CHAPTER IV ACCESSION OF TRANSITION ECONOMIES TO THE EUROPEAN UNION: PROSPECTS AND PRESSURES

The first decade of transition for the countries of central and eastern Europe and the Baltics (CEECs) was marked by a substantial reorientation of their economic and institutional focus toward western Europe. A significant milestone during the second decade of transition is likely to be the formal accession, of at least the countries more advanced in the transition process, into the European Union (EU). The EU has accepted as full candidates for accession ten of the transition economies—Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic, and Slovenia—together with Cyprus, Malta, and Turkey. Detailed negotiations for entry are currently underway in most cases.[1] Although such an enlargement will almost certainly occur in stages, the accession of the ten transition country applicants would increase the population of the EU by more than one-quarter and its surface area by around one-third. The "economic" size of the EU would increase by much less, however, reflecting the much lower levels of income and wealth in the accession countries: GDP on a purchasing-power-parity (PPP) basis would increase by 11 percent, while average GDP per capita would decline by 13 percent.[2]

The goal of EU accession has become one of the key driving forces behind the adjustment and reform efforts that these countries are actively pursuing. Looking beyond EU accession, the prospect of subsequent currency integration through the European Economic and Monetary Union (EMU) provides a further anchor both for monetary policies in the candidate countries and also for their ongoing structural and institutional reforms. Moreover, for the EU and its current members, enlargement is providing an important opportunity and incentive for their own reforms, so that the EU is ready economically and institutionally to accept new members.

This chapter assesses some of the likely benefits, costs, and risks in the accession and convergence process, looking both at the nearer-term prospect of EU accession and at potential euro area membership over the longer term. In particular, by considering the main institutional, microeconomic, and macroeconomic dimensions of EU and euro area enlargement, the chapter aims to address the following questions:

- *Net gains from accession:* What are the prospects of substantial net economic benefits for the candidates (e.g., from further trade and financial market integration), and also for the EU? Are such benefits likely to occur in the short-term, or are they of a longer-term nature?
- *Potential pressures and risks in the EU and EMU convergence process:* How do financial sector development and supervision in the accession countries compare with standards in the EU? Are the accession countries equipped to implement the extensive legal and regulatory requirements of EU entry? Are concerns about large migration flows from east to west following EU enlargement justified? At what point are these countries likely to be ready to meet the fiscal, inflation, and exchange rate criteria associated with full participation in the euro area, given their need for further economic adjustment and convergence?
- *The accession timetable:* What difficulties could arise if EU accession (and later euro area par-

[1]Negotiations with Turkey have not yet begun.

[2]Based on current GDP data. As a point of comparison, the most recent EU expansion in 1995—bringing in Austria, Finland, and Sweden—and also including the reunification of Germany in 1990, led to an 11 percent increase in the EU's population and an 8 percent increase in GDP (on a PPP basis).

ticipation) occurs either too slowly, or too quickly—whether from the perspective of the applicants or of current members? Is the process likely to be prolonged and, if so, would this occur because the candidates are viewed as not ready for the EU or because the EU is not ready for them?

These questions are, in some cases, addressed indirectly. For example, benefits and risks for the applicants could arise from several dimensions of the accession process that are considered in the following sections. A concluding section brings together the main strands of the argument, links these to the questions above, and provides an overall perspective on EU and euro area enlargement.

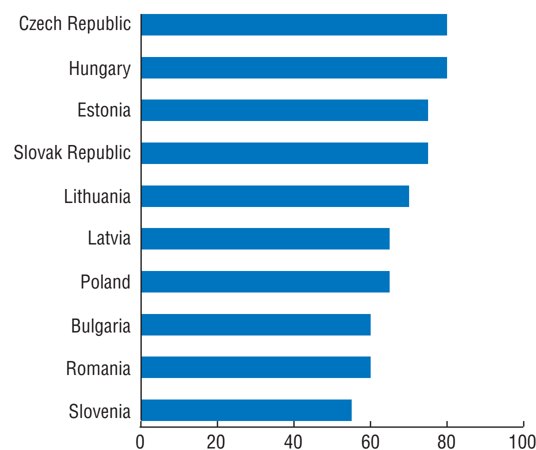
The coverage of this chapter is necessarily selective, given the complex array of economic, political, and other influences that have some bearing on the proposed enlargement. For the most part, the assessment is forward-looking; however, some background and institutionally-oriented information on EU enlargement is set out in Box 4.1 (see page 144), and some comparisons with past enlargements are presented in Box 4.2 (see page 148). The chapter focuses on the ten transition countries in central and eastern Europe noted above, in keeping with the emphasis of this *World Economic Outlook* on the economics of transition. The other candidates—Cyprus, Malta, and Turkey—are not included in the detailed analysis, given their somewhat different economic and political starting points. Some specific issues concerning Turkey's candidacy are, however, covered in Box 4.3 (see page 152).

Where Do the CEECs Stand on the Road to Accession?

As described in Chapter III, all of the accession countries have made substantial strides since the 1989 fall of the Berlin Wall in moving from centrally planned to market economies, with the private sector now accounting for over half of output (Figure 4.1). Most have also resumed growth with moderate or declining inflation although fiscal and external current ac-

Figure 4.1. Private Sector Share of Output, mid-1999
(Percent of GDP)

The EU accession countries have made substantial progress in moving from centrally-planned to market economies, with the private sector now accounting for more than half of output in each country.



Source: European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 1999).

Table 4.1. Central and Eastern European Countries: Macroeconomic Indicators

	Real GDP Growth[1]		Inflation[1]		Fiscal Balance[2]		Current Account Balance[2]	
	1997–99	1999	1997	1999	1997–99	1999	1997–99	1999
Bulgaria	–0.4	2.4	1082.2	2.1	–0.7	–1.0	–0.9	–5.4
Czech Republic	–1.2	–0.2	8.5	2.1	–2.9	–3.7	–3.5	–2.0
Estonia	4.6	–1.1	11.2	3.3	–1.1	–4.7	–9.1	–6.1
Hungary	4.6	4.5	18.3	10.0	–4.4	–3.7	–3.8	–4.3
Latvia	4.1	0.1	8.0	2.4	–1.6	–4.2	–8.4	–9.7
Lithuania	2.6	–4.1	8.8	0.8	–5.5	–8.6	–11.2	–11.2
Poland	5.2	4.1	14.9	7.3	–3.4	–3.7	–5.0	–7.5
Romania	–4.9	–3.2	154.8	45.8	–4.2	–3.4	–5.8	–3.8
Slovak Republic	4.3	1.9	6.1	10.7	–4.6	–3.6	–8.8	–5.7
Slovenia	4.5	4.9	8.4	6.1	–0.8	–0.6	–1.0	–2.9

[1]Real GDP growth and inflation are given in annual average percent terms.
[2]Fiscal and current account balances are given as percent of GDP. The fiscal balance refers to the general government balance.

Table 4.2. Selected European Countries: Economic Indicators

(1999)

	Population	GDP Level		GDP per Capita		Saving	Investment	Broad
	(Millions)	Billions of U.S. dollars	PPP weight in billions	U.S. dollars	PPP weight	Rate[1,2]	Rate[1]	Money[1,3]
Central and eastern European countries	**104.6**	**365.1**	**903.8**	**3,490**	**8,638**	**21.5**	**26.9**	**45**
1998 Group	62.4	282.5	635.9	4,524	10,184	23.0	28.4	50
Czech Republic	10.3	53.1	137.6	5,170	13,389	26.9	28.5	77
Estonia	1.4	5.1	11.8	3,585	8,223	21.3	31.0	39
Hungary	10.1	48.4	113.4	4,805	11,256	26.6	31.5	45
Poland	38.7	154.1	342.2	3,984	8,845	20.1	27.6	43
Slovenia	2.0	21.7	31.0	10,981	15,669	24.9	25.2	33
2000 Group	42.2	82.6	267.9	1,958	6,349	17.8	23.3	34
Bulgaria	8.3	12.7	42.5	1,540	5,149	12.6	18.0	30
Latvia	2.4	6.3	14.7	2,593	6,074	20.8	28.9	37
Lithuania	3.7	10.6	25.2	2,885	6,833	11.8	23.0	21
Romania	22.4	34.2	130.3	1,523	5,807	16.1	19.9	23
Slovak Republic	5.4	18.8	55.2	3,491	10,230	28.0	33.8	68
EU-15[4]	**375.3**	**8509.5**	**8371.0**	**22,672**	**22,303**	**20.9**	**20.7**	**69**
Maximum	82.1	2114.8	1940.8	43,467	36,727	25.9	26.6	96
Minimum	0.4	18.7	15.8	11,433	15,207	16.3	16.9	41

[1]Percent of GDP. For aggregates, weighted by purchasing-power-parity GDP.
[2]Excluding Luxembourg.
[3]1998 for the EU-15.
[4]The EU-15 comprise Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

count deficits generally remain high (Table 4.1). Moreover, according to the European Bank for Reconstruction and Development (EBRD) indicators of transition, the CEECs have for the most part successfully liberalized trade and foreign exchange systems and privatized a significant share of both large- and small-scale enterprises (Figure 4.2, and see below). Prices have also been liberalized, although not to the same extent. By contrast, competition policy reforms, governance improvements, enterprise restructuring, and the development of financial institutions have lagged, but to varying degrees.

All of the CEECs have made progress, but they remain a diverse group—with per capita income in 1999, based on market exchange rates, ranging from about $1,500 in Bulgaria and Romania to almost $11,000 in Slovenia (Table 4.2). The more advanced of these countries—the Czech Republic, Estonia, Hungary, Poland,

and Slovenia[3]—began accession negotiations in 1998, and are now approaching some of the current EU countries across a number of economic indicators. On a purchasing-power-parity basis, the average per capita income of the 1998 group (around $10,200) remains less than half of that of the EU ($22,300),[4] although Slovenia has a higher per capita income ($15,700) than the poorest current EU country (Greece, with a per capita income of $15,200). Other than the Slovak Republic, however, each of the countries that began accession negotiations in 2000[5]—also including Bulgaria, Latvia, Lithuania, and Romania—lags behind with lower per capita income than any member of the EU or the 1998 group. The gap between these economies and the EU is also substantially larger than the gap that existed between acceding countries and the EU during prior enlargements (see Box 4.2).

The per capita income differences among the CEECs appear to be related to how advanced the countries are with reform. The 1998 group countries are further along the transition process (as measured by the EBRD transition indicators) than countries in the 2000 group and also generally have a higher private sector share of GDP. In addition, the 1998 group also has a lower agriculture share of value added and a higher services share, consistent with these economies being more advanced along the transition and development process (Table 4.3). It is noteworthy, however, that the Slovak Republic has more similar characteristics—including per capita income, as noted above—to the 1998 group than the 2000 group.

Other indicators also confirm that the 1998 group is not only more advanced than the 2000 group (again with the exception of the Slovak Republic), but also by some measures quite similar to the EU. Saving rates for the 1998 group

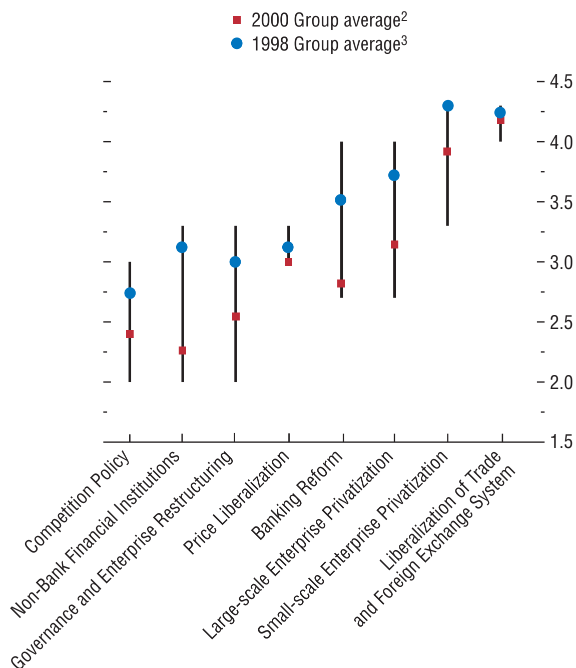
[3]Hereafter, these five countries are called the "1998 group."

[4]These differences are larger when market exchange rates are used.

[5]Hereafter called the "2000 group."

Figure 4.2. Indicators of Transition, 1999[1]

All of the EU accession countries have made substantial progress with some dimensions of transition, particularly with liberalizing trade and foreign exchange systems and privatizing both large- and small-scale enterprises. The 1998 group, however, is more advanced than the 2000 group.



Source: European Bank for Reconstruction and Development, *Transition Report, 1999* (London: EBRD, 1999).

[1]The top and bottom of each line are, respectively, the maximum and minimum for the EU accession countries. Values range from 1 to 4+, with 4+ being the highest rank and set equal to 4.3.

[2]Includes Bulgaria, Latvia, Lithuania, Romania, and the Slovak Republic.

[3]Includes the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

Table 4.3. Selected European Countries: Sectoral Value Added[1]
(Percent share, 1998)

	Agriculture	Industry	Services
Central and eastern European countries[2]	**7**	**34**	**58**
1998 Group[2]	5	34	60
Czech Republic	4	39	57
Estonia	6	27	67
Hungary	6	34	60
Poland	5	32	62
Slovenia	4	39	57
2000 Group[2]	13	35	52
Bulgaria	19	26	56
Latvia	5	29	66
Lithuania	10	33	57
Romania	16	40	43
Slovak Republic	4	32	64
EU-15[2]	**2**	**29**	**69**
Maximum	4	34	72
Minimum	1	26	62

Source: World Bank Development Indicators.
[1]For EU-15, only Austria, Belgium, Finland, France, and the United Kingdom.
[2]Weighted by purchasing-power-parity GDP.

Table 4.4. Selected European Countries: Indicators of Health and Education

	Life Expectancy At Birth (years, 1998)[1]	Secondary School Enrollment (percent, 1997)[2]
Central and eastern European countries[3]	**72**	**86**
1998 Group	73	91
Czech Republic	75	100
Estonia	70	86
Hungary	71	97
Poland	73	87
Slovenia	75	95
2000 Group	70	79
Bulgaria	71	78
Latvia	70	81
Lithuania	72	81
Romania	69	76
Slovak Republic	73	94
EU-15[3]	**78**	**95**
Maximum	79	100
Minimum	75	90

Source: World Bank Development Indicators.
[1]Except 1997 for the Slovak Republic.
[2]Except 1994 for Lithuania and 1996 for the Slovak Republic and Slovenia.
[3]Weighted by population. The EU-15 comprise Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

are in a similar range to those for the EU countries and are actually higher on an average basis. Saving rates in the 2000 group are generally lower than rates for both the 1998 group and the EU countries (see Table 4.2). Investment rates in both CEEC groups are usually higher than in the EU, as would be expected for countries that are catching up and have substantial investment opportunities. The broad money-to-GDP ratio, an indicator of financial deepening, however, is generally lower in both CEEC groups than in EU countries, except in the Czech and Slovak Republics.[6] Indicators of health and education are often used as proxies for the level of human capital.[7] In the CEECs, life expectancy at birth, while relatively high, is somewhat lower than in the EU, and although secondary school enrollment rates among the 1998 group are comparable to those in the EU, they are lower for the 2000 group (Table 4.4).

