact on the structure and the level of wages. While analysing the occupational mismatches in some euro area countries, it is possible to notice that insufficiently differentiated occupational or sectoral

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[8] A. Freytag, *Estonian Labour Market and EMU Membership – Challenges and Policy Options*, http://www.eestipank.info/pub/en/dokumendid/publikatsioonid/seeriad/uuringud/_11_2002/index.en.pdf.

wage structures hinder mobility between occupations and sectors. Furthermore, the educational mismatches indicate that an inadequate dispersion of the educational wage structure reduces incentives to invest in human capital. Apart from that, an insufficient dispersion of regional wage structures limits the firms' incentives to relocate their production to regions with high unemployment, thereby contributing to the persistence of regional labour market mismatches as well as insufficient regional **labour force mobility**.

One more factor contributing to labour force mobility is education policy, in particular, concerning the quality of schooling and vocational training. **Education and training systems** prepare the workforce for changing demands – the better educated the labour force, the higher its potential mobility. Improved education, training and life-long learning contribute to the level of employment, reduce the number of educational and occupational mismatches, and thus they are considered to be important for the future development of the labour market. Lifelong learning is especially important in the contemporarily quickly changing economic environment and very fast technological progress, which requires constant adjustment of employees to volatile market needs. Due to this, improvements in education and training systems should be high on the political agenda in the accession countries.

The next issue that can influence labour market flexibility is **employment protection regulation**. In the presence of strict employment protection regulation, employers tend to fill vacancies only with well-matching employees, as dismissals tend to be costly. This may lead to a substantial reduction of occupational mobility. High firing costs for firms tend to reduce the number of hires during upswings, because employers will be more reluctant to hire if dismissal costs are high. At the same time, they tend to reduce firings during downturns. Consequently, as a result of reduced inflows into unemployment, strict employment protection regulation tends to reduce short-term unemployment. Owing to a smaller outflow, however, it tends to increase long-term unemployment. Running such a policy may cause that the labour market will not be able to adjust to cyclical and structural changes, and thus it may affect negatively productivity.

While analysing the problems of the labour market adjustments, it is also important to remember about **working time flexibility**. Working time accounts as well as the possibility of shifting between full-time and part-time jobs allow firms to adjust the level of employment more flexibly in response to changes in production and employees to adjust working time in line with their private needs. Hence, increased working time flexibility might contribute to a better adaptation of labour supply to changing demand, thereby improving the functioning of the labour market in general.

It is also crucial for the accession countries to increase **effectiveness of employment services**, as they can enhance the efficiency of labour market matching processes through better channelling of information about job vacancies to the unemployed and better mediation between unemployed persons and vacancies (employment agencies seem to be particularly important institutions in this process – their role in improving job mediation in the euro area countries has been notable). Apart from that, more intensive job search assistance not only can improve the situation on the labour market, but also it is said to be cost-effective.

Moreover, it can be very useful to developed and strengthen the **social dialogue**, that is, to settle disputes between trade unions and employers on principle issues. This can be used to develop strategies regarding training and education, not mentioning its importance as far as problems of discrimination or marginalisation are concerned. In addition to the social dialogue, it seems necessary to support the development of entrepreneurship and enterprises.

Additionally, trade unions have a new role to play in the process of labour market adjustments leading to greater elasticity. Flexible labour markets limit the number of unemployed due to possibility to reduce costs of labour. This enables to employ more people with the same amount of money. Trade unions must understand this in order accept labour market reforms. They can then convince their members that the implemented measured are, in longer run, beneficial for the whole labour force.

Finally, the accession countries should remember that the situation on the labour market can be improved by effective absorption of structural funds, mainly European Social Fund. Current prognoses show that full **absorption of Structural Funds** is rather unlikely. Hence, the accession countries should do their best in order to increase their ability to use these resources.

3.3 Conclusions

Labour markets in all accession countries are different due to their specific industry structure, current economic situation, and their recent history. Unemployment rate varies between a little more than 5% (Hungary, Slovenia) and up to almost 20% (Poland, Slovakia). Due to this no integrated approach to labour market policy is possible. Each accession country has to develop workable policies that reflect their particular circumstances and tackle country-specific problems. Naturally, experience of current EU member states is valuable as source of ideas and ready-made solutions, due to considerable successes in fighting unemployment, promoting job creation and providing vocational training. These solutions, however, must be adjusted to suit individual accession countries.

It is also important to stress, that the EMU accession does not explicitly require labour market reforms. Nevertheless, flexible and effective labour markets are necessary to increase fully benefit from euro adoption, and to increase stability of the economy in the situation of a very limited number of other shock absorbers. The path of structural reforms is certainly not easy to take, especially for political reasons, as it is socially unpopular, but it is the only way to achieve a lasting reduction in unemployment and create stable labour markets.

I. 4. Foreign Direct Investments

4.1 Introduction

Foreign direct investments (FDI) play an important role in the process of economic development of EU accession countries. They enhance the export performance of these countries' economies, stimulate job creation and constitute a crucial source of capital, technology and management techniques. Because of that, the incentives which can attract FDI inflows are currently high on the political agenda in most of these countries.

During the last decade, world FDI inflows have risen form just over US $200 billion to around $1 250 billion in 2000.[9] This rapid growth took place mainly due to increased liberalisation brought about by reduced barriers to trade and investment. It was also

[9] *UNCTAD World Investment Reports*, (1991-2003), UN, New York.

influenced by the fact that the benefits of FDI were finally recognised and appreciated, which made many countries focus on improving their investment climates. The 1990s. appeared to be a perfect time for the accession countries, which were dealing with the process of transformation of their economies, to benefit from the inflow of FDI as well. Since the beginning of transformation, FDI inflows in Central and Eastern Europe have kept growing. Much of this increase has been attracted by liberalisation, privatisation, macrostabilisation, relatively favourable investment climates (e.g. well educated and relatively cheap labour force), by prospects of accession to the EU and by expectations of increases in productivity while the economy develops and restructures. In general, progress in transition has been considered to be the most important factor attracting FDI in this region, because even a great economic potential of a given country could not help much if the country showed a lack of will or ability to unlock this potential through market-oriented reforms.

4.2 FDI and pursuit towards common currency

In the 1990s, liberalism became a leading ideology in Central and Eastern European Countries (CEEC) that for many years had been in the grip of the communist regime. Generally, liberalisation has a decisive meaning for macrostabilisation policy, macrostability and non discriminatory treatment of foreign investors are put in first place, as far as attracting FDI inflows is concerned. Capital will not come to an economy where inflation is not under control, hence permanent elimination of the sources of inflation is a necessity. Investments will not be also attracted by an economy which does not liberalise relations with international surrounding, introducing international norms in this respect. A country which wants to attract FDI should be able to exercise corporate governance without arbitrary bureaucratic interference as well as transparent and fair regulatory and legal environment. Otherwise, there are fears that privatisation is a transitional stage, which in short will be replaced by nationalization of production potential, sold previously to foreign investors. Such fears seem probable in undemocratic conditions, when a government changes most of the decisions of the former one, just to gain support of the population by giving new privileges and abolishing old ones. [10]

[10] K. Żukrowska, *Euro and capital flows: the single currency and external economic relations of the EU*, 2003.

