The World Economy in the Autumn of 2003

An abridged version of the Evaluation of the Economic Situation by the following members of the Association of German Economic Research Institutes.

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Overview

The world economic cycle has been stimulated over the past year. Production has increased at an accelerated rate since the spring, and assessments of the economy's prospects are considerably more favourable. The business and consumer climate has improved worldwide, and share prices have risen substantially following their long and strong decline.

There have been various fears that this recovery could be short-lived – indeed, very much like that of last year – especially since the accelerated increase in demand in the United States was largely due to fiscal impulses. However, there are several indications that, this time, worldwide economic expansion is anchored on much firmer foundations. The end of the war in Iraq has reduced world political uncertainties. The adjustment processes undertaken in companies and banks in getting to grips with the dismissals that had occurred as a result of the strong expansion in the second half of the 1990s have made vast progress. Measures implemented to reduce costs are showing signs of success, and profits have been rising noticeably for some time. Opportunities for companies to borrow have improved as a result of the improved profits achieved on stock markets. Since economic policy has, simultaneously, maintained its expansionary course, the conditions for lasting world economic revival are favourable.

While the economic downturn in 2000 affected all countries more or less at the same time, this is not true of the cyclical recovery. Once again, the United States is the frontrunner; its highly expansionary macro policy has led to a very strong increase in domestic demand. Meanwhile, Japan's cyclical recovery has proven to be surprisingly strong – a remarkable feat, given the country's on-going deflation. The Japanese economy seems to be veering onto a path of greater growth, especially since increases in production have not been due to increased government spending, as in previous years. Company restructuring has evidently advanced to such an extent that the central bank's zero-interest rate policy and the strong increase in its money supply are showing increasing effectiveness. In cyclical terms, the euro zone is the 'straggler', since its economic activity has been stagnant since autumn of last year. The noticeable real effective euro revaluation had a dampening effect, and the economic policy impulses were comparatively weak.

Outside the industrialised countries, economic development has also been differentiated. In the East Asian newly industrialising countries (NICs), the temporary slowdown in economic dynamism, due not insubstantially to the SARS virus, has been overcome in recent months. At the same time, the growth in production in Russia has accelerated significantly, partly due to the continuously high price of oil. In the EU accession states, whose economies had demonstrated robustness compared to the weakness displayed in the industrialised countries, production continued to rise consistently.

Latin America, however, has not yet been embraced by the world economic recovery.

World economy on course to recovery

The stimulation of the world economy until now has been due not least to economic policy measures. U.S. financial policy impulses, however, will end next year; in Japan, the course of consolidation will continue; and in the euro zone, financial policy is likely to take a neutral course. At the same time, the opportunities for a self-sustained upturn are good. Monetary policy continues to act as a stimulant, and, despite cyclical recovery, its course will remain virtually unchanged during the forecast period since the price climate remains generally calm. Nevertheless, in order to provide an early signal of its stability orientation, the US central bank is likely to slightly raise its key lending rate around the middle of next year, once cyclical recovery has been secured. The Japanese central bank will maintain its highly expansionary course, while the European Central Bank (ECB) will keep its key lending rate at the current level in 2004, as price increases in the euro zone slow down. The forecast also assumes that currency relations will remain constant; yen and euro exchange rates are not considered likely to rise substantially further against the US dollar, and the remaining East Asian currencies are not expected to revalue. In addition, a crude oil price of US $ 28 per barrel is assumed for next year.
Under these conditions, world economic recovery will continue next year (cf. tables 1 and 2), and the cyclical gaps between regions will be reduced. In the United States, the increase in demand will slow slightly over the course of the year; real GDP and productive capacity, meanwhile, will continue to rise at similar rates. In Japan, continued economic expansion is anticipated. The speed of this expansion will, however, be slightly slower

| Table 1 | Real GDP, Consumer Prices and Unemployment Rates in Europe |
|---------|----------------------------------------------------------|
|         | Weighting (GDP) (%) | GDP | Consumer prices¹ | Unemployment rates² (%) |
|         | 2002 | 2003 | 2004 | Change on the previous year (%) | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| Germany | 22.0 | 0.2  | 0.0  | 1.7  | 1.3  | 1.0  | 1.3  | 8.6  | 9.3  | 9.5  |
| France  | 15.9 | 1.2  | 0.3  | 1.6  | 1.9  | 2.0  | 1.6  | 8.8  | 9.4  | 9.5  |
| Italy   | 13.1 | 0.4  | 0.2  | 1.4  | 2.6  | 2.7  | 2.2  | 9.0  | 8.7  | 8.4  |
| Spain   | 7.2  | 2.0  | 2.1  | 2.6  | 3.6  | 3.1  | 2.5  | 11.3 | 11.4 | 11.3 |
| The Netherlands | 4.6  | 0.2  | −0.6 | 0.9  | 3.9  | 2.2  | 1.7  | 2.8  | 4.1  | 5.0  |
| Belgium | 2.7  | 0.7  | 0.9  | 1.6  | 1.6  | 1.5  | 1.5  | 7.3  | 8.0  | 8.1  |
| Austria | 2.3  | 1.1  | 0.8  | 1.6  | 1.7  | 1.2  | 1.2  | 4.3  | 4.5  | 4.5  |
| Finland | 1.5  | 2.2  | 1.1  | 2.5  | 2.0  | 1.3  | 1.5  | 9.1  | 9.2  | 8.9  |
| Greece  | 1.5  | 4.0  | 4.4  | 4.0  | 3.9  | 3.5  | 4.0  | 10.0 | 9.4  | 9.0  |
| Portugal | 1.3  | 0.4  | −0.8 | 1.2  | 3.7  | 3.2  | 2.3  | 5.0  | 6.8  | 7.5  |
| Ireland | 1.3  | 6.9  | 1.1  | 3.5  | 4.7  | 4.1  | 3.2  | 4.4  | 4.7  | 4.8  |
| Luxembourg | 0.2  | 1.1  | 1.0  | 2.3  | 2.1  | 2.4  | 2.1  | 2.8  | 3.7  | 3.9  |
| EMU countries³ | 73.6 | 0.9  | 0.4  | 1.7  | 2.3  | 2.0  | 1.7  | 8.4  | 8.8  | 8.9  |
| United Kingdom | 17.3 | 1.7  | 2.0  | 3.0  | 1.3  | 1.4  | 1.5  | 5.1  | 5.1  | 5.0  |
| Sweden  | 2.7  | 1.9  | 1.5  | 2.4  | 2.0  | 2.1  | 1.8  | 4.9  | 5.4  | 5.4  |
| Denmark | 1.9  | 2.1  | 0.6  | 1.5  | 2.4  | 2.1  | 2.0  | 4.5  | 5.2  | 5.2  |
| EU-15³ | 95.5 | 1.0  | 0.8  | 2.0  | 2.1  | 1.9  | 1.7  | 7.7  | 8.1  | 8.1  |
| Poland  | 2.0  | 1.4  | 3.2  | 3.8  | 1.9  | 0.8  | 2.0  | 19.9 | 20.0 | 19.0 |
| Czech Republic | 0.8  | 2.0  | 2.5  | 3.3  | 1.8  | 0.0  | 2.0  | 7.3  | 7.0  | 6.8  |
| Hungary | 0.7  | 3.3  | 2.5  | 3.0  | 5.3  | 4.5  | 5.5  | 5.6  | 5.8  | 5.6  |
| Slovakia | 0.3  | 4.4  | 3.8  | 4.3  | 3.3  | 8.3  | 6.0  | 18.6 | 16.5 | 15.5 |
| Slovenia | 0.2  | 3.2  | 2.4  | 3.0  | 7.5  | 6.1  | 5.5  | 6.0  | 5.8  | 5.6  |
| Lithuania | 0.1  | 6.7  | 6.8  | 6.0  | 0.3  | −1.0 | 1.0  | 13.1 | 11.3 | 10.5 |
| Cyprus  | 0.1  | 2.0  | 2.5  | 3.5  | 2.8  | 4.0  | 2.5  | 3.9  | 4.2  | 4.0  |
| Latvia  | 0.1  | 6.1  | 6.0  | 5.5  | 1.9  | 2.8  | 3.0  | 12.8 | 12.0 | 11.5 |
| Estonia | 0.1  | 6.0  | 4.2  | 4.5  | 3.6  | 1.5  | 2.0  | 9.1  | 8.5  | 8.2  |
| Malta   | 0.0  | 1.2  | 1.0  | 2.0  | 2.2  | 1.0  | 2.5  | 7.4  | 7.8  | 7.6  |
| Accession states | 4.5  | 2.4  | 3.1  | 3.7  | 2.8  | 2.1  | 3.0  | 14.8 | 14.6 | 13.8 |
| EU-25³ | 100.0 | 1.2  | 0.9  | 2.1  | 2.1  | 1.9  | 1.8  | 8.9  | 9.1  | 9.0  |
| Memo item: | Weighted by exports⁴ | − | 1.4  | 1.1  | 2.1  | 2.4  | 2.1  | 2.0  | − | − | − |

