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Abstract

Before long the EU's new member states will join the European Monetary Union (EMU) and introduce the Euro. There can be no doubt that taking such a step will accelerate their incorporation into the European integration process. At the same time, however, fierce economic and political risks are likely to arise both for the new and for the old member countries.

In the first place, the new EU members in Central Europe (CE) expect an early accession to the eurozone to result in a rise in capital imports which will allow for a narrowing of the economic gap between the old and the new members that will undoubtedly continue to exist for decades to come. Fixed exchange rates and even a common currency will foster trust and intensify the exchange of goods, services, capital and labour between both regions, while the concurrent economic growth will contribute to political and economic stability in CE.

The introduction of the euro in Central Europe, however, will be attended by considerable economic, political and social risks. Both production and finance structures in Central and Eastern Europe have not yet completely overcome the heritage of decades of communist central planning. Thus, a rapid and premature elimination of monetary and exchange rate autonomy may lead to social hardships that are likely to destabilise these countries. This is particularly true for the labour markets which, as a consequence of monetary opening, are likely to be liberalised. Since structural unemployment, inherited from the planned economic system, remains high, the number of social losers is likely to rise and societal polarisation increase.

Probably the biggest problem the new EU members have to face is their current account deficit, which limits the rooms for political and economic manoeuvring. These deficits, however, are almost entirely financed by volatile capital imports. A way out may be the smooth conveyance of economic strategy from a foreign investment dominated growth path to one of sustainable growth that attempts to minimise the risks of financial crisis. This is particularly true for monetary and exchange rate policies which have to induce the trust of the financial markets with respect to both the choice of the exchange rate regime as well as the actual exchange rate. The success of enlargement depends both on the speed of the process and on the procedure how to implement the right political and economic mechanisms towards sustainable self-financed growth.

A corresponding catalogue of economic policy instruments contains measures that support the liberalisation of goods and factor markets, the stimulation of education and infrastructure, as well as those tax and fiscal activities that induce domestic savings and investment. By employing these measures the current account deficits can be gradually reduced and a sustainable convergence of the new EU members' towards the old ones' economic growth may be achieved. The more effective these measures are employed, the earlier these countries are prepared to compete on the all-European market and to accomplish sustainable growth. Such a development will not be felt as a burden to the „old" EU members. Thus, it is in the well-understood self-interest of the „old" members themselves to support these adjustment processes because it reduces or even eliminates the risks of providing assistance against a betting economic and political destabilisation in Central Europe once the euro is finally introduced.

The Research Project „Ezoneplus – The Eastward Enlargement of the Eurozone" covered the period from July 2001 to June 2004. Its coordinator was Prof. Dr. Michael Bolle from the Centre of Excellence of the Freie Universität Berlin. Further members of the consortium included economists and political scientists from research institutes and universities of Germany, Estonia, Finland, Italy, Poland, Portugal and Slovenia.

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1. Executive summary

The admittance of eight CEECs into the EU, and the subsequent enlargement of the EMU, will cause deep changes within the political, economic, and social settings of both old and new EU-members. The hallmark of the current enlargement process is that it has been a political decision to include new members into the EU. The enlargement process has originated from the realization that post-communist countries required political stabilization. The marked difference between the sizes of the population and of the economies is the prime source of underlying tensions of the enlargement process. The research project *Ezoneplus* focuses on the ensued reshaping of politics and markets. In particular, *Ezoneplus* ascertains how to overcome imponderables in organizing the process of leading new EU-members toward the eurozone. In this regard, *Ezoneplus* tries to get the bottom of ensuring sustainable growth and convergence in respect of new members' run-up to EMU. The simultaneous deepening of the EU *acquis communautaire* and, in particular, the adoption of a common currency entails new challenges for both old and new EU-member states.

Key results of this project may be summarized as follows: First, a common currency induces the reshaping of markets – i.e. markets adapt to new circumstances, thereby pushing the Euro-area closer to an 'optimum currency area'. Nevertheless, reshaping will remain incomplete due to political reasons. National policy-makers cannot sacrifice their own electoral survival by implementing efficient economic and social policies. Second, as a consequence, there is an ongoing tug-of-war on the distribution of costs of social and economic adjustment between old and new member states. The political bargaining on these costs affects the prospects of stabilizing the capital influx towards CEECs and their ability to catch up to living standards in the old EU-member countries.

The stability of the CEECs' convergence process is the main goal of both current and new EU-members. *Ezoneplus* discusses the implications of a particular catch-up strategy and has a look at the economic, political, social and institutional consequences involved. A process of new EU-members joining the eurozone, implying the reshaping of economic determinants that may lead to efficiency gains, has thus to consider economic adjustment and social costs as well because real convergence, based on sustainable increased growth, can only be a long-term process. In addition, both new and old EU-members have to cope with particular challenges that derive from an ageing population, growing immigration, labour shortages in key sectors and social inclusion problems. Failure to attain sustainable convergence

may jeopardize the benefits arising from EU accession and may even be a source of destabilisation for old EU-members. On the one hand, *Ezoneplus* explores these uncharted waters along the lines of capital markets, labour markets, as well as goods and services markets with regard to trade and FDI. On the other hand, the project puts emphasis on policies related to fiscal and exchange-rate issues as well as to the social dimension of new EU-members' convergence towards the eurozone.

The starting point of our considerations is that economies in new EU-member countries have to rely on sizable capital influx in order to stimulate growth and real convergence towards current members of EMU. The track of EU-enlargement has to be politically stabilized and the social acceptance of the course taken be maintained. Hence, the general trend towards real exchange-rate appreciation in new EU-member countries fostering their catching-up is desirable and has to be maintained for a prolonged period.

1.1 Capital markets

As regards capital market integration risks are predominantly to be found in the lacking institutional quality of financial markets in new EU-member countries. National and foreign investments will only lead to more growth if the institutional environment guarantees high and safe returns. The trend real appreciation, ensuing sizable current account deficits, is partly due to a convergence play. The current high valuation is certainly a fair bet reflecting highly profitable investment opportunities. However, any doubts regarding the sustainability of convergence trigger a revaluation of assets that may lead to a reversal of capital flows. Institutional strengthening allows for linking capital markets in CEECs to mature financial markets in the eurozone. Eventually, efficient financial markets are the best preventive measure against overinvestment delivering a fair price signal of risk and chances involved in steady stream of capital influx to new EU-member countries.

1.2 Foreign exchange markets

In addition, capital movements are determined in the foreign exchange market. The exchange rate mirrors macroeconomic fundamentals, microeconomic risks – i.e. particularly capital market imperfections –, and in particular expectations about future economic policies. Exchange rate risk in sustainable growth regimes will eventually vanish at the onset of EMU-membership. But there is still a long way to go for new EU-members. According to Maastricht criteria and in order to achieve the entry conditions of EMU, CEECS have to rely on 'soft pegs' exchange-rate regimes in ERM-II. Correspondingly, to most observers, the period between entering ERM-II and entering EMU is hence the time when risks will be concentrated. Exchange-rate regimes with wide bands and only moderately overvalued conversion

rates – probably achieved by a final devaluation at the outset of admittance to ERM-II – will best serve sustainable growth regimes in CEECS. Though, pursuing false economic policies, will particularly lead to the well-known problems of speculative attacks and currency crises in ERM-II. In this respect, unsustainably high current account deficits may tilt the balance heavily against a successful enlargement of EMU. Guaranteeing, in turn, sustainable capital movements implies heavy burdens for national policy makers, in terms of prudent, most notably restrictive, economic policies. However, whether vote-maximising governments in new EU-member countries achieve to comply with the Maastricht criteria remains doubtful from a perspective of political economy.

1.3 Labour markets

Smoothly functioning labour markets could be of great help in that respect. Flexibly adjusting wages and quantities – as for the latter this would imply high flows of migration between countries – could assure that, firstly, the fulfilment of Maastricht criteria gets easier and, secondly, that convergence of per-capita-income gains speed. But it is well-known that European levels of mobility and flexibility remain conspicuously below the economic efficient values. An additional problem is caused by the high social and labour standards of the old EU-members which are likely to increase labour market rigidities and tighten the problem of unemployment in the CEECS.

1.4 Goods and services markets

Goods and services markets, finally, also show some discomforting patterns so far. On the one hand, though rather small, the incidence of trade diversion between old and new member states is not a *quantité negliable*. This is all the more the case, since losses are unequally distributed across old member states. Next, the patterns of specialisation between Western and Eastern Europe do not show the kind of productivity-enhancing and growth-stimulating feature a sustainable growth strategy would imply. Thus, at least for some years, or even decades, down the road a division of labour could emerge that is characterised by an exchange of eastern agricultural and western industrialised goods, a structure difficult to change. Since many of the CEECS will be able to exploit their comparative advantages only by increased exports of agricultural and low-wage, low-tech products, staunch resistance by the respective lobbies in the “old” member states is to be expected. A more balanced division of labour, even developing intra-industry trade further, depends largely on the creation of an environment that favours foreign direct investment, the transfer of technology and the development of production structures which can master all-European or global competition. In addition, ad-

justing goods and services markets require the political readiness of old EU-members to accept an increasing influx of products and services from CEECS.

1.5 Socially acceptable and feasible policies

The prime 'social' risk of such a growth regime lies in the societal acceptance of economic changes. First of all, any integration process produces winners and losers. It is among those losers where we expect to find the greatest imponderables within the process of sustainable convergence. The successful implementation of reforms hinges upon the ability of national governments to compensate losers. The enlargement process affects different segments of the population differently, dividing the electorate into 'winners' and 'losers' of integration. Hence, the issues redistribution and compensation loom large into the task of implementing a sustainable growth regime.

1.6 Fiscal and exchange-rate policies

Appropriate fiscal and exchange-rate policies strengthening private sector's expectations thus ensuring a steady stream of capital influx are required, but hard to put through. From the viewpoint of political economy, governments strive for office retention. Therefore, incumbent governments may be forced to dampen the detrimental social effects of their run-up to the eurozone. In this respect, the prescribed soft pegs in ERM-II provide perverse incentives as additional fiscal spending gives front-loaded benefits and delayed costs. Governments in CEECs will constantly have to weigh the costs of maintaining necessary policies for Maastricht compliance against the hardship of voter alienation. This holds all the more so, as current members are interested in sustainable convergence of CEECs. The latter will not hesitate to give way to the according moral hazard.

Policies should be organized in a way that the risk of disordered devaluations provoking currency crises and a reversal of capital flows is at least reduced. Prudent fiscal and exchange-rate policies may have to be supported by the old EU-members.

With both sides being reluctant to 'pay the bill' it comes with little surprise that there has been and will be a prolonged tug-on-war between current and new EU member countries. Hence, we expect 'pork-barrelling' in crucial policy areas, ranging from the EU budget, to the modalities of EMU enlargement, and to the coordination between tax and transfer systems. This kind of genuine 'EU risk' could further endanger the sustainable flows of capital within an enlarged Europe.

Knowing all these forms of risks and potential conflicts, *Ezoneplus* establishes what to do about them. The answer is both amazingly simple and inherently complex: The kind of sustainable growth regime intended has to assure a switch from the short terms needs of

guaranteeing stable capital flows to the long term need of raising national saving ratios in Eastern Europe. The point is that the EU will only come to terms with the political and economy tensions outlined so far, if the level of wealth transfer is eventually reduced to sustainable levels. The prime mechanism to do this is by enhancing national savings. Accordingly, policy advice relates to strengthening the capacities of both policies and political institutions on national and European levels to trigger increases of saving ratios in Europe. Such measures will buttress up a sustainable growth regime leading new EU-members towards the eurozone.

2. Background and objectives of the project

The purpose of the project was linked to two problems of special importance to the political economy of eastern enlargement. First, a low degree of economic and political homogeneity between the then accession countries and EU(15) member states pointed to severe economic and political risks. Second, these risks may be aggravated due to developments within the European Monetary Union. On the background of a comparative analysis which focuses on three Central European countries which belonged to the first wave of applicants to join the EU, and four old member countries of the eurozone, representing different economic, political and cultural patterns, the project intended to assess crucial economic, social and, to some extent, also political features of the accession process and the impact with respect to structural market adjustments, policy responsibility, and social stability, on the accession countries themselves and on the countries already being members of EMU.

Given the economic conditions at the outset of eastern enlargement, which are characterized by a distinct gap in per capita income between the present EU members and the new member countries due to differences in factor endowments and factor productivity, options for choosing the right transitory exchange rate mechanisms are at the heart of research. Given different starting points and a different need for economic reform, it is advisable indeed, that accession countries should follow different exchange rate regimes on their path to EMU without incurring the risks of currency crises or even systemic crises. Decisions on exchange rate policies have to take into account the credibility of the commitment, the overall macroeconomic policy and the risks of excessive capital inflows as well as capital outflows. The research conducted aimed at a discussion of this plurality. Prerequisites and impacts of exchange rate regimes turned out to be at the heart of the enlargement process and at the heart of this research.

But research went far beyond pure exchange rate regime analysis by looking at the various individual channels of transmission through which the eastern enlargement will affect accession countries and member states of the EMU. Given different options for currency regimes, it was found out that the extent to which partners will be affected by the enlargement process will vary from one case to another, depending on the intensity of countries' trade and financial relations, the functioning of labour markets, their access to international capital markets and the stance of fiscal and monetary policy as well as the impacts on social fairness.

The main channel of transmission through which eastern economic enlargement will affect the economic conditions runs via the eastern countries' international trade relations with the eurozone. Thus, research was aimed at studying the impact of trade in goods and ser-

vices on the economies of accession countries as well as the EU countries. A second important channel works through foreign direct investment. Countries participating in the first wave of enlargement may become more attractive for foreign investors, which could lead to a redirection of FDI flows outside of and within the eurozone. Because of the introduction of the euro, a wide, deep and liquid financial market will be created, which will also bring about major changes to financial markets in accession countries. The process by which this will happen was studied closely with regard to exchange rate regimes and the credibility of monetary and financial policy.

Research also concentrated on the impact of enlargement on labour markets. There are two aspects involved: First, there is the question of labour market flexibility with regard to wages and legal regulations and, second, there is the aspect of migration. Because of the fact that a large gap in wages is likely to persist, monetary incentives to migration will remain high in the integration process. At the same time, the absorption capacity of labour markets in the countries of destination is restricted by too high unemployment.

Additional risks for accession countries stem from the fact that a smooth economic integration of accessing countries depends on the success of the EMU is by no means clear. Convincing economic arguments in favour of EMU are rare. The merits of the currency union in the absence of an optimum currency area are not obvious at all. Remarkable differences in productivity, the absence of a common economic policy and low labour mobility point to severe economic and political risks. The removal of the exchange rate instruments, the fiscal constraints of Maastricht and the Stability and Growth Pact as well as the no-bail-out clause put considerable weight on the flexibility of markets. The EMU will only work if markets for labour, capital, and goods and services, are flexible enough to absorb asymmetric shocks. At the moment, neither labour nor capital markets are in a good shape. We found out, however, that eastward enlargement and the success of the euro are very likely to contribute to an improvement of market adjustments potentials.

There is no doubt, too, that economic and political support is needed to reduce frustration in accession countries to avoid political destabilisation and social unrest. The project attempted to identify the criteria for a successful inclusion of accession countries that does not lead to distortions in the euro-system's development. National policies as well as the European Union will have an important role to play in providing political support and economic assistance to stabilize the transition process which will bring about the reshaping of European economies. Special attention has been given to policy implications and recommendations on the national and EU level based on principles such as efficiency, subsidiarity, cohesion, and

social fairness. Issues addressed also covered policies to mitigate structural changes, manpower policies, fiscal, monetary and exchange rate policies to minimize financial and systemic risk as well as income and social policies to accommodate the transition period and to avoid social conflicts. Research was based on a strong conviction that findings of this project will not only raise the awareness of upcoming difficulties but also help to improve the next wave of monetary eastward enlargement.

During the lifetime of the project, no major re-orientation of the initially states goals and objectives has taken place.

3. Scientific description of the project results and methodology[1]

3.1 General Overview

Given the complex nature of research facing the project subject, the different strands of empirical analysis have been integrated carefully on the basis of an accurate description of data and methodologies applied. Indeed, it turned out that by using quantitative and qualitative methods the project has become highly innovative in quite a few aspects. However, this research strategy also involved some risks concerning consistency, contingency and feasibility. Taking these considerations seriously into account, theoretical approaches and empirical analyses were carefully designed. Research has been focusing on macro-theoretical and macro-empirical analysis within a framework of modern political economy. Thus, to study economic impacts of political decisions as well as the challenges for the decision-making process the same framework was used to ensure consistency.

The framework is based on the assumption of rational decision-making and principle-agent-links. According to the issues at stake, political and economic decisions are linked via institutions which have been sorted out in an appropriate way. Markets and political institutions were at the centre of the mechanism by which different interests are balanced and decisions brought to equilibrium. This framework helped to model the macroeconomic and macro-political adjustment process in an empirically testable way. As far as the macro-aspects are concerned empirical tests were employed by using standardised data available from the European Commission, European Central Bank, furthermore ILO, OECD, IMF and World Bank. Traditional and more sophisticated statistical methods were used to analyse data on the basis of at least contingent models which are in part highly formalised.

As was said before, research intended to use empirical studies to illustrate some findings and results especially with regard to regions and nations. Quite some part of the project was devoted to the regional input for the macro(European)-model and to highlight national and regional specifics of markets, institutions, the political decision-making process, and social aspirations, conflicts and attitudes. This was also done in a comparative way. Methodology reflected the fact that national specifics count and have to be respected with regard to their impact on the enlargement process. The studies are based on regional and national specific data sets. They are available from country reports on the national or regional economy, the respective institutions, as well as from our country specific research.

[1] This chapter relies heavily on the Ezoneplus Summary and Final reports that have been published so far (Bolle 2002, Bolle 2003, Bolle 2004) and the Ezoneplus WP series (for a complete list see 5.3.2 below, pp. 110-124).

The project structure was set up according to the following chart that visualises information flows twofold: how different work packages are linked and how the time horizon for each work package and the overall project were scheduled.

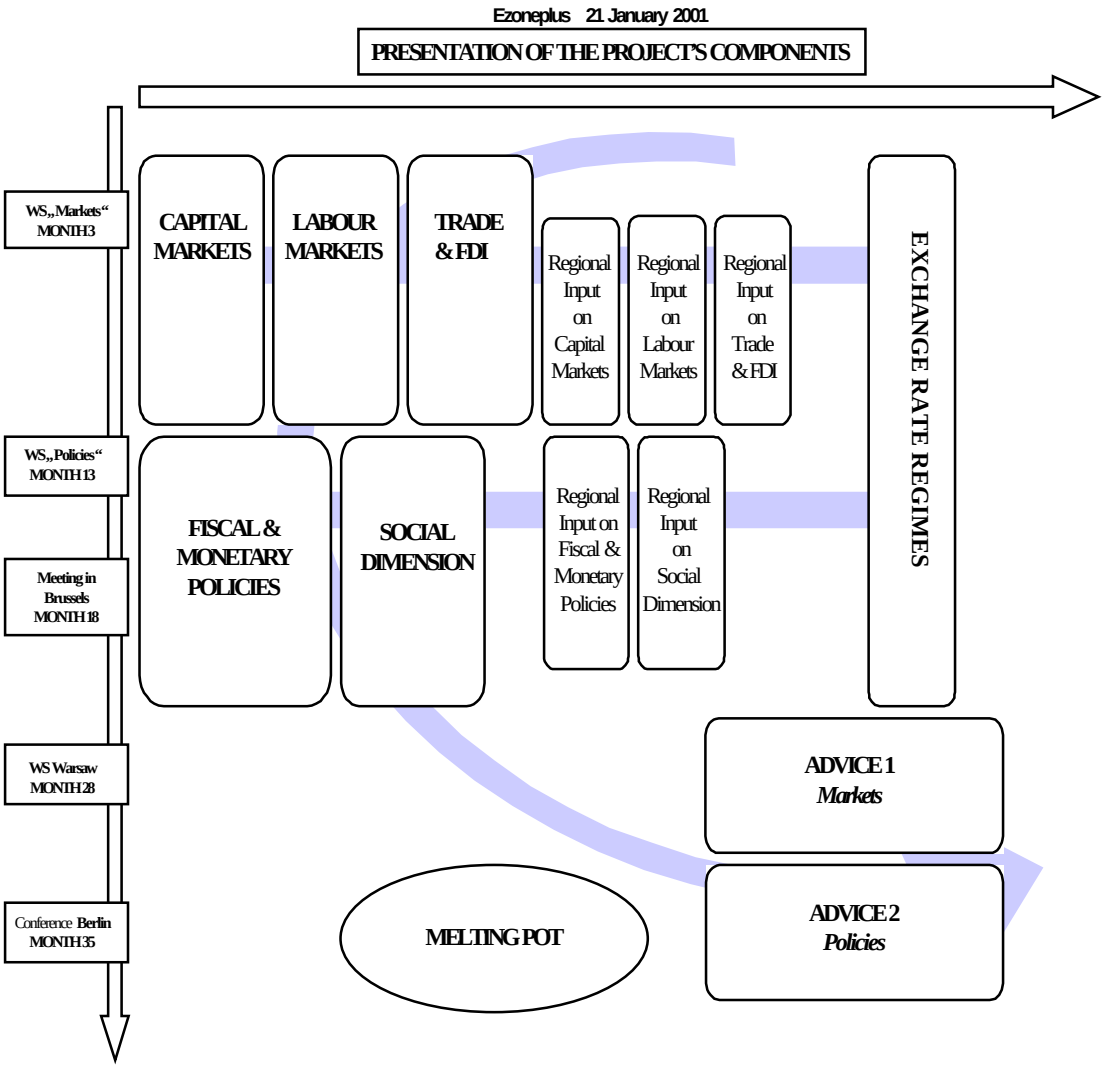

Chart: ***Overview of the project structure***

In accordance to this structural sequence of the project (1. markets, 2. policies, 3. policy advice) the major project results are as follows:

3.2 Project results 1: Coping with reshaped markets

Eight Central and Eastern European countries (CEEC) joined the European Union (EU) on May 1, 2004.[2] Shortly after—and perhaps only two years—after joining the EU, these countries will (and have to) surrender monetary sovereignty and adopt the euro as legal tender, thus, becoming full members of the eurozone, or European Monetary Union (EMU) - including voting rights with regard to the conducting of monetary policy by the European Central Bank (ECB). This step, or, to be more precise, series of steps, has already been taken by the current twelve members of EMU[3], and they are still struggling with the economic and political adjustment processes.

In fact, the third step of European monetary unification in 1999, which fixed the exchange rates between the EMU members irrevocably, has provoked much academic discussion on the pros and cons of a joint currency, usually starting from optimum currency area arguments. A trade-off is assumed between the advantages of economic integration on the one hand—i.e., enhanced and more efficient cross-border allocation of resources—and the loss of political flexibility in terms of monetary autonomy and exchange-rate variations on the other. If the benefits of integration are low, a high probability of asymmetric shocks increases the need for economic discretion. If other means of flexibility, e.g. rapid price adjustments, migration, or fiscal transfers, are lacking, the verdict is returned against a common currency.

Thus, considerations on whether, and how, to benefit from integration and the eastward enlargement of the eurozone turn out to be dependent on the scope of transition in terms of real convergence already achieved. In a dynamic view, EMU and the introduction of the euro can even be expected to deliberately constrain economic policy, though flexibility might be needed. Since the markets are not yet providing such flexibility, they might—or have to—change. Markets themselves adapt and reshape when confronted with changing constraints requiring sufficient institutional arrangements and functional legal infrastructure. Thus in turn, market rationale might coerce public authorities to accommodate this process of reshaping.

As a consequence, public authorities in CEE face a dilemma because they have to respond to cost-bearing market adjustment processes in a way that does not hurt their chances to stay in power. In a nutshell, the question is: How can the adjustment burden be shouldered? Who is going to pay? Conventional wisdom in the EU implies that this kind of question usually leads to extensive bargaining between all parties involved. However, what means do

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[2] They include the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, and the Slovak Republic.

[3] The current EMU members are Austria, Belgium, Finland, France, Germany, Greece, Italy, Luxemburg, the Netherlands, Portugal, and Spain.

CEEC have at their disposal to successfully induce, or force, the EU or the ECB to step in? Can the latter afford, politically and economically, to leave the main load of the adjustment burden to the CEEC alone and run the risk of jeopardizing the accession schedule? On the basis of comprehensive analyses of capital, labour, and goods markets, and existing exchange-rate regimes, this Summary Report will offer some conclusions on the bargaining processes that are to be expected.

3.2.1 Exchange rates and exchange-rate regimes

First, exchange-rate issues are addressed because they are the nexus of the overall economic activity: The exchange rate reflects the performance of all reshaping markets and affects them in turn as well.

Research has focussed on exchange-rate regimes as a means of disinflation, shock absorbing and improving international competitiveness, taking into account the advantages and disadvantages of different arrangements. Optimal exchange rates and exchange-rate regimes have been investigated as well as the CEEC' "timing" dimension, i.e. the question as to when to join ERM II[4] and, eventually, the eurozone. How best, it has to be asked, to smooth the transition process towards EMU, i.e. to prevent the worst-case scenario, an emerging markets currency crisis?

Considering the operation of exchange-rate regimes in CEEC it can be observed that despite the abundance of such regimes during the first half of the 1990s, a common attitude of those rather fixed regimes has been to focus on exchange-rate targeting. During recent years, in fact, some CEEC such as Poland have turned towards more flexibility. Nevertheless, they will have to switch again to fixed but adjustable pegs on account of ERM II. Apart from the original peg with a +/– 15% band, in principle, only tighter bands and hard pegs are permissible. Such regimes are, however, particularly vulnerable to speculative attacks.

With regard to exchange-rate policies, two different stances can be distinguished. First, a government can conduct exchange-rate policy as a subordinated feature of a comprehensive monetary policy in terms of a disinflation strategy, in order to qualify as soon as possible for the adoption of the euro. Second, exchange-rate policy might be conducted in terms of what could be called a "threaten-thy-neighbour"-policy: Provided ERM II member-

[4] ERM II is a revised version of the former exchange-rate mechanism, a system in which EU currencies rates are given a band of plus or minus 15% within which to fluctuate against one another. Membership of ERM is a precursor to joining EMU. Once the first wave countries are 'in', the ERM will be updated to ERM II, allowing for the fact that by then, the euro will be a book currency and the participating currencies will be irrevocably fixed against it. The main parameters of ERM II will be: (1) central rates for currencies will be related to the euro and will be determined on a basis of common agreement, including the European Central Bank; (2) central rates will be able to be adjusted to avoid tensions, with ECB involvement; (3) wide fluctuation bands will exist, but there will be an option for narrow bands if the currency(ies) are more closely converged.

ship is granted, couldn't it be beneficial for CEEC governments to loosen their grip on economic and fiscal policy in order to force others step in? Couldn't such a consideration even provoke a CEEC government to blackmail current members of EMU? In fact, governments could seek to transfer adjustment costs of EMU membership to current and other prospective members of the eurozone. Since CEEC and the EU have conflicting interests, the question of choosing a particular exchange-rate regime and conversion rate is of particular importance: In essence, the answer determines the distribution of costs and risks between the two sides; not to mention opportunity and exit costs in case of a failure in integrating CEEC into the EU.

The legal provisions of 'Copenhagen' and 'Maastricht' largely determine the constraints. Independent of the actual regime adopted, the run-up period will force CEE policy-makers to combine low inflation, financial stability, and continuing structural change in increasingly opening economies – and, thus, to maintain a tight fiscal policy stance. However, the political incentives generated by pegged rates often fail to provide sufficient fiscal restraints to help governments avoid possible currency crises. It goes without saying current members of EMU run such risks as well, but current analyses suggest that CEEC are tempted to exploit those risks to increase their political leverage in financial matters with current members of EMU.

Based on these considerations which indicate a variety of trade-offs as a result of different preferences and restrictions, both the CEEC and the EU have to take into account a still-to-be-determined set of transmission mechanisms affecting the markets in question.

3.2.2 Impacts on labour markets

One of the major links between foreign exchange and labour markets works through currency crisis. If, e.g., unemployment soars in transition economies with a fixed exchange rate, then speculative attacks are a likely consequence. But exchange-rate regimes also produce important qualitative and quantitative consequences for the labour market itself.

An inclusion of CEEC into the EU, and finally EMU, is likely to cause labour movements and may speed up economic convergence between the less and more advanced economies of the union. In a nutshell, a common currency makes the CEEC, and the EU for that matter, more transparent and may create enhanced flexibility and mobility in EMU labour markets (stronger incentives for labour movements).

Two effects have to be looked at, labour mobility and labour market flexibility. Labour market flexibility depends to a large extent on wage flexibility and institutional flexibility. The institutional flexibility characterizes to what extent state institutions and trade unions are involved in the regulation of labour markets. This kind of flexibility so far has

been, at best, mixed because in most CEEC the socialist legacy and the state-oriented mentality of many voters restrict the political decision-makers' room for manoeuvring and limit the success of appropriate, even necessary, initiatives. At this point one could add that CEEC membership in the EU can be considered as a stimulus for more flexible labour markets in EU members-states. Placing stronger emphasis on active labour market programmes—e.g. education and training, including development of lifelong learning, which is now an established priority throughout the EU—is only a long-term perspective and not likely to produce results over the next several years.

Wage flexibility denotes how responsive wages are to market fluctuations. In general terms, in almost all CEEC wages are quite flexible, although differences across countries and economic sectors exist. After all, the labour market policy is under-capitalised, unemployment remains high, and minimum wages and unemployment benefits are low. Western European labour markets, and, in particular, those of the countries neighbouring the CEEC, are still highly rigid in terms of institutional and wage flexibility. Since the consequence is unemployment, this has also delimitating effects for the cross-border movement of people.

With regard to labour mobility, or migration to the EU, it is expected that—once the current regime will be replaced with the right of free movement of labour—the long-run migration potential from the new to the "old" EU member countries will not be that significant: roughly 1 per cent of the EU population, less than 4mn people. Unlimited movement of labour will even cause quite serious pressure on the CEEC's labour markets due to possible movement of better-qualified and more flexible members of labour force (brain drain). Movers will be mainly people with good qualification who do not find appropriate jobs at home.

From these results of the labour markets analyses one can draw the conclusion that neither migration nor labour market flexibility are strong enough to reduce the inevitable adjustment burden of most of the new member countries once they join EMU. They have to look for other means, e.g. for fiscal and labour market policies, to fill the upcoming adjustment gap. But in this respect their flexibility will be limited as well, thanks to the Maastricht criteria and the Stability and Growth Pact. Therefore, it is to be expected that the search for a favourable exchange rate and an appropriate exchange-rate regime will dominate the new member countries' accession strategy.

3.2.3 Impacts on capital markets

The elimination, or enhancement, of exchange-rate risk is probably the key transmission mechanism regarding the eastward enlargement of capital markets. In fact, capital markets involve the most prominent part of the economic system that is strongly affected by monetary

integration. Capital markets comprise more than financial systems and foreign direct investments because they include all productive resources that are not labour, but are priced and traded in an organised way.

The institutional framework plays an important role, in particular with regard to ensuring property rights and enforcing the rules of the game. Financial development and economic growth are increasingly perceived to be complementary. Financial institutions provide a number of important services such as trading, hedging, allocation of capital, screening, and monitoring. Financial development may even enhance the domestic savings rate.

With the enlargement of EMU, costs of cross-border transactions diminish as currency risk, vis-à-vis the euro, vanishes, and other *de jure* and *de facto* barriers to international mobility of financial flows are eliminated. Capital markets have undergone massive changes in the past decade in Western Europe, but of course more fundamentally in the CEEC. To ensure the success of EMU an active and open market stance is required. The euro increases the cost of failure and, thus, provides a strong incentive for countries to comply. Repercussions to current members will be stronger; hence, they will not allow any substantial deviation from the consensus economic policy.

A common currency fosters capital market integration, i.e. liberalisation, deregulation, and consolidation of financial services throughout the currency area. More efficient financial markets improve the allocation of capital and thus contribute to long-term growth and prosperity. The main vehicle is more and better investments.

However, in the short run it will be important to avoid imbalances, which might destabilise the candidate states. Country risks might diminish and capital inflows to the CEEC, that are expected to contribute to economic convergence with the EU, might unexpectedly overshoot a sustainable level and be channelled into unprofitable investments. Eventually this money may be suddenly withdrawn, undershooting the long-term level and depriving the applicant states of financial resources and leading to crisis.

A prudent treatment of these flows requires a developed capital market, something the CEEC are only about to acquire. Hence, applicant states should use foreign capital flows especially to promote capital market development - e.g., facilitating entry of foreign banks. The adoption of the *acquis communautaire* and the Stability and Growth Pact provides a tested institutional framework and macroeconomic stability. At the same time, however, this framework delimits macroeconomic flexibility. Again, the exchange rates and the exchange-rate regime chosen before entering ERM II and EMU are of utmost importance for stabilising

capital flows and, ultimately, the successful mastering of the fragile and risky transition period towards full EMU membership.

3.2.4 Impacts on trade and foreign direct investment

Regarding trade and FDI it can be expected that EU enlargement entails positive effects on the welfare of all countries involved, due to the reallocation of resources and the restructuring of production and trade. Unrestricted movement of goods, services, and capital creates a division of labour and provides opportunities for the exploitation of comparative advantages as well as economies of scale. However, in spite of the expected trade creation effects within the enlarged EU (and, in fact, trade diversion outside), it must be acknowledged that during the transition period difficulties may arise in those regions, sectors, and firms that are confronted most directly with the new competitive challenges.

It is true that trade relations between the CEEC and the EU have been considerably reinforced over the last decade. In addition, the CEEC' sectoral composition of relative comparative advantages underwent profound changes, reflecting a gradual shift towards more advanced, even tech-intensive, exports where wages are relatively high. There exists, however, a strong heterogeneity at the country level, suggesting that geographic proximity to the EU and income convergence stimulate product differentiation and trade of R&D and capital intensive goods. The trade expansion of intermediate products and the emergence of vertical specialisation confirm a progressive and quick entrance of the CEEC into the international division of productive processes. The nature of CEEC-EU trade, however, still reflects a strong factor complementarity between the two groups or the absence of intra-industry trade.

Conventional wisdom and simple economic reasoning confirm the insight that an undervalued currency raises export-generated income contributing to the economic performance of a country. The German post-war *Wirtschaftswunder* may be an appropriate example of this. The German Economic and Monetary Union of 1990 provides an example of the opposite strategy. During the process of German unification and the adoption of the West-German Mark, the East German currency was suddenly appreciated by more than one hundred per cent. Again, exchange rates and exchange-rate regimes matter. To the CEEC they appear to be of extreme importance as far as export earnings, competitiveness, and economic growth are concerned.

International direct investment is mainly determined by host country characteristics such as dimension, potential demand, openness to world trade, and lower relative labour compensation levels. Thus, FDI flows play an important role in the process of transformation of trade structures in CEEC. The most important ones include:

- First, a high volume of FDI contributes to the transformation of these countries' specialisation patterns, leading to the gradual consolidation of export structures based upon products that are intensive in technology and in qualified labour.
- Second, in almost all CEEC changes in trade composition were consolidated by an increased share of intra-industry trade in total trade.
- Third, it helps to introduce organisational changes on the micro level.
- Fourth, it brings in advanced technologies and know-how.

All in all, such consequences contribute to CEEC' international competitiveness. In fact, it has turned out that those CEEC that adopted more radical liberalising reforms and applied more extensive privatisation and macroeconomic stabilisation programmes have attracted higher amounts of FDI and have progressed more in economic terms. Improving export performance and growing attractiveness to direct investment from abroad have played a mutually reinforcing role.

3.3 Project results 2: Implications for monetary, fiscal and social policies

With the advent of the euro in the new EU-members, sovereignty over monetary policy will be passed to the supra-national European Central Bank. This will be a distinct step beyond EU-accession, and will interfere more directly and closely with the domestic economies, and hence, with domestic politics. Fiscal policy will remain the only tool at hand that allows some flexibility in domestic economic policy. Still, even this instrument will be constrained by the Maastricht criteria and the Stability and Growth Pact.

If one follows the classical division by Richard Musgrave, fiscal policy contributes to basically three objectives - stabilisation, distribution, and allocation. We can consider the issues of EMU within these categories. Stabilisation is the most apparent topic. With the loss of monetary and exchange-rate autonomy, fiscal policy faces the challenge to dampen swings in the business cycle. An enlarged eurozone will not be an optimum-currency-area from the beginning; hence divergent developments will be the norm rather than the exception. The ECB can only react to average variation of the whole eurozone, which may not suffice for individual countries. Thus, the policy mix will shift towards fiscal stimuli.

In compliance with the *acquis communautaire*, national central banks had to be set up independently from government intervention. However, some national banks were assigned to support general economic policies besides maintaining price stability, and staff changed frequently back and forth between government and banks. This support will cease with the advent of the ECB which has been awarded an unprecedented degree of independence, and where personal linkages - albeit persistent - are diluted in the complexity of the organisation.

Economic stimuli that go beyond necessary stabilisation - akin to political business cycles - will rely on fiscal policy, too. Buying good-will on short notice will increase the budget deficit rather than inflation. And governments may need to generate substantial good-will if a wary electorate is to be convinced to participate in EMU.

The *acquis* intervenes in many parts of the local economy, sometimes in absurd detail. The general notion is a more liberal economy plus a cumbersome bureaucracy to manage regulations, transfers, compensations, structural help, and so forth. On balance, this approach may increase economic growth, because of a more efficient allocation of resources. It will also lead to substantial restructuring of the applicants' economies, which is certain to create winners and losers. The adjustment of the CEEC agricultural sectors is just the most vivid example. The winners are fine, but potential losers may organise themselves against EU/EMU. Even if they represent a small minority, they might be able to exert considerable influence provided their groups are well organised and highly capable and eager to enter conflict. For political reasons, governments might not be able to stand a conflict with these groups and rather prefer to buy them off (distribution). Increasing subsidies, state transfers, public employment etc are the consequence. The budget will be burdened further because it seems unlikely that revenues would rise at the same pace, for instance because the internal market will increase tax-competition.

The price for excessive debts is paid with a suboptimal allocation of resources. There is well-established, negative link between government spending and growth, in particular when most of the expenditures are for state consumptions and transfers rather than public investment. Unfortunately, that is case with most CEEC. With high growth, most conflicts are easily solved: sacked people find new jobs quickly; business finds new opportunities; tax revenues rise and total indebtedness is more likely sustainable; and foreign capital flows into the country. Without growth, problems get worse. The dilemma lies in the fact that the growth effect of fiscal policy is long term, while its stabilisation and distribution impact is short term. Hence, the CEEC may be caught in a pretty nasty feedback-loop.

Short-term deficits may be considered necessary to stabilise the economy and to calm down inconvenient conflicts. The price may be sluggish growth with rising unemployment and more unhappy people to call for additional spending. Although this would not be stabilising policy any longer, because the roots are structural problems, the mechanisms are the same. If the governments give in, the loop starts again.

Now, this problem is not unique to the CEEC. Indeed, most countries face this trade-off. The applicant states, however, have additional constraints. During ERMII, excessive debt

may blast the country out of the currency regime, because excessive debt may destroy the credibility of the commitment to ERMII and trigger a speculative attack against the local money, as seen in Argentina. Within EMU, the loss of monetary sovereignty may render fiscal debts particularly biting, because no compensation mechanism, such as lower interest rates, is at hand.

Make no mistake. This is the well-intended logic of the European Union behind EMU. The only way out of the feedback loop is structural reform. And that is what current and future members are required to do. Failure to enact these reforms will become more expensive while success will become more rewarding.

The Stability and Growth Pact exhibits the same logic. The long-term goal shall be a balanced budget that allows for temporary deficits in bad times of up to 3 percent of GDP. Countries that do not consolidate their budget in good times have no flexibility left in down-turns, hence, have to pay a hefty price for their failure. Apparently, this mechanism has not worked too well in recent times: Neither Germany, France, nor Italy were able to reduce deficits in the affluent times of 1999 to 2001, and are now on—or beyond-- the verge of violating the Stability Pact, which is about to be scrapped as a reaction.

The CEEC may only scrap the idea of joining EMU, because that is what constitutes the real constraint. In particular Hungary and the Czech Republic are considering suspending the adoption of the euro unless the budgets are under control.

3.3.1 Monetary and fiscal policies

Monetary and fiscal policies in the EU countries have been reshaped dramatically in the past few years in response to the switchover to EMU and the introduction of the euro. Transition to a single monetary policy called for a redefinition of national fiscal policies and of the optimal policy mix between monetary and fiscal policy. On the other hand, accession countries are preparing to join the EU in May 2004 and the euro area a few years later. This brings new challenges to their current and prospective monetary and fiscal policies. The future eastward enlargement of the eurozone poses opportunities and risks for both groups of countries and requires adjustments in their monetary and fiscal policies in order to enable a soft landing of accession countries in the euro area.

In the area of monetary policy it turned out that reshaping monetary policies due to challenges of the EMU-enlargement could not be approached in a uniform fashion for both group of countries, EU members and applicants. The common denominator simply could not be found, as both groups are facing different issues, problems and challenges.

The single European monetary policy now functions, although not without problems. In the process the participating countries first had to prepare for the adoption of the euro and fulfil the Maastricht convergence criteria and then had to learn to live in a monetary union by adjusting to possible symmetric and asymmetric shocks without the instruments of national monetary and exchange-rate policy. There is an ongoing discussion on various issues of the single monetary policy of the ECB, not only in the academic literature. It concerns issues such as the objectives of the monetary policy (price stability as the primary, the only or just one of the goals of the monetary policy), rules versus discretion (e.g. Taylor rule to determine the basic interest rate), monetary strategy (two pillars or inflation targeting), inflation target (0-2% or close to 2%), problems of low nominal and possibly negative real interest rates, the role of asset prices and their bubbles in the conduct of monetary policy, transparency and accountability of the ECB, etc.

From the point of view of euroland the main challenge related to the eastward enlargement of the eurozone is the absorption of new and somewhat different member countries in the eurozone, without endangering the functioning or quality of single monetary policy. Here, two questions are involved: first, are the accession countries really that different in terms of monetary policy? And second, if so, can their inclusion into the euro area really represent a threat to the quality of the single European monetary policy, to the credibility of the ECB and to the stability of the common currency?

Inclusion of accession countries into the eurozone will by definition mean additional problems for the single monetary policy, because the eurozone will become both bigger and more heterogeneous. The accession countries are in the process of transition and in the course of their preparations for the accession to the EU have not yet finished all structural reforms, which would make their economies more similar to those of the current EU member countries. They are definitely lagging in real convergence (e.g. GDP per capita) compared to the EU average and are at the moment not fulfilling nominal convergence criteria (Maastricht monetary and fiscal criteria). However, it should be mentioned that they are not further away from fulfilling the nominal benchmarks than were some EU countries at a comparable time before their participation. Also, for CEEC, stepping into the EU and the ERMII will be a source of potentially significant asymmetric shocks.

It might be that the real threat to the smooth functioning of the single monetary policy could stem not so much from their needs or wishes for an easier monetary policy in the euro area, but from the weaknesses in their financial sectors and payments systems. In other

words, the risks from admitting the accession countries to the eurozone could be more in the implementation than in the stance of the single monetary policy.

The decision-making process in the ECB will have to be adjusted to absorb the accession countries as new members of the eurozone. This will technically complicate decision-making in the governing board of the ECB. Reaching consensus or even letting every member of the board express his position may become extremely difficult. The one country, one vote principle would have to be adjusted to preserve the existing balance of power between large and small countries and to prevent some possible "instability coalitions" between groups of countries. Though having recognised the need for such readjustments, no final agreement on technical solutions has been reached to date.

European monetary policy is determined with regard to the EU as a whole, in other words, with regard to the EU (or EMU, to be more precise) average. From an individual countries' point of view this is by definition not optimal. Economic and financial structures, demand for money, transmission mechanisms of monetary policy and phases of economic cycles differ among individual member countries. The main refinancing interest rate of the ECB is too high for countries in a recession and too low for countries going through an expansionary phase of the cycle. There is no such thing as a "European cycle" which would make the formulation of the single monetary policy much easier. Anyway, this is a situation similar to that between different regions within a country. The inclusion of the accession countries in the eurozone will increase the scope of this problem, particularly if their economic cycles are less synchronised with the EU average.

The risks of EMU enlargement for the single monetary policy therefore derive not only from non-synchronised economic cycles in the accession countries, but also more generally from their exposure to asymmetric shocks (or even from differing responses to symmetric shocks as a result of differing transmission mechanisms) and from their ability to activate alternative mechanisms of adjustment which can absorb these shocks in the framework of the EMU. There are some safeguard mechanisms prepared for the accession countries in their run-up to the eurozone: coordination and surveillance of their economic policies after their EU accession, participation in the ERMII in the interim period before the adoption of the euro, compliance with the nominal convergence criteria and with real convergence requirements. These safeguard mechanisms should provide a soft landing of the accession countries in the EMU. The problems for the single monetary policy from the eastward enlargement of the eurozone would in this case be more of a quantitative (up to 25 countries, greater heterogeneity by definition) than qualitative nature (inclusion of "problematic" member countries).

The final outcome depends on successful preparations, and, last but not least, on the optimal timing of admitting new members to EMU.

As far as the new member countries are concerned, they have for the moment full monetary sovereignty, at least formally, and can implement independent monetary policies. Factually, independence of their monetary policies is constrained by the progress in the liberalisation of their capital flows and is dependent on their choice of the exchange-rate regimes. In the process of adopting the *acquis communautaire*, they committed themselves to liberalise capital flows completely by the time of their EU accession (exemptions and transitional periods required and granted were insignificant), but have already by now eliminated practically all capital controls.

As ERMII is an intermediate soft peg exchange-rate regime whose rules, procedures and interpretations are for the moment not defined precisely enough, accession countries perceive it as a potentially dangerous mechanism that might lead to speculative attacks and currency crisis. Their strategies seem to be to stay within ERMII for as short a period as possible, only for the required two-year minimum period. In line with their ambitions for an early Euro membership they also seem to favour an early entry in ERMII.