Apart from that, an investment climate should include effective markets, sound financial institutions and developed infrastructure. Only if all the above preconditions are fulfilled, it makes sense to attract FDI inflows by active policy measures, e.g. tax policy regulations, higher interest rates and – in case of EU accession countries – the degree of harmonisation of a given country's law with *acquis communautaire*.

Higher interest rates constitute a good solution for all catching-up and transforming countries, as they reduce possibilities to draw bad credits (dangerous both for a banking system and for enterprises) and force to increase productivity by utilisation of simple labour reserves; such reserves are available in all post-communist countries, as they were experiencing full employment (that is, over-employment).[11]

In general, credits for investments are drawn in economies with low level of interest rates and invested in economies where the level of interest rates is high. This mechanism multiplies returns simply by a move of capital from one economy to the other, and the final profit coming out of it depends on differences in development between the economies concerned, that is, the bigger the differences, the higher the profit. In case of an economy with high level of interest rates, there is an inflow of investments which causes direct effects as far as stimulating of this country's economic growth is concerned. On the other hand, however, the economy with low level of interest rates, which exports the capital, is stimulated as well. But in the second case, the effect is achieved with delay, as exported capital stimulates the economy of the country of origin indirectly. It is important to stress here the fact that smaller amounts of capital are needed to stimulate an economy by exporting capital and waiting for indirect effect than it would be the case if the capital was invested directly on domestic market. This is achieved by effect of differences in purchasing power parity (PPP) of developed and catching-up economies.[12]

Countries close to EU accession are using different strategies as far as the level of their interest rates is concerned. Some of them keep reducing the rates, bringing them closer to the level of the interest rate in the EMU, while others keep this rate, on purpose, higher than the EMU one. The best example of these differentiated strategies can be given by Poland or Hungary and the Czech Republic. The interest rate in the Czech Republic

[11] K. Żukrowska, *Level of interest rate and capital flows*, in: K. Żukrowska, D. Sobczak (ed.), *Eastward Enlargement of the Eurozone. Impact on Trade, FDI and Capital Markets*, The Knowledge Institute, Warsaw 2003, p. 131.

[12] K. Żukrowska, *Euro and capital flows*..., op. cit.

were reduced to EMU level, which stimulated the consumption on both state's and households level. Hungary – following the pattern of changes that was applied in Czech Republic –lowered their interest rate as well. Afterwards, however, they had to return to the old level of interest rate, an further even increase it.[13] The low level of the Czech interest rate resulted in an increase in imports and stimulated pressure on inflation. In case of Hungary, similar symptoms were noticed, but as they were perceived as unfavourable by the country's central bank, the bank decided to withdraw from its previous decisions and increase the exchange rate again. In case of Poland, the exchange rate is being gradually reduced, planning to come closer to the level represented by the EMU. However, it will probably stop at a certain point, that is, at a level higher than the one of the EMU, just not to loose the simulative effect on foreign investments.

In general, low exchange rate can be applied without loosing position in attracting foreign investors when other factors increasing competitiveness of the market are introduced. In case of the Czech Republic, the role of such a factor played the decision to lower taxes meaningfully.

Until joining the European Exchange Rate Mechanism 2 (ERM2), the accession countries can also enjoy the possibility to attract FDI by the level of their exchange rate. After becoming EU members, economies of these countries will be still attractive for FDI flows within the internal market, as they will be expected to increase productivity faster than old member states, and their markets will be still less satiated. However, most national currencies in the countries which are characterised by advanced transformation process indicate a tendency to appreciate (so-called *Balassa-Samuelson effect*), which encourages investing. At the beginning of transformation there was just an opposite trend – currencies of these countries went under a pressure of devaluation. Such a situation led to increased competitiveness of exports, decreased competitiveness of imports, and it stimulated FDI inflows when economies were still in protectionist phase. With liberalisation of trade and capital flows, appreciation was stimulating inflows. The type of conducted exchange rate policy matters in case of small economies and not big ones, which are able to absorb increased production. In small economies additional production is mainly sold on foreign markets, thus the level of exchange rate is crucial in calculating profitability. Currently, size of the markets and geographical trends in liberalisation allow

[13] Ibidem.

to say that differences in exchange rate values matter in pointing out directions of the flow of capital and goods. Due to this, keeping higher interest rates can be, in certain conditions, advantageous for a country.

Monetary union membership will limit the number of possibilities of attracting FDI, as new EMU members will not be able to use national exchange rates and interest rates any more. During two years of stabilizing exchange rate in ERM-2, EU members will have the possibility to influence the level of their exchange rates by changing the level of interest rate. While doing so, however, the countries will aim to keep the parity within the band of $\pm$15%, and attracting foreign investors with the use of the above tools will become less important.

4.3 Taxes and inflow of FDI

The next factor which plays an important role in attracting FDI constitute taxes. Countries can stimulate their economy both by lowering personal income tax (PIT) and corporate income tax (CIT). The stimulation brings better effects in case of lowering the level of PIT, as it means that more money are left in disposal of the consumers. While aiming at attracting foreign capital flows, however, reduction of the level of CIT is of crucial importance. For example, in Ireland low corporate taxes – through the stimulation of an inflow of foreign direct investments – made the country reach the highest rate of growth in the EU.

As far as the accession countries are concerned, various kinds of tax breaks and reductions are used. Such measures have been applied by the Czech Republic, Hungary, Latvia, Poland and the Slovak Republic. In the Czech Republic, for example, tax breaks of up to ten years are offered to all firms that make a US $10 million investment in manufacturing through a newly registered company or US $5 million investment in regions with the unemployment rate at least 25 per cent higher than the national average; and in Hungary: (1) corporate tax credit of 50 per cent is offered for an investment in the hotel industry provided that the investment is not less than HUF 1 billion, or that the investment is permanently made in a high-priority region or in an economic zone; (2) a company is eligible for a ten-year tax holiday if it invests at least HUF 3 billion in the manufacturing sector in an underdeveloped region, or if it hires at least 100 additional employees by the second year following the completion of its project and maintains the employment until the end of the tax holiday, or if the sales revenue of the company increases by an annual average of 5 per cent of the investment value; (3) there is a 100 per cent corporate tax allowance for a period of ten years for all investments exceeding US $35,4 million, or US $0,6 million for investments in underdeveloped areas.

