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## The eastward enlargement of the eurozone : state of the art report

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# **The Eastward Enlargement of the Eurozone**

## **State of the Art Report**

Berlin, January 2002

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# 1. Introduction

by Michael Bolle, Project coordinator - Berlin group

European Monetary Union (EMU) and its enlargement to prospective members in central and eastern Europe is a politically highly desired process, given that everything works out smoothly. The future eurozone will show a much higher degree of heterogeneity than now. The CEEC are in the process of transition from a planned to a market economy. Despite considerable progress during the past decade, much remains to be done in economic, social, and political terms. However, it is important to note that monetary integration is not a stand alone project, but is preceded by the EU enlargement and its obligation to adopt the *acquis communautaire*. Both events will be mutually reinforcing: The *acquis* contains numerous rules and institutions to be followed or created by the prospective members, albeit enforcement will be a problem. The success of the eastward enlargement of the eurozone depends on these institutions and, thus, increases the costs of failure. On the other hand, a successfully introduced euro in the CEEC will facilitate the whole integration process.

Accession to the eurozone requires a tremendous structural adjustment in the CEEC. There are the obvious, formal requirements: the *acquis*, the fulfilment of the convergence criteria of the Maastricht treaty and the enlargement conditions laid down in the treaty of Copenhagen, and finally the renunciation of monetary autonomy. But these lead to more, subtle and deeper changes. Competition pressure will increase while at the same time the scope for public intervention will diminish. After all, this is believed to promote efficiency and prosperity in the CEEC, however, it may also prove to be strain at least for a certain time. Whatever the assessment of the net benefit of the eastward enlargement of the eurozone, there will be losers, in the applicant states as well as in the current members. It will be of utmost importance to realise this, to compensate for the losses or to accept them, anyway, to be aware of the political tension that may arise.

This report is part of an international research project on the eastward enlargement of the eurozone (Ezoneplus) supported by the European Commission's Fifth Framework Programme. Research is conducted in three steps: First, the impact of EMU on markets is analysed. The euro will reshape markets in the CEEC as well as in the current euro members, because it sets new rules and incentives. Markets for capital and labour plus trade relations and the patterns of foreign direct investments are at the centre of interest. Second, the scope and constraints of economic policies are scrutinised, i.e., fiscal and monetary policies, but also the social dimension. At a later stage, this project will concentrate on the development of policy advice.

Moreover, the issue of the appropriate exchange-rate regime during the run-up to the euro will be dealt with. It seems to be obvious that exchange rates are most relevant before the very adoption of the euro and cede their relevance afterwards. Hence, analysis and advice is needed right away, and there is no room to maintain the three-step design for this issue.

The first paper focuses on the shaping of capital markets due to the arrival of the euro. It draws on the previous experience of EMU and describes the reduction in cost of capital in course of a lower yield premium which is the result of a vanishing currency risk, higher liquidity of an integrated financial market, better diversification possibilities that lead to a more efficient portfolio of assets, and reduced country risk as consequence of the structural adjustments. Though the latter is already called for by EU enlargement, it is the expansion of the eurozone that gives additional credibility. Hence, liberalisation and the acceptance of foreign entry will reshape the financial scene in the CEEC. In general, the outlook on liberalisation is judged positively by most part of the literature, in particular when two con-

ditions are met, i.e., a stable macroeconomic policy and a functioning institutional framework. Both conditions, this paper argues, are at least tackled in the enlargement process: Macroeconomic stability is required by the Maastricht criteria, and a reliable and tested institutional setting is transferred by the *acquis*. Finally the issue of private investors is addressed. Investments in the CEEC will become more attractive leading to a surge in foreign investment activities which is already visible. These new activities contribute to the enforcement of formal and informal regulations which is still a problem in a number of CEEC. An improved corporate governance is likely.

Second, two articles on labour markets are presented. Labour markets deserve special attention because their flexibility may be needed to offset asymmetric shocks, especially when other means such as monetary and fiscal policies are constrained. Moreover, unemployment has high social costs which may endanger the stability of a political system, thus, ensuring sufficient employment is always a top priority. The paper starts by explaining the pattern of labour market development in the CEEC based on the optimal speed of transition theory and the most influential empirical studies. Special emphasis has to be given to the initial conditions at the beginning of transition. Labour market flexibility has increased and indicates the trend toward a market economy. Whether or not, it has increased enough to cope with the shocks associated with the enlargement of the eurozone is still an open question. Next, migration is a central issue, in particular for those current EMU members that neighbour applicant states. Apart from wage differentials and the existence of social networks, no coherent theoretical framework for the analysis could be found which calls for further research. Labour market policy has to find its way between the reduction of government intervention and the uphold of social minimum standards. The accession of CEECs to both EU and EMU affect goods and labour markets profoundly, inter alia, through migration flows. How to model these processes of adjustment and convergence in the lines of a general equilibrium approach is the main concern guiding the analysis in this chapter.

The part on markets is concluded by a contribution on trade and foreign direct investments (FDI). There seems to be a general consent that exchange rate stabilisation promotes both trade and FDI because transaction costs fall. However, increased exchange of goods, services and capital will lead to a reallocation of resources on the current eurozone as well as in the applicant states. Standard trade theory predict a shift according to factor endowment where the applicants are usually seen as relatively more competitive in labour intense production. Later approaches take into account intra-industrial trade and acknowledge more complex trade patterns. Proximity is an important variable in the discussion as those countries on both sides of the current euro-border will be mostly affected. This raises the question of trade diversion, because the applicant states share some characteristics with peripheral countries in the current eurozone. FDI are a special feature of economic and financial integration. High net capital inflows to the CEEC are needed to level with mature economies capital endowment, if eventually comparable standards of living shall be achieved. Moreover, FDI may be associated with a transfer of technology and management techniques that lifts productivity to EU levels. However, the reliance on FDI can be a mixed blessing, especially a sudden, detrimental shift in expectation may lead to reversal in capital flows that triggers a financial, during the run-up to the euro, probably even a currency crises.

A monetary union is an extreme form of fixed exchange rates. Two questions arise, that are dealt with in the second part on exchange-rate regimes: Is a fixed exchange rate a suitable regime for the CEEC, what are the costs and benefits? More importantly, how should the exchange rate be designed until enlargement is achieved, i.e., avoiding currency crises and minimising adjustment costs. The Maastricht conditions require the membership in ERM 2, the successor of the European Exchange-Rate Mechanism (ERM), for at least 2 years prior to accession. But still there is room to manoeuvre. However, there is no optimal exchange-rate strategy, but account has to be given to any country's particularities, such as openness and flexibility. Moreover, it seems clear that the success of any currency regime depends

less on the strategy itself, but that it needs to be backed by a consistent macroeconomic policy. Nominal convergence, forced by EMU, and real convergence may fall apart. The catching-up process of transition countries entails the danger of higher inflation rates, probably due to different growth rates in productivity of different sectors in the economies. The real exchange rate may appreciate, as no or only limited scope for nominal adjustment remains, damaging competitiveness in the applicant states. The issue of nominal vs real convergence will be central for further research.

The last part in this volume starts with the analysis of fiscal and monetary policies under the constraints of EMU. Monetary authority will be transferred to the European Central Bank which does not respond to individual needs but acts on behalf of the eurozone as a whole, as diverse as it may be. The fiscal criteria of Maastricht and the Stability Pact limit the scope for budgetary intervention. With these tools missing, the costs of asymmetric shocks will rise, however, the exposure may diminish as business cycles tend to converge within a monetary union. Moreover, pressure will arise that pushes structural reform in the direction of more flexibility which will be the only remaining mechanism to offset asymmetric shocks, barring fiscal transfers and migration which do not seem to be appreciated by European politics.

The discussion of the social dimension of eastern enlargement in the last chapter of the book focuses on the political reactions to enlargement and their implications for national and EU welfare policies. The analysis diverges from previous chapters in as far as it shifts the perspective from efficiency arguments to those of political economy. No doubt, factor markets will change during the enlargement, but these changes will affect some people more than others: there will be winners and losers of enlargement. Hence, conflictive political responses are a likely outcome of integration. This is nowhere more obvious than in national labour markets and shifts in the demand for welfare state and protectionist policies have to be expected. Moreover, the EU-level of policy making will mirror these processes of the national level: distributive quarrels about EU-funds between old and new members will arise as well as new demands for common policies.

The stage is set for future research. The contributions to this overview review and apply the existing literature relevant to the eastward enlargement of the eurozone on economic, political, and social grounds. Further research questions are developed to complement what has been achieved. The euro will change markets and minds; accompanying, assessing, and designing this process is what this project does. This state-of-the-art report is the first step.

## 2. Markets

### a. Capital Markets

#### The Shaping of Capital Markets

*by Thomas Meyer - Berlin group*

#### 1. Introduction

Financial development and economic growth are increasingly perceived to be complementary (Levine 1997). Financial institutions provide a number of important services such as trading, hedging, allocation of capital, screening, and monitoring. Financial development may even enhance the domestic savings rate (Pagano 1993). Indeed, a strong correlation of financial and economic development has been found in influential studies such as King and Levine (1993). Countries in central and eastern Europe had no capital market as we know it in place during the time prior to transition. Since then, its installation and improvement has been on top of the agenda. Now, some of the CEEC face an additional challenge: the prospective joining of the EU in accordance to the Copenhagen council and the adoption of the euro as soon as the Maastricht criteria will be fulfilled.

This paper attempts to survey the most important contributions to financial economics with regard to the special circumstances faced by the applicant states. Due to the limited space available the overview must necessarily be rough and superficial and might not do justice to all arguments mentioned therein. The omission of likewise important contributions is not intended to lower their value, but reflects the focused character of this article. The usual caveats apply.

Accession to the EU requires the adoption of the *acquis communautaire*, this 80,000 pages piece of European legal body, which is divided into multiple chapters currently under negotiation. Chapters 4, 5, 11, 24, 28 directly address issues of capital market development, but nearly every chapter touches the issue one way or the other. Provisions therein require the applicants, for instance, to open domestic markets for foreign entry and to ensure a minimum of common and reliable regulation (see, e.g., Carmichael 2001, on the needs and challenges for regulation). The mechanism of capital markets can be broken down to several subtasks, whose individual analyses facilitates research. There is first the supply of capital at low cost. Important variables are the credibility and stability of a financial market, liquidity and diversification possibilities, expected rates of return, and so on. Second, screening and selection of prospective investment projects is a major task. Transparency, accepted standards of accounting and disclosure, appropriate compliance, and many more require a well developed regulation and institutional framework. Finally, incentives provided by the financial system shape the way firms are managed and may improve corporate profitability. This aspect concentrates on issues such as the optimal capital structure and financial contracting.

#### 2. The macroeconomics of capital supply

The eastward enlargement of the eurozone affects capital supply in mainly two ways. First, parts of the financial regulation and monetary conditions of the EU will be expanded to the then new member states. Second, these countries will participate in a well integrated financial market ranging from Lisbon to Athens and Helsinki.

The provisions of the EU's internal markets do not allow substantial barriers for international capital flows anymore. Moreover, legal conditions have to converge to western European standards. Both precipitate the ongoing process of liberalisation and consolidation of the financial sector. Evidence from other emerging markets suggests that this is a



worthwhile endeavour: Liberalisation is generally associated with higher economic growth, because the costs of capital tend to sink (cf. Henry 2000; Bekaert *et al.* 2000).

The arrival of the euro will also put an end to almost any sovereign monetary policy and, thus, reduces the threat of any substantial inflation differential between new and old members of the eurozone. Exit costs out of the euro-system are prohibitively high as to abandon it in any but the most extreme situations (cf. Bolle and Neugart 2000). Moreover, the approval of the European *acquis communautaire* with its extensive regulation will contribute to a reduction of country risk because certain types of misbehaviour will then be prohibited. The current euro-members tried to stress that even a common currency does not induce multilateral liability for public debt, the notorious no-bailout clause. However, this clause is not credible because any euro-country experiencing a financial or fiscal crisis would almost certainly receive assistance, if not for moral obligation, then in order to prevent contagion to the eurozone as a whole. This generosity will of course expand to new members, too. All in all, investment in the applicant states will become more attractive, i.e., risk premiums will be reduced and, hence, capital comes at lower costs.

The other driving force of capital market development in the CEEC is the financial integration into the huge eurozone. Size does matter here. An integrated financial market facilitates the smoothening of supply and demand for funds and hence increases liquidity, i.e., reduces the liquidity premium. The same holds true for the possibilities of diversification. When costs of cross-border transactions fall, investors will draw on a bigger range of assets whose yields are less correlated, and which eventually leads to more efficient portfolios with less systematic risk. Confer the theoretical model in Martin and Rey (2000), for empirical support see Stulz (1999).

However, will CEE transition economies' financial markets integrate? The answer is yes, albeit not without risks. Previous studies, such as Danthine *et al.* (2000), and Galati and Tsatsaronis (2001), have shown that EMU spurs the trends toward a unified capital market with the beneficiary effects described above: While market size increases, the euro-market is bigger than the sum of the previously separated national capital markets, liquidity and fundamental risk is reduced. Hardouvelis *et al.* (1999) estimate a reduction of 2% in the cost of capital due to the process of European integration 1992 - 1998. Moreover, the standardised expression of prices in euro and the creation of a euro-wide yield curve as a benchmark improves market efficiency (Danthine *et al.* 2000). The integrative impact of the euro for the CEEC may even be bigger because the two main aspects of EMU, the elimination of currency risk and the installation of a credible monetary policy, are more important.

Financial markets anticipate the accession to the EU and the adoption of the euro with a certain likelihood. It is, therefore, not necessary to wait for the euro to come in order to reap its benefits: the reasonable expectation of a prospective adoption suffices to generate part of its profit. A similar development was observed during the run-up to EMU, when market confidence was reflected by converging interest rates even when politics still struggled about who to let in and who not. Still, interest rates in applicant states are somewhat higher than in the EU, but the expectation of converging interest rates in the future has already increased demand for CEE bonds and reduced yield spreads. A related empirical point has been put forward by Claessens *et al.* (2001b) who stress that the impact of the entry of foreign banks is felt immediately even before they seize any considerable market share. It is rather the number of entrants that matter.

The generally positive outlook on the progressive applicant countries is reflected by strong capital inflows: Current account deficits among the Luxembourg-group amount to roughly 5 - 7% of GDP and are constantly financed from outside. They contribute to and enable the high investment quotas which are needed to level with mature economies' capital endowment. Gross capital formation in the applicant states amounts to 25 - 29 percent of GDP, which is

higher than the usual low twenties figures of mature economies but less than the 30 percent prevalent in East Asia now. The high investment quotas indicate a closing of the gap with Western countries, however, as they are largely financed by foreign capital inflows, they also represent considerable risk.

Indeed, huge capital inflows spurred by the belief in a splendid economic future and a volatile financial world may resemble the advent of the East Asian turmoil four years ago. What, one may ask, will happen if expectations of future economic improvements are built on sand? Can East Asia be a blueprint for a worst-case scenario in Eastern Europe? In 1997, the sudden devaluation of the Thai baht led to an unexpected, though not unprecedented, reversal of capital flows in a magnitude which has brought down the whole region. What if markets lose faith in a quick accession of applicant countries to the eurozone, or even to the EU? Missing the 2004 deadline of the Gothenburg summit could be a plausible trigger. What if entering the eurozone does not yield the benefits hoped for? It may become clear that merely overtaking the euro does not promote good governance to the expected extent, and thus, market imperfection will persist with investments becoming less attractive (Bolle *et al.* 2001).

What happens once the trigger is pulled is well known from previous crises: The loss of capital inflows threatens to imbalance the balance of payments, and hence, demands depreciation of the local currency in order to reduce trade deficits. The depreciation, however, devalues asset prices such as equity shares. Even if depreciation can be fought off, rising interest rates would harm assets to a similar extent. Investors will try to avoid losses in their stakes and withdraw further funds from that currency thereby precipitating the downward spiral of depreciation. What else happens depends on local circumstances. If large amounts of credit are denominated in foreign currency a financial and banking crisis will be likely (Mishkin 1998).

Anyway, as investors will be satisfied on a first-come, first-served basis, such a crisis resembles the standard multiple equilibria model (cf. Radelet and Sachs 1998). The only necessary condition for a crisis to happen is when the country or region is in scope of general vulnerability. Prospective members of the eurozone will enter at least one dangerous transition period: the time between EU accession and admittance to the eurozone. Then, early benefits will be expected and initial disappointments may appear. Moreover, any delay in enlarging the eurozone will then become obvious and may trigger the crisis. Even if a reversal of financial flows does not immediately lead to crisis, applicant states would forgo considerable benefits. Moreover, the then rising need to reduce the trade deficit will most likely result in a reduction of overall demand and thus harm economic growth (Bolle *et al.* 2001).

### **3. Screening and selection**

Providing capital at low cost highlights only the supply side of capital markets. Demand for financing, too, is shaped by several other factors. If funds are available then there is also the need for profitable investment opportunities. However, the assessment whether or not any given project is profitable is far from trivial. This assessment should be driven by market forces, whether it is a bank-based or stock market-based system. The more developed a capital market the more precise will be its judgement of investments, i.e., the closer the market price will come to the virtual fair value. The pricing close to a fair value in turn improves capital allocation and, thus, contributes to economic growth.

The task of screening and selecting an investment project is complicated by an asymmetrically distributed information between seller and buyer, or debtor and creditor for that matter. If the former cannot credibly communicate the project's quality, any investor will only pay a low-quality price, which the entrepreneur refuses, given that he has outside options (this problem of adverse selection is related to Akerlof 1970). Finally, only low-quality projects may find financing. However, markets and societies have developed multiple ways to circumvent adverse selection.

First, there are laws and regulation that require fund-seekers to report truthfully (the link between law and finance is well established, cf. the various studies of La Porta *et al.* 1997, 2000, 2002; Pistor *et al.* 2000). Moreover, actors are embedded in a complex pattern of norms and values that set certain standards of ethical behaviour; failure of compliance may not be legally traceable but would certainly harm reputation and, hence, impair future business (cf. Williamson 2000, for a systematic overview). However, things in transition economies are different. To be sure, most CEEC have by now adopted commercial law and regulation quite similar to that of mature economies. In fact, some just transferred the respective codes to new grounds. But there is still a significant discrepancy between law on the books and its effectiveness. A glance at the EBRD's transition indicators may be illuminating. It may be true that financial transition indicators may be high in general, though, with regard to securities markets and nonbank financial institutions, i.e., the more advanced parts of a financial system, these indicators are lower, on average two notches (EBRD 2000). Moreover, with regard to the legal framework, i.e., commercial law and financial regulation, it is important to note that there is still a difference between extensiveness and effectiveness according to the respective indicators, extensiveness being ranked usually 0 to 3 notches higher than effectiveness (EBRD 2000), indicating that there is still room for institutional arbitrage. The reason is that it is easy to write down the code of law, but that it takes time for institutions to evolve that give teeth to it.

Investments are constrained by weak property rights more than by limited external supply of capital (cf. Johnson *et al.* 1999). Anecdotes of perky and blunt expropriation of improvident investors fill the recent literature (cf. Black *et al.* 2000, for an excellent survey on the Russian case). The consequence is that the difference between market price and fair value increases and that private information becomes a crucial ingredient for successful business at the expense of investors without insider knowledge. Informed trading contributes to the bid-ask spread of prices (in the sense of Glosten and Milgrom 1985) and, thus, reduces allocation capabilities. Although a recent Czech study did not find an excessive adverse-selection component at the Czech stock market (Hanousek and Podpiera 2000), the fact that progressive applicant states have low interest-rate spreads (below those of Germany) but also low amounts of domestic bank credit in relation to GDP (WDI 2001) indicates a significant degree of credit rationing (cf. Stiglitz and Weiss 1981) which is in turn a standard reaction to adverse selection and which needs to be at least partly overcome by regulation (Carmichael 2001). Moreover, barter and other non-monetary transactions are still a prevalent phenomenon (Carlin *et al.* 2000), showing that business parties seek outside ways of financing when bank credit is limited.

This takes to a second point: Screening and selection of investment opportunities is mostly done by banks as delegated monitors (cf. Diamond 1984). Stock and bonds markets have an important say, too, but they appear here usually at a later stage of capital market development. Domestic banks in CEE are often overstrained by this task. Not only do they often play a dodgy role in the discrimination of minority shareholders (again, a glance at Black *et al.* 2000, is insightful) but are also often too small (cf. Winkler 2000) and too badly trained and supervised. Foreign banks, non-bank financial institutions, and other financial actors can fill the vacancy. They bring the necessary size and sophisticated risk and management techniques to deal in this environment. The appearance of foreign banks will be fostered by the enlargement of the eurozone, because (i) legal barriers that hinder foreign entry will have to disappear in compliance with the Copenhagen criteria, and (ii) without currency risk vis-à-vis western Europe and stable macroeconomic conditions long-term commitments in CEE become more promising.

Foreign banks that enter emerging markets generally have lower interest rate margins and overhead expenses but higher profits than domestic banks, indicating their superior competitiveness. This improves the functioning of capital market and is supposed to have positive welfare effects, at least in the long run (Claessens *et al.* 2001b). Foreign banks (i) improve quality and availability of financial services by increasing bank competition and enabling greater

application of modern banking skills and technology, (ii) serve to stimulate the development of bank supervisory and legal framework, and (iii) enhance a country's access to international capital (Levine 1996). These beneficiary effects are supported by a number of studies, such as Levine (1996), Walter and Gray (1983), Goldberg and Saunders (1981), and Gelb and Sagari (1990).

However, foreign entry comes at a price. First, international financial institutions have less private information about CEE markets, which is a good thing, because it hinders them from informed trading. The downside may be that these institutions will also engage less in lending to small and medium enterprises because they lack the specific knowledge and experience to assess and monitor these businesses. Even domestic banks may abstain from these kind of loans, as they are traditionally low-profit. Increasing foreign competition will slash earnings anyway so that few CEE banks will afford them (cf. Stiglitz 1993). This can be a disaster for economic development because it is the small enterprises that have been most successfully privatised and which now show the biggest economic dynamic in terms of growth rates and employment. Any backlash here would hinder the urgently needed restructuring from Soviet-style industrial conglomerates toward private small-scale and service-oriented business.

For this reason, and others, politicians have always been reluctant to open the domestic financial sector to foreign competition. Moreover, they love to have a strong grip on financial decisions. This is understandable, given that financial decisions may directly affect the possibility of re-election; for instance when the prolongation of loans is refused and local firms go bust with at least transitory higher unemployment. Non-native banks are not rooted in the local community and presumed to show less social responsibility, thus, taking less account of employment effects or alike. Although this improves capital allocation, it may also serve as an argument of domestic financial institutions that demand protection in order to defend their profits, albeit at the expense of the public. But politicians may too easily give in to their plea in order to secure their influence in the financial realm. However, the track-record of governmental intervention is rather mixed, to say the least. For instance, La Porta *et al.* (2002) show that countries with higher government ownership in banks usually suffer from lower growth rates. Though, there might be a case for public intervention in financial intermediaries in order to pursue development objectives, it usually does not outweigh the disadvantages of state ownership.

#### **4. Financial contracting**

When funding is available and promising investments are chosen, it is still important to ensure that the project stays profitable. A careful glance at the corporate governance, thus, seems straightforward. Managers and other important stakeholders, such as banks and the state, may prefer to enjoy private benefits in conducting business rather than maximising firm value.

Agency costs reduce the net present value of cash-flows (Berle and Means 1932; Fama 1980), which is in turn detrimental to economic growth (cf. Jensen 2001). Agents can deviate from their contractual obligation because (i) contracts may be incomplete and (ii) monitoring of agents is costly and not always possible. The latter is especially important when ownership is dispersed and most owners free-ride on the monitoring activities and expenses of few, which leads to a significant under-investment in outside corporate control.

Agency costs are not infinite. Besides monitoring, competition from the product market and the labour market for managers may constrain them. However, both are rather weak forces, particularly in transition countries (cf., for the Russian case, Earle and Estrin 1998). Hence, economic literature has increasingly focused on incentives provided by the capital market to improve corporate governance. Agency costs are presumed to be rooted in managers' discretion over cash-flows, where not the most profitable investment has to be chosen but the one that maximises manager's

welfare, such as perquisite consumption, empire-building etc. Removing manager's discretion by removing such free cash-flows is, thus, straightforward. A high financial leverage may be suited because cash-flows and high profits are necessary to serve debt, leaving little to spend for fancy offices. However, the reduction in agency costs has to be balanced against the increasing probability of going concern. This trade-off leads to an optimal capital structure (Jensen and Meckling 1976; Jensen 1986, 1989). Many studies support this view, including Lehn and Poulsen (1989); Kaplan (1989); Baker and Wruck (1989); Smith (1990); Denis (1994), and Wruck (1994), whereas others, such as Smith jr. and Warner (1979), have been vary. Another means to reduce agency costs is by incentive schemes, which are sometimes presumed to be less expensive than a high leverage (Hart 2001a). However, incentive schemes, that are basically stock option plans, are no easy way out. They may adversely affect manager's willingness to bear risk (Winter 1997), induce managers to fake figures (Yermack 1996), and may only impose temporarily discipline because they shape behaviour only when being at the border of in and out-of money (Winter 1997), or lose most disciplining power because managers may expect a repricing of options when times get bad (cf. Chance and Kumar 2000). But either way, financial tools are a tested instrument to improve corporate governance.

Transition countries often bear the legacy of the Soviet-preference for big industrial conglomerates and its dislike of services (cf. Gros and Suhrcke 2000). Firms may still face the traditional monopolistic structure, where only joint production within the established chain generates profit at all. Hence, exit costs out of this chain are prohibitively high so that profits may be appropriated by business parties with more outside options (cf. Blanchard and Kremer 1997). Investments would be highly specific and are, thus, unattractive because earnings would be endangered by renegotiation from contract partners. Under-investment is the consequence (the seminal contribution is Klein *et al.* 1978). Less investment opportunities leave more cash-flows free, increasing agency costs and underlining the need for instruments to constrain management entrenchment. High leverages may a solution, at least for a transitory period until corporate governance is improved by other means; Holstrom and Kaplan (2001) take the example of the LBO-frenzy in the USA of the late 80s.

On the other hand, the classic manager-shareholder conflict of mature economies is a lesser problem in transition countries, because a widely held firm is rather the exception than the rule. Closely held firms dominate the scene and the discrimination of minority shareholders is a central problem (Berglof and Thadden 2000). A coalition of management, majority shareholders, and sometimes creditors, may pursue asset stripping and other forms of appropriation at the expense of minority shareholders (cf. Aoki 1995). For the Russian case, Black *et al.* (2000) provide an illustrative overview of the mechanisms. That debt keeps its unforgiving power as a disciplining device when banks are within the coalition is at least questionable. Anyway, it seems fair to state that capital market development improves corporate governance because the necessary mechanisms are provided to reduce agency costs. Moreover, a fully fledged capital market provides not only debt and equity financing together with monitoring activities, but also a number of intermediate solutions such as derivatives and convertible bonds. The use of such instruments may facilitate the contingent transfer of control rights depending on the state of the firm in order to put always the most efficient one in control of the business (cf. Myers and Majluf 1984; Aghion and Bolton 1992; Mayers 2000; Hart 2001a).