¹ EU-15: harmonised index of consumer prices (HICP). — ² Standardised. — ³ Total of countries listed. GDP and consumer prices weighted by 2002 GDP in US dollars; unemployment rate weighted by 2001 labour force. — ⁴ Total of countries listed. Weighted by country’s shares in German exports in 2002.

Sources: OECD; ILO; IMF; Federal Statistical Office; Institutes’ calculations; 2003 and 2004: Institutes’ forecast.
than previously, partly because the value of the yen is noticeably higher than before. The euro zone will experience a growing revival in demand and production. However, even in the second half of next year, the production gap will be reduced only slightly. On the whole, real GDP in the industrialised countries will rise noticeably more quickly in 2004 than this year. At 2.7%, the increase will be about as high as the medium-term rate.

In the industrialised countries, cyclical impulses are generated by strong productivity increases in the Asian NICs. The region has once again developed into a world economic growth centre, due not least to the intense economic dynamism in China. With the revival in western Europe, economic expansion is likely to accelerate noticeably in the EU accession states. Rising prices for raw materials will encourage production particularly in Russia and Latin America. And, given the upturn of the world economy, world trade will expand noticeably: in 2004, it will rise by some 7.5%, after 3.5% in each of the past two years.

The problem of the U.S. current account deficit
The high U.S. current account deficit is seen in many quarters as a risk to worldwide economic recovery. It currently stands at 5% of GDP and, given the stronger cyclical dynamism in the United States, will continue to rise.

The U.S. current account deficit indicates fewer savings than investments in the country. The difference is financed by capital imports, i.e. an increase of the net level of external debt. A domestic expectation of excessive debt could lead to a considerable increase in the national savings ratio and to a shortfall in domestic

![Table 2](image-url)

| Weighting (GDP) (%) | GDP | Consumer prices | Unemployment rates (%) |
|---------------------|-----|----------------|-----------------------|
|                     | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 | 2002 | 2003 | 2004 |
| EU-25               | 31.0 | 1.2  | 0.9  | 2.1  | 2.1  | 1.9  | 1.8  | 8.9  | 9.1  | 9.0  |
| Switzerland        | 0.9  | 0.2  | –0.2 | 1.2  | 0.6  | 0.5  | 0.8  | 2.8  | 3.7  | 3.9  |
| Norway             | 0.7  | 0.9  | 0.5  | 1.6  | 0.8  | 2.2  | 1.6  | 3.9  | 4.5  | 4.5  |
| Western and Central Europe | 32.6 | 1.1  | 0.8  | 2.0  | 2.0  | 1.9  | 1.7  | 8.8  | 9.0  | 9.0  |
| USA                | 35.9 | 2.4  | 2.7  | 3.6  | 1.6  | 2.3  | 2.3  | 5.8  | 6.0  | 5.7  |
| Japan              | 13.7 | 0.1  | 2.7  | 2.0  | –0.9 | –0.3 | –0.3 | 5.4  | 5.3  | 5.3  |
| Canada             | 2.5  | 3.3  | 2.3  | 3.3  | 2.2  | 2.7  | 2.0  | 7.6  | 7.7  | 7.5  |
| Industrialised countries | 84.6 | 1.6  | 2.0  | 2.7  | 1.4  | 1.7  | 1.7  | 7.2  | 7.4  | 7.3  |
| Russia             | 1.2  | 4.3  | 6.0  | 5.5  | 15.8 | 14.0 | 12.0 | 8.0  | 7.5  | 7.5  |
| East Asia¹         | 4.5  | 4.8  | 3.0  | 5.0  | –   | –   | –   | –   | –   | –   |
| China              | 4.8  | 8.0  | 8.0  | 8.0  | –   | –   | –   | –   | –   | –   |
| Latin America²     | 4.9  | –0.2 | 0.7  | 3.0  | –   | –   | –   | –   | –   | –   |
| Newly industrialising countries | 15.4 | 4.2  | 4.1  | 5.3  | –   | –   | –   | –   | –   | –   |
| Total              | 100.0| 2.0  | 2.3  | 3.1  | –   | –   | –   | –   | –   | –   |
| Memo item: weighted by exports | –   | 1.6  | 1.5  | 2.6  | –   | –   | –   | –   | –   | –   |
| World trade, real  | –   | 3.2  | 3.5  | 7.5  | –   | –   | –   | –   | –   | –   |

