Comment on "The Global and Regional Outlook in Central Europe," by Miroslav Hrnčíř

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Miroslav Hrnčíř's paper provides a good overview of some of the issues facing the CEECs in the process of deepening European integration. The main focus is on relations with the European Union, particularly the accession negotiations, with the CEFTA playing a useful supporting role. This seems quite correct, and in fact, there was relatively little in the paper with which I disagreed. I should like to develop some of the arguments of the paper a bit further, using the more speculative license given to a commentator, and flag a few points where I am at variance with Miroslav Hrnčíř.

Miroslav Hrnčíř's comments about the hierarchy of Central and East European Countries' goals were particularly interesting. He remarks that for these countries, the goal is not European Union membership *per se*, but catching up with all the things that they have missed since 1939. In a way, membership of the European Union is seen in the Central and Eastern European countries as just another part of the process of rejoining developed country structures. In a recent paper on "How Far is Eastern Europe from Brussels?", Fischer, Sahay and Végh estimate that the two-generation communist experiment cost the Central and Eastern European countries about a generation's worth of growth. It is natural for these countries to view European Union membership as part and parcel of the things that they have been missing for so long and as part of the process of cementing themselves into Western institutions.

But we may be in for considerable disappointment on both sides, as Miroslav Hrnčíř hints. It is not clear that the public or the politicians of the applicant countries have fully grasped the degree of accommodation that they will be required to make as members of the European Union. Parliaments that have only just recovered real power will find that their scope for independent action is considerably circumscribed by the weight of the *acquis communautaire*, and that the degree of harmonisation and consultation extends deeply into many aspects of political and administrative life. Of course, it can be argued that the surrender of sovereignty is only apparent, and that full membership allows the realisation of possibilities that non-membership would not. But this is quite a sophisticated

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argument, and one that requires a lot of hard political experience to accept.

If on the other hand, membership is sold on the grounds that regional and Common Agricultural Policy transfers will be positive, there may also be disappointment. As Miroslav Hrnčíř and András Inotai note, current regional policies and CAP will need to be considerably modified before the new applicants come in, since the present members are unlikely to be willing to finance the transfers involved in maintaining current arrangements. If membership is sold to the population as a way of accessing European Union funds, there could be a considerable backlash if it appears that the rules are being modified just as the negotiations are getting underway. Thus, it would seem essential to do some further thinking on the motivations for membership within the applicant countries, to ensure that there is a constituency for taking part in the construction of Europe, or for reaping the advantages of pooled sovereignty.

Miroslav Hrnčíř draws attention to the cost of enlargement for the existing members of European Union, but he does not pay as much attention to the difficulties ofmicroeconomic adjustment as they deserve. It will be difficult to convince existing members that single market rules are being applied fairly in the applicant countries. These rules cover a range of matters from consumer protection, financial supervision, phytosanitary controls, border controls and tax enforcement to competition policy. In existing member countries, lobby groups, fearful of increased competition from the East, are likely to emerge using the excuse that standards are not being properly enforced. While ultimately, as in the cases of Greece, Spain and Portugal, the political imperative of admitting the countries may rapidly prevail, it will not be without domestic political fights in some of the existing members. None of this should be interpreted that I am at all hostile to the accession of Central and Eastern European countries to the EU, but I don't think we serve the cause by pretending that it is going to be easy.

The other topic I would like to address is how macroeconomic policy will be affected by the regional processes we see underway. A number of the Central and Eastern European Countries can already be characterised as dynamic emerging market economies, and the others should be able to join this group too, if they stick to the right sort of stabilisation and structural reform policies. What are the features that characterise these economies? The first is their enormous growth potential. They have a well-qualified and motivated labour force which can be hired at a fraction of the cost of that in Western Europe. They have good access to nearby West European markets for their output, and constitute obvious investment locations for Western firms seeking to tap both the regional and the European Union market. They can also hope to benefit from a revival in

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their traditional markets to the East. These economies are thus likely to grow very fast, and undergo very considerable structural change.

