Ernst Welteke: On the eve of EU enlargement

Speech by Mr Ernst Welteke, President of the Deutsche Bundesbank, at Danmarks Nationalbank, Copenhagen, 29 October 2001.

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I

Ladies and Gentlemen

It is a pleasure for me to have the opportunity today to present some of my views here at Danmarks Nationalbanken. Thank you very much for your warm welcome.

I have been fortunate to have had the opportunity yesterday to get around a little in Copenhagen and in the northern part of Sealand. Time and again I note and appreciate the friendly atmosphere that exists in Denmark.

And time and again, as a European, I experience a real sense of regret that Denmark will not be one of the countries to make full use of the common European currency from 1 January 2002. Well, I hope you will acquire a taste for the euro later on.

In terms of economics, there are three things that relate Germany and Denmark to each other. Denmark's most important trading partner is Germany. Denmark's coasts and islands are a favourite destination for German tourists. And, of course, Denmark and Germany have a strong common interest in the upcoming eastward enlargement of the EU. That brings me to why I am here today - to discuss this vital topic with you.

II

Unfortunately, no discussion of economic issues can take place today without due consideration being given to the devastating terrorist attacks on New York and Washington.

When the attacks were launched on the United States of America on 11 September, the world economy had already weakened significantly. For the first time since the mid-seventies oil crisis, the G-7 countries are slowing in step, although the nature of the slowing is country-specific. As a result, world trade growth is down to two percent after growth of 12 percent in 2000 [due to a WTO estimate].

The economy in the United States had been slowing down sharply, led by lower investment spending following the IT-investment boom. Via the link to external demand, shrinking US investment expenditure had a negative impact on emerging markets in south-east Asia. Japan has not yet emerged from its decade-long slump. The banking crisis in the 1990s and unresolved structural problems still weigh heavily on the Japanese economy.

The world economy today finds itself in a state of heightened uncertainty. The events in New York and Washington have undermined the confidence of both businesses and consumers. The extent and the duration of the military encounter as well as the extent of the anthrax incidents will determine the level of confidence among consumers and businesses in the coming months.

Part of the current uncertainty lies in the fact that indicators refer to the period before the watershed date 11 September. This portion of uncertainty will recede as ever more figures cover the post-attack period.

In the euro area, economic growth is currently significantly below potential. The economy grew by only half a per cent in the first quarter and stagnated in the second quarter. Business and consumer confidence had been falling even before 11 September and the reduction in unemployment has come to a halt at 8.3 percent. The return to the presumed potential growth path of 2½ percent a year will be delayed.

There are, however, a couple of reasons to remain optimistic for the economic prospects of the euro area in the medium term. The expansionary effects of this year's interest rate cuts are still in the pipeline. It takes some quarters for interest rate measures to start affecting the real economy. In addition, low real interest rates make for favourable financing conditions throughout the euro area.

Increased use of information and communication technology will bolster potential growth. In this respect, the euro area is in a rather favourable position. A major portion of potential productivity gains of IT investment are yet to be realised. Heavy overinvestment in IT had been avoided in the euro area.

Definitely good news is on the price front. Inflation in the euro area has been falling since reaching its peak in May [3.4%]. In September, consumer prices were 2.5 percent higher than in the previous year [August 2.8%]. Early indicators such as producer prices and the prospected German inflation rate in October [2.0%] point to a further fall in inflation in the near future.

Monetary policymakers in the Eurosystem have lowered official interest rates during the course of this year by 100 basis points, acknowledging lower price pressure over the medium term. The Eurosystem's monetary policy measures are tailored to the medium-term outlook for price stability. If, in the Governing Council of the ECB, we see the possibility of reducing interest rates further without compromising price stability, we will do so.

For fiscal policy, it is of the utmost importance that the current situation be assessed in a realistic manner and that the instruments available are applied carefully. Activism and excessive zeal are perfectly understandable - but detrimental. The appropriate stance for fiscal policy now is to make use of built-in stabilisers. There is no room for extra spending programmes in the euro area, as these would clearly compromise consolidation efforts. Furthermore, it is plainly impossible to ensure that additional spending is timed precisely to meet the economies' needs. An extra budget may even turn out to have a procyclical effect.

