COMMUNICATION FROM THE COMMISSION

The EU Economy : 2002 Review
- Summary and main conclusions -
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1. INTRODUCTION

Three years of buoyant growth gave way to a protracted period of sluggish growth.

In early 2000, a sustained growth rate of 3 per cent seemed within reach. Annual growth rates had exceeded 3 per cent in 1998-2000. The expectation that this growth performance was sustainable was fuelled by the successful introduction of the euro in 1999, the ‘new economy’ hype, the global stock market boom, resilience of the euro-area economy to the Asian, Russian and Brazilian crises and favourable world trade developments. Moreover, the key macroeconomic policy challenges of the 1980s and early 1990s had been overcome convincingly alongside a persuasive start to strengthening the structure of the economy. Monetary authorities had credibly established price stability. Most Member States presented budgets in surplus for the first time in decades. Structural reforms contributed to strong employment growth and unemployment was on a declining trend. Despite all of this, the three years of buoyant growth in the euro area up until 2000 unexpectedly gave way to a period of sluggish growth and increasing pessimism. The slowdown, that was initially deemed to be short-lived and shallow, has developed into the most subdued performance since the 1992-93 recession. Average growth is only 1¼ per cent over the years 2001 and 2002 and is expected to accelerate only during the course of 2003.\(^1\)

Conflicting explanations for the slowdown, but the solution appears evident – vigorous policy action to strengthen resilience, dynamism and thus the growth potential.

Whatever the underlying causes for the slowdown and its persistence, either an unfortunate combination of global shocks or internal structural supply-side deficiencies, additional structural efforts are required to meet the challenges put forward by the European Council in Spring 2000. The Lisbon agenda remains appropriate but must be better implemented. The credibility of the budgetary framework must be safeguarded to underpin the confidence of businesses and households during a period of adverse economic conditions and to ensure a balanced policy mix. Moreover, effective implementation of far-reaching structural reforms, particularly those characterised by a growing delivery gap, and furthering of economic integration needs to be addressed to improve growth and welfare in the medium term. Finally, growing concerns about the impact of ageing populations must be dealt with convincingly to reduce citizens’ uncertainty about their future disposable income.

As a background to the policy challenges, the 2002 EU Review provides an analytical focus on five issues related to the EU economic policy agenda.

The 2002 issue of the EU Review analyses in-depth five specific topics in the context of the current policy challenges. First, recent macroeconomic and policy developments in the euro area are discussed. Second, a chapter on structural reforms in labour and product markets examines the main patterns of reforms across Member States and scans their impact on macroeconomic performance in terms of growth and productivity, real wages and employment. Third, as a follow-up to the chapter on financial market integration in the 2001 EU

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\(^1\) See European Commission Autumn 2002 forecast.
Review, a chapter on European bond market integration takes a closer look at this market segment where financial integration should advance rapidly with potential for important welfare benefits. Fourth, a chapter on ageing analyses the potential impact of demographic changes on savings, capital markets and real interest rates. Finally, a chapter on enlargement identifies the conditions that would allow the accession countries to best manage the convergence process.

2. MACROECONOMIC DEVELOPMENTS IN THE EURO AREA

Although an outright recession has been avoided, domestic demand remains sluggish in a lenient macroeconomic environment. Prior to the slowdown that started in the second half of 2000, the euro area experienced three major cycles over the past three decades. Growth cycles peaked respectively in 1974, 1980 and 1992. Although the euro area has avoided an outright recession in the latest cycle, the downturn has been only slightly less sharp than during the 1992-93 recession. The current downturn is characterised by the nearly simultaneous slowdown of all components of domestic demand and of world trade. Nevertheless, due to notable achievements in the field of macroeconomic and structural policies over the last decade, the overall economic picture looks, at first sight, brighter than in previous cycles. Both the strength of the continuing investment recession and sluggish household consumption growth are at odds with developments in traditional macroeconomic determinants, such as real interest rates, profitability and capacity utilisation for investment, and employment and real disposable income developments for consumption. These remain supportive to growth from a historical perspective. This suggests that, in the absence of the considerable progress that has been made in the field of macroeconomic stability and structural reforms, the euro area would likely be faced with outright recession.

