ARTICLES

THE ACCEDING COUNTRIES' ECONOMIES ON THE THRESHOLD OF THE EUROPEAN UNION

On 1 May 2004 ten countries of central and eastern Europe and the Mediterranean will join the European Union (EU). In terms of the number of countries joining, this enlargement is the largest in the history of the EU. It is also notable for the fact that the majority of the prospective new Member States have been engaged in a transition process, making the switch from a planned to a market economy, involving fundamental institutional and structural changes in the economies concerned. The new Member States will participate in Economic and Monetary Union (EMU) with a derogation. This means that, while not yet adopting the euro, they will be committed to joining the single currency at a later stage upon fulfilment of the convergence criteria laid down in the Treaty.

This article takes stock of some of the key macroeconomic and structural characteristics of these economies as the acceding countries stand on the threshold of EU membership. It presents some basic economic indicators, reviews recent economic developments in the acceding countries and then focuses in somewhat more detail on a number of indicators that shed light on their economic interrelations with the current 15-member European Union.

INTRODUCTION

The European Union is set to embark upon its biggest ever enlargement, both in terms of the number of new countries and their diversity. Ten countries of central and eastern Europe and the Mediterranean – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia – are set to join the EU on 1 May 2004. The scope of the enlargement is mainly defined in terms of the large number of countries that will join. The increase in diversity in economic terms, in turn, mainly stems from the fact that all of the prospective new Member States with the exception of the two Mediterranean countries have been engaged in a process of transition from planned to market economies over the past 15 years. During this process, the acceding countries established new institutional and legal frameworks, opened up their economies to international trade and capital flows and reorganised their production structures. As part of the same process, the banking sectors were consolidated and financial markets were established. As a result, the acceding countries have reoriented their external trade mainly towards the countries of the EU and started to attract large inflows of foreign direct investment (FDI). On the eve of their accession to the EU, these countries have reached an advanced stage in this transition process. The prospect of EU enlargement provides a timely opportunity to review recent developments as well as the main structural characteristics of their economies.

1 BASIC FACTS AND FIGURES

The ten acceding countries have a combined population of 75 million, about one-fifth of that of the present EU. There is a wide dispersion in terms of population size among the countries: Poland accounts for about one-half of the total acceding countries' population, followed by Hungary and the Czech Republic with around ten million citizens each. The remaining countries have populations of some five million or less, while the populations of the two Mediterranean countries are below one million. Hence, the majority of the new Member States are relatively small compared with the countries that currently comprise the EU.

The economic weight of the prospective new countries in terms of GDP in the enlarged Union of 25 Member States (EU-25) will be much lower than their share of the population, at 5%. Total GDP at current market prices in these countries amounts to around €440 billion, compared with €9,200 billion in the current Union of 15 (EU-15). This asymmetry is the result of a still relatively large gap in terms of

Table 1 Population and nominal GDP of the acceding countries (2002)

Population (millions)			Nominal GDP (EUR billions)		
1.	Poland	38.6	1.	Poland	200
2.	Czech Republic	10.2	2.	Czech Republic	78
3.	Hungary	10.2	3.	Hungary	69
4.	Slovakia	5.4	4.	Slovakia	25
5.	Lithuania	3.5	5.	Slovenia	23
6.	Latvia	2.3	6.	Lithuania	15
7.	Slovenia	2.0	7.	Cyprus	11
8.	Estonia	1.4	8.	Latvia	9
9.	Cyprus	0.7	9.	Estonia	7
10.	Malta	0.4	10.	Malta	4
AC-10		74.7	AC-10		441
EU-15		381.7	EU-15		9,170
AC-10/EU-15 (%)		20%	AC-10/EU-15 (%)		5%

Sources: European Commission and Eurostat.

per capita income levels between the current and new EU Member States (per capita income differentials and implications for growth dynamics are covered in greater detail in Section III).

2 RECENT MACROECONOMIC DEVELOPMENTS

Macroeconomic developments in the acceding countries have been broadly favourable in recent years, and 2003 has been no exception. The countries have, as a whole, achieved a solid rate of economic growth despite a difficult global environment, and have also managed to keep inflation at bay. As such, they have advanced in both the catching-up and the disinflation process, i.e. in real as well as nominal convergence. The two main weak spots at the current juncture relate to fiscal and current account deficits that have remained high or widened in several countries.

Turning to developments in more detail, recent years have seen a significant disinflation process in most of the acceding countries. In 2003 the weighted average of the HICP inflation rates in the countries as a whole stood at 2.0%, down from 2.7% in 2002 and 5.7% in 2001 (see Table 2). Nevertheless, this disinflationary process has been heterogeneous over time and across countries. Moreover, while the current low rates of inflation in the region as a whole have clearly benefited from policy frameworks with a strong focus on fighting inflation, other factors that may prove to be only temporary, such as developments in food prices, exchange rates and economic activity, have also played a role.

