A H E M Wellink: EU expansion and EMU

Address by Dr A H E M Wellink, President of De Nederlandsche Bank and President of the Bank for International Settlements, at the Nederlands Genootschap voor Internationale Zaken, Utrecht, 13 March 2002.

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Introduction

"We Europeans must create the basis for a broader and deeper community among peoples long divided by bloody conflicts and lay the foundations for institutions which will give direction to a destiny henceforward shared".

These lofty words, formulated over fifty years ago, can be found in the preamble to the Treaty establishing the European Coal and Steel Community. Although they may strike you as slightly passé, the underlying thought has lost none of its poignancy.

- To begin with, we sense a moral and historical duty to unite a long-divided continent in these words. For the first time, countries from Central and Eastern Europe will be joining the European Union, as from 2004.
- Secondly, the Preamble states that Europe should have sufficient institutional power and cohesion to give direction to a shared destiny. As you know, the European Convention which has just started is dealing with this issue; I understand that Dick Benschop will be here next week to elaborate.
- Finally, the text speaks not just of a duty to form a close-knit and strong Europe, but also of the right of every European to share in the fruits of such an undertaking.

We are aware that the tensions between these three principles have grown, as evidenced by renewed power politics at the national level and growing discrepancies between large and smaller Member States. The economic heterogeneity within the EU will only be augmented by the accession of new Member States. It is this very heterogeneity which is exacerbating the discussion on rights and duties and the need for cohesion within the Union.

It is with these consideration in mind that I will be discussing the economic background to the expansion of the EU, with a special focus on Economic and Monetary Union. The central theme in my address will be the specific challenges to economic policy which the accession countries will be facing over the next few years. Given these challenges, the accession countries should, in my view, adopt a gradual approach towards the euro; they should first be properly embedded in the existing process of economic policy coordination.

Situation with regard to expansion

Today, twelve countries are negotiating accession to the EU: the Visegrad countries in Central Europe, the Baltic states and three Balkan countries: Bulgaria, Rumania and Slovenia. These countries must all pass what is known as the Copenhagen test. This test was drawn up by the European Council in Copenhagen in 1993, and consists of three criteria:

- To begin with accession countries must have political and democratic institutions along western lines before they can even enter into negotiations. That is why Turkey, the thirteenth accession country, finds itself in an exceptional position.
- Secondly, the potential Member States must subscribe to the objectives of European integration. This means, among other things, that they must adopt and implement all European legislation and rules, in other words the Acquis Communautaire. Exceptions, such as those made in the past for the British and the Danes with regard to participation in EMU, will not be allowed.
- Finally, the Copenhagen criteria also encompass an economic test: the accession countries must have a functioning market economy and be capable of coping with market forces within the EU. In my opinion, this means they must be able to create a stable macro-economic

climate, where market operators and consumers can take decisions and develop initiatives in a predictable and reliable environment. This presupposes powerful institutions and supervisory authorities, a full-fledged physical and human infrastructure and a developed financial sector. It also means that economic sectors must be sufficiently competitive to be able to operate within the single market.

An indicator of such competitiveness is provided by trade relations with the European Union. Over the past ten years, these relations have tightened considerably. The geographical reorientation and the abolition of trade barriers since 1990 have contributed to an increase in the trade volume between the accession countries and the EU. Today about 67% of these countries' exports go to EU Member States. It is worth noting that trade between the same sectors has also grown materially. There can be no doubt that this is largely the result of vast foreign investment in these countries. The adoption of European rules may, however, impair the competitiveness of, for instance, the agricultural and industrial industries.

In its latest evaluation, of November 2001, the Commission concluded that all accession countries except Rumania and Bulgaria have a functioning market economy. Of these countries, the Baltic states, Hungary, Poland, Slovakia, Slovenia and the Czech Republic are considered capable of holding their own within the single market, provided they continue to reform. Malta and Cyprus already fully meet the economic criterion.

Subsequent to this Commission report, the European Council of Laeken indicated in December that eight to ten countries will be joining the EU as from 2004. The chances of a big bang scenario, with all accession countries except Bulgaria and Rumania joining at the same time, has thus gained in probability. Politically, this would be the preferred route, eliminating tensions between countries joining soon or at a later stage and facilitating the ratification process of individual accession treaties.