1 Weighted average comprising: South Korea, Taiwan, Indonesia, Thailand, Malaysia, Singapore, Philippines. Weighted by 2002 GDP in US dollars. — 2 Weighted average comprising: Brazil, Mexico, Argentina, Columbia, Venezuela, Chile. Weighted by 2002 GDP in US dollars. — 3 Total of countries listed. Weighted by 2002 GDP in US dollars. Sources: OECD; ILO; IMF; Federal Statistical Office; Institutes’ calculations; 2003 and 2004: Institutes’ forecast.
demand. A more pessimistic risk assessment on the part of foreign investors would imply that the influx of capital could be maintained only through increased interest rates. However, a large proportion of capital imports is due to expectations of high yields based on strong productivity growth and the increase in jobs in the U.S. The decisive factor is whether these expectations can be sustained over time.

Experience from other countries suggests that it is virtually impossible to finance a 5% current account deficit in relation to GDP over a long period of time. This implies a fairly substantial risk that markets will force a reduction in the current account deficit in the short or long term. One possibility of reducing this gap between imports and exports would be a strong devaluation of the U.S. dollar. Although the dollar has lost in value over the past 18 months, the effect on the current account deficit has been negligible. To achieve a positive effect, a further significant devaluation would be required, which could happen abruptly. The risk that such a development might occur has risen in recent months, as evidenced by shifts in the structure of capital imports: short-term investments have grown considerably, at the expense of longer term investments, and especially direct investments.

A considerable share of the recent demand for the dollar is due not so much to decisions of individual economic actors, but, rather, economic policy considerations: this year, a number of Far Eastern central banks have either obstructed the revaluation of their currencies against the U.S. dollar (e.g. the Chinese central bank) or slowed this process (the Japanese central bank, in particular) by purchasing comprehensive dollar stocks. Consequently, however, financing the U.S. current account deficit depends heavily on intervention policies of the Japanese and Chinese governments. For both countries, there is the paramount concern at the loss of competitiveness of domestic goods, but also that of possible pressure on the highly fragile financial markets there. A large-scale liberalisation of exchange rates by the Far Eastern central banks is therefore highly unlikely during the forecast period. The risk of a further loss of confidence in the U.S. dollar with continued intervention in favour of the yen and yuan will continue. In this case, the scenario would be similar to that of the previous 18 months: the euro zone in particular, one of the economically weakest of the important economic regions, would have to bear the burden of a strong revaluation thrust. Given the different economic policy intentions of the individual countries, there is the potential for considerable turbulence on currency markets. In addition, a trend towards a protectionist trade policy could increase in the United States. All of this would impair world economic recovery.

United States: upturn is consolidated

In the United States, cyclical expansion has accelerated noticeably since last spring, due in no small measure to strong fiscal impulses. On the one hand, defence spending rose considerably. On the other, tax reforms, which came into effect from the middle of the year, had already encouraged private consumption beforehand. Until the summer, consumption also benefited from low mortgage interest rates, which many households utilised to refinance their debts. In addition, the slower upward trend in prices increased purchasing power. In terms of private investment, the upward trend was consolidated with an end to the war-induced wait-and-see attitude.

Monetary conditions have improved further. The key lending rate was lowered again in June; the Federal Funds Rate now stands at 1%, its lowest level in 45 years. In addition, there was the devaluation of the dollar. Capital market interest rates, on the other hand, rose again slightly after the mid-year point, against the backdrop of the recovering cycle and probably also due to the drastic increase of the government's capital requirements. Next year, the central bank is likely to react to the consolidated economy, especially since concerns regarding deflation will have been dispersed by then. The Federal Funds Rate is likely to be raised slightly – probably from the early summer onwards – and to stand at about 2% by the end of the year. For the entire forecast period, monetary policy is likely to be clearly expansionary.

Through its early implementation of tax reform, financial policy has further increased its degree of expansion. In addition, the costs arising from the military operation in Iraq have been significantly higher than was anticipated last spring, and security and defence spending will remain high. Since the greater share of tax cuts will become effective next year, the national budget deficit will, once again, be higher in 2004. The national deficit will rise to a lesser extent, however, since the Federal States, given their precarious financial situation, are consolidating more forcefully; measured against GDP, this deficit is likely to stand at 4.4% in 2004, as opposed to 3.9% this year and 2.4% last year.

Private consumption will be vigorously stimulated by tax cuts during the second half of 2003 and the first six months of 2004; financial policy impulses will, however, weaken. Moreover, as a result of the slower increase in real estate prices and the anticipated further rise in mortgage interest rates, the tendency among pri-

1 For details on the U.S. tax package, cf. Working Group of German Economic Research Institutes: 'The World Economy in the Spring of 2003'. In: DIW Economic Bulletin, vol. 40, no. 5, May 2003.
private households to save is likely to be slightly greater. Against this background, it is vital – for the further direction of the economy – that the recovery spreads to the labour market. There are doubts currently as to whether the economic acceleration will soon lead to a visible expansion in employment. These doubts are based on employment figures obtained from company surveys that, until recently, showed a strong fall in employment. On the other hand, however, employment figures obtained from surveys of domestic households showed an upward trend since early 2002 (cf. figure 1). The discrepancy between the two is probably largely due to data collection problems. Thus, the growing trend towards outsourcing has evidently meant that employees are left out of company statistics, since parts of companies located elsewhere are not included in the survey samples. This would therefore support the argument that, currently, domestic surveys provide a more accurate description of employment trends. Thus, the labour market situation seems more favourable than is frequently assumed.

The cyclical revival is raising expectations of an accelerated expansion in employment. Supported by linked growth in incomes, private consumption will lose momentum only slightly throughout the year, despite the lack of further tax impulses. Against the backdrop of more favourable sales and profit prospects, company investment will expand more rapidly. Nevertheless, when measured against the trends prevalent in the 1990s, the speed is likely to remain moderate initially, due to as yet incomplete consolidation; at the same time, however, the upturn in general will have a more balanced and lasting structure. Exports, which had been falling until well into the summer, are set for recovery as a result of world economic recovery; however, imports will rise at greater speed.

