

A faint, grayscale topographic map of Europe serves as the background for the central part of the cover.

ENLARGEMENT OF THE EURO AREA

Focus

Paul De Grauwe
Marcelo Sánchez
Reinhard Neck
Michael Bolle and
Oliver Pamp
Carsten Hefeker
Helge Berger

THE DOHA ROUND OF MULTILATERAL NEGOTIATIONS

Special

Dilip K. Das

EU ACCESSION CANDIDATES

Spotlights

THE DOLLAR IS FALLING

STATISTICS UPDATE

Trends

CESifo Forum ISSN 1615-245X

A quarterly journal on European economic issues

Publisher and distributor: Ifo Institute for Economic Research e.V.

Poschingerstr. 5, D-81679 Munich, Germany

Telephone ++49 89 9224-0, Telefax ++49 89 9224-1461, e-mail ifo@ifo.de

Annual subscription rate: €50.00

Editor: Heidemarie C. Sherman, Ph.D., e-mail sherman@ifo.de

Reproduction permitted only if source is stated and copy is sent to the Ifo Institute

www.cesifo.de

Focus**ENLARGEMENT OF THE EURO AREA****On monetary and political union***Paul De Grauwe*

3

Implications of country size and trade openness for euro area enlargement*Marcelo Sánchez*

11

Macroeconomic policy and EMU enlargement*Reinhard Neck with Gottfried Haber*

17

It's political, stupid! – EMU enlargement between an economic rock and a political hard place –*Michael Bolle and Oliver Pamp*

22

The monetary policy consequences of enlargement*Carsten Hefeker*

29

Unfinished business? The ECB reform ahead of euro area enlargement*Helge Berger*

35

Special**The Doha Round of multilateral negotiations: A story of eternal stagnation and final suspension***Dilip K. Das*

42

Spotlights**EU accession candidates: Good economic performance**

48

Is the dollar finally following the fundamentals?

50

Trends**Statistics Update**

51

ENLARGEMENT OF THE EURO AREA

ON MONETARY AND POLITICAL UNION

PAUL DE GRAUWE*

Recent political developments in Europe, in particular the rejection of the European Constitution in France and the Netherlands in 2005, are leading to soul searching about the future of the European Union. There can be little doubt that these developments signal distrust of further political integration in Europe. There can be little doubt that this distrust has been intensified as a result of the enlargement process.

The risk that the process towards political union will be halted or even reversed has triggered a new debate about the link between political and monetary union. Two schools of thought have emerged. According to one school, monetary union cannot survive in the long run without a strong political union among the member states. This school of thought seems to have history on its side. Monetary unions that were not embedded in a strong political union have not survived.

According to the second school of thought, the present degree of political unification reached in the EU is sufficient to guarantee the long-run survival of the monetary union. In this view, the eurozone can survive even if the EU does not become a federal state like the United States of America.

The debate between these two views about the link between political and monetary union is made difficult by a lack of clarity about the meaning of political union. While a monetary union can easily be defined, i.e. it is a union between countries that use the same currency which is managed by one common central bank, such a neat definition is not easily

found for the concept of political union. There are many dimensions and many gradations of political union. In contrast to monetary union, a political union is not a black or white affair that allows us to say when exactly the political union has been reached.

In this article we analyze the link between political and monetary union. We start by clarifying the concept of political union, and we then go on analyzing what kind of political union is necessary to sustain the monetary union in the long run.

The many dimensions of a political union

A political union has many dimensions.¹ Let us distinguish between an institutional and a functional dimension.

At the institutional level one can analyze the nature of the institutions that govern the union. There can be little doubt that the European Union has now developed a whole set of institutions to which the member states have delegated part of their national sovereignty. There is an executive branch consisting of the Commission and the Council. There is a legislative branch consisting of the Council and the European Parliament, and there is a judicial branch, the Court of Justice. Apart from the peculiar role of the Council as an institution with both a legislative and executive responsibility, the European Union has all the institutions of a modern democracy, capable of taking decisions that have a direct impact at the national level. In this sense there is already a significant degree of political union within the EU. The question we will have to analyze is whether the existing level of political union is sufficient to sustain the monetary union.

At the functional level one can ask the question about the areas in which the member states have



What is the link between political and monetary union?

* University of Leuven.

I am grateful to Helge Berger, Elisabetta Croci Angelini, Francesco Farina, Marc Flandreau, Franco Praussello, Francesco Saraceno, Waltraud Schelkle, An Sibert, Cezary Wójcik, Patrizio Tirelli and Frédéric Zumer for comments and criticism on previous versions of this article.

¹ It is not the intention here to develop a full-fledged theory of political unions. We only want to highlight those features that are important for the debate about the link between political and monetary union. For a profound analysis, see the well-known textbook of Wallace and Wallace (2000).

transferred their sovereignty to the European institutions. Here we have a very diverse picture. In some areas, the transfer has been significant. In agriculture, competition policy, external trade policy there is a substantial transfer of sovereignty.

In other areas there has been very little transfer. The most prominent (economic and social) areas where the member states have maintained the whole or close to the whole of their sovereignty is taxation, social security, wage policies, to name the most obvious ones. There are other areas where the transfer of sovereignty has been very limited, e.g. defense and foreign policies.²

Thus it appears that the transfer of sovereignty has proceeded in a very unequal way in the European Union, some areas being characterized by almost complete transfer of sovereignty and others by only very limited transfers.

The question that arises is what areas are important for a monetary union. Do we need a transfer of sovereignty in all these areas so that the European institutions become the embodiment of a true “super-state”, or can this transfer be selective? If the latter is true, what principles should be followed to allocate responsibilities between the union and the member-states? In order to answer these questions we turn to the theory of optimal currency areas.

The theory of optimal currency areas and political union

There is a fundamental difference between the monetary union between the US states and the European monetary union. The US federal government has a monopoly of the use of coercive power within the union, and will surely prevent any state from seceding from the monetary union. The contrast with the member states of the eurozone is a very strong one. There is no supranational institution in the EU that can prevent a member state of the eurozone from seceding. Thus, for the eurozone to survive the member states must continue to perceive their membership of the zone to be in their national interest. If that is no longer the case, the temptation to secede will exist and at some point this temptation will lead to secession.

² For a more detailed analysis see Alesina, et al. (2001) and Alesina and Spolaore (2003).

The theory of optimal currency areas determines the conditions that countries should satisfy to make a monetary union attractive, i.e. to ensure that the benefits of the monetary union exceed its costs. This theory has been used most often to analyze whether countries should join a monetary union. It can also be used to study the conditions in which existing members of a monetary union will want to leave the union.

In its most general formulation the OCA-theory says that if the benefits of the monetary union exceed the costs, member countries have no incentive to leave the union. They form an optimal currency area. Or put differently, they are in a Nash equilibrium, and the monetary union is sustainable.

The conditions that are needed to guarantee sustainability are well-known from the literature on optimal currency areas (OCA).³ They can be summarized by three concepts:

- Symmetry (of shocks)
- Flexibility
- Integration

Countries in a monetary union should experience macroeconomic shocks that are sufficiently symmetric with those experienced in the rest of the union (*symmetry*). These countries should have sufficient *flexibility* in the labor markets to be able to adjust to asymmetric shocks once they are in the union. Finally they should have a sufficient degree of trade *integration* with the members of the union so as to generate benefits of using the same currency.

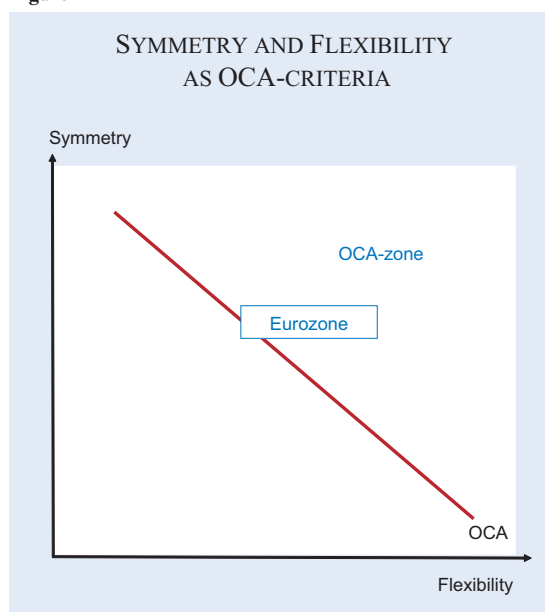
One can summarize this theory in the form of graphical representations. This is done in figures 1 and 2.

Figure 1 presents the minimal combinations of *symmetry* and *flexibility* that are needed to form an optimal currency area by the downward sloping OCA-line. Points on the OCA-line define combinations of symmetry and flexibility for which the costs and the benefits of a monetary union just balance. It is negatively sloped because a declining degree of symmetry (which raises the costs) necessitates an increasing flexibility. To the right of the OCA-line the degree of flexibility is sufficiently large given the degree of symmetry to ensure that the benefits of

³ McKinnon (1963), Kenen (1969).

Some macro-economic policy instruments have been transferred to EU institutions, but without political accountability

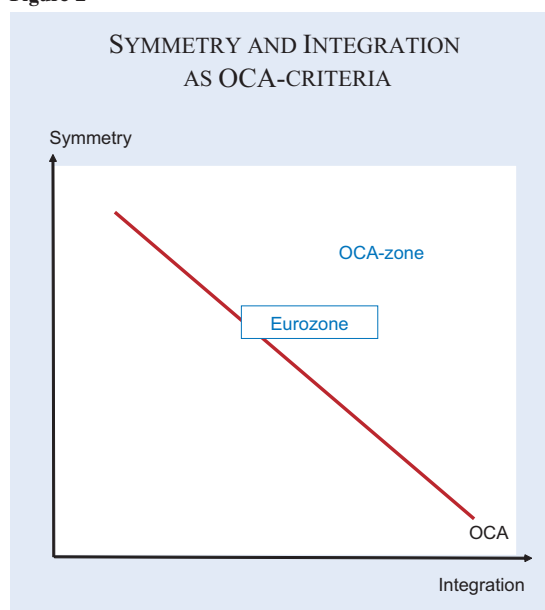
Figure 1



the union exceed the costs. To the left of the OCA-line there is insufficient flexibility for any given level of symmetry.

Figure 2 presents the minimal combinations of *symmetry* and *integration* that are needed to form an optimal currency area. The OCA-line represents the combinations of symmetry and integration among groups of countries for which the cost and benefits of a monetary union just balance. It is downward sloping for the following reason. A decline in symmetry raises the costs of a monetary union. These costs are mainly macroeconomic in nature. Integration is a source of benefits of a monetary union, i.e. the

Figure 2



greater the degree of integration the more the member countries benefit from the efficiency gains of a monetary union. Thus, the additional (macroeconomic) costs produced by less symmetry can be compensated by the additional (microeconomic) benefits produced by more integration. Points to the right of the OCA-line represent groupings of countries for which the benefits of a monetary union exceed its costs.

We have put the present eurozone (EU-12) within the OCA-zone, but close to the border line, taking the view that the eurozone may be an optimal currency area, however, without being really sure of this. The eurozone may also be on the left hand side of the OCA-line. This implies that we are not really sure whether it is sustainable in the long run. As a result, there may be scope for improving the sustainability of the eurozone.

How does political integration affect the optimality of a monetary union?

We take the view that the degree of political integration affects the optimality of a monetary union in several ways. First, political union makes it possible to centralize a significant part of national budgets at the level of the union. This makes it possible to organize systems of automatic fiscal transfers that provide some insurance against asymmetric shocks. Thus when one member country is hit by a negative economic shock, the centralized union budget will automatically transfer income from the member states that experience good economic conditions to the member state experiencing a negative shock. As a result, this member state will perceive the adherence to the union to be less costly than in the absence of the fiscal transfer.

Second, a political union reduces the risk of asymmetric shocks that have a political origin. To give some examples that are relevant for the eurozone. Today spending and taxation in the eurozone remain in the hands of national governments and parliaments. As a result, unilateral decisions to lower (or to increase) taxes create an asymmetric shock. Similarly, social security and wage policies are decided at the national level. Again this creates the scope for asymmetric shocks in the eurozone, like in the case of France when that country decided alone to lower the working week to 35 hours. Or take the case of Germany which, by applying tough wage modera-

The degree of political integration affects the optimality of a monetary union

tion since 1999, dramatically improved its competitive position within the eurozone at the expense of other countries, e.g. Italy (see next section where we elaborate on this). From the preceding it follows that political unification reduces the scope for such asymmetric shocks.

The way one can represent the effect of political unification is twofold (see Figure 3). First, the existence of a centralized budget makes it possible to alleviate the plight of countries hit by a negative shock. Thus the cost of the union declines for any given level of asymmetry. This has the effect of shifting the OCA-lines downward in figures 1 and 2.⁴ Second, political union reduces the degree of asymmetry, thereby shifting the eurozone upwards. As a result of these two shifts, political unification increases the long-term sustainability of monetary unions.⁵

From this brief survey of the OCA-theory we conclude that in order to enhance the sustainability of a monetary union it is important to have a central budget that can be used as a redistributive device between the member states and it also matters to have some form of coordination of those areas of national economic policies that can generate macro-economic shocks.

Figure 3

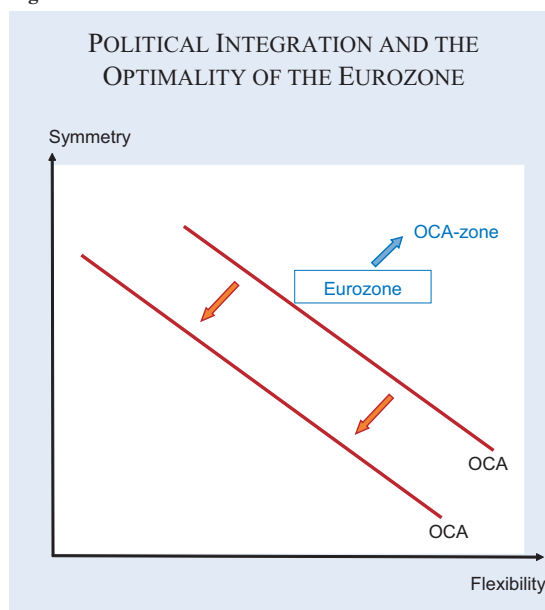
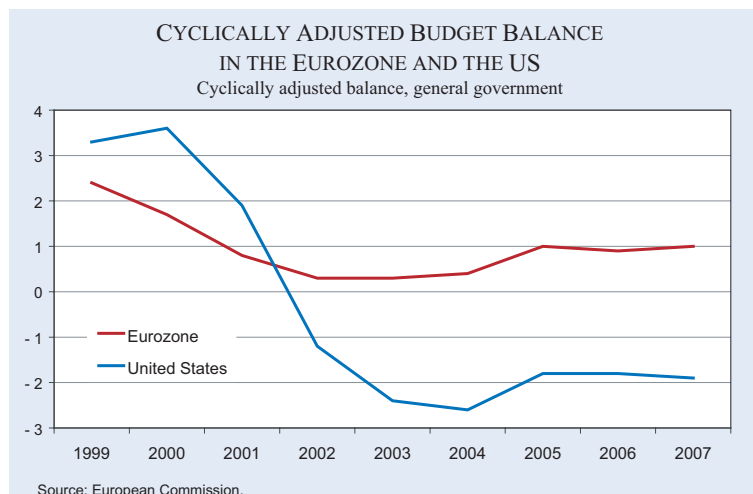


Figure 4



A central budget is important as a redistributive device. It also matters as a stabilizing instrument.⁶ The absence of a central budget in the eurozone implies that no budgetary policy aimed at stabilizing the business cycle in the union is available. The question that arises here is how important this is. In Figure 4 we show the contrast between the US and the eurozone since 1999. We observe that the US allowed its budget deficit to increase significantly as a response to the recession of 2001. There is no central budget in the eurozone but the aggregate of the national budget balances could work in a similar stabilizing way. The evidence of Figure 4, however, shows that this aggregate did not respond to the worsening economic conditions in the eurozone from 2002 on. Thus there is an absence of a system-wide budgetary policy in the eurozone capable of performing a stabilizing role at the level of the eurozone.

Asymmetric shocks and lack of political union

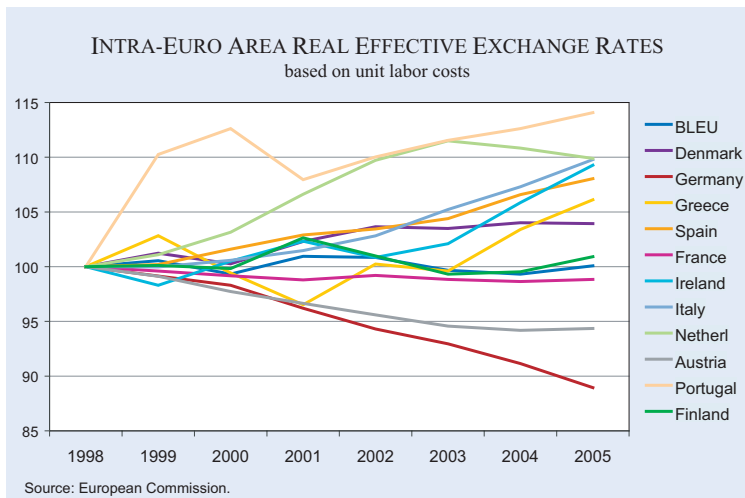
One of the surprises of the functioning of the eurozone has been the extent to which the competitive positions of the eurozone countries have diverged. We show the real effective exchange rates in the

⁴ It is important that these transfers be reversible to maintain their insurance character. If these transfers attain a permanent one way character they are likely to become unpopular in the "donator"-country, leading to a perception of a high cost of the monetary union. This calls for the use of transfers only to alleviate the effects of temporary asymmetric shocks (business cycle movements) or in the case of permanent asymmetric shocks to make these transfers temporary allowing receiving countries to spread the adjustment cost over a longer time.

⁵ A similar analysis can be done using the symmetry-integration space of figure 2.

⁶ Musgrave (1959) introduced the different functions of a government budget, as a distributive, a stabilizing and an allocative function.

Figure 5



eurozone (based on unit labor costs) since 1998 in Figure 5. The striking fact is the extent to which the relative unit labor costs have tended to diverge. As a result of these trends, some countries (Portugal, Netherlands, Spain and Italy) have lost a significant amount of price and wage competitiveness. Others, like Germany and Austria have gained a significant amount of price and wage competitiveness.⁷

There can be no doubt that part of these divergent developments in prices and wages are the result of divergent national wage policies. Since 1999, Germany has followed a tight policy of wage moderation. We show some evidence in Figure 6. This presents the yearly nominal wage increases in Germany and in the rest of the eurozone (excluding Germany). We observe the strong decline of nominal wage increases in Germany. The rest of the eurozone maintained more or less constant wage increases around 3 percent per year. Thus, each year Germany tended to improve its competitive position vis-à-vis the rest of the eurozone. The contrast between Germany on the one hand, and the UK and the US on the other, is even stronger. The latter allowed their wages to increase by 4 or 5 percent per year.

⁷ It could be argued that these trends may also be the result of different initial levels of per capita income so that they reflect a catch-up process (Balassa-Samuleson effect). Since the real effective exchange rates shown here are based on unit labour costs they take into account differences in productivity growth.

This German policy of wage moderation has not been without consequences for the other eurozone countries which have seen their competitive positions deteriorate thanks to these German wage policies. Thus the latter have worked as “beggarthy-neighbor” policies forcing other countries in turn to also institute drastic policies of wage moderation.⁸ In this sense the lack of political union is responsible for a coordination failure and the emergence of a major asymmetric shock that will have to be corrected.

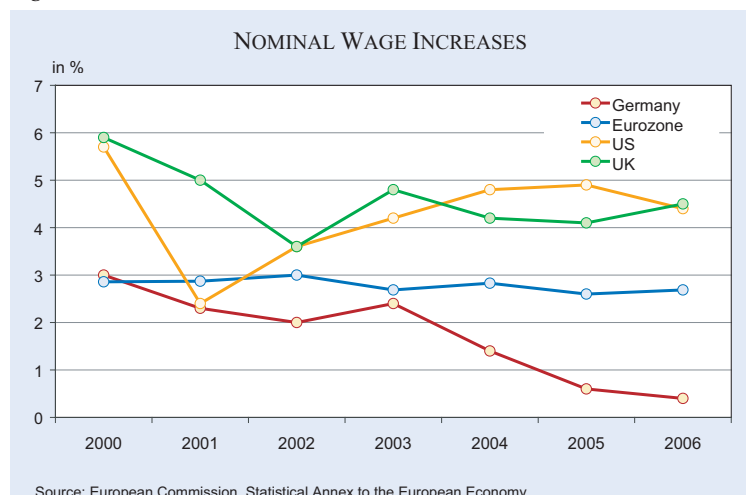
Coordination of national policies would prevent the emergence of asymmetric shocks

The correction mechanism is likely to be painful. Other countries will be forced to intensify their policies of wage moderation, inducing the former again to restrict wage increases.

The divergent movements of competitive positions within the eurozone are not only the result of German wage policies but also of the different speeds in the structural reform process in the member countries. The process of structural reforms (labor market reforms, liberalization of output markets) has remained a strictly national affair. Some countries, e.g. the Netherlands and Spain have gone some way in deregulating employment protection systems, while other countries, e.g. France and Italy have a

⁸ For a similar analysis in the context of the EMS, see Blanchard and Fitoussi(1992).

Figure 6



long way to go. These divergent movements have much to do with differences in national political systems. They generate a potential for divergent movements in employment and output (asymmetric shocks) within the eurozone which will necessitate adjustments in the future. As these are likely to be painful, they are bound to lead to tensions in a monetary union.

The enlargement of the eurozone to the new member states will not make matters easier. Each of the new member states, like the old member states, has its own national idiosyncrasies. Thus an enlarged eurozone will present even more scope for divergent economic developments, creating difficult adjustment processes and tensions within the system.

The institutional weakness of the present eurozone governance

The present institutional design of the eurozone is weak. This weakness manifests itself both at the level of fiscal policies as at the level of monetary policies.

The Stability and Growth Pact (SGP) was supposed to provide the cornerstone of the governance of fiscal policies in the eurozone. The SGP, however, is built on a weak institutional foundation. The reason is the following. As argued earlier, spending and taxation are still very much the responsibility of national governments and parliaments. That is also the level at which democratic legitimacy is vested. As a result, these spending and taxation decisions are backed by an elaborate process that is deeply embedded in national democratic institutions.

The SGP now imposes top down an extensive control and sanctioning system on the net effect (budget deficit) of this democratic decision making process by institutions that are perceived to lack the same democratic legitimacy. Lawyers will undoubtedly object that the SGP is the result of a Treaty that has been ratified by the same democratic institutions, the national parliaments, so that it has the same legitimacy as the national parliaments. This is undoubtedly true from a legal point of view. It is not from a political point of view.

When the Commission starts an excessive deficit procedure which aims at forcing national govern-

ments to cut spending and/or increase taxes, it bears no political responsibility for these decisions. In fact, the national governments do. When these follow up on the Commission's procedure and cut spending and raise taxes they are the ones who will be judged by their national electorates, and who face the threat of being punished by the voters at home. In contrast, the European Commission at no time faces the prospect of being voted out. Thus from a political point of view, the European Commission, which initiates the control and sanctioning procedure of the SGP, lacks democratic legitimacy, because there is no mechanism to make the Commission accountable for its actions to an electorate.

This lack of accountability of the Commission makes the SGP unsustainable. Each time a conflict arises between the Commission and the national governments, the former is bound to loose. This is also what has happened in November 2003 when France and Germany disregarded the SGP. It will happen again when conflicts arise between the Commission and the national governments. Thus, it can be concluded that the SGP is a fragile institutional construction that is unlikely to meet its objective.

On the need for further political integration

In the preceding sections we have argued that there is a deep problem of governance in the Eurosystem. We identified three problems. First, important instruments of macroeconomic policy (monetary policy and the management of the government debt and deficits) have been transferred to European institutions. However, the political accountability for the results of the decisions taken in these fields is still vested with national governments. This creates a tension that is bound to be won by national governments.

Second, the eurozone lacks a system of redistribution that will compensate those who are hit by a negative shock. These negative shocks, quite surprisingly, have remained large within the eurozone. One cannot simply tell those countries faced by such a shock that they should solve the problem on their own. A redistributive system is essential to create an "allegiance" to the union, which in turn is important to maintain its sustainability.