Although lowering the level of CIT constitutes a good incentive to attract FDI inflows, it would be reasonable for EU member states – and particularly for EMU member states – to harmonise their taxes. Otherwise, there is a danger that the existence of a possibility to lower taxes will lead to tax competition. When such a tendency occurs within a group of countries, which form internal market and have a common currency, then disintegrating tendencies will arise and increase tensions among the members of the integrated group.[14] Moreover, competition in this field results in allocation of capital in a manner which is not necessarily most effective.[15] A coordination of taxes or an introduction of a double level system (one bringing revenues to national budget and the other one to the central budget of the EU) could constitute a solution to this problem; if countries do not come to an agreement on common tax levels, than it would be necessary to introduce a flat tax equal for companies and individuals.[16]

Across the region of Central and Eastern Europe, privatisation policies have been a significant factor determining trends and fluctuations in FDI inflows so far. Where strategic sales have been an important component of privatisation relative to the use of vouchers, FDI inflows have generally been the largest.[17]

4.4 Conclusions

There is no doubt that the accession countries, while following the path of liberalisation and privatisation, have been successfully catching up with the rest of the world in the field of FDI. However, both the process of liberalisation and privatisation will

[14] K. Żurowska, *Fiscal policy in Poland after 1989 – background for growth stimulation in transforming and EU economies. Practise and some generalisations*, in: K. Żukrowska, D. Sobczak (ed.), *Strategy of EMU enlargement. Background, optimal choices, consequences.*, The Knowledge Institute, Warsaw 2004, p. 93-130.

[15] T. E. Olsen, P. Osmundsen, *Spillovers and international competition for investments*, Journal of International Economics 59, 2003, p. 211-238.

[16] Ibidem.

[17] *Transition report*, European Bank for Reconstruction and Development, 2000, p. 83-84.

be completed soon and the countries will need new incentives in order to attract foreign investments. It seems that a crucial issue of the post-privatisation era will be how to attract FDI into greenfield ventures and into privately owned assets. While the attractiveness of existing industrial and commercial assets will depend on their valuation in secondary markets, foreign investors who consider greenfield investments need to take into account the cost of new plant and equipment, the business environment and market potential; they should find particularly important the security provided to investors by the existence of enforceable contracts, standardised product classification and business practices as well as all the regulations which are applied while commercial transactions are concluded.[18]

Fortunately, the experience of the transition economies and other emerging markets shows that FDI tend to be closely linked to rising bilateral trade flows. Hence, integration into the European Union which means a removal of barriers to market entry, legal harmonisation and fall of borders control should increase bilateral trade between new and old EU members and thus stimulate new FDI inflows.

In addition, a country can stimulate its competitive advantages, and thus capital inflows, by developing infrastructure, as well as deregulating postal and public services. This phenomenon was discovered by economists. As a result, it was reflected in GATS regulations which formed common framework on global level.[19] Nevertheless practices in individual countries tend to neglect this fact until now.

I. 5. Conclusions

Analysis of the three different segments of real economy provides several interesting conclusions. Firstly, it seems clear that in order to fully benefit from the monetary integration, there must be a certain degree of convergence of real spheres of the economy, especially due to the fact that some stabilising instruments of national authorities will be integrated on the EMU-wide scale. This fact greatly limits differentiation between countries in conducting their own policy, independent from the other member states.

[18] Ibidem, p. 84.
[19] S. Sinclair, Grieshaber, *Return to sender: the impact of GATS "pro competitive regulation" on postal and other public services*, Canadian Centre for Policy Alternatives, 2004.

The current EMU member states have already prepared their economies for the common currency. They have therefore a lot of their own experiences, both positive and negative, which considerably differ among countries. Due to this, Accession Countries should learn from the current EMU members, identifying the best solutions and fitting them to their own specific problems and characteristics.

Taking up the discussion on the most appropriate time for entering the EMU, it must also be kept in mind, that the situation looks very much differently from the point of view of different spheres. Taking into account financial markets, the common currency should be adopted as quickly as possible, as Accession Countries will fully participate in integration of these markets, therefore lack of euro will significantly limit possible benefits and development of this segment. Quite similar conclusion can be drawn for development of FDI, as elimination of exchange rate risk, which is the result of single currency, significantly enhances inflow of FDI. However, labour markets are in different situation. In some countries there is large unemployment, national labour markets in Accession Countries are inflexible, as well as imbalanced. There is also a considerable mismatch between the qualifications of the supply and the demand for labour. In effect, labour markets need deep, often revolutionary reforms, which are often socially unpopular. Introducing them requires time and should be completed before EMU accession.

To conclude, it is also very important that the Accession Countries constantly monitor changes in the EMU and participate in various developments, such as the creation of single financial market or pursuing the goals of the Lisbon Strategy. Doing so, they will ensure progressing convergence, as well as remaining in the core of integration process, thus preparing better for adopting the euro.

II. Policy Advice: Policies

Renzo Orsi et. al.

II. 1. Introduction

In May 2004 eight central European countries are to join the European Union. The EU rewards the remarkable progress Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia and Slovak Republic have made since the collapse of communist central planning. These countries are in the advanced stage of transition to market economies and democracy.

These Central and East European Countries (CEECs) have undergone significant and successful economic and political reforms. Their growth rates have outstripped those of the 15 countries making up the EU today. However the accession countries still lag far behind western Europe. They have a lot of catching up to do in establishing market economies and improving infrastructure, competitiveness and living standards. So the transition process will continue well past the accession date.

In the early stage of integration into the EU – what is sometimes termed *nominal* convergence – the accession countries will fulfil the conditions of joining the union. The second and much longer stage is *real* convergence which means achieving the standard of living in existing EU countries.

For *nominal* convergence on the economic level, much of the change expected in the new EU members will hinge on the requirement that they adopt the euro as their national currency. Joining the *Eurozone* will eliminate exchange rate risks, reduce the long term cost of capital and magnify the benefits of being part of a common market. The accession countries are already making preparations for European Monetary Union membership. These include fiscal and monetary discipline, and several are already pegging their currencies to the euro. The timing of adoption of the euro will depend on the conditions prevalent in each country (see Iacone and Orsi, 2003).

Real convergence will take much longer. The gap in per capita Gross Domestic Product (GDP) between the accession countries and the current EU average is still large. In

1980 the EU had nine members. The three next members, Greece, Spain and Portugal had a per capita income 65% of the level of the nine when they joined. If we do the same calculation for the current 15 and for the 10 candidates, the figure lower, i.e. it is about 45%. The process of catching up will therefore be even more crucial in the years to come than it was for the southern enlargement. Even if annual growth were to average five to six per cent in the accession countries, it would take them about 20-30 years to reach just 75 per cent of EU15 income levels. Such high growth is unlikely: it would be more than double the EU15 average and higher than that sustained by previous accession countries in the past decade.

As the CEECs economies begin to mirror those of the existing EU states, inevitably the accession countries will experience a painful reduction in their agricultural and industrial sectors. The EU institutions will continue to work with these countries to mitigate the social consequences of transition.

The CEECs entering in the EU need investments in both public and private sectors, to sustain the growth and improve living standards that will define *real* convergence. The EU will provide its new members with significant resources to bring their infrastructure closer to EU15 standards but this will not be enough for *real* convergence. And tight budgetary controls imposed by EU membership will make it difficult for the governments to fund this expansion themselves.