In 2004 monetary policies of the new member countries focus on the preparations to meet the Maastricht criteria, as time is running out fast. Over the preceding years, the process of disinflation has been rather successful in most of the accession countries. In those where the inflation rates are still rather high, lowering the inflation rate is the top priority. The question remains whether the results in disinflation are sustainable, as most of the accession countries register some serious underlying macroeconomic imbalances (fiscal disequilibria, balance of payments disequilibria) of substantial proportions. Monetary policy alone may not be enough; coordination of macroeconomic policies is required for the fulfilment of the Maastricht criteria on a healthy and sustainable basis, which can then lead to a soft landing in ERM II and to an early entrance into the eurozone. New member countries' monetary policies will in the interim period have to deal with the challenges of capital flows, Balassa-Samuelson effects (BS) of real exchange-rate appreciation and the task to achieve nominal and real convergence simultaneously. Their readiness for the inclusion in the eurozone can be approached in terms of their nominal convergence, real convergence and optimum currency area criteria.

The link between the eastward enlargement of the eurozone and fiscal policy is less clear and direct than in the case of monetary policy. In the EU countries reshaping of fiscal policies resulted mainly from redefining the role of national fiscal policies after the centralisation of monetary policy and transition to the single monetary policy, and, presently, is deter-

mined by the obligation to keep the fiscal policies within the limits of the Stability and Growth Pact (SGP). Inclusion of the accession countries in the EU will mean additional fiscal costs to which the EU budget and accordingly national fiscal policies of the EU countries will have to adjust. However, inclusion of the accession countries in the eurozone per se will not represent an additional fiscal burden for the EU member countries, at least not directly. However, there are risks of indirect fiscal costs and redistributions which may occur through various possible mechanisms and channels, in case, once in the eurozone, accession countries meet serious problems that the EU countries would be willing to finance or in the final instance would have to finance.

In the EU countries (in fact throughout this text we have in mind EMU countries in particular) fiscal policy had to be redefined as a response to the transition to EMU. The first issue is should there also be, in parallel to the single monetary policy, a "single fiscal policy", centralisation of national fiscal policies at the EU level. From the point of view of finding an optimal policy mix for the EU economy this at first sight might seem a sound idea. However, while there are some economic arguments to support an EU-wide fiscal policy, this remains an academic idea. Political realities in the EU are such that countries want to retain their fiscal responsibilities. The EU budget is, compared to that of similar federal states, very limited in size and inflexible, since most of the expenditures are devoted to agriculture and structural policies, so that the EU budget cannot support the roles of the EU-wide fiscal policy.

Instead of centralisation of fiscal policies in the EU, the concept of co-ordination or harmonisation of national fiscal policies was adopted. The responsibility for the fiscal policy remains at the national level. From the point of view of EU member countries, giving up their national monetary policies should in principle result in more flexibility of their national fiscal policies, merely to compensate for the loss of an instrument of macroeconomic management (adjustment mechanism). However, there are important externalities, spillovers from national fiscal policies, related to their unsustainable fiscal position (excessive fiscal deficits leading to unsustainable debt dynamics), which can harm other member countries and in the final instance also the quality of the single monetary policy. Therefore, national fiscal policies have to be co-ordinated or harmonised, in other words constrained by the common EU rules. This was the approach adopted for the EMU. National fiscal policies remain independent, but severely restrained by the EU-determined rules.

These fiscal rules are first and in the most general manner determined in the Treaty (TEU) in the form of excessive deficit rules and procedures. More concretely, they are defined as the fiscal part of the Maastricht convergence criteria (budgetary deficit, public

debt) as a precondition to qualify for EMU membership. And finally, later on, provisions of Stability and Growth Pact (SGP) were defined so as to protect the sustainability of public finance also after inclusion in EMU. SGP defines general fiscal rules of TEU more concretely, in terms of procedures, including sanctions for non-compliance. EMU countries after joining the eurozone have to comply with SGP rules. In their stability reports they have to present their current fiscal situation and explain how they plan to sustain their fiscal position in terms of compliance with SGP rules in the medium term.

SGP basically limits the public finance deficit (for practical reasons we use the term budgetary deficit here as a shortcut approximation) to a maximum of 3% of GDP annually, except in the case of a precisely defined severe downturn in economic activity. However, in the medium term the budget should be balanced or even in surplus. Other elements of SGP are rules and procedures, such as those pertaining to detection of the problem, the early warning system, the timing of the elimination of the problem and sanctions if the problem is not eliminated in time.

The idea is that in normal times budgetary deficits should be close to zero, so that in bad times countries can afford more expansionary fiscal policy and increase their budgetary deficits up to 3% of GDP (but not above this benchmark, except in severe recessions). Ideally, in the medium term the budgets should be balanced, while within economic cycles they should move according to the phases of the cycles from surpluses to deficits, but within the 3% budgetary deficit limit of SGP. Obviously, the idea is that fiscal policy within the cycle should primarily reflect the working of built-in or automatic stabilisers of the fiscal policy (increase of public spending such as unemployment benefits and/or decrease of collected taxes in times of recession, and vice versa in times of booming economic activity). The functioning of such automatic fiscal stabilisers within the cycles itself contributes to stabilising the economy. More discretionary or activist fiscal policies are subject to much scepticism anyway, as there are problems with timing and tine tuning of such fiscal measures, since various lags are operating here.

There was considerable fiscal consolidation in the run-up to the EMU in the EU countries in the nineties. Among different strategies of fiscal consolidation the more successful and sustainable proved to be those that relied on cutting public expenditures. However, some of the EMU countries remained close to their limits of budgetary deficits of 3% of GDP. In the good times, a couple of years after the introduction of the euro, these countries did not proceed with fiscal consolidation which would have brought their fiscal deficits close to zero or even into surplus. In other words, they avoided needed structural

reforms, which could have improved their fiscal position and perspectives. In the present bad times their fiscal position naturally worsened and started to breach the rules of SGP, triggering reactions from the EU Commission.

In 2004, EMU countries are obviously stuck with an SGP problem. Who is to be blamed and what is the way out? Is SGP just a "stupid" rule, as any rule, which is too rigid and does not adjust to the realities of the (changed) situation? Of course it is perverse to expect countries to restrain their fiscal policies in times of recession, when they would require just the opposite, fiscal stimulus, to help their economies get out of the recession. If sanctions such as fines were to be imposed, countries would be, from the point of view of fiscal policy, additionally hurt in the wrong direction, even worsening the situation in their economies. There are serious calls from different countries to change SGP, or least to interpret it more flexibly, like "temporary softening", to take more account of the economic situation (and of political realities?). Ideas range from exempting some types of public expenditures, such as investment in infrastructure, widening the 3% limit somewhat, or adjusting it to take explicit account of the economic cycle, to concentrating on public debt instead of budgetary deficits, to focusing more on the medium-term target of fiscal sustainability rather than on strict yearly limits of budgetary deficits, etc. The common denominator of alternative solutions is that automatic fiscal stabilisers should be allowed to work themselves out during economic cycles so that fiscal policy could be counter-cyclical and not pro-cyclical as it would be in some cases if SGP rules were strictly applied.

On the other hand, there are reasons for sticking to SGP rules. First, not all EMU countries violate SGP rules or are close to breaching them. Adjustments of SGP rules would implicitly punish their prudent fiscal policies. Lessons from this for the future could be devastating, not only for the credibility of the rules and institutions in the EU, but also in terms of moral hazard. Second, the rules were known in advance, but some countries did not take appropriate steps in the good times when they still could. Problems of their budgetary position are more of a structural than of a cyclical nature. So they should concentrate on structural reforms, painful as they may be. Unfavourable demographic trends, such as ageing of population and impending problems of migration do not ease the fiscal problems, but rather call for undertaking the needed structural reforms without delay in order to support sustainability of their public finance in the medium term.

From the point of view of the accession countries their national fiscal policies are being reshaped as they prepare for the EU membership and will adjust further when they approach and later join the eurozone. For the moment, the new member countries can lead inde-

pendent fiscal policies, at least formally speaking. They are, however, subject to various mechanisms of surveillance and assessment of their fiscal policies (such as pre-accession programmes, fiscal notifications, etc.). With their EU accession the formal situation concerning their fiscal policies will change radically. As EU member countries with the derogation from adopting the euro they will become subject to EU fiscal rules. They will become subject to excessive deficit procedures as defined in the Treaty (TEU). Furthermore, if they have an ambition for an early inclusion in the eurozone, they would have to comply with the Maastricht convergence criteria, including the fiscal part, relatively soon (almost immediately) after the EU accession. And finally, they would be subject to some, but not all, of the requirements of the SGP. After joining the eurozone, they would ultimately have to comply fully with the SGP rules and procedures, including sanctions. From the time of their EU accession they will have to prepare convergence programmes about their fiscal situation and forthcoming challenges, particularly about their plans regarding how and when they would fulfil the fiscal part of the Maastricht convergence criteria.

Even before their EU accession and ERMII membership, their fiscal policies have been conducted in preparation for meeting the Maastricht fiscal criteria, as fiscal consolidation usually takes some time. Most probably, they will not be given exemptions and favourable interpretation, as was the case for some current EU countries before their eurozone membership. As the EU side is not exactly rushing them into the eurozone, it is in their own interest to take care of the timely compliance with the Maastricht fiscal criteria if they want to be prepared for an early eurozone membership. Therefore, the issues of fiscal discipline, fiscal consolidation and fiscal sustainability become equally relevant and pressing for them as they are for the EMU member countries. At this moment, fiscal position in the accession countries is somewhat diversified. In terms of fiscal deficits, some countries are in a better position and practically meet the Maastricht fiscal convergence criteria. Others (particularly some Central European accession countries, like Hungary and the Czech Republic) have considerable problems and substantially exceed the 3% limit of the fiscal deficit. The situation has worsened in the last period. Furthermore, as the structure of their budgets is unfavourable in terms of the inflexibility of much of the public expenditures, there is not much hope for an early and smooth consolidation of fiscal policies. The sustainability of their fiscal position may be the main reason for somewhat less enthusiastic recent statements in some of these countries concerning the dynamics of their ERMII and eurozone membership. As far as their public debt is concerned, the situation is not critical. Their public debt is below the Maastricht benchmark of 60% with a sufficient safety margin. The level of public debt in accession countries is deter-

mined by its low initial level at the beginning of transition, which reflects a specific concept of "public finance" before the transition and does not reflect accumulated past deficits as in the market economies.

Fiscal policies in the accession countries are burdened with multiple tasks. Apart from their traditional roles of allocation, stabilisation and redistribution in the economy, in the accession countries they have to support economic growth and real convergence, provide investment for the catching-up in infrastructure, support macroeconomic stability (dealing with volatile capital flows), finance adoption of the *acquis communautaire* and other institutional adjustments in the process of EU approximation and accession, etc. Just as in the EU countries, in the accession countries current recession and some demographic trends (like population ageing) are causing tensions in the public finance and require structural reforms, including reforms in the pensions and health systems.

After their EU accession, the net transfers from the EU budget will also determine the fiscal position in the accession countries. All accession countries will be net receivers from the EU budget, at least in this period until the new financial framework is determined for the period from 2006 on. The actual level of net financial inflows from the EU will depend on the absorption capacity of the recipients (availability of programmes, co-financing). There are some other problems with net transfers from the EU (dynamics, as outflows come first and are unconditional, while inflows follow later and are conditional, and redistribution within national budgets, as outflows are from the overall budget, while inflows are earmarked for certain sectors/ministries), but these are beyond the scope of this report.

3.3.2 Exchange-rate regimes

Despite sharing a number of common economic features and the common target of becoming a member of the European Monetary Union (EMU), the new member countries in CEE exhibit remarkable diversities in the exchange-rate regimes, ranging from a currency board agreement to a free float.

This diversity bears some relationship to the structural features of each country, but the choice of a specific regime also reflects historical factors, different reactions to economic shocks along with the preferred approach to disinflation: the appropriate exchange-rate regime to attain the objectives of the monetary policy is not obvious, because it is a key determinant of a country's macroeconomic stability, which, in turn, is an important determinant of investment and economic perspectives in the country. This is even more the case for the CEEC, which underwent an impressive revolution in the macro- and microeconomic organisation of production and of distribution, in the structure of the interaction with international partners

and even in the nature of the relations between economic agents. Moreover, exchange-rate regimes, like other important aspects of economic policy of a country, are not chosen once and for all: The general framework of CEEC has long been unstable and subject to a transition, so that policies that were adequate in the early stages may well not be suitable in the later ones.

Accordingly, a multitude of exchange-rates regimes has often been experienced even within a single country, as has been the case with Poland, Hungary and the Czech Republic, which went from a fixed peg to a relatively free float, or with Bulgaria, which took the opposite course and moved from the free float to the currency board. Countries hence changed their regimes frequently, either voluntarily or involuntarily: a particular exchange-rate regime may suit the country's needs at the time, but eventually be abandoned even though inflation has been brought down, because a substantial loss of competitiveness occurred. This is the typical sequence followed by the so-called "exchange-rate-based stabilizations", and only rarely do they lead to permanents pegs.

Exchange-rate management proved very important for the macroeconomic stabilisation required during the transition to the market economy for the CEEC, and it will be no less relevant in the final integration in the EMU. The perspective EMU membership prompted a very wide discussion in the theoretical and in the applied literature: To what extent should the Maastricht criteria be relied upon? When should the EMU membership be granted to the selected CEEC? Which is the best exchange-rate regime meanwhile? What is the correct parity towards the euro for the currencies of the accession countries?

3.3.2.1 Macroeconomic and exchange-rate dynamics

The transition to the market economy of the former socialist countries required the introduction of a radically different institutional and legal framework, along with the simultaneous transformation of the production and allocation structures. It involved the establishment of a proper framework of contractual obligations, the liberalisation of prices and production, the hardening of the budget constraint for the public finance and the creation of a relevant financial market with a two-tier banking system.

Today, the successful macroeconomic stabilisation is usually attributed to the integration in the European economy and to the careful management of the exchange rate. Price liberalisation as one element of macroeconomic stabilisation had the effect of bringing an adjustment of relative prices: The removal of the public subsidies to certain activities was of course one preliminary condition for the strategy, in order to force the local producers to face a hard budget constraint and prevent them from shielding some economic sectors from the conditions of demand and supply. Due to a natural rigidity of prices with respect to

negative corrections and to a certain tendency of the public finance to use seignorage, the realignment of the prices took the form of a sudden increase and a steep inflation followed. Monetary overhang, inherited from the past, fostered this phenomenon in some cases.

The second element of the stabilisation policy was the integration in the international markets: opening to international trade, the countries in transition had a chance to import a price structure similar to that of their commercial partners. Moreover, the price structure in the international market was already given and it was easily observable; it was, above all, stable (the CEEC being only small countries), and this possibly speeded up the transition because in the beginning the economic agents had to became familiar with the system too, and this made the local demands and supplies rather unstable.

Committing to a fixed exchange rate was the last element, because the internal inflation could not rise too much without losing competitiveness with respect to the foreign producers. It is reasonable, then, that the local enterprises react to this pressure partly by reducing inflation, and partly by reducing the output, for example because the productive units are pushed out of the market.

Pegging the exchange rate is more than simply smoothing the volatility and it requires a certain evaluation of the trade-off involved, as it may jeopardize stability, amplifying the adverse effect of some internal or external shocks. The additional advantage, often emphasised in the academic literature and indeed proposed to justify a formal peg in the beginning of the transition, is the opportunity to gain credibility for low-inflation policies: these countries “imported” central bank credibility by adopting a fixed exchange rate with a more stable currency.

After they had committed to the exchange rate, inflation stabilisation followed in the leading CEEC quite quickly: by 1992 the growth rate of prices was already below 30% in the Czech Republic, in Slovakia and in Hungary, while Slovenia passed that threshold in the course of the following year, Poland and Latvia by the end of 1994, Slovenia in 1995 and Lithuania only during 1996. When we consider the pervasive nature of the transition, such a dramatic stage of falling output and high price instability seems to have been inevitable, and it is almost a surprise the speed with which these countries recovered from the recession, regained a certain control over inflation and implemented a preliminary conversion to a market economy. Even for transition countries that started transition with more moderate inflation rates, the exchange rate coupled with the participation in international trade represented the appropriate nominal anchor provided that fiscal policy was sustainable.

The overall success of the macroeconomic stabilisation is impressive but concentrating on it too much is misleading, with the twofold effect to both underestimate and overestimate the extent of the transition. The effort undertaken by these countries was much more than simply regaining control of prices during a phase of hyperinflation in a market economy: indeed, a market economy was simply missing at the beginning, and the most important achievement is that the bases for it were introduced at the same time as the macroeconomic stabilisation was carried out. In fact, for a long while macroeconomic dynamics were dictated more by the pace of the economic reforms than by the sources typically outlined by the standard textbook theory for a market economy, and the conventional interpretation in terms of supply and demand shocks did not apply.

Of course a fixed nominal exchange rate in the presence of double- or even triple-digit inflation induced a strong real appreciation of the currency, and in fact the real exchange rates have risen since the beginning of the transition. Yet it seems unfair to attribute the real appreciation to the exchange-rate commitment only: the crawling band in Hungary and in Poland was run with the purpose of realising a certain real appreciation. Furthermore, Slovenia, which kept the currency formally free to float but managed the exchange rate in practice, experienced a substantial appreciation too: +14% over the period 1992-1995. Moreover, a strong devaluation of the currency prior to the exchange-rate commitment was often undertaken, in the attempt to keep the pressure from the international competitors on the local producers low in the first years. Real appreciation then was part of the stabilisation policy and may have contributed to the transition too: it maintained the competitive pressure on the sector open to international competition high, possibly increasing price-setting discipline and inciting firms to raise productivity from the abysmal initial level.

From 1995 onwards, the further reforms implemented were also aimed at the specific goal of joining the EU, that is, one of the most developed and sophisticated market economies in the world. The second stage, often termed as “convergence”, involved other interventions in the legal framework to foster even more competition and to implement the *acquis communautaire*: this is the institutional framework on which the single market is based, and includes the Treaties, the legislation and the actions defined in order to apply the principles expressed therein.

Meanwhile, the CEEC also needed further progress in terms of real economic integration in the EU regarding international trade, synchronization of macroeconomic fluctuations and convergence of real and nominal economic indicators: it is enough to maintain the focus on inflation here, given its close relation to the exchange rate. In this

respect, in 1995 the EMU level was approximately 2,5% while the level in selected CEEC ranged between 7,2% and 35,7%.

Implementation of the *acquis* also involved the liberalisation of capital controls, although the pace of liberalisation was different in CEEC. While in fact some countries liberalised all types of flows at the beginning of transition, most of them only removed controls on long-term capital movements, initially relying on direct controls to regulate short-term capital flows. Nonetheless, the path of full liberalisation was set by the *acquis*, and it seems that while the transition and stabilisation period was mainly characterized by fixed exchange rates, during the convergence phase most of the countries, with the noticeable exception of the Baltics, weakened the commitment, widening the bands around the parity or withdrawing it completely.

The Czech Republic underwent a speculative attack and abandoned the commitment in 1997: the ±7,5% oscillation band did not prove sufficient to contain the pressure, and the Czech authority switched to a flexible exchange rate. Analysing this devaluation, Horvath and Jonas (1998) reached the important conclusion that the crisis was not prompted by inadequate fiscal policy but by the sustained current account deficit run during the previous years: the devaluation took place when the economy slowed down and the expectations worsened (also because of the contagion effect of the Asian crisis), and despite high interest rates on the Czech koruna (the repo rate reached 75%) and large interventions on the foreign exchange market. In any case, the speculative attack only speeded up a regime change that was, in that macroeconomic situation and given the wide structural current account imbalance, unavoidable: according to the estimates quoted by Horvath and Jonas the Czech koruna was overvalued by 2% to 13% at the time.

Slovakia devaluated one year later (the oscillation band then being at ± 7%), due to the pressures generated on the international foreign exchange market by the Russian crisis, and to the structural macroeconomic imbalance due to excessive government spending, , but also due to the excessive real appreciation over time. Despite formally floating the currencies, both the Czech and the Slovak monetary authorities keep a careful watch on the foreign exchange market, to smooth and absorb excessive capital flows and reduce volatility.

Hungary and Poland proceeded with the crawling band allowing up to a ±15% margin. The introduction of the crawling bands in 1995 (to 7% at the beginning) was due to the fact that the interventions to keep the exchange rate stable became excessive in frequency and volume because Poland was running a current account and a capital account surplus. Certain anecdotal evidence of exchange-rate pressure is often reported for Poland, albeit the different

exchange-rate regime, with the frequent devaluations allowed by the crawling band, may have reduced the incentive to target the zloty for speculative attacks. The National Central Bank of Poland, however, did not wait for an exchange-rate crisis and moved to free float in 2000, applying a policy orientation already proposed two years before by the Monetary Policy Council. The National Central Bank of Poland justified the change in the policy orientation as a test to see what exchange rate would be set by the market when totally free of interference from the monetary authority. Opposite to the case of the tolar and of the Slovak and of the Czech koruna, the zloty is floating freely and the National Bank of Poland does not intervene on the foreign exchange market. In a country which did not experience a truly free float before, this may have seemed a bold move, but indeed the market rewarded it by keeping the path of the currency on the same line followed during the previous phase. In fact, the real appreciation of the zloty did not increase when the full float was officially introduced.

Hungary, on the other hand, still keeps the exchange-rate commitment, and, in June 2003, implemented a small devaluation in order to reduce the competitive pressure. At the same time, the Hungarian government announced a programme of fiscal adjustment, providing another indirect piece of evidence that a precondition for fixed exchange-rate policy is a sound fiscal policy. Consisting only in a 2,26 % devaluation, this is by no means a major crisis, but it signals again that it can be difficult to keep an exchange-rate commitment when the fiscal policy is not tight, because the fiscal deficit may generate a current account deficit and consequently a credibility problem.

Finally, the Baltic States maintained a stable exchange rate for most of the time. Estonia opened the way, committing with a currency board the koruna to the DEM in 1992 (at the rate of 8 EEK for 1 DEM), updating it with the euro in 1999 (15,6466 EEK for each euro); Latvia and Lithuania followed in 1994 when the lat was pegged to the SDR (0,7997 LVL for 1 SDR), and the currency board of the litas towards the US dollar was introduced at 4 litas per US dollar. In February 2002 the Lithuanian CBA switched to the euro, with the exchange rate of 3,4258 litas for 1 euro. The exchange-rate regimes exhibited a remarkable stability despite the exposure to speculative attacks.

In this context, the volatility of exchange rates is also of interest. In particular, the volatility of the Czech and of the Slovak koruna, with respect to the dollar, soared when the exchange-rate commitments were abandoned, while with respect to the D-mark this effect is much less observable. The standard deviation of the daily quotations of the Czech koruna doubled in 1997, but in the following two years it returned to values comparable with the situation before the crisis, and the dispersion of the Slovak koruna, which was four times

bigger in 1998, returned to the pre-crisis levels within three years. Since the two central banks intervene on the market for the purpose of reducing volatility, we cannot conclude that the commitment would have been irrelevant in these last years, because the monetary authorities may have just operated to replicate the desired exchange-rate dynamics, but we also remark that for Poland, which indeed has a purely free float, the dispersion is minimal and apparently it was not significantly affected, if at all, by the change of regime.

As one can expect, the three Baltic States, having the tightest exchange-rate regimes, are also characterised by the lowest volatility. Notice, however, that the standard deviation of the Polish currency is just slightly higher despite the float, and that the progressive widening of the oscillation bands and their final removal did not affect volatility very much. This is completely at odds with the performance of Hungary, which experienced the largest fluctuations, even though the exchange-rate commitment was still formally in place. Finally, Slovenia too experienced rather large fluctuations, despite the interventions taken.

3.3.2.2 Exchange-rate regimes on the way to EMU accession

The bipolar view says that in a world where countries have free access to international capital markets and where capital moves freely, only floating and fixing the exchange rate are sustainable regimes, both meaning a commitment to abandon an independent monetary policy.

It is widely acknowledged that fixed exchange-rate regimes, when combined with a high degree of capital mobility, are exposed to speculative attacks and exchange-rate pressures, as in fact has been the case in the Czech Republic, Slovakia, Poland and Estonia, so that countries should avoid unstable combinations of capital mobility and exchange-rate fixity, since high capital mobility makes exchange-rate commitments increasingly fragile.

The common goal of low inflation and the diversity of exchange-rate regimes may indicate that policymakers in the CEEC lacked a consensus view with regard to the best monetary regime to be adopted in the pre-EMU period. In choosing an exchange-rate regime on the way to EU accession other factors too came into play. First and most important is of course the historical legacy of the transition: with the exception of Slovenia, the CEEC already had a fixed exchange-rate agreement (possibly with crawling bands) in place, and the liberalisation of capital flows has not been instantaneous, but often evenly spread over time. Maintaining the exchange-rate commitment, and the potential benefits in terms of credibility gain and internal stability of international prices was an option at least until the current regime was really put under pressure. Even then, we must remember that at the end of the convergence phase the CEEC expected to join the euro sooner or later, so the exchange-rate commitment can be seen as limited in time: as long as the speculative attack fails to mobilise enough

financial capital in the short run, the CEEC under attack can, in a sense, gamble and make an effort to sustain the attack now because the deadline is set and (probably) near.

In order to avoid potential conflicts in the management of monetary policy, it is also usually advised to establish the inflation rate as the single target, while Poland (for a while) and Hungary (still) coupled it with the exchange rate. On this issue Amato and Gerlach (2002) remarked that when the credibility of the central bank is not yet fully established the exchange-rate commitment might still play a role in forming the expectations on a daily basis. Since the central bank will probably have to use the exchange rate as a monetary instrument to stabilise inflation anyway, Amato and Gerlach argue the possibility of a conflict between the two targets is limited, especially if policy makers maintain a sound economic and fiscal policy. Such conflict will possibly also prevail with respect to CEECs' admittance to ERMII. Yet inflation targeting proved successful overall in the countries which tried it, and it is possible to suggest that the European monetary authority will still be able to control the growth rate of prices, relying on the fact that the intra-EU trade maintains a positive correlation of the local inflation with the overall one when the exchange rate is fixed. There are, however, some costs: the CEEC might experience more inflation and output volatility than they would if they were to retain their monetary independence, while the management of monetary policy and the inflation stabilisation could become marginally more difficult for the eurosystem.

However, potential benefits are often understated and the costs are overstated, particularly when applying conventional analyses of Optimal Currency Area (OCA) criteria: for instance, trade patterns are endogenous and the monetary integration has a highly positive effect on them, while the economic cycles tend to synchronize after the monetary union. Should we evaluate optimality of a currency area on the basis of the classical arguments only, the original EMU itself would be not optimal, due to certain rigidity in the labour market and to the low dimension of the federal budget.

Considering the new EU members, the potential losses are larger, but the gains are larger too. The additional advantages are even larger in the EMU accession of the CEEC because the gains in credibility are to be taken into account: these are indeed relevant for central banks that are very young and are then still struggling to establish a reputation for themselves. Moreover, at the moment the financial markets are still weak, fragmented between the local currency and the euro in a situation where the funds may be too little to allow both of them to work efficiently and this too increases the incentive to introduce the euro.

3.3.2.3 Implications on the way to EMU

The catching-up of CEEC with the euro area countries is far from being completed, and it will last for several years. Meanwhile, the (BS) effect will continue to push the inflation in the accession countries: keeping the exchange rate fixed implies the risk that inflation in the accession countries will exceed the threshold, unless a restrictive policy is implemented.

The potential conflict between inflation and real exchange-rate stability may endanger the fulfilment of the Maastricht criteria without signalling a real misalignment of the economies, or force a recession, which may be unnecessary. This may suggest a revision of the Maastricht criteria: a first-best solution would obviously revise the inflation criterion taking the estimated BS-effect into account, but the reliability of the point estimates is clearly low and an ad hoc solution for each country could give some candidates the impression of unfair treatment.

The BS-effect is likely to cause a systematic imbalance between the inflation rate of the core euro area (the current members) and the newcomers even after the EMU. Weighting the estimated effect for the size of the CEEC' economies relative to the EMU area, it is unlikely that the general inflation would be affected in a significant way, so the risk that the eurosystem would run a monetary policy that is too restrictive for the current members to counter inflation in the CEEC is indeed limited.

Once in the EU, the CEEC have the chance to peg their currency to the euro in the ERMII, adopting in that case a fluctuation band that may be as wide as up to ±15%. The definition or the change of the central parity in the ERMII must be agreed upon by both the ECB and the local national central bank. This provision is not intended to impede changes due to the market conditions and possibly on the inflation differential, but just to prevent competitive devaluations. In fact, the considerations on the BS-effect and the difference in the inflation dynamics may occasionally suggest devaluation.

Participation in the ERMII then does not impose a relevant change in the monetary policy for those countries having a floating exchange rate and possibly another anchor for the monetary policy, because the oscillation bands are wide enough and the option of changes of the central parity is not ruled out, so that the commitment may be more formal than real: the recent inflation targeting experience of Poland, the Czech Republic and Hungary can continue without major modifications. Things may be different for Estonia and Lithuania, because the current parity has been univocally decided years ago, while the one in the ERMII will have to be decided in agreement with the European counterpart and will have to be in line with the macroeconomic fundamentals, and for Latvia, whose current anchor is not the euro yet.

A different policy, consisting of the immediate substitution of the euro for the local currencies, has been broadly discussed. The advantage of an euroization is that the benefits in term of lower interest rates and credibility of monetary policy of the EMU may be acquired immediately by the CEEC. The EU too may benefit from the faster re-orientation of trade of the CEEC towards the Union. Euroization, anyway, has always been opposed by the European institutions, which insisted on the "orthodox" Maastricht criteria. Accepting euroization in fact may appear as a shortcut to avoid the discussion on the effective convergence: if the ECB is involved in the definition of the conversion rate, this would be seen as a form of endorsement of the arrangement, crowding out any discussion on convergence. Avoiding being involved in the conversion is not a much better policy for the ECB, because it gives the CEEC the power to fix the rate at which they will enter the euro area in the future. Moreover, the supply of euro in the EU or in an area with which the EU is well integrated would be out of the final control of the ECB, reducing the effect of the management of monetary policy. We finally note that another potential source of concern for the ECB is that euroization does not constitute a totally safe shortcut to avoid the potential instability, because even currency substitutions may be subject to credibility crisis, as the Argentinean experience proved recently.

The Maastricht criteria remain then the main route towards the euro accession. They impose two years of stable exchange rate with respect to the euro, during which any devaluation must obviously be ruled out: a strict interpretation of the criterion requires formal participation in the ERMII, albeit in the past for Italy, Finland and Greece a preliminary period of stable exchange rate was considered even without participation to the ERMII.

Factors reducing the risk of speculative attacks are the availability of foreign currency reserves to defend a fixed exchange rate, along with the consistency of macro economic policies. Sustainable public finance represents a fundamental requirement in this regard. Another important support to a fixed exchange policy in a context of capital mobility is the endorsement by the central bank of the anchor currency: speculative attacks are often triggered by the fact that the reserves that a central bank can mobilise to defend the exchange rate are limited, and very little when compared to the volume of funds that can be raised on the market. If, however, the monetary authority of the anchor currency is credibly oriented to support the exchange-rate agreement, the chances of success are much reduced, to the point that the expected gain from a speculative attack in such a case can even be negative.

We think that these exchange-rate regimes cannot be managed for an indefinite time, and indeed the failure of several of these arrangements has been a significant source of instability on the international financial market recently; the situation of the currencies joining

the ERMII in the run-up to the EMU may be more favourable because the length of time (up to two years) is short and known, because the final reference is grossly known too, and because they may probably count on more support from the ECB than is typically the case for a small country pegging the exchange rate.

We suggest then at least to the countries that are now floating their currencies (including Hungary, despite the formally different arrangement) not to take a hard commitment in the ERMII but in the last two years before the EMU membership is discussed. A soft commitment, in which pressure to devaluation is smoothed but not contrasted by the monetary authorities, could be introduced too for the period preceding the two years' run-up into the euro, but inflation targeting rather than the exchange-rate commitment should remain the anchor of monetary policy meanwhile. We also think that, since the run-up to the euro may involve some cost in terms of exchange-rate pressures that a country should first put itself in the condition that those pressures are minimized. A sound fiscal policy seems a preliminary requisite for the run-up to the euro.

Finally, we follow Borowski et al. (2002), who note that depreciation above the 2,25% with respect to the central parity may appear as evidence of tension on the exchange rate, and that the role played by interventions in support of the exchange rate must be considered as well. If their interpretation of the documents of the ECB discussed therein is correct (as seems to be the case) the depreciation during the run-up to the euro cannot exceed 2,25%, so Borowski et al. suggest setting an informal intervention rate at 2%. They also notice that for such a 2% informal threshold there is no commitment from the ECB to the intervention to sustain the exchange rate of the CEECs' currency. Thus, the burden of adjustment is all on the CEEC' central banks: to the point that this is perceived by the markets too, the exchange-rate regime is also weakened by this different reference.

Although the wide bands (±15%) cannot totally prevent a speculative attack, they may allow the local currency to absorb some short-term capital fluctuations and even impose some (minimal) costs for a speculative attack, should it fail, reducing the incentive to initiate it, so we suggest using these for the duration of the participation in the ERMII.

The Baltic States, on the other hand, managed to maintain the hard pegs possibly acquiring some credibility in the process, and they currently seem to intend to maintain the same regimes even into the ERMII. Since the current parities have been fixed unilaterally and a rather long time ago, we suspect that a renegotiation of the central parity may take place prior to the ERMII accession, slightly weakening the credibility acquired so far. Latvia will also have to change the exchange-rate anchor from the SDR to the euro. In any case, they

could try and exploit the credibility acquired so far and enter the ERMII with the hard pegs. They should not forget, however, that their goal is not the stability of the hard peg but the euro accession, and that a wide oscillation band also serves this purpose, so they can consider resorting to that in the wake of a speculative attack rather than waiting and opposing it at the risk of internal stability. As in the case of the other countries, a sound fiscal policy must accompany the evaluation phase.

To summarize, there is not a totally safe approach to the EMU that complies with the stable exchange-rate condition within the ERMII, but the countries that are currently floating their currency could minimize the risk by adopting the 15% oscillation band and keeping the central parity fixed only for the duration of the run-up to EMU. Despite the exposure to speculative attacks, it is encouraging to note that in the run-up of Italy or Greece the "convergence play" helped these countries, increasing their credibility and leading them to a smooth accession to the euro.

There is a general consensus on the idea that the EMU enlargement should take place as soon as possible: the real issue is to define when the possibility arises. Most of the academic contributions to the discussion suggest that the EMU enlargement should take place at the same time as the EU enlargement. Even without neglecting the adverse consequences of the Balassa-Samuelson effect (BS), it is commonly argued that waiting for a closer convergence of the real variables could simply take too long, surely more than the two or three years that the mechanism of ERMII would impose. As the President of the Commission stated, "enlargement is not just about economics. It is important primarily for political and ethical reasons", and there is the risk that the CEEC' people could perceive an enlargement without EMU as incomplete.

EMU accession then should be considered as soon as possible, as long as the conditions that ensure stability of the country in the euro area are ensured. With this respect the most important one is the introduction of a sound fiscal policy for the near and the medium term.

Two years' waiting in the "evaluation phase" will admittedly represent a cost in terms of postponed gains from the introduction of the euro and exposure to exchange-rate tension. This will, however, also have some benefits, because the ECB will have a longer time to better assess the effect of the monetary policy on the whole extended EMU area; the additional years could also give to the accession countries some additional time to increase the flexibility of the labour market and to increase the fiscal discipline.

Defining the parity towards the euro in the ERMII and the future conversion rates for the EMU is a delicate task, because any adjustment of a potential misalignment must fall on the real sector, and, given the limited flexibility of the supply side on both the EU and the CEEC, this may take some time. The concept is even more complicated by the fact that alternative definitions are possible: a PPP-based one, a Fundamental Equilibrium Exchange Rate (FEER) and a Behavioural Equilibrium Exchange Rate (BEER).

The notion of the PPP-based parity is the most intuitive one: prices of goods are compared across the two countries and the exchange rate is the one equalising them. Since in practise such a strict version of the PPP does not take into account differences in productivity, the equilibrium exchange rate is rescaled, correcting it by the per capita GDP.

The FEER is computed as the exchange rate that equalizes the current account deficit with the capital financing of it (via FDI) in the long run, while keeping the economy in a steady state type of condition (for example, on the long-run, equilibrium unemployment level). In the advanced countries the long-run, external equilibrium should be at zero current account deficit, but for the CEEC a certain deficit can be tolerated in the long run, if properly financed, because in this way the catching-up can be financed by investments from the more productive EU. The FEER is computed from the trade equations as expressed as a function of the real exchange rate and the internal and international economic activity.

Finally, the BEER is based on the estimation of a potentially co-integrating relationship between the real exchange rate and its macroeconomic determinants. A long-term equilibrium real exchange rate can then be estimated either with the FEER or with the BEER approach.

An extensive survey of the methodologies and of the results in the literature can be found in Egert (2002). The overall conclusion that we can draw from that survey is that the CEEC began the transition with undervalued currencies, and experienced a real appreciation over the years even after correcting for productivity gains. The consensus seems to be that Hungary and Slovenia were quite close to equilibrium, while the Czech Republic overvalued the currency before the 1997 crisis, and, after a short period of undervaluation after the crisis, it was back to overvaluation. The results are rather diverse; different studies are reaching opposite conclusions for the same country over the same period. Evidence that Poland and the Baltic States are overvalued is even more controversial.

The most interesting conclusion that can be drawn on the basis of Egert's (2002) survey is that the econometric results are very fragile and as such not very reliable. Egert, too, finds that the Czech Republic had an overvalued currency (of approximately 30% in 2001),

and the same conclusion is drawn for Poland (+15%) and Slovakia (+10%), while Hungary and Slovenia were close to equilibrium. Evidence of overvaluation for Hungary, Czech Republic, Poland and Slovakia in 2002 can also be found in Šmídková, Barrell and Holland (2002), who still find that Slovenia is approximately at the equilibrium level.

These results are particularly surprising when we consider that Poland floats the currency freely, so the current real appreciation (if it exists) must be induced by the market. Borowski et al. in fact found that this is not the case, and that the current rate is close to the equilibrium one.

3.3.3 Social policies and social conflicts

Within Ezoneplus the Social Dimension was a hybrid in the sense that it includes both the re-shaping of certain policy areas and the socio-political repercussions an Eastward enlargement of the eurozone may entail. Correspondingly, key questions to be addressed can be grouped under two headings: Firstly, what kind of shocks does EU enlargement, and more specifically, the enlargement of EMU, produce on national and EU policies? Secondly, how do national societies and political systems respond to these new constraints? This implies both potential social conflicts enhanced by the enlargement process, as well as their implications for national policy-making. In order to combine both topics, we propose an analysis using insights of modern political economy. In brief, this is to say that rational political actors act in response to Ezoneplus in a way predictable once the socio-economic outcomes of the enlargement process have been analysed.

This introduction sketches a basic motivation for analysing the Social Dimension of Ezoneplus. Section II goes on to interpret some of the major findings of previous steps of Ezoneplus in the light of such a motivation. In particular, it briefly assesses the evolution of major socio-economic trends in employment and income. The third section deals with the degree by which relevant policy areas have already been reshaped by an anticipated adoption of the Euro in Eastern Europe. The policy areas to be inspected here are labour market regulation, wage bargaining, social security systems and EU transfer policies. Together they build the backbone of welfare states that are still national in nature, but are increasingly dependent on policy-making on the EU level. The analysis will show why some political issues are more sensitive than others and why reshaping takes place in some areas, but not in others. The fourth section deals with some aspects of the socio-political process of Ezoneplus. It shows what role public support plays for the shaping of an enlarged currency union. It goes on to exemplify the transmission mechanisms of political protest in the political system, and

concludes with some remarks on so-called soft issues that may be related to the process of enlargement. The last section provides a conclusion.

Why is it important to talk about a Social Dimension of Ezoneplus? Most studies aiming at the proliferation of policy recommendations rely on arguments about economic efficiency. Scholars analyse the effects of policy measures on economic welfare and compare this to alternative instruments. Without doubt this is an academic practice with merits of its own; at times, however there is a considerable lack of implementation of such recommendations. We therefore ask first, what do market outcomes imply for the political stability within and between countries? For example, which political actors favour which kind of policies on the verge of Ezoneplus, and how do actors with different preferences come to a common policy? This requires an analysis how different political conflicts on the enlargement process are mediated in the political system.

Second, what are the implications for society as a whole? Rather than addressing explicitly normative goals such as reducing poverty or inequality, the Social Dimension will focus on the issue of social acceptance of the enlargement process.

With increasing world market pressure, political integration has more to offer than a mere abolition of traditional trade barriers to national product markets. For both sides, old and new member states, enlargement itself might become contingent on the enlargement of the eurozone! This is to say that given an international environment marked by a high degree of trade liberalisation, the enlargement of the currency is a necessary prerequisite to guarantee the mutually beneficial enlargement of EU. Obviously, there are limits to a political union in terms of scope and depth, since regional and national preferences in an enlarging Europe will be more diverse than ever. Therefore in terms of policies, in very general terms, the issue is how to reduce this diversity in preferences. Or more to the point: how to find stable institutional solutions that enable the mediation and harmonisation of diverse preferences.

3.3.3.1 Reshaping Policy Areas Related to the Welfare State

One of the fundamental insights of Ezoneplus is the idea that markets and policy areas have already started to adapt to a future enlargement of the EU and EMU. A common currency will exert considerable pressure on markets and policy-makers and will bring about the socio-economic criteria relevant for the formation of an optimal currency area. The previous stages of the project have begun to show that indeed markets have already started to adjust to an adoption of the Euro. This is plainly visible in the case of capital markets, but – to a lesser extent – this is also true for labour markets. This section applies the same logic to those policy areas most closely related to the Social Dimension of Ezoneplus. On the national level these

areas are labour market policies and institutions, including the way wage bargaining is performed, and the most relevant parts of the social security systems. On the EU level, the policy area most similar to national social policies is Structural Funds (SFs), and the Common Agricultural Policy (CAP). Obviously, these two transfer mechanisms are not the only forms of social policy on the EU level, but they are arguably the most influential in terms of unemployment, income disparities and poverty.

In analogy to the reshaping of markets, reshaping of policies implies that incentives of national policy-makers have changed because of the likely advent of Ezoneplus. Hence, the aim of this section is less to assess the performance of policies and institutions and derive a lack of accommodation in terms of efficient policy-making. Rather, the aim is to show why and under what conditions reshaping takes place. Political institutions and interactions between relevant actors are assumed to be of primary importance for such an analysis.

An enlargement of the eurozone provokes the discussion of three aspects of labour market regulation. First, the overall amount of geographic labour mobility is a decisive factor in balancing the costs of structural adjustment across countries. This section will therefore start with an analysis of the policies regulating East-West migration. The second issue of relevance is what role an enlarged EMU will play in determining the necessity to introduce structural reforms in national labour markets. The motivation for such reasoning is straightforward: even if migration is legally allowed, high unemployment rates in Western Europe will significantly reduce inflows of workers. Most closely related to EMU is, third, the reshaping of national income and wage policies. The changes of wage-bargaining systems an enlarged EMU will hold in store are of fundamental importance for coordinated macroeconomic policy-making.

<u>Reshaping of Migration Policies</u>: The issue of migration is most crucial for two countries sharing extended borders with Eastern Europe: Austria and Germany. A first-best solution is to enhance migration to both countries. But the high levels of unemployment in Germany may be interpreted as a stable, national political equilibrium that significantly reduces labour mobility as a whole. So far, the situation seems to be locked into this equilibrium, thereby limiting migration flows.

However, there is also a social equilibrium in Germany affected by higher inflows of illegal migration. Eastern European workers form a major part of the German and Austrian shadow economies. Hence, it seems only ’natural’ that the German government would try to limit the inflow of migration to Germany from Poland and other countries. In Austria the situ-

ation is different for similar reasons. Unemployment is less of a problem there, but this only suggests that higher labour inflows will form part of a wage risk for the low-skilled sector.

During the negotiations on accession, Austria and Germany managed to achieve substantial temporary exemptions from the principle of free movement of labour. Up to seven years, this arrangement will be delayed, thereby reducing what was perceived to be a significant political pressure on national governments. The European Commission admits that these exemptions were important for gaining social acceptance in the two member states most seriously affected. To explain this outcome of political bargaining between Western and Eastern countries, one could either rely on one of the two cardinal channels of political economy: politicians maximising votes and therefore being responsive to public opinion, or politicians being susceptible to lobbying from special interest groups. In order to analyse the concrete policy outcome, we assume it more useful to look at interest group lobbying than at public opinion. However, we will come to an analysis of public support in the next section of this report. For the moment, the analysis sticks to the role of relevant special interest groups during the bilateral bargaining rounds between the EU and, in particular, Poland.

This bargaining was essentially two-dimensional in nature: on the one hand, Poland had to agree to the adoption of the social *acquis*, entailing all the pieces of EU legislation relevant for labour market and social security regulation. Germany and Austria, on the other hand, had to allow for the freedom of settlement affecting their national labour markets. This provoked lobbying from the side of Western European trade unions and employers' associations. It is reasonable to assume that the consent of both lobbies was necessary for the Austrian and German governments to achieve a politically satisfying result in the negotiations. According to the structure of the lobbies' preferences, the only achievable outcome was to negotiate for an immediate adoption of the social *acquis* in Eastern Europe and a postponement of the freedom of settlement. The trade unions' position proved to be the pivotal stance, and gave them the power of a de-facto veto player – at least for the short run, up to seven years. To put it bluntly, the Polish government had too much to gain from the negotiation to block the result. Nevertheless, it managed to get some compensation by postponing the access to polish real estate markets.

<u>Incidence of Labour Market Reform</u>: Some regional evidence on labour markets contributed to the discussion on whether 'real rigidities' are reduced by eastward enlargement. In short, the argument goes as follows: an enlarged currency union will increase competition between countries, and will therefore induce structural reforms to accommodate this pressure.

A preliminary conclusion was that little impact could be seen in terms of making Western European labour markets more flexible.

