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■ A unified Europe - opportunities and risks

The new EU member states and their role in a European recovery

Firstly, thank you for inviting me to Örebro to take part in this annual conference on economics. I shall speak about some of the challenges we face with a unified Europe. It is now more than one and a half years since ten new countries joined the EU – eight of them countries that had broken free from the bonds of the Communist dictatorship 15 years earlier. Over these years, perspectives have changed. Once these countries were described as recipients of aid and assistance. Now many of them are good examples of how reforms can create rapid growth and thereby lift the population from poverty. Sometimes the new member states are depicted purely as an economic threat when their lower-wage labour force is rhetorically compared with the weak employment growth in many of the old member states.

EU enlargement has given new impetus to the old member states in a situation where growth and employment had stagnated. Ever since the customs barriers between the EU and the acceding member states were abolished in the mid-1990s, trade between the new and old member states has been a growth engine for Europe. For Sweden, the upturn in trade with countries such as Poland and the Baltic states has continued steadily over the economic cycles and has been a particularly important driving force behind growth in recent years, as many of the large European countries have shown weak growth. Much has been said, and quite rightly, about China's role in the globalisation process, but in the case of Sweden it is actually the new EU member states who are more important for our exports, despite the fact that they are much smaller than China. During the decade since the customs barriers were abolished, the new member states' percentage of Sweden's exports has risen steadily from just over 2 per cent to well over 4 per cent, while exports to China only increased from 1 to 2 per cent as a percentage of our total exports; moreover this increase has changed into a stagnation in recent years. The new member states are also the location for many of the most successful Swedish investments abroad, investments which have also contributed significantly to developing these countries' economies. One important example is the Swedish banks' acquisition of and consolidation of almost the entire banking system in the Baltic countries. This has contributed to

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rapid modernisation of the banking system and a credit boom in the Baltic states. As the new member states grow, their potential as an export market for Sweden also increases. Sweden's export growth will benefit from a continued exchange with the new member states and also with other European neighbours outside of the EU. I therefore intend to briefly discuss here four challenges over the coming years to the integration of old and new member states: a single labour market, continued financial integration, the introduction of the euro and continued enlargement of the EU.

A single labour market

Mobility of goods and capital between the old and new member states has been beneficial for both country groups. How has mobility in the labour market affected developments? Prior to the EU enlargement in 2004, the political debate was filled with colourful threat scenarios where citizens from the new member states would move to the old member states and take over less skilled jobs. Concern was expressed that citizens of the new member states would try to move to the existing member states mainly to profit from generous social benefits. This debate was one reason why several EU countries created transitional rules by which citizens of the new member states would only gradually be allowed access to the labour market in the old EU member states. However, almost all qualified calculations indicated that there would actually be very few who would move permanently, for cultural reasons and reasons of accommodation. Countries like Sweden, which in the end did *not* introduce transitional rules, have also been able to conclude that the permanent inflow was very small. The inflow has been very small with regard to skilled professions, where there is a shortage of key persons in the old member states and a more plentiful supply in the new member states, as the work requires language skills and cannot be carried out during brief periods, but requires more long-term residence in the host country. It has actually been necessary for employers in the old member states to advertise vacancies and actively recruit staff in the new member states in order to attract these key persons from the large reserve of highly-educated labour there.

With regard to less skilled professions, the trend that has prevailed for some time in Sweden has continued, with production but not the labour force moving abroad. There are several advantages to moving production to the new member states, such as the proximity to Sweden and the cultural ties which have contributed to the transition being smoother and to key functions being able to remain in Sweden. This type of migration is no new phenomenon, but, like trade, has long contributed to increased welfare and better wages in Sweden. However, a newer trend applies to the less skilled professions; namely people moving to production, in that citizens of the new member states are to a larger degree working temporarily in Sweden while retaining their permanent residence in their home country. The latter means that completely new sectors are being exposed to the type of competition that previously only applied to the export industry. However, the size of this inflow of temporary foreign labour is very difficult to ascertain. It is clear that those who work temporarily in Sweden are not included in the labour market survey's samples. They should be included in measures of employment via companies, but it is difficult to gather from these how many of the employed persons are resident abroad and working temporarily in Sweden. I believe it would be good to have a broad discussion of how the number of people living abroad and temporarily working in Sweden can be measured

statistically. Some of the inflow is probably a growing phenomenon, but better measuring methods will enable us to obtain a clearer picture. In addition, it is important to be clear about which legal rules apply to those working temporarily in other countries.