In 2003 around half of the acceding countries had inflation rates below the EU average, and a few of them have even recorded near-zero or negative inflation rates recently (namely the Czech Republic, Lithuania and Poland). On the other hand, there are several countries in which inflation is still high. In Hungary, Slovakia and Slovenia inflation was in the range of 4.7-8.8% in 2003. In Slovakia, for example, adjustments in a number of regulated prices led to a rise in headline inflation by as much as 5 percentage points in 2003. In general, the completion of price liberalisation towards levels compatible with a market economy is likely to continue to generate upward pressure on price levels in a number of countries. Furthermore, underlying structural price convergence resulting from the catching-up in income levels (the so-called Balassa-Samuelson effect) will also continue to play a role. As a result, a pick-up in inflation rates over the medium term remains a distinct possibility, and the challenge of completing disinflation and entrenching a low-inflation environment in acceding countries remains.

Table 2 Selected macroeconomic indicators in the acceding countries

	HICP inflation (annual percentage change)			Real GDP (annual percentage change)			General government balance (as a percentage of GDP)			Current account balance (as a percentage of GDP)		
	2001	2002	2003	2001	2002	2003 1)	2001	2002	2003 1)	2001	2002	2003 1)
Cyprus	2.0	2.8	4.0	4.0	2.0	2.0	-3.0	-3.5	-5.4	-4.3	-5.3	-4.4
Czech Republic	4.5	1.4	-0.1	3.1	2.0	2.2	-5.0	-6.7	-7.6	-5.4	-6.0	-6.6
Estonia	5.6	3.6	1.4	6.5	6.0	4.4	0.2	1.3	0.4	-6.0	-12.2	-15.2
Hungary	9.1	5.2	4.7	3.8	3.5	2.9	-4.1	-9.2	-4.8	-3.4	-4.0	-6.2
Latvia	2.5	2.0	2.9	7.9	6.1	6.0	-1.6	-3.0	-2.9	-9.6	-7.6	-8.6
Lithuania	1.3	0.4	-1.0	6.5	6.8	6.6	-1.9	-1.7	-2.4	-4.8	-5.3	-5.7
Malta 2)	2.9	2.2	1.6	-1.2	1.7	0.8	-7.0	-6.2	-7.4	-4.4	-1.3	-6.6
Poland	5.3	1.9	0.7	1.0	1.3	3.3	-3.5	-3.8	-4.1	-2.9	-2.6	-2.9
Slovakia	7.0	3.3	8.8	3.8	4.4	3.8	-5.4	-7.2	-5.0	-8.4	-8.0	-3.8
Slovenia	8.6	7.5	5.7	2.9	2.9	2.1	-2.5	-2.4	-2.0	0.2	1.4	0.5
AC-10	5.7	2.7	2.0	2.5	2.4	3.1	-3.8	-5.1	-4.7	-3.9	-3.9	-4.4
EU-15	2.2	2.1	2.0	1.7	1.1	0.8	-0.9	-1.9	-2.7	0.3	1.0	0.5

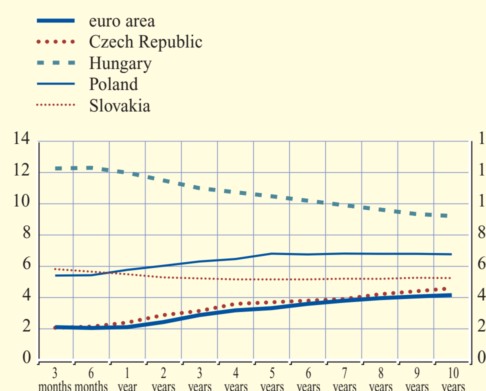
Sources: Eurostat, European Commission, Pre-Accession Economic Programmes (PEPs).
Note: The aggregates are weighted by nominal GDP in 2002.
1) Estimated.
2) For Malta, inflation data refer to CPI. The 2003 figure is the estimate from the 2003 PEP for Malta.

Policy interest rates have fallen in line with the progress made in disinflation and the improved inflation outlook in recent years, and this process has led to declining long-term interest rates in the region as a whole. Nevertheless, policy interest rates are still higher than those of the euro area in almost all of the acceding countries. Moreover, the decreasing trend of policy interest rates has largely come to a halt since mid-2003. In Hungary there has even been a significant reversal, as policy rates have been raised substantially since June 2003. While interest rates in the Czech Republic have closely shadowed those of the euro area over the entire yield curve, the same is not true in the other acceding countries (see Chart 1). In Hungary, and to a lesser extent Slovakia, the yield curve is currently inverted, reflecting a tighter monetary policy stance at the short end of the curve but expectations of lower inflation over the longer term.

Exchange rates have developed in very different ways across the region. In countries with pegs or tightly managed exchange rate regimes, nominal exchange rates vis-à-vis the euro have remained stable. By contrast, significant exchange rate variation has been observed in countries with more flexible regimes. In Poland, the zloty has displayed considerable volatility and depreciated by 14.5% against the euro in 2003. Exchange rate volatility has also increased in Hungary where the forint came under pressure in 2003, depreciating by 10% against the euro, with most of the recent depreciation seemingly related to concerns about the outlook for fiscal consolidation and inflation.