So far, the channels from monetary union to labour market reform are difficult to anticipate. This is all the more the case for the eastward enlargement of the eurozone, since estimates of labour market and output shocks stemming from the enlargement differ considerably. Since theoretical arguments contradict each other, it remains to be seen on empirical grounds that are going to be proved right.

Changes in Wage-Bargaining Systems: The discussion on how to fight structural unemployment with the help of structural reforms is directly linked to the issue of national wage bargaining in an enlarged currency union. Specifically, the costs of wage bargaining, i.e. a potential inflation bias, should be lower than with nationally separated monetary policies. The reason is that exposure to world markets is smaller than for national economies and that nominal wage flexibility is larger than before. Moreover, higher competition among member states will impose wage ceilings on the bargaining system and therefore also reduces 'real rigidities'. As stated above, however, an endogenous lack of structural reform may, in fact, even increase the inflation bias. Once again, theory keeps ambiguous results in store when analysing this problem. On the one hand, increased price transparency and general market competition, may exert disciplinary pressure on national wage bargaining. Moreover, national trade unions can no longer count on their governments to accommodate their wage policies. On the other hand, the external effect of each wage policy on the EU-15 or EU-27 price level is markedly smaller. This may lead to higher inflation than before.

In the new EU member countries trade unions are struggling hard to find their role in post-communist societies because of the political legacy they share with the former regimes. With the notable exception of Slovenia, union density has shown a conspicuous downward trend in Eastern Europe. The differences between Western and Eastern European coverage rates are even more telling. In none of the CEEC-10 are coverage rates above 40 percent, a fact that shows the low political impact trade unions have on national political systems. Public employment is still high in some of the CEEC-10, but since these countries have now experienced one decade of privatisation and transition, the insider power of these employees is much smaller than in Western Europe. Finally, the institutional links between trade unions and some of the most important political parties are much weaker than in tripartite systems in Western Europe.

So far there is little reason to believe that West-East differences in bargaining systems will decline soon. EU-wide coordination will thus be seriously hampered since pre-

ferences of national trade unions are antagonistic, especially in the case of West-East-coordination. The strength of trade unions has both positive and negative effects. Nevertheless, the changes suggest that an enlarged EU and EMU will contain wage bargaining systems that are much more heterogeneous than before with all that entails for economic performance, political stability and social acceptance. In particular, this means that the extent and form of an EU-wide social dialogue will be markedly different in an enlarged currency union.

Summing Up: Due to the politically generated status-quo bias, labour mobility will not become a major mechanism of adjusting markets to asymmetric shocks. Hence, whereas goods and capital markets are on their way to establishing an optimal currency area, labour markets are clearly not. Given the considerations of politico-economic approaches, structural unemployment may even rise in the short to medium term. The reasons are that Western trade unions will strengthen their efforts to influence national policy-makers and that the positive impact of such lobbying will increasingly be concentrated on fewer people. Although Western trade unions will manage to raise social and labour standards in Eastern Europe, differences will remain too high to speak of a genuine European social model. In fact, Eastern European trade unions will not want to buy easily into such logic of harmonising standards across Europe. Both the idea of OCA and the linkages between wage and fiscal policy suggest that an encompassing picture of the consequences of Ezoneplus is only possible, once the social aspects of fiscal policy are included in the discussion. This is the task of the next section, which deals with the effects of Ezoneplus on national social policy-making.

To discuss the likelihood of compensation on a European level, we use politico-economic models of fiscal federalism. A first point of entry to this literature is by simply anticipating which regions, countries and individuals of current member states will lose transfers, and how they will react to this problem. We depart from efficiency considerations of the optimal transfer debate in fiscal federalism and consider ‘pork-barrel politics’ as a convenient way to conceive this process. Regions within a country lobby their national governments for support, while these governments determine the absolute level of transfers on the EU-level. By this means, the demand for SFs and CAP is primarily explained by concerns within a country. A point of further complication in these models is the problem of multi-level governance, typical for fiscal federalism. Regions may lobby sub-governments in federal states that, in turn, voice their demands to their national governments.

A second point of entry focuses on the set of policy alternatives a national government has to respond to enlargement. As, for example, Casella (2002) has shown, the question of coordinating redistributive policies between countries hinges upon the capacity of national

governments to impose barriers to migration. To be sure, these barriers may consist of tools other than simply regulating work permits of foreign workers. An important example is the discretion of governments to grant social assistance and other forms of 'non-tariff' migration barriers. A more mundane, but not totally implausible, way of conceiving this issue is to say that governments try to set national rates of unemployment high enough to prevent migration. Such behaviour has profound consequences for the need of a common fiscal transfer policy across Europe. In fact, the optimal size of international redistribution may be higher than without such politico-economic considerations.

A third important theoretical approach deals with the political economy approach to anticipate reforms of the EU budget. Since net contributors in the EU such as Germany and the Netherlands, fear substantial additional costs once new countries are accepted, they try to reform the EU household before the enlargement. These attempts experience fierce opposition by countries that benefit from the status quo, namely France and Spain.

We start by a simulation of future budget positions of current EU member states. We compare the status quo in 2001 with a one-to-one extension of the budgetary rules to CEEC. This is not realistic since, for instance, CEEC farmers will receive much less immediately after the accession than their Western counterparts. The hypothetical experiment is nevertheless revealing: Measured in percentage of GDP the Baltic countries will gain most from accession, but also bigger countries such as Poland would gain annual net inflows up to three percent of GDP. The only accession country that is likely to be a net contributor is Cyprus. In relative terms, Greece and Spain could lose up to one percent of annual inflows. It goes without saying that in absolute terms, Germany, France and Italy are those countries that pay most of the 'bill'. Accepting 10 new member countries would imply, for instance, that Germany's net position would deteriorate by some five billion euros.

But worse, a budget position is due not only to increasing contributions. EU regional transfers (SFs) will be redistributed, since many regions of current member countries will be pushed above certain thresholds, namely the 75-percent level in relative income that is aligned to the so-called Objective 1. For Germany this implies that six out of seven regions won't be entitled to get SFs in an enlarged Europe. In France three regions and in Belgium and Austria one region will also be dropped. 90 percent of the Objective 1 population would maintain their entitlements in 2007 with no enlargement. With enlargement, the share is reduced to around five percent. Next to Germany the southern European countries are most affected by the diversion of SFs to CEEC.

The problem of CAP is similar in nature; only that Belgium and France are the main beneficiaries of the current situation. However, at first sight, the logic of reform is inverted. Whereas the major criteria for SFs are relative in nature such as the 75-percent threshold of EU GDP per capita, thus holding absolute levels of SFs constant, CAP hinges mainly upon absolute levels of production. In other words, shifting the status quo of EU-15 to EU-25 is regarding SFs mainly a zero-sum game, whereas CAP directly affects the absolute size of the EU budget. For SFs a reform would be interesting for Germany in order to maintain their population within the criteria of entitlement. A reform of CAP would mean the opposite, i.e. down-sizing the entire budget. Given the fierce opposition of farmers in most countries, reforming CAP is politically dangerous. Naturally, an emerging compromise on CAP reform is thus biased against future members. At least for a grace period, new members will not be entitled to the same proportion of CAP-cash that the old members are.

The structure of the EU-budget and its main two components, CAP and SF policies, however, is not very likely to remain stable, once enlargement will have taken place. In that respect, the problem of time inconsistency looms large into the recent past of institutional reforms of EU decision-making procedures. Simply stated, the problem resides in the fact that CEEC can tilt the current status quo towards their ideal position once they are members of the EU. Previous rounds of enlargement have indeed shown that the EU budget and the amount of SFs in particular, have substantively increased once new (poorer than the median) countries were accepted. The Cohesion Fund is the most visible example in that respect and its existence is directly linked to the creation of EMU.

3.3.3.2 <u>EMU-Politics: Support, Opposition and Alienation</u>

So far, we have merely assumed that societies are reluctant to introduce or accept policy changes in the realms of social security and employment. This sort of societal unrest and its political manifestations have been treated as unobservable variables. This is quite natural since hard empirical evidence is difficult to attain and evaluate. Nevertheless, this part of the report tries to nail down some of the strategies individuals and interest groups have to make this unrest visible.

Talking about both the winners and losers of the enlargement process generates a major question: What kinds of strategies do individuals and corporate actors have to complain about their losses or promote their benefits in a politically meaningful way? Two distinctions may help to organise the argument. First, there is the distinction between ‘voice’ and ‘exit’ strategies. Political actors can either choose to make their complaints observable within the political institutions, or they stop their cooperation within these institutions and look for

alternatives outside. A second distinction deals with the capability of organising the voice strategy. Some segments within the population are more apt to form a (unified) political platform and to coordinate strategies than others. Hence this difference is best captured by the notion of 'organised groups vs. dispersed individuals'.

Some of these strategies have already been mentioned in previous parts. This is true for the case of special interest groups. This time, however, we will look more closely at the empirical evidence for the politics of Ezoneplus. First, we will analyse whether support is driven by politico-economic considerations or depends on more general historic and cultural situations in these countries. Second, the report will shed some light on the question whether and how these anti-enlargement attitudes may be transformed into a political position (usually in the form of eurosceptic parties).

The major issue of this part is the question how people respond to the process of eastward enlargement. For instance, sectors in both Western and Eastern Europe that have lived through times of relative protection against foreign competition are likely to face considerable adjustment pressure once integration takes place. This necessarily prompts the fear that those suffering from integration will use any possibility to hinder the enlargement process or, at least, will demand compensation for anticipated losses.

Some wealthy countries such as Switzerland live with comfortably low rates of political inclusion. However, from an analytical point of view, political alienation is, nevertheless, an important aspect when talking about the evolution and convergence of European Union member countries. First, the question remains whether a continual, low participation rate is a symptom of latent social conflicts in an enlarged EU. Second, low participations rates may have consequences for the kind of social model evolving in Eastern Europe and its convergence to or divergence from Western European welfare states.

Traditional political-economy approaches to integration and transition usually claim that liberalisation leads to some form of (organised) political pressure and, hence, to government policies that compensate potential losers. Job loss is arguably the most important 'ingredient' for most political economy models of transition. Hence, as in previous sections structural adjustment costs imply a higher demand for social policy in ways similar to the results of standard median-voter theories on redistributive politics. With democratisation and international openness, the size of redistribution should expand, as (relatively) poorer voters become both more decisive and more exposed to shocks. However, in the context of Ezoneplus these arguments have to be qualified. First, international openness may add to volatility, but not necessarily to relative losses in incomes or employment. On the contrary, the low-skilled in less

developed economies, should, as argued above, favour economic integration. Second, the median voter theorem is empirically not very meaningful, especially in the context of Eastern Europe. As for the latter, a potential exit out of this problem lies in the fact that voter turnout is an important intervening variable in the median-voter and size-of-redistribution model. In many countries richer people are more likely to vote than poorer. Hence, political abstention or alienation is a way of explaining the general lack of redistribution in CEEC.

To evaluate the risk of a lack of political support we need to know how euroscepticism is transformed into (party) politics. Hardliners, in particular, are not members of any government in Western Europe. The political clout of anti-enlargement parties is therefore clearly limited. Most interestingly, Germany has shown a marked resilience against euroscepticism and anti-enlargement parties, a fact that has been related to its federalist political system. The two exceptions, where hard euroscepticism features prominently in the political system, are France and Denmark. However, enlargement has, so far, never been a major issue during recent election campaigns. Soft euroscepticism, frequently related to the enlargement of EMU, is strong in Austria and the Netherlands. In both countries, parties with an outspoken, but not extremist, scepticism towards enlargement are or have been in national governments.

All things considered, party politics does not seem to be a major 'avenue' for societal discontent against enlargement. However, for some parties it seems to be a handy 'tool' for mobilising critical and, at times, extremist voters as the following box suggests. Historical legacies play a crucial role here. In the Czech Republic, the issue of how to deal with the expulsion of Germans after World War II is an important example. But also populist movements against enlargement in Austria illustrate this problem. Especially because of issues concerning labour markets and social security systems, the political discussion on enlargement is, now and then, fused with explicitly nationalistic positions.

To be sure, data on public opinion, euroscepticism or voter turnout is prone to well-known critique. One could try to find complementary measures for societal discontent with enlargement. One of the alternatives to polls is to look at the evidence for manifest political protests. The politics of Brussels is haunted by frequently occurring manifestations and blockades. But Brussels is not the only place to express dissatisfaction; national protests and manifestations may also have a linkage to the EU and enlargement. Empirical data on the incidence of genuinely European protests (i.e. protests about EU-related issues) shows an ascending trend in the nineties. On the national level, the strike is still the most common form of political protest, compared to other forms of public protest. For the case of Brussels politics the 'tone of the discourse' seems to be markedly more confrontational. Moreover, EU policies

may play a role in causing national political predicaments (see above). Hence national waves of protests such as general strikes are indirectly related to EU issues.

All things considered, the way societal reactions are transformed into political concerns depends on the specific policy area, but also on nationally idiosyncratic facts. Labour market regulation and CAP will affect major national veto-players, i.e. special interest groups. Social security systems are rather a problem of 'general interest politics'. No matter what transmission channel is argued for, societies will react towards enlargement and lead to a reshaping of policy areas that is different from one predicted by pure market forces.

3.3.3.3 Of reshaping policies, social conflicts and consequences

Perhaps the most important general finding of this report is that in none of the areas inspected does the social dimension imply catastrophic scenarios sometimes attached to the prospects of EMU-enlargement. To give but one example, early migration studies forecasted an inflow of up to 1mn people p.a. to EU-15 countries. Currently, estimates are much more modest and the societal consequences of reduced inflows should be politically manageable.

However, labour inflows may be too small to absorb the negative consequences of an enlarged currency union. Hence, although, EMU enlargement seems to be feasible, it will not be processed efficiently from an economic perspective. The report indicated reasons that are predominantly situated in the political and social systems of both member and accession countries. An easy absorption of asymmetric shocks, for instance, would demand smoothly working labour market and social policies. Since these policies are formed by other logics than plain economic necessities, powerful interest groups and political institutions were shown to play a major role in determining the amount and direction of reform across Europe.

This holds for both labour market and social policies. From a macroeconomic point of view, the largest risk lies in the possibility that enlargement will increase the inflation bias in the monetary union and could possibly lead to a 'retaliatory' behaviour of the European Central Bank. Since a major part of inflationary pressure is directly or indirectly produced by social security systems, the true source of predicament lies in the interaction of fiscal and social policies. In addition, the political conflicts are highly manifest in the area of regulating social security, and will arguably continue to exist in the near future. Given this prediction, some of the Western European governments will try to loosen fiscal restrictions in the short run and, simultaneously, allow for more EU transfers to be directed to the new member states.

Structural asymmetries in an enlarged currency union will guarantee that a convergence of welfare states across EU-25 will proceed slowly. This will increase the demand for coordination of these policies on an EU level. We assume this to be good news for the whole

of Europe. Although competition among tax and transfer systems is clearly a source of social conflict in some cases, the opposite strategy, a rush to higher labour and social security standards, would be clearly less desirable. Once again the prime example for this predicament is Eastern Germany. From a sociological point of view, there is little reason to believe that the German example may serve as negative role model for eastward enlargement. In short, the immediate adoption of social standards in Eastern Germany was due to unique historic and cultural circumstances. The social acceptability of different standards for West and East was very low. We do not expect this to happen between Western and Eastern Europe, since national diversities are in general much higher than within Germany. In that respect, sustaining national heterogeneity is more a benefit than a curse to the whole of Europe.

3.4 Project results 3: Policy advice

Timing and management of EMU enlargement are the interesting issues, because in the long run benefits of euro adoption are likely to outstrip alleged disadvantages. Unfortunately, there is no unambiguously safe strategy towards the euro; hence, policies always have to strike a balance between diverging interests and goals.

EMU requires substantial adjustments for instance in the form of increased wages and price flexibility or fiscal restraint. In particular, fiscal restraint is often regarded as the bellwether of the seriousness of economic adjustment, because it will be the only remaining macroeconomic instrument. However, one should not underestimate the hardship economic adjustment may put on many people in Central Europe and the political pressure which may arise. Unemployment is rampant from Estonia to Bulgaria which may reduce the willingness to accept cuts in public spending or to embrace international competition. Large agricultural sectors in some countries – e.g., Poland – will have to be downsized, which means that potentially millions of workers will have to switch jobs and change their lifestyles. Such large swings have never been easy.

It is conceptually useful to look at the trade-off with respect to risk premiums. Ideally, risk premiums on investments in Central Europe are an increasing function of current account deficits, starting from a certain base set by economic fundamentals such as the capital/labour-ratio. At some equilibrium amount of capital inflows, risk premiums are such that marginal returns on capital are equalised between poor and rich EU members. A lower risk premium - for instance, by eliminating exchange rate risk via EMU - thus translates into higher equilibrium capital flows.

In reality, the risk premium is determined by an array of different variables, developments, and shocks; and it is not necessarily a smooth function of the current account. Econo-

mic and political variables may affect risk premiums at different speeds, causing whiplash effects and imbalances. Fiscal consolidation, for instance, may signal sound policies to investors, thus boosting foreign investment. These investments, though, will be unlikely to create jobs in those sectors which suffer most from spending cuts, such as agriculture. Angry peasants may take to the streets and cause political instability, hence, pushing up risk premiums. On the other hand, a too generous policy that scares off investors might similarly create unrest because the desired growth would not be accomplished. The political skills show in bringing about the necessary adjustment and maintaining social accordance at the same time.

3.4.1 Exchange-rate regimes and monetary policy strategies

According to the Statute of the European System of Central Banks (ESCB) "the primary objective of the ESCB shall be to maintain price stability. Without prejudice to the objective of price stability, it shall support the general economic policies in the Community" (Art. 2). To achieve this goal, the European Central Bank (ECB) has been designed as an institution independent from the governments of the countries of the euro area. This policy framework is also in place in the eight Central and East European Countries (CEEC) that are joining the EU. In each country the monetary authority was transferred to an external agency, the local central bank, and the commitment to price stability or to preservation of the value of the currency formally guides the monetary policy.

Yet price stability is a general statement. The ECB has interpreted it as a commitment to keep inflation within a precise range: price increases up to 2% over the medium term[5], adopting then a formal inflation targeting.

Not all the CEEC follow the same approach. Poland and the Czech Republic indeed follow inflation targeting, while the Baltic countries pursue price stability and preservation of the value of the currency with a very strict peg of the exchange rate, either with a formal currency board or with a regime that can be assimilated to it (the reference currency is the euro, except for Latvia which still keeps the SDR). Finally, Hungary is in an intermediate position, having a weak exchange rate commitment (with +/-15% oscillation band) but also an explicit inflation target. Slovenia and Slovakia are on the other side of the spectrum, not being currently committed to any explicit quantitative goal. Slovakia in particular follows an implicit inflation target in which forecasts are announced in advance, making the regime similar to a standard inflation target. Slovenia followed a more intermediate approach, in which the anti-inflationary stance was coupled with a certain attention to the external equilibrium, but a more

[5] ECB recently adopted new formulation, up to 2% but close to that.

aggressive strategy had been pursued since 2001, with an active, albeit informal, crawling peg.

The Statute also requires the ECB to "act in accordance with the principle of an open market economy with free competition" (Art. 2) to reach the target. The link between monetary instruments and target then can only be indirect, and the transmission of the policy impulses is left to the markets.

In the interest-rate channel, the monetary authority operates supplying liquidity to the market of reserves, those funds held by the commercial banks to make inter-bank payments and to satisfy the legal minimum reserve requirements. Transmission to inflation takes several stages. Expectations and arbitrage communicate the monetary stance from the overnight deposit market to inter-bank deposits with longer maturity and to other contracts, including bonds and interest-rate swaps, thus determining the term structure of the interest rates, the cost of financing investment through other sources (bank loans and other financial market instruments) and the opportunity cost for current consumption. These factors define the condition of the aggregate demand and determine the quantity of broader measures of money in the system. Assuming for the short run a less than perfectly elastic aggregate supply, there is a trade-off between output and inflation and the monetary authority may try to exploit it and choose the desired combination of the two. In the long run, on the other hand, real income is essentially determined by supply side developments, and inflation is a monetary phenomenon.

Price stability also requires monitoring the external value of the currency, because domestic production uses inputs purchased in the international markets too: especially in the case of energy and raw materials, the domestic demand is rather inelastic and fluctuations of those prices may transfer into local inflation. It is also possible that temporary swings of international relative prices trigger inflation over the medium term, if the indexation in the economy is high. In that case a quick reaction of the central bank may reduce or prevent the undesired effect. The external value of the euro is then watched over too, and the potential influence of the international prices is not neglected.

The exchange rate can also be used to counter the component of inflation originating within the country. Producers that may be relatively big for the domestic market and have a certain ability to set prices can be forced to higher discipline by exposing them to international competition. Under a fixed exchange rate, in fact, domestic entrepreneurs know that the attempt to increase local prices, against a given level of the international ones, will induce consumers to switch the demand to foreign production. Arbitrage anyway may take time and, in practise, not all the consumers move at the same moment. Local producers can initially

adopt a combination of reductions of both prices (for the part exceeding the international ones) and quantities, or even fail to perceive the demand shift or be unable to react to it, and involuntarily increase the inventories. In the short run it is therefore possible to observe a certain discrepancy between domestic and international prices, and a certain trade-off between inflation and output. Yet, under the assumption that prices of internationally traded goods must converge in the long run, local producers will eventually have to set theirs in line with the foreign ones, if they do not want to be driven out of the market, so the trade-off between inflation and output does not extend beyond a certain horizon in this case either.

Active management of the exchange rate thus constitutes a second channel of monetary transmission. This does not necessarily require a commitment to a fixed exchange rate, but the alternative policy of floating it may reduce the anti-inflationary discipline because local producers know that higher prices could be followed by a depreciation before arbitrage shifts too much demand to foreign goods; indeed an exchange-rate policy aiming at the *ex post* stabilisation of the real exchange rate may even prevent a reduction of inflation.

3.4.1.1 Exchange-rate pegs and inflation targeting as monetary anchors

Formally pegging the exchange rate may help the central bank during a difficult situation, such as the transition or a phase of hyperinflation, because the economic agents may perceive the inflation only with imprecision and some delay, keeping the uncertainty high. This may induce conservative behaviour so that inflation is sustained by the expectation of it, as in a self-fulfilling prophecy, and it may cause a relevant risk premium on the interest rates. The fixed exchange rate serves the purpose of providing a nominal anchor for the inflation expectation and of offering the public a reference that is clearly visible and on which the commitment of the central bank can be tested every day. As long as the exchange rate peg is credible and the target currency is stable, the central bank succeeds in informing the local producers that increases of prices will not be accommodated, so inflation in excess of those of international partners will sooner or later drive domestically produced goods out of the market. Anticipating this, local producers should choose a non-inflationary price-output combination.

The argument that the central bank that pegs the exchange rate may buy some of the credibility of the target currency should not be pushed too far, though, and the sustainability of the commitment has to be taken into account. If the peg is not credible most of the advantages are lost because it will not be taken into account by the agents when they set the prices. The exchange-rate commitment may then increase the credibility of the central bank mainly under favourable situations. Restrictions of capital movements, especially with respect to short term and financial flows, can make a speculative attack difficult; large supplies of

international reserves to sustain the commitment and of course the support of the monetary authority of the target currency are other relevant factors that enhance stability. It is also obvious that to be credible the targeted exchange rate must be macroeconomically sustainable.

It is widely acknowledged that fixed exchange rate regimes, when combined with a high degree of capital mobility, are exposed to speculative attacks and exchange-rate pressures, as in fact the Czech Republic, Slovakia, Poland and Estonia have experienced. Countries should avoid unstable combinations of capital mobility and exchange-rate fixity, since high capital mobility makes exchange-rate commitments increasingly fragile. The tight exchange-rate peg was retained only by the Baltic States, which on the one hand had not undergone much pressure so far, despite the experience of Estonia, and on the other one are those who can gain more and lose less from the commitment. Being extremely open to international trade and having much of their public debt in foreign currencies, they benefit a lot from the exchange-rate stability and are not seriously affected by a very high interest rate in the local currency.

The situation at the beginning of the transition phase was favourable for exchange-rate commitments because the credibility of the central banks was nonexistent, making the potential gain very large, and because the restrictions to capital movements were very tight, reducing the sources for speculative attacks. When the progress of the convergence required removal of these controls, the exchange-rate commitments become exposed to speculative attacks. Without explicit support from the target currencies, the credibility of the commitment was weakened even more.

Given that the ultimate task of monetary policy is price stability, the central banks may rather commit to a reference target for inflation without intermediate targets. Accountability is realised primarily by announcing a target for inflation in the following year, and then discussing monetary policy decisions and inflation developments in inflation reports and additional specific communications. After nearly a decade, the central banks of the eight CEEC had acquired some credibility for anti-inflationary policies, and when the Czech Republic dropped the exchange-rate commitment, it replaced it with a formal inflation targeting. Poland introduced inflation targeting in 1999, while Hungary followed in 2001. As a matter of fact Poland and Hungary did not replace the exchange-rate commitment with inflation targeting as suddenly as had the Czech Republic. They both kept the two commitments together for a while (in fact, Hungary still keeps them both), but the introduction of inflation targeting signalled nonetheless a relevant shift in the management of monetary policy.

The introduction of the inflation targeting scheme offers the central bank an alternative approach to inform the expectations, maintaining the commitment to price stabilisation implicit in the old exchange rate peg, and in fact making it explicit. As such, the shift in monetary policy seems to be more apparent than real. In fact, a credible inflation targeting could be superior, because by committing its actions to the stabilisation of the exchange rate, the central bank abandons any room for autonomous policy, thus also renounces the use of many other leading indicators that may well be helpful in predicting the dynamics of the final objective of monetary policy. It may even happen that in particular situations stabilisation of the exchange rate prevents anti-inflationary policies. Furthermore, given that the CEEC are to join the EMU, an inflation-targeting framework may help the public to become familiar with the monetary policy strategy pursued in the Euro-area.

In order to avoid potential conflicts in the management of monetary policy, it is also usually advised to establish the inflation rate as the single target, while Poland (for a while) and Hungary (still) coupled it with the exchange rate. The Hungarian experience in spring 2003 shows that conflicts are possible. In that case one of the two targets must be abandoned. Committing to both the targets could even contribute to confusion in the formation of expectations rather than helping it. Since the target refers to the term of one year, deviations are possible and were indeed frequent. The recent policy has anyway achieved some successes and was explicitly praised by the European Commission in the Regular reports.

Floating their currency freely and lacking a formal inflation-targeting commitment, Slovenia and Slovakia do not have an explicit mechanism to anchor the expectations. In fact, the relatively high inflation of Slovenia in recent years, compared to the other CEEC, was due to the fact that the *ex post* adjustment of the central bank to stabilise the real exchange rate was a discretionary policy, and that the agents internalised it, not feeling enough pressure to revise their expected inflation to a lower level. The informal active crawling peg introduced in 2001 is still exposed to the same risks, to the possibility left to the monetary authority to accommodate shocks using the exchange rate. The situation in Slovakia is different. According to the monetary authority, the main difficulty that has thus far prevented the passage to an explicit inflation targeting is the wide range of administrated prices still present in the economy (this was also acknowledged as the cause of higher than expected recent inflation).

3.4.1.2 Exchange-rate and interest-rate roles in inflation stabilisation

Even assuming a functioning interest-rate channel at the moment, the exchange-rate channel of monetary transmission should be more important in the CEEC, due to the higher openness to international trade of the candidate EU members with respect to the euro area. There is no

doubt about the importance of the exchange rate with respect to inflation stabilisation. Broadly speaking, and ignoring the issues related to the alternative specifications[6], all the empirical analyses found that an appreciation of the real exchange rate significantly reduced the growth rate of prices.

Since the transmission of interest-rate impulses through aggregate demand follows a much more indirect channel, it is generally acknowledged that it could not play a role in the early stage of the transition. Yet in a functioning market economy the financial structure should be in a condition to carry the monetary innovations along the term structure of interest rates up to the aggregate demand, and then to affect the output/inflation mix. This in fact is assumed by the inflation-targeting central banks, and in the inflation reports the conditions of supply and demand are extensively discussed. The empirical evidence supporting the existence of a standard interest-rate channel is still controversial. Results seem to depend strongly on the econometric approach adopted and on the sampling period considered. It is anyway encouraging that the number of studies devoted to the topic increased quickly in the last years, also prompted by the effort of the local monetary authorities.

To summarize, the evidence in favour of the interest channel is weaker, suggesting that the exchange rate should have more importance as an instrument of monetary policy. There is also evidence of a certain evolution of the economic structures over time, which becomes closer to the "textbook" benchmark of a market economy.

3.4.1.3 EMU accession in an optimal currency area perspective

The accession to the EU represents a decisive step in the process of harmonisation. In little more than a decade, these countries developed a "functioning market economy" and "the continuation of their current reform paths should enable them to cope with competitive pressure and market forces within the Union" according to the assessment of the European Commission (2002a).

Participation in the EU also opened the discussion of membership in the EMU, which in turn is one of the chapters of the *acquis communautaire*. Countries accessing the EU will not have the right to opt out of the single currency and are expected to join the euro if and when the Maastricht criteria[7] are met.

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[6] It may even be argued the variety of approaches is interesting, because it indirectly shows that the evidence of the link between exchange rate and inflation resists potential misspecifications.

[7] The macroeconomic Maastricht criteria for EMU membership impose a ceiling on the general government deficit to the GDP ratio at 3 percent and a ceiling on the general government debt to GDP ratio of 60 percent; that the long term nominal interest rate on the public debt has to be within the 2 percentage points of the average in the three countries with the best inflation record; that the annual inflation rate cannot exceed the average of the three best-performing countries by more than 1.5 percentage points; that the EMU candidates keep the exchange rate stable in the ERM II for two years prior to joining EMU.

The accession countries will not be forced to immediately join the ERM II (but they are given the opportunity, if they so want), and this, being one of the parameters considered in the Maastricht criteria, leaves them a certain degree of flexibility in practise. It is of interest to assess whether the accession countries and the current EU/EMU members may benefit from the expansion of the euro area and are then willing to realise it, and when.

Traditional Optimal Currency Area (OCA) theory suggests that the advantage of the EMU includes the removal of uncertainty in pricing in international trade and of the corresponding premium, and the saving of transaction costs. Fixing the exchange rates and entering a monetary union has also potential drawbacks, because the real, asymmetric shocks cannot be countered by adjusting the exchange rate but, apart from being transmitted from one country to the other, require alternative mechanisms of adjustment in the economy. An OCA will then be desirable if the potential gains are high, as they are when the countries involved are open to each other (they have a large trade in common), and if the risks are limited. Local flexibility of prices and of wages, or international mobility of labour, for example, will prevent an asymmetric shock in the partner country from having effects on the quantities in the home country; a system of fiscal transfers could otherwise be established; failing that, it is important that the government has at least the capacity to react to adverse shocks, and for this purpose it is important that the public finance are balanced. The adverse effects of shocks can be also reduced if the countries reach a high diversification of production, because the exposure to a single type of shocks is reduced. Finally, a good degree of macroeconomic convergence is necessary. The inflation rates in the two countries must be similar, so that there is no loss of competitiveness[8], and the economic cycles should be synchronized in order that one not act as a shock for the other.

The first exercise consists in discussing the factors separately. The scope for monetary unification is guaranteed by the small dimension of the CEEC associated with a large degree of openness; the conditions to counter an asymmetric adverse shock are not favourable because of the rigidities still present in the labour market, occasional imbalances in public finances and low synchronisation of the economic cycles. In general, the conclusion was favourable or at least comparable to the one that would be given for some peripheral countries already in the euroarea.

It is also often remarked that the advantages are understated and that the costs are overstated in the conventional OCA analysis, and that the balance should then shift in favour of integration. Trade patterns in fact are endogenous and monetary integration has a highly

[8] Of course a country may keep a higher inflation if it is matched by higher productivity.

positive effect on them[9], while the economic cycles tend to synchronize after joining the monetary union (possibly also because of the larger trade). Should we evaluate optimality of a currency area on the basis of classical arguments only, the original EMU could be non-optimal, due to certain rigidity in the labour market and to the low dimension of the EU budget.

When one considers the CEEC, the potential losses are larger, but the gains are larger too. The additional advantages are even larger in the EMU accession of the CEEC because the gains in credibility are to be taken into account as well. These are indeed relevant for central banks that are young and are still struggling to establish their reputation. Moreover, at the moment the financial markets in CEEC are weak, fragmented between the local currency and the euro in a situation where the funds may be too little to make both of them work efficiently, and this too increases the incentive to introduce the single currency.

3.4.1.4 Monetary policy on the way to the euro

The catching up of the productivity of the CEEC with the euro area countries is far from completed, and it will last for at least several more years. Meanwhile, the Balassa-Samuelson (BS) effect will continue to push the inflation in the accession countries. Keeping the exchange rate fixed increases the risk that inflation in the accession countries will overshoot the Maastricht threshold, unless a restrictive policy is implemented. Pressure on economic activity and on inflation will also come from the reduction of interest rates to the level of the euro-area and from the reduction of the *premia* paid on the CEEC currencies once that the markets expect them to join the euro.

The potential conflict between inflation and exchange-rate stability may endanger the fulfilment of the Maastricht criteria without signalling a real misalignment of the economy, or force a recession that may be unnecessary, at least in the size. This may suggest a revision of the Maastricht criteria. A first-best solution would obviously include a revision of the inflation criterion by taking the estimated BS effect into account, but the reliability of the point estimates is clearly low and an *ad hoc* solution for each country could give some candidates the impression of unfair treatment.

The BS effect is likely to cause a systematic imbalance between the inflation rate of the euro area (the current EMU members) and that of the newcomers even after they join the EMU. The risk that the eurosystem would run a monetary policy that is too restrictive for the current EMU members to counter the inflation in the CEEC is anyway limited because it is

[9] This was very clear to European institutions, which considered the euro essential to foster the integration of the Single European Market.

unlikely that general inflation would be affected in a relevant way, once that the estimated effect is weighted for the size of the CEEC' economies relative to the EMU area.

Once into the EU, the candidate country can choose when to enter the ERM II, when to initiate the evaluation period of the Maastricht criteria before accession to the euro area and what to do in the period preceding that phase.

As EU members, the CEEC will have the chance to peg their currency to the euro in the ERM II exchange rate mechanism, adopting in that case a fluctuation band that may be as wide as ±15%. The central parity is decided jointly with the ECB and changes are possible as long as they are in line with the macroeconomic fundamentals. The ERM II can be a rather flexible regime, but stronger commitments can be undertaken unilaterally towards the euro within the ERM II framework. Even a CBA is feasible, as long as the euro constitutes the only reference and the parity is agreed jointly with the ECB. Participation in the ERM II does not imply any modification of the policies of Hungary, Lithuania and Estonia, apart from a potential change in the actual parity.

The CEEC anyway are not required to join the ERM II upon EU accession, also having the option to postpone the application. The Maastricht criteria remain then the main route towards the euro accession. They impose two years of stable exchange rate with respect to the euro, during which any devaluation must be obviously ruled out. A strict interpretation of the exchange rate stability criterion requires the formal participation in the ERM II, albeit a short preliminary period of stable exchange rate even without formal participation in the ERM II has been taken into account for Italy, Finland and Greece. In any case the commitment to a stable exchange rate is part of the route to the final fixing of the exchange rate and to the accession to the euro area. The current interpretation of Maastricht convergence criterion on exchange-rate stability in the Treaty and in the other relevant documents issued by the European institutions seems to be that the deviation from the central parity during the two years of the evaluation period must not exceed 2.25%, at least on the depreciating side. The same criterion also requires that no tensions occur on the market during that time, so an overactive defence of the parity may be already enough to fail the test.

There is a general consensus among the CEEC on the idea that EMU enlargement should take place as soon as possible. The real issue is to define when the possibility arises. Even without neglecting the adverse consequences of the BS effect, it is commonly argued that waiting for a closer convergence of the real variables could simply take too long, surely more than the two or three years of participation in the ERM II that the exchange-rate stability convergence criterion would impose.

EMU accession then should be considered as soon as possible, as long as the conditions that guarantee stability of the countries in the euro area are ensured. With this respect at least a sound fiscal consolidation and some flexibility of the labour market are necessary. While in the past the CEEC were all eager to join the euro area as soon as possible, a more gradual approach is now emerging, possibly also because these factors are taken into account.

Defining the parity towards the euro and the future conversion rate is a delicate task, because any adjustment of a potential misalignment must fall on the real sector, and, given the limited flexibility of the supply side in both the EU and the CEEC, this may take some time. The CEEC began the transition with undervalued currencies, and experienced real appreciation over the years even after correcting for productivity gains. The consensus in the literature seems to be that Hungary and Slovenia are quite close to the equilibrium, while the Czech Republic overvalued the currency before the 1997 crisis, and, after a short period of undervaluation after the crisis, it is back to overvaluation. Slovakia too has an overvalued currency, but less than that of the Czech Republic. The results in the literature are anyway rather dispersed, different studies reaching opposite conclusions for the same country over the same period. Evidence that Poland and the Baltic States are overvalued is even more controversial.

In relation to earlier decisions concerning the EMU entry rate, Ireland chose to enter the EMU at an undervalued exchange rate. As a matter of fact this helped strengthen an ongoing growth in its industrial system, even if it produced some overheating before the world economy cooling which began in 2001. In general, entering a monetary union at an undervalued exchange rate, first adds to growth, but it produces inflationary pressures. Initial undervaluation is eliminated through extra inflation in a process of adjustment that may take several years to complete under nominal rigidities. Transition countries may find an initially undervalued exchange rate attractive, so as to strengthen their export sector, allowing their price level to rise gradually toward the PPP level, thus having some room for price deregulation once their exchange rate becomes firmly pegged. There is a tendency, for small countries, to opt for entering a currency board or a monetary union at a rate which is intentionally biased downward, as has been observed for Estonia.

Overall, in the decision regarding the exchange rate we think that the CEEC should perhaps aim at a slight over-evaluation. This should ensure a certain pressure on the price-setting agents, favouring the formation of anti-inflationary expectations. More importantly, it may also favour the formation of a current account deficit that can be considered crucial for financing the investments that are necessary to complete the catching up of the CEEC to the standards of living of their EU partners.

The countries that decided to postpone the entry into the ERM II and thus the two-year phase of evaluation of the Maastricht criteria must also choose a monetary strategy for the intermediate period. The opportunity of the fixed-exchange-rate approach has been extensively debated in the past few years. We think that fixed-exchange-rate commitments cannot be managed for an indefinite time without capital controls, and indeed the failure of several of these arrangements had been a relevant source of instability on the international financial markets in the last few years. Narrow bands in general could make the defence of the exchange rate more difficult and increase the risk of a speculative attack. Notice here that the arrangement chosen for the forthcoming ERM II participants from the accession countries, with the 15% oscillation band on each side, seems to acknowledge that. Since the supply of international reserves is limited, even a currency board is not a fully credible exchange-rate arrangement and can be subject to a speculative attack or exchange-rate pressures (as already happened in Estonia) or bank runs. Factors reducing the risk of attacks are the availability of foreign currency reserves to defend a fixed exchange rate, along with the consistency of macroeconomic policies. Sustainable public finance represents a fundamental requirement in this regard. Another important support to a fixed exchange rate in a context of capital mobility is the endorsement of the central bank of the anchor currency. Speculative attacks are often triggered by the fact that the reserves that a central bank can mobilise to defend the exchange rate are limited, and very small when compared to the volume of funds that can be raised on the market. However, if the monetary authority of the anchor currency is credibly oriented to support the exchange-rate agreement, the chance of a success of a speculative attack is much reduced, to the point that the expected gain in such a case can even be negative.

Floating the exchange rate without formal commitment does not mean neglecting it as a policy instrument and as a potential source of disinflation. To the contrary we think that its effect on inflation is faster and more reliable than that of the interest rate. The monetary authorities are expected to use it in conjunction with the interest rate to achieve the target.

Since there is enough evidence that inflation targeting in Poland and in the Czech Republic provided a valid reference for monetary policy and an anchor to the expectations not inferior to the exchange-rate commitment, we think that these two countries should maintain the current monetary arrangement. Slovakia too should introduce this policy regime in an explicit form in order to help the formation of expectations in line with an inflation-stabilisation programme.

We also think that Hungary may abandon the exchange-rate commitment and remain with the inflation target only, especially if a situation of potential conflict between the two

monetary regimes is feared. Failing that, we think the widest possible bands should be chosen and occasional devaluations to follow the macroeconomic fundamentals should not be opposed. If Poland, Slovakia or Czech Republic joined the ERM II and stayed there for more than the monitoring period defined by the Maastricht criteria, we would suggest to them the same policy.

In any case we think that the situation of the currencies joining the ERM II in the process of accession to the euro area may be eased because it is well known in advance that the fixed-exchange-rate arrangement has to remain in place for only a relatively short time. This is true particularly in the case of a clear exit strategy, and also because these countries can count on some sort of support from the target currency (the euro) - in fact from the ECB - at least under some conditions.

We already noticed that Slovenia should explicitly introduce a target for monetary policy to help the formation of expectations favourable for the final disinflation to the euro area level. The detailed time plan for entering the ERM II and the euro area, adopted both by the central bank and the government in 2003 may serve this purpose as well.

Finally, Estonia and Lithuania plan to join the euro as soon as possible, thus having to enter the ERM II with a hard peg immediately. Latvia is planning a slower approach, converting the peg from the SDR to the euro only in 2005, upon accession to the ERM II, and introducing narrow fluctuation bands. The Baltic States could conceivably try and exploit the credibility acquired so far and enter the ERM II with a hard peg, remembering however that their goal is not the hard peg itself but euro accession, and that this purpose is also served by a wide oscillation band or even a free float before the evaluation period of meeting the Maastricht convergence criteria. They can consider resorting to it in the wake of a speculative attack rather than waiting for it and opposing it, putting their internal stability at risk.

3.4.2 Effects on trade and FDI

The fifth enlargement of the European Union (EU) involves deep structural adjustments that will certainly change the competitive position of countries and regions. It is a challenging project that entails opportunities and risks for current as well as new members. It is expected that the Central and Eastern European Countries (CEEC) will experience both the highest risks and the largest benefits, as a result of the singularity of their economic and social structures in relation to EU patterns. Trade and foreign direct investment (FDI) flows have been identified as key elements for economic integration. They have been playing a crucial role in the transition and economic convergence processes and will continue to be paramount for the foreseeable future.

Since the beginning of the transition process, profound economic, political and social changes have occurred in the CEEC. After the collapse of centrally planned regimes, and over the past decade, a progressively deeper liberalisation of markets has been taking place. The European Agreements and the Trade and Cooperation Agreements have also contributed to these countries' reforms. Overall, considerable progress in transposing the *acquis communautaire* has been achieved and a high degree of implementation has been accomplished in many areas, such as in the internal market. Considerable tariff reduction has taken place and the main trade barriers have been dismantled. As a consequence, trade liberalisation is already a reality in almost all sectors and countries involved, which coincided with a trade reorientation towards the EU.

FDI has been assuming a key role in the CEEC' catching up process, not only because of its importance in overcoming inefficiencies in the local financial markets, but also because it is a fast way of transferring technology and market-oriented business culture to previously centrally controlled economies. For both reasons, FDI contributed to the re-structuring of firms and to the transformation of the CEEC' export structures.

3.4.2.1 The Dynamics of EU-CEEC Trade Relations

Following the disintegration of the centrally planned economic regimes, there was a fast and extensive integration of the CEEC into the world markets, with the degree of openness, measured by the ratio of exports plus imports to GDP, increasing from 56% in 1993 to 80% in 2001. Trade relations with the EU have sharply increased, but are more intense with neighbouring countries. In fact, Germany is the CEECs' main trading partner, representing more than 40% of the EU-CEEC trade, followed by Austria and Italy. The progressive reorientation of CEEC' economies towards the EU coincided with a decline in their relationships with the Council for Mutual Economic Assistance members (CMEA). In 2001, the percentage of the CEEC' external trade with the EU was around 65%, comparable to that of most EU members.

The expansion of EU-CEEC trade relations contributed significantly to the deterioration of the CEEC's trade deficits. Indeed, in spite of the efforts to overcome such a trend, these countries still display high structural trade imbalances. Moreover, the catching-up process is expected to induce higher deficits in some cases. This is hardly surprising. During the Southern enlargements the new members' trade deficits also generally worsened after joining the European Community. High levels of investment are necessary to achieve economic modernisation, requiring a higher level of imports, mainly of equipment and capital goods. Furthermore, with the expansion of real incomes, imports of more sophisticated con-

sumption goods will naturally increase. On the other hand, given past developments, an export boom in the Eastern countries is unlikely to occur in the coming years.

Trends in current account deficits vary across the new member states. A significant reduction of such deficits highly depends on the rate of convergence and of industrial restructuring. Therefore, it is expected that those countries that have engaged in more profound reforms of industrial structures, and present a higher convergence in productivity levels, will be in a better position to reduce their deficits. However, given the relatively small economic dimension of some of these countries, bulky investments may also induce a reduction of deficits. Accordingly, the European Commission (2003) predicts that, by 2006, Estonia and the Slovak Republic will experience sizeable improvements in their current accounts.

Given the increase in EU-CEEC trade relations, one key aspect to assess is whether the trade potential between the EU and the CEEC has already been exhausted. Although the empirical literature has not been unanimous, more recent results seem to suggest that, in the short term and for most countries, trade is either close or even above potential levels. However, the results also reveal that exports to the CEEC have converged more quickly than imports from the CEEC. As a consequence, there is still a gap between actual and potential imports from some Eastern countries.

The CEEC's permanent economic transformation makes it difficult to predict with confidence the long run trade potential. Yet, in spite of the great expansion in EU-CEEC trade relations, the volume of trade is expected to continue to rise due to the progress in market reforms and to the increase of real incomes. In addition to accession to the EU, CEEC' adhesion to the Euro-zone will also have positive effects on trade flows.

Gains and losses from trade expansion will not be evenly distributed across countries and regions, nor across industrial sectors. Considering the effects of trade creation and trade diversion, empirical evidence suggests that the CEEC that are geographically and economically closer to the EU are the main beneficiaries of trade creation but, simultaneously, are the most affected by trade diversion. The new members sharing a common border with the EU have a pattern of exports that is similar to the one of incumbent members and, therefore, are in a good position to gain market shares from EU countries. Meanwhile, these countries also represent the best markets for EU exports and are very exposed to the competition from European firms. On the other hand, the exports' dimension and structure of the Baltic and Balkan countries will limit their competitiveness in EU markets.