On the other hand, a big bang scenario should not conceal the persisting – and sometimes substantial – structural differences between accession countries. There is a correlation between potential problems in the economic structure and the stage of transition reached. The consequent specific policy challenges will continue to demand attention even after accession, and notably when participation in the Monetary Union is considered.

Policy challenges for accession countries on the road to convergence

Let me begin by pointing out that over the past ten years the countries in Central and Eastern Europe have engaged in a highly successful catching-up exercise. Painful reforms were enacted, often attended by rampant unemployment. The necessary institutions, such as central banks, were built up from scratch. At the same time, the transition process from a centrally planned to a market economy usually proved more laborious than expected.

The economic downturn was such that only a few countries have managed to regain the GDP level recorded before 1990. The growth potential may exceed the average in the European Union, but so far the margin has been slim. For instance, the Czech central bank puts the potential growth rate of the Czech economy at 2-3% per annum. Income differentials vis-à-vis the European Union will consequently persist for some time to come.

In fact the policy challenges of the accession countries lie in furthering structural reforms aimed at raising the growth potential. Economically, structural and real convergence towards the EU interact. It is a lengthy process, involving such measures as introducing free enterprise and corporate governance, as well as setting up social security systems and fighting abuse and corruption. In this context, the Commission recently announced an action plan intended to boost the institutional capabilities of the accession countries.

Looking at my own field, I see that banking supervision will need to be stepped up. In general, the financial sector is not developing in line with the economy as a whole, and plays no more than a limited role in the financing of local enterprises. The capitalisation rate of banks and share/bond markets in Poland and Hungary is less than a third that in the EU. Financial intermediation must clearly be stimulated if economic development and growth are to be boosted. In parallel, supervisory powers will have to be strengthened further.

Finally, several accession countries face specific sectoral problems. Here the restructuring of heavy industry in Poland and Slovakia comes to mind, as do the depreciation of bad debts in Slovakia and the Czech Republic and the transformation of the vast and unproductive agricultural sectors in Poland

and the Baltic states. The transition to a modern economy will clearly be attended by further economic and hence social friction.

All in all, it seems to me that these structural problems are taken into account in the Copenhagen test, but that the ultimate test is a general and political one. Copenhagen is consequently no guarantee for a high measure of structural convergence towards the current EU Member States. This need not pose problems so long as the structural and administrative challenges are really acknowledged in an expanded Union, an issue I will deal with in greater detail later.

As noted, the prospective Member States face a major challenge in that they need to boost their prosperity, in other words, achieve real convergence with the current EU. The differences in prosperity between the accession countries and the EU are exceptionally large.

Per capita income in Poland is less than 20% of that in the EU. By comparison, per capita income in Portugal, the poorest EU Member State, comes out at over 50% of that in the EU. Slovenia is currently the only accession country where this level is roughly achieved. In order to equal the average of the poorest three EU Member States, Portugal, Greece and Spain, Poland would have to record average annual growth percentages of around eleven percent.

Such real convergence poses several specifical challenges for economic policy. I shall try to explain this without going into too much theory.

- First of all, achieving the necessary high growth rate goes hand in hand with rising prices. In other words: the process of convergence makes inflation go up. This upward pressure can be partly offset through appreciation of the exchange rate. Generally speaking, a flexible exchange rate regime can alleviate the pressure on the economy generated by transition and catching up, for instance, when capital inflows are considerable. Under such circumstances, flexible regimes give less rise to speculative attacks on the currency.
- In addition, fast-growing transition countries are generally vulnerable to asymmetrical shocks (affecting only the country concerned). The Baltic states, for instance, were seriously affected by the Russian crisis of 1998. Another case in point is the Czech banking crisis of the mid-1990s, which ultimately resulted in a foreign exchange crisis.
- Maybe we should see the achievement of EU membership as a shock in its own right. After all, the considerable administrative and financial burden of adopting and complying with the Acquis Communautaire and of the confrontation with competition in the single market constitute a major change to economic functioning. This calls for a flexible policy.

Given these specific challenges to policy posed by transition and convergence, it is worth noting that those accession countries which have made the most progress, such as Hungary, the Czech Republic and Poland, have switched to more flexible exchange rate regimes in recent years. This allows them to exercise greater influence on real appreciation and strong capital inflows, to reduce potential speculative attacks on the currency and to partially absorb shocks.

