Executive Summary

This report is the third annual report by the European Advisory Group at CESifo. It includes five chapters, each addressing a set of emerging policy issues in the euro area and in the European Union as a whole. The executive summary provides a brief synopsis of the report and presents the main conclusions of the group as regards both analysis and policy proposals.

The *first chapter* discusses the current economic situation and the future outlook for Europe stressing the cause and implications of a strong euro as well as the need for a common fiscal framework through an improvement of the Stability and Growth Pact.

The *second chapter* discusses the political constraints that prevent governments from implementing labour market reforms and identifies factors and conditions that, in the current situations could soften political opposition. In addition, it analyses alternative policies that are effective in reducing unemployment, while encountering much less opposition than labour market reforms.

The *third chapter* analyses current pay-setting arrangements in Europe as well as the prospect of reform. It reviews the positive experience of many small European countries that have achieved real wage moderation through co-ordinated collective bargaining as well as the experience of countries where the achievements of collective bargaining are arguably much less positive. In either case, European countries would benefit from more diversity in relative wages.

The *fourth chapter* reviews some aspects of the new draft constitution for the European Union, pointing to possible undesirable consequences from including non-discrimination as a general rule in the European constitution.

The *fifth chapter* presents a "primer" on the ten new members of the EU starting in May 2004. It summarises the income and structural differences between them and the old members of the EU and analyses a number of economic policy issues regarding growth, migration, public finances, trade, foreign direct investment and capital mobility.

The *sixth chapter* discusses the challenge to macroeconomic stabilisation in the ten new members of the EU during the convergence process posed by liberalised capital markets. The focus is on financial and currency fragility created by dangerously high volatility of capital flows and possible policies to reduce macroeconomic vulnerability to a crisis.

The findings in brief

While growth in Europe was disappointing in 2003, there are indicators that point to a moderate recovery in 2004. The first chapter of our report presents our forecasts and a discussion of the macroeconomic outlook. In our forecasts, European GDP will grow at a rate as high as 2 percent in 2004, once again lagging significantly behind the United States. The global macroeconomic imbalances imply a risk of further dollar depreciation, undercutting European growth and potentially creating tensions about the appropriate fiscal and monetary policy mix in the euro area. The failure of the Ecofin Council to enforce the fiscal rules in the Treaty and in the Stability and Growth Pact in November 2002 has already created a discrepancy between the legal rules and their application. This implies a dangerous vacuum. In the 2003 EEAG report we presented a proposal aimed at improving the Stability and Growth Pact which links the size of maximum budget deficits to the stock of public debt. The proposal also aims at reducing political conflicts of interest in the enforcement of the new improved rules by moving these decisions to the European Court of Justice. Better fiscal rules can prevent the current institutional crisis from depriving Europe of a much needed common fiscal framework.

Because of political constraints, the margin of manoeuvre for governments to combat unemployment with radical labour market reforms is typically quite narrow. The second chapter identifies a set of policies to reduce unemployment that would encounter much less political opposition. These include liberalising product markets; introducing a simple "firing tax" that would be paid to the worker as severance payment instead of the current system of legal procedures; replacing welfare payments for the poor with in-work benefits such as earned-income tax credits (a proposal was formulated in the 2002 EEAG report); and ensuring that the search activity of the unemployed be tightly monitored, with sanctions in the form of reduced benefits if search is not active.

But, as shown by the United Kingdom, Spain and more recently Germany, a severe crisis and a sense of urgency can help to implement reforms that would otherwise be politically doomed. A critical point has been reached in a number of European countries, not so much because of overall macroeconomic performance (the current slowdown is milder than the previous one), but because of budgetary problems (including the adverse consequences of labour market rigidities for the financing of valuable benefits such as pensions and health care as well as for long-run living standards) and the feeling that "globalisation" is making the burden of labour rigidities unbearable. This is somehow "good news", but also "bad news" in the sense that the expected economic recovery may cause governments to diminish their reform efforts. This would be regrettable, since a recovery would make the immediate costs of reform much easier to bear.