However, the opposite is also true: Good governance promotes capital market development and bad hinders it. Dogdy governance attracts investors that have insider information and the capabilities to reap private benefits out of the investments, say the firm. The price such investors are able to pay can easily exceed the fair value without private benefits, thus, bad investors drive out the good. Besides informed trading and the distortion of prices at financial markets which aggravates capital market development, shabby investors also reduce firm value because (i) they have

no interest in appropriate corporate governance, i.e. do not bear the associated expenses, and (ii), by definition, these are the ones where agency costs are highest.

Moreover, this reduced firm value must not necessarily be reflected by lower prices for debt or equity because of the mechanism described above. However, the holding of none-controlling stakes in the firm (minority shareholdings, syndicated financing etc.), where private benefits are hard to realise, would be extremely unattractive as they would be subject of discrimination and appropriation. Hence, prudent investors would abstain from acquiring none-controlling stakes, thereby precipitating adverse selection at the capital market.

Good corporate governance should have the opposite effect. When agency costs and the threat of appropriation are low, market prices should be near the fair value of a firm. Adverse selection will be reduced and high-quality investors are encouraged to buy equity and to provide debt. With share- and stakeholders aiming at firm value maximisation agency costs will be further reduced and the pricing ability of the market will increase. Hence, it seems that corporate governance and capital market development precipitate each other, for the good as well as for the bad. More strictly, there may be a path dependency that leads toward a favourable or less favourable equilibrium. Shocks may alter this path.

The arrival of the euro in CEE has the potential to tip the balance for the good, or has already done so. The reduction in currency risk and the EU regulation let the number of foreign investors surge. International banks and financial institutions do not only bring knowledge and capital but are also less able to generate private benefits out of their investments, because they usually lack the necessary network. Corporate governance and financial regulation can only be effective if they are supported by actors that are willing to pay for the monitoring, and eventually the punishment, of misbehaviour. On a path towards a bad equilibrium such expenses might not pay off, but on the trail to euro the lure of stability and profits may be sufficient to bear such costs. Big institutional investors from abroad have a vested interest that law on the books, regulation, governance etc., but also business ethics, are followed in practise. Due to their size, they may also have the power to coerce the compliance of formal and informal rules. For instance, if they feel discriminated as a minority shareholder they will more likely sue the management and demand fair treatment. Calling the courts might not have a positive net present value if regarded as a stand alone project. This explains the reluctance of small investors to do so, which is the very source of agency costs. However, there are positive external effects in the form of a shift towards good governance and positive capital market development. As these big institutional investor resemble in a way universal owners, they are able to internalise these externalities which might render the initial endeavour worthwhile (the idea is related to the concept of fiduciary capitalism, Hawley and Williams, 2001). The evidence that the number of foreign banks is more important for capital market development than their market share (Claessens *et al.* 2001a) supports the argument.

## **5. Conclusions**

The eastward enlargement of the eurozone offers monetary stability and the benefits of an integrated capital market to the prospective applicant states in CEE. Moreover, the adoption of European regulation and its increasing effectiveness, partly due to the appearance of international investors, improve the functioning of the financial system. In general, this should promote efficient allocation of resources and, thus, economic growth. CEEC can even enjoy these benefits before the euro actually arrives as market participants anticipate enlargement and change their behaviour respectively.

However, the process is not free of risk. Market sentiment could turn against eastward enlargement and lead to a sudden reversal of capital flows as has been observed during previous crises such as the Asian crisis of 1997. To

prevent this scenario, a prudent, transparent, and credible process of enlargement is needed. Moreover, the opening and liberalisation of capital markets is associated with increased competition and a loss of control over financial decisions by politicians. Both might cause further tension. Local financial institutions are small and inexperienced compared to their foreign counterparts and will face difficult times ahead. But their skills in providing financing to small and medium sized firms will stay indispensable in the future. Thus, politicians might be tempted to protect local banks and stock markets, if only to prevent a loss of jobs. Here a careful judgement will be needed in order not to harm capital market development. Anyway, the risk adjusted net present value of the eastward enlargement of the eurozone should be positive.

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## **b. Trade and Foreign Direct Investment**

### **Trade and FDI - Survey of Research**

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(research assistance by M. Sousa Galito is greatly appreciated)*

#### **1. Introduction**

Over the past decade, the process of international economic integration has been continuously reinforced. Such phenomenon is especially visible at the regional level, with the increase of Regional Integration Agreements (RIA), such as Mercosur, ASEAN, NAFTA and the process of European Union (EU) Eastern enlargement. These developments have renewed the interest on the economics of regional integration, an area of research firstly investigated by Viner (1950), who introduced the concepts of 'trade creation' and 'trade diversion'. Trade and Foreign Direct Investment (FDI) flows are generally recognised as the two main channels of economic integration. Consequently, the most relevant issues in the debate on RIA relate to trade creation, trade diversion and to the possible reallocation of FDI.

However, despite the main roles played by these two aspects of economic integration, a third element - firms' subcontracting strategies - has to be taken into account. Over the last decades, the increasing fragmentation of productive processes and the development of worldwide production and distribution networks have enhanced economic, financial and technological globalisation. Progress in production technologies and in communications has contributed to the segmentation of production processes, leading to the development of subcontracting. As a result, a vast variety of entrepreneurial agreements has emerged. These agreements generate production and exchange networks between firms of different countries, thus contributing to a renewed system of international labour division (ILD). Subcontracting is an alternative to traditional FDI and has remarkable effects upon international trade. Notwithstanding that, it has not been the object of comparable interest on the part of researchers.

Since the beginning of the negotiation process for the Eastern enlargement of the EU, trade and FDI have played an important role in the approximation of member states and applicants. An asymmetric tariff reduction has taken place from the onset, and currently only some 'sensitive products' are protected. Completion of the process on the part of the Central and Eastern European Countries (CEEC) is expected to take place in 2002. CEEC' transition phase to a market economy may now be considered as completed, since the geographical reorientation of trade, away from the former Council for Mutual Economic Assistance (CMEA) countries towards the EU, seems to have reached its limits (Freudenberg and Lemoine 1999).<sup>1</sup> Industrial recovery and rapidly rising levels of productivity in these countries are likely to induce changes in the sectoral composition of output, which will in turn influence trade patterns. The flows of FDI to the CEEC, and the establishing of subcontracting agreements with EU industrial firms, have become substantial and are crucial to the restructuring process of industrial production and of international trade.

A vast literature, containing a variety of approaches, has put forward evidence confirming the changes that have occurred in terms of volume and structure of foreign trade and FDI between the EU and the CEEC during the transitional period. This paper attempts to survey the most relevant contributions of such literature and to underline the critical issues. In spite of the strong relationships that exist between trade, FDI and other forms of entrepreneurial alliances, for the sake of clarity, the three issues are analysed separately.

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<sup>1</sup> This process was faster in the case of Poland due to the 1990 price liberalisation.

## 2. Economic integration and trade flows

There are several reasons to study trade effects in processes of economic integration such as that of the Eastward European enlargement. First, expected variations in the intensity and in the composition of trade among the countries involved (members and entrants) may provide information on the nature and size of the impacts upon production structures, and on the magnitude of efficiency gains. Second, the identification of differences in the evolution of trade patterns between developed and less developed countries should help design and later implement intra-EU compensation mechanisms. Finally, the analysis of trade developments in the pre-accession period should provide answers concerning the future evolution (i.e. in the context of an enlarged EU) of the current scenario of structural asymmetry among EU countries.

Economic integration aims at reducing various barriers to the free flow of goods, services and factors of production, in order to increase potential gains from trade via a more efficient use of resources. Theoretically, both static and dynamic integration effects can be identified. Static effects are usually related to the existence of diversion or creation of trade, due to reductions of tariff and non-tariff barriers. Dynamic effects are usually associated with the expected increase in competitiveness, scale economies, transformation of trade and investment patterns, or any change on geographical specialisation.

Many studies report changes in terms of volume, composition and nature of trade between EU countries and the CEEC during the process of transition. Different theoretical and empirical approaches have analysed the levels of “potential trade”, the evolution of specialisation patterns and their consonance with factor endowments. The determinants of intra-industrial trade (IIT), i.e. exports and imports of products of the same industry, have also been an object of interest, following the increasing importance of this type of trade between CEEC and EU countries.

Gravity models are usually adopted when modelling the integration process between the CEEC and EU, namely in the assessment of the impact of the enlargement on trade potential. These models are simple specifications that take the form of a linear regression where the dependent variable, in this case bilateral trade flows, is explained by a set of independent factors. Examples of these are country size, factor endowments and transport costs, and other aspects, such as the existence of similar cultures, common borders, different consumer preferences, trade barriers or trade agreements. One advantage of these models is that reliable data is usually available.

Most of these studies conclude that, in spite of the great expansion in the EU-CEEC trade relations, the volume of trade will continue to increase due to the expansion of real incomes and to the progress in market reforms (see, for example, Fontagné *et al.* 1999; Boeri and Brücker 2000; Aussilloux and Pajot 2001). Nevertheless, most analyses suggest that this tendency will not equally affect all countries.

Both theoretical and empirical analyses emphasise the role of geographical proximity in the intensification of trade relations between the EU and the CEEC, along with historical and cultural factors. In fact, countries like Germany, Austria, Finland and Italy are responsible for two thirds of the EU trade with the CEEC, while the Czech Republic, Hungary and Poland represent about two thirds of the Eastern trade with the EU. On the other hand, some studies (Fontagné *et al.* 1999; Aussilloux and Pajot 2001) conclude that, in 1997, countries like Germany and Austria have reached a trade volume with the CEEC that may be considered above the *normal*. Yet, the trade dynamics of these countries has been sustained in the years after.

More recently, general equilibrium models have also been applied (see Egger 2001; Egger and Pfaffermayr 2001, Lejour *et al.* 2001). Egger (2001) stresses the importance of adopting a dynamic perspective in the analysis of European integration. Using a general equilibrium model, the author tries to isolate the impact of growth divergence upon

bilateral trade and investment, and identifies a positive impact on both exports and FDI. Lejour *et al.* (2001) explore the economic implications of enlargement, concluding that some industrial sectors will suffer a decline, both in the CEEC and in the EU.

Much less research has been performed to assess regional effects and effects upon specific industrial sectors. Some studies (for instance, European Parliament 1999) suggest that, although overall positive effects are to be expected from the enlargement process, regional and sectoral unbalances within the EU may also occur.

There are significant differences on trade intensities among regions. It is therefore important to analyse the effects at the regional level. However, due to problems related with data availability at the regional level, existing studies concentrate on some regions on the EU-CEEC borders. The analyses performed by Boeri and Brücker (2000), and Weise *et al.* (2001), indicate that the trade intensity of German regions located in the border with the CEEC doubles the one of other regions.<sup>2</sup>

Moreover, in recent years, the relative weight of IIT flows and of *Outward Processing Trade* (OPT)<sup>3</sup> seem to be stronger among regions with territorial contiguity, indicating also that the ILD is influenced by production cost differentials and low transport costs. Palme (1999) refers that Austrian regions situated closer to Eastern urban centres are better positioned to enjoy potential economies of scale and hence to register significant production growth.

The regional effects of enlargement on trade are related to the specialisation pattern of each region, as well as to the nature of *competition/cooperation* between Eastern and Western firms. It is therefore predictable that the future impact will be stronger in the current EU-CEEC border areas. Either these regions will benefit the most, or they will be the ones suffering the greatest losses, depending on the nature of industrial transformations.

Costs and benefits of the enlargement may also be different at the sectoral level. According to Bachtler *et al.* (1999), Western firms specialised in the production of labour-intensive goods (i.e. textiles and leather goods) and of capital-intensive goods with low sophistication levels (i.e. primary chemicals, printing, and rubber products) may experience serious difficulties in a scenario of higher Eastern competition. Consequently, EU countries and regions potentially more affected by the enlargement may be the ones with higher dependencies, not only in agriculture, but also in low labour-intensive industrial processes. Regions specialised in chemistry products with low sophistication and in assembly industrial units might also be affected. Furthermore, Lejour *et al.* (2001) conclude that the enlargement will negatively affect the energy-intensive products in the CEEC and the textiles in the Southern EU countries.

A sector of particular concern is agriculture. Enlargement will probably affect the primary sector in both the EU and the CEEC. Weise *et al.* (2001) refer that, as the CEEC become part of the Common Agricultural Policy (CAP), gains are expected to overcome the losses. In fact, Eastern countries may benefit from an easier access to Western markets, from technology improvements induced by FDI, and from the privatisation of farms and the introduction of other land reforms.

On the other hand, EU members may benefit from the possibility of exporting to a larger market with lower barriers, especially in the case of CEEC' vicinity. Nevertheless, as the CEEC production is mainly labour-intensive (Cochrane, 2001), and as Eastern countries' prices are significantly lower than Western ones, there are possible negative impacts

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<sup>2</sup> However, even among frontier regions there are considerable asymmetries. For instance, Saxony and Bavaria neighbouring Czech republic exhibit trade intensities with the CEEC of around 20.2% and 8.9%, respectively.

<sup>3</sup> *Outward Processing Trade* was a particular form of subcontracting which existed until mid-nineties and it was characterised by the fact that the leader firm supplied the subcontracted firm intermediary goods for processing which were then forwarded to the firm trading the final output.

on present EU members. This is especially important to the Southern countries producing labour-intensive agricultural products. As a result, Con (2001) questions the necessity of a future PAC reform.

Models of revealed comparative advantages analyse countries' international specialisation on the basis of production cost differences. Hence, in a free trade regime the pattern of comparative advantages should reflect the structure of relative prices in autarky. According to the neo-classical theory of international trade, inspired by the Heckscher-Ohlin-Samuelson model, trade patterns are explained by differences in factor endowments. Therefore, if the EU and the CEEC have different factor endowments, these differences should have an impact on their trade patterns, as countries should specialise on those products that use intensively the relatively more abundant factor of production.

In order to identify trade specialisation patterns, different indicators are used. Trade revealed comparative advantages are mostly measured using the indicators suggested by Balassa, and by Grubel and Lloyd.<sup>4</sup> A different type of index, developed with the objective of normalising the trade structure, is referred to in Freudenberg and Lemoine (1999) as *Contribution to the Trade Balance*. These authors use this indicator with data aggregated following the United Nations' Broad Economic Categories (BEC) and conclude that the CEEC have comparative advantages in primary (upstream production) and in consumption goods (downstream production), but comparative disadvantages in intermediate and capital goods. They also identify reciprocal trade of intermediate products as the most dynamic part of CEEC-EU commercial relations. Primary and intermediate goods had a positive impact upon the trade balance, whereas capital and consumption goods registered a negative contribution.

Within this framework, several studies stress the existence of considerable differences on factor endowments in the EU and in the CEEC (see, *inter alia*, European Commission 1994; Dobrinski and Landesmann 1996; Landesmann 1995, 1996). Most analyses conclude that the CEEC are specialised in labour-intensive industries, as well as in resource and energy-intensive sectors. On the other hand, they reveal comparative disadvantages in capital, R&D and human capital-intensive industries, where the EU registers important advantages. Furthermore, there has been an increased diversification of most CEEC' exports towards engineering products (Lemoine 1998).

Though most trade between the EU and the applicant countries is based on comparative advantages, recent studies uncovered structural changes in the nature of trade, the most unexpected being the rapid increase in IIT. In fact, IIT is usually observed between countries that are similar in terms of income levels, economic structures and size, and geographically proximate. On the contrary, IIT between the EU and applicant countries results mainly from the reorganisation and fragmentation of production processes.<sup>5</sup>

According to Kaminski (2001), the pattern of EU-CEEC trade has evolved during the last decade as a consequence of the 'Europe Agreements', which reinforced incentives for EU firms to locate production units of the same supply chain in different CEEC, or to outsource other partners. Widgrén (2001) finds that IIT tends to be stronger between neighbouring countries, a result that is consistent with the usual outcomes of gravitational analyses.<sup>6</sup>

The traditional and more used methodology to measure IIT was developed by Grubel and Lloyd (1975)<sup>7</sup>. One important problem of the index suggested by the authors, and of other similar indicators, is related with the level of

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<sup>4</sup> The authors focus on the fact that the higher the weight of inter-industry trade, the higher the explanatory power of *comparative advantages*. In this case, differences in country size or factor endowments are determinants of trade patterns. On the other hand, the higher the weight of intra-industry trade, the better imperfect competition explains international trade.

<sup>5</sup> This issue is analysed in detail in section 3.

<sup>6</sup> This also happens with FDI flows, suggesting that geographical proximity and IIT are positively related and confirming the link between IIT and FDI.

<sup>7</sup> Grubel and Lloyd's index is defined as one minus the ratio of the absolute difference between exports and imports of a given sector and the sum of total imports and exports of the same sector.

sectoral and geographical disaggregation (see Fontagné and Freudenberg 1997). Another limitation is the fact that the indices are not informative in relation to the factors that determine this type of trade.

Empirical assessments of IIT determinants<sup>8</sup> suggest that the increasing importance of IIT in the EU-CEEC trade is influenced by factors such as economies of scale, labour intensity of production, product differentiation (Aturupane *et al.* 1997), economic growth, export performance (Hoekman and Djankov 1996) and the international segmentation of production processes (Kaminski 2001).

Some IIT determinants, such as the case of product differentiation, have generated further theoretical developments that try to connect the nature of productive processes of different industries with countries' trade pattern specialisation. For Lassudrie-Duchêne *et al.* (1986) horizontal specialisation should be distinguished from vertical specialisation. The former is defined as the exchange of similar goods that are differentiated by characteristics other than quality and is driven by scale economies and imperfect competition<sup>9</sup>. The latter comprises the exchange of similar goods of different quality and is determined by differences in endowments.

Abd-El-Rahman (1986) developed a methodology that distinguishes between horizontal and vertical specialisation. Using bilateral trade flows, he refined the definition of intra-industry trade at the product level. The author disregarded the concept of IIT, rather adopting the term "two-way trade" either for horizontally or vertically differentiated products. According to Abd-El-Rahman, the concept of product is related to its technical characteristics, which may be captured using disaggregated data. Similarity depends on the product unit value, assuming that differences in prices reflect differences in quality. With this methodology three types of trade may be distinguished: two-way trade in similar products; two-way trade in vertically differentiated products and one-way trade (weak overlap).

Fontagné and Freudenberg (1997) argue that the distinction between varieties and qualities alters the theoretical framework. In fact, the economic distance<sup>10</sup> between countries is still the basis for specialisation of industries, along with comparative advantages. However, economic distance is also the basis for specialisation in different quality ranges. Accordingly, distinct countries trade vertically differentiated products, and similar countries trade horizontally differentiated products.<sup>11</sup> In this context, the comparative advantage determinants are compatible with IIT in vertical differentiated products, therefore explaining the evolution of EU-CEEC trade patterns.

Freudenberg and Lemoine (1999) find that most IIT between the EU and the CEEC is vertical in nature, and that the CEEC are positioned in quality segments different from those of the EU (even the Southern EU members). In their study, CEEC are generally specialised in middle and down market goods (see also Fontagné *et al.* 1999).

Aturupane *et al.* (1997) analyse the determinants of IIT patterns between the EU and the CEEC, disaggregating trade flows horizontally and vertically. The results show that eighty to ninety percent of total IIT, and twenty five to forty percent of total EU-CEEC trade is vertical in nature. The authors find a statistically significant positive relationship between vertical IIT and product differentiation, economies of scale, labour intensity of production and FDI. Their analysis suggests that horizontal IIT is positively related to FDI flows, industry concentration and product differentiation, and negatively associated with scale economies and labour intensity of production.

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<sup>8</sup> Researchers typically estimate an econometric model (usually a logistic model), considering an index of IIT as the dependent variable, determined by a set of explanatory variables.

<sup>9</sup> Krugman (1994), among others, has contributed to the development of new trade theories, stressing the importance of scale economies and imperfect competition.

<sup>10</sup> Such as differences in factor endowments, technology levels, etc..

<sup>11</sup> The approach based on horizontal differentiation, results from the synthesis of Helpman and Krugman (1985). The authors use the concept of "integrated equilibrium" and combine different approaches like the Heckscher-Ohlin model and monopolistic competition.

Given the substantial differences in the values of exported and imported goods, the increasing weight of IIT in the CEEC-EU trade does not result from the equalisation of the traded goods' factorial contents. Thus, the relative decline in inter-industrial trade has coincided with an increasing specialisation in down-market products and in low price market sectors in the CEEC. Boeri and Brücker (2000) consider, therefore, that a scenario of specialisation in processes that are human capital-intensive and labour-intensive may be identified, respectively, in the EU and in the CEEC.

As a consequence, in the Southern EU members, most public debate on the EU enlargement is concerned with fears of delocalisation of industries from these countries to the CEEC<sup>12</sup>, which have lower labour costs and where a sharp expansion of domestic markets may be observed. This could be a problem when vertical IIT occurs, as a result of the reorganisation of production processes, given the important implications on FDI and on firms' location.

Widgrén (2001) refers some factors that may determine firms' location and justifies these concerns on the part of Southern members. Two critical issues are:

1. Concentration of demand is related to concentration of production. Since the CEEC are similar to Southern European members in terms of income and demand, it would be interesting to analyse whether concentration of production can create competitiveness problems.
2. Comparative advantages have an important influence in the location of firms. In this case, the EU countries with comparative advantages in labour-intensive industries and in resource-intensive sectors may have problems. It is therefore important to identify the sectors in which the CEEC have already generated some kind of competitive advantages.

Helpman and Krugman (1985) refer that when trade liberalisation is accompanied by IIT, adjustment costs are expected to be smaller than with inter-industry trade. This happens because the increase of specialisation implies the abandonment of all industries with comparative disadvantages, and the unemployment of resources or their displacement to a limited number of export-oriented industries.

When analysing the effects of enlargement on trade, it is important to consider the consequences of foreign exchange rate stability. Past experiences may shed some light on the issue. Studies by Artus and Ricoeur-Nicolai (1999), and by Bénassy-Quéré and Lahrière-Révil (1999), conclude that Southern countries have benefited from the stabilisation of their currencies. An equivalent advantage from exchange rate stabilisation can be expected in the CEEC, given their similarity with Southern countries in terms of income and economic structures.

In spite of the empirical and theoretical controversy, most studies conclude that exchange rate stability benefits both international trade and FDI. Guérin and Lahrière-Révil (2001) refer that due to the instability of exchange rates, FDI and trade flows may decrease, as export earnings and the costs of imported inputs are difficult to quantify. McKenzie (1999) finds no clear-cut evidence of a negative relationship between exchange rate volatility and the volume of international trade. However, he suggests the existence of a relationship between exchange rate volatility and FDI.

The distinction between horizontal and vertical IIT may also be important when analysing the effects of foreign exchange rates' stability on trade (Guérin and Lahrière-Révil 2001). In fact, when products involved in horizontal IIT have the same or similar prices, any exchange rate volatility must be absorbed by firms' profits and not by prices. On the other hand, with vertical IIT price differences are higher and changes in the exchange rate do not have to be reflected on profits.

It is important to assess the transformations that have already occurred in terms of volume, structure and nature of EU-CEEC trade relationships in bilateral terms. Consequently, an adequate level of data disaggregation, as well as an

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<sup>12</sup> See Emerson and Gros (1998), for further details concerning potential effects on Portugal.

accurate methodology, has to be used in the examination of trade flows. The main objectives are to analyse the challenges faced by the EU's and the CEEC' industry that result from the enlargement and the subsequent adoption of a common currency, by identifying the potential areas of conflicting specialisation between the candidate countries and the EU members and the complementarities generated by the fragmentation of production processes.

### **3. Foreign direct investment**

Since the beginning of the transition process, the economic authorities in the CEEC have realized the importance of attracting FDI as a major factor for improving the growth potential in countries with almost absent financial markets and commercial banking. First, because of the urgent need for strategic restructuring of firms in these countries. Most CEEC presented obsolete equipment and production methods, and needed an urgent improvement in efficiency in order to compete in the international markets. Foreign firms may provide the necessary know-how and the financial means for industrial restructuring, access to new external markets, and also more efficient corporate governance. In fact, Barrell and Pain (1999) find evidence of higher performance in foreign owned firms. Kaminski (2001) refers that, for example, foreign-owned firms account for around forty percent of Poland's exports and eighty percent of Hungary's exports of manufactures to the EU. Second, because foreign investors are expected to generate positive externalities through a know-how and technology transfer to domestic firms. These two effects could have a significant positive impact on production and on employment.

Some authors, however, alert for the possibility of a third negative effect, if competition from foreign firms induces lower production levels in domestic firms and possible higher average production costs. Contrary to previous findings, Konings (2000), employing firm level panel data to study the net effect of the above factors for three CEEC (Bulgaria, Poland and Romania), finds the first effect only in Poland (perhaps due to time lags) and that the third, negative, effect seems to dominate the second.

By the early nineties, FDI flows to the CEEC were still at very low levels. The turning year was 1995, and since then FDI growth has been significant and continuous, especially in countries like the Czech Republic, Hungary and Poland, three of the most developed economies, which have received around two thirds of the FDI in the group (EBRD 1999). According to IMF data (IMF 1999), in 1998 the flows of FDI to the CEEC were ten times their size in 1990. However, in per capita terms, CEEC' values are still much lower than the EU's, with the Czech Republic and Hungary as the only two countries showing comparable figures to those of Western European economies.

The EU is, by far, the main source of FDI in the CEEC, followed by the United States. In general, more than three quarters of the capital flows entering the CEEC come from FDI by firms in the EU member states. German firms, in particular, have traditionally been the main contributors to these flows.

It is important to note that geography plays an important role in the destination of FDI flows from each EU country. The highest concentration of FDI occurs in those countries, which are located close to the EU borders: Poland, Hungary and the Czech Republic. It should be stressed that these are also the countries that have been more successful in reforming, deregulating and opening their economies. Nevertheless, even taking these factors into account, geography appears to matter. German firms focus mainly on the Central European nations, Scandinavian ones tend to invest in the Baltic sea area, Italy seems more interested in the Balkans, and Austria in its neighbours. There are also some differences in the type of firms investing in the CEEC. While the Germans and the French tend to present large-scale deals by large firms, the Italians invest mainly through small and medium-size firms.

Looking at the structure of FDI in the CEEC we observe that, as a whole, it is relatively diversified, covering different economic sectors, with an emphasis on technology-intensive areas, such as the car and electrical industries or



communications, activities with stable domestic markets, such as agri-foods, and in infrastructures, where examples are the electricity, gas and water sectors. In global terms, the manufacturing sector attracts around two thirds of the funds, far ahead of the retail and wholesale trade, the financial sector, agriculture and mining.