Employment growth has been resilient, but labour cost developments could be constraining investment recovery. Progress in meeting policy challenges is reflected in labour market developments. Employment growth in the euro area has been positive throughout the slowdown and unemployment has only crept up marginally from a ten year low of 8 per cent in mid-2001 to 8.4 per cent in October 2002. Continued moderate increases in nominal wages in combination with sustained employment growth underpinned disposable income and consumption during the slowdown, limiting the depth of the downturn. However, a side effect of the positive employment growth in the environment of slow economic growth, has been a, largely cyclical, reduction in labour productivity growth.² Moreover, limited downward sensitivity of wages to the economic slowdown puts the burden of adjustment largely on firms. In combination with the deterioration of labour productivity, there is a risk that profitability and, thus, investment prospects may suffer from relatively high increases in real unit labour costs. This would, in turn, jeopardise future labour market performance and the strength of the recovery.

² Labour productivity is understood here as GDP per employee.
Downgrading of medium-run corporate growth prospects contribute to the stock market slump which, in turn, is affecting balance sheets, capital costs and confidence in the short-run.

The feebleness of domestic demand components coincided with the largest losses on equity markets since the 1930s. The global stock market correction that started early in 2000 quickened in the course of 2002 despite the bottoming out of the economic cycle. Developments in financial markets and heightened uncertainty have given rise to concerns about the sustainability of the recovery and growth prospects in the short and medium run. The dramatic stock price fall since 2000 followed a sharp acceleration of an already rising trend of equity prices in the 1990s. In an environment of buoyant expectations with the ‘new economy’ hype reaching its zenith, markets priced in a spectacular increase in corporate profits and trend growth and a decrease of output growth volatility. The declining capital costs and excessive profit expectations, especially in the ‘new economy’ sectors, induced over-investment and misallocation, particularly in the US but with important knock-on effects in the euro area. The downgrading of optimistic medium-term perspectives and gradual uncovering of these supply-side disturbances is reflected in the stock market slump, which has been more pronounced in the euro area than in the US. Domestic demand has been affected directly by the less buoyant expectations. In addition, stock market developments have functioned as a catalyst for further denting short-run growth prospects. Wealth, capital cost and confidence are negatively affected, thereby providing ingredients for a ‘vicious cycle’.

Despite headwinds and greater uncertainty, continued moderate recovery is likely in the short run. Confidence is a key factor.

For a sustainable recovery the euro-area’s policy agenda has to be forcefully implemented.

Despite downside risks and medium- to long-run concerns, a continued moderate recovery of demand is likely in the short run. The inventory cycle turns and the negative contribution of investment growth is likely to fade out. Still, as long as uncertainty and worries about the medium-term outlook for profitability prevail and the cost of capital increases, investment is unlikely to rebound strongly. A full-blown recovery depends crucially on the return of strong consumer demand, for which confidence is a key factor. Increased uncertainty about future pension income may have also been a contributing factor to increased savings and low household consumption growth. Ageing and pension challenges are increasingly at the centre of economic policy making, leading to increased media coverage affecting households’ lifetime wealth perception. The savings effect of pension income worries may have been strong recently since it has been compounded with declining stock market wealth both directly and indirectly through pension funds.

In this economic setting, characterised by a high degree of uncertainty, it is crucial to press ahead with sound policies that foster consumer and investor confidence. This will strengthen domestic demand in the short run. Therefore, macroeconomic stability has to be preserved while the growing delivery gap in the implementation of announced economic reforms needs to be addressed. In turn, this will increase the euro-area’s growth potential and its ability to adjust to short-term shocks and structural changes in the economy. The alternative to forceful action is muddling ahead with protracted, slow and vulnerable growth in a rigid economic environment, similar to the early 1980s.
Monetary policy has firmly established price stability, but inflation is rather sticky considering the sluggish growth environment.

Preserving price stability is one of the key elements in the macroeconomic policy strategy of the euro area. Price stability has firmly been established and incorporated in households and investors expectations in the euro area, enabling monetary conditions to be accommodative to domestic activity. However, the behaviour of inflation in the slow-growth environment has been disappointing. Headline inflation has been close to the ECB’s upper ceiling since spring 2002 and core inflation has remained uncomfortably high at around 2.5 per cent after having risen gradually from below 1 per cent in 1999. Sticky inflation seems to a large extent due to limited competition in the services sectors. These are generally characterized by low labour productivity growth and, in mature economies, by relative strong demand. Wage costs in the service sector can more easily be passed on to consumers due to the lower degree of competition, allowing for wage increases in line with those of high productivity growth sectors. These factors that induce structurally high inflation in service sectors are no longer offset by large one-off labour productivity increases and price declines in industries from the liberalisation of network industries (e.g. telecom) in the late 1990s.

