www.developmentandtransition.net

DEVELOPMENT & TRANSITION

4

JUNE 2006

Albania Armenia Azerbaijan Belarus Bosnia and Herzegovina Bulgaria Croatia Cyprus Czech Republic FYR Macedonia Georgia Hungary Kazakhstan Kosovo (Serbia and Montenegro) Kyrgyzstan Latvia Lithuania Malta Moldova Poland Romania Russian Federation Serbia and Montenegro Slovakia Slovenia Tajikistan Turkey Turkmenistan Ukraine Uzbekistan

Published by the United Nations Development Programme and the London School of Economics and Political Science

EU enlargement and the wider neighbourhood

Two years after its May 2004 enlargement, the 'widening versus deepening' debate remains a perennial feature of the European Union's engagement with the post-communist states. Since then serious doubts among some of the old member states about the viability of future enlargement have been galvanized by the EU's internal divisions over the Constitution for Europe. By choosing 'post-enlargement' as our theme, we aim to address three principal challenges for the region – future enlargement, the European Neighbourhood Policy and European Monetary Union.

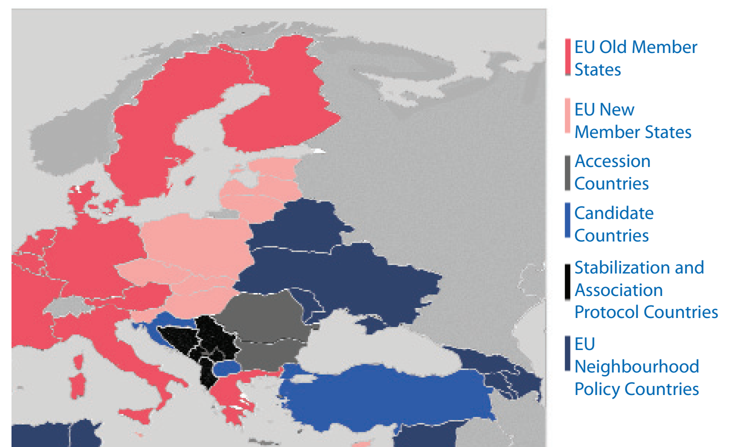
First, we examine the enlargement process. Heather Grabbe argues that the EU's conditionality for enlargement is consistent, and that the door remains open. Several contributions assess the implementation of EU conditionality, both as regards the capacity of the new member states to access and manage the benefits of membership, such as structural funds, and the success of candidates and prospective candidates in meeting political conditions and making structural reforms (Turkey, Serbia). Miroslav Beblavy and Kalman Mizsei highlight one of the key weaknesses of the EU's approach to the region's developmental challenges by demonstrating how its 'risk-of-poverty' measure skews social policy priorities.

Second, we examine the European Neighbourhood Policy, which is intended to be an alternative to accession, for those CIS countries that have made a 'European choice'. Gwendolyn Sasse analyses the inconsistencies in the ENP's development, and argues that the EU's political concerns, notably in Ukraine, have diluted the use of ENP as a barrier to enlargement.

Third, Willem Buiter and Anne Sibert address the prospects for an enlargement of the Eurozone. Whereas Slovenia meets the Maastricht convergence criteria for EMU membership, the prospects of membership for others, such as Estonia and Lithuania, now seem to be fading.

The articles point to a multi-track EU that is characterized by intersecting rather than concentric circles (the Eurozone, the Schengen area, and countries permitting free trans-border labour movements). This heterogeneity is also apparent in the EU's policies vis-à-vis the 'wider neighbourhood'. The unevenness of accession negotiations and prospects call into question the credibility of future enlargement. While some delay allows the EU to maximize its leverage over its neighbours, prolonged delays make the prospect of membership too distant, thus weakening the EU's leverage for reform in the region, and possibly destabilizing the 'wider neighbourhood'.