However, the analysis of each country in particular suggests that in some of them (Bulgaria, Latvia, Slovakia and Slovenia) FDI tends to concentrate in a few different sectors, reflecting in some cases diverse privatisation strategies. Furthermore, the distribution of FDI by the different sectors may change according to the country's transition stage. Bellak (1998) argues that at an early stage FDI is directed at existing firms, and later at growing and new industries.

A vast literature has dealt with the identification of FDI determinants. In theoretical terms it is useful to distinguish between horizontal and vertical FDI (see, e.g., Braconier and Ekholm 2001). Horizontal FDI is a substitute for trade, as the decision to invest abroad seeks to eliminate trade costs associated with exports. Vertical FDI, on the other hand, aims at minimizing production costs by taking advantage of price differences in production factors between countries. Large external markets, high trade costs and large factor cost differences may therefore induce FDI flows.

The traditional theory that tries to explain the geography of FDI and provides a framework to identify its main determinants was developed by Dunning (1977, 1981), and is known in the literature as the 'OLI framework' - OLI standing for Ownership, Location and Internalisation. Producers are supposed to compare ownership, location and internalisation advantages with the costs of locating a production centre abroad and, whenever the former outweighs the latter, FDI rather than exports takes place.

Ownership advantages in relation to local rivals are related to aspects such as a patent, a trade secret or reputation. Location advantages can be due to trade barriers, transport costs, customer access or low factor prices. Internalisation advantages are related to asymmetries of information that favour the opening of a production site in a host country rather than servicing that market via licensing, such as the existence of highly skilled workers with a good knowledge of the firm's technological characteristics and secrets.

The disadvantages that have to be weighted against the OLI advantages are the costs involved with the location of production abroad, and include information costs on local tax procedures and regulations, risk of expropriation, foreign exchange rate risk, and other costs related with the placing of personnel abroad whenever such procedure is necessary. This theory has explanatory power in some scenarios and supplies the tools for the analysis of multinational companies, but it may not explain all the characteristics of current FDI flows, namely those of bilateral horizontal FDI that take place between developed countries (see among others Di Mauro 1999).

A more recent body of literature, commonly referred to as the 'New theory of FDI' (see, for instance, European Commission 1996) has focused mainly on refined concepts of ownership and location in the context of general equilibrium trade models. The work of Helpman (1984), Markusen (1984), and Helpman and Krugman (1985) relates the decision of producing abroad with observed differences in relative endowments of production factors across countries. Such framework is useful for the explanation of vertical FDI, i.e. the location of different stages of production in different locations, following relative advantages in factor costs. However, like the former theory, it may not explain flows of horizontal FDI between similar countries.

These aspects are taken into account in the work of Brainard (1993), and Markusen and Venables (1998), according to which the key elements to consider are plant and firm level economies of scale, and tariff and transport costs. Following this approach, multinational production activities are not determined by differences in factor endowments between countries, but by a trade-off between proximity and concentration advantages. In cases where production is characterised by firm level economies of scale, advantages related to proximity to consumer markets dominate. Con-

centration in one location is preferred in cases where plant level economies of scale are present. This type of analysis allows the existence of both vertical and horizontal FDI, as it takes into account two of the critical determinants for investing abroad: market and efficiency seeking motives. Brainard (1997) uses 1989 data on trade flows and multi-nationals' affiliates sales to examine the proximity-concentration hypothesis and finds out that affiliate production is directly related with transport costs and foreign trade barriers, and inversely related with foreign investment barriers and plant level scale economies.

Empirical studies of FDI have adopted different approaches. Some analyses are based on standard or modified versions of the neo-classical model, according to which capital should leave areas where it is relatively abundant in search of higher returns in locations of relative scarcity. One example may be found in the work of Zegrebs (1998), who demonstrates the inadequacy of the standard neo-classical model to explain FDI flows to developing countries. In fact, many analyses report that a substantial part of FDI flows, especially horizontal FDI, takes place between countries with similar economic structures (see for instance Markusen and Venables 1998; Brainard 1997).

Locational models are based on the theories of international trade and industrial organisation, and also on the chaos theory, whose foundations belong to the fields of physics and mathematics (Resmini 2000). Spatial agglomeration of firms used to be explained on the basis of the OLI analysis. More recent approaches adopt a dynamic framework, where centripetal and centrifugal forces are confronted. The presence of positive externalities works to concentrate firms, but the competition generated by this type of agglomeration may also work in the opposite direction. The dominance of centripetal or centrifugal forces depends on the existence of plant level or of firm level economies of scale, respectively (again, see Markusen and Venables 1998, and Brainard 1997).

Gravity models are usually employed to analyse trade, but have also been used in empirical studies of FDI.<sup>13</sup> Such specification may be used to identify both flows of vertical FDI, which are determined by efficiency seeking motives, and horizontal FDI, driven by market seeking goals. Di Mauro (1999) investigates the determinants of FDI using data on FDI flows to seven developed host countries. She concludes in favour of the 'New theory of FDI', as FDI flows appear to be mainly horizontal and dominated by market seeking objectives. Developing the gravity approach to uncover FDI determinants at the sectoral level, Resmini (2000) finds that in the CEEC, and concerning manufacturing activities, horizontal FDI dominates vertical FDI. The consolidation of the restructuring and opening processes appear to be the main determinants of FDI in science based and in capital-intensive sectors. In traditional sectors, wage differentials are the key issue, being the resulting FDI in these activities of a vertical nature. Buch *et al.* (2001) use the gravity approach to investigate if there is FDI diversion from the periphery of the EU to the CEEC. The gravity model is employed to derive a benchmark for expected FDI flows and stocks, which are then compared with actual data. The hypothesis of diversion is rejected.

Using a macro general equilibrium model, with a panel data set of 18 market- and 11 transition-economies, Bevan and Estrin (2000) find that FDI is mainly determined by labour costs, market size, gravity factors and country risk, with the latter, in turn, being influenced by the private sector share, industrial development, government balance, reserves and corruption. These FDI flows seem to have been directly affected by the different pace in the negotiations for accession and, with a lag, in the country's credit rating, promoting further FDI flows to first wave countries, in a virtuous cycle. Conversely, this may have negative effects on the other CEEC. In fact, Baldwin *et al.* (1997) claim that the main advantage for these countries of joining the EU is increased investment, due to lower domestic risk and higher FDI flows.

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<sup>13</sup> Examples of this utilisation may be found in the work of Brenton (1996), Eaton and Tamura (1996), or Brenton and Di Mauro (1999), among others.

It seems reasonable to assume that, as integration evolves, FDI flows will increase, since foreign investors will feel more secure, due for instance to the future abolition of foreign exchange rate uncertainty, as well as to lower institutional and political risks, and demand lower risk premia. Previous integration experiences have shown a major influx of FDI to new member countries, at least for a transitional period - Spain and Portugal are good examples.

It is however more uncertain what may be the consequences for the present EU countries, or even to third countries. There may be, for example, a reduction in the investment potential of some EU members, either due to FDI diversion to the CEEC or to an interest rate increase caused by additional capital demand in the EU.<sup>14</sup>

Another possible consequence for EU firms would be a demand shift towards CEEC exports, although empirical evidence suggests the predominance of market over export-oriented investments (Freudenberg and Lemoine 1999). Almost half the FDI from the EU is directed to non-tradable sectors such as public utilities and communication, financial intermediation and other services (Boeri and Brücker 2000). Only in the textiles and clothing sectors do labour costs seem to influence the reallocation of labour-intensive production.

Finally, an important aspect also to be taken into account in the analysis of the enlargement's effects on FDI, is the net impact upon employment. In fact, low wages in the CEEC may have a negative influence on EU employment, either through import competition or as result of the transfer of some firms' production sites to these countries.

#### **4. International fragmentation of production and trade flows**

Growing economic globalisation and the subsequent need for competitiveness improvement among firms has originated a progressive division in the production processes that lead to an increase on trade of intermediary goods. In fact, trade contributes to the segmentation of production processes, as goods are designed, produced and assembled in different locations.

Subcontracting is a special form of enterprising alliance, under which subcontractors may focus on the production engineering while the leader firm is responsible for design, marketing and financing issues. Subcontracting and FDI have been responsible, although not in equal terms, for the consolidation of the division of production processes. A firm's option between these two forms of internationalisation depends heavily on the existing risk in the target market. Under economic and political instability, if investments are not significantly high, subcontracting is preferable, as FDI should be considered a riskier option.

The effects upon international trade will be different according to entrepreneurs' preferences for subcontracting or FDI. Andreff and Bensebaa (2000) state that FDI leads to the development of intra-firm trade, in which the substitution or complementary nature of investment determines whether there is trade creation or not. On the other hand, subcontracting involves intermediary and/or final goods flows, leading to trade among independent firms.

The consideration of these organisational aspects of trade in the analysis of international specialisation allows a better understanding of its pattern and determinants. Gereffi (1999) concludes that some technological upgrading has been occurring essentially in products and activities inside global supply chains. Therefore, the study of trade flows should take into account the importance of the different types of industrial networks, especially the ones involving subcontracting activities.

However, the inclusion of these issues creates additional complexity in the identification and understanding of trade determinants. These forms of associated trade, which Radosevic (1999) defines as *non-equity production networks*, have not been considered in the theories of factor endowments, or in transaction costs approaches (related to the interna-

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<sup>14</sup> Bartolini and Symansky (1995), for example, estimate a half percentage point increase.

lisation theory of Rugman and Caves). The lack of a unified theory in the literature that explains these global industrial supply networks, has led to the use of international trade and multinationalisation theories in empirical studies.

The emergence of new production and trade patterns, and their relation to the international fragmentation process of production, has promoted the development of theoretical models that aim at combining both features. Deardorff (1998) shows that the segmentation of production processes and their reallocation to a different country may induce comparative advantages for certain goods. Likewise, Jones and Kierzkowski (1997) consider that, due to international fragmentation, a labour-abundant country that is not competitive in the production of a given final product may become specialised in the production of labour-intensive segments included in that product. Consequently, there have been significant changes in the countries' comparative advantage patterns that need to be properly analysed. For an accurate understanding of these changes, it is important to adopt methodologies that use highly disaggregated data.

Subcontracting comprises products' and factors' exchange. In fact, trade flows take place when the subcontracted tasks are completed, representing a flow that associates exports and imports. On the other hand, flows of production factors also exist as know-how (for instance, design and training given by the contractor), and technology transfers may occur. These may have similar effects to those of FDI flows that also promote productive delocalisation.

According to Kaminski and Smarzynska (2001), the ILD has been influenced by the worldwide expansion of production and distribution networks, following the technological progress and the improvement on transports and communications. Subcontracting is part of the international segmentation of production and, therefore, its determinants depend on the factor and technological content of the goods involved. Production is located in low labour cost countries whenever transport costs do not jeopardize this strategy. Thus, firms located in increasing labour cost countries have been able to recover part of their competitiveness, especially on labour-intensive sectors, by means of subcontracting. Nevertheless, Gereffi (1999) argues that, although production costs have been the main determinant of subcontracting, exchange rate variability, trade policies and historical and cultural factors may also affect the location of activities and the dimension of the subcontracting networks.

The intensity and content of CEEC-EU trade flows have been influenced by subcontracting, which has benefited from cost differentials in labour-intensive production segments, as well as from the economic opening of Eastern economies. Eichengreen and Kohl (1998) claim that, although at the initial phase of the transition process subcontracting between Western and Eastern firms has taken place mainly in sectors such as textile and clothing, metallic products and machinery, more recently FDI flows have been replacing subcontracting in these sectors. The development of subcontracting between Western and Eastern firms has allowed higher competitiveness and flexibility to adjust to market conditions in the EU countries, due to a decline on production costs (especially on wages).

Lemoine (1998) refers that industrial exports of subcontracting firms in CEEC represented around twenty per cent of global exports. However, trade created by subcontracting activities has been decreasing, especially in the more developed countries, thus suggesting that internationalisation of production, which is based mainly on low wages, is temporary. On this respect, Radosevic (1999) disregards some negative impacts as he considers that the CEEC have been following a pattern of international integration different from the one adopted by the Asian countries. In fact, he stresses that not only did the CEEC register technological upgrading in the nineties, but also the nature of comparative advantages in the two groups of countries is different.

Assessments of the impact of subcontracting activities in the CEEC reveal the existence of both positive and negative aspects. For example, Szalavets (1997) concludes that this kind of co-operation with foreign firms has increased productivity of Hungarian firms, as they benefited from their foreign partners' transfers of technology and equip-

ment. However, following an initial increase in productivity, the productive and technological integration dynamics did not continue as a result of the persistence of structural barriers.

A particular form of subcontracting, OPT, was common in EU-CEEC trade relations in the nineties and until the complete removal of trade barriers. OPT did not involve the payment of taxes and this encouraged subcontracting activities. Naujoks and Schmidt (1994) consider that this kind of trade creation was highly industry-specific. Moreover, the existence of low unit value products exchanged within this regime of trade was mainly driven by labour costs differentials. Also, subcontracted firms presented, in general, low levels of technology (Eichengreen and Kohl 1998). On the other hand, Pellegrin (1999) considers that OPT represented an opportunity to industrial restructuring in the CEEC, and that there was no evidence of destruction of export capacity in subcontracting firms, even after the increase on wage levels and the subsequent disappearance of OPT activities.

## **5. Concluding remarks**

The CEEC' integration in the EU will promote a broad market liberalisation and a higher level of economic and monetary stability. The new competitive environment will reinforce the role of the market as a mechanism of economic adjustment and of efficient resource allocation. As a consequence, industrial and entrepreneurial restructuring, and the sectoral and geographical reorientation of trade patterns of the countries involved, will be reinforced.

In such process, the dynamics of trade flows and of foreign investment, along with the strengthening of other forms of entrepreneurial cooperation, are the most visible channels of economic and technological integration of the two European areas. However, the assessments developed so far suggest that economic benefits have not been evenly distributed at the geographical and the sectoral levels. Hence, the enlargement entails, from the onset, different risks for the several agents involved.

In what relates to trade relationships, profound changes in terms of intensity, composition and nature of flows have been taking place. Theories of economic integration suggest that, in a context of significant differences in countries' factor endowments (both in terms of quality and quantity), the liberalisation of trade and factor movements may contribute to the maintenance of structural asymmetries and of a heterogeneous distribution of benefits and costs. Therefore, it is of major importance for the stability of the integration process, to identify such risks and to take previous action by means of appropriate policy measures.

Most researchers recognise that the enlargement will reinforce CEEC' process of economic transition, thus providing the conditions for the enhancement of the area's attractiveness for FDI flows. Positive effects to the CEEC are expected, as transfers of technology and new methods of management will stimulate an improvement in competitiveness and in the access to international markets. It is not certain, however, that the integration in the EU is a crucial determinant in the locational strategies of multinational companies. Consequently, the process of consolidation of CEEC' structural reforms has to be assured.

It has been recognised that CEEC' technological progress and economic openness has contributed to a new ILD, via the implementation of production and distribution networks involving Eastern and Western European firms. These networks have contributed to a stronger integration of Eastern firms in the world economy, in spite of the fact that some forms of entrepreneurial alliance have not generate the upgrade or the technological autonomy of these firms. In the context of the enlargement there is a potential risk of generalization of such non-equity forms of industrial cooperation, therefore contributing to an asymmetric integration of Europe.

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## **b. Labour Markets**

### **The Enlargement of the Eurozone and Labour Market Adjustment**

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#### **1. Introduction**

The European Union is committed to being ready to accept new members. The eastern enlargement of EU poses a major challenge both for current member countries and accession countries to integrate a large number of national economies with different structures and income levels. The new members of EU will get full access to the European Single Market with free movements of goods, services, labour and capital between countries.

When accessing the European Union the new member countries will also join the Single Market. It is usually expected that the integration will redirect trade, cause factor movements and speed up economic convergence between the less and more advanced economies of the Union. The convergence of the economies should be achieved by increased trade and specialisation, which requires structural changes. Capital movements from old to new member countries through FDI and transfers from the EU cohesion funds can facilitate these.

The likely membership of the new member countries in the eurozone will make these changes faster by increasing the transparency of costs and prices and by reducing the transaction costs. With a common currency the transparency of the economies will be increased and stronger incentives for factor movements will be created. What the likely effects of capital flows and structural changes are to accession countries will depend to a large extent on the working of the labour markets of those countries. Migration flows – often a cause of political concerns – will also be affected by the labour market institutions of old member countries. If the labour markets of the accession countries fail to adapt to the challenges of monetary union, the convergence process will be hindered. This, in turn, may result in unemployment and migration.

#### **2. The accession process and the candidate countries**

##### *The accession process*

At present, relations between the EU and the applicant countries are based on bilateral 'Europe Agreements', which set out the framework for the political and economic integration of the CEE countries with the EU. The first of these agreements were signed in 1991 with Hungary, Poland and Czechoslovakia, and subsequently with Bulgaria, Romania and the three Baltic states. However, the first agreements did not contain any statements referring to membership.

The Europe Agreements form a comprehensive framework for bilateral relations between the EU and each of the CEECs. From an overall economic perspective, the most important areas covered are the establishment of a free trade area for industrial goods, the liberalization of capital movements, the approximation of laws relevant for the EU internal market and competition policy, and the financial co-operation, notably under the Phare Programme<sup>15</sup>.

However, the Europe Agreements fall short of full membership of the EU in certain important areas. While they include provisions for dismantling quantitative restrictions on agricultural products and improved market access in both directions, they do not yet give the CEECs free trade in the agricultural sector. Another economically important

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<sup>15</sup> Mayhew (1998) gives a detailed presentation of the contents of these agreements.

area where the CEEC-10 does not have full access to EU markets is in the area of labour mobility: migration from the CEEC-10 is still strictly regulated.

At the Copenhagen European Council in June 1993 a decision was reached on the long-term political strategy for European Union enlargement under which the associated countries of central and eastern Europe could apply for EU membership. At the same time the general criteria for accession of the associated countries were adopted. Known as the Copenhagen criteria, these stipulate that applicant countries must have:

- 1) stable social institutions to guarantee democracy, the rule of law, human rights and respect for minorities and their status;
- 2) functioning market economies and the ability to cope with the pressures of competition and market forces in the Union, and
- 3) the ability to assume the responsibilities of membership, including the creation of a political union and the objectives of Economic and Monetary Union.

**Table 1: Candidate country groups**

	<b>Year</b>	<b>Countries</b>
Luxembourg group of candidate countries	1997	Poland, Czech Republic, Hungary, Slovenia, Estonia, Cyprus
Helsinki group of candidate countries	1999	Latvia, Lithuania, Slovakia, Malta, Bulgaria, Romania
Candidate country status granted	1999	Turkey

In December 1997 the EU decided to begin membership negotiations with the countries subsequently known as the Luxembourg group – Estonia, Poland, Hungary, the Czech Republic, Slovenia and Cyprus. At the Helsinki summit in 1999 it was decided to begin negotiations with Latvia, Lithuania, Slovakia, Romania, Bulgaria and Malta – the so-called Helsinki group. Turkey was also granted the status of applicant country, but negotiations have not yet started. A membership perspective has also been promised to the countries of the western Balkans, with whom the intention initially is to conclude Stability and Association Agreements.

#### *The candidate countries*

There are currently around 10 candidate countries that can be expected to become EU members in the next 3 to 10 years. Sizeable differences exist between the group of current member states and candidate countries as well as within the group of candidate countries. They include small, medium-sized and one large country – Poland. Table 2 presents the population figures of the applicant countries of central and Eastern Europe and their income level relative to the average of the current EU Member States. The candidate members clearly diverge from the relatively homogeneous group of the current Member States.

In terms of their population, most of the applicant countries are small or medium-sized. Correspondingly, the economies of these countries are also small, which further accentuates the big differences in price levels in different countries. Since the applicant countries are at least economically small states, the economic effects of their accession are

small from the perspective of the EU. However, the large number of countries relative to the present EU-15 presents problems and challenges for the decision-making institutions of the Union.

**Table 2: The candidate countries: population and income**

<b>Country</b>	<b>Population</b>	<b>GDP (billion €)</b>	<b>GDP per capita as percent of EU15 average (PPP)</b>
<b>Poland</b>	38.7	140	37
<b>Czech Republic</b>	10.3	50	60
<b>Hungary</b>	10.1	42	47
<b>Slovakia</b>	5.4	18	46
<b>Lithuania</b>	3.7	10	31
<b>Latvia</b>	2.4	6	27
<b>Slovenia</b>	2.0	17	69
<b>Estonia</b>	1.4	5	37
<b>Cyprus</b>	0.7	8	79
<b>Malta</b>	0.4	3	40
<b>Total of the above 10 countries</b>	75.1	299	
<b>EU15</b>	375	7550	100
<b>Romania</b>	22.5	37	27
<b>Bulgaria</b>	8.2	11	23

The total population of the 10 most likely applicant countries – the most likely new Member States – is 75 million. Although this is a high figure, it is only 20 per cent of the Union's current population of some 375 million. The population of the first wave of candidate countries is thus so low in relative terms that even significant migration from these countries would not cause any major changes in the population of the current Member States.

Economic and other differences between the applicant countries are significant. On the one hand, the income level in the most advanced applicant countries (the Czech Republic and Slovenia) is close to that of some current Member States. The weakest countries, on the other hand, are still well behind the EU level. On average, the income level of the applicant countries is around 40 per cent of that in the EU measured by PPP values. Thus, the differences in income between the current EU countries and the countries aiming at membership are larger than when Portugal and Greece acceded to the Union. Their income level was 60 to 70 per cent of the average of the then EEC. Nowadays, the income level of Slovenia and the Czech Republic is close to the member of the current Union with the lowest income level, Greece – the other applicant countries being well below this level.

The applicant countries differ in their economic structure. Compared to current EU Member States, the share of agriculture of aggregate GDP is relatively large in applicant countries. Furthermore, the relative share of primary production in terms of total labour force is even higher than the corresponding relative figure of value added implying that the labour productivity compared to other sectors is lower in applicant countries than in the EU – which will

make the need for structural change even greater. The agricultural sector in Poland is large in absolute terms. It produces almost 50 percent of the total value added of agriculture in the whole group of 10 candidate countries. The number of people employed by agriculture in the candidate countries is 40 percent of that in the current EU.

The applicant countries have managed to avoid uncontrolled inflation and to keep the monetary economy relatively stable. Almost all countries have some form of exchange rate system based on a fixed exchange rate. The current account deficits and the need to finance these makes most of the candidate countries dependent on continual imports of foreign capital, and hence also vulnerable to changes in investor sentiment. Compared to the current EU countries, all candidate countries still have a low income-level and low labour costs. As a consequence, applicant countries have succeeded in attracting relatively large amounts of foreign capital in the 1990s.

#### *The transition process*

All post-socialist countries suffered from a significant output decline during the transition processes (Table 3). The output decline was predominantly related to supply side shocks and structural imbalances, which have been accumulated for decades under the socialist regime (Holzmann *et al.* 1995).

**TABLE 3: GDP levels in the East and Central European Countries, 1989-1999**

(GDP index, 1989 = 100)

	<b>1990</b>	<b>1991</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999*</b>
<b>Bulgaria</b>	90.9	80.3	74.4	73.3	74.6	76.2	68.5	63.7	65.9	65.9
<b>Czech Republic</b>	98.8	87.4	84.6	85.1	87.8	93.4	96.9	97.2	95.0	95.0
<b>Estonia</b>	91.9	79.4	68.1	62.0	60.8	63.4	65.8	72.8	75.7	75.7
<b>Hungary</b>	96.5	85.0	82.4	81.9	84.3	85.5	86.6	90.6	95.2	98.1
<b>Latvia</b>	102.9	92.2	60.0	51.1	51.4	51.0	52.7	57.2	59.2	60.1
<b>Lithuania</b>	95.0	89.1	70.1	58.9	53.3	55.2	57.9	62.2	65.4	65.4
<b>Poland</b>	88.4	82.2	84.3	87.6	92.1	98.6	104.6	111.8	117.1	121.2
<b>Romania</b>	94.4	82.2	75.0	76.1	79.1	84.7	88.2	82.1	76.1	73.0
<b>Slovakia</b>	97.5	83.3	77.9	75.0	78.6	84.1	89.6	95.4	99.6	101.4
<b>Slovenia</b>	95.3	86.8	82.0	84.3	88.8	92.5	95.7	100.1	104.0	107.6

Source: EBRD Transition Report 1999; \* - predictions

At the beginning of the EU eastward enlargement processes, in 1999, the Baltic states still had not achieved the GDP level that they had had before the transition processes started, but other first round applicant countries like Poland, Czech Republic and Slovenia had already succeeded to achieve this. Poland and Slovenia started with market economy oriented reforms earlier and their initial conditions were more favourable for economic reforms and serious restructuring of their economies. Poland used a shock therapy while Slovenia has relied more on gradual reforms.

Transition reforms reduced output and affected also severely employment in all CEE countries. Reductions of output invariably reduced employment and increased both the number of the unemployed and inactive individuals. But the mode of adjustment differed significantly between countries both regarding how strongly employment was affected and which non-employment destinations were used. One of the most conspicuous consequences of the

reforms of all former socialist economies was the emergence of large-scale unemployment (Table 4). At the beginning of the EU accession processes, the unemployment rate was around 10 per cent in the three transitional countries, Estonia, Poland and Slovenia (9.6, 10.6, and 7.9 per cent). There have been some differences in the dynamics of unemployment rates between these countries over the period 1991-1998. Slovenian unemployment rate has been rather stable, between 7 and 9 per cent. Poland's unemployment rate increased rapidly during the first years of transition (1991-1994), it declined in 1994-1998, and has been increasing again since 1999.

**TABLE 4: Unemployment rate in the East and Central European Countries, 1991-1998, based on labour force surveys**

	1991	1992	1993	1994	1995	1996	1997	1998
<b>Bulgaria</b>	-	-	21.4	20.5	14.7	13.7	15.0	16.0
<b>Czech R.</b>	-	-	3.9	3.8	4.1	3.9	4.8	6.5
<b>Estonia</b>	1.5	3.7	6.5	7.6	9.7	10.0	9.7	9.6
<b>Hungary</b>	-	9.3	11.9	10.7	10.2	9.9	8.7	7.8
<b>Latvia</b>	-	-	-	-	18.9	18.3	14.4	13.8
<b>Lithuania</b>	-	-	-	17.4	17.1	16.4	14.1	13.5
<b>Poland</b>	-	13.7	14.9	16.5	15.2	14.3	11.5	10.6
<b>Romania</b>	-	-	-	8.2	8.0	6.7	6.0	6.3
<b>Slovakia</b>	-	-	12.2	13.7	13.1	11.1	11.6	11.9
<b>Slovenia</b>	7.3	8.3	9.1	9.0	7.4	7.3	7.4	7.9

Source: Central European Countries' Employment and Labour Market Review, EUROSTAT, Theme 3, 1999-1

### **The Baltic trio**

Estonia, Latvia and Lithuania form a cluster called "The Baltic states". The countries in this group are almost identical to each other in every aspect considered within the model, but there are also some intra-cluster differences between the Baltic economies.