An important dimension of labour market reform concerns pay-setting arrangements, which have significant implications for both macroeconomic performance (by affecting the level of real wages) and economic efficiency (by defining incentives for achieving higher productivity). The third chapter analyses current pay-setting arrangements in Europe as well as the prospect of reform. A main conclusion is that most Western European countries would benefit from more diversity in relative wages. This applies to small European countries that have achieved real wage moderation at the aggregate level through highly co-ordinated collective bargaining as well as to a country like Germany where wages are determined at the sectoral level. Acceding countries are advised to stick to their current (Anglo-Saxon type) systems of industrial relations, with limited importance for collective bargaining and decentralised bargaining at the level of the individual firm if such collective bargaining does take place. Pay-setting systems are very slow to change: it takes a very long time or extraordinary circumstances to achieve radical changes. Therefore, specific recommendations for individual countries, that are to have an effect in the medium term, must be limited to improvements of the existing bargaining systems, which for historical reasons may differ fundamentally among countries.

In the fourth chapter we review some aspects of the new draft constitution for the European Union. It is, we believe, not the intention of the European Union to give to its courts the policy-making vote that the Supreme Court of the United States has assumed. But the assertion of 'non-discrimination' as a fundamental European value to be written into the constitution invites this very consequence. We fully share the objectives of those who argue for measures against discrimination: the elimination of racism, the advancement of women in public and business life, greater support for disabled people, and the establishment of a true common market in which national origin ceases to be of economic relevance. Yet there is a danger that the necessarily pragmatic pursuit of policies to achieve these objectives will be overtaken by the semantic interpretation of exactly what constitutes discrimination and non-discrimination if non-discrimination were to be included as a general rule in the European constitution. Some forms of "discrimination" are in fact essential in a well-functioning society. For instance, without statistical discrimination for insurance purposes, asymmetric information between economic agents would make many important insurance markets disappear, with possibly high costs in terms of general welfare. Similarly, in our proposal of welfare state reform included in the 2003 EEAG report, we stress that delayed integration of new foreign workers into the national welfare system could prevent

an undue scaling back of the welfare state, which would be damaging for both national and foreign workers.

What should European citizens expect from the accession of ten new members in the EU in May 2004? The fifth chapter of the report presents a "primer" on acceding countries, summarising the income and structural differences between the new and the old members of the EU and analysing a number of economic policy issues regarding growth, migration, public finances, trade, foreign direct investment and capital mobility. Our analysis emphasises that convergence of the new countries' income to the EU average will be a very long process with considerable uncertainty about modalities and possible structural and policy problems emerging along the way. This conclusion counters the widespread view that problems in acceding countries are quite minor because convergence will be relatively quick. The few examples of rapid and successful convergence, such as Ireland, are the exception rather than the rule. Large-scale migration, unemployment, financial instability and fiscal imbalances will prevail for some time. Existing studies tend to downplay the importance of the impact of accession on the current EU member states, stressing that the main effects are likely to be felt at the sectoral and/or regional level. But the uncertainty surrounding the economic and policy problems in the post-accession phase is enormous. If anything, the large differences in the rate of return of capital in acceding countries and the rest of the EU suggest that the implications of accession for Western European countries are larger than suggested by the weight of acceding countries' GDP in total EU GDP. Migration and trade can substantially influence the current problems in the labour markets and of the welfare states in most current EU countries. A major problem will be the decline in the wages of low-skilled workers in the current EU countries. Ultimately, this decline is associated with gains from trade in the enlarged EU area: ideally it should result from a smooth and rapid structural adjustment process. But a wage decline cannot easily be administered with the present pay-setting institutions, especially in countries where the welfare system pays high replacement incomes. We therefore fear that the transition will be unnecessarily difficult for some of the existing EU economies, unless they find effective and socially acceptable ways to reform their institutions, so as to allow for the necessary wage flexibility in the near future (our proposals are discussed in Chapter 2 of this report as well as in the 2002 EEAG report).

How soon should acceding countries enter the EMU? The sixth chapter of the report reconsiders the challenge to macroeconomic stabilisation during the convergence process posed by liberalised capital markets. A number of factors inherently linked to convergence are likely to create financial and currency fragility and lead to dangerously high volatility of capital flows. There is no single strategy that could be recommended to all acceding countries as regards macroeconomic stabilisation on the road to the euro. Countries that are already able to sustain hard pegs (mostly small countries) should be helped to achieve a smooth and fast transition to the euro. Delaying participation in ERM II is instead a realistic option for countries that are currently unable to sustain such hard pegs. Here the policy priority is the reduction of domestic imbalances, achieving a sustainable fiscal stance and stabilising inflation at the correct relative prices. For both groups of countries, the convergence criteria in terms of inflation, interest rates, debt and deficits provide desirable targets to guide policy and should not be relaxed. Once countries enter ERM II, the risk of crisis is somewhat reduced, but not eliminated, by letting acceding countries make full use of the 15 percent bilateral exchange rate bands.