From an economic point of view, the increasing element of temporary foreign labour in Sweden is in practice the same thing that labour in the export industry has long faced; namely that less skilled parts of production are carried out by people in other countries. The new element is that the freer labour market means that production in Sweden can also be carried out by labour not permanently resident here. This basically gives the same opportunities, at least in the long term, for increased welfare and higher wages in Sweden. However, if the trade unions demand the same average wages for those working temporarily in Sweden as for those living here permanently, the situation becomes more complicated, if their productivity is not the same. Let me explain what I mean here. A driving force behind the export industry's previous use of foreign labour, by moving less skilled production to other countries, has been that although wages and productivity were lower among the host countries' workforces than among the Swedish workforce, it has been profitable for the companies to use highly-productive, better-paid Swedish labour for the more skilled tasks and to outsource the less skilled production to other countries. They have made use of the respective countries' comparative advantages. Swedish productivity and wages have thus been able to rise. The new trend with people moving temporarily to production has been driven by the same business incentives as when production is moved to people in other countries. If temporary foreign labour in Sweden with a lower level of productivity and skills is to be paid the higher wage received by Swedish labour, the majority of this simpler production will not be carried out in Sweden. Instead, the greater part will be moved to other countries and imported to Sweden, for instance, in terms of house-building, the parts will be prefabricated abroad and only the assembly will be carried out in Sweden. In the case of many services, the person buying and the person producing the service have to meet physically, but IT and telecommunications developments have increasingly led to cross-border trading in the services sector. One example of this is call-centres in other countries. The result for other services such as some medical care and dental care may be different in that production occurs abroad and the customers cross the borders as travel costs are no longer as high. We have already seen the beginning of this development. Expressed more simply, there is competition all the time – either in our midst or slightly further away. It is an important challenge for the social partners to meet this essentially welfare-increasing new situation in the same flexible manner as previously was the case with the traditional export industry.

There is no doubt that Sweden has a lot to gain from open trading in services in the EU, as we did from trade in goods. Sweden is namely one of the countries with the largest percentage of services in the economy and already has a large share of trade in services as a result of large parts of the service sector being linked to the manufacturing industry. The EU's services directive, which is aimed at making it easier for services companies to become established and carry out temporary services in other member states, has been brought into question by many EU countries and it still remains to be seen whether a solution can be reached. Sweden is in favour of the directive, but wishes to see changes that safeguard the employee's rights and to ensure that the Swedish collective agreement model is not undermined.

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Continued financial integration

Let me now take up another challenge – the effects of financial integration on oversight, deposit guarantees and crisis management. Swedish and Finnish banks currently own more than 95 per cent of the banks' assets in Estonia and Lithuania. The integration process has spread to other parts of the financial system; the stock markets in Sweden, Finland, Denmark and all three Baltic states are now merged into one single stock market, OMX. However, this development is not unique to northern Europe. At present there are 43 banks in Europe with extensive cross-border operations and all the signs are that financial integration in the EU will continue. The foreign ownership share of the banks in the new member states now amounts to an average of 70 per cent, compared with 24 per cent for the 15 "old" member states. In the insurance sector, too, foreign ownership is particularly evident in the new member states; over 90 per cent in several countries.

These developments entail improved competition and thereby better and cheaper services. However, integration makes new demands of those of us working at various authorities with responsibility for regulations et cetera for financial institutions; supervisory authorities (such as Finansinspektionen), central banks and finance ministries. Companies work along business lines, while authorities still follow national boundaries. It is we, the authorities, who need to change our methods of working in order to meet the new challenges. We must find new forms to exercise supervision of cross-border financial institutions, to ensure that financial stability and efficiency remain good and, in particular, to be able to manage financial crises. When looking for new methods of working we must not forget that companies are integrating across national boundaries as governments and parliaments have made this possible because it contributes to increased competition and thereby more efficient companies and ultimately, therefore, higher growth.

