

# FIVE YEARS OF EU MEMBERSHIP

*Five years ago, on 1 May 2004, the European Union (EU) welcomed ten new Member States. On 1 January 2007, a further two countries – Bulgaria and Romania – joined the EU. After reviewing some institutional aspects concerning euro area integration, this article describes key macroeconomic and structural features of the 12 countries concerned, putting developments into perspective since EU accession. Many of the countries referred to above have made significant progress in terms of “catching-up” on various levels and in strengthening their potential for integration in the euro area. Four of these countries – Cyprus, Malta, Slovenia and Slovakia – have already adopted the euro. The other countries are still faced with some important challenges with a view to ensuring sustainable convergence with the euro area.*

## I INTRODUCTION

Five years ago, the EU grew from 15 to 25 countries in what was the biggest enlargement since its foundation. The Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia and Slovakia joined the EU on 1 May 2004. On 1 January 2007, the most recent enlargement of the Union, involving Bulgaria and Romania, led to the EU in its current composition.<sup>1</sup> Upon their accession to the EU, these 12 countries (hereinafter New Member States or NMS) assumed – in a strict legal sense – the same rights and obligations as all EU Member States, thereby participating in EMU with the status of a “Member State with a derogation”, which implies that they are committed to preparing for euro area participation, under the conditions set out by the Treaty establishing the European Community.

Following their accession to the EU, the NMS have to regard economic policies as “a matter of common concern” (Article 99 of the Treaty) and take part in the EU policy coordination and surveillance procedures, which relate in particular to the relevant provisions of the Stability and Growth Pact and the excessive deficit procedure. Furthermore, upon accession, the central banks of the NMS joined the European System of Central Banks and their governors became members of the General Council of the ECB.

Since their accession to the EU in 2004, four countries – namely Cyprus, Malta, Slovenia and Slovakia – have met the convergence

criteria specified in the Treaty and adopted the euro at different points in time. Consequently, the national central banks of these four countries have joined the Eurosystem and their governors have become members of the Governing Council of the ECB. The remaining eight NMS are still in the process of further advancing convergence and preparing for the adoption of the euro.

This article reviews several institutional and economic features related to the enlargement of the EU. The following section describes some institutional aspects concerning the process of integration of the NMS in the euro area. While Section 3 describes key macroeconomic and structural features of the 12 countries concerned, Section 4 elaborates on the main challenges that the NMS are likely to face, to different degrees, in the catching-up phase. Finally, Section 5 provides the concluding remarks.

## 2 THE ROAD TO THE EURO: THREE DIFFERENT STEPS

Progress towards the adoption of the euro following EU accession should be seen as a continuous process, which is divided institutionally into three main steps: (i) EMU membership with a derogation; (ii) participation in the European exchange

<sup>1</sup> See the article entitled “The EU economy following the accession of the new Member States” in the May 2004 issue of the Monthly Bulletin and the article entitled “The enlarged EU and euro area economies” in the January 2007 issue of the Monthly Bulletin.

rate mechanism (ERM II); and (iii) full EMU membership and the adoption of the euro, following the fulfilment of specific economic and legal conditions.

As “Member States with a derogation”, the NMS have to treat their exchange rate policy, which remains a national competence, “as a matter of common interest” (Article 124 of the Treaty). When deemed appropriate, they can enter ERM II subject to a common agreement on the central rate for their currency against the euro, with a standard fluctuation band of  $\pm 15\%$ . ERM II provides a stability-oriented framework supporting the convergence process and helping to anchor the currencies of the participating countries in the run-up to adoption of the euro. Only a sufficiently long period of participation in ERM II (the Treaty foresees participation of at least two years before the assessment of convergence), maintaining stable exchange rates, allows a reliable test of how the economy functions under conditions that are relatively similar to those in operation after adoption of the euro.

Owing to differences in the state of economic convergence and other country-specific circumstances, it is natural that countries follow different convergence paths.

Over the last five years, seven of the twelve NMS have joined ERM II. On 28 June 2004, the Estonian kroon, the Lithuanian litas and the Slovenian tolar entered the mechanism. In the case of Estonia and Lithuania, it was then agreed that their currencies could join with their existing currency board arrangements in place, as a unilateral commitment, thus placing no additional obligations on the ECB. On 2 May 2005, the Cyprus pound, the Latvian lats and the Maltese lira entered ERM II. While the Maltese authorities declared their intention to maintain the exchange rate of the Maltese lira at the central rate as a unilateral commitment, the Latvian authorities declared that they would maintain the exchange rate of the lats

at the central rate with a  $\pm 1\%$  fluctuation band as a unilateral commitment. Finally, on 28 November 2005, the Slovak koruna entered ERM II. In each case, the agreement on participation of these currencies in ERM II was based on a firm commitment by the respective national authorities to implement policies aimed at preserving macroeconomic stability and ensuring the sustainability of the convergence process.

Following the two-year minimum period of participation in ERM II, a country can, in principle, adopt the euro, if it has achieved a sufficiently high degree of sustainable convergence. This is assessed using the convergence criteria listed in the Treaty. The criteria refer, in particular, to inflation developments, long-term interest rates, exchange rate stability and the fiscal position in terms of general government deficit and debt. On the basis of these criteria, the European Commission and the ECB examine the degree of sustainable convergence achieved by each Member State. In addition, they look at the compatibility of each Member State’s national legislation, including the statute of its national central bank, with the Treaty provisions and the Statute of the ESCB. Taking into account these assessments, the Council decides, acting by qualified majority on a recommendation from the Commission, after consulting the European Parliament and after discussion in the Council, meeting in the composition of the Heads of State or Government, whether or not to abrogate the derogation of the Member State concerned.

Following the procedures laid down in the Treaty, Slovenia was the first NMS to qualify to adopt the euro and on 1 January 2007 it became the 13th member of the euro area. Similarly, following positive assessments of sustainable convergence, Cyprus and Malta joined one year later. The latest country to have joined the euro area is Slovakia, which adopted the euro on 1 January 2009.

### 3 CONVERGENCE AND INTEGRATION<sup>2</sup>

#### 3.1 GROWTH PATTERNS AND PER CAPITA INCOME

By the time of EU accession, significant progress towards macroeconomic stabilisation had been made in all NMS and a wide range of growth-enhancing structural reforms had already been implemented. After joining the Union, most of the NMS continued to experience robust economic expansion, which had, in part, been spurred by the prospect of accession. This, together with the high degree of trade and financial integration within the EU and the relatively low per capita income levels prevailing in most NMS, facilitated large capital inflows, attracted by expectations of high returns. Expectations of rapidly increasing income and wealth levels, based on ongoing productivity gains and a significant tightening in labour markets, also encouraged household borrowing to finance consumption spending. In addition, output growth in the NMS was supported by external conditions, in terms of both robust external demand and favourable financial conditions for external funding. Moreover, the NMS received substantial EU structural funds. Consequently, following EU accession, output

growth accelerated notably in almost all NMS (see Chart 1). The main exception was Hungary, where GDP growth rates actually declined, reflecting the adjustment costs the country had to pay for excessively loose fiscal policies in the first half of this decade.