The initial conditions of transition and the first steps of macroeconomic stabilization in the Baltic states have been analysed by Ardo Hansson and Jeffrey Sachs (see Hansson and Sachs 1994; Hansson 1997) in the middle of the 1990s. According to Hansson (1997, pp. 256-261), the Baltic countries have been undergoing the same transformation as the CEE countries. At the same time, the Baltic countries stabilized their economies under much less favourable conditions than those of most CEE countries and Russia. They experienced larger terms of trade shocks, due both to a high dependence on energy imports and to relatively lower energy prices that prevailed in the FSU as compared to CEE. The small Baltic countries were more affected by the collapse of trade than other economies in transition. In fact, Russia was least affected. In spite of their relatively reformist stance, the Baltic countries inherited more distorted economies than, say, Poland, Slovenia and Hungary, which had already introduced some market elements during the previous decade. The Baltic countries, however, enjoyed better initial conditions by starting from a position of zero foreign debt, as Russia took over all of the foreign assets and liabilities of the FSU.

After regaining their independence in 1991, the Baltic states lacked macroeconomic policy completely. The economy had collapsed and there was the legacy of hyperinflation from the Soviet Union. Since, all Baltic governments have followed almost similar principles of economic policy that were directed to solving the following main tasks:

- 1) liberalising prices and eliminating gradually all of the state subsidies;
- 2) privatising state owned enterprises;
- 3) introducing a separate currency by means of a currency board system (Estonia and Lithuania) or regular pegs (Latvia);
- 4) maintaining a conservative fiscal policy;
- 5) implementing a comparatively liberal foreign trade regime.

The Estonian economic, and foreign trade, policy has been the most liberal. Estonia introduced a foreign trade system without tariffs or quantitative restrictions. Lithuania introduced a relatively extensive system of trade barriers. Latvia has been somewhere between Estonia and Lithuania with its trade policy liberalisation.

### **3. The effects of integration**

#### *Factor mobility and trade privatisation*

The CEE countries' trade is already directed very much towards the EU. Imports of industrial products from the CEECs to the EU have been liberalised since the start of 1997. The end of 2001 will conclude liberalisation of exports of industrial products from the EU to the applicant countries. The overall trade implications will be much more pronounced in the applicant countries because CEE exports represent just under one per cent of the GDP of the current EU, whereas exports to the EU represent 15 per cent of the GDP in CEECs. Growth in CEE trade may continue to be rapid on account of economic growth and differences in growth rates, even if EU membership itself does not produce any further significant boosts to growth.

The free trade provisions do not cover agricultural products, which are important to the CEECs. The concessions made by the EU under the Europe Agreements to agricultural products are negligible. The applicant countries give considerably less support to their agricultural sectors than in the EU, both in terms of border protection and domestic subsidies. Under the Europe Agreements, certain agricultural products from the EU are given preferential treatment in the applicant countries and most quantity restrictions have also been abolished. Thus the agricultural trade surplus of the EU with the CEECs is largely attributable to asymmetrical trade liberalisation. EU membership will alter this situation to the benefit of the new Member States unless the change is hampered by long transition periods.

Apart from some sensitive sectors, EU enlargement ought not to cause major changes to trade flows. On the other hand it is generally assumed that membership will have a major influence on investments even though most of the CEECs have a relatively open investment climate already. The biggest change associated with full membership is likely to be the reduction in investment-related risks and greater stability and credibility. Legislative harmonisation and a reduction in institutional uncertainty may have a significant effect on investment growth both in the short and long term. In practice this means that investments will partly be redirected from old to new Member States. The experience of Spain's accession to the EEC supports the view that membership will lead to a spike in investment flows (see Baldwin *et al.* 1997).

So far foreign direct investment has been concentrated only on the most successful CEECs. Those countries, which have been most proficient in implementing reforms, which have gone furthest in privatisation, and have succeeded in combating inflation, have also succeeded in attracting foreign investment. Privatisation has already advanced very far, especially in Hungary and Poland and in recent years also in the Baltic States. This means that most of the companies that attract foreign investors have already been sold through privatisation programs. Therefore the most advanced applicant countries are increasingly dependent not on companies being purchased but on true direct in-

vestments – new investments. Any reduction in direct investments would slow the catch-up process with the EU. Direct investments have also been the most important means of funding current account deficits.

The movement of capital via direct investments is generally easier and quicker than the movement of labour from one country to another. Capital is more mobile than labour. EU membership is likely to increase the credibility and attractiveness of the transition economies joining the Union as investment destinations. The prospect of EU membership and efforts undertaken by some of the transition economies themselves have already led to significant direct investments (particularly in Poland, the Czech Republic, Hungary and Estonia). When capital moves into the new Member States, labour does not need to move away. The movement of capital into the new Member States will slightly dampen demand for labour and the growth in real wages in the old Member States and will thus marginally weaken their attractiveness as destinations for migration. Direct investments will correspondingly increase demand for labour, productivity and real wages in the new Member States, and will, in turn, reduce migration. If this favourable trend continues for long enough, the final outcome will be that the economies become more similar and the differences in living standards disappear.

#### *Effects of EU membership*

The enlargement implies two kinds of changes for the economic environment of the new entrant economies. New members are affected by changes in traditional trade policy as well as institutional factors that will follow from the adoption of common market rules and institutions. In the sense of traditional trade policy, enlargement is a formation of a custom union. This implies the removal of all bilateral border measures between the EU and CEECs and the adoption of common trade policy measures against third parties. Since tariffs in industrial trade are removed when the enlargement is planned to take place, the most important aspect in the bilateral trade relations are the removal of trade barriers in agricultural and food production and the introduction of Common Agricultural Policy (CAP) to new entrant economies. The customs union implies also the harmonisation of new entrants tariffs against third parties to those applied in EU.

Trade policy is only one aspect of the integration. EU is a single common market area with harmonised commercial legislation and industrial standards. Unified regulations cover common competition and state-aids policy as well as administrative procedures to implement these regulations. The internal trade is also free of border formalities. Despite the duty free character of trade in manufactures, this trade is subject to rules of origin regulations that impede completely unparalleled access to the internal markets of EU countries. The membership in Union removes these frictions in trade. Baldwin *et al.* (1997) have emphasised the importance of these aspects for the improved business confidence in new member countries. Harmonised market rules constrain the opportunity of new entrants to conduct arbitrary commercial and industrial policy. In addition to the goodwill effects, regional integration reduces transaction costs of bilateral trade with new partners in common market area.

If membership takes place without transition periods and without changes in the current EU policies, it will mean an immediate transition to the free movement of labour, significant income transfers to agriculture within Common Agricultural Policies, and subsidised investments in infrastructure through the structural funds. The new members will also be involved in EU decision-making. Because agriculture and structural funds are overwhelmingly most important categories in budgetary terms, they will also be of major importance for new members states.

The Structural Funds are transfers to poorer member states and regions in the EU. Funds are targeted to increase 'social cohesion', which is generally taken to mean convergence of per capita incomes. EU structural policy has a strong regional bias, but there are also non-regional objectives. From the Single European Act onward, Structural

Funds have been allocated within operational periods. In period 1994-1999 regional policies were addressed under four objectives and non-regional cohesion policies under three objectives. These policies were financed from four different funds. In Agenda 2000 the number of objectives was diminished into three:

- Objective 1: Regions that are lagging behind,
- Objective 2: Economic and social conversion of areas facing structural difficulties,
- Objective 3: Adaptation and modernization of policies and systems of education training and employment.

In addition to these, there is a special Cohesion Fund for less developed member states to support the development to meet the criteria of monetary union. There is also a separate Community initiative program to support transnational, cross-boarder and inter-regional actions.

The first two objectives are regional and the third one uses horizontal measures that are not region specific, but are however directed towards regions with high unemployment. Only regions that are not qualified for support on the basis of objectives 1 and 2 are eligible for support on the basis of objective 3. Previously the subsidies under objective 1 were based solely on the level of regional GDP per capita. Regions where GDP per capita was less than 75 per cent of EU average, measured by PPP-standards, were entitled to this support. Unemployment has been added to as supplementary criteria for allocating the funds. According to Weise's *et al.* (1999) estimates, two thirds of the expenditures of this objective go to Greece, Portugal and Spain. The expenses under objective 1 cover 60 per cent of all structural subsidies. Germany, France and UK, but also Spain, are main recipients of objective 2 and 3 funds.

#### *Convergence and migration*

The main economic effects of EU enlargement are related to movements in the factors of production and the convergence of economies. Experience from previous enlargements, when countries poorer than the average acceded (Ireland, Greece, Spain, Portugal), shows that membership leads to growth in foreign trade and investments and to accelerated technical progress in the new member states (Baldwin *et al.* 1997). Closer participation in the international division of labour raises the economic welfare of nations participating in integration. Free movement of factors of production and freedom of trade lead to gradual convergence. Integration does not only bolster trade but also creates incentives for increased investment in low-income countries and for labour to move to high-income countries.

The result of these changes is economic convergence. This will mean that income and production differentials between the countries of an enlarged EU will narrow, and especially in the new Member States structural change in the economy will accelerate. The greatest benefit from membership accrues to low-income applicant countries. Although the old Member States have to foot the bill for income transfers to the new Member States, they are also likely to benefit in this process; trade increases, the division of labour intensifies, and markets expand. It is also likely that in the old high-income Member States low-wage sectors will be exposed to greater competition and wage differences will grow as a result of movements in the factors of production. For the old Member States, however, the changes will be slight. Experience from earlier enlargements of the EU shows that the adjustment processes have not been easy for new member countries. In most cases unemployment has increased significantly in candidate countries. Unemployment has usually started to rise at the same time when the countries have applied for the EU membership (and started to reform their economies in order to adapt them to membership). The period of increased unemployment has lasted for several years. That happened in Ireland in the 1970s, in Spain (and to lesser extent in Greece and Portugal) in the 1980s, and in Finland and Sweden in the 1990s.



The population of the current EU is around 375 mn, the labour force ca. 175 mn. The total population of the candidate countries accounts for 104 mn and the labour force is around 53 mn (including Bulgaria and Romania). There are currently around 12 mn foreigners living in the EU, with around 5.3 mn foreign employees in the workforce (Eurostat 2000). Of this population, around 800,000 persons are from the present candidate countries. Of these, around 300,000 are legally employed in the EU area. According to the Commission's report (2001), total annual immigration to the EU area in recent years has been around 800,000 and there have been around 300,000 asylum-seekers. Boeri and Brücker (2000) have estimated that in the first years, following the enlargement, total migration from the new to old member countries can be around 350 thousand peoples per year. This figure will decline within 10 years to less than half and become negligible in twenty years. Compared to current population flows from non-EU countries, the immigration caused by EU enlargement cannot be considered dramatic. The total flows would be small. However, if the migration concentrates to only few regions, it will have larger local effects. The countries neighbouring the accession countries are the most likely target countries.

#### *The impact of monetary union*

Joining the EU will cause a major impact on the new member countries and speed up the convergence process. The new member countries are also expected to participate in the monetary union – sooner or later. If full membership is not feasible from the beginning, there will be some kind of transitory exchange rate mechanisms, which links the currencies of the accession countries to the European ERM. Estonia, for instance, already has tied her currency to the euro through a currency board system. At the moment it is not clear what kind of monetary and exchange rate policies the new members countries will adopt and when they will join the EMU. Assuming the new EU member countries would also become members of EMU and the eurozone, it is interesting to ask what kind of economic consequences – and especially labour market consequences – such a regime shift would have?

All three Baltic States have made use of a liberal foreign exchange policy. In 1994, the Baltic countries established the convertibility of their currencies in accordance with Article 8 of the IMF. The role of the central banks of the Baltic States in the money supply has been relatively modest so far. Estonia and Latvia are all pursuing policies of fixed exchange rates in the context of a currency board and Latvia in a regular peg to SDR. There are some minor differences between the currency board regimes introduced in Estonia and Lithuania, which find expression not only in anchor currencies (German mark/euro in Estonia and the US dollar in Lithuania), but also in legal coverage of some aspects of currency board operations.

The currency board regimes in Estonia and Lithuania and fixed exchange rate regime in Latvia have been central elements in economic strategies and cornerstones of macroeconomic policy, and they have provided a rather predictable and stable policy framework and supported the credibility of the governments' policies. As a result of comparatively stable and liberal economic policies, the Baltic economies have been successful in attracting foreign direct investments, which has had a positive influence on the rapid restructuring of their economies and has enabled the countries to finance large current account deficits during the transition period.

In the real world, exchange rate regimes and monetary policies are not neutral. To the contrary, monetary shocks tend to have large and long-lasting real effects, as shown by the experiences of the Finnish and Swedish currency crises in the early 1990s. How large and long-lasting such effects are depends partly on the functioning and flexibility of labour markets.

The Baltic states economies have been seriously influenced by the political and economic situation in Russia. In the aftermath of the Russian crisis in August 1998, their experience was similar in many respects:

- 1) Exports declined driven by the collapse of the CIS markets.
- 2) Economic growth turned negative.
- 3) The budgetary positions weakened.

The current accounts adjusted differently in each Baltic country, although imports declined in all three cases. In Estonia, the recession led to a pronounced improvement in the current account to a deficit of about 6 per cent of GDP in 1999. This resulted from a strengthening in the private sector savings-investment balance by about 13 per cent of GDP between 1997 and 1999. In contrast, the current account deficits for Lithuania remained high at around 11 per cent of GDP as the deterioration of the fiscal position broadly cancelled any improvements stemming from strengthened private sector saving-investment balances. In Latvia, the current account deficit widened from about 5 percent in 1997 to about 10 per cent in both 1998 and 1999 (Keller 2000). Some main indicators of the Baltic economies in the period 1997-1999 are presented in table 5.

**Table 5. Selected indicators of the Baltic economies in 1997-1999**

Indicator	Estonia			Latvia			Lithuania		
	1997	1998	1999	1997	1998	1999	1997	1998	1999
<b>Inflation</b>	11.2	8.2	3.3	8.4	4.7	2.4	8.9	5.1	0.8
<b>Unemployment rate (%)</b>	9.7	9.9	11.7	15.9	14.7	14.0	14.1	13.3	14.2
<b>Employment rate</b>	61.2	60.5	59.2	60.2	59.3	58.4	61.2	61.7	61.9
<b>GDP growth</b>	10.6	4.7	-1.4	8.6	3.6	...	7.3	5.1	...
<b>Average monthly gross wages (US \$)</b>	257	298	326	207	226	267	195	232	287

*Source:* Statistical Office of Estonia. Estonia, Latvia, Lithuania in Figures 2000, Tallinn, 2000; Balance of Payments, the Bank of Estonia, [www.ee/epbe](http://www.ee/epbe) (May, 2000); Estonian Statistics Monthly 2000, No 1 (97), Tallinn, 2000

Recent years have pointed out the strengths and weaknesses of the Baltic economies. On the positive side, the currency board-based monetary system proved its performance efficiency in the economic downfall. In the case of Estonia, for instance, monetary policy framework coped with the sharp changes in the economic environment, but real sector recovery was slower than expected. The year 2000 has shown that the economic growth rate was picking up slowly.

Russia's crisis in 1998 also gave lessons to develop a more active economic cooperation and better trade relations with the neighbour countries around the Baltic Sea. The Baltic Sea region provided a first experience for restructuring the Baltic economies according to western rules, which enables them to be less dependent on the economic and political situation in Russia and to be more open to the EU negotiations and the adjustment process.

The EMU membership of the accession countries is not likely to cause problems for them – at least not in the beginning. The system of irreversibly fixed exchange rates and monetary union are close to the current exchange rate regimes of most accession countries. Joining EMU would decrease the devaluation and country risks and hence yield lower nominal and real interest rates, which would boost demand and economic growth – at least in short run. However, it is not impossible that financial bubbles could emerge with subsequent recessions and painful adjustments. There are many examples in economic history that such monetary expansions can cause overshooting, if the perceived absence of currency risk and the improved availability of capital induce firms and households to build up ex-

cessive debt. The adjustment processes needed to restore financial balance, especially with unregulated capital movements and an exchange rate peg, maybe painful. Such risks can materialise also in the case of asymmetric shocks.

By definition, a membership in a monetary union means common money, the Euro. This will have real consequences. Joining the eurozone will decrease transaction costs and increase transparency. Wage and price differentials between countries will become more visible, which is likely to speed up convergence and factor movements. If these effects were taken into account in an economic model, they could be analogous with lower transport or trading costs. Hence, adoption of common money would increase the incentives to migrate (or if not to move permanently, to work shorter periods in the high-wage labour markets).

In principle, the membership in eurozone will increase the importance of fiscal policy as the only means of national economic policy and stabilisation. However, the effective use of fiscal stabilisers will be restricted in accession countries not only by the Growth and Stability Pact but also by financial market reactions. Adjustment processes and the risk of asymmetric shocks emphasises the need for sufficient labour market flexibility.

#### **4. Determinants of migration**

Economic theories of migration as well as past experiences of international population movements help us to understand the factors affecting migration flows and to assess their magnitudes. The basic idea of economic theory is straightforward: people move to other countries if they expect to be able to earn higher incomes in the target country. Hence the crucial variable affecting the migration decision is the income difference between the target and source countries. Since the wage and GDP differentials between the old EU member countries ('the West') are large, one might expect a great flow of people from the CEE countries ('the East') when they join the EU. However, it is obvious that there are also other factors, which should be taken into account.

Search theory is widely used to describe and analyse labour market flows. The theory assumes that firms search for suitably qualified workers to fill their vacancies and workers search for good jobs (wage offers). It is assumed that there is lack of information in both sides of labour market and for this reason search is costly. So firms and workers need to consider how much resources should be devoted to search activities and what offers should be accepted. If unemployment is high relative to number of vacancies, the probability to find a job is low. The matching probability can be increased by higher search activity but that is costly.

The potential migrants in the East need to consider how likely it is that they will find a job in the labour market of West and what will be the expected wage level. This expectation has to be compared with the expected future incomes in the East. If the wage level in the East can be expected to grow faster than that in West (that is the case if there is convergence) and if there is high unemployment in the West lowering the matching probability, then it is not so obvious that current large wage differentials are sufficient to induce large migration flows from East to West. The situation gets, of course, reversed if the Western labour market moves close to full employment (when the probability to find a job increases) and if for any reason the convergence process would be disturbed. In such a case the expected future income differential would be even higher than the current income differential between the source and target countries and the incentives to move would increase. The most important variables affecting migration are listed in Table 6.

It is quite obvious that differences in expected future incomes and in current unemployment rates affect migration. According to empirical studies of migration also absolute income levels matter. The higher is the absolute income level in the source country, the less likely are people of that country to move although they could increase their incomes by doing so. This result applies especially to European countries. It is well known that European labour mobi-

lity is low if compared to that of the US because of language barriers and cultural differences. People clearly prefer to live in their home regions. That is why migration will cause non-pecuniary costs, too. If there are such cultural costs of moving and if people are risk averse, then sufficiently high absolute income level in source country can compensate for the expected benefits of migration.

**Table 6: Factors affecting migration**

<b>Variable</b>	<b>Effect on migration from low-income source country to high-income target country</b>
Expected future incomes in target country	Positive
Expected future incomes in source country	Negative
Absolute real income level in source country	Negative
Unemployment rate in target country	Negative
Unemployment rate in source country	Positive
FDI to source country	Negative
Income transfers to source country	Negative
Structural change in source country	Positive

In the case of EU enlargement, there are to main outside factors, which affect the labour market of East and hence also the incentives to migrate. Foreign direct investment to East increases the capital-labour ratio and also the wages, incomes and future incomes. Thus FDI decreases migration. The other important variable is the income transfers from West to East through the EU. They increase the capital stock in East (structural funds channelled to infrastructure investment) and raise the disposable income (agricultural subsidies). Structural change, which is likely to speed up as a result of membership and specialisation, is expected to increase unemployment in short and medium run and that will increase pressure to migrate.

The labour market indicators of Table 7 show that there is quite a lot of need for labour-saving structural change in the candidate countries. In most of them, the labour shares of agriculture and manufacturing industries are higher than in the old member countries. There are pressures to decrease the labour share of these sectors and increase the underdeveloped service sectors. While beneficial in long run, such a structural change is likely to increase unemployment in short and medium run. The nominal income levels are low and unemployment rates relatively high in the most CEE countries.

Given that there will be migration from East to West, what will be the likely effects of such a change? These effects are summarised in Table 8. First, migration will decrease labour supply and unemployment in the source country. If the capital stock is given, that will mean higher capital-labour ratio and eventually also higher real wages in source countries. Thus migration will help to achieve convergence in income levels. In Western countries the effect will be the opposite: migration will slow the rate of increase of capital-labour ratio and real incomes. However, since West is much larger than East, the negative income effect will in relative terms be much lower in West than the positive income effect in East.

The migration is not likely to have a uniform effect on the Western labour market. It is usual that immigrant workers start their careers in low-skilled jobs. This means that migration will increase the supply of low- or unskilled labour in

West, which in turn will cause a downward pressure on the relative wage of that group. If lower relative wages will be reflected in lower relative prices in labour-intensive goods, skilled labour in West will benefit.

**Table 7: Labour market indicators 1998**

Share of labour force in								
	Labour force (Millions)	Participation rate (%)	Unemployment rate (%)	Agriculture (%)	Manufacturing (%)	services (%)	GDP per capita 1998 (€)	EU FDI stock in 1997 mio €
<b>Poland</b>	17.2	68	10.6	19.1	32.1	48.8	3639	7165
<b>Czech Republic</b>	5.2	73	6.5	5.5	41.3	53.2	4869	7669
<b>Hungary</b>	4.0	59	7.8	7.5	34.2	58.3	4201	8120
<b>Slovakia</b>	2.6	70	12.5	8.2	39.5	52.3	3356	1290
<b>Lithuania</b>	1.6	75	13.3	21.0	27.6	51.4	2567	390
<b>Latvia</b>	1.2	72	13.8	18.8	26.2	55.0	2337	177
<b>Slovenia</b>	1.0	71	7.9	11.5	39.2	49.3	8797	809
<b>Estonia</b>	0.7	73	9.9	9.5	33.2	57.3	3181	399
<b>Cyprus</b>	Na	62	9.6	9.6	na	Na	12217	269
<b>Malta</b>	na	Na	5.1	1.8	Na	na	8201	Na
<b>CEEC10</b>								
<b>Romania</b>	11.6	76	6.3	16.9	29.4	53.7	1507	748
<b>Bulgaria</b>	3.6	63	14.1	26.2	30.6	43.2	1337	347

**Table 8: The labour market effects of migration**

Variable	Effect of migration from source to target country on:
Capital-labour ratio and wage level in source country	Positive
Capital-labour ratio and wage level in target country	Negative
Real wage of skilled labour in target country	Positive
Real wage of unskilled labour in target country	Negative
Unemployment rate in target country	Depends on labour market flexibility
Unemployment rate in source country	Negative

What happens to unemployment rates in the West is not clear. It is possible that migration will – in the medium term – increase unemployment. Kiander and Viren (2001) have presented evidence that the West European labour markets have in past been relatively sluggish to adapt to population changes. However, there is also evidence from large migrations, which have not caused unemployment or falling wages in the target regions. If labour markets are flexible enough and if macroeconomic policies support expansion, then it is not impossible that increased labour supply would transform smoothly to higher employment and higher output.

## 5. Modelling the enlargement effect on labour market - general equilibrium approach

The consequences of such a change have been studied by using computable general equilibrium models (CGE). However, usually such models are based on the assumption of flexible prices and wages, and the questions related to gradual adjustment and nominal rigidities have been neglected.

In recent years, CGE models have become one of the most widely used tools for the analysis of policies and shocks that involve structural changes in the economy. Francois and Reinert (1997) survey a comprehensively CGE analysis applied on trade policy issues. CGE-models contain the necessary data on both the structures and markets of an economy that are necessary for such analyses. The distinguishing characteristics of computable general equilibrium models are as follows.

- (i) They include explicit specifications of the behaviour of several economic actors. Typically, they represent households as utility maximizers and firms as profit maximizers or cost minimizers. Through the use of such optimising assumptions, they emphasize the role of commodity and factor prices in influencing consumption and production decisions by households and firms.
- (ii) They describe how demand and supply decisions made by different economic actors determine the prices of at least some commodities and factors. For each commodity and factor they include equations ensuring that prices adjust so that demands added across all actors do not exceed total supplies. That is, they employ market *equilibrium* assumptions.
- (iii) They produce numerical results (i.e., they are *computable*). The coefficients and parameters in their equations are evaluated by reference to a numerical database. The central core of the database of a CGE model is a Social Accounting Matrix (SAM) that shows, for a given year, the flows of commodities factors and transfers between industries, households, governments, importers and exporters. The SAM data is usually supplemented by numerical estimates of various elasticity parameters. These may include substitution elasticities between different inputs in production processes, price and income elasticities of demands by households, and foreign elasticities of demand for exported products.

The main strength of CGE models is the analysis of inter-industry linkages of policy shocks or exogenous impulses. CGE models link industries via economy wide constraints, e.g. constraints on deficits in balance of trade, constraints on availability of labour, capital and land. With these constraints in place, the economy-wide implications of stimulation of one industry can be negative and a favourable outcome for some industries can be at the expense of others.

The main deficiency of conventional CGE models is that they are suitable only in analysing the efficient use of given resources. All policy-induced effects on factor accumulation are out of the scope of this type of analysis. The existing distortions, caused e.g. by taxes, tariffs and subsidies, may be magnified in the growth context, either because of productivity growth or capital accumulation. In dynamising a comparative static CGE model, three inter-temporal links may be added to connect the individual simulation periods in the model: (1) accumulation of fixed capital, (2) accumulation of financial claims, and (3) lagged adjustment mechanisms (see, e.g., Dixon and Rimmer 2000).

In multi-regional settings, it is highly important to model financial claims in order to take into account the implications of the cross-ownership of wealth caused by capital movements (McDougall and Ianchovichina 2001). If on a regional basis investments and saving can permanently diverge from each other, this will lead to changes in the areas' financial position over time. Changes in the financial position affect the definition of payments to the factors of production made abroad and received from abroad. GDP and gross national income (GNI) diverge from one another over time as the domestic and foreign financial positions change. In terms of local spending decisions and welfare, national income is a relevant variable because it describes changes in available income, unlike GDP, which describes economic activity in the region.

The model contains two types of lagged adjustments. Investment expectations may differ from the actual level of return on capital. Expectations adjust towards equilibrium by means of error-correction mechanisms. Similarly, in

labour markets in which unemployment is at a level at which the price trend is stable, wage demands may diverge from wages. The trend of wages towards NAIRU equilibrium is described by means of error-correction mechanisms as set out by Solow (1990).

## **6. Conclusions**

EU enlargement will have a significant impact on economic development in the new Member States. The countries of central and Eastern Europe will gain substantially from EU membership. For the current EU Member States, on the other hand, the economic effects of enlargement – both the benefits and the costs – will be small. This difference results from the difference in size between the current and the new Member States. The total population of the new Member States is only around a quarter of the population of the current EU, and their economies are very small compared to the economy of the old Member States.