Let me begin with the question of *supervision*. At present the EU's supervision is based on what is known as the home country principle. This means that the country in which a bank has its legal domicile is responsible for supervision of both the parent bank and its branch offices in other countries. Subsidiary banks, on the other hand, are under the supervision of the host country, as they are banks that have received the approval of the host country's authorities. However, this division of supervisory responsibility means that there is a risk that no authority will have a particularly good picture of the *entire* bank group, which could lead to incorrect assessments of the banks' financial situation and risks. Moreover, developments have gone one step further; the banks are trying to make their operations more efficient by specialising some functions to a particular part of the bank; common examples of this are risk and liquidity management. This has led to the distinction between branch offices and subsidiary banks becoming vaguer, which emphasises the risk that the supervisory authorities will not have a sufficient overview under the current regulations. The current system means that the bank's choice of organisation governs where the supervisory responsibility lies.

An initial step is therefore being taken within the EU towards "gathering together" supervision so that the home country's authorities can gain an overview in their assessments of a bank. As I see it, this is a step in the right direction, although it leaves some questions unanswered. It is a classic example of responsibility differing from powers of authority, as even if the home country's

supervisory authority detects a problem requiring a solution within a subsidiary, it may be impossible for the home country to intervene in a subsidiary in another country. The new system could also entail a dilemma for the host country; this country would still have responsibility for safeguarding the stability of its financial systems, but the responsibility for supervising the central companies, the banks, would be partly managed by another country. The unclear allocation of responsibility and powers of authority also risks complicating the ability to manage crises if a bank with cross-border activities faces problems. During the summer, a step was taken to improve the joint capacity to manage crises in cross-border financial institutions; the finance ministries, central banks and supervisory authorities of the 25 EU countries signed a Memorandum of Understanding on exchanging information in the event of financial crises. There was already a corresponding MoU between the central banks and supervisory authorities within the EU. The central banks of the Nordic countries signed an agreement a couple of years ago on cooperation in the event of a crisis within cross-border banking groups.

Financial integration also entails new challenges for the *deposit guarantee*, which I would like to mention briefly here. At present, all EU countries have introduced a deposit guarantee on the basis of an EU directive, and this partly protects depositors' money in the event of a bank failing. In Sweden an amount of up to SEK 250,000 is guaranteed for transaction accounts. The only similarity between the EU countries is that they **have** systems for deposit guarantees; otherwise these systems differ with regard to scope, level and the form of financing. This leads to problems with both competition neutrality and the capacity to manage crises. A bank that wishes to start up operations in the form of a subsidiary in another country is then covered by different regulations than in its home country. If the bank instead chooses to establish itself by means of branch offices, the home country's regulations apply, but the bank is competing with the host country's banks. This can make things easier for the bank, but mean that the bank's customers in branch offices in the host countries are covered by a different protection than other bank customers in that country. It also means that the bank's choice of organisational form governs where the responsibility for the deposit guarantee lies.

In my opinion, the different regulations could comprise an obstacle to continued integration. Moreover, the current system entails a more complicated situation for the authorities involved with regard to crisis management. No country's deposit guarantee has sufficient funds to cover a large-scale bank crisis. Ultimately, therefore, the responsibility for financing the deposit guarantee lies with the respective country's government, as it may need to supplement the guarantee by borrowing on behalf of the deposit guarantee authority. In the end, it is always the tax-payers who bear the risk. As the deposit guarantee in the home country covers branch offices in other countries, the home country's tax-payers also bear the risk for the depositors abroad. The supervision being "gathered together" in the home country means that the host country's opportunities for providing supervision for subsidiary banks declines, while this country retains the responsibility for the deposit guarantee with regard to these banks.

These questions are now being discussed within the EU. I am convinced that it will be possible to find solutions to these challenges, which will entail competition neutrality, stimulate further integration and reinforce the capacity for crisis management.