As the CEEC economies have become more market-oriented, they have also become more integrated with western Europe, with the majority of their trade and capital transactions now occurring with the EU. Nonetheless, looking ahead in particular to euro area membership, the potential vulnerability of the CEECs to asymmetric shocks is suggested by the fact that output growth and inflation in some of these countries are not as yet well correlated with the corresponding indicators in Germany, the largest EU country (Table 4.5). However, because the CEECs are undergoing substantial structural and economic regime changes—including EU accession and subsequently euro area participation itself—it is hard to predict how exposed and vulnerable the CEECs will remain to these shocks

[6]The higher ratio in these two countries, however, may reflect banking sector problems.
[7]For the CEECs, they may be weaker indicators of human capital because many of the workers in the accession economies may have inappropriate skills, gained during a period when these economies were centrally planned and before the structural changes due to transition.

Table 4.5. Selected European Countries: Correlation of Output and Inflation, 1993–99

	Germany		Poland	
	GDP growth	Inflation	GDP growth	Inflation
Central and eastern European countries				
1998 Group				
Czech Republic	0.03	0.84	0.53	0.74
Estonia	0.53	0.98	0.80	0.89
Hungary	0.75	0.43	0.10	0.71
Poland	0.37	0.88	1.00	1.00
Slovenia	0.81	0.98	0.19	0.89
2000 Group				
Bulgaria	0.38	–0.07	–0.41	–0.20
Latvia	0.76	0.96	0.62	0.80
Lithuania	0.50	0.92	0.72	0.70
Romania	–0.11	0.86	0.24	0.57
Slovak Republic	0.74	0.90	0.85	0.70
EU-15[1]				
Average	0.71	0.60	. . .	. . .
Maximum	0.96	0.99	. . .	. . .
Minimum	–0.61	–0.78	. . .	. . .
Euro-11[1]				
Average	0.69	0.69	. . .	. . .
Maximum	0.93	0.99	. . .	. . .
Minimum	–0.61	–0.40	. . .	. . .

Source: IMF staff estimates

[1]EU-15 and Euro-11 data exclude Germany. The other 14 members of the EU-15 are Austria, Belgium, Denmark, Finland, France, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. The other ten members of the Euro-11 are Austria, Belgium, Finland, France, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.

by the time they are fully integrated in the euro area, especially if they follow appropriate complementary policies.[8]

Accession and Convergence: Costs, Benefits, and Risks

EU membership requires applicants to meet a broad set of political, economic, and institutional requirements, as summarized in the EU's Copenhagen criteria set out in Box 4.1. Briefly, the criteria include guarantees for democratic principles and human rights, and the existence of a fully functioning market economy. A key issue that arises in this regard concerns the candidates' ability to adopt and—especially—to enforce the legal and regulatory frameworks that are required not just as part of EU membership but, more generally, as the underpinnings of well-functioning, market-based economies.

Beyond these overall criteria for membership, the conditions for EU and EMU accession can be grouped into two categories. The first involves a number of specific and absolute requirements for membership, where the candidate countries generally have little or no choice as to the form of compliance. The second category covers a broader range of conditions, guidelines, and expectations, often in the form of minimum standards, but where the applicants retain some choice about where they position themselves prior to (and following) accession. Key examples of the former are the common external tariff and associated requirements for the customs union and the full opening of the capital account. In each case, if any derogations from full compliance are permitted, they would likely be of very limited scope and duration. For these issues, the focus is on the extent to which the applicants already meet these EU membership criteria, and the implications of moving to full compliance. A particular question that arises in this regard is whether capital account liberalization is being pursued while the financial sector is at less than full health (raising the same concerns as in the recent financial crisis in Asia). The condition of the financial sector in the accession countries and the quality of supervision are therefore critical issues.

Turning to the second category of accession conditions noted above, a particularly important example concerns labor market policies. Under the *acquis communautaire*, the candidate countries need to follow a range of basic guidelines in such areas as health and safety conditions, protection of worker rights, bargaining arrangements, and so on. But, as indicated by the wide range of regulations and practices among cur-

[8]Economic convergence may help to prepare a country for currency union. See Tamim Bayoumi and Barry Eichengreen, "Ever Closer to Heaven? An Optimum-Currency-Area Index For European Countries," *European Economic Review,* Vol. 41 (April 1997), pp. 761–70.

Box 4.1. Formalities and Procedures of EU Enlargement[1]

The formal requirements and procedures underlying EU enlargement have been established largely through a series of resolutions arising from meetings of the European Council (the EU's summit-level, decision-making body). This box sets out briefly, and in approximately chronological order, the main decisions and elements of this process, and summarizes the current state of play regarding the accession proceedings.

Initial cooperation. In the very early stages of their transition, most of the countries of central and eastern Europe and the Baltics (CEECs) declared their interest in joining the EU. Although not initially recognizing accession of these countries as a formal EU objective, the EU nevertheless fostered closer relations with them both through the provision of financial assistance, and especially through trade and cooperation agreements—subsequently transformed into association or Europe Agreements. These bilateral documents provide a detailed legal framework for closer political, economic, and cultural cooperation, including the timing and scope of trade liberalization.

Copenhagen Criteria. In June 1993, the Copenhagen European Council formally agreed that the associated countries would be allowed to join the EU as soon as they were able to "assume the obligations of membership by satisfying the economic and political conditions required"—the so-called Copenhagen Criteria. In particular, membership requires that the "candidate country" has achieved:

- stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;
- the existence of a functioning market economy, as well as the capacity to cope with competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership, including adherence to the aims of political, economic, and monetary union."[2]

Application and initial assessment—the Luxembourg Agreement. In mid-1997, the European Commission submitted its assessment of political and economic progress in the economies that had applied for membership, recommending that accession negotiations begin with six—the Czech Republic, Estonia, Hungary, Poland, and Slovenia among the transition economies, together with Cyprus.[3] This recommendation was accepted at the Luxembourg European Council in December 1997, although the Council also left open the possibility that other applicants could subsequently join this "first wave."

Negotiations begin—the acquis communautaire. Accession negotiations opened in March 1998 with these six candidates (referred to as the "1998 group"). The focus of these negotiations is on the *acquis communautaire*—the detailed body of laws and regulations that underpins the EU. The *acquis* is structured into 31 chapters—covering, for example, policies in specific sectors (e.g., agriculture, fisheries, and the financial sector), social policies, the environment, and external relations. One of the chapters also covers economic and monetary union (see below). The bilateral negotiation process works through these different chapters, starting with a screening exercise in which each country sets out its position, including proposed derogations from the *acquis* or transitional periods before full compliance occurs, and then continuing (if necessary) with detailed negotiations.

[1]This box draws mainly on material on enlargement available via the Internet on the EU website (http://europa.eu.int/comm/enlargement); on Erik Berglof and Gerard Roland, "From 'Regatta' to 'Big Bang'?—The Impact of the EU Accession Strategy on Reforms in Central and Eastern Europe," unpublished manuscript prepared for this *World Economic Outlook*; and on Heliodoro Temprano-Arroyo and Robert A. Feldman, "Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Accession," *Economics of Transition,* Vol. 7, No. 3 (1999), pp. 741–806.

[2]See the Accession Criteria page of the EU website at http://europa.eu.int/comm/enlargement

[3]The ten associated CEECs submitted formal applications for EU membership during 1994–96. Applications had previously been submitted by Turkey (1987), Cyprus (1990), and Malta (1990, reactivated in 1998).

Helsinki Summit—from "waves" to a more open accession process. The Helsinki meeting of the European Council (December 1999) decided that accession negotiations should begin with the other five transition economy applicants and Malta, and that Turkey should be accepted as a full candidate. As part of this decision, the Council moved away from the "wave" approach to negotiation and eventual accession, to a more open approach. Under the latter, each candidate country's accession prospects would depend on its progress with negotiations through the *acquis*. This decision therefore opened up the possibility for countries to move up or down the accession queue—with original second wave countries, for example, possibly joining or even moving ahead of those placed earlier in the first wave.

What is the status of negotiations and when could enlargement occur?

For the original first wave countries, negotiations have been opened on all chapters of the *acquis*, and provisionally concluded in many cases. Much of the negotiating process has been of an exploratory nature, however. In the areas that pose most problems, notably agriculture, regional policies, and the free movement of labor, substantive negotiations are just beginning and final decisions will depend in part on the EU's own policy reforms in these areas. Negotiations opened in February 2000 with the remaining candidates (apart from Turkey). [4] The initial steps have involved the screening of candidates' positions on individual chapters, followed by the opening of negotiations on selected chapters.

Overall, there are no commitments as to the precise date of accession of any of the candidates. No "accession treaty" is to be signed before the EU-15 have agreed on reforms in the Union's common institutions (discussed in the main text). The European Council concluded in December 1999 that the EU should be in a position to admit new members "from the end of 2002," based on the assumption that the intergovernmental conference on reform of EU institutions would be concluded successfully by December 2000, and taking into account that ratification of a treaty usually takes close to two years. The European Union's Commissioner for Enlargement indicated in July 2000 that the "window of opportunity" for accession of the next new members of the EU would be between 2003 and 2005. The countries that are more advanced in the negotiating process have signaled that they plan to be ready for accession by 2003.

[4]That is, with Bulgaria, Latvia, Lithuania, Malta, Romania, and the Slovak Republic.

What are the linkages between EU accession and participation in the euro area?

While economic and monetary union is one of the negotiating chapters of the *acquis*, the candidate countries are not expected to become full members of the euro area, adopt specific exchange rate regimes, or meet the convergence requirements set out in the Maastricht Treaty on European Union, as preconditions for EU membership (that is, they are likely to enter the EU with derogations regarding these aspects of the *acquis*). As elaborated in the main text, substantial adjustment periods could be required for at least some of the applicants before they are able to meet the Maastricht criteria on a durable basis. Furthermore, the EU recognizes that it would be neither in its own interest nor in that of the applicants to impose on the latter an exchange rate system that might not be credible or sustainable. The Copenhagen Criteria make provision for an adjustment period by referring to the need for candidates to adhere to the *aims* of monetary union, rather than adopt the euro itself. Nevertheless, the EU has decided that new EU members will eventually be required to join the euro area (i.e., there will be no more opt-out clauses) and, under the *acquis,* all EU members are to "treat their exchange rate policy as a matter of common interest." It is not clear precisely what this means in practice. However, the EU has indicated that new members will need to be able to "avoid excessive fluctuations of their exchange rates which could endanger the functioning of the Single Market."

rent EU members, the applicants will still have substantial flexibility about how labor market policies are to be applied domestically once they comply with the minimum standards. Labor as well as product market arrangements need to support these economies' overall adjustment requirements and must be consistent with their macroeconomic policy frameworks.

The EU accession process does not set specific requirements for fiscal and monetary policies in the applicant countries, although assessing the sustainability of macroeconomic policies is clearly a central part of the overall determination of these countries' economic preparedness for entry. The key issue here is the potential pressures that could arise in the fiscal and monetary positions in the lead-up to, and following, EU accession—for example, the implications for public spending of complying with EU legislative requirements, the availability of funding from the EU, and pressures on monetary policy that could arise from increased capital flows.

Macroeconomic requirements are much more precisely defined when it comes to entry into the euro area, although this process cannot begin until EU accession itself has occurred. Under the convergence criteria of the 1993 Maastricht Treaty on European Economic and Monetary Union, countries are required to keep their exchange rates within "normal fluctuation margins" for at least two years in the exchange rate mechanism (ERM); ERM II is based on margins of +/–15 percent against the euro.[9] Also, inflation must remain no more than 1.5 percentage points higher than the average of the three lowest inflation rates in EMU member countries, the fiscal deficit must be below 3 percent of GDP, and government debt must be below 60 percent of GDP or declining at a satisfactory pace. As noted in Box 4.1, the candidate countries are expected eventually to join the euro area, but they have considerable latitude as to the timing of their full participation. Such decisions will depend in part on the ongoing adjustment and convergence needs of these economies.

Overall Preparedness for EU Accession: Institutional Underpinnings

The importance of *institutions* in economic development has been receiving growing attention in recent years.[10] The evidence from a number of sources is that progress with institution building has contributed to the generally stronger economic performance among the transition economies that are now on the EU accession track compared with those in the Commonwealth of Independent States (CIS). This section looks at just the former group, considering how they compare with the EU and among themselves in terms of institutional progress. Such progress is assessed from two perspectives that correspond closely with the first two Copenhagen criteria outlined in Box 4.1—namely, the degree of *political and civic freedom* in the accession countries, and their progress in establishing the *underpinnings for market-based economic activity*.

Political and Civic Freedom

The European Commission has concluded that all of the transition country applicants fulfill the Copenhagen political criteria.[11] The Commission noted, however, that there was

[9]In its Convergence Reports, the European Commission interprets "normal fluctuation margins" as meaning that exchange rate fluctuations should remain within +/– 2¼ percent bands, although breaches of this band should be individually examined to see if they resulted from severe tensions.

[10]See, for example, Oleh Havrylyshyn and Ron van Rooden, "Institutions Matter in Transition, but so do Policies," IMF Working Paper 00/70 (Washington: International Monetary Fund, 2000); Beatrice Weder, "Institutional Reform in Transition Economies: How far have they come?" background paper for this *World Economic Outlook;* Luc Moers, "How Important are Institutions for Growth in Transition Countries?" Tinbergen Institute Discussion Paper (Amsterdam, 1999).