James Hughes and Ben Slay



The conditionality at the heart of EU enlargement policy — Heather Grabbe — 2
Make spurious poverty statistics history — Miroslav Beblavy, Kalman Mizsei — 4
Structural funds and the new member states: lessons learned — Vasil Marinov, Hachemi Bahloul, Ben Slay — 5
EU integration and Turkish SMEs — Murat Gursoy — 8
EU accession and human development in Serbia — Paola Pagliani, Rastislav Vrbensky — 10
The European Neighbourhood Policy: 'conditionality-lite'? — Gwendolyn Sasse — 12
The European Neighbourhood Policy and development: the case of Moldova — Arcadie Barbarosie — 14
Opinion: Eurozone entry of new EU member states from Central Europe: Should they? Could they? — Willem H. Buiter, Anne C. Sibert — 16

Eurozone entry of new EU member states from Central Europe: Should they? Could they?

Willem H. Buiter
Anne C. Sibert

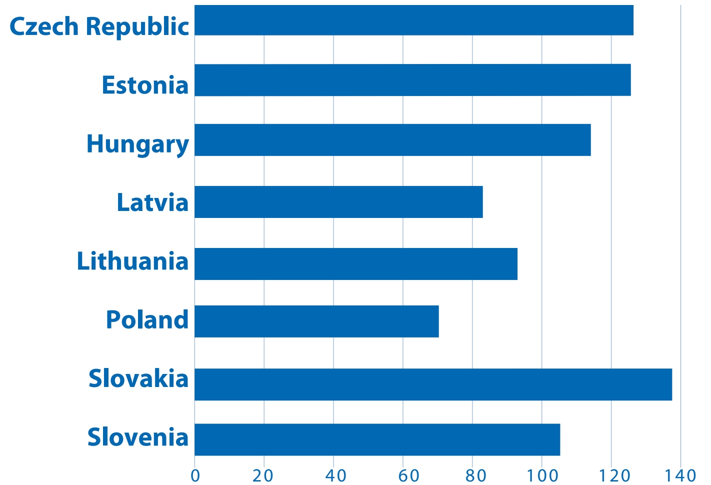
Estonia, Lithuania and Slovenia hope to become members of the Euro area by January 2007; Latvia targets full membership in 2008 and Slovakia hopes to join the Eurozone in 2009. We consider whether or not the eight new members of the European Union from Central and Eastern Europe (EU8) would benefit from joining the Eurozone and whether the Eurozone has any economic grounds for excluding them.[1] We ask whether or not the countries that have set target dates for membership are likely to achieve them.

I. Should the new nembers join the Eurozone?

The theory of optimal currency areas suggests that it is in the interest of the EU8 to join the Eurozone as soon as possible. They are too small, too open and too vulnerable to speculative attacks against their national currencies to be optimal currency areas. For the smallest ones among them, it is doubtful whether a national currency is a viable option in the medium to long run.

In terms of economic size, as measured by their per centage share of world GDP, the EU8 are tiny. Several are about the size of Luxembourg (0.05 per cent) and collectively (at 1.93 per cent) they are about the same size as Canada (1.84 per cent). The EU8 are also relatively dependent on trade.[2] Their share of trade in GDP, calculated as the percentage of the sum of imports and exports to GDP ranges from about 70 per cent for Poland to nearly 140 per cent for the Slovakia (see fig. 1). This contrasts with the United States, where the share of trade in GDP is about 24 per cent and with France, where it is about 56 per cent. Moreover, their openness is increasing and should become significantly higher. These countries still trade significantly less than would be expected, given their size, per-capita income, distance from trading partners and man-made barriers to trade. The latter impediment is primarily the legacy of misdirected central planning which has still not been completely overcome.