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The introduction of the euro in the new member states

The new member states' entry into the EU will be complete when they have adopted the euro. At least four of these countries, Estonia, Latvia, Lithuania and Slovenia, are only little more than a year away from adopting the euro, according to their own timetables. Even though Sweden has not adopted the euro, this process will still have significance for the Swedish economy, because of these countries' importance as trading partners and because Swedish banks are so deeply involved in the Baltic banking system.

The Baltic states are in a way already using the euro. Estonia and Lithuania have currency boards anchored to the euro, that is, units of their own currency are only issued in the same amount as the euro exchanged, each unit of their own currency thus has a back-up in euro and their own currency is in practice a kind of "shadow euro". Latvia has a very similar system. The currency boards have contributed to bringing down inflation to low levels and to a stable investment climate. These economies have been highly flexible in terms of wages and prices, and have thereby been able to manage situations where developments in the Baltic countries have deviated from those in the euro area, at the same time as their government finances have been relatively sound. The fact that they now also have the opportunity to introduce the euro is expected to provide further advantages for trade and price comparisons.

The new member states must, of course, meet all of the convergence criteria in the Treaty of Maastricht in a sustainable manner in order to be accepted into the monetary union. The economic convergence criteria concern government finances, interest rates, inflation and exchange rate stability. With regard to the inflation criteria, the requirement is that inflation should not exceed the rate in the three EU countries with the best performance. "Best performance" is interpreted as the *lowest* inflation rate (however, in practice countries with deflation are excluded here). It may be regarded as perfectly normal for countries not to be allowed to participate in the euro area if they cannot keep their inflation rate down, but there is a dilemma here. Countries with a fixed exchange rate and a higher growth rate than average, which is the fortunate position of the Baltic states, to some extent gain higher inflationary pressure in accordance with the Balassa-Samuelson effect. This effect entails, in simple terms, high growth in productivity and wages in the export sector pushing up wages in the less productive domestic services sector, and thereby inflation. Naturally, there may be other factors in the economy that hold back this inflation impulse and lead to total inflation being low. However, this is not the case at present; inflation has increased through transient effects of rising oil prices. Together these effects have meant that the upturn in inflation that we saw, for instance, in the Baltic states following EU membership, has not waned as rapidly as expected. There is a risk here that it may delay several countries' entry into the monetary union, despite the fact that they have had surprisingly low inflation rates, given their high GDP growth. These countries would need to subdue their growth significantly to bring down inflation to be in line with the three EU countries with the lowest inflation, according to the present interpretation of the convergence criteria.

I consider that the current interpretation of the convergence criterion for inflation can be called into question for economic reasons, now that the euro has been introduced. It is rather strange that the comparison is made with all EU countries, when the convergence should actually be towards the euro area countries. I also consider it rather peculiar to single out the three individual countries with the

lowest inflation rates. The objective is not to have the lowest possible inflation rate. It would be more reasonable if the requirement were to follow the ECB's price stability target as closely as possible. This is currently defined as just under 2 per cent inflation, according to HICP.

Several of the larger countries, Poland, the Czech Republic, Hungary and Slovakia have a different situation prior to adopting the euro. For some of these countries the main problem concerns government finances, with large budget deficits and rather unambitious budget consolidation. The large countries do not have currency boards; their currencies float, like the Swedish krona. If they are to introduce the euro they need to change to a fixed exchange rate regime within ERM2 in order to receive approval with regard to exchange rate stability.

Weak public finances are not a good starting point for a currency peg like ERM2, which must consistently maintain credibility in order to hold (unlike a single currency, which is credible as it quite simply cannot be changed). As we in Sweden experienced at the beginning of the 1990s, poor public finances can undermine the credibility of a fixed exchange rate regime and create expectations that the currency peg will be dropped. Should the expectations be strong enough they can become self-fulfilling, as they were in Sweden in 1992. The problem in several central European countries is that their government finances deteriorated drastically at the beginning of the 2000s. If they were to peg their currencies to the euro within ERM2 before their government finances have become sound, they could risk currency speculation. Should the fixed exchange rate regime not contribute to hastening budget consolidation, they risk remaining in that precarious situation for a long time before gaining approval to introduce the euro; another criterion for joining the euro is as we know a maximum public finances deficit of 3 per cent.

