Introduction

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This book is about the subset of eight of the European Union's ten new Member States admitted in the most recent (1 May 2004) enlargement. These are the countries collectively known as the Central Eastern European countries (or CEECs, for short). They comprise: Hungary and Slovenia, the Czech Republic and Slovakia, Poland and the three Baltic countries Estonia, Latvia and Lithuania. Shortage of data is one of the reasons for excluding consideration of Cyprus and Malta, the other two countries admitted in the 2004 enlargement.

Earlier enlargements brought with them distinct challenges and opportunities both for the new participants and for the existing members of the Union. The one we are concerned with here is no exception.

In particular, the latest enlargement is unparalleled in terms of the *number* of countries involved, provoking the need for a change in the governance structure of the European Union (EU). Otherwise the enlargement could be seen as leading to paralysis in decision-making. Secondly, the average level of prosperity and economic development of the new Member States is clearly well below that of the Union average and by a larger margin than had been seen in any previous enlargement. The extent to which the epithet 'poorer and more rural' applies to this set of countries can be judged from Table 0.1.

It is easy to see from the table that, with the exception of Slovenia, GDP per head was lower in the CEECs in 2003 than it was in Portugal, the least developed EU-15 member, on this measure. Compared to the average for the new enlarged Union of twenty-five, it can be seen that four of the CEECs were only half as prosperous, whilst even the more advanced among them – Slovenia, the Czech Republic and Hungary – fell below the level recorded for Greece, the next poorest country of the EU-15. The proportion of the employed workforce working in agriculture (which includes fishing and forestry) – with the single exception of the Czech Republic – was everywhere above the average for the original EU-15, in some cases (Poland, Lithuania, Latvia) markedly so.

Table 0.1. *Poorer and more rural*

Country	GDP per head, 2003 PPS[a]	Employment, % agriculture 2003
Germany	108	2.4
Italy	107	4.4
France	111	4.1
UK	119	0.9
EU-15	109	4.0
EU-25	100	5.2
Portugal	75	12.6
Greece	81	14.6
Slovenia	77	11.0
Czech Republic	69	3.9
Hungary	61	5.5
Slovakia	52	4.4
Poland	46	19.3
Estonia	49	6.0
Lithuania	46	17.8
Latvia	41	13.3

[a] Purchasing Power Standard (PPS) comparisons are used to allow for price variations between countries. Thus one PPS buys the same given volume of goods and services in all countries, whereas different amounts of national currency units are needed to buy this same volume of goods and services in individual countries, depending on the price level.

Another characteristic shared by these countries is that all had been to a greater or lesser extent subject to the central planning regimes of the Soviet bloc and have only recently recovered from the transition recession. Taken together, these characteristics might suggest that the impact of membership for the countries in question – and perhaps for some countries of the pre-existing Union – could be profound.

The EU response to the governance issue is represented in the proposed Constitution for the European Union, whose fate is still unsettled as this book goes to press; meanwhile, the partial responses agreed upon at the Treaty of Nice hold sway. However, governance is not one of the issues addressed by this book. Rather, the papers presented here represent a response to the second aspect of the enlargement. They attempt to describe the economic situation in these countries and its likely development and outline the nature of the impact that membership of the EU may involve. They provide answers to a number of pertinent questions and respond to some of the apprehensions that enlargement has brought with it; and they provide essential background material that might be used to help answer yet other questions not directly posed in the book. As clarified further below, the authorship of this book is multinational, drawing upon the resources of the European Forecasting Network (EFN). The EFN is briefly described in the acknowledgments which precede this introduction, and the authors, with their institutional affiliations, are listed on pp. xvii–xix above.

The rest of this introductory chapter proceeds by identifying some of the principal issues that arise in this enlargement, and explains how the subsequent chapters cast light on them. Four such broad themes are identified. First, there is the overarching issue of the impact of the enlargement and its distribution; secondly, there is the issue of regional policy and the handling of structural funds from which the new Member States can hope to benefit considerably; thirdly, we look at the macroeconomic trajectories of these economies to date and their likely future development; fourthly and finally, we bring together the analyses to be found in the subsequent chapters in so far as they relate to the debate about accession to the European Monetary Union (EMU).

