CHAPTER 1

THE ECONOMIC SITUATION IN THE ECE REGION AND SELECTED POLICY ISSUES

1.1 The ECE economies in 2003

A global recovery started in the second half of 2003 after the economic uncertainties created by the conflict in Iraq and the outbreak of the SARS epidemic in Asia had dissipated. Rising activity was accompanied by increases in business and consumer confidence, and was mirrored in stronger demand and rising prices for industrial raw materials and crude oil. In the international financial markets, the recovery of investors' confidence, in anticipation of increased profits, led to a rebound of equity prices, which in turn has improved the financing conditions for enterprises. Narrowing yield spreads on corporate sector borrowing reflected a more optimistic assessment of risks by financial investors. In the financial and non-financial corporate sectors, the necessary balance sheet adjustments required to reduce the excessive leverage built up during the boom in the second half of the 1990s have been significant, although the process has not finished yet. These have been reflected in rising profitability. Global economic activity continued to be supported by expansionary economic policies, especially in the United States, which has been leading the recovery. The buoyancy of the Asian economies, notably the continued boom in China and the unexpectedly strong recovery in Japan, has also underpinned the global recovery.

In the *ECE region*, economic activity continued to be marked by pronounced differences among the major economies and subregions in 2003 (table 1.1.1). In the *United States*, the annual increase in real GDP accelerated to 3.1 per cent. In contrast, the euro area remained the principal "weak spot" of the global economy in 2003, mainly because of sluggish activity in the three largest economies (France, Germany and Italy – see table 1.1.2). Real GDP in the *euro area* as a whole rose by only 0.5 per cent in 2003. For the *European Union* as a whole, real GDP rose by 0.8 per cent in 2003, slightly more than for the euro area because of the resilience of the United Kingdom to the global downturn during 2002.

The disappointing overall performance of most of the current EU member states contrasts with the strong economic growth in the 10 countries that will be joining the Union at the beginning of May 2004. Real GDP in these 10 countries combined rose by 3.6 per cent in 2003, up from 2.5 per cent in 2002 (table 1.1.1). Had these countries already been members in 2003, real GDP growth in the enlarged Union would have risen to 1 per cent, the small improvement over that of the EU reflecting the relatively small weight of the accession countries, which currently account for only some 5 per cent of the nominal GDP of the enlarged EU. But their economic weight will increase in the future if they are successful in their medium- and longer-term objective of catching up with the average real per capita income in the EU.

Economic activity in *eastern Europe* as a whole strengthened in 2003, aggregate GDP growth accelerating to 3.8 per cent. As in 2001 and 2002, domestic demand remained the principal source of growth throughout the region; with very few exceptions (Poland and Slovakia), net exports pulled down the growth of output. Thanks to the ongoing restructuring of these economies and the expansion of their productive capacity, domestic suppliers were able to benefit from the strong domestic demand; some east European economies also greatly increased their exports despite the continuing weakness of the west European economies. Improved financial intermediation and a booming credit market, a consequence of successful banking reforms, also contributed to the general strengthening of economic activity in the region.

While all the east European economies grew in 2003, economic performance varied considerably among them. After two years of near stagnation, growth in eastern Europe's largest economy – Poland – gained momentum during the year and GDP rose by 3.7 per cent (table 1.1.3). The accelerating recovery in Poland was underpinned by expansionary fiscal and monetary policies and by gains in competitiveness that boosted the contribution of net exports to GDP growth. At the same time there was a slowdown of growth in Hungary and Slovenia, where aggregate output increased by less than 3 per cent. Activity in the Czech Republic picked up somewhat compared with 2002 but GDP grew only moderately (by some 3 per cent). In all three countries growth in 2003 was mostly driven by private domestic demand, net exports generally making a negative contribution to GDP growth despite some recovery of exports in the Czech Republic and Hungary.

TABLE 1.1.1

Annual changes in real GDP in the ECE region, 2000-2004
(Percentage change over previous year)

	2000	2001	2002	2003	2004
ECE region	4.1	1.4	2.1	2.5	3.6
Western Europe	3.7	1.3	1.3	0.9	2.2
European Union	3.6	1.7	1.1	0.8	2.1
Euro area	3.5	1.7	0.9	0.5	1.9
North America	3.8	0.6	2.3	3.0	4.5
United States	3.7	0.5	2.2	3.1	4.6
Eastern Europe	3.9	3.2	3.0	3.8	4.5
CIS	8.9	6.1	5.2	7.6	5.7
Russian Federation	10.0	5.1	4.7	7.3	5.5
Memorandum items:					
EU acceding countries-10	4.0	2.6	2.5	3.6	4.2
Enlarged EU-25	3.6	1.8	1.2	1.0	2.3
Europe (east and west)	3.8	1.5	1.5	1.2	2.5
Europe (east and west) and CIS	4.4	2.1	2.0	2.1	2.9

Source: Tables 1.1.2 and 1.1.3.

Note: The regional aggregates are computed by summing over all countries the constant prices series rescaled to the price level of the common base year 2000 and converted into dollars using the GDP purchasing power parity of the year 2000.

Latvia and Lithuania were the fastest growing east European economies in 2003, with GDP increasing by 7 and 8.9 per cent, respectively. Both economies benefited from growth in all the components of final demand, which provided a strong stimulus to domestic economic activity. Growth also remained relatively strong (above 4 per cent) in Albania, Bulgaria, Croatia, Estonia, Romania and Slovakia. Slovakia was the only east European economy where GDP growth was entirely driven by a surge in net exports (reflecting increases in the capacity of the FDI-driven and export-oriented automotive industry). In the other economies, the strength of output mirrored strong domestic demand coupled with a negative impact of net exports on GDP growth. Thus, while exports of goods and services from Bulgaria, Croatia and Romania grew strongly in 2003 (following the recent acceleration of FDI-led restructuring of these economies), they were outpaced by an even stronger growth of imports.

In parts of south-east Europe, economic activity remained weak in 2003. In Serbia and Montenegro GDP was almost stagnant, reflecting a difficult adjustment to the opening up of the economy and the start of major reforms. Economic activity in The former Yugoslav Republic of Macedonia picked up somewhat in 2003 but the economy has still not fully recovered from the slump caused by the internal conflict in 2001. In contrast, growth in Bosnia and Herzegovina continued to slow down for a fourth consecutive year (table 1.1.3). In both countries the rate of GDP growth in 2003 was below the average for eastern Europe as a whole.

After some deceleration in 2002, economic activity in the *CIS region* surged in 2003, led by rapid growth in Russia. Aggregate GDP in the CIS grew by 7.6 per cent, making it one of the fastest growing

TABLE 1.1.2

Changes in real GDP in the developed market economies, 2001-2004
(Percentage change over previous year)

	2001	2002	2003	2004
France	2.1	1.2	0.2	1.7
Germany	0.8	0.2	-0.1	1.7
Italy	1.8	0.4	0.5	1.6
Austria	0.8	1.4	0.9	1.9
Belgium	0.6	0.7	1.0	1.9
Finland	1.2	2.2	1.4	2.6
Greece	4.0	3.8	4.0	4.1
Ireland	6.2	6.9	2.3	3.8
Luxembourg	1.2	1.3	1.2	2.0
Netherlands	1.2	0.2	-0.8	1.0
Portugal	1.6	0.4	-0.8	1.4
Spain	2.8	2.0	2.4	3.0
Euro area	1.7	0.9	0.5	1.9
United Kingdom	2.1	1.7	2.1	2.8
Denmark	1.4	2.1	0.3	2.2
Sweden	1.1	1.9	1.6	2.4
European Union	1.7	1.1	0.8	2.1
Cyprus	4.0	2.0	2.0	3.4
Iceland	2.9	-0.5	1.9	3.7
Israel	-0.9	-0.8	0.8	1.9
Malta	-1.2	1.7	0.8	2.7
Norway	1.9	1.0	0.4	2.9
Switzerland	0.9	0.2	-0.4	1.6
Turkey	-7.5	7.8	5.0	4.9
Western Europe	1.3	1.3	0.9	2.2
Canada	1.9	3.3	1.7	3.1
United States	0.5	2.2	3.1	4.6
North America	0.6	2.3	3.0	4.5
Japan	0.4	0.1	2.3	2.1
Total above	0.9	1.6	2.0	3.2
Memorandum items:				
EU acceding countries-10	2.6	2.5	3.6	4.2
Enlarged EU-25	1.8	1.2	1.0	2.3
Western Europe and North America	1.0	1.8	2.0	3.4

Source: Eurostat; OECD national accounts; national statistics; European Commission, *European Economy*, No. 5 (Brussels), 2003; *OECD Economic Outlook* No. 74 (Paris), December 2003; Consensus Economics, *Consensus Forecasts*, 12 January 2004; *The Economist*, 5 February 2004.

Note: All aggregates exclude Israel. Data for 2003 are preliminary estimates. Data for 2004 are forecasts.

regions in the world. A combination of favourable external conditions (especially higher export prices for oil and gas) and a continuing strong recovery in domestic demand contributed to this outcome. The enduring buoyancy in domestic demand – reflecting growing consumer and investor confidence in many of the CIS economies – is a sign that the difficult reforms in these transition economies are finally starting to bear fruit. Several years of strong growth have also contributed to some improvement in living standards in the region.

The average rate of growth in the CIS reflects the strong performance of the region's largest economies: Russia, Ukraine and Kazakhstan, where GDP increased by 7.3 per cent, 8.5 per cent and 9.1 per cent, respectively. All the factors mentioned above apply with full force to the

TABLE 1.1.3

Changes in real GDP in eastern Europe and the CIS, 2000-2004
(Percentage change over previous year)

