How Well Prepared Are the New Member States for the

European Monetary Union?

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Abstract

From a purely economic perspective we find more arguments in favor of early EMU
membership than against, since the New Member States have largely adjusted their economic
policies and economic indicators converge to the EMU average. The benefits of early
accession (reduction of administrative costs, serious commitment, etc.) outweigh or even
reduce most of the remaining risks. If all 25 EU members at once would become members of
EMU the overall rate of inflation in EMU would increase by 0.1 per cent, the average budget
deficit would remain unchanged at 2.7 per cent, the average debt level would fall from 70.4 to
63 per cent, the average rate of interest would go up from 4.1 per cent to 4.5 per cent (while
the Maastricht reference level is at 7 per cent). The only significant risk of early EMU
enlargement for confidence in the Euro would emerge from the high level of bad debts in
Poland and Malta, but this could be resolved within a year if serious action would be taken.

Keywords

European Monetary Union, EMU enlargement, Euro Zone, ERM II.

1. Introduction

Enlargement of the European Monetary Union (EMU) and EU constitution building and are the next most important steps of deepening European integration after EU enlargement in 2004. Contradicting arguments for earlier or later EMU enlargement can be attributed to divergent perspectives perceptions and interests of different actors within old and New Member States and the organizations of EMU and EU.

The authors of this paper see a significant difference between economic policies required to set up the Monetary Union (the Maastricht process) and the process of enlargement of EMU when new members join an EMU that has been put into effect. There is also a difference to be made between the assessments from the perspectives of new members, of members participating in EMU, of EU members not participating in EMU, of the managers of the European Central Bank (ECD), of the European Commission, and the economics of EMU as a whole. In this paper we do not deal with the politics of EMU enlargement and the hoped for disciplining effects of critical announcements that due to numerous prevailing issues foresee an EMU enlargement only at a later stage.

The gist of this paper is that of EMU enlargement from the perspective of economists who pursue the research questions: What are the advantages and the risks of EMU enlargement here and now? Are these risks manageable for the EMU as a whole or could those risks destabilize the EMU and weaken confidence in the Euro? The paper is organized as follows: After setting the stage with the fact that the 2004 EU enlargement is economically marginal, but politically very important, we deal with the conflicting views between the prevailing Maastricht concept and the dynamic Optimal Currency Area theory (Robert Mundell), and with the order of magnitude and possible impact of the Balassa-Samuelson effect. Then we

turn to issues of financial sector size, bad debt, foreign ownership, bank concentration and product availability in financial markets. While in all that fields we can identify problems that are remarkable and important from the perspectives of other economic policy areas we solely deal with these issues from the EMU enlargement perspective and draw appropriate conclusion in the final chapter.

2. The 2004 EU Enlargement – politically prominent, economically marginal

The 2004 EU enlargement is more a prominent political than an economic event. Due to its historic dimension – it ends the political separation of Europe – the economic impact takes the backseat. Poland's blocking of the finalization of the European Constitution in December 2003 underlines the political potential at least of some of the New Member States in the EU. With the exception of Poland (38.6 million inhabitants) – which is a middle power in the EU like Spain (41 million) – all New Member States dispose of either around 10 million inhabitants (Czech Republic and Hungary) or much less, with the smallest countries Malta and Cyprus (400,000 and 700,000 inhabitants, respectively). Estonia (1.4 million) and Slovenia (2 million) disposing only of a population size like those of the Austrian City of Vienna. Besides the political importance of the recent EU enlargement, it amplifies the cultural diversity of the Union. Apart from the multitude of the cultural and national enrichment, the number of official languages will jump from 11 in EU-15 to 20 in EU-25.

The enlarged European Union grew by 10 countries from 15 to 25, its area increased by 23 per cent from 3,236 to 3,975 thousand square kilometers and population increased by 20 per cent from 380 million to 455 million to be compared with the population of the USA of 283 million. The economic potential of the 10 New Member States is marginal, it increased absolute EU GDP only by 5 per cent (at current Euro prices) or by 9 per cent (at PPP units). EU 25 GDP amounts to 9,715 billion € (at current prices) or to 10,151 billion € (at PPP units).

The comparable US GDP figures are 9,616 billion € or 9,904 billion PPP units. Due to the marginal economic weight of the ten New Member States any disturbance originating from these countries should be no major problem to tackle with in the old EU member states. Eight of the New Member States – the former Comecon states in Central and Eastern Europe – are still in a process of transformation. Although their market economies already function, many aspects of the systemic transformation are still under way. It takes time to establish a proper administration which is able to execute law in conformity with the EU acquis communautaire) The New Member States are all "poor" countries. Measured at current € prices their GDP per capita amounts only to 24 per cent of EU-15 GDP per capita. Measured at PPP the ten New Member States arrive at 48 per cent of EU-15 GDP per capita. The huge gap between current prices and PPP is due to the Balassa-Samuelson effect which is still strong in these countries. Statistically the 2004 enlargement makes the people of the EU "poorer" by around 12 (at current prices) or by nearly 9 per cent (at PPP units). EU-25 per capita GDP decreases to 21,232 (at current € prices) or to 22,185 (at PPP units), respectively. The comparable figures for the USA are 33,017 or 34,005, respectively. Thus, the March 2000 strategic target of the EU (Lisbon summit) became a far distant prospect. In the next decade the European Union unlikely will *"become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion."*

 3. Maastricht versus Mundell – more political than theoretical arguments for the Euro?
In the freshly enlarged Union we are faced with a similar debate as in old EU at the advent of the EMU: which country is eligible to join the EMU? There are at least two answers to this question: a legal one, based on the convergence criteria of the Maastricht EC Treaty and – as always in economics - several theoretical ones, most of them resting upon one or the other interpretation of the optimum currency area theory (OCA).

Legally the participation in the EMU is ruled by a clear-cut official "road map", issued in

2000 by the ECB (2000a, p. 121) and in 2001 by the Ecofin council (EU, 2001), respectively.

The Governing Council of the ECB renewed its policy position on exchange rate issues

relating to the New Member States in the press release on December 18, 2003[1]:

"The ten New Member States will all join the European Union as Member States with derogation in the field of European Economic and Monetary Union (EMU). This means that, while not yet adopting the euro, they will be committed to striving towards the eventual adoption of the euro upon fulfillment of the convergence criteria laid down in the Treaty establishing the European Community. The Treaty foresees that at some point following accession, New Member States will join the Exchange Rate Mechanism II (ERM II)".

Consequently, after EU accession on the basis of the single market with derogation

concerning EMU at the next step new EU members are expected to strive for fulfilling the

Maastricht convergence criteria. New Member States shall treat their exchange rate policy as

"a matter of common interest" (EC treaty Art. 124) what implies no competitive devaluations.