In the EU, the members potentially more affected by CEEC competition are also those which will benefit the most from the integration of Eastern domestic markets into the

Single European Market. In contrast, the countries that will benefit the least will also be the less affected by the increasing competition. Portugal is an exceptional case due to its exports profile and geographical location. Indeed, the country does not have the conditions to gain substantial market shares in the markets of the new members. Furthermore, it may be affected by CEEC' competition in the access to EU markets, resulting in a significant trade diversion.

3.4.2.2 The role of FDI in economic restructuring

FDI provides funding for projects which would otherwise not find domestic financing. It is recognised as a simple and quick way of transferring business culture and technology to developing regions, performing a pivotal role in the transition process of the former centrally planned economies. In the early nineties, FDI flows to the CEEC were relatively insignificant in global terms. The turning year was 1995 and, since then, FDI growth has been considerable and continuous.

The CEEC have even been an exception in the worldwide decline of FDI since 2001, continuing to attract increasing volumes of foreign investment. Nevertheless, CEEC' FDI stocks, in per capita terms, are still significantly below the EU's average, suggesting a continuation of the growth trend in the next few years. FDI projects in the CEEC are very heterogeneous, differing in terms of magnitude, objectives, technology, geographical location, ownership, control structures and geographical origin. The EU is, by far, the main source of FDI in these countries, followed by the United States. More than three quarters of the capital flows entering the region originate in EU member states. Germany is the main partner in terms of FDI flows, followed by the Netherlands and Austria.

On the part of the capital suppliers, a variety of motivations influence an entrepreneur's decision to invest abroad, following the optimum management strategies of multinational corporations. In the process of European integration, the perceived reduction of overall risk in the integrated area has been a key aspect, as FDI increased in the new members after every previous enlargement process.

Spatial proximity and specific economic characteristics attract FDI to Eastern locations. Trade and FDI flows concentrate in the bordering countries, with Poland, Hungary, and the Czech Republic, three of the most developed economies, receiving around two thirds of the FDI in the CEEC. Apart from confirming the importance of geographic location, it should also be stressed that these are also the countries that have been more successful in reforming, deregulating, and opening their economies. In addition, host country characteristics, such as its economic dimension, potential demand, openness to world trade, and lower relative labour compensation levels (wages plus supplementary benefits) add up to the list of

main FDI determinants. According to these results, peripheral countries, such as Portugal, may have severe disadvantages in attracting and maintaining foreign investment, not only because of geographical distance, but also due to weak potential demand and low purchasing power. Investors engaged in market-seeking FDI may become less interested in these countries. Efficiency-seeking investors, though, may continue to seek these locations as long as the labour force remains relatively cheap.

The gap in unit labour costs between the new and the incumbent EU members is expected to narrow, thus reducing CEECs' attractiveness from the cost efficiency point of view. Furthermore, all EU members will face the competition of non-member CEEC, who will try to attract efficiency-seeking FDI in the new 'frontier countries'. It should be noted, however, that market potential is expected to increase in the new members, due to GDP growth and the consequent reduction in the economic distance that separates them from the EU average standards. Changes may also be anticipated in the type of FDI directed to the CEEC, as the catching-up process will probably enhance investments by horizontal multi-nationals and depress investment by vertical multinationals.

The dynamics of FDI flows is expected to promote economic growth in the CEEC, especially due to capital accumulation and the renewal of capital stocks. Besides the positive effects upon restructuring, there are also impacts on the productivity, export performance, product quality and costs. In some successfully restructured sectors, where foreign investors have improved productivity and provided access to foreign markets, cost benefits have been above average and continue to improve. However, there are concerns that economic growth in some Southern EU countries may be negatively affected, due to a diversion effect or to a crowding-out effect. Specific sectors and regions may become affected. Among these are the border regions in Germany and Austria, but also some regions in cohesion countries, highly dependent on the performance of specific sectors (textiles, for example) which will probably be affected by FDI reallocation processes.

Finally, it is important to consider the relationship between FDI and the trade dynamics. Exports structures reflect changes in a country's specialisation pattern and, naturally, the reorientation of exports towards products intensive in technology and qualified labour. The CEEC that have attracted larger amounts of FDI are those that have better adjusted to the dynamics of the EU imports. In fact, countries with higher stocks of FDI per capita display a bigger share in their exports of products with the highest rate of growth in the EU imports. Therefore, there appears to be a link between high volumes of FDI and the reshaping of specialisation patterns. These countries have speeded up the process of transfor-

mation of trade structures and improved their qualitative competitive position. Moreover, the structural changes in trade composition were consolidated by increasing shares of IIT in total trade, particularly in the countries receiving the highest amounts of FDI.

3.4.2.3 The challenges ahead

The CEEC' accession to the EU will reinforce the integration process. It has already brought increasing opportunities and is expected to keep on generating benefits for economic agents in both new and incumbent member states. Nevertheless, it will also entail several risks. Therefore, it is necessary to prevent the potentially harmful effects, and this will require policies aimed at sustaining past convergence trends of the new member states, or formulating special financial programs, and implementing structural reforms to achieve income convergence between old and new members and strengthen cohesion. Furthermore, it is important to correct possible negative impacts from trade diversion and FDI reallocation, or from the increasing probability of asymmetric shocks.

Before considering particular regions, countries or groups of countries, it is appropriate to focus on the EU's perspective as a whole. The Single Market might be considered the "microeconomic core" of the EU and the mutual recognition principle is a key issue which depends on mutual confidence among countries. Distortions may arise after the application of the established standards in each country. Additionally, negotiations concerning standardisation will also become more difficult when 25 countries instead of 15 are involved. Therefore, administrative and judicial capability is a fundamental element in the application of mutual recognition. Market surveillance and enforcement authorities along with appropriate means of rectification and sanctions are also important.

The viability of certain firms in the new member states may also be affected by the requirement of complying with the *acquis*, given the substantial investment efforts required. The CEEC must harmonize their regimes with the EU regulations, not only to guarantee full access to the Single Market and to increase competitiveness, but also to benefit the most in terms of investment promotion from the EU regional development funds. Financing the transposition of the *acquis* is exactly one of the areas identified by the European Commission (2003) where specific policies will have to be introduced after enlargement.

Non-tariff barriers are at the centre of the discussion on the functioning of the Single Market after enlargement. Even though it is expected that such barriers will be eliminated in the process of economic integration, it is also plausible that both old and new members will try to protect a number of vulnerable sectors, arguing with public policy and public security reasons. In fact, different kinds of non-tariff barriers may be an important obstacle to trade.

Technical barriers are the main impediment to the trade of goods and result mainly from the execution of regulatory policies (for instance for safety and health reasons) and from voluntary standards adopted by domestic industries. In what relates to trade in services, the key issues relate to differences in regulatory regimes across countries, which seriously limit the ability of firms to effectively operate on a European-wide basis. The EU should therefore take the necessary steps to prevent abusive behaviour of regulatory measures from all its members.

Most assessments of the impact of enlargement on trade and FDI dynamics indicate that the benefits are proportionately much larger for the new members. This conclusion is based on the higher weight of the EU in CEEC exports, when compared to the weight of the CEEC in EU exports, and on the smaller dimension of their economies. Moreover, not only an unequal distribution of the benefits between these two groups of countries is expected, but it is also likely that differences will arise within both groups.

Overall, it may be anticipated that, although in the short run high volumes of FDI may continue to flow to the CEEC, eventually diverted from the old Southern EU members, a reversal is expected in the near future. The main immediate beneficiaries may be the new Eastern EU neighbours, now already offering lower wages and similar education levels. Among the new competitors is the group that is expected to join the EU in the next enlargement - Bulgaria and Romania - but also other Eastern countries such as Ukraine. In the manufacturing sector, for example, wages in Poland are already five to six times above those in Ukraine, an incentive for firms to move across the border and further east.

Under these circumstances, there is a need for specific policies to attract FDI in the more vulnerable new and incumbent members, which are likely to suffer idiosyncratic shocks. More selective promotion strategies should be implemented, favouring high technology and export-oriented activities. Efforts should be made to implement structural reforms capable of generating the necessary conditions to attract market-seeking FDI and upgrade the demand for efficiency-seeking projects. National policies should be conceived to exploit positive externalities produced by FDI flows, namely in productivity, employment, technology transfers and human capital development. On the one hand, negotiations with social partners will be essential to achieve a sustainable development. On the other hand, current technology gaps have to be identified. If such gaps are very pronounced, the technology transfer process between local and multinational companies will be compromised and situations of oligopoly, or even monopoly, may occur. There is still space for further restructuring of domestic firms, despite the structural changes already promoted by FDI. Furthermore, policy makers should promote the development of local innovative firms' clusters and of other alternative ways of generating

local synergies. Investment in R&D-driven activities and in innovation is a strategy that should attract FDI with high technological content, which is precisely the more desirable from the host country point of view.

At the same time, there is the need for an efficient system of financial intermediation. Flexible and quick ways to find funds for entrepreneurial activities and easily available risk capital are important to strengthen the entrepreneurial environment. In spite of the remarkable progress already achieved with the privatisation of the large state banks and the entry into the financial sector of EU and USA strategic investors, further reforms towards the restructuring of the financial system and its regulatory environment should not be neglected. This is particularly important given the urgent need to address the problem of the escalating current account deficits in most CEEC, reflecting the convergence process. This entails non-negligible risks for these countries' financial stability, as the Asian experience demonstrates, given the possibility of sudden reversals of capital inflows. Current accounts have been largely financed by FDI, which is considered to be less harmful than short-term capital. However, given its expected reversal in the near future, as noted above, the relative importance of FDI inflows may be replaced by riskier portfolio investments, as external investors gain confidence with EU accession and try to explore short-term gains. It is therefore prudent to maintain current account deficits within sound limits, to prevent the risks of sudden capital reversals.

One remaining question is related to the timing of the euro adoption on the part of new members. From the commercial point of view, there appears to be no need for an immediate entry into EMU. However, given the rapid structural changes in trade patterns that occurred during the transition period and the growing importance of foreign investment, the adoption of the common currency seems to be inevitable. In fact, the euro may contribute to strengthening the credibility of the ongoing industrial restructuring processes, and may have positive effects upon the new division of labour on the European scale. Notwithstanding this, the integration into EMU will bring additional challenges for new member states, in terms of economic growth and employment, which inevitably will affect trade and FDI. In this respect, the difficulties in complying with the Stability and Growth Pact currently felt by some members are a hint of what the future may entail for new members.

All in all, EU membership will promote a broader market liberalisation and a higher level of economic and monetary stability in the CEEC. The new competitive environment will reinforce the role of the market as a mechanism of economic adjustment and promote a more efficient allocation of resources. Therefore, the current processes of industrial and entrepre-

neurial restructuring, and the geographical reorientation of trade patterns, in the countries involved, will be reinforced. In fact, transfers of technology and new methods of management have improved competitiveness and the access to international markets. CEEC' technological progress and economic openness have contributed to a new international labour division, via production and distribution networks that involve Eastern and Western European firms.

In the context of enlargement, the greater risks are related to the fact that such dynamics, upon which the internationalisation of the Eastern emergent economies was based, may not be sustainable in the long run. Regarding external investment, it is recognised that foreign firms, stimulated by the privatisation processes and by the prospects of EU enlargement, gradually took positions in CEEC's markets, substituting in a way for the scarcity of domestic funds. FDI flows were also a compensation for the increasing current account deficits. In some countries, however, the inflow of FDI has already slowed down and, in cases such as that of Poland, has declined, thus raising concerns about future developments.

Summing up, in the future, the greatest risk is related to the mounting signs of partial exhaustion of this growth model. Furthermore, given the evident differences in terms of economic performance and in the degree of internationalisation of domestic and foreign firms in the CEEC, social tensions and regional asymmetries are increasing. Probably the enlargement in itself will not alter recent trends in a significant way, so that growth sustainability in the near future should rely on the dynamics of domestic economies and on processes of economic adjustment. The incentives to increase domestic saving and to modernise and internationalise domestic firms are the most important challenges to the success of enlargement, since they determine both the rhythm of convergence towards the EU and the balance of current accounts. Appropriate economic policies and EU financial support for the modernisation of infrastructures will undoubtedly help to achieve those goals.

3.4.3 The social dimension of the eurozone enlargement

The eastern enlargement of the European Union and the requirements of the European Monetary Union call for increased flexibility of labour markets in all EU countries; obviously the challenges are bigger in the new Central European member countries. If labour markets and labour market institutions are inflexible within the larger Union and especially within larger EMU, labour market disequilibria and related social problems may turn out to be almost permanent.

The increased labour mobility and migration which are expected to follow the enlargement will exert pressure on the labour markets of the recipient and source countries – i.e., the old EU15 countries and the new member countries. Increased labour supply may yield

higher unemployment in EU15 if there is not sufficient demand for labour or if the structural problems related to the functioning of labour markets cannot be solved. Migration to EU15 may help to reduce unemployment in the new member countries, but since these countries also experience ageing populations, migration may cause shortages of skilled labour.

Various research-based estimates put the long-run migration potential from the CE8 roughly at 1% of the EU15 population (hence, about 3.8 million). Surveys suggest a strong preference of CE8 nationals for temporary work, which implies also important flows of return migration. Based on some predictions about the situation in absence of administrative restrictions on labour movement, the initial immigration from the CE8 countries to EU15 would be around 70, 000 workers annually (that means all-in-all 200, 000 people, including also family members) or only 0.05% of the EU15 population.

According to a study by Boeri and Brücker (2000), labour migration will concentrate only in a few member states and enlargement will not significantly affect the wages and employment in the EU. It is thought that two-thirds of the labour migration flows from the CE8 will be absorbed by Germany (hence, around 45, 000 – 50, 000 workers per year in the first few years), while Austria will absorb about 20% of these labour flows. The forecasts show that the share of the CE10 (the new members plus the applicants, Bulgaria and Romania) people in the population of the EU15 will rise from 0.2% in 1998 to 1.1% in 2030. In sum, according to the predictions, the movement of labour between the EU countries after eastward enlargement will not be significant.

Economic theory of migration as well as past experiences of international population movements help us to understand the factors affecting the migration flows and to assess their magnitudes. The basic idea of economic theory is straightforward: people move to other countries if they expect to be able to earn higher incomes in the target country. Hence the crucial variable affecting the migration decision is the income difference between the target and source countries. Since the wage and GDP differentials between the old EU member counties, or the EU15 ('the West') are large, one might expect a great flow of people from the CE8 countries ('the East') when they join the EU. However, it is obvious that there are also other factors, which should be taken into account.

The potential migrants in the East need to consider how likely it is that they will find a job in the labour market of the West and what will be the expected wage level. This expectation has to be compared with the expected future incomes in the East. If the wage level in the East can be expected to grow faster than that in the West (that is the case if there is convergence) and if there is high unemployment in the West lowering the matching probability,

then it is not so obvious that current large wage differentials are sufficient to induce large migration flows from East to West. The situation gets of course reversed if the Western labour market moves close to full employment (when the probability of finding a job increases) and if for any reason the convergence process were to be disturbed. In such a case the expected future income differential would be even higher than the current income differential between the source and target countries and the incentives to move would increase.

An additional factor influencing the international migration flows are the benefits of the social system offered in the destination of international migration, i.e. the amount of unemployment and other welfare benefits in the destination country. In the case of the eastern enlargement of the EU that aspect cannot be neglected, since in some cases even the basic social welfare benefits available in EU15 countries exceed the wage level in CE8 countries.

Migration flows change the labour market equilibrium both in source and destination countries. Migration decreases labour supply and unemployment in the source country. If the capital stock is given, that will mean a higher capital-labour ratio and eventually also higher real wages in source countries. Thus migration from CE8 to EU15 will help the new member countries to achieve convergence in income levels faster than they would without migration. In the EU15 countries the effect will be the opposite: migration will slow the rate of increase of capital-labour ratio and real incomes. However, since the West is much larger than the East, the negative income effect will in relative terms be much lower in the West than the positive income effect in the East.

The migration is not likely to have a uniform effect on the Western labour market. It is usual that immigrant workers start their careers in low-skilled jobs. Thus, migration will increase the supply of low- or unskilled labour in the West, which in turn will cause a downward pressure on the relative wage of that group. If lower relative wages will be reflected in lower relative prices in labour-intensive goods, the skilled labour in the West will benefit.

Membership in the EU will boost the economic catch-up process of the new member countries. Thus it will be highly beneficial for them and their citizens. Better resources will undoubtedly also have beneficial effects on social welfare. However, integration also creates a continuous pressure for structural change. That has already taken place but the process will continue. Structural change will create adjustment costs and unemployment, and these burdens will not be distributed equally. It is likely that the young and well-educated will benefit, and those with weaker capabilities and opportunities may suffer. There is also a potential conflict between the desired increased labour-market flexibility (usually linked with reduced social protection) and some other social goals related with welfare and equity (like the quality

of life). The dark side of higher flexibility is that it implies lower job security (shorter average duration of employment relationship, more flows between unemployment and employment, more job creation and job destruction) and thereby lower quality of life and higher risks for individuals. The social safety nets of the new member countries are not fully prepared to face these challenges.

The analysis of past labour migration experiences from the previous stages of EU enlargement induces us to conclude that the eastern enlargement in 2004 with 8 new Central European member countries would not induce anything like a mass migration from the new member countries to the old EU15 countries. Due to the relatively small size of the CE8 populations (Poland being the only large country in the group) in comparison with the EU15 population of 380 million, labour migration from the CE8 countries into the EU15 countries will be mostly insignificant and thus will not exert any notable pressure on the EU labour market. Such an outcome can also be verified by numerical model–based calculations of the likely effects of factor movements following the enlargement. Free movement of labour will not place any significant pressure on the labour markets (not on unemployment and nor on wages) of the EU15 countries. However, the main absorbers of the labour flows from CE8 will be the neighbouring countries of the new members, i.e. Germany and Austria, and to lesser extent Finland and Sweden. Those countries will see some differences caused by increased labour supply of immigrants. In broad economic terms the recipient countries will gain from immigration. However, unskilled workers in industries facing competition from the new member countries (transport, constructions, some services) may see their relative position deteriorated over time. Cross-border movement of labour is expected to grow, which may make the local labour market more competitive.

The impacts of migration will mostly be felt by the home countries of migrants. Free movement of labour will create a certain burden on the home countries' economy as it is predictably well-qualified and more flexible workers that will start moving. However, reduction of labour supply may also tighten the labour market and put upward pressure on wages in these countries.

The adoption of euro by the new member countries will speed up the integration and convergence processes. It will reduce the real rate of interest in the CE8 countries and induce faster capital formation. However, nominal convergence requiring higher inflation in the new member countries may have risks for the macroeconomic stability and labour markets in the new EU member countries. There is a potential conflict between the price stability objective of the European Central Bank and the rising relative price levels of the new member

countries. That can lead to too low real interest rates in the new member countries, and possibly to an overheating of their economies. The use of common currency implies irreversible nominal exchange rates, and that may increase the risk of difficult macroeconomic imbalances (inflation, exchange rate overvaluation and structural current account deficit). In the absence of exchange-rate flexibility stable macroeconomic development depends on the soundness of fiscal policy and the flexibility of labour markets.

Although the changes are much bigger with respect to the new member countries than to the old ones, there are also challenges to the EU15 economies. In order to be able to successfully absorb new immigrants and to adjust to the increased capital flows to the new member countries, the old ones need to significantly reduce their currently high unemployment rate and to raise the participation rate in their labour markets. Stable growth in all the European countries in the context of an enlarged EU underlines the need to increase labour demand and labour-market flexibility. This is indeed consistent with the Lisbon targets.

The labour markets in the CE8 have been relatively flexible during the transition process in the 1990s. There is a risk that this flexibility will decline in the future because of the strengthening of the enforcement of labour legislation, further institutional convergence, strengthening of the trade unions and increase of minimum wages. On the other hand, the level of social protection should be improved in the CE8 countries. Further integration is going to induce further structural changes which will also cause unemployment. It is necessary that the social safety nets are sufficient to prevent poverty and social exclusion. At the same time, the social-protection systems in most EU countries should reformed to be more supportive of re-employment.

3.4.4 Fiscal policy

When analysing the impact of the eurozone's eastward enlargement on fiscal policy, it is crucial to take into account the fiscal stances in accession countries, together with their development perspectives, as well as the Community influence on shaping national fiscal policies.

3.4.4.1 Fiscal position and its middle-term perspectives in accession countries

Having described the evolution of the fiscal stances of current EMU Member States in the period of adjustment to the Maastricht fiscal criteria, as well as after the accession to the eurozone, we should analyse the current fiscal position of accession countries in order to draw conclusions regarding their perspectives of fulfilling the criteria in the next years. It is important to identify the main problems, as well as evaluate the consolidation programmes which governments of these countries are going to implement.

Current public debt levels in the accession countries depend very much on initial levels. The countries which started with high debt levels (41,8% in Poland in 2002) are still heavily indebted. On the other hand, the countries with a low level at the beginning of transformation have kept a lower indebtedness (in Latvia, for example, it is only around 16%). In some countries, however, notably in the Czech Republic, debt ratios started to rise. Nevertheless, none of the countries in question is seriously threatened with surpassing the reference value of 60% of GDP.

The budgetary situation in the accession countries shows significant differences. Deficit ratios to GDP vary between a balanced budget (Estonia) and a considerable deficit (Hungary, the Czech Republic). But still some general observations can be made and similarities found. This is particularly true for the group of four Central European countries – Czech Republic, Hungary, Poland and Slovakia, which had the highest deficits in 2001 and 2002. The budgets of these countries are characterized by a high proportion of so-called mandatory expenditure, for example on pensions and social benefits, which means that they are inflexible and difficult to reform. As a result, efforts to reduce expenditure in those countries were not sufficient to attain low deficits. Together with country-specific problems such as costs of restructuring the banking sector (most notably in Slovakia and Czech Republic), a pronounced economic slowdown (Poland) and political pressures to increase spending (Hungary), this has led to high deficits in those countries in 2001. Slovenia has also had to deal with the problem of high level of fixed spending in the budget, but its overall fiscal stance had been tighter than that of the four Central European accession countries.

Moreover, the phase of buoyant growth in recent years was not used for reducing deficit to GDP ratios in the Central Europe. In fact, deficits in most Central European countries were unchanged or on the rise in the period implying that the positive impact on growth acceleration was offset or even overcompensated by a worsening of structural balances. This contrasts with the developments in the Baltic countries. The Baltic countries faced a rapid increase in deficit ratios in 1999 attributable to the shock caused by the Russian crisis. Although the Russian crisis led to economic slowdown, fiscal positions were brought under control very quickly as growth re-gained momentum. While the Central European countries followed a pro-growth fiscal stance, this has not been the case for the Baltic countries, although the fiscal positions of Latvia and Lithuania could be facing pressures of planned tax and pension reforms, both causing deterioration of the budget balance in the short term.

In sum, two types of policies, which explain the increase in budgetary deficits, were applied in these countries. First, additional costs appeared due to the second phase of

budgetary reforms, which in the medium term should bring some relaxation to the public finances. Second, these were pro-growth expenses, which are a doubtful remedy for the economic slowdown and problems with public finances. This is so, especially in the light of change of the shape of the cycle, from a sinusoid looking like curve into a swinging up-and-down increasing trend. The stimulative role of the budget spending is taken over by a banking system with a low interest rate. When the rate is still high in a country, investors can borrow abroad, where interests are lower.

At present, many CEE accession countries have to face the problem of budget deficit reduction. In general, the budget deficit can be reduced in two ways: by increasing revenues or by decreasing expenditures. It is also possible to use both of the above methods at the same time and create in this way a third method, which constitutes a policy mix, applied on both sides of the budget (increasing incomes and reducing, restructuring expenditures).

An increase of revenues can be obtained generally in two ways: by diminishing taxes and increasing turnover, which means increasing total revenues with reduced unit taxation, and by increasing taxes. Increased taxes (direct and indirect) result in diminishment of investments and end up bringing about tensions to the budget revenues. In the short term they fulfil their task of increasing revenues. In a longer term, however, the increase of taxes can result in an acceleration of the disinvestment process, especially in conditions when a number of countries apply different fiscal policies and liberalise capital flows internationally. This is the case with most developed economies, which have liberalized the flows of capital (long-, medium-, and short-term) to a different degree in different economic groupings, e.g. the deepest liberalization took place within the Single European Market, a rather complex liberalization we can observe within OECD, and the medium one within WTO.

The difficulties of most EMU Member States in adhering to the fiscal requirements of the Maastricht criteria derive from the fact that while preparing for EMU membership, the countries decided to increase tax burdens in order to reduce their budget deficits. This has worked but the effect was rather short-sighted. With the passage of time the budget revenues started to shrink as business was sluggish. The economic slowdown was not simply a result of the shape of the cycle (which was flattened by an increase of international division of labour, especially by the move from inter-branch to intra-branch specialization). It was caused by de-regulation of the economy, which appeared as a result of the increased taxes. Generally, it does not matter which type of taxes are increased (direct or indirect), as each of the tax burdens works in same direction: it collects money from investors or consumers, reducing in this way demand or savings. Both direct and indirect taxes have their impact on decisions

concerning buying goods and services, financing investments, and they influence the availability of capital on the money market (savings).

A change in personal income tax affects disposable incomes of the households, and thus affects consumer demand. Such an interdependence makes it is possible to stimulate consumer demand, that is, to make the demand fall by increasing income tax and stimulate its growth by decreasing this tax. However, the rate of income tax is a politically sensitive issue and its increases and decreases can become subject to lengthy policy discussions.

A change in corporate income tax affects the expenditures of the enterprises, and thus can attract investments. This tax policy instrument is considered to be one of the most important investment incentives as far as FDI inflows are concerned. Both EU and CEE countries use various kinds of tax breaks and reductions. Ireland provides a good example of such a policy; low corporate taxes – through the stimulation of an inflow of foreign direct investments – allowed the country to reach the highest rate of growth in the EU. As far as the accession countries are concerned, such measures have been applied by the Czech Republic, Hungary, Latvia, Poland and the Slovak Republic.

A change in the rate of value-added tax lets the government redistribute households' consumption over time. Hence in situations of economic overheating it is possible to increase temporarily the value-added tax and thus reduce private consumption. When the economy is slackening it is possible to do just the opposite, that is, to increase private consumption by a temporary reduction of VAT. The variations in the rate of VAT affect consumption through two different channels, because the temporary change in VAT:

- alters the relative price of consumption in different periods;
- changes the general price level which in turn affects the households' real disposable income.

Moreover, one should remember that changes in the VAT rate have to be made effective as soon as possible after they have been decided. Otherwise, when the households become aware of a future VAT increase, they might step up consumption just before the change is implemented, and similarly – they can postpone consumption just before the tax is decreased.

After analysing different fiscal policy instruments it is worth pondering how they should be used in order to reduce the budget deficit. If we review the history we can notice that methods of budget deficit reduction applied by different countries reduced their budget deficits very gently at beginning of 1990s and more rapidly in late 1990s. In general, tax policy should depend on the state of a given country's economy, that is, different solutions can be applied during different phases of international economic development.

To sum up, decisions leading to an increase in taxes accelerate processes, which otherwise would be difficult to undertake from a political point of view. The decisions have a direct impact on:

- stimulation of disinvestment and acceleration of structural changes of the economies, in which an increase of services is expected;
- they stimulate outflow of capital to economies which are in chronic need of money (transforming economies, catching-up economies, developing economies);
- they stimulate decisions in the EU, leading to further deepening of economic integration by introducing some coordination in the field of tax policy.

If a given economy aims at budget deficit reduction, it should implement a policy based on a decrease in the tax burdens. This is the most effective method, as it stimulates both investments and consumption, and – in a longer term – it leads to an increase of the given country's budget revenues.

The implementation of a tax burden reduction policy will lead people to increase consumption, which in turn can lead to a rise in the current account deficit. Hence if the aim of the CEE accession countries is to reduce their current account deficits, they should use some tools in order to counteract that effect. This can be achieved by implementing a policy of encouraging savings. Such a policy will relax the pressure on increased consumption and thus on the current account increase. But is it really necessary to reduce a considerable current account deficit in the case of CEE accession countries? This seemed to be correct in a national, protected economy.

Nowadays, however, in an internationalized environment and open economy the approach should be to stimulate consumption and turn potential markets into real consuming ones. Production is moving into those potential markets, enabling them to self-finance their consumption by creating jobs and decreasing costs by lowering wages and other competitive advantages, especially higher rates of productivity growth. Under these new circumstances, one has to look at the interdependence between fiscal policy strategy and current account balance in a different manner. The increasing current account deficit cannot be seen as a factor limiting the range of choice of fiscal policy strategies. Fiscal policy should go through deep reform reducing the tax burdens and ending with a flat tax rate, which would embrace CIT, PIT and VAT. Moreover, there is also no need to diminish current account deficit by increasing the level of savings. An economy with an open capital market can develop without specific stress put on stimulation of savings, which can be considered to constitute a difference in comparison to a closed capital market economy, in which savings are required to be close to the level of investments. At present, differentiation in the development of regions (groups of

countries) stimulates transfers of capital and in that way stimulates growth without forcing savings. In such circumstances, savings grow in parallel with wealth development but they still lag behind the investment requirements. An economy applying a catching-up strategy can use savings from countries that have reached higher levels of development and thus are characterized by higher levels of savings. Moreover, in developed economies there are additional conditions which stimulate the outflow of investments, that is: limited flexibility of consumption (in comparison with catching-up economies), relatively lower interest rates as well as rates of return on investments in field of consumer goods. In time, along with the growth of wealth, savings in catching-up economies will grow, which in turn will allow these countries to invest abroad according to the same pattern, as more developed economies invest in their economies today.

As far as the present level of current account deficit is concerned, in Poland, for instance, it shows a tendency to decrease, which can be ascribed to appreciation of the euro, which increases the competitiveness of Polish exports. Of course, this situation cannot be considered permanent. Going beyond the period when euro started to appreciate, one can notice that – after a period of deterioration – the current account deficit in Poland started to decrease, indicating an increase of competitiveness of the economy (brought about by FDI flows and the process of restructuring of the economy). However, the time perspective in which both savings and the current account deficit can converge with the levels of today's EU Member States is difficult to predict. It can take 20-30 years to apply proper policies (deregulating the economy, increasing the competitiveness of production, labour market flexibility, opening trade with third countries, lowering taxes, developing infrastructure, etc.) and see their results. It can be done quicker with the opening of Commonwealth of Independent States' (CIS) economies under the condition that they will continue to grow and restructure. Moreover, if the EU integrates politically, current account deficits of the accession countries may be reduced in a technical way; the countries concerned will become in this case a part of a bigger market, which would probably experience a surplus bigger than the sum of CEE countries' current accounts deficits.

Apart from that, it is also not advisable to implement an economic strategy of import substitution. Such an approach suggests an active industrial policy, moving investments to "any" type of production, of products being imported. The strategy of import substitution does not take into account certain conditions that characterize the economic policies of individual EU countries today. First of all, the division of labour is based on intra-branch division, not inter-branch, which means that strategy of import substitution is nearly impossible. Second,

the states have limited financial means with which to implement such a policy. Third, there are also limited tools available in the range used by individual countries to indicate that certain types of production should be required (in this case import substituting types of production). In sum, import substitution was applied in a different economic environment, and at present it could not be considered as most effective policy of production factor use.

3.4.4.2 Fiscal costs of accession to the European Union and perspectives of fulfilment of the Maastricht fiscal criteria

In all countries accession to the European Union incurs certain costs which can have some influence on their fiscal position. A significant part of the fiscal burden consists of costs of implementation of the *acquis communautaire* in the run-up to the EU membership. Such costs however will not disappear once the accession countries join EU. The applicants negotiated a bulk of transition periods which allow them to spread the necessary adjustments over longer periods. This means that the impact on budgets will be felt longer. The Polish Ministry of Finance estimates that the transfers from the central government budget to the EU will amount to about 1,7 to 1,8% of GDP per year. Poland will be a net recipient but many of the EU payments require contributions from the national budget. Actually, according to the estimates of the Ministry of Finance, the net transfers in the period 2004-2006 should be positive, provided that will be able to take advantage of the assigned structural funds.

It is as yet too early for definite declarations regarding future euro adoption by the accession countries. The economies keep growing. GDP rate was 3,5% recently, which makes a positive picture of the countries' policies, which were applied last year.

Nevertheless, all of these countries, with the single exception of the Czech Republic, intend to meet the Maastricht Treaty fiscal criteria by 2005. In the cases of some of them, a considerable adjustment shall be required, but overall, their fiscal situation is better than that of current EMU members at the beginning of their consolidation process.

None of the ten accession countries, except for Malta, has a public debt to GDP ratio exceeding 60%. Furthermore, the three Baltic States and Slovenia had a deficit below the Maastricht reference value already in 2002. On the other hand, the four Central European accession countries – Czech Republic, Hungary, Poland and Slovakia, have let their fiscal positions deteriorate considerably in recent years. Three of those countries – Hungary, Poland and Slovakia – are aiming for a deficit reduction in the next few years. Their strategies are outlined in their Pre-accession Economic Programmes (PEPs). It would thus be interesting to consider how these strategies compare to those employed by EU countries in the 1990s and how likely they are to succeed in attaining a lasting improvement in the budget balance.

Examining the budget consolidation programmes of the three countries aiming at meeting the Maastricht criteria for EMU membership, the positive conclusion is that all three are planning to rely on spending reductions, rather than raising taxes, to achieve this goal. On the contrary, they all introduced some reductions of corporate tax to 19-20%, which can result in acceleration of economic activities and thus be conducive to an increase in the budget revenues. As evidence of consolidations in EU countries in the 1990s shows, such strategies are more likely to succeed. However, another important factor determining the success of fiscal consolidations is their size and persistence. Half-hearted measures, particularly those based on one-off measures, are likely only to cause a short-term contraction of demand and then be reversed. Considering these arguments, the fiscal consolidation plans of Hungary may be a cause for concern. The strategy calls for reduction of some spending, but at the same time for increases in other categories and sweeping tax cuts. This raises doubts whether a considerable adjustment will actually be attained.

The strategy outlined in the Polish PEP also does not fully satisfy the criteria of a successful fiscal consolidation. The strategy relies to some extent on an anticipated economic upturn to attain an improvement in the budget balance. Meanwhile, the forecast of public expenditures suggests that the adjustment on the expenditure side will occur more in the form of small steps, than an extensive overhaul. Although this may be sufficient to lower the deficit below 3% of GDP, the improvement may prove not to be lasting.

Of the three consolidation programmes presented above, that of Slovakia appears to be the closest to the model approach. It includes several systemic measures aimed at lowering expenditures. If these measures are bold enough, the consolidation strategy could well attain the objective of a lasting reduction in the deficit together with all its positive consequences seen in those euro countries where such a strategy had succeeded.

3.4.4.3 Other issues related to fiscal stability

Both old and new European Union members should consider that each step towards further convergence of their economies has to be based on the principle of sustainable growth. In general, sustainable growth towards convergence can be defined in two ways. First of all, it concerns growth which respects the requirements of environmental protection. The second meaning of the notion covers all the aspects which eliminate (by applied policies) deep fluctuations in the rate of growth – so-called negative rate of growth – but it approves certain changes in the range of the growth indicators. However, the latter definition is quite general, especially in current conditions of deep deregulatory changes in the world economy; making

it more precise requires taking into consideration different groups of countries, as each of the groups is characterised by different prerequisites for economic growth of the states concerned.

In the case of CEE countries (the same applies to developing countries) the rate of growth can and should be higher than that of developed countries, as the level of productivity in this group is lower, and transfers of capital and technology as well as organizational skills can have a greater impact in stimulating productivity (hence CEE countries can reach much higher productivity rates than developed economies). At the same time, however, the rate of growth in core EU countries can also accelerate due to deregulation, reaching the levels experienced in the United States, which are still the highest. In both cases this requires special policies, addressed towards achievement of such results, as things will not happen automatically. If the process of catching-up in CEE economies is to be finished in a period of time shorter than 50-60 years, the rate of growth in these countries should reach 7-8%, while the rate of growth in EU core members should increase from 1-2% to 3-4%. This will be possible with:

- an accelerated process of privatisation,
- the creation of conditions to make the labour market flexible,
- further advancement of restructuring of the economy pushed forward by the introduction of a common currency (and conditions on which this move was predicated), appreciation of the euro (intensifying competition on internal market), eastern enlargement of EU and further liberalization of trade with third countries (e.g. close association with Cotonou, MERCOSUR; PCA agreements with CIS countries, etc).

To sum up, sustainable growth towards convergence understood as a positive and high rate of growth is not only desirable for CEE economies, but it is a must, which will enable these countries to implement the catching-up strategy. Achieving and maintaining the same rate of growth as EU Member States would mean either keeping the development gap or even increasing it, if EU core economies would accelerate to a 3-4% rate of growth. High and positive rates of growth seem to be the only method which can somehow guarantee a closer convergence of CEE economies with the economies of core EU countries.

3.4.4.4 The validity of the Stability and Growth Pact

When the start of stage III of EMU was approaching, some Member States (mainly Germany) felt that those provisions of the Treaty were not sufficient to ensure sound public finance that would not endanger the stability of the common currency. After a long debate a consensus was reached at the 1997 Amsterdam European Council, which on 17 June 1997 adopted a *Resolution on the Stability and Growth Pact*. Based on that political agreement the Council

adopted two regulations, which together with the above *Resolution* form the Stability and Growth Pact. The Pact took effect in full only after the euro was launched in January 1999.

The controversies about SGP have surged lately when some Member States broke the reference value of the budget deficit. The discussion escalated when the President of the Commission called the Pact "stupid". But are such restrictions really necessary? The benefits of budgetary discipline are obvious:

- sound public finance helps to maintain low interest rates which foster investment and growth,
- together with monetary policy they stabilize inflation expectations,
- by reducing the interest burden, they help to restructure public spending and reduce taxation,
- they allow an increase in public saving in order to cope with adverse economic consequences of an ageing population,
- create room for manoeuvre in case of adverse economic disturbances and asymmetric shocks.

Before the imposition of fiscal discipline on countries wanting to participate in the EMU, the state budgets in the EU mostly ran considerable deficits. In a monetary union there are even greater incentives to keep the public finance in the red. The cost-and-benefits calculus of running a deficit is evidently positive for the individual country, while negative for the union as a whole. Consequently, some restrictions had to be applied in order to prevent the EMU from falling apart. Excessive deficit procedure and SGP were, as P. de Grauwe pointed it, "a vote of no-confidence" of Member States in one other, but the lack of trust was underpinned by the historical evidence, that many EU countries failed to keep their houses in order.

Current fiscal developments in EMU countries support rather than diminish the importance of the SGP, in spite of the views of some of its critics. If, even with the SGP - its objectives, rules and sanctions - some countries did break the deficit limits, how it would be in the absence of any rules? Most of arguments against the SGP concern the fact, that currently, in the situation of not yet fully consolidated budgets in the EMU countries, with most of them still running deficits and obliged to service a considerable public debt, during an economic slowdown, which results in smaller budget revenues, the provisions of the Pact, with a 3% ceiling and financial penalties imposed for surpassing it, actually create additional burdens for the budgets, making them even harder to balance.

The European Commission indicates that euro area countries missed the opportunity to exploit the favourable growth conditions of the years 1999 and 2000 and to consolidate their public finance. In the euro area as a whole the rate of growth-adjusted primary balance deteriorated in 2000 and 2001. Taking into account the positive output gap during those years

the conclusion is that the policy in the euro area was hampering growth. Failure to consolidate public finances in times of rapid growth constitutes the main reason for the inadequate room for automatic stabilizers and rapidly deteriorated budgetary stance in the subsequent slowdown. The current troubles with the SGP point to a failure of enforcement mechanism based on peer pressure rather than of rule-based fiscal policy strategy. Moreover, fiscal policy could learn a lot from monetary policy, where rule-based strategies have been successfully applied for at least a decade.

Questions about whether the quantitative rules provided by the SGP are adequate for all Member States are not appropriate in the current stage of economic development and international relations. Budget expenditures are no longer considered to be an instrument for stimulating growth because this role has been taken over by the level of interest rates, which determine the conditions of credit and investment. Capital flow liberalization increases the role of this new condition for investments as stimulants to national economy can come from outside by increased imports of goods pulled by foreign investments in national enterprises. This is the result of a simple mechanism: low interest rates in an economy can be used at home or abroad. Investments abroad stimulate imports from the country of origin of the investor. Nevertheless, this impulse can be sustainable only in specific conditions, which means the introduction of an environment conducive to entrepreneurship. This means deregulation and reduction of tax burdens. In other words, the doubts about the effectiveness of the SGP can be rejected but this requires a new approach to incentives that stimulate growth and dissemination of such a philosophy.

3.4.4.5 Fiscal centralization in the European Union

Government budgets are responsible for resource allocation, income redistribution and economic stabilization. As a consequence, much of the debate on the need for fiscal integration revolves around the question of whether these functions should be provided by national or by supranational authorities. In the past, most crucial decisions in the shaping of European integration were taken from political, rather than by economic, motives. Although there are no reasons to believe that the decision-making process will change substantially in the future, it is important to ascertain if a rationale for or against fiscal integration can be established in terms of economic efficiency. The researchers' attention has been recurrently drawn to this issue, in the European and in other contexts. Theoretical assessments of the appropriate level of responsibility over fiscal instruments essentially consist of analysing the three budgetary functions in light of three criteria: the existence of significant cross-border spillovers, of economies of scale and of political homogeneity.

In the EU, and in most other market economies, the allocation function of domestic budgets is mainly directed to the supply of public goods such as defence, health and education, which usually account for the majority of public expenses. Defence activities generate important externalities, and economies of scale could be exploited by provision at the EU level. On the contrary, in relation to health and education, not only are the spillovers less important, but there also appears to be a lack of homogeneity in preferences across member states, thus suggesting that responsibility over these issues should remain national.

The distribution function contributes to the spatial harmonization of incomes and to the abolition of economic disparities. It is particularly important in regions prevented from using some macroeconomic instruments, as is the case of members of a monetary union. In fact, the absence of redistribution mechanisms may expose economic blocs to social, political and economic tensions that may become unbearable if persistent. In purely theoretical terms, it is suggested that this function should be performed by the higher tiers of government, which in the case of the EU, would be the Community level. However, in the absence of a common budget, the transfers necessary to assure an efficient distribution function would have to be provided by the richer countries. Such a situation, if prolonged, is also unsustainable as it is not easily accepted by those countries' public opinion and is therefore prone to political exploitation. As a result, the distribution function is implemented mainly in the context of the EU regional policy.

The existence of considerable externalities deriving from domestic fiscal policy actions is one of the most often cited arguments for the centralization of fiscal policies in a context of integration. Another justification relates to the benefits of sharing the risks of random symmetric shocks. In fact, if such disturbances occur, member states may lack the incentive to take the appropriate measures, as part of their effort will be reflected in their partners' economies, thus reducing the effectiveness of national fiscal procedures. In such circumstances a more adequate reaction would result from a centralized fiscal policy.

The problem of redistribution can be solved beyond the budget structure, and the EU institutional and legal systems are prepared for such a move. Nevertheless, before we explain how this can operate, it should be clearly stated that certain coordination of fiscal policies is required, as current solutions will result in competition in lowering taxes – a situation, which is desired but in the longer run can bring dangerous outcomes. Returning to the new distributive role of the EU system, one has to mention the liberalisation of capital flow, which should, in a natural way, stimulate growth in peripheral and neglected areas of the internal market. This will be so especially when one turns the attention of investors to the fact that areas which

are, c.p., catching up give higher returns, because of higher rates of productivity growth, as they start from lower levels of development. In addition to capital flows (internationally) there are international finance and economic organisations (banks) that can take over the distributive role of the EU budget. The money used here will come from taxes of the Member States, but those taxes will not increase over time without the approval of the Member States, as they will be granted in a form of credits, which means that after a certain period the capital will return to the institution which granted the credit.

At the beginning additional transfers to those institutions can be expected, as most Member States possess excessive currency reserves, which are much higher than their needs, formed during the stage of national policy of exchange-rate stabilisation, while with the EMU those responsibilities are transferred to the EU level. It is sufficient to compare the size of currency reserves of the United States and France (low level) to size of reserves of the United Kingdom, Germany, Poland, etc. In other words, the new situation requires adjustments in different spheres, which can result in lowering the burdens of EU membership, accompanied by the possibility of higher transfers. This sounds paradoxical but cooperation would produce many surprises leading to a reduction rather than an increase in membership burdens. This conclusion is based on the assumption that aid transfers can be replaced by transfers of FDI and credits from international financial and economic institutions. In both cases the solutions are less costly for Member States, the transferred capital possesses an owner (which has a considerable meaning) and finally it is more effective in utilisation in comparison with the currently existing solutions.

This analysis produces arguments that are mostly in favour of a centralization of fiscal policies in a context of economic integration. Moreover, such a conclusion is reinforced in the particular case of monetary integration given that, in such a context, the instruments available to provide economic adjustment and stabilization following specific disturbances are scarce and the externalities of domestic policy measures are increased. Nevertheless, fiscal centralization was not an option in the EU. It has been considered that, even in cases of evident externalities, scale economies and political homogeneity, fiscal policy centralization would be a solution only if the alternative hypotheses of policy co-ordination or policy harmonization could not be envisaged (vide the subsidiary principle in the Maastricht Treaty). This was the case despite the fact that economic theory suggests that policy co-ordination or harmonization could be valid strategies only when monitoring by involved parties is possible. If this is not the case, non-compliance would be the rational option, thus making the decision to centralize the most appropriate one.

The after-EMU policy regime tends to strengthen the relations between an "active" monetary policy and a "passive" fiscal policy. It is an effect of the institutional framework within the eurozone. On the one side, a single independent bank, the ECB, is in charge of conducting monetary policy with a strong mandate for preserving price stability, explicitly defined as an inflation rate below 2% over the medium term. On the other side, the Stability and Growth Pact constrains the behaviour of the various independent national governments in conducting fiscal policy. In other words, the Pact calls for fiscal policy to be "passive" in member states.

