

Central and eastern Europe

Assessing the early benefits of EU membership

In May 2004, the European Union (EU) undertook its most significant enlargement to date, accepting Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia as new members. With the recent announcement that Bulgaria and Romania will join in 2007, the EU will soon comprise no fewer than 27 states. Apart from Cyprus and Malta, all the new members are located in central and eastern Europe (CEE-10).

Two years on, what is the verdict on EU membership for those eight countries in central and eastern Europe that joined in 2004? And what is the outlook for Bulgaria and Romania? The IMF's European Department has just completed a Regional Economic Outlook for the CEE-10 (see growth table). As part of this undertaking, IMF staff compared recent economic performance and financial market developments in the CEE-10 with other emerging market countries (see Charts 1–6).

Economic performance has been strong in the new EU members. But these generally low-saving countries are relying heavily on capital inflows to finance high levels of investment. This produces large current account deficits—in contrast with most other emerging market countries. Current account deficits usually raise red flags, but financial markets generally seem impressed by the performance of the CEE-10: the IMF's analysis shows that many of the CEE-10 are paying, on average, 50–100 basis points less on their external debt than other emerging markets with comparable policies and economic conditions. This indicates there may be an “EU halo effect”—EU membership and the expectation that the CEE-10 will eventually adopt the euro reduces the perceived investment risk. Camilla Andersen of the *IMF Survey* spoke with Susan Schadler, a Deputy Director of the IMF's European Department, about these and other findings.

IMF SURVEY: What has EU membership meant for the eight countries from central and eastern Europe [CEE-8] that joined in 2004?

SCHADLER: We are still in the early days of assessing the impact of EU membership, but signs are that there has been a considerable boost to growth. The CEE-8 have, on average, increased their per capita GDP growth from just below 5 percent in the years prior to membership to about 6 percent now. In some countries, it is much higher. Membership has brought major opportunities, most obviously in the form of transfers, comprising both investment and income support from the EU. On a more general level, it has made these countries more attractive as bases for offshoring and outsourcing from the 15 original members of the EU [EU-15]. Most of the CEE-8 are also experiencing rapid export growth and strong export penetration into the EU-15.

IMF SURVEY: When to adopt the euro is a burning issue for the new members. Some remain keen on joining the euro area as quickly as possible whereas others now want to wait. What is the IMF's advice to the new member states?

Quick facts

CEE-10 comprises Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

Population 102 million
GDP (2006) \$866 billion

EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and United Kingdom.

Population 387 million
GDP (2006) \$13,458 billion

Data: IMF, World Economic Outlook database, and staff estimates.

CEE-10: Growth at a glance

(real GDP, annual percent change)

	Actual 2004	Actual 2005	Proj. 2006	Proj. 2007
CEE-10 ¹	6.6	6.2	6.6	6.1
Baltics¹	7.8	9.2	9.1	7.8
Estonia	7.8	9.8	9.5	8.0
Latvia	8.6	10.2	11.0	9.0
Lithuania	7.0	7.5	6.8	6.5
Central Europe¹	4.9	4.7	5.2	4.7
Czech Republic	4.2	6.1	6.0	4.7
Hungary	5.2	4.1	4.5	3.5
Poland	5.3	3.4	5.0	4.5
Slovak Republic	5.4	6.1	6.5	7.0
Slovenia	4.2	3.9	4.2	4.0
Southeastern Europe¹	7.1	4.8	5.5	5.8
Bulgaria	5.7	5.5	5.6	6.0
Romania	8.4	4.1	5.5	5.5

¹Unweighted average.

Data: IMF, *World Economic Outlook*, September 2006.

SCHADLER: We see euro adoption as a major opportunity to enhance growth prospects for all the new members. Most researchers agree there are gains associated with joining a currency union, especially for emerging market countries, although just how large these gains are is in dispute. One such gain comes from increased trade. IMF research shows that the establishment of the euro area has resulted in significantly higher trade among the 12 current euro area members than would have occurred had the single currency not been introduced.

Given their status as emerging market countries, the new members will be able to enjoy two other significant advantages once they adopt the euro. First, they will be able to substantially lower the emerging market risk premium they currently pay for their externally issued debt. This represents a substantial gain because all the CEE-8 countries are currently paying a risk premium relative to debt issued by advanced countries. Second, because people are anticipating euro adoption, they are starting to change their behavior. Both households and businesses are increasingly borrowing in foreign currencies—especially in

euros—because they can get lower interest rates and because they anticipate that, by the time they have to repay, they will be receiving their income in euros. Now, all this is fine as long as the new member states actually do adopt the euro. But if expectations about the timetable for euro adoption turn out to be too optimistic, the foreign currency exposure of households and businesses will create a significant risk in the event of turmoil in global markets. This is why these countries need an exit strategy. Euro adoption is tailor made for this purpose.