After accession, but not immediately, the New Member States are expected to join the ERM

II[2]. In ERM II stable, but adjustable central exchange rates of the participating currencies to

the euro are to be established, with maximum fluctuation bands of +/- 15 per cent around the

central rate. After New Member States have remained in the ERM-II for at least two years

with their exchanger rate within the fluctuation band they can formally apply to become

member of EMU. Then the New Member States will be evaluated according to the Maastricht

convergence criteria. Many commentators (e.g. Buiter, 2004) find this 2 year ERM period an

unnecessary austere "purgatory".

A first evaluation based on 2003 data exhibits the following picture concerning the Maastricht

convergence criteria for entering the EMU (see Table 1).

Table 1: Maastricht Convergence Criteria: New Member States and Candidate Countries

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[1] For an exhaustive overview of the role of ERM II and its different perceptions, the position of the Eurosystem and those of the New Member States and the widespread interpretation of ERM II (when to enter, which bands, how long to stay in this "waiting room"), see Backé & Thimann (2004).
[2] The ERM II itself is defined in the „Resolution of the European Council on the establishment of an exchange rate mechanism in the third stage of the Economic and Monetary Union", Amsterdam, June 16, 1997.

Despite the notorious Balassa-Samuelson effect inflation came down considerably in the New Member States. As a result the lowest inflation rate in the enlarged Union are already exhibited in some of the New Member States (Lithuania, Czech Republic and Poland). Some New Member States, however, lack still inflation convergence with inflation rates above four per cent (Cyprus, Hungary, Slovakia and Slovenia). One of the biggest problems is the high budget deficits in the majority of the newcomers. Only Estonia, Latvia, Lithuania and Slovenia are below the benchmark of a three per cent deficit. In contrast sustainability seems to be secured, because the debts to GDP ratios are in the majority of the newcomers below the 60 per cent benchmark. Looking at the performance of the exchange rates in the last two years one can state that half of the ten New Member States devaluated against the Euro, half of them revaluated. Poland's, Latvia's and Slovenia's currencies devaluated relatively strongly over the last two years (20, 14 and 7 per cent, respectively). An astonishing convergence took place in the field of long-term interest rates. The most recent data indicate that all newcomers would fulfill this criterion. In summing up, with the exception of Lithuania, presently no newcomer would meet all convergence criteria. For most of the newcomers the huge budget deficits are one of the biggest obstacles for joining the Euro zone. Combined with external imbalances this leads to multiple "twin-deficit" problems in the New Member States.

Of course, the newcomers have to move along the path determined in the official "road map" to the Euro. The question is whether this purgatory makes sense from an economic point of view. As the Euro project is unique in economic history no conclusion can easily be drawn from past experience. Most arguments and empirical studies are therefore based on Mundell's OCA theory of 1961. The early Mundell seemed to argue in favor of smaller rather than larger currency areas. This would rather support the doubters of a large EMU, because many "shocking" studies (e.g. by Bayoumi & Eichengreen, 1994, 1997) concluded that only a small core EMU can cope with asymmetric shocks. Why then is Mundell named the intellectual

father of the Euro? Contrary to his 1961 insights, since 1970 he enthusiastically advocated European monetary unification (in particular in Mundell, 1973b). McKinnon (2001) makes us aware that there are two Mundell models (1961 and 1973a). In the earlier model of 1961 with stationary expectations Mundell argues that policymakers balance the savings in transaction costs from the creation of a single currency against the consequences of diminished policy autonomy. The loss of the exchange rate is more costly when macroeconomic shocks are "asymmetric". For the case that other adjustment mechanisms are less effective, like rigid relative wages and low labor mobility, the "shocking" findings by Bayoumi & Eichengreen (1994, 1997) pointed to a small core currency union in Europe. In the later model Mundell (1973a) took into consideration the forward looking nature of the foreign exchange market and international risk sharing: He countered the idea that asymmetric shocks undermine the case for a common currency. Mundell showed how countries with a common currency can mitigate shocks by better reserve pooling and portfolio diversification. A country suffering an adverse shock can better share the loss with a trading partner when both countries hold claims in a common currency on each other's output. Whereas the "earlier Mundell model" (1961) favored a small monetary union, the "later Mundell model" (1973b) is supportive to a large EMU.

The multitude of exchange rate systems gives each of the New Member States a different starting position when participating in ERM II. Two of the ten New Member States have a currency board (Estonia fixed the krone to the Euro; Lithuania re-pegged the litai from the USD to the Euro in February 2002). The remaining countries dispose of one sort or the other of flexible exchange rates: Poland's zloty is free floating, Cyprus' pound and Latvia's lats are floating within bands. Three currencies (Czech and Slovakian koruna and Slovenian tolar) proceed with a managed float system. Three countries follow a pegged rate system: Hungary's forint a crawling peg, Latvian lats a fixed peg, and the Maltese lira is pegged to a basket (Table 1).

According to the verdict of Mundell (1997, 2000) "the pegged rate system deserves to be discredited as the worst of all systems". Which countries would fit the ERM-II obligations? In the first place those which already more or less fixed their exchange rates to the Euro, either via a currency board (Estonia and Lithuania) or those with relative small fluctuations to the Euro (less than +/-15 per cent) since its inception. With the exception of Lithuania (up to February 2002 there was a strong appreciation because of a currency board with a peg to the USD) and Slovenia (strong depreciation to the Euro) all other currencies fluctuated within this band (Backè & Thimann, 2004, pp. 16-17).

The recent exchange rate performance indicates that from an economic point of view most of the Euro aspirants would be already qualified for a membership in the Euro zone, irrespective of their current exchange rate regimes and the formal Maastricht convergence criteria. Prior to EMU participation nominal more than real convergence is a necessary condition for entry into the Euro zone. According to Buiter (2004), nominal convergence defined as convergence to the equilibrium rate of inflation of the EMU is helpful, but not essential, real convergence (convergence of productivity levels, real per capita income, structures of production and employment, quality of regulatory and supervisory institutions) takes time and is "utterly irrelevant for euro adoption". Achieving fiscal sustainability is the major and only necessary condition for euro adoption. Therefore, it should also be the only sufficient condition for Euro zone membership (Buiter, 2004; Mundell, 2000, p. 158).

Fixing the exchange rates too early with too narrow bands will on the one hand bring unnecessary exposure to potentially unstable and de-stabilizing international capital flows with the danger of exchange rates crises (see Begg et al., 2003; Eichengreen, 2003), on the other hand the costs of giving away a policy instrument might be high. "Such an enforced two year period in ERM-II purgatory represents a potentially costly investment without any return" (Buiter, 2004).

A series of arguments can be put forward in favor of a more rapid and broader monetary integration of the New Member States seen from the point of view of the EMU incumbents, but also that of the newcomers (Gros, 2000):

- First of all, the longer more member states (13) operate with their own currencies and only a minority (12 countries) owns the Euro the EU single market is at risk and does not merit the name "single market". Even if in the long run most of the newcomers want to become members of EMU participation in ERM II is by no means compulsory, in spite of the formal obligation to treat the exchange-rate policy as "a matter of common interest" before entering EMU. Lasting non participation may open the door for recurrent disturbing exchange rate devaluations. "Really I do believe you cannot have a common market when you have fluctuating exchange rates in an area. This would be ridiculous" (Mundell, 2000, p. 164). A large number of EMU outsiders will cause high administrative cost for the EMU.

