Five Years after EU Eastward Enlargement

Marek Belka[1]

The inclusion of ten former Soviet bloc countries into the EU marks a high point in 20 years of East-West integration. In many ways, it concluded the region's struggle to join the family of Western democracies and market economies. At the same time, it created huge opportunities to bring living standards in the East closer to those enjoyed in the rest of the EU. The new Member States seized these opportunities, as evidenced by their impressive growth in the immediate years after EU accession (2004–2007). But the financial crisis, which deepened in late 2008, also shows that convergence cannot be taken for granted. This serves as a powerful reminder of the value of sound economic policies and as a call for better policy coordination across Europe.

In looking back at these five years of rapid change, three aspects of the new Member States' economic performance seem worth exploring. First, how resource inflows from the old Member States and the EU's policy framework contributed to the region's impressive achievements. Second, how these successes may have concealed the build-up of vulnerabilities. Finally, how such underlying weaknesses explain why the recent financial crisis has hurt some countries in the region more than others. A period of five years is too short to pass definite judgment. Nevertheless, the new Member States' experiences during both the catching-up period and the crisis allow for some tentative lessons for policymaking, both at the country and at the EU level.

1 Achievements

The new EU Member States' growth and policy performance in recent years has been truly impressive, second only to East Asia. While it may be difficult to establish a clear causality (due to the lack of an appropriate counterfactual), there is strong evidence that entry into the EU played an important role in this success – a process that in fact started before countries officially joined. Since the early 2000s, the economies of the new Member States have been growing considerably faster than the economies in other regions with similar initial income levels. Econometric evidence from a recent IMF study (Čihák and Fonteyne, 2009) suggests that with EU accession, real per capita incomes increased about one percentage point faster than can be explained by conventional growth determinants.

Growth has been consistently higher than in the old Member States, thus contributing to real convergence of per capita income levels. Price levels (in euro terms) have also been converging, to some extent via higher inflation (especially in countries with currencies pegged to the euro), but mostly via nominal exchange rate appreciation. With a few exceptions, the appreciation of real exchange rates appears to have been an equilibrium phenomenon, in line with productivity developments.

As part of this catching-up process, new and old Member States have become more and more integrated. Supermarkets in Warsaw offer the same variety of goods as in Berlin, and Czech vacationers share the Austrian ski slopes with Dutch and Scandinavians. Behind these changes in everyday life lies a remarkable increase of economic linkages, which has greatly enhanced the mobility of goods, capital and labor (except for services, where the internal market remains fragmented).

[1] *Director of the European Department of the International Monetary Fund, former Prime Minister and Finance Minister of Poland.*

For example, the share of new Member States' exports in old Member States' imports increased 2½-fold between 1993 and 2008. Growing interlinkages are also illustrated by the increasing degree of business cycle synchronization between new Member States and the euro area.

EU membership has accelerated real convergence through two key channels. First, it greatly facilitated the transfer of financial resources from West to East. Contrary to the experience in other emerging countries, capital in Europe flowed "downhill": excess savings from the West were invested in the relatively capital-poor East, where a low initial capital stock and good growth prospects offered higher returns. This was achieved in the first place through the increase of cross-border financial linkages, especially the active role played by EU-based banks in deepening financial markets in the new Member States and providing access to global capital markets. Foreign direct investment was equally important for growth, especially where it went into productivity-enhancing greenfield projects, such as car assembly plants in Slovakia or computer manufacturing in Poland. Finally, official capital transfers in the form of EU structural funds are increasingly contributing to growth, particularly under the EU's 2007–2013 financial perspective.

The second impact of EU membership was on the policy framework. Adopting the acquis communautaire implied many important institutional reforms, from strengthening central bank independence to codifying property rights. In addition, the Maastricht criteria for euro adoption and the Stability and Growth Pact provided a framework for macroeconomic policy discipline. There is evidence that macrofinancial performance improved among the new Member States, although there have been substantial differences between individual countries. Inflation performance has been better in countries with inflation targeting regimes, where upward price pressures due to capital inflows and commodity price hikes could be absorbed through nominal currency appreciation. Fiscal performance – as measured by general government balances – has generally been stronger in the smaller countries. These countries also did better in terms of structural reforms toward meeting the Lisbon agenda objectives.