[11]European Commission, "Composite Paper: Reports on progress towards accession by each of the candidate countries" (Brussels, 1999), available via the Internet at http://www.europa.eu.int. In its 1999 review, the Commission cited the particular improvements that had recently been made in the Slovak Republic, which, two years earlier, was the only one of the ten candidates judged to not satisfy the political criteria.

scope for further strengthening of democratic principles and human rights in many of the applicant countries, particularly in their support for minorities and for independence of the media. The Commission's assessment is consistent with indicators compiled by other agencies and researchers. In terms of an indicator of "voice and accountability," based on estimates of political and civic progress compiled by a range of different organizations, most of the applicant countries do not differ significantly from the EU average (Figure 4.3).[12]

Support for Market-Based Economic Activity

More dispersion is apparent among the candidate countries with indicators of economic progress.[13] Following the European Commission's 1999 assessment, based on each applicant's economic framework, policies, and achievements, the Commission concluded that six countries (the Czech Republic, Estonia, Hungary, Latvia, Poland, and Slovenia) could be regarded as having functioning market economies, two (Lithuania and the Slovak Republic) were "close," Bulgaria had made substantial progress from a poor starting point, while the situation in Romania was "very worrying."[14]

There have, however, been important signs of convergence with institutional reform, probably reflecting both the anchoring role of prospective EU membership in domestic reform agendas and also the incentive effects arising from the more open accession process introduced in late 1999,

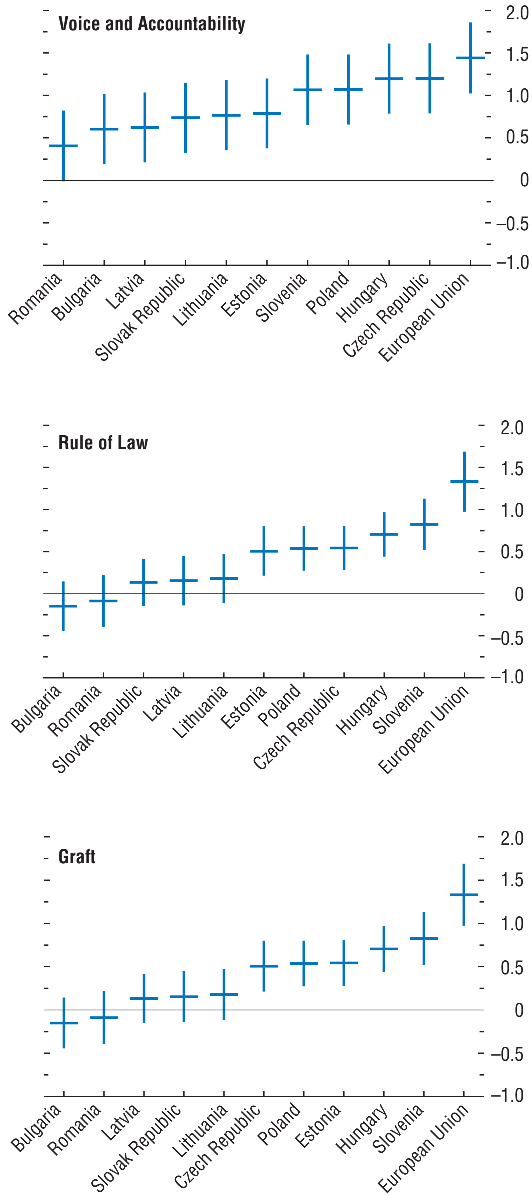
[12]This indicator and the following two indicators (covering the rule of law and graft) are presented in Daniel Kaufmann, Aart Kraay, and Pablo Zoido-Lobatón, "Governance Matters" (unpublished; Washington: World Bank, 1999).

[13]It is also noteworthy that, in terms of the economic indicators discussed in this section, the gap between the accession countries and current EU members closes significantly if the indicators are adjusted for differences in GDP per capita (Weder, "Institutional Reform in Transition Economies").

[14]European Commission, "Composite Paper: Reports on progress towards accession by each of the candidate countries."

Figure 4.3. Indicators of Institutional Development[1]

The more advanced transition economies have largely caught up with the EU in terms of political and civic freedom, but still lag behind in terms of application of laws and freedom from corruption.



[1]These indicators are from D. Kaufmann, A. Kraay, and P. Zoido-Lobatón, "Governance Matters" (Washington: World Bank, 1999), and are available via the Internet at http://www.worldbank.org/wbi/governance/pubs/govmatters.htm.

The vertical axis measures the number of standard deviations from the global mean for each indicator (constructed to follow a N(0,1) distribution). The horizontal bar for each country shows the mean level of the indicator concerned, and the vertical bars represent 90 percent confidence intervals. With each indicator, a higher score indicates stronger performance (greater freedom and less corruption, etc.).

Box 4.2. Previous EU Enlargements

The accession of the transition economies of central and eastern Europe and the Baltics (hereafter, CEECs) to the European Union (EU) poses distinctive challenges for the Union and the candidate countries, particularly in comparison to past enlargements. Since the Treaty of Rome (in 1957), the EU has expanded on four occasions: Denmark, Ireland, and the United Kingdom in 1973; Greece in 1981; Portugal and Spain in 1986; and Austria, Finland, and Sweden in 1995.[1] Although future expansion will probably not occur all at once, the size of the potential enlargement—in terms of number of countries, population, and land area—is without precedent (see the first table).[2] Moreover, as a group, the CEECs differ from the typical (or average) previous EU candidates (at the time of accession), especially in terms of per capita GDP and inflation relative to the EU, but also in terms of other factors such as openness to trade. However, a few of the previous acceding countries—namely Ireland, Greece, Portugal, and Spain—are more similar to the current applicant group. This box attempts to derive some lessons for the current candidates by examining the past enlargements, particularly the accession of these countries into the Union.

The figure shows a number of economic indicators for these previous candidate countries—Ireland, Greece, Portugal, and Spain—in the 16 years around the year of accession, year *t* (including five years before and ten years after year *t*), and for the CEECs in the last six years (with year *t* being 1999).[3] Per capita output on a purchasing-power-parity basis in the previous candidates ranged from about half (Portugal in 1986) of the then EU average to over 70 percent (Spain in 1986). By comparison, per capita output in the CEECs currently ranges from about 20 percent (Bulgaria) to almost 70 percent (Slovenia) of the EU average. After accession, the gap in per capita output relative to the EU narrowed in three of the four previous acceding countries—the exception was Greece—during the ensuing five years by at least 1 percent a year and continued to narrow in subsequent years. Indeed, GDP per capita in Ireland now exceeds the EU average, while the gap has narrowed substantially in Portugal and Spain.

These differences in the relative per capita growth performance are reflected in, and perhaps explained by, the differences in other economic variables. Fiscal deficits and the gap in inflation between the acceding countries and the EU decreased in Portugal and Spain and, to a lesser extent, in Ireland (where the fiscal deficit remained large) after accession. Trade and inward foreign direct investment as a percentage of GDP (on a purchasing-power-parity basis) increased—in particular, soon after accession—in these countries.[4] The bilateral real exchange rate (relative to Germany) also increased in the years after accession in these countries, possibly indicating convergence with the rest of the EU. In addition, the correlation of real output growth between the acceding countries and Germany increased after accession both in ab-

[1]The founding members of the Union were Belgium, France, Germany, Italy, Luxembourg, and the Netherlands.

[2]Although in percentage terms relative to the existing EU at the time of each enlargement, the current enlargement is similar to some previous ones in terms of increases in population and area. The non-transition candidates, Cyprus, Malta, and Turkey, would add an extra 65.6 million in population and 787 thousand square kilometers in area.

[3]In the figure, GDP per capita and inflation are compared to these indicators for existing members of the EU when these countries joined the Union. For Ireland, the comparator group includes the founding members of the Union—namely, Belgium, France, Germany, Italy, Luxembourg, and the Netherlands. For Greece, Portugal, and Spain, the comparator group includes the founding members and Denmark, Ireland, and the United Kingdom.

[4]Previous EU enlargements have tended to be trade creating, although there were trade-diverting effects in the 1973 and 1981 enlargements. See Tamim Bayoumi and Barry Eichengreen, "Is Regionalism Simply a Diversion? Evidence from the Evolution of the EC and EFTA," in *Regionalism Versus Multilateral Trade Arrangements,* NBER—East Asia Seminar on Economics, Vol. 6, edited by Takatoshi Ito and Anne O. Krueger (Chicago: University of Chicago Press, 1997).

EU Enlargements

	Population[1] (millions)	Area[2] (thousands of square kilometers)	GDP Market based (billions of U.S.dollars)	GDP PPP based (billions of U.S.dollars)	GDP/capita Market based (U.S. dollars)	GDP/capita PPP based (U.S. dollars)	Inflation[3] (percent)	Openness[4] (percent of PPP-based GDP)
1973 enlargement (Denmark, Ireland, and the United Kingdom)								
Candidates	64.3	358.2	217.0	267.9	3,374	4,166	9.3	41.5
Existing EU[5]	209.4	1279.8	885.5	854.3	4,229	4,081	8.1	47.2
Candidates/EU (percent)[6]	30.7	28.0	24.5	31.4	79.8	102.1	1.2	–5.6
1981 enlargement (Greece)								
Candidates	9.7	131.9	44.5	55.0	4,575	5,653	24.5	37.8
Existing EU[5]	278.5	1638.0	2528.0	2521.3	9,078	9,054	11.6	61.5
Candidates/EU (percent)[6]	3.5	8.1	1.8	2.2	50.4	62.4	12.9	–23.7
1986 enlargement (Portugal and Spain)								
Candidates	48.5	597.1	275.0	403.2	5,667	8,308	9.2	26.4
Existing EU[5]	290.0	1769.9	3257.3	3497.4	11,232	12,060	2.9	52.1
Candidates/EU (percent)[6]	16.7	33.7	8.4	11.5	50.5	68.9	6.3	–25.7
1995 enlargement (Austria, Finland, and Sweden)								
Candidates	22.0	870.9	605.1	443.7	27,521	20,180	2.1	100.6
Existing EU[5]	350.0	2367.1	8000.1	6780.5	22,856	19,372	3.0	65.7
Candidates/EU (percent)[6]	6.3	36.8	7.6	6.5	120.4	104.2	–0.9	35.0
Current status (1999)								
Candidates (Transition countries)	104.6	1076.9	365.1	903.8	3,490	8,638	11.3	35.3
Existing EU[5]	375.3	3237.9	8509.5	8371.0	22,672	22,303	1.3	63.3
Candidates/EU (percent)[6]	27.9	33.3	4.3	10.8	15.4	38.7	10.0	–28.0

[1]From World Bank Development Indicators.
[2]From *CIA World Factbook 1999*.
[3]IMF, *International Financial Statistics*.
[4]For Greece, exports and imports are from the *International Financial Statistics*.
[5]Members of the EU prior to the enlargement.
[6]Ratio of the candidates to the existing EU, except for inflation and openness where the data refer to candidates minus the existing EU.

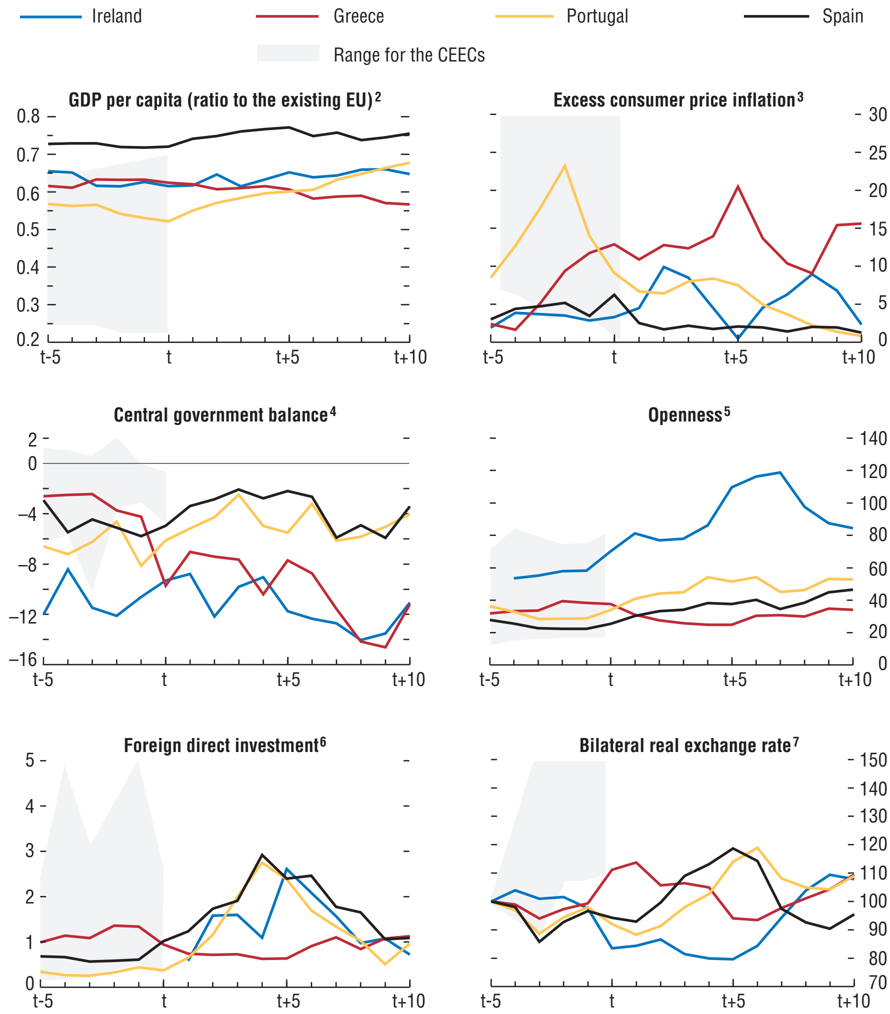
solute terms and relative to the corresponding correlations between existing EU members and Germany (see the second table). The picture is more mixed with inflation: only for Ireland (and the 1995 enlargement candidates) does the correlation with Germany increase.[5] By contrast, in Greece, where macroeconomic and structural reforms were more limited, inflation (relative to the rest of the EU) and the fiscal deficit increased, while trade, inward foreign direct investment, and the output correlation with Germany did not.

These comparisons highlight that convergence occurs in most countries after accession—the exception is Greece, where the gap in per capita GDP remained at about the same level in 1999 as when the country joined the EU. The comparisons also highlight that accession, while providing a key external anchor, does not itself necessarily lead to improved economic perform-

[5]For Portugal and Spain, however, the decrease in the correlation of inflation with Germany after accession may not be due to a lack of convergence. The decrease may instead reflect the relative increase in German inflation during the period of reunification—as underscored by the decreased correlation of German inflation with the rest of the existing EU.

Box 4.2 *(concluded)*

Comparison to Previous EU Enlargements[1]



[1]t is the year of accession to the EU, except for the CEECs where t is 1999. For Ireland, t is 1973; for Greece, 1981; and for Portugal and Spain, 1986.

[2]On a purchasing-power-parity basis. The existing EU is the EU prior to the enlargement date.

[3]IMF, *International Financial Statistics* data. Excess inflation (in percentage points) relative to the existing EU prior to the enlargement date. For the CEECs, the maximum excess inflation exceeds 30 percentage points during t-5 to t.

[4]Percent of GDP.

[5]Exports plus imports as a percent of GDP on a purchasing-power-parity basis. For Greece, exports and imports are from the *International Financial Statistics.*

[6]*International Financial Statistics* data. Percent of GDP on a purchasing-power-parity basis.

[7]*International Financial Statistics* data. Indexed to 100 at t-5. Relative to Germany deflated by relative consumer price indices. For the CEECs, the maximum bilateral real exchange rate is above 150 during t-3 to t.

Correlation with Germany around EU Accession [1]

	Real GDP Growth		Consumer Price Inflation	
	Before	After	Before	After
1973 enlargement				
Ireland	0.21	0.46	0.74	0.85
Average for the other candidates	0.32	0.68	0.60	0.60
Existing EU (excluding Germany)[2]	0.44	0.60	0.79	0.73
1981 enlargement				
Greece	0.59	0.42	0.40	0.12
Existing EU (excluding Germany)[2]	0.69	0.23	0.36	0.82
1986 enlargement				
Portugal	0.24	0.59	0.24	0.06
Spain	0.24	0.51	0.41	0.24
Existing EU (excluding Germany)[2]	0.50	0.28	0.79	0.13
1995 enlargement				
Average for the candidates	0.30	0.58	0.21	0.29
Existing EU (excluding Germany)[2]	0.33	0.55	–0.01	0.27

[1]Correlations for ten years before and ten years after the EU enlargement, with the exception of the 1995 enlargement. In the latter case, correlations are for only four years after enlargement because of insufficient data availability.
[2]Members of the EU prior to the enlargement.

ance and integration.[6] Appropriate ancillary policies before and after accession—including macroeconomic stability (through fiscal and monetary policies) and other policies that foster greater openness to trade and an improved climate for inward foreign investment—are vital, particularly as the current candidates also expect to join the monetary union at some point following EU accession. Although the gap in per capita GDP for most of the CEECs is larger than for countries in previous enlargements, other economic indicators are more similar. As a result, the CEECs are well placed to benefit from further integration with Europe as long as these countries continue to adopt far-reaching—and sometimes difficult—reforms.