- There are several types of economies of scale in the formation of currency areas (Mundell, 1997). First, there are economies in policy formation. When a small country (with the exception of Poland all the New Member States are small) fixes its currency to that of a larger country (EMU) with a low inflation rate or enters the Euro zone, it sets the conditions for its wage policy and the rest of its macroeconomic policy repertoire. Second, the more countries join EMU there are higher economies for protection against external shocks. Third, because money is a unit of account, there are economies of information and convenience in having a single currency that reduce transaction costs in trade with goods and services, compared with the cost to manage an own currency under flexible exchange rates. If more countries join a currency area, it will be more efficient!

- The present EMU members already experienced a considerable trade bonus. Micco, Stein & Ordonez (2003) estimate with a panel covering bilateral trade flows of 22 developed countries from 1992 to 2002 that the positive effect of EMU on bilateral trade between the 12 member countries ranges between 4 and 10 per cent, when compared with trade among

non-EMU countries. The larger the EMU the greater this trade bonus. Rose (2002) in a world wide study came to much higher trade effects of currency unions.

- These findings complement Mundell's argument that one cannot have a single market without having a common currency. According to the endogenous OCA hypothesis a positive link between income correlation and trade integration is postulated. Monetary integration reduces trading costs beyond the elimination of the costs from exchange rate volatility. A common currency among partners is seen as a much more serious and durable commitment. Among others, it precludes future competitive devaluation, facilitates foreign direct investment and the building of long-term relationships, and might over time encourage forms of political integration. This in turn promotes reciprocal trade, economic and financial integration and business cycle synchronization among the countries sharing a single currency (Mongelli, 2002, p. 29 and Kucerova, 2003). Therefore, a country's suitability for entry into a currency union has to be reconsidered when endogenous OCA properties are satisfied or "countries which join EMU, no matter what their motivation may be, may satisfy OCA properties ex-post even if they do not ex-ante!" (Frankel & Rose, 1998). A faster integration of the newcomers into EMU would accelerate business cycle synchronization – a prerequisite of a functioning central monetary policy in the EMU. Until now, there is not yet a strong correlation of business cycles of the New Member States with those of the EMU countries (except with Germany; see Fidrmuc, 2001; Mahlberg & Kronberger, 2003) nor is there a strong similarity of supply and demand shocks in both country groups (see Fidrmuc & Kohornen, 2003; Kucerova, 2003).

- As far as openness (an additional OCA criteria formulated by McKinnon (1963)) is concerned the New Member States quickly redirected their trade flows to the EU markets after the breakdown of their relations with the former Comecon and with Russia, in particular. Fostered by the asymmetric trade liberalization of the Europe Agreements between the EU and the CEECs the trade integration of six CEECs with the EU single

market is already deeper than that of many old EU member states. While intra-EU-15 trade amounts to around 61 per cent, Hungary exports 75 per cent of its total exports to the EU, followed by Estonia, the Czech Republic and Poland with 69 per cent, Slovenia and Latvia with 62 per cent and 61 per cent. The other four New Member States report smaller than 50 per cent trade shares of the EU. A rapid takeover of the Euro would further enhance trade between the new and the old EU member states.

- GDP growth and inflation differential will increase after EU enlargement simply due to the greater heterogeneity of the New Member States. Among the EU 15 the mean and dispersion of the inflation declined in the years running up to EMU, but increased again after introduction of the Euro in 1999. Estimates by Honohan & Lane (2003) indicate that the weakness of the Euro in the early months of EMU had different effects on different member states.

- The Balassa-Samuelson productivity growth effect has not yet played an important role, although it could be more significant after accession of the New Member States. After EU enlargement, of course, within the EU the dispersion of the rate of inflation will increase by ½ to one per cent point. This provides another economic argument for a more rapid monetary integration of the newcomers into the Euro zone. The EU-15 exhibited a quite considerable decline of dispersion of the growth rates of real GDP since the inception of the EMU in 1999 what indicates the gradual emergence of a "European Business Cycle" (Artis, Krolzig & Toro, 2004). EU enlargement will temporarily reverse this positive process: the standard deviation of the growth rates of real GDP of the enlarged EU will increase by ½ per cent point. Quick monetary integration of the newcomers could foster not only the convergence of inflation rates, but also that of the business cycle.

4. Is the Balassa-Samuelson effect an obstacle for joining EMU?

New Member States which are former Central and Eastern European countries are still in a process of transformation what is mirror-imaged by several macroeconomic disequilibria. Most of the New Member States report huge budget deficits. In addition, with the exception of Slovenia all newcomers have huge current account deficits. These deficits are partly financed by a steady increase of net-inflow of foreign direct investment (FDI), but they also reflect a strong correlation between real effective exchange rate increases and current account deficits. Bussière, Fratzscher & Müller (2004) estimated an intertemporal model with structural current account positions for a panel of 33 countries, including the ten new EU members. They find that from an intertemporal perspective in most acceding countries current accounts are currently broadly in line with their structural current account positions.

The miss-match of actual exchange rates with PPP indicates that the newcomers are still in a catching-up process. Whereas GDP per capita in Cyprus and Malta at current prices (69 per cent and 44 per cent, respectively) is already quite close to those at PPP (74 per cent and 53 per cent of the average of EU-15), the respective figures of the former eight CEECs differ by 1:2. An exception is Slovenia where GDP per capita at current prices (51 per cent) and at PPP (74 per cent of average EU-15) converged already faster than in the other CEECs. These gaps, of course, are due to the Balassa-Samuelson effect.

Figure 1: Real effective exchange rates: New Member States vis à vis EU-15

There is a whole bunch of estimates of the B-S effect (for recent surveys see Breuss, 2003; Égert, 2003; Égert & Lommatzsch, 2003). The results vary with the approach chosen and the estimation method. It seems that in all CEEC the B-S is still working with a probable lower bound of around 1 ½ per cent point contribution to domestic inflation. Due to this fact, Buiter (2004) suggests to account for the B-S effect when the convergence criteria are evaluated to decide about EMU membership, since the B-S effect in most of the New Member States

translates into a steady real appreciation (Figure 1). Exceptions are Cyprus, Malta and Slovenia. Slovenia takes into account that the Euro zone is the largest market for their goods and deliberately targets a constant real exchange rate to the Euro.

Summarizing the arguments, one must conclude that real exchange rate appreciations that reflect productivity gains in the tradable sector (due to the B-S effect) are an equilibrium phenomenon and do not erode competitiveness. The important policy conclusion is that these currency appreciations do not require a policy response in the process of becoming full-fledged market economies (Breuss, 2003). When real appreciation stops transformation will be completed. One must take into consideration that the economic distance for the new entrants to catch up is much larger than for any previous entrants to the EU. It is about twice that faced by Greece or Portugal when they joined the EU.