Hence the need for direct investments to fund infrastructures, skills training, and private sector initiatives, and to advise on policy and regulatory change and implementation, all to underpin sustainable economic expansion. High levels of investment in CEECs in recent years have been directed at improving capital stock; the CEECs are also in need of funding for environmental and social infrastructures that will be part and parcel of improved living standards. From the financial side it is important to continue to help the development of the accession countries' financial sectors to encourage a wider mobilisation of savings and more efficient allocation of these savings through private sector investments. It must be noticed that at present only 20 per cent of investments in these countries is from internally-generated private savings, compared with over 100 per cent in the EU15. The properly functioning financial sector would, for example, support development and growth of middle-sized companies, and it is well known, according to the experience of the actual EU15 members, that a lack of finance for small and medium sized enterprises stifles their development.

The policy advices will be considered in the next sections separately for the Foreign Direct Investments, the Labour Market and the Social Dimension, and will be presented by each of the teams which studied in a deep way these markets.

II. 2. Exchange Rate

(R. Orsi and F. Iacone, Bologna)

There is a general consensus on the idea that the EMU enlargement should take place as soon as possible: the real issue is to define when the possibility arises. Most of the academic contributions to the discussion suggest that the EMU enlargement should take place as the same time as the EU enlargement. Even without neglecting the adverse consequences of the BS effect, it is commonly argued that waiting for a closer convergence of the real variables could simply take too long, surely more than the two or three years that the mechanism of ERM2 would impose. As the President of the Commission stated[20], "enlargement is not just about economics. It is important primarily for political and ethical reasons", and there is the risk that the people in the CEECs could perceive an enlargement without EMU as incomplete.

EMU accession then should be considered as soon as possible, as long as the conditions that guarantee stability of the country in the euro area are ensured. With this respect at least a sound fiscal consolidation and some flexibility of the labour market are necessary. While in the past the CEECs were all eager to join the euro-area as soon as possible, a more gradual approach is now emerging, possibly also because these factors are taken into account.

Defining the parity towards the euro and the future conversion rates is a delicate task, because any adjustment of a potential misalignment must fall on the real sector, and, given the limited flexibility of the supply side on both the EU and the CEECS, this may

[20] in his speech to the European Parliament on 9 October 2002.

take some time. The CEECs begun the transition with under-valuated currencies, and experienced a real appreciation during the years even after correcting for productivity gains. The consensus in the literature seems to be that Hungary and Slovenia are quite close to the equilibrium, while the Czech Republic over-evaluated the currency before the 1997 crisis, and, after a short period of under-evaluation after the crisis, is back to over-evaluation; Slovakia too has an over-evaluated currency, but less than the Czech Republic. The results in the literature are anyway rather dispersed, different studies reaching opposite conclusions for the same country over the same period. Evidence that Poland and the Baltic States are over-evaluated is even more controversial.

The countries that decided to postpone the two years phase of evaluation of the Maastricht criteria must choose a monetary strategy for the intermediate period. The opportunity of the fixed exchange rate approach was extensively debated in the last few years. We think that fixed exchange rate commitments cannot be managed for an indefinite time without capital controls, and indeed the failure of several of these arrangements had been a relevant source of instability on the international financial markets in the last few years. Narrow bands in general could make the defence of the exchange rate more difficult and then increase the risk of a speculative attack: notice here that the arrangement chosen by the current ERM2 participants, with the 15% oscillation bands per side, seems to acknowledge that. Since the supply of international reserves is limited, even a currency board is not a fully credible exchange rate agreement and can be subject to a speculative attack or exchange rate pressures (as it already happened in Estonia) or bank runs. Factors reducing the risk of attacks are the availability of foreign currency reserves to defend a fixed exchange rate, along with the consistency of macro economic policies. Sustainable public finance represents a fundamental requirement with this regard. Another important support to a fixed exchange policy in a context of capital mobility is the endorsement of the central bank of the anchor currency: speculative attacks are often triggered by the fact that the reserves that a central bank can mobilise to defend the exchange rate are limited, and very little when compared to the volume of funds that can be risen on the market. If anyway the monetary authority of the anchor currency is credibly oriented to support the exchange rate agreement, the chance of a success of a speculative attack are much reduced, to the point that the expected gain in such a case can even be negative.

Floating the exchange rate without formal commitment does not mean neglecting it as a policy instrument and as a potential source of disinflation: on the contrary we think that its effect on inflation is faster it is more reliable than the interest rate. We then expect the monetary authorities to use it in conjunction with the interest rate to achieve the target.

Since there is enough evidence that inflation targeting provided in Poland and in the Czech Republic a valid reference for monetary policy and an anchor to the expectations not inferior to the exchange rate commitment, we think that these two countries should maintain the current monetary arrangement. We think that Slovakia too should introduce this policy regime in the explicit form in order to help the formation of expectations in line with the inflation stabilisation programme: if the weight of the administrate prices is too large, an alternative, "net", target can be considered instead[21].

We also think that Hungary may drop the exchange rate commitment and remain with the inflation target only, especially if a situation of potential conflict between the two monetary regimes is feared. Failing that, we think the widest possible bands should be chosen and the occasional devaluations to follow the macroeconomic fundamentals should not be opposed; if Poland, Slovakia or Czech Republic join the ERM 2 before the monitoring period defined by the Maastricht criterion, we suggest them the same policy.

In any case we think that the situation of the currencies joining the ERM 2 in the process of accession to the euro area may be eased because it is well known that the fixed exchange rate arrangement has to remain in place for only a relatively short time, and because it can count on some sort of support from the target currency (the euro) at least under some conditions.

We already noticed that Slovenia should explicitly introduce a target for monetary policy to help the formation of expectations favourable to the final disinflation to the euro area level: with this respect the detailed plan described in the accession programme, subscribed both by the central bank and by the government may serve to that purpose too.

Finally, Estonia and Lithuania plan to join the euro as soon as possible, thus having to enter the ERM 2 with the hard peg immediately. Latvia is planning a slower approach,

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[21] A certain feedback may still take place from the administrated to the marketed prices, making inflation targeting more difficult: this could justify the adoption of a relatively larger fluctuation band. The central bank could even allow for a "scenario dependent" target, in which the final reference is defined as a function of the administrated prices.

converting the peg from the SRD to the euro only in 2005, upon accession to the ERM 2, and introducing narrow fluctuation bands. The Baltic States could conceivably try and exploit the credibility acquired so far and enter the ERM 2 with the hard peg, but remembering that their goal is not the hard peg itself but the euro accession, and that this purpose is also served by a wide oscillation band or even a free float before the evaluation period, so they can consider resorting to that in the wake of a speculative attack rather than waiting for it and opposing it putting at risk the internal stability.

II. 3. Foreign Direct Investments

(Jose Caetano, Evora)

The expansion and adjustment of FDI flows are expected to have a positive effect on economic growth. However, the impact will differ across regions and sectors, both in the new and in current EU members. Several studies agree that border regions will be potentially more affected by enlargement, stressing out that the direct economic effects on the EU-15 will be mostly concentrated in Germany and Austria. Other regions, in less developed member states, such as the Cohesion countries, will face indirect effects arising from increasing competition, difficulties in attracting FDI and in preventing its diversion to the East, and from possible adjustments of structural funds. From the new members' perspective, challenges go beyond dealing with the competition pressures of an enlarged single market. Unfinished structural reforms and the need to comply with the *acquis communautaire* may generate additional problems. Besides considering particular regions, countries or groups of countries, one should also focus on the European Union's perspective as a whole and consider the possible negative impacts on cohesion.