There is, however, room for structural reforms in the euro area. Higher flexibility of labour and product markets can, first, bolster confidence in the euro area. It will, second, enable the euro area to even better cope with external shocks.

Economic and financial links bring economic weaknesses in other parts of the world to our doorstep faster now than ever. The euro area, however, is well equipped to weather many a storm. In its brief history, the Eurosystem, has already dealt with three external shocks and crises. The keywords are "the Asian crisis", "the oil price shock" and now "terror". That means that we have withstood what has been regarded as the worst case scenario for the new currency.

Looking back on three years of European monetary union we can therefore safely say that in the Eurosystem we have coped with various forms of stress. Our success is founded on the common stability orientation. The Eurosystem is obliged by the EC Treaty to maintain price stability. Fiscal policy is committed to sound public finances by means of the Stability and Growth Pact. Productivity growth is now usually taken into account when wage agreements are negotiated.

A generally stable currency and markets that trust the stability-orientation of central banks make for lower price increases in times of crises. They also anchor inflation expectations at low levels .The greater currency area is able to cushion external shocks. Now, with a common currency, Europe is taking a more important place in the world arena and will therefore be able to assume a position of greater responsibility.

III

Ladies and Gentlemen,

The attacks on New York and Washington coincide with the intensifying of a debate about the opportunities and threats of globalisation. Both issues are linked to some extent. Both lead to the conclusion that isolationism is not a workable concept in today's world.

Therefore, a need arises for us all to get involved in the debate. A broad based appreciation of the world economic order coupled with the prospect of prosperity for developing countries will cut the ground from under the terrorists' feet in the long run.

One of the answers to the questions posed by recent events is to expand international trade. The World Trade Organisation - the WTO - is crucial in this respect. At its meeting in the state of Qatar in November, the Ministerial Conference will formally confirm China's admission to the WTO. One billion more people will then benefit by trade liberalisation.

A new round of world trade negotiations must not fail again. In the current situation, it would be wrong to restrict openness. Quite the reverse - the opening of the world's economies must be speeded up.

Empirical research[1] confirms that if the degree of an economy's openness - measured by trade volume as a percentage of GDP - rises by one percentage point, GDP per capita rises by two percentage points. Clearly, this is only a rule of thumb, but these gains would represent nearly one trillion of additional world GDP annually. That equals about one-tenth of the US economy.

Developing countries derive exceptional benefit from free trade. If international trade were liberalised completely, they could see an increase of three percent in their annual GDP or - more impressive - three times the foreign aid they receive annually. Even if this figures exaggerated the effects, let's not forego that globalisation dividend!

Higher trade volumes and, of course, inward direct investment provide opportunities to participate in prosperity. Thirty years ago, for example, South Korea, was as poor as Ghana. Thanks to industrialisation, to high internal savings and to its integration into the world economy, it is now as rich as Portugal. Globalisation is not a zero-sum game. It is to the benefit of all people. Therefore the advanced countries must avoid trying to protect certain industries. Isolationism is clearly not a promising alternative.

Balancing interests internationally cannot stop at world trade. As the emerging markets' share in the world economy increases, they need to be integrated into the institutional arrangements of the world economy. In 1996 the Bank for International Settlement admitted emerging markets such as South Korea, China and Russia. Emerging markets play a key role in heightening the acceptance of the world economic order.

As a dedicated European, I would like to see Europe playing a mediating role. Europe does not seem to be a superpower destined to attract admiration or envy. Europe is therefore virtually predestined to be a mediator in balancing interests in the world.

Today, looking after national interests is done less and less effectively at the national level. After the terrorist attack, this has become obvious for a whole host of policies. Domestic and foreign policy are no longer separate issues. A transnational approach is now called for. Again, isolationism is no longer an option.

In Europe, we have already gone a long way towards this new approach. Monetary policy currently completes this process. Monetary policy in the euro area is denationalised.

In Europe we will go further along this path as we advance towards EU enlargement.

IV

In June, the European summit in Gothenburg proclaimed the accession process "irreversible". It is envisaged that negotiations with the first group of countries will be complete as early as the end of next year. We can truly say that we are on the eve of the eastward enlargement of the EU.