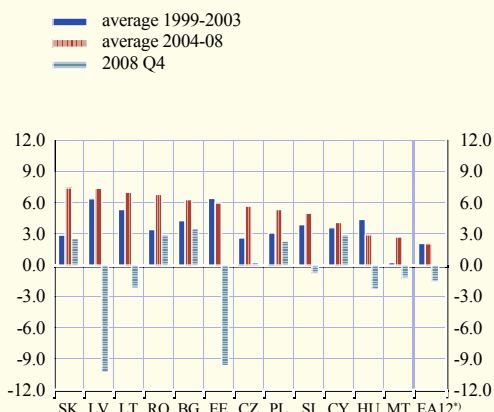
In the course of 2008, however, this trend of rapid economic expansion in the NMS came to a halt in the context of the global financial crisis, which exacerbated the cyclical economic slowdown that was already taking place in many NMS. The slowdown in growth was particularly severe in those countries that had previously experienced the highest growth rates – most notably the Baltic States, which saw a sharp contraction in output. In the remaining countries, output growth also declined notably in the course of 2008.

The relatively strong growth performance in the NMS over recent years has generally contributed to a convergence in per capita income levels towards euro area levels. However, significant differences across countries exist. The catching-up with respect

2 The cut-off-date for the data included in this article is 14 April 2009.

Chart 1 Real GDP growth

(annual percentage changes)



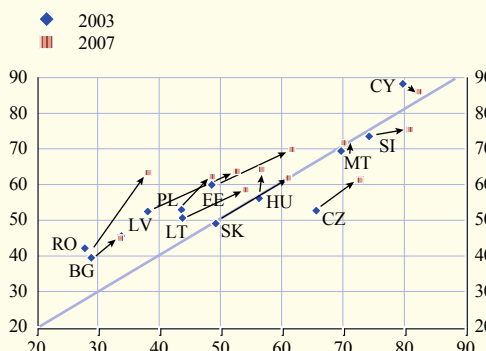
Source: Eurostat.

Note: NMS are ordered according to GDP growth rate over the period 2004-08, starting with the highest.

\*) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

Chart 2 GDP per capita income and price levels

x-axis: GDP per capita in PPP (EA12 = 100)  
y-axis: comparative price levels (EA12 = 100)



Source: Eurostat.

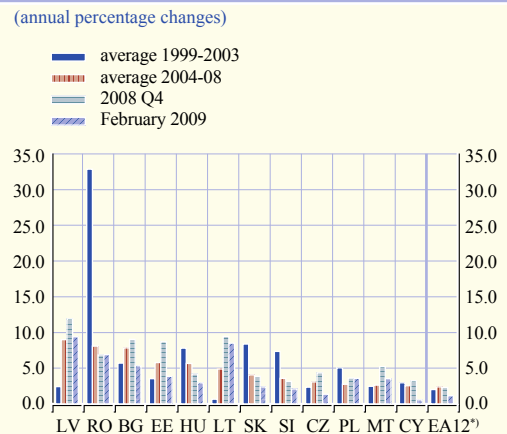
Note: PPP stands for purchasing power parity.

to the euro area was most pronounced in the three Baltic States, Romania and Slovakia, where per capita income levels have increased by 10 percentage points or more since 2004. By contrast, real convergence has virtually progressed no further in Cyprus, Hungary and Malta since these countries joined the EU. Overall, in 2008 GDP per capita income levels in the NMS remained generally well below those in the euro area, ranging from around 34% of the euro area average in Bulgaria to above 80% in the case of Cyprus and Slovenia (see Chart 2).

### 3.2 INFLATION DEVELOPMENTS

With the exception of Romania, inflation had declined to single digit levels in all NMS by the time of EU accession (see Chart 3), although it remained relatively high in some countries (e.g. Hungary, Slovakia and Slovenia). Improved institutions, including central bank independence, and more stability-oriented macroeconomic policies supported this development. The broad moderation in the growth of food and energy prices in 2003-04 was an important factor that helped to maintain the disinflation gains achieved by most NMS, given the relatively large weight of these two components in the consumption basket of these countries (on average around 43% of the total). Furthermore, enhanced liberalisation of product and labour markets, strong competition – notably from emerging Asia – and the overall impact of globalisation also contributed to containing inflation in many NMS. In some countries with flexible exchange rates, price increases were also partly dampened by an appreciating currency, especially in the Czech Republic, Romania and Slovakia. At the same time, the gradual liberalisation of administered prices and changes in indirect taxes that were implemented following EU accession represented a factor contributing to inflation (and inflation volatility) in many NMS. Overall, annual HICP inflation remained broadly contained in 2005-06 in most NMS. However, along with robust output growth and, in some cases, insufficiently tight fiscal policies,

**Chart 3 Harmonised index of consumer prices**



Source: Eurostat.

Note: NMS are ordered according to average inflation rate over the period 2004-08, starting with the highest.

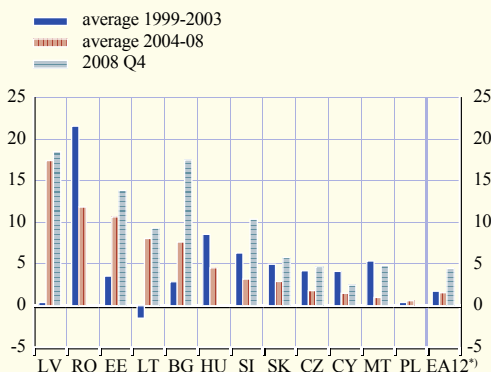
\*) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

there were increasing signs towards the end of 2006 that the process of disinflation had come to a halt in several NMS.

Indeed, by mid-2007 significant inflation pressures had emerged in most NMS, with inflation rising to double-digit levels in some countries (e.g. the Baltic States and Bulgaria). Both domestic and external factors were responsible for this development. On the domestic side, strong domestic demand, underpinned by robust growth in disposable income, large inflows of foreign direct investment and, importantly, monetary factors, such as low real interest rates and buoyant credit growth, contributed to these pressures. Moreover, the rapid tightening of the labour market, exacerbated by labour outflows to other EU countries, contributed to rapid increases in wages, often significantly above labour productivity growth, leading to high growth in unit labour costs particularly in the fastest growing economies (see Chart 4). Under such circumstances, capacity constraints and signs of overheating emerged in many countries, notably in the Baltic States, Bulgaria and Romania. As for the external factors, the rapid increase in energy and food prices since mid-2007 was a main contributor. Overall, HICP inflation followed a

Chart 4 Unit labour costs

(annual percentage changes)



Source: Eurostat.