Finally, the fact that large areas of economic policies remain in the hand of national governments create

Without further political integration, EMU is at risk

asymmetric shocks that undermine the sustainability of the monetary union.

These three problems call for further steps towards political union. Without a political union the eurozone is at risk. The previous analysis allows us to describe how such a political union should look.

A first element of such a political union is a certain degree of budgetary union, giving some discretionary power to spend and to tax to a European executive, backed by a full democratic accountability of those who are given the authority to spend and to tax. This will allow setting up an insurance system against asymmetric shocks in the eurozone. This can take many forms, and several proposals have already been made (see e.g. Méhitz and Vori (1993), Von Hagen and Hammond (1995)). The transfer of budgetary power does not have to be spectacular as was shown by the previous authors. Nevertheless, it will require a European budget that increases significantly relative to its present level of about 1 percent of GDP.

Second, an increased institutionalized coordination of a number of economic policy instruments that have macroeconomic consequences will be necessary. We have mentioned social policies (including structural reform policies) and wage formation. The need to coordinate does not imply that these areas should be fully centralized. Rather it means that spillover effects of decisions in these areas into the monetary union should be internalized. Thus, decisions like cutting the working week in France which have obvious implications for the eurozone as a whole should be a matter of common concern, and should not be allowed to be decided by individual countries without consultation with other countries. Similarly, national wage policies will have to be coordinated in order to avoid asymmetric developments in competitive positions of the member countries.

An omitted “deep” variable

The German monetary union between West and East Germany that came about in 1990 after a transition period of barely six months stands in great contrast with the European monetary union. The German monetary union was part of a larger political union. Thus, on July 1, 1990 the monetary union was established together with a unification of all important macroeconomic instruments (budgetary

policies, transfer system, wage bargaining, social security, regulatory environment). There can be no doubt that such a comprehensive political union came about as a result of a strong national sense of common purpose and an intense feeling of belonging to the same nation.⁹ In a way it can be said that this sense of common purpose was the deep variable that made the monetary and political union possible in Germany. Put differently, monetary and political union were endogenous variables that were driven by a common force. The existence of this deep variable made it inconceivable that Germany would have started with a monetary union without having a centralized budget capable of making large transfers between regions, or without a unified social security system.

This deep variable is absent at the European level. It is this absence that makes the progress towards political union so difficult in Europe. The lack of a deep variable also explains why Europe started with monetary union. The latter can be considered to be the easy part on the road to political union. But at the same time it puts the whole process at risk. Without a sense of common purpose it is very doubtful that further progress towards political union will be made. And as we have argued, without these steps towards political union the monetary union will remain a fragile construction.

From this perspective, the enlargement of the eurozone, which starts on January 1, 2007 with the entry of Slovenia, is not good news. There can be little doubt that the enlargement will weaken the sense of common purpose. The deep variable that drives the dynamics towards political union will become even weaker than it already is. Thus the enlargement of the eurozone will set back the dynamics towards political union even further, thereby increasing the fragility of the eurozone.

Conclusion

The long-run success of the eurozone depends on the continuing process of political unification. Such a political unification is needed to reduce the scope for the emergence of asymmetric shocks and to embed the eurozone in a wider system of strong political ties that are needed to take care of the inevitable divergent economic movements within the euro-

Without a deep sense of common purpose, progress towards political union will remain evasive

⁹ See Baldwin and Wyplosz (2006) on this issue.

zone. In addition, such a political union is necessary to deal with the flaws in the governance of the eurozone. The major flaw is that while national politicians continue to bear the full political responsibility for unfavorable trends, key instruments to deal with this problem have been taken away from them and have been transferred to European institutions that bear no political responsibility for their decisions.

The recent “no” votes concerning the European constitution signal that there is a strong “integration fatigue” in the European Union today, making it unlikely that significant progress in political unification can be made. The recent enlargement of the European Union will make it even more difficult to move towards political union. It may even lead to a loosening of the political ties within the EU.

The absence of a political union will continue to make the eurozone a fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the eurozone has little chance of survival.

References

- Alesina, A., I. Angeloni and F. Etro (2001). “The Political Economy of Unions,” *NBER Working Papers*, Cambridge, MA.
- Alesina, A., and E. Spolaore (2003). *The Size of Nations*, MIT Press.
- Baldwin, R., and C. Wyplosz (2006). *The Economics of European Integration*, 2nd edition, McGraw Hill.
- Berger, H., and S. Danninger (2006). “The Employment Effects of Labor and Product Market Deregulation and their Implication for Structural Reform,” *CESifo Working Paper*, no. 1709, May.
- Fitoussi, J.-P. et al. (1993). *Competitive Disinflation and Economic Policy in Europe*, Oxford University Press: Oxford.
- Blanchard, Olivier, and F. Giavazzi (2003). “Macroeconomic Effects of Regulation and Deregulation in Goods and Labor Markets,” *Quarterly Journal of Economics*, Vol. 118, No. 3, 879–907.
- Conway, Paul, V. Janod, and G. Nicoletti (2005). “Product Market Regulation in OECD Countries: 1998 to 2003,” *OECD Economics Department Working Paper*, 419 (Paris: OECD).
- European Commission, *EMU after Five Years, European Economy*, Special Report.
- Gros, D., T. Mayer and A. Ubide (2005). *The EMU at Risk*, 7th Annual Report of the CEPS Macroeconomic Policy Group, Brussels.
- Kenen, Peter B. (1969). “The Optimum Currency Area: An Eclectic View”, In Mundell and Swoboda, (eds.), *Monetary Problems of the International Economy*, Chicago: University of Chicago Press.
- McKinnon, R. (1963). “Optimum Currency Areas,” *American Economic Review*, 52, 712–725.
- Méltz, J., and S. Vori, (1993). “National Insurance against Unevenly Distributed Shocks in a European Monetary Union,” *Recherches Economiques de Louvain*, 59, 1–2.
- Mundell, R. (1961). “A Theory of Optimal Currency Areas” *American Economic Review*, 51, 657–665.
- Mundell, R. (1973). “Uncommon Arguments for Common Currencies,” in H. Johnson and A. Swoboda (eds.), *The Economics of Common Currencies*, London: Allen&Unwin, pp. 114–32.
- Musgrave, R. (1959), *The Theory of Public Finance*, New York: McGraw-Hill.
- Sinn, H.-W., and M. Reuter (2001). “The Minimum Inflation Rate for Euroland,” *NBER Working Paper* no. 8085.
- Von Hagen, J. (1996). “Währungsunion, Fiskalunion, Politische Union“ mimeo, Universität Mannheim, May.
- Von Hagen, J. and G. Hammond (1995). “Regional Insurance against Asymmetric Shocks,” *CEPR Discussion Paper*, no. 1170.
- Wallace, H. and W. Wallace (2000). *Policy-Making in the European Union*, Oxford University Press, Oxford.

IMPLICATIONS OF COUNTRY SIZE AND TRADE OPENNESS FOR EURO AREA ENLARGEMENT

MARCELO SÁNCHEZ*

The EU is a group of economies exhibiting differences in terms of their structural characteristics, as is the euro area which comprises a subset of EU countries. The structural differences between these countries have enabled them to exploit gains from specialisation in production which is at the root of the observed strong trade interactions. Euro area countries, by sharing the same currency (the euro) and thus avoiding risks derived from bilateral exchange fluctuations, have seen trade expand by a somewhat larger proportion.¹

In addition to benefiting from expanded trade flows, countries joining a currency union face the cost of foregoing national monetary stabilisation actions. Analysts have drawn welfare implications at both the monetary union and country levels based on the degree of business cycle synchronisation across participating states. Cross-country structural differences affect the performance of a currency union's monetary stabilisation in other ways. Two key structural characteristics that may play a role in this respect are country size and the trade-off between output and inflation. The latter, which is known to imply a difficult policy choice, is a supply-side feature that is influenced by the degree of openness to international trade. Therefore, the fact that EU economies differ in size and trade openness may have an impact on monetary union stabilisation as well as welfare implications for both actual and prospective euro area countries.

The study of the euro area enlargement process requires detailed consideration of EU countries' structural characteristics and the conduct of monetary union stabilisation. This article presents results in this direction, devoting some attention to the likely welfare consequences of EU countries' differences in size and trade openness.

Country size and trade openness

Table 1 reports data on size and trade openness for the EU, including the euro area's current twelve participating states.² Country size is measured as the respective share in EU's real GDP, while openness is measured as the ratio to real GDP of the average of exports plus imports from outside the respective country or region. The latest information is reported, the year 1991 (the year after German reunification) being used as a reference point.

One first conclusion from Table 1 is that EU countries exhibit considerable differences in both country size and trade openness. Moreover, these two structural parameters do not exhibit a very clear pattern. Although there is some evidence of an inverse relationship between size and openness, the link is subject to many exceptions – in line with existing international comparisons.³ Naturally, every euro area country is both smaller and – in light of significant intra-regional trade – more open to global trade than the region as a whole. Also in line with an inverse relationship between size and openness, the three largest euro area countries, namely, Germany, France and Italy (which altogether account for almost 70 percent of euro area GDP), tend to be relatively more closed – in terms of trade to GDP ratios. Among non-euro area EU countries,



EU countries differ considerably in size and openness

* European Central Bank. This article draws on results in previous work by the author. The views expressed here do not necessarily reflect those of the European Central Bank.

¹ Evidence produced by Rose (2000) and others suggests that currency unions have historically led to a substantial increase in trade. This increase in trade may take place slowly over time, as the more modest increases in trade that have sometimes been attributed to EMU to date would indicate. For a survey on this literature, see Rose and Stanley (2005).

² Slovenia will adopt the euro on 1 January 2007.

³ Alesina et al. (2005) summarise both the evidence and arguments in favour of such inverse link. The evidence is rationalised with the notion that trade openness, by enhancing the magnitude of the market facing a given country, increases the benefits of small size. Conversely, small countries have a strong interest in maintaining access to international markets (including via multilateral and regional means). However, many studies report that there is no simple linear relationship between size and openness, with size in particular being influenced by many other determinants that have not only economic but also historical and socio-cultural roots (see e.g. Alesina and Spolaore, 2003).

Table 1
Country shares in EU real GDP and trade openness

	Share in EU real GDP in %		Trade openness ^{a)} in %	
	1991	2004	1991	2004
<i>EU</i>	100.0	100.0	-	-
<i>Euro area countries</i>	79.6	71.1	8.8	16.6
Austria	2.6	2.4	36.3	48.6
Belgium	3.1	2.8	68.2	82.3
Finland	1.5	1.5	22.4	34.3
France	17.6	15.8	22.2	25.8
Germany	28.1	23.5	26.0	35.5
Greece	1.3	1.4	22.1	25.2
Ireland	0.6	1.1	55.4	72.5
Italy	12.3	10.3	26.2	29.7
Luxembourg	0.2	0.2	102.7	135.4
Netherlands	4.5	4.2	52.7	62.7
Portugal	1.2	1.2	33.6	34.5
Spain	6.6	6.8	17.6	27.5
<i>Non-euro area countries</i>	20.4	28.9	-	-
Cyprus	0.1	0.1	53.0	49.1
Czech Republic	0.3	0.9	33.6	71.4
Denmark	1.7	2.1	34.2	42.9
Estonia	0.0	0.1	29.3	82.6
Hungary	0.4	0.9	35.2	67.6
Latvia	0.2	0.1	14.0	51.6
Lithuania	0.3	0.2	6.0	55.8
Malta	0.0	0.0	95.7	80.6
Poland	1.0	2.2	23.3	38.8
Slovenia	0.2	0.3	33.9	60.7
Slovak Republic	0.4	0.4	13.1	76.1
Sweden	3.1	3.0	26.5	42.1
United Kingdom	12.7	18.6	23.7	26.9

^{a)} Trade openness is defined as the ratio to real GDP of the average of exports plus imports from outside the respective country or region.

Sources: Eurostat, OECD and IMF.

Most of the new member states are small open economies

the UK is likewise the largest and least outward-oriented economy. Examination of EU countries other than the four largest suggests that it is much more difficult to identify a pattern in terms of the relationship between openness and size. On the one hand, the inverse relationship between these two characteristics receives support from many small economies that are also very open to international trade. This is especially the case of the euro area countries Belgium, Ireland and Luxembourg, as well as most of EU's new member states (NMS) with the exception of Poland. For other EU countries, the evidence suggests that the inverse link between size and openness is not so clear. With regard to the two euro area countries of intermediate size, the

Netherlands is rather open to international trade, while Spain instead ranks among the most closed euro area economies. Among the remaining countries, Finland, Greece and Portugal appear not to be so open to trade, while Austria, Denmark, Poland and Sweden exhibit a higher degree of openness.

The wide diversity of situations concerning size and openness implies that different countries may experience different outcomes as a result of adopting the euro. Despite such diversity, it is worth emphasising that most of EU NMS can be safely characterised as a group of small open economies. At present, the smaller of these participate in ERM II and have plans to join the euro area in 2010 at the latest. Moves towards EMU entry appear to proceed at a slower pace in the three largest EU NMS (namely, Czech Republic, Hungary and Poland), which currently aim at fulfilling the convergence criteria (see Table 2). In the following, reference will be made to all EU NMS as a single group in order to help derive the welfare implications involved in euro area enlargement for countries of small size and a high degree of trade openness. The reader

should bear in mind that the relevant time frame for euro adoption varies from case to case.

A simple monetary union framework

There are different ways to analyse the role of structural cross-country differences in monetary union stabilisation. One framework that is very useful for this purpose is the one developed by Sánchez (2006a, 2007). It is arguably the simplest approach that can adequately address the type of problems at hand. The model refers to two heterogeneous countries and distinguishes between two types of exogenous driving forces, namely, aggregate shocks and sectoral productivity shocks. Furthermore, despite the

Table 2
Economic convergence indicators

		Annual HICP inflation (in %)	Long-term interest rate (in p.p.a.)	General government deficit ^{a)} (in % of GDP)	General government gross debt ^{a)} (in % of GDP)
Cyprus	2004	1.9	5.8	- 4.1	71.7
	2005	2.0	5.2	- 2.4	70.3
	2006	2.3	4.2	- 2.1	69.1
Czech Republic	2004	2.6	4.8	- 2.9	30.6
	2005	1.6	3.5	- 2.6	30.5
	2006	2.4	3.7	- 3.2	31.5
Estonia	2004	3.0	-	1.5	5.4
	2005	4.1	-	1.6	4.8
	2006	4.4	-	1.4	3.6
Hungary	2004	6.8	8.2	- 5.4	57.1
	2005	3.5	6.6	- 6.1	58.4
	2006	3.0	6.9	- 6.7	59.9
Latvia	2004	6.2	4.9	- 0.9	14.6
	2005	6.9	3.9	0.2	11.9
	2006	7.0	3.8	- 1.0	11.3
Malta	2004	2.7	4.7	- 5.1	75.5
	2005	2.5	4.6	- 3.3	74.5
	2006	3.1	4.3	- 2.9	74.0
Poland	2004	3.6	6.9	- 3.9	41.8
	2005	2.2	5.2	- 2.4	41.9
	2006	1.3	5.1	- 3.0	45.5
Slovak Republic	2004	7.5	5.0	- 3.0	41.6
	2005	2.8	3.5	- 2.9	34.5
	2006	4.1	4.1	- 2.7	34.3
Sweden	2004	1.0	4.4	1.8	50.5
	2005	0.8	3.4	2.9	50.3
	2006	1.4	3.6	2.2	47.6
Latest reference values		2.8	6.1	- 3	60

Note: No information on the exchange rate criterion is reported. Unless otherwise stated, data for 2006 cover the period up to August only.
^{a)} Country information for 2006 are European Commission forecasts. Reference values are for 2005.
 Deficit is indicated by (-), while surplus is indicated by (+).

Sources: Eurostat and European Commission.

model's simplicity, its key results remain insightful when one allows for a larger number of countries and some additional transmission channels.⁴

More concretely, the simple framework used here includes the following features:

i) An aggregate supply equation links real output to inflation at the country level. The slope of the supply

⁴ Sánchez (2006c) obtains the same conclusions for the aggregate supply shocks in a multi-country approach. Moreover, exogenous factors other than aggregate supply disturbances (such as policy those affecting aggregate demand, risk premia and the inflation objective) are found to play the same role as the present sectoral productivity shock. For an application of such multi-country framework to the analysis of monetary union prospects in East Asia, see Sánchez (2006b).

schedule is normally seen as being positively related to the degree of openness of the economy: for a given real exchange rate depreciation associated with output expansion, the inflationary effect is larger the more open the economy is (see e.g. Romer, 1993). That is, a more open economy displays a steeper supply curve.

ii) Real exchange rates are driven by sectoral productivity shocks. This can be interpreted as a Balassa-Samuelson effect, through which higher productivity growth in tradable goods production compared to non-tradables induces a real appreciation.

iii) Welfare comparisons involve consideration of monetary authorities for both the currency union and a given reference country. Both authorities care about relevant deviations of output and inflation from desired levels. In the union's monetary policy case, what matters are deviations of aggregate output and inflation resulting from using country sizes as weights.⁵ Under monetary autonomy, a country's nominal exchange rate may fluctuate.

iv) Shocks may affect countries in the same way ("common" shocks) or be country-specific. In the latter case, two situations are considered, depending on whether disturbances hit just one country ("idiosyncratic" shocks) or hit both countries in opposite directions ("asymmetric" shocks).

Welfare implications of joining a monetary union

Two types of welfare implications can be drawn from the analysis conducted here. First, the situation of a given economy under currency union participation is

⁵ In the present context, it is convenient to define size as the share of a given participating country in the currency union's economy.

Welfare analysis requires consideration of relevant cross-country structural differences

compared with that under autonomous monetary policy. Second, the single monetary policy's stabilisation properties are also assessed against the monetary autonomy scenario.

Under both welfare analyses, the benchmark is thus given by autonomous monetary policy. This suggests that there is an important difference between aggregate supply and sectoral productivity shocks. National monetary authorities are only concerned with an exogenous shift in aggregate supply, that alters their choice of inflation and output. Their loss function is unaffected by sectoral productivity disturbances. Instead, either shock type influences both monetary union performance and the welfare of participating countries. The reason is that the single monetary policy is not only concerned with aggregate supply shocks, but may also be affected by sectoral productivity shocks potentially entailing an additional inflationary impact.⁶

How are the single monetary authority and member states affected by sectoral productivity shocks?

Unexpected developments in sectoral productivity fail to affect welfare under monetary autonomy. The currency union's policymaker would also be spared if participating countries had the same output-inflation trade-off and/or if they were hit by the same shock. Otherwise, a sectoral shock will worsen the choices available for stabilisation under the currency union. To see this, consider, for example a sectoral shock hitting only one country or both countries in different directions. Any of the two countries would prefer the single monetary policy to remain unchanged. However, the latter must react to partially offset the shock. Therefore, the sectoral disturbance implies that both the monetary union's policymaker and each participating country are outperformed by the alternative of monetary autonomy. The scenarios of country-specific shocks analysed here make the difference, and the currency union is thus dominated by autonomous monetary policy under sectoral productivity disturbances. Welfare considerations are clear-cut in the latter case. In particular, they do not necessitate consideration of parameters such as size and openness which do play a role under aggregate supply shocks.

What is the role of size and openness under aggregate supply shocks?

When economies are hit by aggregate supply shocks, both the currency union and the autonomous policymaker are confronted with a worse choice between output and inflation. If the two countries exhibit the same supply curves, monetary union makes no difference to individual countries. Otherwise, the analysis is somewhat more complex, involving in particular a discussion about size and openness. Let us now turn to these welfare considerations.

Consider first an aggregate supply disturbance of the idiosyncratic or asymmetric type. In either case, the shock facing the currency union's policymaker is of smaller magnitude than under the alternative autonomous monetary arrangement. That is, the latter is outperformed by the union's policy. Of course, the mirror image of this is that countries should adjust to shocks hitting them by more than would be the case with the help of domestic stabilisation tools. In the remaining case of common supply shocks, welfare considerations are not that clear-cut. Which monetary arrangement dominates its alternative depends on the slope of the reference country's supply schedule. If the latter is steep, that is, if the country enjoys an unfavourable output-inflation trade-off, monetary union is the best option.⁷ Monetary autonomy instead outperforms its alternative for countries with flat supply curves. Given that a steep supply curve is associated with high trade openness, one corollary is that currency union performance is enhanced against the alternative of an open economy operating under monetary autonomy.

This discussion suggests that, contrary to the adverse welfare implications of sectoral productivity shocks, monetary union exhibits much better stabilisation properties under aggregate supply disturbances. Instead, both types of shocks entail stabilisation costs for member states. As a result, countries are expected to join a monetary union insofar as the latter entails strong favourable effects, as given for instance by a rise in trade flows and potential credibility gains. In this context, it is worth estimating the likely effect of size and openness on monetary stabilisation costs implied by monetary union membership under aggregate supply shocks. Table 3 presents estimated welfare changes due to an increase in size

⁶ As mentioned above, in a richer model aggregate demand or risk premium shocks would play a comparable role to that played here by sectoral – as opposed to aggregate – supply shocks.

⁷ A steeper supply curve (open economy) is known to entail monetary stabilisation costs since a supply shock makes the deviation of inflation from target larger for a given change in the output gap.

Sectoral productivity shocks pose a challenge for monetary union stabilisation

Table 3
Estimated welfare effects under monetary union participation

	1% larger country size	1% steeper supply curve
Common shock	12.8	6.3
Asymmetric shock	0.0	3.6
Idiosyncratic shock	1.7	2.0

Note: The entries in this Table are percentage changes in welfare relative to autonomous monetary policy in the event of aggregate supply shocks.

and a steeper supply schedule (as induced by a higher degree of trade openness), in both cases evaluated at baseline calibrated values. Both parameter changes appear to alleviate stabilisation costs.⁸ This implies that the assessment of the likely consequences of euro adoption for small open EU NMS economies would be mixed. While their high degree of trade openness reduces stabilisation costs from joining the euro area, small size favours the use of national monetary policy.

Externalities, endogeneity and dynamic considerations

Two externalities involved in currency union enlargement are worth discussing. First, as new countries join, the economic weight of existing member countries declines. The results discussed earlier in this section would point to an across-the-board welfare loss in this case. Second, already participating states may now occupy a different ranking in terms of openness and thus the output-inflation trade-off. Focusing on enlargement to EU NMS, it is worth stressing that a substantial fraction of their trade is with the euro area. This means that, despite EU NMS being very open to trade, the latter's geographic composition implies that their participation need not make the old members' supply curve flatter compared to the enlarged union. Therefore, it is only the first, size-related externality that appears more likely to raise stabilisation costs to former members from ongoing euro area membership. However, the magnitude of such costs would be bounded by the size of the new entrants, with EU NMS altogether amounting to some 7 percent of a hypothetical enlarged euro area real GDP. The effect would naturally be stronger if other economies were to join as well.

⁸ The result that size does not matter under asymmetric shocks simply stems from the latter being defined to exactly offset each other at the union's aggregate level. The magnitude of the shocks in each country thus adjusts to changes in the relative size of both economies, with fully neutral welfare consequences.

Some important economic developments may be endogenous to monetary union, as examined by Frankel and Rose (1998). One such development is the enlargement-induced rise in overall trade. Stronger trade integration has no very clear implications for the distribution of shocks within the union. It could make business cycles more synchronised, but it might as well lead to specialisation and thus

increase the likelihood of country-specific shocks (Kalemli-Ozcan et al., 2001). Neither do overall increased trade interactions have clear implications in terms of the role of openness discussed above. This analysis shows that openness reduces a given country's stabilisation costs from monetary union membership. However, this does not necessarily carry over to the case where all members trade more, which does not by itself translate into a change in any of the countries' output-inflation trade-offs relative to the union's average.

Finally, it is worth looking at some dynamic considerations. EU NMS evolve through a catching-up growth process, their size being projected to rise over time in comparison to other EU countries. For an expanding euro area, changing relative sizes would point to a zero-sum game in which stabilisation costs are redistributed across participating countries. Again, the importance of this effect is constrained by the combined size of catching-up economies joining – the only difference here being that one should factor in these countries' increasing economic weights over time.

Conclusion

This article discusses monetary union stabilisation, with a focus on structural aspects that are expected to exert an influence on the euro area enlargement process. In particular, consideration of (common and country-specific) shocks is combined with the analysis of the likely role of country size and trade openness.