[6]See also Erik Berglof and Gerard Roland, "From 'Regatta' to 'Big Bang'?—The Impact of the EU Accession Strategy on Reform in Central and Eastern Europe," unpublished manuscript prepared for this *World Economic Outlook*.

in which all accession candidates are to be considered on an equal footing.[15] In particular, most of the countries left out of the 1998 group appear to have made especially strong efforts to catch up.[16] At the same time, the EU expressed concern at inadequacies in the reform momentum in several of the 1998 group countries, including institutional strengthening and adoption of the *acquis*. These concerns were consistent with those of outside observers.[17] On balance, the EU's decision to move to a more open approach to accession should reinvigorate the reform process, both for

[15]For a fuller discussion, see Erik Berglof and Gerard Roland, "From 'Regatta' to 'Big Bang'?—The Impact of the EU Accession Strategy on Reform in Central and Eastern Europe," background paper prepared for the October 2000 *World Economic Outlook*.

[16]Reflecting these efforts, the Commission "upgraded" Latvia to functioning market economy status in its 1999 assessment; the implementation of recent reforms in the Slovak Republic and Lithuania were expected to lead to their reaching this status in 2000; and Bulgaria, as noted, was cited as having made remarkable progress since its 1997 economic crisis.

[17]For example, Berglof and Roland, "From 'Regatta' to 'Big Bang'?" also suggest that there were signs of complacency in reform efforts in some of the first wave countries following their selection to be in this group.

Box 4.3. Accession of Turkey to the European Union

Although this chapter focuses on the ten transition countries that are negotiating for EU membership, Cyprus, Malta, and Turkey have also been accepted as candidates for accession. This box presents a few points regarding the candidacy of Turkey—by far the largest of these other three applicants in terms of economic and population size. Turkey's prospects for integration in the European Union took a significant step forward at the 1999 Helsinki European Council meeting, when the Council declared that Turkey is "a candidate State destined to join the Union on the basis of the same criteria as applied to the other candidate States...[and]... will benefit from a pre-accession strategy to stimulate and support its reforms."[1]

Economic size and structure: some indicators and comparisons

Turkey's economy is substantially larger than those of the other EU applicants, with a level of GDP that is about 25 percent larger than that of Poland, the next largest, and a population size that exceeds all of the 1998 negotiating group put together (see the table). GDP per capita (on a purchasing-power-parity basis) is close to the average of the 2000 group, placing Turkey above Bulgaria, Romania, and Latvia, and below Lithuania and the Slovak Republic. In comparison with most of the other EU candidates, apart from Bulgaria and Romania, Turkey's economic structure is weighted relatively heavily toward agriculture: as in Romania, this sector generates around 16 percent of value added and accounts for about 40 percent of employment. The shares of industry and services in value added are close to those of Bulgaria. With around 50 percent of exports going to the EU, Turkey is comparable to Bulgaria and also Lithuania.

Readiness for EU accession

In its 1999 report on progress toward EU accession, the European Commission concluded that Turkey did not yet meet the Copenhagen political criteria (see Box 4.1). Considering economic readiness for accession, the Commission concluded that Turkey had many of the characteristics of a fully functioning market economy. In particular, the Commission argued that liberalization efforts under way since the late 1980s have given shape to an economy capable of withstanding competition. Moreover, Turkey's industrial sector proved resilient after the opening up of international trade following the signing of the 1995 customs union with the EU. Although progress has been made in achieving macroeconomic stability, the economic reform process nevertheless would need to be consolidated to permanently reduce inflationary pressures and cut public deficits. Furthermore, continuing structural reforms are needed to modernize underdeveloped sectors and regions "in order to ensure that the whole of the economy has the ability to cope with competitive pressure and market forces within the Union."

The Commission also found that, in order to implement and enforce the *acquis communautaire*, Turkey was in need of modernizing its administrative institutions, providing training to its civil servants, and strengthening its judicial capacity. The Commission and Turkey are expected to adopt later in 2000 an Accession Partnership framework that should cover, among other items, the priorities for membership preparation—in particular, adopting the *acquis* and the financial support for that purpose.

[1]The conclusions of the Helsinki Summit and other material on Turkey's progress toward EU accession are available via the Internet on the EU's website at http://europa.eu.int.

Turkey and Other EU Accession Countries: A Comparison

(1999 data, unless otherwise stated)

	Turkey	1998 Group[1]	2000 Group[2]
Population (millions)	66.1	62.4	42.2
GDP (U.S.$ billions)	191	283	83
GDP (PPP based; U.S.$ billions)	426	636	268
GDP per capita (PPP based; U.S.$)	6,443	10,184	6,349
Sectoral value added:			
Agriculture	16	5	13
Industry	27	34	35
Services	57	60	52
Share of EU in exports	50	68	56

Sources: European Commission; IMF staff estimates.
[1]Czech Republic, Estonia, Hungary, Poland, and Slovenia.
[2]Bulgaria, Latvia, Lithuania, Romania, and Slovak Republic.

Table 4.6. Legal Transition Indicators[1]

	Commercial Law		Financial Regulations	
	Extensiveness	Effectiveness	Extensiveness	Effectiveness
Bulgaria	4	4–	3	2+
Czech Republic	3+	3–	3+	2+
Estonia	3+	4–	4	3+
Hungary	4	4–	4	4
Latvia	4–	3	3	2
Lithuania	4	3	3–	2
Poland	4	3	4	4
Romania	3+	4–	3	3–
Slovak Republic	3+	3	4	3+
Slovenia	4	4	3+	3+

Source: European Bank for Reconstruction and Development.
[1]The scale for these indicators is from 1 to 4+, the latter representing the level reached by the advanced economies.

the original first wave of candidates and for those that were in the second echelon.

The Commission noted that all the candidates needed to further strengthen their legal framework. The most commonly cited concerns included the need to improve bankruptcy proceedings, augment protection of industrial and intellectual property rights, and improve other aspects of the legal environment for business. More broadly, all the applicants were urged to further strengthen their judiciaries, and to tackle what was described as a widespread problem of corruption.

Indicators available from other sources paint a broadly similar picture to that of the Commission. The "rule of law" indicator in Figure 4.3, drawing on around a dozen different sources, reflects perceptions of such factors as the extent of criminality, enforceability of contracts, and general effectiveness of the legal system and judicial authorities. The measure of "graft" reflects outside observers' assessments of the extent of corruption among public officials, attitudes towards corruption, and resulting disruptions to business practices. In each case, there is a sizable shortfall between the EU average and even the best of the accession countries—more so than in the comparison of political development discussed earlier. Moreover, the five countries in the 1998 group appear to be substantially stronger in terms of these measures of legal development than are countries in the 2000 group. As noted above, the rapid reform efforts pursued by the latter group over the last couple of years may have helped reduce this gap (the indicators are based on data from the 1996–98 period). However, a very similar ranking appears in the latest index of property rights protection published by the Heritage Foundation.[18]

A further perspective comes from indicators of commercial law reform and financial market regulation developed by the EBRD.[19] In each case, experts' views are sought both on the *extensiveness* of reforms—i.e., the extent to which legal rules and standards resemble those of more advanced economies; and on their *effectiveness*—i.e., the clarity of rules and the adequacy of implementation, enforcement, and corrective action.

The latest legal transition indicators reveal four major points (Table 4.6). First, the EU ac-

[18]Available via the Internet at http://www.heritage.org; this index, which is included in the indicator of "rule of law," from Kaufmann, Kraay, and Zoido-Lobatón, "Governance Matters," is one component of the Heritage Foundation/*Wall Street Journal* 2000 Index of Economic Freedom Rankings. In this latest index of property rights, the five first wave countries all received a score of 2 (on a scale of 5), indicating a high level of property rights protection but lax enforcement; Bulgaria, Latvia, Lithuania, and the Slovak Republic received a 3, indicating moderate protection, but some risk of expropriation and the possibility that the judiciary may be influenced by other branches of government; and Romania received a 4, suggesting little legal protection and a poorly functioning judicial system.

[19]European Bank for Reconstruction and Development, *Transition Report 1999* (London: EBRD, 2000).

Table 4.7. Selected European Countries: Trade

	Openness[1] 1999	Openness[2] 1999 (PPP basis)	Tariff Rate 1999 (Percent)	EBRD Index[3] 1999	TRI[4] 1999	WTO (Membership date or status)
Central and Eastern European Countries						
Bulgaria	87.7	26.2	15.1	4+	6	1996
Czech Republic	128.6	49.7	6.8	4+	1	1995
Estonia	186.0	81.1	0.0	4	1	Signed accession protocol
Hungary	137.6	58.8	13.3	4+	5	1995
Latvia	120.6	51.5	5.3	4+	1	1999
Lithuania	89.9	38.0	4.5	4	1	Negotiations ongoing
Poland	48.9	22.0	11.6	4+	2	1995
Romania	62.1	16.3	23.8	4	4	1995
Slovak Republic	134.5	45.9	12.0	4+	2	1995
Slovenia	112.6	78.9	10.6	4+	5	1995
EU-15[5]	74.5	80.6	5.0	. . .	4	

[1]Exports and imports as a percent of GDP using market exchange rates.
[2]Exports and imports as a percent of GDP on a purchasing-power-parity basis.
[3]Trade and foreign exchange liberalization index from the European Bank for Reconstruction and Development. The highest rating is 4+, which means that the countries have achieved the standards and norms of advanced industrial countries, including the removal of most tariff barriers and World Trade Organization membership.
[4]Trade Restrictiveness Index. On a scale of 1–10, 1 is the least restrictive rating. See Appendix I in IMF, *Trade Liberalization in IMF-Supported Programs* (Washington: International Monetary Fund, 1998) for an explanation on the construction of the index.
[5]Unweighted average. The EU-15 comprise Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.

cession countries are rated rather highly with respect to the extensiveness of legal reform, probably reflecting in part the influence of (and specific standards derived from) the EU accession process.[20] Second, the effectiveness ratings are usually somewhat lower than those of extensiveness, consistent with the suggestion above that all of these countries need to make further efforts to strengthen the judiciary, improve legal implementation, and reduce corruption. Third, indicators of financial regulation are generally lower than those for commercial law reform. Some countries receive particularly low ratings for the effectiveness of financial measures, reflecting difficulties in such areas as the supply of trained personnel, the conduct of supervision, and timely implementation of corrective measures in the event of financial problems. The EBRD also notes that, within the financial sector, securities legislation appears to be implemented less effectively than banking laws, a result in part of the relatively new and underdeveloped institutions in the former area. Fourth, regarding the legal transition indicators as a whole, there does not appear to be a clear distinction between the 1998 and 2000 negotiating groups.

Joining the Customs Union

The CEECs have made substantial progress in meeting the trade policy requirements of joining the EU because trade has already been extensively liberalized during the past decade—particularly with the EU.[21] Most of these countries are now relatively open, with trade (import

[20]The assigned ratings suggest that most parts of commercial law and financial regulation are reasonably well developed, although with scope for further elaboration and refinement in some areas.

[21]Bilateral agreements with the EU, mainly the Europe Agreements (EAs)—which came into force in all of these countries between 1994 and 1998—have been one of the primary external factors in encouraging trade liberalization, although the General Agreement on Tariffs and Trade (GATT) Uruguay Round, the World Trade Organization, and other special trading arrangements have also played a role. Of course, in the transition from central planning to market economies, the accession countries may have liberalized trade even without these external agreements, although the speed of liberalization may not have been as fast in all countries, the scope not as broad, and the commitment not as deep.

plus export) shares of GDP above the EU average and low tariff rates (Table 4.7).[22] The CEECs also are all either members of the World Trade Organization (WTO) or in the process of WTO accession, rank highly in the EBRD index of liberalization of the trade and foreign exchange system, and are mostly ranked on a comparable or less restrictive level to the EU in the IMF's Trade Restrictiveness Index (TRI). Furthermore, the candidate countries have diversified trade away from other transition countries, and since January 1998, goods exports—other than agricultural goods—from the CEECs to the EU have been duty free (Figure 4.4).[23] The CEECs have also shifted the composition of exports toward expected areas of comparative advantage, such as textiles and natural resources, and some of the leading applicants are experiencing rapid development of FDI-induced, intra-industry trade in such areas as car production and electronics.

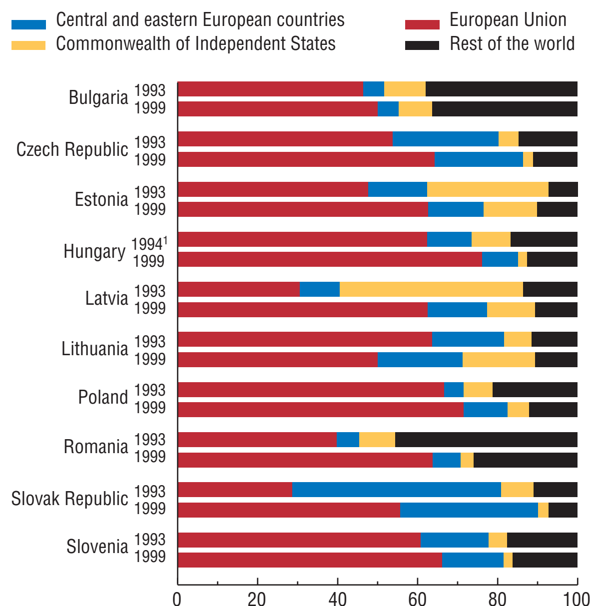
Nonetheless, further progress in the candidate countries will be needed in a number of areas. These include removing remaining import restrictions, including non-tariff barriers, on EU exports to the accession countries so as to allow the freedom of movement of goods and services to other EU member states, adopting the Common External Tariff (CET), and ensuring the compatibility of domestic trade policy with the EU's bilateral and multilateral commitments, including extending preferential treatment to third countries.[24] As part of the Europe Agreements, import restrictions on non-agricultural goods from the EU are expected to be

[22]It should be noted, however, that trade shares of GDP, measured using GDP on a PPP basis, are mostly lower than the EU average.

[23]See also Robert Feldman and others, *Impact of EMU on Selected Non-European Union Countries,* IMF Occasional Paper No. 174 (Washington: International Monetary Fund, 1998).

[24]Non-tariff barriers that exist are generally on imports of consumer products and are more prevalent in Hungary and Poland. See Constantine Michalopoulos, "The Integration of Transition Economies into the World Trading System," paper presented at the Fifth Dubrovnik Conference on Transition Economies, Dubrovnik, Croatia, June 23–25, 1999.