Note: NMS are ordered according to average growth in the unit labour cost over the period 2004-08, starting with the highest. Quarterly data are not available for Hungary, Poland or Romania.

\*) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

broadly upward trend until mid-2008. Thereafter, the sharp decline in commodity prices, the deterioration in the global economic outlook and the significant output adjustment in many NMS supported a decline in HICP inflation. In early 2009, in all NMS except Cyprus, HICP inflation remained above – and in some cases significantly above – the euro area average.

For a full understanding of inflation developments in the NMS relative to those in the euro area, it is also important to consider differences in price levels. Increasing integration of markets in the euro area and the process of catching-up in real income should generally bring about – through goods market arbitrage and the gradual narrowing of productivity differentials – convergence of price levels across a relatively large range of goods of identical characteristics. This convergence process can be a potential source for lasting inflation differentials between the NMS and the euro area and needs to be taken into account when designing monetary and exchange rate policies for the convergence process and when deciding on the appropriate time for adopting the euro. Notwithstanding some data limitations, differences in price levels between the euro area

and the NMS are generally quite sizeable, with significant differences across individual NMS. Price differentials in 2007 ranged from 86% of the euro area average in Cyprus to 45% in Bulgaria (see Chart 2). Price differentials tend to be larger, the wider the gap of GDP per capita income between the NMS and the euro area. Moreover, Chart 2 suggests that in 2007 price level convergence was more advanced than per capita income convergence in all NMS, with the notable exception of the Czech Republic and, to a lesser extent, Slovenia.

Overall, it appears that further real convergence with the euro area will bring about significant increases in price levels in the NMS. Such convergence will entail a sizeable real exchange rate appreciation of the NMS currencies against the euro. This implies an important policy choice for the monetary authorities of the countries involved so as to strike the appropriate balance between nominal exchange rate appreciation and positive inflation differentials vis-à-vis the euro area. This balance may change over time depending on the specific features of each individual country on the path to adopt the euro. Overall, however, and in line with the Treaty, the maintenance of price stability needs to provide the focal point around which any monetary policy strategy should be designed. By anchoring inflation expectations, price stability contributes to sustainable convergence in nominal wages, thereby preserving competitiveness over the medium term and limiting the risks of excessive output and asset price volatility.

### 3.3 LABOUR MARKET DEVELOPMENTS

Robust growth in the years before and after EU enlargement contributed to a significant increase in labour demand in most NMS. Consequently, unemployment has declined strongly in the NMS since 2004, including significant declines in youth unemployment. With the exception of Slovakia, unemployment rates were below the euro area level in 2008 (see Table 1). This fall in unemployment mainly reflected robust employment growth. Employment rates have increased in the NMS since 2004, with the

exception of Hungary, where the employment rate has stagnated in recent years. Notwithstanding this improvement, employment rates remained below euro area levels in 2008, except in the Czech Republic, Estonia, Cyprus, Latvia and Slovenia.

Developments in labour market participation rates have been more heterogeneous across the NMS. While the participation rate has increased in the majority of the NMS since 2004, it has fallen slightly in the Czech Republic, Lithuania, Poland and Slovakia. Although the participation rate of Estonia, Cyprus, Latvia and Slovenia was higher than that of the euro area in 2008, some NMS (e.g. Hungary, Malta, Poland and Romania) still had participation rates significantly below the euro area level.

In addition to the relatively low participation rates in some countries, the high incidence of long-term unemployment and the significant regional disparities in unemployment rates suggest that labour market mismatches and structural rigidities remain in a number of NMS.

As a result of many years of strong growth, a large number of NMS have experienced significant labour shortages. Labour shortages

have been particularly significant in certain sectors, such as the construction sector, which has experienced a boom in demand. The sector-specific labour shortages have been exacerbated by a significant labour outflow in a number of countries.<sup>3</sup> According to Eurostat data<sup>4</sup>, in particular Bulgaria and Romania, and to a lesser extent, Latvia, Lithuania and Poland have experienced significant net labour outflows relative to total population. Interestingly, the net labour outflows appear to have been much more significant during the five years before 2004 than afterwards. Moreover, some NMS have actually experienced labour inflows since 2004. In particular, Cyprus has attracted very significant labour inflows and, although to a much lesser extent, the Czech Republic, Malta, Hungary, Slovenia and Slovakia recorded net positive migration flows in the period between 2004 and 2007. This indicates that the accession

3 See Heinz, F., and M. Ward-Warmedinger (2006), "Cross-border labour mobility within an enlarged EU", ECB Occasional Paper No 52.

4 The measurement of cross-country labour flows is associated with a high degree of uncertainty and available data can, therefore, only provide a rough indication of actual labour movements. The comparability of data across countries is, in addition, complicated by the fact that no commonly agreed statistical definition of migration exists.

**Table 1 Labour market performance**

(percentage)

	Unemployment rate			Employment rate <sup>1)</sup>			Participation rate <sup>2)</sup>		
	1999	2004	2008	1999	2004	2008	1999	2004	2008
Bulgaria	13.3 <sup>*)</sup>	9.8	4.8	50.4 <sup>*)</sup>	54.2	63.8	60.7 <sup>*)</sup>	61.8	67.8
Czech Republic	6.2	6.4	3.7	65.6	64.2	66.5	72.0	70.0	69.6
Estonia	9.3	7.5	3.6	61.8	63.0	69.9	70.0	70.0	73.5
Cyprus	5.1 <sup>*)</sup>	4.8	3.9	63.7	69.1	70.8	63.7	72.6	73.6
Latvia	11.2	8.4	5.4	58.6	62.3	69.4	68.4	69.7	74.5
Lithuania	11.5	9.5	3.9	61.4	61.2	64.5	72.2	69.1	68.0
Hungary	5.1	4.8	6.3	55.6	56.8	56.6	59.8	60.5	61.4
Malta	6.4	7.2	6.0	54.5 <sup>*)</sup>	54.0	55.3	58.2 <sup>*)</sup>	58.2	58.8
Poland	9.2	14.2	5.5	57.5	51.7	59.0	65.8	64.0	63.7
Romania	4.7	5.7	4.2	63.2	57.7	59.3	68.4	63.0	63.2
Slovenia	7.6	6.5	4.5	62.2	65.3	68.5	67.3	69.8	71.7
Slovakia	16.4	18.3	9.8	58.1	57.0	62.0	69.5	69.7	68.8
EA12 <sup>3)</sup>	10.4	9.2	7.4	60.2	62.9	66.2	67.1	69.2	71.5

Source: Eurostat.

1) Employment rate is defined as percentage of employed people in total labour force (working age population which is actively employed or looking for work).

2) Participation rate is defined as the ratio of the sum of employed and unemployed over the total working-age population.

3) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

\*) Refers to 2000.

to the EU increased the attractiveness of the NMS as places to work.