The findings by chapter

The European economy: Current situation and economic outlook (Chapter 1)

In 2003, the European economy was close to stagnation. With real GDP growth of only 1/2 percent, the euro area was the least dynamic region of the industrial world. Despite further easing of monetary policy, domestic demand remained weak and exports declined, reflecting low growth in world trade and the strengthening of the euro. After stagnation in the first half of 2003, output in the euro area increased

again in the second half, and business confidence also recovered. In 2004, the European economy is expected to recover with growth in the euro area amounting to 2 percent. This will, however, not be strong enough to reduce unemployment. This forecast is built on the assumption of a continued upturn in the world economy, leading to a turnaround in exports and investment. But the upturn remains fragile as it depends to a large extent on external factors. As external imbalances continue to widen – the US current account deficit is expected to increase to above 5 percent of GDP – there is a risk of a continued weakening of the US dollar and a further appreciation of the euro. While this would reduce import prices and support real incomes in the euro area, it could become a major obstacle to an export-led recovery in Europe.

How weak will the dollar become in the next few months? There is no sensible answer to this question, as it is well known that exchange rates in the short to medium term are well approximated by a random walk. But history reminds us that, at the current euro parity, the value of the D-mark fluctuated between (approximately) 0.60 and 1.40 dollars per euro. The value of the Japanese yen fluctuated in the range of 80-140 yen per dollar. It is not unreasonable to expect similarly wide ranges to be relevant also for the euro-dollar exchange rate.

The strong dollar in the initial phase of the euro was arguably good news for EMU. As noted by many observers, in the 1980s and 1990s, some currencies in Europe (for example, the Italian lira) would strengthen vis-à-vis the D-mark when the dollar was strong and weaken otherwise. This view is dubbed "dollar-D-mark polarisation". By reducing the tensions in the exchange markets for say, the Italian lira, the Spanish peseta, and the Portuguese escudo, a strong dollar arguably strengthened cohesion in the EU before the introduction of the euro. But there is also the other side of the coin to consider. In a situation of a weakening dollar, different countries experience different problems. Before the introduction of the euro, these led to exchange rate pressures. The European currency crisis in September 1992 followed a "dollar crisis" culminating in August that year. Many of the realignments in the Exchange Rate Mechanism of the European Monetary System were preceded by dollar swings. What would be the reaction within the euro area to a further sharp fall of the dollar? Have the factors underlying the dollar-D-mark polarisation disappeared with the single currency or are they still active, potentially affecting real and financial markets? If they have not disappeared, they are likely to bring about conflicts over the common monetary policy and over fiscal policy in the various euro-area countries.

There could soon be a need for further interest rate cuts or a need to keep interest rates at the current level, even if (as widely anticipated) the US Fed alters its stance in 2004. In the past, the ECB has been much less active than the Fed in changing rates. In this respect, the conclusions from the ECB's assessment of its own monetary policy strategy in 2003 does not point to any substantial change in behaviour in the future. A monetary relaxation relative to the United States is unlikely to happen before there is a significant appreciation of the euro. Different regions in the euro area may respond quite differently to interest rate and exchange rate stimuli. In some regions, cuts in interest rates per se may bring little relief, unless they substantially affect the exchange rate.

Conflicts over fiscal policy are a major concern in the present situation. The failure of the Ecofin Council to enforce the fiscal rules in the Treaty and in the Stability and Growth Pact in November 2002 has created a dangerous vacuum. There is a blatant discrepancy between the legal rules in force and their application – a discrepancy that undermines the credibility of fiscal rules at the EU level and in the long run threatens to undermine fiscal discipline.

In the 2003 EEAG report we presented a proposal aimed at improving the Stability and Growth Pact. A key ingredient of our proposal is to link the size of maximum deficits to the stock of public debt. The proposal also aims at reducing political conflicts of interest in the enforcement of the rules by transferring the decisions on sanctions in the excessive deficit procedure from the political level of the Ecofin Council to the judicial level of the European Court of Justice.

