Macroeconomic Performance
of the Main Central European Candidates for Joining the European Union

Stanislaw Gomulka, professor
London School of Economics, Department of Economics

1. The questions

The primary purpose of this short paper is to consider and give preliminary answers, with respect to the main EU candidate countries, to the following questions:

1. Has macroeconomic stability already been, or is soon to be, accomplished?
2. Do these candidate countries comply with the most basic EMU requirements, e.g. sound fiscal policy, independent central bank, etc.?
3. Are there any factors which might, during the run-up to EU membership, complicate their macroeconomic policy, e.g. bad debts, tax arrears, infrastructural and environmental investments, things which may lead to large fiscal deficits?
4. Could liberalisation of their (perhaps still fragile) financial services' markets and/or systems cause macroeconomic problems? Should these markets/systems be further developed/deepened first?
5. Given the answers to questions 1 to 4, are these countries really ready for EU membership?

2. The divergence problem, how large?

Table 1 provides a selection of basic data on the eight CE countries which are regarded in this paper as primary EU candidates. Enlargement will be for them, as indeed it will also be for the present EU countries, a major institutional innovation. Any such innovation, before it begins to bring about benefits, must initially entail some short-term adjustment costs to both sides.

Entry requirements are formulated with the intention of minimising these initial costs. Such costs will be related to the divergence of the CE–8 from the EU–15, and to the magnitude of the enlargement. Both factors will determine the size of the 'enlargement shock'. The data in Table 1 provide a basis for an evaluation of the development gap between the two groups of countries—one of several dimensions of divergence—and of the size of the enlargement shock.

Table 1.

Population and GDP for the CE–8 and the EU–15 countries

No.	Country	Population (in millions) 1999	GDP *per capita* (in thousands PPP $) 1998	GDP (in billions PPP $) 1998	GDP (in billions, US$) 2000	GDP *per capita* % of EU *per capita* 2000	
						PPP $	US$
1.	Czech Republic	10.3	12.5	129	54	62	24
2.	Estonia	1.5	7.6	11	5	38	17
3.	Hungary	10.1	10.2	103	49	50	22
4.	Latvia	2.4	5.6	13	7	28	12
5.	Lithuania	3.7	6.4	24	11	32	14
6.	Poland	38.7	7.7	298	156	38	18
7.	Slovak Republic	5.4	9.8	53	22	49	18
8.	Slovenia	2.0	14.3	29	21	71	48
9.	CE–8	74.1	8.9	660	325	44	20
10.	EU–15	376	20.2	7600	8300	100	100
11.	CE–8 as % of EU–15	19.7	44	8.7	3.9	44	20

Sources: Historical data are from *Transition Report 1999*, EBRD (The exception is Poland's external debt which is Ministry of Finance estimate). CPI and CA forecasts for 2000 are those by EIU.

The EC–8 group is dominated by one country, Poland, which in terms of population and GDP accounts for about half of the group's totals. This makes the transition progress in Poland important for the success or otherwise of the entire enlargement project. Using market exchange rates, the GDP of the CE–8 group is only about 4% of the EU's GDP, which means that it is about half the GDP of Spain. By this measure the prospective enlargement will be a relatively small affair. One important implication is that net transfers from the EU budget to the Eight will represent only about 0.1% of the EU's GDP. In the course of the next decade, the gap between market exchange rates and purchasing power parity (PPP) rates will probably narrow, thereby increasing somewhat the GDP weighting of the Eight. Nevertheless, both the size of net transfers and this GDP weighting should remain relatively small.

The statistics which may cause concern for the Fifteen is the 20% population weighting of the Eight. Given the presently large wage gap between the two groups and high unemployment rates within the EC–8, especially in Poland, the incentive for some labour migration from the poorer to the richer countries of the enlarged EU will be strong. However, the expected real appreciation of the EC–8 currencies and a faster productivity growth within the EC–8 should reduce this wage gap significantly, and with it also the migration incentive.

3. Macroeconomic stability of the EC–8, how firm?

The mini-crises which both Hungary (1994–96) and the Czech Republic (1997–99) have experienced, has led these two countries to adopt new policies,

both macroeconomic and structural, intended to restore and maintain macroeconomic stability. These experiences by two of the leaders in transition send a strong warning to other countries of the Eight that stability can be quickly lost by any country of the group and that its restoration can be very costly. This warning has now become a factor in inducing all the CE–8 countries to monitor early crisis indicators with a view to adjusting policies, before it is too late. Table 2 contains the basic data needed to assess the quality of the macroeconomic stability in each of the eight candidate countries. These data tell us that the Eight have already met or are close to meeting the Maastricht criteria on budget deficit and public debt. These two criteria are related to each other, since the constancy of the debt/GDP ratio, D/PY, requires that