The main structural changes that should accompany this process are rising productivity, increasing real wages and massive inward investment flows. While these developments are welcome, they also pose a number of challenges to macroeconomic management. As real wages rise, there should be a continual process of reallocating labour between sectors. Certain sectors which are profitable at current exchange and wage rates are likely to become unprofitable over time, requiring the closure of existing firms. If the economy is managed well, new employment opportunities should be created at the same time, meaning that the released labour can be absorbed – but this rapid structural change can create a number of problems. First, there is the level of unemployment, which is likely to have a higher frictional component than in other countries. Second, the expected high rate of failure among companies can create severe problems for domestic banking systems if they do not have strong enough financial basis. Third, it maybe difficult to accommodate the structural change in the economy without a certain amount of inflation.

Another aspect of the outlook for these countries comes from the large inflows of external capital that are already occurring. From the experience of a number of countries, we have already seen how large-scale capital inflows, while bringing major benefits, can complicate the process of macroeconomic management. Capital inflows make it difficult to judge the stance of balance of payments policies. They put pressure on the exchange rate for an appreciation as the improved capital account leads to a worsened current account balance. It can be very hard to tell if the worsening of the current account is appropriate (for example because of increased imports of investment goods) or if it reflects an excessive worsening of the country's competitiveness. As the experience of other countries has shown, international capital flows can be extremely sensitive to domestic macroeconomic conditions and to confidence effects, thus requiring governments to bevery careful in their macroeconomic policymaking for fear of the reversal of flows. They put the domestic financial system in the line of fire, making it a matter of the highest priority that governments ensure that their domestic banking systems are sound.

A third characteristic is the tightness of the fiscal position of these countries. The collapse of the traditional tax system, the reduced reliance on trade taxes, and the difficulty of spreading the tax net widely have meant that it has required great effort to keep fiscal revenues strong. At the same time, the need to finance relatively generous social security systems, and the various costs of enterprise restructuring – such as recapitalisation of banking systems, unemployment compensation, etc – have left these coun-

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tries with high levels of expenditures. In an effort to keep budget deficits under control, the level of taxation and related contributions for those actually paying have become very high. The correct policy response to the high inflows of capital include a tightening of the fiscal stance to encourage a reduction in interests rates, to ensure that the capital can be productively invested, and to reduce the likelihood of a reversal of flows.

These various aspects of policy – fiscal policy, real exchange rate appreciation, structural change and capital inflows – will all acquire a new dimension with the accession to the European Union. The countries will be entering the Union at the time that Phase III of the European Monetary Union is underway with the Exchange Rate Mechanism 2 in place. This will impose certain demands and constraints on macroeconomic management in the acceding countries. They will be required to make their central banks independent and subscribe to price stability as the overriding goal of monetary policy; they will be obliged to seek a balanced budget as a central feature of fiscal policy; they will be obliged to draw up convergence plans. It is unclear at this point whether the acceding countries will be obliged to enter ERM2 as part of the *acquis communautaire*, or whether they will be permitted to derogate from it. The Council resolution does talk of membership remaining voluntary, though countries are expected to join as soon as they can. But this may apply only to existing European Union members.

The fiscal objectives in the EMU area seem to be appropriate for the acceding countries. I have already mentioned the pressing need of these countries to keep the fiscal situation under control. Price stability may be more difficult to achieve, given the structural shifts occurring in these countries. Even more problematic may be undertaking exchange rate obligations. First, the secular trend should be for a real exchange rate appreciation, and this is better done through a gradually appreciating rate rather than through higher inflation. If the rate is expected to appreciate, other European Union members guided by concerns of their own competitiveness may press for the appreciation to take place sooner rather than later. However, this runs up against the problem of judging the stance of policy, given the rapid structural shifts and the skittishness of the capital inflows. There is a real danger of countries' getting stuck temporarily with too appreciated exchange rates and running into balance of payments crises. While there is an obligation (presumably on both sides) under ERM2 to defend the limits of the band with unlimited intervention, in practice, we can expect to see parities abandoned. In sum, I see these countries as having a need to retain flexibility on exchange rate policy until structural convergence has gone much further. I am encouraged by Joan Pearce's remarks that the EC would give highest priority to the need of these coun-

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tries to achieve convergence in terms of real growth, and whatever system was finally decided, the existing members would not encourage the Central and Eastern Countries to follow an exchange rate policy that would undermine these goals.

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