The overall impact

Despite the stark contrast between the CEECs and most of the existing Member States in terms of their levels of prosperity and development, there are a number of reasons for thinking that the apprehensions of a large impact on *existing* member states are mistaken. There are three simple and straightforward reasons for thinking this. The first is that a great deal of what it means to be a member of the EU had already been achieved by the CEECs in the years before formal membership – trade flows for example had all been substantially freed of tariffs and controls. Secondly, the largest immediate effect about which there was (and remains) serious apprehension is the prospect of a substantially freer flow of labour from the CEECs to the existing Member States, but for most Member States special transitional arrangements have suspended this likelihood. We have not investigated, here, what will happen when these transitional arrangements expire. (Much economic analysis has used the evidence from previous enlargements to argue that the effects on labour migration might not be large and the prospects for further rapid growth in the CEECs should blunt the desire to migrate; and it may be that the transitional arrangements could be extended in some form for as long as deemed necessary.) Thirdly, there is the fact that the CEECs, with the exception of Poland, are small in size relative to the EU-15; big impacts for them may translate to only small impacts for the existing Member States. The issue is dealt with formally in detail and in a sophisticated way by the authors – Bchir, Fontagné and

Zanghieri – of Chapter 2 here. These authors apply a computable general equilibrium (CGE) model to generate estimates of the effects on trade, output and welfare over a period of time; the model gives multi-sectoral detail and incorporates an assumption of imperfect competition outside the agricultural sector, yielding predictions for the number and size of firms in specific sectors. By rehearsing different scenarios the authors are able to point out that the further impacts to come from more liberalized trade alone are relatively small – relative, that is, to a baseline which already incorporates the continuation of established trends in expanding trade. However, more is to be expected from the subsequent adjustment in market structure and specialization, and (largely speaking) more again from the effects of admitting the countries to a modified form of the Common Agricultural Policy (CAP), the form agreed upon at the Copenhagen Summit. By 2015 and relative to the base line, the authors predict large expansionary impacts on the output and welfare of most of the CEECs – in the order, for GDP, of 7–8%. The Baltic countries form the exception, their pattern of industrial specialization inhibiting them, according to the model, from making rapid gains (and possibly producing losses). By contrast, the impacts on the pre-existing members of the EU are, overall, reckoned to be slight – in terms of GDP a possible fall of less than 1 per cent.

Regional policies and the structural funds

The large gap in output levels between the new Member States and the existing EU members (see Table 0.1 above) is an immediate indication that the CEECs might expect to be the recipients of substantial structural fund disbursements. Several issues then arise: are the aims and objectives of EU regional policy proper concerns, and is the policy well conducted with respect to its declared aims? What does past experience in similar situations tell us about the optimality (or otherwise) of these policies? Is it true that public sector infrastructure investment, a strong candidate for stimulus, can provide the kind of boost to growth that some economic theory (e.g. endogenous growth theory) suggests? Finally, will the diversion of funds from existing recipient regions to the new ones in the new Member States represent a strongly negative factor for those States?

The authors of Chapter 3 – Mora, Vayá and Suriñach – concentrate initially on estimating specialization and concentration indices using gross-value-added data for a large number of regions, examining first what can be said about the change in these measures over the period from 1985 to 1995. This period is selected to start before the EU's