Overall, some fundamental questions remain. First, it is necessary to prevent harmful effects from enlargement. For example, how to sustain past convergence trends of the new member states and what kind of policies would make them sustainable, or how to achieve income convergence between old and new members and strengthen cohesion. Second, it is necessary to correct possible negative impacts: to lessen adverse effects from FDI reallocation or from the increasing probability of asymmetric shocks. Besides, an additional effort should be directed to turning the legal framework and administrative capacity capable of matching "the conditions of efficiency and legal certainty prevailing in the EU" (European Commission, 2003). In the new members, the enforcement of intellectual and industrial property rights and the effective application of competition rules and environmental legislation are still incomplete. Visible efforts should also be made to control corruption.

The European Union as well as the national authorities, have to assure the effective implementation and enforcement of the *acquis* and this will require a massive monitoring effort. An interesting point of view on this respect relates to the frequent dependency between the effective implementation of EU policy and the disposition of national and regional authorities to combine EU priorities with their own specific interests. The promotion of EU as a "facilitator" which employs "not only sticks but also carrots, including through the EU budget" (Sapir et al. 2003) seems adequate. Nevertheless, it is also prone to criticism, especially on the part of those who are not net receivers or that are against subsidising, unless other instruments, apart from the EU budget, are considered.

The possibility of FDI diversion should not be excluded. Even though results from previous work do not fully support this scenario (Caetano et al., 2002 and Boeri and Brücker, 2001), specific sectors and regions may be affected. Among these are the border regions in Germany and Austria, but also some regions in cohesion countries, highly dependent on the performance of specific sectors, which are likely to be affected by FDI reallocation processes (textiles, for example). In addition to the usual determinants of FDI, as labour costs or market potential, the desire to move closer to the Central European market may give rise to important FDI reorientations. The difference between unit labour costs in the new member states and in the EU is likely to become narrower, which may reduce CEEC attractiveness in this respect. Furthermore, due to the presumed increase in labour costs after enlargement, the new and old member states face the competition from the other CEEC who will try to attract efficiency-seeking FDI, looking for lower cost locations in the new 'frontier countries'.

On the other hand, potential market is expected to increase due to the probable growth in the new members' GDP and the consequent reduction in the economic distance between the EU and these countries. One should note, however, that market-seeking FDI flows depend essentially on the speed of income convergence, which may vary within the new EU members. Furthermore, not only adjustments are likely to occur in the FDI destination regions but also in the type of FDI involved, since the catching-up process will probably cause an increase in investments by horizontal multinationals and depress investments by vertical multinationals (Carstensen and Toubal, 2003).

Under these circumstances, there is a need for specific policies to attract FDI, not only in the new member states, but also in the more vulnerable incumbent members, which are likely to suffer idiosyncratic shocks. Efforts should be made to implement structural reforms capable of generating the necessary conditions to attract market-seeking FDI and upgrade the demand for efficiency-seeking projects. In the particular case of the CEEC, having to comply FDI regimes with EU regulations, and therefore to give up some existent special incentives to attract FDI, several CEEC might improve international competitiveness by lowering corporate taxes below the EU average (UNCTAD, 2003).

CEEC national policies should be conceived to explore positive externalities produced by FDI flows, namely in productivity, employment, technology transfers and human capital development. On the one hand, negotiations with social partners will be essential to achieve a sustainable development. On the other hand, current technology gaps have to be identified. If such gaps are very pronounced, the technology transfer process between local and multinational companies will be compromised and situations of oligopoly, or even monopoly, may take place. Besides, space for further restructuring of domestic firms subsists, despite the structural changes promoted by FDI, and there is a need for policy makers to foster the development of local innovative firms' clusters, or other forms of creating synergies. Investment in R&D driven activities and in innovation arise as two crucial areas in order to attract FDI with high technological content. Additionally, there is the need to address the deepening of the financial system and to promote mechanisms of financial intermediation. Flexible and quick ways to find funds for entrepreneurial activities and easily available risk capital are important for the strengthening of the entrepreneurial environment and, therefore, reforms towards the liberalisation of the financial system should not be neglected.

The viability of certain firms in the new member states may also be affected by the requirement of complying with the *acquis communautaire*, given the substantial investment efforts required. CEEC must harmonize their regimes with the EU regulations, to guarantee full access to the Single Market and to increase competitiveness, but also to benefit the most in terms of investment promotion, from the EU regional development funds. Financing the transposition of the *acquis* is exactly one of the areas identified by the European Commission (2003) where specific policies will have to be introduced after enlargement.

Bearing in mind national specificities, the increasing heterogeneity deriving from enlargement and the rising number of legitimate national public policy objectives, a logical consequence will be the constraining of the future level of integration in the EU. The diversity issue has to be fully addressed for a number reasons. In order to achieve the EU goals of economic growth with more and better jobs and greater social cohesion, several issues will have to be dealt with, such as the need to increase employment rates, to upgrade labour force skills, to introduce higher flexibility in the labour market and to ensure that inter-sector mobility of the labour force will not result in increased regional disparities. The Structural and Cohesion funds will probably be the most suitable instruments to deal with the social and regional consequences of enlargement. However, although structural funds will play an important role in strengthening cohesion, national and regional specific policies have also to be undertaken. National policies should take into account possible asymmetric effects and, therefore, national governments could encourage territorial-based policies and regional networks.

Finally, the future integration into the European Monetary Union (EMU) will bring additional challenges for new members states, in terms of economic growth, employment and FDI flows. The difficulties that some members are facing in order to comply with the Stability and Growth Pact (SGP) are a warning signal of what may be ahead for new members. The choice between an immediate accession to EMU and the establishment of a transition period is controversial. However, if accession to EMU is immediate, EU and national policies should take that into account. Possible solutions are the creation of a special SGP directed to the CEEC specificities, or the reformulation of the original Pact.

II. 4. Labour Market

(Tiiu Paas, Tartu)

The beginning of transition brought significant social difficulties and new social problems emerged that were unknown in the previous communist societies: unemployment, increasing inequality, emergence of poverty and social exclusion. Though according to some quantitative measures the problems are perhaps not more severe than in Western Countries, the issues are urgent also because of the living previously in relatively egalitarian societies, the inhabitants of CEE countries are sometimes less willing to tolerate the existing inequalities, and the institutions meant to tackle with social issues (social protection systems) are lagging in their development behind the social needs.

The enlargement of the European Union creates the potential of large movements of capital towards Central Europe precipitating the decline of the industry in Western Europe and leading to large asymmetric developments in the business cycles between East and West. Consequently, the Eastern enlargement of the European Union and the requirements of the European Monetary Union call for increased flexibility of labour markets in both the current EU members and candidate countries. If labour markets and institutions are rigid in the monetary union, market disequilibrium is likely to grow.