Chart 1 Yield curves in selected acceding countries in January 2004

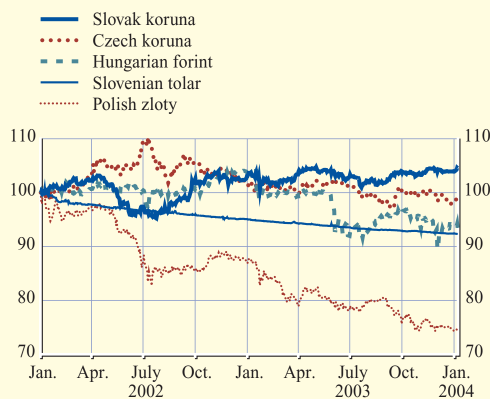
(percentages; maturities)



Sources: Bloomberg and ECB calculations.

Chart 2 Nominal exchange rates against the euro

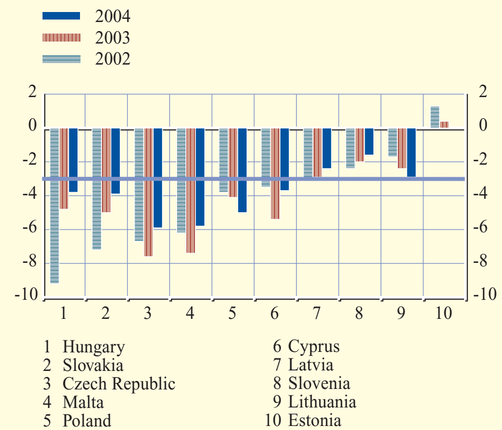
(upward movement = appreciation of the national currency; index January 2002 = 100)



Source: ECB.

Chart 3 General government budget balances

(as a percentage of GDP)



Note: 2002 figures denote outcomes, 2003 and 2004 figures are targets. Ranked by 2002 figures. For 2004, the Estonian authorities are targeting a balanced budget. The horizontal line indicates the deficit level of 3% of GDP.
Source: 2003 Pre-Accession Economic Programmes.

In terms of output performance, real GDP growth remained resilient last year, at an estimated rate of about 3.1% for the acceding countries as a whole. This is a relatively rapid rate of expansion, especially given the difficult global environment and low growth in the EU. It is noteworthy that in many of the acceding countries the composition of growth changed last year, with a larger contribution coming from private consumption and government expenditure, while gross fixed capital formation and, above all, net exports played less of a part in economic expansion.

Turning to fiscal policy, performance has been weak in several acceding countries in recent years and the overall fiscal deficit in all of the countries is estimated to have remained broadly unchanged at about 5% of GDP in 2003. Hence, the widening of deficits from 3.8% of GDP in 2001 to 5.1% of GDP in 2002 has not been reversed despite accelerating growth rates. Moreover, in most acceding countries the current fiscal deficits seem to be mainly of a structural nature, while the size of the automatic stabilisers appears limited. Thus, to stabilise the fiscal situation, the acceding countries will need to further reform their public expenditure and revenue structures in a sustainable and forward-looking manner. At country level, fiscal imbalances in 2003 were most notable in Cyprus, the Czech Republic, Hungary, Malta and Slovakia. For this group of countries the general government deficit is estimated at a weighted average of 6.1% of GDP. According to the 2003 Pre-Accession Economic Programmes (PEPs), most acceding countries have also relaxed their medium-term fiscal strategies compared with their plans for the preceding year, thereby further postponing the necessary fiscal consolidation. As a result, the level of public debt is rising in several countries, although the average for the group is much lower than the current EU average. The debt level per GDP ranges from 5.4% in Estonia to 66.4% in Malta (see Table 3).

Current account deficits have widened further in 2003 to 4.4% of GDP in the ten countries as a whole. These deficits have been particularly high in the Baltic States, where they have widened to close to 9% of GDP. Looking ahead, the acceding countries can be expected to have current account deficits, given higher returns on

Table 3 General government debt in 2003

(as a percentage of GDP)