Iberian enlargement as a way of mimicking the period to follow the latest enlargement. In key respects the earlier experience should provide a model for the later – the development disparities are similar and the policies to be followed perhaps not much different. The first result obtained is that at the level of broadly defined sectors ('agriculture, forestry and fishery products', 'building and construction' etc.) there is not a great deal of difference to be found between the indices for 1985 and for 1995: there is no sweeping tendency to a 'core and periphery' dichotomy to be found, nor indeed the contrary tendency to greater equalization. The authors are concerned that the results obtained for broadly defined sectors and summarized in the indices employed may conceal some movements of interest that would be evident in a more detailed look at the relevant distributions. Kernel density functions are estimated to probe for the presence or new formation of 'regional clubs' in particular industrial sectors. Indeed, some bimodality is evident in some of their plots, consistent with this idea and tests for spatial dependence are quite positive. In an extension to this exercise the authors augment their data base with data for a (super-) enlarged EU of twenty-seven members (including also Romania and Bulgaria). The comparison of the EU-15 and this EU-27 suggests an increase in the sectoral specialization coefficient for agriculture, forestry and fisheries, which is hardly surprising, but relatively little change elsewhere. Chapters 11 (Moreno, López-Bazo and Artís) and 12 (La Ferrara and Marcellino) use evidence from the experience of other countries, with some claim to be 'representative', to analyse issues of relevance for the form of regional policy. In Chapter 12 the authors use regionally disaggregated data for the Italian regions to discover whether public sector infrastructure investment is favourable for total factor productivity, output growth and cost efficiency. The results show that public sector infrastructure investment scores favourably on all counts, but more so in the regions of the Centre and South than in those of the North; this might be regarded as a good augury for the relative value of making public sector infrastructure in the CEECs rather than in the older Member States of the Union. The authors of Chapter 11 look to the experience of Spain for comparable instruction. They take a sample period which predates Spain's accession to the EU to examine the effect of public sector infrastructure investment on regional output, using a data base which contains data for fifty regions (provinces). Public sector infrastructure investment is divided into two categories – transport and other: one of the features of the results is that the returns seem larger for the latter type of investment rather than for the more glamorous transportation sector (which is also the one favoured by EU-related and funded projects). Relative to some earlier studies, the positive effects estimated for public sector infrastructure investment are not large, but they are positive and they are obtained in a context where suitable controls can be, and are, used in the estimation. The author of Chapter 13 – Boldrin – takes a different tack. Whilst arguing that the CEECs are indeed in much the same position, relative to the rest of the EU, as were Spain, Greece and Portugal at the earlier enlargements, he is inclined to attribute little if any of the catch-up in growth that these countries have shown to the effects of the structural funds disbursements. These are liable to result in a lack of 'additionality', as recipient States effectively spread the funds received over their own project-portfolio, undermining any EU-inspired sense of priorities. In the limit they become pure income transfers. At the same time, he argues, these policies can have negative political side-effects in encouraging rent-seeking and policies aimed at attracting income transfers at the expense of activities which could lead to sustained economic development. The Mezzogiorno is cited as a standing example of the 'dark side' of regional economic transfers.

The macroeconomic trajectory

Several chapters in this volume, starting with Chapter 1 (Rossi and Tabernacki), review the trajectory of macroeconomic development of the CEECs. All these countries experienced a recession of greater or lesser degree in association with their transition from the preceding centrally planned regime but have since embarked on a relatively uninterrupted expansionary path. For the analysis of cycles, as the authors of Chapter 5 (Artis, Marcellino and Proietti) point out, the combination of a short sample period free of structural break and the sequence of transition recession and growth mean that the concept of the classical cycle is hardly useful. The classical cycle requires for an upper turning point to be identified a succeeding period of absolute decline in economic activity. On this basis, some of the CEECs exhibit no, or only one, cycle. The concept of the deviation cycle is more productive as variations in the growth of output are pervasive: the authors examine especially carefully the co-movements of output growth within the group of the CEECs. They discover that there is little such concordance between the CEECs in their business cycle developments – nor, with a few exceptions, is there much concordance between their cycles and those of the Euro area or leading Euro area economies. Good forecasting is an essential input to good macro-policy making. Chapter 4 (Banerjee, Marcellino and Masten) aims to uncover what the CEECs can hope for, in this respect. The short sample period of relevant, post-transition data and experience inhibits reliance on standard time series methods. The authors therefore explore carefully how well dynamic factor models can perform, given that these have the potential to exploit a wider range of data points, with encouraging (though variable) results. Zanghieri's Chapter 9 aims to analyse the current account dynamics likely to apply to these countries. The emergence of chronic balance of payments deficits – already visible – is liable to continue. It is to be expected that economies in course of development and catch-up will have justifiable investment needs well beyond their savings capabilities, implying the need to import capital and correspondingly to run a deficit on the current account. This process should be a virtuous one, with the investments 'paying off' the cumulated deficits in the course of time. There are possible problems to be faced though – an excessive build-up of debt might trigger doubts about sustainability and precipitate a crisis; on the other hand, excessive confidence might appreciate the exchange rate to such an extent that competitiveness is prejudiced. In the case of the CEECs also the prospect of future accession to the Euro area throws its shadow into the present though the effects are equivocal in principle and depend greatly on the form of interim exchange rate regime chosen. The author suggests that the quality (or type) of capital inflow may be critical – a high proportion of FDI is stabilizing to the extent that FDI does not add to the financial debt burden. Meanwhile, and into the medium term (up to 2007), the authors of Chapter 1 suggest that output growth will continue to remain strong, if not outright spectacular, with the Baltic countries leading the way on growth rates in the 6% range, whilst other countries in the bloc may grow at more modest rates of 3.5 to 5%.