For much of the region, euro adoption remains the main outstanding building block to fully integrate in the EU's policy framework. Only two new Member States – Slovenia and Slovakia – have so far succeeded in meeting the Maastricht criteria and adopting the single currency. The remaining countries in the region are firmly committed to joining the euro area, although target dates vary. Before the crisis upset these plans, the main obstacles were the inflation criterion (mainly for smaller countries with fixed exchange rates) and the fiscal criterion (mainly for the larger Central European countries). In this context, there continues to be a debate about whether the Maastricht criteria are suitable for fast-converging economies.

Until recently, EU membership appeared to have had another tangible impact, the so-called "halo effect": financial markets rewarded EU membership through lower borrowing spreads, beyond what can be explained by policy performance. This phenomenon has been explained by the implicit bail-out guarantee offered by the EU, the disciplining role of its policy framework or the prospect of imminent euro adoption. With the onset of the crisis, financial markets started to treat the new Member States like other emerging markets, focusing on risks and fundamentals.

2 Vulnerabilities

High growth rates and rapid financial deepening, driven by capital inflows, came at a price. From 2005 to 2008, several new Member States experienced a serious bout of overheating, characterized by high inflation rates, soaring real estate prices, large current account deficits (in some cases coupled with an overvalued exchange rate), and tight labor markets. Stock vulnerabilities in these countries increased as well, especially external debt ratios. Households and corporates incurred currency mismatches, as they took advantage of the lower interest rates offered by loans denominated in euro and Swiss franc. All this made countries prone to boom-bust cycles and heightened the vulnerability to sudden shifts in the exchange rate.

Fiscal policy was also weaker than met the eye. Structural deficits increased in most countries, even before one takes into account that potential growth was probably lower than assumed at the time. As revenues increased on the back of high GDP growth, many governments allowed nondiscretionary expenditures to expand rapidly. Fiscal policy was in many cases procyclical, adding fuel to the fire of already overheating economies.

To be sure, great differences exist between countries. In the larger Central European countries, external vulnerabilities remained largely contained, while they increased substantially in the smaller countries with fixed exchange rates, especially in the Baltics. Moreover, overheating pressures, especially in the latter countries, were accompanied by an erosion of competitiveness. Much of the capital inflows that drove economic growth went into nontradables, such as real estate, retail, and financial services, i.e. sectors that are unlikely to generate the income necessary to service the large debt built up during the boom years. Overall wages soared both in these sectors and in the rest of the economy, which further undermined competitiveness.

With the benefit of hindsight, could more have been done to detect and contain these risks and vulnerabilities? There were indeed warnings during the boom years, but they probably were not forceful enough considering how severely some countries were affected by the crisis. This reinforces the case for strengthening surveillance by international bodies like the European Commission and the IMF. Analytically, however, there remains a fundamental problem of separating vulnerabilities that are a natural byproduct of convergence from those that warrant policy intervention. Establishing such "speed limits" has proven exceedingly difficult.

Even if these risks had been fully recognized at the time, there remains the question of what policies could have been employed to contain them. With pegged exchange rate regimes, the countries experiencing the most acute overheating problems had no effective monetary policy tools at their disposal. More prudent fiscal policies could have helped, although realistically most countries would have found it politically difficult to tighten budgets well beyond what was required under EU rules. Tighter financial regulation, aimed directly at credit growth and currency mismatches, was at times hindered by coordination issues between home and host country supervisors. Ultimately, excesses – especially in lending and real estate markets – were grounded in unrealistic expectations about the speed of income convergence and quick euro adoption. Market participants, regulators, politicians and other opinion makers must take their share of the responsibility for not having done more to lean against the wind.

3 The Crisis

The post-accession boom in the new Member States came to a halt in the fall of 2008, when the global financial crisis intensified (growth in fact started slowing earlier in the Baltics). Decoupling, a popular theory earlier in the crisis, proved to be an illusion: the region's close trade and financial integration with the old Member States implied that the recession was quickly shared across the entire EU. Nevertheless, the new Member States as a group are growing somewhat faster than the old Member States. Real convergence is therefore continuing, albeit at a slower pace.

Contrary to perceptions by some outsiders, the effect of the crisis varies widely across the new Member States. Countries with high vulnerabilities were hurt most, as they were forced to adjust their large imbalances in much shorter time and at much higher cost than others. In many cases, the capacity to absorb the double shock of lower capital inflows and lower exports was limited by a commitment to hard currency pegs against the euro. The desire to qualify for euro adoption as soon as possible – the Central European countries' exit strategy from exchange rate vulnerabilities – further confines options in fiscal and exchange rate policy.