Monetary conditions remained accommodative to domestic demand as upward risks to price stability decreased…

Up until the end of November 2002, the ECB has kept interest rates on hold, after having loosened monetary policy in the aftermath of 11 September 2001 to alleviate concerns about liquidity and slow economic growth. The long awaited appreciation of the euro somewhat reduced upward pressure on inflation. Then, gradually, as the economic outlook worsened and equity prices tumbled, expectations of an increase in policy interest rates disappeared. As a result, monetary conditions in the second half of 2002 are more accommodative to domestic demand than was expected at the start of the year. At the end of 2002, short-term interest rates are more than 100 basis points below market expectations in spring. Meanwhile, long-term interest rates have declined by over 50 basis points.

…but firms’ financing conditions have tightened due to increased uncertainty.

Despite the accommodating monetary conditions and low real long-term interest rates, financing conditions for firms have tightened in the course of the year. Due to increased uncertainty about the general economic outlook and industry- or company-specific risks, the cost of raising capital on the stock market has risen significantly. Moreover, the decline in benchmark market interest rates has not been transmitted to generally lower financing costs for the corporate sector. Growing investor discomfort about accounting practices following the uncovering of malpractices may have contributed as well to difficult conditions for firms to raise funds.

Four Member States need to get their budgets in order, to the benefit of all.

The main fiscal issue confronting the euro area is for four Member States to get their budgets in order as soon as possible, in line with the requirements of the Stability and Growth Pact (SGP). Fiscal policy in the euro area remains a national prerogative, but through the Treaty and the SGP, governments are obliged to respect a common framework ensuring both fiscal discipline and budgetary flexibility. Under these rules, countries have agreed that their budget deficits will not exceed 3
per cent of GDP and that budgetary positions will be close to balance or in surplus in the medium run. The framework is sound and well-suited to the fiscally decentralised structure of EMU. If adhered to, as is the case in eight out of twelve euro-area Member States, it allows for flexibility and the full working of automatic stabilisers to cushion downturns, while safeguarding long-run budgetary sustainability.

Risks of excessive deficits are the result of failure to consolidate in the ‘years of plenty’.

The current budgetary challenges stem essentially from the failure on the part of these four Member States to have completed the transition phase to balanced budgets or surpluses in 1999 and 2000 when growth conditions were favourable. As a result, in the current period of anaemic growth, the budgetary framework is strained and credibility is dented. Already two Member State are in breach of the 3 per cent of GDP reference value. There is a distinct possibility that budgetary positions deteriorate in others, should growth conditions continue to remain subdued. In these Member States, immediate action has to be taken.

Required adjustment need not be costly, if credibility of the framework is strengthened simultaneously.

The required adjustment, especially in less prosperous times, is difficult but feasible, and need not be costly in terms of output losses. A credible fiscal adjustment will lead to a more balanced policy mix throughout the adjustment period. Furthermore, forceful budgetary consolidation, in combination with unambiguous support for the SGP, may have important beneficial effects on business and consumer confidence, reflecting positive implications for future tax burdens and improved financial market sentiment. The effects may lead to non-conventional effects of fiscal easing and tightening on growth. As such, fiscal consolidation, if done in the right way, may not entail high short-term costs in terms of growth and may even be growth-enhancing. Furthermore, in EMU, these so-called non-Keynesian effects may be stronger than before for two reasons. First, capital flows may react more strongly to expected future taxes. Second, the Treaty's deficit rules will reinforce expectations that any fiscal expansion is likely to be followed by future – and not-too-distant - fiscal contraction. Confidence effects are generally intangible, but considering the alternative of no consolidation with a breakdown of EMU’s fiscal co-ordination framework, resulting in uncertainty and interest rate premiums, the actual effect of the simultaneous fiscal adjustment in the four Member States may in fact turn out significantly positive for all euro-area Member States. Moreover, the medium- to long-run benefits of a swift completion of the budgetary transition are undisputedly of a much larger magnitude than any costs or benefits in the short run, both in terms of credibility and the functioning of the macro-economic framework.
Strict annual requirements and improved surveillance should improve budgetary consolidation in the future. To reinforce the Pact, the Commission has suggested strengthening the surveillance for countries that are in transition to the medium-term balanced position, in order to obtain consistent improvements in good and bad economic times. Until a budget position of “close to balance or in surplus” has been reached, effective budgetary surveillance requires a strict and enforceable adjustment path. The 3% of GDP reference value for deficits is and remains a binding constraint. Any breach of the limit, or risk thereof, will be dealt with decisively in full compliance with Treaty requirements and the Regulations of the Pact. In addition, a required rate of structural annual adjustment of at least 0.5 per cent of GDP should take the cyclically-adjusted deficit back to its medium-term position in a foreseeable time horizon. Moreover, countries with debt levels above the 60 per cent of GDP reference value should outline a detailed strategy to reduce their debt level at a satisfactory pace. Fiscal objectives should err on the side of caution, in particular with regard to growth and potential growth assumptions. The updated stability programmes should clearly define the measures that are being taken to obtain structural adjustment of at least 0.5 per cent of GDP. It should be considered that one-off measures only postpone structural adjustment and do not help in the long run. Moreover, the quality and timeliness of budgetary statistics needs to be improved to ensure adequate surveillance and policy co-ordination.