			2002		*2003*		*2004*
	2000	*2001*	*Jan.-Sep.* [a]	*Full year*	*Jan.-Sep.* [a]	*Full year* [b]	*Forecast*
Eastern Europe	3.9	3.2	2.9	3.0	3.6	3.8	4.5
Albania	7.7	6.5	..	4.7	..	6	6
Bosnia and Herzegovina	5.4	4.5	..	3.7	..	3.2	4
Bulgaria	5.4	4.1	5.3	4.8	4.2	4.8	5.3
Croatia	2.9	4.4	5.0	4.6	4.6	4.7	5
Czech Republic	3.3	3.1	2.1	2.0	2.7	3.0	2.8
Estonia	7.3	6.5	6.1	6.0	4.0	4.5	5-6
Hungary	5.2	3.8	3.3	3.5	2.7	2.8	3.3
Latvia	6.8	7.9	5.3	6.1	7.4	7	6-7
Lithuania	4.0	6.5	6.7	6.8	8.3	8.9	6.2
Poland	4.0	1.0	1.1	1.4	3.3	3.7	5
Romania	2.1	5.7	4.5	4.9	4.8	4.8	5.5
Serbia and Montenegro [c]	6.4	5.5	..	3.8	..	1	3-4
Slovakia	2.0	3.8	4.1	4.4	4.0	4.1	4.1
Slovenia	4.6	2.9	2.9	2.9	2.2	2.6	3.6
The former Yugoslav Republic of Macedonia	4.5	-4.5	-0.3	0.9	3.5	3.1	3-4
CIS	9.0	6.1	4.7	5.2	7.0	7.6	5.7
Armenia	5.9	9.6	10.6	12.9	15.2	13	7
Azerbaijan	11.1	9.9	9.8	10.6	10.5	11.2	9
Belarus	5.8	4.7	4.9	5.0	6.0	6.8	6-7*
Georgia	1.8	4.8	4.2	5.5	8.3	8.6	4.5
Kazakhstan	9.8	13.2	9.2	9.9	9.2	9.1	7
Kyrgyzstan	5.4	5.3	-2.3	–	5.1	6.7	4.1
Republic of Moldova [d]	2.1	6.1	5.9	7.8	6.2	6.3	5
Russian Federation	10.0	5.1	4.0	4.7	6.7	7.3	5.5
Tajikistan	8.3	10.2	8.9	9.5	7.9	10.2	8
Turkmenistan [e]	18.6	20.7	..	19.8	..	17	..
Ukraine	5.9	9.2	6.4	5.2	7.8	8.5	4.8
Uzbekistan	4.0	4.5	3.0	4.2	4.0	5	6
Total above	6.9	4.9	4.0	4.4	5.6	6.1	5.2
Memorandum items:							
EU acceding countries	4.0	2.5	2.3	2.5	3.4	3.7	4.3
Baltic states (BS-3)	5.6	6.9	6.2	6.4	7.0	7.3	6.1
Central Europe (CE-5)	3.9	2.2	2.0	2.2	3.1	3.4	4.1
South-east Europe (SEE-7)	3.7	4.9	4.4	4.5	4.1	4.3	5.1
CIS without Russian Federation (CIS-11)	6.6	8.4	6.4	6.5	7.5	8.2	6.1
Caucasian CIS countries (CCIS-3)	6.9	8.2	8.2	9.5	10.9	10.8	7.2
Central Asian CIS countries (CACIS-5)	7.7	9.2	6.7	7.5	7.0	7.9	6.9
Three European CIS countries (ECIS-3)	5.7	7.8	5.9	5.2	7.2	8.0	5.3

Source: National statistics, CIS Statistical Committee; direct communications from national statistical offices to UNECE secretariat; reports by official forecasting agencies.

Note: Forecasts are those of national conjunctural institutes or government forecasts associated with the central budget formulation. Aggregates are UNECE secretariat calculations, using PPPs obtained from the 1996 European Comparison Programme. Aggregates shown are: eastern Europe (the 15 countries below that line), CIS (the 12 member countries of the Commonwealth of Independent States). Sub-aggregates – Baltic states (BS-3): Estonia, Latvia, Lithuania; central Europe (CE-5): Czech Republic, Hungary, Poland, Slovakia, Slovenia; EU acceding countries: Baltic states and central Europe; south-east Europe (SEE-7): Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, Serbia and Montenegro, The former Yugoslav Republic of Macedonia; Caucasian CIS countries (CCIS-3): Armenia, Azerbaijan, Georgia; central Asian CIS countries (CACIS-5): Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan, Uzbekistan; three European CIS countries (ECIS-3): Belarus, Republic of Moldova, Ukraine.

a Over the same period of the previous year.

b Preliminary estimates.

c Excluding Kosovo and Metohia.

d Excluding Transdniestria.

e Figures for Turkmenistan should be treated with caution. In particular, the deflation procedures that are used to compute officially reported growth rates are not well documented and the reliability of these figures is questionable.

explanation of the robust performance in these three countries. The strong upturn in Russia was also underpinned by an expansionary monetary policy, which sought in the first place to prevent an excessive real appreciation of the rouble. There were also signs of a deeper and more extensive restructuring of the Russian enterprise sector, partly in response to growing competitive pressure. Thanks to the strength of its domestic demand and its impact on imports, Russia's role as an engine of growth for the neighbouring CIS economies increased in 2003.

Kazakhstan's economic growth – which continued for a fourth consecutive year – was mostly due to the rapid expansion of fuel-related exports. In 2003 the continued surge in the volume of commodity exports was coupled with large windfall revenue gains from higher export prices. There has also been a notable recovery in other sectors of the economy in recent years and this continued in 2003. In Ukraine, a sharp export-driven upturn in some manufacturing sectors (such as steel and chemicals, which benefited from strong external demand) contributed to the large increase in GDP in 2003.

Other CIS economies were also unusually buoyant in 2003. GDP grew at double-digit rates in Armenia, Azerbaijan, Tajikistan and Turkmenistan (although the official GDP data for the latter country should be treated with caution – see the note to table 1.1.3). Economic growth accelerated in Belarus and Georgia (with GDP increasing by 6.8 per cent and 8.6 per cent, respectively) and in Kyrgyzstan the economy recovered from the stagnation (caused by a major mining disaster) of 2002. Despite some slowdown, GDP in the Republic of Moldova rose by 6.3 per cent. A remarkable sign of the general strength of growth in the CIS is the fact that in Uzbekistan, the slowest growing economy in the region, GDP still increased by some 5 per cent in 2003.

1.2 The short-term economic outlook

(i) Western Europe and North America

World economic activity is expected to strengthen further in 2004. World output growth is set to exceed 4 per cent, up from 3¼ per cent in 2003. This should be accompanied by a marked acceleration in the volume growth of world merchandise trade to some 8 per cent, twice the rate in 2003.

In the *United States*, real GDP growth is expected to accelerate to an average annual rate of some 4.5 per cent in 2004, up from 3.1 per cent in 2003.[1] The recovery should continue to be supported by the strong growth of domestic demand. Personal consumption spending is forecast to remain strong, rising by some 3.5 per cent over 2003. The expected pick-up in employment and a further fall in the rate of inflation support the continued growth of real disposable incomes. But the savings ratio is expected to edge up and the stimulus from the tax cuts and mortgage equity to diminish. Non-residential business fixed investment is expected to rise strongly by some 10 per cent in 2004, encouraged by expectations of further increases in profits and rising capacity utilization rates. Residential investment is also forecast to continue rising strongly, although less favourable financing conditions are likely to lead to a slower rate of increase than in 2003. Exports are expected to grow at a brisk rate, supported by the depreciation of the dollar and a broadening global recovery. These external influences on GDP, however, are likely to continue to be more than offset by the strong growth of imports.

Strong labour productivity growth is likely to weaken the demand for labour, although it should, nevertheless, begin to edge up in 2004. The unemployment rate is forecast to decline somewhat in 2004 and consumer price inflation is expected to fall below 2 per cent. The current account deficit is forecast to increase to some $575 billion in 2004 although it should remain at some 5 per cent of GDP.

The stance of monetary policy is expected to remain very accommodative as long as there are no firm indications of a self-sustaining recovery. This holds notwithstanding the change in the language of the FOMC, which recently stated that "it can be patient in removing its policy accommodation",[2] in contrast to preceding statements that "policy accommodation can be maintained for a considerable period". Fiscal policy will probably remain expansionary, but the fiscal impulse should diminish significantly (to about half a percentage point of GDP), which is appropriate given that most of the output gap is likely to disappear in 2004 and in view of the significant deterioration of the medium-term fiscal outlook. The federal government's budget deficit is projected to rise to $477 billion, or 4.2 per cent of GDP, in fiscal year 2004.

In the *euro area*, recovery is expected to gain some momentum in the course of 2004 but, for the year as a whole, real GDP is currently forecast to rise by only 1.9 per cent. This reflects the combined effect of a pick-up in exports and a slight strengthening of final domestic demand. Exports should benefit from the stronger growth in world trade, which should help to offset the dampening effects of the recent appreciation of the euro in real effective terms. Changes in the volume of net exports, however, are likely to have a broadly neutral effect overall as a result of the stimulus to imports from the stronger euro. The forecast rise in final domestic demand largely reflects an upturn in business spending on machinery and equipment; construction investment is also picking up slightly, following two years of consecutive decline. Private consumption growth in 2004 is unlikely to be much stronger than in 2003. The recovery might produce a slight increase in demand for labour – a reflection of both the weak rate of output expansion in 2004 and labour hoarding during the cyclical downturn – but this will probably not be sufficient to prevent the unemployment rate from rising to an annual average of 9 per cent. Consumer price

[1] The strong cyclical momentum in the United States in the course of 2003 creates a significant statistical carry-over effect of 1.9 percentage points. If real GDP in the United States were to stagnate in 2004 at its level in the fourth quarter of 2003, the annual growth rate would still be 1.9 per cent in 2004. Thus, even a stagnating United States economy *in the course of 2004* would still produce the same average annual rate of economic growth in 2004 as is currently forecast for the euro area.

[2] Federal Reserve Board, *FOMC Statement,* Press Release, 28 January 2004 [www.federalreserve.gov].

inflation should fall to an average of some 1.5 per cent in 2004, significantly below the European Central Bank's (ECB's) ceiling of 2 per cent.

The stance of monetary policy is assumed to remain broadly accommodative in view of the restraining effects of the real effective appreciation of the euro and the favourable inflation forecasts. Earlier expectations of a tightening of monetary policy in the first half of 2004 have been revised; indeed, in view of the strong appreciation of the euro, a lowering of interest rates would now appear to be necessary to avoid a further tightening of monetary conditions let alone to provide a relaxation. This is all the more necessary because fiscal policy is set to be broadly neutral in 2004.

Among the three major economies of the euro area, real GDP in *France* is forecast to grow slightly below the euro area average in 2004 (table 1.1.2). An export-led recovery is expected to be supported in the course of the year by a moderate pick-up in business fixed investment and the rebuilding of inventories. Private consumption growth is likely to remain moderate, reflecting cautious consumer behaviour in the face of a weak labour market and only small gains in real disposable income. Fiscal policy is expected to be tightened significantly, but the actual budget deficit is forecast to remain above the 3 per cent Maastricht reference value.

In *Germany*, the cyclical recovery is expected to be relatively subdued in 2004. Real GDP is forecast to increase by only 1.7 per cent after a slight fall in 2003.[3] The export-led recovery should stimulate business fixed investment. Industrial output, moreover, should be supported by the rise in global demand for investment goods, a traditional specialization of the German economy. But consumer spending should increase only moderately, given the depressing effects of falling employment on aggregate disposable income and consumer confidence. The cautious spending behaviour of consumers is likely to lead to a further rise in savings. The modest tax cuts adopted in December 2003 are expected to have only a negligible impact (equivalent to 0.2 percentage points of GDP), since they will be partly offset by increases in health charges and cuts in subsidies and social security benefits. The general government budget deficit is forecast to fall somewhat but to remain significantly above the Maastricht threshold of 3 per cent.

In *Italy*, the export-led recovery in 2004 is forecast to be supported by a moderate increase in private consumption and a pick-up of business investment in machinery and equipment, following a sharp fall in 2003. Construction investment should continue to increase at a relatively strong rate. Increased import demand is expected to neutralize the effect of the rise in exports on economic growth in 2004. Fiscal policy is set to be slightly restrictive and the general government budget deficit is projected to rise further, approaching the 3 per cent reference value in 2004. In sum, real GDP is forecast to increase by 1.6 per cent in 2004.