Fig. 1. Share of Trade in GDP

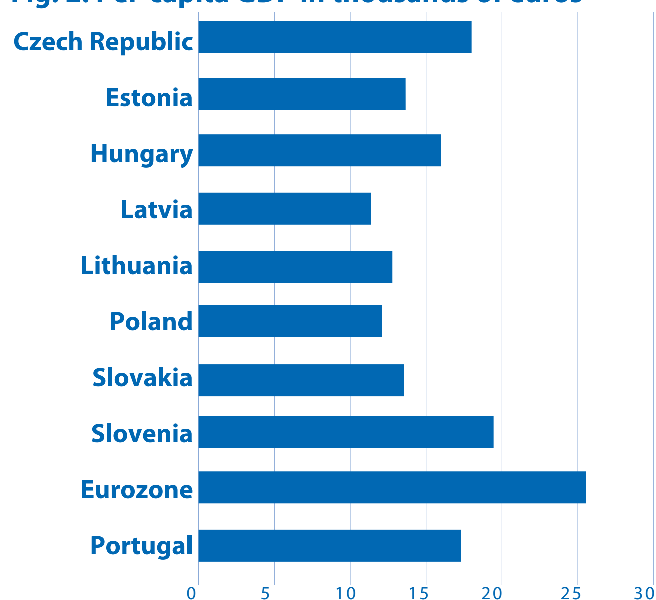


While openness to trade is high, financial openness is nearly complete. As part of the process of qualifying for EU membership, virtually all institutional barriers to financial capital mobility have been lifted. An open financial account has many advantages: it permits nations, such as the EU8, with high economic potential to draw on foreign savings to augment their domestic capital stocks; it permits foreign direct investment, which brings financial resources and transfers skills, knowledge and technology. It increases the efficiency of financial intermediation and permits cross-border risk sharing. However, it exposes countries to whims of international financial markets. Average *daily* turnover in the global foreign exchange market is about $2 trillion and a single large hedge fund may have more financial resources than the monetary authorities of most of the new member states.

Their small size and financial openness and vulnerability imply that for the EU8, a national currency is a liability. If they peg their exchange rates, then sooner or later they will almost certainly undergo a sudden and costly disruption to their financial sectors. The disastrous experiences of East Asia, Russia and Latin America in the late 1990s and 2002 serve as a warning that, for small open economies with mobile financial capital, pegged or heavily managed exchange rates lead to turmoil and output loss. The current situation of Iceland and New Zealand illustrates the problem with the alternative floating exchange rate regime. Swings in capital flows brought about by external events can force central banks to have to choose between cutting off growth with high interest rates or allowing precipitous declines in the value of their currency.

Wolfgang Munchau of the *Financial Times*, argues that Estonia and Lithuania are too poor to join the Eurozone.[3]

Fig. 2. Per-capita GDP in thousands of euros



Indeed, Estonia and Lithuania are poor relative to most of the other new member states and the new member states are poor relative to the Eurozone (see Fig. 2). But, the gap is narrowing and the Czech Republic and Slovenia are wealthier than the Eurozone member Portugal. Moreover, if poverty implies that sharing a common currency with wealthier neighbours is undesirable, perhaps Tower Hamlets should leave the sterling area.[4] Fortunately, having similar levels of per-capita income is not an Optimal Currency Area criterion.

The smallness and openness of the member states implies that the exchange rate is not an effective instrument or buffer, allowing them to achieve the necessary changes in international relative costs and prices with small transitional costs of excessive inflation and unemployment. Instead, the foreign exchange market itself is a source of excess volatility, instability and, at times, persistent misalignment.

A cost of joining a common currency is losing an independent monetary policy to stabilize country-specific shocks. However, because of an incentive to use monetary policy opportunistically and because, even when the policy makers are competent and credible, monetary policy in a small open economy with unrestricted capital mobility and a floating exchange rate is a poor stabilization instrument, giving up the monetary stabilization instrument is no great loss for the EU8.

A factor which might mitigate any cost associated with losing a stabilization role for the central bank is the surprisingly high degree of cross-country labour mobility between the EU8 and the few EU member countries that have allowed labour immigration from the new member states since May 2004. Labour mobility can serve as a substitute for conventional stabilization policy in coping with country-specific shocks.

