Joining the EU – The Experience of Selected Current Members

In May 2004, ten countries will join the European Union. Most of them are small post-socialist economies that have made huge progress in market reforms and economic integration with industrially developed countries. Nevertheless, EU entry will bring new challenges and clarify issues that have to be resolved for sustainable convergence. In looking for solutions, the new members will have lessons at their disposal from the current EU countries. In an attempt to extract these lessons we have collected a few papers describing the experiences of selected small countries that either opted for EU membership relatively recently or had less developed economies when entering the EU. The selection has the potential to deliver lessons that are particularly relevant for the countries of Central and Eastern Europe.

The first post-socialist country to join the EU was the ***former East Germany***. Although this particular accession was rather a unique event, it seems to have been unjustifiably forgotten in the discussions on EU enlargement. East Germany's current state of progress with convergence may reveal problems that will have to be resolved by other acceding countries some time after May 2004. ***Philipp Rother and Ralph Süppel*** compare economic developments in the former East Germany and the countries of Central Europe with the aim of highlighting the potential risks associated with the excessive optimism generated by the benefits assigned to EU membership. They warn that Central Europe could, on a smaller scale and in selected aspects, repeat the East German experience. Unification with Western Germany (and thus EU accession) proceeded swiftly and real incomes and investment soared in the early 1990s thanks to generous public transfers. The boom ended abruptly in 1995 with a downshift that has persisted to the present day, East German per-capita disposable incomes have remained stuck at around 80 percent of the western level. As productivity failed to catch up with wages and prices, unit labour costs in East Germany rose strongly. The German economy had to go through a painful contraction period to regain its competitiveness. This process seems to be still far from complete.

Accession will provide the region with more ample funding, as it facilitates access to global financial markets and unlocks sizeable public transfers. There may be a temptation, similar to East Germany, to boost investment and incomes in the accession countries in order to "front-load" real spending convergence. Using an intertemporal equilibrium model, the authors show that this front-loading would occur partly through an overshooting of the real external value of Central European currencies. It may take a long time for the real external value of the currencies to adjust back downward to equilibrium, leading to output losses and rising unemployment in the meantime. This may entail a prolonged period of poor economic performance. Averting this pitfall requires fiscal discipline, price and wage flexibility and a continued focus of macroeconomic policy on competitiveness. Especially in the field of fiscal policies, care must be taken not to fuel or accommodate the demand pressures on the economy. With overall tax burdens already high, the necessary public investment expenditure will need to be financed by expenditure restraint in other areas.

The paper on ***Ireland*** by ***Frank Barry*** reveals very important lessons for current EU acceding countries, because it explains that success is by no means guaranteed. Barry convincingly contrasts the poor economic performance of Ireland during the post-war decades with its dramatic growth in the 1990s. He warns that there may be something in the political economy of poorer countries that makes their macroeconomic stance vulnerable to general economic slowdowns. The fact that convergence did not take place until almost two decades of EU membership had passed highlights the importance of domestic policies with respect to development and convergence. The analysis shows that fiscal balance can be viewed to a large extent as a joint indicator for policymakers to address structural problems of the economy. Ireland was able to jump on a "virtuous circle" of growth only after a decisive change in fiscal strategy in the late 1980s. It is by no means surprising that fiscal deficits are now viewed as one of the key problems of the acceding countries. One of the dangers that can also be seen in some acceding economies is the creation of a "double-speed" economy. In the Irish case, this means the coexistence of a weak indigenous sector and a strong foreign sector. Indigenous manufacturing firms are primarily located in low-tech sectors, have a relatively low export-output ratio, are strongly dependent on the UK market, and are highly exposed to sterling fluctuations. This source of vulnerability creates rather a large challenge for policymakers. There is one more important lesson, concerning the importance of EU regional aid programmes. These hardly constitute the key to convergence; their role is no more than to prevent further divergence. On the contrary, if the acceding countries want to replicate the high-tech route, they need to achieve a strong R&D environment, a high level of industrial sophistication and an abundance of human capital.

João Amador focuses on macroeconomic developments in ***Portugal***, which 40 years ago was a fairly closed economy and also a closed society. Since entry to the European Free Trade Association in 1960, significant structural changes have occurred, the economic integration process has deepened and the economy has achieved substantial nominal and real convergence to EU levels. Nevertheless, the process has been complicated and painful. Portugal was hit by several negative supply shocks and, as a consequence, serious macroeconomic imbalances mounted and the economy entered a phase of macroeconomic turbulence with "stop-and-go" policies. This lasted until 1985, when the accession treaty was signed.

The motivations for accession were threefold – political, strategic and economic. On economic grounds, membership implied a higher degree of openness, generating higher gains from trade. In addition, the European structural funds made it possible for the economy to maintain private and public investment at higher levels without incurring unsustainable foreign account imbalances. And what is most important, membership induced the adoption of macroeconomic, structural and financial reforms that might otherwise have taken longer to occur. Up until 1997 the fulfilment of the public finance criteria required by EMU accession was the priority. However, the consolidation process, relying on interest savings and higher revenues, did not deliver long-run results. Consequently, macroeconomic imbalances emerged consisting of high financing needs in the private sector, relatively high general government deficits and, consequently, high foreign account deficits. In addition, decreasing interest rates and prospects of higher income led Portuguese households to increase their consumption and investment, mostly in housing. The significant investment in housing was financed by domestic bank credit, which in turn relied on external borrowing. The investment in housing contributed to a boom in the construction sector and to a rise in real estate prices. The expectations of higher productivity and higher income did not materialize and private agents needed to readjust their balance sheets. After reaching a general government deficit of 4.2 percent of GDP in 2001, clearly above the 3 per cent reference value established by the Stability and Growth Pact, fiscal policy must definitively turn to a contracting stance.

Currently, the Portuguese economy is experiencing an adjustment process, which is expected to continue in the years ahead. There is a very clear lesson for the countries of Central and Eastern Europe. Sustained output growth must rely on supply-side policies that increase total factor productivity. Otherwise, macroeconomic imbalances eventually emerge and a protracted period of low growth is then required to correct them.

One of the key policy determinants in EU countries during the last decade was the run-up to monetary union. The paper by ***Tapio Korhonen*** focuses on the salient aspects of ***Finland's*** monetary and exchange rate policies during that period. He explains the changes in policies that were pursued after an economic and banking crisis in the early 1990s. Finland's financial system nonetheless developed rapidly. Even though almost all varieties of policy were tried, it was the strategy of a floating exchange rate regime combined with inflation targeting that was successful. Using that strategy, euro adoption was accomplished without serious problems at the start of 1999. This is a very valuable experience for acceding countries using the same policies now.

Finland is also an example of fast and successful liberalization of the financial market. A legacy of the decades-long regulation era was a large number of national features of the financial markets, which were highly bank-centred. Surprisingly, one of the consequences of the economic crisis of the early 1990s was balance in areas of the economy that had traditionally given rise to problems and adaptation of the financial system to the new situation. Despite the initial severity and huge costs of the crisis, the financial system developed favourably and became increasingly globalized. Despite this concentration of banking business, competition between the banks has increased. Similar developments can also be seen in some of the countries of Central and Eastern Europe.

We hope that this monothematic volume of ***Finance a úvěr – Czech Journal of Economics and Finance*** will help our colleagues in the economic profession in the countries of Central and Eastern Europe and beyond to understand better the challenges, risks and opportunities that will arise from the arrival of the ten new members in the European Union next year.

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