Outside the euro area, real GDP is forecast to increase by 2.8 per cent in the *United Kingdom* in 2004. More than half of the increase will be due to the continued strength of private household consumption. Government spending will also continue to make a substantial contribution to growth. Exports are expected to recover strongly, driven by the increase in world trade, but strong import demand will more than offset the positive impact on domestic activity. The current account deficit is expected to increase to some 3.5 per cent of GDP. Fiscal policy remains expansionary, but the fiscal stimulus is likely to be much smaller than in 2003. The general government budget deficit is set to exceed the EU Treaty's 3 per cent mark. Monetary policy was tightened again in early February 2004 (the base rate was raised by a quarter of a percentage point to 4 per cent) against a background of above-trend growth in the final quarter of 2003 and low margins of spare capacity in the total economy. A major policy concern remains the housing boom and the considerable build-up of household debt, which now corresponds to more than 130 per cent of annual disposable income.

(ii) Risks to the short-term outlook

Although the baseline forecast is for a sustained global recovery in 2004 and its continuation in 2005, the short-term economic outlook remains, nevertheless, vulnerable to serious downside risks. Some of these have been present for some time and are mainly related to the legacy of the United States economic boom in the late 1990s. Additionally, a recent emerging concern is that avian influenza could spread from Asia to the rest of the world.

A major source of uncertainty, given its strong impact on economic growth in the rest of the world, is the sustainability of the recovery in the United States. A persistent source of worry is the large current account deficit, which now corresponds to 5 per cent of GDP, the highest level on record. The other side of this large and rising deficit is the progressive deterioration in the net international investment position of the United States that has led to a significant rise in its net foreign debt since the late 1990s, which now corresponds to 25 per cent of GDP. The "financing" of the current account deficit now relies to a large degree on purchases of United States government bonds by foreign central banks and private investors and not, as in the late 1990s, on inflows of FDI.

Concerns in international financial markets about the sustainability of the current account deficit are reflected in the pronounced weakening of the dollar since early 2002. Selling pressure on the dollar could well

[3] Annual GDP data are not adjusted for variations in the number of working days. In Germany, about half a percentage point of the average annual growth rate in 2004 is accounted for by calendar effects, which lead to an exceptional increase in the total number of working days compared with the preceding year.

increase in the short and medium term, because the United States recovery and the associated strength of domestic demand is likely to offset, with a lag,[4] and to a more or less large extent, the favourable effects of the dollar's depreciation on net exports. The correction of the current account deficit will also be restrained by the asymmetric reaction of net exports to changes in domestic and foreign incomes: a 1 percentage point increase in United States real incomes tends to lead to a larger increase in imports than a corresponding rise in real incomes abroad stimulates exports.[5] In the face of a persistently large current account imbalance, therefore, the risk of sudden and disruptive capital flows and the associated changes in exchange rates cannot be excluded.[6]

The problem is that the weakness of the dollar has occurred at a time when the recovery in both the euro area and Japan is still fragile, and when both, to a large extent, are relying on an initial strong impulse from foreign demand. A dilemma is that the adjustment of the current account imbalance cannot be brought about by the exchange rate alone. What is also required is a stronger rate of growth of domestic demand in the rest of the world.[7] Also required is a sustained slowdown in real income growth in the United States,[8] combined with an increase in the national savings rate.

In principle, creditor countries (i.e. those with current account surpluses) should be prepared to facilitate the adjustment of debtor countries (i.e those with current account deficits) by accepting an appreciation of their currencies. But the risk is that the dollar depreciation will overshoot in 2004 and choke off the recovery in Europe and Japan, via its adverse impact on exports, profits and business investment.

The main challenge for governments, therefore, is how to ensure both a sustained global recovery and a steady and progressive correction of the major current account imbalances in the global economy. As noted above, exchange rate flexibility is a necessary but not sufficient condition to accommodate this inevitable adjustment process. Another major issue is how to ensure an acceptable sharing of the burden of a dollar depreciation among the major trading partners of the United States.[9] So far, this burden has fallen disproportionately on the euro area, although in recent months there has also been a significant appreciation of the yen.[10] But there remains the thorny issue of Asian currencies, such as the Chinese renminbi, that are formally or informally pegged to the dollar.

It is very important to bring about a more balanced distribution of growth among the major regions of the world economy. In Europe, the successive downward revisions of (already moderate) growth forecasts risk having a negative effect on long-term growth expectations in the business sector, with attendant negative effects on productive investment and the growth of potential output. The ambitious goals of the EU Lisbon strategy now look increasingly elusive and are likely to be even more out of reach after enlargement.[11] While the need for supply-side reforms is undisputed, they need to be complemented with a coherent macroeconomic policy framework that is conducive to economic growth. It is therefore important that the envisaged reform of the Stability and Growth Pact finds an appropriate balance between the need to ensure fiscal sustainability over the medium and longer term and sufficient flexibility for fiscal policy to support economic growth.[12] A broader mandate for the ECB – emphasizing the importance of giving due attention to both inflation and the growth of employment – would also be helpful.

In the United States, the downside risks continue to be associated with the persistently high level of private household debt. This could become a serious problem in the event of a large increase in interest rates, leading to a higher debt-servicing burden. A sharp reversal of the boom in the housing market, which helped to sustain personal consumption growth during the cyclical downturn, would dampen household demand and overall economic growth as a result of the negative wealth effects. Another uncertainty is the currently much weaker link between economic growth and employment compared with previous recoveries, at least so far. If new job creation continues to be weaker than expected, it could dampen consumer confidence and spending propensity. Persistently large fiscal deficits could, moreover, trigger a rise in United States long-term interest rates, which would probably spill over to the euro area and Japan, with adverse consequences for interest-sensitive expenditure items. The sharp rise in equity prices in 2003 appears to have been based on very favourable expectations about profits growth. Any slowdown in the rate of recovery is therefore likely to trigger a significant fall in prices, with negative wealth

[4] This is the so-called J-curve effect, which describes the adjustment path of the trade balance in response to a real depreciation.

[5] C. Mann, *Is the U.S. Trade Deficit Sustainable?*, Institute for International Economics (Washington, D.C.), 1999, pp. 123-126.

[6] UNECE, *Economic Survey of Europe, 2003 No. 1*, p. 12.

[7] Ibid.

[8] C. Freund, *Current Account Adjustment in Industrialized Countries*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, No. 692 (Washington, D.C.), December 2000.

[9] *Statement of G-7 Finance Ministers and Central Bank Governors* (Boca Raton, FL), 7 February 2004 [www.g7.utoronto.ca].

[10] The Japanese authorities, however, continued to intervene strongly in the foreign exchange markets in January 2004 to check the appreciation of the yen.

[11] Commission of the European Communities, "Delivering Lisbon – reforms for the enlarged Union", *Report from the Commission to the Spring European Council,* COM (2004) 29 (Brussels), 21 January 2004.

[12] See section 1.3(i).

effects on households and the financing conditions for the corporate sector and hence on private sector spending.

In the *euro area*, apart from the concern that a stronger euro could choke off the recovery, business investment could be held back by the lingering balance sheet problems in the corporate sector in several countries, especially France, Germany and Italy. Such problems would risk being amplified by a sharp fall of equity prices. Another uncertainty is how far household spending propensities will be affected by the long-standing discussions about future pension entitlements and the funding of increased health care costs. There has also been a sizeable increase in household debt in recent years, largely related to a surge in house prices in several countries (notably Greece, Ireland, the Netherlands and Spain). As in the United Kingdom and the United States, there is a risk that rising interest rates could trigger a fall in house prices with adverse effects on consumer spending.

Another concern is the boom in emerging market debt in 2003, largely a result of low interest rates in the industrialized countries stimulating investors to search for higher yields on riskier assets. As a result of the surge in demand for emerging market bonds, yield spreads (over United States treasuries) have fallen to very low levels that were last seen before the Asian and Russian financial crises. An unanticipated rise in United States interest rates, or a weaker than expected global recovery, could trigger a sharp change in investors' perceptions of risk in emerging bond markets and lead to disruptive capital outflows.[13]

(iii) Eastern Europe and the CIS

In the short run, eastern Europe and the CIS are poised to remain the most dynamic parts of the ECE region. However, growth rates in these two groups are forecast to diverge in 2004: while GDP growth in eastern Europe is expected to accelerate to some 4.5 per cent (from 3 per cent in 2002 and 3.8 per cent in 2003), in the CIS it is set to slow down from the exceptionally high rate of 7.6 per cent in 2003 to a still relatively high 5.7 per cent in 2004, a rate similar to that in 2001 and 2002 (table 1.1.3).

The generally optimistic forecasts for the *east European economies* reflect expectations of a strengthening of the recovery in western Europe, which is their main export market. Most countries in eastern Europe are relying on stronger demand for their exports in 2004 (than was the case in the previous two years) not only to support domestic activity but also as a way to revert to a more balanced pattern of growth. Growth in eastern Europe in 2002 and 2003 was predominantly driven by domestic demand (and often largely by consumption), which in some cases led to sizeable macroeconomic imbalances. A shift towards export-led growth (a pattern that prevailed throughout most of the 1990s) would help to reduce these imbalances.

In *central Europe* it is expected that the strengthening of west European import demand, coupled with the positive effects of EU accession on business and consumer sentiment, should lead to stronger growth in 2004. Growth in eastern Europe's largest economy, Poland, was steadily accelerating during the course of 2003 and is expected to continue to do so in 2004, thanks to exports of manufactured goods and a strong revival of private fixed investment. Supportive policies (as envisaged in the budgetary policy framework for the year) and the recovery of private consumption should provide further support to activity. Taken together those factors should underpin an acceleration of Polish GDP growth to some 5 per cent in 2004. However, the envisaged fiscal stimulus implies a further increase in the budget deficit and a worrying escalation in the level of public debt. Hence, the implementation of the long-delayed reforms in the country's public finances is increasingly urgent, despite their possible negative short-term implications for economic activity.

In Hungary, the expected modest strengthening of GDP growth in 2004 (to 3.3 per cent) presupposes a major shift towards export-driven growth. This, in turn, is conditional on significant gains in competitiveness and profitability (resulting from wage moderation and rapid productivity growth) leading to a stronger recovery of business investment, a revival of FDI inflows and a sharp upturn in exports. If successful, this adjustment should lead to a large increase in the contribution of net exports to GDP growth that would be sufficient to offset the negative effects of the envisaged tightening of macroeconomic policy (in response to the twin deficit problem and the currency turmoil in 2003) on private and public consumption. Similarly, the Czech authorities face difficult policy choices related to the threat of unsustainable twin deficits, a consequence of earlier expansionary policies. The response to these threats is likely to involve fiscal retrenchment and, possibly, a tightening of monetary policy as well. The possible withdrawal of policy support to domestic activity (a support that prevented a more severe slowdown in 2002 and 2003) is expected to lead to a deceleration in growth to 2.8 per cent in 2004, despite the likely revival of exports. In Slovenia, the present policy of wage restraint should strengthen competitiveness and this, together with the recovery of west European demand, should provide a boost to exports in 2004. As a result, the recovery in aggregate output should accelerate to 3.6 per cent in 2004. In Slovakia growth is set to remain strong in 2004, with GDP increasing by some 4 per cent. The export-oriented manufacturing sector should benefit from stronger external demand, and the economy as a whole should also gain from the confidence-enhancing effects of EU membership and structural reforms focused on

[13] International Institute of Finance, "Net private capital flows to emerging markets rose sharply in 2003 and are set to continue at robust rate in 2004", Press Release, 16 January 2004 [www.iif.com].

improving the fiscal position and strengthening work incentives. In contrast to other central European economies, final domestic absorption can also be expected to increase in Slovakia in 2004, providing further support to domestic economic activity.