$$\frac{\Delta D}{PY} = (\pi + g)\frac{D}{PY} \tag{1}$$

where D is public debt, Y is GDP, P is the price level, π is inflation and g is the growth rate. The LHS of (1) is the budget deficit as a proportion of GDP, and D/PY on the RHS is the targeted debt-to-GDP ratio. The Maastricht criteria are based on the assumption that $\pi = 2\%$ and $g = 3\%$. However, the EC–8 countries are expected to grow for some time at a rate of 4 to 6% rather than 3%. Equation (1) implies that, in order to meet the criteria on inflation and the budget deficit, these countries should keep their public debt at a level lower than 50% if $g = 4\%$, lower than 43% if $g = 5\%$, and lower than 38% if $g = 6\%$. In the light of these numbers, the debt is still excessive in Hungary.

Public finance performance has been recently somewhat stronger than indicated by comparisons with the past official statistics. The reasons are twofold. One is the recent adoption by all the candidate countries of the Eurostat convention to regard privatisation revenue as an instrument of either deficit financing (an item below the 'line' rather than above the 'line') or debt reduction. The other is the adoption of a multi-pillar pension reform by several countries, above all Hungary and Poland. The pension reform will in the course of the next 20–30 years reduce substantially the implicit (hidden) public debt in the form of state obligations to pensioners. This reform will also be instrumental in increasing savings in the private sector.

From Table 2 it is also evident that inflation rates have been reduced to levels which prevailed in Western Europe not long ago. The Eight plan to join the EMU soon after admission to the EU. This would require them to meet the Maastricht criteria on inflation and interest rates. These criteria will provably prove very demanding for the five countries (all except the Baltic countries) which do not operate a fixed exchange rate policy (under the currency board arrangement). Meeting these criteria may well require acceptance of high(er) unemployment and the adoption of much tighter fiscal policies. Higher unemployment may in its turn induce liberalisation reforms of the labour market and force the Eight to reject the Social Chapter which the EU is promoting.

Table 2.
Key macroeconomic indicators for CE–8 countries

No.	Country	GDP growth 5 years to end 1999	CPI Inflation 2000	GG Budget Balance, % of GDP, 4 years to end 1998	GG expend-itures, % of GDP 1998	CA, % of GDP 2000	Gross reserves, months of CA exp. 1998	Broad money, % of GDP 1998	External debt, % of GDP 1998	Public debt % of GDP 1998
1.	Czech Republic	1.5	4.2	–1.9	41.1	–2.8	4.1	70.3	41.7	27.5
2.	Estonia	4.4	4.5	–0.3	38.6	–5.3	2.0	35.5	55.8	4.6
3.	Hungary	3.4	9.2	–4.7	46.4	–6.1	3.7	45.1	55.9	60.3
4.	Latvia	3.0	3.5	–1.6	41.5	–10.5	2.2	n.a.	47.6	n.a.
5.	Lithuania	3.3	2.7	–4.2	39.3	–8.6	3.1	19.5	34.8	n.a.
6.	Poland	5.8	9.0	–3.1	45.5	–7.7	6.8	42.0	35.9	43.0
7.	Slovak Republic	5.2	14.0	–3.0	44.5	–4.6	2.3	64.9	58.5	n.a.
8.	Slovenia	4.2	7.7	–1.0	46.2	–2.4	3.7	51.6	25.4	24.0

Sources: Historical data are from *Transition Report 1999*, EBRD (The exception is Poland's external debt which is Ministry of Finance estimate). CPI and CA forecasts for 2000 are those by EIU.

The basic EMU requirements also include the establishment of a fully independent central bank (this requirement applies only to countries which did not replace their central banks with currency boards). Poland and Slovenia have monetary policy councils of the ECB style. These set interest rates and are independent of governments. This institutional arrangement has yet to be adopted by the Czech Republic, Hungary and Slovakia. Poland also adopted constitutional provisions forbidding the Central Bank to finance any budget deficit and setting the limit on public debt at 60% of GDP.

4. Macroeconomic policy in the run-up to EU membership, any major risk?

The usual candidates for sources of macroeconomic risk include bad debts to banks, large tax arrears that are effectively bad debts to governments and the fiscal costs of meeting the entry requirements in such fields as infrastructure, environment and agriculture. However, a massive privatisation of banks is shifting the problem of any bad bank debts to the private sector. The problem of tax arrears is also helped by such privatisation. Moreover, profit taxes in any case represent only a small proportion of total public revenues. The infrastructure and environment investments necessary to meet the average EU standards are so massive that the EC–8 countries cannot, and are not ex-

pected to, reduce significantly the present gap during the run-up period. The same point applies to quality standards in agriculture.