3.4.4.6 Substantial institutional changes needed

The analyses of the fiscal developments in EMU countries bring up some very important conclusions for the process of eastward enlargement of the eurozone. Certainly, the new member states will face a much stricter environment than during the pre-accession period. The macroeconomic policy options compatible with the framework of new "member state with a derogation" could be severely limited, in particular if the country aims at a prompt adoption of the euro. A member state will be of course still free in its monetary and fiscal policy. However, the aspiration to adopt the common currency will push the national central bank to define price stability as its overriding goal in order to meet the Treaty criteria. Fiscal policy, under these constrains, could become unduly restrictive, in order to avoid an excessive deficit while still having to bear the burden of any adjustments necessary for the catching-up process, countering external imbalances, external shocks or simply reversible capital movements.

It is then apparent that the most important period for any new member state will start just after its accession but will not finish automatically after the adoption of euro. The attempts to comply with the EMU *acquis* can imply substantial changes in the institutional macroeconomic framework in the majority of new EU members. Budgetary policy will play a crucial role in this process. Fiscal adjustment will be the key instrument to overcome internal and external imbalances given the freedom of capital flows, the independent monetary authorities' goal of price stability, and the progressive reduction in the flexibility of exchange-rate policy.

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4. Conclusion and policy implications

The inclusion of eight Central and Eastern European Countries (CEEC) on May 1st, 2004, into the European Union (EU), and subsequently into the European Monetary Union (EMU) some years later, will cause deep changes within political, economic, social setting of the Union as well as in the new member countries. The enlargement forces the EU not only to reform its institutions to fit for a much larger number of member countries. Enlargement also means deeper economic integration. The new members will get full access to the European single market that allows for free movement of goods, services, labour and capital with their western neighbours. Over the next years, participation in monetary union will be a further step to include CEEC into the EU's integration process.

The project's underlying idea is that the new EU members in Central and Eastern Europe should continue to pursue an economic strategy of real convergence to the economic levels of the "old" member countries as rapidly as possible by securing sustained growth, e.g. by increasing private savings and by reducing the current account deficit. The attempt to catch up to EU levels has produced considerable progress indeed over the recent years because the new Member States have grown faster that the EU 15 since the mid-1990s by 1.5 per cent above the EU average. The GDP per head gap, however, is still considerable: In 2002, only Slovenia and the Czech Republic had a GDP per capita in PPS terms above 60 per cent of the EU average, Hungary above 50 per cent, Poland, Estonia and Lithuania around 40 per cent, and Lithuania just 35 per cent.

This report will discuss the implications of a "catch-up" strategy and have a look at the economic, political, social and institutional consequences for EMU enlargement. A process of CEE joining the eurozone, implying the reshaping of economic determinants that may lead to efficiency gains, has thus to consider economic adjustment and social costs as well because real convergence, based on sustainable increased growth, can only be a long-term process, lasting for decades. It comes at a time when all the EU members, old and new, have to adapt to a world experiencing rapid economic and social change and restructuring, as well as trade globalisation. They will also have to come to terms with the particular challenges that derive from an ageing population, growing immigration, labour shortages in key sectors and social inclusion problems. Failing real convergence[10] may jeopardize the benefits coming from EU accession and could even be a source of destabilisation for current members. It will be shown that monetary integration may fail if the CEE do not succeed in providing rigorous

[10] At this point it should be noted that real convergence is connected with other costly kinds of convergence CEEC have to strive for, e.g., nominal convergence that calls for meeting the Maastricht criteria when entering EMU, or institutional convergence aimed, e.g., at the implementation of EU legislation.

and comprehensive changes of their respective economic, political and institutional environment and care for appropriate social acceptance.

4.1 Exchange-rate policies

The project *Ezoneplus* has investigated the exchange-rate policies of CEECs. A concluding examination focuses on the time period from CEECs' attainment of the EU status of 'members with a derogation' until the ultimate decision upon their final conversion rates at the dawn of EMU. Exchange-rate policies deal primarily with the choice of exchange-rate regimes and their timing. In addition, exchange-rate policies are evidently linked to fiscal and financial policy issues respectively. Because of the prescribed fixed exchange-rate regimes in ERM II, the choice of central parities and fluctuation bands as well as the choice of final conversion rates vis-à-vis the euro are addressed in the following.

The starting point of our considerations is that CEECs' economies have to rely on sizable capital influx in order to stimulate growth and real convergence towards current members of EMU. The track of EU-enlargement has to be politically stabilized and the social acceptance of the course taken be maintained. Hence, the general trend towards real exchange-rate appreciation in CEECs fostering their catching-up is desirable and has to be maintained for a prolonged period. Though, the trend real appreciation in course of leaps in productivity as well as possibly due to erroneous economic policies is in peril of undermining the stability of the convergence process. The particular problem is that Maastricht criteria and especially ERM II stipulate the adoption of those kinds of fixed exchange-rate regime—i.e. so-called soft pegs—which are particularly prone to speculative attacks impeding the process of sustainable convergence. Accordingly, exchange-rate policies should be organized in a way that the risk of disordered devaluations and currency crises is at least reduced.

At the outset of EU-membership in May 2004 CEECs lose to a considerable degree their monetary sovereignty and exchange rate issues become a matter of common concern according to Article 124 (ex Article 109m) of the Treaty establishing the European Community. Decisions upon exchange-rate policies are shaped within specific areas of European governance. The according agreements lay the foundations for success or failure of CEECs' sustainable convergence towards current EMU-members. In the following, we ascertain the range of decision-making processes within this particular European sphere. The aim is to reveal imponderables and lacking institutional precautions of EU exchange-rate policy coordination.

First, we outline general interests of current and new members of EMU. Second, the institutional setting of European exchange-rate affairs is delineated. Although we refer to the ERM II, the insights can be generalized. Finally, we explain why CEECs have the upper hand

over exchange-rate regime choice. This applies to their exchange-rate policies prior to the Maastricht qualification process as well as with regard to their passing through the ERM II.

The stability of the convergence process is the main goal of both current and new members of EMU. This is a prerequisite for successfully completing the enlargement project in all its political, economic and social facets. The most obvious things to ensure sustainable convergence is, first, to keep CEECs as long as necessary at long range until these countries get their economies mature. Thus, CEECs should slow down their rush to EMU. Second, fluctuation bands should be as wide as possible in order to allow catching-up economies for equilibrium real exchange-rate appreciations.[11] This applies, third, also to the choice of central parities and in a similar manner to that of conversion rates. A final devaluation before entering ERM II—such as in the case of the Greek drachma which devalued by 13%—would counteract the negative impact of trend real appreciation on the stability of fixed exchange-rate regimes. This is also valid with regard to rather undervalued central parities[12] which may allow for absorbing devaluation pressure stemming, for instance, from exogenous shocks.

However, preparing for the EMU-club is not a free-lunch as nominal and real convergence can turn out to be conflicting objectives in the run-up to the EMU. The policy mix required particularly for achieving compliance with Maastricht criteria qualifying for EMU-membership is likely to slow down output activity and employment. The nature of the arising conflict between current and new EMU-members originates from both parties admittedly inclined to complete the enlargement process but less willing to burden the cots. Because the 'ins' are also interested in CEECs' sustainable convergence, CEECs will have leeway in passing some of these costs on to current members. Exchange-rate policy choice during the CEECs' run-up to the EMU reflects the then hard bout of haggling over sharing the burden of the costs involved.

Current EMU-members' general interest is evident: According to the Maastricht provisions applicant countries are incurred with all arising costs. CEECs shall stick to Maastricht and burden the costs entirely themselves. The current members' position regarding the ex-

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[11] However, even such broad bands might be not sufficient to prevent speculative attacks: In January 2003 speculators attempted to drive the Hungarian Forint (soft peg with a +/– 15\% band) above its upper limit and thus to trigger a revaluation of its central parity. Although revaluations do not really contradict the provisions of ERM II and the speculative attack was stalled, the occurrence of an attack points to the fragility of even such broad bands. In May 2003 the pendulum swung back: The central bank could not get the hang of excess inflation stemming from the run on the forint during the previous crisis in January. Therefore, devaluation expectations rose and the central bank was forced to devalue the forint's central parity to the euro at the beginning of June 2003.

[12] Generally, from an economic point of view, equilibrium exchange rates would be most favourable. They would neither distort purchasing powers, competitiveness, nor contribute to a redistribution of wealth, i.e. no effects on stocks of debts and claims. Yet to be added, it can be said that undervalued central parities favour agents accounting for debts denominated in domestic currency, but makes agents having obligations denominated in foreign currency worse off. The opposite holds for the case of overvalued central parities.

change-rate policy choice of CEECs is as follows: The legal provisions of ERM II allow for the time being only a few alternative exchange-rate regimes. Actually currency boards are not considered to be a substitute for participation in ERM II. However, accession countries that are currently operating with a currency board might not necessarily be required to, firstly, float their currency within ERM II before they, secondly, re-peg it to the euro later. Currency boards would offer accession countries an opportunity to draw on the ECB credit facilities quite directly and, thus, possibly impair the ECB's price stability objective. Moreover, an early accession, even unilateral euroisation, will provoke too much heterogeneity inside the EMU. This will seriously impair controlling in terms of monetary policy, for instance, because the transmission mechanisms of monetary policy and the functioning of automatic stabilisers in CEECs are still unclear. Therefore, a premature inclusion of CEECs will result in a mark-up on the euro's risk premium.[13] Most notably, however, the Council of Ministers would have no influence to determine the final conversion rates at which the accession countries enter the eurozone.

If both 'outs' and particularly 'ins' are interest in completing the present enlargement process, then CEECs will have leeway in passing some of the costs incurred on to current members. From the viewpoint of political economy, governments strive for office retention. In this sense, CEECs will hardly burden the entire costs. They will attempt to dampen the detrimental social effects of their run-up to EMU. In doing so, they constantly weigh the costs of maintaining necessary policies for Maastricht compliance against the hardship of voter alienation. This holds all the more so, as current members are interested in sustainable convergence of CEECs. The latter will not hesitate to give way to the according moral hazard. Basically, the most appropriate means of ruling-out exchange-rate turmoil impeding CEECs' sustainable convergence is (unilateral) euroisation. In addition, there are also some microeconomic advantages, for instance, the lowering of transaction costs and the transparency of prices. These would foster economic integration, both through increased trade and FDI. Euroisation may be advisable for extreme small open economies where trade is a considerable share of national income such as in case of the Baltic countries. In such countries a relative erratic exchange-rate performance would hamper any stabilisation efforts.[14]

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[13] In this respect, ERM II can be regarded as a measure to continue testing the operation of automatic stabilisers and channels of monetary policy in new member countries.

[14] Certainly, there are also some costs of replacing the national currency by issuing the euro such as the necessity of previously accumulating large scale currency reserves, the loss of instruments of cushioning exogenous shocks, the loss of seignorage, the loss of a lender of last resort etc. Whether a country should opt for unilateral euroisation as net benefits are possibly positive is in the end an empirical question.

Above all, however, the most striking difference to the prescribed soft pegs in respect of policy-makers' incentive structures is that unilateral euroisation can be very unpleasant to national voters as social and economic drawbacks can hardly be offset. On the contrary, rather the opposite is valid for soft pegs. Exchange-rate pegging gives front loaded benefits and delayed costs. Fiscal laxity would undermine a peg only after some time, forcing a discrete devaluation in the future. Assuming that the time horizon of politicians is sufficiently short, a government may be tempted to conduct fiscal laxity. When exchange-rate policy affects private citizens' welfare and accordingly their level of support for the government, the latter will favour relaxed budget spending. As a consequence, necessary austerity policies in order to strengthen the stability of a fixed exchange-rate regime and, thus, sustainable convergence will be delayed too long.

Fixed exchange-rate regimes are conducive to office-seeking policy-makers in CEECs particularly when these countries are already credibly committed to joining the EMU for political reasons. Some bigger CEECs will make use of the prescribed soft pegs at the latest during their passing through the ERM II. Threatening to put their sustainable convergence towards the EMU and the entire enlargement process at risk would enable CEECs to incur current members with a portion of the aforementioned costs. Accordingly, such policy stance is hereafter denoted as a *'threaten-thy-neighbour'*-policy. Whether CEECs can carry through their interests hinges upon the specific European governance structure.

The conflicting interests of current and new members regarding the distribution of the incurred costs are resolved in European intergovernmental bargaining. There will be a fierce bargaining for redistributing these costs. This dispute is settled in context of the European governance for exchange-rate policy coordination.

The basics of the institutional design of ERM II are as follows: According to the Resolution, decisions on central parities and the fluctuation band are taken by mutual accord of the ministers of the eurozone, the ECB and the minister and central bank governor of a respective accession country intending to participate in ERM II. The European Commission and the Economic and Financial Committee (EFC) are only consulted within this procedure.

Decisions concerning ERM II and exchange-rate issues in general are taken within this specific realm of European governance. On request of an accession country the above-mentioned parties can agree on narrower fluctuations bands than the standard one—such as has been the case with Denmark running presently a fluctuation band of +/– 2,25% margins.

Interestingly and in contrast to the provisions of the former EMS, all parties have the right to initiate a confidential procedure if central rates are deemed to be realigned. Ideally,

this procedure enables to reconsider central rates before they deviate too much from real equilibrium exchange rates and currency crises become inevitable. Though realignments in terms of devaluation would infringe on the provisions of the Treaty, revaluations of central parities are compatible with ERM II (Article 121, ex Article 109j).

While we can simply assume that the ECB and central bank governors are in general guided by price-stability objectives, the other decision makers might strive for entirely different goals. The new EMU-member country and the ministers of the eurozone—i.e. the 'euro-group', so to speak, an ECOFIN without the 'members with a derogation'—act as a forum for intergovernmental bargaining allowing for political compromise in terms of issue-linkages, side-payments etc. For that reason the resulting outcome regarding the determination of central parities in ERM II will most probably fall short of economic first-best solutions as regards the stability of the convergence process.

Countermeasures against CEECs' *'threaten-thy-neighbour'*-policy have to be deliberated within this institutional setting. Countermeasures comprise the above-mentioned broad fluctuation bands and devalued central parities as well as keeping CEECs at long range.

As regards the choice of broad bands, the problem is that sovereign CEECs can just as they like introduce small bands before entering ERM II. A subsequent widening of the fluctuation bands, though, will signal that both parties cannot agree on an appropriate exchange-rate regime. Accordingly, market sentiments might shift and cause a destabilising process putting sustainable convergence at stake. In addition, it is doubtful that CEECs put up with devaluetion. On the contrary, rather overvalued central parities and conversion rates respectively will allow these countries to import and consume more resources. When consumption possibilities positively affect CEECs' governments level of support, then they will push rather overvalued exchange rates ahead. Apart from central parities and fluctuation bands the timing of entrance to ERM II might be another subject matter of potential countermeasures. However, CEECs being sovereign countries can likewise as 'members with a derogation' choose exchange-rate policies up to their interests.

In summary, there are no institutional constraints within governance structures of exchange-rate policy affairs in ERM II to curb CEECs' moral-hazard behaviour. There are effective no countermeasures that enable current members of the EMU to keep new members in check; unless, the 'ins' can set up issue-linkages allowing for specific political compromises or change the rules of the game. The latter would require a revision of the Treaty Establishing the European Community which is very far beyond any plausibility.

Therefore, the only feasible option left to keep CEECs in check is to pay them for conducting prudent exchange-rate policies. Two solutions are conceivable: First, current members agree to (slightly) overvalued central parities in ERM II allowing CEECs access to more resources. Second, both current and new members agree on additional funds for CEECs. The latter would easily enable them to offset the costs of their run-up to EMU in terms of detrimental social and economic effects. In that way, the stability of sustainable convergence and a successful completion of the enlargement process would be ensured.

4.2 Sustainable capital flows?

Most observers agree that substantial capital flows towards the new member states are beneficial, because they allow a rapid catch-up without immediate sacrifices in consumption. Moreover, they follow elemental economic logic which suggests that poorer countries with a lower capital density should boast numerous investment opportunities and are thus attractive to foreign money. Too often, however, such enthusiasm towards a region or market has turned sour, which calls for some caution with the current development. The Asian crisis of 1997 and the burst of the new economy bubble are among the most vivid reminders. The question is, are current capital flows a sign of overinvestment in new members' assets, or do they reflect genuine profit opportunities? Whatever the answer to this question might be, it seems clear that most new members steer through troubled waters on their way towards the euro.

The Warsaw Stock Exchange (WSE) reports rocketing price/earning (P/E) ratios: In 1998 was the average P/E ratio at 16.3 which is in line with what most observers regard as healthy. In 2002, the average P/E ratio reached 101.5; and in 2003 it was a breathtaking 284.9. This means that the average company at WSE needs nearly 300 years of current profits to earn its valuation. Those who hold these shares obviously believe that profits will soar in the near future, and there are many reasons to support this. If, however, such a belief fails to materialise, share prices will have to fall substantially to realign P/E ratios with sustainable levels. Plummeting asset prices may then trigger a vicious spiral where banks amass bad loans, refuse further financing, and send prices down the drain. In course of such a spiral it is very likely that prices will undershoot reasonable levels and only gradually improve after the dust settles. Since early sellers reap highest prices, every investor would be fast at selling if he fears the beginning of a downward spiral. This explains why prices move violently as soon as they appear hollow. Even a wrong suspicion of overvaluation may become self-fulfilling in the end. If asset prices tumble and cause financial crisis the effect on the domestic economy may be devastating.

A high valuation, such as at WSE, must not necessarily be an overvaluation. It rather reflects investors' confidence in future profits. Nor must it be devastating if stock markets in the new members crash, because their importance is limited with a market capitalisation of 15 to 22 percent of GDP in the three biggest economies, Poland, Hungary, and the Czech Republic, compared to more than 67 percent in Germany and even 153 percent in the US. However, these figures may blur the relative importance of stock markets, because the capitalisations have to be related to other indicators of financial development. For instance, the ratio of domestic credit to market capitalisation is a little more than one in the US and a little more than two in Germany, indicating the higher importance of equity financing in the US. In Poland this ratio is 2.4; in Hungary 2.6, and in the Czech Republic it is 2.0—ie, close or below the German level. Hence, stock markets, though small, are still an important source of financing in the new members. Moreover, they might reflect a general trend that goes beyond publicly listed companies. If overvaluation takes place in regular stock markets then why not in other parts of the economy?

A high valuation may turn into overvaluation for basically two reasons: (i) Exogenous events compromise the initial profit expectations, and the adjusted calculations lead to substantially lower prices. (ii) Initial profit expectations have been hollow in the first place, but over-enthusiasm and speculation has driven investments further. Low yields in mature markets may also induce investors to take higher risks in emerging economies.

With regard to EU and eurozone enlargement, most investors attach a high probability to a by and large smooth integration—the so called convergence play—which explains the currently high valuation and the steady stream of capital. Although, this seems to be a fair bet, there is still a chance that things may not work out that way. The recent row over the EU constitution may give a taste of what may lay ahead. If convergence fails to materialise as successfully as predicted by most market participants, than a revaluation of assets may lead to a reversal of capital flows. True, the affluent EU member would jump to assist those in trouble, but it may become prohibitively expensive even for the wealthy countries to reverse downward market sentiment. The crisis of the first ERM system is a telling example. Moreover, if political tensions arise between old and new members, such as the row over Iraq, the appetite to help may be severely reduced.

The best insurance against overinvestment is efficient financial markets which deliver fair price signals on risks and chances. The new members from Eastern Europe have experienced modern financial systems for 15 years or less, which indicates that there is still some room for improvement. In the table we try creating a composite indicator on relative

financial development in the new member states by aggregating several normative measures which are usually deemed important in that respect. The division in quantity and quality reflects the notion that both are necessary to create sustained growth: Big financial markets facilitate capital provision and contribute to investments and growth, but may fall prey to over-enthusiasm and asset-overvaluation, unless intermediaries are sophisticated enough to assess risks appropriately.

Table

***Ezoneplus* composite indicator on relative financial development**[15]

Country	***Quantity***	***Quality***
Bulgaria	-5.2	-3.1
Czech Republic	5.6	4.7
Estonia	3.6	3.6
Hungary	3.7	0.8
Latvia	-0.4	-1.3
Lithuania	-4.5	0.9
Poland	-2.6	-1.9
Romania	-6.2	-3.9
Slovakia	2.2	2.0
Slovenia	1.0	-1.8

Data: World Development indicators (2003),
European Commission (2002), PRS Group (2004).

The Ezoneplus composite indicator (ECI) gives an impression of the relative performance of a country's financial sector vis-à-vis its peers. The average is zero. It cannot say whether the new members are generally vulnerable to financial crisis, but it illustrates where problems may be more acute.

The three top performers in the quantity division, Czech Republic, Estonia, and Hungary, have nevertheless different reasons for their success. The Czech Republic has a strong money and quasi money-base M2 as well as a liquid stock market. Estonia boasts a high market capitalisation of listed companies, albeit little turnover, and high volumes of domestic credit. Hungary, too, has substantial domestic credit and a liquid stock market. On the quality side, again the Czech Republic and Estonia stand out, in particular because foreign activities

[15] The quantity measure includes the following seven indicators: (i) Market capitalisation of listed companies (% GDP); (ii) stock market turnover (% GDP); (iii) domestic credit provided by the banking sector (% GDP); (iv) M2 (% GDP); (v) capital-account surplus (% GDP); (vi) gross capital formation (% GDP); and (vii) GDP per capita (at constant 1995 US$). These indicators are casually used to proxy the size of a financial sector. The quality measure consists of (i) net FDI inflows (% GDP); (ii) interest-rate spread in the banking sector; (iii) bank liquid reserves to asset ratio; (iv) the share of majority foreign-owned banks in total assets (%); (v) inflation (CPI); and (vi) the ICRG indicator on institutional quality. The *Ezoneplus*-composite indicator (ECI) is the sum of the *Z*-standardised values for each country. The ECI uses generally 2002 data where available, otherwise data of 2001. There were no comparable data available for a Romanian interest-rate spreads, thus we left it aside. Slovakia's current-account deficit is taken from 2000. The ICRG is generally from 2003. Bulgaria's share of foreign ownership in banking dates back to 1998.

have been strong: both indicators, FDI and foreign ownership in banks, are wide above the average. Slovenia suffers from its sluggish opening towards foreign capital, which is reflected by low foreign ownership and low FDI, mitigated only by a top rating for institutional quality. A similar pattern holds on the quantity side: Slovenia is a net exporter of capital which depresses its ECI, but it boasts highest GDP per capita as a balance. Since Slovenia recently started to embrace foreign capital, its ratings will surely improve in the future. Poland, the most populous new member, has FDI and capital formation far below average and high interest-rate spreads, which lead to the low scores in both divisions of the ECI. Unsurprisingly, Romania and Bulgaria, the latecomers expected to join the EU not before 2007, score lowest with slight advantage to Bulgaria.

Sustainability of capital flows may be in question whenever quantity outpaces quality; but fortunately substantial differences appear only with Hungary and Slovenia, and to a smaller extent with Latvia and the Czech Republic. The reasons for Slovenia's results have been laid out before. Hungary receives a high quantity ECI because of strong domestic credit and high stock market turnover; however, it looses ground on the quality side in particular because of high interest-rate spreads and low foreign ownership.

Lithuania is the only country where quality severely lacks behind quantity, which is good news to sustainability, but may also indicate forgone possibilities. Lithuania scores low in almost every aspect of ECI quantity, but in particular has a low volume of domestic credit. Since there is an obvious trade-off between size and security of the financial sector, Lithuania may have opted too stark for security.

The ECI, again, does only provide a picture of relative performance among the new members and those, Romania and Bulgaria, which are expected to arrive soon. However, if we pretended that one of the Asian-5 countries, South Korea, the Philippines, Thailand, Malaysia, and Indonesia, were in Eastern Europe and the year were 1997, the start of the Asian-crisis, how would they look like?[16] Indonesia for instance would have scored an ECI quantity of 8, but an ECI quality of only -1.3; the Philippines had an ECI quantity of 10.8 and ECI quality of -2.2. Only Malaysia and Thailand had above Eastern Europe quality but by far higher volumes (68.5 and 17.3, respectively). Though this comparison serves just at a quick illustration it shows that, far from perfect, financial development in the new members is on much more solid ground.

[16] We could not find comparable data on foreign ownership, thus, we left it aside. Since ownership was generally lower in East Asia, partly thanks to legal restrictions, this overestimates ECI quality.

Financing Real Convergence in CEEC – Three scenarios

The case for investments as a leading indicator for growth in the long run remains strong for it is theoretically compelling and empirically robust (Levine and Renelt 1992). To catch up to the EU15 living standards, the new member states have to invest more than they can currently save. The savings gap could be filled with foreign savings (net capital imports) or increased domestic private savings. Whereas it is assumed that foreign savings could compensate for the lack in domestic savings only in the short run, long run sustainable growth requires the CEE countries to provide their own savings to finance domestic investments, i.e. to attain an external balance in the economy. Net capital imports from the EU15 to finance growth could be interpreted as opportunity costs of the Enlargement for the "old" member countries as they represent savings not made available for investments in the EU15. The following three scenarios present these costs when it is assumed that 80% of capital is imported from EU15 countries. Scenario I extrapolates the status quo. Scenario II calculates accumulated costs for the EU15 if real convergence if financed – ceteris paribus – with increased capital imports. Scenario III reflects the idea, that sustainable growth is attainable only by a balanced current account in the new member countries and hence increased private savings.
The assumptions are as follows: EU15 GDP growth is kept constant at 1.5%. The sample of CEECs should catch-up to 75% of EU15 GDP in 2015 (Poland: 60%), the start year is 2000. We impose a linear relationship between investments and output change. Absolute values are expressed in purchasing power parity international US$.

Scenario I: Extrapolating the status quo

If the status quo is extrapolated to the future, i.e. the net capital imports and domestic private saving quotas remain constant, only the Czech Republic and Slovenia will reach the imposed convergence target. The EU15 will face accumulated costs of 618 billion ppp international US$ which represents 0.47% of the accumulated EU15 2000-2015 GDP.

	GDP 2000	Current account 2000 (% GDP)	GDP 2015	% of convergence target	Accumulated costs for the EU15 2000-2015 in billions	% of accumulated EU15 2000-2015 GDP
Czech Republic	13868	- 5.23	22545	99.15	122,96	0.09
Estonia	10183	- 5.72	18690	82.20	14,08	0.01
Hungary	12228	- 2.85	17589	77.36	54,49	0.04
Poland	9844	- 6.34	16982	93.36	411,22	0.31
Slovenia	16486	- 3.02	23599	103.79	15,3	0.01
All countries					**618,01**	**0.47**

Scenario II: Financing real convergence through net capital inflows

If the countries are supposed to reach the convergence target in 2015, implying an external balance, the costs for the EU15 nearly double to 1135 billion representing 0.86% of accumulated EU15 GDP. Current account deficits would rise substantially by 1 to 18,4 % per year except for the case of Slovenia.

	Current account 2000 (% GDP)	Current account 2015 (% GDP). Growth rate of capital imports in ()	Accumulated costs for the EU15 2000-2015 in billions	% of accumulated EU15 2000-2015 GDP
Czech Republic	- 5.23	-6.07 (1 %)	133,99	0.10
Estonia	- 5.72	-24.55 (10.2 %)	38,39	0.03
Hungary	- 2.85	-35.90 (18.4%)	319,01	0.24
Poland	- 6.34	-12.63 (4.7%)	634,91	0.48
Slovenia	- 3.02	-0.84 (-8.2%)	8,2	0.01
All countries			**1134,54**	**0.86**

Scenario III: Sustainable growth – Substituting foreign capital with domestic savings

When it is assumed that current account deficits are not sustainable in the long run, transition economies are to finance the catch-up bit by bit by themselves. Then savings by households have to fill the financing gap released by lowering capital imports to zero in 2015 implying reduced consumption. Substituting foreign savings with domestic private savings implies the private saving quotas to rise from below 21% to more than 30% of disposable income. This policy would reduce the associated accumulated costs for the EU15 to 80 billion which represents 0.06% of accumulated EU15 GDP and 7% of the costs associated with scenario II.

	Savings quota of households (% of disposable income) 2000 in % GDP	Savings quota of households (% of disposable income) 2015 in % GDP. Growth rate of household savings in ()	Accumulated costs for the EU15 2000-2015 in billions	% of accumulated EU15 2000-2015 GDP	% of costs of scenario 2
Czech Republic	20.5	31.9 (3.0 %)	15,63	0.01	11.6
Estonia	14.5	44.8 (7.8%)	1,80	0.001	4.7
Hungary	13.3	44.5 (8.4%)	8,48	0.01	2.7
Poland	14.6	34.0 (5.8%)	53,82	0.04	8.5
Slovenia	12.7	15.4 (1.3%)	2,36	0.002	29.0
All countries			**80,02**	**0.06**	6.97

4.3 The social dimension

In the short history of eastward enlargement, migration stands out as the prime concern of those national governments most affected, Germany and Austria. Public opinion is still tilted against an immediate integration of labour markets between East and West. Rather ironically, however, policy-makers should be more concerned about too little migration than too much. With small international mobility costs of adjustment will be heavily concentrated in Eastern Europe, and asymmetric shocks will deviate an enlarged monetary union from its way of becoming an OCA.

So far, it seems, migration cannot function as a primary mechanism of adjustment for CEEC. One major reason, why migration is so low, concerns politics. In the negotiations on enlargement, Germany and Austria insisted on the postponement of a fundamental principle of the internal market: the freedom of settlements.[17] Free movement of eastern European workers will not be allowed before (max.) 2011. By that time, however, ambitious CEEC may have already entered ERM-II. Without freely adjusting labour markets between East and West this may be a serious problem if CEEC are hit by financial crises. Even more importantly, if, say, increasing unemployment, is itself a trigger for currency crises as some economists argue, lifting barriers to migration would not only reduce the actual pressure from national governments, but would also signal to markets that tightness of national labour markets will not spill over to capital markets.

Public sentiment is but one reason for the imposition of these legal barriers. Interest groups in Western Europe have also had their stake in the enlargement negotiations. In fact, CEEC have had to implement the full *acquis communautaire* of the EU, whereas the old member states have not. As a consequence and contrary to traditional fears of social dumping, which on an anecdotal basis may be right on their own, so far enlargement has been rather a burden for Eastern European labour markets than a source of alleviation via competitive advantages. Hence, for reasons of both economic efficiency and redistributive fairness, Western European governments should seriously consider whether to exert the full seven years of postponing freedom of settlements or not.

By far more intricate is the problem of non-clearing labour markets in Western Europe. With unemployment rates being around 10 per cent in continental Europe, incentives to migrate from CEEC to EU-15 countries are moderate at best. In combination with legal barriers to migration unemployment leads to skyrocketing numbers of informal and illegal

[17] Only recently, other EU-15 governments seemed to have joined the band-wagon by implementing similar legal provisions against Eastern European workers.

East European workers in Western Europe, some of whose jobs are highly precarious. It goes without saying that unemployment has numerous reasons. From a policy-maker perspective, however, an enlarged EMU will only become an OCA once Western European labour markets overcome structural deficits. Since public opposition towards such policies still remains fierce in most of EU-15, this will be only feasible in the long run.

In the short run, CEEC labour markets will be inflicted with costs of adjustment. Some studies claim an initial job loss of up to 1mn for all CEEC-10 in the first few years of EU accession. Costs of EMU accession will arguably be higher in the beginning. Moreover, people most likely to loose in the nascent process of enlargement are usually also those who are most sceptic towards enlargement and the Euro. As a consequence, CEEC governments will be put under additional pressure as demand for compensation will increase. Hence, the likelihood of implementing sound fiscal policies, as required by Maastricht criteria, may seriously dip down once the burden of structural adjustment is to start.

A first best solution to costs of structural adjustment is, of course, reforming national labour markets in Eastern Europe. The question, however, remains how big actually the room for manoeuvre of Eastern governments will be. Some of eastern European labour market institutions, such as non-employment benefits for example, have helped to spur growth and productivity in these countries. In the light of Ezoneplus, the scope of reform seems to be, *grosso modo*, limited,[18] and should be concentrated on those institutions that have a visible impact on national inflation rates. A prime channel to be investigated here is the so-called Balassa-Samuelson effect. Simply put, countries experiencing phases of high growth also see inflation on the rise, since there are spill-overs between economic sectors with different productivities. The degree, to which these spill-overs occur, however, crucially depends on national labour market and social policies. In brief, Eastern European policymakers are better including the inflationary impact of these policies at the eve of EMU enlargement.

Some Eastern European countries will readily embark on further reforms of the tax and social security systems as recent evidence shows. There is some evidence that the euro has sped up will to reform in Western Europe, but that this has been, so far, of limited consequence. Political opposition towards reforms exerted by the use of numerous political institutions such as parliaments, referenda or constitutional courts has halted these reforms in many countries. Similar things will apply to Eastern Europe, where only some of the smaller countries such as Estonia or recently the Slovak Republic seem to implement strategies that, ultimately would also challenge traditionally strong welfare states in, say, France or Germany.

[18] This does not deny the fact that for some countries labour market institutions need an overhaul.

Since the likelihood for such social dumping across the whole of Eastern Europe seems to be small, even in an enlarged currency union the problem is of limited gravity in the short run.

This all lends to the idea that, at least some, new members will demand more compensation, once they are members of EU/ EMU. There are politico-economic reasons to believe that the pleas of CEEC will be, at least partially, fulfilled on the level of EU cash transfers. A stylised model in which Eastern European countries merely exert their voting power in the Council of Minister shows that these countries could almost double their share of EU transfers (up to 20bn p.a.) by the use of crude political power. Moreover, some Western European governments, being under considerable pressure of national interest groups[19] themselves, might eventually agree to increases in their own contributions, as long as strictness of SGP rules is loosened. With the existence of barriers to cross-national migration, there may be even good efficiency-based arguments for such international redistribution. It is, finally, in the tradition of European integration to create new funds for deeper stages of integration; cf. the example of the Cohesion fund created in the Maastricht negotiations.

If such fiscal transfers from West to East are necessary for guaranteeing the political legitimacy of an enlarged E(M)U, an enlargement of the currency union nevertheless urges the need for further reforming the ways these transfers are allocated. EMU enlargement amplifies the need of efficient, i. e. least costs solutions, and numerous studies have shown that transfers should be focussed on genuinely poor regions and on fostering human capital investments rather than structural change per se. Moreover, EU cash should be made conditional on the implementation of structural reforms in social and labour market policies, such as strict administration of unemployment benefits or activisation of labour market policies. Another example would be in-work benefits that not only reduce fiscal costs relative to other measures, but arguably stir national inflation rates less than institutions that enhance general wage compression.

Welfare states of different types and sizes will lead to externalities which are difficult to handle for national governments in the long run. This problem will be enhanced dramatically by enlarging the currency union: whereas the heterogeneity of social policy preferences will increase through new member countries, the constraints for financing these preferences converge in a currency union. It is therefore not only politically, but also economically reasonable to think about how to reduce these externalities in the long run. The introduction of a

[19] Among these ‚interest groups' are also subnational regions that are recipients of sizeable transfers form Brussels either in the form of Common Agricultural Policy or Structural Funds. These regions have been seen to lobby heavily for the maintenance of their cash flows, even if this is to mean higher overall net contributions for the country as a whole.

pan-European safety net guaranteeing a social minimum is an important policy proposal to be pondered in the near future. The crucial task will lie in stirring mobility of factors of production where lack of coordination between welfare states stifles it, whereas containing mobility that is exclusively due to differences in the benevolence of national systems.

4.4 Institutional implications

In order to overcome the obstacles addressed in the previous sections, the European Union has to deepen its institutional reforms. The draft design of the European Constitution is an important step into this direction. Other institutional changes, however, might still get improved in both scale and scope. The key challenge for the EU comes with its simultaneous enlargement of both political and economic structures. While the new member states already adapted the *acquis communautaire*, their inclusion into European redistributive politics and regulatory decision making necessitates the anticipation of likely consequences.

As regards labour markets, Europe experiences far-reaching structural change triggered by the Euro. With the accession of new member countries which are socially and economically below the EU average, labour market institutions of the incumbent members get under increased pressure. This is especially true for established wage-bargaining systems and labour mobility. Within the next years, the EU has two address both topics. Especially in regard to established wage bargaining systems in Western Europe, national players will demand some sort of compensation for being exposed to Eastern European competition. Therefore a tighter coordination across Europe in terms of income policies and wage-bargaining could be helpful, especially if it is backed by enhanced reforms in labour markets. In addition, quantitative adjustments of labour markets are also greatly fostered by the adoption of a common political stance concerning migrants from so-called third countries. This would also be a highly efficient step towards solving the problem of rising shadow economies in most Western European countries.

Fiscal policy still remains an important means for European governments to cope with social imbalances and labour market distortions. As discussed in the section below, however, uncoordinated national fiscal policies might endanger exchange rate policies in the new member states, consequently, their accession strategy to the Euro. The EU already provides for a certain degree of fiscal policy co-ordination by the Maastricht criteria. As recent examples show, however, the lack of compliance of member states increasingly undermines the Growth and Stability Pact's capacity of co-ordination. On the other hand, the EU is unlikely to get the institutional backing to enforce fiscal compliance. The European constitution does not foresee a strong constitutional role of the Commission in European fiscal policy. On the other hand,

the economic circumstances of the member states may substantially vary influencing national demands for fiscal policies.

The performance of exchange-rate policy stems most notably from the formation of fiscal policy. The latter puts probably the stability of transitional exchange-rate arrangements in CEECs at risk. A breakdown would all EU-/EMU-members worse off in terms of output, employment as well as a smooth functioning of European decision-making processes. Therefore, there are incentives for internalising such external effects even in advance. Possible institutional consequences are retracting fiscal competencies from CEECs, i.e. centralizing fiscal policy on the European level; alternative: modifying the SGP in terms of controlling investive and curtailing consumptive budget expenditures.

The enlargement of the ECB board by new members has a major impact on European monetary policy. Although the new member states will not immediately join the Euro, their accession will alter the decision making structures of the board. With economically more heterogeneous members the optimal fit of European monetary policy is difficult to agree upon. Monetary decision making risks of suffering institutional deadlock. CEECs can be suspected to opt for growth promoting monetary policy in an enlarged eurozone fostering their real convergence towards the EU. In turn, a common monetary policy can be too restrictive, i.e. curtailing output and employment in CEECs. In this regard, ambiguous institutional changes within the decision-making process of the ECB can put the price stability of the euro at stake. This applies particularly when market sentiments expect the ECB to be too much inclined to CEECs' concerns and to accept possibly higher inflation in the periphery, thus, forfeiting credibility. Again, there are possibly external effects which make all EMU-members worse off. Possible institutional consequences are modification of existing transparency rules in the ECB. They may be designed to dampen volatile market expectations.

5. Dissemination and/or exploitation of results

Throughout the duration of the project, the participants have come up with a mixture of both more traditional ways of dissemination, such as publishing articles and reports and organising or contributing to regional conferences for multipliers in political and economic education, and more innovative means, by using extensively all sorts of information technology. The dissemination activities of the project consortium demonstrate the effectiveness of European research promotion. The project includes means of publication not just for specialists but also and especially for non-specialists.

5.1 The project's website: http://www.ezoneplus.org

Of particular importance has been the introduction of a special website of the project (www.ezoneplus.org). This website allows immediate access to a description of the project, to the outcomes of the research, and further project-oriented information. The site consists of seven components:

- Project introduction (objectives, methodology)
- Information on the partners
- Publications and Working Papers
- Links (categories: research cooperation, research institutes, EU, EMU, research engines, data and statistics, journals, important texts)
- Contact
- Newsletter
- Restricted area with access by project participants only

All project participants had been encouraged to contribute to the website's content by uploading research outcomes at an early stage and before printing. Over the reported time period from July 1, 2002, to June, 2004, Ezoneplus's website was accessed ca. 280.000 times, i.e., on average almost 12.000 times per month.

It is planned that the website can be publicly accessed until 31 March 2005.

5.2 Newsletter

The Newsletter could be subscribed by anybody via Ezoneplus's website. Its purpose was to provide information on events such as lectures, workshops and seminars; research outcomes such as discussion papers and publications; and project-oriented events and publications elsewhere. By mid-2004 the newsletter had been subscribed by 290 persons. Here is a synopsis of the publication dates and website addresses of the newsletters that have been issued:

December 2001	http://www.ezoneplus.org/incs/News/newsl1.html
February 2002	http://www.ezoneplus.org/incs/News/newsl2.html
May 2002	http://www.ezoneplus.org/incs/News/newsl3.html
August 2002	http://www.ezoneplus.org/incs/News/newsl4.
December 2002	http://www.ezoneplus.org/incs/News/newsl5.pdf
March 2003	http://www.ezoneplus.org/incs/News/newsl6.pdf
July 2003	http://www.ezoneplus.org/archiv/ezp_news_7.pdf
November 2003	http://www.ezoneplus.org/archiv/8th_Ezoneplus_Newsletter.pdf
April 2004	http://www.ezoneplus.org/archiv/9th_Ezoneplus_Newsletter.pdf
June 2004	http://www.ezoneplus.org/archiv/10th_Ezoneplus_Newsletter.pdf

5.3 Conventional ways of dissemination

As can be seen from the annexed list (annex 1), conventional ways of dissemination have been applied comprehensively, including

- publications (articles, reports, books), lectures,
- conferences (reports; summaries) and
- local/regional meetings.

All participating institutes and scholars were encouraged to contribute to an increased public awareness of the difficulties that may arise from an enlargement of the euro-zone.

5.3.1 Ezoneplus books

Bolle, M. (ed.) 2002. *Eurozone Enlargement – Exchange-Rate Choice and Adjusting Markets.* Berlin: Berliner Wissenschafts-Verlag. ISBN 3-8305-0350-4.

Bolle, M. (ed.) 2003. *Eurozone Enlargement – Reshaping Policies and Social Conflicts.* Berlin: Berliner Wissenschafts-Verlag. ISBN 8305-0576-0.

Bolle, M. (ed.) 2003. *Eurozone Enlargement – Exploring Uncharted Waters.* Berlin: Berliner Wissenschafts-Verlag. ISBN 8305-0834-4.

Caetano, J. (ed.) 2003. *The European Union Enlargement – Social and Economic Impacts.* Évora: Centro de Documentação Europeia. ISBN 972-9051-41-0.

Zukrowska, K. and D. Sobczak (eds.) 2003. *Eastward Enlargement of the Eurozone / Impact on Trade, FDI and Capital Markets*. Warsaw: Instytut Wiedzy. ISBN 83-89132-10-9.

Zukrowska, K. and D. Sobczak (eds.) 2004. *Strategy of EMU Enlargement. Background, Optimal choices, Consequences*, Warsaw: Instytut Wiedzy. ISBN 83-89132-13-3.

Zukrowska, K., R. Orsi, V. Lavrac (ed.) 2004. *Fiscal, monetary and exchange rate issues of the Eurozone* enlargement, Warsaw: Instytut Wiedzy. ISBN 83-89132-16-8.

5.3.2 Ezoneplus working papers 2001 - 2004

Working Paper No. 1: *M. Bolle, C. Fahrholz, H.-D. Jacobsen, T. Meyer*, New Risks Ahead: The Eastward Enlargement of the Eurozone, http://www.ezoneplus.org/archiv/ezoneplus_wp_one.pdf.

Abstract WP 1

Eastward enlargement is one of the hot topics in European economics. The accession of central and eastern European Countries (CEEC) into the European Union (EU) is accompanied by an extension of the eurozone to this region. This paper surveys likely outcomes and challenges of this specific feature of EU enlargement. Moreover, the ar-ticle represents the start of an international research project dealing with these questions. Research is structured along different markets. Hence, the impact of an adoption of the euro is analysed for capital and labour markets as well as with respect to exchange rate and monetary policies. Our main position is that the euro has in general beneficiary effects for the CEEC and the current EU in all examined markets. However, these benefits evolve mainly in the long run, whereas the short-term costs of adaptation to the new situation may be high. Although we believe that the present value of long-term benefits exceeds these costs, it is by no means clear that policy-makers will share this view. Due to the usual political-economy transformation, the assessment of costs and benefits may be different for politicians than compared to any overall perspective. If official policies become unforeseeable, so will private behaviour. International investors may reverse their capital flows, draining precious liquidity, and leading to currency and financial crises whenever they perceive the authorities' commitment to EMU less credible. This article highlights some thinkable mechanisms how any such crisis could evolve. It, thus, sets the agenda for further research, mainly, with the focus on appropriate policy strategies to keep adaptation costs as low as possible, minimise other external risks, without hampering the long-term benefits.

JEL-Classification: E0, E6, G3; Keywords: EMU, EU enlargement, monetary integration

Working Paper No. 2: Ezoneplus Participants, The Eastward Enlargement of the Eurozone: State of the Art Report, http://www.ezoneplus.org/archiv/ezoneplus_wp_two.pdf.

Abstract WP 2

European Monetary Union (EMU) and its enlargement to prospective members in central and eastern Europe is a politically highly desired process, given that everything works out smoothly. The future eurozone will show a much higher degree of heterogeneity than now. The CEEC are in the process of transition from a planned to a market economy. Despite considerable progress during the past decade, much remains to be done in economic, social, and political terms. However, it is important to note that monetary integration is not a stand alone project, but is preceded by the EU enlargement and its obligation to adopt the *acquis communautaire*. Both events will be mutually reinforcing: The *acquis* contains numerous rules and institutions to be followed or created by the prospective members, albeit enforcement will be a problem. The success of the eastward enlargement of the eurozone depends on these institutions and, thus, increases the costs of failure. On the other hand, a successfully introduced euro in the CEEC will facilitate the whole integration process.

Accession to the eurozone requires a tremendous structural adjustment in the CEEC. There are the obvious, formal requirements: the *acquis*, the fulfilment of the convergence criteria of the Maastricht treaty and the enlargement conditions laid down in the treaty of Copenhagen, and finally the renunciation of monetary autonomy. But these lead to more, subtle and deeper changes. Competition pressure will increase while at the same time the scope for public intervention will diminish. After all, this is believed to promote efficiency and prosperity in the CEEC, however, it may also prove to be strain at least for a certain time. Whatever the assessment of the net benefit of the eastward enlargement of the eurozone, there will be losers, in the applicant states as well as in the current members. It will be of utmost importance to

realise this, to compensate for the losses or to accept them, anyway, to be aware of the political tension that may arise.