The two key elements in the new Member States' earlier success – capital inflows and adoption of the EU's policy framework – have implications for the region's ability to cope with the crisis. As mentioned above, dependence on capital inflows and associated large current account deficits made the region particularly vulnerable to the cross-country transmission of shocks. At the same time, integration was also an advantage; the impact of global deleveraging has been more muted in countries where a large part of external financing needs is covered by strong parent banks based in other EU countries. The first new Member States to experience balance of payment problems were therefore those with large domestically-owned banks without such recourse. On the other hand, close financial linkages have increased policy spillovers; for example, when some old Member States increased deposit coverage in late 2008, new Member States had to follow suit so as not to lose the confidence of depositors.

Similarly, the EU's policy framework offers advantages at the same time as it imposes constraints in times of crisis. The European Commission has effectively used several instruments to support new Member States in difficulties: its balance of payment facility is already providing exceptional external financing in Hungary, Latvia and Romania, jointly with funding from the IMF. The availability of EU grants and European Investment Bank loans was eased, which has made it possible to finance public expenditures that would otherwise have been cut and has led to provide a welcome countercyclical stimulus. The ECB has entered repo arrangements with central banks in several new Member States, which partly relieves constraints on foreign currency liquidity. More generally, EU institutions provide a much needed forum for policy coordination in times of crisis.

By the same token, institutional constraints imposed by EU membership can limit policy options. As mentioned above, fiscal deficit ceilings under the Maastricht criteria and the Stability and Growth Pact may make governments reluctant to provide countercyclical stimulus by letting automatic stabilizers operate fully, even if this is warranted. Countries participating in ERM II face additional constraints, as any change in their central exchange rate parity would have to be agreed with the euro area countries and the other ERM II members. They will, in any event, hesitate to allow adjustment through the exchange rate so as not to run foul of the currency stability criterion. The prospect of euro adoption, while a useful anchor for sound policies in good times, may therefore provide an undue straightjacket in times of crisis.

4 Policy Lessons

When we look back at the past five years, EU enlargement has been a great success. It has helped narrow the historical income disparities on the continent, anchored democratic and market institutions and created new opportunities for millions of people in both the East and the West. But convergence has not been without bumps in the road, with several years of exceptionally high growth followed by the painful recession that we are now seeing in some countries. This shows that EU membership is no panacea. The challenge going forward is to solidify sound policies and to modify EU institutions to help minimize such disruptive boom-bust cycles.

One lesson of the crisis experience is that sustainable policies do pay off. Countries that were able to reign in overheating pressures and contain vulnerabilities during the post-accession boom phase are now doing better and have stronger prospects to emerge quickly from the current slump. Flexible economic structures, be it in labor and currency markets or the fiscal sphere, are clearly of advantage when adjusting to rapid changes in a closely integrated environment. This calls for continued macroeconomic discipline and structural reforms.

The financial sector has played a key role both in the origins and in the transmission of the crisis. Given the high integration of banking systems in the new Member States with the rest of the EU, close cross-border cooperation at all levels is essential. Financial stability must ultimately become a shared responsibility, between supervisors in home and host countries as well as between financial regulators, fiscal authorities and central banks within countries. The recently published "De Larosière" report is a useful starting point for an important Europe-wide debate on these issues.

The EU's policy framework has greatly contributed to the new Member States' improved policy performance after accession. But, as outlined above, a rigid pursuit of the Stability and Growth Pact and the Maastricht criteria can at times get in the way of appropriate policies to deal with crises. Clarity on the euro roadmap is therefore all the more important, especially in the present testing economic environment. Other areas where the ECB could support non-euro area Member States include making available currency swap arrangements (to help stabilize exchange rate movements) or allowing their sovereign debt to be used as collateral for its monetary operations (to prevent crowding out through sovereign borrowing by euro area countries).

To sum up: If there is a lesson from the crisis for Europe, it is that a tightly integrated region requires a regional perspective from policy makers.

References

Čihák, M. and W. Fonteyne. 2009. Five Years After: European Union Membership and Macro-Financial Stability in the New Member States. IMF Working Paper 09/68.

The High-Level Group on Financial Supervision in the EU. 2009. De Larosière Report on EU financial supervision. Retrieved from http://ec.europa.eu/internal_market/finances/docs/de_larosiere_report_en.pdf on July 20, 2009.