In the medium run, growth depends on efficient markets to provide for flexibility and smooth adjustment of resource allocation. In the medium run, the capacity to grow at a sustainable high rate depends on efficient use of production factors. Flexibility and adjustment to changing circumstances between and within sectors will contribute to fully using the potential for growth in the euro area. Ageing of populations makes smooth and effective economic adjustment all the more important. The euro-area economy requires efficient product, labour and financial markets, in addition to financially and socially sustainable pension and health systems and sound public finances, to weather the imminent demographic transition to an aged population.

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3 On 27 November, the European Commission adopted two communications on “Strengthening the co-ordination of budgetary policies” and “On the needs and the means to upgrade the quality of budgetary statistics”.

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3. **Structural reforms in labour and product markets and macroeconomic performance in the EU**

Building an economic framework that is both flexible enough to adjust to shocks quickly and robust enough to weather adverse economic developments and prevent the building-up of imbalances requires stepping up the pace of economic reform. Credible, judicious and forceful action will underpin confidence, increase resilience and smoothen adjustment. Both in the short and in the long run, the average short-fall of actual output from the economy’s potential will be reduced. In addition, microeconomic structural policies can make a significant contribution to achieving faster sustainable growth with high levels of employment. By improving the functioning of markets, structural reforms can remove impediments to full and efficient use of resources and allow for higher dynamic efficiency, making it easier to achieve widely accepted economic and social goals.

Both labour and product market reforms have notable effects on productivity and employment. Labour market reforms firstly provide stronger incentives to participate in the labour market. They are aimed at cracking down on insider-outsider barriers and reducing structural unemployment as well as increasing productivity through skill upgrading and improvement of working conditions. Secondly, better working labour markets allow for a more efficient allocation of labour, thereby further raising productivity growth and real incomes. Similarly for product market reforms. They increase competition and reduce monopoly rents in previously sheltered sectors, leading to higher efficiency and productivity growth. There is increasing evidence that more competition drives up the rate of technological and organisational innovation and leads to a higher variety and quality of goods and services. Product market reforms also effect labour market functioning. Equilibrium unemployment is lowered and employment increased by reducing excess rents for producers or workers, as market imperfections are addressed. Moreover, as prices and wages become more sensitive to market conditions, they adjust faster than in the past to changing economic conditions. As a result, cumulative losses in output and employment due to slow adjustment are reduced.

Interactions between different structural reform policies make a strong case for a broad-based reform strategy, exploiting synergies arising from a comprehensive approach to improve the functioning of product, capital and labour markets. Sound macroeconomic policies provide the best framework for reaping, as quickly as possible, the full benefits of structural reform policies. Stability-oriented fiscal and monetary policies have a direct bearing on lowering unemployment, predominantly via reducing risk premiums on interest rates, inducing higher investment. Successful structural reform policies affect potential...
output and raise the speed limits for growth, allowing aggregate demand expansion without generating inflationary pressures. Therefore, implementation of structural reform policies should be done in a co-ordinated manner. As a single country cannot expect a loosening of monetary policy in response to structural improvements, the momentum for reform may be reduced in individual countries. A broad-based approach could limit the initial, and possibly adverse, adjustment effects of reforms. These occur as economic agents adjust to the reduction and redistribution of rents that are intended by the reform and which will benefit the economy in the medium run.