The fact that the New Member States must first join the ERM II and then can join EMU is an important constraint which affects both the behavior of forward-looking financial markets and the authorities. In addition, at the time of previous accessions capital controls were not actively disallowed. Greece, Portugal and Spain all made extensive use of this possibility. Halpern & Wyplosz (2001, p. 15) "guesstimate" that the B-S effects was responsible for an average annual rate of real appreciation of around 3 per cent. During the two-year ERM membership period, which is required prior to EMU entry there will be a trade-off between exchange rate stability and the inflation target. Keeping the nominal exchange rate stable as required for accession to EMU could lead to inflation rates 3 per cent points above that in the euro area. Preventing such inflation rate, what is another condition for entry into the EMU (Maastricht convergence criteria), will require nominal exchange rate appreciations of 3 per cent points per year. Over two years this amounts to half of the ERM II bandwidth. In addition, real appreciation could be reinforced by capital inflows which will affect the real exchange rate both via the nominal rate and via the B-S effect as FDI raises productivity

growth significantly more in industry then in the service sector. Desired FDI inflows could absorb the remaining half of the bandwidth for ERM II.

Since most of the FDI inflows come from the Euro zone the upward pressure on nominal exchange rates would disappear after joining the EMU and as the share of the New Member States in the GDP of EU-25 is only 5 per cent the overall impact of the regional Balassa-Samuelson effect on the Euro will remain marginal. In addition, regional real appreciations that are due to productivity gains do not require policy action. Therefore, from a macro economic perspective we conclude that arguments against a quick accession of the New Member States to EMU weigh less than arguments in favor.

5. Financial sector integration – institutional hurdles for the adoption of the Euro?

Since not all macroeconomic conditions for joining the EMU are met we have to raise the question whether a banking crisis in a New Member State is likely and could destabilize EMU after enlargement? Five issues stick out with regard to the microeconomic safety and soundness of the New Member States' financial sectors: the small size and limited level of financial intermediation and markets; foreign bank ownership; the level of concentration and competition; bad debt; and the product range.

Several financial services sector issues were already addressed by the EU membership criteria (ECB, 2000b:47; ECOFIN, 2000; European Commission, 2003):

• The *existence of a functioning market economy*, including that the financial sector is sufficiently developed to channel savings towards productive investment.

• The *capacity to withstand competitive pressure and market forces …*, including the availability of a sufficient amount of capital at an appropriate cost for all types of economic agents.

- The *capacity to take on the acquis and other obligations of membership …*, including free flow of capital, appropriate judicial capacity, the prohibition of any direct public sector financing by the central bank and the prohibition of privileged access of the public sector to financial institutions.

In its autumn 2003 assessment of the candidate countries, the European Commission (2003a) concluded that, while the acquis in the banking sector is particularly well established, several countries need to enhance transposition in the finance sector and strengthen financial supervision till joining the EU. In the EU membership negotiations minor transitional periods were granted on certain financial services issues, e.g. on the use of certain types of land for collateral lending (Table 2). Given their phasing out by 2007 for quite a while the New Member States' financial sectors will have proven the ability to operate under the same regulatory regime as other EU countries.

Table 2: Required Enhanced Efforts till EU-Membership and Transitional Arrangements in Financial Services

6. Small Size Argument: Slim financial intermediation and markets

Financial markets of New Member States are small in both absolute and relative terms (Jaffee & Levonian, 2001; ECB, 2004).[3] While total financial intermediation (measured as sum of stock market capitalization, bonds outstanding and credit granted by monetary financial institutions in 2001) relative to GDP is about 300per cent in the Euro zone and in the EU, it is a mere 85 per cent of GDP in the New Member States (NM-10) and especially low in the Baltics with 36 per cent of GDP. Only the small financial markets of Cyprus and Malta come somewhat closer to the EU average of financial intermediation, partly due to their function as

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[3] To account for structural differences between regions the countries are grouped: CEE-5 includes the Czech Republic, Slovakia, Hungary, Poland, Slovenia; BALTIC-3 includes Estonia, Latvia and Lithuania. CEE-8 is the sum of CEE-5 and BALTIC-3. CEE-10 adds Bulgaria and Romania to the CEE-8. The New Member States (added Cyprus and Malta to CEE-8) are termed NM-10 in the tables. As Turkey and Croatia may join at a yet undetermined date, they are included in the ENL-14, but not further discussed. Even adding all 14 instead of 10 would not change the general picture.

offshore financial centers (Georgiadou, 2002; Pullicino & Saliba, 2002). In these two countries total bank assets including domestic and foreign assets with 388 per cent and 361 per cent of GDP are larger than total domestic financial intermediation with 267 per cent and 221 per cent of GDP (Table 3).

While aggregate bank assets are about 200 per cent of GDP in the Euro zone and the EU, the ratio is below 80 per cent for the new EU members, ranging from 29 per cent in Lithuania to 103 per cent in the Czech Republic. Private credit granted by monetary financial institutions (mainly banks) is about 100 per cent of GDP in the Euro zone and the EU and again at about a third of that level in the New Member States (Table 3).

Table 3: Relative Size of Financial Sector

The New Member States also had to re-establish capital markets and respective institutions. In 2001 average stock market capitalization was only 16 per cent of GDP. Initially formal privatization under mass-voucher schemes led to grossly inflated equity markets in a few countries, notably the Czech Republic and Slovakia. In these two countries after major corrections market capitalization relative to GDP fell to 14 per cent and 3.3 per cent of GDP in 2001. A combination of gradual liberalization of foreign portfolio investment and parallel enforcement of stringent listing requirements and information dissemination rules proved more successful in the case of Hungary and Poland. Equity market capitalization still is low with 15 per cent of GDP (POL) and 20 per cent (HUN) compared with the Euro zone average of 70 per cent of GDP. On the bond markets, which play a pivotal role for establishing reliable long-term interest rates, the situation is similar (ECB, 2003; Backé & Thimann, 2004). The volume of bonds outstanding amounts to 125 per cent of GDP within the Euro zone and 34 per cent of GDP in the New Member States.

Table: 4: Absolute Size: Financial Sectors Relative to Euro Zone and Old EU

While New Member States financial markets are small relative to the size of the respective economies, this is also the case in absolute terms. Total domestic financial intermediation (measured as sum of stock market capitalization, bonds outstanding and credit granted by monetary financial institutions in 2001) of the New Member States amounts to 1.7 per cent of the EUR-12 Euro zone and to 1.2 per cent of the EU-15. Total bank assets (including foreign assets) and private credit amount to 2.4 per cent and 2.1 per cent of the Euro zone, respectively. The capital markets are even smaller, with stock market capitalization and bond volume outstanding of 1.4 per cent and 1.6 per cent of the Euro zone.