Real GDP is anticipated to rise by 2.7% on an annual average in 2003, and by about 3.6% next year (cf. figure 2); the negative production gap in the U.S. will be virtually closed by the end of 2004. Price increases are likely to accelerate slightly throughout the year, but remain moderate on the whole. One risk factor in addition to the continuously increasing current account deficit is that the budget deficit will remain very high for the foreseeable future. This involves the danger that interest rates to finance the government capital requirements will rise significantly and exert pressure on the economy.

Figure 1
United States: Employment Trends, Applying Different Statistical Concepts

1 Indices (monthly values).
Sources: Bureau of Labor Statistics; NBER; Institutes' calculations.
Japan: considerable growth in production

The Japanese economy has expanded noticeably since the beginning of last year (cf. figure 3). In the process, the buoyant forces have increasingly shifted away from foreign demand to private domestic demand. As a result of decisive profit increases and improved sales expectations, company investment in particular has grown considerably. The stabilised labour market situation has encouraged the expansion of private consumption.

A number of indicators point to the fact that the economy is currently much more robust than during the brief periods of recovery in 1996 and 1999. Restructuring in the company sector has made noticeable progress. In contrast to previous periods of economic revival, the financial policy's expansionary impulses have no role in this; government spending has been reduced slightly since mid-2002, and the tax cuts that came into force this year are faced with increases in other duties. Monetary policy remains firmly on an expansionary path. The Bank of Japan has maintained not only its zero-interest policy and further massively increased liquidity on money markets; it has also lowered capital market interest rates through increased purchases of government bonds; it has encouraged a noticeable recovery in share prices by purchasing blocks of shares from bank securities; and it has recently even begun to buy up debts of companies outside the banking sector. These unconventional measures have added to the brighter future expectations of companies and consumers.

For the period of this forecast, a change of direction for monetary policy is not anticipated, especially since deflation is only gradually expiring. However, monetary conditions have deteriorated due to a considerable revaluation of the yen compared with the U.S. dollar, which had been prevented until recently by comprehensive intervention on currency markets. As a result, the price competitiveness of Japanese producers fell. And the as yet unresolved structural problems in the banking sector, which continue to render the financing of private investments difficult, continue to have a braking effect. Thus, it is expected that the cyclical upturn will lose some of its speed.
The Economy of the European Union

Euro zone moves hesitantly out of stagnation

Economic production stagnated in the euro zone during the first half of 2003 (cf. figure 4). At the beginning of the year, uncertainty linked with the crisis in Iraq dampened the willingness of companies to invest and of consumers to spend. Price competitiveness was impaired by the sharp euro revaluation; exports fell. The less favourable profit prospects led companies to restrict investment with continuously high excess capacity. Development of private consumption was also weak, given the gloomy labour market prospects. Unemployment rose slightly during the year; in August, the seasonally adjusted unemployment rate stood at 8.8%. Compared with previous periods of weakness, the labour market has remained relatively robust until now, with employment falling only marginally. And while jobs were lost in the industrial and construction sectors, they were created in the services sector. The rate in the increase of prices, which had temporarily stood at 2.5% at the beginning of the year due to rising energy prices, fell slightly during the course of the year. The euro revaluation and moderate wage increases have contributed to this outcome.

Financial policy continues on virtually neutral course

The situation of public budgets in the euro zone has deteriorated further this year; the aggregate deficit in relation to GDP will rise to 2.8% (cf. table 3). In most countries, the targets prescribed in the national stability programmes will not be achieved. The weak economy is decisive for the increase of deficits in some countries and the reduction of surpluses in others. The structural deficit will remain virtually unchanged in the euro zone. In many countries, it is falling slightly due to efforts at consolidation. In France and Austria, however, it is once again on a significant rise this year. In Italy, the deficit is being contained particularly due to the fact that discretionary measures, such as tax amnesties, are leading to considerable added income this year.

For next year, measures have been agreed in most countries that will aim to limit the further increase in government spending and therefore reduce the structural deficit. In this context, Finland and Ireland are exceptions; however, both countries have been successful in consolidating their government finances in recent years. Since the acceleration of the euro zone economy next year will be only gradual, the aggregate deficit is unlikely to fall substantially during this forecast period. On the whole, the financial policy course will remain virtually cyclically neutral. Germany’s and France’s budget deficits continue to exceed the upper limit stipulated in the Stability and Growth Pact.

Monetary conditions remain favourable

At the beginning of June, the ECB lowered the authoritative key lending rate by 0.5%, for the seventh time in a row. Since then, the market rate for three-month funds stands at 2.1%, which, with the current inflation rate at roughly 2%, implies a short-term real interest rate of virtually zero. The euro zone’s monetary policy must thus be described as clearly expansionary. Moreover, the return on 10-year government bonds fell noticeably until mid-year, but had again reached the early 2003 level of 4.2% at the beginning of October. Since then, long-term interest rates have probably fallen slightly in real terms (cf. figure 5). Borrowing conditions for companies have also improved, owing to the fact that the added risk surcharge for company borrowing without first-class ratings has fallen since the beginning of the year compared to government borrowing. Also, the recovery on share markets has been a favourable development.
The M3 money supply has continued to expand strongly in recent months. The strong increase is explained mainly by investor preference - in view of lower capital market interest rates: short-term investments in securities that form part of M3 were held. Even the moderate credit extension points to the fact that demand-effective liquidity is currently increasing less vigorously. Thus, the expansion of bank advance facilities to the private sector fell significantly until mid-year; lately, it has accelerated again.

The revaluation of the euro, which had begun in early 2002, continued more or less without interruption this year. Between January and September, the euro gained a nominal 6% in value against the U.S. dollar; since January 2002, in fact, this figure has stood at 27%. The real effective revaluation during the same periods stood at 4% and 16%, respectively. This counteracted the expansionary course steered by the ECB, so that monetary conditions have remained virtually unchanged this year, despite interest rate cuts. On the whole, they have remained favourable.

Assuming a constant exchange rate against the U.S. dollar, and seen against the backdrop of a more or less constant production gap, inflation next year is not likely
to be above the levels compatible with the ECB’s targets on price level stability. It is therefore anticipated that, for the period of this forecast, the ECB will maintain the key lending rate at its currently low level. Given the worldwide cyclical recovery, capital market interest rates will rise slightly.