Reforms have already raised both employment and output growth… Reform efforts in the second half of the 1990s have been successful in stimulating employment and strengthening the EU economy. The reforms included cuts in payroll taxes for targeted groups, in-work financial support for low-wage earners, more active and preventive labour market policies, and a modernisation of work organisation, including the facilitation of part-time work and more flexible work contract arrangements. There is little doubt that they have produced significant results in terms of a trend increase in labour force participation and employment rates, and a reduction in levels of structural unemployment. While it is difficult to establish precisely the contribution of the various reform efforts, illustrative macro-economic simulations indicate that labour and product market reforms, in combination with observed wage moderation, in the period 1996-2001, may have increased the level of potential output by 3-4 per cent relative to a no-reform baseline path. This translates into an acceleration of annual output growth of a little less than ½ percentage point over a period of 7 to 8 years. Without reforms and moderate wage developments, average growth in the EU would have been around 2.2 per cent instead of 2.6 per cent over the 1996-2001 period. This would translate into 5-6 million fewer jobs in the EU and unemployment would have been 2 million higher.

...but forceful action is required now, as effects of past reforms fade out over time. However, the growth stimulus of reforms has to be maintained. If reform efforts are not continued forcefully in the EU, the medium term growth path is unlikely to exceed 2 per cent by much. To achieve a higher annual rate of growth over a prolonged period of time, the momentum and the breadth of structural reforms will have to be increased, in line with the Lisbon agenda. Forceful action is required with regard to the growing delivery gap in implementing the announced structural reforms. The current weakness in economic activity must not be taken as an excuse for delays in implementing the comprehensive structural reform agenda as agreed in Lisbon and reinforced in Stockholm.

4. Bond market integration in the EU

Financial market integration improves economic performance by better

Well-functioning financial markets are crucial for an efficient channelling of savings to investment. Financial integration enhances the development of the EU’s financial system. This, in turn, will result in an improved economic performance. Much of the benefit of
Financial market integration stems from scale and scope effects. Increasing breadth and depth of the market increases efficiency as it reduces transaction costs and widens the possibilities for risk sharing, thereby improving the allocation of savings to investment opportunities within countries and across borders. In addition, increased competition as result of market integration has similar effects by reducing the quasi-rents enjoyed by financial intermediaries. These benefits in terms of improved resource allocation translate into lower costs of capital for the borrower and higher returns for investors.

**The euro-area government bond market is highly integrated, but the private bond market needs more time.**

There is evidence that the government bond market is highly integrated in the euro area. The elimination of exchange rate risk led to a sharp downward convergence in bond yields among the euro area Member States. However, yield spreads of between 10 and 50 basis points – mainly relative to Germany – have persisted since 1999. These remaining spreads between the government bonds of the different Member States are largely due to institutional and size factors. Part of the spreads can be explained by the benchmark role that German long-term government bonds have acquired. Another reason for the persistence of spreads is related to differences in liquidity. Member States with relatively limited issuance face a liquidity premium. Credit quality premiums play a limited role as ratings have reached a very high level in euro-area countries and have been broadly stable since the introduction of the euro. The integration trend of the private euro bond market has also progressed, albeit at a slower pace. Progress in the integration of the euro-denominated bond market is likely to proceed more rapidly in the future supported by, *inter alia*, increased co-operation of supervisory bodies and regulators, the EU’s Financial Services Action Plan and a strong private-sector trend towards consolidated market infrastructures.

**The historically underdeveloped corporate bond market has taken off.**

Europe’s historically underdeveloped corporate bond sector made a promising takeoff in 2001. Difficult market conditions and increased investor’s risk aversion have overshadowed this positive start during 2002. Nevertheless, growth of the euro corporate bond market is expected to resume as soon as the financial market climate improves. Efficient long-term debt management is of key importance to European firms. Traditional financial bond issues continue to underpin banks refinancing, but product innovation like asset-backed securities have the potential to expand further, stimulated by a competitive environment. Direct corporate bond issuance increasingly provides a close substitute for bank lending. This reduces the dependence on banks intermediary function in the channelling of savings to investment and provides a potential for further efficiency gains.
5. ECONOMIC AND FINANCIAL MARKET CONSEQUENCES OF AGEING POPULATIONS