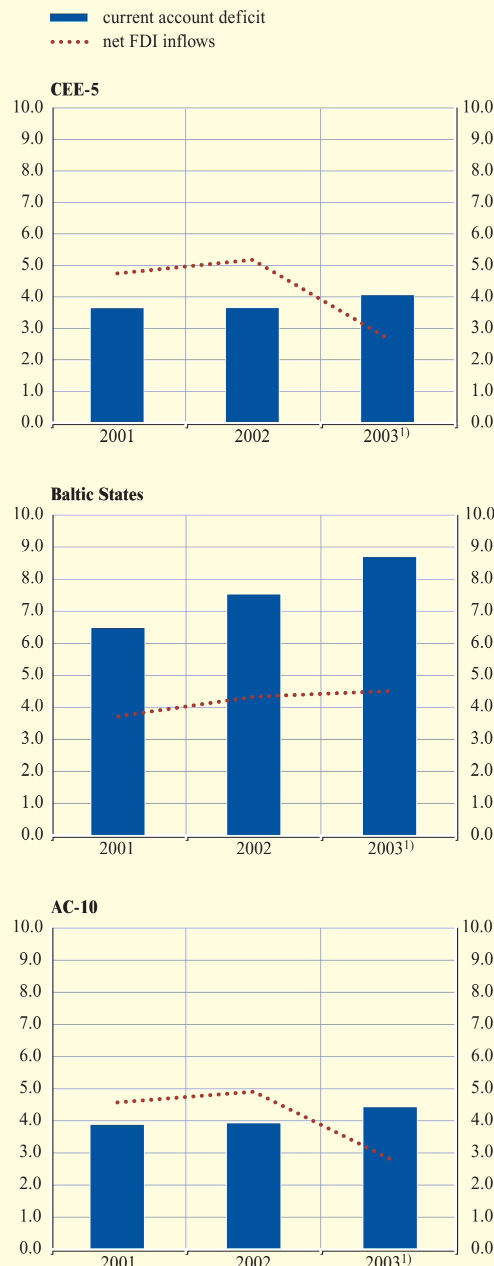
Cyprus	60.3
Czech Republic	30.7
Estonia	5.4
Hungary	57.9
Latvia	16.7
Lithuania	23.3
Malta	66.4
Poland	45.1
Slovakia	45.1
Slovenia	27.4
AC-10	42.4
EU-15	64.1

Source: European Commission, Autumn 2003 forecasts.

investment. However, if current account deficits are so large that they set off unfavourable external debt dynamics, then medium and longer-term sustainability may be endangered. Given their high growth prospects, the acceding countries attract significant capital inflows. In this context, it is important to note that the bulk of inflows still appears to be related to productivity-enhancing investment. However, the composition of capital inflows has changed recently, away from FDI and towards a greater share of debt-creating inflows, including public debt. While in previous years, almost the entire current account deficit was covered by FDI inflows, these inflows fell in 2003 and a significant gap opened up between the FDI amounts and the overall deficits (see Chart 4). This is partly attributable to the completion of the privatisation process and the fact that rising fiscal deficits have led to the issuance of more bonds, which have, in turn, been purchased to a considerable extent by foreign investors.

Chart 4 Current account deficits and FDI inflows

(as a percentage of GDP)



Sources: ECB, European Commission, Pre-Accession Economic Programmes and IMF.
Note: The five central and eastern European countries (CEE-5): Czech Republic, Hungary, Poland, Slovakia and Slovenia; the Baltic States: Estonia, Latvia and Lithuania. Figures are weighted by nominal GDP in 2002.
1) Projections.

Table 4 Economic size and employment distribution of sectors (2002)

	Economic size (as a percentage of GDP)			Employment distribution (as a percentage of total)		
	Agriculture	Industry and construction	Services	Agriculture	Industry and construction	Services
Cyprus	4.1	20.3	75.6	5.1	23.4	71.4
Czech Republic	3.2	37.3	59.5	4.8	40.0	55.3
Estonia	5.4	29.3	65.3	6.9	31.2	62.0
Hungary	3.7	30.7	65.6	6.2	34.1	59.7
Latvia	4.7	24.7	70.6	15.1	24.4	60.5
Lithuania	7.1	30.5	62.4	17.4	27.4	55.2
Malta	2.8	28.1	69.1	2.0	31.7	66.3
Poland	3.1	30.3	66.5	26.3	26.2	47.5
Slovakia	4.4	31.1	64.5	6.2	38.5	55.3
Slovenia	3.3	36.0	60.7	11.0	37.0	52.0
AC-10	**3.5**	**31.6**	**64.9**	**15.8**	**31.2**	**53.0**
Greece	7.0	22.3	70.8	15.3	24.2	60.4
Portugal	3.5	28.0	68.5	12.0	34.0	54.0
Spain	3.2	28.5	68.2	5.9	29.4	64.7
EU-15	**2.0**	**27.0**	**71.0**	**3.9**	**28.2**	**67.8**

Sources: European Commission and Eurostat.

3 STRUCTURAL FEATURES OF THE ACCEDING COUNTRIES' ECONOMIES

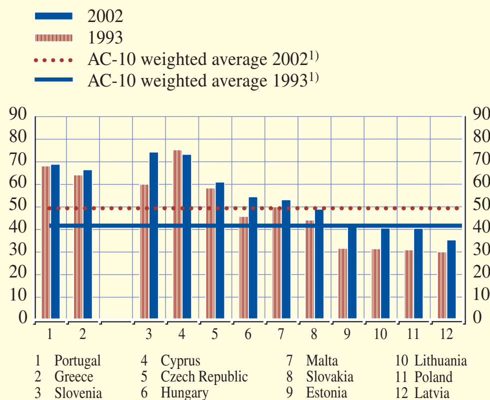
This section explores some key structural characteristics of the acceding countries in order to shed further light on their economies on the eve of EU accession. The focus is on sectoral structures, key features of economic dynamics, product and labour markets, trade patterns, external competitiveness and financial sector developments.