At the same time we proposed that the EU member states should take steps to reform their national procedures for fiscal policy-making with the aim of both strengthening the incentives for fiscal discipline and improving the possibilities to use fiscal policy for stabilisation purposes. A minimum requirement is to institute a more transparent policy framework with clearly defined medium-term budget targets and sta-

bilisation objectives as well as clear operating guidelines for how fiscal policy is to be used to smooth cyclical fluctuations. As suggested in last year's EEAG report, one ingredient in such an institutional reform could be the establishment of an independent advisory Fiscal Policy Committee at the national level. The committee could be given the task of assessing the cyclical position of the economy and the consistency of the budget balance with medium-term objectives. The committee's task would be to make recommendations on the appropriate budget balance and on specific tax and expenditure changes to help stabilise the economy. If there were to be a virtual breakdown of the common EU fiscal framework, even more thorough-going reforms of national fiscal policy institutions might become desirable: one radical reform would be to delegate the actual decision-making regarding variations of actual budget deficits or specific taxes around levels determined by the parliament to an independent Fiscal Policy Committee.

Labour market reform in Europe (Chapter 2)

Because of political constraints, the margin of manoeuvre for governments to combat unemployment with institutional reforms is typically quite narrow. In this chapter we first identify alternatives to labour market reform that can reduce unemployment perhaps less efficiently but would encounter less opposition. Second, we argue that present circumstances in Europe could make more radical reforms possible in the near future, pointing out several reasons why governments have become more ambitious in this area.

An important alternative to labour market reform is product market liberalisation. Increasing competition in product markets can have a strong beneficial effect on the equilibrium rate of unemployment. This is because more competition raises firms' productivity and imposes discipline on pay setting, since it reduces monopoly rents that are available to workers. In Sweden, for example, aggressive product market deregulation in the 1990s may have contributed to the large fall in unemployment.

A second approach consists in eliminating inefficiencies in the welfare system without radical changes in its basic structure. Relevant measures include the following.

- Dismissal costs can be made more efficient in many countries by replacing the current system of legal procedures with a simple "firing tax" which would be paid to the worker as severance payment.
- Incentives to work could be increased by replacing means-tested welfare payments with in-work benefits such as earned-income tax credits (a proposal was presented in the 2002 EEAG report).
- Search activity of the unemployed should be tightly monitored, with sanctions in the form of reduced benefits if search is not active. However, an open issue in this respect is how to make sure that the unemployment insurance administration engages in effective monitoring and applies sanctions.

Third, there are specific institutions or reforms that may enhance convergence of the interests of employees (who do not profit from many reforms) and firms (who gain from reforms). An important example is provided by "profit sharing" and the promotion of stock ownership among workers. These can make policies of wage moderation, which boost profitability and job creation, more acceptable to workers. If adopted on a large scale, they can be an efficient means of reducing equilibrium unemployment. A second example is provided by recent reforms liberalising temporary employment contracts, which have increased labour market flexibility in many European countries. These reforms have met with much criticism. For instance, it has been pointed out that the reforms may increase the protection of permanent workers. Yet, there has been substantial mobility from temporary to permanent contracts in many countries, and firms value temporary contracts as a way to test the quality of new workers.

The experiences of the United Kingdom and, to a lesser extent, Spain suggest that in situations perceived as "crisis", government can be more ambitious in pushing reforms directly targeted at the labour market. In principle, a critical point has also been reached in a number of European countries, not so much because of overall macroeconomic performance (the current slowdown is milder than the previous one), but because of budgetary problems and the feeling that "globalisation" is making the burden of labour rigidities unbearable. What are the main factors that could promote, or delay, reforms in the next few years?

First, paradoxically, the very efforts made by governments to combat unemployment tend to make it a

bigger problem, as they tend to increase social spending per unemployed worker. Active labour market policies in France and Sweden require considerable spending per recipient. But in France they have failed to produce a reduction in unemployment, and in Sweden their efficiency has been question (one view is that they may have succeeded in reducing registered unemployment, but at the cost of lowering regular employment). Similarly, when high persistent unemployment is erroneously fought using fiscal and monetary policies, this leads to excess deficits and/or inflation, which in the end creates the need for more drastic structural reforms.

Second, financial problems in other politically sensitive areas, such as pensions and health care, raise the social value of high employment rates. The recent drive for labour market reform in Germany stems from a more general crisis of the welfare state with the recognition that the pre-reform state commitments in this area are unsustainable. Opposition to the removal of labour market rigidities weakened as it became clear that failing to reform the labour market would increase the need for reductions in pension and health insurance benefits that are more valuable than the gains from existing rigidities.

Third, changes in the international economic environment may raise the cost of labour market rigidities. Increasing openness reduces producers' ability to transfer changes in their labour costs to prices. Since a faster pace of technical progress raises the need for labour turnover, it penalises those societies that impose a tax on turnover in the form of employment protection provisions. New technologies may increase the demand for skilled workers and reduce the demand for unskilled workers, thus reducing the real wages and/or employment of the latter.