Demographic factors play an important role in the economic outlook for countries in the medium and long run. Over the next 50 years the EU will witness dramatic changes in the structure of its population. The ageing of the large post-war cohorts (‘baby boom’), low fertility rates and growing life expectancy will decrease the size of the working-age population and increase the number of pensioners. The overall economic impact of these changes over the period 2000-2050 might be that EU potential growth will fall from the present underlying rate of 2-2½ per cent to around 1¼ per cent, in a scenario of no policy changes. This translates into a reduction of per capita GDP growth in the EU on average by about 0.4 per cent per year. A similar outlook applies to Japan. For the US, a much more sanguine picture emerges, especially for potential growth rates due to a better outlook for the size of the working age population and for investment. These persistent differences in potential growth rates between the EU and the US could result in large changes in their relative economic importance in the world. In a scenario of no policy changes, the EU’s present share of 18% of world production is expected to fall to 10% in 2050. That of the US could continue to rise from 23% in 2000 to 26% in 2050.

A large pool of retirement savings will affect domestic markets and global financial flows.

A growing pool of developed-world retirement savings will intensify the search for high returns and geographical diversification. These global capital flows will result in significant changes in countries’ balance of payment and net foreign asset positions. They imply adjustments of real exchange rates and generate a world-wide decline in rates of return of about ¾ of a percentage point over the next fifty years. In order to avoid stock market bubbles and over-investment, EU and global financial markets will need to efficiently channel savings to productive investments in developed and developing economies. In this context, the EU has a large vested interest in encouraging significant institutional reforms in the developing world, where ageing will become an issue later than in the EU. This would open an additional channel for efficiently allocating surplus savings in the future through current account surpluses with the developing world. At the moment, global capital flows are dominated by two-way capital flows amongst developed economies with similar demographic outlooks. This situation is likely to continue in the future unless developing economies are more effectively integrated into the global financial system.

Budgetary sustainability needs to be safeguarded, while employment and productivity growth

To moderate the economic burden of ageing, EU Member States will have to pursue a range of macro and structural policies. In terms of fiscal policy, the EU already has an appropriate framework: the Stability and Growth Pact (SGP). In the face of substantial age-related spending pressures, balanced budgets over the cycle are crucial in
are promoted.

EU labour markets have an important role to play in enabling EU economies to withstand the demographic developments. Increases in labour force participation rates, reductions in structural unemployment and a progressive increase in the EU’s effective retirement age from less than 60 at present by about 5 years as called for by the Barcelona European Council. are highly desirable reforms. Finally, the EU must also continue to promote higher factor productivity growth through structural reforms aimed at both enhancing allocative efficiency and at increasing the flexibility of goods, services and capital markets, whilst simultaneously ensuring open and competitive trading conditions at the global level.

Partial shift to funded pension system needs to be accompanied by growth-promoting, substantive reforms and to be monitored in view of possible distribution effects.

While a partial shift to funding of EU’s pension systems would contribute to their long-term sustainability, it must be ensured that the social policy objectives of the pension provisions continue to be achieved. The partial shift to funding would lead to additional savings and to a significant build up of financial assets in public and private pension funds in the EU. In the absence of growth-promoting reforms in the EU, this increase in EU pension funds will to a large extent result in additional investments occurring outside the Community. Consequently, a partial shift to funding, if implemented on its own as opposed to being part of a broad growth promoting package of reforms, would do little to enhance the EU’s productive capacity. This underlines the need to boost the effectiveness of a shift to funding by enhancing domestic growth and investment opportunities through the implementation of fundamental labour, product and capital market reforms. Illustrative model simulations predict that a significantly higher proportion of the additional pension fund assets would be invested in the EU due to the improved domestic growth environment, if a package of reforms aimed at increasing labour force participation rates and lengthening working lifetimes is introduced first.

6. REAL AND NOMINAL CONVERGENCE IN ACCESSION COUNTRIES: SELECTED ISSUES

The EU-15 will become EU-25. The process of economic convergence is crucial.

Upon recommendation of the European Commission, the European Council of Brussels gave its green light to conclude negotiations on the enlargement of the EU, with the accession of ten new Member States in mid-2004. Most of the new Member States have been in a transformation process from centrally planned regimes to market economies for over a decade. The initial phase of the transformation has been very costly in terms of output and income losses. In the course of the 1990s, positive growth rates returned in all prospective Member States. Macro-economic stabilisation has played a major role in the transition countries in helping the economy to turn around. Overall, all acceding countries have made impressive progress in nominal convergence. In particular, all countries’ inflation rates are

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down to one-digit levels from two- (or even three-)digit levels at the beginning of the 1990s. However, the real convergence process of GDP per capita has proceeded at a much slower pace.