Another issue is that the introduction of euro calls for higher levels of labour market flexibility. The Central and Eastern European countries labour markets are already now relatively flexible, and the concerns are that joining with the European Union might rather decrease the flexibility in the labour markets. The dark side of higher flexibility is that it implies lower job security (shorter average duration of employment relationship, more flows between unemployment and employment, more job creation and job destruction) and thereby in some aspect lower quality of life. The importance of trade unions is much smaller in CEE countries than in Western European countries.

Labour market flexibility should be measured at two distinct levels: the macro level and the micro level. At a macro level the flexibility can be further divided into institutional and wage flexibility. The institutional flexibility of a labour market denotes to what extent state institutions and trade unions are involved in the regulation of the labour market. Wage flexibility shows how responsive wages are to market fluctuations. Micro level flexibility relates to labour market flow analyses. A labour market can be characterized by various flows of transitions to and from employment, unemployment and non-participation, as well as flows of job creation and job destruction. In practice, different aspects of flexibility are interrelated, presumably in a hierarchical way. If institutional involvement is very high, workers' transition rates are likely to be low. If trade unions are weak, then wages are more flexible. Thus, macro level flexibility can partly be measured via the indicators of micro level flexibility.

Thus, the flexibility of European labour market means that workers are willing to accept a wage cut so as to keep firms in the country, and/or that workers are willing to move with the exiting firms to the countries that experience an economic expansion. If labour markets are flexible, their institutions allow to cut wages, labour force are ready for geographical mobility and able to adjust with the changes in wages (declining of wages) and in requirements to the qualifications and working skills.

Presumably, there is a limit to what extent the citizens in Europe will accept in terms of flexibility. One reason of rather low flexibility of European labour market comparing to the U.S. labour market is the absent of a common language. Also impacts of the trade unions, other institutions, working habits and cultural traditions on the European country's labour markets are significant.

The job-less growth phenomena has been widely observed and perhaps can not be ruled out also when we talk about the impact of *Eurozone* enlargement. For instance, the increasing foreign direct investments and availability of financing could further encourage the replacement of low-skilled labour with capital and thereby decrease employment. Though the currently low wage level may help to preserve low-skilled jobs in CEE countries, the higher level of inflation erodes that advantage over the time. Important aspect here is the strictness of labour market institutions. The relatively moderate taxation of capital compared to the taxation of labour may foster such developments.

What can happen if labour markets are not flexible enough?

In the situation of asymmetric shocks some countries will have negative output shocks, while others will have positive ones. If the labour forces are not flexible and social security is organized at the national level, the budget situation of the country losing output deteriorates and unemployment goes up. As a result, the authorities of this country are forced to cut back on spending and to hike taxes. All this makes the economic condition precarious. Some of the countries hit by a negative shock may decide to let the budget deficit increase and may end up in an unsustainable debt situation leading to debt crises. Undoubtedly, the monetary union would be put under great strain. Some countries would blame the union for their misfortunes, creating political tensions and crisis. If the crisis were to go on, a disintegration of the union would be inconceivable.

What to do?

There are two simultaneous ways to avoid possible tensions and crisis.

Implementing structural reforms that increase flexibility of labour markets (including also educational reforms, development of social policies, etc).

Declining and aging European population needs big investments into human capital (education, training, health of people) in order to support flexibility of labour market and to avoid its disequilibrium.

The social protection measures should be more targeted to the most vulnerable groups of population in order to avoid social exclusion.

The requirements to employment protection regulations, minimum wages, social benefits and pensions should be less centralized taking into account specific conditions of the countries, the members of the enlarged EU. Centralized labour market institutions and strict labour regulations may reduce labour flexibility and increase unemployment.

2) Providing both public and private insurance schemes against asymmetric shocks. These schemes allow transfer income from the countries enjoying an expansion of their output to those countries hit by a negative output shock.

There are two ways to put *public insurance* into operation, but both of them will often not function properly when countries need it most.

Centralizing some part of the government budgets of the member countries at the European level in order to distribute this financial source in the case of asymmetric shocks. Of course, there is high probability that this insurance system may lead to a moral hazard problem. In the case when EU25 countries will be in trouble, the insurance mechanism through budgetary centralization will not be available.

Using nationally based insurance mechanism that bases on the public debts. This approach reduces the risk of moral hazard. At the same time, the nationally based insurance system is not always available. In particular governments with a high debt who faces a negative asymmetric shock cannot easily allow their budget deficit to increase.

The *private insurance scheme* operates through the financial markets. To the extent that the Eurozone-25 will lead to the creation of a unified financial market (integrated bound market), it also automatically creates its own insurance mechanism allowing countries that experience negative output shocks to obtain temporary compensation and to smooth their consumption. Of course, it is necessary to take into consideration that financial market provides insurance if markets function efficiently. If financial markets are not working efficiently, instead of an equilibrating force, they themselves may be a source of disturbances. In normal times (not in the conditions of bubbles and crashes) the financial market integration is an important insurance mechanism. But we should keep in mind that financial markets sometimes fail to provide this private insurance service and then they become a source of instability. In those times it is important to have a publicly provided insurance mechanism to back this up.

Suggestions for policies.

We suggest that the aim of social policies in the enlarged *Eurozone* should be targeted at sustainable development and the quality of human capital. That assumes flexible workforce, able to change the profession and job, that assumes among other things good basic education. In order to decrease the long term unemployment level, it is necessary to target active and possible labour policies though that people have access to necessary re-training while incentives to work and to supply labour are not hurt by the replacement of income during the time of unemployment. The issue is whether the goal of policy should be economic efficiency subject to the constraints of social needs, or social needs subject to the constraints of economic efficiency.

We emphasize the concept of sustainable development as it is usually understood (the needs of current generations are met without impeding future generations in meeting theirs to the same extent). The social situation of both generations can be improved by investing in infrastructure, technological development and human resources.

An important policy question to be answered is how in the enlarged *Eurozone* to assist countries who have due to asymmetric shock fallen into economic difficulties. The usage of fiscal policies by accumulating budget deficits is constrained by Maastricht criteria (though enforcing these rules seems to be a tricky issue, as indicated by the policy of France and Germany). Some kind of possible insurance systems, by which countries having problems received payments from central funds, creates other problems (similarly to the other forms of insurance). For instance, a moral hazard problem will emerge if the individual countries have less incentives to avoid problems themselves, less incentives to follow sound macroeconomic policies *et cetera*.

4.1 The Baltic States' View

The Baltic States have dutifully observed the main international standards regulating labour relations in accordance with the EU rules. Comparing the Baltic States' labour market with those of EU15 and the other candidate countries, one comes to the conclusion that the Baltic States' labour markets are flexible. The most flexible among them is the Estonian labour market followed by that of Latvia. However, predictably, after joining the EU, the labour markets of the new members may become more rigid due to the increasing influence on them of institutions and trade unions, and due to more generous funding of labour market policies. Moreover, a decline of wage flexibility can be predicted.