Monetary union performance depends on structural factors, including the type and cross-country distribution of shocks hitting participating states. Sectoral productivity disturbances pose a challenge to the single monetary policy. The latter displays a much bet-

Inclusion of catch-up countries may raise the stabilisation costs facing old members

ter performance under aggregate supply shocks compared to a small open economy operating under monetary autonomy.

Euro area enlargement currently hinges on the entry of new EU member states that are small open economies. These countries' decisions on monetary union participation involve a comparison of favourable trade and credibility considerations with stabilisation costs implied by foregoing monetary autonomy. Size and openness weigh on such stabilisation costs, with the outcome failing to be clear-cut. New member states' small size makes a currency union less appealing as it limits their role in the single monetary policy. In contrast, trade openness lowers costs related to euro adoption indirectly by inducing the domestic output-inflation trade-off to be less favourable. New member states' participation in the euro area would also have an influence on the countries that have already adopted the single currency. Likely trade-enhancing effects could also be accompanied by a number of externalities and dynamic impacts. One such extra effect on current euro area participants would be a reduced share in the enlarged monetary union. The potential stabilisation costs involved by this are, however, constrained by the rather modest size of the new entrants.

References

- Alesina, A. and E. Spolaore (2003). *The Size of Nations*, Cambridge, MA: MIT Press.
- Alesina, A., E. Spolaore and R. Wacziarg (2005). "Trade, Growth and the Size of Countries," in P. Aghion and S. Durlauf (eds.), *Handbook of Economic Growth*, Amsterdam: North Holland.
- Frankel, J. and A. Rose (1998). "The Endogeneity of the Optimum Currency Area Criteria," *Economic Journal*, 108, 1009–1025.
- Kalemli-Ozcan, S., B. Sørensen and O. Yosha (2001). "Economic Integration, Industrial Specialization, and the Asymmetry of Macroeconomic Fluctuations," *Journal of International Economics*, 55, 107–137.
- Romer, D. (1993). "Openness and Inflation: Theory and Evidence," *Quarterly Journal of Economics*, 108, 869–903.
- Rose, A. (2000). "One Money, One Market: Estimating the Effect of Common Currencies on Trade," *Economic Policy*, 15, 7–46.
- Rose, A. and T. Stanley (2005). "A Meta-Analysis of the Effect of Common Currencies on International Trade," *Journal of Economic Surveys*, 19, 347–365.
- Sánchez, M. (2006a). "Implications of Monetary Union for Catching-Up Member States," ECB Working Paper N° 630.
- Sánchez, M. (2006b). "Is Time Ripe for a Currency Union in Emerging East Asia? The Role of Monetary Stabilisation," *Journal of Economic Integration* (forthcoming).
- Sánchez, M. (2006c). "Monetary Stabilisation in a Currency Union of Small Open Economies," mimeo, European Central Bank.
- Sánchez, M. (2007). "Monetary Stabilisation in a Currency Union: The Role of Catching-Up Member States," *Journal of Policy Modeling* (forthcoming).

MACROECONOMIC POLICY AND EMU ENLARGEMENT

REINHARD NECK
WITH GOTTFRIED HABER*

On 1 May 2004, ten states (mostly from Central and Eastern Europe) became members of the European Union. Fears have been expressed that the accession of the CEEC (Central and Eastern European countries) might increase economic divergence within the EU and result in more asymmetric shocks acting on European economies. In particular, some observers regard the membership of former Communist countries as a threat to the macroeconomic stability of the EU as the political systems in some of them are seen to have only a weak tradition of macroeconomic policies for stability and growth.

In this article, we discuss some possible consequences of CEEC membership in the euro area (EA) for the design and the effects of macroeconomic policies. To do so, we study scenarios both with and without the CEEC being members of the EA. For the European Central Bank (ECB), we consider several alternative intermediate targets. For fiscal policy, we assume that the governments of both incumbent and new EA members may either refrain from pursuing active stabilization policies or follow either non-cooperative or cooperative activist fiscal policies.

Policy analysis with the MSG2 Model

To date, there exist many publications focusing on several aspects of monetary unions, especially on EMU. See, for example, Hughes Hallett et al. (1999); Hughes Hallett and Mooslechner (1999); Eijffinger and de Haan (2000); Neck (2002; 2002a); Neck and Holzmann (2002); Buti and Sapir (2003); Allsopp and Artis (2003); De Grauwe (2005). These authors arrive at different conclusions as to the “best” strategy for the ECB and/or the fiscal policy-makers. Some are

specifically devoted to assessments of the effects of an enlargement of the EA; for instance, Fidrmuc and Maurel (2004); Dabrowski and Rostowski (2006). In earlier work (Haber et al. 2002), we gave some hints concerning the choice of intermediate targets and the desirability of macroeconomic policy coordination in a European and global context. More recently, we analysed a greater variety of scenarios, focusing on the results of different policy arrangements after an EA enlargement (Neck et al. 2004, 2005; Haber and Neck 2005).

For these calculations, we used the MSG2 Model (McKibbin-Sachs Global Model), in its European version MSGR44A. This is a dynamic, intertemporal general-equilibrium model of a multi-region world economy. It exhibits a mixture of classical and Keynesian properties: partly rational expectations in combination with various rigidities to allow for deviations from fully optimizing behaviour. In particular, nominal wages are assumed to adjust slowly in the major industrial economies (except in Japan). Nevertheless, the model solves for a full intertemporal equilibrium. The model is described in full detail in McKibbin and Sachs (1991); additional resources are available on the web (<http://www.msgpl.com.au/>).

The MSGR44A version of the MSG2 Model consists of models of the following countries and regions: the United States, Japan, Germany, the United Kingdom, France, Italy, Austria, the rest of the EA (REA), the rest of the OECD, Central and Eastern European economies, non-oil developing countries, oil-exporting countries, and the former Soviet Union. For the last three regions, only foreign trade and external financial aspects are modelled whereas the industrial countries and regions are fully modelled with an internal macroeconomic structure. The basic theoretical structure for all industrial regions is the same but institutional differences are taken into account, especially when modelling labour markets.

In order to analyze the welfare effects of different strategies followed by the ECB and the fiscal policy-makers, we define a normative measure of the economic outcomes of different simulation runs. We cal-



What are some possible effects of EMU enlargement on macro-economic policies?

* Klagenfurt University, Klagenfurt, Austria.

culate economic welfare losses caused by various shocks by assuming an additively separable quadratic welfare loss function, where losses in each period are the sums of the weighted quadratic differences between the actual values and the optimal values for each of the target variables. Welfare losses in each future period are discounted to their present values and summed up over an infinite time horizon to obtain the measure of total welfare loss. Such a welfare loss (objective) function is specified for Germany, France, Italy, Austria, REA, and CEEC. The assumed target variables are the rate of inflation, real GDP, the current account and the budget deficit of the public sector. All target variables are given equal weight. The baseline values of the target variables (simulated values without any shocks) are considered to be their optimal values, because this reference simulation run represents a stable path towards a long-run equilibrium of the model. European objective function values are calculated as weighted averages of the relevant country-specific values, with weights derived from the values of GDP at market prices.

When a country is assumed to pursue an “active” optimizing economic policy, the four economic target variables mentioned above enter the objective function of its government. In these cases, the policy variable is a fiscal instrument (nominal government consumption) for each “active” country. EA monetary policy is set independently by the ECB according to some assumed intermediate monetary target. The CEEC are assumed not to implement active monetary policy in scenarios in which they do not belong to the EA. First, it is assumed that the other non-EA countries and regions in the model do not pursue “active” fiscal or monetary policies, i.e. they are assumed not to react to shocks and European policies.

Six European “institutional scenarios” are considered for each of the shocks and each of the assumptions about ECB policy rules. “No-policy” scenarios are regarded as baseline scenarios for the different types of shocks, while the other four scenarios are combined with the different ECB policy rules. The no-policy scenarios assume no active policy, neither monetary nor fiscal, for the present EA and the enlarged EA, respectively, i.e. the values of the fiscal and monetary instrument variables are kept at their baseline values. Enlargement of the EA always means that all the CEEC are members alongside the present EA members. The non-cooperative scenarios assume non-cooperative strategic economic policy-

making in Europe in the sense that none of the policy-makers (the ECB and fiscal policy-makers in the EU) cooperate. On the other hand, the cooperative scenarios assume full cooperation between all these policy-makers. No intermediate constellations (coalitions) are considered.

For each of the institutional scenarios, alternative ECB strategies (intermediate targets or policy rules) are studied. First, five different policy rules for the ECB are considered: the no-policy rule leaves the monetary instrument (money supply) of the ECB at its baseline values. This policy is identical to monetary targeting. Inflation targeting, income targeting, exchange rate targeting (a unilateral peg of the EUR to the USD) and price level targeting are alternative strategies of the ECB considered.

In the non-cooperative scenarios, the ECB and the governments of the five countries/regions minimize their own welfare loss functions subject to the dynamic model and given the optimizing behaviour of the other players. This leads to a Nash-Cournot equilibrium of the dynamic policy game. In the cooperative scenarios, a joint welfare loss function, which is a weighted sum of the individual objective functions, is minimized subject to the dynamic model. This can be interpreted as the result of an agreement between the policy-makers of the five countries/regions. Under full cooperation, the ECB gets a weight in the joint objective function that is equal to the sum of the weights of the European countries/regions, which implies a rather strong central bank. In our view, assigning equal weight (“power”) to the ECB and the total of the EMU countries’ governments is a realistic model for cooperative policy design in Europe, given the difficulty of arriving at an agreement between the fiscal policy-makers of five or six (in reality: twelve or up to 22) countries. To avoid time inconsistency, all non-cooperative simulations are carried out by calculating a closed-loop feedback (Markov-perfect) equilibrium solution of the dynamic policy game under consideration.

For all scenarios considered, we calculate the effects of a temporary negative supply (total productivity) shock and a temporary negative demand (autonomous consumption) shock. A productivity shock can be interpreted as a temporary inward shift of the production possibility frontiers of the countries affected. A negative demand shock shifts the aggregate demand curve to the left. Here, we simulate the consequences of a temporary exogenous decrease in real private consumption. For both types of shocks we can distin-

Six institutional scenarios are considered for each of the shocks and ECB policy assumptions

guish between a shock affecting the CEEC block in the model, a shock affecting the present EA, a shock affecting the present EA and the CEEC block alike, and a world shock for all fully modelled regions in the model.

Policy results for Europe

Negative supply shocks cause the well-known stagflation dilemma: GDP decreases while the price level increases. Dealing with this type of shock is non-trivial, as expansionary policy measures would also increase inflation while restrictive economic policy would further reduce real output. The demand shock does not raise this issue as the price level decreases in this case. These effects occur fully only in the reference (baseline) simulation where policy-makers abstain from any action beyond “business as usual”. The scenarios examined differ with respect to the interventions of the policy-makers who try to counteract lower output and higher prices.

First, consider an asymmetric demand shock affecting only the CEEC. As expected, there are only very small welfare effects for the current EA when the consumption shock is limited to the CEEC. For the present members of the EA, we find that active fiscal policy is desirable while neither the institutional setup (EA enlargement vs. no enlargement) nor the choice of a specific intermediate target for monetary policy matters that much. A completely different picture arises from the point of view of the CEEC for this shock. A monetary union reduces the ability of the CEEC to counteract their domestic shock as it abolishes the possibility of adjusting exchange rates between the CEEC and the euro. Therefore all scenarios with an enlarged EA show higher welfare losses than their counterparts with the present EA. The difference is most notable for the baseline simulations where no other accommodating policy instruments are available that might be substituted for the protective effects of adjustable exchange rates.

If a negative demand shock is limited to the present EA, the choice of the intermediary monetary policy target for the ECB is no longer irrelevant. Exchange rate targeting and nominal income targeting produce higher welfare losses than the baseline simulations without active policy-making; inflation targeting and price level targeting appear to be reasonable strategies in most scenarios. The best result is achieved in the cooperative scenario for an enlarged EA under

price level targeting by the ECB. The spillovers to the CEEC are not negligible for this shock. Non-cooperative scenarios always dominate the cooperative scenarios. This can be attributed to the fact that the CEEC can use their fiscal instruments to pursue their own objectives in the non-cooperative case while cooperation causes this instrument to be used for optimizing the joint welfare loss function in which the CEEC objectives enter with a small weight only.

Under a symmetric demand shock affecting the present EA and the CEEC, exchange rate targeting and nominal income targeting produce high welfare losses, and inflation targeting and price level targeting are the most acceptable strategies. Monetary targeting is always better than the baseline but inferior to the inflation and price level targeting strategies. Here, cooperation dominates non-cooperation for the present EA countries, and the enlarged EA always produces better results than the original one. For the CEEC, the enlargement is advantageous in most cases, but no general judgment can be made for them on the issue of cooperation. The best results for both the EA incumbents and the CEEC are obtained in the price level targeting scenario with an enlarged EA and full cooperation. The qualitative results for a global consumption shock are very similar to the results for the symmetric European shock.

Next, we consider the effects of transitory supply shocks on the results of macroeconomic stabilization policies. For an asymmetric CEEC supply shock, the spillovers to the EA are very small. For an asymmetric supply shock to the present EA, results are mixed with respect to the advantages or disadvantages of cooperation versus non-cooperation and with respect to the present versus the enlarged EA for the present EA members. Again, the no-policy scenarios dominate all scenarios with active policies of the ECB and/or the governments. Spillovers of the asymmetric supply shock are present but not very substantial for the CEEC. Under a symmetric European supply shock, the fixed-rules no-policy scenarios are again the overall winners. Income targeting again turns out to be unsustainable. The cooperative inflation targeting scenarios give the best results among active policies, regardless of the size of the EA. For the CEEC, no clear decisions can be made, apart from the dominance of the fixed-rules policy. Again, the worldwide symmetric supply shock provides no significant further insights over those obtained from the symmetric European shock.

Given a negative demand shock, the best result is achieved in the cooperative scenario under price level targeting by the ECB

To summarize, the analyses show that the advantages and disadvantages of different institutional setups strongly depend on the nature of the shock the economies are faced with. Fixed rules can be recommended as an answer to supply shocks, more active (flexible) policy rules as a reaction to demand shocks. Exchange rate targeting and income targeting by the ECB can lead to instability. For demand-side shocks, inflation targeting and price level targeting mostly produce acceptable results. In most of the scenarios, the EA enlargement does not lead to significant welfare effects on its present members. Thus, additional macroeconomic noise resulting from CEEC membership does not seem to be too much of a problem for the EA incumbents. On the other hand, no significant advantages can be identified for them either. For the new EU members, introducing the euro causes reductions in macroeconomic welfare losses in some cases.

Global effects of an EA enlargement

An enlargement of the euro area, which will eventually create a full monetary union of a size comparable to the United States, may have non-negligible consequences on the world economy. Policy-making in other parts of the world may be affected and will possibly have to adapt to the changing environment of world trade and finance. Therefore, we examined possible consequences of CEEC membership in the EA on the welfare effects of macroeconomic stabilization policies in a similar way also under alternative assumptions about fiscal and monetary policies of the United States. The US government and the Federal Reserve Board are regarded as one single decision-maker. US macroeconomic policies are considered either as passive (no reaction on shocks and on policy changes abroad) or as actively stabilizing according to an objective function. In order to keep the analysis as simple as possible, no other countries are assumed to pursue active policies.

Some modifications of the assumptions concerning the simulations are required. An objective function is defined for the United States in an analogous way to that for the European countries/regions. We introduce another distinction of scenarios: in scenarios called “only European policies”, we assume that no other non-EA country and region of the model pursues “active” fiscal or monetary policies, i.e., these countries are assumed not to react to shocks and European policies. In “US active policies” scenarios, US mone-

tary and fiscal policy-makers are assumed to jointly optimize an objective function of the same type as those for the “active” European countries. For the ECB, we confine ourselves to strategies of monetary targeting (or no policy) and inflation targeting.

In the “US active policies” scenarios, some arrangement is assumed between the European and the US policy-makers (for example, a binding agreement concluded at a summit of policy-makers). This may not seem to be a very realistic possibility at the moment, but it may serve as reference for comparisons with non-cooperative scenarios. In the “US active policies” scenarios, the US policy-makers (government and Fed) are always regarded as one player, i.e., full cooperation is assumed between the US policy-makers also in the (globally) non-cooperative scenarios.

The results of the demand shocks are mostly similar in the cases where the United States do or do not react upon European policies. Active policies in the EU are better than no-policy scenarios for both the EU and the US. For the asymmetric demand shock affecting only the CEEC, all scenarios with an enlarged EA show higher welfare losses than their counterparts with the present EA. The difference is most notable for the baseline simulations, where no other accommodating policy instruments are available that might be substituted for the protective effects of flexible exchange rates. Within an enlarged EA, cooperation is better than non-cooperation. Active policies of the US reduce the welfare losses of the US, and they reduce the welfare losses of the other blocks slightly in most cases.

Under a symmetric demand shock affecting the entire EU (including the CEEC), the smaller EA is slightly worse for the incumbents but better for the CEEC. On the other hand, with active fiscal policies, entering the EMU is advantageous for the CEEC. ECB inflation targeting is mostly better than monetary targeting for the EMU members but worse for the US. Active US policies reduce spillovers to this country without causing visible negative spillovers back to the old continent. Without active US policies, the regions of the “new” EA are better off under cooperation than under non-cooperative stabilization policies; but when the US reacts in an active way, cooperation is primarily advantageous for them only.

The qualitative results for the global consumption shock are similar to the results for the symmetric

In most scenarios, EA enlargement has no significant welfare effects on present members

European shock but imply higher losses for most regions (especially, of course, for the US). Here monetary targeting by the ECB gives particularly high values of welfare losses for the EA incumbents; it is also inferior to inflation targeting from the perspective of the CEEC. Under the global demand shock, the US can considerably improve its performance when combating the world recession of this case by countercyclical policies, especially when it cooperates with European policy-makers.

Under a supply shock, the following results are obtained: For the European regions, no-policy strategies (fixed rules) are best. For the United States, on the other hand, the reverse holds: active fiscal and monetary policies unambiguously improve the performance when compared to a strategy of benign neglect. Moreover, activist EU fiscal policy helps the US; activist monetary EU policies (ECB inflation targeting) hurt the US in terms of the welfare measure chosen. Cooperation is good for the “larger” player (the EA in the case of inactive US policies, the US in the case of active US policies). Differences between the present and the enlarged EA are small, except for the case where the EU governments and the ECB follow an activist policy – there it is definitely advantageous for the CEEC to be within EMU.

Altogether, there are important differences with respect to the international spillovers and feedbacks of shocks and policies. Previous results on the advantages of fixed rules in the case of supply shocks and more activist policies for demand shocks are supported by this analysis for the European countries, but not for the United States. Cooperation is not necessarily better than non-cooperative activist policy-making, and in most cases, cooperation comes at the expense of the “smaller” player and favours the “larger” one (on a global level, the US). Again, in most of the scenarios, the EA enlargement does not lead to significant welfare effects for the present members of the EA. For the CEEC, EA membership provides significant reductions of macroeconomic welfare losses only in a few cases. The results for the US are not substantially affected by including the CEEC in the EA, which may lead to the conjecture that global effects of the EA enlargement will be minor. It remains to be shown how robust these results are with respect to variations in the model used and to the assumptions about the objective functions. At present, it appears that the decision about EA participation of the new EU members need not primarily be influenced by macroeconomic policy considerations.

References

- Allsopp, C. and M. J. Artis (eds.) (2003), “EMU, Four Years On”, *Oxford Review of Economic Policy* 19 (1).
- Buti, M. and A. Sapir (eds.) (2003), *EMU and Economic Policy in Europe*, Edward Elgar, Cheltenham.
- Dabrowski, M. and J. Rostowski (eds.) (2000), *The Eastern Enlargement of the Eurozone*, Kluwer, Dordrecht.
- De Grauwe, P. (2005), *Economics of Monetary Union*, 6th ed. Oxford University Press, Oxford.
- Eijffinger, S. C. W. and J. de Haan (2000), *European Monetary and Fiscal Policy*, Oxford University Press, Oxford.
- Fidrmuc, J. and M. Maurel (eds.) (2004), “Eastward Enlargement of the European Union”, *Journal of Comparative Economics* 32 (2).
- Haber, G. and R. Neck (2005), “Shall the New EU Members Introduce the Euro? Some Macroeconomic Policy Effects”, *Atlantic Economic Journal* 33, 139–49.
- Haber, G., R. Neck and W. J. McKibbin (2002), “Global Implications of Monetary and Fiscal Policy Rules in the EMU”, *Open Economies Review* 13, 363–79.
- Hughes Hallett, A., M. J. Hutchison and S. E. Hougaard Jensen (eds.) (1999), *Fiscal Aspects of European Monetary Integration*, Cambridge University Press, Cambridge, UK.
- Hughes Hallett, A. and P. Mooslechner (eds.) (1999), “Challenges for Economic Policy Coordination within European Monetary Union”, *Empirica* 26 (3).
- McKibbin, W. J. and J. D. Sachs (1991), *Global Linkages*, Brookings Institution, Washington, DC.
- Neck, R. (ed.) (2002), “The Macroeconomics of EMU”, *Open Economies Review* 13 (4).
- Neck, R. (ed.) (2002a), “The Euro After Three Years”, *Atlantic Economic Journal* 30 (3).
- Neck, R., G. Haber and W. J. McKibbin (2004), “European Monetary and Fiscal Policies after the EU Enlargement”, *Empirica* 31, 229–45.
- Neck, R., G. Haber and W. J. McKibbin (2005), “Global Macroeconomic Policy Implications of an Enlarged EMU”, in F. Breuss and E. Hochreiter, eds., *Challenges for Central Banks in an Enlarged EMU*, Springer, Vienna–New York, 235–57.
- Neck, R. and R. Holzmann (eds.) (2002), “European Monetary and Fiscal Policies: Myths and Facts”, *Empirica* 29 (3).



IT'S POLITICS, STUPID! – EMU ENLARGEMENT BETWEEN AN ECONOMIC ROCK AND A POLITICAL HARD PLACE –

MICHAEL BOLLE* AND
OLIVER PAMP**1



With the accession of the new member states in 2004, it was widely taken for granted that the subsequent introduction of the euro in these countries would merely be a formality – a purely technical process. Indeed, at the outset, all countries of central and eastern Europe (CEEC)² voiced their intention to join the eurozone as soon as possible. Two years later, much of this momentum has been lost. Of all CEECs, only Slovenia will manage to introduce the common currency already on 1 January 2007. All other countries have either not committed themselves to the fulfilment of the economic conditions for eurozone membership or have not managed to meet them yet. Estonia and Lithuania, which also aimed at a eurozone membership in 2007, had to postpone their entries. The same holds for Latvia whose target date of 2008 was revoked recently by the government. The Baltic states' difficulties stem from their high inflation rates which are at odds with one of the stipulations of the Maastricht convergence criteria.³ However, they along with Slovenia and Slovakia have already taken the road towards the euro by entering the fixed exchange rate mechanism (ERM II), a step that has not even been taken yet by the Czech Republic, Hungary and Poland. Indeed, these latter countries have either only announced a vague entry date for 2010 (Czech Re-

public and Hungary) or do not even have a target date at all (Poland).

This begs the question of why this allegedly technical procedure has stalled recently, especially in the three biggest states. We maintain in this article that not only inconsistencies in the Maastricht criteria, as is often claimed in the economic debate, are the reason for these difficulties. Rather, in a context of real convergence, the economic prerequisites of EMU membership are at odds with the political incentives that decision-makers face in their countries. There is no doubt that EMU membership offers the prospect of economic gains; as De Grauwe and Schnabl (2004, 243) correctly put it: "The CEE countries have the unique opportunity to complete the catch-up process of an emerging market with the interest rate of a highly developed economy." The usual questions apply, however: who will benefit, when do benefits materialize and how much of these benefits can be reaped? There will be losers and winners in this process, and even winners may want to have their benefits now rather than twenty years from now. In a democratic society, and we are talking about democracies here, these preferences will not only be expressed economically in the market place but also politically by the act of voting. If voters are myopic and biased towards present consumption, they will reward governments who promise present consumption and punish those that ask them to wait. Governments seeking majorities in the voting process may be tempted not only to promise immediate higher consumption, but also to deliver it by increasing transfers, cutting taxes on households, providing subsidies and public goods for consumption. The resulting budget deficit may hamper growth and increase the danger of inflation but secure political survival and societal support for the

Prerequisites of EMU membership are at odds with political incentives

* Professor of Political Economy, Director of the Jean Monnet Centre of Excellence for European Integration, Freie Universität Berlin

** Senior Research Assistant, Jean Monnet Centre of Excellence for European Integration, Freie Universität Berlin

¹ We would like to thank Andreas Kern and Sönke Ehret for their helpful comments and valuable research assistance.

