SPEECH

DATE: 20 September, 2004

SPEAKER: First Deputy Governor Eva Srejber

LOCALITY: Ronneby

SVERIGES RIKSBANK
SE-103 37 Stockholm
(Brunkebergstorg 11)

Tel +46 8 787 00 00
Fax +46 8 21 05 31
registratorn@riksbank.se
www.riksbank.se

■ New EU countries - opportunities and risks

It is almost six months now since 10 countries became new EU members, eight of which were central European nations that once were under the control of communist dictatorship. It is said that when Henry Kissinger asked Zhou Enlai, Mao's right-hand man, to comment on the significance of the French revolution, he replied "too early to say". As regards the enlargement of the EU, which is one of the biggest events in Europe in our time, it is likely to be many decades before we can take stock of the full consequences, even in the limited area I intend to discuss here today – the economic situation.

Nonetheless there is much to say about the dynamics that have been created by the enlargement, changes that were initiated as soon as the EU opened the door to membership in the 1990s and that are now continuing following entry: In the short term the immediate problem for the new member states is to govern their economic policy in the right way, given their objective of not simply becoming members of the EU but also joining the eurozone. In the long term there are the opportunities that the free movement of goods, capital and not least people provide for economic growth in both the "old" and "new" parts of the EU. Finally, I intend to touch upon how the discussions in the EU have changed now that the 10 new member states have joined the debate.

I will deliberately try to avoid using the words "west" and "east". Partly because it is quite simply geographically misleading; we say "eastern Europe" even though Prague and Ljubljana are situated west of Stockholm, not to mention Vienna or Athens. We forget that Riga and Tallinn are closer to Stockholm than Gothenburg is. But partly also because it is historically misleading since the new member states do not constitute a cultural or political bloc. Besides their fifty years of oppression, Hungary, Latvia and Slovenia have less in common with each other historically than with Austria, Sweden and Italian, respectively, and belong moreover to three completely different language groups. I prefer instead "new" and "old" as a way of referring to the situation that the 10 new member states find themselves in.

SVERIGES RIKSBANK

The short term: the path to EMU

In connection with the EU enlargement there has been an intense discussion in recent years, both in the old and new EU countries, about what requirements should be imposed on the new member states' economic policy. The discussion has not dealt with entry to the EU, for which the key issues have already been settled, but the next step: the euro. Nine of the ten new member states have announced their intention to introduce the euro as quickly as possible. For some of them the changeover would be entirely undramatic and opportune. For example, Estonia and Lithuania have long had currency boards anchored to the euro, whereby the currency is only issued against a certain statutorily established quantity of euro – in practice a kind of "shadow euro". The currency boards anchored to the euro are considered to have contributed to falling inflation and a stable investment climate. Their economies have been highly flexible in terms of wages and prices and their government finances have been in order, and they have thereby been able to manage situations where developments in the Baltic countries have deviated from those in the euro area. The fact that they now also have the opportunity to introduce the euro is expected to provide further advantages for trade and price comparisons.

But for some of the other new member states a hurried transition to the euro could give rise to problems. To qualify for participation in the eurozone the countries must meet the convergence criteria which lay down various requirements for inflation, interest rates, the exchange rate and government finances. The Baltic States are very close to meeting these criteria today, or have already fulfilled them. But the largest new member states have bigger difficulties.

One of the criteria for introducing the euro is that a country keeps its exchange rate stable within the bands set by the exchange rate mechanism ERM2, which allows a maximum movement in the exchange rate of 15 per cent up or down. The largest of the new member states – Poland, the Czech Republic and Hungary – today have a floating exchange rate.

In this regard there is a more theoretical and more immediate danger for the countries. The theoretical problem has to do with the pressures that high growth exerts on a country's economy and that, according to the Balassa-Samuelsson theorem, either leads to a rise in the exchange rate (nominal appreciation) or to a higher inflation rate than in other countries (real appreciation). If the new member states peg their exchange rates to the euro and at the same time have higher growth than the euro area countries, which they should, then according to the theory they will have higher inflation than the euro area. The problem is that one of the convergence criteria for introducing the euro is that inflation must not be more than 1.5 percentage points higher than in the three countries in the EU with the lowest inflation. This appears to be a potential catch-22 situation. The variation in the exchange rate is limited for two years, while inflation cannot rise too much; but that is what will happen if growth in the new member states is considerably higher than in the euro area, which is what everybody wants. However, I would say that this is mainly a theoretical problem – in practice it has proven pos-

SVERIGES RIKSBANK

sible to keep inflation reasonably low despite a fixed exchange rate and high growth; this has been the case in the Baltic region, for example, where Lithuania has even experienced deflation and high growth. This is because inflation is also affected by a number of other variables (competitive pressures, the productivity of the domestic services sector, taxes and foreign demand). Countries such as Ireland and Spain have shown that inflation can be driven lower ahead of joining the euro despite high economic growth, at least during the years when the convergence criteria are to be assessed.