Trade unions in the Baltic States, like in all the Central and East European countries, are rather small in terms of both union density and collective agreement coverage. The importance of trade unions has been declining in the CEE and Baltic countries since the beginning of the 1990s. At the end of the 1990s, trade union density was less than 35% in all the transition countries except Slovenia. In the Baltic States, trade union density is even smaller than the CEE countries' average, with the highest density rate in Latvia. Collective agreement coverage in the Baltic States is not much higher than UE countries' density. This is mainly due to the small number of sectional level agreements. Collective wage bargaining in the Baltic States takes place mainly at the enterprise or national level, while bargaining at sectional or regional level is less developed. Due to the low coverage by collective agreements, it can be concluded that the majority of employees in the Baltic States rely on individual employment contracts.

The Baltic States' labour policies are rather insufficiently funded in comparison with the EU, the share of active measures being relatively low. In Lithuania 40% and in Estonia even 60% of the overall employment policy budget is allocated on passive measures. At the same time, the overall coverage of the unemployed by the system of income maintenance is still low in all the three states. The status of the unemployed is regulated and they have several rights. In Latvia the unemployed enjoy higher unemployment benefits than in Lithuania and especially in Estonia, where the benefit is currently so small that an unemployed person has to apply for subsistence benefit as well.

The participation of registered job seekers in active labour market measures is low as well. In accordance with the European Union's employment guidelines, the goal is to achieve the involvement rate of 20% of unemployed people. At the moment, the respective number is largest in Estonia — 10%, followed by 4% in Latvia and 3% in Lithuania. It could be concluded that, because of the undercapitalization of the labour market policy, unemployment benefits are low and therefore fail to remarkably decrease labour market flexibility. On the other hand, by laying more emphasis on active labour market programs, a positive impact of labour policy on labour market flexibility could be increased. In this context, more attention should be paid to education and training, including development of lifelong learning which is now an established priority throughout the EU. In Estonia one of the main problems is the poor targeting of the programs (e.g. the aid to starting business). In Lithuania there is a need to expand active labour market programs and re-balance provision away from temporary work, in favor of training and other measures designed to increase employability. Also passive policies need to be reformed in Lithuania in order to improve coverage, eliminate disincentives, and emphasize activation rather than passive receipt of benefits. The public employment service should play a more active role in reintegrating the unemployed.

Analyzing wage flexibility in the Baltic States, it is possible to admit that on the whole wages are rather flexible, but there are also differences between the countries and economic sectors. Nominal wages are most rigid in Lithuania and most flexible in Estonia. At the same time, minimum wages are lowest in Estonia and highest in Lithuania. The most flexible wages are in the construction sector in all the three countries. In Estonia and Latvia, wages are also flexible in fishing, agriculture, and the hotels and restaurants sector. The wages of the public sector and of the financial sector are mostly rigid. The data also confirm that if the wages are low, they are more flexible. In the context of EU enlargement, it is possible that wages in those sectors where they are most flexible will converge faster with the EU wage level if EU labour market policies are liberalized. It may also happen that, if the Baltic States' labour markets become as highly regulated as those of the EU, wage flexibility will decrease in all the three countries, but especially in Estonia. The last option is rather realistic.

Why will the labour market of the Baltic States become more rigid?

First, the influence of institutions will increase. From the formal point of view, the legal regulation of the labour market seems to be in place and the calculated indexes show that, on average, the worker is even better protected in the Baltic States than in the EU. However, in practice it is obvious that at the level of firms, the state regulations are not always complied with. There is a lot of evidence that these regulations have been violated, at least in the case of Estonia. The influence of institutions will grow because the control over observance of the regulations will increase, caused by increasing administrative capacity.

This leads to the second point, the power of trade unions. At the moment, trade unions are very weak in all the three countries. We believe that trade unions are in the process of recovering and their strength, both in terms of density and coverage, is increasing. Firstly, more workers will start to realize that they need unions and will get organized. Secondly, unions will learn more from the past and will become more attractive and visible in society. Also sister organizations in the Nordic countries and the central EU level organizations will provide help to local trade unions, training local trade union managers, giving financial support, organizing joint seminars, etc. Thirdly, if trade unions start to expand and strengthen, wage flexibility will accordingly decline, because today the collective agreement coverage rates in the Baltic States are extremely low. Fourthly, the state should contribute more to labour policies and the share of active labour market programs should be increased.

These tendncies will definitely decline the flexibility of labour markets and there exists a danger that in the nearest future we will have to grapple with the same labour market problems (long term unemployment, high labour turnover cost, weak motivation for job search), which are so common for the EU member states. In order to maintain sufficient economic growth, the Baltic States will have to reduce their unemployment rate, in particular, structural unemployment, and increase labour force participation.

Free movement of labour as a natural consequence of EU eastward enlargement will have its impact on market disequilibrium particularly during the first years of enlargement. It will put pressure on the labour markets of the Baltic States due to the possible outflow of better-qualified and flexible labour force.

Movers will be mainly people with good qualifications, also young people with a secondary school (gymnasium) education, who cannot find qualified jobs at home. They are ready to work abroad as blue collar workers, getting relatively higher salaries than they would expect to get in their home countries. Analyzing the labour migration problems of the Baltic States, attention should also be paid to the possible cross-border labour movements within the Baltic Sea Region. Cross-border movement is costly to the country of residence, which may lose the income tax revenue from the worker but has to finance the social expenditure and local infrastructure for the benefit of the workers' family.

II. 5. Social Dimension

(Achim Kemmerling, Berlin)

5.1 How to evaluate the social dimension of Ezoneplus

Since the report has already deviated from standard economic accounts of integration processes, this contribution necessarily deals with normative evaluations of a (slightly) different form. The normative benchmark against which alternative policy proposals should be judged cannot be economic efficiency alone. From a perspective of political economy, policies also have to be, at least, also politically feasible in the short run, if not even socially acceptable in the long run. The reason for this is rather mundane: if policy proposals are made they may be economic first-best solutions, but if these proposals risk, for example, electoral defeat, their implementation is highly questionable. Hence, also from a normative perspective we should be interested in second-best policies that are both politically and economically preferable (Saint-Paul '00). In a broader view, 'societies' should even have an interest in guaranteeing support of most of its members, since, ultimately, political and economic welfare also depends on the extent of social acceptance of important political decisions.

5.2 Welfare State and Social Policies

The competition between tax and transfer systems could stir major irritations across nations, since it makes 'globalisation' plainly visible in its regional context. Though some economists may believe this is an efficient solution to the problems of stabilisation and structural reform (Siebert '97), political interactions between countries will necessarily distort these effects and could lead to less efficient outcomes. As in the case of the fear about wage dumping, social dumping looms large on the integration of a monetary union. CEECs may be tempted to export (unskilled) labour and import foreign direct investment to a degree that puts a strain on western governments (Boeri et al. '02).

The economic problem behind the claim of social dumping is the externality of systems with different generosity of benefits and different tax burdens. Obviously rich people are tempted to move to low-tax countries, whereas poor people would rather opt for well-endowed welfare states (Sinn '00). A series of recommendations has been suggested how to deal with this problem: (1) principles of discrimination, (2) and of harmonisation, (3) international compensation (cf. next part on EU transfers), (4) EU-level substitutes. The first recommendation stems from Sinn (Sinn '99) who argues that the best alternative to stop these processes of dumping would be to use a legal system of discrimination between national workers and immigrants. At least in the short term, migrating workers should be entitled only to their home country benefits, in order to stop this form of artificial incentives for migration. Most critics argue that this necessarily confronts the *acquis communautaire*, since EU law has abolished such practices of discrimination. Sinn argues that it is time for an entire review of the *acquis*. But there is also, still, the possibility of using this instrument for CEECs as the case of the FoS has shown.