Figure 4.4. Export Markets
(Percent of total exports)



Source: IMF, *Direction of Trade Statistics.*
[1]Data unavailable for Hungary in 1993.

eliminated by 2001. In addition, most of the countries need to continue to lower tariffs (to the level of the CET) for goods imported from third countries, although in some cases—such as Estonia—the process of EU accession is resulting in an increase in tariffs.[25]

The direct effects of further trade integration during the EU accession process should be limited as far as industrial products are concerned, because trade in the CEECs has already been extensively liberalized. However, there is substantial scope for further trade in agriculture (see below), and probably also in services—such as financial services—which are becoming increasingly traded. On balance, accession is likely to be trade creating, largely because tariff rates to third countries will on average continue to fall during the accession process and also as a result of longer-term gains from a larger EU economy and from further falls in non-tariff barriers. Trade diversion is expected to be limited because the EU countries are already the primary trading partners of the CEECs. Moreover, benefits to third countries will include a larger, more uniform export market—particularly for countries that already have preferential arrangements with the EU—for example, the ACP (African-Caribbean-Pacific) countries.

Some trade could be diverted, however, from the CIS countries, which are still substantial trading partners of the CEECs, although these and other countries will gain from larger markets due to increasing income and wealth in the accession countries.[26] It will be incumbent on the EU and the new member states to limit trade diversion that would lead to distorted or suboptimal trade patterns (including among the CEECs if accession does not occur at the same time for all these countries) as trade regimes are brought in line with the European Community regulations, including by adapting policies to allow special trading arrangements to persist and, more importantly, by continuing to expand multilateral and other regional trade relationships.[27] Expansion and diversification of trade from the CEECs into the EU could also be hindered by the administrative costs of implementing and enforcing the *acquis* on the freedom of movement of goods in the member countries—particularly with respect to consumer protection, indirect taxation, health, safety, phyto-sanitary conditions, and mutual recognition of national legislation—given the candidate countries' comparatively lower levels of development.

Capital Account

One of the major challenges for the applicant countries in the next several years will be to manage rising capital inflows while liberalizing the capital account, a requirement of accession. The *acquis* obliges countries to maintain free capital movements with the rest of the EU, although transitory derogations for acceding countries may be provided for certain types of flows (such as short-term ones) and safeguards are provided that allow temporary restrictions on capital movements in the case of balance of payments difficulties. In addition, the Maastricht Treaty requires that countries liberalize capital flows with the rest of the world.

[25]Estonia started increasing its tariffs in January 2000.

[26]Gravity models suggest that although trade with the CIS countries has fallen substantially since the breakup of the Council of Mutual Economic Assistance in 1991, it remains higher than what would be expected given the geographic distance between the CEECs and the CIS countries and the size of the CIS market. See, for example, EBRD *Transition Report 1999,* and Jarko Fidrmuc and Jan Fidrmuc, "Integration, Disintegration, and Trade in Europe: Evolution of Trade Relations during the 1990s," ZEI Working Paper (Bonn: Center for European Integration Studies, December 1999).

[27]In part to limit the trade diversion effects of the Europe Agreements, the EU has already encouraged the CEECs to conclude bilateral arrangements to liberalize trade among themselves. Intraregional trade agreements include the Baltic Free Trade Agreement for the three Baltic countries and the Central European Free Trade Association, comprising the other seven accession countries. To reduce potential trade diversion, the EU has also relaxed rules of origin for valued-added content from the CEECs by allowing the accumulation of content among the CEECs and other countries with preferential trade arrangements.

Table 4.8. Central and Eastern European Countries: External Account Liberalization

	Year of IMF Article VIII Acceptance	Indices of Capital Account Liberalization[1]				
		Overall	Direct investment	Real estate investment	Credit operations	Portfolio Flows
Bulgaria	1998	35.3	66.7	50.0	37.5	25.0
Czech Republic	1995	73.7	100.0	50.0	62.5	70.0
Estonia	1994	97.6	100.0	75.0	100.0	100.0
Hungary	1996	59.5	100.0	75.0	75.0	33.3
Latvia	1994	97.6	100.0	75.0	100.0	100.0
Lithuania	1994	85.7	83.3	50.0	62.5	100.0
Poland	1995	55.3	100.0	50.0	75.0	35.0
Romania	1998	12.5	83.3	0.0	0.0	0.0
Slovak Republic	1995	23.7	83.3	50.0	50.0	0.0
Slovenia	1995	40.5	83.3	50.0	37.5	25.0

[1]As of December 31, 1997; from Heliodoro Temprano-Arroyo and Robert A. Feldman, "Selected Transition and Mediterranean Countries: An Institutional Primer on EMU and EU Accession," *Economics of Transition,* Vol. 7, No. 3 (1999), pp. 741–806. The indices can take values between 0 and 100, with 100 representing the maximum degree of liberalization of the capital flows under consideration.

The accession countries have already begun to liberalize external flows (Table 4.8). All have now accepted the obligations of Article VIII of the IMF Articles of Agreement on current account convertibility and have removed most restrictions on foreign direct investment-related transactions. Except in the Baltic countries (and to a lesser extent the Czech Republic), controls on most other capital transactions remain, particularly with regard to portfolio flows and real estate investments. Controls on the latter remain, even in Estonia and Latvia—which have the most open capital accounts—partly because of concerns that foreigners will purchase large portions of the available land. Enforcement of these capital controls in some of these countries, however, is thought to be weak.

In 1999, all but one of the accession countries (the Czech Republic) had external current account deficits larger than 3 percent of GDP, with Lithuania (11¼ percent of GDP), Latvia (9¾ percent of GDP), and Poland (7½ percent of GDP) having the largest (see Table 4.1). The relatively large deficits in most of these countries have raised concerns about their sustainability, particularly since the process of capital account liberalization in an environment of weak financial institutions can lead to large and unsustainable capital inflows—as highlighted by the recent financial crises in east Asia. Sizable external financing currently may be appropriate—because of the investment opportunities offered by transition and convergence and lower than normal domestic saving in some countries on expectations of rising real incomes. But, large current account deficits make countries more vulnerable to reversals in financial market sentiment and thereby can lead to currency and financial crises, and also may be an indicator of other imbalances within an economy.[28]

The method by which a current account deficit is financed may provide some evidence about its sustainability, with foreign direct investment (FDI) generally preferred largely because it is less liquid and generally less volatile than other flows (particularly short-term debt).[29] A large share of capital inflows to the CEECs has been FDI, reflecting the substantial investment opportunities in these countries and early removal of restrictions on FDI inflows (Figure 4.5). Even though privatization in most of the CEECs is almost complete, foreign firms are likely to continue to make greenfield investments partly

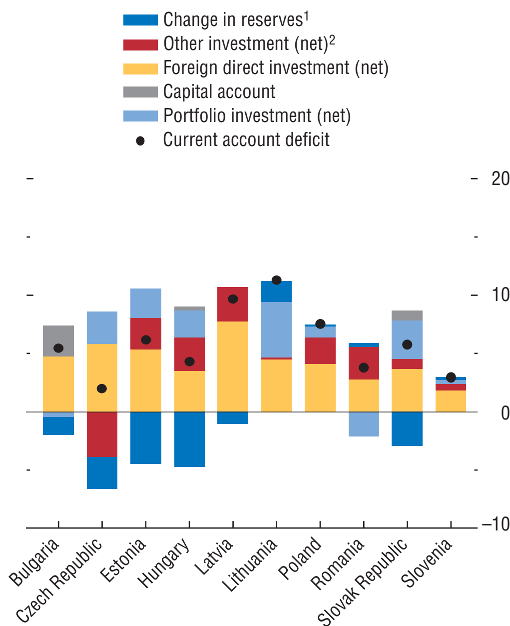
[28]See Gian Maria Milesi-Ferretti and Assaf Razin, *Current Account Sustainability,* Princeton Studies in International Finance, No. 81 (Princeton, New Jersey: Princeton University, October 1996) and the May 1998 and May 1999 editions of the *World Economic Outlook.*

[29]Even FDI can be quite volatile, however, if it is based on a few large-scale privatizations.

Figure 4.5. Financing the Current Account Deficit,1999

(Percent of GDP)

Although mainly financed through foreign direct investment, current accounts deficits in the EU accession countries are high, potentially indicating vulnerability to changes in financial market sentiment.



[1]A negative number indicates an increase.
[2]Includes net errors and omissions.

because of expectations of EU accession. Empirical evidence on whether further integration with the EU will increase these flows is mixed, however.[30]

As the CEECs move to further liberalize their capital accounts, several issues warrant consideration. During the liberalization process, appropriate ancillary policies and supporting institutions need to be developed and maintained. In particular, these include fiscal and monetary policies consistent with the exchange rate regime and macroeconomic stability, and policies that help strengthen and deepen financial institutions and capabilities—for example, in regulation, supervision, and risk management. The risk of rapid reversals in financial flows if investor sentiment changes—together with contagion as these countries are grouped more and more together—implies that the accession countries should continue to liberalize longer-term flows first and shorter-term flows only later. More generally, full transparency regarding economic policies and accession prospects is important, to reduce the scope for surprises in financial markets.

Financial Sector Development

Creating liberalized markets and effective institutions in the financial sector has been a significant challenge in transition countries, particularly as market-based banking systems and capital markets have been created from scratch.[31] From a macroeconomic viewpoint, the financial sector is special in four senses, as a number of transition economies have learned to their

[30]See, for example, Paul Brenton, Francesca Di Mauro, and Mathias Lucke, "Economic Integration and FDI: An Empirical Analysis of Foreign Investment in the EU and in Central and Eastern Europe," CEPS Working Document No. 124 (Brussels: Center for European Policy Studies, November 1998) and references therein. See also Box 4.2 for a comparison of FDI inflows following previous EU enlargements.

[31]Detailed individual country presentations can be found in *Capital Market Development in Transition Economies,* OECD Proceedings (Paris: Organization for Economic Cooperation and Development, 1998).

cost.[32] First, a banking crisis can cause sizable fiscal costs. Second, soundness in this sector is crucial to ensure predictable and effective monetary transmission. Third, efficiency of intermediation is key for financing growth. Fourth, risk management in this sector is a crucial safeguard against the problems that could arise from increased levels of debt-creating inflows as capital accounts are progressively opened.

As the accession countries approach the date of EU entry, their experience with financial sector development illuminates three major issues. First, there have been problems with enforcement of banking rules and regulations in most accession countries. Second, there is a threat posed to transparency and standards of disclosure in equity markets, with insider trading presenting particular difficulties in this regard. Third, there is a need for further growth of institutional and retail sectors in securities markets.

In the banking sector, the central and eastern European countries have generally adopted EU regulations, including universal licensing for all banks. Implementing effective banking supervision has in some cases turned out to be difficult, however, because of a lack of trained personnel and supporting infrastructure. As the candidates enter the EU, such differences between banking regulation and supervision standards—in particular enforcement of such standards—could create problems. For example, difficulties could arise if banks located next to each other in the same country were regulated with different degrees of scrutiny in their respective "home" countries.[33] Hence, there is a need for the accession countries not only to adopt the international set of banking standards, but also to apply a similar quality of supervision and enforcement.

In capital market development, above average progress has been achieved by most of the accession countries according to the transition indicators developed by the EBRD. In particular, since the mid-1990s, market infrastructures and market efficiencies have improved and financial markets are now starting to look more similar to those in the current EU countries.[34]

Furthermore, most accession countries now have independent agencies or commissions with an exclusive mandate for market supervision and enforcement (Table 4.9). Even though capital markets are efficient and have developed quickly, however, they often do not yet perform fully the key function of providing an effective alternative to bank funds. Capitalization and liquidity ratios remain relatively small in some of the accession countries, reflecting lack of enforcement of regulations, inadequate financial disclosure, and insufficient transparency of trading. Besides sound monetary and fiscal policies, several measures are still needed to develop an effective cushion against potential contagion effects of financial crises. These include an effective system of bank monitoring and supervision, a lower reliance on debt in relation to equity, and a higher degree of transparency for financial institutions.[35] These will be priorities in the run-up to EU membership and future EMU participation, as investors may want to test the credibility of the prevailing monetary regime; such pressures could be costly in a situation without a sound financial system.

[32]Robert Feldman and Maxwell Watson, "From Transition to Membership in the European Union," *Finance and Development*, Vol. 38 (September 2000), pp. 24–27. This paper is based on background work for a forthcoming IMF Occasional Paper on developing policy frameworks in central Europe.

[33]In the case of branch banks, regulatory responsibilities fall on the authorities of the country where the headquarters is located.

[34]Randall Filer and Jan Hanousek, "The Extent of Efficiency in Central European Equity Markets," in *Capital Markets in Central and Eastern Europe,* ed. by Christian Helmenstein (Northampton, Massachusetts: Edward Elgar, 1999). In Peter Christoffersen and Torsten Sløk, "Do Asset Prices in Transition Countries Contain Information About Future Economic Activity?" IMF Working Paper 00/103 (Washington: International Monetary Fund, 2000), evidence is found that asset markets in transition economies display the same leading indicator properties as observed in the current EU member countries.

[35]Lucjan Orlowski, "The Development of Financial Markets in Poland," Center for Social and Economic Research Working Paper Series No. 33 (Warsaw: Central European University, 1999).

Table 4.9. Comparative Market Development Data for Selected Accession Countries: Market Regulation and Supervision

	Independent Securities Commission	Insider Laws and Investor Protection	Disclosure and Compliance Regulation and Enforcement
Czech Republic	Yes, since 1998	Contained in New Securities Law recently approved by Parliament	Enhancement of standards and strengthening of enforcement capabilities needed
Hungary	Capital market and banking supervision integrated into one independent institution under Government supervision	Legal provisions and regulation converging toward International Organization of Securities Commissions (IOSCO) standards	Standards well developed
Poland	Yes, since 1991	Legal provisions and regulation converging toward IOSCO standards	Standards well developed
Romania	Yes, National Securities Commission reports directly to parliament	Certain provisions exist in 1994 Securities Law, but enhancement underway in line with market development	Regulations developed by National Securities Commission and self-regulatory organizations (SROs) but enforcement procedures not in place
Slovenia	Securities Market Agency fully independent from Ministry of Finance	Provision exists in 1994 Law on Securities Market. New law in drafting stage will bring harmonization with EU legislation	Standards developed and enforcement capabilities being strengthened
Slovakia	No, Control Office within Ministry of Finance exercises supervision	The government has approved legislation on the Financial Market Authority which should become effective later in 2000	Standards developed and enforcement capabilities being strengthened

Source: OECD, *Capital Market Developments in Transition Economies* (1998); and IMF staff.

Labor and Product Market Reforms

The accession countries have experienced dramatic changes in their labor and product markets since the beginning of transition. The dismantling of a large part of the public sector and the creation of a private sector is still taking place, and a key requirement for convergence is the ongoing movement of labor to productive, market-oriented, and privately owned companies, including many that can compete successfully with producers in the rest of the EU.

An essential element in facilitating the continued adjustment of the accession economies is labor market flexibility. If labor markets are characterized by low real wage flexibility, low mobility, and a high degree of employment protection such as high costs of firing and hiring, then adjustment is likely to be slow and costly. In some respects, labor markets in the accession countries appear to be more flexible than those among current EU members, although this picture is not entirely consistent across all indicators.[36] In the area of employment protection, for example, the candidates seem to have greater flexibility than the average EU country. The Organization for Economic Cooperation and Development (OECD) has estimated the overall extent of protection using indicators such as the direct costs of dismissal and delays of dismissal for permanent and temporary workers. On a scale from 1 to 6 (with 1 being the least restrictive), the EU average for 1998 was 2.4, whereas Poland, the Czech Republic, and Hungary were significantly lower with values of 1.9, 1.7, and 1.4, respectively.[37]

Table 4.10 examines real wage flexibility during transition for five CEECs—the Czech

[36]Unfortunately, the EBRD transition indicators that are widely used to assess progress with structural reforms do not include the labor market. The wide range of labor market arrangements among current EU members also needs to be noted.