**Full convergence will take its time.**

The convergence process will be lengthy as the average per capita income in the prospective new Member States was 40 per cent of the EU average in 2001. In a number of countries, income levels have just started to exceed the levels prevailing before the dramatic fall in the wake of the initial transition shock. If current output growth rates are extrapolated, catching-up to the EU average income level might be a process of decades rather than years. An acceleration of the real convergence process can be expected after EU membership. Capital flows to these countries might increase notably should the conditions for high expected real rates of return be met. This could lead to continued rapid modernisation and upgrading of production facilities and infrastructure. To benefit fully from the potential of EU membership, conditions should be identified, including those at the Community level, that would allow accession countries to best manage the real convergence process. Since their application for membership, a large part of the required reforms has taken place in the adoption of the single market ‘acquis’.

**Differences between countries are large and affect the pace of real convergence and the nature of adjustment.**

The economies of the accession countries are in quite different positions concerning their state of real convergence. This holds clearly for overall output and labour productivity levels. The different stages in the convergence process are even more striking in their structural transformations and pattern of integration into the EU economy, in particular in cross-European trade structures. Such a diversity will undoubtedly have a bearing on how they will cope with the additional adjustments required by the accession process and speed of the catching-up process. Technologically more advanced industries show relatively fast catching-up, with a dynamic pattern of integration into the European division of labour. Others have so far been ‘locked in’ in a rather traditional pattern of trade and industrial specialisation, making it difficult to improve their position.

**The evolution of exchange rate regimes in the transition is a key question.**

As a result of the enlargement strategy, the accession countries, despite their diversity, share the goal of eventually adopting the euro. Due to the success of the euro in providing exchange rate stability, price stability and low interest rates, most new Member States ambitiously aspire to join the euro area as soon as possible. However, an adoption when micro- and macroeconomic conditions are not yet fully adapted to the requirements of a monetary union, poses important risks to managing the transition process to euro-area membership, to macroeconomic developments afterwards and to catching-up and the convergence process in general. In the run-up to euro-area membership, a key question is the evolution of exchange rate policy regimes. Currently, a wide spectrum of exchange rate regimes exists, with strongly fixed exchange rate arrangements in the form of currency boards, on the one side (Estonia, Lithuania, Bulgaria), relatively free floating exchange rates, on the other (Czech Republic, Poland and Hungary), and a number of countries choosing a degree of exchange
rate flexibility in between these two extremes. In part, the differences in exchange rate regimes reflect the general diversity of approaches with which these countries tackle transition but also the underlying differences in their real economies.

Persistent inflation differentials may pose a risk to fixed exchange rate regimes. In general inflation rates in accession countries are still above those observed for the majority of the EU Member States. Differentials in inflation between the accession countries and the EU Member States may represent an equilibrium phenomenon which is linked to the lower price levels in the accession countries and the catching-up process itself. More precisely, countries growing faster tend to experience higher rates of inflation (through the so-called Balassa-Samuelson effect) without a deterioration of the country’s cost competitiveness. Estimates of the size of this effect vary widely for the accession countries, as it is difficult to disentangle this effect from inflationary effects due to the transition from a planned economy with government price setting to a market economy. It has, however, undeniably an impact on the inflation rate during the catching-up process. The presence of strong Balassa-Samuelson effects would provide an argument for maintaining some flexibility in exchange rates in the period after accession. In such a case, nominal appreciation of the exchange rate and a real interest rate in line with the countries requirements can limit the risk of overheating of the domestic economy, which could seriously disrupt the real catching-up process.

One important advantage of an early adoption of the euro would be the elimination of the transaction costs associated with maintaining a separate currency and a reduction of interest rates by eliminating the exchange rate risk. This would attract badly needed additional investment which would foster the process of real convergence. It is sometimes argued that the costs of holding the exchange rate fixed may be relatively low for small and open economies in which monetary policy is an inherently difficult task.

Elements pro and contra early participation have to be weighted carefully on a country-by-country basis. The evolution will depend on the country’s position in the transition process, its size and the progress on product, labour and capital market reform and its budgetary challenges. Joining the euro is not an end in itself. The ultimate objective is full and successful economic integration. In any event, the relevant Treaty provisions will prevail.