Outlook

Early indicators point to the fact that economic production in the euro zone will experience a slight revival in the second half of 2003. Thus the purchasing manager index and the indicators on assessment of the economy published by the European Commission are pointing towards an upturn. The mood in the services sector has brightened in particular. Moreover, share prices have risen markedly in recent months. Next year, expansion will become more dynamic. Fading out of the effects of euro revaluation, as well as stronger foreign demand, will stimulate exports, which will have an effect on the domestic economy. Positive sales and profit expectations will induce companies to expand investments. This will be facilitated by continuously favourable borrowing conditions. In addition, unit labour costs will rise only slightly, given the moderate wage increases and a cyclically dependent rising labour productivity. The situation on the labour market will not improve until towards the end of the forecast period. Against this background, therefore, private households are likely to expand their consumer spending only slowly. On the whole, GDP will increase by 0.4% in 2003 and by 1.7% in 2004 (cf. table 4).

The after-effects of the euro revaluation will initially dampen the buoyancy of prices. In addition, given continuously low capacity utilisation, opportunities for companies to increase prices remain limited. In general, the inflation rate is likely to reach 2.0% this year and to fall to 1.7% next year.

### Table 3
Public Budget Indicators for the EMU Countries

|                | Gross debt | Financial balance |
|----------------|------------|-------------------|
|                | 2000 | 2001 | 2002 | 2003 | 2004 | 2000 | 2001 | 2002 | 2003 | 2004 |
| Germany        | 60.2 | 59.5 | 60.8 | 63.9 | 65.5 | –1.2 | –2.8 | –3.5 | –4.0 | –3.5 |
| France         | 57.2 | 56.8 | 59.0 | 61.7 | 63.4 | –1.4 | –1.6 | –3.1 | –4.1 | –3.9 |
| Italy          | 110.6 | 109.5 | 106.7 | 105.8 | 105.0 | –1.8 | –2.6 | –2.3 | –2.5 | –2.9 |
| Spain          | 60.5 | 56.8 | 53.8 | 52.0 | 50.5 | –0.9 | –0.3 | 0.1 | –0.5 | –0.4 |
| The Netherlands| 55.9 | 52.9 | 52.4 | 54.0 | 54.6 | 1.5 | 0.0 | –1.6 | –2.4 | –2.5 |
| Belgium        | 109.6 | 108.5 | 105.8 | 103.0 | 100.1 | 0.2 | 0.4 | 0.1 | –0.4 | –0.1 |
| Austria        | 66.8 | 67.3 | 67.3 | 68.5 | 68.5 | –1.9 | 0.2 | –0.2 | –1.3 | –1.1 |
| Finland        | 44.6 | 44.0 | 42.7 | 41.5 | 40.0 | 7.1 | 5.2 | 4.2 | 3.0 | 2.1 |
| Greece         | 106.2 | 106.9 | 104.7 | 103.0 | 101.0 | –1.9 | –2.0 | –1.2 | –1.5 | –1.3 |
| Portugal       | 53.3 | 55.5 | 58.1 | 60.0 | 60.5 | –3.2 | –4.2 | –2.7 | –3.3 | –3.0 |
| Ireland        | 38.4 | 36.1 | 32.4 | 31.8 | 31.5 | 4.4 | 0.9 | –0.4 | –1.0 | –1.5 |
| Luxembourg     | 5.5 | 5.5 | 5.7 | 5.7 | 5.7 | 6.4 | 6.1 | 2.5 | 0.5 | 0.0 |
| EMU countries2 | 69.5 | 69.2 | 69.0 | 70.2 | 70.6 | –0.9 | –1.6 | –2.2 | –2.8 | –2.7 |

1 As % of gross domestic product; apportionment according to Maastricht Treaty; financial balance excluding extra revenue from the sales of mobile transmission licences. — 2 Total of countries listed. Weighted by 2002 GDP in euro.
Sources: Eurostat; 2003 and 2004: Institutes’ forecast.

### Table 4
EMU Countries: Key Forecast Figures

|                | 2002 | 2003 | 2004 |
|----------------|------|------|------|
| Real GDP       | 0.9  | 0.4  | 1.7  |
| Private consump. | 0.4  | 1.4  | 1.6  |
| Government consump. | 2.8  | 1.9  | 1.7  |
| Gross fixed capital formation | –2.6 | –1.3 | 1.9  |
| Exports1       | 1.7  | –0.5 | 3.5  |
| Imports1       | 0.0  | 1.9  | 3.7  |
| External surplus/deficit2 | 0.7  | –0.8 | 0.0  |
| Consumer prices3 | 2.3  | 2.0  | 1.7  |
| Balance of payments | 0.8  | 0.1  | 0.3  |
| Budget surplus/deficit4 | –2.2 | –2.8 | –2.7 |
| Unemployment rate5 | 8.4  | 8.8  | 8.9  |

1 Exports and imports include goods and services, including cross-border trade within the EMU. — 2 Change on the previous year as % of the previous year’s GDP. — 3 HICP — 4 Standardised.
Sources: Eurostat; Institutes’ calculations; 2003 and 2004: Institutes’ forecast.
The Forthcoming Enlargement of the European Union

On 1 May 2004, the European Union will be enlarged, to include 25 countries (see box 1). In addition to the eight central and eastern European countries (CEECs) of Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Hungary and Slovenia, two Mediterranean countries, Malta and Cyprus, will also join. This step has effects not only on growth, but also brings with it considerable economic policy implications for both the current and prospective members. Accession to the EU is linked simultaneously to accession to European Economic and Monetary Union (EMU). When, and under what conditions, the euro will be introduced is likely to have a profound influence on the economic development of these countries.

Long-term effects of the integration process

In the long term, EU enlargement will strengthen economic growth in the countries concerned. Trade in particular will be intensified, and the mobility of labour and capital as factors of production will increase. Moreover, there will be important redistribution effects via the EU budget.

In the course of the accession process, per capita income in the current EU (i.e. EU-15) will rise by up to 0.7%. Of course, this will affect each of the countries very differently. For example, in economic terms, Austria, Finland and Germany are linked much more closely with the accession states than, say, France, the United Kingdom or the Netherlands. The closer the links, the greater, tendentially, will be the anticipated growth in income. On balance, therefore, countries that have only loose economic links with the accession states will have to face losses and will also have to be prepared for considerable cuts in the amount of EU structural funding allocated to them.

The growth effects resulting from the per capita income are likely to be much greater for the accession states than for the EU-15. For Poland and Hungary, for example, they are estimated to constitute between 8% and 9%, and for the CEECs in total 5% to 8%. The effects are, for one thing, more significant, because the mobilisation of productivity reserves, linked with a more efficient distribution of labour and capital accumulation, will be greater than in EU-15, given the lower levels of income. Moreover, compared with the current EU members, the accession countries are small. For this reason, their growth in market potential resulting from integration is higher than for existing EU countries.