The actual effects of the EU eastern enlargement will depend on when and in what order enlargement takes place and what transition periods are applied. Eastern enlargement will imply liberalised trade also in agriculture, growth in direct investments to the new Member States, large agricultural and structural policy income transfers to the new Member States and migration from new to old Member States as a result of the free movement of labour. Direct investments and increased investor confidence will potentially be of major significance for growth in overall production in the region. Foreign investments will accelerate GDP growth, but their effect on the incomes of the factors of production in the region is considerably smaller. This is because part of the profits is ploughed back to the foreign investors.

The migration of labour from the new Member States to the current EU area will reduce economic growth as measured by GDP in the new Member States. But at the same time, the contraction in the labour force will increase the salary level and per capita incomes. Thus migration will help to narrow the differential in living standards between the new and the old EU countries.

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# The Adjustment Processes of Labour Markets in Transition

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## 1. Introduction

The partners of the *Ezoneplus* research project – three Central and East European countries, which belong to the first wave of the EU eastward enlargement processes (Estonia, Poland and Slovenia), and four countries of the euro-zone (Finland, Germany, Italy and Portugal) – represent different economic, social and political patterns of accession, transition and integration processes. The eastward enlargement of EU poses a major challenge both for the current member countries and for applicant countries: the integration of national economies with rather different structures. The new candidates of the EU eastern enlargement have to combine transition processes with the requirements of the accession. Solving these tasks is certainly not easy. In addition, the initial conditions of transition economies have a crucial role in determining dimensions of these adjustment processes. Therefore, it is necessary to analyse the EU eastward enlargement processes case by case.

The economic literature of the recent decade, which stresses both theoretical and empirical aspects of transition, attempts to explain structural changes of economies in transition and to generalize the outcomes of transition processes (see Aslund 1994; Balcerowicz 1995; Lavigne 1995; Blanchard 1997; Hansson 1997; Stern 1997; Roland and Verdier 1999, Sachs *et al.* 2000). It comes not at a surprise that there is still no solid theoretical background to explain processes of transformation from one economic system to another. Since transition economics is still in its infancy empirical analysis and generalization of transition experiences are of great importance for developing this new field of economics.

Labour market is one of the key factors of transition. The main changes in the labour market during a transition process can be viewed as the reallocation of resources from the old less efficient sector, the government sector, to the new more efficient private sector. The optimal speed of transition (OST) theory, which started with the contributions of Burda (1993), Katz and Owen (1993), Blanchard and Aghion (1994), describes the optimal speed of resource reallocation between the government and private sector. Most of the OST theory's empirical testing has been concentrated on estimating the creation and destruction of jobs based on the Davis and Haltiwanger (1992) paper.

Empirical analysis of transition processes is important not only for developing transition economics. Their results could also provide information for policy makers dealing with the EU enlargement processes. Policy debates have to combine the results of analyses of both the macroeconomic issues, which continues to be essential but requires mostly standard policies, and microeconomic issues. These include the enforcement of a market-friendly legal framework, and enhancing the functioning of a flexible labour market, firms and household behaviour in the changing marking conditions. Hence, empirical studies of transition processes should be based on macroeconomic data of national and international authorities and micro data such as labour force, household and enterprise surveys.

Theoretical and empirical studies in labour economics have been significantly broadened and accelerated by the advent of large-scale micro datasets. A remarkable growth in national data collection efforts took place in the late 1960s and the 1970s, and a large number of these datasets were and are appropriate for labour economics research because of efforts to relate data base design to questions implied by theoretical models (Stafford, 2001). The Central and East European (CEE) countries started with the development of the labour force surveys that meet the requirements of the International Labour Organization (ILO) and Eurostat in the beginning of the 90-ies. The use of

these data sources is also important for exploring the EU enlargement process and, in particular, for examining the changes of labour supply and for predicting possible labour movements after full accession to the European Single Market. The development of micro datasets allows also to elaborate synthesis models of labour market supply and demand. A prototype is the hedonic labour market model, but of course, such models are rather difficult to construct because this needs a demand side theory as well as a supply side theory, and such synthesis leads to much more limited prospects for identification. Using micro data, we usually face selection problems, and using macro data there could be the causality problems.

Key areas for research concerning the impact of the EU enlargement processes on the labour markets are labour market flexibility, and the aspect of migration. Based on the main research tasks of the project, this paper is going to provide an overview on the theoretical considerations and empirical results of previous labour market studies that are present in the current economic literature. This overview may be treated as a framework for forming the main research questions of Ezoneplus for exploring adjustment processes of labour markets in transition economies.

The paper is organized as follows: In section 2, some theoretical reasoning on the transition of labour markets is presented, putting emphasis on the reallocation of labour and the so-called optimal speed of transition theory. Following the statement that initial conditions take up a crucial role in determining dimensions of the EU enlargement, section 3 gives a brief description of initial conditions of transition. Section 4 presents a short overview of labour market flexibility problems. Section 5 gives some important empirical results of labour and job flow analysis. Section 6 focuses on determinants that could increase labour flows from CEECs to EU countries and the possible influences of the migration processes on the EU eastward enlargement.

## **2. Theoretical reasoning on labour market developments in transition economies**

The reallocation of labour and the optimal speed of transition are central issues for a theoretical framework that explores labour market developments in transition. The optimal speed of transition (OST) theory, which started with the works by Burda (1993), Katz and Owen (1993), Blanchard and Aghion (1994), describes the optimal speed of resource reallocation between the government and private sector.

Crucial assumptions of OST are that labour supply is fixed and that the closure rate of the public sector depends on the specific government policy. According to Aghion and Blanchard (1994), governments determine the amount of subsidies to public enterprises. Governments can also influence the speed of transition by altering the level of unemployment benefits. According to this model, unemployment benefits are essential in the beginning of transition to establish the support of workers for reforms. The growth of the private sector depends on market forces. If the price of labour is high, the demand for labour is low. Government must choose the rate of closure of the public sector knowing that if it is too slow, a low level of unemployment increases the price of labour and decreases the growth of the private sector. On the other hand, if the public sector decreases too fast, unemployment rises, so that the tax base deteriorates. Governments have to increase taxes and the price of labour increases again.

According to OST model predictions, the link between the growth of private sectors and unemployment can be described by an inverse U-shaped graph. Low levels of unemployment create excessively slow private sector development as well as too high a level of unemployment affects the growth of private sectors negatively. The result of the transition process depends on the initial unemployment rate. As described, unemployment influences the reconstruction process through the wage, which determines the speed of private sector growth rate. In the end, the economy converges to a stable unemployment rate where jobs destruction and jobs creation are equal.

The policy implications from OST theory are that public sector closure should happen in a moderate way, which does not allow long-term unemployment. OST theory views unemployment benefits to be essential in the beginning of transition for creating support for further reforms. Later the benefits should be decreased.

The influence of the public sector closure rate on private sector growth has been described through different channels. In the paper of Castanheira and Roland (2000) too fast a public sector closure rate lowers private sector growth through the decrease of total output and savings. Chadha and Coricelli (1994) describe the negative effect of fast restructuring through higher pressure on government budget.

One of the initial assumptions of OST has been that the reallocation of labour happens through the state of unemployment. This should only create short-term unemployment. Later this assumption has been relaxed in the models of Brixiova and Yousef (2000) and Castanheira and Roland (2000). They specify models where on-the-job search is allowed. The idea behind this model is that when reallocation is allowed only through unemployment state, short-term unemployment increases but long-term unemployment should not develop. In reality, there is evidence of persistent unemployment in transition countries. One explanation for this can be the behaviour of firms, which prefer to employ directly from public sector rather than from the unemployment pool<sup>16</sup>.

In the beginning of OST theory, empirical evidence supported its arguments. The public sector was decreasing; the private sector was growing and so was unemployment. But then the development did not follow exactly the lines of OST theory. Not expectedly it turned out that

- a large number of labour left the labour force,
- long-term unemployment increased and a stagnant pool of unemployed was created.

A growing literature that analyses transition processes also stresses several weaknesses of OST (Boeri 2000 and 2001; Eamets 2001; Castanheira and Roland 2000; Katz and Owen 2000). Boeri (2000; 2001) stresses that unemployment in transition countries is caused by wrong unemployment benefits system. He views unemployment benefits as incentives to leave<sup>17</sup> the public sector voluntarily, which has created the stagnant unemployment pool. This also questions the OST theory assumption that governments can alter the speed of public sector closure. Empirical evidence suggests that the destruction has been an endogenous process.

Summing up, the theory of an optimal speed of transition does not explain the changes very well that took place in transition economies. Also the particulars of each country, the stages of transition and the speed and order in which reforms were introduced are playing an important role in the adjustment of the labour market. Therefore these processes have to be analysed on a case-by-case basis.

Most of the OST theory's empirical testing has been concentrated on estimating the creation and destruction of jobs based on the Davis and Haltiwanger (1992) paper which uses US data. Aghion and Blanchard (1994) analysed state and private sector employment changes and unemployment rates in 1989 and 1992 in five transition countries. They found that as the model predicts restructuring does not happen when the initial unemployment level is too high. They predicted that the restructuring in Hungary, Poland and Slovakia does not speed up before the creation of private sector jobs has lowered the unemployment rate. The somewhat more favourable picture in the Czech Republic is due to its lower level of unemployment. In Bulgaria unemployment was high and the reallocation process had not

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<sup>16</sup> Jurajda, Terrell (2000) found on the Czech Republic data that most of the reallocation from public to private sector takes place without unemployment period. Bilsen and Konings (1998) found the same evidence from Hungary and Romania.

<sup>17</sup> The empirical evidence from transition countries suggests that people voluntarily leave public sector.

started, so they predicted that high unemployment is not supporting the start of restructuring processes. The OST theory hypotheses have also been tested on the Czech Republic in a paper by Jurajda and Terrell (2000). They argue that, initially, job destruction in the private sector is small and job creation in the public sector is close to zero. Moreover, there is strong evidence that job destruction in the public sector takes place before job creation in the private sector is to occur.

*To sum up*, the general conclusion of the OST model is that labour market disequilibria and the flow into unemployment are absorbed by the rate of private job creation. It also implies that initial adjustment to changes can lead to a rate of short-term unemployment that exceeds the market equilibrium rate. In this case, restructuring does not take place until job creation has reduced unemployment to low levels. If unemployment is high, and private job creation slow, the adjustment processes to changes in the labour market will take much more time. Also particular national circumstances, the stages of transition, and the speed and order in which reforms were introduced, are playing an important role in the adjustment of labour markets to processes of restructuring. Based on the results of a case-by-case analysis, it is possible to generalize the outcomes of transition and to develop a theoretical framework for analysing the EU's eastward enlargement.

### **3. The initial conditions of transition**

It is evident that the transition from command to market economy is a unique process. This change has been representing one of the most fundamental economic phenomena of the twentieth century. Employment, output, wages and prices suddenly ceased being set by planners and became results of market forces in the context of newly emerging institutions. The process has been turbulent and in the early phases of the transition one could observe major changes in the figures of key economic variables. These developments, together with increasing availability of data, have attracted economists to examine the underlying phenomena.

Most economists recognize that important actions of economic transition are macroeconomic stabilization, price liberalization, privatisation and institutional reform. Due to different economic and political situations, every economy in transition requires a specific package of political and economic measures to create a well-functioning market economy and to achieve a flexible, market-driven allocation of resources.

The initial conditions play a crucial role in a framework for evaluating transition and integration processes. There are three main types of the initial conditions of transition:

- 1) "Fixed" initial conditions are those that are invariant and impossible to change (e.g. geography, natural resource endowment, culture).
- 2) "Hard" initial conditions are primarily those that can be changed in the long run (e.g. quality of institutions, industrial structure, ownership, public attitudes, level and quality of human and physical capital stocks).
- 3) "Soft" initial conditions primarily refer to government policies such as the tax code as well as international relations and agreements (Sachs *et al.* 2000).

In several papers it has been found that a country's initial conditions have been important in determining the dimension of economic depression (Berg *et al.* 1999; Havrylyshyn and van Rooden 2000). It is also important to stress that the poor official statistics of former socialist countries in the beginning of 1990s, seriously complicated the comparison of seemingly analogous figures.

Transition reforms having drastically reduced output severely affected employment, too. Reductions of output have invariably reduced employment and increased both the number of unemployed and of inactive individuals. But the mode of adjustment differed significantly between countries both regarding how strongly employment was affected

and which non-employment destinations were used. One of the most conspicuous consequences of the reforms of all former socialist economies was the emergence of large-scale unemployment. The transition thus produced a new group in the population that required both income transfers and programs facilitating its adjustment to requirements of a market economy: the unemployed. Economies where open unemployment had been unheard of before the transition were thus confronted with the difficult task of protecting the unemployed without imposing undue fiscal costs and creating adverse incentives to take up work.

*To sum up*, different initial conditions of transition partly explain the differences in speed and radicalism of the economic reforms of transitional countries. The EU eastward enlargement process started when macroeconomic stabilization had already been achieved but social instability was increasing in the applicant countries. Transition processes have not yet finished for the people. The twin adjustment processes of labour market to national and EU-wide market standards will not only take much more time than expected but they will also influence the changes of people's behaviour in long run.

#### **4. Labour market flexibility**

The flexibility of labour markets is an important feature of a well-functioning market-based economy. Davis and Haltiwanger (1999) report that in most western economies roughly one in ten jobs is created and one in ten jobs is destroyed every year. On the one hand, the flexibility permits the rapid reallocation of resources to their highest value used in a world of rapid changes in technology. On the other hand, the high pace of job reallocation involves significant worker displacement with associated significant earnings losses for the impacted workers (Jacobson, *et al*, 1993). But without doubt, the flexibility of labour markets is an important channel by which there will be nominal and real convergence between the less and more advanced economies.

Flexibility of labour has a direct connection to wage flexibility, which depends on the wage bargaining system, the dispersion of wages (relative wage flexibility) and the working-time flexibility. Labour market flexibility studies also concentrate on geographical/job-mobility (focussing on increased transparency and large transaction costs) as well as on reforms of labour market institutional frameworks (regulation of hiring and firing with regard to costs and unemployment benefits). The analysis of these issues should be evaluated against the background of their impact on inflation and unemployment.

A starting point for analysing labour flexibility of transitional labour markets is to examine the restructuring and reallocation processes that are key issues for moving from a command based economic system to a market-oriented economy. Analysing lessons from job and worker reallocation processes in the industrialised economies is helpful for understanding and predicting labour market trends in accession countries.

The high pace of job and worker reallocation is often viewed as a mixed blessing for market-based economies. With regard to EMU member states the currently leading hypothesis is that high structural unemployment rates in the EU can be explained, to large extent, by the type of labour market institutions prevailing in those countries. The leading explanation for the lack of reform in this field is that existing institutions represent a social equilibrium. Any deviation from that equilibrium will bring about significant political costs to governments, unions and employers, which they consider to be unbearable.

The reallocation of employment opportunities across various economic activities accounts for a large fraction (roughly 30 to 50 percent) of the overall pace of worker reallocation (Davis and Haltiwanger 1999). Market economies experience high rates of job creation and job destruction. Changes in the number and mix of jobs at individual firms and production sites reflect many forces: the diffusion of new products and technologies, the success or failure

of research and marketing efforts, negotiations with employees and labour organizations, learning by doing on the part of managers and workers, the costs of hiring, training and firing workers, ownership changes and corporate restructuring, regulatory and tax law changes, the growth and decline of particular markets.

On the macroeconomic level, 'liquid' reallocation and matching processes operate smoothly and determine the difference between successful and unsuccessful economic performance. The persistently high unemployment rates in France, Spain and several other Western European countries over the past two decades point to the enormous costs of a particular breakdown in the reallocation and matching processes (Davis and Haltiwanger 1999).

The recent and ongoing transition to market oriented economies in Central and Eastern Europe brought tremendous shifts in the industrial structure of employment and in the ownership and operation of business enterprises. Large differences in output movements, unemployment rates, private-sector expansions and other performance indicators in transition economies suggest that the efficiency of the restructuring and reallocation processes varies greatly. There is an emerging literature examining job flows concerning transition economies paying attention to comparative analysis of labour flexibility in CEE countries (Haltiwanger and Vodopivec 2001; Davis and Haltiwanger 1999, Faggio and Konings 1999; Bilsen and Konings 1998, Konigs *et al.* 1996). Faggio and Konings (1999) also examine job flows for Estonia and Slovenia, and Davis and Haltiwanger (1999) conducted a similar comparative analysis for Estonia and Poland.

It is evident that reallocation of resources, job creation and losses, as well as flows between labour market states are extremely important for transition economies. It shows the flexibility of these labour markets. High labour market flexibility leads to higher economic growth and to faster transition. Recent economic literature exploring and generalizing transition processes raises the question whether rapid or gradual economic reforms are more advantageous for restructuring the labour market (Haltiwanger and Vodopivec 2001; Eamets 2001; Katz and Owen 2000; Dewatripont and Roland 1995; Dorenbos 1999, Callabero and Hammour 1996 and 2000).

As emphasized by Callabero and Hammour (1996 and 2000), the reallocation process involves hold-up problems associated with the specificity in market relationships. Overcoming this hold-up and other market distortions, labour markets can yield distortions in the pace and timing of reallocation. Whereas it may be difficult to measure or test for such distortions directly, the examination of the pace and timing of changes in job flows that follow the start of transition provides evidence that can delve into the nature and importance of such distortions. Synchronization of changes in job creation and destruction give evidence for a well-functioning dynamic labour market with efficient reallocation and flexible labour force. A large gap in the timing between a surge in job destruction and a rise in job creation implies an increase in unemployment and associated high costs of reallocation processes. Such unbalanced restructuring and reallocation are signs of inefficiency.

The experience of transition economies offers a pattern of variations in the pace of reallocation that can be used to evaluate the nature of synchronization of flows and the factors that contribute to synchronized or de-synchronized flows. According to Callabero and Hammour (2000), there may be problems of both sclerosis and unbalanced restructuring. Sclerosis refers to a situation where outdated, low-productivity business survives longer than they would in an efficient equilibrium. Unbalanced restructuring refers to a situation where destruction is excessive relative to creation. It is not paradoxical for sclerosis and unbalanced restructuring to happen at the same time. This means that the rate of destruction is lower than it should be, but still excessive given an economy's inefficiently sluggish creation rate.

It should also be emphasized that job flows are closely connected to worker flows. They are also connected to unemployment behaviour and individual wage dynamics, to the evolution of firms and industries, to economic struc-

turing and aggregate productivity growth. This means that much research on job flows and also labour flexibility has to be carried out at the intersection of labour economics, macroeconomics and industrial organization. The development of new datasets has helped to build new bridges and to solidify old links between labour economics, the industrial organization literature, and other fields of economics and social sciences.

According to the information presented in the Handbook of Labour Economics (1999, Volume 3B; Davis and Haltiwanger, 1999), two economies in transition, Estonia and Poland, offer the richest data on labour market flows. These data are used in order to sketch a more detailed picture of labour flows in post-communist countries and to analyse the flexibility of their labour markets. Both Poland and Estonia undertook more radical liberalization than most of the other transition economies and they did so with markedly better outcomes. Poland implemented major reforms in 1990; Estonia implemented major reforms in 1992. Both countries sustained the course of liberalization – initial reforms remained largely intact and further reforms followed suit. Initial conditions were also relatively favourable in both countries.

Job flows of both countries indicate that Polish and Estonian labour markets are evolving from a central planning regime and moving towards integration into the EU with sharply curtailed worker mobility and job reallocation to a regime similar to that of the United States of America or of Western Europe. The Estonian economy has already progressed a great leap toward US style labour market flows. The evidence for Poland points to a less rapid evolution of the labour market and it may be fair to conclude that the Polish trend moves toward the kind of labour markets we know from many Western European countries. Davis and Haltiwanger (1999) also draw on evidence for these two countries in an effort to sketch a more detailed picture of labour flows in the post-communist transition.

*To sum up*, due to remarkable restructuring and reallocation processes, the labour markets of the applicant countries are moving rapidly to a market-oriented regime. But there are also considerable differences in the reallocation of labour, the developing of reforms and the restructuring of economies between the accession countries and between different stages and periods of transition and integration. Theoretical considerations and the results of previous studies analysed in this part of the paper are mainly based on the empirical analysis of the first period of transition (1989-1995). It should be emphasized that the situation in labour markets is changing rapidly and that the people's behaviour during the EU accession processes differs from the behaviour during the first stages of transition. It is evident that the individual adjustment process to the economic and social conditions of a market economy have a time lag; the results of which are rather difficult to predict. In order to use the results of the studies for elaborating proposals for policy making processes, empirical studies that examine labour flexibility should be based on comparable analyses of the recent and previous stages of the transition and EU enlargement processes.

## **5. Labour and job flow analysis**

The reallocation of labour can be viewed as a flexibility measure of labour markets. Reallocation takes place by creating new jobs, destructing the old ones, and by reallocating workers between jobs. The labour market flows approach concentrates on measuring job and worker reallocation, job creation and destruction, worker flows between jobs, and inflows and outflows from different states of labour market.

Empirical research of transitional labour markets has revealed evidence for low labour mobility measured in gross labour flows. The result is surprising, considering the amount of restructured production in terms of ownership and sectoral composition. Transition countries are also described by low inflow and outflow into unemployment. This makes us observe an increase of long-term unemployment and the existence of stagnant unemployment pools. This indicates that reasons behind the high unemployment rate in transition countries lie in the long duration of unem-

ployment spells, and not in the number of unemployment incidence. Boeri and Flinn (1999) have addressed the issue, concluding that a small number of unemployment incidence and a high speed of reallocation of production factors (including labour) can coexist only if the reallocation process takes place directly from one sector to another, not through unemployment, as was assumed in the beginning of transition period. This also explains why the measured labour mobility is low: when reallocation from one job to another takes place through the unemployment state, then it accounts for two movements, excluding the unemployment state only one movement is measured, which lowers the value of aggregate mobility index.

Research on the Czech Republic and Estonia – both of which have been success stories of labour market transition – has found out that both countries are characterised by high mobility and low unemployment rates (Faggio and Konings 1999; Haltiwanger and Vodopivec 1999; Eamets 2001; Jurajda and Terrell 2000). The conclusion has been that low unemployment rates have resulted from high mobility.

Still, there are differences between countries of high labour mobility. Comparing the analysis of several transition countries such as Bulgaria (Boeri 1998), East Germany (Bellmann et al. 1995), Poland (Gora and Lehmann 1995), and Russia (Foley 1997), Sorm and Terrell (2000) conclude that the Czech Republic exhibits lower unemployment inflows and higher rates of job-to-job movements compared to other transition countries. The results from Haltiwanger and Vodopivec (1999) for Estonia reveal that the inflow and outflow rate from unemployment is not lower than in other transition countries. Thus, one may conclude that while in the Czech Republic labour reallocation has taken place mainly through job-to-job transitions, Estonia has reallocated labour also through the unemployment state.

The analysis of job destruction and creation has revealed that in early transition job destruction dominates job creation, while the latter is increasing with a lag period (Bilsen and Konings 1997; Faggio and Konings 2001, Haltiwanger and Vodopivec 1999).

Here some main results from the job flow analysis are listed:

- Most job reallocation occurs predominantly across sectors in the beginning of transition while later reallocation takes place within the sector (Bilsen and Konings 1997).
- Foreign firms have higher job creation rates (Faggio and Konings 2001).
- Small businesses are most dynamic in terms of job reallocation (Faggio and Konings 2001).
- During the active Estonian transition process more than two thirds of the worker reallocation was accounted for by job reallocation (Haltiwanger and Vodopivec 1999).

## **6. Labour migration**

Lately, the issue of East-West migration has become very popular within political discussions and academic debates in Europe. Up to now the migration flows from CEE countries are still restricted by EU member states. By and large, barriers to trade, FDI and other capital movements have already been removed. Thus, the free movement of labour has become a central dimension of economic integration. In this section, economic reasons for migration and possible consequences of the eastward enlargement of the European Union are considered.

There are two basic terms that characterize the movements of labour: “mobility” and “migration”. These terms are often unsettled in the literature and sometimes even used synonymously. In general, mobility is any movement of labour from one region to another (interregional mobility) or within the geographical region (intraregional mobility) (Tassinopoulos and Werner 1999). Spatial movement of labour with a change of residence is migration. Hence, mi-



gration is characterized by its permanent nature. If the residence of labour does not change in spatial movement, then one refers to commuters (*ibid.*).

There is no single, coherent theory of international migration, only a fragmented set of theories that have developed largely in isolation from one another, sometimes separated by disciplinary boundaries. Patterns and trends in immigration suggest that a full understanding of contemporary migratory processes will not be achieved by relying on the tools of one discipline alone, or by focusing on a single level analysis. Rather, their complex nature requires a sophisticated theory that incorporates a variety of perspectives, levels and assumptions (Massey *et.al.* 1993).

Reasons for migration can be divided into so-called pull-factors and push-factors. The former come into play when the level of income that can be earned in the potential immigration county is high and there are employment opportunities. The latter consist of factors such as the lack of employment opportunities, unemployment or low earnings in the home country (Hönekopp and Werner 2000).

These considerations are the starting-point for neoclassical migration theories. According to them, countries with a large endowment of labour, relative to capital, tend to have low equilibrium market wages, whereas countries with a limited labour endowment, relative to capital, are characterized by high market wages. The resulting wage differences entice workers from low-wage countries to move to high-wage countries. As a result, the supply of labour decreases. Wages rise in the countries of origin and the supply of labour increases; wages fall in the country of destination. This leads to a new equilibrium in which wage differences reflect only the costs of migration (Russell 1995).

The neoclassical theory of international migration has some limitations, including its failure to take into account the international political and economic environment, as well as the effects of political decisions that influence individual decisions regarding migration. Furthermore, it assumes that there is homogeneity of skills between the regions of origin and destination (i.e., labour is completely interchangeable) and that full employment is maintained in both areas during the migration process (Maresova, 1999).

To cope with these limitations, other theories have been developed: the new economics of migration, dual labour market theory, and world system theory. In addition to economic theories of migration, some theories are based on different considerations: network theory, institutional theory, and cumulative causation theory. Thoroughgoing treatments of these theories can be found in articles by Cohen (1996), Massey *et.al.* (1993) and Oberg (1997).

Classical foreign trade theory shows the nexus between trade and migration. It assumes that there are two countries, which produce two goods and labour is immobile. Following the Heckscher-Ohlin (HO) theorem, a country concentrates on producing the goods in which it has a comparative advantage, i.e. it produces them with relatively lower costs. If all the assumptions of the HO model hold, then the international trade equalizes prices in different countries: the HO-Samuelson theorem. From this standpoint labour migration is unnecessary. Trade is a substitute for labour migration and capital is more mobile than labour (Krugman 1991). In reality the full equalization of factor prices is not very likely, due to discrepancies in resources, trade barriers and technology. Different structures of demand, differences in tastes or varying production functions do not grant full economic integration (*ibid.*).