BROAD SECTORAL STRUCTURES

Economic transformation has brought about substantial changes in the structures of the central and eastern European acceding countries, moving their sectoral structures closer to those of the EU. Structural change has been less pronounced in Cyprus and Malta, the two acceding economies that did not undergo transition. Overall, the economic size of the three broad sectors – agriculture, industry and services – and the distribution of employment across these sectors have gradually moved towards EU averages. However, in 2002 the current shares of the agriculture and industry sectors in GDP were still higher in the acceding countries than in the EU, while the services sector is somewhat smaller (see Table 4). Sectoral differences vis-à-vis the EU tend to be more pronounced in terms of the distribution of employment across the three main sectors. Moreover, individual countries display noticeable differences with respect to sector shares and employment distribution. In particular, Latvia and Lithuania have a considerably larger agricultural sector than the EU average, in terms of both GDP and share of total employment. In Poland the share of employment in the agricultural sector is more than six times higher than the EU average, while the economic size of the agricultural sector is rather similar to that of the EU, pointing to a large productivity gap. Given the age structure of the farming community in the acceding countries, with many farmers being close to retirement, a fast reduction in employment in the agricultural sectors of acceding countries is likely over the years to come. In the Czech Republic and Slovenia the economic size of the industrial sectors is considerably larger than the EU average, while the services sectors are still significantly smaller.

Chart 5 GDP per capita in PPP terms

(as a percentage of the EU average)



Source: European Commission.
1) Weighted by nominal GDP in 2002.

KEY FEATURES OF ECONOMIC DYNAMICS

Economic growth in most acceding countries has developed quite differently from that of the EU throughout the transition process of the last one-and-a-half decades. Following recessions at the beginning of the transformation in the early 1990s, most acceding country economies have expanded faster than the economies of the EU. Furthermore, many acceding countries have experienced sharper cyclical fluctuations than the EU Member States and have been subject to several idiosyncratic shocks, including stabilisation episodes associated with periods of slow or negative GDP growth (see Box 1).

The acceding countries posted an average GDP growth rate of 3.6% during 1996-2002, compared with 2.3% in the EU. Within the group of acceding countries, the Czech Republic is an outlier, with real GDP expanding by only 1.6% as a result of the stabilisation crisis in 1997-99. Higher growth rates in acceding countries can mainly be explained by improved macroeconomic stability and, in the mid to late 1990s, also by the correction of very low activity levels after the recession in the initial phase of transition. As shown in Chart 5, GDP-per-capita levels of the acceding countries as a whole increased from 42% of the EU average in purchasing power parity (PPP) terms in 1993 to 49% in 2002. Differences in levels between the individual countries are considerable, ranging from 35% in Latvia to 74% in Slovenia and Cyprus in 2002. While some countries did not catch up with EU averages, or did so only marginally, others – in particular Poland, Lithuania, Estonia, Hungary and Slovenia – made noticeable progress. Given the differences in income levels, closing the gap with the EU in terms of real GDP per capita may involve significantly different time spans for individual countries. Moreover, as historical evidence within and outside the EU shows, successful convergence is dependent on sound economic policies and a range of other factors that determine economic growth. Under the assumption that real GDP growth remains around potential in the EU and that acceding countries will enjoy positive growth differentials with the EU of 2 percentage points, the most advanced acceding countries (Cyprus and Slovenia) could reach the EU average by around the middle of the next decade. In the case of the Czech Republic, real income convergence would occur in the 2020s; and for Hungary, Malta and Slovakia, three decades from now. Finally, the lower-income countries would achieve income convergence around the middle of the century. Convergence to the relative position of Portugal and Greece, which today are the two EU countries with the lowest GDP-per-capita levels at close to 70% of the EU average, has already been achieved by Cyprus and Slovenia, while it would require – under the assumptions made – between six and 35 years for the other countries.

The average standard deviation of real GDP growth was 2.4 percentage points in the central and eastern European countries between 1996 and mid-2003, and was therefore much higher than in the five largest economies in the euro area where the deviation was in the range of 1.1 to 1.8 percentage points. The standard deviations of the acceding countries were scattered in a broad range. The five central and

Box

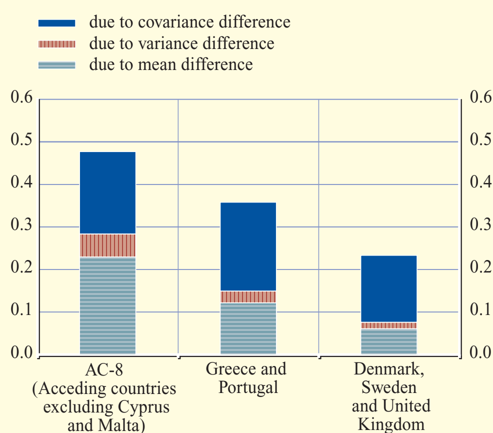
THEIL'S INEQUALITY COEFFICIENT TO MEASURE DIFFERENCES IN GROWTH DYNAMICS

A convenient way of condensing differences in economic dynamics into a single indicator is to use Theil's U inequality coefficient, introduced by Henri Theil in 1967. It has been widely used in the area of the welfare economics of income distribution and, more recently, has also been applied to time series. Formally, the inequality coefficient between two time series is defined as their scaled root mean squared difference.[1] When applied to growth dynamics in acceding countries, the index reveals that there is still a significant degree of difference between these countries and EU countries. This is due to differences in average growth rates, somewhat larger output swings and differences in the timing of troughs and peaks.