IMF SURVEY: Some politicians from new members have called for a change in the criteria for joining monetary union, saying the current rules are too strict. Do they have a case?

SCHADLER: Yes and no. In our view, euro area membership offers major opportunities, but to be a success, macroeconomic policies need to be right. We especially emphasize the need for strong fiscal positions—and by this I mean a balanced budget or even a surplus.

EU membership appears to have had a positive effect on new members' growth rates—and this boost should become even more pronounced once they join the euro area. In this kind of setting, a brake on activity is typically warranted. By limiting the growth of the public sector's participation in the economy, the countries will create room for private investment. Countries should also ensure that conditions in their labor and product markets are sufficiently flexible so that any shocks to the economy that do not affect the rest of the euro area can be absorbed by internal adjustment.

Once these conditions are in place, we would place less importance than the Maastricht criteria do on inflation as a guarantor of future performance in the euro area (see box). That said, the EU has set the rules of the game, and they are very unlikely to change. So regardless of the economic merits



Eugene Salazar/IMF

Schadler: "I see the enlargement of the EU as a localized version of globalization."

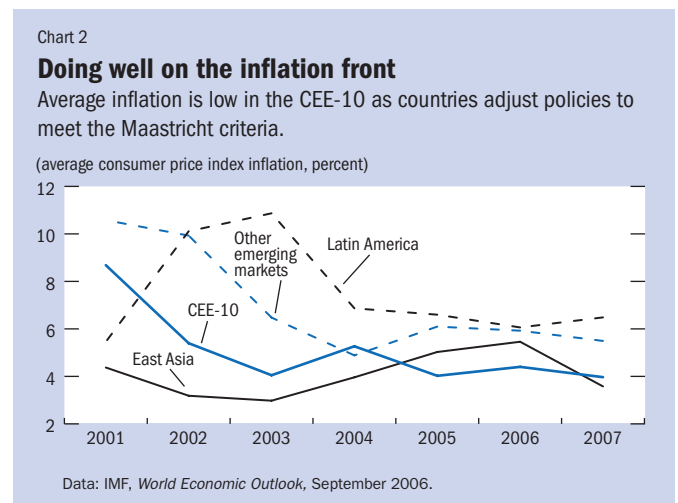
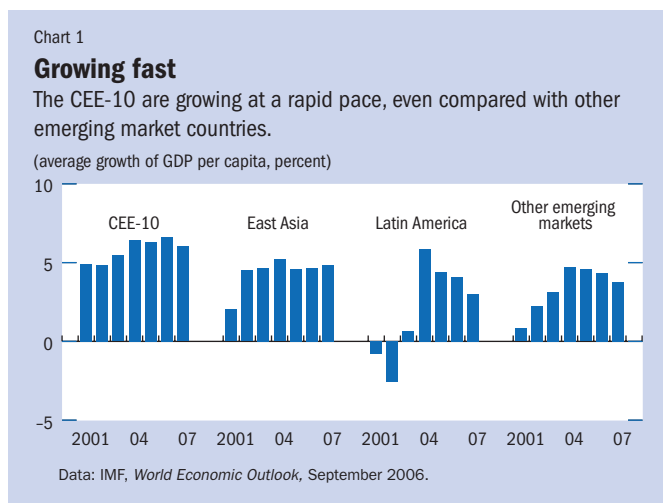
of this discussion, the new members will need to meet the Maastricht criteria. The sooner they do it, the better.

IMF SURVEY: With expectations of a rapid transition to full membership of monetary union fading, is it risky for new member states to extend their stay in ERM2, the exchange rate arrangement that is a prelude to euro adoption?

SCHADLER: These risks are fully manageable as long as an end point is in sight. For the countries with currency boards and fixed exchange rates, not much has changed with ERM2 membership. However, while the risks are not major at this time, that could change. As I said, the prospect of euro adoption is encouraging households and businesses to borrow in euros. If their expectations about euro adoption were to change radically, the situation could become risky.

IMF SURVEY: The three Baltic countries have all enjoyed high growth. Estonia in particular is doing well. What accounts for the relative success of the Baltics?