This report is part of an international research project on the eastward enlargement of the eurozone (Ezoneplus) supported by the European Commission's Fifth Framework Programme. Research is conducted in three steps: First, the impact of EMU on markets is analysed. The euro will reshape markets in the CEEC as well as in the current euro members, because it sets new rules and incentives. Markets for capital and labour plus trade relations and the patterns of foreign direct investments are at the centre of interest. Second, the scope and constraints of economic policies are scrutinised, i.e., fiscal and monetary policies, but also the social dimension. At a later stage, this project will concentrate on the development of policy advice. Moreover, the issue of the appropriate exchange-rate regime during the run-up to the euro will be dealt with. It seems to be obvious that exchange rates are most relevant before the very adoption of the euro and cede their relevance afterwards. Hence, analysis and advice is needed right away, and there is no room to maintain the three-step design for this issue.

Working Paper No. 3: *H.-D. Jacobsen, A. Stuchlík*, Die Osterweiterung der Eurozone: Einige grundlegende Überlegungen zu Möglichkeiten und Risiken, http://www.ezoneplus.org/archiv/ezoneplus_wp_three.pdf.

Abstract WP 3

Once part of the European Union no "opt-out" means, for CEE applicant countries, that they will have to become members of the Eurozone as soon as they fulfil the Maastricht criteria. However, compliance with the Stability and Growth Pact and aiming at nominal and real convergence imply efforts which are significantly higher than the "simple" implementation of the *acquis communautaire*. Torn between completing their transformation process on the one hand and linking their economies as fast as possible to euroland on the other, most CEE countries face the risk of fixing their currency too eagerly, thus, being trapped to choose disinflation over growth.

This paper presents the increased risk potential across the most important policy areas: capital markets, trade & FDI, labour markets, exchange rate policy, and monetary and fiscal policy. Moreover, a brief comparison of the Czech Republic and Poland reveals the need for further specific country analysis, since CEE countries' exposure to possible risks of the Eurozone enlargement vary significantly.

JEL-Classification: E0, F0, P2; Keywords: EMU, EU enlargement, monetary integration

Working Paper No. 4: *A. Kemmerling*, Transition und Tertiarisierung, http://www.ezoneplus.org/archiv/ezoneplus_wp_five.pdf.

Abstract WP 4

This working paper surveys the relevant literature in both political science and economics to explain why and how the Eastward enlargement of the EU has been agreed upon. The focus lies on delivering a politico-economic account of EU's recent history. The comments stress the role of two findings. First, EMU enlargement may be considered as a necessary requirement for EU enlargement itself to take place. This adds to an understanding why the final outcome of the negotiations led to full membership as opposed to other alternatives. Second, such a full membership entails redistributive effects both across and within countries. This explains why full membership was renegotiated in sensitive policy areas, once the prime decision for enlargement had been taken.

JELClassification: H0, F0; Keywords: Political economy; EU/ EMU enlargement; bargaining

Working Paper No. 5: *T. Meyer*, The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets, http://www.ezoneplus.org/archiv/ezoneplus_wp_five.pdf.

Abstract WP 5

- Capital markets have undergone massive changes in the past decade; in Western Europe but of course more fundamentally in the Central and Eastern European Countries (CEEC).

- The euro has fostered the transformation of financial systems toward a more market based approach. Its impact in Eastern Europe will be even stronger.
- To ensure the success of EMU an active and open-market stance is required. The euro increases the cost of failure and thus provides a strong incentive to comply.
- Repercussion to current members will be stronger; hence, they will not allow any substantial deviation from the consensus economic policy.
- A common currency fosters capital market integration—i.e., liberalisation, deregulation, and consolidation of financial services throughout the currency area. Competition increases and will lead to higher efficiency.
- More efficient financial markets improve the allocation of capital and hence contribute to long-term growth and prosperity. The main vehicle is more and better investments.
- In the short run it will be important to avoid imbalances which might destabilise the CEE applicant states.
- Capital inflows to the CEEC might overshoot a sustainable level and be channelled into unprofitable investments. Eventually this money may be withdrawn all of a sudden undershooting the long-term level and depriving the applicant states of financial resources and leading to crisis.
- A prudent treatment of these flows requires a developed capital market, something the CEEC are only about to acquire. Hence, special attention should be given to the evolution of financial institutions and a sufficient regulatory framework. Applicant states should use foreign capital flows to promote capital market development—eg, in the form of foreign entry of banks.
- The adoption of the *acquis communautaire* and the Growth and Stability Pact provides a tested institutional framework and macroeconomic stability. Both support financial development.

JEL-Classification: G1; Keywords: Capital Markets, Transition Economies, EMU

Working Paper No. 5A: Project Participants, The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets - Regional Inputs on Data and Statistics, http://www.ezoneplus.org/archiv/Working-Paper-5A.pdf.

Abstract WP 5A

The introduction of the euro is about to change capital markets in the applicant states as well as in the current eurozone. This paper tries to reflect recent developments in some of the eurozone's core countries, its two biggest economies, France and Germany, and Belgium, Luxemburg, and the Netherlands. External finance has gained much prominence in continental Europe. During the 90s, the amounts of outstanding stocks, private credit and bonds have soared in mature European economies. This has coincided with a number of developments – for instance, German unification, the completion of capital mobility, liberalisation and privatisation of big public utilities, most notably the telecom sector, the dot.com-bubble, the return of fiscal austerity as the economic policy of choice, and so forth. However, European Monetary Unification (EMU) has its stake, too. Capital market integration, brought forward by the euro, has enabled the placement of debt securities in new dimensions; necessary not only to buy fancy gadgets such as UMTS-licenses, but also to finance mergers and takeovers needed in order to consolidate corporate Europe.

Working Paper No. 6: *J. Kiander, R. Vaittinen, T. Paas*, The Eastern Enlargement of the Eurozone and Labour Market Adjustment, http://www.ezoneplus.org/archiv/ezoneplus_wp_six.pdf.

Abstract WP 6

This paper analyses the economic effects of the eastern enlargement of the EU both on the existing Member States and the candidate countries using simulation results of a dynamic computable general equilibrium model. In addition to conventional trade policy impacts such as custom union formation and common agricultural policy, the effects of factor mobility, induced by institutional changes, are analyzed. The analysis is based on six different scenarios. According to the results EU membership will accelerate growth in output, investment and consumption in the candidate countries in all scenarios. However, it turns out that factor mobility effects dominate those of conventional trade policy. Growth in national income will lag behind GDP growth because profits will be paid out to foreign investors. Migration will slow output growth in the candidate countries and accelerate growth in the existing Member States, while the trends in per capita consumption will be reversed; migration increases per capita consumption in the new Member States and reduces it slightly in the existing ones.

JEL-Classification: C68, F10, F15, R23; Keywords: Eastern enlargement of the EU, General equilibrium modelling, Integration, Migration, Trade policy

Working Paper No. 6A: *T. Paas, R. Eamets, M. Rõõm, R. Selliov, A. Jürgenson, J. Masso, A. Kemmerling*, Regional Input: Labour Markets, http://www.ezoneplus.org/archiv/ezoneplus_wp_sixA.pdf.

Abstract WP 6A

Western European labour markets show a considerable lack of flexibility in terms of employment and wages. In the beginning of the 21st century, two main events are expected to increase pressure for a more flexible job market in Western Europe: The European Monetary Union and the eastern enlargement of the European Union. European Monetary Union enhances pressure on labour markets in three respects. First it tightens fiscal policy in accordance with the so-called stability pact and thus forces governments to cut spending on social security systems. Labour market policies will have to find better ways to get unemployed people back to work more quickly. Second, since there is no room for devaluation of national currencies, opportunities for job creation by increasing exports are forgone, too. Third, the integration of product and capital markets in a common currency area will lead to more transparency. This fosters competition between firms and thus, again, market forces are going to cut bargaining power of trade unions and put wages and employment protection under pressure. If labour markets and institutions do not become more flexible, higher unemployment rates will be the consequence. The same results become true for eastern enlargement of the European Union.

Keywords : Statistics on Labour markets, Regional Input, Labour migration, Wage flexibility

Working Paper No. 7: J. *Caétano, A. Galego, E. Vaz, C. Vieira, I. Vieira*, The Eastern Enlargement of the Eurozone. Trade and FDI, http://www.ezoneplus.org/archiv/ezoneplus_wp_seven.pdf.

Abstract WP 7

The objective of this study is to examine recent developments in trade and FDI flows between the EU and the CEEC, trying to anticipate future consequences from the economic integration of the two blocks. Economic theory suggests that integration conveys positive effects upon welfare, due to the reallocation of resources and the restructuring of production and trade. The Eastern enlargement represents both an opportunity and a risk for the EU members as well as for the CEEC. As a result of the differences in size between the two groups of countries involved, it is likely that on average the CEEC will face the highest risks but may also experience the largest benefits. It is expected that both trade and FDI flows will increase with deeper economic integration. However, the free circulation of goods, services and capital over a wider geographic area creates opportunities for the exploitation of scale economies, which may lead to the geographical concentration of production. Therefore, in spite of the expected positive global effects, it is acknowledged that, during the transition period, difficulties may arise in those sectors, regions and firms confronted with new competitive challenges. In the CEEC, transition from centrally planned to market economies coexists with the plans for future integration in the EU. Both processes prompt internal and external liberalisation processes, with social and economic consequences that are difficult to predict. In order to develop a coherent study in such

a complex context, an attempt is made to integrate different analytical perspectives. The exhaustive assessment of the changes in the pattern of trade between candidates and current EU members comprehends an analysis of the global intensity of trade flows and of potential trade creation and diversion effects. The study also examines tendencies for sectoral specialisation and the evolution of the position of countries in the process of international segmentation of production. In respect to FDI, an empirical assessment of its main determinants is followed by the evaluation of potential diversion of investment flows from the EU periphery to the CEEC.

JEL-Classification: F15, F17; Keywords: Trade and FDI, Economic Integration

Working Paper No. 7A: *K.Zukrowska, M. Gracik, A. Pochylczuk, D. Sobczak, J.a Zombirt*, FDI and Trade. Exemplification of Poland and other Post-communist States, http://www.ezoneplus.org/archiv/ezoneplus_wp_sevenA.pdf.

Abstract WP 7A

Study is focused on mutual relations between FDI and foreign trade in economies going through systemic transformation after 1989. Its aim is to indicate: (1) how big were the streams of FDI inflows and outflows; (2) what were the institutional arrangements for liberalization of FDI and trade; (3) what type of impact had FDI flows on foreign trade: was it stimulated and if so, in what direction (imports or exports); (4) who were the main investors (states engaged in capital exports) and branches most attractive for investors. The study is illustrating a new approach to international economic relations in which assumption that production factors are not transferable internationally on large scale and thus stimulating foreign trade is replaced by an assumption that production factors are transferable and thus stimulating trade and in consequence wealth. They also increase interdependence within the process of integration on regional scale and globalization on worldwide scale. Study is aimed at showing scale of flows and their role in restructuring and deregulating the economies in transformation, bringing them at the same time closer to newly formulated division of labour in which globalization is a process seen as integration on a wider scale than during previous years within the divided world.

JEL–Classification: F02, F15; Keywords: Eastern Enlargement of the EU, Trade, FDI

Working Paper No. 8: *F. Iacone, R. Orsi*, Exchange Rate Management and Inflation Targeting in the CEE Accession Countries, http://www.ezoneplus.org/archiv/ezoneplus_wp_eight.pdf.

Abstract WP 8

We consider a small structural model to describe the transmission mechanism of monetary policy and the dynamics of inflation. We first verify the validity of the general structure estimating it for Germany which represents a sort of benchmark model. At least one of the links required for the transmission mechanism of monetary policy, when we analyse the Central and Eastern European Countries (CEECs), reveals to be not significant when considered on the whole sample. On the contrary the results are closer to a textbook description when the attention is shifted to the second part of the sample only. We interpret this as a piece of evidence indicating that the transition is indeed operating, but it is still ongoing and in some cases it is not complete yet. We also verify that the effects of the exchange rate on both the aggregate demand and on the inflation are in agreement with the economic theory. We conclude that the exchange rate should be actively used to control the inflation in the CEECs.

Working Paper No. 9: *R. Golinelli, R. Orsi*, Modelling Inflation in EU Accession Countries: The Case of the Czech Republic, Hungary and Poland, http://www.ezoneplus.org/archiv/ezoneplus_wp_nine.pdf.

Abstract WP 9

Inflation in Central and East European countries varied considerably over the transition phase, and econometric relationships between prices, money, wages and exchange rates are said to have been unstable during this period. In order to shed some light on the issue, this paper analyses some empirical models of the inflation process in the three earliest east European

transition economies: the Czech Republic, Hungary and Poland. Since the end of the 1980s these economies have experienced high rates of inflation, although significant disinflation measures were introduced during the mid-nineties to enhance these countries' chances of joining the EU, and they succeeded in getting inflation under control without high costs in terms of lost output. Given this, the determinants of inflation need to be empirically analysed not only in order to understand the disinflation measures, but also to assess the possible effects of future pressure on prices. Price stabilisation is an essential complement to the success of transition. Policies to contain inflation are necessary for transition economies to grow and firms to restructure. In the present paper, we first look at inflation within the context of multivariate co-integration, where domestic and foreign price determinants are initially assessed in separate blocks (each single-theory based) in order to obtain a number of long-term attractors. We then formulate consumer and producer inflation equations from more general VEqCMs for each country. The importance of theory-based imbalances (from previous co-integration experiments) in explaining inflation can be assessed at this stage. Our most significant empirical findings seem to substantiate the idea that many, if not all, theoretical determinants of inflation are of importance in those countries in question: the exchange rate and the output gap would appear to be of particular importance in explaining the phenomenon.

JEL-Classification: C4, E5; Keywords: Inflation modelling, transition economies, European Union enlargement

Working Paper No. 10*: R. Golinelli, R. Rovelli*, Monetary Policy Transmission, Interest Rate Rules and Inflation Targeting in Three Transition Countries, http://www.ezoneplus.org/archiv/ezoneplus_wp_ten.pdf.

Abstract WP 10

In 1991, the rate of inflation in the Czech Republic, Hungary and Poland was between 35% and 70%. At the end of 2001, it is below 8%. We setup a small structural macro model of these economies to explain the process of disinflation. Contrary to a widespread scepticism, which permeated a large part of previous research on these issues, we show that a simple open macro-economic model with forward looking inflation and exchange rate expectations, can adequately characterize the relationship between the output gap, inflation, the real interest rate and the exchange rate during the course of transition. We use the estimated models to interpret the main features of monetary policy in each country and identify the channels of policy transmission. We characterize the policy rules and assess the relative importance of the interest rate channel (on aggregate demand) and the exchange rate channel (which affects both aggregate demand and supply) in determining the path of (dis)inflation. In the same context, we also tentatively analyze the consequences of attempting a faster path of disinflation. Finally, we evaluate the appropriateness of the inflation targeting framework which has been adopted recently in all three countries, and discuss to what extent it represents a discontinuity with the past.

JEL-Classification: E31, E52, F41, P24; Keywords: Disinflation policy, Interest rate rules, Inflation targeting, Transition economies, Small open-economy macro models

Working Paper No. 11: *T. Paas, R. Eamets, M. Rõõm, R. Selliov, A. Jürgenson, J. Masso*, Labour Flexibility and Migration in the EU Eastward Enlargement Context: The Case of the Baltic States, http://www.ezoneplus.org/archiv/ezoneplus_wp_eleven.pdf.

Abstract WP11

The eastward enlargement of the European Union and the requirements of the European Monetary Union increase pressure for flexibility of labour markets. This paper analyses main changes in the Baltic States' labour market over the period 1990 – 2001 giving emphasis on the problems of labour market flexibility and migration in the EU eastward enlargement context. Labour market flexibility issues are analysed paying attention to wage flexibility and institutional flexibility (regulations, labour policy, trade unions) while labour migration problems are discussed giving emphasis on pull and push factors of migration and on labour migration experience during the previous stages of EU enlargement. In conclusion labour market flexibility is relatively high in all three Baltic States, being a bit higher in Estonia and lower in Lithuania. In all three states the

flexibility has declined in the course of transition. The weakness of the trade unions compared to EU has contributed to the high wage flexibility, while the insufficient funding of labour policies and high share of passive measures might have had negative effect on flexibility. Labour migration from the Baltic States into the EU15 countries will not be significant in the near future. Still the free movement of labour will have pressure on the labour markets of the Baltic States due to possible movement of better-qualified and flexible labour force and due to possible cross-border movement of workers in the Baltic Sea region.

JEL-Classification: J21, J30, J50, J61, J80, H50; Keywords: Labour market flexibility, labour migration, Baltic States, eastward enlargement of the European Union

Working Paper No. 12: *B. Yilmaz*, Turkey´s Competitiveness in the European Union: A comparison with five candidate countries - Bulgaria, Czech Republic, Hungary, Poland, Romania - and the EU 15, http://www.ezoneplus.org/archiv/ezoneplus_wp_twelve.pdf.

Abstract WP 12

The main purpose of this paper is to examine the international competitiveness of the Turkish economy and the structure of specialisation in foreign trade in comparison with the five EU candidate countries - Bulgaria, the Czech Republic, Hungary, Rumania, and Poland - and the EU/15. This research work attempts to find out Turkey's ability to overcome difficulties and challenges that might arise from the hard competition with the enlarged EU, mainly in the field of foreign trade.

JEL-Classification: F14, F15; Keywords: International Competitiveness of Turkish Economy, EU 15, EU Candidate Countries

Working Paper No. 13*: A. Kemmerling*, Social Dimension of Eastward Enlargement of the Eurozone, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteen.pdf.

Abstract WP 13

This report discusses both the reshaping of certain policy areas and the socio-political repercussions an Eastward enlargement of the euro-zone may have. The focus lies on the potential for social conflict enhanced by the enlargement process and their consequences for national policy-making. The paper first surveys some of the major socio-economic changes to be expected in the course of enlarging the euro-zone. This allows to isolate the sensitive segments and areas in which enlargement will arguably lead to costs of adjustment. Next, the paper discusses the political economy of major issues concerning national welfare states. It is shown that, whereas capital and goods markets are already in the process of reshaping, there is substantive political resistance against the flexibilisation of labour markets and social policies. This has implications for both national wage bargaining systems and national net contributions to the EU public budget. Two most significant projections are that the Stability and Growth Pact will be put under increasing pressure, since politicians will fear the negative consequences of fiscal retrenchment, and that CEEC will manage to double their share of EU transfers once they join EU and EMU. Finally, the report addresses ‘soft issues’ such as public opinion on the adoption of the Euro. The analysis of micro-data shows that although support is primarily driven by national legacies, welfare state institutions may well play a role in cushioning the short-term costs of *Ezoneplus*.

JEL-Classification: D6, H0, J0, F4, E6; Keywords: Labour Market, Social Policies, Welfare Economics, EU-enlargement, EU-budget costs

Working Paper No. 13A (WP No. 13 Supplement): *T. Paas, M. Rõõm, A. Sikk, R. Liiv, C. Schumann, and O. Szirko*, Social and political dimensions of the Eurozone Enlargement in the case of the Baltic States, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteenA.pdf.

Abstract WP 13A

This Regional Input is a supplement to Ezoneplus Working Paper No. 13 on the Social Dimension of the Eastward Enlargement of the eurozone. Political transition from authoritarian to democratic society has been extensive in all three Baltic States. The Baltic States are often examined together in political studies despite of the fact that there is much more variation

among these countries in the political sphere than in the economic and social spheres. The problems stemming from the political sphere might be even more crucial for EU enlargement because of their relative instability and slow working comparing that to the economic and social concerns. Therefore this study emphasises some major political differences between the Baltic States that should be taken into account when analysing EU eastward enlargement processes. The paper aims to analyze social and political dimensions of eurozone enlargement in the Baltic States emphasizing also negative consequences of transition and integration processes and their possible impact on EU accession.

Working Paper No. 13B (WP No. 13 Supplement): *A. Galego, J. Caétano, S. Costa*, The Eastward Enlargement of the Eurozone: Social and policy aspects in Portugal, Spain and Italy, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteenB.pdf.

Abstract WP 13B

This preliminary report explores some features of the social dimension of enlargement regarding the Southern EU-Member countries, namely Portugal, Spain and Italy. Economic theory suggests that integration may affect wages, employment and income distribution through changes on trade, FDI and migration flows. By removing all barriers to the free movement of goods and services, capital and labour, Eastward Enlargement will affect the location of economic activities, innovation and technology. Subsequently, the need for economic readjustments will impose extra difficulties at national, regional and sector levels. These aspects have been analysed in several studies, stressing that the regional and social dimension of enlargement as well as the effects on cohesion, have to be taken into account when conceiving EU policies.

Working Paper No. 13C (WP No. 13 Supplement): *A. Kemmerling*, Regional Input on the social dimension of Ezoneplus: Belgium, The Netherlands, France, Austria and Germany, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteenC.pdf.

Abstract WP 13C

Within Ezoneplus the Social Dimension is a hybrid in the sense that it addresses both the re-shaping of certain policies and the socio-political repercussions an Eastward enlargement of the euro-zone may have. Correspondingly, key questions to be answered can be grouped under two headings: Firstly, what kind of external shocks does EU enlargement, and more specifically, the enlargement of EMU produce on national and EU policies? The three policy areas here to be inspected are social security systems, labour market regulation, and EU structural and agricultural policy. Secondly, how do national societies and political systems respond to these new constraints? This implies both potential social conflicts enhanced by the enlargement process, as well as their implications for national policy-making. In order to combine both topics, we suggest an analysis using insights of modern political economy. In brief, this is to say that rational political actors act in response to Ezoneplus in a way predictable once the socioeconomic outcomes of the enlargement process have been analysed.

Working Paper No. 13D (WP No. 13 Supplement): *J. Kiander*, The Nordic Welfare State in the 1990s: Consequences of disinflation and fiscal consolidation in the three Nordic EU Countries, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteenD.pdf.

Abstract WP 13D

This paper reviews the current state of the so called Nordic welfare state and the experiences of Denmark, Finland and Sweden in the 1990s in adjusting their public sectors to fiscal consolidation. The economic crises and structural changes of the1990s are viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. Even after these hardships the Nordic model remains clearly distinctive and in many respects successful. Although the Nordic welfare model has survived many difficulties, there lie further challenges in the future. The most important of them are possible tax competition which may threaten the financial basis of current welfare systems, especially in Denmark and Sweden, and expected demographic change, which will add excess burden to the public finances within the next 20 years. However,

the all Nordic countries have a currently healthy fiscal surplus which gives them a better position than for most other Western European countries.

Keywords: welfare state, integration, Nordic countries

Working Paper No. 14*: C. Fahrholz*, Strategic Exchange-Rate Policy of Accession Countries in ERM II. http://www.ezoneplus.org/archiv/ezoneplus_wp_fourteen.pdf.

Abstract WP 14
Exchange-rate policies of Central Eastern European Countries (CEEC) have often been a subject matter. Yet, some new insights in terms of political economy considerations upon exchange-rate policy are provided. It is pointed out that it is more appropriate to analyse exchange-rate policy in course of Exchange Rate Mechanism II (ERM II) with regard to a changing incentive structure. In doing so, considerable moral hazard problems become apparent. ERM II shall provide for an adequate level of convergence between prospective and current members of European Monetary Union (EMU). However, this institutional arrangement and, particularly, its impact on the incentives for exchange-rate policy making might enable CEEC to load considerable costs of convergence onto current members. Accordingly, the phase of ERM II is considered to be a bargaining on the distribution of costs of convergence between prospective and current members of EMU. In return, accession countries would offer to maintain public support for European integration. The CEEC' leverage in this bargaining rests on brinkmanship, i.e. putting exchange-rate regimes at risk, thus possibly undermining the according public support. This paper delineates the basic assumptions and conditions for successful brinkmanship, points out the specific transmission mechanisms, and characterises this kind of exchange-rate policy as 'threaten-thy-neighbour'. Overall analysis results in a cautious outlook on probable effects of such strategic exchange-rate policies on European institutional and economic matters.

JEL-Classification: E0, F0; Keywords: brinkmanship, exchange-rate policy

Working Paper No. 15: *V. Lavrac, T. Zumer*, Exchange Rate Regimes of CEE Countries on the way to the EMU: Nominal Convergence, Real Convergence and Optimum Currency Area Criteria, http://www.ezoneplus.org/archiv/ezoneplus_wp_fifteen.pdf.

Abstract WP 15
Central and Eastern European (CEE) countries are expected to join the European monetary union (EMU) in a couple of years after their accession to the EU. According to the official views of the European Commission and the European central bank (ECB), monetary integration of CEE countries in the euro area should be a multilateral, successive and phased process, leading finally to their adoption of the euro.

The paper starts from the description of alternative exchange rate regimes currently in use in Central and Eastern European EU candidate countries. Their present exchange rate arrangements differ substantially, as they cover the whole spectrum of possible solutions, from currency boards to floating exchange rate regimes. By now it is known that these countries will first enter the EU and the ERM 2 (exchange rate mechanism, devised for the so-called pre-in countries, as a preparatory stage before their EMU membership), and only a few years later join the EMU and adopt the euro. The paper therefore tries to evaluate present arrangements of the candidate countries from the point of view of how compatible these arrangements are with the future ERM 2 and EMU requirements.

The paper addresses some issues which are still open in the process of inclusion of CEE countries in the EMU. First, what are the interests of both parties involved (CEE countries and the EU side) regarding the dynamics of the accession of CEE countries to the EMU, and related to this, what is its likely scenario (early or late inclusion in the EMU), taking into account the balance of powers between the two sides. Second, the paper discusses the criteria for measuring readiness of individual CEE countries for joining the EMU. The analysis is focused on the debate on nominal convergence (represented by the famous Maastricht convergence criteria) versus real convergence (catching up in economic development). In short, the discussion concentrates on the question whether monetary integration is possible and desirable among countries at a different level of economic development.

Finally, special attention is paid to optimum currency area criteria, not only as a theoretical background for monetary integration, but also as an additional insight into the measurement of relative suitability and readiness of individual candidate countries for joining the EMU. As an illustration, the paper attempts to measure some of the optimum currency area indicators for the case of Slovenia, and finds out that Slovenia is relatively quite suitable for joining monetary integration and relatively well prepared for joining the euro area. In particular, Slovenia is not expected to be exposed to serious asymmetric shocks, once Slovenia joins the EMU.

JEL-Classification: E0, F02; Keywords: Exchange Rate Regimes in CEEC, Optimum Currency Area, Slovenia

Working Paper No. 16: R. *Orsi, F. Iacone*, Exchange Rate Regimes, http://www.ezoneplus.org/archiv/ezp_wp_16.pdf.

Abstract WP 16

The CEEC are approaching the accession to the EU with a variety of exchange rate regimes. The authors find that these differences depend on economical factors as well as on the history of the countries. For that purpose, they discuss the role of the exchange rate in the stabilization of the inflation rate at the beginning of the transition from the central planning to the market economy, finding that, combining internal price liberalisation, openness to the international trade and a commitment to exchange rate stability the countries in transition – with the exception of Slovenia – provided the system with a nominal anchor by importing the price structure of the trade partners. Later, the capital liberalisation required for the progressive integration in the EU exposed the CEEC to speculative attacks and exchange rate pressure and most of them weakened the exchange rate commitment or withdrew it at all. The Baltic States are the only ones still maintaining a strong exchange-rate commitment. The authors conjecture that this is due to the smaller size of these countries, which makes the interest rates of the domestic currency of little importance to the economy when compared to the exchange rate. Policy advice completes this report.

JEL-Classification: E0, E5, F0; Keywords: Exchange Rate Regimes in CEEC, Optimum Currency Area

Working Paper No. 17: V. Lavrac (ed.), K. Zukrowska, D. Sobczak, M. Marzo: Final Report: Monetary and Fiscal Policy, http://www.ezoneplus.org/archiv/ezp_wp_17.pdf.

Abstract WP 17

This report reflects on recent trends in fiscal and monetary policies at the onset of EU-enlargement. Particularly, the authors focus on necessary adjustment processes for future EU-members. How to smooth best the transition period between "normal" EU-accession and eventual participation in the eurozone? Having conducted empirical regional reports, the Ezoneplus research consortium combines the results in two main parts: Katarzyna Zukrowska and Dominik Sobczak reveal trends and risks in fiscal policy issues, such as divergent consolidation policies in Western Europe, possible lessons for CEE countries and the importance of the Stability and Growth Pact. Then, Massimiliano Marzo elaborates a comprehensive picture of the impact of monetary policy, especially inflation targeting in three CEE countries.

JEL-Classification: *E5, F4, E 61, E 65*; Keywords: Exchange Rate Regimes in CEEC, Optimum Currency Area, Slovenia

Working Paper No. 17A (WP No. 17 Supplement): *R. Lättemäe*, EMU Accession Issues in Baltic Countries, http://www.ezoneplus.org/archiv/ezp_wp_17A.pdf.

Abstract WP 17A

After joining EU, the accession countries are expected to join the EMU and the euro-area. This cannot take place immediately after EU enlargement, as prior joining euro-area the accession countries should apply to the European Commission for entering EMU stage three and fulfil Maastricht convergence criteria's. There is no deadline, when accession countries should make

the decision to join euro-area. However, there is no opt-out clause for accession countries either, like there was for Denmark and UK in 1999. All accession countries are expected to join the monetary union in some stage. This paper analyses briefly the EMU accession issues in Baltic countries. In addition, a formal inspection of the OCA criteria in Baltic countries is carried out, using the structural VAR methodology. The results of Baltic countries are compared with the results of other accession countries and EU countries.

Keywords: Regional Input, Optimum Currency Area, VAR

Working Paper No. 17B (WP No. 17 Supplement): *J. Kiander*, Macroeconomic Policy and Performance in the Nordic EU Countries in the 1990s, http://www.ezoneplus.org/archiv/ezp_wp_17B.pdf

Abstract WP 17B

This paper reviews the macroeconomic policies and performance of the three Nordic EU countries. The experiences of Denmark, Finland and Sweden from the turbulent economic developments of the 1990s and from adjusting their public sectors to fiscal consolidation are illustrating, not least for the discussion of the future challenges of. The economic crises and structural changes of the 1990s as well as the choices done in monetary and fiscal policies can be viewed as a part of adjustment to integration and globalisation, especially to financial deregulation. In this paper the monetary and fiscal policies of the three Nordic EU countries is compared to the averages of EU15. The economic performance of these countries is assessed in terms of growth and employment. The main conclusions of the paper are: (i) the fixed (but adjustable) exchange rate regimes may be costly in terms of output and employment if they are not fully credible; and (ii) large economic fluctuations create easily equally large changes in fiscal balances, which may exceed the limits of the Stability and Growth Pact.

Keywords: welfare state, integration, Nordic countries

Working Paper No. 17C (EP No. 17 Supplement*): C. Fahrholz, P. Mohl*, Fiscal and Monetary Policy in Belgium, France, Germany, Luxembourg, and The Netherlands, http://www.ezoneplus.org/archiv/ezp_wp_17C.pdf

Abstract WP 17C

This regional input analyses recent developments and future prospects of fiscal policy (part I) and monetary policy (part II) of Benelux, France and Germany (EMU-5) covering the period of 1997-2004. The fiscal policy part concentrates on budgetary effects of the eastward enlargement. Besides, socio-economic developments are considered, as well. In context of monetary policy affairs, the heterogeneity of EMU-5 members is surveyed. The brief analysis of two main aspects of the monetary union – the GDP growth rates and the inflation rates – indicates that diversity among the surveyed countries still prevails.

JEL-Classification: E5, F4, E61, E65; Keywords: EU-budget costs, ECB, EMU, EU enlargement, fiscal and monetary policy, heterogeneity, Stability and Growth Pact

Working Paper No. 17D (WP No. 17 Supplement): *M. Marzo*, Challenges for Monetary Policy and the Enlarged Euroland, http://www.ezoneplus.org/archiv/ezp_wp_17D.pdf

Abstract WP 17D

The recent outset of European Monetary Integration with the introduction of a unique currency and a full centralization of monetary policy together with the increasing integration of global capital markets, stimulated a large body of research on monetary policy rules. Since Lucas' critique, the need to find rules which are at the same time simple and accountable has been a first goal for researchers and policy makers. In fact, policy can be effective only if it is credible. Credibility is enhanced thorough the adoption of simple, accountable monetary policy rules. However, the big question is: what kind of rules? This paper tries to address the critical aspects in monetary policy modelling with a special emphasis to euro enlargement.

Keyword: Monetary Policy Modelling

Working Paper No. 17E (WP No. 17 Supplement): *K. Zukrowska*, Monetary and Fiscal Policies in Poland and The Czech Republic in the light of an accession to the Eurozone, http://www.ezoneplus.org/archiv/ezp_wp_17E.pdf

Abstract WP 17E
The study comprises several contributions on monetary and fiscal policy problems in Central and Eastern Europe, starting with "Fiscal aspects of EU accession - Poland and Czech Republic" by Marcin Zogala, then Tomasz Jedrzejowicz looks at "The Maastricht-induced fiscal consolidation in EMU Member States - conclusions for accession countries". The third chapter is delivered by Jolanta Zombirt "Monetary and fiscal policies in Poland and Czech Republic in the perspective of EMU accession". Finally, and more strictly from a monetary perspective, Marek Rozkrut and Tomasz Chmielewski focus on Exchange-rate movements and the Maastricht 'challenges' in their contribution: "Monetary policy in Poland in perspective of accession to the EMU".

JEL–Classification: E42, E52; Keywords: Regional Input, Monetary Policy, Fiscal Policy, Poland

Working Paper No. 17F (WP No. 17 Supplement): *C. Vieira, I. Vieira, S. Costa*, Monetary and Fiscal Policies in EMU: some relevant issues, http://www.ezoneplus.org/archiv/ezp_wp_17F.pdf

Abstract WP 17F
The coexistence in EMU of one common monetary policy and several domestic fiscal policies raises a number of problems of both academic and political interest. First, there are reasons to assess a hypothetical need to also centralise fiscal policies in such circumstances, according to what prevails in federal states. Second, given that this hypothesis has not reached consensus in the EU, nor is it expected to do so in the near future, the issue of how to co-ordinate monetary and fiscal policies, in order to achieve the desired outcomes in both global and individual terms, arises. Third, the fact that policy spill-overs are enhanced in the EMU, the need to avoid free riding behaviour on the part of member states and the apparent non-reliance on financial markets to discipline sovereign debtors led to the option of restricting the autonomy of domestic fiscal policies by setting up constraints upon the relative levels of deficits and debts. Due to these restrictions, it is important to investigate the existence of alternative options in case of economic shocks that are specific to an economic area, or that do not equally affect all EMU members. Theory suggests that financial markets, when integrated, can provide relief by supplying the means to finance recovery. However, the lack of integration, uncovered by empirical analyses especially in peripheral EU areas, indicates that financial markets cannot be fully relied upon as mechanisms of adjustment. The current study analyses these topics of interest for monetary and fiscal policies in EMU.

Keywords: Regional Input, Monetary and Fiscal Policies, EMU

Working Paper No. 17G (WP No. 17 Supplement): G. *Caprirolo, V. Lavrac*, Monetary and Exchange Rate Policy in Slovenia, http://www.ezoneplus.org/archiv/ezp_wp_17G.pdf

Abstract WP 17G
The paper is divided in three sections presenting some stylized facts concerning monetary and exchange rate policy framework in Slovenia. Three periods are covered: Money-based Stabilization Policy (1991 -1995), Price and Real Exchange Rate Stability Dual Targeting Policy (1996-2001), and Exchange Rate Based Stabilization Policy and Accession to ERM2 (2001 -).

Keywords: Regional Input, Monetary Policy, Exchange Rate Policy, Slovenia

Working Paper No. 18 *V. Lavrac*, Institutional Aspects of Dynamics of Inclusion of Accession Countries into the EMU, http://www.ezoneplus.org/archiv/ezp_wp_18.pdf

Abstract WP 18
The main topic of the paper is optimal dynamics, i.e., timing of entry of the accession countries in the ERM 2 and EMU. Some of the crucial questions addressed in the paper are as follows: a) Should accession countries aim at an early or a delayed entry into the EMU? b) What are

economic and other arguments for an early or late inclusion? c) What are the institutional external constraints which may prevent an early inclusion of accession countries? Institutional rules of the phased process of monetary integration for the accession countries are not quite transparent and leave much room for discretion to the EU side. In such circumstances it is difficult for the accession countries to devise clear and consistent strategies with respect to the timing of entry in the ERM 2 as an interim institutional mechanism in the run-up to the EMU.

Keywords: EMU, ERM 2, monetary integration, institutional economics

Working Paper No. 19 *B. Yilmaz, S. J. Ergun*, The Foreign Trade Pattern and Foreign Trade Specialization of Candidates of the European Union, http://www.ezoneplus.org/archiv/ezp_wp_19.pdf

Abstract WP 19

The enlargement of the European Union will bring many political, economical and structural changes on the Continent, which require careful and deep analysis to be made. This paper will grasp the enlargement of the European Union from the aspect of the trade pattern and trade specialization of six major European Union candidates; namely, Turkey, Bulgaria, Hungary, Romania, Poland and the Czech Republic by focusing on the years from 1996 to 2002. In other words, the main purpose of this paper is to examine the international competitiveness of six candidate countries and to compare the structure of specialization in foreign trade with each other and the EU/15.

Keywords: Trade and FDI, Economic Integration

Working Paper No. 20 *R. Orsi, K.Zukrowska et al.*, Policy Advice: Markets and Policies, http://www.ezoneplus.org/archiv/ezp_wp_20.pdf

Abstract WP 20

This paper aims at the provision of applicable recommendations for institutions and actors involved regarding the EMU accession process both in CEE and in the eurozone. In order to provide topical advice, the first part, on markets, will concentrate on theory and empirics of labour markets, financial markets and foreign direct investment, whereas the second part, dealing with policies, will put emphasis on exchange rates, FDI, labour markets, and the social dimension. It turns out that benefits and losses of EMU accession may differ with regard to the different issue areas. To get to clear-cut recommendations, diverging impacts and their balance have been taken into consideration. Special regard has been given to divergent groups of winners and losers during accession, its impact on the political decision making process, and ways to compensate for them.

JEL-Classification: E0, E5, E6, D6, F0, F1, F2, F4, H5, G1, J2, J3, J6; Keywords: EU enlargement, monetary integration, economic integration, EMU, ERM 2, trade and FDI, financial markets, fiscal and monetary policy, labour markets, social policies, exchange rate regimes for CEE

Working Paper No. 21 *V. Lavrac.* Fulfillment of Maastricht Convergence Criteria and the Acceding Countries, http://www.ezoneplus.org/archiv/ezp_wp_21.pdf

Abstract WP 21

This paper first touches upon the definition and purpose of the Maastricht convergence criteria, and next analyses the rules, procedures, methodology and interpretation of meeting the Maastricht convergence criteria. It is shown how acceding countries presently fulfill the Maastricht convergence criteria and how the present EMU countries complied with them at a comparable time distance before their own entry in EMU. Some of the related issues, such as monetary and fiscal policy, coordination among economic policies and relationship between nominal and real convergence are dealt with only as much as they have a bearing on the fulfillment of the Maastricht convergence criteria.

JEL-Classification: E42, E62; Keywords: Maastricht convergence criteria, EMU, ERM2

Working Paper No. 22 The Berlin Group. Economic, Political, Institutional as well as Social Risks and Opportunities of EMU Enlargement, http://www.ezoneplus.org/ archiv/ezp_wp_22.pdf

Abstract WP 22
The inclusion on May 1st, 2004 of eight Central and Eastern European Countries (CEEC) into the European Union (EU), and subsequently into the European Monetary Union (EMU) some years later, will cause deep changes within the political, economic, and social settings of the Union as well as in those of the new member countries. This paper's underlying idea is that the new EU members in Central and Eastern Europe should continue to pursue an economic strategy of real convergence to the economic levels of the "old" member countries as rapidly as possible by securing sustained growth, e.g. by increasing private savings and by reducing the current account deficit. This report will discuss the implications of a "catch-up" strategy and have a look at the economic, political, social and institutional consequences for EMU enlargement.

JEL-Classification: D78, E20, E30; Keywords: EMU-enlargement, eurozone, (real) convergence

Working Paper No. 23 C. Fahrholz, P. Mohl. EMU-enlargement and the Reshaping of Decision-making within the ECB Governing Council: A Voting-Power Analysis, http://www.ezoneplus.org/archiv/ezp_wp_23.pdf

Abstract WP 23
The monetary policy of the European Central Bank (ECB) is the subject matter of this paper. We analyze the prospects for future price stability in an enlarged European Monetary and Economic Union (EMU). At the heart of this study are the potential effects of altering decision-making procedure within the Governing Council of the ECB on price stability in the eurozone. The authors compare the impact of three alternative reform scenarios of the ECB Governing Council with the help of a voting-power analysis. It is presumed that a considerable loss of current EMU-members' influence power especially in favour of joining Central Eastern European Countries (CEECs) results in a loss of monetary credibility of the ECB: As transparency of the decision-making process within the ECB is lacking, markets may consider the ECB to be too much inclined to the economic performances of the CEECs. This has then a negative impact on the level of price stability in Europe. The voting-power analysis indicates which reform proposal is best with respect to a price-stability benchmark.

JEL-Classification: D72, D78, E58; Keywords: power indices, Banzhaf, ECB, monetary policy, enlargement, eurozone. 2, trade and FDI, financial markets, fiscal and monetary policy, Maastricht convergence criteria

Working Paper No. 24 Oliver Pamp. Partisan Preferences and Political Institutions: Explaining Fiscal Retrenchment in the European Union, http://www.ezoneplus.org/archiv/ ezp_wp_24.pdf

Abstract WP 24
Driven by the desire to fulfil the Maastricht fiscal criteria and pressed by mounting debt burdens that have accumulated over the past 30 years, a majority of EU-15 countries attempted to reduce their budget deficits during the 1990s. Yet, these nations have exhibited remarkable differences in their ability to pursue such retrenchment policies. This paper endeavours to illuminate the political and institutional factors that can help explain those differing degrees of fiscal retrenchment in European Union countries for the time period 1990-2001. Several variants of the partisan approach and the veto players' framework are elucidated and applied to the question of budgetary consolidation. These elaborations yield four working hypotheses which are empirically tested using a time-series cross-section data set of 14 EU countries. The results lend support to the notion that a low number of institutional veto players increases likelihood and extent of a budgetary retrenchment. Given these findings it is possible to draw some conclusions concerning the effectiveness and deficiencies of the Stability and Growth Pact.

JEL-Classification: C23, D72, D78, H62; Keywords: deficits, fiscal adjustment, partisan theory, veto players, time series cross-section models

Working Paper **No. 25** Elena Bardasi, Chiara Monfardini. Women's Employment, Children and Transition: An Empirical Analysis on Poland, http://www.ezoneplus.org/archiv/ ezp_wp_25.pdf

Abstract WP 25

The effect of transition from centrally planned to market economies on female employment is unclear a-priori. Many studies have pointed out that the emergence of labour markets created obstacles to but also new opportunities for women's employment. A frequently mentioned potential explanation of the lower female participation during the transition period is represented by the reduction of childcare facilities, which created a major constraint on the participation of women with dependent children. However, we must not forget the effect of forces of opposite sign, first of all the household necessity of having two earners during the turbulent transition period. The aim of this paper is to give an empirical assessment on how the transition to a market economy affected the relationship between motherhood and labour force outcomes in Poland. We estimate random effects probit models on two PACO panel datasets covering a four year period before the reform (1987-1990) and a three year period afterwards (1994-1996). Our findings indicate that during transition small children were much less of a deterrent to the employment probability of their mother than it was before transition.

JEL classification: J13, J22, P23, C23; Keywords: female employment, fertility, transitional economies, Poland, panel data

An indicator on the download frequency of the Working Papers is being provided in Annex 3 which lists data on the access statistics via RePEc**,** the largest bibliographic database dedicated to economics and available on the Internet.

According to these data the number of file downloads, from October 2002 to August 2004, of the Ezoneplus Working Paper Series amounted to 4.448, the number of abstract downloads to 10.699 (see http://logec.hhs.se/scripts/seriesstat.pl?item=repec:ezo:ezppap).

These figures do only reflect numbers of downloads via RePEc, not the ones directly taken from the ezoneplus website.

5.3.3 Conferences and seminars

Conferences and seminars have turned out to be an integral part of the project's dissemination measures because they are an important vehicle for the creation of regional networks bringing together the institute's specialists and multipliers from academia, the business community, political institutions and the media.

List of project-oriented conferences

Date	Location and local host	Subject
18-21 Oct. 2001	Berlin: Freie Universität Berlin	"Eurozone Enlargement – Markets"
26 Apr. 2002	Berlin: Freie Universität Berlin; Humboldt Universität Berlin	Politische und ökonomische Dimensionen der Osterweiterung der Eurozone
4-7 July 2002	Bologna: University of Bologna	"Eurozone Enlargement – Policies"
21-24 Nov. 2002	Krakow: Warsaw School of Economics; Institute of Strategic Studies	"Impact on Trade, FDI and Capital Markets"

8-10 May 2003	Brussels: Freie Universität Berlin	"Eurozone Enlargement – Policy Advice"
12-13 Dec. 2003	Warsaw: Warsaw School of Economics	"Eurozone Enlargements – Recommendations"
17-19 June 2004	Berlin: Freie Universität Berlin	Final conference: "Eurozone enlargement – Exploring Uncharted Waters"

The respective programs and extensive minutes taken at all of these conferences are available at http://www.ezoneplus.org/conferences.php?kindOf=0.