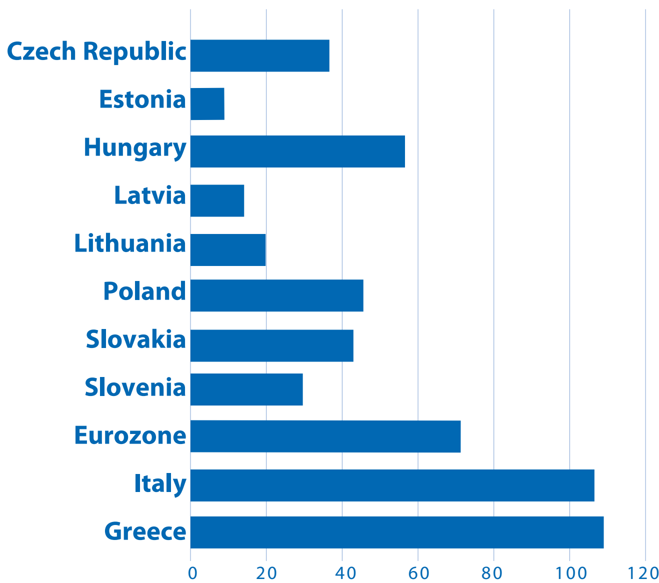
The cost of a common monetary policy to countries such as Estonia and Lithuania would not necessarily be greater than the cost to the existing Eurozone members. In the 14 years since their independence, Estonia and Latvia have been remarkably successful in transforming themselves into flexible and resilient market economies. The World Bank publishes an index measuring the ease of doing business in different countries. The index depends on such factors as business regulations, property rights and labour market rigidities. On this index, Lithuania and Estonia rank 15th and 16th in the world, ahead of Germany (19th place) and France (44th place).[5]

II. What are the prospects for Estonia, Lithuania, Latvia, Slovakia and Slovenia to satisfy the Maatstricht convergence criteria?

There are four Maastricht criteria for full membership in EMU. The first is a pair of fiscal conditions that government deficits be less than three percent of GDP and government debt less than sixty percent of (annual) GDP. The second is an interest rate criterion: long-term nominal interest rates on government debt are to be within two percent of the average in the three EU member countries with the best inflation record. The third is an inflation criterion that specifies that the annual inflation rate cannot exceed the average of the three best performing EU member countries by more than 1.5 per cent during the year prior to the candidate's formal assessment. Finally, there is an exchange rate criterion: the exchange rate has to remain within the normal fluctuation margins (15 per cent around a fixed parity with the euro) without severe tensions for at least the last two years before the formal assessment. This two-year ERM 'waiting room' or purgatory has been characterized as an investment without return: a country that demonstrates it is capable of managing its exchange rate in this way is rewarded with membership in the monetary union and thus the permanent loss of its ability to manage its exchange rate.[6]

In terms of the theory of optimal currency areas, only the fiscal criteria are rationalizable and even these are questionable: the Maastricht fiscal criteria are neither necessary nor sufficient for fiscal sustainability. Note that the candidate countries are required to achieve

Fig. 3. Government debt as a percentage of GDP



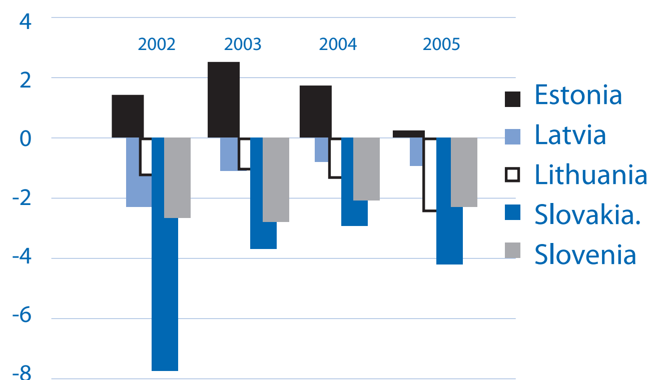
three nominal targets simultaneously - inflation, interest rate and exchange rate. Most central banks have trouble targeting even one.