² In this article, we will focus on the new member states from central and Eastern Europe. We also looked at Bulgaria and Romania, since most likely they will join the EU 1 January 2007.

³ The Maastricht criteria set out the economic obligations that need to be fulfilled before adoption of the common currency is granted. In particular, these criteria demand that the budget deficit and total government debt do not exceed 3 percent and 60 percent of GDP respectively. Moreover, compared to those three member countries that boast the highest price stability, applicant states' inflation rates and long-term interest rates may not exceed the reference group's inflation rates and long-term interest rates by more than 1.5 percent and 2 percent respectively. Finally, all countries need to prove their exchange rate stability by fixing their exchange rates for at least two years within the framework of the European Monetary System (ERM II) without devaluing against the currency of another member state.

EU. The immediate political costs associated with necessary economic reforms may induce policy makers particularly in the bigger CEECs to postpone necessary economic adjustment required for entering the euro-zone. The economic rationale may thus conflict with the political rationale.

Long-term prospects and short-term solutions

As is often the case, telling the story of a political dilemma starts within an economic context. Comparing the current per capita income levels of the CEECs with those of the eurozone average and projecting them into the future shows that all CEECs will still need at least one or two generations to catch up with the eurozone member states (see Table 1).

It seems reasonable to assume that new member states will try to speed up the catching-up process. High growth rates require high investment rates. Yet the new member states feature low domestic saving rates. The result is that, with the exception of Slovenia, all of these countries exhibit a considerable savings gap, with Estonia leading the pack with a striking 15.7 percent difference (see Figure 1). This imbalance is reflected in large current account

deficits that are needed to fill the gap between saving and investment rates. These range from around 2 percent in Slovenia to as high as almost 13 percent in Estonia (see Figure 2).

The negative difference between exports and imports of goods and services can be considered as the continued use of foreign savings. From the point of view of welfare economics, this can be understood as imports of resources. From a monetary perspective, this implies capital imports to finance the current account deficit and to stabilize the exchange rate. To run a high current account deficit is a risky strategy. It entails volatilities and may easily end up in a currency and banking crisis. The inflow of foreign capital needed to stabilize the exchange rate cannot be taken for granted. The very open CEECs are not the U.S., their financial markets are rather small and less deep, and their currencies are not the US dollar. Recent experiences in Asia and Latin America give testimony to the havoc wreaked when investor sentiments turn sour. Hence, although some economists have argued that from a theoretical perspective there should be no reason to be concerned about current account deficits (Sachs 1981), recent lessons of many emerging markets should provide a warning that in the medium- to long-run CEECs' exter-

Most of the CEEC have big gaps between saving and investment rates and hence big current account deficits

Figure 1

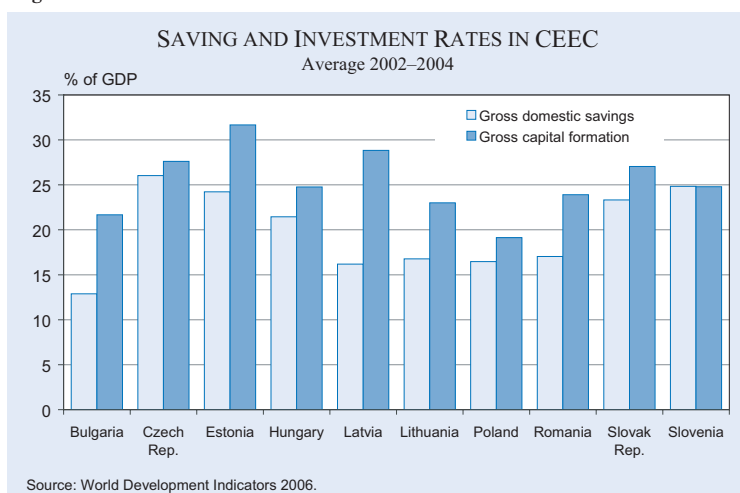


Table 1

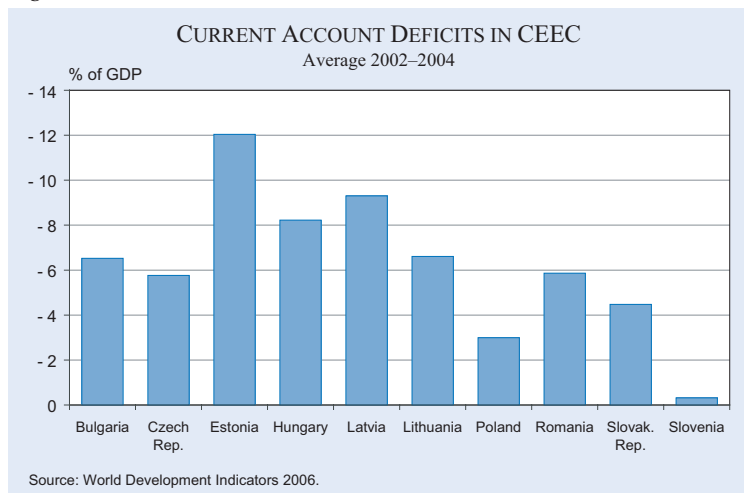
Time for convergence to 100% of EMU-GDP per capita for different growth scenarios

Country	Average growth 2000 to 2005 continued (average growth rates in brackets)	at 8% growth rate
Slovenia	34 years (3.37%)	10 years
Czech Republic	53 years (3.79%)	19 years
Hungary	43 years (4.65%)	21 years
Estonia	21 years (8.04%)	21 years
Poland	76 years (3.39%)	23 years
Slovak Republic	52 years (4.43%)	24 years
Lithuania	25 years (7.58%)	24 years
Latvia	21 years (7.20%)	23 years
Romania	54 years (5.76%)	36 years
Bulgaria	53 years (6.05%)	37 years

Notes: Base year is 2005. EMU's per capital GDP is assumed to grow by 1.5% per year. Countries have been ranked according to the level of real convergence achieved in 2005.

Source: Own calculations based on World Development Indicators 2006.

Figure 2



nal imbalances could pose a threat to macroeconomic stability (Edwards 2004). In the long run, large current account deficits imply risks for monetary stability as well as the fundamentals of an economy, even if most capital inflows to the CEEC are still foreign direct investments rather than more volatile portfolio flows. Yet despite these risks, in the short run CEECs have no politically viable alternative to a current account deficit route if they want to pursue fast economic catching-up.

This all holds true for transition economies everywhere. For the CEEC, however, entering the EU in 2004 has helped a lot to stabilize capital inflows because it fuelled favourable market expectations about future economic stability and growth. These positive expectations would be even reinforced in case of EMU membership. Joining a single currency abolishes the currency risk and reduces the inflation risk. Therefore, expected eurozone membership further increases the confidence of international financial markets. It helps to ensure that capital keeps on coming in and makes large current account deficits less risky in the medium run.

From a purely economic perspective, the policy prescriptions seem to be clear: enter EMU as fast as possible to reduce the danger of currency-induced volatilities. If CEECs wait too long, the result could be large exchange rate movements, which may induce sudden current account corrections; or a currency crisis could be triggered by strong current account movements. If markets become convinced that the euro will not be introduced eventually, then capital could be redirected. Often voiced recommendations that these countries should finish their struc-

tural reforms or complete real convergence first, seem ill advised. The risks associated with such a delay are not worth taking.

To ensure a steady inflow of capital, favourable conditions are needed: price stability is paramount. There is already pressure on prices from the supply side because of the productivity catch-up in these countries. To prevent high inflation, domestic demand has to be in equilibrium with overall supply. This implies that the burden of macroeconomic stability lies on fiscal policy. The size of the needed fiscal adjustment depends on the size of the current account deficit given continued low saving rates and the need for high investment rates. Estimating sustainable levels of the current account is complicated, however, and necessarily depends on the methodology employed and the underlying assumptions about steady state values of the important economic variables. However, if the currently slower growing CEEC, such as Hungary or Poland, tried to speed up the convergence process, then the burden on fiscal policy would be heavier still. Even a simple back-of-the-envelope projection for these countries would end up with very high investment rates and extreme current account deficits, given current low private saving rates and a growth rate of, for example, 8 percent.⁴ This would call for a very prudent fiscal policy with extremely low deficits. Some governments would even have to run budget surpluses to ensure macroeconomic equilibrium between supply and demand and to prevent demand-driven inflation.⁵ This is especially true for the big CEEC with their high fiscal deficits. What this reasoning implies is that the 3 percent deficit margin of the Maastricht fiscal criterion seems to be rather too generous for most of these countries. Table 2 provides an overview of country-specific growth rates (averages of 2003 to 2005) and the country-specific situation of the general government balances. The last column displays some, however crude, assessments of the needs for fiscal adjustment if countries want to speed

up

⁴ While this seems to be an extraordinary high growth rate, it has to be noted that the Baltic countries had even higher ones in the last few years.

⁵ Precise quantitative estimates depend on a number of crucial assumptions of, for example, private saving rates and the marginal product of capital. That is why we only point out the qualitative implications without providing exact numbers.

To ensure a continued inflow of capital, price stability is needed and small fiscal deficits

Table 2

Economic growth, general government balances, fiscal pressures

Country	Strong economic growth above 8%	Moderate growth between 3% and 6%	General government budget close to balance or in surplus	General government budget of – 3% or lower	Fiscal adjustment needed for 8% growth
Bulgaria		x	x		
Czech Republic		x		x	**
Estonia	x		x		
Hungary		x		x	**
Latvia	x				
Lithuania	x				
Poland		x		x	**
Romania		x			*
Slovak Republic		x		x	**
Slovenia		x			*

Note: Growth rates and general government balances are averages of 2003 to 2005.

Sources: Eurostat, WDI.

up economic growth. No star points to a somewhat comfortable situation with regard to the budget balance (like in Estonia), one star (like for Romania and Slovenia) indicates the need for moderate consolidation efforts. A country with two stars seems to be in a bad situation because it would need a reduction in its fiscal deficit to achieve the goal of a higher growth rate at stable prices given the necessary current account deficit.

An economic rock ...

There are quite some lessons to be learnt. The most important one is that fiscal policy becomes a dependent variable and is no longer at the discretion of policy makers. The economic rationale of the catch-up process requires a specific budget strategy to ensure macroeconomic equilibrium, thereby stabilizing low inflation rates and creating confidence in the sustainability of the current account deficit. However, politically this may be very hard to sell. It may be even harder to sell the decision of joining ERM II right away and, later, the eurozone. These decisions entail forgoing monetary sovereignty and the inevitable loss of the exchange rate and monetary policy as policy instruments. This may not come with high costs for small countries, like the Baltics with their already existing currency board arrangements. As the discussion above amply demonstrated, fiscal policy also has only a very limited capacity as a macroeconomic instrument, which will leave CEECs, once in ERM II, without any macroeconomic instrument at all.⁶ The burden of adjustment would then be on wages, prices and employment. At

this stage, this seems to be unacceptable for the big CEEC.

Fulfilling the Maastricht inflation criterion is also not an easy task because it may be judged as overly restrictive. First, ECB monetary policy is based on the eurozone inflation average, whereas the Maastricht inflation criterion judges price stability in comparison to the three EMU countries with the highest price stability. Secondly, the inflation criterion does not take into account that transition countries have structurally higher inflation rates due to the catch-up process itself, which entails different productivity developments in sectors of tradable and non-tradable goods. The former sector, exposed to international competition, experiences higher productivity leaps than purely domestic sectors. As a result, prices and wages in the latter are also pushed up leading to a surge in inflation – the famous Balassa-Samuelson effect.

This productivity induced price pressure could be solved by letting the currency appreciate. Yet, the exchange rate criterion demands that countries willing to join EMU peg their currency to the euro for at least two years, obeying a narrow fluctuation band of 2.25 percent.⁷ This is not enough room to accommo-

⁶ Recent conflicts about monetary policy and “blame games” between governments and central banks in Poland (in 2002) and Hungary (ongoing), as well as reform efforts that reduce the independence of the central bank (Czech Republic in 2000), give testimony to the ongoing struggle of policy makers to keep monetary policy in their reach.

⁷ ERM II came into being in 1997 and has actually a standard fluctuation band of ± 15 percent. Nevertheless, the Commission decided to apply the 2.25 percent band of ERM I as an exchange rate criterion. Note that ERM I de facto collapsed in 1993 due to massive speculative attacks, making the Commission’s insistence on applying the narrow fluctuation margin hard to understand.

Giving up macro-policy sovereignty is politically hard to sell

date the inflationary pressures created by the catch-up process, thereby rendering it very hard for countries observing high economic growth rates to fulfil both the inflation and the exchange rate criterion simultaneously. Indeed, Estonia and Lithuania, which could not even exploit the 2.25 percent margin because they run currency board arrangements that are permitted within the ERM II framework, failed to qualify for eurozone membership in 2007 because they missed the inflation target.

Moreover, ERM II is a tricky economic prerequisite for another reason. As has been forcefully argued before (Begg et al. 2003), a soft peg regime such as ERM II combined with a completely liberalized capital account, which is mandated by the *acquis communautaire*, may become very vulnerable to currency distress and may therefore lead to sudden current account corrections, endangering the convergence process. Capital flows would become more volatile, and more short-term portfolio flows would be attracted under such a regime.

As a result, CEECs are faced with an inflation criterion that is a little bit too strict and in combination with ERM II somewhat contradictory, as well as an exchange rate criterion that is potentially risky.

Fulfilling the Maastricht inflation criterion may be too demanding

... and the political hard place

Given these economic rocks, a reasonable economic policy is necessary, especially with respect to the timing of accession. EMU entry should not be delayed for too long, because CEECs need to ensure the stability of the current account. Yet, too fast an approach is also not viable because the political challenges associated with meeting the prerequisites for euro adoption are even more daunting. We know from modern political economy research that politicians do respond to short-term electoral pressures that are not necessarily in line with the long-run needs of the economy. Therefore, economic policy serves as a tool to garner votes, and policies that are damaging at the polls will rarely be enacted.

Accession to the European Union has created high hopes among the people in the CEECs for a fast increase in their standards of living. These hopes may be easily disappointed. A Eurobarometer poll one year after EU accession showed that 74 percent of the respondents in the new member states consid-

ered their economic situation to be “bad” (European Commission 2005). Thus, governments are expected to deliver exceptional growth rates (as is currently the case in the Baltic states) or face serious electoral punishment. The political instability currently observed in some CEECs regarding government durability can be partly attributed to disappointments stemming from the gap between personal economic gains and individual expectations – Poland, Bulgaria and Hungary are only a few recent examples in this respect.

Voters in CEECs have a clear benchmark for their expectations, which is the income level of the western European countries. They expect fast convergence to these standards. We have shown above that this takes at least one or two generations (see Table 1). It is reasonable to assume that voters are much more short-sighted. They want to have the cake now and eat it soon. This is the catch: growth is needed for economic convergence, but at the same time the populace yearns for fast increases in consumption. This dilemma translates into the challenges for fiscal policy and the government budget. On the one hand, the economic rationale requires fiscal discipline given the aim of long-run growth. On the other hand, voters want governments to enable public and private consumption.⁸ This may help to explain why many of the CEECs boast such high public expenditure rates given their level of economic development, with Hungary even exhibiting an expenditure rate of more than 50 percent of GDP. If governments follow the economic rationale, re-election is seriously at risk. If they follow the political rationale, they may stay in power but a fast increase in economic wealth will not be attainable.

Looking at the expenditure rates of the CEECs, it is evident that the bigger countries, which tend to be more heterogeneous in terms of preference distributions and social cleavages within the population, exhibit higher spending levels. Parties and candidates compete for political power by offering pork and redistribution: the more diverse the populace, the more spending is needed to secure office. This is even more necessary once economic growth slows down.

⁸ Alesina and Fuchs-Schündeln (2006) try to explain the preferences for redistribution of west Germans and east Germans. They find that people who grew up in the Communist part have much stronger preferences for redistribution and state intervention. They attribute these findings to the experience of a paternalistic, intrusive state under socialism. We would expect the same pattern in all CEECs, since they all share a similar socialist experience.

From this perspective, the Baltic states are in a favourable position: they are small, and had enormous growth rates in the last two years, ranging from 7.5 percent in Lithuania up to 10.8 percent in Latvia. As a result, a political window of opportunity

to enter EMU has opened up there. However, the tight inflation criterion prohibits their quick accession. It is doubtful that even under these favourable economic circumstances, governments have the political willingness to implement the austerity measures that would be needed to curb inflation.

The three biggest CEEC are in the trickiest situation, and similar arguments could also be made with respect to Slovakia. They have rather high fiscal deficits, not only compared to the 3 percent Maastricht criterion but also with respect to what would be necessary given their current account deficits (see Table 3). Yet engaging in budgetary retrenchment is politically difficult. As a result, entering the ERM II straightjacket is postponed and the eurozone is officially considered as not advisable (a position currently taken by Poland). Political decision makers simply have no incentive in these countries to take on the front-loaded costs of approaching EMU membership, demanding painful fiscal adjustment and the giving up of the monetary emergency exit. The costs are immediate and would be felt at the next elections, while the timing for reaping the benefits remains unclear. The EMU entry date is not fixed and depends on the fulfilment of the not-easy-to-achieve and somewhat contradictory inflation and exchange rate criteria. Policy makers would lose their last crucial economic instrument that is a valuable tool for political competition.

Given this political dilemma, we do not expect the Czech Republic, Hungary and Poland to change their current reluctance to introduce the euro anytime soon. Given the current growth rates, budgetary conflicts and the political dilemmas pointed out above, we attempted to make an informed guess about EMU entry prospects; these are summarized in Table 3.

The Baltic states are on track and should therefore manage to introduce the euro, once the inflation criterion is fulfilled. This will happen when the currently very high growth rates slow down and the strong growth in domestic demand recedes. Slovakia is in a somewhat unclear position, having entered ERM II,

Table 3

Possible Scenarios for EMU entry

Fast entry 2007	By 2010	Intermediate, still unclear	Longer term, but still conceivable	Another Sweden?
Slovenia	Estonia, Latvia, Lithuania	Slovakia	Czech Republic	Hungary, Poland

but still needing to consolidate its budget. The Czech Republic suffers from the problems explained above, but very recently experienced a surge in economic growth, which could open up a window of opportunity for policy makers. Finally, Hungary and Poland are in a situation in which striving towards the euro seems politically not viable. We expect them, just as Sweden, to postpone EMU entry for the foreseeable future.

Evasion tactics and how to prevent another Sweden

All CEECs are so-called ‘members with a derogation’ and are obliged to introduce the euro once they fulfil the Maastricht requirements. Unlike Great Britain and Denmark, they do not have an opt-out clause. However, the belief that the euro is simply an option is widespread in the CEECs. A recent Eurobarometer poll (2006) showed that in every CEEC surveyed (Bulgaria and Romania were not included), a great majority of the respondents thought that euro introduction is not obligatory. As a result, a strategy of blaming the need for painful fiscal adjustments on the introduction of the euro will not work in any of these countries. Sweden provides a good example of how to avoid the euro. Countries not willing to incur the economic and political costs may follow this example and postpone entry into ERM II – indefinitely if politically necessary.

Given these economic and political realities and to ensure sustainability of the CEECs’ economic catch-up strategy, fast entry into EMU is essential. If market participants became convinced that a country would not introduce the euro in the foreseeable future, a redirecting of capital flows to other CEEC would likely occur, entailing a current account reversal with all its adverse consequences for financial stability and sustainable economic growth. Hence, a combination of domestic policy measures and political incentives by the EU seems to be necessary. Introducing the right institutions might help mitigate the political obstacles.

The three big CEEC have no incentives to incur the economic and political costs of EMU but are obliged to introduce the euro

At the domestic level, CEECs should encourage private savings to reduce the current account deficit in the long run. This could be achieved, for example, by introducing pension reforms that induce households to rely less heavily on pay-as-you go pension schemes and more on personal savings (see Bolle and Pamp, forthcoming). Some CEECs have started moving in that direction, but much more is needed. In addition, growth strategies of the CEECs have to be linked to a strengthening of the export base, thereby diminishing the current account deficit. Both of these strategies are aimed at the medium to long run. Nevertheless, CEECs have to stabilize capital inflows by widening and deepening domestic financial markets. Given high capital inflows, efficient allocation becomes paramount and overheating as well as asset-price bubbles are serious threats in fast growing transition economies (see Bolle and Meyer, 2004).

Beyond domestic efforts, the European Union should engage in technical as well as financial assistance to help CEECs tackling their budgetary dilemma. With regard to technical assistance at the domestic level, one may think of introducing budgeting systems for improved governance like “Zero Base” and “Outcome Focused Budgeting” in Great Britain (Ellis and Mitchell 2002). At the European level, already existing budget coordination mechanisms in the framework of the broad economic policy guidelines could be strengthened with the help of institutions like the Bureau of European Policy Advisers (BEPA). This may even lead to an annual review process of the progress made by CEECs towards EMU membership. This would resemble the pre-accession process, where the Commission closely monitored progress and published annual reports. This institution building could be complemented by financial assistance in a similar way as the EU’s pre-accession instruments that provided funds to CEECs in return for commitments to implement the prerequisites of EU accession. Countries undertaking the necessary steps towards the eurozone could be financially rewarded through investment grants that should be earmarked for investment spending. The institutional and financial incentives together could also help domestic policy makers in CEECs to play soft tight-hand strategies with their voters.

Eurozone enlargement is a political process. Simply telling the CEECs to reduce their budget deficits and in some cases even create surpluses is not an advice that policy makers in those countries

could follow easily, given high hopes of the populace and next elections always just around the corner. Providing positive political incentives and offering external constraints would make it easier for policy makers to implement the necessary economic steps.

References

- Alesina, A. and N. Fuchs-Schündeln (2005), “Good bye Lenin (or not?): The Effect of Communism on People’s Preferences”, *NBER Working Paper* no. 11700.
- Begg, I., B. Eichengreen, L. Halpern, J. von Hagen and C. Wyplosz (2003), “Sustainable Regimes of Capital Movements in Accession Countries”, *CEPR Policy Paper*, no. 10.
- Bolle, M. and T. Meyer (2004), “Euro Adoption and Growth in Central Europe: Managing a Political Process”, *Intereconomics* 39, 236–241.
- Bolle, M. and O. Pamp (forthcoming), “Sustainable Convergence and Pension Reform in Central and Eastern Europe”, in A. Stuchlik, ed., *Rentenreform in Mittel- und Osteuropa. Impulse und Politikleitbilder für die Europäische Union*. Wiesbaden: VS-Verlag für Sozialwissenschaften.
- De Grauwe, P. and G. Schnabl (2004), “EMU Entry Strategies for the New Member States”, *Intereconomics* 39, 241–246.
- Ellis, K. and S. Mitchell (2002), “Outcome-focused Management in the United Kingdom”, *OECD Journal on Budgeting* 1, 111–128.
- European Commission (2005), “Eurobarometer – Public Opinion in the European Union”, *Standard Eurobarometer* 63.
- Edwards, S. (2004), “Thirty Years of Current Account Imbalances, Current Account Reversals, and Sudden Stops”, *IMF Staff Papers* 51, 1–49.
- Sachs, J. (1981), “The Current Account and Macroeconomic Adjustment in the 1970s”, *Brookings Papers on Economic Activity* 1.
- The Gallup Organization Hungary (2006), “Introduction of the euro in the New Member States – Analytical Report”, *Flash Eurobarometer*, no. 183.

Beyond domestic efforts to diminish current account deficits, the EU should give technical assistance

THE MONETARY POLICY CONSEQUENCES OF ENLARGEMENT

CARSTEN HEFEKER*

Most real effects of the extension of European Monetary Union (EMU) to new member states have arguably already been realized. EMU might increase trade because uncertainty from changing currency values disappears, and for the same reason it might also increase investment. But given that many of the candidates for enlargement are already de-facto members of EMU, as several operate currency boards or have other forms of more or less tight pegs to the euro, one should be forgiven for not expecting tremendous changes in these areas. However, enlargement is likely to have an impact on the way monetary policy is set. With enlargement of the common currency area there will also be an enlargement of the council which sets the policy of the European Central Bank (ECB). New members in the council could change the policy stance of the larger institution. Moreover, a larger currency area might imply changes in the optimal policy with enlargement. Both changes could have substantial influence on the way monetary policy is set and how the private sector in member countries reacts to these changes.