The other problem is more palpable. A currency peg must be credible at all times if it is to last (unlike, for example, a single currency, which is credible since it quite simply cannot be changed). As Sweden experienced at the beginning of the 1990s, unhealthy government finances can erode credibility and give rise to expectations that the politicians will abandon the currency peg and devalue so as to pull through the crisis. Should the expectations be strong enough they can become self-fulfilling, as they did in Sweden in 1992. The problem in several central European countries is that their government finances deteriorated drastically at the beginning of this decade. Poland, the Czech Republic and Hungary are all, despite spending cuts, still running public deficits over 5 per cent of GDP this year. Should they peg their currencies so as to meet the convergence criteria, they could in other words risk speculation. In addition, they risk remaining in that precarious situation for a long time before gaining approval to introduce the euro; another of the criteria for joining the euro is, as we know, a maximum public deficit of 3 per cent. The worst scenario would therefore be if the countries, in their euphoria over EU entry, were to peg their currencies at a high exchange rate in order to quickly proceed to EMU. In such a situation, the problems in the countries' government finances would put downward pressure on their currencies, while the euro introduction would be postponed further into the future for the very reason that the criterion for the government finances was not met as quickly as anticipated.

It now appears that the risk of such a scenario has been averted. The four largest new member states, spearheaded by the Czech Republic, have made clear that their government finances must be in order before the process to enter the eurozone begins. New spending cuts have been planned to consolidate the government finances so that the countries after a few years can take the next step and peg their currencies at the prospect of euro entry. However, this does not allay all concerns on the path to the euro. It is not sufficient either, for instance, to simply save so that a deficit during a boom exactly meets the criterion of 3 per cent of GDP. Firstly, the Stability and Growth Pact contains a requirement to keep budgets at least close to balance over an economic cycle. But most of all there must be margins in the budget to cope with situations when developments in a country are weaker than in the euro area as a whole (which was pointed out in the Swedish official report before the euro referendum, Stabilisation Policy in the Monetary Union (SOU 2002:16), and in the Riksbank's statement on this). Otherwise there is a risk that the new member states will end up in Germany's or France's current situation – saving despite the fact that the slowing economy has needed stimulation. For this reason deficits during a boom should be considerably lower than 3

per cent so that a margin exists when the economy is put to a harder test during slowdowns. On the whole there is concern that the pressure to put government finances in order will lessen when the objective of joining the euro is postponed. The future will tell whether the saving plans are really implemented as intended.

The long term: mobility and prosperity

Although much of the debate necessarily focuses on the short term, the key issues are those that concern the long run. On the one hand, how can the new member states catch up sustainably on the EU average in terms of prosperity and productivity? On the other hand, how can the "old" EU countries benefit from the enlarged EU in order to boost growth, which in many cases has left much to be desired?

Firstly, let me point out where we stand today. According to the EU's statistical agency, Eurostat, the purchasing power adjusted GDP per capita of the eight new eastern and central European member states ranges from 77.3 per cent of the EU average in Slovenia to 42.6 per cent in Latvia. The richer new member states – Slovenia, the Czech Republic and Hungary – are in terms of purchasing power closer to the EU average than Spain and Portugal were when they joined in 1986 (Slovenia is actually on a par with Portugal and Greece today). The other countries are all just under the relative level that Portugal had in 1986. Sometimes the GDP curves are extended up to the beginning of the 1990s and the fall in output that followed the liberation from communism. These figures are in many ways misleading, however. Firstly, there was considerable manipulation of statistics under the dictatorship, making correct data difficult to reconstruct. Secondly, output in 1989, at the end of the communist era, comprised a very large component of heavy military material and moreover inferior equipment and consumption goods that never came close to being sold or valued in a market, the majority of which were most likely unsellable in a market economy, and many of which were unusable even in a planned economy. The convergence towards the EU average went on during the entire period from 1992-1993 when we had reliable statistics. GDP has grown faster than in the EU and more rapidly in the poorest countries in the group than in the richer ones. This is exactly what we can expect from theories on international economics and long-term convergence in productivity and prosperity.