The value of the U statistic lies between zero and unity. For two series that are equal, U is zero and the higher U is, the greater the inequality. The coefficient can be further decomposed into three components which indicate the relative contribution of three specific sources to the overall inequality between the two series. These include (i) the difference in the averages of the series, (ii) the difference in the series' respective variation and (iii) the lack of synchrony or co-variation between the series. This decomposition is particularly interesting as it shows how inequality in growth patterns is related to three different origins, namely different averages (differences in the level of trend growth), different variances (differences in output volatility) and a lack of covariance trend (cyclical asynchrony and changing dynamics of trend growth). The chart displays the differences in growth dynamics and their components between the eight "transition" acceding countries (AC-8) and the five largest economies in the euro area, using quarterly data for 1996 to mid-2003.[2] The chart shows that inequality was, on average, higher for acceding countries than for Greece and Portugal on the one hand and for Denmark, Sweden and the United Kingdom on the other.

Differences of GDP growth between selected groups of countries and the five largest economies in the euro area[1)]

(Theil's inequality coefficient and components, 1996-2003Q2, based on year-on-year percentage growth rates)



Source: Eurostat and ECB calculations.
1) Aggregate of Germany, France, Italy, Spain and the Netherlands.

It is noteworthy that inequality due to covariance difference has been of a similar magnitude across these three sets of countries, while mean differences have been somewhat more pronounced in the case of the acceding countries than in Greece and Portugal. Differences also exist between the acceding countries and the two other sets of countries in terms of variance difference, i.e. output volatility. Furthermore, it should be noted that there has been considerable divergence in inequality between various acceding countries.

1 See R. Pindyck and D. Rubinfeld (1997), *Econometric models and econometric forecasts,* 4th Edition, pp. 210-211.
2 See also R. Süppel (2003), "Comparing economic dynamics in the EU and CEE accession countries", *ECB Working Paper* No. 267.

eastern European economies posted on average a much smaller standard deviation than the Baltic countries, which partly reflects the recession in the aftermath of the Russian crisis in 1998 and the subsequent recovery, but may also have to do with the small country size.

All in all, it can be concluded that growth patterns differ to some extent from those of the EU, which may pose challenges for policy-makers. However, further trade integration, intra-industrial specialisation and macroeconomic stabilisation, if managed properly, will add to further synchronisation with the current EU over the years to come.

LABOUR AND PRODUCT MARKETS

In the acceding countries as a whole, unemployment rates are high (13.6% on average for all countries in 2002). However, large differences exist across countries, with unemployment rates ranging from 3.9% in Cyprus to 19.9% in Poland. The share of long-term unemployment (longer than one year) in the acceding countries is substantial – in 2001 it was on average over 50% of all unemployed – and thus similar to shares observed in many EU countries (EU average in 2001: 45%). In a number of acceding countries, economic growth has not (or has only very recently) been associated with a decrease in unemployment. In conjunction with the high level of long-term unemployment, this suggests that unemployment is to a large extent a structural rather than a cyclical phenomenon. Likely sources of the persistently high unemployment rates are skills mismatches and low levels of inter-regional labour mobility. In fact, high-unemployment regions are much more common across acceding countries than within the EU.

Mobility across jobs and the creation of new jobs, as measured by the job turnover rate, have declined significantly in most acceding countries since the early 1990s, when the initial stages of transition led to a high job turnover rate. In more recent years, the job turnover rates in most acceding countries have stood at levels similar to those in the EU. Where available, other indicators of labour market flexibility, such as employment protection legislation, shed a positive light on the acceding countries. In fact, employment protection legislation can be regarded as less strict than in the EU.

Nominal wage growth in the acceding countries has largely moderated alongside disinflation. This seems to suggest that in most of the acceding countries nominal wage dynamics react to changes in inflation rates. So far there has been little need in the acceding countries for downward flexibility of nominal wages owing to the catching-up process on the one hand and, until recently, higher average inflation than in the EU on the other. One exception was the experience of certain sectors in the Baltic countries which were particularly hard hit by the Russian crisis and where nominal wages appeared to be flexible downwards. However, partly on account of large wage gaps between the private and public sectors, sizeable one-off adjustments of public sector wages have recently occurred in a few acceding countries, a development that may have demonstration effects for private sector wages, increasing overall wage demands. In addition, a number of acceding countries may face wage pressures resulting from minimum wage regulations and upward adjustments of regulated prices. Substantial rises in minimum wages, as observed in some countries recently, may easily spill over into higher wage brackets, thereby increasing overall wage growth with some time lag.