Changes in the ECB council

The new member countries are characterized by shock structures that are different from those of the older members. Especially the larger current members often exhibit a low if not negative correlation to supply and demand shocks in the new member states (Fidrmuc and Korhonen 2003). This implies that new members will often prefer a different monetary policy compared to that of current members, reinforcing the problem that one-size common monetary policy

does not fit all. Moreover, some of these countries are still characterized by higher growth rates and therefore often have stronger price pressures due, among other factors, to the Balassa-Samuelson effect. This again might imply that new board members bring different preferences to the ECB council meetings. It does not mean, however, that new members will favor more inflation as is often feared. It is just as likely that they will push for a tighter monetary policy in order to stem price pressures in their national economies (Kenen and Meade 2003).

Of course, all this would mean nothing if all ECB members were to represent only the European interest and if all of them would have the same preferences concerning the trade-off between inflation and stabilization of the real economy. In this case, additions to the monetary union would hardly influence the common monetary policy stance, as new member states are economically small and thus unlikely to influence the European average by much. However, this interpretation is probably too benign. More and more evidence belies the officially voiced position that decisions are taken by consensus and that the ECB council decides solely with a truly European perspective. This is not surprising as the whole point of having regional representatives on the council is to have someone representing regional perspectives. Regional representation is meant to ensure that more adequate information on regional developments is available to the council and also to ensure that regional interests influence the common decision. Accordingly, empirical evidence suggests that regional delegates vote with a distinct regional perspective, something that is also found in other federal central banks, such as the US Federal Reserve System and the German Bundesbank before EMU. There is also suggestive evidence that this is not different in the ECB council (Meade and Sheets 2002, Heinemann and Hufner 2004).

This being the case, one might expect that the whole monetary stance of the ECB could change if new members were to bring different preferences or needs for monetary stabilization to the council meetings. To avoid too big a shift in monetary policy, a



Regional representatives to the ECB vote with a regional perspective

* University of Siegen and CESifo.

plan has been accepted by the European Council that mandates a change in the ECB board once the number of member states reaches 15 (European Central Bank 2003). The ECB proposed a two-stage reform, depending on the number of members. In a first step, applicable for a monetary union of 15 to 21 members, two groups would be formed, the first comprising the five largest economies (measured in terms of GDP and the size of the banking sector). This group would have between four and five votes, the rest being rotated among the second group of smaller economies. The overall number of votes for national representatives would be restricted to 15. A third group of countries would be formed once the number of member states exceeds 21. In this case, the first group would have 4 votes (so that members in this group will be entitled to vote 80 percent of the time), the second group, comprising half the member states, would rotate through eight votes, and the smallest economies would share three votes (see Table). Since members in the respective groups rotate through the assigned voting rights, larger countries are more often entitled to vote than smaller ones. However, at any given time, all countries that do vote have the same weight and all members are invited to discuss policy decisions, so that non-voting countries are not excluded and could contribute their opinion and expertise. The members of the board, however, will retain full voting rights, so that the overall number of voting members on the council will remain at 21.

This reform, accepted by the European Council and ratified in all members states, is a combination

of rotation, like it is practiced in the US Federal Reserve System where some districts are not entitled to vote all the time, and the system of representation used in the International Monetary Fund, where smaller countries form groups. Of course, the reform implicitly leads to a higher centralization of monetary policy, because relative power is shifted to the board, and a slight correction of the under-representation of larger countries that currently exists in “the one country, one vote” setup is achieved. The change in the council incidentally follows the example of the extension of the German monetary union to the former GDR. Then as well, every federal state (Bundesland) was no longer represented in the council of the German Bundesbank which would have meant 16 regional representatives in addition to nine board members. Instead, groups of federal states were formed and the total number of regional representatives was reduced to nine, while the number of board members was restricted to a maximum of nine (of which not all are filled). This implicitly gave more power to the Bundesbank board just like the ECB reform gives more power to the ECB board (Hefeker 2003).

Increased divergence of monetary transmission

A more important change will probably follow from the fact that the new board, taking decisions in consensus or voting on them, will face the fact of an increased divergence of economic structures among member states after enlargement. Different indus-

Rotation System in the Enlarged Euro-Area Central Bank Governing Council

		<i>Euro Area composed of 15 or more members</i>					
		<i>Number of governors in the council</i>					
		16	17	18	19	20	21
1st group	Votes/governors	5/5	5/5	5/5	4/5	4/5	4/5
	Voting frequency	100%	100%	100%	80%	80%	80%
2nd group	Votes/governors	10/11	10/12	10/13	11/14	11/15	11/16
	Voting frequency	91%	83%	77%	79%	73%	69%
Votes		15	15	15	15	15	15
		<i>Euro Area composed of 22 or more members</i>					
		<i>Number of governors in the council</i>					
		22	23	24	25	26	27
1st group	Votes/governors	4/5	4/5	4/5	4/5	4/5	4/5
	Voting frequency	80%	80%	80%	80%	80%	80%
2nd group	Votes/governors	8/11	8/12	8/12	8/13	8/13	8/14
	Voting frequency	73%	67%	67%	62%	62%	57%
3rd group	Votes/governors	3/6	3/6	3/7	3/7	3/8	3/8
	Voting frequency	50	50	43	43	38	38
Votes		15	15	15	15	15	15

Source: Monthly Bulletin of the ECB, May 2003.

To avoid too big a shift in monetary policy, a reform of the ECB board was agreed

trial structures, different banking systems, and different degrees of labor market centralization imply that the transmission of monetary policy will become more unequal than in the existing monetary union where a considerable convergence of transmission seems to have been taking place in recent years (Angeloni and Ehrmann 2003). Because of this convergence, starting even before the introduction of the euro, monetary policy tends to have largely similar effects in most euro-zone countries. However, the convergence among the candidates for new membership is less advanced. Monetary policy works differently in these countries and it is asymmetric within the group of candidate countries (Ganev et al 2002, de Haan et al. 2005, Egert and McDonald 2006). What does this imply for the monetary policy of the ECB?

A stronger divergence in the transmission of monetary policy should lead the ECB to give more attention to those countries which diverge from the average (Gros and Hefeker 2002, Benigno 2004). This recommendation simply follows from the fact that more variability in output and inflation results in increasing losses in any country. The more a country diverges from the average, the less adequate is a policy tailored to the average of the member countries, and hence the more risk there is that these countries will suffer from inflation and output variability. Hence, more weight should be placed on developments in countries which are further away from the average and for which transmission of monetary policy is highly asymmetric.

This, of course, presumes that differences in transmission are well known and can be adequately addressed by the central bank. But this need not be the case in the larger EMU, at least in the immediate and foreseeable future. The transmission of monetary policy is not only asymmetric, it will also be uncertain because the ECB might not fully know about how monetary policy translates into real variables in new member states, not least because many of these countries are still in a process of restructuring (De Grauwe and Senegas 2004). The sensible response of a central bank to increased uncertainty is to react less aggressively to economic shocks, simply because it is prudent to be less active when the outcomes of one's actions are uncertain (Brainard 1967). A highly asymmetric and uncertain transmission of monetary policy hence implies that the ECB will pursue a less active monetary policy than it has

been doing in the past. While the ECB has been frequently criticized for pursuing a less active strategy than other central banks such as the US Fed, this criticism is not justified once one realizes that monetary policy in the eurozone is inherently much more difficult than in other currency areas. The logic for this is of course grounded in the fact that EMU member states are more diverse than those of other single currency areas, and that the ECB, at least initially, was faced with uncertain territory. This problem is reinforced by enlargement of EMU and so even more prudence can be expected from the ECB.

The changed central bank reaction should obviously have consequences for financial markets and the private sector as well. Private agents will realize a lower ability and willingness of the common central bank to respond to economic shocks or to intervene to compensate for the negative effects of too generous wage and price increases. While the ECB has always emphasized that it is not attempting to stimulate employment or output with the help of monetary policy, it has nevertheless intervened to stabilize the economy in response to economic shocks (albeit preserving the primacy of a low inflation rate). Wage and price setters should realize that monetary policy will be even less available as an instrument of adjustment in a larger monetary union than before. This should result in less aggressive wage setting by unions and more careful price setting by enterprises (Hefeker 2005). In a sense, this might have beneficial effects, as wage and price setters should place no expectations on the central bank concerning a possible bail-out and instead should make greater efforts themselves to become less vulnerable to economic shocks. While this had been the case for the smaller member countries in the European Monetary System even before the introduction of the euro, where countries like the Netherlands, Austria and Belgium had long ago given up their independent monetary policy and pegged their currencies closely to the deutschmark, this was less the case for the larger countries in the EU. The same applies to the new member states; there are some, like the Baltics and Slovenia that gave up independent monetary policy from the beginning, while others, like Poland and Hungary, will have to do so upon entering EMU. Enlargement of EMU will imply at least for the larger countries that they will also have to adjust to a less active monetary policy which is no longer able to address national needs.

Differences in transmission mean that ECB policy must be more cautious with all the consequences for financial markets and the private sector

Increased uncertainty about central bank behavior

But uncertainty will not only increase for the central bank. One can also expect the larger ECB council to become less predictable for financial markets and the private sector, at least initially, than the smaller council had been. This has to do with the fact that new members with potentially different preferences will enter the council which might shift the monetary policy of the ECB. More members can shift the majority on preferred monetary policy in comparison to the previous situation because systematically different preferences influence the median position that determines policy (Hefeker 2003). Some observers, in contrast, claim that the ECB council is dominated by some members, and that the official ‘one country, one vote’ system does not adequately reflect the de-facto power distribution (Fatum 2006). However, even in this case it is well possible that a larger group might effect a different outcome as relative powers in the council could change. In fact, even observers from national central banks argue that the envisaged change in the council’s decision-making system will lead to more uncertainty, as nobody so far has any idea on how exactly decisions are going to be taken in the larger council (Servais 2006).

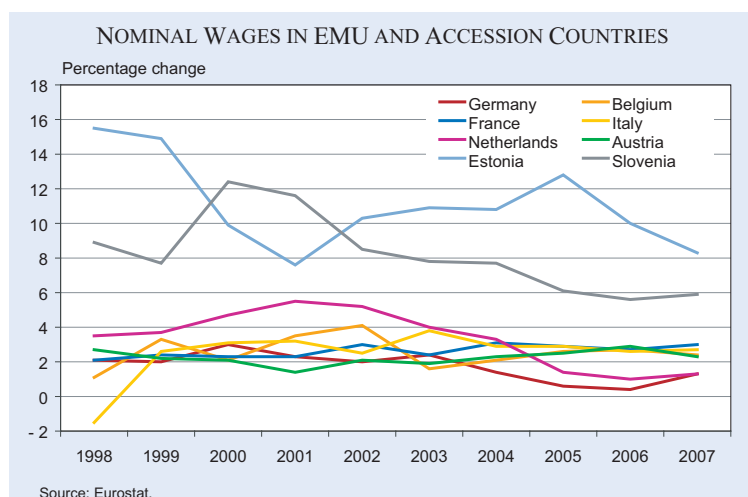
This at least is what happened in the early years of the newly created ECB (Goldberg and Klein 2005). It took financial markets a considerable time to decipher the position of the new institution and to form an adequate perception of what the position, behavior and reaction of the ECB to any given development would be. Only over time did markets and the private sector learn what type of reaction could be expected from the new central bank to real developments in member states. There is little reason to expect that there will not be a more or less prolonged period of uncertainty this time as well.

Again, it is reasonable to expect that the private sector will adapt its behavior to any increase in the uncertainty about the type of central bank it faces. Just as the central bank becomes less active when setting monetary policy in reaction to uncertainty, the private sector will become less aggressive in terms of wage and price setting in response to

increased uncertainty about the monetary authority’s reaction function. Theoretical work has shown that an uncertainty reaction function of the central bank will lead to more restraint in unions’ wage setting (Grüner 2002), and there is empirical evidence as well to show that for certain types of national labor markets a disciplinary influence of increased uncertainty on wage setting behavior of labor union can indeed be found (Grüner et al. 2005). Preliminary evidence for the eurozone accordingly shows that wage setting in the common currency area has become less aggressive in response to the introduction of EMU (Posen and Gould 2006). This is reflected in the moderate development of nominal wages in recent years (see Figure). The positive effect on employment should be reinforced when EMU is enlarged.

Not only the private sector should be influenced by the increased uncertainty about the reaction function of the central bank, government policy should adapt as well. Losing monetary policy as an alternative adjustment instrument in response to economic shocks should increase the willingness of governments to implement politically undesirable structural reforms in labor and product markets. (Hefeker 2006). Governments, which are usually averse to reforms in product and labor markets because of the political cost of reforms, will usually rely on the central bank to help stabilize the economy in case of economic shocks. When monetary policy can no longer provide this service, more efforts have to be undertaken by the private sector, and the government might itself be forced to help make the economy less vulnerable to shocks by increasing product and labor market flexibility. A loss of monetary policy will thus even pressure reluctant governments to

When markets are more uncertain about the ECB’s reaction function, wage setting will be less aggressive and governments will undertake more reforms



undertake more reforms. An increase of uncertainty about the central bank's behavior will reinforce this process as it is, from the point of view of government, akin to a loss of monetary policy as an instrument of adjustment or a shift to a more conservative central bank.

Incidentally, this result has also implications for the debate about central bank transparency (Geraats 2002). Observers often criticize the ECB for being not open enough and being less transparent than other central banks, like the Bank of England or the Swedish National Bank. While there are many good arguments for high central bank transparency, the argument introduced above suggests that not having full transparency can have beneficial effects on wage setting and government reform policy.

Enlargement is likely to have positive effects

While conclusions about the likely effects of an enlargement of EMU are highly speculative and subject to a large degree of uncertainty, one conclusion at least seems quite clear: There is no indication whatsoever that the monetary policy of the ECB will become more active than it is currently. As argued above, it is likely that the larger central bank's policy will become less active because of higher transmission uncertainty and because economic divergences among member countries will increase, making it even less likely that the ECB will tailor its policy to the need of any particular group of countries. This confirms the old conclusion that monetary policy in a monetary union is less of a ready-to-use instrument than national monetary policy implemented by a national institution.

While this situation is relatively new for Germany, it is well known for the smaller members of the old EMU, where countries like Belgium, Austria and the Netherlands were used to having a monetary policy aiming mainly at stabilizing exchange rates so that national adjustment had to come from other areas and policies. And it is also a well known principle in the Baltic countries and Slovenia. Germany, and possibly Poland and Hungary, will have more problems with acknowledging that monetary policy is lost for good as an instrument for stabilization. More adjustment will instead have to come from the labor markets and the deregulation of product markets and the service sector.

Enlargement is therefore likely to be a continuation and reinforcement of a process in which member states increasingly realize the loss of an economic policy instrument which had been used more or less freely before monetary union. Larger states will have more problems adjusting to this situation than smaller ones, but eventually they will also have to do so. In the best case, enlargement can work to speed up reforms. Enlargement is thus as much in the interest of the older members as it is in the interest of the candidates. If, however, larger members fail to realize the implications of enlargement, there will be transitory adjustment costs.

References

- Angeloni, I. and M. Ehrmann (2003). "Monetary Transmission in the Euro Area: Early Evidence", *Economic Policy* 37, 469–501.
- Benigno, P. (2004). "Optimal Monetary Policy in a Currency Area", *Journal of International Economics* 63, 293–320.
- Brainard, W. (1967). "Uncertainty and the Effectiveness of Policy", *American Economic Review* 57, 411–425.
- De Grauwe, P. and M. Senegas (2004). "Monetary Policy Transmission Asymmetries: Some Implications for EMU and its Enlargement", *Journal of Common Market Studies* 42, 757–775.
- De Haan, J., S. Eijffinger and S. Waller (2005). *The European Central Bank: Credibility, Transparency and Centralization*, Cambridge: MIT-Press.
- Egert, B. and R. MacDonald (2006). "Monetary Transmission Mechanism in Transition Economies: Surveying the Surveyable," CESifo Working Paper 1739.
- European Central Bank (2003). "The Adjustment of Voting Modalities in the Governing Council", *ECB Monthly Bulletin*, May, 73–83.
- Fatum, R. (2006). "One Monetary Policy and 18 Central Bankers: The European Monetary Policy as a Game of Strategic Delegation", *Journal of Monetary Economics* 53, 659–669.
- Fidrmuc, J. and I. Korhonen (2003). "Similarity of Supply and Demand Shocks between the Euro Area and the CEECs", *Economic Systems* 27, 313–334.
- Ganev, G., K. Molnar, K. Rybinski and P. Wozniak (2002). "Transmission Mechanism of Monetary Policy in Central and Eastern Europe", Center for Social and Economic Research, Warsaw, CASE Report 52.
- Geraats, P. (2002). "Central Bank Transparency", *Economic Journal* 112, F 532–565.
- Goldberg, L. and M. Klein (2005). "Establishing Credibility: Evolving Perceptions of the European Central Bank", *NBER Working Paper* 11792.
- Gros, D. and C. Hefeker (2002). "One Size Must Fit All. National Divergences in a Monetary Union", *German Economic Review* 3, 247–262.
- Grüner, H. (2002) How Much Should Central Banks Talk? A New Argument, *Economics Letters* 77, 195–198.
- Grüner, H., B. Hayo and C. Hefeker (2005). "Monetary Policy Uncertainty and Unionized Labor Markets", European Central Bank Working Paper 490.
- Hefeker, C. (2003). "Federal Monetary Policy", *Scandinavian Journal of Economics* 105, 643–659.
- Hefeker, C. (2005) Uncertainty, Wage Setting and Decision Making in a Monetary Union, *CESifo Working Paper* 1485.
- Hefeker, C. (2006). "Monetary Policy Uncertainty and Economic Reforms", *CESifo Working Paper* 1767.

Monetary policy in a monetary union is less active than that of a national central bank

Heinemann, F. and F. Hüfner (2004). "Is the View from the Euro-tower Purely European? National Divergence and ECB Interest Rate Policy", *Scottish Journal of Political Economy* 51, 544–558.

Kenen, P. and E. Meade (2003). "EU Accession and the Euro: Close Together or Far Apart?", *International Economic Policy Briefs* 03-9, Institute for International Economics.

Meade, E. and N. Sheets (2002). "Regional Influences on U.S. Monetary Policy: Some Implications for Europe", Board of Governors of the Federal Reserve System, *International Finance Discussion Paper* 721.

Posen, A. and D. Gould (2006). "Has EMU Had Any Impact on the Degree of Wage Restraint?" Institute for International Economics, *Working Paper* 06/6.

Servais, D. (2006). "The Future Voting Modalities of the ECB Governing Council", Oesterreichische Nationalbank, Proceedings of Workshops 7/2006, 246–264.

UNFINISHED BUSINESS? THE ECB REFORM AHEAD OF EURO AREA ENLARGEMENT¹

HELGE BERGER*

Central banks like to be known as institutions with steady hands, but this does not mean that they do not change – quite to the contrary. The US Federal Reserve System (Fed) re-shaped the way in which it had reached decisions until the 1930s, the Bundesbank reorganized in the late 1950s and again in the 1990s, as did the Swedish Riksbank, the Bank of England, as well as numerous other central banks during this period. The ECB reform of 2003 is only the latest addition to that list.

These changes were aimed at the efficiency of the decision-making framework for monetary policy. For instance, the Bundesbank reform of 1992 prevented a significant increase in the number of voting state governors in its Central Bank Council due to German unification. Before the reform, each state had a representative in the committee, and without reform, membership would have exceeded 22 – a number that, according to the Bundesbank, “would have greatly complicated that body’s decision-making processes” (Bundesbank 1992, p.50). In addition, the reform aimed at strengthening the position of the Directorate within the council to ensure a federal perspective. And the asymmetric rotation system within the Federal Open Market Committee (FOMC) is a direct result of an attempt to secure fair representation of the economic weight of regional Fed districts in US monetary policy (Meltzer 2003).

With an eye on euro area enlargement, the ECB reform of 2003 moved into similar directions. The reform limited the number of national central bank governors voting in the Governing Council to 15,

irrespective of the number of euro area members and introduced an asymmetric rotation scheme organizing the way governors will exercise these voting rights once membership exceeds the number of votes.² As euro area membership increases, governors will be divided into two and then three groups out of which they rotate into a limited number of voting seats. Country representatives will be allocated to groups by economic size, and groups encompassing larger countries hold more voting rights in the Governing Council. The open question is whether this will be enough.

Searching for benchmarks to evaluate the ECB’s state of preparedness for euro area enlargement, three basic issues stand out: First, how many people should be responsible for monetary policy decisions? Second, how much weight should be given to central or regional representation in decision-making? And, lastly, should regions be represented according to their economic weight?

Three principles of optimal central bank design

Size

Size matters, when it comes to the efficiency of monetary policy making, and to some extent bigger may be better. A larger monetary policy committee (MPC) may be better able to form a view on the state of the economy than relying on a single individual (Gerlach-Kristen 2006). Faced with an uncertain environment, MPC members pool individual information, cooperate on information processing, and will, as a rule, form better decisions with a smaller tendency to go to extremes (Blinder 1998, Riboni and Ruge-Murcia 2006). Blinder and Morgan (2005) and Lombardelli et al. (2005) second this argument based on empirical results from experiments.

But larger MPCs also come at a cost. One argument is that the information processing advantages of



Euro area enlargement necessitates ECB reform according to size, centralization and representation

* Freie Universitaet Berlin & CESifo.

¹ The paper draws heavily on Berger (2006). See Sibert (2006), Fujiki (2005), and Gerling et al. (2003) for relevant surveys.

² ECB (2003). See, inter alia, Hefeker (2002), Berger (2002), Dvorsky and Lindner (2003), Meade (2003), Berger et al. (2004), de Haan et al. (2004).

larger MPCs are likely to be diminishing because members may have an incentive to “free-ride” on the efforts of others. In addition, decision-making costs are likely to increase exponentially with MPC membership (Berger 2006). Larger MPCs will spend considerable more time just taking note of positions and “sounding each other out” bilaterally before or during meetings. This is a particularly relevant scenario in consensus-based MPCs such as the Fed and the ECB. And while effective leadership by the board or directorate will surely be a limiting factor, there is no denying that larger MPCs will have to spend more time and effort on decision making than smaller MPCs.

Weighing costs and benefits, the optimal size of a monetary policy committee is likely to be a moderately large number. To provide perspective, Table 1 (upper panel) shows the distribution of central bank governing bodies that are concerned with setting policy goals as well as the distribution of bodies implementing and/or deciding monetary policy. The median in both categories falls into the 7 to 9 and 10 to 12 member range, respectively. The median MPC surveyed by Fry et al. (2000) has 5 to 10 members. The lower panel suggests that the ECB’s Governing Council, with 18 voting members in 2006, is among the larger MPCs, comparable only to the Fed’s FOMC or the pre-1999 Central Bank Council of the German Bundesbank. If, however, euro area membership were to increase to 24 members – a

likely scenario assuming entrance of the ten new EU member countries as well as Rumania and Bulgaria – the Council would comprise 30 members. And while the 2003 ECB reform limits the number of voting members to 21, actual meeting participation is likely to be higher. Remarkably, even the ECB (2003, p.83) seems to consider this problematic: “[Th]e participation of *all* [emphasis in original] governors at the meetings of the Governing Council will not necessarily make deliberations easier ...”

Centralization

The ratio of centrally appointed to regionally appointed MPC members is a matter of concern if regions differ in economic terms and regional MPC representatives display “home bias”, focusing less on the area aggregate than on developments at home. It is probably safe to assume that some of the differences in economic developments within the euro area will continue to persist (de Haan et al. 2004, Giannone and Reichlin 2005). Moreover, there is empirical evidence of regional influences along these lines in federal central bank systems such as the Fed and the Bundesbank (Meade and Sheets 2005, Berger and de Haan 2002).

Against this background, one direct benefit of a higher degree of MPC centralization is a reduction in the regional bias in decision making of regionally appointed committee members. Centrally appointed members are more likely to focus on area-wide targets such as Eurostat’s weighted HCPI index (e.g., von Hagen and Süppel 1994).