The labour inflows (both to some of the NMS and to a number of old Member States) during the years of the upswing helped to alleviate labour market mismatches and decrease wage pressures. At the same time, labour outflows in a number of NMS contributed to sector-specific labour shortages and wage and inflationary pressures. However, migration has also had beneficial effects for these countries. For instance, in some of the NMS (notably Romania), workers' remittances have been a significant source of financing. In the long run, the balance of positive and negative effects for the countries with net labour outflows depends mainly on whether labour migration is primarily temporary or permanent. Returning migrants may give a boost to economic growth by bringing in capital, skills and new ideas acquired abroad. This may offset the initial losses of human capital caused by the loss of some part of the young labour force.

Restrictions on labour mobility from the NMS to the other EU Member States still prevail in some countries, in contrast with one of the central principles of the EU: the free movement of labour. These restrictions may decrease the efficient use of labour resources in the face of

demographic change and globalisation and hamper an important adjustment mechanism within the euro area.

### 3.4 PUBLIC FINANCES

Public finances exhibited considerable differences across the NMS in terms of both the initial budgetary situation in 2004 as well as budgetary developments. As regards general government budget balances, in 2004 only Bulgaria and Estonia had achieved budgets in balance or surplus, while the remaining NMS recorded budget deficits (see Table 2). In the Czech Republic, Cyprus, Hungary, Malta and Poland, these deficits were at or above the reference value of 3% of GDP. With 6.4% of GDP, Hungary recorded the largest budget deficit in 2004, which rose even further, to 9.3% of GDP, by 2006. By 2007, budget balances had improved in all countries compared with 2004, reflecting not only consolidation efforts but also the favourable economic environment.<sup>5</sup> However, the rapid economic downturn in 2008 showed that several countries had failed to make

5 At the end of 2008, Hungary was the only country that was subject to an EU Council decision on the existence of an excessive deficit. In other NMS, excessive deficit procedures had been abrogated (for Cyprus and Malta in 2007 and for the Czech Republic, Poland and Slovakia in mid-2008).

**Table 2 General government fiscal position**

(percentage of GDP)

	Budget balance				Gross debt		
	average 1999 – 2003	2004	2006	2008	average 1999 – 2003	2004	2008
Bulgaria	-0.2	1.6	3.0	3.2	64.1	37.9	13.8
Czech Republic	-5.3	-3.0	-2.7	-1.2	23.7	30.4	27.9
Estonia	-0.4	1.7	2.9	-2.0	5.4	5.0	4.3
Cyprus	-4.0	-4.1	-1.2	1.0	62.3	70.2	48.1
Latvia	-2.5	-1.0	-0.2	-3.5	13.4	14.9	16.0
Lithuania	-2.6	-1.5	-0.4	-2.9	22.6	19.4	17.1
Hungary	-5.7	-6.4	-9.3	-3.3	55.9	59.4	71.9
Malta	-7.1	-4.7	-2.3	-3.5	60.9	72.1	63.3
Poland	-4.3	-5.7	-3.8	-2.5	40.7	45.7	45.5
Romania	-3.2	-1.2	-2.2	-5.2	23.9	18.7	15.2
Slovenia	-3.0	-2.2	-1.2	-0.9	26.8	27.2	22.1
Slovakia	-7.4	-2.3	-3.5	-2.2	46.6	41.4	28.6
EA12 <sup>1)</sup>	-1.9	-2.9	-1.3	-1.7	68.5	69.5	68.7

Source: European Commission's January 2009 Interim Forecast.

1) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

sufficient use of the favourable conditions to create budget surpluses and entered less favourable times lacking fiscal leeway. In some countries, fiscal balances deteriorated sharply in 2008, reflecting loose policies and the impact of the economic cycle.

With regard to general government gross debt, the large differences across countries that existed in 2004 continue to persist. In 2004, Cyprus, Hungary and Malta exhibited gross debt ratios at or above the reference value of 60% of GDP, while in the Baltic States and Romania they stood at low levels below 20% of GDP. Over the last five years, owing mainly to strong growth performance, debt-to-GDP ratios declined in most NMS. Only in Hungary and Latvia did the debt ratio rise during this period – by 12.5 percentage points and by around 1 percentage point respectively. The Czech Republic, Latvia, Hungary and Romania had in 2007 relatively high shares of short-term debt (i.e. debt with a maturity up to and including one year) in total government debt and thus tended to be more exposed to declining capital inflows. At the same time, some countries had relatively high shares of foreign currency denominated debt in total debt, which is mostly denominated in euro, making them vulnerable to potential national currency devaluations.<sup>6</sup>

In an economic environment characterised by strong “catching-up” dynamics, fiscal policies have to be geared, in particular, towards supporting sustainable growth and containing inflationary pressures. Against the background of low stocks of public capital and large investment needs regarding, inter alia, infrastructure and education, many of the countries aimed to shift their public expenditure structures towards productivity-enhancing categories, thereby raising their capital expenditure-to-GDP ratios. This was supported by sizeable EU funds offered under the EU’s cohesion policy, with allocations amounting, on average, to more than 2% of these countries’ GDP in 2007 and 2008.<sup>7</sup>

At the same time, several NMS aimed to raise potential growth by pursuing reforms in their tax and benefit systems. These entailed lower tax wedges on labour to enhance work incentives and thus reduce work in the shadow economy and raise labour supply. Several countries simplified their income tax systems, often introducing flat-rate systems and broadening tax bases.<sup>8</sup> Several countries reformed their social security systems mainly in the areas of old-age pensions and health care. At the end of 2008, mandatory funded pension pillars existed in most NMS, namely Bulgaria, the Baltic States, Hungary, Poland, Romania and Slovakia. This notwithstanding, against the background of ageing populations, an increase in total age-related public spending is projected in the coming years for most NMS, posing a challenge for the sustainability of current pension systems.<sup>9</sup>

Overall, with strongly rising real GDP growth and accelerating inflation in many countries, it has become obvious that fiscal policies were often insufficiently tight to contain the emerging macroeconomic imbalances. In many countries, public wages have risen at a significantly faster pace than productivity growth. Moreover, with regard to budget frameworks, the behaviour of public expenditure during the year points to weaknesses in budget implementation. Windfall revenues or saved resources from other areas tend to be spent at year-end, inducing a tendency towards pro-cyclical spending and risking an inefficient allocation of scarce public funds. In a similar vein, the accumulation of reserve funds that can be spent without further parliamentary

6 See the ECB’s Convergence Report of May 2008.

7 Excluding Cyprus and Malta. EU fund allocations differ from actual payments and tend to increase towards the end of the planning period due to “teething problems” at the start of the period. For further details, see, for example, Kamps, C., N. Leiner-Killinger and R. Martin (2009) “The cyclical impact of EU cohesion policy on fast growing EU countries”, *Intereconomics*, Vol.1.