The reform package called "Agenda 2010" recently adopted in Germany is a good illustration of these effects. The reform was pushed forward because it had become clear to the political elite of the country that Germany's welfare state was no longer affordable and proved incompatible with the degree of wage flexibility required by globalisation. In addition to a large number of minor reforms, the package abolishes the second-tier unemployment benefit system, which used to pay roughly 60 percent of the worker's last net wage until retirement age. While Agenda 2010 falls short of reforming the welfare system and the system of wage bargaining, where major reasons for the inflexibility of the German labour market can be sought, it goes much further than seemed possible only a year ago. The German example is therefore a good illustration of how a severe crisis and a sense of urgency enhance reform possibilities and help to implement fundamental changes that are otherwise politically doomed.

Pay-setting systems in Europe (Chapter 3)

Macroeconomic performance is also intimately associated with the functioning of pay setting. It has become commonplace to relate the rise in western European unemployment in the 1970s and 1980s to aggregate real wage rigidities. The reduction in unemployment in many of the smaller EU countries throughout the 1990s was associated with real wage moderation. But in some countries a badly functioning pay-setting system has contributed to persistent unemployment: in Germany, for instance, a crucial problem has been the compression of pay differentials between eastern and western Germany. Another important aspect of pay setting relates to the use of pay as an incentive to promote effort and labour productivity. Increased international competition and new forms of work organisation have substantially increased the importance of this last aspect of pay setting.

A key feature of pay-setting arrangements that is common to most western European countries is the high coverage of collective agreements, usually above 60 percent of employees. The main exception is the United Kingdom, where in 2001 the overall coverage rate was estimated to be as low as 36 percent. In most western European countries the main bargaining level is the sectoral one. But the general trend is toward enlarging the scope of local bargaining. Somewhat paradoxically, in some countries this development has occurred simultaneously with social pacts between top level labour market organisations, sometimes also involving governments, that have set norms for pay increases at the national level. In some EMU countries, such co-ordination efforts have been a means to restrain wage increases. The most far-reaching examples are Finland, Ireland and the Netherlands, but less ambitious schemes have also been adopted in Belgium, Greece and Spain.

Most of the new EU member states in Eastern and Central Europe find themselves in an entirely different situation from that of the present EU states. In

most of the acceding countries collective bargaining is of much less importance than in Western Europe. When collective bargaining does take place, the main level is the enterprise one. Estonia, the Czech Republic, Hungary, Latvia, Lithuania and Poland are all characterised by decentralised pay bargaining at the level of the enterprise and low unionisation and coverage of collective agreements.

The forces behind the decentralisation of pay bargaining in the past decades are likely to keep operating also in the future: one should expect further decentralisation in western Europe. There are three possible scenarios.

The first scenario is massive decentralisation, de-unionisation and reduction in the importance of collective bargaining, as has happened in the United Kingdom, New Zealand and Australia. In these countries, single-employer bargaining has almost completely replaced multi-employer bargaining. The Anglo-Saxon model of pay setting has its advantages. The combination of enterprise-level bargaining and low unionisation/coverage of collective agreements is likely to produce aggregate real wage restraint. At the same time, it promotes relative-wage flexibility and the use of incentive pay. But the radical change in pay-setting practices in the United Kingdom, New Zealand and Australia have only occurred following fundamental changes in the legal system. Without sweeping legal reforms, a development in this direction in continental western European countries is unlikely.

The second scenario is a slow and disorganised process of decentralisation, leading to a reduction in the importance of collective bargaining in Western Europe. This has occured in eastern Germany, where many firms have left the employers' associations or violated sectoral collective agreements in order to reduce wage levels. However, because of the inertia of wage-bargaining institutions, a process of spontaneous, disorganised decentralisation is likely to be slow. In principle, decentralisation could promote real wage restraint, although the effects might not be large. But it is also possible that a move to single-employer bargaining weakens the incentives for wage restraint. This risk is actually great if coverage of collective agreements and unionisation remain high.

A third scenario is organised decentralisation, according to which higher-level union confederations and employers' associations choose voluntarily to leave more scope for local bargaining. This could involve larger freedom at the enterprise level to determine the margin for wage increases and its distribution among individual employees.