On the other hand, Moser (1999) and Hallerberg (2002) point out that regional representation can foster the institution’s independence by adding further veto players on the political side. The Bundesbank seemed to support this view, when it called the presence of regional governors in the Central Bank Council an “important element in the Bundesbank’s ... independence” (Bundesbank 1992, p.49–50). In addition, Goodfriend (2000), Berger (2002), and Maier et al. (2003) argue that having regional representatives within the Council

Too big a monetary policy committee is counterproductive

Table 1
Number of members in governing bodies 2003

(a) Distribution

	Distribution of Members (in percent)					Obs.
	1–3	4–6	7–9	10–12	≥ 13	
Policy Committees	4	28	47	11	10	50
Implementation Committees	4	10	10	40	40	95

(b) Selected Examples

Bank (Federal)	Number	Bank (Central)	Number
Bundesbank pre-1957	10	Australia	9
Bundesbank 1998	17	Canada	7
Fed	12 (19) [#]	New Zealand	1
ECB (2006)	18	Sweden	6
ECB (EMU24)	21 (30) [#]	UK	9

[#]: The FOMC has 12 voting members, but 19 regular members participate in FOMC meetings. Taking into account the 2003 ECB reform, the ECB Governing Council would have 21 voting members and 30 members overall if euro area membership increased to a hypothetical 24 (“EMU24”), comprising the current 12 members, the ten recent EU entries, and Bulgaria and Rumania.

Source: Berger (2006).

Table 2

Structure of governing bodies 2003

<i>(a) Distribution</i>					
	<i>Distribution (in percent)</i>				<i>Obs.</i>
	<i>Sectoral representation</i>		<i>Regional representation</i>		
	Yes	No	Yes	No	
Policy Committees	8	92	8	92	50
Implementation Committees	7	93	7	93	94

<i>(b) Selected Examples</i>				
	<i>Board</i>	<i>Regional Central Bank governors</i>	<i>Overall council members</i>	<i>Political weight of Governors</i>
<i>Federal central bank models</i>				
Bundesbank 1998	8	9	17	52.9
Fed	7	5 (12)	12 (19)	41.7 (62.2)
ECB (2006)	6	12	18	66.7
ECB (EMU24)	6	15 (24)	21 (30)	71.4 (80.0)
<i>Centralistic central bank models</i>				
Australia	9	0	9	0
Canada	7	0	7	0
New Zealand	1	0	1	0
Sweden	6	0	6	0
United Kingdom	9	0	9	0

Notes: Numbers without (with) parentheses indicate voting (non-voting) membership.

Source: Berger (2006).

could enhance the precision with which regional economic data is perceived and analyzed.

The implication is that there are advantages in an intermediate degree of centralization. And, indeed, while Table 2 shows that a majority of central bank governing bodies is fully centralized, larger federal central bank systems tend to have regional MPC representation.³ Germany, the United States, and the euro area all fall into this category – another one would be Switzerland (Lybeck and Morris 2004). Note, however, that the ECB shows the smallest degree of centralization: the voting rights attached to regional representatives in the Bundesbank's Central Bank Council and the Fed's FOMC are much lower, and the gap is bound to increase as EMU membership increases. Similar conclusions hold for total MPC membership including non-voting governors.

Representation

Taking the degree of centralization of MPCs as given, the question is whether the voting rights of regional governors (or their otherwise defined political clout

within the committee) should be in line with the economic weight of the region they represent. In other words, should the committee be organized along the "one region, one vote principle"?

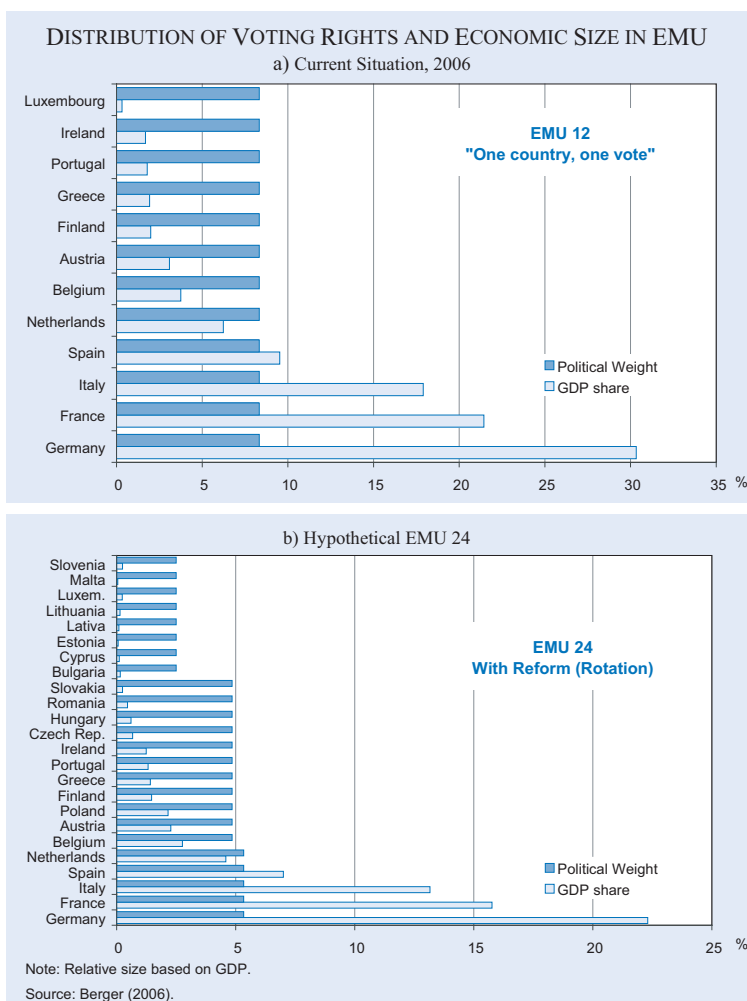
There are arguments pointing in both directions. If regions differ in economic as well as preference terms and their representatives show signs of a "home bias", misrepresentation of economic size could lead to MPC decisions deviating from policies chosen by a social planner looking at the weighted area average. For instance, a majority of over-represented smaller member states burdened with inflation above the weighted inflation average might favor too contractionary a policy stance. To avoid regional bias in monetary policy, voting weights should match regional economic weight.⁴ On the other hand, the "one region, one vote" principle could foster political stability. Assume that regional policy preferences are subject to shocks of similar volatility with the potential to distort MPC decisions. Then a more equal distribution of voting rights can help to moderate the

Regional representation should reflect the countries' economic weight

³ The same holds for sectoral representation, which could be argued for along similar lines as regional representation.

⁴ Broadly speaking, this is also true if monetary policy decisions are based on a bargaining approach as long as voting rights influence fall-back positions (Berger 2002). See Bindseil (2001), Baldwin et al. (2001) and Fahrenholz and Mohl (2004), among others, for a related discussion that takes into account coalition building.

Figure 1



impact of these shocks on MPC decisions by allowing shocks to compensate each other (Berger 2002).

As a rule, “one region, one vote” will not be optimal, but neither will be a perfect alignment of voting rights and relative economic size. Berger and Müller (2005) show that optimal regional representation will reflect both economic size and the stochastic properties of economic and preference shocks. Under plausible conditions, this suggests an intermediate solution, with some limited over-representation of relatively smaller countries.

By this standard, the misrepresentation of economic weight within the ECB’s Governing Council may be extreme. Figure 1 compares the relative economic size of current euro area members with the voting power allocated to the governors representing these members (upper panel). Under current “one region, one vote” rules, seven out of 12 member countries are over-represented compared to their economic weight. This ratio could increase to 20 out of 24 in the EMU24 scenario despite ECB reform. As a conse-

quence, an economic minority may, on occasion, decide monetary policy for the whole area.

Figure 2 adds to this picture by comparing time series for the sum of the squared difference between regional MPC vote shares and relative economic size in a given year for the US, Germany, and the euro area.

Some important stylized facts emerge. First, misrepresentation is not constant but changes over time, with institutional reform being the driving factor.⁵ Second, both the Fed and the Bundesbank significantly reduced misrepresentation through the introduction of asymmetric rotation schemes to reflect relative economic size (Fed), the redrawing of regional districts to eliminate separate representation of smaller regions (Bundesbank), and the strengthening of the Board (both). This was no coincidence. For instance, the Bundesbank (1992) stressed that the 1992 redistricting ended a period of strong misrepresentation of regional economic size

within the MPC, and Eichengreen (1992, p. 14) interprets the “early history of the Federal Reserve System” as a “cautionary tale” pointing “to the advisability of reducing existing European central banks to mere branch offices of the ECB or of eliminating them entirely.” Finally, Figure 2 clearly identifies the ECB as an extreme case, with the misrepresentation indicator for the ECB’s Governing Council reaching values about seven times higher than for the Fed or the Bundesbank. Despite the 2003 reform, this gap is likely to increase in the EMU24 scenario.

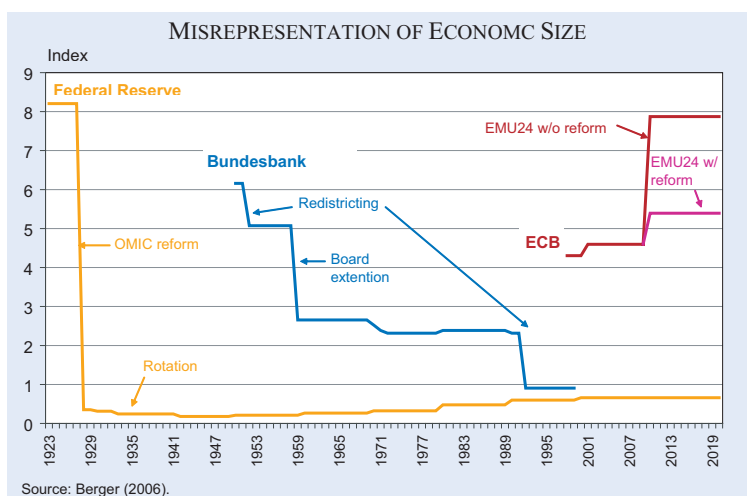
Unfinished business? Implications for ECB reform

Status quo

The discussion in Section 2 establishes certain benchmarks (however crude) that help us to broad-

⁵ See, e.g., Thygesen (1989) and Berger (1997).

Figure 2



Notes: The misrepresentation index measures the sum of the squared difference between regional vote shares in the monetary policy committee and relative economic size in a given year. It is assumed that Board members weigh regional developments according to a region's relative economic size – see Berger (2006) for a detailed discussion. Absent institutional reform, the data is updated in 10-year intervals. The likely entry of Slovenia into the euro area in 2007 is not taken into account.

ly characterize efficient central bank design – and, as of 2006, the ECB looks broadly in line with two out of three benchmarks. With a *size* of 18 members, the ECB's Governing Council is about on par with the pre-1999 Central Bank Council and the number of participating (if not voting) FOMC members. Looking at *centralization*, the ECB stands out somewhat more. At about 66 percent, the vote share commanded by regional representatives in the Governing Council clearly exceeds the ones in the Bundesbank and Federal Reserve. The most striking difference between these three banks occurs regarding the *representation*-benchmark, however. As just discussed, the “one country, one vote” principle causes a degree of misrepresentation of regional economic size that is stunningly larger than in the Fed or Bundesbank, and euro area enlargement is set to further increase the distance to the benchmark.

The 2003 reform of the ECB statute will moderate but not reverse the impact of enlargement. First, the reform will limit the number of voting members to 15 (out of 24) national central bank representatives and six Board members, but all 30 will participate in Governing Board meetings. Second, the reform will curb the decline in the degree of centralization, with regional representatives holding about 70 percent of voting rights (but about 80 percent of seats) in the Governing Council. Finally, the introduction of the asymmetric rotation system will check the increase in misrepresentation in the EMU24 scenario. Clearly, however, while the 2003 reform works in the

right direction, it will only partially compensate the effects of enlargement, leaving the ECB farther away from the benchmark along all three dimensions than already today. There is, in short, room for improvement.

Alternatives for further reform

There are a number of reasons to expect the book on ECB reform to be opened again. First, the particularities of the asymmetric rotation scheme imply an unintended discontinuity in the difference between the voting frequencies of large and medium-sized countries in the Governing Council when EMU membership increases from 18

to 19 – which may require further discussion. Second, more generally, the introduction of new members to the euro area might lead to additional debates regarding, among other things, the way member countries are size-ranked and allocated rotation frequencies. Finally, looking back at the dynamics of central bank design in the United States and Germany, there is little reason to expect any central bank statute to be cast in stone – especially when potential inefficiencies are looming.

In this case, what are options for (further) ECB reform and how do they compare with the benchmarks discussed above? Table 3 gives a brief overview some of the possibilities.

One principal option would be to substitute the planned rotation scheme by alternative setups to better reduce the mismatch between political and economic weights of regional governors in the Governing Council. Their shared disadvantage is that, despite a reduction in the *de jure*-size of the MPC, they would not necessarily reduce decision making costs. With *IMF-style representation*, regional governors are likely to indirectly participate in the decision-making process at the group level. The same applies to *Bundesbank-style redistricting* of national central bank regions, if representatives of countries forced into one district would continue to influence the behavior of the district's MPC representative. *EU-style weighted voting* under the consensus approach falls into the same fold.

More reforms will be necessary as enlargement proceeds

Table 3

Alternative ECB reform scenarios

<i>Alternative scenarios</i>	<i>Size</i>	<i>Centralization</i>	<i>Representation</i>	<i>Plausible?</i>
(1) Substitute rotation:				
(a) IMF-style representation: Equal-sized groups of CBs with restricted mandate	Very large (de facto)	Low	Close(r) to proportional	Unlikely, at least de jure
(b) Buba-style redistricting: Redistricted regional CBs of similar economic size	Possibly optimal	Low	Close(r) to proportional	Unlikely, at least de jure, in the short-run
(c) EU-style weighted voting: Size-weighted governor votes, all participate	Very large (de facto)	Low	Proportional	Unlikely
(2) Move to full centralization: Decision power rests with Board alone	Small	Very high	Proportional via Board	Unlikely
(3) Fine-tune reform: More asymmetric rotation; larger Board, fewer governors	Very large (de facto)	Optimal	Close(r) to proportional	Perhaps

A second principal option remains *full centralization*. Bringing the ECB into the main stream of central bank design would require giving up the existing federal structure, which would constitute an even more radical departure from the status quo than substituting the envisaged rotation scheme. The advantages of a fully centralized solution include the likely absence of a regional bias in decision-making and low decision-making costs. A possible disadvantage could be a reduction in factual independence due to the absence of checks and balances.

Perhaps the greatest problem with the reform scenarios discussed so far is that their chances of being implemented are, at best, modest. This is particularly true of the centralization option, which runs against the organizational principle underlying most other European institutions and would require EMU member countries giving up even the last iota of influence on ECB policy after having given up monetary sovereignty for a seat in the Governing Council (Berger et al. 2004). Differentiating between schemes to substitute rotation, weighted voting is perhaps the least plausible option because it does achieve little more than the envisaged rotation system, and rotation is seen as more compatible (at least in formal terms) with the idea that each member casts “one vote” (ECB 2003). In comparison, redistricting and representation seem somewhat more likely to be implemented – if not formally, than perhaps on a factual basis. Redistricting could be a natural longer-run solution to the strains of the ever increasing demands of full-scale membership in the Eurosystem put on smaller member countries. Similar forces could lead to the factual introduc-

tion of elements of representation within the envisaged rotation scheme (for instance, by smaller countries collectively organizing meeting-preparation or even voting).

The most likely further reform effort, however, is probably a *fine-tuning of the rotation scheme* setup – and this might not be a bad thing. Such a reform could take the form of a reduction of the regional component through an increase in the Board’s vote share and a more asymmetric allocation of voting rights among regional representatives (by changing the vote allocation of country groups or increasing the number of groups) to reduce misrepresentation. A further reduction in the number of Governing Council seats in an attempt to limit decision-making costs would also be conceivable, but, as with representation and weighted voting, the impact on actual decision-making costs would depend on the Governing Council’s willingness to enforce decision-making by vote and forgo consensus-based practices involving all members. Nevertheless, such fine-tuning may have the potential of bringing the ECB closer to the benchmark at least in two out of three areas (i.e., centralization and representation). In that sense, the most likely approach to further ECB reform might very well be among the more promising ones in efficiency terms.

References

- Baldwin, Richard, Erik Berglöf, Francesco Giavazzi, and Mika Widgren (2001), “Preparing the ECB for Enlargement,” *CEPR Policy Paper*, 6, CEPR: London.
- Berger, Helge (1997), “The Bundesbank’s Path to Independence. Evidence from the 1950’s”, *Public Choice*, 93, 427–53.
- Berger, Helge (2002), “The ECB and Euro-Area Enlargement,” *IMF Working Paper*, 02/175.

A reduction in the number of Council seats and a changed allocation of regional voting rights might improve centralization and representation

- Berger, Helge (2006), "Optimal Central Bank Design: Benchmarks for the ECB", *The Review of International Organizations*, 1(3), pp. 207–235.
- Berger, Helge and Jakob de Haan (2002), "Are Small Countries too Powerful Within the ECB?" *Atlantic Economic Journal*, 30 (3), 1–20.
- Berger, Helge, Jakob de Haan, and Robert Inklaar (2004), "Restructuring the ECB," in: Helge Berger and Thomas Moutos (eds.), *Managing EU Enlargement*, Cambridge: The MIT Press, 29–66.
- Berger, Helge and Till Müller (2004), "How Should Large and Small Countries Be Represented in a Currency Union?" *CESifo Working Paper*, 1344.
- Bindseil, Ulrich (2001), "A Coalition-Form Analysis of the "One Country-One Vote" Rule in the Governing Council of the European Central Bank," *International Economic Journal*, 15(1), 141–64.
- Blinder, Alan (1998), *Central Banking in Theory and Practice*. The MIT Press: Cambridge, MA.
- Blinder, Alan and John Morgan (2005), "Are Two Heads Better Than One? Monetary Policy by Committee," *Journal of Money, Credit and Banking*, 37(5), 798–811.
- Deutsche Bundesbank (1992), "Restructuring the Bundesbank," *Monthly Report*, August, 48–53.
- Dvorsky, Sandra and Isabella Lindner (2003), "Institutionelle Entwicklungen im ESZB. Anpassung der Stimmrechtsmodalitäten im EZB-Rat," *Österreichische Nationalbank, Berichte und Studien*, 2, 144–59.
- Eichengreen, Barry (1992), "Designing a Central bank for Europe: A Cautionary Tale from the Early Years of the Federal Reserve System", in: Matthew Canzoneri, Vittorio Grilli, and Paul Masson (eds.), *Establishing a Central Bank: Issues in Europe and Lessons from the US*, Cambridge University Press, Cambridge, 13–40.
- European Central Bank (ECB) (2003), "The Adjustment of Voting Modalities in the Governing Council," *Monthly Bulletin*, May, 73–83.
- Fahrholz, Christian and Philipp Mohl (2004), "EMU-enlargement and the Reshaping of Decision-making within the ECB Governing Council: A Voting-Power Analysis," *Ezoneplus Working Paper*, 23.
- Fry, Maxwell, Deanne Julius, Lavan Mahadewa, Sandra Roger, and Gabriel Sterne (2000), "Key Issues in the Choice of Monetary Policy Framework," in: Lavan Mahadewa and Gabriel Sterne (eds.), *Monetary Frameworks in a Global Context*, Routledge: London, 1–216.
- Fujiki, Hiroshi (2005), "The Monetary Policy Committee and the Incentive Problem: A Selective Survey," *Monetary and Economic Studies*, October, 37–82.
- Gerlach-Kristen, Petra (2006), "Monetary Policy Committees and Interest-Rate Setting," *European Economic Review*, 50(2), 487–507.
- Gerling, Kerstin, Hans Peter Grüner, Alexandra Kiel, and Elisabeth Schulte (2003), "Information Acquisition and Decision Making in Committees: A Survey," *ECB Working Paper*, 256.
- Giannone, Domenico and Lucrezia Reichlin (2005), "Trends and Cycles in the Euro Area: How Much Heterogeneity and Should We Worry About It?" *Mimeo*, Université Libre de Bruxelles.
- Goodfriend, Marvin (2000), "The Role of a Regional Bank in a System of Central Banks," *Federal Reserve Bank of Richmond Economic Quarterly*, Winter, 7–25.
- Haan, Jakob de, Helge Berger, and Robert Inklaar (2004), "Is the ECB Too Decentralized?," in: Hans-Werner Sinn, Mika Widgren, and Marko Köthenburger (eds.), *European Monetary Integration*, Cambridge: The MIT Press, 71–97.
- Hagen, Jürgen von and Ralph Süppel (1994), "Central Bank Constitutions for Federal Monetary Unions," *European Economic Review*, 38, 774–82.
- Hallerberg, Mark (2002), "Veto Players and Monetary Commitment Technologies," *International Organization*, 56 (4), 775–802.
- Hefeker, Carsten (2002), "Monetary Policy in a Union of 27: Enlargement and Reform Options," *Intereconomics*, November/December, 315–20.
- Lombardelli, Clare, James Proudman, and James Talbot (2005), "Committees Versus Individuals: An Experimental Analysis of Monetary Policy Decision Making," *International Journal of Central Banking*, 1(1), 181–205.
- Lybeck, Tonny and JoAnne Morris (2004), "Central bank Governance: A Survey of Boards and Arrangements," *IMF Working Paper*, 04/226.
- Maier, Philipp, Beata Bierut, and Robert-Paul Berben (2003), "The Role of Regional Information in the Optimal Composition of a Committee," *MEB Discussion Paper (De Nederlandsche Bank)*, 2003–08.
- Meade, Ellen (2003), "A (Critical) Appraisal of the ECB's Voting Reform," *Intereconomics*, 38(3) 129–131.
- Meade Ellen and Nathan Sheets (2005), "Regional Influences on FOMC Voting Patterns," *Journal of Money, Credit and Banking*, 37(4), 661–677.
- Meltzer, Allan (2003), *A History of the Federal Reserve*, Volume I: 1913 to 1951, The University of Chicago Press: Chicago, IL.
- Moser, Peter (1999), "Checks and Balances, and the Supply of Central Bank Independence," *European Economic Review*, 43, 1569–93.
- Riboni, Alessandro and Francisco Ruge-Murcia (2006), "The Dynamic (In)efficiency of Monetary Policy by Committee," Typescript, University of Montreal.
- Sibert, Anne (2006), "Central Banking by Committee," *DNB Working Paper*, 91.
- Thygesen, Niels (1989), "Decentralization and Accountability within the Central Bank: Any Lessons from the US Experience for the Potential organization of a European Central Banking Institution?" in: Paul de Grauwe and Theo Peeters (eds.), *The ECU and European Monetary Integration*, MacMillan: London, 91–114.

THE DOHA ROUND OF MULTILATERAL NEGOTIATIONS: A STORY OF ETERNAL STAGNATION AND FINAL SUSPENSION

DILIP K. DAS*

*If we are facing in the right direction, all we need to do is to keep on walking.
– A Buddhist Proverb*

Introduction

If one observes the developments and events of the preceding three decades, it is easy to comprehend how the evolutionary process of the multilateral trade regime has become progressively challenging. There is no gainsaying the fact that the Doha Round of multilateral trade negotiations (MTNs) has proved to be egregiously problem-prone. Deep dissensions among the World Trade Organization (WTO) members and country groups, far-apart negotiating positions on crucial issues and inordinate delays in coming to a rare agreement – if and when they did come to one – on the material issues of process and substance led to the suspension of the Doha Round, and brought the multilateral trade regime to a crisis point.

The factors contributing to this unacceptable, if not melancholy, state of affairs went beyond the mercantilist mindset of the negotiators from the principal trading economies and the country groups that wield significant negotiating weight in the multilateral trading system. The Cancún Ministerial Conference (2003) collapsed amidst controversies and deep dissensions among the members. The Hong Kong Ministerial Conference (2005) did not fail but achieved little of substance. Contretemps and mishaps continued even after that. The crucial deadline of June 30, 2006 was missed and two mini-Ministerials of January 2006 and July 2006 failed to achieve anything, causing a great deal of gloom and disillusionment in the community of multilateral traders and trade policy mandarins. In this article, we inter alia examine

causal factors behind the stagnation in the Doha Round and its eventual suspension.