CEE-10 countries: How they compare with other emerging markets (2006 and 2007 data are projections)



SCHADLER: It is important not to read too much into differing performances, even over a period as long as five years. All of the CEE-8 have gone through a transition where GDP dropped quite sharply and then rebounded. The rebound has occurred with varying strength across time in different countries. That said, the Baltics, for the past 10 years, do have a slightly stronger growth record than the larger countries. IMF research also shows the Baltics are well positioned for growth somewhat above that in the other CEE countries over the next few years. Why? First, their lower average per capita GDP means that there is more catch-up potential. Second, the Baltic countries have relatively low population growth, and that helps in terms of increasing the productivity of the labor force. Third, these countries have developed strong trade ties with some of the more vibrant markets in Europe. This has stimulated competition and increased efficiency, thereby creating conditions for stronger growth. Fourth, education systems are relatively good.

IMF SURVEY: The three larger countries—Poland, the Czech Republic, and Hungary—have a more uneven track record. Why are these early reformers having problems?

SCHADLER: Again, it is important not to read too much into a few years' experience. It is also worth emphasizing that central Europe is a very mixed bag of issues. All of these countries are experiencing some difficulty in setting a clear path for their governments to follow. That has created political uncertainty—particularly in the past year or so. But the countries are different in many other respects. In Hungary, government expenditures are much higher than revenues, and that has resulted in rising public debt that has now reached high levels by emerging market standards. So the sustainability of fiscal policy is in doubt, and that has affected market confidence. Poland is a little different. While it also has fiscal weaknesses, its public sector deficit and debt are not as high

Requirements for adopting the euro

All EU countries (apart from Denmark and the United Kingdom, which have opt-outs) are required to adopt the euro. But before doing so, they must comply with criteria set out in the 1993 Maastricht Treaty. Compliance with the Maastricht criteria is assessed for each country by the EU's Council of Ministers, based on reports by the European Commission and the European Central Bank. Assessments are carried out every two years or when member states request them. The criteria, which are evaluated on the basis of the most recent data releases, are as follows:

- Year-average inflation must not exceed by more than 1.5 percentage points the average of the three “best-performing” EU members in terms of price stability.
- The nominal interest rate on a 10-year government security must not exceed by more than 2 percentage points the average in the same three countries.
- The fiscal deficit on a calendar-year basis must not exceed 3 percent of GDP.
- The stock of government debt must not exceed 60 percent of GDP.
- Countries must participate in ERM2 for at least two years, with the currency remaining within “normal fluctuation margins” around the agreed central parity.

as in Hungary. The Czech Republic has a much smaller public sector deficit and debt, but because it started from a per capita income level that was much higher than in Hungary and Poland, its growth potential is lower.

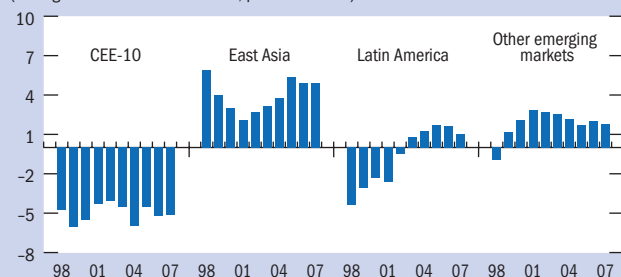
All three have lost reform momentum. Ten years ago, there were active changes taking place in the Czech Republic, forced by a banking sector crisis; in Hungary, by turmoil in the balance of payments; and, in Poland, by a change in government. Today, the slowdown in structural reform means not only that conditions

Chart 3

Running large current account deficits

In contrast to most other emerging market countries, the CEE-10 all have large current account deficits.

(average current account balance, percent of GDP)



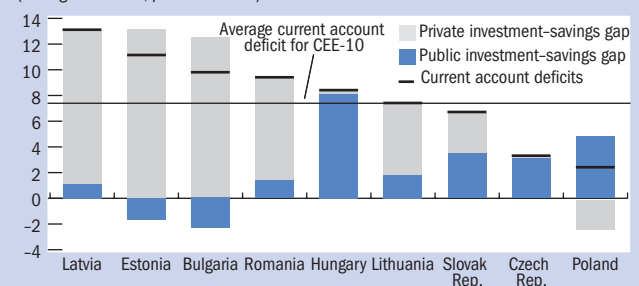
Data: IMF, *World Economic Outlook*, September 2006.

Chart 4

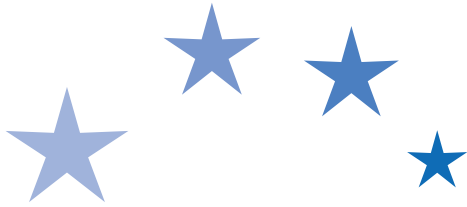
Private imbalances dominate

Most current account deficits reflect private investment-savings gaps rather than government deficits.