Theoretical considerations and empirical results show that migratory flows are affected by differences in income and by rates of both unemployment and employment in the migrants' country of destination. But besides that it is also necessary to take into account additional factors. Migration theory emphasizes the importance of networks: existing immigrants tend to attract more immigrants from the same origin. Most importantly, the existence of networks is determined by the direction of migratory flows (Hönekopp and Werner 2000). Cultural and geographical proximity is also notable. For Germany's neighbour, Poland, it is surely significant: in 1998 there were 69,000 Poles working in

Germany. This accounts for almost two-thirds of all Polish workers in the EU (ibid.). Moreover, good economic expectations in the potential migrant's own country reduce the propensity to migrate (European Commission 2001).

In a situation where there are remarkable differences in the economic and social level of development between CEE and EU countries, the direction of labour movement is obviously from CEE countries to EU where the wage level is considerably higher. Due to geographical proximity and intense ties possible directions are (Kulu 2000):

- the so-called Germanic region: countries such as Germany, Belgium, the Netherlands, Luxemburg, Austria are threatened by immigrants from Poland, Hungary and the Czech Republic;
- the Northern region: the possible labour streams from Baltic states to Denmark, Sweden and Finland.

Push-factors of CEE countries can be the changes in employment that were caused by restructuring the economy during the transition period and differences in level of incomes and living standards compared to the EU average. The European Commission (2001) also features geographical proximity. It is a particularly important factor for non-permanent labour migration. Proximity also gives rise to commuting, which falls outside the concept of migration but is another relevant economic phenomenon. Pull-factors of the EU side entail the demand for low-wage labour force due to rigid and overly regulated labour market, extensive systems of social warranties, and the aging population in the EU (Kulu 2000).

There is one strong argument against the idea of increasing migration from CEE countries: the historical evidence. During previous enlargement rounds, fears of a massive waves of immigration proved unfounded. For the six founding members of the European Economic Community, the free movement of workers has been reality since 1968 (Hönekopp and Werner 2000). In the beginning, Germany and France feared massive immigration flows from Italy. But these fears did not materialize. The accession of the United Kingdom, the Republic of Ireland, and Denmark in 1973 neither created extensive immigration flows. The same was true for Greece (1987), Spain and Portugal (1992) as well as Austria, Sweden and Finland (1995) (Hönekopp and Werner 2000).

The movement of labour force into the EU has been very small in terms of volume. On average, less than 2% of the entire workforce in EU countries comes from another Member State. This percentage has been almost constant for 15 years (Hönekopp and Werner 2000). Officially, 300,000 persons from candidate countries work in the EU, which is about 0.3 per cent of the EU labour force (Boeri and Brücker 2000).

One might say that in previous enlargements differences in income level were smaller than between CEECs and the EU. Considering the German unification, however, where the income gap between East and West Germany was huge – in 1989 the East German wage rate was much below the West German one (Sinn 1999) –, a massive migration has not happened. During the ten years following the opening of the border between East and West Germany, around 7.3 per cent of the eastern population moved to live in the western part of Germany (European Commission 2001). In addition, there has been a reversed movement from West to East, and from the mid 1990s on both flows have been of similar magnitude (Hunt 2000). The reasons for the lack of massive migration could be the rapid convergence of wages between East and West Germany and the transfers from the West to the East (Sinn 1999). In the literature, expectations of such a convergence (Burda 1995) are another important cause. Hunt (2000) endorses the importance of unemployment and wage differentials, but equally emphasizes the low labour mobility in East and West Germany.

The accession of the CEE countries to the European Union will fundamentally alter the conditions of migration. Some current EU member countries, especially Austria and Germany, are concerned that unlimited movement of labour to these countries might generate a wave of new entrants that could overwhelm their labour markets. Indeed,

the large gaps in per capita income and wages between the present EU members and the accession candidates provide incentives for East-West migration.

Boeri and Brücker (2000) argue that the basic fears of current EU countries regarding this matter are widely unjustified: there are growing unemployment rates and decreasing wages of incumbent workers. It must be pointed out that this notion has some support from trade theory. In the HO model trade and migration are substitutes. The changes in factor endowments that result from migration are absorbed by corresponding changes in the output mix rather than in factor prices (Fidrmuc 2001).

Israel is a good example for labour market behaviour in case of massive immigrant flows (Gandal, Hanson, and Slaughter 2000). In the early 1990s, Israel experienced a large and concentrated surge from the former Soviet Union, increasing the total population by 11 per cent and the total labour force by 14 per cent. The notable aspect of the Russian immigration was its high-skilled composition. What were the results of this immigration wave? Gandal, Hanson and Slaughter (2000) conclude that, despite the size of this immigration shock, the research has found only weak evidence that it affected wages and unemployment. Besides, after the immigration shock the output mix of Israel adjusted by specializing in high-skill intensive products. Thus, immigrants in Israel have affected her economy mostly positively.

There are theoretical arguments that suggest that the population in the immigration country will gain from the immigration from labour and the emigration country will lose. If market clearing is assumed, immigration leads to increased output. Real wages of labour will fall, due to an increase of labour supply, but as productivity exceeds remuneration, additional profits are created and the capital income of the domestic population increases. This increase is greater for the domestic population than the loss of income through falling real wages (Brücker and Weise 2001).

In real life it is reasonable to assume that markets are not always clearing. Then the effects of migration depend on the structure of labour immigrating. Inflows of skilled workers who complement the groups particularly affected by unemployment will help to reduce unemployment. But immigration of workers who can substitute the groups affected by unemployment can increase the unemployment. (Brücker and Weise 2001)

Fidrmuc (2001) researched labour mobility aspects in Czech and Slovak Republics and found that these countries display relatively low mobility despite sizeable wage and unemployment differentials across regions. Second, results of the research show that wages have a positive and negative effect both on inflows and outflows, probably because of a large fraction of movers are high-wage earners. Fidrmuc says that if this pattern continues after the entry of candidate countries to the European Union, free mobility of labour may have negative effects for entrants and positive to current members, in as much as it involves migration of high-skilled workers. Numerous studies have been performed that try to predict migration after EU enlargement (see Brücker and Boeri 2000; Sinn 2001; Walterkirchen and Dietz 1998; Bauer and Zimmermann 1999; Hille and Straubhaar 2000; Salt 1999). The forecasts of labour movements after accession vary a lot, which shows the uncertainty and variety of forecasts.

According to various studies, the long-run migration potential is expected to be about 1 per cent of the EU-15 population. The early yearly flows from the eight CEE countries aspiring to access in 2003 are estimated at 70,000 – 150,000 workers per year (European Commission 2001). Surveys also note that there is a preference of CEE workers to do only temporary work. Most of the studies find that the overall impact on the EU labour market should be quite limited. Enlargement would not have strong effects on wages and employment in the EU.

All these studies have the methodological problem that there are conditioning effects between employment and wage levels in the different regions and sectors on the one hand, and migration on the other. The results of these studies

depend to a large extent on the significance given to this interdependence (Brücker and Weise 2001). Econometric models predict the possible migratory flows are based on past patterns of behaviour. But the eastward enlargement of the EU is a unique process easily modifying the past behavioural patterns. Besides that, macroeconomic migration determinants may establish the potential pressure to migrate, but the migration decision of individuals also depends on the “advantage of staying” (Hönekopp and Werner 2000). People’s social and cultural ties to their local environment are important obstacles to migration and are usually underestimated in theoretical economics (Staubhaar 2001).

*To sum up*, there is no a single coherent theory of international migration of labour that could be used for predicting a free movement of labour as a consequence of the eastward enlargement of European Union. Migration forecasts are only one element while looking at such a complex event as the EU enlargement and the adjustment processes in the transitional labour markets. This topic needs to be given broader theoretical consideration and empirical studies, concerning the variability of migration conditions and importance of labour movement for growth and development.

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# 3. Exchange Rates

## Exchange Rate Regimes – Survey of Research

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### 1. Introduction

Research on optimal or appropriate exchange rate regimes of the Central and Eastern European Countries (CEEC) should, from the viewpoint of the project “Eastern enlargement of the eurozone”, be seen in the light of future accession of these countries to the European Union (EU) and to the European Monetary Union (EMU). Relevant academic literature conventionally starts from the description of alternative exchange rate arrangements actually used in these countries and goes on to compare their relative advantages and disadvantages (Edwards and Sevastano 1999; European Parliament 1999; Calvo and Reinhart 2000; Feldman 1998).

In spite of the importance that real exchange rates have attained in policy discussion, till now there have been few attempts to analyse empirically the forces behind real exchange behaviour in transition economies. Transition has brought about important changes in production and productivity, and these changes should also influence the equilibrium exchange rate.

A recent trend in the literature is the debate on nominal vs. real convergence (Bjorkstein 2000). While nominal convergence, embodied in the Maastricht convergence criteria has to do with macroeconomic stability, real convergence has to do with catching-up in the GDP per capita level and related to this with structural reforms and finishing the transition process for the candidate countries. Within this framework, a recently fashionable topic is the Balassa-Samuelson (B-S) effect for CEEC (Pelkmans 2000; Coricelli and Jazbec 2001). This is the main supply-side based explanation and is also mentioned as the B-S “productivity hypothesis”. According to this theory, there is a trend appreciation of the real exchange rate in transition economies, which originates from differential growth of productivity in the tradable vs. non-tradable sector in the catching-up economies (Clark and MacDonald 1998; Halpern and Wyplosz 1997). Since wages are assumed to be linked between the tradable and non tradable sectors, wages and prices will also increase in the non tradable sector. This will lead to an increase in the overall price level in the economy which will in turn result in an appreciation of the real exchange rate. The implication is that transition economies due to the B-S effect should experience somewhat higher inflation rates. Some authors therefore suggest that the Maastricht convergence criterion on inflation should be adjusted for the case of CEEC to take account of the transition-inherent inflation dynamics in their catching-up process (Pelkmans 2000; Szapary 2000).

The transition process is still ongoing, with the various transition countries at different stages of the process. Some countries more advanced in the transition now are on a path of robust growth and substantial productivity gains. Other transition countries only recently have shown signs and recovery from the initial output collapse, and they have not yet been able to generate consistent productivity increases in the tradable sector. Productivity in the tradable sector has begun to pick up in the CEEC and the Baltics, but not in Russia and other countries of the former Soviet Union. These different productivity and exchange rate patterns suggest that the BS effect may be operating differently in the CEEC and Baltics than in other transition countries.

### 2. Aspects of exchange rate regime choice

Candidate countries actually opted for very different arrangements, from the very rigid to almost completely flexible exchange rate regimes, for instance: *currency board arrangements* for Estonia, *floating regimes* for Czech Republic and

Poland, *crawling peg* (with a band of  $\pm 2.25$  per cent) for Hungary. A common goal of these countries is to move toward meeting the Maastricht criteria while completing the transition, but there seems to be no direct link between the exchange rate regime in place and the progress achieved in meeting that goal. For instance, close to EU-inflation level has been achieved in Estonia with a currency board and in the Czech Republic with a floating regime; approximately the same path of disinflation has been secured in Poland with a wide band crawling peg and in Hungary with a narrow band crawling peg.

Essential insights from research on exchange rate regimes of CEEC in the recent literature are the following: First, no exchange rate regime is *a priori* superior to others, choice of the exchange rate arrangement should be tailored to specific circumstances of a country (Frenkel 1999). Therefore, in this phase, before the EU accession, all exchange rate regimes in use are acceptable for the candidate countries on their way to the EU and to the eurozone (ECB 2000; EU Commission 2000). Second, interim solutions, such as fixed but adjustable pegs, are found to be particularly problematic, since in the circumstances of increased capital mobility they are particularly exposed to possible speculative attacks and are therefore inherently vulnerable (Begg 1998). Third, in the last two years there were quite a few shifts in the exchange rate arrangements of the CEEC in the direction of the so-called corner or bipolar solutions. This means that interim regimes of the fixed but adjustable type were abandoned in favour of either very rigid arrangements (such as currency boards) or very flexible arrangements (such as almost free floating) (Backe 2000). An alternative explanation would be that there was a general move towards increased flexibility of the exchange rate regimes of the CEEC, while currency board arrangements should be seen as a result of very specific circumstances (serious lack of credibility) (Bulde 2000). Fourth, it is important that countries design timely exit strategies in order to prepare for smooth shifts to the new exchange rate arrangements (Eichengreen 1998, 1999).

Nevertheless, in addition to the exchange rate regime other policies matter. For example, the CEEC still face relative price adjustments beyond the B-S effect, due to the continuous structural reforms and liberalisation in such areas as telecommunication, energy, transportation and healthcare. The inflationary impact of these changes is less stable and progressive than the B-S effect, because it is linked to the timing of reforms that, in turn, is often linked to the privatisation of those alternatives.

Economic analysis concentrates on determinants of the exchange rate regime choice, which can be found in structural characteristics of individual countries or in the main focus of their macroeconomic policies, i.e., the nature of the problem that the exchange rate policy is primarily – nominal anchoring, disinflation, external competitiveness, capital inflow problem etc. – concerned with (Begg *et al.* 1999; Kopits 1999; Masson 1999). After their EU accession, exchange rates of the CEEC become the matter of common concern and their currencies are expected to join the Exchange Rate Mechanism 2 (ERM 2). Due to the limited experience of this mechanism (only two currencies participating, only less than three years of functioning), literature on these exchange rate arrangements is only starting to emerge. However, some issues, such as its design, rules and procedures, its performance etc. deserve additional research, particularly since the ERM 2 is – through its role in the Maastricht exchange rate criterion – crucial for determining the dynamics of joining the euro area for the CEEC. Open questions, which are particularly relevant for CEEC, are the following: First, is this exchange rate arrangement flexible enough for these countries to prepare their currencies for a soft landing in the eurozone? Second, does ERM 2 as a specific form of adjustable peg expose the candidate countries to particular exchange rate vulnerability? Third, how should exit strategies from present arrangements be designed, particularly in the light of recent evolution of the very basic concept of the ERM 2? If ERM 2 is being understood as a broader framework (EU Commission 2000; ECB 2000), which can include most individual



exchange rate arrangements, except for those, which are clearly incompatible with its requirements, this problem should be largely overcome.

The largest part of the academic literature dealing directly or indirectly with the exchange rate regimes of the CEEC is in fact forward looking, in the sense that the issue is analysed in the framework of future inclusion of these countries in the monetary union. This body of literature is based on optimum currency area theory (Mundell 1961). It starts from analysing the exposure to symmetric vs. asymmetric shocks in a monetary union and from discussing the availability and flexibility of alternative mechanisms of adjustment (such as fiscal policy, labour mobility, flexibility of wages) which come into play once a country joins a monetary union and gives up its exchange rate as an instrument of adjustment. This is the basis for the assessment of expected costs and benefits from joining the monetary union (Fidermuc and Schardax 2000; DeGrauwe and Lavraè 1999; Boone and Maurel 1999). However, as the membership in the European monetary union is mandatory for the new EU countries, the issue of costs and benefits, although analytically relevant, is irrelevant from a decision-making perspective. Research should perhaps be directed more to the dynamics of expected costs and benefits of joining the monetary union, which should give some additional insight into the debate on too early vs. too late accession of the candidate countries to the euro area.

According to the EU official views, nominal and real convergence should run in parallel. In other words, candidate countries should for the moment not concentrate too early and too intensively on meeting the Maastricht nominal convergence criteria, at the expense of neglecting structural reforms leading to their real convergence. The central issue in this debate is the following: Is monetary integration possible among countries at the different level of economic development? Experience of historical monetary unions, of EMU itself and of some federal states which can be seen as functioning "monetary unions", demonstrates that it is possible, although perhaps more demanding. This issue is very relevant for the debate on the dynamics of the inclusion of the CEEC in the eurozone. Further research should be devoted to costs and benefits of a too early vs. a too late admission of CEEC to the eurozone, to explore the risks for both sides – the euro system itself and for the candidate countries.

Finally, as a shortcut to the membership in the European Monetary Union, suggestions for a unilateral adoption of the euro emerged in the academic literature in the candidate countries (Rostowski 2000; Nuti 2000; Coricelli 2000). Inspired by earlier experience and debate on dollarisation (Berg and Borenstein 2000), particularly in Latin America, the idea is to abandon domestic currency and to adopt the euro, thereby unilaterally and informally joining the European Monetary Union. The costs and benefits of this solution are well established, but the overall evidence is not conclusive (Wojcik 2000). Anyway, the EU is opposing this idea, which runs counter to its concept of the phased process of successive steps in joining the euro area for the candidate countries.

In concluding, it could be said that the research on appropriate exchange rate regimes of CEEC on their way to the eurozone will intensify in the next few years and will find new challenges as their ERM 2 and eurozone membership comes closer.

### **3. Aspects related to the exchange rate policy: the dynamics of prices**

If the downward flexibility of prices is rather low, a certain level of inflation appears to be necessary in order to allow the adjustment of the relative prices. It is not surprising then that the CEEC begun their transition to the market economy with an inflationary outbreak and a parallel devaluation of the local currencies. In 1995, a two-digit inflation was still the rule, but in the last five years several countries successfully reduced it to a level much closer to the one in the EU. The negotiation to strengthen the relations of the CEEC with the EU anyway progressed even faster, and it is relevant to assess in which measure did the economies converge.

As far as inflation and prices are concerned, we found several definitions of convergence that we grouped in three categories. The first one replicates the one of Barro and Sala-i-Martin (1992) for economic growth; the second one is derived from the Law of One Price (LOP); the last one is referred on the Maastricht criterion.

Barro and Sala-i-Martin termed convergence the tendency for the lagging economies to grow faster and catch up with the richer ones; in the empirical literature this is often associated with a reduction of the dispersion of the data too, despite the warning by the authors that this additional effects also depends on the variance of the shocks hitting the economies. For the second definition, according to the LOP, the price of the same good must be equal across different locations, allowing only for transportation cost to justify a moderate deviation; if the prices are quoted in different currencies, the LOP should hold as long as the prices are converted to the same base. Extending this to the prices of all the goods of the economy, the Purchasing Power Parity (PPP) should hold too. Finally, the Maastricht criterion, where a certain level of inflation is stated as a necessary requisite: it is the only one referred to the inflation and the only one having had official consideration so far (in the first round of the monetary union in Europe).

The intuition of the LOP is immediate: prices achieve convergence if they are equal. Yet the empirical evidence is not in favour of this finding: in an extensive survey Koujianou and Knetter (1997) report rejections for several countries using a cross sectional technique. If anyway the dataset covers a reasonably long past history, a time series approach can be introduced with the purpose to distinguish between the short term and the long-term effects. After the contribution of Johansen and Juselius (1992), exploring the so called PPP puzzle with the Maximum Likelihood approach indeed become a popular exercise in the applied literature. In many analyses the researchers verified that even though the PPP did not hold in the short run, it was the driving force for the dynamics of prices (or inflation) and exchange rates in the long run. In most of the cases this result only emerged when an ad-hoc dynamic parametric model was specified, while failing to appear or to be statistically significant under robust techniques. In some cases anyway the LOP/PPP dynamic appeared to be the force effectively driving the results even with some less structured models: recently Koujianou and Verboven (2001) and Cecchetti *et al.* (2000) find evidence of a stable long run relation in the EU and across the US cities, providing evidence of economic integration for those markets.

The emphasis on the inflation rate in the Maastricht criterion on the other hand is justified by the autocorrelation displayed in the past history. Albeit a decomposition in forward and backward looking component is debatable, it is widely observed that several factors (for example, the presence of long term contracts) that induce dependence of the inflation on the past and prevents an immediate adjustment to completely encompass a new stance in the monetary conditions: this lagged and slow reaction is also proposed to explain the short run trade off characterized in the Phillips curve and is one of the arguments in favour of a gradualist approach to the monetary policy. The rationale for that criterion is that countries with a higher level of inflation would suffer from an erosion of competitiveness in a monetary union.

Since this effect is larger the deeper the integration of the market it is sensible for the European authorities to point to a common long-term rate of inflation for the European partners. But when some locations start with a lower level of prices, the integration of the market will have the effect to push the prices of the traded goods upwards, experiencing in the transition a higher level of inflation (a Barro and Sala-i-Martin type of convergence of prices). This will also impact on the wages and on the prices of the non-traded goods, with an even bigger effect of inflation. A supplementary dynamics, provided by the B-S effect, goes through the “real” convergence of the productivity levels, that is assumed to stem from the sector of traded goods: the wages of the workers producing them are pushed upwards, positively affecting the salary in the production of the non-traded goods, as well.

The convergence of the prices should then be twofold: for the level and the growth rate. The paradox here is that fixing the exchange rate (either with a currency board or with a participation to an ERM-type of agreement) prevents the contemporaneous achievement of convergence of price levels and inflation: Szapáry (2001) argues that this is the cause of the high inflation observed for Spain, Portugal, Greece and Ireland in the recent past.

That a combination of these effects was at work during the last decade can be observed simply by comparing the level of the prices in the accession countries with respect to the one in the EU in 1990 and in 1999: Rogers (2001) estimates that at the beginning the absolute prices in Prague, Warsaw and Budapest ranged from 30 to 40% of the corresponding prices in the major European cities, reaching a ratio of 60 to 70 per cent in 1999, and similar levels, referred to the whole countries, are presented for the last period in Beaumont *et al.* (2000). Using a detailed, “micro” dataset, Ěihak and Holub (2001) compute in about 1 to 2 per cent the additional inflation due to this effect for the Czech Republic, and a similar estimate is in Corker *et al.* for Hungary, Poland and Slovenia, and in Rogers, who included Estonia. Another advantage of an analysis in which the disaggregated data are considered is that the researchers can assess the dynamics of the whole range of the components of consumption and compute a measure of dispersion: there is a wide consensus that the catching-up in convergence to the European prices went alongside with the reduction of the dispersion around the reference level.

A time series approach is much more complicated by the frequent breaks and by the instability intrinsic in the transition process. A robust, univariate analysis of an inflation gap of the CEEC can be run considering an higher order of integration (it seems arguable that the frequent breaks of the transition may be represented with an I(2) model), and imposing the instability already in the parameters of the model: the Kalman filtering also allow to take into account the unobserved components. The advantage of this approach is that it identifies as convergence the dynamic towards the equilibrium rather than the long run behaviour that did not emerge completely yet. Estrin *et al.* (2001) applied a similar technique the real income, but on the light of the dynamics of prices the extension to the inflation differential appears to be very promising.

The main advantage of the time series approach is often that it also allows for forecasts and simulations: a multivariate approach is then the natural framework since in it the explanatory variables are modelled as well. To endogenize the B-S effect, for example, Golinelli and Orsi (2000) introduce a measure of the labour productivity, confirming the evidence of the impact of that effect on the level of prices (their estimates ranging from 3 to 6%). They are also able anyway to assess that this component is indeed acting as an exogenous driving force for the dynamic of prices.

#### **4. Convergence**

Due to the extremely unbalanced situation at the beginning of the transition period, it is of particular importance to distinguish between “ongoing convergence” and “achieved convergence”. It is widely recognized that most of the accession countries are moving on a convergence-path for prices and inflation, but in the short run these two dynamics may be in conflict. It is also debatable whether the convergence process reached a satisfactory point or not: Nuti (2000) and Schweickert (2001) both argue that the process is not complete even in the most advanced countries, but they also conclude that it progressed enough and it is not likely to be a major cause of concern in the overall picture of the convergence of the economies.

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# 4. Policy Responses

## a. Fiscal and Monetary Policies

### Fiscal Policy – Survey of Research

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#### 1. Introduction

The eastward enlargement of the eurozone concerns fiscal policies in both EU countries and in the Central and Eastern European EU candidate countries (CEEC). Fiscal policies in CEEC are affected by fiscal policies in the EU countries and are constrained by the fact that their fiscal position should shortly adjust to the EU fiscal requirements. They are already involved in fiscal surveillance procedures. After their EU accession their economic policies, including fiscal policies, become the matter of common concern and subject to coordination and supervision procedures. And finally, CEEC will have to comply with the fiscal rules of the EU, in particular with excessive deficit rules and Stability and Growth Pact requirements.

#### 2. The Stability and Growth Pact

On the way to the eurozone, before adopting the euro, CEEC will have to meet the two Maastricht fiscal criteria (on fiscal deficit and public debt). After joining the EU and before entering the eurozone they will be subject to some of the provision of the Stability and Growth Pact and will have to prepare convergence reports on the fulfilment of the Maastricht convergence (including fiscal) criteria. After joining the euro area, CEEC will have to comply with all Stability and Growth Pact requirements and will have to prepare stability reports, with the aim to report on the sustainability of their fiscal position in the monetary union. All these processes and requirements from their joining the EU and eurozone will call for considerable effort and adjustments in their current fiscal policies and positions. On the other hand, fiscal policies of the EU countries themselves are being affected by the prospect of eastern enlargement of the eurozone, as the eastern enlargement will be a burden for the EU budget, although actual costs are still undetermined and subject to negotiations on the last, most difficult and financially most demanding chapters in the negotiations on the EU accession of CEEC.

Literature of fiscal policy issues, particularly in Europe, is concentrated on the role of the fiscal policy itself (and in relation to monetary policy) in the framework of EMU. Along with more traditional issues such as fiscal discipline (Von Hagen 1996; Canzonieri 1996 and 1998; Kopits 1998), sustainability of fiscal position (Perotti 1997; Bayoumi 1995a; Alesina 1997 and 1998; De Bandt 2000), optimal macroeconomic policy mix (Begg 2000), the emphasis is on the constraints on national and EU-wide fiscal policies which derive from the single monetary policy in the EMU (Mongeli 1999; Fatas 2000; Masson 1996 and 2000). As regards the EU-wide policy, literature focuses on issues related to fiscal federalism (Hewitt 1992; Kletzer 2000; Ter-Minassian 1997; von Hagen 1996; Mihaljek 1998). The debate touches first the question of distribution of fiscal powers among different levels of government (supranational, national, regional, local) and next, related to this, should the EU aim for a EU-wide fiscal policy, modelled on the fiscal system of the federal states (von Hagen 1993; Sala-i-Martin 1992; Bayoumi 1995; Persson 1996). Of course, contrary to monetary policy, there is no such thing as a single fiscal policy, so even in the EMU fiscal policy remains decentralised and in the hands of individual member countries. The question is primarily about the size of the EU budget, which is compared to national federal states extremely small and furthermore inflexible, i.e. earmarked for specific purposes, mostly for agriculture (CAP). However, in the literature the question is raised whether with the move to

the EMU there is a need to substantially increase fiscal powers at the EU-wide level. For political reasons, it seems very unlikely that any substantial change in the size of the EU budget will be possible, at least in the short-term.

### **3. EU-wide and national fiscal policies**

The idea for a EU-wide fiscal policy derives from the roles of the national fiscal policies, which through their allocative, stabilising and redistributive effects can affect economic situation in individual regions within the state. Through automatic stabilisers or even with active fiscal policy the state can redistribute income in the direction of those regions which have suffered negative asymmetric shocks and thereby help to stabilise their income. In the EMU, member countries adopted the single currency, gave up their own monetary and exchange rate policies and became from a monetary point of view similar to regions within the states. In case of negative asymmetric shocks, which lead to decrease in their output and/or employment, they would need additional or alternative macroeconomic policies, common fiscal policy in the first place, which could substitute for the loss of the monetary and exchange rate instruments of adjustment in the monetary union in order to help them neutralize negative shocks (Obstfeld 1998). Based on the above argument, current literature deals with the issue of whether it is possible and advisable to build an EU-wide common fiscal policy (Melitz 1991; Belke 1998; Fatas 1998).