Which pay-setting system should the EU countries opt for? While there is no general answer to this question, there are a few basic guidelines for reform. We summarise them as follows:

- Pay-setting systems are very slow to change: it takes a long time or extraordinary circumstances to achieve fundamental changes. Therefore specific recommendations for individual countries would have to take into account the existing bargaining systems, which for historical reasons may differ considerably among countries.
- There are good reasons for keeping existing bargaining systems in those current EU member states that have achieved wage restraint through formal or informal co-ordination of bargaining at the multi-sector level. Such arrangements have worked well especially among smaller countries. But aggregate real wage moderation should be combined with relative wage flexibility. One way to achieve this could be to publicise a "corridor" for wage increases, rather than a single figure, when wage norms are formulated. Alternatively, a co-ordinated agreement on a "normal wage increase" could be reached with the understanding that "above-normal" wage raises should only be granted in areas with labour shortages.
- The recommendation of allowing more relative wage flexibility applies in particular to Germany, where wage bargaining mostly takes place at the sectoral level. In Germany, there is a strong need for diversity in wages between the western and the eastern regions, as well as for greater opportunities to set wages at the enterprise level that are lower than the norms agreed upon at the sectoral level. If Germany's stagnation problem is to be solved, labour market reform must be extended to pay-setting practices as well, which so far has not taken place.
- The acceding countries, with industrial relations are of an Anglo-Saxon type (low unionisation, low coverage of collective agreements, and collective bargaining at the level of the enterprise when bargaining takes place) should keep their present systems. These countries are likely to face strong pressures from Western European trade unions, and possibly also from EU institutions, to change

their industrial relations systems so as to conform better to "EU standards". Such pressures should be resisted. The existing combination of enterprise-level bargaining and limited importance of collective agreements is likely to produce better macroeconomic outcomes than a move to sectoral bargaining of the Western European (German) type.

What will be the outcome of the present trend towards greater importance of local-level pay setting in Western European countries? For political and economic reasons, it may turn out to be impossible to combine aggregate real wage restraint with relative-wage flexibility within the current bargaining systems. If this is the case, one cannot, in the long run, rule out a development towards an Anglo-Saxon system in which a move to single-employer collective bargaining is accompanied by massive de-unionisation and a decline in the importance of collective bargaining in general. But such a development would probably occur only as a consequence of a long period of deep economic crisis, followed by radical reform of basic labour legislation. This point is underlined by the failure to include even modest changes of the pay-setting system in the recently adopted labour market reforms in Germany.

The economics of discrimination (Chapter 4)

The draft of the European constitution asserts the principle of non-discrimination as a fundamental European value, to be explicitly written into the constitution along with such values as pluralism, tolerance, justice and solidarity. We fully share the objectives of those who argue for measures against discrimination: the elimination of racism, the advancement of women in public and business life, greater support of disabled people and the establishment of a true common market in which national origin ceases to be of economic relevance. But we are concerned with the danger that the necessarily pragmatic pursuit of policies to achieve these objectives will be overtaken by the semantic interpretation of exactly what constitutes discrimination and non-discrimination, if non-discrimination were to be included as a general rule in the European constitution.

The reality of this danger is illustrated by the experience of German reunification. In this case, the political and constitutional imperatives of non-discrimination between the residents of the former eastern and the residents of the former western provinces required a common benefit system and common labour regulation across areas at very different stages of economic development. This both imposed costly burdens and held back development in the eastern *states*.

In this chapter, we examine the application of non-discrimination rules in three broad areas of European policy: gender discrimination in goods and services (essentially in the insurance market); disability discrimination and discrimination on grounds of nationality. In each of these areas, policy effectiveness can be much better achieved by careful analysis of costs and benefits, and different policy trade-offs in relation to objectives than by the legal application of general principles which sound rhetorically attractive but whose precise meaning and practical consequences are often unclear and must necessarily be the subject of future judicial determination.

In these and other areas covered by the proposed anti-discrimination provisions we suggest that in general the European constitution should contain non-binding statements of objectives and give the Commission and member states the responsibility of introducing specific measures of implementation. The confused and repetitive provisions of the draft constitution dealing with non-discrimination, which conflate a variety of policy issues into a single heading, should be replaced by a declaratory statement of the European Union's objectives in these areas. Such a statement would include a commitment to combat racism, to promote the advancement of women in business and public life, to give greater opportunities to disabled people and to promote the free movement of goods, services and people within the EU. Where there are trade-offs to be made between competing objectives or between different means of achieving the same objectives – which is true in all these cases – these trade-offs should be made through the ordinary political processes rather than by the courts, whose central but limited role in policy should be the defence of the union's fundamental values and ensuring the propriety of its processes.

