Speech

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A reunited Europe – the roles played by Sweden and the Riksbank

Baltic Financial Network

Thank you for inviting me here to speak of and discuss this important subject with such a knowledgeable public.

The enlargement will change Europe and Sweden and will also affect the Riksbank. For those of us in western Europe, this is an important opportunity to regain the right geographical, economic and historical perspectives. We talk about "eastern Europe", despite the fact that Prague and Ljubljana lie west of Stockholm, we forget that Riga and Tallinn are actually closer to Stockholm than Gothenburg. We often still have a mental curtain where the iron curtain once prevailed.

Now this division will soon be at an end. A hundred million Europeans, who lived under a totalitarian Communist dictatorship for half a century, can now finally return to a single European community. The political dimension is undoubtedly the most important. The new community confirms democracy and thereby guarantees peace and stability throughout Europe, which will in turn provide a good foundation for growth and development. Today I intend to say a few words about an important facet of the EU enlargement, namely the economic consequences, which will affect the work of the Riksbank more directly.

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Before I go into the major socio-economic contexts, I thought I might begin with an anecdote from a smaller context, a personal experience from one of my most recent visits to Hradec Králové, in Bohemia, Czech Republic, the region where my relatives come from. Every time I return there I am pleased and surprised at the changes that have taken place, but during my most recent visit last year I was quite astonished. There, in the small provincial town of Hradec Králové, with only around 100,000 inhabitants, they now have a shopping mall worthy of Stockholm's smartest shopping area, as well as a couple of large discount stores and a D.I.Y. store, all selling goods of better quality but a fraction of the price of those in Sweden, and all full of shoppers. When I left the shops loaded up with shopping bags to take home to Sweden, I remembered how things used to be, when we in Sweden sent parcels to family and friends containing clothing, medicine and even decent soap and washing powder, along with various other things that weren't available in Czechoslovakia then. And here I was doing all my shopping there!

This is just a fragment from daily life, but to me it illustrates two things that are typical of our relationship to the coming new members of the EU. One thing is how quickly these countries have changed, how rapidly they are integrating with and moving closer to western Europe. The other is how difficult most of us in western Europe find it to understand how rapidly things are moving and how much has already occurred in these countries. The image of a west European with shopping bags full of aid to the poor neighbours in the east still remains, while we are incapable of seeing how much we can pick up from the new member countries.

How poor are the candidate countries?

I should like to begin with a critical examination of the picture we normally give of the applicant countries. Two common illustrations of the economic side of the EU enlargement eastwards are graphs showing the development of production since the fall of Communism and a table of the income differences between east and west.

If we look at the statistics summed up in the European Commission's reports, GDP per capita adjusted for purchasing power (PPP), the gap certainly looks huge. The riches of the 10 central and east European candidate countries, Slovenia, with 72 per cent of the EU average, and the Czech Republic, with 60 per cent of the EU average, are around as poor as countries like Greece, Portugal and Spain were before they joined the EU. However, the poorest countries in the applicant group, Bulgaria and Rumania, have only approximately 25 per cent of the EU average. The graphs for production levels since 1990 look equally gloomy, only at the end of the 1990s do they reach the same level as at the fall of the Berlin Wall. The conclusion is, according to these figures, that the candidate countries will not catch up to the EU countries for a long while yet.

These figures reflect partly real poverty, particularly in regions beyond the cities and regions that already have an intensive exchange with the EU. However, a considerable part of the statistical comparison is misleading. This is partly because the statistics were often rigged under the dictatorship, which makes it difficult to reconstruct proper data, and partly because production in 1989, at the end of the Communist regime, contained a large percentage of heavy military equipment as well as inferior machinery and consumer goods that never came anywhere near marketing or market valuation. Much of this would probably be impossible to sell in a market economy, and much would be unusable even in a planned economy. It was necessary to adjust this production, close down parts of it and it is quite impossible to compare it to what these countries are manufacturing today. As the official figures for GDP from before the changeover were exaggerated, the decline in GDP is also an exaggeration, while the improvement in quality in recent years is underestimated, as are the growth figures.