In July 2006, the MTNs were in a desolate state. They had never picked up momentum after the launch of the Doha Round in November 2001. What could possibly be achieved by their satisfactory culmination was not a mystery. The global community needed to adopt the policy objectives of economic growth and poverty alleviation by means of an ambitious program of multilateral trade policy reforms. To be sure, such a reform program needed to have an ambitious vision of coordinated global policy action at the highest political level, at the Group-of-Eight (G-8)¹ level, which comprises strong and most influential global economies. Growth, poverty alleviation, trade expansion and global economic integration are worthy policy objectives, calling for the attention of top political leaders and public policy professionals. In July 2006, the G-8 leaders, in partnership with those from larger Group-of-Twenty (G-20)² economies, needed to infuse fresh political capital in bringing the Doha Round negotiations back to their feet and moving.

Was mercantilism the *bête noire*?

For the consistent lack of progress in the Doha Round, the mercantilist mindset of the participants was blamed most frequently, almost in a routine manner. This observation applies to both academic writings as well as to the economic and financial press. It is also regarded as the primary culprit behind the ignominious collapse of the Cancún Ministerial Conference as well as for the lean harvest of the Hong Kong Ministerial Conference. It is time to put this accusation in a proper perspective and determine whether it has been an impetuous, unjust and excessive accusation. Does mercantilism have a strong grip on the minds of the negotiating trade ministers and delegations? Perhaps this was not the entire explanation of the stagnation in the Doha Round.

¹ The Russian Federation is not a member of the WTO as yet. To that end, negotiations are in progress. Therefore it is correct to say that the G-7 countries had some contribution to make in this regard.

² The so-called Group-of-Twenty (G-20) was born before the Cancún Ministerial Conference. At the time of writing, the G-20 has the following 21 members: Argentina, Bolivia, Brazil, Chile, China, Colombia, Costa Rica, Cuba, Ecuador, Egypt, Guatemala, India, Indonesia, Mexico, Nigeria, Pakistan, Paraguay, Peru, Philippines, South Africa, Thailand, and Venezuela. The role of collegial leaders of G-20 was played by Brazil, China, India and South Africa.

* Toronto, Canada.

Simplicity of reciprocal tariff slashing

The earlier rounds of the MTNs, under the General Agreement on Tariffs and Trade (GATT) regime, could be completed more swiftly and on target, because they were relatively easier and negotiations were relatively simpler. They essentially dealt with reciprocal tariff slashing on manufactured goods. Besides, they took place among the industrial economies, which were far less diverse in their economic structures and objectives than the present membership of the WTO. With increasing membership, the economic diversity of member economies went on rising and the simplicity of reciprocal tariff slashing was lost forever. The present-day multilateral trade regime demonstrates an incredible range of asymmetry between players.

With the passage of time, the multilateral trade regime matured, mutated, and the agenda of MTNs went on becoming progressively larger, more multifaceted, and grew increasingly challenging to negotiate. The Uruguay Round exemplified this trend. Its agenda was exceedingly difficult in terms of spread of issues and their complexity, and the Doha Round was no less so. The most problematical areas in the Doha Round are agriculture, non-agricultural market access (NAMA), services and the one Singapore issue that is still on the table, namely, trade facilitation. Such intricacy and complexity of the negotiating issues contributed to stupefaction and caused sluggish progress.

At the present stage of the multilateral trade regime, many negotiating issues are far from simple. Sophistication and intricacy of issues under negotiation have been exacerbated by, firstly, a much larger number of negotiating member economies than during the GATT era, with a large variation in expectation from the multilateral trade regime. The present membership of the WTO is 149. This number is expected to increase further and touch 170 by 2010. Negotiations among a large number also have the innate disadvantage of homeostasis and drift. Secondly, much enhanced economic diversity among the negotiating member economies than ever before contributes to difficulty and delays in coming to agreements. Not only the range of individual players in MTNs is much larger than in the past, but new country groups like G-20, G-33 and G-90 have also emerged which throw around their negotiating weight in the MTNs. Thirdly, during the GATT era, the Quad

commanded hegemonic status and had a massive influence on the decision-making process as well as the final results of MTNs. The GATT system worked through the Green Room negotiation process, with an active Quad.³ This is no longer true. In groups, developing economies have also come to have negotiating weights. Leaders in these groups have been proactively seeking to secure developing countries' interests. This changed the fabric and character of MTNs. The negotiation process tended to become far more time-consuming and demanding than before.

Wide diversity in objectives

Due to the diversity of objectives of the member countries, MTNs increasingly became failure prone. Contrary to the GATT era, many developing economies now have important stakes in international trade and therefore participate proactively. Many of them try to contribute to and influence the decision-making process in the manner they consider best for their domestic constituencies. For the first time, they have begun taking the attitude of "What do we get out of the MTNs?" Each member country wants a plaque for domestic display out of the negotiations as a justification for concessions made to the trading partners. These new proclivities make negotiations taxing, testing and prolonged.

Frequent allegations of intransigence were made against the EU, Japan and the U.S., and of late it has been difficult to say that they are incorrect. However, it is ignored that these large traders have very little left to put on the negotiating table at the MTNs in terms of market access, except for things that are very difficult for them to negotiate from the perspective of their domestic interests and considerations.

³ During the life and time of the GATT, the Green Room process worked well and facilitated consultations among the Contracting Parties (CPs). This process got its name from an actual green room that existed next to the Director General's room in the GATT headquarters, at 154 rue de Lausanne, Geneva, where the most important meetings took place. The GATT period is known for its businesslike diplomacy and negotiating effectiveness. The flip side of this coin was that a lot of relatively smaller traders had to play the role of the second fiddle. Since the birth of the WTO this legacy of the GATT came in for a lot of criticism and was painted in villainous colors. An increasing number of WTO members were eager to contribute to the decision-making process. Accession of many sovereign countries in quick succession slowed down the decision-making process. Participation in the Green Room process was decided on the basis of the issue, and only the most active delegations were invited to participate. As for the question which CPs were typically included for consultations other than the members of the Quad, the answer is Australia, New Zealand, Norway, Switzerland, sometimes one or two transition economies and some developing economies.

Domestic polity considerations

There are areas of domestic political, social and economic sensitivities, which the incumbent governments often do not wish to disturb because of their high political costs. The industrial economies have kept agriculture and textiles and apparel under stringent protection for decades. These two areas of trade have survived as protected areas for eight rounds of MTNs. To be sure, there can be little economic justification for not putting them on the negotiating table. If anything, it is poor economics not to do so, but for domestic policy considerations and political sensitivities, these large trading economies find it onerous to allow market access in these areas. It is not easy for trade ministers and negotiators to ignore domestic public opinion, legislatures and parliaments.

Opposition to outsourcing in general and business-process outsourcing (BPO) in particular in the industrial economies has the same reasons, that is, domestic policy considerations and politics. Until political leadership and populations in these countries are better educated on these issues and learn to recognize the benefits of free trade and payoffs from the principle of comparative advantage, industrial economies will find it daunting to put these issues on the negotiating table. Market access in these areas will continue to be limited for the developing economies. Political will among the large WTO member countries could indeed surmount the difficulties and resolve stand-offs in the MTNs, but that has patently been in short supply. Sentiments that underlie the general lack of political will include the adverse reaction of domestic constituencies and the widespread anti-globalization sentiment in the large industrial economies that are also the large traders.

To persuade the EU, Japan and the U.S. to make market liberalization offers in agriculture, textiles and other manufacturing sectors, the G-20 economies need to make attractive balancing offers in their market opening. The emerging-market economies (EMEs) have not made it a secret that they are unwilling to sharply lower their trade barriers.

Active role of NGOs

In addition, the active role played by non-governmental organizations (NGOs) oftentimes led to

stand-offs in the MTNs. The large international NGOs, which are highly resourceful, significantly influenced the positions taken by the developing economies, particularly the least-developed countries (LDCs).⁴ While the large NGOs have an impressive knowledge base and technical prowess in MTN-related issues, there were occasions when their advice did not contribute to smooth progress in the MTNs. A case in point is the services negotiations during the Doha Round, particularly during the Hong Kong Ministerial. By advising developing economies not to participate in plurilateral negotiations, NGOs did a disservice to the cause of developing country trade and the MTNs.

Commitment by the G-8

The looming possibility of failure of the Doha Round worried the political leadership in the large industrial nations. To infuse political momentum into the moribund Doha Round, five G-20 members (Brazil, India, China, Mexico and South Africa) were invited to the St. Petersburg G-8 summit of July 15 to 17, 2006. The objective was to avert the hiatus of several years and come to agreement in the principal areas of divergence. The stalled Doha Round was the subject of intense and exhaustive discussion on the second day of the G-8 Summit. All the participants agreed that flexibility was badly needed for coming to core modalities. The G-8 communiqué called for "a concerted effort to conclude the negotiations of the WTO's Doha Development Agenda (DDA) and to fulfill the development objective of the Round."⁵

Together, the participants set a deadline of mid-August to settle the outstanding issues and decide on the core modalities. Once again the French briefly resisted the new deadline. Jacques Chirac argued that the EU's stance on trade policy was not an issue for the G-8 countries to decide, but he relented due to lack of support. The sense of resolve could translate into a long-awaited breakthrough. The G-6 countries (Australia, Brazil, the EU, India, Japan and the U.S.) became active in putting together a framework for an agreement and the long awaited modalities that could be acceptable to the 149 members of the WTO. The G-6 began deliberations in Geneva on

⁴ Several large international NGOs are known to have larger budgetary resources than the WTO.

⁵ See the G-8 Joint Statement on Trade on the Internet at <http://en.g8russia.ru/docs/16-print.html>.

the 17th of July, with the hope of arriving at the modalities by mid-August.

Suspension of the Doha Round: Pyrrhic victory for the protectionists?

Potential compromise offers were informally made in a fourteen-hour long G-6 meeting in Geneva. Pascal Lamy, the Director General of the WTO, tried to bring the members to concur on or around the compromise formula he had proposed. However, they failed to bridge the differences in positions on modalities on agricultural subsidies and industrial tariffs. The large trading economies evidently preferred a collapse to a compromise-based, if somewhat diluted, final outcome of the Doha Round. The gavel came down on July 24 formally suspending the Doha Round, leading to a veritable crisis of some magnitude in the life of the WTO. This collapse epitomized defeat of the common good by special-interest politics and therefore was “senseless and short-sighted” (The Economist, 2006).

The immediate result was furious recrimination and blamesmanship among members. Candidly critical of the US stance, the EU, India and Japan put the blame for the collapse on the U.S. Most trade delegations were disappointed at the U.S. for not coming up with any new proposal on domestic farm subsidies in Geneva, as did the other G-6 members. The US response was that no such new offer was necessary because the EU and the EMEs, particularly India, failed to table meaningful improvements on agricultural market access. The U.S. was also critical of the exceptions to farm tariff cuts sought by the EU and the EMEs, arguing that they were looking for loopholes to avoid legitimate trade liberalization. Judged fairly, not the U.S. alone could be blamed for the demise of the Doha Round, many other participants were also culpable. From the point of view of a trade economist, trade-distorting subsidies should not have been there in the first place. It was paradoxical that the U.S. was demanding a *quid pro quo* of extensive market opening measures for the removal of trade-distorting subsidies. Such a stipulation was something approaching the absurd. Furthermore, the stand taken by the U.S. was tantamount to spurning the July Framework Agreement of 2004.

The U.S. deserved to receive a disproportionate amount of blame for the demise of the Doha

Round for three principal reasons. First, the compromise package that Pascal Lamy was tending towards after the G-8 Summit would have brought real, albeit modest, reductions in agricultural tariffs and subsidies in the industrial countries as well as industrial tariffs in the EMEs. To an extent, it would also have led to a liberalization of trade in services. However, the U.S. took a hard line and insisted that it was not in favor of a modest kind of Doha Round agreement. If an agreement of appropriate magnitude was not reached, the U.S. had made it known that it would not settle for a weak final outcome. Second, the U.S. was perceived as being overly responsive to the demands of its domestic politics and insensitive to multilateral needs. During the negotiations it had frequently demanded maximum concessions, making it impossible for the MTNs to progress at an even pace. It was evident that the political clout of the US farm lobbies was enormous. It outweighed any promise to take the suitable and effective measures for alleviating global poverty (Switzer, 2006). Undeniably, political leadership cannot ignore the demands of the domestic constituencies, but there was a need to balance it with multilateral obligations and the need to be a good global citizen. Third, in the recent period, the commitments of the U.S. in the MTNs and its deeds have remained far apart. Rhetoric was seldom backed by action. In the recent past, the U.S. has been turning away from its traditional commitment to multilateralism. The U.S. signed 9 of its total 12 FTAs between 2001 and 2006. An additional six FTAs were awaiting approval by the Congress. When the Doha Round was suspended, 11 more were at various stages of negotiation.

Finger pointing apart, reforms that the EU was expected to agree to by the G-6 member countries were difficult but doable, considering the past agricultural policies in the EU. Likewise, a slashing of farm subsidies by the U.S. was politically difficult, more so against the background of the November mid-term elections, but absolutely possible. All that was needed was political commitment to right the long-term wrongs. The demise of the Doha Round evidenced political unwillingness of the member countries to face up to the protectionist lobbies, particularly farmers, in their own countries. Complacently ignoring the right agricultural subsidy structure was wrong for the U.S. for an additional reason. The US farm bill is to be reauthorized in 2007. The Doha Round was an ideal opportunity – and instrument – for the U.S. to start eliminating farm subsidies.

Failure of the Doha Round effectively eliminated an opportunity for overhauling the US farm subsidy program and structure. Loss of this opportunity made the US government vulnerable to litigation at the Dispute Settlement Panel of the WTO. The WTO had found the US cotton subsidies illegal in 2004; rice and soybean subsidies may well be the next to be declared illegal under the WTO rules.

By letting the Doha Round collapse after prolonged stagnation, the industrial economies also exposed themselves to another allegation. The Doha Round was conceived as the first ever development round, and the intentions of the members were to rebalance the multilateral trade regime. That the development objective of this round is highly valuable has been noted since the beginning, at the time of the launch, down to the G-8 Communiqué of July 2006. Accordingly, since the launch of the Doha Round, industrial economies had promised support for the DDA, which was expected to help the developing economies, particularly the small and low-income ones, through brisk trade expansion. It was also believed that the Doha Round would help achieve the Millennium Development Goals (MDGs), particularly the first one of halving the global income-poverty by 2015. Goodwill and commitment to these noble objectives were expressed repeatedly in various Ministerial Declarations in enthusiastic and effusive terms. Demise of the Doha Round was an obvious loss of credibility for the rich countries in this regard. It became a testimony of insincerity of the political leadership at the highest levels.

Breakdowns in MTNs are not unknown. In December 1990, the Uruguay Round had caved in because of insoluble differences between the EU and the U.S. on agricultural subsidies. It was resuscitated by the erstwhile Director-General of the General Agreement on Tariffs and Trade (GATT), who came up with the unusual plan of preparing a draft compromise agreement and presenting it to the Contracting Parties (CPs) as the basis of a future agreement. He succeeded. The Uruguay Round was completed after all because eventually all CPs were willing to make compromises and accommodations, although it took much longer than originally planned. Could the Doha Round be a repetition of history? An optimist always has enough to go on.

Suspension of the Doha Round cannot be seen as a Pyrrhic victory of the protectionist lobbies and

forces. It was not followed by calls for increasing protectionism and the ocean of world trade remained calm at the sad news of the demise of the Doha Round. During the contemporary period, multilateral trade has been growing at a higher rate than global GDP. Although a major setback, the failure of the Doha Round represents an inability to advance the multilateral trade regime, but not a retrograde movement in it. While the probability of the multilateral trade regime falling apart in the short term is virtually nonexistent, with the passage of time this failure will decisively show its pernicious effect and cast a debilitating shadow over the multilateral trade regime.

Summary and conclusions

Thus far the Doha Round of MTNs proved to be most problem-prone. It had stagnated since its inception and was finally suspended. Deep dissensions among the WTO members, far-apart negotiating positions on crucial issues and inordinate delays in coming to a rare agreement on the material issues brought the Doha Round to a crisis point. A mercantilist mindset of the participants was frequently blamed for the stagnation in the Doha Round. It was also regarded as the primary culprit behind the ignominious collapse of the Cancún Ministerial Conference as well as for the lean harvest of the Hong Kong Ministerial Conference. However, there was more to it than just that. Over time, the MTNs have become more complex, whereas the simplicity of reciprocal tariff slashing of past rounds no longer exists. Besides, the WTO has a large number of diverse countries as its members seeking different policy objectives to meet the expectations of the domestic stakeholders. The active role of the NGOs also has rendered the MTN process difficult.

After the Hong Kong Ministerial Conference that brought no noteworthy achievement, participating members of the WTO had promised to continue intense negotiations and converge their respective negotiating positions with an explicit objective to set down firm agreements in the most important and basic areas of MTNs by the end of April 2006. For this reason the self-imposed deadline of April 2006 became vitally important to meet. To this end, a mini-Ministerial was organized in January 2006 in Davos. It ended without any meaningful progress of the MTNs towards the objectives. Despite intense negotiations at various levels, the self-imposed dead-

line of April 30 was missed. This was seen as an enormous collective mistake by the members, if not the end of the multilateral trading system. Another desultory mini-Ministerial was called by the WTO in Geneva during the period of June 29 through July 2, 2006, with an objective to negotiate on modalities in agriculture and NAMA. This mini-Ministerial was marked by apathy and again failed to achieve anything of substance.

With the passage of time it became obvious that expressions of positive and virtuous intentions were completely misleading. There was a wide gap between what was being promised and what was being achieved in terms of tangible agreements and core modalities. Although the New Quad had come into being, the MTNs acutely suffered from a lack of imaginative and responsible leadership. Settling on the core modalities was not impossible, but when the sticking points called for creativity and flexibility, important trading economies, and the members of the New Quad – particularly the two trade superpowers that have the largest negotiating weight – responded by apathy. In July 2006, the languishing Doha Round seemed ripe for complete failure.

The G-8 leaders, in collaboration with the select members of the G-20, tried to infuse political momentum into the moribund Doha Round during the St. Petersburg G-8 summit of July 15 to 17, 2006. All the participants agreed that flexibility was badly needed for designing the core modalities. The G-8 communiqué called for a concerted effort to conclude the negotiations of the WTO's Doha Development Agenda (DDA) and to fulfill the development objective of the Round. Notwithstanding these endeavors, the Doha Round was formally suspended on the 24th of July 2006, precipitating the first major crisis in the life of the WTO.

References

- The Economist*, 2006. "World Trade: Under Attack". July 8. pp. 65–66.
- Switzer, T. 2006. "Bilateral Deals Mock Doha". *The Australian*. July 31. p. 6

EU ACCESSION CANDIDATES: MORE PROGRESS NEEDED IN THE POLITICAL AREA, BUT GOOD ECONOMIC PERFORMANCE

Bulgaria: Government budget in surplus

Based on the findings of the EU Monitoring Report of September 26, Bulgaria must make further efforts at judicial reform and the fight against organised crime and corruption. In the area of money laundering, Bulgarian legislation is now largely in line with the *acquis communautaire*. Implementation of legislation, however, is limited to date and so far no successful prosecutions for money laundering can be reported.

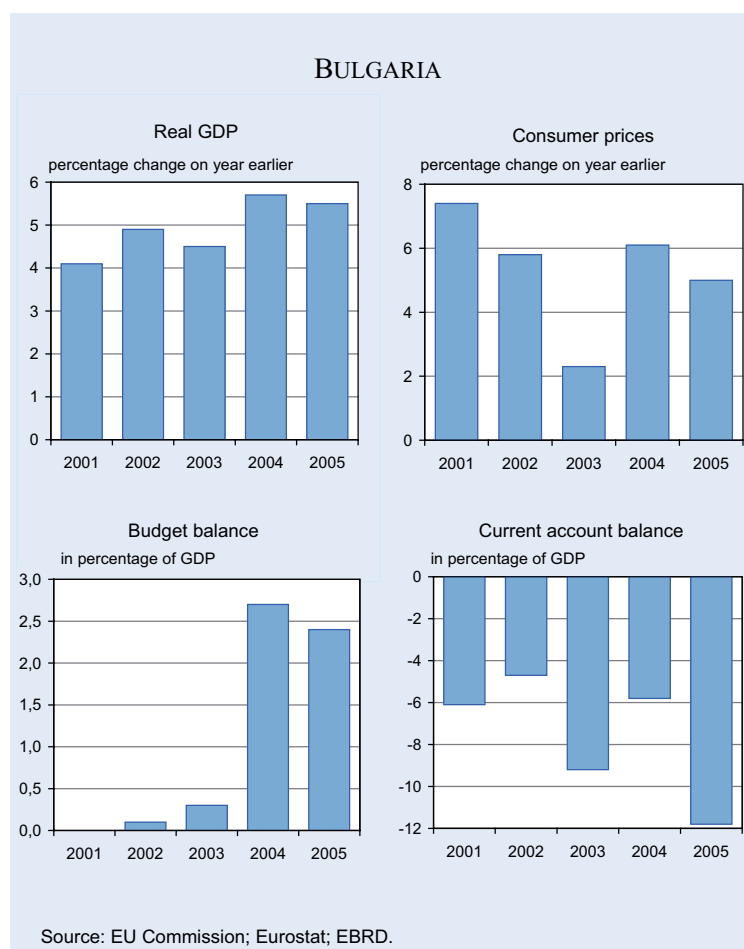
In contrast to the political area, Bulgaria has made substantial progress in the economic area. Useful steps were taken to contain the external deficit. The privatisation process and the liberalisation and restructuring, notably of utilities, have well advanced.

Some additional progress has been made in improving the business environment and in reducing non-wage labour costs. However, the current account deficit widened warranting continued prudent fiscal and wage policies. Regarding the structural reforms, further easing of the regulatory burden on business is required. The labour market also needs to be made more flexible.

The macroeconomic situation shows GDP growth at 5.5 percent for 2005 and an estimated 5.4 percent in 2006. Economic growth is mainly driven by strong investment growth as well as by a rebound of consumption. The catching-up in terms of GDP per capita, however, has been slow reaching 32.1 percent of the EU-25 average in 2005. The gap between imports and exports of goods and services increased further to 20.2 percent of GDP for the full year 2005. The current account deficit widened accordingly to 11.3 percent of GDP. Average consumer price inflation dropped from 6.1 percent in 2004 to 5 percent in 2005. The unemployment rate (ILO methodology) declined further to reach 9.0 percent of the labour force in the second quarter of 2006, compared to 10.1 percent in 2005 and even 12.0 percent one year earlier.

Apart from sustained job creation in the private sector, this seems to be due also to an increasing shift of informal employment to the formal sector, following the reduction of social security contributions at the beginning of 2006. Real annual average wages grew by around 4.1 percent in 2005 and thus largely in line with productivity gains.

Following a better than expected revenue performance in 2004 and 2005, the general government balance achieved a surplus of 2.7 percent and 2.4 percent of GDP respectively. In 2006 a further government surplus of 3.3 percent of GDP is expected. Public debt has continued falling from above 100 percent of GDP in 1997 to 29.8 percent of GDP in 2005.



Romania: Sectoral restructuring

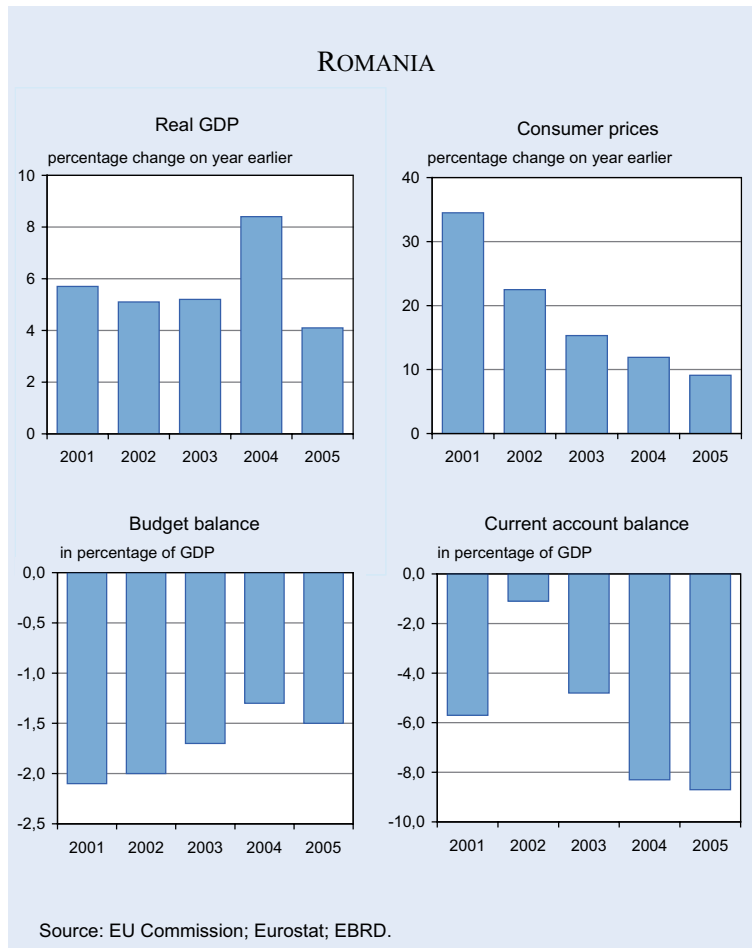
A liberal “Government programme” was adopted on 28 December 2004. The period 2005 to 2008 is presented as the “second modernisation of Romania”. The September 2006 Monitoring Report confirms that Romania made further progress to complete membership preparations, notably in the key areas of justice and the fight against corruption, demonstrating its capacity to apply EU principles and legislation from the accession date.