One must consider, however, that the economic integration of the EU-15 with the accession states has already progressed immensely, so that some of the income effects are already in progress. Trade in goods was liberalised to a large degree in the 1990s within the scope of the Europe Treaties. The more intensive links in foreign trade since then is reflected in the increasing synchronisation of the cycles in industrial production in the EU-15 and the accession countries (cf. figure 6). Only in agriculture, which has until now been excluded from trade liberalisation, are considerable welfare gains still possible by moving towards free trade. However, precisely with regard to integration into the Common Agricultural Policy, a long transition period was agreed. Because of the customs union within the EU, some accession states will have to raise the degree of protection with third countries. On the one hand, this provides impulses for trade within EU-25; on the other, this redirection of trade impairs growth in the accession states.

Joining the European Union favours capital mobility. Considerable effects are anticipated, initially particularly with regard to short-term financial assets, which currently are still subject to regulations that will be lifted with EU accession. Conditions for the influx of long-term capital into the accession states will also improve tendentially. It is therefore likely that risk premiums for financing investments, which have until now been high, will fall, an effect likely to become stronger in the run-up to the introduction of the euro. This would...

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5 The effects of eastern enlargement through EU budgets depend to a large degree on how the additional expenditures for the accession states are financed, i.e. whether this is primarily via a shift of funds within the Structural Funds, a shift of funds away from the Common Agricultural Policy to the Structural Funds, or an increase of contributions. For further details, cf. B.J. Heidra, C. Keuschnigg and W. Kohler: 'Eastern Enlargement of the EU: Jobs, Investment and Welfare in Present Member Countries.' CESifo Working Paper, no. 718. Munich 2002; cf. also: C. Weise: 'How to Finance Eastern Enlargement to the EU.' DIW Discussion Papers, no. 287. Berlin 2002.

6 F. Breuss (2002): 'Benefits and Dangers of EU Enlargement.' Eupforica, 29, p. 245-274.
Comparing the economic structures in EU-15 and the accession states

As a result of EU enlargement to the east, the surface area of the European Union will increase by some 23% and its population by about 20%. Nominal GDP, on the other hand, will rise by just under 5%. Taking account of the differences in purchasing power, per capita GDP in the accession states was about half the EU-15 level in 2001. Only in Slovenia and Cyprus has per capita GDP measured in this way exceeded per capita income levels of Portugal and Greece, the poorest EU-15 member states. Nevertheless, the increase of real GDP in the accession states, averaging 3.9% annually between 1995 and 2002, has been significantly higher than the EU-15 average of 2.1%.

With regard to economic structure, there are differences between the regions. At 63%, the share of gross value added achieved in the accession states' services sectors was slightly lower than the EU-15 average, while the share of the industry and construction sectors, at 26% and 7% respectively, was slightly higher than in the EU; here, corresponding shares were 71%, 22% and 5%, respectively. At 4%, the share of agriculture in gross value added in the accession states is higher than the EU average of 2%. The proportion of both exports and imports is significantly higher in the accession states than in EU-15.

The structural change that is occurring as a result of the transformation process has left deep traces in the central and eastern European countries' labour markets. At 14.4%, the 2002 unemployment rate in the accession states as a whole was almost twice as high as that in EU-15 (7.6%). However, there were considerable differences between the individual accession countries: unemployment was particularly high in Poland, Slovakia, and the Baltic states; in the other countries, meanwhile, rates were even below the EU average.

Table 5
Key Economic Figures for EU-15 and Accession States (B-10), 2001

|                  | EU-15 | B-10 | Poland | Czech Republic | Hungary | Slovakia | Slovenia | Lithuania | Cyprus | Latvia | Estonia | Malta |
|------------------|-------|------|--------|---------------|---------|----------|----------|-----------|--------|--------|---------|-------|
| Surface Area     | 3 191.1 | 738.5 | 312.7 | 78.9          | 93.0    | 49.0     | 20.3     | 65.2      | 9.3    | 64.6   | 45.2    | 0.3   |
| (1 000 km²)      |       |      |        |               |         |          |          |           |        |        |         |       |
| Population (in million, Jan. 2002) | 377.1 | 74.8 | 38.6 | 10.3 | 10.2 | 5.4 | 2.0 | 3.5 | 0.8 | 2.3 | 1.3 | 0.4 |
| GDP (billion euro) | 8 843.1 | 411.7 | 204.1 | 63.3 | 57.8 | 23.3 | 20.9 | 13.4 | 10.2 | 8.5 | 6.2 | 4.0 |
| GDP (per capita) | 100.0 | 47.7 | 40.5 | 59.0 | 52.8 | 48.2 | 69.8 | 39.6 | 74.0 | 33.4 | 39.8 | 55.0 |

| Shares and rate (%) | EU-15 | B-10 | Poland | Czech Republic | Hungary | Slovakia | Slovenia | Lithuania | Cyprus | Latvia | Estonia | Malta |
|---------------------|-------|------|--------|---------------|---------|----------|----------|-----------|--------|--------|---------|-------|
| Agriculture, share of gross value added | 2.1 | 4.1 | 3.8 | 4.2 | 4.3 | 4.6 | 3.1 | 7.1 | 4.0 | 4.7 | 5.8 | 2.4 |
| Exports, share of GDP | 35.9 | 48.5 | 28.1 | 71.3 | 74.3 | 75.9 | 57.8 | 50.9 | 46.8 | 44.4 | 89.4 | 87.4 |
| Imports, share of GDP | 34.7 | 52.4 | 31.8 | 75.8 | 75.8 | 84.6 | 58.2 | 56.4 | 51.5 | 55.6 | 93.1 | 92.2 |
| Unemployment rate | 7.6 | 14.4 | 19.9 | 7.3 | 5.6 | 18.6 | 6.0 | 13.1 | 3.9 | 12.8 | 9.1 | 7.4 |
| Share of exports, EU-15 | 11.3 | – | 3.6 | 2.8 | 2.4 | 0.8 | 0.7 | 0.3 | 0.1 | 0.2 | 0.3 | 0.1 |
| Share of imports, EU-15 | 10.3 | – | 2.5 | 2.4 | 2.4 | 0.8 | 0.9 | 0.3 | 0.3 | 0.3 | 0.2 | 0.2 |
| Share of exports, B-10 | – | 61.2 | 69.2 | 68.9 | 74.3 | 59.8 | 62.2 | 50.2 | 52.3 | 61.2 | 69.5 | 44.6 |
| Share of imports, B-10 | – | 56.6 | 61.4 | 61.8 | 57.8 | 49.7 | 67.6 | 44.4 | 50.8 | 52.6 | 56.5 | 63.0 |