6. Acknowledgements

The success of the Ezoneplus project would not have been possible without the support of the partner institutions as well as various external institutions and persons. This is a list of people who actively, either by providing scholarly input or material funds, assisted in making this project run:

Dr. Peter Backé	European Central Bank, Frankfurt/Main
Dr. Vít Bárta	National Bank of the Czech Republic
Jan Krzysztof Bielecki	CEO, Pekao S.A. and former Prime Minister, Warsaw
Dr. Peter Blomeyer	Auswärtiges Amt Berlin
Dr. Jakub Borowski	National Bank of Poland, Warsaw
Prof. Dr. Jacques le Cacheux	SciencePo, Paris
Dr. Klaus Deutsch	Deutsche Bank Research Berlin
Dr. Hubert Gabrisch	Institut für Wirtschaftsforschung, Halle
Prof. Dr. Gert-Joachim Glaessner	Humboldt Universität Berlin
Prof. Dr. Roberto Golinelli	University of Bologna
Prof. Dr. Jerzy Hausner	Minister of Economy, Labor and Social Policy
Prof. Dr. hab. Leszek Jasinki	Polish Academy of Science, Warsaw
Prof. Dr. Mieczyslaw Kabaj	Institute of Labour and Social Affairs, Warsaw
Professor Dr. Ingeborg Nemcova,	Department of Economic Policy, University of Economics in Prague
Prof. Dr. Witold Orlowski	Advisor in Economic Affairs to the President of Poland
Dr. Reinhold Rickes	Deutscher Sparkassen- und Giroverband, Berlin
Prof. Dr. Riccardo Rovelli	University of Bologna
Prof. Dr. Bazyli Samojlik	Warsaw School of Economics
Prof. Dr. Andrzej Slawinski	Warsaw School of Economics
Prof. Dr. hab. Stanislaw Swadzba	University of Economics in Katowice
Prof. Dr. Karel Zeman	Institute of Integration of the Czech Republic into the European and World Economy
Prof. Dr. Anna Zielinska-Glebocka	Gdansk University
Prof. Dr. Wieslawa Ziólkowska	National Bank of Poland, Warsaw

7. Annexes

Annex 1[20]: List of publications, conference presentations, etc.

Table of Contents

1. Jean Monnet Centre of Excellence, Freie Universität Berlin, Germany (Project Coordinator)

Michael Bolle

Professor of Political Science, Director of the Jean Monnet Centre of Excellence, Department of Social and Political Science, Freie Universität Berlin

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- August 2001. (with C. Fahrholz, H.-D. Jacobsen, T. Meyer): "New Risks Ahead: The Eastward Enlargement of the Eurozone." Ezoneplus Working Paper No. 1 (www.ezoneplus.org).
- Sep 2001. Lecture "The Eastward Enlargement of the Eurozone", Center for European Studies, Harvard University.

[20] This section was compiled by Stefan Hohenberger.

- Sep 2001. Faculty Seminar "EU Enlargement: Will it Work?" Queen's University, Canada.
- Sep 2001. Lectures on "EU Enlargement and the Euro – Will It Work?" aboard of "Queen Elizabeth II", New York – Southampton.
- 10–13 January 2002. Presentation of the Ezoneplus project and discussion about future cooperation Prof. Carraro, Venice, and Prof. Macho-Stadler, Barcelona, at "7th Coalition Theory Workshop", Istituto Canossiano, Venice.
- January 2002. Contribution to State of the Art Report, Ezoneplus Working Paper No. 2 (www.ezoneplus.org).
- March 2002. Presentation of the Ezoneplus project and discussion about future cooperation with Profs. Grazia, Marini and Nardis at the Istituto di Studi e Analisi Economica, Rome.
- 27–28 May 2002. Presentation of the Ezoneplus project and discussion about future cooperation with Antonio Lettieri at a Workshop on "The Well-Being of Labour Market Participants", Centro di Investigazzione della Studie Soziale, Rome.
- July 2002. Workshop 'The Eastward Enlargement of the Eurozone' in Bologna.
- 11–13 October 2002. Participation at the Seventh Annual Meeting of the Latin American and Caribbean Economic Association (LACEA), Madrid.
- 27 November 2002. The Federal Trust for education & research: "The Convention on the Future of Europe - The Parliamentary Experience", Goodenough College, London.
- 6–8 December 2002. Lectures at the University of Sczcecin, "The European Union and Approches towards the Eurozone".
- 2002. (with Achim Kemmerling): "Investing Subjective and Objective Notions of Well-Being across Countries", Paper presented at the final conference of the New LMStats-Project, funded by the Ford Foundation", Bellagio.
- 23-24 January 2003: Exchange of Ideas on Endogenous Formation of Social and Economic Networks, The Coalition Theory Workshop, GREQUAM, University of d'Aix-Marseille, France.
- 25 January 2003. Presentation of the Ezoneplus-Project and discussion about future co-operation at the 8th Coalition Theory Workshop, "Endogenous Formation of Social and Economic Networks", Greqam, Aix-en-Provence.
- 11-12 April 2003. Presentation of the Ezoneplus-Project and discussion about future co-operation at the University in Rabat, meeting "Marché du travail et genre dans les pays du Maghreb".
- 15 April 2003. Intensifying Interdisciplinary Scientific Cooperation, European Study Group, Prof.Martin, Complutense University, Madrid.
- 27 June 2003: The Process of European Integration- A rational-choice based Interpretation, Universität Stettin, Prof. Matusiewicz.
- 10-11 July 2003. Intensifying Research Cooperation- Economics and Political Science, Professores Ernesto Longobardo and Prof. Antonio Uricchio, University of Bari, Italy.
- 20-24 August 2003. European Enlargement and Institutional Reshaping, Prof. Jonas Agell, University of Stockholm. Swedish Institute of European Studies. European Economic Association, Stockholm, Sweden.
- 5-8 September 2003. Enlargement of the Eurozone and Reshaping Markets, Profs. Laffan, Harms, Lane and Benoit, University and Colleges of Dublin, Ireland.
- 1-2 October 2003. The Eastern Enlargement of the Eurozone – Political and Economic Aspects, Romanian Institute for European Research, Prof. Dragan, University of Bucarest , Romania.
- 6-8 October 2003. The Eastern Enlargement of the European Union – will it all work?, Prof. Yilmaz, Sabanci University, Istanbul, Turkey.

- 9-11 May 2003. Contribution to the workshop "Eurozone Enlargement. Exchange Rate Choices and Adjusting Markets". In Brussels.
- 15-16 November 2003. Contribution to the workshop "Assessing the Political and Economic Impacts of the Eastward Enlargement" at the Teikyo University Campus, Berlin Schmöckwitz.
- 23 March 2004. Lecture on "Enlargement of the EU- Will it all work ?" at Universidade Técnica de Lisboa.
- 18 June 2004 Contribution to the Final EzonePlus Conference "Eastward Enlargement of the Eurozone" in Berlin.
- 3-5 June 2004. Contribution to the second YouREC conference at Riga, Latvia.

PUBLICATIONS

- 2001. (with H.-D. Jacobsen): "New Risks Ahead: The Eastward Enlargement of the Eurozone." Intereconomics, 36, 6, pp. 298 – 304.
- 2002. (ed.): "Eurozone Enlargement - Exchang-Rate Choices and Adjusting Markets.", Berlin: Berliner Wissenschaftsverlag.
- 2003. (ed.): "Eurozone Enlargement - Reshaping Policies and Social Conflicts.", Berlin: Berliner Wissenschaftsverlag.
- 2004. (ed.): „Eurozone Enlargement - Exploring Uncharted Waters", Berlin: Berliner Wissenschaftsverlag.

TEACHING ACTIVITIES

Winter term 2001/2002

- „Empirische und theoretische Aspekte der Wirtschaftspolitik", Freie Universität Berlin.

Summer term 2002

- „Theoretische und empirische Aspekte der Wrtschaftspolitik", Freie Universität Berlin.
- with Thomas Meyer: „Europäische Kapitalmärkte im Wandel: Theorie und Empirie", Freie Universität Berlin.
- "Die Osterweiterung der EU: Warum, wie und mit welchen Folgen?", Freie Universität Berlin.
- with Victor Sokov: „Markt und Staat heute: Grundsätze moderner politischer Ökonomie", Freie Universität Berlin.

Winter term 2002/03

- with Achim Kemmerling and Jochen Blessing: „ Einführung in räumliche Modelle der Politikwissenschaft anhand empirischer Beispiele aus der Europäischen Union", Freie Universität Berlin.
- Theoretische und empirische Aspekte der Wirtschaftspolitik, Freie Universität Berlin.
- with Kai Oppermann: „Theoretische und empirische Aspekte der Wirtschaftspolitik", Freie Universität Berlin.
- Politische Ökonomie heute und ihre Anwendung in der EU, Freie Universität Berlin.
- ÜV zum Problemfeld Politik und Wirtschaft, Freie Universität Berlin.

Summer term 2003

- with Sabine Schwarz: „Theorien der Europäischen Integration", Freie Universität Berlin.
- „Theorie und Empirie der Wirtschaftspolitik", Freie Universität Berlin.

- with Achim Kemmerling and Thomas Meyer: "Politik und Ökonomie in der EU: Entwicklungs- und Transitionsländer", Freie Universität Berlin.
- „Die Europäische Union – mysteriös", Freie Universität Berlin.
- „Konkurrierende Theorien der Wirtschaftspolitik", Freie Universität Berlin.

Winter term 2003/04

- „Theoretische und empirische Aspekte der Wirtschaftspolitik", Freie Universität Berlin.
- with Achim Kemmerling: „Die soziale Dimension der Osterweiterung", Freie Universität Berlin.
- with Sandra Pogodda: „Die Euro- mediterrane Freihandelszone: Politische Ökonomie der EU-Mittelmehrbeziehungen", Freie Universität Berlin.
- with Thilo Bodenstein: „Die politische Ökonomie der EU- Osterweiterung", FU Berlin.
- „Politische Ökonomie - heute", Freie Universität Berlin.
- with Sabine Schwarz: „Einführung in die Wirtschaftspolitik unter besonderer Berücksichtigung der Europäischen Integration", Freie Universität Berlin.

Summer term 2004

- „Überblicksvorlesung Politik und Wirtschaft", Freie Universität Berlin.
- with Christian Fahrholz and Phillip Mohl: „Einführung in die spieltheoretische Analyse europäischer Mehrebenenentscheidungen", Freie Universität Berlin.
- „Theoretische und empirische Aspekte der Wirtschaftspolitik", Freie Universität Berlin.
- „Internationale Politische Ökonomie - heute", Freie Universität Berlin.
- with Thomas Meyer and Jochen Blessing: "Political Economics: Explaining International Economic Policy", Freie Universität Berlin.
- with Sabine Schwarz: „Kooperation, Koordination und Integration", Freie Universität Berlin.

FURTHER ACTIVITIES

- August – Sep 2001. Research stay at the Minda de Gunzburgh Center for European Studies, Harvard University, Cambridge/USA. Presentation of the project and discussion about future cooperation with Profs. Peter Hall and Andrew Moravcsik, Harvard University. Prof. Barry Bluestone, Northeastern University. Prof. Alessandra Cassela, Columbia University.
- 4 – 28 March 2002. Research Stay, presentation of the Ezoneplus project and discussion about future cooperation with Prof. Longobardi, Claretti, Lettieri and Raspeni at the Centro deli Studio Sociale, Rome/Italy.
- 31 May 2002. Presentation of the project to Arthur D. Clarke, Boston Consulting.
- 20 – 26 June 2002. Presentation of the project and discussion about future cooperation with Prof. Andrei Kusnetsov, Vice-Rector for International Cooperation, High School of Economics, Prof. Ivan Tjulin, Pro-Rector at the State University of International Relation, Prof. Juri Borko, Jean-Monnte-Professort and Director of EU Research Center, Europe Institute, Academy of Sciences, Dr. Ksenia Judaeva and Prof. Ekatarina Zhuravskaja, Center for Economic and Financial research, Moscow/ Russia.
- 13 August - 9 Sept 2002. Research stay at the IER, Ljubljana. Presentation of the projects and dicussion about future co-operation with Prof. Boris Majcen (Director) and Dr. VladimirLavrac.
- 8 – 13 October 2002. Presentation of the project and discussion about future co-operation with Prof. Dr. Carmela Martín, European Economy Group – EEG, Universidad Complutense de Madrid, Dr. D. José María Beneyto Pérez, Instituto de Estudios Europeos, Universidad San Pablo

CEU, Prof. Juan José Dolado, Universidad Carlos III de Madrid.

- 22 – 26 October 2002. Presentation of the project and discussion about future co-operation with Prof. Ph. D. Iordan Bliznakov, University of National and World Economy, Prof. Dr. Nikolay Nenovsky, Bulgarian National Bank, Ph. D. Tsvetan Manchev (CEO), Plamen Kaloyanchev (Chief Expert), Agency for Economic Analysis and Forecasting, Sofia.
- 27 – 29 June 2003. Presentation of the project and discussion about future co-operation with Professor Glowacki, Professor Matusewicz, University of Szczecin.
- 16 - 17 July 2003. Meeting with Prof. Glowacki, Dr. Ruszkowski, Dr. Matusewicz, University of Szczecin.
- March 2004. Visiting Professor at the Departemento de Economia, Universität Évora, Portugal.

Christian Fahrholz

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- August 2001. (with M. Bolle, H.-D. Jacobsen, T. Meyer): “New Risks Ahead: The Eastward Enlargement of the Eurozone.” Ezoneplus Working Paper # 1. Text downloadable at www. ezoneplus.org/archiv/ ezoneplus_wp_one.pdf.
- 19 October 2001. Comment on the Presentation of Thomas Meyer “Capital Markets” at Berlin Workshop “Markets” – The Eastward Enlargement of the Eurozone, Berlin.
- 12 April 2002. Presentation: “Risks and Opportunities of EU-Enlargement – The Case of Poland.” European Law Students Association at Freie Universität Berlin, Berlin.
- 26 April 2002. Synopsis of panel Discussion: “Politische und ökonomische Dimensionen der Osterweiterung”, Regional Workshop of Ezoneplus, Berlin.
- 27 August 2002. Presentation: "New Political Economy of Exchange-Rate Policy." ECPR Summer School "Analytical Approaches to European Integration: Decemberision-Making and Policy Implementation", Leiden.
- 23 November 2002. Presentation "Economic Policies at the eve of EMU"at SIE Project Course: "Economic Policy in Europe", Stettin.
- 10 May 2003. Comment on “Exchange-Rate Regimes” by Renzo Orsi and Fabrizio Iacone at Ezoneplus 3rd Official Workshop “Policies”, Brussels.
- 28 June 2003. Presentation “Verteilungspolitische Konflikte zwischen ‚Ost und West’: Maastricht Konvergenz und Währungspolitik der mittel- und osteuropäischen Beitrittskandidaten im Wechselkursmechanismus II” at DGO/OWK “11. Brühler Tagung junger Osteuropa-Experten”, Brühl.
- 19 September 2003. Presentation “Prospective Bargaining for Costs of Convergence in ERM II” at ECPR 2nd Annual Conference, Marburg, Germany, 18-21 September 2003.
- 30 January2004. Presentation “Bargaining for Costs of Convergence in ERM II” at the YouREC Conference, Szczenin, Poland, 30 January- 1 February 2004.

- 14 April 2004. Presentation “The Impact of EMU-enlargement on Decemberision-making in the ECB Governing Council” at the ECPR Joint Sessions, Uppsala, Sweden, 13-18 April 2004.

PUBLICATIONS

- 2002. (with A. Kemmerling): "Transition und Tertiarisierung: Zu den realwirtschaftlichen Folgen eines unbalancierten Wachstums", Arbeitspapiere und Materialen – Forschungsstelle Osteuropa, Bremen. Nr. 36, pp. 56-62.
- 2002. "Introduction". In: Michael Bolle (ed.). Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets (Ezoneplus Summary Report). Berlin: Berliner Wissenschafts-Verlag, 9-17. (with Hanns-D. Jacobsen and Andrej Stuchlík)
- 2002. (with Hanns-D. Jacobsen and Andrej Stuchlík): "Prospects of Exchange-rate Policies". In: Michael Bolle (ed.). Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets (Ezoneplus Summary Report). Berlin: Berliner Wissenschafts-Verlag, 35-38.
- 2002. (with Hanns-D. Jacobsen and Andrej Stuchlík): "Concluding Remarks". In: Michael Bolle (ed.). Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets (Ezoneplus Summary Report). Berlin: Berliner Wissenschafts-Verlag, 75-78.
- 2003. "Strategic Exchange-Rate Policy of Accession Countries in ERM II", Ezoneplus Working Paper No. 14 (www.ezoneplus.org).
- 2003. "Verteilungspolitische Konflikte zwischen ‚Ost und West’: Maastricht Konvergenz und Währungspolitik der mittel- und osteuropäischen Beitrittskandidaten im Wechselkursmechanismus II", Forschungsstelle Osteuropa Bremen – Arbeitspapiere und Materialen Nr. 45: Krisen und Konflikte im Osten Europas – Beiträge für die 11. Brühler Tagung junger Osteuropa-Experten, 63-67.
- April 2003. (with Philipp Mohl): "Regional Input on Monetary and Fiscal Policies – Belgium, France, Germany, Luxembourg, and the Netherlands", Ezoneplus Working Paper No. 17C (www.ezoneplus.org).
- 2003. "Prospective Bargaining for Costs of Convergence in ERM II" Paper prepared for the ECPR 2nd Annual Conference, Marburg, Germany, 18-21 September 2003.
- June 2004. (with Philipp Mohl): "EMU-enlargement and the Reshaping of Decemberision-making within the ECB Governing Council" Ezoneplus Working Paper No. 23 (www.ezoneplus.org).

TEACHING ACTIVITIES

- PS 15053 “Moderne Politische Ökonomie und Europäische Integration” with Michael Bolle, summer term 2001.
- PS 15075 “Nationale Modelle des Wohlfahrtsstaates in Europa: Ex pluribus unum?” with Achim Kemmerling, summer term 2002.
- HS 15245 “Die politische Ökonomie der europäischen Wirtschaftsintegration” with Thilo Bodenstein, summer term 2003.
- HS 15153 “Einführung in die spieltheoretischen Analyse europäischer Mehrebenen-entscheidungen” with Philipp Mohl, summer term 2004.

PROSPECTS

- 4 September 2004. Presentation “Bargaining for Costs of Convergence in ERM II: When Rubinstein meets the Enlargement of the Eurozone” at the APSA Annual Meeting, Chicago, IL, USA, 2 September - 5 September 2004.

- Submission of “Altering Power within the ECB Governing Council in the course of the EMU-enlargement” (with Philipp Mohl):for a special issue of the quarterly journal Homo Oeconomicus “Measuring Power” edited by Gianfranco Gambarelli and Manfred J. Holle, 15 October 2004.
- Book “The New Political Economy of Exchange-rate Policies and the Enlargement of the Eurozone”, Doctoral Thesis at Freie Universität Berlin. (end of year)

Hanns-D. Jacobsen
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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 3 July 2001. Lecture: "Germany's Role in an Enlarging European Union." Institut für Auslandsbeziehungen Stuttgart, Berlin.
- 18-21 October 2001. Contribution to the Berlin Workshop of Ezoneplus: "The Eastward Enlargement of the Eurozone." Centre of Excellence/Freie Universität Berlin, Berlin.
- 7-9 November 2001. Contribution to the Conference: "Osterweiterung der EU." WeltTrends, Potsdam/Instytut Zachodni Poznan, Potsdam. January2002.
- Editor: "State of the Art Report." Ezoneplus Working Paper # 2. Text downloadable at www.ezoneplus.org/archiv_wp_two.pdf.
- 20-27 January 2002. Paper: "The Stability Pact for South East Europe - Did it work?" Contribution to the Isodarco 15th Winter Course, Andalo, Italy.
- 6 April 2002. Lecture: "Trade and FDI". Schmöckwitz Seminar of the Ezoneplus Berlin Group.
- 10 May 2002. Lecture: "Challenges of EU Enlargement". Teikyo University Faculty Seminar, Berlin.
- 24 May 2002. Lecture: "The Eastward Enlargement" Collegium Polonicum, Slubice, Poland.
- 19 November 2002. Lecture on „The Eastward Enlargement of EU and EMU". Ost-West-Kolleg Brühl.
- 21-24 November 2002. Ezoneplus Regional Conference "Impact on Trade, FDI and Capital Markets", Cracow, Poland.
- 17 December 2002. Panel Discussion „Turkey and the European Union". European Association of Turkish Academics, Stuttgart.
- 4 March 2003. Lecture "The Eastward Enlargement of the European Union". University of Hawaii at Manoa, Honolulu, USA.
- 24 March 2003. Lecture "EU and EMU Enlargement". University of Rochester, Dept. of Political Science, Rochester, N.Y., USA.
- 10 May 2003. Conference Contribution „Eurozone Enlargement – Political and Economic Risks". Conference of the Ezoneplus Research Project, Brussels.
- 18 May 2003. Lecture: "Germany's Role in an Enlarging European Union". Institut für Auslandsbeziehungen Stuttgart, Berlin.
- 13 December2003. Conference Contribution "Policy Advice: Financial Policies". Conference of the Ezoneplus Research Project, Warsaw.
- 1 April 2003. Lecture: "The Eastward Enlargement of EU and EMU". Nazareth College of Rochester, N.Y., USA.
- 17 May 2004. Lecture "Germany's Role in an Enlarging European Union". Institut für Auslandsbeziehungen Stuttgart, Berlin.
- 18 June 2004. Conference Contribution "Eurozone Enlargement: Risks and Opportunities". Final Conference of the Ezoneplus Research Project, Berlin.
- 28 July 2005. The Provision of Economic Security in EU-CIS Relations. ICCEES World Conference, Panel IX.18 (acc.)

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- 2001. (with M. Bolle): "New Risks Ahead: The Eastward Enlargement of the Eurozone." *Intereconomics*, 36, 6, pp. 298 – 304.
- 2002. "Patient, Arzt und falsche Medizin – Russland und der IWF" (Patient, Physician, and the Wrong Medicine – Russia and the IMF), *Osteuropa Wirtschaft*, 47, 3, pp. 289 - 309.
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- 2002. (with C. Fahrholz and A. Stuchlik). "Introduction" and "Concluding Remarks". In M. Bolle, ed.: Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets, Berliner Wissenschaftsverlag, Berlin.
- 2003. (with A. Kemmerling). „Introduction" and „Thoughts and Questions Leading to Policy Advice". In M. Bolle, ed.: Eurozone Enlargement – Reshaping Markets and Social Conflicts, Berliner Wissenschaftsverlag, Berlin.
- 2004. (with the Berlin group): „Economic, Political, Institutional as well as Social Risks and Opportunities of EMU Enlargement". In M. Bolle, ed.: Eurozone Enlargement – Exploring Uncharted Waters, Berliner Wissenschaftsverlag, Berlin.
- 2004. (with V. Sokov). "Russland und UdSSR". In M. Neu/W. Gieler/J. Bellers, ed.: Handbuch der Außenwirtschaftspolitiken, Lit Verlag, Hamburg, pp. 767-777.
- 2004. „Economic Security and the Stability Pact for South-eastern Europe" In I. Peters et al.: The Future of Transatlantic Relations, Festschrift for Helga Haftendorn, tbp.

TEACHING

- September– December 2002. "Challenges to the European Union", Nazareth College – in – Berlin Programme, Studienforum Berlin, Berlin.
- January–April 2003. „The Eastward Enlargement of the European Union", Teikyo University, Berlin.
- September–December 2003. "Challenges to the European Union – Euro Introduction and Enlargement", Nazareth College – in – Berlin Programme, Studienforum Berlin, Berlin.
- January – April 2004. „Economic and Political Integration in an Enlarged European Union", Teikyo University, Berlin.
- May–June 2004. "Enlarging the EU and EMU", University of Hawaii Summer School, Studienforum Berlin, Berlin.

CHAIRS

- 21-24 November 2001. Panel Chairman: "Economic and Financial Problems of Transition Countries." The Federal Trust/EAB/Heinrich-Böll-Stiftung, Berlin.
- 25-27 November 2001. Panel Chairman: „Das Ende der Transformation? Eine Bestandsaufnahme." Annual Economic Conference, Deutsche Gesellschaft für Osteuropakunde, Berlin.
- 10 May 2003. Panel Chairman: "The Reshaping of Markets". Conference of the Ezoneplus Research Project, Brussels.

- 13 Dezember 2003. Panel Chairman: “Policy Advice”. Conference of the Ezoneplus Research Project, Warsaw.
- 18 June 2004. Conference Chairman: „Eurozone Enlargement – Exploring Uncharted Waters“, Ezoneplus Final Conference, Berlin.

MEDIA

- 8 May 2002, 18.40. Interview with Deutschlandfunk, broadcasted in the program „Was passiert, wenn der Euro zu früh in den Osten geht?“, by Rozalia Romaniec, Hintergrund Politik. The manuscript is available at www.dradio.de/cgi-bin/es/neu-hintergrund/607.html.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 19 October 2001. Comment on the Presentation of Thomas Meyer “Capital Markets” at Berlin Workshop “Markets” – The Eastward Enlargement of the Eurozone, Berlin.
- January 2001. Contribution to State of the Art Report on “Social Dimension”, Ezoneplus-Working paper no 2. text downloadable at www.ezoneplus.org/archiv/ezoneplus_wp_two.pdf.
- 7–10 Feb 2002. Lecture: "The Political Economy of Labour Mobility in Europe", Lecture for the AGEE-Conference on European Employee Mobility in Europe, Prague.
- 23–26 Mar 2002. Paper: "National Regimes of Welfare State Taxation. Empirical Evidence from 18 OECD countries", Paper presented at ECPR Joint Sessions, Turin.
- 26–29 Mar 2002. Paper: "Diverse Notions of Well-Being across Europe", Paper presented at the Meeting of the Well-Being Team, "New Labour Market Statistics Project", Rome.
- 2002. Paper: "The Political Economy of Eastward Enlargement: A General Framework", forthcoming as Ezoneplus WP.
- 12 April 2002. Presentation: “Risks and Opportunities of EU-Enlargement – The Case of Poland.” European Law Students Association at Freie Universitaet Berlin. Berlin.
- 26 April 2002. Synopsis of panel discussion: “Politische und ökonomische Dimensionen der Osterweiterung”, Regional Workshop of Ezoneplus, Berlin.
- 2002. "The Political Origins of Impeded Worker Mobility Between Eastern and Western Europe", Ezoneplus Working Paper WP 4.
- 18 January 2003. "Eastward Enlargement of the Eurozone", SIE-Seminar Szeczin,. slides downloadable at http://www.polwiss.fu-berlin.de/osi/more/coe/texte/Slides_Stettin.ppt.
- 2 April 2003. "Die Osterweiterung der EU: ein polit-ökonomischer Erklärungsansatz", Forschungslogik und Methoden der Internationalen Beziehungen und der Europaforschung, DVPW AK Integrationsforschung, Hofgeismar.
- 11 April 2003. "The Political Economy of Support for Eastward Enlargement", O Alargamento da União Europea. Impactos Socio-Económicos, University of Èvora/Portugal. text and slides downloadable at http://www.polwiss.fu-berlin.de/osi/more/coe/index.html.
- 2003. "Report on the Social Dimension of Ezoneplus", Ezoneplus Working Paper 13, (http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteen.pdf)

- 2003. "Regional Input Social Dimension", Ezoneplus Working Paper 13c (http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteenC.pdf)
- 21 November 2003. "Die Messung von Brutto- und Nettosozialleistungen", 14. Wissenschaftliches Colloquium des statistischen Bundesamtes, 20./21.11., Wiesbaden.
- 13 November 2003. „The Employment effects of different Regimes of Welfare State Taxation: An Empirical Analysis of Core OECD Countries“, inaugural ESPAnet Conference Changing European Societies - The Role for Social Policy, 13-15 November 2003, Copenhagen.
- 18 September 2003. "The Political Economy of Tax Mixes in OECD countries", paper presented at the 2nd ECPR general conference, Marburg, 18-21th September, 2003.
- 24 July 2003. “Investigating Subjective and Objective Notions of Well-Being across National Labour Markets”, Challenges for Quality of Life in the Contemporary World, Fifth Conference of the International Society for Quality-of-Life Studies, July 20-24th, Frankfurt a.M.
- 21 February 2004. „From Economic Shocks to Political Conflicts? The Social Dimension of an Eastward Enlargement of the European Monetary Union”, 8th Graduate Student Conference BMW Center for German and European Studies Edmund A. Walsh School of Foreign Service, “An Expanding Europe: Reflections and Prospects”, Georgetown University.
- 24 April 2004. "The Political Economy of Eastward Enlargement", SIE-Seminar Sczeczin, University of Sczeczin.

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- 2002. (with Andreas Stephan): “The contribution of local public infrastructure to private productivity and its political economy: Evidence from a panel of large German cities”, Public Choice 113: 403-424.
- 2002. "The Employment Effects of Different Regimes of Welfare State Taxation. An empirical examination of 18 OECD countries", Max Planck Institute for the Study of Societies, Cologne Discussion Paper 02/8.
- August 2003. “The Political Economy of Support for Eastward Enlargement. Job Loss, Institutions, and Political Alienation in Central and Eastern European Countries”, in José Manuel Caetano (ed.). The European Union Enlargement - Social and Economic Impacts. Évora: Centro de Documentação Europeia, 2003, pp. 33-50.
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- 20-21 November 2004. Die Messung von Brutto- und Nettosozialleistungen, 14. Wissenschaftliches Colloquium des Stat. Bundesamtes , Wiesbaden.

TEACHING ACTIVITIES

- 2002. Nationale Modelle des Wohlfahrtsstaates in Europa: Ex pluribus unum?, Freie Universität Berlin (with C. Fahrholz).
- 2002/03. Introduction to Spatial Modelling: the case of the European Union (with Michael Bolle and Jochen Blessing).
- 2003. The Political Economy of Development: Eastern Europe and other developing countries compared (with Michael Bolle and Thomas Meyer).

- 2003. PS Introduction to modern political economy approaches: the case of the European Union (with Andrej Stuchlik).
- 2003/04. The Social Dimension of an Eastward Enlargement of the European Union (with Prof. Michael Bolle).
- 2004. The Political Economy of Development: Eastern Europe and other developing countries compared (with Michael Bolle and Thomas Meyer).
- 2004. Introduction to International Political Economy (with Sandra Pogodda).

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- August 2001. (with M. Bolle, C. Fahrholz, H.-D. Jacobsen): "New Risks Ahead: The Eastward Enlargement of the Eurozone." Ezoneplus Working Paper # 1. Text downloadable at www.ezoneplus.org/archiv/ezoneplus_wp_one.pdf.
- 18-21 October 2001. Contribution "Capital Markets" to the Ezoneplus Berlin Workshop.
- January 2002. Contribution to State of the Art Report: "Shaping of capital markets" Ezoneplus-Working paper no 2. text downloadable at www.ezoneplus.org/archiv/ezoneplus_wp_two.pdf.
- 11-12 April 2002. Contribution to the Financial Conference at D.A. Tsenov Academy of Economics, Svishtov, Bulgaria.
- 26 April 2002. Contribution to the Conference: Regional Workshop Berlin Schmöckwitz.
- 13-14 June 2002. Contribution to the Amadeus Conference on EMU Enlargement, Marne-La-Vallée, France.
- 2002. "Capital markets in Benelux, France, and Germany", Regional Input for Ezoneplus, Ezoneplus WP 5A (www.ezoneplus.org).
- 2002. "Shaping of capital markets", Ezoneplus Report "Capital Markets", Ezoneplus WP 5 (www.ezoneplus.org).
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- 4–7 July 2002. Contribution to the Ezoneplus Conference: Bologna, Italy.
- 21–24 November 2002. Contribution to Workshop on Trade, FDI and Capital Markets, Cracow, Poland.
- 9–10 May 2003. Contribution to the Ezoneplus-Conference: Exchange-rate choices and adjusting markets in Brussels, Belgium.
- 2-3 July 2003. "Endogenous institutions: private action and capital flows", Paper presented at the XV International Economic Seminar, Villa Mondragone, Rome.
- 2003. Monetary and Fiscal Policies-Introduction, in Michael Bolle (ed.), Eurozone enlargement: Reshaping Policies and Social Conflicts, Berliner Wissenschaftsverlag, pp 11-13.
- 1 April 2004. "A theory on economic development with endogenous institutions", paper presented to the Scottish Economic Society, Perth.

- 3-7 May 2004. "Institutions and prosperity: a model of reciprocal development", Paper presented at ESNIE, Corsica.

TEACHING ACTIVITIES

- Proseminar: Konkurrierende Theorien der Wirtschaftspolitik, Freie Universität, Berlin.
- Advanced Seminar: Europäische Kapitalmärkte im Wandel: Theorie und Empirie, Freie Universität, Berlin.
- Proseminar: Konkurrierende Theorien der Wirtschaftspolitik, Freie Universität, Berlin.
- Advanced Seminar: Europäische Kapitalmärkte im Wandel: Theorie und Empirie.
- Advanced Seminar: Ökonomie und Politik in der EU: Entwicklungs- und Transitionsländer, Freie Universität Berlin.
- Proseminar: Konkurrierende Theorien der Wirtschaftspolitik, Freie Universität, Berlin.
- Advanced Seminar: HS - Political Economics: Explaining International Economic Policy, Freie Universität Berlin.
- Proseminar: PS: Politik und Ökonomie europäischer Transitions- und außereuropäischer Entwicklungsländer im Vergleich, Freie Universität Berlin.
- Lecture: Economics of EU integration, University of *Szczecin*, 10th January2004.
- Lecture: Economics of EU integration, University of *Szczecin*, 25th April 2004.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 7–11 November 2001. Conference contribution "Economic Development and Competitiveness of the Baltic Sea Region Economies in Transition" 6th International Conference on Global Business and Economic Development, Bratislava.
- 23-24 November 2001. (with H. Kaldaru): Conference Proceeding "Measuring of Estonian competitiveness and international comparison." 2nd Conference of Estonian Social Scientists, Tartu.
- 23-24 November 2001. (with K. Philips): Conference Proceeding "Long-term unemployment in Estonia." 2nd Conference of Estonian Social Scientists, Tartu.
- 2001. Proceeding "Competitiveness of the Baltic Economies in the Global and Regional Environment." Conference "Economies and Business in Transition: Facilitating Competitiveness and Change in the Global Environment", Global Business and Technology Association, Istanbul, pp. 695-702.
- November 2001. Paper "Competitiveness of the Baltic Sea Region Economies." Tallinn Technical University Working Paper no. 40, 2001 (TTUWPE No 37-45, Papers of the 52nd International Atlantic Conference presented by Estonian participants) Athens, Greece.

- 7-11 November 2001. Paper "Economic Development and Competitiveness of the Baltic Sea Region Economies in Transition – States and Markets: Forging Partnership for Sustainable Development. Vol. II. Eastern European Perspectives. Proceedings of the 6th International Conference on Global Business & Economic Development, Bratislava, Montclair, 11 p.
- January 2002. (with E. Opman, M. Rõõm): Contribution to State of the Art Report: "The Adjustment Processes of Labour Markets in Transition", Ezoneplus-Working paper no 2. Text downloadable at www.ezoneplus.org/archiv/ezoneplus_ wp_two.pdf.
- 13–17 March 2002. Paper "Gravity Approach for Exploring International Trade Flows of the Baltic Sea Region" International Atlantic Economic Society, Paris.
- May 2002. Paper "Economic Integration and Trade Flows: A Gravity Approach", Seminar at VATT, Helsinki.
- 25–29 June 2002. Paper "Labour Market Adaptation with the Eastward Enlargement of the Eurozone", International Conference of the Global Business and Technology Association, Rome.
- 27-29 June 2002. (with R. Eamets): Conference Proceeding "Flexibility of the Estonian labour market in the context of EU accession." 10th Conference on The effect of European Union expansion on Estonian economic policy, Värska, pp 54 - 64.
- 27-29 June 2002. (with K. Philips): Conference Proceedings "Long-term unemployment in Estonia: to support passive adaptation or active development?" 10th Conference on The effect of European Union expansion on Estonian economic policy, Värska, pp 143 - 150.
- June 2002. (with R. Eamets, N. Rõõm, R. Selliov, A. Jürgenson, J. Masso): Regional Input "Labour Flexibility and Migration in the EU Eastward Enlargement Context: The Case of the Baltic States". Ezoneplus Working Paper No 11, 79 pp (www.ezoneplus.org).
- June 2002. (with J. Kiander and R. Vaittinen): "The Eastern Enlargement of the Eurozone and Labour Market Adjustment). Ezoneplus Working Paper No 6, 59 pp (www.ezoneplus.org).
- 2002. "Gravity Approach for Exploring Baltic Sea Regional Integration in The Field of International Trade", HWWA Discussion Paper, No 180, Hamburg, Hamburg Institute of international Economics, 35 p.
- 2002. "Modelling International Trade Flows of the Baltic Sea Region Countries." In: Global Business & Economics Review - Anthology 2001, Selected Papers of Business and Economics Society International, Worcester, USA, pp. 607-618.
- 16-18 June 2002. Workshop on Border Regions, Presentation: "Gravity Approach for Exploring Baltic Sea Regional Integration in the Field of International Trade, Hamburg Institute of International Economics (HWWA).
- August 2002. (with Jaakko Kiander, Risto Vaittinen): "The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets - Regional Inputs on Data and Statistics", Ezoneplus Working Paper No. 5A (www.ezoneplus.org).
- August 2002. (with Jaakko Kiander, Risto Vaittinen): "The Eastern Enlargement of the Eurozone and Labour Market Adjustment", Ezoneplus Working Paper No. 6 (www.ezoneplus.org).
- 27-31 August 2002. Participation in a conference "The 42nd Congress of the European Regional Science Association, Dortmund, Paper" European Integration and EU Eastward Enlargement Process in International Trade: Using a Gravity Approach foe Exploring Bilateral Trade Flows.
- September 2002. (with R. Eamets, N. Rõõm, R. Selliov, A. Jürgenson, J. Masso, A. Kemmerling): Regional Input "Labour Markets". Ezoneplus Working Paper No 6A (Working Paper No 6 Supplement), 51 pp (www.ezoneplus.org).
- September 2002. (with Raul Eamets, Marit Rõõm, Rena Selliov, Anne Jürgenson, Jaan Masso): "Labour Flexibility and Migration in the EU Eastward Enlargement Context: The case of the Baltic States". Ezoneplus Working Paper No 11, 51 pp (www.ezoneplus.org).

- 2003. (with Eamets, Raul. Masso, Jaan. Rõõm, Marit): Labour Market Flexibility and Migration in the Baltic States. Working Papers Series, No 16, University of Tartu, Faculty of Economics and Business Administration, Tartu, 101 p.
- January 2003. (Rõõm Marit, Sikk Allan, Schumann Christopher, Szirko Orzolya): "Social and Political Dimensions of the Eurozone Enlargement in the Case of the Baltic States." Ezoneplus Working Paper No. 13A, Freie Universität Berlin (Working Paper No 13 Supplement), Jean Monnet Centre of Excellence, 110 p. (www.ezoneplus.org).
- 2003 (with Võrk, Andres): Social Consequences of Transition: Who Recognize Themselves To Be Poor in Estonia? - Eesti majanduspoliitika teel Euroopa Liitu. XI teadus- ja koolituskonverentsi artiklid. Berliin. Tallinn: Verlag Arno Spitz GmbH. Mattimar OÜ, lk. 366-376.
- 13-16 March 2003: Regionalism in International Trade in the Context of EU Eastward Enlargement, International Atlantic Economic Society Conference, Vienna.
- 11-12 April 2003. Social Consequences of Transition and EU Enlargement Processes in the Case of the Baltic States. International Seminar organized by Evora University, Portugal,
- 1-2 June 2003. (Võrk, Andres): "Self-assessment of Estonian households' Economic Situation as an Expression of Adjustment to Transition and European Integration Processes." International Conference organized by Stockholm School of Economics in Riga "Human development in EU Accession Countries", Riga, Conference Guide, pp. 99-101.
- 19-22 June 2003. "Social Consequences of Transition and EU Enlargement Processes in the Case of the Baltic States, International Seminar" organized by University of Turku, Jean Monnet Centre of Excellence "European Union in the Baltic Sea Region", Turku.
- 13-14 June 2003. "Economic Integration and the Role of Regionalism in the EU Eastward Enlargement." International Seminar organized by Warsaw School of Economics „Economic Integration – Step Forward or Finish", Warsaw,
- 1-4, July 2003 "European Integration and Effects of Regionalism on Adjustment to the EU Eastward Enlargement." Eight Annual Conference on Econometric Modelling, Stellenbosh University, South-Africa.
- 26-28 June 2003. (with Võrk, Andres): "Self-assessment of Estonian households' economic situation - an expression of social conditions of the society?" Conference "Estonian Economic Policy on the Way towards the European Union" Tartu-Värska.
- 2003. "Social Consequences of Transition and European Integration Processes in the Baltic States." Papers of the 43rd Congress of the European Regional Science Association (ERSA), Periphere, Centres and Spatial Development in the New Europe. ERSA, Jyväskylä University, 16 p.
- 2003. "Poverty and Social Exclusion as Consequences of Transition and EU Enlargement in the Case of the Baltic States. The European Union – Socio-Economic Impacts." ed. by Jose Manuel Caetano, Evora: Europeia, pp. 9-32
- June 1-2, 2003. (with Võrk, Andres): Self-assessment of Estonian households' Economic Situation as an Expression of Adjustment to Transition and European Integration Processes. International Conference organized by Stockholm School of Economics in Riga "Human development in EU Accession Countries", Conference Guide, pp. 99-101.
- October 2-4 2003. "A role of Statistics in Evaluating Quality of Life in the Baltic States", International Conference „Research Statistics – the Basis of Social Sciences and Education", Latvian Statistical Association, University of Latvia, Central Statistical Bureau of Latvia, Riga.
- 2004. "Labour Market." In R.Orsi and K. Zukrowska (ed.):"Policy Advice. Markets and Policies", Ezoneplus Working Paper, No 20, March 2004, pp.39-46.
- 2004. (with Rõõm-Hinnosaar Marit. Schumann, Christopher. Jaan Masso): „Income Inequality, Poverty and Unemployment as Main Social Consequences in the Baltic States" ed. by K.

Zukrowska and D. Sobczak, Strategy of EMU Enlargement. Background, Optimal Choices, Consequences. Warsaw, Warsaw School of Economics, pp. 163-194.

- 18-20 June 2004. Ezoneplus conference "Eurozone Enlargement: Exploring Uncharted Waters", Berlin, Jean Monnet Centre of Excellence, Freie Universität Berlin. Presentation: Labour Markets and Social Dimension.
- 8-12 June, 2004. Global Business and Technology Association Conference. Navigating Crisis and Opportunities in Global Markets: Leadership, Strategy and Governance, Cape Town, South Africa. Presentation: Trade Integration in the Context of EU Enlargement.
- 15-29 July 2004. Presentation of the results of the Ezoneplus project at the University of Wuppertal to the working group of Prof. Paul Welfens. Two presentations were made: "Social Dimensions of EU enlargements I the Case of the Baltic Stares" and "Trade integration in the Context of EU Eastward enlargement: a Gravity Model Based Approach".

PUBLICATIONS

- 2001. (with N. Scannell): "The Role of Multinational Corporations and Foreign Direct Investment in Transition Economies", *Journal of Development Alternatives and Area Studies*, 20, 2/3 (Sep-December), pp. 81-101.
- 2002. (with N. Scannell): "Initial Conditions as Factors in Economic Transition – The Case of Estonia", *Pakistan Journal of Applied Sciences*, 2, 4 (April), pp. 433-436.
- 2002. (with N. Scannell): "Financial Sector Restructuring and Monetary Reform", *Russian and East European Finance and Trade*, 39, 3 (May-June), pp. 18-32.
- 2002. "The Main Determinants of Transition and Competitiveness of the Baltic States", *Journal of East-West Business* (forthcoming).
- 2002. "Labour Market Adaptation to the Eastward Enlargement of the Eurozone. – Beyond Boundaries: Challenges of Leadership, Innovation, Integration, and Technology." Nejdet Delener and Ch.Chao (ed.), Global Business and Technology Association, Rome, Italy, pp.906-913,
- 2002. (with Kiander, Jaakko, Vaittinen, Risto,): "Labour Market Adjustment". M. Bolle (ed.): "Eurozone Enlargement: Exchange-Rate Choices and Adjusting Markets". Berlin:Berliner Wissenschafts-Verlag, pp. 39-48.
- 2003: Scannell, Nancy J., Tõnisson, Eve. and Paas, Tiiu. Foreign Direct Investment and its Relationship with International Trade in the Baltic States during Transition, Journal of Global Business (JGB), Volume 14, Number 26, Spring 2003, ISSN 1053-7287, pp. 35-49.
- August 2003. (with A. Kemmerling, C. Vieira, I. Vieira, J. Caetano, E. Vaz, A. Pinheiro, L. Fernando de la Macorra y Cano; L. Masa Godoy, A Covas, A. Galego): "The European Union Enlargement: Social and Economic impacts" (J. Caetano Coordinator), Centro de Documentação Europeia da Universidade de Évora, Évora, ISBN: 972-9051-41-0.
- 2004. (with Kiander, Jaakko, Masso, Jaan, Paas, Tiiu, Vaittinen, Risto): "Labour Market, Social Dimension and Eurozone Enlargement". M. Bolle (ed.): "Eurozone Enlargement: Exploring Uncharted Waters". Berlin, Berliner Wissenschafts-Verlag, pp. 67-88 (ISBN: 3-8305-0834-4).

CHAIR

- 13-17 Mar 2002. Panel Chairperson "International Trade and Exchange – Gravity vs. Globalisation", International Atlantic Economic Society, Paris.

DISCUSSION FORUM

- Estonian Union of Scientists on "Competitiveness of the Baltic Economies".