[37]Giuseppe Nicoletti, Stefano Scarpetta, and Olivier Boylaud, "Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation," OECD Economics Department Working Paper No. 226 (Paris: Organization for Economic Cooperation and Development, April 2000).

Republic, Hungary, Poland, the Slovak Republic, and Slovenia—and, for the 1990–1998 period, estimates how much employment changed when real wages changed. The table also gives corresponding estimates for France, Italy, Germany, and Spain.[38] The statistical analysis reveals that, in the beginning of transition, the employment response to wage changes in the five CEECS, while statistically significant, was quite modest. This indicates that, in the early phase of transition, there were many factors other than real wages determining labor adjustment. The estimate for the more recent period—although based on fewer observations—is, however, almost identical to the estimate for the current EU members. This simple measure may suggest that labor markets have been through part of their adjustment and are now—at least in some respects—functioning in a similar fashion as in the current EU countries.

The accession countries appear to have generally low mobility across sectors, occupations, and regions, and this has important implications for the pace of adjustment. The evidence shows that overall there are relatively low levels of turnover in the unemployment pools of the accession countries[39] and there is also evidence that there are significant flows from employment to inactivity.[40] Explanations for this low mobility include informational failures, inappropriate skill structure, housing market rigidities, and high costs of moving from public to private enterprises for those with substantial job tenure and labor market experience in the public sector.[41]

Table 4.10. Estimates of Labor Market Flexibility

	Accession Countries[1]		Current EU Countries[2]
	1990–95	1996–98	1990–98
Labor demand elasticity	–0.06 (2.08)	–1.23 (7.88)	–1.22 (3.98)

Source: IMF staff calculations.
Note: t-statistics in parentheses.
[1]Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia.
[2]France, Italy, Germany, and Spain.

The main part of the *acquis* that relates to labor markets is the European Social Charter, which is a range of basic guidelines that accession countries must implement before they can join the EU. The Social Charter sets out minimum standards in areas that are an integral part of almost all well-functioning market economies, including the bargaining system, social welfare, migrant workers' rights, conditions of work, severance protection, protection of workers' claims in the case of bankruptcy, and rights of workers' representatives (Table 4.11). The accession countries have some choice about how far above these minima they pitch their labor market policies. In this regard, several studies have questioned the potential impact of rigorous adoption of the Social Charter on flexibility.[42] In particular, it has been emphasized that, since the accession countries continue to require significant adjustment, labor market policies should rather be defined in the context of what the accession countries need to and can realistically accomplish. Moreover, the enforcement of EU style regulation of labor markets may have adverse consequences on the forma-

[38]The fixed effect panel labor demand elasticity that is estimated for the two groups of countries has the following form: $\log(\text{Employment}_{i,t}) = \text{constant} + \alpha\log(\text{Real wage}_{i,t}) + \log(\text{Real income}_{i,t})$, where i denotes country $i = 1,..n$ and t is time.

[39]See Tito Boeri, "Transitional Unemployment," *The Economics of Transition,* Vol. 2 (1994), pp. 1–26. Vit Storm and Katherine Terrell, "A Comparative Look at Labour Mobility in the Czech Republic: Where Have All the Workers Gone?" CEPR Discussion Paper No. 2263 (London: Center For Economic Policy Research, October 1999), however, provides evidence that mobility in the Czech Republic has been relatively higher.

[40]Tito Boeri and Scott Edwards, "Long-term Unemployment and Short-term Unemployment Benefits: The Changing Nature of Non-employment Subsidies in Central and Eastern Europe," *Empirical Economics,* Vol. 23, No. 1/2, (1998), pp. 31–54.

[41]Tito Boeri and Christopher Flinn, "Returns to Mobility in the Transition to a Market Economy" (unpublished manuscript; April 1999). O. Blanchard, S. Commander, and F. Corricelli, eds., *Unemployment, Restructuring, and Labor Markets in Eastern Europe and Russia* (Washington: World Bank, 1995).

[42]Michael Burda, "The Consequences of EU Enlargement for Central and Eastern European Labour Markets," CEPR Discussion Paper No. 1881 (London: Center for Economic Policy Research, 1998), and János Gács, "Accession to the EU: A Continuation of or a Departure from Transition Reforms?" IIASA Interim Report–99–002 (Laxenberg, Austria: International Institute for Applied Systems Analysis, 1999).

Table 4.11. The European Social Charter and the Labor Market[1]

Institutional bargaining system[2]	"Everyone has the right to bargain collectively" and countries should "promote where necessary the machinery for voluntary negotiations between employers and employers' organizations and workers' organizations, with a view to the regulation of terms and conditions of employment by means of collective agreements." In addition, "the right of workers and employers to collective action in cases of conflicts of interest, including the right to strike . . ." should be recognized.
Social welfare[3]	"Everyone has the right to benefit from social welfare services."
Migrant workers' rights[4]	Countries signing the Charter agree "to promote co-operation, as appropriate, between social services, public and private, in emigration and immigration countries" and "to secure for such workers . . . treatment not less favorable than that of their own nationals in respect of . . . a) remuneration and other employment and working conditions; b) membership of trade unions and enjoyment of the benefits of collective bargaining; c) accommodation."
Conditions of work[5]	Countries signing the Charter agree to provide: "reasonable daily and weekly working hours"; "for public holidays with pay"; "for a minimum of four weeks' annual holiday with pay"; "that workers performing night work benefit from measures which take account of the special nature of their work."
Severance protection[6]	Countries signing the Charter agree to recognize: "the right of all workers not to have their employment terminated without valid reasons for such termination connected with their capacity or conduct based on the operational requirements of the undertaking, establishment or service"; "the right of workers whose employment is terminated without a valid reason to adequate compensation or other appropriate relief."
Protection from consequences of bankruptcy[7]	Countries signing the Charter agree to recognize: "that worker's claims arising from contracts of employment or employment relationships be guaranteed by a guarantee institution or by any other effective form of protection."
Rights of workers' representation[8]	Countries agree to undertake that workers' representatives: "enjoy effective protection against acts prejudicial to them, including dismissal based on their status of activities"; "are afforded with such facilities as may be appropriate in order to enable them to carry out their functions promptly and efficiently."

[1]The full text of the European Social Chapter is available on the Internet at http://www.coe.fr
[2]European Social Charter, 1961, article 6.
[3]European Social Charter, 1961, article 14.
[4]European Social Charter, 1961, article 19.
[5]European Social Charter, revised, 1996, article 2.
[6]European Social Charter, revised, 1996, article 24.
[7]European Social Charter, revised, 1996, article 25.
[8]European Social Charter, revised, 1996, article 28.

tion of new firms and industries. High start-up costs may lead to fewer new firms than would otherwise have been the case. And such slower business formation due to excessive costs of hiring, employing, and firing labor may inhibit the transition toward a private sector based economy and may ultimately slow the process of CEEC income levels catching up with those in the EU.

Although concerns about outflows of *skilled* workers (or "brain drain") often appear to predominate when lower income countries integrate with more advanced economic areas, the EU enlargement process has given rise to concerns—especially on the EU side—about possibly large flows of *unskilled* workers from East to West. Indeed, there is some evidence suggesting that there are larger real wage differences between low-skilled workers in the accession countries and the current EU member countries compared with the case of skilled workers.[43] As

[43]These disparities in wage rates for lower-skilled workers may result in part from labor market distortions among EU members that have led to compressed wage differentials and reduced job opportunities for unskilled labor.

discussed below, however, fears of a significant increase in migration flows following accession of the candidate countries may be overstated, particularly in view of the many other factors besides wage differentials that determine migration patterns, including cultural and social influences.

A further key element of EU membership is the existence of competitive markets for goods. Most of the accession countries adopted competition laws at an early stage of transition, and removed product market regulations to intensify competition. In contrast though to some of the labor market indicators, product market deregulation in the most advanced accession countries generally still lags the EU.[44] The OECD has estimated the overall extent of product market regulation in some of these countries using indicators such as state control, barriers to entry, barriers to trade and investment, economic regulation, and administrative regulation.[45] On a scale from 1 to 6 (with 1 being the least restrictive provisions), Hungary's "score" of 1.6 for product market regulation was identical to the average for current EU members, while the Czech Republic and Poland were above the most regulated EU countries (Italy, Greece, and France), with values of 2.9 and 3.3, respectively. It remains possible, however, that product market competition will intensify as trade integration and other economic linkages with the EU deepen. Evidence from the first half of 1999 suggests that foreign competition, as well as improvements in enforcement and institutional effectiveness, has significantly enhanced competition in the transition economies.[46]

Fiscal Implications of EU and EMU Accession

The accession countries face the prospect of both increased public expenditures and increased revenues as a result of the EU accession process. These trends would be occurring in a context where almost all of the applicants already have ratios of public spending and revenue to GDP that are relatively high in comparison with other countries of similar income levels, although not out of line with the EU average (Figure 4.6). The fiscal implications of accession can, to some degree, be divided into those that arise—or at least begin—prior to EU membership, and those that would follow accession. The two largest areas of pre-accession expenditure stem from the costs of complying, first, with the legal and institution building requirements of the *acquis* and, second, with EU environmental standards (e.g., concerning water pollution, air pollution, and waste management). The latter appears to be the most costly area of compliance, although environmental improvements are clearly essential for the long-run development of these countries and increases in their living standards. While the level of expenditure varies substantially among the candidates, estimates in several of the more advanced applicants suggest that the average annual cost of complying with EU environmental standards for the next five years will be around 1.5 percent of GDP per year.[47] An illustration of EU-related spending, in the case of Hungary, is shown in Table 4.12: the costs of both environ-mental development and legal adjustments, as well as other areas of economic development, increased substantially between 1999 and 2000, and total accession-linked spending is now around 2½ percent of GDP.

Not all of this spending falls on domestic budgets, however. The EU has made available a total of €22 billion in pre-accession support for the applicants for the period 2000–06, implying

[44]EBRD, *Transition Report 1999,* Table 2.1, p. 24.

[45]Nicoletti, Scarpetta, and Boylaud, "Summary Indicators of Product Market Regulation with an Extension to Employment Protection Legislation."

[46]Mark Dutz and Maria Vagliasindi, "Competition policy implementation in transition economies: an empirical assessment," EBRD Working Paper No. 47 (London: European Bank For Reconstruction and Development, December 1999).

[47]Dominika Anna Dziegielewska, "How Much Does It Cost to Join the European Union and Who Is Going to Pay for It? Cost Estimates for the Czech Republic, Hungary, Poland and Slovenia, Complying with the EU Environmental Standards," IIASA Interim Report–00–001 (Laxenburg, Austria: International Institute for Applied Systems Analysis, 2000).

Table 4.12. Hungary: EU-Related Spending and Financing

(As percent of Hungary's GDP)

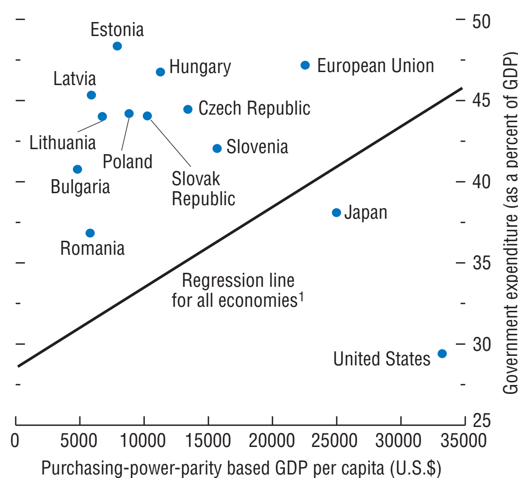
	1999	2000	2001
Legal approximation	0.3	0.8	0.8
Economic development	0.8	1.7	1.6
Key sectors: Agriculture	0.0	0.2	0.3
Transport	0.0	0.2	0.2
Environment	0.7	1.1	1.0
Regional development	0.1	0.3	0.2
Total	1.2	2.5	2.4
Financed by: Central budget	0.7	1.1	1.2
EU assistance	0.2	0.8	0.6
Other[1]	0.3	0.6	0.6

Source: IMF, *Hungary: Selected Issues and Statistical Appendix,* April 2000.

[1]Local governments, nongovernmental organizations, and the private sector.

Figure 4.6. Government Expenditures in Relation to GDP per capita, 1999

General government expenditure (as a share of GDP) in the EU accession countries is relatively high by world standards, but generally comparable with the EU average.



Source: IMF staff calculations.

[1]The regression line is estimated using data from 172 developing, transition, and advanced economies.

annual support averaging around 1 percent of GDP for the candidates. Some of the accession costs—especially those associated with environmental improvements—are expected to be borne by the private sector, such as the polluting companies themselves. However, contingent fiscal risks may also arise in this context as a result of public ownership of some of these companies together with possible pressure for public support for others. Assistance in the form of loans is also available to the applicants—for example, from the European Investment Bank and the EBRD.

Following accession, the new EU members would gain access to a substantial level of EU structural funds and agricultural support although, as considered below, further reforms of these programs will probably make them less generous than in the past. For example, under current rules for Structural and Cohesion Funds, the most advanced accession countries would have gained significantly—a net transfer of more than 7 percent of GDP in the case of Hungary, for instance.[48] But, reflecting in part its concerns about the size and affordability of

[48]Jørgen Mortensen and Sándor Richter, "Measurement of Costs and Benefits of Accession to the European Union for Selected Countries in Central and Eastern Europe," WIIW Research Report No. 263 (Vienna: Institute for International Economic Studies, 2000).

these transfers, the EU has capped structural assistance in any member state at 4 percent of national GDP. Given the need for a new financial perspective after 2006, the levels and forms of future EU assistance are uncertain. On the expenditure side, some of the above increases, including in administrative and environmental costs, would likely continue following full accession of the candidates to the EU. In addition, new members will have to contribute to the EU budget. While the specific level of these contributions—from current as well as prospective members—is subject to ongoing negotiations, the EU budget as a whole is subject to a ceiling of 1.27 percent of EU aggregate GNP.

Several other fiscal implications, both before and after accession, should also be noted. On the one hand, the overall institutional strengthening by EU applicants under the accession process should lead to improvements in the administration of taxes and spending, in procurement practices, and in the general efficiency of the public sector—efforts that should contribute, over the longer run, to improvements in public revenues and to better control over public spending. Interest rates and hence debt servicing costs may well fall, especially as the applicants move closer to euro area membership—as happened with current members—and, indeed, reductions in country risk premia are already evident among some EU applicants. On the other hand, the accession countries are also likely to face several sources of fiscal pressure over the medium term. Some countries still face the need for substantial real and financial sector restructuring, and this may have a significant impact on their public finances. Most of the CEECs also need increased public investment to upgrade aging infrastructure—an area where EU structural funds could continue to make an important contribution. In addition, several of the applicant countries have recently joined the North Atlantic Treaty Organization (NATO), and have committed themselves to higher defense spending in the coming years. As with current EU member countries, all of the transition economies face increased pressure on their public finances as a result of demographic changes. Reforms to pension and social benefit arrangements—including, for example, improved targeting of the latter—will be required if large tax increases or benefit cutbacks are to be avoided.[49]

Overall, while EU assistance may go a long way toward offsetting the costs associated with accession, the fiscal risks and uncertainties facing the applicants argue strongly for them reaching and maintaining conservative fiscal stances. The high public expenditure ratios of almost all the applicants, and the fiscal and debt pressures currently faced by some, imply that the candidate countries generally have little scope for fully accommodating accession-related spending or other fiscal risks. They may therefore need to reduce spending in other areas. Moreover, these countries need to retain substantial fiscal flexibility to help them manage the shocks they are likely to encounter as small, open economies. The need for such flexibility is all the more apparent in the longer-term perspective of euro area membership.