1 In purchasing power parity (% of EU-15 average). — 2 2002. — 3 Proportion of exports to (or imports from) B-10 as share of total EU-15 exports (or imports) within special trade definitions. — 4 Proportion of exports to (or imports from) EU-15 as share of total B-10 exports (or imports) within special trade definition. Sources: European Parliament; European Commission; IMF; OECD; Deutsche Bundesbank; national statistics and forecasts; Institutes’ calculations.
imply a clear drop in the real interest rate level, as was the case in Spain and Ireland before 1999; in these countries, there was a strong impulse for economic development. Influx of capital will, last but not least, result from taking advantage of the EU Structural Funds. The investment required to improve transport infrastructure as well as for environmental protection are estimated at an annual 4% of GDP over the next 15 years.8

Migration of large numbers of workers has not been observed, primarily due to the restricted freedom of movement. Given the considerable differences in income between the accession countries and the current EU member states – which are substantially greater than in the case of the Mediterranean enlargement – a stronger influx of labour is anticipated after accession.9 Given the long transition periods in terms of removing barriers to the existing mobility, however, large-scale effects are not likely in the short term. In the long term, such migration could lead to an increase in jobs especially in Germany and Austria. It is difficult to estimate how much of this is linked with growth effects in both the old and new EU member states, since these effects depend on the migrants’ qualifications.

Macro-economic conditions

With accession, the same legal rules and regulations will apply to the new member states as to current members, although there will initially be certain restrictions, especially with regard to the free movement of workers and the Common Agricultural Policy. In terms of macro-economic policy, the new member states will adopt the EU’s fiscal regulatory framework. This includes, in particular, the avoidance of excessive deficits, based on Article 104 (1) of the EU Treaty; however, in the event of a breach against this ruling no procedure will be introduced, as long as these countries have not yet introduced the euro. Even in the run-up to accession, the accession states put forward two ‘Pre-accession Economic Programmes’, precursors of the convergence programmes that all member states must submit within the framework of the Stability and Growth Pact.

The public budgets in the accession states will be affected by EU membership in a number of ways. The countries must make a contribution of a maximum 1.25% of their GDP to the EU budget. In addition, there are expenditures to transpose EU legal standards, for example in the area of the environment. On the other hand, there are payments from the EU to the new members. Most significant in this context is the funding influx from the EU’s Structural and Cohesion Funds.10 These are limited to a maximum of 4% in relation to the receiving country’s GDP. Projects supported by the Structural or Cohesion Funds must, however, receive a minimum of 25% co-funding from the accession countries themselves. Difficulties in funding this share, the lack of sufficient projects that meet the strict conditions for EU funding and lacking administrative capacity indicate that these funds will be tapped only gradually; this is supported by the experience of previously supported EU projects carried out in these countries. Further additional income for the accession states will generally stem from adapting their tax systems to EU norms; loss of income will be due to the dismantling of existing customs.

On the whole, it is expected that public budgets will initially be burdened by EU entry. To counteract this,

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8 Cf. European Parliament, Working Group of the Secretariat-General’s Task Force ‘Enlargement’: ‘Environmental Policy and Enlargement’ (Briefing, no. 17, 23 March 1998); ‘Energy Policy and the Enlargement of the European Union’ (Theme Paper, no. 43, 10 June 1999); ‘Transport Policy and the Enlargement of the European Union’ (Paper no. 44, 28 July, 1999), www.europarl.europa.eu/enlargement/.
9 Empirical estimates of the anticipated migration reach very divergent results, however.
10 Payments within the framework of the Common Agricultural Policy go directly to the recipient and therefore do not directly relieve public budgets.

Figure 6
Changes in Industrial Production in CEECs and in EU-15

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\[\text{Change on previous year (\%); three-month moving average.}
\text{Sources: Eurostat; national statistics; Institutes’ calculations.}\]
degressively phased lump-sum payments, or 'compensatory payments', to the new members are being put in place until 2006. If they introduce the euro, the accession states’ budgets will be further relieved as the interest burden is reduced in the course of convergence. At the same time, tax incomes will rise, a result of the positive effects of accelerated economic growth.

The consequences for monetary policy will be the institutional preconditions, such as the independence of the central banks, which must be created to enable these countries to join the euro zone. Moreover, capital movements must be completely liberalised. With EU entry, the accession states’ central banks become full members of the European System of Central Banks (ESCB); at the same time, the central bank presidents will become full members of the Extended Governing Council of the European Central Bank.  

Towards a common currency

With entry into the EU, the accession countries also automatically join European Economic and Monetary Union (EMU), although initially with the status of a country falling under the exceptional ruling – based on Article 122 of the EU Treaty – that the euro is not yet valid as official legal tender. Before adopting the euro, the countries must first join the Exchange Rate Mechanism II (ERM II). This will be followed by regular reviews to assess whether the countries fulfil the Maastricht convergence criteria on exchange rates, inflation, long-term interest rates, the budget deficit, and public debt. Upon receiving a satisfactory assessment at the end of a two-year period, the euro is automatically introduced as official legal tender. In contrast to some of the ERM founding members, the accession countries do not have the option of deciding against joining the euro on principle (the so-called ‘opting-out clause’). They are able, however, to determine the timing of their participation in the ERM II, which de facto provides them with the opportunity to abstain from joining the common currency.

For some countries, participation in the ERM II will, in practice, make very little difference, since they have already firmly coupled their currencies to the euro (cf. table 6). Other countries are already aiming at this stage to maintain the exchange rate in a bandwidth of 15% each side of a central value, as the ERM II also stipulates. In these countries in particular, the aim is to join the exchange rate mechanism shortly after accession to the EU. Currently, the inclination to take this step is less pronounced in Poland and the Czech Republic in particular.

The Maastricht criterion of exchange rate stability stipulates that, in addition to ERM II participation, the nominal exchange rate remains in the same bandwidth without major tensions. At present, it seems unclear which margins for fluctuation will ultimately be tolerated.

In determining the central exchange rate within the ERM II, both currency undervaluation (which leads to inflationary impulses) and overvaluation (which damages the competitiveness of domestic producers) should be avoided at all costs. This is important, so as not to obstruct the achievement of the convergence criteria, and to lessen the risk of speculative attacks.