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- January 2002. (with E. Opman, M. Rõõm): Contribution to State of the Art Report: "The Adjustment Processes of Labour Markets in Transition", Ezoneplus-Working paper No. 2. text downloadable at www.ezoneplus.org/archiv/ezoneplus_ wp_two.pdf.
- 27–29 June 2002. Paper "Structural unemployment in Estonia", Proceedings of the 10th Conference on "The Effect of European Union Expansion on Estonian Economic Policy", Värska.
- 9 May 2003. (with Hinnosaar, M.): "Reservation Wage, Job Search Intensity and Unemployment Benefits", Labour Market Research in Estonia: Papers of the Research Seminar, Tallinn.
- September 2002. (with R. Eamets, T. Paas, R. Selliov, A. Jürgenson, J. Masso, A. Kemmerling): Regional Input "Labour Markets". Ezoneplus Working Paper No 6A (Working Paper No 6 Supplement, www.ezoneplus.org) .
- September 2002. (with R. Eamets, R. Selliov, A. Jürgenson, J. Masso): Regional Input "Labour Flexibility and Migration in the EU Eastward Enlargement Context: The Case of the Baltic States" Ezoneplus Working Paper No 11, 79 pp. (www.ezoneplus.org).
- January 2003. (Tiiu Paas, Sikk Allan, Schumann Christopher, Szirko Orzolya): "Social and Political Dimensions of the Eurozone Enlargement in the Case of the Baltic States." Ezoneplus Working Paper No. 13A, Freie Universität Berlin (Working Paper No 13 Supplement). (www.ezoneplus.org).
- 9 May 2003. (with Hinnosaar, M.): "Labour Market Impact of the Minimum Wage in Estonia", Labour Market Research in Estonia: Papers of the Research Seminar, Tallinn.
- 27–29 June 2003. Minimum wage when joining EU and regional differences in the impact of minimum wage on employment in Estonia. — Proceedings of the 11th Conference on The Effect of European Union Expansion on Estonian Economic Policy, Tartu – Värska, pp. 329-336.
- 2003. Eesti tööturu institutsionaalne raamistik rahvusvahelises võrdluses. (The institutional framework of Estonian labour market in international comparison.) — Bank of Estonia, Working Paper, 2003, No 7.
- 2003. Reservation wage in Estonia. – Bank of Estonia, Working Paper No 1.
- 2004. (with Paas, T., Masso, J., M. and C. Schumann) "Income Inequality, Poverty and Unemployment as Main Social Consequences of Transition Processes in the Baltic States", in K. Zukrowska and D. Sobczak (Eds.), Strategy of EMU Enlargement. Background, Optimal Choices, Consequences, Warsaw School of Economics, Warsaw, pp. 163-194.
- 2004. (with Paas, T., Hinnosaar, M., Masso, J. and O. Szirko): "Social Protection Systems in the Baltic States", Forthcoming in the Faculty of Economics and Business Administration Working Paper No 26, University of Tartu (Estonia), 87 pp.

PUBLICATIONS

- 2003. (with Raul Eamets, Epp Kallaste, Jaan Masso): "How flexible are labour markets in the CEECs? A Macro level approach." TRANSFER (Quarterly of the European Trade Union Institute) 1/2003, pp. 101-121.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- September 2002. (with Paas, Tiiu, Eamets, R., Rõõm, M., Selliov, R., Jürgenson, A.)"Labour flexibility and migration in the EU eastward enlargement context: the case of Baltic States". Ezoneplus Working Paper No 11, 79 pp. (www.ezoneplus.org).
- September 2002. (with Kemmerling, Achim. Paas, T., Eamets, R., Rõõm, M., Selliov, R., Jürgenson, A.,.): Regional Input: Labour Markets. Ezoneplus Working Paper No 6A, 51 pp. (www.ezoneplus.org).
- 22-23 November 2002. "Employment Protection Regulation in the Baltic States". Estonian-Finnish Joint Seminar "Economic Integration and the European Union Enlargement", Tallinn.
- 2003. (with Raul Eamets, Marit Rõõm): Labour Market Flexibility and Migration in the Baltic States: Macro Evidences. University of Tartu, Faculty of Economics and Business Administration Working Paper Series, No. 16, 101 pp.
- 2003. (with Raul Eamets): Labour Market Flexibility and Employment Protection Regulation in Baltic States. Forthcoming in Working Papers of the Tallinn Technical University in 2003.
- 2003. Public policy intervention in the Labour Markets: regional variation in enforcement of labour laws in Estonia. Eesti Majanduspoliitika teel Euroopa Liitu. XI teadus- ja koolituskonverentsi ettekanded-artiklid, Berlin-Tallinn 2003, pp. 346-356.
- 2003. The State of "Informatization" in the Baltic States: A Comparative Analysis, pp.121-145. – Nowe Porganicze Europy. Litwa, Lotwa, Estonia, Pod. Red. Eufemia Teichmann, Polskie Wydawnictwo Economiczne, Warszawa, 2003.
- 15 March 2003. "The Efficiency of Labour Usage in Estonian Manufacturing enterprises". Seminar in UNU Wider within PhD Course "Topics in Applied Microeconometrics",
- 26-28 June 2003. "Public policy intervention in labour markets: regional variation in enforcement of labour laws in Estonia". XI scientific and educational conference "Estonian Economic Policy on the Way Towards the European Union" in Värska (Estonia).
- 2003. (with Almas Heshmati): Optimality and Overuse of Labour in Estonian Manufacturing Enterprises. University of Tartu, Faculty of Economics and Business Administration Working Paper Series, 2003, No. 20, 58 pp.
- 2003. (Raul Eamets): Labour Market Flexibility and Employment Protection Regulation in the Baltic States. In: Open Minds. Europe in Global World – blending differences. Conference for young academics. 13-14 September, Lodz, Poland, pp. 225-228.
- 2003. (with Almas Heshmati): The Optimality and Overuse of Labour in Estonian Manufacturing Enterprises. Institute for the Study of Labour (IZA), IZA Discussion Paper No. 884, 37 pp. ftp://ftp.iza.org/dps/dp884.pdf.
- 20-24.07.2003. "The Efficiency of Labour Usage in Estonian Manufacturing enterprises". Presentation in the summer school of the Faculty of Economics and Business Administration , Roosta (Estonia).
- 13-14 September 2003. Labour Market Flexibility and Employment Protection Regulation in the Baltic States. Open Minds. Europe in Global World – blending differences. Conference for young academics. University of Lodz, Lodz, Poland.
- 28-29 November 2003. Presentation "Labour Market Flexibility and Employment Protection Regulation in the Baltic States" at "International Workshop Business, Law and Economics", Scandinavian Association of Law and Economics, Helsinki.

- 17 December 2003. Tööturu paindlikkus ja töösuhete regulatsioonid (Labour Market flexibility and labour relations regulations). Presentation in the Estonian Employers Association's seminar "The regulation of employment relationships in Germany and Estonia".
- 2004. (with Raul Eamets): Labour Market Flexibility and Employment Protection Regulation in the Baltic States. Institute for the Study of Labour (IZA), IZA Discussion Paper No. 1147, 37 pp. pp. ftp://ftp.iza.org/dps/dp1147.pdf.
- 2004. (with R. Eamets): "How Flexible is Estonian Labour Market? Micro Evidence from Firm Demographics Data", – Eesti majanduspoliitilised perspektiivid Euroopa Liidus. Economic Policy Perspectives of Estonia in the European Union. Tallinn, Berlin: Mattimar OÜ, Berliner Wissenschaftsverlag (BWV), pp. 237-245.
- 2004. (with Paas, T., Rõõm-Hinnosaar, M. and C. Schumann): "Income Inequality, Poverty and Unemployment as Main Social Consequences of Transition Processes in the Baltic States", in K. Zukrowska and D. Sobczak (Eds.), Strategy of EMU Enlargement. Background, Optimal Choices, Consequences, Warsaw School of Economics, Warsaw, pp. 163-194.
- 2004. (with Eamets, R., and K. Philips): "Job Creation and Job Destruction in Estonia: Labour Reallocation and Structural Changes". University College London, Centre for the Study of Economic and Social Change in Europe Working Paper No. 39, 39 pp.
- 2004. (with Paas, T., Hinnosaar, M., O. Szirko): "Social Protection Systems in the Baltic States", Forthcoming in the Faculty of Economics and Business Administration Working Paper No 26, University of Tartu (Estonia), 87 pp.
- 13-14 May 2004. (with R. Eamets, K. Philips): "Job Creation and Job destruction in Estonia: labour reallocation and structural changes". Presentation in the Workshop "Growth and Restructuring of a New EU Member", London, School of Slavonic and East European Studies.

PUBLICATIONS

- 2002. "Financing constraints as determinants of investment behaviour among Estonian firms." Baltic Journal of Economics, Vol. 3, Number 1, pp. 8-30.
- 2003. "How flexible are labour markets in the CEECs? A Macro level approach." TRANSFER (Quarterly of the European Trade Union Institute) 1/2003, pp. 101-121. (with Raul Eamets, Epp Kallaste, Marit Rõõm).
- 2004. (with Kiander, J., Paas, T. and R. Vaittinen): "Labour Market, Social Dimension, and the Eurozone Enlargement", in M. Bolle (ed.), "Eurozone Enlargement. Exploring Uncharte Waters", Berliner Wissenschafts-Verlag, pp. 67-88, Vol. 3 (ISBN: 3-8305-0834-4).
- 2004. (with Almas Heshmati): "Optimality and Overuse of Labour in Estonian Manufacturing Enterprises". Forthcoming in "Economics of Transition".

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 2003. (with Leetmaa, R., Võrk, A): "Evaluation of Active Labour Market Programs in Estonia"', Labour Market Research in Estonia: Papers of the Research Seminar, Tallinn, May 9, 2003.
- 2003. Philips, K., Priinits, M., Võrk, A. "Migratsiooniga kaasnevad probleemid Euroopa Liidu idalaienemisel" (The problems with migration in the process of eastern enlargement of the

European Union) – Articles of the 11th Conference on The effect of European Union expansion on Estonian economic policy, Värska. Berlin, Tallinn: BWV, Mattimar OÜ 2003, pp. 377-384.

- 2003. Birk, M., Võrk, A. "Majanduspoliitilised võimalused sündimuse ja naiste tööturukäitumise mõjutamiseks Eestis“ (Economic Policy measures to influence fertility and female labour behaviour in Estonia) – Articles of 11th Conference on The effect of European Union expansion on Estonian economic policy, Värska. Berlin, Tallinn: BWV, Mattimar OÜ 2003, pp. 311 -320.
- 2003. Paas, T., Võrk, A. "Social consequences of transition: who recognize themselves to be poor in Estonia?“ –Articles of 11th Conference on The effect of European Union expansion on Estonian economic policy, Värska. Berlin, Tallinn: BWV, Mattimar OÜ 2003, pp. 366 -375.
- 2003. Leetmaa, R., Võrk, A. Peretoetuste mõju pereplaneerimisele ja riigieelarvele. (The impact of family benefits on family planning and state budget). Policy Analysis No 5, Centre for Policy Studies PRAXIS, 2003. www.praxis.ee.
- 2003. Selliov, R., Võrk, A. Eesti toiduainete nõudluse hinna- ja sissetulekuelastsuste hindamine. (Estimation of the price and income elasticities of demand for food products in Estonia) – Articles of the 11th Conference on The effect of European Union expansion on Estonian economic policy, Värska, Berlin, Tallinn: University of Tartu, Mattimar OÜ 2003, pp. 422-430.
- 6 June 2003. Presentation "Ökonomeetriaga ökonoomsem ökonoomika" (More economical economy with econometrics), at the day of the Faculty of Economics and Business Administration in Tartu.
- 1-2 June 2003. Paas, Tiiu. Võrk, Andres: Self-assessment of Estonian households’ Economic Situation as an Expression of Adjustment to Transition and European Integration Processes. International Conference organized by Stockholm School of Economics in Riga “Human development in EU Accession Countries”, Conference Guide, pp. 99-101.
- 2004. Uudeküll, K., Võrk, A. "Ennetähtaegne vanaduspension ja selle seos tööturukäitumisega Eestis“ (Early Retirement and it’s connection with labour market behaviour in Estonia) – Articles of the 12th Conference on The Economic Policy Perspectives of Estonia in the European Union, Värska. Berlin, Tallinn: BWV, Mattimar OÜ 2004, pp. 278-287.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 2002. „Presidendivalimised 2001“ (Presidential elections 2001), in Rein Toomla (ed.) „Presidendiraamat“, Publishing Office of University of Tartu, 2002, pp.
- January 2003. (with Tiiu Paas, Marit Rõõm, Christopher Schumann, Orzolya Szirko): “Social and Political Dimensions of the Eurozone Enlargement in the Case of the Baltic States”, Ezoneplus Working Paper No. 13, Freie Universität Berlin, Jean Monnet Centre of Exellence, 110 p. (www.ezoneplus.org).

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 2001. Arro, R, , Järve, J., Kallaste, E., Philips, K.: Labour Market Flexibility and Employment Security: Estonia. Employment Paper 2001/25, International Labour Office, Geneva
- 19-22 September 2002. . Varblane, U, Sõstra, K. External macroeconomic shocks and Estonian Economy: How did Russian financial crises affected Estonian unemployment and foreign trade. EALE 14th annual conference, Paris, University Sorbonne.
- 7-9 April 2002. The free movement of labour and changes in the Estonian labour market. Does education matter? Internationa conference Higher Education and Economic Development "BalticTransfer", FHTW Berlin.
- 2002. Estonian labour policy in the context of EES, paper presented in EES Challenges and Perspectives for the Social Partners in the Candidate Countries, European Trade Union Institute, June 20-21, Brussels.
- September 2002. (with M. Rõõm, T. Paas, R. Selliov, A. Jürgenson, J. Masso, A. Kemmerling): Regional Input "Labour Markets". Ezoneplus Working Paper No 6A (Working Paper No 6 Supplement, www.ezoneplus.org).
- September 2002. (with Tiiu Paas, Marit Rõõm, Rena Selliov, Anne Jürgenson, Jaan Masso): "Labour Flexibility and Migration in the EU Eastward Enlargement Context: The case of the Baltic States". Ezoneplus Working Paper No 11 (www.ezoneplus.org).
- 22-23 May 2003.Free Movement Inwards, Closing Gates Outwards – the Impact of the Enlargement of on the EU's New Eastern Border regions, paper presented in 4th International Conference of the Otto Brenner Foundation, Berlin.
- Sept.3-5, 2003.The New European Social Model. Labour Market in Europe: Old Problems and New Challenges after Eastward Enlargement., Presention in seminar "Key Groups to Key Position" European Union in the Baltic Sea Region, Helsinki.
- 9-10 October. 2003. Is there enough flexibility for adaptability in CEE countries?" international seminar 'The Unification of Europe: The role of social partners in the EES', Berlin.
- 24-25 November 2003. How to solve skills gap problem in Estonia Presention in seminar Tartu-Turku Co-operation and Bologna Process, Tartu.
- December 2003. Labour Market Flows and the Adjustment to Macroeconomic Shocks in the Baltic States, CERGE-EI Discussion paper No 102.
- 6-8 December 2003. CEE labour markets, definitions, statistics, future prospects, presentation in CHANGEQUAL network meeting „Comparative Research on Inequality and Quality of Life: integrated or diverse measures for East and West", Tartu.
- 2004. (with Masso, J): "Labour Market Flexibility and Employment Protection Regulation in the Baltic States", IZA Discussion Paper No 1147.

PUBLICATIONS

- 2003. (with Epp Kallaste, Marit Rõõm, Jaan Masso): "How flexible are labour markets in the CEECs? A Macro level approach." TRANSFER (Quarterly of the European Trade Union Institute) 1/2003, pp. 101-121.

- 2003. External Macroeconomic Shocks and the Estonian economy: How did the Russian Financial Crisis affect Estonian Unemployment and Foreign Trade? *Baltic Journal of Economics*, Vol 3, No 2 Spring/Summert 2003, pp 5-24 (with Urmas Varblane and Kaja Sõstra)
- March 2004. Labour Market Flows and Adjustment to Macroeconomic Shocks in the Baltic States, *Post-Communist Economies*, Vol 16, No1, pp 47-71

TEACHING ACTIVITIES

- Based on this research I have prepared 2 lectures "Institutions and labour market flexibility" and "Migration and free movement of workers". These lectures are included to three different courses taught in undergraduate and graduate level.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- January 2003. (with Tiiu Paas, Marit Rõõm, Allan Sikk, Reilika Liiv, Christopher Schumann): Social and Political Dimensions of the Eurozone Enlargement in the Case of the Baltic States. Ezoneplus Working Paper No. 13, Freie Universität Berlin, Jean Monnet Centre of Excellence, January2003, 110 p. (www.ezoneplus.org).
- 14-16 June 2003. (with O. Szirko): "Disability benefits in Estonia", Tenth International Research Seminar on "Issues in Social Security" - "Social Security and Participation in Social and Economic Life", Sigtuna, Sweden, (organised by The Foundation for International Studies of Social Security (FISS)).
- 2004. Paas, T., Hinnosaar, M., Masso, J. and O. Szirko, "Social Protection Systems in the Baltic States", Forthcoming in the Faculty of Economics and Business Administration Working Paper No 26, University of Tartu (Estonia), 87 pp.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- Social and Political Dimensions of the Eurozone Enlargement in the Case of the Baltic States.
- January 2003. (with Tiiu Paas, Marit Rõõm, Allan Sikk, Christopher Schumann, Orzolya Szirko): Ezoneplus Working Paper No. 13, Freie Universität Berlin, Jean Monnet Centre of Excellence, January2003, 110 p. (www.ezoneplus.org).

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- May 2003. "EMU Accession Issues in Baltic Countries" Ezoneplus Working Paper No. 17A (Working Paper No. 17 Supplement).

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 23-24 November 2001. T. Paas and K. Philips: Conference Proceeding "Long-term unemployment in Estonia." 2nd Conference of Estonian Social Scientists, Tartu.
- 27-29 June 2002. T. Paas and K. Philips: Conference Proceeding "Long-term unemployment in Estonia: to support passive adaptation or active development?" 10th Conference on The effect of European Union expansion on Estonian economic policy, Värska, pp 143 - 150.
- 2004. Kallaste, E., Philips, E. "Tööjõu vaba liikumine: kas tõsine oht Eesti tööturule" (Free Movement of Labour: a threat to the Estonian labour market) – Articles of the 12th Conference on The Economic Policy Perspectives of Estonia in the European Union, Värska. Berlin, Tallinn: BWV, Mattimar OÜ 2004, pp. 278-287.

3. Government Institute of Economic Research (VATT), Helsinki, Finland

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 2001. (with M. Viren): "Measuring labour market flexibility in the OECD countries". Empirica, 28..
- 13 December 2001. Presentation "Enlargement and labour markets" Finnish Economic Society, Helsinki.
- January2002. (with Project Participants): "The Eastward enlargement of the Eurozone: State of the Art Report", Ezoneplus Working Paper No. 02 (www.ezoneplus.org).
- April 2002. (with Project Participants): "Capital Market Deregulation, Financial Integration and Macroeconomic Performance in the Nordic Countries in the 1980s and 1990s: Are there any lessons?" Ezoneplus WP 5A (www.ezoneplus.org).
- 20 May 2002. Presentation at a conference on enlargement and migration, Labour Ministry, Helsinki.
- 29-31 May 2002. International Conference on the Northern Dimension of the EU, in Helsinki, organised by the Government Institute for Economic Research.

- 5 July 2002. Presentation (with R. Vaittinen): "Eastern enlargement of the Eurozone and the adjustment of labour market", 2nd official Ezoneplus workshop, Bologna.
- August 2002. "Capital Market Deregulation, Financial Integration and Macroeconomic Performance in the Nordic Countries in the 1980s: And there any Lessons?" in T. Meyer et al: The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets – Regional Inputs on Data and Statistic, Ezoneplus Working Paper No. 5A (www.ezoneplus.org).
- August 2002. (with Tiiu Paas, Risto Vaittinen): "The Eastern Enlargement of the Eurozone and Labour Market Adjustment", Ezoneplus Working Paper No. 6 (www.ezoneplus.org).
- October 2002. (with H. Lönnqvist): "Hyvinvointivaltio ja talouskasvu (Welfare state and economic growth)", WSOY, Helsinki.
- October 2002. Presentation "Julkisen talouden haasteet ja verotuksen keventäminen (The challenges of public finance and taxation)", Annual VATT Conference, Helsinki.
- November 2002. Presentation "Hyvinvointivaltion tulevaisuus Suomessa (The future of welfare state)", The Association of Finnish Local and Regional Authorities, Helsinki.
- December 2002. "Tarvitseeko Suomi ulkomaista työvoimaa? (Does Finland need immigrants?)", PTT katsaus 4/2002.
- December 2002. (with T. Paas and R. Vaittinen): "Labour market adjustment" in M. Bolle (ed.): Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets. Berliner Wissenschafts-Verlag.
- 2002. "The Finnish macroeconomic policy and performance in 1995–2000", in Ministry of Labour: National evaluation of the effects of the European employment strategy in Finland.
- January 2003. "Ikärakenteen muutos, hyvinvointivaltion rahoitus ja verotus (Demographic change, taxation and financing the welfare state)" in J. Pekkarinen and I. K. Kavonius: Suomi, EU ja maailma – puheenvuoroja talouspolitiikasta. Helsinki: Työväen sivistysliitto.
- January 2003. (co-edited with Reino Hjerppe, Seppo Kari and Panu Poutvaara): "Verokilpailu ja Suomen verojärjestelmä (Tax competition and taxation in Finland)", WSOY, Helsinki.
- February 2003. "The Nordic Welfare State in the 1990s: Consequences of disinflation and fiscal consolidation in the three Nordic EU Countries.", Ezoneplus Working Paper No. 13D (www.ezoneplus.org).
- May 2003. "Macroeconomic Policy and Performance in the Nordic EU Countries in the 1990s", Ezoneplus Working Paper No. 17 B (www.ezoneplus.org).
- June 2004. (with J. Masso, T. Paas and R. Vaittinen): "Labour market, social dimension and the Eurozone enlargement" in M. Bolle (ed.): Eurozone Enlargement – Exploring uncharted waters. Berlin: Berliner Wissenschafts-Verlag; Vol. 3 (ISBN: 3-8305-0834-4).
- June 2004. "Growth and employment in Nordic welfare states in the 1990s: a tale of crisis and revival", Government Institute for Economic Research, Discussion Paper no. 336.

TEACHING ACTIVITIES

- Fall 2001. Lecture course on labour market adjustment at the University of Helsinki
- Spring 2002. Lecture course on labour market adjustment at the Helsinki School of Economics.
- Spring 2003. Lecture course on the challenges of economic policy at the Helsinki School of Economics.
- Lectures on the effects of enlargement at the Universities of Turku (Feb 2003 and March 2004) and Jyväskylä (April 2003).

- Spring 2004. Lecture course on economic policy and European integration at the Helsinki School of Economics

OTHER

- Advisor to the permanent expert group of the Finance Ministry on EU eastern enlargement, 2000-2003.
- Advisor to the parliamentary supervisory committee of Bank of Finland, 1999-

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- 5 July 2002. Presentation (with J. Kiander): "Eastern enlargement of the Eurozone and the adjustment of labour market", 2nd official Ezoneplus workshop, Bologna.
- 5–7 July 2002. Presentation "Labour Martkets – Final report", 2nd official Ezoneplus workshop, Bologna.
- July 2002. "Eastern Enlargement of the EU: Factor Mobility and Transfers – which Matters Most? Sustainable Development and the General Equilibrium Approach", Proceedings of 5th annual Conference on Global Economic Analysis.
- August 2002. (with J. Kiander, T. Paas): "The Eastern Enlargement of the Eurozone and Labour Market Adjustment", Ezoneplus Working Paper No. 6 (www.ezoneplus.org).
- 22–23 October 2002. Presentation "Eastern Enlargement of the EU: Factor Mobility and Transfer – Which Factors Dominate?" Estonian-Finnish Joint Seminar: Economic Integration and the European Union Enlargement, Tallinn.
- December 2002. (with J. Kiander and T. Paas): "Labour market adjustment" in M. Bolle (ed.): Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets. BWV.
- January 2003. Presentation "Impact of Enlargement on European Labour Markets", Enlargement of the European Union – Nordic and Baltic views, Nordic-Baltic Research Seminar, Helsinki.
- 12.–14.6.2003. Vaittinen Risto – Honkatukia Juha – Fudala-Poradzinska Iwona – Januaryiak Monica: Poland's EU Accession – Results from a Study Utilising the PolGem -Model of the Polish Economy, 6th Annual Conference on Global Economic Analysis, Scheveningen, Haag.
- 13.6.2003. Poland's EU Accession – Results from a Study Utilizing the PolGem – Model of the Polish Economy, Seminar on Nordic Dimension, Warsaw.

PUBLICATIONS

- 2004. "Trade Policies and Integration - Evaluations with CGE Models", VATT Research Reports 109 (Ph.D. Dissertation).
- 12.3.2004. "Consequences of Eastern Enlargement", presentation to Finnish journalists.
- 25.3.2004. "Impacts of labour mobility after enlargement", Interview at Helsingin Sanomat (leading Finnish newspaper).
- 2004. (with J. Kiander, J. Masso, T. Paas, R. Vaittinen): "Labour Market, Social Dimension, and the Eurozone Enlargement", In "Eurozone Enlargement Exploring Uncharted Waters", Michael Bolle (ed.), Ezoneplus Final Report 2004, Berlin: Berliner Wissenschafts-Verlag; Vol. 3.

TEACHING ACTIVITIES

- 3–4 Sept 2002. (with J. Honkatukia): CGE Modeling Course at the University of Tartu.

OTHER

- Frequent advice to the permament expert group of the Finance Ministry on EU eastern enlargement.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- June 2003. "Euroopan unionin itälaajentuminen ja maahanmuutto Suomeen (The Eastern enlargement and migration to Finland)", VATT research reports 98. Helsinki.
- February 2004. "Euroopan unionin itälaajentuminen ja maahanmuutto Suomeen (The Eastern enlargement and migration to Finland)", Conference presentation in The XXVI Annual Meeting of Finnish Economists. Kuopio.
- June 2004. "Uusista EU-maista tulevan maahanmuuton makrotaloudellinen merkitys (The Impact of Immigration from the New EU Member States on Finnish Macro-Economy)", Finnish Labour Review 2/2004 Vol. 47: 8-25. Helsinki.
- Forthcoming. "Maahanmuuton taloudelliset vaikutukset Suomelle" (The Impact of Immigration on Finnish Economy), VATT research reports. Helsinki.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- January2002. (with Project Participants): "The Eastward enlargement of the Eurozone: State of the Art Report", Ezoneplus Working Paper No. 02 (www.ezoneplus.org).
- August 2002. (with Project Participants): "The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets - Regional Inputs on Data and Statistics", Ezoneplus Working Paper No. 5A (www.ezoneplus.org).
- 4 –7 July 2002. Coordinator of the Bologna workshop.
- July 2002, Presentation of the Intermediate Report on "Exchange Rate Regimes" with discussion in the Bologna Workshop.
- August 2002. (with F. Iacone):"Exchange Rate Management and Inflation Targeting in the CEE Accession Countries", Ezoneplus Working Paper No. 8 (www.ezoneplus.org).

- 2002. "Exchange-rate Regimes" In: Michael Bolle (ed.). Eurozone Enlargement – Exchange-Rate Choices and Adjusting Markets (Ezoneplus Summary Report). Berlin: Berliner Wissenschafts-Verlag (ISBN: - 3-8305-0350-4), 19-35.
- June 2003. (with F. Iacone): "The Eastward Enlargement of the Eurozone (Ezoneplus)" Final Report on Exchange Rate Regimes", Ezoneplus Final Report on Exchange Rate Regimes, Ezoneplus Working Paper No. 16 (www.ezoneplus.org).
- August 2002. (with R. Golinelli): "Modelling Inflation in EU Accession Countries: The Case of the Czech Republic, Hungary and Poland", Ezoneplus Working Paper No. 9 (www.ezoneplus.org).
- December12, 2003 participation at the conference on "Strategy on EMU Enlargement" organized at Warsaw School of Economics where we presented the paper entitled "Monetary Policy Strategy for Accession Countries" (with F. Iacone). The paper has been published on the book "Strategy for EMU Enlargement" edited by K. Zukrowska and D. Sobczak, Warsaw 2004.
- March 2004. (with Katarzyna Zukrowska et al.): "Policy Advice: Markets and Policies", Ezoneplus Working Paper No. 20 (www.ezoneplus.org).
- March 2004. (with F. Iacone): "Exchange Rate Regimes and Monetary Policy Strategies for Accession Countries" published on "Fiscal, Monetary and Echange-Rate Issues of the Eurozone Enlargement" edited by K. Zukrowska, R. Orsi and V. Lavrac, Warsaw School of Economics, Warsaw, 2004.

PUBLICATIONS

- December12, 2003 (with F. Iacone): at Warsaw, presentation of the Final Report on Policy Advice, Markets, entitled "Exchange-Rate Regimes", published on "Eurozone Enlargement – Reshapling Policies and Social Conflicts", edited by M. Bolle, Berliner Wissenschafts-Verlag, Berlin 2003. Vol. 2
- June 18, 2004 (with F. Iacone and V. Lavrac): participation at the final conference of the Eurozone Enlargement at Berlin, presentation of final report entitled "Exchange Rate Regimes and Monetary Policy Strategies for New Member Countries" published on "Eurozone Enlargement – Exploring the Uncharted Waters" ed. by M. Bolle, Berliner Wissenschafts-Verlag, Berlin 2004. Vol. 3.

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- April 2002. "The Evolution of the Banking Industry in Italy and Austria after the Introduction of the Euro". Regional Input for the Ezoneplus "Report on Markets".
- August 2002. (with Thomas Meyer, Jaakko Kiander, Carlos Vieira and Isabel Vieira, Vladimir Lavrac): "The Eastward Enlargement of the Eurozone: The Shaping of Capital Markets - Regional Inputs on Data and Statistics", Ezoneplus Working Paper No. 5A (www.ezoneplus.org).
- March 2003. "Challenges for Monetary Policy and the Enlarged Euroland".Ezoneplus Working Paper No. 17D (Supplement to Working Paper No. 17, www.ezoneplus.org).
- June 2003. „Inflation Targeting and Monetary Policy: Some Preliminary considerations for Three Accession Countries".
- September 2003. (with Vladimir Lavrac (ed.), Dominik Sobczak, Katarzyna Zukrowska): "Final Report: Monetary and Fiscal Policy" Ezoneplus Working Paper No. 17 (www.ezoneplus.org).

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PAPERS, CONFERENCES, LECTURES AND SPEECHES

- August 2002. (with R. Orsi): "Exchange Rate Management and Inflation Targeting in the CEE Accession Countries", Ezoneplus Working Paper No. 8 (www.ezoneplus.org).
- 2003, Brussels Workshop, May 9 Panel on "Exchange Rates", presentation and discussion.
- June 2003. (with R. Orsi): "Final Report on "Exchange Rate Regimes", Ezoneplus Working Paper No. 16 (www.ezoneplus.org).
- 2004. (with R. Orsi, V. Lavrac): "Exchange rate regimes and monetary policy strategies for accession countries" In *Ezoneplus Final Report 2004*, Ezoneplus Working Paper No. 16 (www.ezoneplus.org).
- 2004. (with R. Orsi): " inflation control in Central and Eastern European Countries": status of the paper: we completed the work and are currently revising it. we plan to send it to a specialised, peer – revised journal soon. We also intend to present it in conferences dedicated to the issues of inflation control and euro – area enlargement.

PUBLICATIONS

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PROSPECTS

- with R. Orsi, we plan to explore empirically the issue of the definition of an equilibrium exchange rate for the currencies of the CEECs. Again, we intend to make the best use of the research we previously realised in the course of the Eurozone project. We aim at covering this topic by end 2004 or in 2005.

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- Economics and politics of the postsoviet states – 2002, 2003, 2004 – winter and summer semester, Warsaw School of Economics.
- Competition in the EU treaties – 2003, 2004 – winter and summer semester, Warsaw School of Economics.
- Poland in the EU – 2003 winter semester, Warsaw School of Economics.
- Structures of cooperation and security 2003 and 2004 summer semester.
- Macroeconomic of integration 2003 winter semester.
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TEACHING ACTIVITIES

- April - May 2003. 9 full-day information seminars on Poland's integration with the European Union in 9 small Polish towns in the South-East of the country.
- "Impact of establishing Economic and Monetary Union on capital markets in Europe" – lecture delivered at post graduate studies at Warsaw School of Economics
- "Functioning of Economic and Monetary Union" – a 15-hour course at graduate studies at Warsaw School of Economics

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- May 2003. Participation in the Ezoneplus Workshop "Eurozone Enlargement – Exchange Rate Regimes and Adjusting Markets, Goethe-Institut Inter Nationes Bruxelles, Brussels, 2003.
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- February 2004. Que Modelo Económico e Social numa Europa alargada? (What Economic and Social model for an enlarged Europe?), Seminar organized by o Instituto Politécnico de Beja, Beja.
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- 2002. with Tina Zumer: "Exchange rate arrangements of accession countries in their run-up to EMU - Nominal convergence, real convergence and optimum currency area criteria", Working paper 2002/13, Institute for economic research, Ljubljana.
- 2002. "Monetary, fiscal and exchange rate policies from the viewpoint of the enlargement of the eurozone - Survey of the literature", Working paper 2002/14, Institute for economic research, Ljubljana.
- 2002. Exchange rate regimes of Central and Eastern European EU candidate countries on their way to EMU, Working paper No.7, ICEG (International center for economic growth), European Center, Budapest.
- 30 January 2003. Lecture for the Banking Association of Slovenia, on the topic Slovenia and EMU
- May 2003. (with Gonzalo Caprirolo): "Monetary and exchange rate policy in Slovenia, Regional input", Ezoneplus WP No.17G (Working Paper No. 17 Supplement, www.ezoneplus.org).
- 24 March 2003. Lecture for the Faculty of economics, University of Ljubljana, course on International finance on the topic European monetary integration.
- 26 March 2003. "Invited discussion on the presentation by Laszlo Halpern on CEPR policy paper 10: Sustainable regimes of capital movements in accession countries", Slovenian macroeconomic forum, Faculty of economics, University of Ljubljana.
- 9 April 2003. Lecture for the Faculty of economics, University of Ljubljana, summer school, on the topic Slovenian monetary policy.
- 2003. (with Tina Žumer): Accession of CEE countries to EMU. Nominal convergence, real convergence and optimum currency area criteria, Bank Valetta Review, 2003/27.

- 2003. Slovenian Exchange Rate Policy, Monthly report, WIIW, 2003/6.
- June 2003. (with T. Zumer): "Exchange Rate Regimes of CEE Countries on the way to the EMU: Nominal Convergence, Real Convergence and Optimum Currency Area Criteria", Ezoneplus Working Paper No. 15 (www.ezoneplus.org).
- June 2003. Vladimir Lavrac: Institutional aspects of dynamics of inclusion of accession countries in the EMU, Ezoneplus WP No.18 (www.ezoneplus.org).
- 19-21 June 2003. Dynamics of Inclusion of Accession Countries in the EMU: Some Institutional Aspects, Conference. Institutions in Transition, Institute for macroeconomic Analysis and Development, Kranjska gora.
- 2003. ERM2 and Dynamics of Inclusion of Acceding Countries in EMU, European University Institute, Florence, Discussion Paper.
- 2003. ERM2 Strategyy for Accession Countries, Institute for Economic Research, Ljubljana, Working paper No.19.
- September 2003. (ed.) (with Katarzyna Zukrowska, Dominik Sobczak, Massimiliano Marzo): "Final Report: Monetary and Fiscal Policy" Ezoneplus Working Paper No. 17 (www.ezoneplus.org).
- 16-17 October. 2003 with Kalman Dezseri: The Introduction of the Euro: Theoretical approaches and practical consequences, presentation at the bilateral conference Slovenia and Hungary - New Members of the EU, Ljubljana.
- 2004. Izpolnjevanje Maastrichtskih konvergencnih kriterijev in Slovenija, (English translation: Slovenia and Fulfillment of the Maastricht Convergence Criteria), Bancni vestnik, Posebna številka, Slovenija ob vstopu v EU: Stanje, problemi in izzivi, 2004/5 (Fulfillment of Maastricht Convergence Criteria and Slovenia, Banking Newsletter, Special Issue, Slovenia at the Time of EU Accession: Situation, Problems, Challenges, 2004/5).
- 2004. Fulfillment of Maastricht Convergence Criteria for Slovenia and Other Acceding Countries, Institute for Economic Reesearch, Working Paper No.22 (www.ezoneplus.org).
- April 2004. "Fulfillment of Maastricht Convergence Criteria and the Acceding Countries", Ezoneplus Working Paper No. 21 (www.ezoneplus.org).
- 2004. Round Table at the Press Conference on the Occasion of Issuance of Banking Newsletter, Special Issue, Slovenia at the Time of EU Accession: Situation, Problems, Challenges, 2004/5, (presentation, TV and Radio appearance).
- 2004. Makroekonomska tveganja ob vstopu v ERM2 in EMU (English tranlation: Macroeconomic Risks at the Time of ERM2 and EMU Accession, Research paper for UMAR (Institute for Macroeconomic Analysis and Development, Ljubljana.

PUBLICATIONS

- 2003. (with Thomas Meyer, Dominik Sobczak, Katarzyna Zukrowska): "Monetary and fiscal policies" In: M. Bolle (ed.): "Eurozone enlargement. Reshaping policies and social conflicts", Ezoneplus Summary Report vol. 2, Berliner Wissenshafts-Verlag, Berlin, s. 11-30 (ISBN: 3-8305-0576-0).
- 2003. (with Neven Borak): "An outline of banking regulatory and supervisory system in Slovenia", in: David Green amd Karl Petrick (editors): Banking regulation and financial stability in Central Europe - Integrating transition economies into the European Union, E.Elgar, Cheltenham, Northampton, p.105-124.
- 2004. (with Fabrizio Iacone, Renzo Orsi): "Exchange rate regimes and monetary policy strategies for accession countries", In "Eurozone Enlargement Exploring Uncharted Waters", Michael Bolle

(ed.), Ezoneplus Final Report 2004; Berliner Wissenschafts-Verlag, Berlin 2004. Vol. 3. (ISBN: 3-8305-0834-4).

- 2004. (with Gonzalo Caprirolo): Slovenia's Monetary and Exchange Rate Framework in the Run-up to ERM2, in the book Souza L.V. and Aarle, Bas van (ed.) The Euroarea and the New EU Member States, Basingstoke, New York, Palgrave Macmillan.

TEACHING ACTIVITIES

- Teaching and lectures at the Faculty of Economics, Course: International Finance (topic: European Monetary Integration).
- 24 May 2004, and International Course: Slovenia and the EU Economy (topic: Slovenian path to the Euro).
- 25 March 2004, at the Banking Association, Course for Young Bankers (topic: Slovenia and European Monetary Integration).

FURTHER ACTIVITIES

- The inputs and results of Ezoneplus would be in one way or another included as a starting point in the forthcoming research project (2004-2007) Theory of Optimum Currency Areas and Economic Effects of Inclusion in EMU (approved for financing by the Slovenian Government, starting July 2003), where V.L. is one of the three researchers from the institute for Economic Research, Ljubljana.

MEDIA

- 24 January 2003. Interview for Reuters on Maastricht convergence criteria for Slovenia.
- 20 Feb 2003. Interview for Newspaper Delo on UK and EMU.
- 26 - 27 March 2003. Radio and TV appearance on Capital flows in ER
- 2003. Interview: Ne vemo še, kaj nas caka (in english translation: We do not know yet what is ahead of us, Profit newspaper, 2003/23
- Interview: Zagovarjam cimprejšnji prevzem evra (in english translation: In favour of an early adoption of the euro), Mag newspaper, 2003/46
- 2004. ERM2 and EMU, Interview for the Newspaper Delo, Ljubljana.

Annex 2: List of Deliverables*

Contract No.: HPSE-CT 2001-00084	Title: The Eastward Enlargement of the Eurozone	Project Coordinator: Prof. Dr. Michael Bolle, Freie Universität Berlin, Germany

No.	Ref. period	Title	Date of issue; reference
D1	month 3	Berlin Workshop: "Markets"	19-21 October, 2001; see http://www.ezoneplus.org/conferences.php?kindOf=1
D2	**months 1 to 6**	**"State of the Art"-Report**	**January 2002, published as Working Paper # 2 at the Ezoneplus website, downloadable at www.ezoneplus.org/archiv/ezoneplus_wp_two.pdf**
D3	months 1 to 11	Report "Capital Markets"	June 2002, published in August '02 as Working Paper # 5 at the Ezoneplus website, www.ezoneplus.org/archiv/ezoneplus_wp_five.pdf
D4	months 1 to 11	Report "Labour Markets"	June 2002, published in August '02 as Working Paper # 6 at the Ezoneplus website, downloadable at www.ezoneplus.org/archiv/ezoneplus_wp_six.pdf
D5	months 1 to 11	Report "Trade and FDI"	June 2002, published in August as Working Paper # 7 at the Ezoneplus website, www.ezoneplus.org/archiv/ezoneplus_wp_seven.pdf
D6	month 13	Bologna Workshop "Policies"	July 4 – 7 July, 2002; http://www.ezoneplus.org/conferences.php?kindOf=4
D7	**months 1 to 15**	**Summary Report: "Eurozone Enlargement – Markets"**	**published in December 2002, Berliner Wissenschafts-Verlag;** ISBN 3-8305-0350-4
D8	month 18	Brussels Workshop: "Policy Advice"	May 9 – 10, 2003; see http://www.ezoneplus.org/conferences.php?kindOf=6
D9	months 13 to 24	Report "Fiscal and Monetary Policies"	July 2003, published in September '03 as Working Paper # 17 at the Ezoneplus website, http://www.ezoneplus.org/archiv/ezp_wp_17.pdf
D10	months 13 to 24	Report "The Social Dimension"	June 2003, published in August '03 as Working Paper # 13 at the Ezoneplus website, http://www.ezoneplus.org/archiv/ezoneplus_wp_thirteen.pdf
D11	months13 to 24	Report "Exchange Rate Regimes"	July 2003, published in October '03 as Working Paper # 16 at the Ezoneplus website, http://www.ezoneplus.org/archiv/ezp_wp_16.pdf
D12	**months 12 to 23**	**Summary Report: "Eurozone Enlargement – Policies"**	**published in December 2003, Berliner Wissenschafts-Verlag;** ISBN 3-8305-0576-0
D13	**month 29**	**Warsaw Workshop "Recommendations"**	**12-13 December, 2003;** http://www.ezoneplus.org/conferences.php?kindOf=7
D14	months 24 to 30	Report "Policy Advice"	February 2004, published in March '04 as Working Paper # 20 at the Ezoneplus website, www.ezoneplus.org/archiv/ezoneplus_wp_20.pdf
D15	**month 35**	**Berlin Final Conference**	**18-19 June, 2004; see** http://www.ezoneplus.org/conferences.php?kindOf=8
D16	**months 24-36**	**Final Report: "Exploring Uncharted Waters"**	**published in June 2004, Berliner Wissenschafts-Verlag;** ISBN 3-8305-0834-4

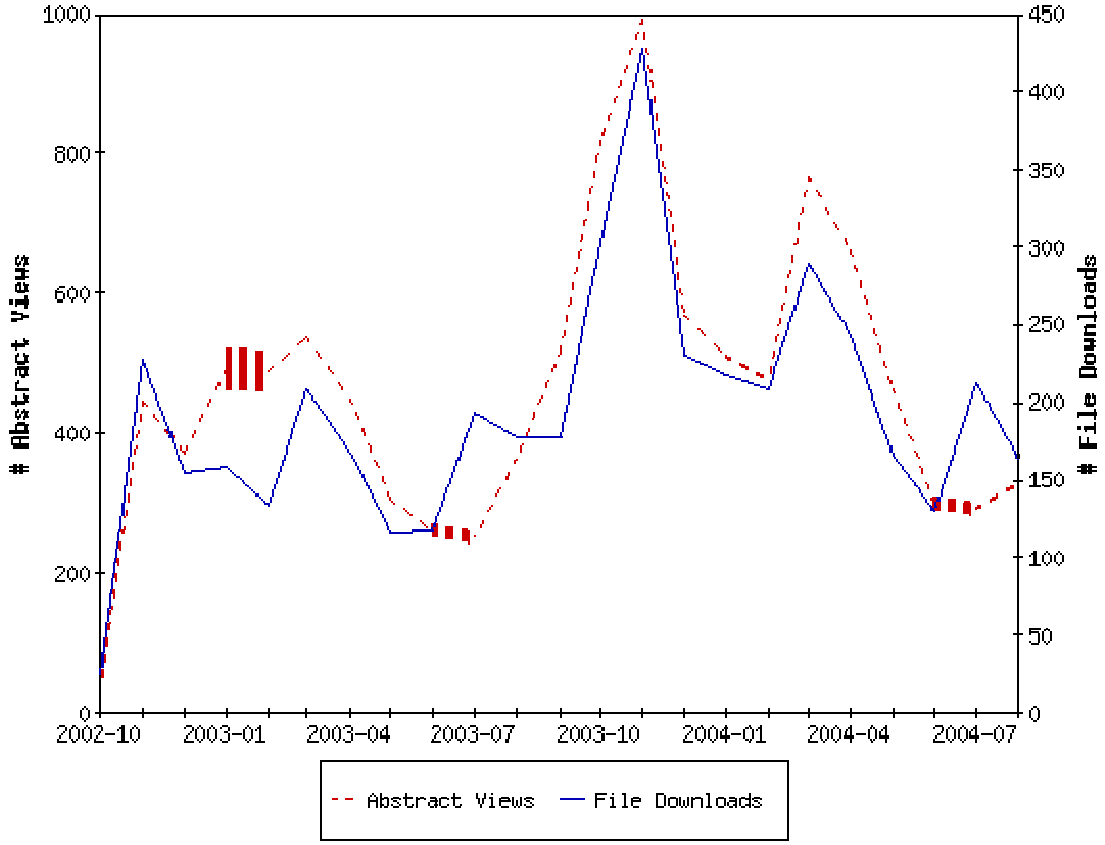
*** Milestones are in bold letters**

Annex 3: Download Overview of Ezoneplus WP

Eastward Enlargement of the Eurozone Working Papers

Free University Berlin, Jean Monnet Centre of Excellence

There are currently 32 items in this series, of which 32 are downloadable.



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File Downloads	**Abstract Views**	**File Downloads**	**Abstract Views**	**File Downloads**	**Abstract Views**
408	**859**	**2410**	**6047**	**1630**	**3793**

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