Behind these figures lies a revolutionary change that makes structural change in EU countries pale by comparison. For each component of GDP that has shrank, another component has grown; for each day that an old heavy industry has closed its gates, dozens of new small enterprises have started up. Allow me to give some examples: In 1991 the private sector constituted 10 per cent of GDP in Estonia; today it is over 80 per cent. Manufacturing, which accounted for 47 per cent of GDP in the Czech Republic in 1992, now comprises 38 per cent, while services at the same time have risen from 44 to 58 per cent.

Nevertheless, economic growth in the new member states is not high enough. Ireland and the dynamic Asian economies grew 9-10 per cent a year during their

SVERIGES RIKSBANK

most intense catch-up phase. But the largest of the new member states – Poland, Hungary and the Czech Republic – are only growing a few percentage points faster than the average for the old countries; an average that furthermore is being pulled down by the poor performances of Germany, France and Italy. From this we can come to at least two conclusions: Firstly, Poland, Hungary and the Czech Republic, which already have fairly substantial public expenditures for their income level, should take care not to end up in the same situation as Germany, France and Italy, with high expenditures, large deficits and considerable needs for reform. Secondly, both new and old countries need a broader injection from the enlargement for their economic performance.

Mobility for goods has been one of the key factors behind the new member states' growth. When the process towards EU entry was initiated in the mid-1990s, the majority of the EU's barriers to trade for the future member states were abandoned through the Europe agreements. This resulted in one of the most dramatic and least publicised changes in trade in modern time – far more significant for most EU countries than, for instance, trade with China today. The future member states, which previously had been among Europe's most closed economies, were transformed in a few years to the most open economies in Europe – foreign trade corresponds to more than 130 per cent of GDP in Hungary and the Czech Republic, more than countries of an equivalent size in the EU, such as Austria and Sweden. The EU became completely dominant in trade, while Russia and the former Soviet republics shrank to become a relatively small trading partner. The countries' share of the old EU countries' trade rose quickly. For Sweden the eight new member states have been the trading partners that have always increased their share steadily from the beginning of the 1990s - through the Asian crisis and the bursting of the IT bubble - and that today comprise 5 per cent of Sweden's foreign trade, i.e. on a par with France and more than double China's share.

All indications suggest that the trend will both continue and deepen. The proportion of intermediate goods (components) produced in the new member states on behalf of Western companies is becoming an increasingly large part of trade, as is the proportion of goods with higher technological content from the new member states.

Mobility for goods has gone hand in hand with mobility for capital. Several studies of the balance of earnings and costs associated with enlargement (e.g. from the European Commission and the independent institution CEPR) have highlighted increased investment as one of the most significant advantages of EU entry. When a country has received a timetable for EU entry, investors know that, despite political and economic upheaval, there is a certain fundamental security in its institutions. They know the rules that apply to membership in the shape of democracy, a market economy and the EU's acquis – all the regulations agreed so far that each new member state adopts. This has very much been the case with the eight new member states that became free from communism. Between 1993 and 2003 more than EUR 130 billion (SEK 1150 billion or almost half of Sweden's current GDP) was invested in the eight countries, of which large parts were capi-

tal from old EU countries. The investment was mainly channelled into capital in industry and into infrastructure such as energy and telecommunications.

A significant Swedish example is the large-scale investment undertaken by Swedbank and SEB in the Baltic banking system. From 1998 both of these Swedish banks have each acquired a part of the Baltic banking system, comprising a total ownership of almost 90 per cent. The Baltic banking system, which previously has been hit by several banking crises, has since then grown very fast, with an annual credit growth of 20-30 per cent, giving increased opportunities for both large and small firms, but also mortgages for individuals. A number of new services, including Internet banking, have been introduced and become widespread. Competition has been relatively tough, with decreasing margins on ordinary financial services and other foreign banks that have gradually tried to gain entry. It is likely that the banking system's fast development has contributed to the continuous growth in the entire Baltic region during the current decade.

Investment flows can also help strengthen the complementariness between industrial structures in different parts of Europe. Outsourcing of labour-intensive stages to low-wage countries has recently taken the blame for the weak jobs growth in the United States. In reality the data indicate something else: that the integration with the fast-growing countries in Latin America and the Pacific Rim have been a crucial factor for the United States' capacity to raise its productivity and prosperity increasingly faster during the 1990s and the 2000s. One study carried out by independent researchers at the institutes NBER in the United States, CEPR in Europe and the IMF show that outsourcing to low-wage countries even strengthens employment growth in the long term. The consultancy firm McKinsey has estimated that each dollar invested in outsourcing to India gives the United States an economic gain of USD 1.12-1.14 and a gain of USD 0.33 in India. In this regard the enlargement affords a similar opportunity for the EU and Europe. There are innumerable examples of how investment in companies in the new member states results in sophisticated cooperation with Western firms. Hungary is now competing with Ireland to attract computer assembly, and Slovakia is on the way to becoming one of Europe's major car manufacturers, while Estonia is a subcontractor of both Swedish clothing firms and Ericsson.