Fifty years after the signing of the Treaty of Paris, the European Union is more attractive than ever. It is a success. The entire history of the European Union is one of enlargements. In a first sweep the Union extended northwards - Denmark, Ireland and the United Kingdom joined the "club" in 1973. During the 1980s Greece and then Portugal and Spain became new member states - in what was known as the southern enlargement. In 1995 the accession of Austria, Finland and Sweden rounded off the picture.

The EU has some experience of enlargement already. In principle, therefore, any upcoming enlargement should be no big deal. In practice, however, it *is* a big deal. The eastern enlargement is special; indeed it is unique for three reasons.

(1) Most of the accession countries are still working on their transition. Former communist states have become democracies, state-led economies are being transformed into market-led economies. This is a demanding process. For the people that are now reaching out towards the EU many things have already taken a turn for the better. Joining the European Union and one day becoming full members of European monetary union are the logical steps on a path to freedom, stability and prosperity.

(2) The upcoming enlargement is also special in terms of its scope. Negotiations are currently being held with 12 countries. Once they have all joined the EU, the number of member

1 Frankel, Jeffrey and David Romer (1999). "Does Trade cause Growth?" In: American Economic Review 89(3), p 379-399.

states will have nearly doubled. The EU institutions need to be reshaped if they are to be appropriate to the larger community. The upcoming enlargement is, therefore, an opportunity to improve the functioning, the transparency and thus the acceptance of the European Union.

(3) A further challenge is presented by the substantial heterogeneity which exists between the EU and the group of accession countries. The people in the twelve accession countries will increase the EU population by roughly one-third. Nominal GDP, however, would rise by five percent only. The wealth gap between the current member states and the accession countries is larger than that between the countries involved in the earlier enlargements. In addition, there is a striking degree of heterogeneity among the accession countries themselves. GDP per capita ranges from 24 percent (Bulgaria) to 82 percent (Cyprus) of the EU average.

Contemplation of EU enlargement always provides an opportunity to review the benefits of integration. Integration is most clearly visible in monetary policy. The single monetary policy is designed for the euro area as a whole. Sharing a stable currency has become a hallmark of European economic integration. Some two months ago details of the new banknotes and their safety features were presented to the public. We are now halfway through the frontloading phase of distributing the new currency. Intensive information campaigns are being conducted. Monetary integration is thus taking on shape and meaning for the man and woman in the street.

The single monetary policy - even during the run-up to EMU - has provided many countries with an unprecedented degree of price stability. Trade has intensified and financial markets in Europe are integrating fast. Businesses, consumers and investors alike are seeing the benefits.

And even more is to be gained. Three countries are currently “member states with a derogation” (Article 122 of the Treaty). This basically means that they do not yet participate in European Monetary Union, implying that there is still some scope for enlargement within the EU as it is at present. The single currency is the consequent development of the common market. The status of “member state with a derogation” is designed to be an intermediate stage on the path to full EMU membership.

V

EU accession is basically a political process that passes through three stages. Accession partnerships prepare accession to the EU which will culminate in full EMU membership. EU accession is conditional on the fulfilment of the “Copenhagen criteria”. These encompass,

first, “the stability of institutions guaranteeing democracy, the rule of law, human rights, and the respect for a protection of minorities” - the political criterion;

second, “the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the EU”; and

third, “the ability to take the obligations of membership, including adherence to the aims of political unification, as well as Economic and Monetary Union (EMU)”.

The Copenhagen criteria define the common ground of the future European Union.

Integrating countries is, however, about far more than simply defining common ground. Economic integration is crucial, as the very stability of the large monetary union hinges on economic cohesion. A monetary union can only be stable over the longer term if - as the Treaty states in Article 121 - “a high degree of sustainable convergence” is achieved. I would like to present my view of what a “high degree of sustainable convergence” is.

“Sustainable convergence” encompasses all three types of convergence: nominal convergence, real convergence and structural convergence. Each type is important in its own right.

The Maastricht “convergence criteria” are set out to measure *nominal* convergence. These fiscal and monetary criteria relate to the inflation rate, capital-market interest rates, sustainable fiscal policy and exchange-rate stability. They are, in a way, both “stability criteria” and “convergence criteria”. They ensure that a country is not pursuing policies which might have an adverse effect on the stability of the common currency.