Strong GDP growth (at rates around 6 per cent or more) is expected to continue in all three *Baltic states* in 2004. The three economies rely heavily on exports to western Europe and should benefit from a recovery in domestic and import demand in the EU. However, the very large current account deficits in Estonia and Latvia may lead to a tightening of macroeconomic policies which, in turn, may somewhat moderate their growth rates.

Economic performance in *south-east Europe* is likely to remain mixed in 2004. Robust growth is set to continue in Bulgaria, Croatia and Romania, with GDP in each of them increasing by some 5 per cent or more. The prospect of EU membership has not only provided a stimulus to policy reforms but has also raised the attractiveness of these economies in the eyes of foreign investors, leading to a surge in inward FDI.[14] In turn, the acceleration of FDI-led restructuring has strengthened the supply side of their economies, and this provides a basis for a sustained recovery in the coming years. However, all three countries have large (and in some cases growing) current account deficits; Croatia also suffers from a chronically large fiscal deficit. Consequently, a tightening of policies in some of these economies, with possible adverse effects on economic activity, cannot be excluded. In Serbia and Montenegro, after a considerable slowdown in 2003, growth is expected to gain some momentum in 2004, with GDP increasing by 3-4 per cent. The completion of a number of major privatization deals in 2003 (some of them to strategic foreign investors) should boost the process of enterprise restructuring in this country. At the same time, a number of important policy reforms have been put on hold as a result of the early parliamentary elections held in 2003. The other south-east European economies are expected to maintain their rates of growth in 2004.

While the short-term outlook for eastern Europe as a whole is generally positive, there are some important downside risks to these forecasts. The most serious is the presently lacklustre west European import demand which, if it fails to improve, could disappoint east European hopes of robust export growth. Additional uncertainties about east European export growth stem from the increasingly strong competitive pressures coming from Asian producers. The macroeconomic imbalances in a number of east European economies are another important source of downside risks: policy makers are under increasing pressure to take action to correct large and sometimes growing current account deficits. In addition, if efforts to consolidate the public finances in central Europe fail to reduce the large fiscal deficits, a further tightening of monetary policy (driven by efforts to meet the Maastricht targets) may be the prospect. Such policy responses are likely to have negative consequences for economic activity in the countries involved and in eastern Europe as a whole.

In the *CIS*, some moderation of growth is expected in 2004, with aggregate GDP increasing by some 5.7 per cent. This reflects expectations of a slowdown in the region's largest economies (especially Russia), which, in turn, is mostly related to uncertainties surrounding the external environment. Nevertheless, robust output growth should generally prevail throughout the CIS region.

Russia's long-term economic strategy, adopted in 2003, calls for the doubling of GDP in 10 years. This implies that Russia's GDP should grow by more than an average annual rate of 7 per cent during this period. As discussed in more detail in chapter 4, while in principle the Russian economy has the potential to grow rapidly, provided its resources are used more efficiently, its declining population (which leads to a diminishing labour force) could become a serious constraint on its ability to meet such an ambitious growth target. In addition, the realization of its long-run growth potential – which is in any case below the annual target mentioned above – will depend on the acceleration and deepening of systemic and structural reforms.

In the short run, economic activity should generally remain buoyant in Russia but GDP growth is set to slow down slightly in 2004, to some 5-6 per cent. Russia's economy is still very dependent on the oil sector and developments there are likely to have a major impact on its overall economic performance. According to recent estimates, the growth of Russian oil production (which has been a major driving force of the economy in recent years) is expected to decelerate considerably in 2004 (to some 3 per cent, after increasing by 11 per cent in 2003) and this will undoubtedly affect the growth of GDP.[15] An additional uncertainty surrounding Russia's economic prospects in 2004 is the outlook for world oil prices. Economic performance in the non-oil sectors of the economy will also depend on the rouble's exchange rate: a sharp real appreciation could place another obstacle in the way of a stronger recovery in the manufacturing sector, unless key product market reforms (including bankruptcy proceedings) are implemented more effectively than hitherto.

Despite some moderation, Kazakhstan's economic expansion should continue at a fast pace in 2004, with GDP expected to increase by some 7 per cent. Several

[14] Bulgaria and Romania are aiming at a quick finalization of their accession negotiations in pursuit of their ambition to join the EU in 2007, while Croatia has recently voiced its desire for speedy accession to the EU.

[15] Statement published by Russia's Ministry of Energy, *Reuters News*, 31 December 2003, reported in Dow Jones Reuters Business Interactive (Factiva).

years of strong growth have contributed to a significant rise in living standards and to a rehabilitation of the public finances. In turn, this has allowed the government, after years of austerity, to refocus the priorities in its budgetary policy. In particular, the 2004 budget envisages an increase of the share of social programmes in public expenditure; in addition, the government plans to allocate more resources to economic diversification, innovation and technological development.[16] While these policies target important economic and social goals, the authorities probably need to exercise some caution when engaging in policy activism. The current robust economic performance and the budgetary surplus largely reflects windfalls from the recent high world market prices for energy resources; an abrupt reversal of such prices could quickly undermine the government's ability to allocate large funds to social programmes and industrial policy. At the same time, some of these measures (especially those related to entitlements) could be very difficult to reverse. From this point of view, a less risky policy priority, but nevertheless with significant long-term returns, would be public investment in the development of human capital and in growth-enhancing public infrastructure. Attracting FDI to the non-oil sectors could be another important way to promote economic diversification.

After exceptionally strong growth in 2003, Ukraine's economy is also expected to slow down in 2004 with GDP increasing by some 5 per cent. The outcome in 2003 was partly due to a one-off recovery in the external demand for some key export items (such as steel and chemicals) for which spare capacity was available; such a concurrence of factors is unlikely to be repeated in 2004. Domestic economic policy (and performance) in 2004 is likely to be influenced by the forthcoming elections. Some planned reforms, such as the restructuring of key sectors of the economy (the coal and mining industries, energy and telecommunications, among others), are likely be put on hold until after the elections. At the same time, some loosening of policy ahead of the elections, involving a shift in public spending from investment to consumption, cannot be ruled out.

In January 2004, the Belarusian government adopted a set of long-term policy measures intended to accelerate the restructuring of the economy and raise its competitiveness. However, the success of this programme hinges on the willingness of the authorities to undertake the painful measures needed for the restructuring of the ailing enterprise sector, which has so far largely escaped reform. Belarusian firms have been shielded from competitive pressure through various subsidies (including directed soft bank credit), which have also had detrimental consequences for the banking system and for macroeconomic stability. The 2004 programme can only achieve its goals if the authorities radically change these policies by imposing hard budget constraints on firms and banks and accelerate the much delayed privatization of the enterprise sector. The economic programme calls for an increase in GDP of some 9-10 per cent in 2004; while growth in Belarus is likely to remain relatively strong, this is probably an over ambitious target.

The Kyrgyz economy has recovered from the slump which followed the temporary closure of the Kumtor gold mine; however, due to existing macroeconomic imbalances, the forecast for 2004 is somewhat cautious, envisaging an increase in GDP of some 4 per cent. A deceleration in economic growth is also envisaged in 2004 in the Republic of Moldova where GDP is forecast to increase by some 5 per cent, which is below the average rate of the last three years. The slowdown is due to the balance of payments constraint arising from heavy foreign debt service requirements. The resumption of official assistance to the Republic of Moldova by the international financial institutions is vitally important for easing this constraint and thus releasing much needed resources for the restructuring of the economy and strengthening its prospects for growth. The macroeconomic situation in Georgia is similar to that in the Republic of Moldova: the more restrictive policy stance envisaged for 2004 (prompted by the large external deficits) is likely to result in a slowdown of GDP growth.

In Uzbekistan, the official GDP growth target for 2004 (6 per cent) should be judged against a major policy dilemma that the authorities are facing. On the one hand, if they maintain the relatively tight policy stance of 2003 – launched in an effort to prevent an excessive depreciation of the sum ahead of the introduction of currency convertibility (see chapter 4) – without reverting to currency controls, the target may be rather difficult to achieve. On the other hand, a loosening of policy could trigger unwanted inflationary pressures (through the expected currency depreciation), while the eventual reintroduction of currency controls would compromise the effort to make the currency convertible. Growth in Tajikistan is expected to remain strong in 2004, at around 8 per cent, thanks to progress in macroeconomic stabilization and the general improvement in the economic climate in the country. Relatively high rates of growth are also expected in the rest of the CIS economies in 2004.

Apart from the uncertainties surrounding world commodity markets, there are additional downside risks to the short-term outlook for the CIS economies. Macroeconomic imbalances in some of them may prompt governments to tighten macroeconomic policies (after a general relaxation in 2003), and this could lead to some moderation in growth rates. Some of the more indebted CIS economies may encounter balance of payments constraints that could further weaken their growth. Finally, the developments in the Russian economy in

[16] In a broader context, these measures are the first steps in implementing the long-term national Industrial Development Strategy (covering the period until 2015), which was adopted in 2003.

2004 will continue to have a significant influence on economic performance in the rest of the CIS: if Russia's growth falls below expectations, there will be negative repercussions for all the other economies in the region.

1.3 Selected policy issues

(i) The future of the Stability and Growth Pact

(a) Background

On 25 November 2003, the Economic and Finance Council of Ministers (ECOFIN) decided not to follow the recommendations of the European Commission to take disciplinary actions (in line with Article 104(9) of the EU Treaty) against France and Germany, despite their non-compliance with earlier Council recommendations – based on Article 104(7) of the Treaty – to take effective action to reduce their budget deficits below the 3 per cent ceiling by 2004. Instead, the Council agreed by a simple majority "to hold the Excessive Deficit Procedure [for France and Germany] in abeyance for the time being".[17] The two countries, however, made unilateral commitments to reduce their budget deficits below 3 per cent in 2005. But failure to achieve this would no longer trigger any sanctions as foreseen in the Stability and Growth Pact (SGP). For the Commission, this decision of the Council is in conflict with the spirit and the letter of the Treaty and the SGP, and it has appealed to the European Court of Justice to rule against the decision of the Council.[18]

The causes of the current crisis concerning the fiscal rules of the Economic and Monetary Union (EMU) can be traced in part to the sins of omission in good economic times when both countries failed to exploit the available scope for fiscal consolidation. Doubts about the credibility of the EU fiscal rules had already arisen in early 2002, when the ECOFIN refused to send an early warning to Germany and Portugal, which were anticipated to develop excessive deficits in that year. But the current crisis has also to be seen against the background of a persistent controversy surrounding the EMU's fiscal rules ever since the adoption of the Stability and Growth Pact in 1997. This controversy is not so much about the need for fiscal rules in a monetary union, but rather about their specific design.