With regard to the criterion of price level stability, the EU Treaty stipulates that a country’s inflation rate may not exceed by more than 1.5% the inflation rates

| Accession States’ Exchange Rate Systems |
|----------------------------------------|
| **Current Exchange Rate System**       | **Notes**                                |
| Poland                                 | Free-floating                            |
| Czech Republic                         | Managed Floating                         |
| Hungary                                | Exchange Rate Band ± 15% around central euro exchange rate |
| Slovakia                               | Managed Floating                         |
| Slovenia                               | Managed Floating                         |
| Lithuania                              | Currency Board                           |
| Cyprus                                 | Exchange Rate Band ± 15% around central euro exchange rate |
| Latvia                                 | Fixed Rate                               |
| Estonia                                | Currency Board                           |
| Malta                                  | Fixed Rate                               |

Source: National central banks.

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Table 6

11 Following the introduction of the euro, the accession states’ central bank presidents also gain the status of a full member of the European Central Bank Governing Council. Voting rights in the council are to be limited to 21. One permanent vote will continue to be given to the six members of the directorate; the remaining 15 votes will rotate between the Central Bank Presidents. The ECB’s principle of ‘one member, one vote’ will be maintained.

12 While an explicit limitation of the bandwidths in the ERM II is not evident from the Treaty text, EU Commissioner Solbes, in charge of currency affairs, evidently feels that the accession states’ currencies should fluctuate within a bandwidth of only 2.25% either way (www.euractiv.com; ‘Solbes warns against new EU Members’ joining the euro soon’. Last access, 8 October 2003).
the three EU member states with the lowest levels of inflation. With regard to price level stability, the accession states have made considerable progress. Since 2001, inflation in all the countries has achieved single-digit values, and 6 of the 10 countries may even fulfil the criterion for convergence this year.

The interest rate criterion is fulfilled when the long-term nominal interest rate is no more than 2% above that of those member states with the lowest rate of inflation. Although long-term interest rates in general are still much higher than those in the euro zone, which still assumes the possibility of a risk mark-up, the difference in interest rates has become smaller, and could be further reduced with approaching euro introduction; this, at least, was the experience prior to the implementation of Stage Three of EMU.

Between achieving the exchange rate and interest rate criteria, there could be a conflict of objectives, which was also significant during the creation of monetary union. This revolves around the question of whether – and to what extent – real and nominal convergence are likely to obstruct each other. While nominal convergence in this context means the alignment of inflation rates and tension-free nominal exchange rates, real convergence implies the alignment of per capita incomes and price levels.

In countries with low per capita income, price levels are, as a rule, initially lower, but then converge in the course of the catching-up process. If the approximation of price levels were to occur by means of higher inflation rates, nominal and real convergence are likely to conflict with each other. The accession countries do, indeed, demonstrate lower price levels than the EU-15 (cf. figure 7). In addition, all (except Malta) demonstrate a real revaluation of their currencies against the euro. To explain real revaluation in the catching-up process, the Balassa-Samuelson Effect in particular is often applied. Currently, however, this effect is not quantitatively significant in the accession states, in particular because the weighting of market services is comparatively low in the consumer price index. The higher inflation rate results primarily from the increase of administered prices, which will in future be lower. In addition, prices of industrial goods (i.e. tradable goods) are rising more quickly than in the EU. This is due in large part to the fact that the quality of these goods is dramatically on the increase in the accession states. In this case, a higher price does not imply a loss of purchasing power, and the real revaluation caused by this does not lead to a loss in international competitiveness.

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13 After EU enlargement, the new member states will therefore also be included in the formulation of the reference value.

14 According to this, in countries involved in a real convergence process, there is an upward pressure on the price level, which originally emanates from productivity increases in tradable goods (i.e. especially industrial goods) and which initially shows up in a higher wage level in this sector. This has secondary effects on wage levels in the sector of non-tradable goods (especially services); with lower productivity growth there, prices of non-tradable goods rise. This mechanism implies a real upward valuation of currencies, which, with a fixed exchange rate, occurs via higher inflation rates. With a flexible exchange rate, this can also occur via a nominal upward valuation.

15 If B. Egert et al.: 'The Balassa-Samuelson Effect in Central and Eastern Europe: myth or reality?' Journal of Comparative Economics, vol. 31, 2003, p. 502-572.

16 The currently high rate of inflation in Slovakia can be explained primarily with reference to this effect.
The inflationary dynamism still appears to be a problem in Hungary and Slovenia, where the central banks’ weak reputation is keeping inflation expectations high and where indexation mechanisms are contributing to stubborn wage inflation. In this case, a re-orientation of monetary and wage policy is needed.

In addition to the monetary criteria, financial policy criteria must also be fulfilled in order for the euro to be introduced. The gross rate of debt may not constitute more than 60%, and new public budget debt not more than 3%, in relation to GDP. The criterion concerning the gross debt level was met by all accession states (with the exception of Malta) in 2002. The situation is different in terms of the deficit. With the exception of the Baltic States and Slovenia, all of the remaining countries exceeded the upper limit last year (cf. table 7). Especially in the largest accession states, i.e. Poland, Czech Republic, Hungary, and Slovakia, net newly incurred debt has in fact increased. This is partly due to a dropping off of the economy, but also partly owing to expansionary financial policy.

Thus there is a considerable requirement for consolidation in the accession countries. Although the Pre-Accession Economic Programmes do provide for a substantial reduction of the budget deficits, so that, according to the planning phase, by 2005 only the Czech Republic will be considerably off the mark where the deficit criterion is concerned. However, the underlying growth assumptions for many of the countries are optimistic; for the most part, they are considerably higher than the Institutes’ forecasts and those of the OECD and the European Commission. In addition, in some countries, achieving the goal of consolidation through tax reforms could become more difficult, since the resulting effect would, at least in the short term, increase the deficit. EU accession will also – as has already been described – undoubtedly place a burden on public budgets. In some countries, a lack of budgetary discipline is currently a major obstacle to the speedy introduction of the euro. But here, too, experience prior to the beginning of Stage Three of EMU shows that, given a specific date, considerable progress in terms of budget consolidation is possible in a short time. In addition, the public budgets are being relieved by interest rate trends, and the accession states are likely to benefit considerably from EU membership over the longer term.

Conclusion

Over the longer term, positive growth effects will be derived from EU enlargement, which will be considera-
ble especially for the accession states. These will, however, take some time to develop, especially since full integration will not occur immediately in certain areas. The effects on the economy are therefore expected to be small.

Real convergence, i.e. the approximation of income levels in the accession states to the EU average, will tendentially be accompanied by higher inflation rates in the accession countries. Nevertheless, this effect is not so significant that it would make it significantly more difficult to achieve the Maastricht criteria. Staying on course with regard to the deficit criterion could, given the tense budget situation in some countries, require greater effort.