An unsustainable fiscal policy in a candidate Eurozone member can be viewed as a potential cost of their membership to the existing members: an actual or threatened insolvency might jeopardize the entire Eurozone financial system or destabilize the common currency by forcing the European Central Bank into a bail-out. Establishing whether or not a country is following a sustainable fiscal policy is not a straightforward matter, but government insolvency and debt default is a threat whenever the outstanding stock of debt is high relative to the ability and willingness of present and future governments to generate primary budget surpluses, that is surpluses before interest payments.

Figure 3 shows that the existing debt-to-GDP ratios of the EU8 are well below the average of the Eurozone and much lower than the levels of Greece and Italy.[7] As is clear from Figure 4, however, Poland, Hungary and the Czech Republic have persistently run larger conventional budget deficits than the Eurozone. They also show no evidence of being capable and willing to generate primary surpluses. Fundamental doubts about fiscal sustainability, rather than a failure to meet the wholly arbitrary Maastricht numerical deficit criterion, justify the claim that Poland, Hungary and the Czech Republic are not ready for Eurozone membership.

The three Baltic countries and Slovenia, and possibly even Slovakia, have run surpluses or small deficits and are ready for Eurozone membership now (see Figure 2); indeed they are more *ready* than Italy, Greece, and quite

Fig. 4. Goverment surplus as a percentage of GDP



possibly also France and Germany, none of which can be confidently stated to have sustainable fiscal programmes.

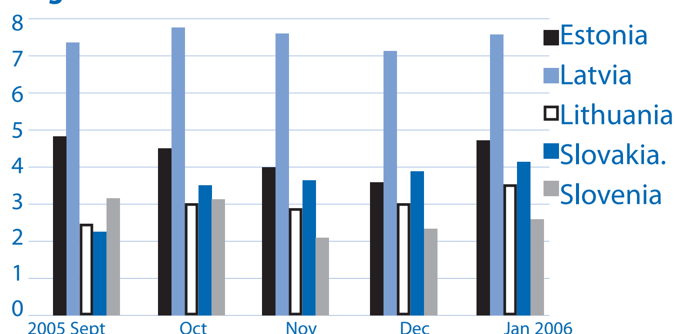
The five candidate countries should easily meet the long-term interest rate criterion and appear likely to meet the exchange rate criterion. Bond yields within the Eurozone have converged and rates in the EU8 are not much higher. Estonia, Lithuania and Slovenia joined ERM in June 2004. Estonia and Lithuania have successfully maintained a currency board arrangement that keeps their currencies at the central parity rate; Slovenia's monetary policy is aimed at stabilizing its exchange rate and its currency has traded close to its central parity rate since entry. Latvia joined the ERM in May 2005 and its currency has also remained well within its target zone of plus or minus 1 per cent around the central parity. After Slovakia entered the ERM in Nov 2005, its currency appreciated, but has since stabilized between 1 and 2 per cent above the central rate.

The EU8's inflation, measured as the change from the same month of the previous year, is shown in Figure 5.[8] We calculate that the benchmark average of the three lowest inflation rates in the EU plus 1.5 per cent was about 2.5 per cent in early 2006. Thus, Slovenia appears to have a good chance of satisfying the inflation criterion. It is clear that Latvia is far from being able to satisfy the inflation target; it appears unlikely that Estonia, Lithuania and Slovakia will satisfy it. Given their success in maintaining their exchange rates against the euro, the inflation rates in Figure 5 are no surprise. In the face of external shocks, either a small open economy's exchange rate fluctuates or its inflation rate varies. It is not possible to achieve both an inflation target and an exchange rate target simultaneously, except by chance. Since June 2004 Estonia has maintained an unchanged exchange rate in the ERM. However, mainly as a result of oil price rises, its inflation rose to 4.1 per cent in 2004. As

a consequence, Estonia will not meet the Maastricht inflation criterion by June 2006; it is unlikely to meet it in 2007.