Now the risk of these countries joining ERM2 too early appears to have declined. 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 euro area begins. New spending cuts have been planned to consolidate government finances so that these countries can take the next step after a few years and peg their currencies at the prospect of euro entry. However, this does not allay all concerns on the path to the euro. Nor is it sufficient, for instance, to simply save so that a deficit in public finances exactly meets the criterion of 3 per cent of GDP during a boom. The Stability and Growth Pact contains a requirement to keep budgets at least close to balance over an economic cycle. Above all, there must be margins within the budget to manage situations where a country develops more weakly than the euro area as a whole. 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 actually needs stimulation. The budget deficit during a boom should therefore be considerably less than 3 per cent, preferably a surplus, so that there is a good margin to prevent the budget deficit from becoming larger than 3 per cent when the economy is put to a harder test in periods of low growth. On the whole there is concern that the pressure to put government finances in order will lessen when the objective of adopting the euro is postponed. The future will tell whether the necessary budget consolidation really will be implemented as intended. I hope that this will be the case, as this is important regardless of adopting the euro; macroeconomic stability forms the foundation for good growth.

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Continued enlargement

The fourth major challenge, as I see it, is to use the success of the enlargement as a basis to continue widening the circle of member states in the EU, as long as these meet the entry requirements of democracy and market economy (the Copenhagen criteria). Even if we adopt a narrow economic perspective and entirely disregard the geopolitical and democratic dimension, it is evident that the opportunity for entry into the EU provides countries with the motivation to reform their economies – this is clear, for instance, in the gap in economic reforms and population welfare between the Baltic states and Russia, between Rumania and its neighbour Moldavia. In addition, it is of course unreasonable to disregard the value, both economic and human, to both the old EU member states and the people in the new member states of the conversion from planned economy and dictatorship to market economy and democracy having taken place so quickly and so peacefully. I consider this to be a clearly underrated effect of the EU; that its powers of attraction have enabled this peaceful conversion among our neighbouring countries.

Next in line are Bulgaria and Rumania, who plan to become members in 2007. Their average income is way below the EU average. However, in recent years these two countries have made, and are still making, a real effort to reform their economies and meet the EU's requirements. If this process were to be delayed because of political tactics used to achieve other purposes, what is sometimes in Brussels oddly termed "enlargement fatigue", this progress would be jeopardised.

The next stage includes even larger potential members; Turkey, which has already formally begun its negotiations, and Ukraine, which is hoping to enter the EU as a democratic and free country after its "orange revolution". Many of the countries that were formerly part of the Yugoslavian republic are now also standing in line, the relatively prosperous Croatia being the first of these. Here, too, regardless of geopolitical considerations, the ambitions for economic reform depend on the EU not closing its doors. Ukraine's reform programme is still in its infancy, but those who advocate powerful measures have not been assisted by the negative attitude shown by the EU.

The discussions that took place prior to the starting shot for Turkey's EU membership negotiations provide a good illustration of the political complexity entailed in the EU's continued enlargement. Turkey, with its large population and its cultural and religious differences from the current EU members, evidently arouses fears that future cooperation will become more difficult with this country as a full member. The negotiations will probably take a long time, but there are already signals from some current EU member states that the final accession treaty will require ratification in referendums - something that has never occurred before in the EU. A decisive argument in favour of nevertheless taking the step of initiating membership negotiations with Turkey was that this would provide an important incentive for continued reforms in Turkey and create a politically more secure development in what is currently the EU's immediate neighbourhood.

The discussions on where the boundaries for the EU's continued enlargement should be drawn will probably continue. One particular reason for this is that enlargement is often set against deeper cooperation, where different member states have rather different ambitions and visions. The recently stranded treaty on an EU constitution entails an attempt to manage a union with more than 27 member states, and after Bulgaria and Rumania have joined the treaty will nevertheless need to be reviewed in order to be able to take in more members.

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Conclusion

The daily detailed discussions on joint regulations and further steps towards integration within the EU often forget the overall perspective: that the EU cooperation has contributed to creating new opportunities for people to act and companies to develop within the union, that unification is a great opportunity for higher growth both for the old member states and the new member states – an opportunity that has already brought advantages in terms of economic growth.