Monetary Convergence

Given the prospect of eventual membership in the euro area, parliaments in most accession countries have already adopted legislation with a view to making monetary arrangements more compatible with the requirements of the Maastricht Treaty.[50] For example, central bank independence has been strengthened, and the enacted limitations of fiscal financing have become more binding. In terms of the formal re-

[49]For example, projections for Lithuania based on the current share of people contributing to the pension system show that only 54 percent of the old-age population would be covered by the pension system in 2025. See Svend Erik Hougaard Jensen and others, "Reforming Social Security in a Transition Economy: The Case of Lithuania," unpublished working paper, supported by the European Union's Phare ACE program (June 2000).

[50]Eduard Hochreiter and Tadeusz Kowalski, "Central Banks in European Emerging Market Economies in the 1990s," OeNB Working Paper No. 40 (Vienna: Oesterreichische Nationalbank, April 2000).

Table 4.13. Exchange Rate Arrangements and Anchors of Monetary Policy
(As of July 2000)

Country	Exchange Rate Regime	Monetary Policy Framework	Date Introduced
Bulgaria	Currency board arrangement	Exchange rate anchor (Euro)	1997
Estonia	Currency board arrangement	Exchange rate anchor (Euro)	1992
Lithuania	Currency board arrangement	Exchange rate anchor (U.S. dollar)	1994
Latvia	Conventional fixed peg arrangement (peg to SDR)	Fund-supported or other monetary program	1995
Hungary	Exchange rate within crawling bands	Exchange rate anchor (Euro)	1994
Poland	Managed float with no pre-announced path for exchange rate	Inflation targeting framework	1999
Slovak Republic	Managed float with no pre-announced path for exchange rate	No explicitly stated nominal anchor; rather, the central bank monitors a number of indicators in conducting monetary policy	1998
Czech Republic	Managed float with no pre-announced path for exchange rate	Inflation targeting framework	1997
Slovenia	Managed float with no pre-announced path for exchange rate	Broad money (M3) targeting framework	1991
Romania	Managed float with no pre-announced path for exchange rate	Fund-supported or other monetary program	1997

quirements for euro area membership, the candidates would need to make adjustments to their monetary frameworks in the future. There is, however, no imperative for them to adopt a common strategy for their monetary and exchange rate policies in the near term—particularly in view of the further economic adjustments they are likely to face.[51]

Throughout the transition period, the accession countries have adopted widely different monetary and exchange rate regimes. Currently, Estonia, Bulgaria, and Lithuania are under a currency board arrangement, Latvia has adopted a firm exchange rate peg, Hungary has adopted a narrow crawling band, while the Czech Republic, Poland, Slovak Republic, Slovenia, and Romania have floating exchange rates with different degrees of inflation targeting (Table 4.13).[52] A striking feature of monetary developments in the accession countries is that, independently of the choice of exchange rate regime, real exchange rates in most cases have appreciated steadily since the beginning of transition (Box 4.4).

Looking forward, as the accession countries converge with the EU, there will be three main sources of tension for the monetary and exchange rate policy frameworks.[53] First, the changing structure of the financial economy and shifts in money demand will complicate the choice and use of nominal anchors. The transmission mechanism may be unpredictable, affecting, notably, inflation- and monetary-targeting regimes. Second, sizable and possibly volatile capital flows will likely complicate the task of monetary management, whether the exchange rate is fixed or floating. Third, these economies may have difficulty in achieving convergence to very low inflation levels while at the same time achieving exchange rate stability, be-

[51]Robert Corker and others, “Exchange Rate Regimes in Selected Advanced Transition Economies—Coping with Transition, Capital Inflows, and EU Accession,” IMF Policy Discussion Paper 00/3 (Washington: International Monetary Fund, April 2000). This study also discusses post-accession issues for the accession countries.

[52]For a discussion of the choice of exchange rate regimes in transition countries, see Michael Mussa and others, *Exchange Rate Regimes in an Increasingly Integrated World Economy*, Occasional Paper No. 193 (Washington: International Monetary Fund, 2000).

[53]Feldman and Watson, “From Transition to Membership in the European Union.”

cause of the Balassa-Samuelson effect described in Box 4.4.

The pressures that may arise from high capital inflows and real convergence could present particular challenges for the monetary frameworks of the accession countries as they continue to reform and liberalize their economies. In these circumstances, there is some potential for conflict between, on the one hand, the exchange rate and price level implications of these pressures and, on the other, policy goals of securing very low inflation, nominal exchange rate stability, and hence the degree of real exchange rate stability that would be desirable to secure a fairly smooth path of output and expectations in the economy.[54] Such concerns, however, do not necessarily argue in favor of fundamental changes in the current exchange rate regimes used by the accession countries, at least during the earlier stages of convergence. Instead, the point is that somewhat higher rates of inflation or nominal exchange rate movement among the applicants, compared with the more advanced economies, should be viewed as a normal and expected part of the convergence process. For example, the currency boards and hard pegs used by the Baltic countries and Bulgaria appear to have served these countries well—proving quite robust, for example, in the presence of external shocks (notably the 1998–99 Russian financial crisis).[55] The other countries may well choose to continue with (and, in some cases, strengthen) regimes that give a high weight to inflation objectives while providing substantial exchange rate flexibility, but also allowing policymakers to signal the limits to the variability they are prepared to countenance.

Looking ahead, the adjustments—if any—that the EU accession countries may wish to make in their exchange rate regimes as preparation for integration in the euro area, and the pace of their participation, will depend largely on individual country circumstances, including the extent of convergence with existing members, the state of their banking sectors, and other fiscal and monetary risks. However, when overall convergence has advanced to the point where more formal monetary linkages between the candidate countries and the EU become feasible, notably through the Exchange Rate Mechanism, the further step of full euro area participation should probably follow rather quickly in order to remove the exchange rate risks that these countries could face from stronger capital flows as accession nears—particularly as the credibility of these countries' monetary frameworks is likely to increase during this period.

Challenges for the EU as It Prepares for Enlargement

The accession of the CEECs will entail significant changes and challenges for the EU, increasing the pressure for reforms in several critical areas. While the direct economic impact on the EU may initially be modest, considering that the applicant countries have a relatively small aggregate economic weight and will need considerable time to catch up with current EU members, enlargement will require substantial changes in some key EU institutions and policies. As noted in Box 4.1, the EU has set a target date of year-end 2002 for being ready to accept new members. There have, however, been widespread expressions of concern about the limited progress that has been made so far on the reforms that are required within the EU, and most outside commentators doubt that the end-2002 goal will be achieved. This section focuses on the principal reform requirements and areas of tension within the EU arising from the proposed enlargement, and on the implications of some of the proposed solutions.

[54]Paul Masson, "Monetary and Exchange Rate Policy of Transition Economies of Central and Eastern Europe after the Launch of EMU," IMF Policy Discussion Paper 99/5 (Washington: International Monetary Fund, 1999) examines the choice of monetary framework in the accession countries.

[55]See, for example, Anne-Marie Gulde, Juha Kähkönen, and Peter Keller, "Pros and Cons of Currency Board Arrangements in the Lead-up to EU Accession and Participation in the Euro Zone," IMF Policy Discussion Paper 00/1 (Washington: International Monetary Fund, 2000).

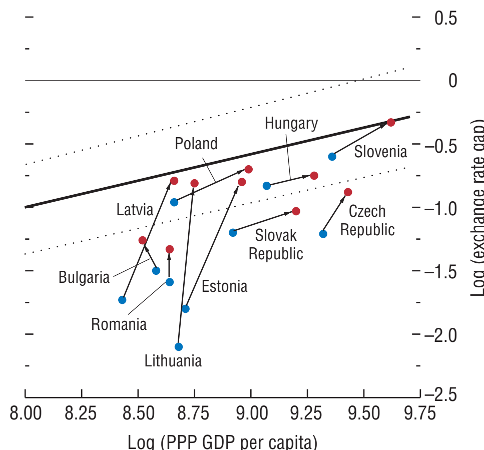
Box 4.4. Convergence and Real Exchange Rate Appreciation in the EU Accession Countries

The degree of over- or undervaluation of a country's exchange rate can be assessed in several ways.[1] One method is to calculate the exchange rate gap between its actual U.S. dollar exchange rate and its purchasing-power-parity-based U.S. dollar exchange rate once the level of development has been taken into account.[2] The relationship between this exchange rate gap and GDP per capita measured at purchasing-power-parity (PPP) for advanced and developing countries is shown in the figure. The bold line, based on a simple linear regression, shows the relationship between these two variables for 149 non-transition countries in the world using 1999 data. The dotted lines in the figure indicate the statistical confidence intervals around the estimated line.[3]

After an initial sharp depreciation of exchange rates in all transition economies in the early 1990s, the exchange rates of the accession countries have since appreciated significantly.[4] The movements from 1993 to 1999 are indicated by the arrows in the figure.[5] The accession countries have moved closer to similar countries elsewhere—the distance from the estimated line is smaller in 1999 than in 1993. Most of the countries are by now inside the confidence intervals. This indicates that they now have broadly similar exchange rate gaps as market economies at comparable levels of development. Or, put differently, judging from their current positions in the figure, these countries have largely or fully eliminated the exchange rate gap associated with the distortions inherited from central planning.

The narrowing of the exchange rate gap illustrated in the figure can be explained by many factors, including further correction of initial sharp undervaluations of these currencies, and broader improvements in macroeconomic stability and policy credibility. Another contributing influence is likely to have been efficiency improvements experienced in the industrial sectors of the accession countries. Productivity gains in these sectors relative to those in the rest of the world and associated productivity-

Exchange Rate Gap and Income Level for EU Accession Countries[1]



[1]The bold line shows the estimated relationship between the exchange rate gap (between actual and PPP-based exchange rates) and GDP per capita (in PPP terms) for 149 non-transition countries in 1999. The dotted lines are plus/minus one standard deviation. Arrows indicate movements for the accession countries from 1993 to 1999.

[1]See, for example, Ronald MacDonald and Jerome Stein, *Equilibrium Exchange Rates,* Kluwer Academic Publishers (Boston, Massachusetts: 1999).

[2]To be precise, the exchange rate gap for each country is calculated as log (actual U.S. dollar exchange rate/purchasing-power-parity-based exchange rate). For further information on the derivation of PPP exchange rates and weights, see *World Economic Outlook,* May 2000, Box A1, and Anne Marie Gulde and Marianne Schulze-Ghattas, "Purchasing Power Parity Based Weights for the *World Economic Outlook,*" *Staff Studies for the World Economic Outlook*, December 1993.

[3]Calculated as plus/minus one standard deviation. For details on these calculations, see Mark De Broeck and Torsten Sløk, "Interpreting Real Exchange Rate Movements in Transition Countries," forthcoming IMF Working Paper.

[4]However, there are several cases where the real exchange rate, calculated using unit labor costs, has depreciated.

[5]The starting year was set to 1993 since by then a major portion of goods prices had moved toward international levels (see also Vincent Koen and Paula R. De Masi, "Prices in the Transition: Ten Stylized Facts," *Staff Studies for the World Economic Outlook*, December 1997).

based wage increases led to more generalized wage and price increases elsewhere in the economy, in line with the so-called Balassa-Samuelson effect.[6] For a given nominal exchange rate, price increases relative to the rest of the world imply an appreciation of the real exchange rate. The higher inflation and associated appreciation of the real exchange rate are not monetary phenomena but are a reflection of an adjustment mechanism involving relative wages and prices. The positive slope seen in the figure indicates that this mechanism also operates in non-transition countries at various income levels, and is a natural part of economic development. The effect is expected to be more pronounced in the transition economies, however, because they started from a situation where liberalization and movements in relative prices led to restructuring and reallocation of resources to more productive, often exporting, sectors.

The slope of the estimated line in the figure also makes it possible to quantify roughly the implications of convergence for inflation in transition economies relative to the rest of the world. Although, as discussed above, the accession countries appear to have largely eliminated the exchange rate gap associated with the distortions inherited from central planning, they are expected to have higher growth rates than in the advanced economies as part of the ongoing convergence in per capita incomes. The slope suggests that "excess" growth of 1 percent (implying convergence with more advanced economies) will lead to a relative increase in price levels of 0.4 percent. Note that this does not imply that there will be no other sources of inflation, including those that are monetary or expectational in nature.[7] But it does imply that, as the accession countries continue to catch up with the EU, they can expect, for example, a 5 percent growth differential with current members to be associated with a 2 percent inflation differential.

[6]Bela Balassa, "The Purchasing Power Parity Doctrine: A Reappraisal," *Journal of Political Economy,* Vol. 72 (1964), and Paul Samuelson, "Theoretical Notes on Trade Problems," *Review of Economics and Statistics,* Vol. 46 (1964).

[7]For a discussion of the factors determining inflation in transition, see the papers in Carlo Cottarelli and György Szapáry, eds., *Moderate Inflation: The Experience of Transition Economies* (Washington: International Monetary Fund, 1998).

Institutions

The EU's institutional framework has remained broadly unchanged since its adoption by the original six founding members, despite successive enlargements and increases in the scope of common policymaking. Its reform has been made a precondition for enlargement, on the grounds that an increase in membership with current procedures would stifle the decision-making process. In particular, change is considered a necessity to avoid three problems:

- The European Commission, the EU's executive, might become excessively large. At present there are 20 Commissioners, with the five largest countries appointing two and all others appointing one. The 10 CEECs, with Poland probably qualifying as a large country, plus Cyprus and Malta, with whom negotiations are also proceeding, would raise this number to 33.
- A larger membership might increase the difficulty of taking decisions owing to the requirement of unanimity in the Council of Ministers in many key areas. Unanimity remains the rule regarding the Union's institutions, membership, economic policy (including controversial matters such as tax harmonization), immigration (from third countries), justice, and foreign policy. As is currently under consideration, the problem might be attenuated by broadening the scope of decisions by qualified majority voting, which is virtually the rule for matters pertaining to the internal market.
- With the present weighting of votes, decisions by qualified majority could be taken in the

Council of Ministers by countries accounting for barely half of the total population, reflecting the number of small countries.[56]

These issues are on the agenda of the EU's intergovernmental conference, which started earlier this year and is due to be concluded in December 2000. More broadly, in recent months a wide-ranging discussion has begun on the longer-term future of the EU's institutions, including allowing groups of member states to embark on closer integration within the EU framework.[57] Many see a more tightly knit institutional framework as an essential requirement for successful common policies. Whatever this may entail in the long run, it should be of little consequence for the accession of the CEECs, as no common views have yet emerged and several member states firmly oppose going beyond the agreed agenda at the present stage.