It goes without saying that designing a set of common fiscal rules for a relatively large group of countries that differ in terms of their levels of economic development as well as the state of their public finances, especially the levels of government debt, is not an easy task given the need to combine considerations of economic efficiency and credibility with political acceptance. There appears to be no simple fiscal rule that at the same time can satisfy plausible economic criteria and be politically acceptable.[19]

(b) The fiscal rules of the EU

The introduction of fiscal rules for the EU member states started with the Maastricht Treaty of 1992, which stipulated the convergence criteria that have to be met before a country can be admitted to the monetary union. As regards government finances, maximum reference values of 3 per cent and 60 per cent of GDP, were fixed for general government budget deficits and general government gross debt, respectively. The European Union Treaty (Article 104(1)) adopted in Amsterdam in 1997 stipulated that member states shall avoid "excessive deficits", maintaining the 3 per cent reference value fixed in the Maastricht Treaty. There is no explicit reference any more to the 60 per cent debt ceiling.[20] An excessive deficit is allowed only in certain exceptional circumstances,[21] such as a severe recession, defined as an annual decline in real GDP by 2 per cent (a very unusual occurrence for EU member states). But an excessive deficit may also be tolerated if the decline of GDP is within the range of 0.75 to 2 per cent. A violation of the 3 per cent reference value in normal times should trigger the "excessive deficit procedure", which involves a protracted process of warnings and peer pressure. Failure to reduce the deficit sufficiently within a defined timeframe can lead to sanctions, at first in the form of a non-interest bearing deposit which eventually may be converted into a fine.

The Stability and Growth Pact, adopted in June 1997, introduced a system of multilateral budgetary surveillance[22] and a procedure for speeding up and clarifying the implementation of the excessive deficit procedure.[23] The third element of the Pact is a resolution[24] which commits member states, while strictly observing the 3 per cent reference value for budget deficits in the short term, to achieving a budgetary position that is close to balance or in surplus over the medium term in order to be able to deal with normal cyclical fluctuations, i.e. to have

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[17] European Commission, 2546th Council meeting, *Economic and Financial Affairs,* Press Release 14492/1/03 Rev.1 (Brussels), 25 November 2003 [europa.eu.int].

[18] European Commission, *Commission Sets Out Strategy for Economic Policy Coordination and Surveillance*, Press Release IP/04/35 (Brussels), 13 January 2004 [europa.eu.int].

[19] W. Buiter, "Ten commandments for a fiscal rule in the E(M)U", *Oxford Review of Economic Policy*, Vol. 19, No. 1, 2003, pp. 84-99; M. Buti, S. Eijffinger and D. Franco, *Revisiting the Stability and Growth Pact: Grand Design or Internal Adjustment?,* European Commission, European Economy, Economic Papers, No. 180 (Brussels), January 2003.

[20] This may reflect the assumption that in view of a deficit limit of 3 per cent of GDP, debt ratios will eventually converge to the 60 per cent level, assuming nominal GDP growth of 5 per cent per annum.

[21] These are detailed in a Protocol on the excessive deficit procedure, annexed to the Amsterdam Treaty.

[22] Council Regulation (EC) No. 1466/97.

[23] Council Regulation (EC) No. 1467/97.

[24] Resolution of the European Council of 17 June 1997 on the Stability and Growth Pact.

sufficient scope for the operation of automatic stabilizers. But, legally, the resolution is non-binding, i.e. it provides only "firm political guidelines", which cannot be enforced.

The budgetary rules apply to all EU countries, but sanctions can only be imposed on members of the euro area. For countries wanting to adopt the single currency, the condition that the debt ratio should be 60 per cent or less is, in principle, still operational in addition to the requirement that the budget deficit should not exceed 3 per cent.

(c) The economic rationale for the Pact

Although the fiscal rules apply to all EU member states, strictly speaking they were designed only for countries joining the monetary union. The main objective of the SGP was to ensure that the fiscal discipline that the Maastricht convergence criteria imposed on countries wanting to qualify for the single currency area would continue after their membership of the EMU. The need for fiscal rules in a monetary union is mainly explained by the potential adverse spillover effects of irresponsible fiscal policy in one or more member states on the other countries in the EMU. This may take the form of upward pressures on real interest rates as a result of excessive government borrowing, or upward pressures on inflation, which would complicate the task of monetary policy in achieving price stability. Empirical evidence, however, suggests that these potential spillover effects are likely to be of secondary importance. The major concern is that fiscal leniency by some governments could lead over time to an unsustainable increase in government debt, which could then force the ECB into an inflationary bailout.

Although there is a "no bailout" clause in the Treaty, it is generally seen to lack credibility. The reason for the lack of credibility is that a debt default of a member state of the EMU could trigger a systemic crisis in its banking system, with more or less large repercussions on financial stability in other EMU countries.[25] This could force the other countries to arrange a bailout and would also be likely to force the ECB to get involved by monetizing a large part of the debt. The possibility that financial markets view the "no bailout" clause as not credible therefore risks weakening the incentives for governments to pursue responsible fiscal policies. If the clause were credible then debt rising to excessively high levels in a given country would be accompanied by a fall in its credit rating and rising risk premia on its government bond issues. But although there is a large variation in the size of government debt as a proportion of GDP among the members of the euro area, there have been only very small differences in the national yields on long-term government bonds since the start of EMU, thus pointing to negligible default premia.

It might be argued therefore that the SGP is a medium-term coordination device that was created to address this potential moral hazard problem.[26] Such medium-term coordination, however, may reduce the effectiveness of short-term fiscal coordination as a tool of demand management.[27] More recently, the need for rules to ensure fiscal discipline has also been motivated by the longer-term implications of population ageing on public pension liabilities, health care expenditure and the sustainability of public finances. But *stricto sensu* these factors have nothing to do with the motive for creating fiscal rules in a monetary union.

(d) Main criticisms of the SGP rules

The SGP has come under increasing criticism since the onset of the cyclical downturn in the EU in 2001. The main points of concern have been the arbitrariness of the fiscal benchmarks, the built-in procyclical bias of the Pact, the excessive focus on annual budget deficit targets, the neglect of levels of debt, and scepticism about the effective enforcement of rules. The Pact has also been criticized because it enforces a one-size-fits-all fiscal policy in the euro area, which can lead to problems in the event of asymmetric shocks, given that monetary policy is no longer available as a policy instrument at the national level. The Pact also neglects the importance of establishing an appropriate policy mix between monetary and fiscal policy in the euro area for achieving sustained growth and adjusting to shocks.[28] But this is itself a controversial area, and in the following the focus is only on the rules of the SGP proper.

Arbitrary and imperfect fiscal benchmarks

The 3 per cent reference value for budget deficits is arbitrary and cannot be defended on the basis of economic logic. The same holds for the reference value for government debt and the requirement to achieve budgetary positions "close to balance or in surplus" over the medium term. The fact that the fiscal policy benchmarks are arbitrary makes them difficult to defend and leads to their legitimacy being questioned at times of serious economic stress. The target of broadly balanced budgets over the medium term constitutes a significant

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[25] B. Eichengreen and C. Wyplosz, "The Stability Pact: more than a minor nuisance?", *Economic Policy*, Vol. 13, Issue 26, April 1998, pp. 65-104.

[26] J. Pisani-Ferry, "Fiscal discipline and policy coordination in the euro zone: assessment and proposals", paper presented at the European Commission, high-level Group of Economic Analysis meeting *Fiscal Policy: Coordination, Discipline and Stabilization* (Brussels), 16 April 2002 [europa.eu.int/comm.].

[27] R. Barrell and M. Weale, "Monetary and fiscal coordination in the euro area", in I. Begg (ed.), *Europe: Government and Money – Running EMU: The Challenges of Policy Coordination* (London, The Federal Trust, 2002), pp. 71-82.

[28] C. Allsopp, "The coordination of monetary, fiscal and labour market policies in the euro area", in I. Begg (ed.), op. cit., pp. 83-100.; see also R. Barrell and M. Weale, op. cit.

constraint on government borrowing for financing public investment, which can be justified by the "golden rule".

The annual budget deficit, moreover, is not a good measure for the sustainability of government debt. Nor is the current level of government debt a good indicator of the sustainability of government finances. The notion of debt sustainability is not well defined, but in any case, it is necessary to take implicit government debt into account (such as pension obligations), as is done in the calculation of so-called "fiscal sustainability" gaps.[29]

It may also be questioned why the fiscal reference values should be uniform for all countries. Debt sustainability will vary among countries, depending, for example, on their trend growth rates of real GDP and structural inflation rates. Demographic trends also may differ. Countries with a higher trend rate of output growth, *ceteris paribus*, can afford a higher budget deficit-to-GDP ratio; similarly, for a given interest rate and debt level, a higher inflation rate reduces the real burden of public debt. The latter point is especially relevant to the accession countries, where the real convergence process (i.e. the process of catch-up in per capita real income) and associated real exchange rate appreciation will lead to higher nominal income growth that will tend to ease the governments' intertemporal budget constraint.[30]

Procyclical bias

The 3 per cent ceiling for nominal budget deficits could turn out to be a binding constraint in a cyclical downturn, enforcing procyclical policies by preventing a discretionary increase in government spending or limiting the operation of automatic stabilizers and thereby increasing output volatility. This would unlikely be the case once a broadly balanced budget position has been achieved, although this would also depend on the specific variation in budget deficits in reaction to fluctuations in economic activity as well as the size and term structure of government debt.[31] But the transition to this favourable position may be difficult and entail considerable "transition costs" in the event of unfavourable cyclical developments or uncompetitive economic structures.

The need for fiscal retrenchment at a time of a weakening business cycle risks making matters worse in the country concerned. In fact, an increase in the budget deficit at such a time is more likely to be part of the solution, rather than a problem. Depending on the country size and the degree of fiscal tightening required by the Pact, there will also be adverse spillover effects on the other member states of the euro area. The losses incurred by blocking the stabilizing role of fiscal policy will increase with the size and number of countries that have to curtail the operation of their automatic stabilizers.

The SGP also implicitly assumes that all business cycles follow a standard pattern, with a downturn followed swiftly by a cyclical upturn. A protracted economic stagnation, as experienced by Germany over the past three years and its adverse impact on budgetary positions, was not anticipated in the rules.

The Pact also operates asymmetrically by potentially constraining governments' room for manoeuvre in a cyclical downswing, but placing no constraints on procyclical fiscal policies in good times, which could lead to a deterioration in the underlying or structual fiscal balances. The lack of incentives for countries to pursue fiscal consolidation during good times is one of the core problems of the EU fiscal rules.[32]

Low credibility of enforcement of sanctions

The credibility of the fiscal rules hinges on their impartial and consistent enforcement. As the imposition of fines in case of a persistent excessive deficit is bound to lead to a further increase in the deficit and the level of debt, the threat of fines as the end-point of the excessive deficit procedure was never really credible. The imposition of sanctions is also unlikely because of the associated political consequences. Given the uncertainty about the imposition of sanctions and fines, it has been argued that it is the loss of government prestige that is the real discipline: "It is the pressure from the public and the peer pressure that makes the SGP most effective."[33] But this contrasts with the actual budgetary slippages in recent years, which point to a diminishing political ownership of the SGP.[34]

It has also been surmised that the ECOFIN – as a group of ministers, who are responsible for their national budgets – is partisan when having to decide whether there has been a breach of the rules in one or more countries. From a strategic point of view, ministers may anticipate that a lenient interpretation of the rules may also be applied to their own countries in the event that one day they exceed the deficit limit.