Given that the candidate countries have nevertheless shown high growth figures during the late 1990s, this would indicate a revolutionary changeover that makes the structural transformation in the OECD economies pale in comparison. The creativity that was suppressed during the time when standard of living, work, education, housing and travel depended on the grace or wrath of the Communist party has now been released to create new ideas. For each part of the GDP that has declined, another part has grown, for each old, heavy industry that has closed its doors, a dozen new, small businesses have started up. Let me give some examples: in 1991 the private sector accounted for 10 per cent of GDP in Estonia, today it accounts for 80 per cent. Manufacturing, which stood for 47 per cent of GDP in the Czech Republic in 1992, now accounts for 42 per cent, while services have increased their share from 44 to 54 per cent.

In addition, the development of eastern Europe has proved that wise economic policy and improved institutions have a real importance in liberating human creativity. This is actually more important than the Communist inheritance and the pre-war traditions that some analysts said would predetermine the countries' economies in the new capitalist era. Few believed, for instance, that "agrarian" Poland would grow much more quickly during the 1990s than the former GDR, which boasted of its old industrial traditions during the Communist days, but thanks to Poland's more efficient economic policy, this is exactly what has happened. Unfortunately this dynamism of *creative destruction and renewal* does not show very clearly in the figures for GDP per capita.

A remarkable growth in trade

However, in one area the figures show clearly how great the changeover has been: trade. Many who have not had the opportunity to study the former planned economies in central and eastern Europe believe that they, for historical reasons, are fairly closed and that their trade is relatively Russia-oriented. In actual fact, the candidate countries are among Europe's most open economies, with a larger percentage of trade in their GDP, and a larger percentage of this trade with EU countries, than many EU countries have themselves. The EU's trade with the 10 candidate countries is increasing more rapidly than that with any other geographical area in the world. During the period 1995-2000, i.e. in just five years, this trade has doubled. The percentage of intermediate goods (components) for western companies is growing, as is the percentage of goods with a high technology content. There are numerous examples of how eastern European companies are specialising to adapt to sophisticated co-operation with western European companies. Hungary is now competing with Ireland to attract the assembly of computers and cars, Estonia is a large sub-contractor to both Swedish clothing firms and to Ericsson, Nokia and their suppliers.

Eastern Europe may be Europe's major opportunity at the beginning of the 21st century, after having trailed behind the USA in terms of growth at the end of the 1990s. The USA's increase in growth in the 1990s was partly due to the US economy being internationalised more rapidly than before, with a larger percentage of GDP exposed to international competition than the EU. If eastern Europe is now integrated more closely with western Europe, this could create a more efficient division of labour and raise productivity in western Europe. The challenge of EU enlargement eastwards could rouse decision-makers in western Europe to a more intensive reform effort so they can fully take advantage of what will, in total, be the world's single largest market. There are parallels here to Japan's success story in the 1970s and 1980s, when Japanese industry, which had not yet subsided into its own structural problems, benefited from the interplay with the dynamic Asian economies that complemented the Japanese companies. Just as the dynamic Asian economies additionally formed a bridge to China, the candidate countries comprise a bridge to Russia (particularly the St Petersburg region where Sweden is concerned), the Ukraine and the other CIS countries – areas that should also become a growing part of the EU's trading sphere. Moreover, unlike many dynamic Asian economies, the candidate countries' populations have always had a very high level of education; in science and technology it is fully comparable with the level in the current EU member countries.

The east European trade is particularly important to the Swedish economy, which is already one of the most open and trade-dependent economies in Europe, at the same time as we have strong historical ties to several eastern European countries, particularly the three Baltic states and Poland. Already, central and eastern Europe as a whole is a *larger* market for Swedish foreign trade than, for instance, Japan or East Asia. When the Riksbank makes its inflation forecasts, central and eastern Europe will move gradually from being a brief footnote to becoming an important area in the international forecasts.