In Romania, too, economic performance has been remarkable, although the gap of GDP per capita at 32.9 percent of the EU average remains wide. In the first half of 2006, GDP grew by 7.4 percent, up from 4.9 percent in the same period of 2005. In the same period, industrial production grew strongly by 7.1 percent y-o-y, despite the reallocation of output growth from labour-intensive sectors such as textiles, clothing and footwear to capital and technology-intensive ones such as automobiles, car parts, equipment and appliances. Growth continued to be driven by strong domestic demand in the second quarter of 2006. Private consumption increased by 12.7 percent

while the growth of gross fixed capital formation remained equally vigorous at 12.2 percent. Although imports expanded more than exports, the trade deficit widened further to around 10.9 percent of GDP in the second quarter of 2006. The current account deficit stood at 8.7 percent of GDP in 2005 and at 9.8 percent in the second quarter of 2006. Registered unemployment stood at 5.1 percent in July 2006, lower by 0.5 percent points than one year earlier. Deflated by consumer price inflation, average net real wages in July grew by 8.6 percent over one year earlier.

The 2005 end-year inflation stood at 8.6 percent, missing the target that had been initially set at 6 percent by the central bank. The relatively restrictive monetary stance adopted in the first half of 2006 led to a decline in CPI inflation to 6.0 percent y-o-y in August. The more rapid than expected disinflation process was also supported by the rescheduling of increases in administered prices and the appreciation of the currency.

In the fiscal notification submitted in September 2006, the Romanian authorities revised upwards the general government deficit for 2006 from originally 0.5 percent of GDP to 2.5 percent of GDP. This pro-cyclical policy deviates from the medium-term fiscal policy earlier presented by Romania. It creates a higher risk of exceeding the 3 percent of GDP reference value for the budget deficit in the future. Budgeted expenditures were increased by nearly 3.5 percent of GDP, of which 0.4 percent of GDP is for higher public wages.



IS THE DOLLAR FINALLY FOLLOWING THE FUNDAMENTALS?

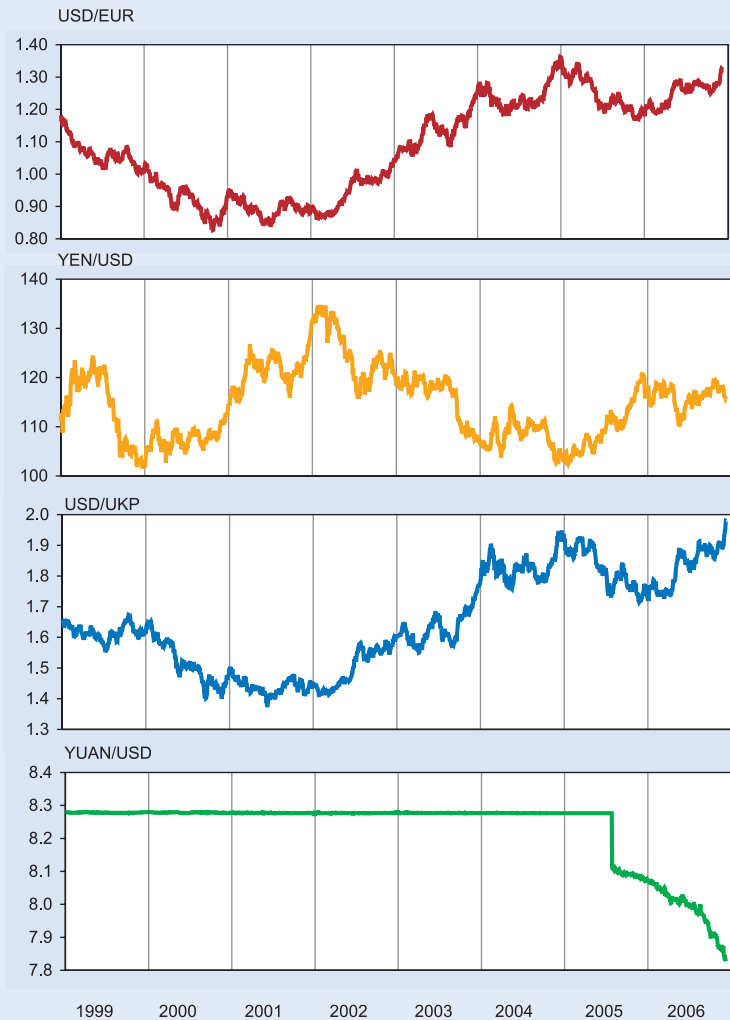
The huge twin deficits of the United States – in the federal budget and the current account of the balance of payments – have fed expectations for some time now of a substantial decline in the exchange rate of the dollar in line with a general readjustment in the currency markets.

Also, a gloomy outlook on the US economy initiated by the housing bust, on the one hand, and surprisingly strong economies in the EU and in Asia, on the other, means interest rate movements in opposite directions: The US Federal Reserve last raised interest rates five months ago and if the economy gets bad enough, the Fed may start to cut interest rates. At the same time, the European Central Bank is continuing its step-up in key rates and the Bank of Japan is also considering a long-postponed move to raise interest rates again. Sooner or later the dollar had to fall. And so it has.

Against the euro, the dollar had been dropping, little by little, for more than a month before it broke through 1,30 on November 28th, going on to hit a 20-month low. Against the pound, on November 28th, the greenback was at its weakest in two years. It also slipped against the yen and against the yuan, politically the most sensitive exchange rate these days.

The Chinese yuan has picked up the pace over the past few months, rising at an annual rate of almost 7 percent against the US dollar since September – four times as fast as over the previous 14 months since it broke its link with the dollar. This has prompted expectations that the yuan could approach

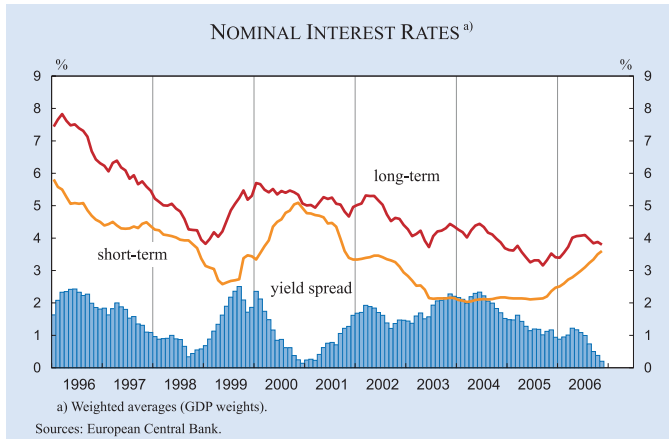
EXCHANGE RATE OF THE US DOLLAR



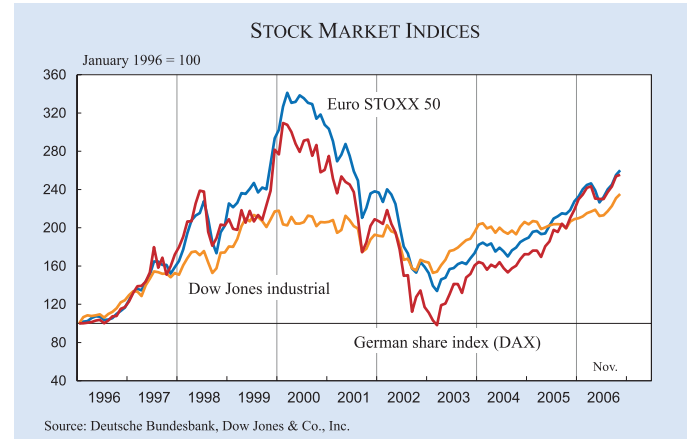
Source: US Federal Reserve Board.

parity with the Hong Kong dollar, its traditionally stronger neighbour, by the end of the year.

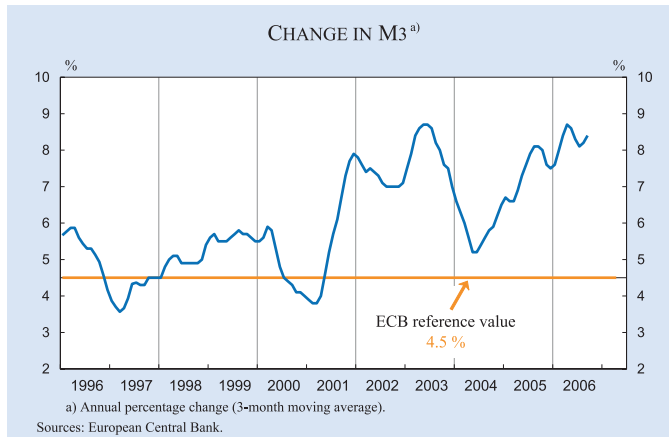
FINANCIAL CONDITIONS IN THE EURO AREA



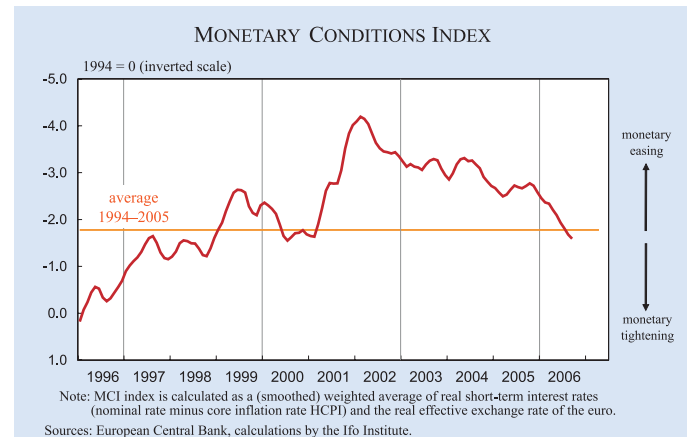
In the three-month period from September to November 2006, short-term interest rates rose over their entire range. The three-month EURIBOR increased from an average 3.34% in September to 3.60% in November. Ten-year bond yields rose from 3.84% in September – a decline from 3.97% in August – to 3.88% in October and a somewhat lower 3.80% in November. The yield spread continued to shrink to 0.20 points.



The German stock index DAX had breached the 6,000 mark in September and reached an average of 6,300 points in November. The Euro STOXX also rose continuously during this 3-month period, breaching the 4,000 mark in November. Finally, the Dow Jones Industrial continued its upward trend from an average 6,000 points in September to an average 6,300 in November.

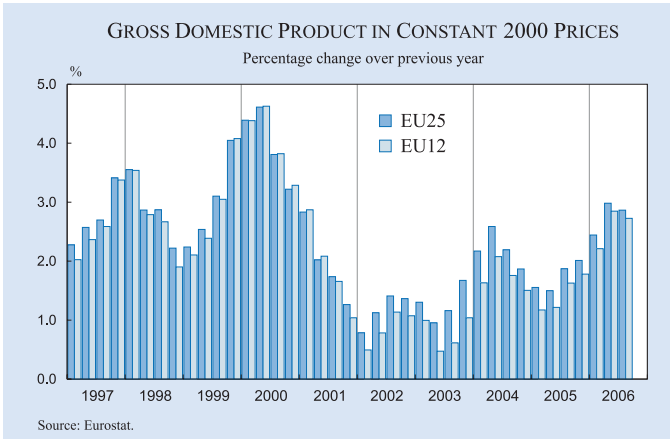


The annual rate of growth of M3 stood at 8.5% in October 2006, unchanged from the previous month. The three-month moving average of the annual growth rates of M3 over the period August to October 2006 rose to 8.4% from 8.2% in the period July to September 2006. The annual rate of growth of M1 declined to 6.3% in October, from 7.2% in September and August. It averaged 6.9% for the three-month period August to October.

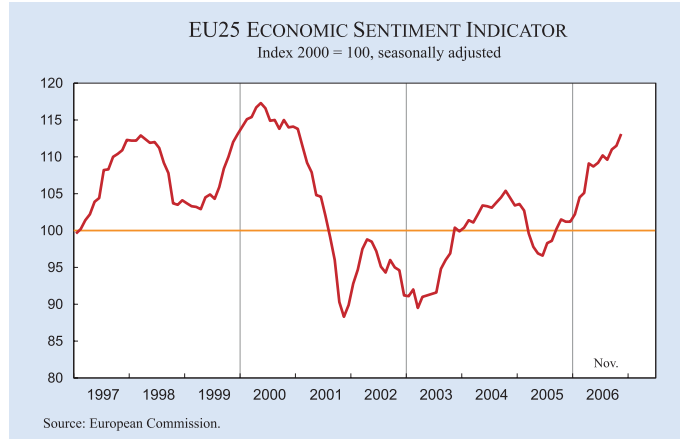


In September 2006, the monetary conditions index continued its decline that had started in late 2005, signalling further monetary tightening. This is the result of a further substantial rise in short-term real interest rates and a small decline in the real effective exchange rate of the euro in September.

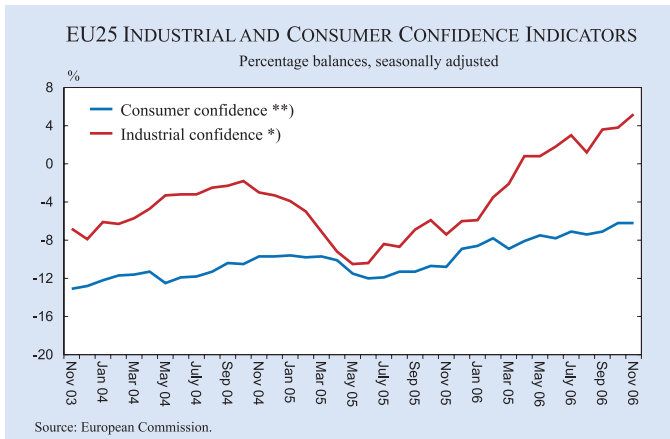
EU SURVEY RESULTS



According to first Eurostat estimates, euro area real GDP grew by 0.5% in the third quarter of 2006 and EU25 real GDP by 0.6% compared to the previous quarter. Compared to the third quarter of 2005, GDP rose by 2.7% in the euro area and by 2.9% in the EU25m after 2.8% and 3.0%, respectively, for the previous quarter.



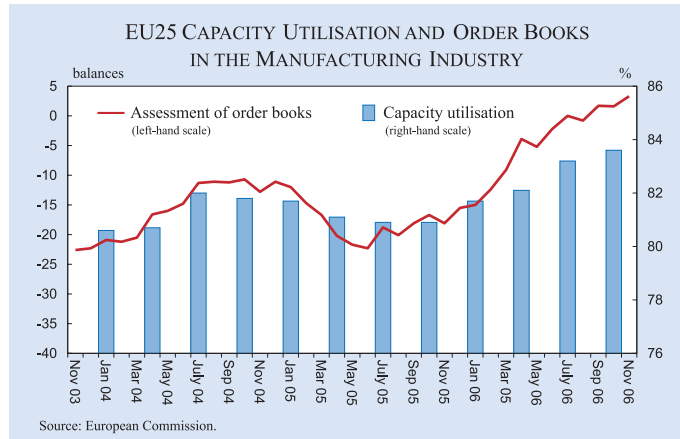
The EU Economic Sentiment Indicator continued to rise in November, reaching its highest level since the beginning of 2001. The indicator rose by 1.6 points in the EU to 113.1, having been on an upward trend since mid-2005. Confidence improved in Germany, France, Poland and in the UK, while it decreased in Italy and Spain.



* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).

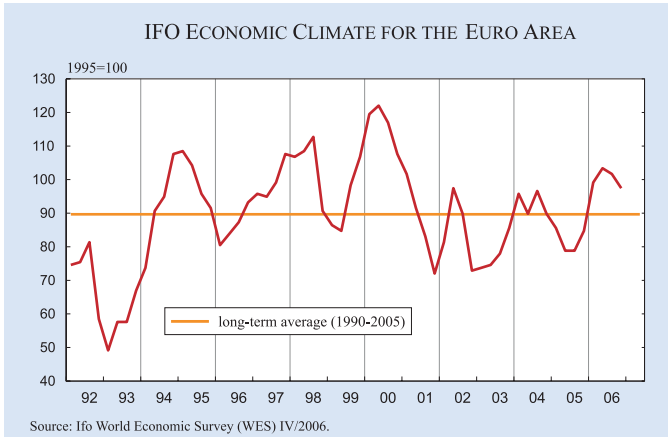
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

The industrial confidence indicator improved in most EU member states. While it fell in Italy, it remained virtually unchanged in France and Spain. EU Consumer confidence stayed at the same level in November. Although the level is currently above its long-term average, it is significantly below the record level of 2000. At the country level, the results show confident consumers in all large countries except the UK.

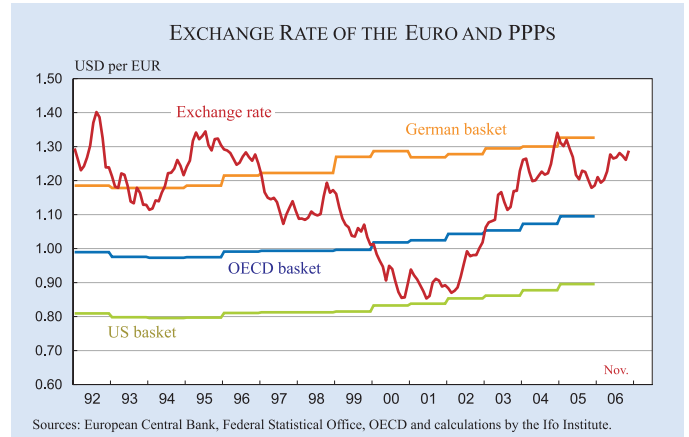


Economic confidence in the EU rose in all three underlying components: production expectations, stocks of finished products and order books. The assessment of order books improved from 1.6 in October to 3.3 in November. Capacity utilisation rose to 83.6 in the fourth quarter from 83.2 in the third quarter.

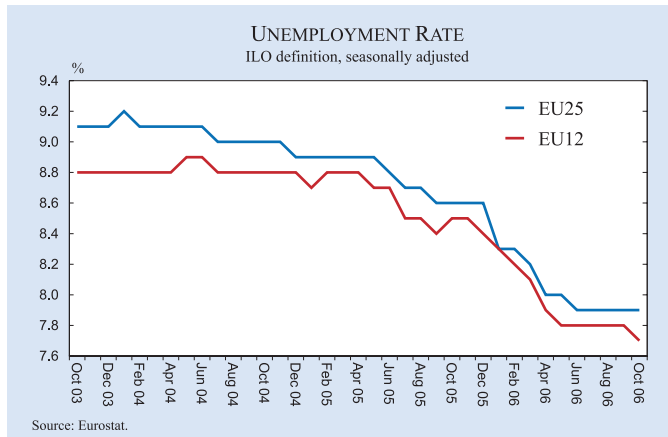
EURO AREA INDICATORS



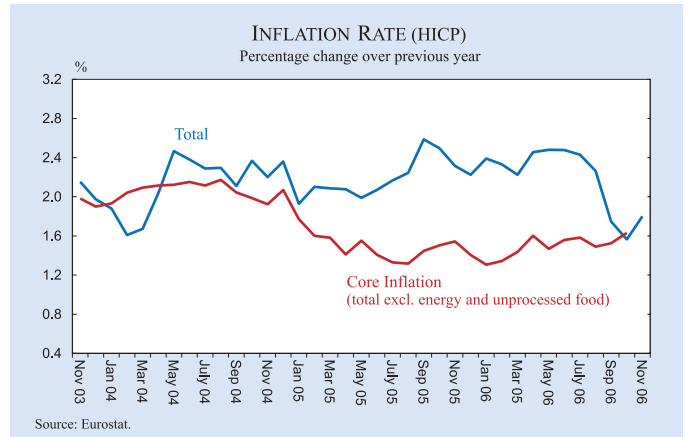
The Ifo indicator for the economic climate in the euro area again weakened slightly to 101.7 points in the fourth quarter of 2006. As in the previous quarter, this decline was solely the result of less optimistic expectations for the coming six months. Assessment of the current economic situation improved further, reaching a five-year high. The latest survey results indicate a continuation of the economic recovery in the euro area, albeit at a weakened pace.



The exchange rate of the euro against the US dollar averaged 1.29 \$/€ in November 2006, up from 1.26 \$/€ in October, fluctuating within a narrow band since last May.



Euro-area unemployment (seasonally adjusted) declined to 7.7% in October 2006 compared to 7.8% in the previous five months, and was lower than the year earlier rate of 8.5%. EU25 unemployment stood at 7.9% in October 2006, unchanged since June, but 0.7 points lower than a year earlier. The lowest rates were registered in Denmark (3.5% in September), the Netherlands (3.9%), Estonia and Ireland (both at 4.2%), and Austria (4.7%). Unemployment rates were highest in Poland (14.0%), Greece (9.0% in the second quarter), France (8.8%), and Spain (8.4%).



Euro area annual inflation (HICP) was estimated at 1.8% in November 2006, up from 1.6% in October. A year earlier the rate had been 2.3%. In October, the lowest annual rates were observed in Luxembourg (0.6%), the Czech Republic (0.8%), and Finland (0.9%) and the highest rates in Hungary (6.3%), Latvia (5.6%), and Estonia (3.8%). Year-on-year core inflation (excluding energy and unprocessed foods), rose to 1.63% in October 2006 from 1.53% in September.

New online information services of the CESifo Group, Munich



The Ifo Newsletter is a free service of the Ifo Institute and is sent by e-mail every month. It informs you (in German) about new research results, important publications, selected events, personal news, upcoming dates and many more items from the Ifo Institute.

If you wish to subscribe to the Ifo Newsletter, please e-mail us at: newsletter@ifo.de.



CESifo publishes about 20 working papers monthly with research results of its worldwide academic network. The CESifo Newsletter presents selected working papers (in English) in an easily understandable style with the goal of making its research output accessible to a broader public.

If you wish to subscribe to the CESifo Newsletter, please e-mail us at: saavedra@cesifo.de.

If you wish to receive our current press releases, please e-mail us at: presseabteilung@ifo.de.

You can also request these services by fax:

Ifo Institute for Economic Research, fax: (089) 9224-1267

Please include me in your mailing list for:

- Ifo Newsletter CESifo Newsletter Ifo Press Releases

Name:

Institution:

Street:

City:

Telephone:

Fax:

E-mail:

CESifo WORLD ECONOMIC SURVEY

VOLUME 5, No. 4

NOVEMBER 2006

WORLD ECONOMIC CLIMATE

Soft-landing is likely

ECONOMIC EXPECTATIONS

Assessments of the current economic situation continue to improve, economic expectations somewhat downgraded

INFLATION

Expectations: Only moderate further increase

INTEREST RATES

Upward trend is slowing down

CURRENCIES

Japanese yen still seen as somewhat undervalued

SPECIAL TOPIC

The suspension of the WTO trade negotiations



CESifo International Spring Conference 2007

Announcement

Conference Theme:

**Europe's Prospects in the Face of Slower
Global Economic Growth**

To be held on

Thursday 22 and Friday 23 March 2007

Please note:

The Conference will be held on this occasion in Frankfurt:

AUDITORIUM of the Commerzbank AG

Große Gallusstraße 19

60261 Frankfurt am Main

The CESifo logo consists of the word 'CESifo' in a stylized font. 'CES' is in red and 'ifo' is in blue. The letters are bold and have a slight shadow effect. The background of the entire page is a faded image of the Frankfurt skyline, featuring the Commerzbank Tower and other skyscrapers, with a bridge over the Main river in the foreground.

CESifo