Labor Markets

Immigration has become an increasingly sensitive issue in the EU, with the opposition often transcending traditional political lines. The possibility that enlargement could lead to large flows of workers from east to west, with attendant risks of job displacement and wage losses for incumbents, has therefore become a matter of concern in some EU countries. However, the free movement of labor is an integral part of EU membership. Whether full integration occurs immediately upon enlargement, or is delayed by means of a transition period, will be determined in the course of negotiations on this part of the *acquis*.

Turning to some of the evidence on this issue, currently available projections suggest that fears of large-scale migration from the CEECs to the EU as a whole are probably ill-founded.[58] For example, a recent comprehensive analysis of this issue suggests that the number of residents from the ten accession countries in the EU could initially increase by around 335,000 people a year following the introduction of free movement of labor, declining to below 150,000 people within a decade.[59] This projected initial inflow is comparable with the peak level of recorded net migration of about 350,000 people a year from the candidate countries to the EU reached in the early 1990s. Since 1993, however, net migration has been negligible (and even negative in some of the applicants), as a result of tighter restrictions placed on such flows by the EU countries. The projected migration would be unevenly distributed, with most migrants moving to the EU nations that are adjacent to the CEECs (such as Austria and Germany), and probably being concentrated in the border regions of these countries. For example, around two-thirds of the initial flows noted above would be to Germany. Migration is expected to exercise some downward pressure on wages at the lower end of the pay scale, owing to the preponderance of less skilled workers among the migrants, but to have only a modest overall impact on labor market conditions.

Based in part on evidence of migration between eastern and western Germany, the most important factors that determine the degree of migration appear to be differences in per capita income, the employment rate in destination

[56]Currently, the qualified majority is 71 percent of the votes. In the EU-15, the votes are distributed as follows: France, Germany, Italy, and United Kingdom have 10 votes each; Spain has 8; Belgium, Greece, Portugal, and Netherlands have 5 each; Austria and Sweden have 4 each; Denmark, Finland, and Ireland have 3 each; and Luxembourg has 2. With this weighting of the votes, a decision can be blocked by member states accounting for 12 percent of the population. With a membership of 27 (the EU-15, the CEEC-10, Cyprus, and Malta), this percentage would be lowered to 10.

[57]At present, there is such enhanced cooperation in the case of EMU and the Schengen agreement. Under the latter, all member states except Ireland and the United Kingdom have adopted common rules for visas, asylum rights, and checks at the area's external borders. Iceland and Norway are associated members without voting rights.

[58]Thomas Bauer and Klaus Zimmermann, "Assessment of Possible Migration Pressure and Its Labour Market Impact Following EU Enlargement to Central and Eastern Europe," DFEE Research Report No. 138/139 (London: UK Department for Education and Employment, December 1999) and Tito Boeri and Herbert Brücker, "The Impact of Eastern Enlargement on Employment and Labor Markets in the EU Member States," study for the European Commission (Brussels: European Commission, 2000).

[59]Boeri and Brücker, "The Impact of Eastern Enlargement on Employment and Labor Markets in the EU Member States."

countries, and employment rates in the countries of origin.[60] As emphasized elsewhere in this chapter, policy measures that foster employment growth in the CEECs and rapid convergence of their income levels with those of the EU will therefore be crucial to determining the extent and duration of possible migration pressures. The EU also has an important role to play in this regard. Labor market and other reforms among current members would improve the flexibility of these economies, helping to raise their potential growth rates, add to their employment creation capacity—especially for lower-skilled labor—and hence increase their ability to cope with larger migration inflows.

Intra-EU Solidarity

The EU's budget—which serves to finance the common policies—is currently governed by a "financial perspective," a quantified budgetary framework expressed in real terms, for the period 2000–06. There are ringfenced appropriations for the present member states, together with pre-accession aid and notional appropriations for new members that would become effective upon their accession. From this perspective, then, enlargement would not affect the rights of the present members before 2007.[61]

The negotiation of the next financial perspective may alter these current arrangements. The bulk of budget expenditure is accounted for by structural policy—that is, assistance to areas that are lagging in development—and by the EU's common agricultural policy (CAP). Under current arrangements, structural policy would not necessarily change much on account of enlargement. Per capita GDP—a chief determinant of assistance—is clearly much lower in the CEECs than in the EU-15, and the EU has estimated that, under unchanged criteria, the population of an enlarged EU that would be eligible for assistance would more than double.[62]

Furthermore, the European Commission noted that the high proportion of population eligible for assistance (60 percent) would "be contrary to the principle of concentration of effort on which the effectiveness of assistance depends."[63] Reflecting these concerns, along with the limited capacity of the candidates to absorb structural funds, the current EU members have decided that structural assistance in the current financial perspective is subject to a ceiling equivalent to 4 percent of GDP (as noted earlier).

Matters are different for agricultural policy. The accession of the ten CEECs will represent a major change for the EU's agricultural sector, with the land devoted to agriculture increasing by close to 50 percent and the number of those employed in the sector more than doubling. Agriculture in the CEECs is already tending toward excess production and has considerable scope for increasing production, given its present relatively low productivity. As farm incomes and prices are low in the CEECs compared to the EU-15, it is feared that production would be given a major boost if new members were to be given the full protection of the EU's CAP—adding to the agricultural surpluses that already exist in the EU. Moreover, a sudden sharp increase in farm incomes might retard economic modernization by drawing resources to the agricultural sector.

The EU's 2000–06 financial perspective includes a steadily increasing amount of agricul-

[60]The migration from eastern to western Germany after the unification increased dramatically, but today the net emigration is close to zero. Jennifer Hunt, "Why Do People Still Live In East Germany?" CEPR Discussion Paper No. 2431 (London: Center for Economic Policy Research, April 2000), ascribes this dramatic change to the narrowing of the unemployment and real wage gaps over time.

[61]The financial perspective was drawn up on the assumption that enlargement would begin with a first wave of six countries. It would therefore have to be revised if all twelve recognized active candidates were admitted into the Union before 2006.

[62]In an impact study prepared as part of the Agenda 2000 program in 1997, the European Commission estimated that if the EU were enlarged to include the ten CEECs along with Cyprus, the population eligible for assistance would increase from 94 million to 200 million under the prevailing criteria (European Commission, "Impact Study: The Effects on the Union's Policies of Enlargement to the Applicant Countries of Central and Eastern Europe," Brussels, 1997).

[63]See the Impact Study referred to in the previous footnote.

tural support for new members, starting at €1.6 billion in 2002 and rising to €3.4 billion in 2006 (in constant 1999 prices). By way of comparison, the CAP budget for current members averages €43 billion over this period, out of a total budget of around €90 billion for the EU-15. The EU's agriculture budget for new members is intended to cover only the price and market support components of the CAP, however, while farmers among current EU members also receive "direct" support based on the land area under cultivation and the number of animals. If such support were also extended to new members, this would increase CAP costs by an additional €4.6 billion a year. [64] Although these sums are not large in relation to the total economic size of the EU, extending the full range of agricultural support to the candidates as they joined the EU would imply that the total cost of the CAP—accounting for nearly one-half of the EU budget—would increase by over 14 percent as new members started receiving these funds. Already, costly surpluses have made it necessary to lower the support granted under the CAP. In two reforms, of which the latest entered into force in January 2000, greater sway has been given to market forces by lowering institutional prices and cutting back on intervention purchases, while compensating farmers partly with direct payments.[65]

If new members are to be accepted under the same terms and conditions as incumbents, enlargement is therefore likely to increase pressure for further reform of the CAP. Moreover, the way in which the CAP is reformed and extended to new members could well have spillover effects on the rest of the world, especially in view of the significant distortions that already exist in international agricultural markets.

Conclusions and Policy Implications

This chapter has provided an assessment of the potential benefits, costs, and risks arising from the prospective accession of the transition economies of central and eastern Europe into the EU and, later, into the euro area. The overall picture that emerges is that, in general, the accession countries have made substantial progress with economic liberalization and adjustment, including reorienting their trade to the west, strengthening capital markets, and improving macroeconomic stability. Based on this assessment, it is probably reasonable to conclude that the accession process is being driven forward not so much by the prospect of strong, tangible gains for the applicant countries in the near term, but by the long-term benefits that will arise from the firm economic and political linkages that accession will confirm. For example, these countries have already realized substantial gains from trade in goods with western markets, although benefits from further financial market integration, removal of non-tariff barriers, and increased trade in services may well occur. Although the EU's future policies concerning support for agriculture and allocation of structural funds are still to be determined, funds for new members from these sources will probably be less generous than these programs would have delivered in the past. Nevertheless, structural transfers could still amount to a significant share of the candidate countries' GDP.

Over the longer term, however, the anchoring of the applicants' economic, institutional, and political structures to the group of advanced western European nations is likely to lead to the former countries being viewed as more secure places for doing business. Such a perception should lead to a reduction in the risk premia associated with these countries, and help to foster further investment, stronger trade flows, and other forms of integration that will hasten economic convergence.

The analysis in this chapter has also pointed to several policy directions and priorities that would enhance these longer-term gains from EU

[64]Direct support estimates from Goldman Sachs, *Global Economics Weekly* 00/26 (July 2000).

[65]Disposing of new surpluses with the help of export subsidies is not an option, given the limits set in the Uruguay Round Agreement on Agriculture.

and euro area membership, and mitigate the risks. It will be important, for example, for the candidate countries to ensure relatively flexible microeconomic structures, particularly in labor and product markets. All of the applicants still face substantial adjustments—in their mix of occupations and industries (including agriculture), in trade patterns, in the financial sector, and other areas. The changes that are needed will occur more smoothly and at lower economic cost if markets are able to operate efficiently and convey clear price and wage signals.

The candidate countries also need to continue strengthening the institutions that support market activities. The chapter has pointed to several areas of weakness in this regard, particularly in the implementation of laws and regulations: there are concerns, for example, about the functioning of the judiciary, weaknesses in banking supervision, and persistent corruption. Implementation difficulties are probably not surprising, given the rapid pace of legislative development, especially the extensive body of laws that applicant countries need to adopt under the *acquis*. By putting in place a legal framework designed for economically advanced economies, the accession countries have the opportunity to "leap frog" others at a comparable stage of development. But, to fully realize these gains, the transition economies still face a substantial effort to build up the human capital and administrative capacity to ensure that laws are applied and enforced effectively.

As the anchor in the accession process, the EU has a central influence on the form and pace of enlargement. To be ready for new members, its responsibilities include carrying out internal reforms and shaping applicants' expectations about when full membership could occur. In each of these areas, however, substantial progress is still required. The EU needs to tackle critical reforms in such areas as voting procedures, agricultural support, and regional transfers so that it is in a position, both institutionally and fiscally, to include new countries on equal terms with current members. As things stand at present, delays in these reforms have raised substantial doubts about the conditions under which enlargement will occur, and when full membership can realistically be expected for even the first group of applicants.

These concerns could present significant risks to the accession process: either membership could be delayed, or new members could be placed in some form of transitional status (e.g., with less than full labor mobility, reduced access to EU programs, and so on). Such delays or interim "solutions" may not fundamentally matter—as long as the candidates continue to put in place the reforms that are needed to move them toward the mainstream of well-functioning market economies. But the risk is that slow or incomplete accession would weaken the commitment to and momentum of reforms, erode support for accession (among the applicants or current members), and make the transition economies more susceptible to economic or political shocks that could move them away from the accession track. For example, the sizable current account deficits of most of the applicants underscore the importance of their retaining the support of international investors—support that, to some degree, may be based on expectations of timely EU accession.

The EU therefore faces the urgent responsibility of reforming its institutions and policies in order to be ready for enlargement. In particular, more ambitious progress with its own reforms would help the EU to clarify the terms and conditions of entry, and hence enable a more credible and certain timetable for enlargement to be established. Such progress would then help to anchor the expectations and reform efforts of the applicants. An analogy can be drawn with the Maastricht Treaty criteria for European Economic and Monetary Union. In this case, clear requirements and a firm timetable anchored a process that was able to resist unexpected pressures (including various episodes of financial turbulence), that stimulated reform efforts among the member states—including some that were not originally expected to adopt the euro in the first wave, and led to the desired outcome when the common currency was introduced on schedule.

Turning to macroeconomic policies and, in particular, a longer run look at the prospective path to euro area membership, the transition countries under consideration have in most cases demonstrated a substantial capacity to achieve macroeconomic stability. Moreover, this progress has come about under a range of monetary arrangements and economic pressures. It is noteworthy, for example, that these macroeconomic frameworks proved generally resilient during the recent international financial market turbulence that severely affected other economies in the region. Given these strengths, the applicant countries' desire to secure the even greater degree of monetary stability that would come from adoption of the euro, at some point following their entry into the EU, is understandable and reasonable.

Nevertheless, while the process of EU accession may be occurring "too slowly" from the perspective of a number of candidates, there could be risks for at least some of the applicants if they sought full euro area membership "too quickly." In particular, the inflation and fiscal disciplines of the Maastricht economic convergence criteria could potentially conflict with the real adjustment and convergence requirements that the applicants will continue to face for some time. There is also a risk that, during this convergence process, the types of shocks hitting accession countries and those in the euro area could be asymmetric—as illustrated, for example, by the large impact of the 1998–99 Russian crisis on some of the transition economies—requiring some scope for independence in policy responses.

Four points need to be noted in this context. First, the earlier analysis has shown that initial undervaluations in real exchange rates among the candidate countries have generally been corrected. Further real exchange rate appreciation should be expected, however, as these countries steadily converge with the more advanced economies of the west, requiring that their price levels or nominal exchange rates (or both) be able to adjust. For some applicants, especially those that still face substantial adjustments, the scope for real convergence could be impaired if rapid euro area accession was their goal, bringing with it the need for very low inflation in the pre-accession period and a tighter currency peg. Moreover, it would not be desirable for these countries to artificially suppress inflation through other means—for example, by slowing the liberalization of regulated prices.

Second, turning to fiscal policy, some potential sources of pressure on the fiscal position and public debt levels also need to be recognized. For example, several of the accession countries still face uncertainties associated with the necessary fiscal accommodation of costs of bank restructuring and recapitalization, compliance with EU environmental and other requirements, and reform of public health and pension systems. While ongoing fiscal discipline is clearly important, it would probably not be appropriate to tie fiscal policy to an external anchor until these underlying pressures have been adequately addressed.

Third, with capital flows to the accession countries potentially increasing as they become more attractive and secure as investment destinations, monetary and fiscal policies would need to work together to counteract any adverse effects associated with the level and volatility of these flows. Such coordination suggests that the countries concerned retain a substantial degree of macroeconomic policy flexibility—in some cases possibly more than would be permitted by early adoption of the Maastricht economic convergence criteria.

Finally, while euro area participation in the near term would not necessarily be desirable for the candidate countries, membership may well provide a key policy target once the more immediate adjustment and convergence pressures have been dealt with. However, full economic convergence with the income levels of western Europe will take years—probably decades in most cases—to accomplish, well beyond any prospective timetable for adoption of the euro. As a result, the importance of microeconomic flexibility again must be emphasized, as a means of providing crucial support for long-term adjustment and convergence.