Another research topic considers the role of the national fiscal policies in the EMU, where two opposing views can be detected. According to the first, because of the EMU, member countries should have more flexibility in the conduct of their national fiscal policies, while according to the second (which prevailed in the EU), national fiscal policies should be constrained by the fiscal rules of the EU.

The first view starts from the belief that the burden of macroeconomic stabilisation in a member country of a monetary union should to a larger extent now fall on their national fiscal policies, since their monetary policies are lost. In case of a negative asymmetric shock, a country should depend on its fiscal policy, by letting automatic stabilisers, if not by its active fiscal policy, counteract recessionary impact of the negative shock. According to this view the fact that a country joins a monetary union calls for a greater role of its national fiscal policy, therefore the EU fiscal rules should allow for autonomy and flexibility of national fiscal policies.

The second view starts from the belief that national fiscal policies in a monetary union have strong spill-over effects which can cause negative externalities for other member countries or for the EMU as a whole. Fiscal rules of the EMU should therefore limit the flexibility of national fiscal policies. A country which would use its fiscal policy to counteract a negative asymmetric shock, risks that its fiscal position becomes unsustainable, if unfavourable public debt dynamics develops. Negative external effects for other member countries come in the form of higher interest rates, which spill-over the entire EMU, and/or pressures on the ECB to lead a more accommodating monetary policy (if we leave aside the bailing-out problem, which, however, according to the literature may or may not exist). To prevent free-riding and spill-over effects, the EU rules seriously constrain national fiscal policies of member countries. This is the reason for adopting excessive deficit rules in the Treaty on EU, for the fiscal Maastricht convergence criteria as a precondition to joining the EMU, and for the Stability and Growth Pact for the period after joining the EMU. In particular, the rules of the Stability and Growth Pact raised some controversies in the literature (Buti 1998; Eichengreen 1998). First issue is their enforceability, since the sanctions require a 2/3 majority of votes, which may be hard to achieve, and second issue is that sanctions have negative economic impacts on countries which are already in trouble. Third issue finally is that currently some member countries are close to the upper limits of their fiscal deficits according to the Stability and Growth Pact provisions, which limit their room for leading flexible fiscal policies in case of an early recession. In fact, according to recent developments this seems to be a realistic

danger. In concluding it can be said that research still needs to answer the question where to draw the right line between centralisation and national competencies of fiscal policies in the EMU.

These issues seem to some extent forward-looking from the current viewpoint of the CEEC, but they show the direction of fiscal adjustments which they will have to undertake in not so distant future (Ministry of Finance 2000). For the moment they have to concentrate on the right mix of macroeconomic policies and on overcoming some burdens of transition-related fiscal situation (Tanzi 1992) and, in particular, to move from fiscal dominance to monetary dominance, which is a precondition for the soft landing of these countries in the eurozone.

#### **4. Public finances and public debt**

Concerning fiscal policy requirements for the candidate countries to be included in the enlarged Euro area, some crucial issues call for additional analysis. First, it is important to provide a first assessment about the state of public finances in the candidate countries. This implies a deeper analysis of low frequency observations available for fiscal policy variables. This way, it could be established not only if the fiscal policy requirements are met, but it could also be tested if public finances of the candidate countries are exposed to cyclical shocks. In fact, a full time series analysis of the data on fiscal policy variables would highlight how public finances are exposed to shocks hitting the economy. Further, it would be interesting to see how important the adoption of the Stability pact for those economies will be. It would be interesting to show, through some simulations, the convergence of fiscal policy variables to the levels required by the Maastricht criteria for those countries which do not fulfil the requirements of the Stability pact.

A second aspect is related to the structural characteristics of transition economies of candidate countries, with a special emphasis on fiscal policy. Many candidate countries suffer from a lack of large structural investment to have a harmonised economic system, which could be better integrated with the other part of Europe. It is feasible to argue that the enlargement of Europe will call for a growth of public expenditure for those countries. Then a question arises naturally: In this context, it would be useful to investigate the role of fiscal shock in the accumulation of public debt. In other words: It is important to assess to what extent a fiscal policy shock (say an increase in public expenditure) will translate into a growth of public debt. What can the government do to mitigate the effect of the growth of public expenditure in the day to day management of public debt?

To answer this kind of question, three aspects should be studied: First, to test what is the contribution of exogenous shocks to variations in the primary surplus and to measure empirically their importance for the accumulation of public debt. Next, to show how a policy of fiscal risk management can mitigate the adverse consequences of these external influences, and to estimate the potential gains from fiscal risk management in terms of improved fiscal sustainability. This could be tested through a simulation analysis by following the procedure adopted by Lloyd-Ellis and Zhu (2000). The second issue to be studied involves the analysis of solvency tests for the existing government budget constraint, following the approach outlined in Bohn (1998), Corsetti, Roubini (1991), Hamilton, Flavin (1991).

The third and final issue concerns the persistence of debt variables. When public debt turns out to be more persistent than other macroeconomic variables, this is a signal of highly incomplete markets. Thus, the next step is to investigate how this aspect is important to determine the evolution of government debt. In fact, the EU enlargement implies the inclusion of euro-denominated stock of public debt coming from the Central and Eastern European candidate countries. It should be tested how the response of debt to fiscal shocks changes under both complete and incomplete markets. The presumption is that if bond markets are complete, the market value of government debt is persistent no more than other real variables in the economy. Under incomplete markets, public debt increases in response to adverse government expenditure shocks.



## 5. Final questions

Finally, there are some open questions: Will the market of public debt become more complete or less complete, after the *EU* enlargement? What are the implications of this future state of the art for the management of public debt? How will country-specific shocks affect the overall level of public debt? What are the implications for the long-run sustainability of the public debt? These are the issues to be explored by referring to the data set for Central and Eastern European candidate countries.

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## Monetary Policy – Survey of Research

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### 1. Introduction

Research on eastward enlargement of the eurozone involves monetary policy issues both in the EU member countries and in the EU candidate countries. In this survey we will first shortly focus on some more general monetary policy issues dealt with in recent academic literature, and then concentrate on some more specific problems of monetary policy, first from the point of view of the European central bank and then from the point of view of the candidate countries.

### 2. Goals of monetary policy

Recent academic literature on monetary policy issues covers a very wide spectrum of topics within the central theme of what central bankers do or should be doing (for a survey, see Clarida 1999; King 2000; Herrero 2001). In this survey we can have only a very limited ambition to discuss some of the issues which may have a particular relevance for the topic of the eastward enlargement of the eurozone. In this context, we limit ourselves to two general issues: a) the ultimate goal of monetary policy, which involves discussion on price stability and on specifics of monetary policy in low inflation environment, and b) the intermediate target of monetary policy, which involves discussion on alternative monetary strategies and on inflation targeting in particular.

Considering the ultimate goal of the monetary policy and the primary responsibility of a central bank the literature now widely agrees that the final goal of monetary policy should be (only) price stability. This final goal is being increasingly incorporated in the statutes of national central banks, including the ECB and those of the candidate countries. The question remains whether this should be the sole ultimate goal of monetary policy or there is room for any other additional goals which central banks should try to achieve with their monetary policies? There is a common understanding that price stability should have a definite and explicit primacy over any alternative final goals, such as output or employment stabilisation (Feldstein 1999; Smets 2000; Österreichische Nationalbank 1999; ECB 2001). Such alternative goals should be clearly subordinated to the goal of price stability and pursued only to the extent where they are not in conflict with the primary goal. However, it is recognised that in practice central banks in the actual conduct of their monetary policies sometimes follow some simple rules, such as Taylor rule or Taylor-type rules, where in setting the interest rate they take account of both inflation and output gaps (Clarida 1998; McCallum 1997; Taylor 1999a and b).

A related question is what is actually meant by price stability, how it should be determined and measured. In particular, does it mean zero inflation rate, or is perhaps some low level inflation rate consistent with the idea of price stability? As the result of experience of past decades price stability is now widely accepted as a value *per se*, which led to its unquestioned position as an ultimate goal of monetary policy. Inflation is detrimental to long term growth. The Phillips curve is considered to be vertical, which means there is no trade-off between inflation and unemployment. By higher inflation a country does not get more growth and/or employment but just ends up with more inflation. Inflation has serious negative economic effects, as it impairs the functions of money, distorts price signals, causes additional costs (such as shoe-leather costs, having to do with activities devoted to economising on money held, and such as menu costs, having to do with frequent pricing changes) and leads to socially undesirable redistributions. The

effects of inflation of course depend on how far an economy is indexed, whether there is some money illusion and possibility for surprise inflation and which rigidities, nominal or real, prevail in the economy.

However, recent monetary literature emphasizes specifics of low inflation (Akerlof 1996; Svensson 2000; Herrero 2001). According to these views, the Phillips curve may at low inflation level be sloped, and there may be some gains from low inflation, particularly if nominal rigidities prevail over real rigidities in the economy. Low inflation can have some beneficial effects, like allowing for an easier adjustment of relative prices (the so-called grease in the wheels effect). Other authors, however, find evidence of opposite effects, particularly when real rigidities prevail. According to them, even low inflation is harmful (the so called sand in the wheels effect).

The conduct of monetary policy in an environment of low inflation gave rise to a discussion on some specific issues in the academic literature, such as zero-bound problem and the problem of measurement (overstatement) of inflation (Svensson 1999a; Herrero 2001; Akerlof 1996). According to the first, with very low inflation there is a natural limit to lowering of the interest rate, when it approaches the zero value, as it can not become negative in nominal terms. According to zero-bound view in this case monetary policy loses its most important instrument and can become ineffective. Opponents argue that there are other mechanisms of transmission and instruments which can be activated so that monetary policy remains effective. The second problem is related to the measurement of inflation, particularly to possible overstatement of inflation. This may have as a consequence that at a low level of inflation deflationary pressures are in fact present, which give rise to different problems and tasks for the monetary policy. Both these concerns combine to the belief that some low level inflation can be more desirable than setting the price stability goal of the monetary policy actually at zero inflation rate.

### **3. Monetary strategies**

The second issue on which we concentrate in this survey is the choice of the monetary strategy among alternative available monetary frameworks such as monetary targeting, inflation targeting and exchange rate targeting (Mahadeva 2000). In recent academic literature particular emphasis is being given to inflation targeting as a relatively new and still evolving monetary strategy (Mishkin 1999 and 2000; Svensson 1997; Bernake 2000; Haldane 1995). Adopting inflation targeting as a monetary framework is a fashionable trend also in practice, since an increasing number of countries are actually adopting this monetary strategy while others are still considering to switch to it. Inflation targeters are to be found in all groups of countries, including the transition economies. In comparison with other alternative monetary strategies, inflation targeters perform better (Mishkin 2001).

Inflation targeting in fact can mean quite different arrangements with differing technical solutions, which share the common principle – to anchor inflationary expectations by giving clear and transparent commitment to the public by the monetary authorities. Some open questions (Smets 2000; Svensson 1999b; Mishkin 2000) remain the following: a) What should be targeted, inflation rate or price level? b) Point inflation rate or inflation band? c) Band with the middle point or without it? d) Closed band or one-sided open band? e) Length of the targeted horizon? f) Use of escape clauses in case of missing the target? g) What price index to use? h) Core or headline inflation? One specific question dealt in the literature is the role of asset prices in inflation targeting (Bernake 2000; Mishkin 2001). Should asset prices such as housing prices, stock prices and exchange rates be included in price indices and thus targeted? The prevailing view is that asset prices should be helpful in preparing inflation forecasts, but that the central banks should not try to control such overall price indices and target asset prices directly, mostly because of the problem of identifying the bubbles in asset prices.

#### **4. The European Central Bank (ECB)**

Next we move from these more general issues of monetary policy dealt with in the academic literature to those more directly relevant for the theme of the research project, first to those having to do with the ECB and the conduct of the single European monetary policy since the move to EMU in 1999 (Begg 1998; Favero 2000; Buiter 1999; ECB 1999 and 2001; Gaspar 2001; Gerlach 1999 and 2000; Issing 2000). The issues which were discussed rather critically in the literature can be grouped under these main headings: a) ultimate goal of the ECB (price stability), its concrete definition (inflation rate of 0.2 per cent in the medium term) and the results in achieving it, b) monetary strategy of the ECB (two pillars strategy, which many authors find an unclear and inconsistent mix of monetary targeting and inflation targeting), c) exchange rate policy of the ECB (benign neglect concept, with discrete interventions as opposed to the rules, such as target zones), including the weakness of the euro, d) issues of independence, accountability and transparency of the ECB, including the communication of its monetary policy decisions to the public, e) problems of leading the single European monetary policy compared to national monetary policies (with issues such as lack of track record and inherited credibility, stability of money demand in new circumstances, differences in transmission mechanisms among member countries, and how to accommodate national specific cycles into "average" economic conditions in the eurozone which a single monetary policy should be addressing).

However, from the point of view of the eastward enlargement of the eurozone, the most important question concerning the ECB is the following: Is there a danger for the single European monetary policy from letting the candidate countries join the eurozone, and in particular, from letting them join the eurozone too early? The assumption here is that the first theoretically possible date for the candidate countries for joining the eurozone is 2006. This is based on the assumption of their joining the EU and the ERM 2 in 2004 and their joining the eurozone two years later, in 2006. The more realistic scenarios which add legal, technical and economic reason for delaying somewhat this process, do not define this time frame precisely, but have in mind postponing the entry of the candidate countries in the eurozone for a couple of years.

Can the inclusion of candidate countries' supposedly weaker currencies in the euro area lead to additional problems of the European single monetary policy and to the less stable euro? In particular, can it corrupt the decision-making process in the ECB when formulating its monetary policy, leading to lower credibility of the ECB and to easing of the single European monetary policy? For various reasons we think that these potential dangers should not materialise: a) by that time, after all the adjustments having been made and the Maastricht convergence criteria fulfilled, the currencies of the candidate countries need not be less stable, b) being small countries (with some exception of Poland) their combined weight in the euro is negligible, so they cannot have an effect on the euro that would be worth mentioning, c) decision making process on the single European monetary policy in the ECB is based on stability culture, and not on weighing and averaging individual nationally determined interests regarding monetary policy, d) with the inclusion of the candidate countries in the eurosystem, the rules and procedures of decision making on monetary policy in the ECB may change, so as to accommodate the larger number of countries in the governing board of the ECB without making the decision making process on single monetary policy too complicated and inefficient.

#### **5. CEEC's monetary policies**

We now turn to monetary policies of the candidate countries with particular view on how the process of their EU and EMU accession as well as their transition-specific characteristics will shape their monetary policies in the period before their joining the eurozone. It should be noted that monetary and exchange rate matters are particularly for these economies heavily interrelated, so – to avoid repeating and overlapping – some of the monetary policy issues

that are directly related to their exchange rate policies are covered in the chapter on exchange rates in this state-of-the-art report (pp. 62-68).

At the moment the candidate countries experience very different monetary arrangements and policies (Begg 1996 and 1999; Cottareli 1999), but in the process of their EU, ERM2 and EMU accession they will have to adjust their monetary arrangements in the not so distant future to the requirements of the single monetary European policy. In other words, they will have to prepare to make their monetary policies more and more compatible with the single European monetary policy.

This is also the result of legal requirements in the process of accession negotiations and adoption of the *aquis communautaire* in the field of EMU, which put additional constraints on monetary policies of the candidate countries. They have to make their central banks independent, completely open themselves to capital flows, prohibit direct financing of the government by the central bank and prevent any privileged access of the government to financial institutions, by the time of their EU accession. Finally, before joining the EMU and adopting the euro, the candidate countries will have to meet the Maastricht convergence criteria on a sustainable and healthy basis. These include, alongside with the two fiscal criteria, three monetary criteria, which clearly define the mandate of their monetary policies in the period before their inclusion in the eurozone. The Maastricht convergence criterion on inflation implies they have to focus on disinflation in this interim period. In the specific circumstances of these countries, to which we turn in more detail later, disinflation from present levels of inflation to the Maastricht reference value may be a demanding challenge. However, the role of the monetary policy should not be seen in isolation and overemphasised. Monetary policy should be consistent with and supported by other macroeconomic policies, particularly by prudent fiscal and income policies. Overburdening the monetary policy otherwise can result in too strict monetary policies, which may lead to unnecessary losses in output and employment, which can run against their needed catching-up process and real convergence with the EU.

At the moment, before their EU accession, the candidate countries have their full monetary sovereignty, both from the formal and from the factual point of view. Formally, they will retain their monetary sovereignty until they adopt the euro and join the single European monetary policy. Factually, their monetary policy independence is becoming more and more limited, the more they come closer to fixing the exchange rate and to liberalising their capital flows. With the entry in the EU and ERM 2, their exchange rate policies (and for that matter, their economic policies in general) become the matter of common concern, which means subject to coordination and surveillance. Those candidate countries, which already completely liberalised their capital flows and completely fixed their exchange rates (currency board regimes) or are planning to do so in the near future (unilateral euroisation) are giving up their factual (if not yet formal) monetary sovereignty. In this respect they are already in a (unilateral) monetary union, as their monetary policies are completely tied to the single European monetary policy.

During the last decade, several economies in transition have achieved both monetary and real stabilization. In many cases, this has been a remarkable story of success. Partly in retrospect and partly looking forward, it seems natural to pose three questions: (i) how did monetary stabilization take place? (ii) could it have been faster or, instead, would a more gradualist approach have reduced the costs of stabilization? (iii) once the process of disinflation has been largely completed, how should the strategy of monetary policy be adjusted, in particular to take into account the aspiration to EU and EMU membership?

On the face of it, the first question is the hardest to answer. Re-constructing and interpreting the history of disinflation in those countries may seem an adventurous task. Reading the official policy reports of some central banks

during the past decade, one often encountered statements implying that: (i) monetary aggregates behaved unpredictably, (ii) the relation between money and growth was unpredictable; (iii) price indexes were unreliable and essentially responded to domestic cost pressures; (iv) there were lots of distortions arising from administrative prices; (v) changes in interest rates did not significantly affect domestic demand ...; (vi) but might instead induce undesirable appreciations of the exchange rate ...; (vii) thus fuelling into inflation (*sic*) either through the induced currency inflows or (viii) via wealth effects and aggregate demand pressures ...

What might monetary policy do in such circumstances? Things were not necessarily as bleak as they were described, and throughout the years of transition monetary policy has been a powerful and reliable tool for controlling aggregate demand. In particular the role of interest and exchange rates in the transmission mechanism from 1991 to 2000 must be investigated. By appropriately setting a moderately restrictive path for nominal and hence for real interest rates and thus inducing a controlled appreciation of the real exchange rates, monetary authorities have been able to gradually steer their economies towards single-digit inflation, while containing the output costs of the stabilization. For recent survey and interpretation of monetary strategy and stabilisation in three advanced candidate countries, see Bofinger and Wollmershaeuser (2000), Kutan and Brada (2000), Orlowski (2000).

From the point of view of candidate countries, their monetary policies should be focused on devising credible disinflation strategies, preparing themselves for the soft landing in the eurozone. Their monetary policies should be framed in the context of the process of their accession to the EU, ERM 2 and EMU, and considering their transition-specific circumstances, such as the following:

- a) The need for building up institutions (independence of central banks, supervision of the banking sector, development of money and capital markets) and to speed up structural reforms in the real and financial sector;
- b) Special importance of the exchange rate (as small and open economies) and exposure to capital flows, particularly before their EU entry, but perhaps also in the ERM 2 period before their accession to the eurozone;
- c) The need for real convergence and catching up, leading to their exposure to transition - specific price dynamics (Ballassa-Samuels effect – trend appreciation of the real exchange rate).

## **6. Inflation targeting**

Taking into account the fact that a number of candidate countries switched recently to inflation targeting, we conclude this section with a discussion on the scope of inflation targeting as a possible monetary strategy for transition economies of the candidate countries. Recent literature has analyzed in depth both the pre-requisites and the specific characterization of an inflation targeting policy strategy, also in the context of emerging economies, and among them, transition economies. Mishkin (2000) suggests that an inflation targeting strategy encompasses five main elements: (i) announcement of targets, (ii) institutional commitment to price stability, (iii) information-inclusive strategy (iv) transparency of strategy (v) accountability of central bank for attaining the stated objectives. Amato and Gerlach (2001) observe that these criteria, while they capture the spirit of inflation targeting, "are not very helpful in formally defining this policy framework" and suggest that "inflation targeting is best thought of as a range of strategies". This observation is correct, and we think that it should not be interpreted as a criticism of Mishkin. The point is that almost all "strategies" which are not formulated in terms of a stringent rule should best be thought of as defining the policy *framework* chosen by the central bank with respect to other macro agents (the government, financial markets, price and wage setters). For instance, as von Hagen (1999) succinctly states with respect to the monetary-targeting strategy of the Bundesbank: "Money growth targeting served the Bundesbank a number of politico-economic functions: It marked the end of the old regime where the Bank was powerless to control monetary conditions in Germany; it defined the central bank's monetary policy goal and its role in the macro economic policy game; and it served

as a focal point in council meetings, strengthening the pursuit of a consistent monetary policy geared at price stability over time". We suggest that inflation targeting strategies for Central and Eastern European candidate countries have analogous politico-economic functions. In particular, the adoption of an inflation targeting strategy by these countries may be interpreted as a clear *signal* that:

1. The central bank is committed to price stability.
2. The goal of price stability is in close sight.
3. The central bank is independent of the government and other actors on the macroeconomic scene, who might in their turn be engaged in the pursuit of other goals. The independence of some central banks of transition economies is assessed in Cukierman, Miller and Neyapti (2001).
4. The financial position of the government is sustainable without recourse to monetisation. Hochreiter and Rovelli (2001) discuss this point in greater detail.
5. The exchange rate policy is not (or not any longer) to be seen as the main anchor (or intermediate target) of the disinflation policy - in particular, since the latter has been almost completed, the pre-announcement of a rate of crawl no longer plays a central role in the strategy for disinflation (see Szapary and Jakab (1998)), which in turn is a pre-requisite that ...
6. Inflation forecasts have become the main intermediate target, the announcement of which helps to anchor inflation expectations
7. The central bank will adopt an "all-inclusive" information stance, looking at the determinants of inflation within a structured and broad analytical framework, without placing specific emphasis on the role of monetary aggregates.

We think that these seven "signals" convey the role and purpose of inflation targeting in most emerging countries, and also with specific reference in the candidate countries (Kutan and Brada 2000 express a different opinion on this issue). However, for those signals to be meaningful, some prerequisites must be satisfied. Amato and Gerlach (2001) list four such preconditions: (i) central bank independence; (ii) sound fiscal policy; (iii) resiliency of the economy to changes in interest and exchange rates; (iv) need for econometric models of the inflation process and the transmission mechanism. They also point out, however, that these preconditions "apply equally well to *any* other monetary policy framework". This observation should imply that, to the extent that monetary policy has been successful in bringing about disinflation, the above prerequisites must have been satisfied also in the past, at least to some extent. In fact, this seems to have been the case: as a proof *by contradiction*, for instance, several authors have pointed out that temporary setbacks in the process of stabilization have occurred at times when fiscal policy has behaved inconsistently, and central bank independence has been side-stepped (Begg 1998).

## **7. Evidence**

But what about the econometric evidence on the inflation process and the transmission mechanism? On the one hand, it is easy to point out that the size and sophistication of money and financial markets, and the composition and quality of bank portfolios, have improved considerably in the course of transition. Thus the channels of transmission must have evolved somewhat. Also, the productive sector has been subject to considerable restructuring, so that in principle one might expect to find some evidence of instability in the equations that reflect the pricing-setting behavior of producers or their sensitivity to the cost of capital. On the other hand, it is also true that in some of the advanced candidate countries the basic structure of money markets was already in place at the beginning of the 1990s, and interest rates have been liberalized towards the beginning of the decade. Hence, the extent to which the macroeconomic features of the transmission mechanism have remained stable, in a broad sense, throughout this period is largely an empirical question.



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## **b. Social Dimension**

### **The Social Dimension of Regional Integration – Survey of Research**

*by Achim Kemmerling - Berlin group*

#### **1. Introduction**

The stabilisation of newly emerging economies and democracies is the primordial strategic argument of those who advocated the eastward enlargement of the EU shortly after 1989. Since then, more and more critical observers have pointed out potential political risks and harmful by-products of the enlargement process. This debate has triggered research on the 'social dimension' of the enlargement process. In the line of this research, this review surveys theoretical approaches of both economics and political science by differentiating the subject-matter of this dimension into two aspects: On the one hand, the social dimension has to be distinguished between countries that are already member of the EU and those that are candidates for accession. The logic of factor market integration generates different and, at times, opposite effects for both groups. On the other hand, the overview combines three related, yet distinct fields: changes in factor allocations, the transformation of welfare states, and implications for the EU-level.

The first section of this review probes into the political economy of factor allocation, which is likely to be changed by the enlargement process. It analyses the problems of sectoral change triggered or, at least, accelerated by regional integration. For the social dimension, the factor of highest relevance is labour. Here, questions arise such as who potential winners and losers of enlargement are, in terms of employment and income. In turn, unemployment, income inequality and poverty are the three most sensitive issues for political debates touched in this section. How do these societal changes transform political responses of voters, parties and interest organisations? The nexus of socio-economic outcomes of the enlargement and the political stimulus generated by these is one of the prime questions of this review.

In the following section, the survey deals with a broad array of topics covered by the term 'welfare state'. The reallocation of factors of production automatically induces changes in the demands for individual welfare state policies and in the constraints imposed by the process of integration. In addition, the enlargement leads to problems of collective action between current and future EU welfare states. Among these issues, divergent social standards and social transfer systems with different degrees of redistribution raise concerns for the stability and efficiency of an enlarged EU. Another point in case is the issue of collective wage bargaining systems in European countries. The double task of adjusting to both the EMU and the eastward enlargement will lead to significant changes in the configuration of these systems and their outcomes.

The last section of this survey goes beyond the national level of analysis and investigates some of the implications for the EU-system. The first part of this section briefly discusses approaches of how to model the political decision-making process in the EU. It focuses on the political economy literature and, specifically, on the idea of a two-level game taking place in the EU. The second part analyses the formation of policy positions adopted by national governments. Interest groups and the public opinion have an important influence on a range of accession-specific policy areas such as migration or FDI. The third part looks at the EU-level of policy making. National preferences are mediated through bargaining institutions within the current EU and the negotiations in the verge of the enlargement process. This implies changes and re-distributive quarrels in EU policy areas such as budget and social policies. In addition, the very bargaining mechanism, for instance the voting rules in the European Council, are put under pres-

sure by the enlargement process. Hence, a final feedback loop has to look at possible sources of political risks for the overall stability of EU and EMU institutions.