Nominal wage contracts in acceding countries are typically of a relatively short duration. Wage-setting frameworks and the role of trade unions in wage formation differ across countries. When collective bargaining takes place in acceding countries it does so mostly at the company level. With the exception of Slovakia and Cyprus, where sectoral wage bargaining is dominant, and Slovenia, where wage formation takes place mainly in a centralised framework, the wage bargaining process in the acceding countries is highly decentralised.

Nominal rigidities are not only a potential issue for labour markets but for product markets, too. Nominal price flexibility is typically closely linked to the degree of product market regulation. Acceding countries have proceeded fairly quickly with product market deregulation. The adoption of the single market *acquis* has been instrumental in advancing this process. While acceding countries essentially liberalised all commodity prices a number of years ago, the prices for water, power, heat and other utilities have remained regulated in most instances. Consequently, regulated prices still account for a relatively high share in the consumer baskets of some of these countries. According to the EBRD's 2003 Transition Report, the share of administered prices in the consumer baskets of the central and eastern European countries averaged roughly 16% in 2003, with considerable variation among individual countries. Moreover, the EBRD reported that a number of countries have found it difficult to move utility prices to levels that would cover costs fully.

In the EBRD's assessment, competition policy in the acceding countries is characterised by "some enforcement actions to reduce abuse of market power and to promote a competitive environment, including break-ups of dominant conglomerates [and a] substantial reduction of entry restrictions". According to the EBRD, a substantial share of market entry restrictions have been removed. Furthermore, the high degree of openness that characterises most acceding countries indicates a relatively high level of competition in tradables sectors.

OPENNESS AND TRADE PATTERNS

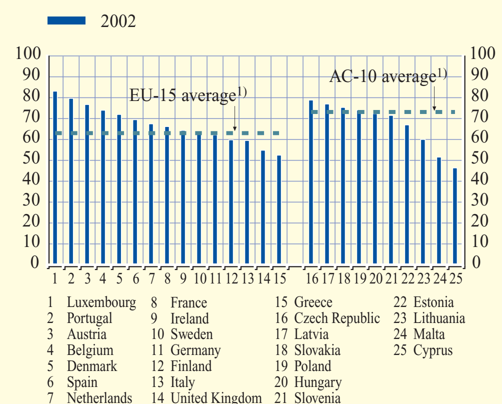
The acceding countries, with the exception of Poland, are small and highly open economies, with the average degree of openness for the acceding countries as a whole accounting for 99.3% of GDP, compared with 69% for the weighted average of individual EU countries if intra-EU trade is included. The most open countries among the acceding countries are Estonia, Malta and Slovakia. Interestingly, the countries displaying the highest trade shares with the EU-15, such as the Czech Republic, Hungary, Poland and Slovenia, are not those with the highest degree of openness, while the most open economies, such as Estonia and Malta, are somewhat less integrated with the EU. For the Baltic States, trade with Russia is still relatively more important, while Malta trades significantly with Asia on account of foreign investment from that region.

As shown in Chart 6, the acceding countries' foreign trade with other countries of the enlarged EU is on average higher than that of the current EU Member States. All acceding countries except Cyprus, Lithuania and Malta are above the EU average in this respect.

While most acceding countries have recorded relatively large current account deficits throughout the transition process so far, they have been able to develop external markets, as evidenced by the increase in their share of total world exports from 1.6% in 1996 to 2.4% in 2002. The development of the acceding countries' market shares in EU imports shows a similarly or perhaps even more encouraging picture (see Chart 7). The total share of the ten

Chart 6 Trade within the enlarged EU

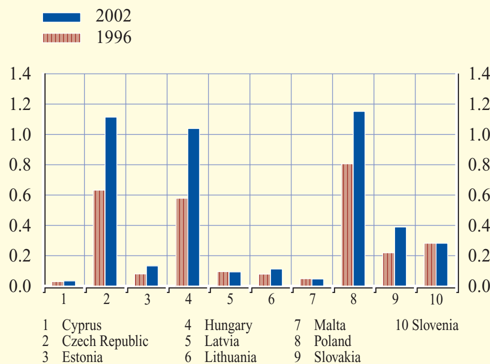
(Trade with the future EU-25 as a percentage of total trade)



Sources: IMF, DOTS and Eurostat for weights.
Note: Data for 1997 instead of 1995 for Belgium and Luxembourg.
1) Weighted by nominal GDP in 2002.