The importance of membership

The recipe for success behind the trade integration between the EU and eastern Europe is a little-known international trade agreement. While the WTO and NAFTA steal the headlines, few people are aware of the agreement that created the boost in east-west trade in Europe, the “Europe agreement” between the EU and the eastern European countries. There are major shortcomings in this agreement, but it includes free trade for almost all industrial goods and thereby enabled the rapid changeover to become reality.

However, a decisive factor for the success of the Europe agreement is that all of those involved knew that actual membership of the EU would come in the near future. Membership is that major and important step, when the rules of the game are confirmed and investors know that the institutional conditions are stable and up to EU standards. This assurance is accentuated in many studies of the enlargement and said to be the most important individual factor for continued strong growth in the eastern European countries.[1] It is also at the point of actual membership that the final trade barriers will be abolished and the investment channels will be fully opened. We can make a comparison with the countries that entered the EU earlier with income levels way below the average, i.e. Spain, Portugal and Ireland. For these countries membership meant a large inflow of capital and technology as well as a further increase in trade. The economic policy of the new member countries became more stable. Rapid growth and a convergence in the standard of living followed. This led to major gains for both the richer, existing member countries and for the newcomers.

It would therefore be regrettable if the candidate countries' membership were allowed to delay or be diluted. Fortunately, there is now a clearer timetable and a strong probability that 8 of the 10 countries will become members in the coming years. However, after the enormous efforts made by the candidate countries in recent years, their actual membership must not be blocked by internal power games and ultimatums between the existing EU members.

However, the attempts in recent years to create transition periods before candidate countries can enjoy the EU's free mobility for labour are worrying. This would probably also prove counterproductive, as many studies show that the exemption for labour would not reduce, for instance, cross-border black market crafts and services – what a special transition period creates are barriers to mobility for qualified, professional workers for which there is often a large demand. At the same time, there are no signs, in the studies made by the European Commission, and others, that free mobility for labour would lead to mass immigration from the east. Although the comparison is slightly lame as we now have the Schengen Treaty, there was no mass immigration to Germany from Portugal and Greece when they became members of the EU. If there is an opportunity for improvements in their home country, most people prefer to stay there.

There is also a risk that we are exaggerating the costs of allowing the new countries to be part of the EU's agricultural and regional policy. The high costs and peculiar incentives of the EU's agricultural policy are a problem in themselves, which require a new way of thinking, but in my opinion it is not the actual enlargement eastwards that is the major stumbling block. According to the Commission's most recent calculations (based on a gradual increase in the support

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[1] The Centre for Economic Policy Research presented the first major study in 1997 by R. Baldwin, J.F. Francois and R. Portes (Economic Policy 24, 1997) emphasising the importance of institutional assurance for investors. The European Commission also highlights the importance of this in its study published in May 2001.

to the new member states), the total budget cost of the enlargement would be equivalent to only around 0.15 per cent of the EU's total annual GDP over 15 years. If the EU's GDP during the corresponding 15-year period increases by only 0.2 per cent a year thanks to the integration with central and eastern Europe, the enlargement would involve socio-economic gains.

The remaining obstacles

Having said this, there is no reason to believe that the enlargement process will be simple and painless, for either the new members or the old.

Despite all of the changes the candidate countries have undergone over the past decade, EU membership will involve a period of major new upheavals. Many countries still have remnants of unprofitable state-owned industries that are propped up by central government finances. The banking system is still undeveloped – lending still corresponds to only a fraction of the countries' GDP, while in countries like Sweden it is roughly the same size as GDP. A properly functioning housing market and housing financing does not yet exist. The actual EU entry requirements involve extensive changes in legislation, administration and the implementation of regulatory frameworks, in addition to the weighty but necessary investments that are required to bring environmental protection and infrastructure up to EU standards.

It is precisely because there are already so many requirements made of the countries, that the EU process should not further burden them with informal requirements and expectations. Perhaps the biggest danger for the candidate countries is that they will come under too much pressure.