8 See the box entitled “Flat taxes in Central and Eastern Europe” in the September 2007 issue of the Monthly Bulletin.

9 Economic Policy Committee and European Commission (2006), “The impact of ageing on public expenditure: projections for the EU25 Member States on pensions, health care, long-term care, education and unemployment transfers (2004-2050)”.



approval also raises the risk of pro-cyclical fiscal policies.

At the end of 2008, Hungary and Latvia received financial support from, inter alia, the IMF and the EU as they were faced with rising difficulties in meeting external financing needs. In March 2009, the Romanian government also announced that the country was in need of international financial assistance. By the end of that month, the Romanian authorities had reached a staff level agreement with the IMF as part of a coordinated financial support package involving the EU and other multilateral financial institutions. Fiscal policies that failed to convince investors in terms of their capacity to contain macroeconomic and financial imbalances (Latvia and Romania) or of their capacity to ensure the long-term sustainability of public finances (Hungary) contributed to these developments.

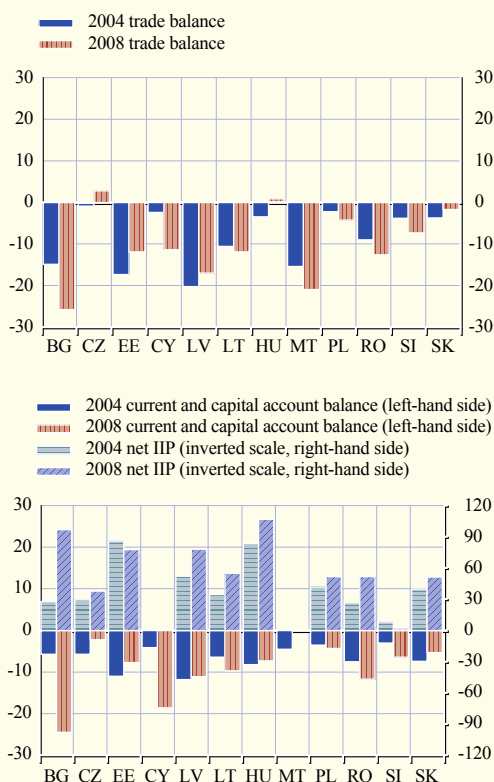
### 3.5 TRADE DEVELOPMENTS AND INTEGRATION

Since 2004, trade in the NMS has expanded considerably and the majority of these countries have significantly increased their market share in world exports. However, despite strong export performance, buoyant domestic demand has contributed to large trade deficits in the NMS over the last five years, especially in countries with fixed exchange rate regimes (see Chart 5). The unfolding financial crisis and contracting growth resulted, in the meantime, in partial reversals in import dynamics, contributing to the narrowing of trade deficits in the course of 2008 in many NMS, particularly the Baltic States.

As regards the product structure of exports, goods continue to dominate strongly over services in the vast majority of countries, notwithstanding some heterogeneity. Some economies, such as the Czech Republic, Lithuania and Slovakia, have tended to increase further the share of goods in their exports, whereas others have expanded more in services. The latter pattern was visible in Romania and, to a greater extent, in Malta, where exports of services surpassed exports of goods in 2008.

Chart 5 Balance of payments and external position

(percentage of GDP)



Sources: Eurostat and ECB calculations.

Note: No current account balance data for 2008 are available for Malta. Net IIP data are for September 2008 in all countries, with the exception of Cyprus and Malta, for which data are not available.

Trade specialisation patterns have also changed over the last five years, with diverse developments across countries. With the exception of Bulgaria and Lithuania, trade specialisation, as measured by the Herfindahl Index,<sup>10</sup> has tended to decrease somewhat in the NMS. Slovenia stands out as a country with exports highly concentrated in a small number of industries, although the export base appears to have also become more diversified over recent years. Other countries with relatively high levels of specialisation are Cyprus, Lithuania and Slovakia.

<sup>10</sup> The Herfindahl Index is a concentration measure, computed for each country and each year as a sum of squared export shares over all industries within one country, based on SITC-3 data.

With regard to geographical trade patterns, the composition of NMS exports has shifted to a greater extent towards non-euro area<sup>11</sup> markets over the last five years, both within and outside the EU. In particular, in most countries the share of exports to other NMS in overall exports has increased. For many economies, the importance of export markets outside the EU has also increased considerably. Notwithstanding this trend, for the vast majority of NMS exports to the EU continue to dominate over exports to other destinations (see Chart 6).

Turning to the characteristics of trade linkages, in a number of NMS, and particularly in Latvia and Romania, the importance of intra-industry trade has increased since EU accession (see Chart 6). Intra-industry trade appears to be especially important in the Czech Republic, Hungary, Malta and Poland, while it plays a relatively small role in the case of Cyprus. With the exception of Slovenia, intra-industry trade is especially prevalent in trade relationships with other EU countries, whereas trade outside the EU is concentrated more in inter-industry trade. Within the EU, intra-industry trade is even more important for trade among the 12 NMS

themselves than for trade between the NMS and the euro area.

### 3.6 FINANCIAL SECTOR DEVELOPMENTS AND INTEGRATION

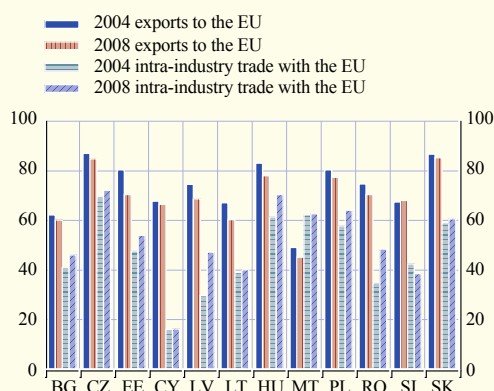
The process of European integration has greatly facilitated the channelling of funds between the euro area and the NMS. Indeed, the massive inflows of private capital into the region have played a key role in the convergence of the NMS towards higher living standards. While all NMS have been running current account deficits, the extent of reliance on external financing and the structure of financing has varied considerably across economies.

As regards the structure of financing, the Czech Republic, Poland and Slovakia have financed their current account deficits primarily through foreign direct investment inflows, whereas some other countries – the Baltic States in particular – have relied heavily on debt financing, mostly in the form of loans from parent banking institutions. This has, in turn, been reflected in the strong growth in these economies' levels of indebtedness. In all NMS, however, the banking sector has played a vital role in intermediating capital inflows, quickening the pace of financial deepening. Between 2001 and 2007, for instance, the share of assets of branches and subsidiaries of credit institutions belonging to EU Member States in total bank assets in the NMS increased, on average, from 40% to 78%, rising above 90% in the Czech Republic, Estonia and Slovakia.