EU enlargement (Chapter 5)

EU enlargement in 2004 will most likely yield major benefits to the new member countries in the long run. Acceding countries are likely to reap vast gains

from trade in goods and services and from a continued inflow of financial and real capital. Capital inflows to these countries are already substantial, as suggested by current account deficits in the order of 4 to 6 percent for the major ones. Most of these capital flows are in the form of direct investment from present EU member countries. To a large extent these flows respond to profit opportunities created by the currently very low wages in acceding countries. While firms in the current EU member states have already outsourced labour-intensive parts of their product chains to Eastern Europe in the pre-accession stage, outsourcing is likely to gain further momentum after accession in 2004.

Without doubt, these processes will significantly speed up economic growth in Eastern Europe. However, even under optimistic assumptions, catching-up with the EU-15 countries will be a time-consuming process that will take at least several decades. The crucial issue is the degree to which EU membership will enhance economic growth in the accession countries. Attracting private FDI will be a key element of fast economic growth: preconditions for further large FDI flows are well-functioning goods and financial markets, an improved infrastructure and a high quality of public services.

The existing EU member countries will also participate in the gains from trade in the long run. However, the internal adjustment processes caused by enlargement may involve significant costs and frictions in the short and medium term. In particular, trade with acceding countries will increase downward pressures on the wages of low-skilled workers. Cuts in pre-tax real wages for this group may become necessary to prevent a further increase in unemployment rates and an excessive dismantling of labour-intensive production, yet such cuts will be difficult to implement. In chapters 2 and 3 of this report, we discuss reforms of labour market institutions that would enhance wage flexibility. As regards pay-setting practices, for instance, such reforms should entail measures to promote relative-wage flexibility among sectors, regions, and occupations. But policy priority should also be given to specific measures to combine wage flexibility with socially acceptable standards of living for low-wage employees. The first EEAG report (EEAG 2002) suggested a system of social assistance according to which low-wage incomes from employment could be topped up with employment tax credits that would generate the necessary pre-tax wage differentials while preventing socially undesirable declines in the living standards of low-skilled workers.

The economic consequences of EU enlargement will also depend on the policies pursued by the new members. Acceding countries currently have fairly delicate macroeconomic situations. Many of them have significant public sector deficits. Even if the stocks of public debt are low or moderate, sustainability of public finances can become a major policy concern.

There are a number of potentially positive fiscal effects from EU membership, including significant transfers from the EU and indirect gains from interest rate convergence and higher growth rates. These effects notwithstanding, the new EU members are likely to face pressures on public spending after accession: the countries will have to co-finance EU-funded projects, and the implementation of EU regulations will entail fiscal costs. Improvement of the infrastructure as well as social insurance reform and education,will be additional major items in public spending.

In many accession countries, high unemployment rates imply that there is significant underutilisation of resources. At best, these resources can provide further impetus for rapid economic growth, but they could also feed major labour migration to the EU-15 countries. Migratory pressure is likely to be felt most strongly in Germany and Austria, countries that are geographically close to the new members.

EU membership and fully open borders will gradually lead to industrial changes as well. The decline of manufacturing in the Baltic and Central and Eastern European accession countries throughout the 1990s has been reversed in recent years. Some manufacturing sectors have recovered and are likely to keep expanding in the future. Significant parts of the relatively low-skill manufacturing industry and services may gradually shift from EU-15 to the new member countries.

Agricultural productivity is quite low in the acceding countries and there is significant potential for improvement. Agricultural and food production are likely to increase in some of these countries, though food safety and other regulations could contain the rate of expansion. An important role in shaping the future of the agriculture and food processing industry in Europe will be played by international WTO negotiations.

The road to the euro (Chapter 6)

The ten EU accession countries are supposed to join EMU in the next few years – the third and last phase of accession. Participation in EMU is conditional on satisfying the convergence criteria established in the Maastricht Treaty. When should these countries adopt the new currency? What are the challenges to policymakers in the period between EU accession and the adoption of the euro?

There are clear benefits from participating in EMU. The traditional argument is the credibility of low inflation, which applies to acceding countries as it did to southern European countries in the 1990s. A common currency eliminates currency risk and therefore drastically reduces interest rate differentials. In addition, a common currency is likely to increase trade with other EU countries. In this respect, adopting the euro is equivalent to a drop in transaction costs in cross-border exchanges of goods and services within the EU economic area. Also, by reducing the stock of external debt denominated in foreign currency, adopting the euro will substantially reduce vulnerability to currency and financial instability (although in principle EMU countries could still issue large stocks of dollar-denominated debt). The main and well-known disadvantage of participation in a monetary union is the loss of national monetary policy as an instrument of macroeconomic stabilisation and of the exchange rate as an adjustment mechanism. Whether and under what circumstances the adoption of the euro is a net economic benefit is the subject of an ongoing academic debate and political discussion in present EU countries that are not members of EMU. However, from a political point of view it appears certain that the accession countries will ultimately join EMU, so the relevant policy issue is one of timing.