## **2. The political economy of factor allocation**

The Eastward enlargement will induce clear distributive effects for various groups of factor owners. The shaping of goods and capital markets already triggers sectoral change in national economies and enhances flows between them. Both phenomena will have an impact on political actors and the demands for policy-making.

Winners and losers of goods market integration: The four freedoms of factor movements constitute the core of the Single European Act (SEA) adopted in 1986. Contrary to traditional models of trade theory, the abolition of trade barriers has led to comparatively small changes in the pattern of intra-EU trade flows (Bieling and Deppe 1996). This is mainly due to relatively homogenous factor endowments and heterogeneous product specialisations that have led to significant proportions of intra-industrial trade. Moreover, sensitive sectors such as agriculture have been excluded from full competition to a considerable extent. Hence, so far the EC has tried to minimise the costs of sectoral change, a fact that has greatly alleviated the societal pressures from disadvantaged sectors (*ibid.*). Equally, most of the intra-European FDI is dedicated to the expansion into new markets rather than to genuine re-location of plants. Correspondingly, competition about scarce physical capital (*Standortwettbewerb*) has, so far, been of minor importance.

The concomitant processes of monetary integration and eastward enlargement, however, might induce bigger changes. Factor endowments are much more diverse between EU-members and accession countries (Boeri 2000). Agriculture in Eastern Europe seems to be particularly prone to major transformations in the short, run due to low levels of productivity (Baldwin *et al.* 1997; Weise 2001). Additionally, transition economies typically show symptoms of a 'perverse' specialisation in trade patterns as they export homogenous, capital-intensive products of their industrial legacy (Boeri 2000). Public subsidies, incompatible with EU-norms of common market regulation, have sustained these trade patterns and have stirred complaints of producers in EU-countries.

In anticipation of these threats Polish farmers, among others, begin to show indications of militancy against EU-accession. In general, rising political unrest may lead to backlashes either against the process of enlargement in general or against trade liberalisation in particular. A recent study (Facchini and Willmann 2001) showed that up to a sixth of the population in OECD-countries is affected by changing trade patterns and acts as clientele for protectionist political lobby groups. Although the degree of organisation of political veto power might be lower in Eastern Europe – import competing industries are weakened by the transformation process –, the large extent of people affected by trade integration and FDI-location could more than compensate this; the result would be even higher levels of political protest.

Albeit to a lesser extent, similar processes are possible in current member states, especially in those that share borders with accession countries. Although the overall extent of trade and FDI re-direction may be small, some sectors such as textile and metal industries are already exposed to high levels of eastern competition (cf. e.g. Quaisser *et al.* 2000), whereas producers of chemicals and machinery are – so far – beneficiaries of increasing trade with Eastern Europe. Saksen and Sørensen (2001) discuss the question under which circumstances trade unions and employees may find foreign direct investment beneficial for themselves. They conclude that this depends mainly on the kind of task that is performed abroad. If this task is highly complementary (substitutionary) to the production at home, workers will accept (oppose) FDI. Correspondingly, political reactions of trade unions follow this pattern: as long as FDI in CEECs is clearly market-expanding, resistance will be low. The more attractive CEECs become for the core business of western European enterprises, the more likely '*Standortwettbewerb*' becomes a political issue.

The general economic framework to discuss distributive effects of goods market liberalisation is the specific factors model (e.g. Krugman and Obstfeld 1997). According to the static version, owners of factors that are specific to exports – owners of capital in Western Europe and owners of land and primary resources in Eastern Europe – gain from increasing trade whereas import-specific factors will yield less returns for their owners. In a dynamic version, Fischer (2001) shows that land-abundant countries will experience higher levels of inequality in the short run, but an immediate liberalisation of the capital account can counteract this distributive effect partially. Frieden (1991), however, argues that there is a crucial difference between long- and short-run consequences of goods and capital market integration. In the short run, liberalisation of capital accounts favours owners of unspecific assets and disfavors owners of specific assets. This approach recurs to the idea of ‘asset specificity’ developed by Williamson (1981) and shows that there are clear distributive consequences within factors of production such as capital and labour. Industry-specific knowledge of workers in those sectors that are declining is an important example of specific assets and generates political responses such as lobbying (Alt *et al.* 1999). Given the fact that most transition economies start from perverse specialisation trade amplifies the distributive and political effects.

Finally, the dynamic approach is completed by the incorporation of factor price evolutions. The accession (or alignment) to the EMU gradually erodes two main sources of competitiveness for Eastern European countries – low exchange rates and low unit labour costs (Boeri 2000). In this respect, the mobility and flexibility of labour markets is a prime concern for an enlarged EMU in a double sense: on the one hand flexibility is necessary to stabilise the gains of a common currency (e.g. DeGrauwe 1997; Bolle and Neugart 2000); on the other hand flexibility and labour mobility will lead to changes in factor prices. The latter point implies that comparative advantages and the division of labour between West and East will change and that this induces new waves of structural change in an enlarged union.

The Politics of Labour Markets: Migration, Unemployment and Poverty: Unemployment, poverty and migration are key issues for labour market politics. In relative terms, the impact of capital and trade flows on Western Europe seems to be rather small. For example, aggregate FDI outflows of EU-countries to CEECs account for less than one per cent of total outflows. However, as far as labour markets are concerned, Eastern Europe is no ‘quantité négligeable’ (Boeri and Brücker 2001). The population of CEEC-10 countries adds up to 28 per cent of the people currently inhabiting the EU. In addition, although factor price equalisation may be feasible in the long run, there is consensus in the academic community that in the short- to medium-run high differences between real wages in Western and Eastern Europe will persist (Boeri and Brücker 2001; Sinn 2001). Hence considerable amounts of labour migration will be a likely consequence. Once again, the overall effect of migration on Western European labour markets may be small, but some regions and economic sectors will more likely be hit than others (*ibid.*).

Due to labour market asymmetries, immigration may be beneficial for some sectors as in the case of German farmers that highly welcome Polish and Czech seasonal workers. For sectors such as the construction industries (illegal) migration of workers produces adverse consequences for the native work force and creates political pressures from sector-specific trade unions.

In more general terms, given the assumptions of classical trade theory, skilled workers are the beneficiaries of immigration of low skilled workers to Western Europe, whereas the situation in Eastern Europe is vice versa (Söllner 1999). The problems of insiders and outsiders in European labour markets could further aggravate the situation (Bolle and Jacobsen 2001): less wage flexibility is bought with higher unemployment ratios for unskilled workers.

From the perspective of voters and the public opinion, the issues of immigration and national unemployment seem to be contradictory. At least in current member states, inflows of Eastern workers are perceived to be unduly stress-

ful for tight labour markets. Hence, the political response to immigration in Western Europe might be much bigger than the actual economic effect on labour markets. In candidate countries, west-bound migration is ambiguous. On the one hand, emigration constitutes an example of 'human brain drain' and could lower the rate of skill-driven growth in these countries. On the other hand, national governments in candidate countries may be tempted to solve national labour market problems by exporting labour force.

In 1999 national unemployment rates ranged between 4.7 per cent in the Czech Republic and 10.5 per cent in Poland. These figures do not seem to be excessively high in comparison with the average EU-rate of unemployment of 8.8 per cent. (Rosenberg 2000). A number of caveats, however, are in order. First, these statistics are not always reliable and probably underestimate the true values. Second, systems of unemployment benefits are much less benevolent than those of EU-countries (cf. European Parliament 1998). Thus, unemployment is a bigger poverty risk than in the current member states. Third, unemployment rates have been criticised as a vague indicator of true labour market performance (e.g. Scharpf 2000). A closer look at the employment rates (as per cent of working-age population) reveals a decreasing capacity of Eastern economies to generate jobs. The rates of labour force participation before transition have been continuously declining so that, in some Eastern countries, they are now way below the EU-average of 69.9 per cent. Moreover, reduction of labour force participation hits some segments of the population more heavily than others. For instance, more and more women experience a trade-off between work and family, which had not been the case before transition set in.

All things considered, there are good reasons to emphasise the links between employment and poverty, above all in Eastern European countries. The political problem of poverty, in turn, is related to the issue of income distribution of rapidly growing economies and between these economies (Kittel 2001). In the intra-societal dimension, traditional approaches to income inequality are not viable given Eastern transformation experiences. 'Leading' transformation economies do not show the seminal inverse (Kuznets) relationship between growth and inequality (Brezinski 2001). The so-called 'transatlantic consensus' (cf., e.g., Hölscher 2001) explains rising inequality in OECD-countries with demand shifts from unskilled to skilled workers. Exogenous shocks such as growth in trade or technology changes raise the wage premium of highly qualified workers. This model excludes significant determinates of inequality such as institutional settings of wage bargaining and the role of human capital. Moreover, it assumes that wages are the driving force of income distribution and neglects other sources of income (Hölscher 2001). Similarly, other approaches of modelling the link between growth and income distribution show serious shortcomings. One of the most important issues for income inequality, the accumulation of human capital, and its link to the emergence of capital markets in transition economies is still under-theorised (Hölscher 2001). Yet the proliferation of education and other 'trickle-down' mechanisms are of crucial importance for the legitimacy of the enlargement-cum-transformation process in the CEECs.

Viewed through a 'political lense', internal distribution of income is, on first sight, not conspicuously unequal when measured against EU standards (Bolle and Jacobsen 2001). In 1999, Gini-coefficients settled around the EU-average 0.29. In none of the CEECs inequality grew excessively during the last decade (Brezinski 2001). However, a relatively equal income distribution at the on-set of the decline in output (early 90s) means that a big proportion of the population has been exposed to poverty in the transition period (cf. Przeworski 1999). This suggests that not only more but also *less* inequality could be a source of social unrest in the future if shocks force major proportions of the population below the poverty line.

### 3. The transformation of the welfare state

The transformation of welfare states is the second main issue for the social dimension of eastward enlargement. It is directly linked to changes in factor allocations through the channels of the labour market and the funding of the welfare state. In the following, three different forms of regulation are differentiated. First, differences in social security standards will be discussed. Such standards may include classical working place safety regulations as well as other non-monetary social standards. Second, social security may be regulated in terms of direct or indirect social transfers to (targeted) segments of the population. These regulations imply a certain level of redistribution of the national product on a quantitative level. Third, regulation may be directed to the labour market and, more specifically, to the procedure how wages are negotiated. In this respect, the level of bargaining and the degree of state intervention are important institutional features determining macroeconomic outcomes such as unemployment and wages.

At times, these three forms may be fused, but for the analytic purpose of detecting the consequences of eastward enlargement, it is essential to keep them separated in the following sections (Sinn 2001).

Social Security and Labour Standards: The issue of labour and social security standards across Europe is a controversial one and leads to diverging policy conclusions. The European Commission (1999), for example, favours the maintenance of comparatively high standards in incumbent member states. However, the variation of these standards is quite high even within Europe, and to many observers the level is excessive for the future economic integration of the EMU (Bolle and Neugart 2000; OECD 2000; but see Nickell 1999). Hence, even on the side of current member states it is not quite clear to which level common standards should finally converge. Moreover, there are obvious strategic interests of wealthier states vis-à-vis poorer member states (Scharpf 1996). Whereas poorer states favour low levels and the non-coordination of these policies, wealthier countries, given that they indeed share higher standards, fear a deregulatory downward spiral.

The accession of transition economies complicates the picture further. Sinn (2001) rejects the fear of social dumping – East vs. West – on the basis of two assumptions. First, factor price equalisation will eventually erode competitive advantages of CEECs. Second, levels of social security regulation are evolving across time as an increasing proportion of national income, i.e. wealthier countries share higher social standards. Unfortunately, both assumptions are rather strong. As mentioned before, the convergence of factor prices in an enlarged EU will take quite some time. Moreover, cross-national comparisons of welfare states show a diverse pattern of levels of social security regulation even between states with similar levels of income (Esping-Andersen 1990; Scharpf 1997). Policy conclusions are thus, so far, very contradictory. Sinn (2000; 2001) argues against harmonisation and standardisation of social security between countries with different levels of national income. A paradigmatic worst case is, in his eyes, the German unification, as Germany has spread social security standards too fast over Eastern Germany. This has had detrimental impacts on the productive basis of the whole region and has made it necessary to transfer major social payments towards Eastern Germany. In general, a premature adoption of the social acquis is seen as an obstacle to further economic growth. Advocates of harmonisation in both academia and politics, however, fear that less social regulation in Eastern Europe will lead to enduring, but unjustified, competitive advantages for these economies.

Social Security Systems: Sinn (2001) carefully distinguishes between non-monetary social security provision and social transfers. As the latter show a re-distributive component, social dumping is even possible in the case of an incentives-compatible social security system (Sinn 2000). Correspondingly, most observers assume high non-wage labour costs to be a serious problem for relatively benevolent welfare states. This is due to the fact that capital owners or wealthy individuals would choose low levels of social security whereas poor people would opt for bigger

social spending. Comparative statics shows that increasing pressure on western social security systems is, *prima facie*, not a necessary consequence. For example, higher inflows of young labour into aging Western societies can contribute to the stabilisation of pension and health care systems (Weise *et al.* 2001). A dynamic perspective would argue for more than less pressure on social expenditures as integrating capital markets will lead to increased risk premiums for the funding of welfare states (Bolle and Neugart 2000; Garrett 1998; Mosley 2000).

The previous remarks imply that the enlargement process aggravates welfare state problems on the revenue side. In that respect, it will interact with the consequences of increasing monetary integration on fiscal policies (De Grauwe 1997). As long as common tax policies remain unachievable given the bargaining mechanism of the EU (e.g. Genschel and Pluemper 1997), the opportunity costs of social spending will rise in current EU-countries.

In addition, the economic transition in Eastern Europe affects 'emerging' welfare states profoundly. Structural changes and the vanishing of entire industries raise the demand for additional social transfers, whereas most countries face increasing problems of financing their systems. Among other things, this is due to intrinsic problems of the transition process, for example imperfect systems of tax collection (Schaffer and Turley 2000). The economic integration of mature and benevolent welfare states in Western Europe with recently transformed pendants in Eastern Europe will create new problems. On a macroeconomic level, budget constraints of the EMU will impose severe restrictions on the reorganisation of social security in Eastern Europe. On a microeconomic level, competition could lead – among other things – to 'tourism' for social security provision, e.g. health care (Sinn 2001).

From a political economy perspective, the function of a welfare state is more than its material transfer of wealth and security. The fact that most welfare states focus their re-distributive system on the middle classes – these are generally the main contributors *and* beneficiaries of social transfers – illustrates the important role of social security systems as a source of political legitimacy. This has been observed for both Western and Eastern European welfare states (Korpi and Palme 1998; Heller and Keller 2001). Hence, political repercussions of welfare retrenchment could have a bigger impact than expected. The literature of the new political economy has, so far, little to say about the phenomenon of intra-personal redistribution. Standard approaches to the explanation of social expenditures in advanced economies mainly deal with the issue of inter-personal or, at most, inter-temporal redistribution (e.g. Meltzer and Richard 1991). An interesting point of departure is – once more – the concept of asset specificity. Iversen (2001) shows that workers with relatively high levels of firm- or industry specific human capital favour higher levels of taxation and social spending as they want to avoid major losses in income once they become unemployed. In general, a prime concern when dealing with the social dimension is to find appropriate models for the political demand for welfare policies.

One of the most prominent political problems is the question of portability of social rights. Although some convergence in the levels of social transfers will be achieved in the next years, institutional differences are too large to be completely harmonised. A perfect portability of social rights could lead to an increase of competitive pressures on relatively benevolent welfare states. Therefore, Sinn (2000), for example, favours a home-country principle that would allow for maintaining different standards while achieving high levels of labour mobility. Another suggestion is to harmonise social security on a European level according to relative national wealth (Scharpf 1997). Both ideas have not been without critique, but they epitomise the contemporaneous debate about a common 'European social model' (e.g. Abraham 2000; Kittel 2001).

Social Dialogue and Income Policy: The bargaining process of the industrial partners is the third aspect of relevance for European welfare states. In general, the EMU has broad implications for the industrial relations in member coun-



tries. In particular, income policy in a monetary union is a 'double-edged sword' (Abraham 2000): strategic interaction might induce excessive wage moderation or acceleration depending on the institutional context of fiscal and monetary policies as well as the underlying economic assumptions (e.g. Soskice 1999). Whereas differences in wage moderation across countries lead to 'wage dumping', strategic coordination failures lead to wage drift and inflation.

The macroeconomic outcome of industrial relations across an enlarged EU will be contingent on the relative bargaining power of trade unions and employers' associations. In most accession countries organised industrial relations and trade unions in particular are rather weak. There are, however, important exceptions such as Poland where the two main unions as well as the sector of public employees are traditionally very influential (European Parliament 1998). Moreover, the state looms large into wage negotiations in some CEECs and impedes a clear-cut division of labour between governments and social partners (Gruber and Höpfl 2000).

Even within the current EMU, collective bargaining systems are highly diverse (e.g. Traxler 1998; Iversen 1999). Differences not only occur in terms of outcomes such as wage moderation and compression, but also in terms of the institutional structure: the level of wage bargaining, its 'encompassingness' of relevant actors etc. There is a rapidly growing literature on the economic consequences of different institutional features of wage coordination. Calmfors and Driffils (1988) build a model that includes external effects and product market competition. They conclude that system with industry-wide wage coordination leads to the highest wage pressure, whereas both decentralised and centralised systems perform better. Other approaches make the link between wage bargaining institutions and economic performance contingent on the role of the central bank and its monetary policy (Hall and Franzese 1998; Iversen 1999; Scharpf 1987).

Hence, the specific nature of how to organise social dialogue on the European level is a contested issue. Such diversity notwithstanding, the strategic importance of social partners in most welfare states, makes their participation in the process of Eastward enlargement essential. At the same time, the eastward enlargement increases the credibility of relocation threats of employers vis-à-vis trade unions. Correspondingly, the impact of Eastward enlargement exceeds the actual level of plant relocation, i.e. FDI, and weakens the position of Western European trade unions (Kittel 2001).

All things considered, the concomitant evolutions of the EMU and the Eastward enlargement leads to a decentralisation of wage bargaining and an increase in wage inequality both within and between national economies. Coordination and the reform of wage bargaining systems are key issues for both incumbent member states and accession candidates. It is commonly assumed that high unemployment rates are the key source of instability for a future enlarged EMU (Bolle and Neugart 2000). The specific roots of unemployment are, however, multiple. Hence, the reduction of so-called labour market rigidities seems to be necessary, but the successful implementation hinges on the political support of broad segments of the population. Moreover, there are several 'roads' that lead to reduced rigidities, some of them already practiced in EU-member states. Dutch and Danish versions of 'flexicurity', for instance, combine higher labour market turnover and less job and wage security with social policy 'cushions' (e.g. Wilthagen 1998). In general, the interlocking of social transfers and taxation with labour market regulation will be a principal area of future investigation and policy advice in order to secure the Commission goals of 'employability' and 'social cohesion'.

#### **4. Political risks of enlargement in the European Union**

The eastward enlargement affects the production and distribution mechanisms in both member and candidate countries. So far, this review only mentioned the consequences of changing factor allocation for different segments of the population and their demand for welfare states. Therefore, the next step in the analysis has to proceed to the

EU-level and to deal with possible feedback loops for the political process of enlargement. Models of modern political economy guide the analysis of the connections between political processes on different levels of the decision-making system and their socio-economic outcomes.

Modelling the EU bargaining system: According to modern political economy, the political decision-making process of the EU is frequently modelled as a two-level game (e.g. Putnam 1988). The first level of analysis takes place within nation states. National governments are conceived to be utility maximising and receive two sorts of supports: votes from the population and campaign contributions from interest organisations (e.g. Facchini and Willmann 2001). Governments transform preferences – for instance, the preference for being re-elected – into national policies and bargaining positions on the EU-level.

The concomitant ‘shocks’ of the formation of the EMU and the eastward enlargement have already begun to reshape national markets and their respective societies. This transformation determines the economic and political performance in individual countries and thus influences the preferences of the nation states as the principals on the second level of analysis: the EU. A basic conceptualisation of the EU is to consider it as a negotiated framework for future negotiations between nation states that have given up – voluntarily – national sovereignty rights. For principal changes of common policy areas, principals themselves bargain according to defined voting procedures in the European countries (e.g. Tsebelis and Garrett 2001). On the level of policy implementation, these principals deal with a couple of agents such as the Commission and the European Central Bank. Given this briefly sketched framework, the analysis turns to each level.

Endogenous Policies on the national level: On the national level of policy-making, political-economy models deal with the endogenisation of policy positions towards factor mobility between the EU and candidate countries. As previously mentioned, government behaviour is assumed to depend on bids from interest organisations for specific levels of protection (e.g. Facchini and Willmann 2001; Grossman and Helpman 1994). Governments optimise their pay-offs from these organisations and the level of political support from voters.

Empirical examples of processes subject to political pressures are manifold. German trade unions, for instance, lobbied heavily for the postponement of the freedom of settlements between the EU and the accession candidates. The mirror image of such a restriction is the delay of free investment of EU-citizens in CEEC-estates. Both policies are concessions to organised interests and the general public opinion that may be tilted against an (rapid) accession of candidate countries without such exemptions (Heinemann 2000; Weise *et al.* 2001). Package deals or compensation payments are another method how bargaining proceeds. As already happened in the case of EU-CEEC negotiations about migration, the current member states will face demands of monetary compensations from the accession countries (Lavenex 2001) and other member states to guarantee the support for exemptions. In more general terms, a high influx of labour into Western Europe could evoke xenophobic reactions and the rise of right-wing parties. Although so far no significant connection between voting behaviour and the Eastward enlargement is visible (Kittel 2001), governments include this possibility in their calculations and try to mitigate or absorb such tendencies once they threaten their re-election chances.

The bargaining between the EU and the CEECs is not conceivable without an account of asymmetries in the bargaining power of both sides. Oatley and Nabors (1998) show for the case of international banking regulation that international cooperation is not merely a process of how to acquire an international public good efficiently. International cooperation, which the enlargement negotiations are just a particular example of, also implies redistribution of private goods. Equivalently, current member states try to minimise the costs of accession and hence offer little

willingness to concede major changes in the status quo: candidate countries have to accept the *acquis* without further amendments in the long run.

Endogenous Policies on the EU-level: Both the estimated changes in factor movements and the specific problems they pose for welfare states will automatically touch the level of the European Union in at least three different aspects: it will change the demand for and the supply of financial transfers across countries; it will change the requirements for a common European social policy; it will have implications for the institutional setting of EU and EMU.

The EMU offers a very limited menu of policy options for dealing with (asymmetric) shocks on the national level. However, the accession of Eastern European economies will, more than anything else, increase the likelihood of potential asymmetries and disparities in the short run. Income levels, for example, are markedly lower in the candidate countries. In per cent of average EU-figures for 1999, per capita income ranges between 37 (Estonia) and 63 per cent (Czech republic) (Weise et al. 2001). Consequentially, increased political demand will penetrate the EU-level of policy making. Estimates of the absolute volume of budgetary costs of the Eastward enlargement still differ considerably (e.g. Baldwin *et al.* 1997; Weise et al. 2001) but do not seem to be excessive. However, dealing with the 'social dimension', the relative distribution of gains seems to be of more relevance than absolute cost measures. Specifically, enlargement induces a pork-barrel style of budget politics as old regions, so far subsidized via structural and cohesion funds, will compete with new regions with lower levels of income. The last EU-summits have already shown a considerable level of resistance coming from current net recipients of EU-cash (Weise et al. 2001). For instance, 27 out of 60 regions subsidised according to objective one for structural funds would rise above the 75 per cent ceiling of an EU-25 (*ibid.*). Thus, cohesion funds and CAP-cash are unlikely to be extended to accession candidates on a one-to-one basis, although the demand for funding the convergence process of an enlarged EMU may be even higher than in previous accession rounds.

The adoption of the qualified majority voting rule in the Maastricht Treaty has significantly affected future changes in an enlarged EU. New member countries could use their combined interests to shift European social policy towards their own specific needs. At the same time, an increase in labour mobility will add new demands to the traditionally heterogeneous European social policy (Geyer 2000). EU programmes such as anti-poverty measures and unemployment targets will have to be extended to specific problems of transition economies. In addition, some of the policy recommendations mentioned so far – for instance the home-country principle for social benefits – directly contradict the social *acquis* (European Parliament 1998; Sinn 2000).

Potential 'looser countries' of an EU-enlargement, namely current net beneficiaries will try to freeze the current status quo before newcomers will have their saying (Heinemann 2000). The result of the Nice summit may be interpreted along these lines. The establishment of multiple qualified majority rules, increases the number of 'veto players' in the bargaining system. This, in turn, reduces the chances of re-negotiating policies in an enlarged EU if the results contradict the preferences of current member states (*ibid.*). Hence, the anticipation of Eastward enlargement already constitutes a serious test for the bargaining mechanisms of member countries in the EU-Council (e.g. Kandogan 2000; Schröder 1998; Tsebelis and Garrett 2001).

In spite of the attractive growth perspectives of an enlargement, the Eastward integration bears some political risks on a systemic level. These risks can emanate in processes of destabilisation of EU institutions and the membership of individual countries in these institutions. Currently, a drastic example is Argentina, where a prolonged fiscal crisis in combination with a permanently fixed exchange rate has led to severe civil unrest that, in turn, threatens the viability of the Argentine currency board. Obstfeld's (1994) interpretation of the EMS crisis points in the same direc-

tion. In the early 1990s, growing public dissatisfaction with the economic conditions (unemployment) led to a reduced credibility of the EMS. More generally, postponing accession may lead to hostility towards enlargement in candidate countries and so does a rushed adoption of the *acquis* given that the latter induces higher adjustment costs. Last but not least, the fragile democracies in Eastern Europe might face problems of legitimacy once these countries will have transferred their barely experienced democratic sovereignty to the European Union, a supranational body notorious for its democratic deficits (e.g. Beyme 1994).

## 5. Conclusion

Without doubt, the Eastward enlargement offers major benefits for both current member states and accession candidates. In order to 'harvest' these benefits, an enlarging EU has to tackle some of the actual and potential social risks deriving from the integration process.

Three cardinal sources of these risks have been discussed in this review: consequences of changing patterns of factor allocation, the transformation of welfare states and new demands and problems on the European level. The mobility of labour will be of decisive importance for the stabilisation of an *Ezoneplus* and is, politically, a highly sensitive issue. Furthermore, processes of sectoral change will be accelerated by the accession process and will make measures of 'social correction' inevitable. The analysis of the transforming welfare states poses important questions about the coexistence of different standards and monetary levels of labour and social security. In addition, the changing role of income policies across the EMU suggests the consideration of industrial relations in the wake of integration. On a European level, candidate and member states may face new demands for protectionism. New conflicts about the distribution of EU-funds may emerge, and the demands for a common social policy will change. Finally, the interaction of political, social and economic sources of risks is the underpinning for the entire analysis of the social dimension in an enlarged EU.

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