Since EU accession, the extensive use of foreign financing has often resulted in a significant deterioration in the net international investment position (IIP). In many NMS, the negative net IIP exceeded 50% of GDP in September 2008, reaching 100% of GDP in the case of Hungary; only Slovenia experienced a broadly balanced net IIP (see Chart 5). The availability of foreign funds has fuelled the credit expansion in all

Chart 6 Trade developments and integration

(percentage\*)



Sources: Eurostat and ECB calculations.  
Note: Intra-industry trade based on the Grubel-Lloyd index for SITC-3 data.

\*) Exports to the EU as a percentage of total exports; intra-industry trade to the EU as a percentage of total trade with the EU.

11 The euro area aggregate relates to the 12 EU Member States that had adopted the single currency before 2004.

countries in the region, sometimes contributing to stock or housing price bubbles. The annual growth of credit to the private sector has exceeded, on average, 30%, with significant cross-country differences (see Chart 7).<sup>12</sup> At the same time, a growing share of loans denominated in foreign currency has become an important characteristic of bank lending in the NMS, ranging from more than 80% of total loans in Estonia to less than 10% in the Czech Republic.<sup>13</sup> The heavy reliance on un-hedged borrowing in foreign currency involves risks for financial stability in the countries concerned, as it implies that any large exchange rate depreciation would have an adverse effect on household and corporate balance sheets, reducing their capacity to serve their debts and increasing the probabilities of loan defaults.

In many NMS, current account deficits are a normal feature of the “catching-up” process to the extent that they reflect favourable investment opportunities and inter-temporal consumption smoothing (see Chart 5). Some of the persistent, very large current and capital account deficits have, however, also been driven by buoyant domestic demand and benign global financing conditions. The onset of the global financial turmoil in 2008 and its spillover to the real economy led to both a significant

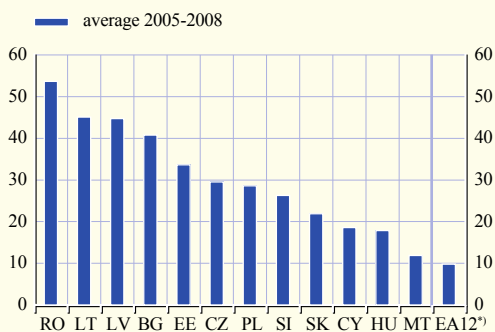
slowdown in domestic demand growth and a greater reluctance on the part of international investors to lend capital, thereby contributing to a narrowing of deficits in some NMS. This notwithstanding, difficulties in financing the existing large imbalances created acute balance of payments crises in some countries leading to the previously mentioned support programmes of the IMF and the EU in the cases of Hungary, Latvia and Romania.

Turning to bond markets, government bond markets in some countries have, since the end of the 1990s, also experienced substantial growth on the back of public financing needs and the commitment of the respective governments to establish key components for local bond market development. Compared with those in the euro area countries, most of the bond markets in the NMS are relatively small and illiquid, notwithstanding a more than doubling of the ratio of outstanding government bonds relative to GDP between 2000 and 2007.

As regards long-term interest rates, since accession government bond yields of most NMS have fluctuated around a declining trend. In 2007 spreads ranged from 15 basis points in the Czech Republic to more than 300 basis points in Romania and Hungary. Since mid-2007, bond markets have been affected by the global financial crisis, when a general increase in investors’ risk aversion, as well as portfolio changes motivated by flight-to-safety considerations, strongly reduced the demand for local government bonds. In addition, the deterioration in macroeconomic conditions and increased differences in perceived credit

Chart 7 Credit to the private sector in the NMS

(annual percentage changes; annual averages of monthly data)



Source: ECB.

Note: Data for 2004 are only available for Czech Republic, Latvia and Hungary. Data for 2005 are not available for Cyprus, Malta and Slovakia. Data for 2006 are not available for Slovakia.

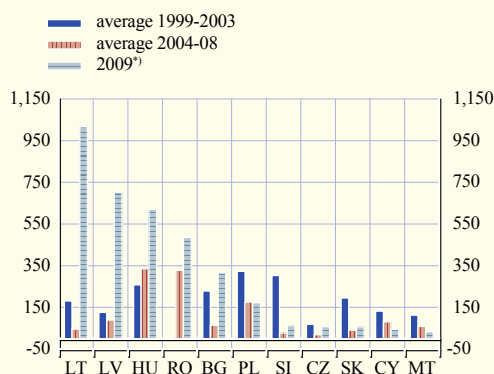
\*) Euro area aggregate comprises the 12 EU Member States that had adopted the single currency before 2004.

12 The rapid expansion of credit is strongly related to the initial levels of financial deepening of the NMS. In most NMS, the stock of credit is still low compared with their income levels and relative to the levels that would prevail if per capita income continued to converge towards euro area levels.

13 Interest rate differentials between local and foreign currency are an important determinant of the choice of borrowing in domestic versus foreign currency. In addition, the credibility of the underlying currency regime and expectations regarding exchange rate movements and inflation differentials play an important additional role together with national characteristics. See Rosenberg, C. and M. Tirpák (2008), “Determinants of foreign currency borrowing in the new Member States of the EU”, IMF Working Paper No 173.

**Chart 8 Long-term government bond spreads against euro area**

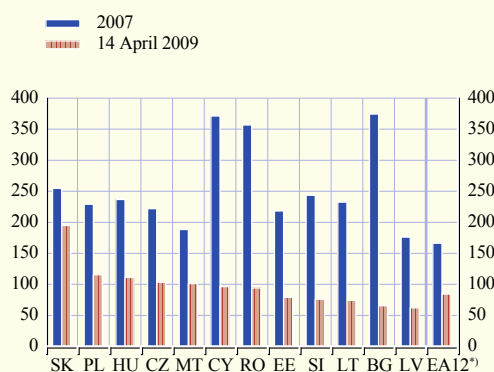
(basis points; annual averages of monthly data)



Source: ECB.  
Note: NMS are ordered according to average spread in 2009, starting with the highest.  
\*) Average to March 2009.

**Chart 9 Stock price indices**

(indices rebased to 100 on 30 April 2004; end-of-period data)



Sources: Bloomberg, Thomson Reuters and ECB calculations.  
Note: NMS are ordered according to stock price index performance between 30 April 2004 and 14 April 2009, starting with the best performer.  
\*) Euro area aggregate is represented by the Dow Jones Eurostoxx index.

risks across countries pushed government bond spreads to historical peaks driving, for instance, differences across the NMS to more than 900 basis points in March 2009 (see Chart 8).

In parallel with the developments in bond markets, equity markets have also played an important role in supporting economic growth in the NMS since accession<sup>14</sup> by providing liquidity for listed companies as well as opportunities of high returns for local and foreign investors. However, the size of stock markets has remained relatively modest when compared with those in the euro area. At the end of 2008, Bulgaria, the Czech Republic, Poland and Slovenia had a stock market capitalisation of around 20% of GDP, while in the case of Hungary it was above 10%. The remaining non-euro area countries recorded a stock market capitalisation of less than 10%. Cyprus and Malta have much higher ratios, reflecting their more developed financial markets. In most countries, the ratio is well below the euro area level, which was around 38% at the end of 2008.