Anti-inflationary monetary policy is at the core of a stability-oriented policy. In most of the accession countries the process of disinflation is well under way. Hyperinflation is an issue of the past. This year all accession countries (with the exception of Romania[2]), have one-digit inflation rates. Expected outcomes range from 1.3 percent (Lithuania) to 8.5 percent (Hungary and Bulgaria[3]).

Weighted average CPI inflation in the 12 accession countries has been going down since 1999 at a rate of about two percentage points a year and will be slightly more than 8 percent this year. An average inflation rate of 8 percent a year is still four times higher than price stability as defined by the Eurosystem. Disinflation policies will have to be pursued further.

The so-called Balassa-Samuelson effect has been given much attention recently. According to this theory, countries are expected to have to deal with relatively higher inflation rates during the process of catching up. As they experience high productivity growth in the tradeables sector, wages in the non-tradeables will tend to go up in sync, leading to a higher overall rate of inflation.

This effect, however, does not suggest the Maastricht criteria to be revised. The inflation criterion already allows for inflation to diverge by 1.5 percentage points from the three best performing members of the currency union. Nor does the Balassa-Samuelson effect suggest to loosen the two percent ceiling for price-stability in the euro area, which leaves enough room for price increases due to catching up.

Sustainable convergence in inflation rates is crucial. Inflation rates can be kept at a sufficiently low level only if other policies comply with the stability orientation. Prudent wage policies will contribute to containing overall price developments. Structural policy also has a role to play. Currently, 25 percent of prices in accession countries are still administrated. Microeconomic reforms and further price deregulation have to be carried out. Only then can the price mechanism fully work through to the economy - a defining feature of a fully functioning market economy.

Fiscal policy is of special importance in this respect. Excessive deficits are to be avoided. The public sector deficit is the decisive measure of a government's demands on the financial markets. It is the benchmark for its stability orientation. Last year general government deficits among the accession countries ranged from 0.4 percent of GDP (in Estonia) to 7.1 percent of GDP (in Malta). Eight of the accession countries had not yet met the Maastricht budgetary criterion. However, the debt criterion - public debt less than 60 percent of GDP - was met by a broad majority of the accession countries.

There are still a few years in which to pursue convergence and to prove its sustainability. Nominal convergence is not a goal to be reached at a certain point in time; it is, rather, the natural and sustainable state of a stable currency union.

Apart from nominal convergence, *real* convergence is of importance in a monetary union. I use the term here in the sense of synchronicity of business cycles. The Governing Council of the European Central Bank designs monetary policy appropriate to the euro area as a whole. A country whose business cycle gets grossly out of step might suffer if it is subject to a monetary policy that is inappropriate to its national economy.

However, marching in absolute lockstep is not necessary, as can be seen in the USA, where certain regions grow faster than others. Growth rates of states and regions within a currency union may differ to some degree. It is the size of the gap between actual and potential growth rates which matters. If potential output growth rates differ, actual growth rates can differ as well. They do not necessarily indicate a lack of real convergence.

VI

In the longer run, stability must be built on economic integration. An extensive body of theory has evolved on the characteristics of optimum currency areas. Most important is, that prices and wages must be able to adjust flexibly. Mobility of goods, labour and capital shall provide for market integration. Therefore central criteria call for a high degree of structural convergence.

We have to distinguish between different types of structural differences. Most critical are structural differences that may hamper market integration. These structural differences we must work to abolish as they may hamper the functioning of the monetary union. For example, differing regulatory frameworks may prevent financial markets from integrating.

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2 Romania has already indicated that it would prefer accession to take place after 2004.

3 Bulgaria also prefers a later accession date; IMF data.

However, there are two other types of structural differences which are not in themselves a problem for a monetary union.

> First, there are diverse structures of production and consumption. Countries specialising in different areas will tend to exchange goods and services. Complementarity of economic structures entails market integration and is in no way detrimental for a monetary union.
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> Second, there are structural differences that help us to cross-check the sustainability of nominal and real convergence. The Treaty explicitly quotes the state and development of the balance of payments and unit labour costs.