Policy challenges and participation in EMU

What is the relationship between the challenges posed by structural and real convergence and participation in Economic and Monetary Union? As you may know, countries acceding to the European Union may begin to consider changing over to the euro after two years. The question arises whether under the given circumstances early introduction of the euro is always advisable. It must be remembered that the instrument of exchange rate flexibility is no longer available to countries which have joined the monetary union.

There is furthermore a considerable chance that a new Member State eager to change over to the euro quickly may find the euro area-wide monetary conditions incompatible with its specific circumstances. On the one hand, an accession country which has been successful in its efforts to catch up will temporarily face structurally higher inflation levels. On the other, such a country’s economic weight is too insignificant to affect the ECB’s monetary policy. In such a situation, negative real interest rates, overheating of the economy and erratic economic cycles may occur, making very heavy demands on macroeconomic management and the flexibility of the economy, notably the labour market. This brings us back to structural convergence and the requirements and implementation of the Copenhagen test.

New Member States in the European process of policy coordination

Given these structural and real challenges to policy, it would seem advisable to continue to comply with the essence of the Copenhagen test following accession to the EU. This would give the accession process the necessary flexibility if a big bang scenario were actually enacted, so that transition periods might be considered for specific parts of the Acquis Communautaire.

In fact, such an approach would also allay the fears voiced by the Scientific Council for Government Policy regarding potential erosion of the single market. Their central concern is that new Member States should not only incorporate all 90,000 pages of the Acquis Communautaire in their national legislation, but actually implement them.

[As a matter of fact, the European Union is already paying the necessary attention to transition- and catch-up-related policy challenges in the financial and economic field. Both the European Council of Ministers of Finance and the Eurosystem have entered into active consultations with the accession countries to discuss diverse issues such as the monetary policy strategy, financial stability and fiscal policy. During these consultations, the EU addresses not just the challenges inherent in joining the Union, but also the manner in which successful convergence can be continued after accession.]

A major element in this surveillance is exchange rate poliy. Sooner or later the new Member States will take part in the European exchange rate mechanism, ERM II. The Treaty provides for a minimum participation period of two years before changeover to the euro can be considered. It cannot be sufficiently stressed that apart from this requirement, participation in the mechanism can offer the necessary stability and flexibility for a successful convergence process.

The ERM offers stability in the form of a central parity anchor against the euro, and flexibility in the shape of ample fluctuation margins and the option of central parity adjustments. Participation in ERM II should therefore not be perceived as an obligatory hurdle on the road to the euro, as some policy-makers in Central and Eastern Europe unfortunately do.

[Actually, the financial and economic dialogue with the accession countries could be incorporated into the regular process of European policy coordination and surveillance, with special emphasis on the monitoring of transition periods, specific challenges to policy and administrative capacity. Changeover to the euro will eventually follow, when a sufficient degree of structural convergence can guarantee the desired price stability in an environment marked by an irrevocably fixed exchange rate and a centralised monetary policy.]

Conclusion

Having set out the specific policy challenges facing the accession countries consequent on accession, transition and convergence, I am coming to the end of this address. Obviously these challenges will continue to present themselves in some way or another to newly joined Member States.

In this context, I warned against premature changeover to the euro. The surrender of exchange rate flexibility and the euro area-wide orientation of monetary policy may not be compatible with the challenges posed by structural and real convergence. It is important that these challenges (continue to) be explicitly acknowledged in the regular process of European policy coordination. This will guarantee the successful economic integration of new Member States into the Union.

Expanding the EU is a duty which ensues from the essence of the European integration process. At the same time, both the cohesion of Europe and the rights which European citizens derive from Europe must be guaranteed. In this light, it is imperative, and in the interests of all, that new Member States succeed in catching up economically. The current participants, on their part, bear the responsibility of preparing the Union for expansion.

Permit me, in this context, to issue a warning before the Genootschap’s next discussion, on the institutional powers of a heterogeneous Europe. There can be no doubt that European interests are Dutch interests. This means that we must reform the single agricultural policy and structural policy in Europe before the EU expands any further. Moreover, it would only be natural if a new European regional policy were to address only the poorest regions in an extended Union.

Dutch interests are best served by a strong role for the European Commission and the European Parliament, especially in an extended, more heterogeneous Union. I would therefore like to warn against a French form of intergovernmental centralisation – a gouvernement economique. If such a power policy-based authority were established, the position of the Netherlands could become bogged down in the trade-off between the interests of large Member States, with the Netherlands receiving financial compensations on the periphery. And the greater the number of countries joining the Union, the larger the periphery.