A second option is to harmonise systems across Europe, a suggestion which necessarily fails in the short run, because of a lack of common principles across European welfare states. It has been argued, for instance, to adopt a certain form of social minimum for each country as a function of its GDP p.c. (Scharpf '97). Unfortunately, the link between wealth and welfare state is far from perfect, and many countries would oppose such a suggestion. Rather, if rich western countries want to avoid excessive competition of CEECs in tax and transfer systems, they could also subsidise the expansion of the welfare state in these countries (Boeri, Bertola, Brücker, Coricelli, and al. '02: 18). Structural funds could be used as policy instrument to guarantee this form of monetary transfer between western and eastern Europe. These transfers, however, have to be conditional on the capacity building of these welfare states rather than to guarantee additional monetary transfers to welfare state recipients. Moreover, the kind of programs to be subsidized has to be chosen with care (Boeri, Bertola, Brücker, Coricelli, and al. '02: 19/20). Similar recommendations could apply to the issues of improving tax administration in CEECs.

Ultimately, however, the EU has to think about the question how to implement a pan-European social safety net that guarantees, at least, a social minimum acceptable to all countries (ibid. 21). Of course, this entails a lot more than all the other recommendations. It would mean nothing less than a complete revision and re-structuring of EU-level transfer policies, with which will deal in the following section.

5.3 EU transfer and regulative policies

A political-economy perspective would start from a different point of view. Maybe EU transfer policies are not so much due to efficiency considerations, but neither they are - at least not exclusively – political rents. Inhabitants of eastern German Länder and French farmer seem to have pivotal power in their national political systems so that they have managed to secure their transfers at least for the medium run. This is astonishing since France had to negotiate a principle of discrimination versus Polish farmers and eastern Germans will have to get special provisions not to be kicked out of so-called Objective 1 regions (Kemmerling '03).

As Rodríguez-Pose and Fratesi (Rodríguez-Pose and Fratesi '03) argue that structural funds (SFs) may not so much be seen as a development policy but rather as a social policy. Most observers would agree that SFs have failed to achieve regional convergence in Europe, but it is quite likely that this has never been the foremost aim. Rather SFs, and to some extent, CAP-cash have impeded greater divergence that might have occurred since it is usually the urban clusters that benefit most from integration and FDI-inflows (Boeri, Bertola, Brücker, Coricelli, and al. '02; Caetano et al. '02: 47/48). In addition, there is some evidence that SFs and CAP raises the acceptability, if not legitimacy of the European Union (Mattila '01 also Austin ??)

Nevertheless, it is obvious that monitoring the distribution of SFs has to be improved dramatically. Only some 10 per cent of SFs are invested in human capital (Rodríguez-Pose and Fratesi '03: 9), although these investments are arguably the most profitable of all SFs. Moreover, cross-national performance of cohesion countries has been very diverse. For the Irish and Iberian case, cohesion cash seems to have been beneficial, whereas little convergence, so far, has been visible in Greece. *Nota bene* that the cohesion fund is a facility introduced in order to account for the costs of structural adjustment as poor countries approaches EMU. As a consequence, it seems safe to argue that the true political conflict lies in the problem that rich countries may be forced to pay higher contributions, whereas political acceptance of such a policy is low among their national electorates.

The source of this conflict lies in the potential of new members to re-negotiate their 'slices of the EU budget cake' once they will be members of EU. Stylised forecasts show that new members, making use of their newly acquired political weight, could double their share of EU transfers (Kemmerling '03: 27/8). This holds for CAP-cash, since it is a deviation from EU legal practices to begin with, but also for SFs, albeit to a minor degree, since the take-up of SFs is not easy for poor countries due to the principle of co-financing projects. As a mirror image, budget quarrels loom large into current efforts of EU-15 countries to introduce new voting rules in the legal corpus of the EU convent (König '01). Those efforts notwithstanding, it seems to be safe to argue that the EU will redistribute more money than before. But if this is the case, EU-15 countries should negotiate as hard as possible to introduce some levels of structural reforms to both SFs and CAP.

The most radical approach is to do cross-country redistribution in the simple form of lump sum payments. Tabellini (Tabellini '03: 89) argues that if this redistribution is only due to smooth negotiations by giving side payments, the best answer is to do it unconditionally. Governments should know better how to buy consent among their electorate. This suggestion would also reduce the problem of mixed financing between different entities in fiscal federalism. Germany is a well-known example where this form of mixed financing has lead to notorious problems of accountability and decision-traps (Scharpf '94). But lump sum transfers are implemented, the EU-Commission will have to be compensated by other mechanisms how to guarantee a direct form of (output-oriented) legitimacy for European peoples.

Apart from questions of institutional design, all these efforts are, however, only short-term cures to a long-term problem. Both the problem of externalities in diverse tax systems, and the increasing demand for redistribution across member states, calls for the introduction of a common European tax (cf. Tabellini 93). In addition, there may be a more powerful, but admittedly also more opaque argument in favour of such a tax. If one lesson can be drawn from the modern history of democracy from a political economy perspective it is the principle that representation follows taxation. If a European demos, an identity or however you may call it, is to be created at all, a pervasive way to do that is to raise the stakes involved. The current problem of a lack of democracy in the EU, and the lack of political power of the European parliament, may be less due to the role of institutional rights. Ultimately, the power of a parliament depends on the subject matter it has to decide upon. If high transfers and taxes are at stake, European electorates will have to become more interested in these parliamentary proceedings.

II. 6. Some concluding remarks

To summarize, CEECs should only access the euro area if they are able to forfeit the exchange rate as a monetary policy instrument. Fiscal stabilisation and flexibility of the labour market are then essential to counter asymmetric shocks to the real economy and adverse phases of the economic cycle.

The Maastricht criteria require two years of stable exchange rate in the ERM 2. Since fixed exchange rate are exposed to speculative attacks, countries that are currently floating their currency could minimize the risk staying out of the ERM 2 until the beginning of the evaluation period; meanwhile, the role of anchoring the expectations should be left to an explicit inflation targeting; a formal and detailed programme of euro accession strategy may constitute a valid alternative especially for those countries where inflation targeting has not been implemented yet. Adopting the 15% oscillation band could be a second best solution.

Of the countries currently having a fixed exchange rate, only Latvia is planning to postpone the accession to the euro area, thus entering an *interim* phase. Shifting the peg to the euro, it could try and exploit the credibility acquired in these years of fixed exchange rate entering the ERM 2 with very narrow bands, but keeping in mind that the goal in perspective is the accession to the euro area, and not the defence of the peg in the short term.

Despite the exposition to speculative attacks, it is encouraging to notice that in the run up to the monetary union of Italy or Greece the "convergence play" helped these countries, increasing their credibility and leading them to a smooth accession to the euro.

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