EMU accession

Several papers in this volume relate to the issue of the EMU participation of the CEECs. An interesting first observation is that those chapters which provide evidence that might be used, on traditional optimal currency area (OCA) grounds, to support or oppose EMU accession (these are Chapters 5, 6 and 7), would provide a lot of evidence *against* accession. This is because these chapters show that the business cycles of the CEECs are not (with a few exceptions) strongly correlated with those of the Euro area (Chapter 5: Artis, Marcellino and Proietti), whilst the stochastic experience of the CEECs examined by Ramos and Suriñach in Chapter 6 likewise displays little or no relationship to that of the Euro area. These findings are partly modified by those of Chapter 7 (again by Ramos and Suriñach) where the monetary transmission mechanism in the new potential members is found not to differ greatly from that in the Euro area – suggesting that at least asymmetric shocks arising from the exercise of a common monetary policy need not be anticipated. Still, according to traditional OCA theory, findings like these suggest that Euro-area monetary policy would be ill-adapted to the needs of most of the CEECs, and EMU participation is counter-indicated. This, however, is to assume that the CEECs have in substantial degree the option of a well-adapted stabilization policy by staying out of EMU. But this is something which is widely doubted for countries with small domestic capital markets and little reputation, where highly mobile financial capital has the potential to disrupt the best attempts at autonomous stabilization policy. (Chapter 5 considers this literature and gives some references on it.) Whether for this reason or for some others, it is clear enough that the CEECs themselves are to the contrary quite intent on joining EMU. Already three of them (Slovenia, Latvia and Lithuania – the latter two have particularly low business cycle synchronization with Euro area countries) have entered the ERM II, which is the antechamber for entrance into EMU, whilst others among the group have evinced a strong desire to participate. Whilst these countries are not yet members of the Euro area, however, the opportunity remains for the European Commission and the European Central Bank to 'call the shots' – notably the section of the reform of the Stability and Growth Pact which observers saw as the most effective is the part that refers to the EMU qualification of non-members. This must still involve satisfying the Treaty of Maastricht, including its fiscal criteria. The CEECs' particular history raises special concerns about their ability to meet these criteria: Chapter 8 (Rossi and Tabernacki) reviews the problems facing Hungary, Poland and the Czech Republic in some detail, in recognition of the special salience of this issue. Chapter 10 (Movit) contributes a timely analysis also of the problem of banking stability in the CEECs. From the transition the banking systems of these countries have had to move rapidly across unfamiliar territory to a situation where they can cope with possible shocks and continued pressures from the integration of their economies into the global scene. Accession to EMU requires particular attention be paid to the stability of these systems.