From the relatively small degree of financial intermediation, several conclusions can be drawn. In the short run domestic banks and capital markets cannot have a strong impact on economic growth in the New Member States (Drakos, 2003; Kuivu, 2002). The modest depth of financial intermediation is a constraint to effectiveness of interest rate and credit channels (Backé & Thimann, 2004; ECB, 2004). New customer and product groups are increasingly targeted, especially retail banking with a share of the overall market of 36 per cent in the CEECs compared to 55 per cent in the EU in 2001 (Di Maggio, Romanowski & Walter 2003). Compound annual growth for the CEECs' banking sector 2001-2010 is forecast to reach 14 per cent, of which 18 per cent in the retail banking sector (Di Maggio, Romanowski & Walter 2003).

From an overall EMU perspective the financial sectors of the New Member States are so small that they cannot cause major disturbances at EMU level. Numerous banks and investors in the EMU which are significantly larger than these financial markets rather could cause disturbances in small New Member States.

7. Bad Debt, Foreign Ownership and Bank Concentration

After 1990, the new state owned commercial banks started life with an inherited overhang of troubled assets (the "stock problem"). During transition, a wave of new bad debt had to be swallowed by the banks, and later on by the respective taxpayers via repeated recapitalizations (the "flow problem"). Average annualized net fiscal cost of bank restructuring (direct fiscal costs minus sales proceeds of state banks) was above 1.5 per cent of average 1995-2002 GDP in the Czech Republic and Turkey, in the 1-1.5 per cent-range in Croatia and Romania, in the 0.5-1 per cent range in Bulgaria, Hungary, Lithuania and Slovakia and below 0.5 per cent in Latvia and Slovenia (Sherif, 2003). The process of cleansing the accounts of the politically sensitive state-owned enterprises and of the banking system brings hidden liabilities of the public sector to the surface (Pelkmans, Gros & Ferrer, 2000:112). Under ESA 95 rules, these costs have to be reflected in the general government net balance the year it is incurred (European Commission, 2001b:11). In the Czech case, taking the Consolidation Agency activity into account drives general government deficit up from 3.9 per cent of GDP to 6.7 per cent of GDP in 2002, with total holdings of bad assets amounting to about 15 per cent of GDP (European Commission 2003c:15f).

Table 5: Non-Performing Loans Relative to Total Loans

Non-performing loans accounted for 13.6 per cent of total loans in the New Member States in 2001. Only the Baltic countries reached a low level of 3.6 per cent comparable with the EU-15 level. On the negative side Poland and Malta stand out with 25 and 18 per cent of non-performing loans in 2002, a level corresponding to Japan (Hall, 2000; Berger, Nast and Raubach, 2002), the Ukraine, and Turkey (IMF, 2003). 25 per cent non-performing loans in Poland and 18 per cent in Malta could destabilize financial markets in both countries. This could serve as an important argument against early accession of Poland and Malta to EMU. However, bad debts of all new EU members together amount to less than 0.4 per cent of

private credit in the Euro zone. From that perspective the threat of bad debt is manageable at EMU level.

Figure 2 – foreign banks

More stringent lending policies by foreign-owned banks helped to reduce bad debt levels. On average roughly 70 per cent of the banking market in the New Member States is under control of foreign banks – way above the 16 per cent foreign bank assets in the Euro zone. In Estonia, Lithuania, Malta and Slovakia (and also Croatia) local banks are essentially owend by foreign banks. In the Czech Republic, Hungary, Poland and Croatia the share of foreign owners is around 80 per cent (Adahl, 2002; Backé & Thimann, 2004; Buch, Kleinert and Zajc, 2003). Slovenia and Cyprus are notable exceptions with continuing state and/or dominant domestic ownership (European Commission, 2003c). Total foreign bank assets in the New Member States amount to about 1.8 per cent of total Euro zone bank assets and, thus, are of minor importance in aggregate terms. The regional picture is differentiated, but still no matter of concern for the regional supervisory authorities. Two thirds of the Baltic banking assets are Swedish hands. Greek and Italian banks are most active in South-Eastern Europe. Austrian and German banks are strongly involved in the neighboring CEE5-markets (Czech Republic, Slovakia, Hungary, Poland, Slovenia and Slovakia). For Austrian banks business in the CEECs (including assets abroad and direct cross-border loans) accounted for 10 per cent of consolidated total assets and 22 per cent of their operating profit (OeNB, 2003:36). At the end of 2003 the IMF Financial Sector Assessment Program (FSAP) checked the CEEC credit exposure of Austrian banks and found that "risk from the exposure of Austrian banks was manageable" (IMF 2003a). The "neighbor content" of the New Member States' banking systems seems to be a sound way of stabilizing and modernizing financial intermediation while at the same time ensuring long-term commitment of the foreign bank owners to the host country (Bokros, 2000:11). Foreign banks so far substitute for domestic financial supervision

(Wagner & Iakova, 2001) which still needs to be improved in most New Member States (European Commission, 2003c).

Figure 3 - Concentration

Hand in hand with the high involvement of major banking groups from neighbor countries goes a high level of market concentration. In 2001 the top five banks accounted for 65 per cent of aggregate bank assets in the New Member States, way above the Euro zone-12 average of 41 per cent (regional averages weighted with total assets). Of course, when considering EMU as a unified market, the level of concentration in the overall EMU is much lower than concentration in any of the single EU member states.

Despite the strong foreign involvement and general success in transforming banking markets, there still are some weak spots with regard to product availability and the market setting. Missing pieces and gaps in the New Member States include entrepreneurial finance, developed bond markets, leasing, housing finance, institutional investors and non-bank financial intermediaries and supervisory structures (Bonin & Wachtel, 2003). The degree of availability and terms of consumer finance, most importantly mortgage finance, make these services accessible only to a limited fraction of the population (Saccomanni, 2003). In several New Member States, credit constraints limit the growth of small and medium sized enterprises (SME). Among the main issues mentioned by the European Commission (2003c) that deter banks from collateral-based lending are: lack of implementation or experience with bankruptcy laws; the length of court proceedings and other deficiencies in the judicial process; and the absence of a properly functioning land registry that make it difficult to establish ownership over land and thus use property as collateral in loans. Venture capital markets in the New Member States suffer from rather narrow and weak stock markets that limit investors' exit opportunities (European Commission, 2003e). On the positive side it has to be mentioned that

in most New Member States, growth is especially strong in those hitherto neglected financial products and that capital markets are gaining ground, including bond markets.

8. Conclusions and policy recommendations

The political importance of EU enlargement in 2004 by far outweighs the economic significance, since EU population increased by 20 per cent and GDP only by 5 per cent. No doubt, Lithuania is the only country that meets the Maastricht criteria, but are these criteria the only possible and reasonable yardstick to be applied? If all 25 EU members would be also members of EMU the overall rate of inflation would increase by 0.1 per cent, the average budget deficit would remain unchanged at 2.7 per cent, the average debt level would fall from 70.4 to 63 per cent, the average rate of interest would go up from 4.1 per cent to 4.5 per cent (while the Maastricht reference level is at 7 per cent).