Even without an energy price shock, we should expect that as the accession countries' productivity levels catch up with Euro area countries, their real exchange rates will appreciate. This is because productivity catch-up to the level of the EU15 is faster in the traded goods sector than in the non-traded goods sector. The relative price of non-traded goods to traded goods will therefore be rising faster in the EU8 than in the EU15 – the real exchange rates of the EU8 countries will appreciate. This phenomenon is called the Balassa-Samuelson effect. If their nominal exchange rates are stable against the euro, then their inflation rates will be higher than in the Eurozone. Current estimates of the magnitude of the Balassa-Samuelson effect are in the range of 1.5 - 2.5 per cent per year.[9]

Fig. 5. Inflation



As the Maastricht Treaty only allows for inflation to be 1.5 per cent above the best-performing members of the EU, this creates a serious problem for Estonia and Lithuania. They can, with a fixed exchange rate, simultaneously satisfy the inflation and the exchange rate criteria only by luck. There are just two other macro-economic policy options to meet the inflation criterion. Either they abandon their highly successful currency boards and adopt a more flexible exchange rate system: the 15 per cent exchange rate bands may permit more leeway than the 1.5 per cent band in the inflation target. Or, they can use fiscal policy to create a recession which reduces inflation to the point where both criteria can be met. Neither choice seems particularly appealing.

The most bizarre feature of the Maastricht inflation criterion is that its benchmark is based on the three lowest inflation rates among the 25 EU members, and not just on the inflation performance of the 12-member Eurozone. Indeed, in recent months, two of the three lowest inflation rates were for countries that are in the EU but not in EMU - Poland and Sweden. It would make as much economic sense to base the decision on admitting the candidate Eurozone members on the inflation performance of Sub-Saharan Africa as on that of EU members that are not in the Eurozone. Indeed, even requiring convergence to the level of inflation of existing members is not essential: membership in the Eurozone itself will assure inflation convergence.

Conclusion: what to do when 'the law is a ass'

Of the five candidate Eurozone members - Estonia, Latvia, Lithuania, Slovakia and Slovenia - only Slovakia is not yet a convincing candidate for immediate Eurozone membership. All that stands between the four countries and a Eurozone membership that would benefit both them and the existing EU members is the likelihood of the rigid application of an arbitrary inflation criterion.

This raises the problem of what to do when 'the law is a ass'. Failure to enforce a treaty-based rule weakens the institutions of the European Union, as does enforcing a rule that makes no sense and inflicts unnecessary harm. Fortunately, in the case of the numerical Maastricht criteria for inflation, debt and deficit, interest rate and exchange rate - none of which make any sense at all - this dilemma has already been resolved: the criteria have been violated both in spirit and in the letter so frequently that little or no further damage will be done by a flexible interpretation of the inflation criterion. Italy, Greece and Germany joined EMU despite not meeting the debt criterion; Finland, Italy and Greece joined without satisfying the exchange rate criterion; Estonia, Latvia, Lithuania and Slovenia should be allowed to join as well.

Willem H. Buiter is Professor of European Political Economy, European Institute, London School of Economics and Political Science, Universiteit van Amsterdam, Centre for Economic Policy Research (CEPR) and National Bureau of Economic Research.

Anne C. Sibert is Professor of Economics, Birkbeck College, University of London and CEPR.

1. The Eurozone has 12 members. The UK, Sweden and Denmark, as well as the 10 new EU members that joined the EU on 1 May 2004, are not members of the Eurozone.
2.World Bank Development Indicators, 2004.
3. 'Monetary union is not for the poor', 30 Jan 2006.
4. Tower Hamlets is among the poorest boroughs of London, although it contains Canary Wharf, London's new financial centre.4. Eurostat, OECD.
5. World Bank, Doing Business in 2006, overview. The first three countries are New Zealand, Singapore and the United States, respectively.
6. See Willem H. Buiter *To Purgatory and Beyond: When and How should the Accession Countries from Central Europe Become Full Members of the EMU*, 2004; http://www.nber.org/~wbuiter/vienna.pdf
7.Source: Eurostat, OECD
8. Source: Eurostat
9. See Willem Buiter (2004) op. cit.