The eastern expansion of the EU continues a story of progressive enlargement of the Union. The incorporation of the CEECs undoubtedly presents some novel and important challenges both for the existing members of the Union and for the acceding countries themselves. The chapters presented in this book, we hope, will help fulfil the need for more information and more perspective on some of the issues arising.

1 New Member States: macroeconomic outlook and forecasts*

Emilio Rossi and Zbyszko Tabernacki

1.1 The recent economic recovery in the new Member States

The entry of the new Member States into the European Union (EU) on 1 May 2004 marked the culmination of a historic process of economic transition that commenced with the fall of Communism in 1989. Fifteen years after the initiation of far-reaching reform in Eastern Europe, eight of the formerly centrally planned economies together with Cyprus and Malta joined the existing fifteen EU members in the largest EU enlargement to date. And, while the combined economic weight of the new members might seem relatively small compared to the EU-15, the dynamics of growth, commitment to internal reforms, and the desire to close the income gap with the rest of the EU, may well provide a key impulse to future economic development in Europe.

From the cyclical perspective, the new Member States are entering the EU with indisputably strong growth dynamics. Following the economic slowdown of 2001 and 2002, caused both by the unaccommodating external environment and serious domestic policy mistakes, and the moderate recovery of 2003, the first half of 2004 marks the first period of very strong growth across most of the region, in particular in the largest economies. More importantly, with only a few exceptions, the current growth recovery is overwhelmingly broad based, combining the benefits of stronger demand in the traditional Western European export markets with steady growth in private consumption, and, even more importantly, with a gradual recovery in domestic capital spending. This structure of growth makes the current recovery less sensitive to the potential reversal in European economic fortunes as global economic growth starts to decelerate in 2005.

* The projections and forecasts reported in this chapter are based on the analysis of Global Insight, with information available until the first quarter of 2004. These were contained in the Autumn 2004 Report of the European Forecasting Network.

The unexpectedly strong acceleration in growth rates in the largest economies of the new Member States is clearly the most positive development of the last few quarters. Poland, Hungary, Slovakia and, to a lesser extent, the Czech Republic have reported very strong growth entering 2004. Economic growth in the Baltic States and Slovenia also exceeded our preliminary expectations, boosting the annual average growth forecast for the new Member States to 5.2% year on year in 2004, well in excess of the 1.8% year-on-year growth for the Euro area.

In Poland, the largest of the new Member States, economic growth has accelerated from 4.7% in the last quarter of 2003 to 6.9% year on year in the first three months of 2004, and is expected to average 6.4% in the first half and around 6.0% for the full year 2004. These rates of growth will propel Poland again to the position of indisputable pacesetter within the region, the position the country enjoyed for most of the mid-1990s. Growth in Poland has been supported by a very strong net export component of national accounts, as local exporters enjoying the benefits of a weaker currency for most of 2003, as well as through accelerated internal restructuring, found ways to increase their market share in the key EU markets. Import growth, although accelerating gradually into 2004, remained relatively subdued on the back of a still only modest pick-up in investment spending. On the other hand, personal consumption continued to expand at an average annual rate in excess of 4.0%, complementing exports as a key driver of growth.

Slovakia, another growth leader in the region, features an economy that in 2003 was driven almost entirely by exports. Personal consumption and gross fixed investment actually declined moderately. GDP still managed to expand by 4.2%, an impressive performance, although considered a disappointment by the Slovak government. The growth in consumption was severely restricted by Slovak tax reform, which raised VAT, resulting in an inflationary surge, as well as by the cabinet's fiscal reform plans. While a broadening of the growth base in the coming years is expected, net exports are likely to determine Slovakia's growth pattern in the nearest future. As elsewhere among the new Member States, the success in expanding exports to the EU-15, despite rather lacklustre developments in aggregate demand in that region, was aided by the increasing integration of their economies with those of Western Europe. In Slovakia, this has had a particular focus in the automobile industry. In addition to the expansion of the crucial investment in the automotive sector by Volkswagen AG, two other large greenfield auto manufacturing plants will be coming on line in the next two years that will convert the Slovak economy into one of the largest car producers in the world.