(average 2004-06, percent of GDP)



Data: IMF, *World Economic Outlook*, September 2006.



for potential investors are not improving but also that current investors are wondering where these countries are headed.

IMF SURVEY: Most of the EU newcomers are running large current account deficits. Is that something to worry about?

SCHADLER: In general, when we see current account deficits in the double digits, as they are in some of these countries, red flags go up. No question. So it is absolutely critical that the situation be watched carefully and that signs of acute vulnerabilities be caught as soon as they arise.

But in some countries, these current account deficits are different from what we have seen elsewhere in the past. The CEE-8 decided some time ago to fully open their capital accounts—and this in an environment of strong growth potential. These countries sit right next to one of the wealthiest parts of the world, but they have much lower wages and therefore offer profitable investment opportunities. In our globalized world, this combination of open capital accounts and attractive investment opportunities can only lead to large current account deficits—capital flows in and investment pushes up imports and consumption.

This is how incomes are equalized across countries. We are talking about countries that typically have low savings rates, and it makes sense for them to use foreign savings to increase their investment rates and smooth consumption. This is the essence of globalization. But it also means these countries are exposing themselves to changes in market sentiment. Their high-growth strategies need to be managed carefully with strong policies. There is no room for big mistakes.

IMF SURVEY: Rapid credit growth poses a risk to financial stability in many of the CEE-10. What should they do to keep such risks under control?

SCHADLER: The ultimate protection is strong bank supervision. These countries all started out with repressed financial

conditions—small banking sectors and low household indebtedness. Opening the capital account means that money has come in and that borrowing opportunities for households and businesses have grown. So rapid credit growth is part and parcel of the strategy these countries are following.

But it does create risks, and bank supervisors need to be fully on top of what is going on. They must ensure that banks are managing risk well so as to catch problems before they translate into nonperforming loans. Borrowers also need to be made aware of the risks.

IMF SURVEY: The original EU-15 tend to focus on the negative aspects of enlargement. What are the positive aspects?

SCHADLER: There are a number of positive aspects, although people tend to lose track of them in the short term. But they will become increasingly apparent if they are allowed full play over the medium term. The opportunities for offshoring and outsourcing may at first excite political resistance in the EU-15 as jobs are relocated to central and eastern Europe. But over time, people in western Europe will realize that moving some activities offshore will make their companies stronger in a fiercely competitive global environment, allowing companies that would otherwise have to close down to stay in business.

At the same time, it is going to put pressure on western Europe to move its labor force into areas requiring more advanced skills. I see the enlargement of the EU as a localized version of globalization where companies can take advantage of the synergies between a very advanced part of the world and a part of the world that still has substantial catch-up potential. ■

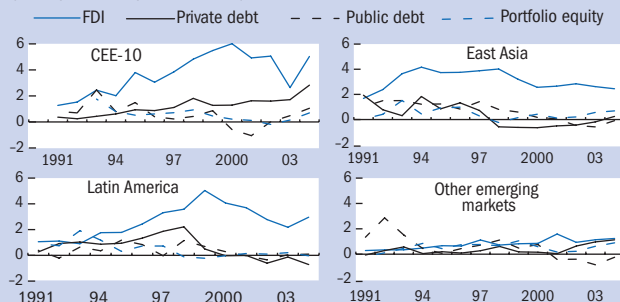
Some of the findings in this article will be published as an IMF Working Paper, “Do Economists’ and Financial Market Perspectives Differ for the New Members of the EU?” by Pipat Luengnarumitchai and Susan Schadler (forthcoming).

Chart 5

Attracting a lot of foreign direct investment (FDI)

FDI inflows are big, which makes the large current account deficits look less worrisome. However, debt-creating inflows are also rising.

(net capital flows, percent of GDP)



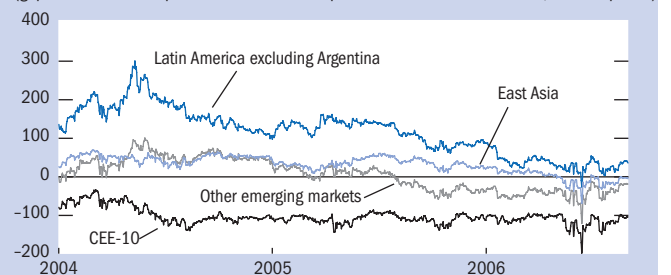
Data: World Bank, Global Development Finance database.

Chart 6

Paying less to service debt

The CEE-10 are paying 50–100 basis points less to service their debt than what economic fundamentals would seem to warrant.

(gap between actual spreads and calculated spreads based on fundamentals, in basis points)



Data: IMF staff calculations.