Is it worthwhile to bother about these few marginal shifts to the worse or better and consequently forego important gains from a larger monetary union? Economies of policy formation, a higher level of protection against external shocks, reduced transaction costs, the positive consequences of a serious and durable commitment which foster business cycle synchronization, and a high share of internal trade outweigh the possibly disciplining effects of clinging to the Maastricht criteria for sake of political power games. Anyway, after accession to EMU the stability pact would exert the same disciplining effect as the Maastricht criteria.

Due to the Balassa-Samuelson effect and the desired inflows of foreign direct investment for individual New Member States the risks of the two year purgatory in ERM II are higher than those of immediate accession to EMU. Within EMU large FDI inflows would not push up the nominal exchange rate. The Balassa-Samuelson effect that is due to significant productivity gains in the goods production sector is desired and unavoidable anyway. It will lead to somewhat higher regional inflation. Due to the small size of the New Member States this

higher inflation will hardly impact overall EMU inflation. On the other hand the implicit real appreciation that will take place within Monetary Union does not require policy action as it is induced by productivity gains.

Remain the institutional arguments: small financial sectors, high levels of bad debt in Poland and Malta, large share of foreign ownership in the financial sectors, high concentration in the banking sector and a not completely developed structure of bank products. Collateralized debt and venture capital markets are yet to be developed.

The small size argument is rather in favor of early EMU enlargement. Why bother with that number of small economies that cause more administrative cost then the involved remaining risk could do harm to EMU as a whole? Who bothered about debt levels or budget deficits of Andorra, Monte Carlo, San Marino, or the Vatican? There are a large number of banks in Europe which have larger total assets than most of the New Member States as a whole. Large foreign ownership and high bank concentration in the hands of foreign banks are important stabilizing factors. If foreign banks are properly supervised in their home countries the banking system in the New Member States will be stable enough.

The fact that not the whole range of bank products is at offer in New Member States does not affect EMU at all.

Finally, there is the relatively high bad debt in Poland and Malta. Of course, if all bad debts would default at once that would trigger a major banking crisis. If the EU commission and ECB would give Poland and Malta one year to resolve that problem, EMU could be enlarged at once by 10 new members with relatively small financial sectors. The gains would outweigh risks.

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Table 1: Maastricht Convergence Criteria: New EU Member States and Candidate Countries

(Precondition to enter EMU)

	Inflation	Government budgetary position		Exchange rate regime	Exchange rates	Long-term interest rates
	CPI (HICP) [1] %-change	Deficit in % of GDP	Debt (gross) in % of GDP	[2]	%-change vis à vis €[3]	Lending rate in %
	2003	2003	2003	2003	2003/2001	2003
Reference value EU-25	*1.4*	*-3.0*	*60.0*	-	*No deva-luation*	*7.0*
Cyprus	4.3	-6.3	72.7	FB (€)	DP	4.6
Czech Republic	0.0	-12.9	37.6	MF (€)	AP	4.1
Estonia	1.6	+2.6	5,7	CB (€)	-	6.4
Hungary	4.6	-5.9	59.0	CP (€)	AP	6.5
Latvia	2.5	-1.8	15.6	FP (SDR)	DP	5.1
Lithuania	-0.9	-1.7	21.9	CB (USD/€)	AP	5.1
Malta	1.3	-9.7	72.0	PB	DP	5.8
Poland	0.7	-4.1	45.4	FF	DP	5.9
Slovakia	8.5	-3.6	42.8	MF	AP	4.9
Slovenia	5.9	-1.8	27.1	MF	DP	5.5
New EU Members	2.3	-5.0	42.4	-	-	5.0
Bulgaria	2.0	-0.0	50.8	CB (€)	-	9.4
Romania	15.3	-2.7	21.6	MF	DP	28.9
Turkey	45,0	-8.0	89.1	FF	DP	92,0
Candidate countries (CC-13)	2.8	-5.6	55.4	-	-	6.5
Euro area	2.1	-2.7	70.4	-	-	4.1
EU-15	2.0	-2.6	64.0	-	-	4.2
EU-25	2.2	-2.7	63.0	-	-	4.5

[1] HICP = Harmonized index of consumer prices.

[2] CB = Currency Board (Latvia repegged from USD to the Euro in February 2002); CP = Crawling peg; FB = Floating with bands (+/- 15%); FF = Free float; FP = Fixed peg; MF = managed float (Slovenia, exchange rates within crawling bands); PB = Pegged to a basket (Malta: 70% Euro, USD, Pound Sterling);

[3] DP (depreciation) or AP (appreciation) against the Euro.

Sources: EBRD (2003); European Commission (2003e); Eurostat (2004); AMECO data base of the European Commission.

Table 2: Required Enhanced Efforts till EU-Membership and Transitional Arrangements in Financial Services

Enhanced Efforts Till EU-	Membership
POL	accelerate transposition of the acquis in the financial sector
CZ, LAT, LIT, SLK	accelerate transposition in the insurance sector
CYP, EST, LAT, LIT	accelerate transposition in investment services and securities markets
Transitional Arrangements	in the "Freedom to Provide Services"
CYP	exclusion of co-operative credit and savings societies until end 2007
HUN, LAT, LIT, POL	exclusion of specialised banks/credit unions until end 2007
EST, LAT, LIT, POL	lower levels of bank deposit guarantee and investor compensation until end-2007
BUL, HUN, SLK	lower level of investor compensation until end 2006 (SLK); end-2007 (HUN); end-2009 (BUL)
SLO	lower level of capital requirements for savings and loan undertakings until end 2004
Transitional Arrangements	in the "Free Movement of Capital"
SLO, MLT	real estate investments (MLT: permanent national legislation)
CYP, CZ, HUN, POL	secondary residence investments
CZ, HUN, EST, SLK, LAT, LIT, POL	agricultural land and forest investments

Source: Backé & Thimann (2004); European Commission (2003a, 2003b).

Table 3: Relative Size of Financial Sector (in per cent of GDP)

2001	CZ	SLK	HUN	POL	SLO	EST	LAT	LIT	CYP	MLT	BUL	ROM	TUR	CRO
shares	14%	3%	20%	15%	18%	15%	9%	10%	65%	38%	1%	3%	30%	16%
bonds	46%	28%	57%	28%	22%	3%	5%	15%	36%	60%	44%	12%	68%	34%
private credit	47%	26%	35%	27%	39%	16%	23%	12%	166%	123%	14%	7%	17%	44%
financial intermediation*	108%	56%	112%	70%	79%	34%	38%	37%	267%	221%	58%	22%	115%	94%
bank assets**	103%	92%	64%	56%	86%	38%	67%	29%	388%	361%	39%	24%	59%	89%

2001	USA	JPN	EUR-12	EU-15	CEE-5	BALTIC-3	CEE-8	CEE-10	NM-10	ENL-14
shares	137%	55%	**70%**	86%	15%	12%	15%	13%	**16%**	19%
bonds	176%	143%	**124%**	124%	36%	8%	33%	32%	**34%**	42%
private credit	145%	172%	**101%**	109%	32%	16%	31%	28%	**35%**	28%
financial intermediation*	458%	370%	**296%**	318%	83%	36%	79%	81%	**85%**	88%
bank assets**	94%	287%	**190%**	209%	70%	42%	67%	74%	**78%**	69%

 * total domestic financial intemediation; ** total domestic and foreign bank assets

Data source: dataset as described in Blum, D., Federmair, K., Fink, G., & Haiss, P. (2002).