[29] R. Perotti, R. Strauch and J. von Hagen, *Sustainability of Public Finances*, Centre for Economic Policy Research (CEPR), Discussion Paper, No. 1781 (London), November 1997.

[30] W. Buiter and C. Grafe, "Reforming EMU's fiscal policy rules. Some suggestions for enhancing fiscal sustainability and macroeconomic stability in an enlarged European Union", in M. Buti (ed.), *Monetary and Fiscal Policies in EMU: Interactions and Coordination* (Cambridge, Cambridge University Press, 2003), pp. 92-145.

[31] R. Barrell and K. Dury, "Will the SGP ever be breached?", in A. Brunila, M. Buti and D. Franco (eds.), *The Stability and Growth Pact* (London, Palgrave, 2001), pp. 235-255.

[32] This is encapsulated in the quip that, "The Pact is all sticks but no carrots".

[33] R. Beetsma, "Does EMU need a Stability Pact?", in A. Brunila et al., op. cit., p. 36.

[34] European Commission, Communication from the Commission to the Council and the European Parliament, *Strengthening the Coordination of Budgetary Policies,* ECFIN/581/02/EN Rev.3 (Brussels), 21 November 2002 [europa.eu.int].

(e) Proposals for reform

A rethinking of the Pact has been underway for some time and the need for reform is now generally acknowledged, not only by EU member states but also by the Commission as well as the ECB. What is uncertain is the extent and timing of a reform of the EU fiscal rules. One constraint is that the benchmark value for budget deficits is part of the Treaty. A first step towards clarifying the *interpretation* of the Pact was made in March 2003, when the ECOFIN agreed that the budgetary position of "close-to-balance-or-in-surplus" to be achieved over the business cycle (i.e. in the medium term) is to be understood as referring to cyclically adjusted (or "underlying") budget balances.[35] As these cyclically adjusted balances cannot be directly observed, this requires prior agreement among the EU member states on a common methodology for estimating output gaps, i.e. the deviation of actual output from potential output, and the associated cyclical budget elasticities. The focus on cyclically adjusted fiscal balances, however, does not remove the potential deflationary bias of the 3 per cent deficit threshold in the event that there is a large underlying deficit at the onset of a cyclical downswing. Nor does it soften the tight constraints on government borrowing for financing public investment.

The golden rule: borrowing for public investment

The introduction of the "golden rule" of public finance in the EU fiscal framework has been advocated, *inter alia,* in order to remove the financial constraints on public investment in the euro area. This would encourage countries, in the short run, to shift the composition of domestic demand rather than to reduce it in order to avoid breaching the deficit threshold.[36] The golden rule is that government borrowing should be limited to the level of government net investment spending. The rationale of this is that investment normally leads to future returns and therefore its cost should be spread over time. What is also relevant in this context is the aspect of intergenerational equity in sharing the financial burden of today's infrastructure investment and the principle of tax smoothing, which aims to minimize the economic costs of raising taxes in response to large variations in government expenditures.

This "golden rule" is being applied in the United Kingdom, where government borrowing over the business cycle is not to exceed investment spending. It has been complemented by the "sustainable investment rule", which requires that public sector net debt as a proportion of GDP will be held at a "stable and prudent level", defined by the government to correspond to 40 per cent of GDP.[37] In a similar vein, the constitution in Germany limits the annual federal government budget deficit to public investment expenditure. The application of the rule requires agreement on a coherent definition of public investment, which is not obvious.

For the EU accession countries from eastern Europe, which have a considerable need for public investment to upgrade their infrastructure, considerations of both intergenerational equity and economic efficiency strongly suggest the need for financing these investments not from current revenues but by borrowing.[38]

Among the various *other reform proposals* that stick with the need for common fiscal rules, the main thrust is to put more emphasis on the level of government debt in the public finance surveillance process, given that the main objective of fiscal policy in the longer term is to ensure debt sustainability. Related to this is a more or less larger degree of flexibility in respect of meeting the 3 per cent deficit threshold in normal times.

A proposal of the Commission

In November 2002, the Commission proposed putting greater emphasis on the debt ratio in the budgetary surveillance process *within the existing framework of the SGP*.[39] At the same time, the budgetary surveillance process would be used to prevent countries from pursuing pro-cyclical policies in periods of strong economic growth. While the 3 per cent deficit ceiling is to be observed in normal times, the Commission proposed that limited flexibility could be introduced with regard to deviations from the medium-term target of close-to-balance underlying budget positions. A small temporary deviation (in the sense of a deterioration) from the medium-term target could be allowed under certain conditions for the financing of large structural reforms (such as productive public investments or tax reform) to promote the goals of the Lisbon strategy. An additional requirement is that the debt ratio should be below the 60 per cent reference value. A small deviation from the longer-term target for the underlying budget position could be allowed in case of debt levels well below 60 per cent. The main feature of this proposal is the additional discretionary power it gives to the Commission in granting a very limited increase in budgetary flexibility.

Making allowed deficits dependent on debt levels

A more far-reaching proposal is to abandon the common 3 per cent reference value for the actual budget deficit and replace it with a value dependent on a

[35] European Commission, 2493rd Council meeting, *Economic and Financial Affairs*, Press Release 6877/03 (Brussels), March 2003 [europa.eu.int].

[36] O. Blanchard and F. Giavazzi, *Improving the SGP through Proper Accounting of Public Investment*, CEPR Discussion Paper, No. 4220 (London), February 2004.

[37] This target, however, is as arbitrary as the Maastricht Treaty reference values.

[38] W. Buiter and C. Grafe, op. cit.

[39] European Commission, Communication from the Commission to the Council and the European Parliament, *Strengthening the Coordination of Budgetary Policies,* ECFIN/581/02/EN Rev3 (Brussels), 21 November 2002 [europa.eu.int].

country's debt ratio.[40] While countries with government debt corresponding to 60 per cent of GDP and above would still be constrained by the 3 per cent ceiling, this would no longer be the case for countries where government debt was below 60 per cent. The latter would be permitted to run deficits larger than 3 per cent in a cyclical downturn, thus providing more scope for counter-cyclical policies. The degree of permitted "overshooting" would vary with the level of government debt, but if it is exceeded the "excessive deficit procedure" would be triggered. In principle, this should provide stronger incentives for countries to pursue fiscal restraint in order to reach this more comfortable financial position. A major problem is to find plausible criteria for determining how far the deficit should be allowed to exceed the 3 per cent benchmark for any given debt ratio below 60 per cent. Another problem is that the actual level of government debt is not necessarily a reliable indicator of fiscal sustainability and it would have to be complemented by estimates of a government's implicit (contingent) financial liabilities. There would also be a need for stringent transitory arrangements for countries which still had an "excessive" level of government debt.

A debt sustainability pact

Another proposal, which broadly goes in the same direction as that above, offers countries the option to subscribe to a 'debt sustainability pact', which would be complementary to the SGP.[41] This would involve a commitment to publish regular comprehensive government financial accounts, including assessments of contingent (off-balance sheet) liabilities; to keeping the current debt ratio below a certain threshold (but, in any case, below the 60 per cent reference value of the Maastricht Treaty); and setting medium-term targets for the debt ratio as a benchmark for budgetary policy. Countries accepting all three commitments would be allowed to let their budget deficits rise above the 3 per cent threshold; i.e. if all three conditions are met then the excessive deficit procedure would be waived. In addition to the problems arising with the previous proposal, this one is somewhat ambiguous because of its unclear relationship to the SGP.

Abandoning reference values for budget deficits

A somewhat different proposal is to focus exclusively on sustainable debt and to drop annual budget deficit targets altogether.[42] Although for all countries the maximum debt ratio should not exceed the Maastricht Treaty reference value of 60 per cent, there would be a requirement to reduce the debt level more or less significantly below this threshold depending on the size of the government's unfunded, future financial liabilities. Once the target debt ratio has been attained it will have to be maintained broadly constant over the business cycle. This proposal also requires agreement on the criteria for imposing long-term debt targets below the standard 60 per cent reference value.

An independent institution for the enforcement of fiscal rules

A crucial aspect of any policy rule is its consistent enforcement over time. This does not necessarily mean its rigid application under all circumstances. There may be circumstances (which may not be known in advance) where enforcement of the rule would lead to a worse outcome compared with a relaxation of the rule.[43] This time-inconsistency problem could lead to a loss of credibility, especially if the decision-making process is strongly politicized. It has therefore been proposed that the task of judging compliance or non-compliance with reformed rules of the SGP could be shifted to the ECB Governing Council or an independent body composed of members from each of the EMU member states.[44]

A more radical proposal, building on the delegation of monetary policy to independent central banks, is to address the problem by creating independent national fiscal policy committees (to be appointed by national parliaments), whose sole mandate would be to ensure debt sustainability by fixing legally binding annual limits to budget deficits over the medium term.[45] The size of the budget as well as the tax and revenue structure would continue to be determined by the national governments and parliaments. A main difficulty with this proposal is that decisions about the level and structure of government revenues and expenditure (and resulting budget balances), made in the pursuit of allocative and distributive objectives, are interdependent and inherently political.[46]

(f) Conclusion

The EU Treaty in conjunction with the Stability and Growth Pact provides a set of common fiscal rules for all EU member states. Although the rules are simple, the benchmark values are arbitrary and not directly linked to the ultimate objective of ensuring long-term fiscal sustainability. The rules are rigid because they do not

[40] European Economic Advisory Group (CESifo), "Fiscal policy and macroeconomic stabilization in the euro area: possible reforms of the Stability and Growth Pact and national decision making", *Report on the European Economy* (Munich), 2003, chap. 2, pp. 46-75.

[41] J. Pisani-Ferry, op. cit.

[42] P. De Grauwe, "The Stability and Growth Pact in need of reform", University of Leuven, September 2003, mimeo [www.econ.kuleuven.ac.be/ew/academic/intecon/degrauwe].

[43] The strict application of the SGP rules to France and Germany under the prevailing economic circumstances may be a case in point.

[44] W. Buiter, loc. cit., p. 97.

[45] C. Wyplosz, *Fiscal Policy: Institutions vs. Rules*, HEI Working Papers, No. 030/2002 (Geneva), 2002 [heiwww.unige.ch].

[46] "Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung", *Jahresgutachten 2003/04* (Wiesbaden), December 2003, p. 269.

exclude procyclical behaviour of fiscal policy in a cyclical downturn. The objective of achieving cyclically adjusted balanced budgetary positions over the medium term allows for only very limited scope for financing public investment by borrowing. This is a particular matter of concern for the accession countries, given their considerable needs for infrastructure investment. The rules are asymmetric, because they fail to prevent fiscal profligacy in a cyclical upswing. There are also problems with the impartial enforcement of the rules, and there appears to be a justified lack of credibility that sanctions, the final step in procedure if there is non-compliance with ECOFIN recommendations, will ever be imposed.