One such risk is the exchange rate regime. From the point of view of foreign investors, the years immediately before and after membership run the risk of being characterised by unwarranted euphoria. The inflow of capital to equity and real estate markets in these countries can be so large that asset prices and real exchange rates become overvalued. When the capital flows then wane slightly and some capital leaves the countries again, this may come as a surprise. In connection with EU membership, with fixed nominal exchange rates, even within a fairly broad band, pressure on the exchange rate can arise. The best thing then is to have clear regimes with a clear target. Several of the large countries now have inflation targets with a floating exchange rate, which is not as exposed to speculation attacks. Other smaller and very open candidate countries have currency boards in euros and have shown that they can adapt flexibly to both shocks such as the Russian crisis and rapid fluctuations in investment flows.

The choice of an exchange rate regime can affect flows of foreign capital. But it does not in itself change the pressures for real appreciation and depreciation created by large capital inflows or outflows. However the actual effect will vary depending on the regime.

Under a fixed exchange rate regime the real appreciation takes place through higher inflation and real depreciation through lower inflation, while with a floating exchange rate it occurs through nominal appreciation or depreciation. A tight fiscal policy can counteract the extraordinary real appreciation due to capital flows. A strong central government budget also makes it possible to respond with an expansive fiscal policy if the capital flows are turned into outflows. However, this requires that fiscal policy has ample reserves.

The convergence criteria for public finances in the EMU, particularly the target for a budget deficit no greater than 3 per cent of GDP, therefore function as sound targets for the candidate countries. Despite the recent criticism vis-à-vis the budget criterion I believe that 3 per cent is a sufficient margin for fiscal policy, as long as it is in balance over the cycle. Yet there are still risks in rushing to meet *all* of the convergence criteria – especially if EMU membership cannot realistically occur for several years. There is a discussion in academic circles on whether very low inflation figures, that is to say, much lower than most candidate countries have now, are really compatible with rapid growth and a fixed exchange rate. The export sector's rapid growth creates pressure on the domestic economy through the 'Balassa-Samuelson' effect and raises domestic prices, creating a 'natural' inflation. To then artificially press down inflation to *very* low levels could be overly ambitious.

An even greater risk for both candidate countries and the EU could be to try to transfer the entire system of subsidies and taxes applying in several richer EU countries to central and eastern Europe. Most of the candidate countries already have higher tax levels and a greater degree of state influence in the economy than the majority of countries in the world at their welfare level, and much more so than in countries such as Taiwan and South Korea, which have succeeded in rapidly attaining a higher standard of living. To further increase the tax pressure and subsidy levels would risk subduing growth.

Here I should like to highlight a warning example and a good example. The warning example is the former East Germany. It is often said that it was the fact that the East German mark was replaced at parity by the West German mark that led to the economic difficulties in the former GDR. This perhaps was not the decisive factor; rather it was the fact that wages and subsidy levels, together with the rest of the West German system, were transferred to a much poorer economy, which needed much greater room for manoeuvre. Despite massive investments, the new eastern länder suffered a recession and mass unemployment. The positive example is actually none of the strong economies in eastern Europe, not Estonia, Poland or Hungary, but Ireland – which made good use of all opportunities to compete with its cheaper and increasingly well-educated labour force after EU membership, while gradually reforming its tax and subsidy system. During the 1990s, Ireland doubled its growth rate from just over 3.5 per cent a year to over 7 per cent – well in line with the most dynamic Asian economies – and GDP per capita, which was 40 per cent below the EU's average as recently as in the 1970s, is now *above*. We must hope for the sake of both the EU and the candidate countries that the new members will follow the example of Ireland and not that of the former GDR.

It is important to *focus* the enlargement process on what is relevant to the real economy. What is important for the candidate countries and the current EU economies is that the new members are given the chance to catch up with the EU. Free trade (as in the Europe agreement), stable institutions (adopting and applying the EU's fundamental regulations, what is known as the "acquis") and a wise macroeconomic policy are the things we should hope for and expect – no more than that.