Table 4: Financial Sectors: Absolute Size and Relative to Euro Zone (EUR-12) and EU-15 in billion Euro and per cent
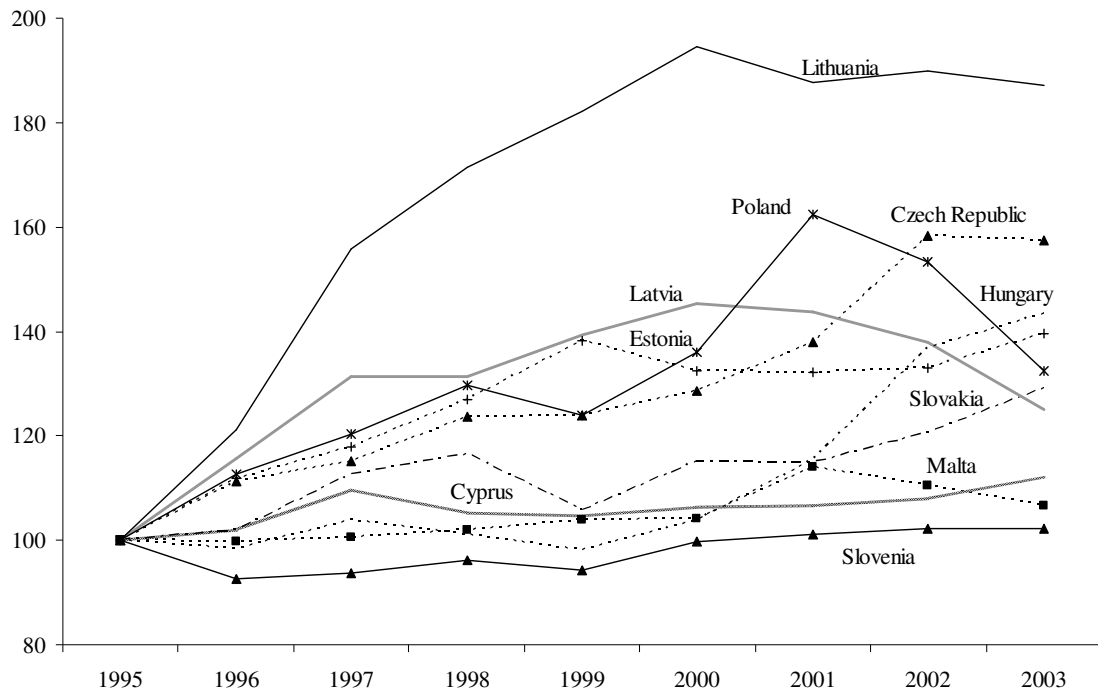
Aggregate Markets in EUR bn (2001)										
2001	**USA**	**JPN**	**EUR-12**	**EU-15**	**CEE-5**	**BALTIC-3**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**
GDP	11,252.5	4,626.4	6,819.9	8,834.8	362.2	32.7	394.9	455.1	409.1	668.1
2001	**USA**	**JPN**	**EUR-12**	**EU-15**	**CEE-5**	**BALTIC-3**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**
shares	15,688.9	2,588.1	4,874.7	7,682.4	54.5	3.8	58.3	59.6	66.4	125.0
bonds	20,165.8	6,709.2	8,618.2	11,124.5	128.8	2.7	131.5	143.5	137.6	277.6
private credit	16,589.8	8,091.5	7,000.3	9,797.2	117.0	5.2	122.2	127.6	144.1	188.3
financial intermediation*	52,444.5	17,388.8	20,493.2	28,604.1	300.3	11.7	312.0	367.0	348.1	590.9
bank assets**	10,706.3	13,503.0	13,198.1	18,790.9	252.0	13.8	265.8	336.4	319.9	460.7

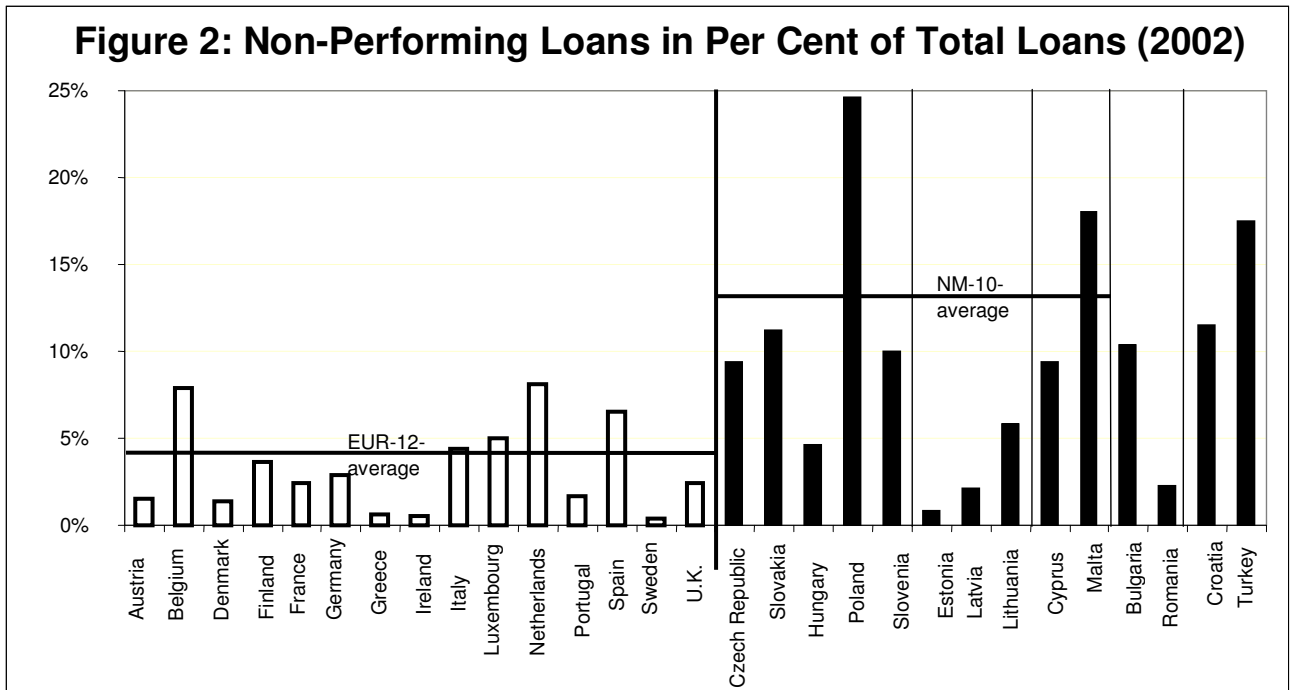| In per cent of the EUR-12 Eurozone							In per cent of the EU-15			
2001	**CEE-5**	**BALTIC-3**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**
GDP	5.3%	0.5%	5.8%	6.7%	**6.0%**	9.8%	4.5%	5.2%	**4.6%**	7.6%
2001	**CEE-5**	**BALTIC-3**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**	**CEE-8**	**CEE-10**	**NM-10**	**ENL-14**
shares	1.1%	0.1%	1.2%	1.2%	**1.4%**	2.6%	0.8%	0.8%	**0.9%**	1.6%
bonds	1.5%	0.0%	1.5%	1.7%	**1.6%**	3.2%	1.2%	1.3%	**1.2%**	2.5%
private credit	1.7%	0.1%	1.7%	1.8%	**2.1%**	2.7%	1.2%	1.3%	**1.5%**	1.9%
financial intermediation*	1.5%	0.1%	1.5%	1.8%	**1.7%**	2.9%	1.1%	1.3%	**1.2%**	2.1%
bank assets**	1.9%	0.1%	2.0%	2.5%	**2.4%**	3.5%	1.4%	1.8%	**1.7%**	2.5%