Again, structural differences which hamper market integration have to be removed. The degree of market integration is crucial in assessing EU enlargement. Much has been achieved in terms of market integration between the 15 EU member states and the accession countries since the iron curtain was lifted in 1989. Bilateral “Europe Agreements” with the EU paved the way for future integration.

Early on, reciprocal free trade in industrial products was complemented by steps towards the free movement of services and capital. The EU is by far the most important trading partner of the accession countries. Around 65 percent of their exports are destined for one of the 15 EU member states. A slightly lesser share of their imports originates in the EU. EU imports from the accession countries grew at an annual rate of 12 percent between 1989 and 1999. If they continue at that pace, they will double every six years.

We can see clearly why trade has presented opportunities for both trading partners. The EU has specialised in advanced technological products. The transition countries import these investment goods in order to revamp their economy. They have shifted their exports from resource-intensive goods towards labour-intensive goods, thereby utilising their comparative advantage.

The complementarity of production structures allows specialisation gains to be exploited and the international division of labour leaves everybody better off. At 50 percent, the share of intermediate goods in accession countries’ trade - exports as well as imports - is rather high. This indicates how well the newcomers have already been integrated into international production chains.

With the early liberalisation of capital, market integration has been furthered to a considerable extent by foreign direct investment (FDI). During the 1990s some two-thirds of capital inflows in the accession countries originated from the European Union. Again, the neighbouring states Austria and Germany have been the most actively involved.

Labour markets are a lot less integrated internationally than goods and capital markets. Freedom of movement is one of the “four basic freedoms” of the single market in the European Union. Labour mobility within the EU - that is, both migration and cross-border working in border regions - is possibly the most sensitive issue in the current debate on EU enlargement. At least this is true of Germany and Austria. Anxieties abound - and they need to be taken seriously.

Economic integration can only take place if the four basic freedoms are granted. There is neither a way nor a need to exempt the labour market. Only then can we make full use of the market mechanisms. Moreover, a meaningful judgement of achieved convergence requires all four basic freedoms to be granted.

How much migration and cross-border working is to be expected? At the moment labour mobility is strictly regulated. Emigration from central and eastern European countries into the European Union peaked in 1990. Afterwards, when things improved in those countries, net emigration receded. Emigration became more costly than staying at home. No serious study predicts that EU enlargement will lead to extended migration. As long as the accession process is being pursued seriously, the potential for intensified migration looks rather limited. This was also the experience at the time of the southern enlargement.

The financial sector in accession countries still has some way to go. The banking sector in general is still tiny, highly concentrated and foreign-owned. Total banking assets in the EU are more than twice GDP. Of the transition countries, only the Czech Republic has total banking assets the size of its GDP. In all the other transitional economies involved in the enlargement process, the corresponding figure is only one-half. It is foremost the private sector that suffers from the low degree of financial intermediation.

Capital account liberalisation is a precondition for financial integration. However, fully liberalised capital flows entail certain risks for stability as long as the financial sector is still underdeveloped. We should allow sufficient time for financial integration between the accession countries and the EU to take place in order not to destabilise vulnerable financial sectors in the European emerging markets.

VII

Ladies and Gentlemen!

We are on the eve of enlarging the European Union eastward. Much has been attained so far - as regards the transition to fully-functioning market economies, in terms of macroeconomic stability, and in terms of prosperity.

However, the process of political, economic and financial change is still far from complete. To become full members of European *monetary* union requires accession countries to be fully-functioning market economies with a clearly defined stability orientation.

I am strongly in favour of EU enlargement. I am strictly against setting up new hurdles. I am also strongly opposed to the slightest compromise of the long-term prospects for a stable European monetary union. It is in our own best interest and in the best interest of the accession countries for nominal *and* structural convergence to be fully achieved before EMU is enlarged.

Warsaw, Prague and Budapest are essentially European capitals. A European Union is incomplete without the central eastern European countries.

With the eastern enlargement, things will come full circle in Europe. Mutual understanding of the people is bound to deepen, as relations grow ever closer in a union sharing basic convictions. A free and democratic enlarged European Union is a reliable and a stable partner in the world economy - in times of strain or prosperity.