A major macroeconomic risk nevertheless exists; it lies in the possibility that the private sector's foreign debt will expand too fast, leading to a currency crisis and, subsequently, to stagflation. This risk is low with respect to the Czech Republic and Hungary—mainly because these two countries have already suffered such a crisis. As a result, the euro wages have been adjusted downwards in Hungary, while the prolonged recession has adjusted imports downwards in the Czech Republic. The countries which remain most exposed to such a crisis are Poland and the Slovak Republic. High inflation is forcing the Central Banks in these two countries to adopt a policy of very high real interest rates. At the same time these countries, along with other members of the Group, are liberalising capital account transactions. This liberalisation is expected by the European Commission to be fully implemented "in good time" before enlargement. In addition, the prospect of EU membership is inducing capital inflows. In Poland these inflows will also be larger in the years 2000 and 2001 because of an unusual concentration of big privatisations in those two years. Moreover, high interest rates at home are inducing local enterprises to seek cheaper foreign credits. Large capital account surpluses keep exchange rates stable despite large current account deficits. This high exchange rate stability creates a false perception that the exchange rate risk is small, and so sustains high foreign borrowing.

The private sector foreign debt in Poland stands in 2000 at about 15% of GDP and is increasing at a rate of about 4% of GDP per year. Short-term capital, both debt and portfolio investments, is still much lower than official reserves. A payments crisis is therefore not imminent. Nevertheless, the risk of such a crisis is increasing. Policies are being adopted to slow down the process sufficiently for the foreign debt to be still manageable at the point when Poland joins the EMU, the only measure capable of eliminating completely the risk of financial instability. These policies include setting aside some privatisation revenues to pay off foreign debts, full flotation of the exchange rate, reduction of the budget deficit, and a more gradual liberalisation of the capital account.

The question of a potential macroeconomic instability in the Slovak Republic deserves a much closer examination than I can give in this paper. Let me only note that although the foreign debt is already high, the CA deficit is low and improving.

5. Capital market liberalisations; should financial markets be developed first?

The development of financial services' systems and markets has been accelerated by the privatisation policy with respect to banks, pension funds and insurance institutions. In particular, Poland has changed its earlier policy to-

wards both licensing and ownership with a view to allowing greater foreign participation. This participation is now already very high, and about the same in Hungary and Poland. Similar developments are taking place in the three Baltic countries. The radical pension reforms in Hungary and Poland are beginning to make pension funds major players in financial and capital markets. Bank assets are largest, in relation to GDP, in the Czech Republic and Slovakia. Therefore the quality of the banking sector matters more in these two countries than in other countries of the group. Their banks are burdened with large under-performing debts.

A recent comparative study of the banking sector systemic risk [Kawalec, 1999] assigned to Slovakia the score of 5 (very high risk) and to the Czech Republic the score of 4 (high risk). The score assigned to both Hungary and Poland was 1 (very low risk). The quality of work and the transparency of rules governing regulatory bodies likewise appear superior in these latter two countries. An early emphasis on capital market liberalisation and the coupon privatisation of banks have been the main features of the transition strategy in the Czech Republic as regards banking. The experience of the 2nd half of the 1990s appear to vindicate the superiority of the strategy adopted by Hungary and Poland. These two countries placed emphasis first on proper privatisation and regulation of the financial sector and are only now, or soon will be, in a position to allow full capital market liberalisation.

6. Conclusion: are they ready to join?

Despite several question marks with respect to institutions and microfoundations, and the presence of significant risks to stability, the evidence suggests that the macroeconomic environment prevailing in all the EC–8 countries broadly meets the minimum conditions required for EU membership. The quality of this environment was tested severely in the years 1999–2000, following the Russian financial crisis, a sharp increase of world energy prices, and a large devaluation of the Euro. These three external shocks worsened current accounts, increased inflation and reduced growth. Nevertheless, all eight economies have shown a remarkable ability to absorb these quite large shocks at relatively little costs. Thus the countries have passed this test well, which supports my overall conclusion.

However, the years between now and the date of the EC–8 actually joining the EU and, especially, joining the EMU, will be a period when the risk of macroeconomic instability will probably be enhanced. One reason is the fact that the EC–8 countries, with possibly the exception of Slovenia, are and will continue to be subject to the Balassa-Samuelson effect. This will make the task of reducing inflation to the EU level more difficult. Central banks may respond by attempting to maintain high interest rates, ignoring the fact that increased capital markets liberalisation and the prospect of EU membership must imply higher international capital mobility. The EC–8 countries are therefore likely

to enjoy large and rather unstable capital account surpluses already in the pre-accession years, without as yet having the security provided by the EU institutions. These inflows will lead to a real effective appreciation of the eight exchange rates, hence also to high current account deficits and sharply increased foreign debts. The risk of speculative currency attacks, followed by stagflation, will therefore increase. This risk may be greater the longer the waiting period for the EMU membership.

References

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