Chart 7 Share in EU imports

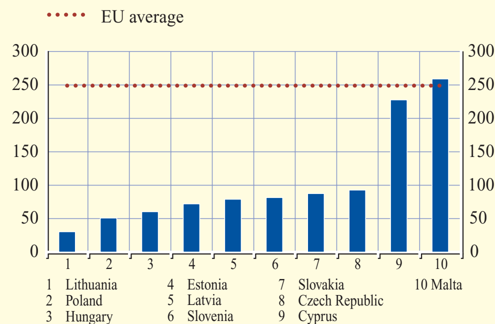
(percentage of total EU imports)



Source: IMF.

Chart 8 Size of the banking sector (2002)

(banking assets as a percentage of GDP)



Sources: IMF and national central banks.

countries in EU imports rose from 2.8% in 1996 to 4.4% in 2002. This suggests that acceding countries have succeeded in preserving their external competitiveness. To maintain this position, acceding countries will have to ensure that relative price and wage developments go hand in hand with the gradual closure of the productivity gap with the EU.

FINANCIAL SECTOR DEVELOPMENTS

A central feature of the acceding countries' financial sectors is the dominance of the banking industry, while the role of the capital markets in financial intermediation is generally limited. The acceding countries are joining the EU with banking sectors that, although small, can be considered as being consolidated and sound. Banking sector soundness has substantially improved in recent years as capitalisation, profitability and asset quality have strengthened considerably. Poland is an exception, however, since profitability is smaller and the share of non-performing loans bigger (the latter resulting partly from differences in loan classification rules). The level of financial intermediation remains low in most acceding countries, although it has begun to increase over recent years. Chart 8 shows total assets of banking systems as a ratio to GDP in the acceding countries in 2002, compared with the level prevailing in the EU. Only Cyprus and Malta have reached a level comparable with the EU average, on account of the fact that their economies did not have to undergo a transition and offshore banks have played an important role in the development of their financial sectors. For the other acceding countries, the level of banking sector assets to GDP is considerably lower than that of the EU countries with the lowest degree of financial intermediation.

A closer look at the financial market segments in the acceding countries shows that government bill and bond markets are relatively liquid in the Czech Republic, Hungary, Poland and Slovakia. Corporate bond markets in the acceding countries are, however, little developed, while equity markets that also attract foreign investors mainly exist only in the Czech Republic, Hungary and Poland. Liquid foreign exchange markets have developed in four acceding countries, namely the Czech Republic, Hungary and Poland (both spot and forward markets) as well as in Slovakia (spot market).

A further characteristic of the financial systems in acceding countries is a substantial level of foreign ownership. This is observable in all market segments but is particularly strong in the banking sector. Foreign entities, mostly from the EU, own the majority of total assets of commercial banks in acceding countries, which is significantly higher than the share of cross-border ownership in the EU. Estonia, Hungary, Latvia and Poland have the highest foreign-

owned share of total assets, while Cyprus and Slovenia have the lowest. The variation in the levels of foreign ownership among the central and eastern European acceding countries can be explained by differences in the banking sector privatisation and rehabilitation strategies. The strong presence of foreign-owned banks has been instrumental in broadly improving the performance of all banks in the acceding countries. Foreign entities, and EU entities in particular, also play a significant role in the stock and fixed income markets of most acceding countries.

Financial sector development has strengthened monetary transmission through interest and credit channels in most acceding countries, although the effectiveness of these channels – compared with the exchange rate channel – is still constrained as a consequence of the modest depth of financial intermediation. There has been significant convergence of bank interest rates to the levels prevailing in the EU, and spreads between deposit and lending rates have declined in recent years to around the range seen in EU countries, albeit with significant and fairly persistent differences across countries.

In recent times, highly dynamic rates of expansion in credit to the private sector have been observed in many acceding countries. For example, loans to private individuals in 2002 rose by 74% in Hungary and by about 40% in Estonia and Latvia. Although the stock of credit remains low, and much of it is collateralised through mortgages, this development raises increasing intermediation and supervision challenges, pointing to the need to review prudential regulations and oversight, in line with the ongoing efforts in many of these future Member States.

4 CONCLUSION

The ten acceding countries will join the EU having already realised major economic accomplishments. They have achieved broad macroeconomic stabilisation, with marked progress in disinflation, sustained considerable improvements to their economic fundamentals and structural policies.

The economic structures of the acceding countries have become more similar to those of the current EU Member States, the degree of openness is high and trade, as well as financial integration with the EU, is well advanced in most cases. Progress has also been made with regard to financial stability. The prospect of EU membership has served as a powerful anchor for policy change in this process well before actual accession. However, there are significant differences among the acceding countries in terms of a range of nominal, real and structural conditions, and, in particular, labour market features, interest rate convergence, external positions and fiscal performance. The degree of integration also differs considerably from country to country. Furthermore, income-per-capita levels still tend to be low relative to the EU average, highlighting the central importance of policies that increase the potential growth rate of the acceding countries.

Joining the EU is a milestone for the acceding countries, but the process of transition will not end with accession and reforms will have to proceed as planned. The macroeconomic policies of the acceding countries will need to be geared to both preserving past achievements during the catching-up process and facing the challenges that will arise mainly as a result of external and fiscal imbalances.