A major problem is that EU member states differ significantly in their economic structures, and this in turn affects their longer-term economic potential. The economic rationale for imposing a one-size-fits-all fiscal policy framework thus appears highly questionable. Such an approach will become even more difficult to justify after the enlargement of the EU in May 2004, which will lead to a further increase in the heterogeneity of economic structures across the EU membership.

The major elements that an envisaged reform should include can be summarized as follows:

- A regular assessment of long-term sustainable debt levels including implicit government financial obligations (such as pay-as-you-go pension entitlements);
- The creation of an effective mechanism for controlling the growth of government debt beyond a certain agreed limit (as a per cent of GDP);
- A shift in the focus of the budgetary surveillance process from annual budget deficit targets to multi-annual (e.g. five-year) targets;
- A review of the too restrictive definition of "exceptional circumstances" that allow the 3 per cent budget deficit threshold to be exceeded (if the latter is to be upheld);
- A waiver of the 3 per cent budget deficit ceiling for countries with low and clearly sustainable levels of debt;
- The introduction of the golden rule, i.e. to allow borrowing for the financing of public investment;
- Allowing automatic stabilizers to operate freely in a cyclical downturn;
- The control of fiscal profligacy in periods of strong growth;
- A mechanism for ensuring non-partisan assessment of compliance (or non-compliance) with the fiscal rules.

The main requirement of any reform of the SGP is to create a coherent set of fiscal rules that combine sufficient flexibility for fiscal policy to stabilize economic activity in the short run with a mechanism that prevents an excessive growth of government debt in the medium and longer term. Reform of the SGP should aim for a more flexible framework that, to the greatest extent possible, should allow for the differential treatment of countries based on commonly agreed principles and transparent fiscal sustainability criteria.[47] The various reform proposals sketched out above therefore go in the right direction, despite doubts about some of their specific features. To ensure broad political support for the reformed fiscal framework, considerable efforts must be made to explain its rationale and functioning to the wider European public.

But the ultimate test is not whether governments can be held to the rules but whether the rules can ensure – or ease the way to – better economic performance and improved levels of welfare. If they are seen to obstruct such improvement – and this will be especially important for the new EU members – then the framework will lose legitimacy and eventually collapse.

(ii) The challenges of EU membership for the acceding countries

While EU membership is an acknowledgment of the enormous progress achieved in their economic and political transformation, it also entails major new policy responsibilities for the acceding east European countries. Accession is by no means the end of the reform process, quite the opposite: the new members will have to accelerate their ongoing structural and other economic reforms in order to fully benefit from EU membership, and to be effective partners in the Union and contribute to its common goals. Having successfully led their economies through the most difficult part of the transition from plan to market, policy makers in the acceding countries now have to face the post-transition challenges of EU membership.

One of the important new responsibilities of the new members is to participate on an equal footing in the EU's joint decision-making bodies and administrative institutions. This will involve tough and complex international negotiations on policy issues when the new EU members have yet to master the art of contributing to the making of joint EU decisions, while at the same time defending their own national interests. The recent difficulties in the negotiations about the future constitution of the EU underscore the increased complexity of the decision-making process in a Union comprising 25 member states.

The acceding economies will undoubtedly benefit greatly from EU membership. But participation in a supranational union comes at a price: it entails a partial sacrifice of some aspects of national sovereignty.

[47] Differential treatment of countries is likely to become a more widespread feature in the enlarged EU. It should be recalled that the proposed change in the voting system in the ECB Governing Council de facto leads to different degrees of involvement of countries in the process of monetary policy making (see chap. 2, box 2.2.1).

Henceforth, policy-making in the new EU members will be shaped to a considerable degree in an environment of multilateral cooperation and joint decision-making, and this is an aspect of EU membership to which the populations of these countries will have to get accustomed. This will not be an entirely new experience as the policy agenda of the acceding countries during recent years has been largely determined by the demands of meeting the criteria for joining the Union.

The mammoth task of closing the 30 negotiating chapters had already been successfully completed in 2002 but last minute fine-tuning of details was still underway at the time of writing this *Survey* and probably some outstanding issues will be carried over beyond the formal accession date. As the European Commission noted in its regular Monitoring Report in November 2003, although the acceding countries fully meet all the political and economic criteria for membership, most of them still need to finalize a number of important economic reforms in order to fully comply with EU rules and norms.[48]

One of the areas where the acceding countries will be expected to make further progress is policy harmonization and synchronization. Thus, as discussed at more length in chapter 5 of this *Survey*, important tax reforms (most of which aim at harmonization with EU practice), as well as structural reforms with fiscal implications, are still underway in most of these countries. Some of these matters are not confined to the new members: a number of unresolved issues and problems related to tax harmonization concern the EU as a whole and enlargement will undoubtedly stimulate new debates about how to harmonize tax policies within a Union comprising 25 or more members.

Upon accession, the EU's *acquis communautaire* will also enter into force for the new members, *inter alia,* removing or relaxing some of the remaining barriers to trade (although some derogations, most notably in agriculture, will be in effect for several years). For the new EU members this means that (apart from the derogations) they will have to remove any remaining trade restrictions on imports from EU member states and realign their tariffs on imports from third countries with those of the EU. Thus, the acceding countries will now face full competitive pressures from both the single market in most sectors of their economies and from cheaper imports from third countries and regions such as east and south-east Asia.

The new EU members will automatically assume the obligations stemming from the EU's Stability and Growth Pact; in particular, they will have to abide by the rules and norms of the EU's fiscal policy framework. However, this policy framework is now in serious disarray and major problems will have to be resolved (both on the part of the EU and by the acceding countries) in order to ensure its smooth functioning. As discussed in section 1.3(i), the 2003 ruling of the EU's Economic and Finance Council of Ministers not to apply the relevant procedures after France and Germany breached the deficit limits has dealt a serious blow to the credibility of the SGP and of EU policy rules in general. There has been an erosion of public confidence in the capacity of the EU's institutions to apply policy-related sanctions in a non-discriminatory manner but also in the policy framework itself.

On the other hand, the stringent requirements of the SGP have important policy implications for the acceding countries. A major problem is that most of the central European countries will be joining the EU with fiscal deficits that are well above the SGP deficit ceiling of 3 per cent.[49] Upon accession they will be required to submit to the European Commission stability and convergence programmes setting out the course of action they intend to take in order to meet the SGP targets. As their fiscal deficits are largely structural, the required fiscal consolidation will present some of the new EU members with difficult and painful policy choices. But overall, the main challenge for the acceding countries in the area of macroeconomic policy lies in their preparation for EMU accession. Unlike some of the current EU members, the new members will not be able to "opt out" from participation in the euro area; they will only have discretion with respect to the timing of their application for entry into the EMU. But the decision on euro area entry will be taken jointly by the national authorities, the European Commission and the ECB.

In accordance with the EU Treaty, participation in the Economic and Monetary Union requires that the applicants comply with the Maastricht criteria.[50] Progress in meeting the Maastricht criteria by the acceding countries has been mixed. Thus, their public debt levels at present are below the reference target and most of them are unlikely to face major problems in meeting this target.[51] But, as noted above, large fiscal deficits are a problem. While virtually all the acceding countries have adopted medium-term plans for fiscal consolidation (in the

[48] European Commission, *Comprehensive Monitoring Report on the State of Preparedness for EU Membership of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia* (Brussels), 5 November 2003 [europa.eu.int/comm/enlargement/report_2003/].

[49] Chap. 3, table 3.1.1.

[50] Three of the five criteria refer to nominal convergence with the euro area economies: the rate of inflation in the candidate country should not exceed by more than 1.5 percentage points that of the three best performing EU economies; the candidate's average nominal long-term interest rate should not exceed by more than 2 percentage points that of the three member states with the lowest rates of inflation; and the candidate's exchange rate should be stable, as demonstrated by at least two years of smooth participation in ERM-2. The other two criteria refer to fiscal sustainability in the candidate countries: their general government deficit should not exceed 3 per cent of GDP and their gross general government debt should not exceed 60 per cent of GDP.

[51] Chap. 3, table 3.1.2. As a word of caution, the debt ratios reported in this table do not all comply with EU methodology.

context of their Pre-accession Economic Programmes) with the aim of reducing their fiscal deficits below 3 per cent (and, indeed, meeting all the Maastricht criteria by that year), it remains to be seen how fast they will be able to meet these objectives.

Most acceding countries have made steady progress in disinflation and in some of them inflation rates in 2003 were, in principle, in line with the Maastricht criterion (table 3.3.1). However, the favourable performance in 2002 and 2003 partly reflects the prevailing global deflationary trends. At the same time, some transition-related developments (such as the ongoing restructuring of relative prices and the expected liberalization of more administrative prices) are likely to continue to exert upward pressure on price levels for some time to come. In addition, the acceding countries are likely to be subject to catch-up inflation (associated with the Balassa-Samuelson effect), which will accompany their productivity catch-up with the current EU member states. While nominal interest rates have also been declining in the acceding countries, the interest rate differential vis-à-vis the euro area is still large, reflecting not only underlying inflationary expectations but also the risk premia required by financial investors.[52] It would thus be premature to conclude that meeting the EMU inflation and interest rate targets is within easy reach.

The Maastricht criterion for exchange rate stability requires participation – without severe tensions – for at least two years in the EU's exchange rate mechanism ERM-2 prior to EMU entry. ERM-2 is essentially a fixed exchange rate regime with a fluctuation band of ±15 per cent around the central parity (the central parity rate can be changed only in the direction of appreciation), jointly supported by the participating economies and their institutions.[53] However, this type of monetary regime carries potential risks for the economies that join it.[54] The principal one arises from the combination of a fixed (although adjustable to some extent) exchange rate and the absence of capital controls, which leaves local financial markets vulnerable to volatile movements of speculative capital. This was clearly demonstrated by the experience of Hungary (a country that runs an exchange rate regime similar to ERM-2) in 2003 (box. 3.1.1).

The choice of policies towards EMU accession remains one of the most debated issues in the acceding countries.[55] Initially, the monetary authorities in most of the acceding countries favoured a strategy of rapid entry into the euro area, which meant joining ERM-2 immediately upon EU accession. The main rationale behind such a strategy is to reduce the period during which the economy would be exposed to the risks of macroeconomic and financial instability caused by volatile capital flows (which also includes the interval between EU accession and entry to the ERM-2). Targeting early EMU entry was also regarded as a disciplinary instrument for accelerating structural reforms. However, more recently, most of the acceding countries appear to have abandoned this ambitious timetable and now envisage a further preparatory period of some four to five years after accession to the EU.[56] The ECB has also warned the acceding countries of the risks associated with a "premature rigidity of the exchange rate" and suggested that "it might be appropriate for some new member states to only consider applying for ERM-2 membership after a further degree of convergence has been achieved."[57]

The policy debate over the strategy for joining the euro area also raises the question as to whether the Maastricht criteria in their present form should be applied to the new EU members.[58] Thus it has been argued that the presence of catch-up inflation (which is not rooted in lax policy) could justify a reinterpretation of the Maastricht inflation criterion.[59] Another relevant issue is that the acceding east European economies still suffer from poor infrastructure and hence more public

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[52] Chap. 3, table 3.1.3. Again, a word of caution is needed. The Maastricht interest rate criterion refers to average nominal long-term interest rates; however, so far, not all the acceding countries report a reference series of this type, one of the underlying reasons being the lack of depth in their still underdeveloped financial markets.