The accession of these countries to the EU attracted the interest of many investors

worldwide, which was reflected in the strong performance of almost all indexes with respect to the euro area stock prices (see Chart 9). By mid-2007, stock market prices in all the NMS reached historically high levels. However, since then, significant declines, which accelerated in the context of the intensification of the financial crisis in the autumn of 2008, have taken place. By the end of 2008, stock markets had fallen by 60% on average in the NMS, with losses closer to 80% in Bulgaria.

#### 4 CHALLENGES AHEAD

Looking ahead, the NMS are likely to face three main challenges in the run-up to the adoption of the euro, as well as in order to ensure smooth participation in the euro area once they have become full participants in EMU. These challenges relate to (i) ensuring macroeconomic stability, (ii) ensuring sound fiscal policies and (iii) making further progress with structural reforms.

<sup>14</sup> See Iorgova, S. and L. Ong (2008), "The capital markets of emerging Europe: institutions, instruments and investors", IMF Working Paper Series No 103.

#### 4.1 ENSURING MACROECONOMIC STABILITY

Recent years have seen much progress in real convergence among most of the NMS, but the progress differed significantly across countries. Hungary's convergence has stalled, as it is suffering from significant fiscal imbalances that have accumulated over time. In other NMS, too, events over recent years have shown that the catching-up process has not always been a smooth one. In this respect, several countries have been confronted with periods of overheating, characterised by large departures from price stability and wide external imbalances followed by periods of large output corrections. Large swings in asset prices have accompanied this process. A key challenge for all the countries in the region, therefore, is to ensure the continuation of real convergence in an environment of domestic price stability and sustainable macroeconomic developments.

As regards price stability, it is clear from the experience of the first few years of EU membership that for countries with a significant income gap compared with the euro area, pursuing an inflation targeting regime has been more conducive to keeping domestic inflation under control than pegging their exchange rates. This outcome is not surprising, since higher trend potential growth rates than in the euro area imply a gradual real exchange rate appreciation trend of the currencies of the NMS against the euro. Such real appreciation needs to materialise through inflation differentials, nominal exchange rate appreciation or a combination of both. Countries that have chosen to fix their exchange rates are therefore bound to record higher inflation rates than those who let their currencies appreciate. However, for countries that have opted to peg their exchange rates, there is also a risk that relatively low interest rates lead to excessive borrowing. This in turn may stimulate domestic demand and exacerbate inflationary pressures, eroding cost and price competitiveness over the medium term and contributing to large external deficits. Furthermore, such low interest rates imply the risk of triggering unsustainable asset price

developments. For countries that have opted for an inflation targeting strategy, it is, in principle, more straightforward to maintain price stability, since they retain autonomy over their domestic interest rates. However, in these countries, excessive nominal exchange rate volatility due to changes in investor sentiment and risk premia has also sometimes posed a challenge for the conduct of monetary policy.

Indeed, a key challenge facing all NMS is to absorb, in an orderly manner, the large capital flows that are attracted by the higher marginal return on fixed capital in these economies. The potentially disruptive effect of capital inflows largely depends on the structure and use of the external funding. To the extent that capital flows are geared towards enhancing potential output growth in the NMS and their long-term repayment capacity, capital inflows strengthen the fundamentals of the economy. However, in many NMS a significant part of capital inflows has taken the form of cross-border transactions that, supported by the process of financial deepening, have, until very recently, stimulated domestic credit growth used for consumption spending or speculative investment in the construction sector. Hence, in many countries the export base has not been significantly strengthened, while external funding has supported increased external debt ratios that make countries more vulnerable to changes in investor sentiment. In addition, in most NMS, large capital inflows have been coupled with strong increases in asset prices, in particular house prices. Furthermore, the large and increasing share of un-hedged borrowing in euro and other foreign currencies is of particular concern, as it increases the vulnerabilities of the private sector to exchange rate fluctuations. Although the rapid expansion of credit to the private sector from relatively low levels partly reflected the ongoing convergence process and structural improvements in the banking sector (i.e. privatisation and increased competition), it has posed a challenge to macroeconomic and financial stability during the catching-up phase.

The experience of the NMS over the past five years generally suggests that avoiding a

temporary demand boom fuelled by capital inflows may be difficult. In order to achieve sustainable convergence, it is important that such external funding is not primarily used on resources aimed at serving domestic demand, but rather in the development of an export base of increasingly high added value. In addition, the conduct of sound monetary and fiscal policies, the implementation of structural reforms and improvements in the institutions and the business environment seem crucial for achieving and maintaining price stability and limiting the risks of excessive output fluctuations. In this respect, it is also important to contain the balance sheet risks in the economies concerned by keeping the exposure to asset price and foreign exchange rate fluctuations low.

#### 4.2 ENSURING SOUND FISCAL POLICIES

As recent economic developments show, countries whose fiscal policies are not perceived as sound have been particularly adversely affected by the financial crisis. The fact that Hungary has continuously recorded excessive deficits since joining the EU in 2004 has undermined confidence in its fiscal policies and contributed to the economic challenges the country is facing at the beginning of 2009. It is thus decisive that the fiscal policies of the NMS are solidly anchored and comply with the Stability and Growth Pact by avoiding excessive deficits.

According to the European Commission's January 2009 Interim Forecast, budget deficits in 2009 are projected to be at or above the reference value of 3% of GDP in the Baltic States, Hungary, Poland and Romania. They are expected to reach very high levels of, for example, 6.3% of GDP in Latvia and 7.5% of GDP in Romania. Government debt ratios are projected to rise in the majority of the NMS, most dramatically in Latvia (by 14.4 percentage points in 2009). In the current situation of a shift in investor sentiment away from emerging market assets, deteriorating growth prospects and still prevailing macroeconomic imbalances in several countries, it is essential that fiscal adjustment be undertaken to support confidence

in the soundness of public finances and the economy at large. This holds true, in particular, for those countries where fiscal vulnerability is compounded by external imbalances and where there has been a failure to achieve sufficiently high surpluses in good economic times. Countries with large budget deficits should, therefore, consolidate their public finances as soon as possible and ensure a sufficient safety margin to avoid breaking the 3% of GDP deficit limit, as required by the Stability and Growth Pact. For an effective reduction of their vulnerabilities to lower capital inflows, governments with debt refinancing risks associated with high shares of foreign currency denominated and/or short-term debt should start to adjust their debt structures accordingly.