The EU's institutions

There was a discussion at the European Council meeting in Nice in December 2000 on the shaping of the EU's decision-making processes when the union is enlarged to include many more members than it has today. With regard to the ECB, the current regulations would lead to a situation where 34 persons would have the right to vote on monetary policy in the ECB Council, if all of the candidate countries were also to take part in the monetary union. The Council of Europe therefore decided to introduce a clause into the regulations enabling the rules in the ESCB charter for participation in the Governing Council to be changed without having to call an intergovernmental conference. However, a change would still require unanimous support from all member countries and ratification by each of them. A proposal for a change in the voting right could be put forward by the ECB or the European Commission. The new clause will come into force together with the Treaty of Nice when it is ratified by all of the current member countries.

There is no given method of organising decision-making in a monetary union with many participants. An attempt to analyse the decision-making process in an enlarged ECB Governing Council has been made by the Centre for Economic Policy Research (CEPR) in a report published in October 2001. The report discusses three models for improving the efficiency of the ECB Councils' decision making in an enlargement of the number of participants in the monetary union: rotation, representation and delegation. That is to say, a rotating voting right between a number of central bank heads, similar to the Federal Open Markets Committee in the USA, the formation of constituencies of central bank heads with joint representatives on the ECB Council, rather like at the Bundesbank following the German reunification, and finally delegation to a small group of experts, roughly like the Monetary Policy Committee in the UK. The CEPR report then gives an account of the advantages and disadvantages of the three models. The discussion will probably intensify when the Nice Treaty comes into force.

The roles played by Sweden and the Riksbank

Sweden as a country plays an important role in the whole of this enlargement process, because of the support from both politicians and the general public for our neighbouring countries in the east. The Riksbank tries to contribute where we can. We share our experiences regarding monetary policy and financial stability, particularly with the three countries that, like Sweden, have inflation targets;

Poland, the Czech Republic and Hungary, as well as, of course, Estonia, Latvia and Lithuania. The latter are particularly important, bearing in mind Swedish banks' large ownership in the Baltic banking system. Economists from the Baltic and central European central banks visit the Riksbank regularly and we visit them. The Riksbank is also involved when the candidate countries present their "Pre-accession Economic Programmes" (PEP) for the EU countries. These PEP programmes are exercises where the countries attempt to analyse and present their economic challenges in the way they will in future, as EU members, present stability and convergence programmes and consult on economic policy within the framework of the Broad Economic Policy Guidelines. Hopefully, the Riksbank will be able to contribute with analysis of economic activity and structural issues in these countries, not merely for our own forecasts but also in relation to the EU and ECB.

What we can learn from the candidate countries

Before I finish, I would like to go from speaking of what the candidate countries can learn from us to pointing out what we can learn from them. Several of the former planned economies are now in some areas better adapted to the EMU than today's EU countries. Several of them have, for instance, a flexible labour market and wage formation. This appears to have contributed to enabling the Baltic states to cope with the Russia crisis and the breakdown of the Russian market, without their reform efforts and growth coming to a standstill. This flexibility also makes them extremely well suited in this respect for a monetary union like the EMU. The preparedness to implement structural reforms also appears greater. First Estonia, Latvia, Lithuania and Hungary and now most recently Poland, have implemented fundamental pension reforms similar to the Swedish reform with a partly funded system. In addition, Estonia has had a very consistent free trade policy, which has benefited the country during the transition to a market economy. The country has been so free trade friendly that it is now unfortunately forced to raise the customs duties on certain goods against some countries in preparation for EU membership. It is in areas such as this that the EU can learn something from the candidate countries (and countries like Ireland) rather than the other way round.

The new candidate countries can enrich the EU in this way and many others, not merely in a pecuniary sense, but also institutionally and in a cultural and humane sense. The enlargement eastwards will send new stimuli to the EU, not merely for trade and economic integration, but also with regard to the EU's institutions and the current member countries, just as the candidate countries have received stimuli from the EU during the process. This means not only that a reunited Europe can become richer, but also that the EU can, hopefully, become even more successful and function even better.