* total domestic financial intemediation; ** total domestic and foreign bank assets

Data source: Dataset as described in Blum, D., Federmair, K., Fink, G., & Haiss, P. (2002).

Figure 1 : Real effective exchange rates: New EU Member States to EU-15
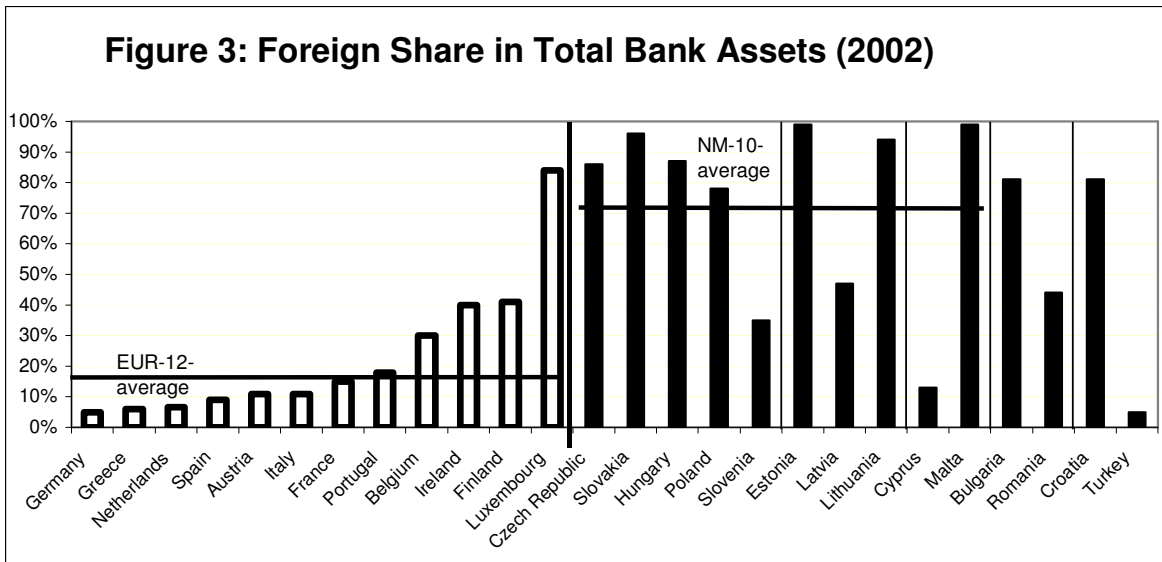(Relative unit labor costs; 1995=100)

Source: European Commission (2003f).

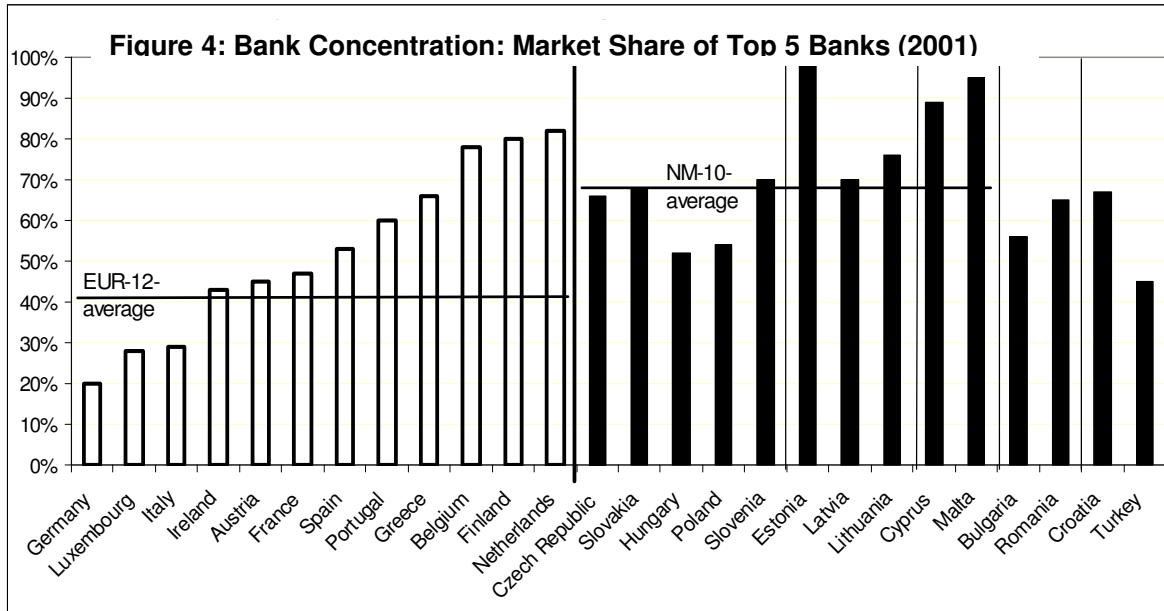## Figure 2: Non-Performing Loans in Per Cent of Total Loans (2002)

Note: non-performing loans include substandard, doubtful and loss classification categories for loans, but exclude loans transferred to a state rehabilitation agency or consolidation bank, end-of-year. Regional averages were weighted with national private credit.
Data source: for CEEC: EBRD (2003); CYP, MLT: European Commisson (2002); TUR and EU: IMF (2003a); JPN: Berger et al (2002).

Figure 3: Foreign Share in Total Bank Assets (2002)

Note: Regional averages weighted with total assets.
Data source: Adahl, 2002; Bank Austria Creditanstalt, 2003; Buch, Kleinert & Zajc, 2003;
Georgiadou, 2002; Pullicino & Saliba, 2002.