Generally, in order to avoid excessive output fluctuations, fiscal policies should set ambitious medium-term budgetary objectives and create budget surpluses in good times to ensure sufficient room for manoeuvre in case an economic downturn sets in. In this respect, attention must be paid to not overestimating the strength of structural budgetary positions in times of fast growth.<sup>15</sup> Furthermore, in order to contain inflation, fiscal policies should pursue a sufficiently tight stance. Empirical evidence suggests that expenditure-based fiscal consolidation in these countries will tend to be more successful as it enhances the credibility of fiscal reforms.<sup>16</sup> In this respect, given the leading role of public wages for overall wage developments in some countries, it is important that public wage developments support competitiveness and contain inflation. Moreover, governments are well-advised to review pension and public wage indexation schemes to ensure that they do not raise public expenditure in times of declining growth and budgetary situations. Furthermore, the use,

<sup>15</sup> In fast growing economies, the strength of the budgetary position, as measured by the structural balance, may be overestimated because of positive revenue surprises, which may be reversed in a downturn.

<sup>16</sup> See Afonso, A., C. Nickel and P. Rother, "Fiscal consolidation in the Central and Eastern European Countries", 2006, *Review of World Economics*, Vol. 142, 2.

inter alia, of EU funds must not have a procyclical effect in times of high growth.

Finally, more emphasis should be placed on implementing fiscal rules that ensure a sustainable development of public finances, including longer planning horizons, the implementation of constitutional debt limits that trigger budgetary adjustments in case the debt limit is reached, compliance with expenditure plans and performance budgeting. The global financial crisis, while posing substantial challenges for public finances, offers the chance for the fiscal policy framework to be adjusted so as to ensure that, where necessary, public finances function in a more sustainable manner during future downturns in the economy. Moreover, in order to ensure the long-term sustainability of public finances, reforms of social security systems should continue.

#### 4.3 IMPLEMENTING STRUCTURAL REFORMS

Structural policies can make a significant contribution to sustained real convergence and competitiveness over the medium term. Labour market rigidities have contributed to the rapid tightening of labour markets in the NMS, exacerbating the risks of overheating and inflation pressures in the catching-up phase. Over the medium term, quality of education is essential for developing an economy oriented to the production of high added value goods and services. Similarly, growth bottlenecks are less likely to appear in an economy with highly liberalised product markets and a business environment that encourages competition and innovation.

Looking at the structural features of the NMS, it seems that in several respects, these countries do compare relatively well with the euro area and can be broadly considered as flexible. Wage bargaining in most NMS is highly decentralised and takes place at the company level, with a limited role being played by trade unions – features which are generally considered to be conducive to wage flexibility.

At the same time, the NMS face a number of structural challenges. While most of these challenges are rather country specific, some general problems can also be identified. In particular, a key deficiency of the labour markets in many NMS is high labour taxation and, partly as a consequence, a high tax wedge. A reduction in labour taxation could help the NMS to utilise untapped labour resources. The ability to decrease labour taxation is strongly linked with the efficiency of public finances. In general, fiscal policy should focus on improving the supply side of the economy to foster competitiveness and sustainable growth. This requires a strengthened focus on improving the quality and efficiency of public expenditure and tax and benefit systems in terms of enhancing productivity. In this regard, a thorough review of the use of EU funds with respect to improving their efficiency is also indispensable. More specifically, improving the responsiveness of the educational systems to the needs of the labour market and stronger emphasis on active labour market policies could ease skills mismatches in the labour markets of the NMS, thereby supporting job creation and growth.

In addition to the labour market and fiscal challenges, the NMS also have to address a number of issues to improve the effectiveness and flexibility of their product markets. In particular, the energy intensity of manufacturing is fairly high in a number of NMS. Improving energy efficiency is important for both supporting growth and increasing energy security (an aspect that appears to be increasingly important). Moreover, the NMS need to stimulate innovation and R&D activities, as spending on R&D tends to be much lower than the euro area average, mainly due to the lower involvement of the business sector in R&D spending. This phenomenon is partly the result of the fact that the export sector of most NMS is dominated by multinational companies that typically concentrate their research activities in their headquarters. Policies that encourage a higher involvement of the private sector in R&D would help the NMS to accelerate the transformation of their product structures towards higher value added products and services.

## 5 CONCLUSIONS

Five years on from EU accession, most NMS have significantly advanced their convergence with the euro area and have, at the same time, become increasingly integrated with the euro area. Following their accession, most of the NMS have continued the economic expansion on which they embarked, and the citizens of the NMS have seen their living standards increase. Supported by relatively high real GDP growth, notable declines in unemployment were recorded. The enlargement of the EU has also strengthened trade links between the NMS and the euro area, particularly as regards intra-industry trade. Yet, while trade with the euro area has increased notably, the NMS have also become more present in world markets. In addition, increased financial links with the euro area and further financial deepening and strengthening have played an important role in financing growth and current account deficits in the NMS.

Notwithstanding these significant achievements, the experience of the past five years also demonstrates that the progress was uneven across countries, reflecting, to a significant extent, important decisions made in the field of monetary, fiscal and structural policies. Indeed, the process of catching-up is not without risk. In particular, given the low starting point in terms of per capita income levels of many NMS, the absorbance of significant, potentially volatile capital inflows in the catching-up phase has posed a challenge. In fact, in several NMS, the strong expansion of the past years has been associated with the build-up of large external imbalances, which, in many cases, reflected overheating domestic demand conditions. In addition, in a number of countries, low domestic real interest rates and significant external funding has supported the expansion of credit growth, often coupled with strong increases in residential investment and asset prices, in particular house prices. A large and increasing share of borrowing taking place in euro and other foreign currencies has made the countries vulnerable to swings in foreign exchange rates.

The global financial crisis and rapid changes in investor sentiment towards the region has exposed the NMS to an increasingly challenging environment of rapid – and possibly disorderly – adjustment. The previous phase of favourable expansion was not used to push ahead with fiscal consolidation and to build up additional fiscal buffers that would have provided room to alleviate the ongoing output adjustment. Similarly, despite the increased flexibility in labour markets, high nominal wage growth has often contributed to eroding cost and price competitiveness in a number of countries. Without a correction of these trends, there are risks of setbacks in the convergence process.

Looking further ahead, following the achievement of a high degree of sustainable convergence with the euro area, all NMS eventually are expected to adopt the euro. Four of them have already done so. However, joining the euro area is not and should not be seen as the end of the road. In order to take full advantage of participation in the euro area and, in particular, to make such participation smooth it is essential that current and future euro area countries are well-equipped. The recipes for success are known and are not very different from what is needed anyway to succeed in an increasingly globalised world. The adoption of the euro will make the very close surveillance of the evolution of competitiveness indicators inside the euro area even more important. An appropriate strategy includes the pursuit of sound fiscal policies and prudent financial supervision based on close cooperation between home and host country supervisors. In addition, it is important to strengthen labour and product market institutions required to increase the flexibility in the wage and price formation process, and to develop institutions that encourage competition and investment in human and physical capital. Only by following those recipes will countries make the best progress to achieving sustainable convergence, thereby contributing, in the long run, to a dynamic and competitive enlarged euro area.