Perhaps the most interesting consequence of EU membership is mobility for people, or, as its known, labour. A common premise in that discussion is that labour from the new member states threatens to invade the labour markets of the old EU countries and that this will be a problem for the old countries even if it benefits the new member states' inhabitants. I would argue instead that it is quite the reverse: Unfortunately not enough people from the new member states will work in the old countries, which is a disadvantage for us, but which possibly benefits them.

Allow me to begin with what the studies say about the potential migration from the new member states. According to a number of studies by independent academics, the flow of people to the old countries if no country had introduced transition rules would not have been larger than after Spain's and Portugal's entry to the EU, amounting to 40 000-670 000, in other words less than 2 per thousand

of the population in the old countries. The reasons for the modest forecast is partly that such a move is associated with costs, that the same rules apply for immigrants and domestic workers in the labour market, and last but not least that mobility is fairly low in the new member states, for cultural and housing reasons among others. A big problem in countries with very high regional unemployment, such as Poland, is that people are not even moving within the country, in spite of vacant jobs and wage differentials of over 50 per cent. Even though six months is undeniably too short a time for assessment, it has been recorded in Swedish media that not a single person from the new member states to date has applied for social welfare or other form of benefit for living in Sweden. Looking for work or applying for benefits in another EU country is both associated with more bureaucracy and rules and is more costly in terms of living and housing than what many people who have never been in that situation know.

This is a problem because the labour in the new member states is needed in the old ones. The old countries in the EU have presently a highly unfavourable demographic situation, as previously broad age groups are retiring and the base of active people to support them is being reduced. In Sweden today, each person in the active population supports 0.29 people over 65; by 2030 this ratio is estimated to have risen to 0.42. The corresponding figures for Italy and Belgium are even more alarming. One way to reduce the dependency burden and increase the labour force is to try to get people that are unemployed, sick or in early retirement back to work. Historically, however, the most reliable way to steadily boost the labour force has been immigration, as has been the case in the United States, for example. Experiences and studies also show that people with the most advanced qualifications and best training most often have the greatest incentive to move, partly because the wage differential is bigger and partly because they find linguistic and cultural barriers easier to overcome. So to consolidate the welfare in the old countries, an increase inflow of highly qualified labour from the new member states would be desirable. The question is whether this is not correspondingly a disadvantage to the new member states. They have a somewhat different demographic situation, their dependency burden is lower today, but will later rise sharply and in several countries exceed Italy’s or Sweden's in 20-30 years. There is also a risk that it would be the best-qualified labour that would emigrate first.

Meetings in a broader circle

Having considered these prospects, I would like to provide an insight into how the enlargement changes the functioning of the EU. The Riksbank participates in a large number of EU committees. I myself am a member of the Economic and Financial Committee (EFC), where senior officials from the finance ministries and deputy governors of the central banks in the EU discuss economic issues. The fact that there are now 25 countries instead of 15 and therefore considerably more at the table implies changes, of course. On the one hand, there is less scope for each country – the central banks, for example, don’t participate as often in the EFC after the enlargement and the speaking time per person places greater de-

mands on concise, brief contributions. On the other hand the discussion has been vitalised by the new countries, which in some ways are less bound by tradition and which have new angles of approach, sometimes for the simple reason that many leading decision-makers in the new member states are much younger than their colleagues in the old countries.

An important point is that it is not just the new member states that have to learn from the old ones; they can also give the old countries something to think about. For example, several of the former planned economies today are in some areas better adapted for EMU than the present EU countries. Their wages and prices have been more in line with their economic performance, which could be one reason, for example, that the Baltic States have been able to pull through the Russian crisis and the breakdown of the Russian market with only a brief loss of growth. The flexibility of their wages and prices makes them therefore unusually well-suited to a currency union like EMU. At the same time, these countries have not shied away from reforms that many leading EU countries have not yet been able to bring about. Estonia, Latvia, Lithuania, Hungary and Poland have, for example, carried out comprehensive reforms of their pension systems, which now resemble the Swedish model with savings partly invested in funds. In these areas in particular, it is rather the EU that has something to learn from the candidate countries than the other way around.

It is as Pope John Paul II said, that now finally can "Europe breathe with both lungs". The new member states enrich the EU, not just economically but also intellectually, and of course also culturally and in human terms. The enlargement puts the EU in motion; not just the trade and investment, but also the institutions and the ideas.