[53] At present it is still not clear whether the same fluctuation band will apply to the countries that are now joining the EU.

[54] For a discussion of some of these risks see D. Begg, B. Eichengreen, L. Halpern, J. von Hagen and C. Wyplosz, *Sustainable Regimes of Capital Movements in Accession Countries*, CEPR Policy Paper, No. 10 (London), March 2003.

[55] See, among others, UNECE, "Alternative policies for approaching EMU accession by central and east European countries", *Economic Survey of Europe, 2002 No. 1*, chap. 5, pp. 181-193; W. Buiter and C. Grafe, *Anchor, Float or Abandon Ship: Exchange Rate Regimes for the Accession Countries*, CEPR Discussion Paper, No. 3184 (London), January 2002; A. Csajbók and Á. Csermely (eds.), *Adopting the Euro in Hungary: Expected Costs, Benefits and Timing*, Hungarian National Bank, Occasional Paper, No. 24 (Budapest), 2002; J. Rostowski, *When Should the Central Europeans Join EMU*, Center for Economic and Social Research (CASE), Working Paper, No. 253 (Warsaw), October 2003.

[56] Estonia is still targeting EMU entry in 2006; Lithuania and Slovenia have set their expected entry date for 2007 but the remaining countries have set still later dates.

[57] European Central Bank, *Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries,* ECB Press Release (Frankfurt), 18 December 2003 [www.ecb.int].

[58] For a discussion on this issue see W. Buiter and C. Grafe, *Patching up the Pact: Some Suggestions for Enhancing Fiscal Sustainability and Macroeconomic Stability in an Enlarged European Union*, CEPR Discussion Paper, No. 3496 (London), August 2002; F. Coricelli and V. Ercolani, *Cyclical and Structural Deficits on the Road to Accession: Fiscal Rules for an Enlarged European Union*, CEPR Discussion Paper, No. 3672 (London), December 2002; G. Szapáry, "Les critères de Maastricht sont-ils trop sévères?", *Revue d'Economie Financière*, No. 71, 2003, pp. 225-244.

[59] This issue has been raised by W. Buiter and C. Grafe, *Anchor, Float or Abandon Ship:…*, op. cit. and G. Szapáry, *Maastricht and the Choice of Exchange Rate Regime in Transition Countries During the Run-up to EMU*, Hungarian National Bank, Working Paper 2000/7 (Budapest), July 2000.

investment could improve considerably their growth prospects. In turn, this would justify a reinterpretation of the required deficit target for these economies in terms of the "golden rule" of public finance, that is, the deficit should be net of debt-financed public investment (section 1.3(i)). Moreover, in terms of monetary policy *stricto sensu*, the application of the Maastricht criteria (of which ERM-2 is a part) prior to EMU entry has a built-in compatibility problem because it requires central banks to aim simultaneously at two targets: the exchange rate (as part of ERM-2) and the inflation rate (as one of the parameters of nominal convergence). The presence of multiple targets may lead, however, to conflicts in monetary operations which, in turn, may instigate financial instability. Similar problems (related to conflicting targets and perceived inconsistency in the monetary policy regime) generated massive financial speculation in Hungary between December 2002 and January 2003 (box 3.1.1).[60]

Finally, it must be emphasized that EU membership and further policy harmonization within the EU does not in any way imply that policy makers in the acceding countries will also give up responsibility for the design and conduct of a coherent domestic economic policy. The past performance of the current EU members has varied significantly (in particular, in terms of the growth in per capita incomes), and this largely reflects the consistency and appropriateness of their domestic policies. The bottom line is that the responsibilities of the governments of the new EU members will only increase upon accession: while they will have to meet their obligations of operating in a cooperative multilateral environment, they will also remain fully accountable to their constituencies for their policies affecting domestic living standards. The electorates in the new EU members will legitimately expect that their governments meet these new challenges.

(iii) Towards closer economic integration in the CIS

In September 2003, the heads of state of the four largest CIS economies, Belarus, Kazakhstan, Russia and Ukraine, signed an agreement stipulating the establishment of a Single Economic Space (SES) among them. This is the most ambitious initiative for economic integration (compared with several previous ones) among the successor states of the Soviet Union, and essentially aims to create an economic union of the participating economies.[61] If successful, this could lay the foundations of a large economic area in which there would be free movement of goods, services, capital and people. The SES agreement is also open to other states that accept its goals and principles.

The document signed by the four presidents is so far just a concise framework agreement, which altogether contains 11 clauses. Basically it proclaims the political will of the four states to go ahead with the new integration project. But compared with previous similar ventures, the 2003 initiative sets much more ambitious goals.

According to the document, economic integration within the SES will encompass six main areas of economic policy:

- Establishment of a free trade area eliminating all tariff and non-tariff restrictions on multilateral trade within the SES together with a common internal competition policy and a common trade policy vis-à-vis the rest of the world;
- Unification of internal technical norms and standards including sanitary and phytosanitary norms;
- Harmonization of macroeconomic policy;
- Abolition of all restrictions on the free movement of goods, services, capital and labour;
- Harmonization of all legislation related to the functioning of the SES in the member states;
- Harmonization of regulations concerning the operation of "natural" monopolies (including railways, telecommunications and the energy sector).

The 2003 agreement specifies briefly some aspects of the envisaged institutional framework that should support the smooth running of the SES. The top decision-making body will be the Council of the Heads of State of the member countries where each state will have one vote and which will take decisions on the basis of a consensus. The agreement also stipulates the establishment of a "Joint Regulatory Body" with supranational decision-making powers. The decisions of this body are to be taken by a weighted majority vote, voting rights being proportional to the "economic potential" of each country. In the event of such decisions being contested, the Council will serve as arbiter.

In accordance with the decision taken at the inaugurating meeting, a High-Level Working Party was instituted with the objectives of making the SES concept operational and drafting a set of key policy measures necessary for its formal launching. The first draft of this programme (covering 22 policy areas) was finalized in December 2003 and was due to be discussed in February 2004.

While rather terse, the framework agreement on the formation of the SES is far-reaching in its ambitions. For the first time, and unlike previous attempts at CIS

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[60] Within the framework of ERM-2, the contradiction between the price and exchange rate stability criteria has been acknowledged by allowing a revaluation of the central parity. However, as shown by the Hungarian experience, this does not eliminate the risk of financial destabilization associated with a perceived conflict between monetary targets.

[61] On past initiatives for economic integration in the CIS see UNECE, "The evolution of institutions for economic integration within the CIS", *Economic Survey of Europe*, *2003 No. 1*, chap. 6.2(iv), pp. 176-183.

integration, it spells out clearly the goal of establishing a common economic area that has all the essential features of an economic union, especially the free movement of goods, services, capital and people.[62] In many aspects, the philosophy embodied in this concept is rather similar to the EU's *modus operandi* in the earlier phases of its development.

The main unknown, however, is to what extent this agreement will actually be put into effect and how fast the four countries will be willing and able to move towards closer economic integration. While there have been similar attempts in the past, none of them has been able to achieve any significant degree of integration or even trade liberalization among the participants. Past attempts at economic cooperation in the region have been largely driven by geopolitical and other foreign policy goals rather than by common economic interests and this has proved a stumbling block when it came to actual implementation. The lessons from these attempts (as well as from the EU's rich experience in advancing economic integration) suggest that policy makers in the founding members of the SES should carefully define their joint economic interests and focus their initiatives along these common interests. This is all the more important given that public support for the new initiative as well as the intensity of current economic cooperation differ among the four countries.[63]

Trade is among the highest priorities for the four countries and will probably be one of the first to be addressed in the implementation phase. The four signatories are the largest CIS economies, they are geographically close neighbours, and their bilateral trade flows are very important. In 2001, exports to the group accounted for 57 per cent of total exports in the case of Belarus, 26 per cent for Kazakhstan and Ukraine and 13 per cent for Russia. On the import side, the shares were 71 per cent for Belarus, 45 per cent for Kazakhstan, 38 per cent for Ukraine and 23 per cent for Russia.[64] Nevertheless, previous attempts to liberalize trade among the CIS economies have encountered serious problems. One of the main practical obstacles to the process has been the uneven degree of general liberalization of their domestic markets, and in particular the existence of various subsidies and price controls (especially as regards energy) which greatly inhibit competition between local producers and importers. The existing prevalence of these subsidies and price controls are also among the main stumbling blocks in the four countries' ongoing WTO membership negotiations. The SES proposal partly addresses this issue in that it envisages harmonization of competition policy in the member states. From this perspective, one of the potential dangers for the SES is that if the opening of these economies towards each other is not accompanied by further liberalization of trade with the rest of the world, their increased dependence on mutual trade in subsidized (and hence inefficient) products will in fact undermine their international competitiveness and prove an obstacle to further integration with the world economy. More generally, WTO membership could provide further support for the efficient functioning of a viable free trade area among the four countries.

At present, the composition of trade among the four countries is dominated by mineral products (mostly fuels) and manufactured goods subject to relatively low degrees of processing (such as chemicals and metals).[65] Harmonization of technical norms and standards between the four can help to stimulate their mutual trade and establish closer ties between firms in the different countries. However, one of the problems here is related to the existing supply constraints: trade in high value added manufactured goods among the CIS countries is low partly because the local supply of such goods is low. Thus, the development of such trade will also be conditional on success in restructuring and modernizing these economies.

Some of the other areas envisaged for future economic integration – such as the harmonization of macroeconomic policy and other legislation – would seem to belong to later phases in the integration process. The successful creation of a functioning free trade area will be a necessary first step before the member states can turn to these more advanced levels of integration. In addition, it should be noted that although the CIS economies have made considerable if variable progress in their economic and political transformation, a number of difficult issues still remain on their reform agenda.[66] Ultimately, closer integration of the four countries will depend on deepening and widening the process of systemic and structural reforms.

[62] In informal statements, some politicians have also floated the idea of a common currency for the SES but this idea is not so far shared by all four countries.

[63] Thus in Ukraine, which has been seeking closer ties with the EU, opponents to the proposal have already expressed serious reservations about the participation of the country in the SES and its supranational decision-making bodies. In contrast, even before the SES agreement, Belarus had already established very close integration links with Russia: in 1999 the two countries signed a treaty which envisages the formation of a "union state"; they also aim at introducing a single currency in 2005.

[64] UNECE, *Economic Survey of Europe*, *2003 No. 1*, p. 169.

[65] Ibid, p. 172. The main exception to this pattern is Belarus where machinery and equipment account for a major share of its exports to Russia.

[66] For a more detailed analysis see UNECE, "Progress in systemic reforms in the CIS", *Economic Survey of Europe*, *2003 No. 1*, chap. 5, pp. 123-147.