The road to EMU may be quite difficult. Policy choices on the timing of EMU participation directly impinge on the acceding countries' ability to use monetary policy to stabilise their economies in the next few years and to build an economic environment that favours high rates of investment and growth, economic integration and financial stability.

Fiscal and monetary authorities in the acceding countries now operate in a regime of high capital mobility. This is the result of a relatively rapid process of liberalisation and deregulation implemented in the last few years. But it is too early to say whether or not the financial and legal systems of these countries can weather volatile capital movements. However, it would be naïve to hope for the better and envision years without large (global or region-specific) shocks.

Our last chapter points at the intrinsic financial and currency fragility of fast-growing emerging markets in a world of liberalised capital flows. Based on the experience of the 1990s, emerging markets may be exposed to highly volatile capital flows, which can be a formidable challenge to macroeconomic stability. In boom periods, large inflows of short-term capital lead to domestic overheating and high rates of domestic credit expansion, causing excessive risk taking. Since debt is usually denominated in foreign currency, these inflows also expose domestic institutions and individuals to severe currency risk. In bust periods, currency devaluation worsens the balance sheets of banks and production firms.

EU accession is likely to increase short-term speculative capital inflows into the acceding countries. These flows may also respond to moral hazard distortions at both domestic and euro-area levels. Vulnerability to crises and contagion emphasises the need for building well-established mechanisms at the EU level to deal with such contingencies.

As discussed in Chapter 5, structural imbalances in the acceding economies may cause acute problems. Deteriorating fiscal conditions could constrain the use of budget policies for stabilisation purposes. Stabilisation is likely to fall disproportionately on monetary and financial authorities, both from a macro perspective and from a financial stability perspective. In such an environment, mandatory adoption of a regime of limited exchange rate flexibility (ERM II) for two years before entering EMU is controversial.

Overall, there is no single strategy that may be recommended to all acceding countries as regards macroeconomic stabilisation on the road to the euro. Arguments in favour of adopting the euro as early as possible includes smaller financial risk due to the elimination of currency mismatch in the balance sheets of banks and firms (which implies the risk of a self-fulfilling run on the country's debt); interest rate convergence (with the associated gains in terms of the interest bill for the government as well as investment financing by firms); and overall gains in monetary credibility. Arguments for a slower pace to the euro

include the need to remove financial distortions creating moral hazard and therefore raising the country's default risk; easier relative-price adjustment without the need of costly nominal wage and price adjustments; and the need to make fiscal and financial policy sustainable and compatible with a fixed exchange rate before participation in the EMU.

The following recommendations may be made, however:

- Countries that are already able to sustain hard pegs should be helped to achieve a smooth and fast transition to the euro. In this set of countries, mainly small ones, priority should be given to institutional reforms and building a policy framework consistent with participation in the euro area without suffering from major macroeconomic imbalance.
- Delaying participation in ERM II is a realistic option for countries that are currently unable to sustain hard pegs and have large domestic imbalances. Here the policy priority is achieving a sustainable fiscal stance and stabilising inflation at the correct relative prices. This task requires both institutional and policy reform.
- For both groups of countries, the convergence criteria in terms of inflation, interest rates, debt and deficits provide desirable targets to guide policy and should not be relaxed. Though they are not first-best targets, these convergence criteria should be judged relative to existing distortions that could derail the stabilisation efforts.
- ERM II allows for large fluctuation bands around the exchange rate parity. Once in the ERM, a country should be able to use the exchange rate flexibility implied by such an arrangement: exchange rate stability should not be mechanically assessed with reference to much narrower bands. Fluctuations in the exchange rate in response to domestic and foreign shocks are not necessarily an indicator of tension in the foreign exchange market, but can be part of an efficient adjustment process. If the dollar suffers further depreciation, it would be reasonable to expect exchange rate fluctuations within ERM II. Declaring that acceding countries will be accepted in the euro area only if they can peg to the euro within narrow bands may raise the possibility of speculative attacks driven by self-fulfilling prophecies. During the transition to the euro, strict domestic stabilisation with some exchange rate flexibility is better than exchange-rate based stabilisation with very limited flexibility.