What price the euro?
The social impact of eurozone accession for the new member states

edited by
Béla Galgóczi

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European Trade Union Institute for
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Foreword

The idea of a project on the implications for social and economic development of the eurozone accession of the new Member States from Central and Eastern Europe emerged in the context of a series of research projects on the European Employment Pact.

Previous ETUI studies have covered the Cardiff, Cologne and Luxembourg processes and have focused on, among other things, the interdependence of macroeconomic and employment policies. One publication having already examined the relevance of the European Employment Strategy to the new Member States, it was logical to examine what impact the run up to the euro, involving the adoption of the Stability and Growth Pact criteria, might have on development prospects overall and on labour markets in particular.

By now it is clear that the medium-term macroeconomic policies of the new Member States are being determined by the timetable of their EMU accession, with far-reaching implications for economy and society as a whole. As one of the basic ambitions of the European Employment Pact is to find a balance between macroeconomic policy and sustainable employment growth, and the central objective of the Lisbon strategy is 'more and better jobs', it is crucial to examine how these objectives manifest themselves in the new Member States in the context of eurozone accession.

Henning Jørgensen Brussels June 2005
Director, Research department, ETUI-REHS

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Introduction: social and economic impact of the eurozone accession of CEE member states

Béla Galgóczi

1. Introduction

Our aim in this project was to provide an overview, country by country, of how the policy choices related to euro adoption emerged and how they appear in public debates and at the level of national social dialogue. We also examined the potential impact of eurozone accession on real convergence, social protection and employment growth.

The Stability and Growth Pact (SGP) criteria are well known and well documented (Gros et al. 2004; ECB 1999). However, it is worth recalling their main features and the underlying rationale.

> It is a unique feature of the eurozone that monetary policy is centralised in the hands of the European Central Bank (ECB), while fiscal policy remains decentralised in the hands of the individual member states. It was therefore recognised that to support the ECB's responsibility to maintain price stability and to prevent free-riding, fiscal policy had to be subject to rules in order to ensure discipline of public finances. These rules consist of two pillars. First, member states' general government deficit/GDP ratio cannot exceed 3% (only under exceptional circumstances) and its general government debt/GDP ratio cannot exceed 60% (in cases of a higher debt ratio, it must be reduced). How were these reference values chosen? It has been suggested (Thygesen, 2002) that 60% was the average debt ratio of the EU Member States in 1990 and if countries kept their deficit at the 3% limit, their debt would converge to 60%, assuming that

> nominal GDP is rising at a trend rate of ca. 5% real growth (assumed to be the potential output growth of the EU at that time) plus 2% inflation (in line with the ECB's inflation target). (Orban and Szapáry 2004)

Euro adoption is framed by a very particular context in the CEE new Member States. Being transformation economies in dynamic change, their social and economic environments are fundamentally different from those of the established market economies of the eurozone. The first question which arises is, what is the urgency of imposing the 'strait-jacket' of the euro on these countries that are so different from the core eurozone countries and find themselves in a different phase of development?

Examining recent debates on eurozone accession one may wonder to what extent the issue is being tackled on a rather simplified, technical basis at most levels of policy making. It is taken for granted that early entry into the eurozone is beneficial for the development of all these countries.

Horst Koehler (at that time director of the IMF) in a keynote speech at an international conference said:

> Joining the common currency area will provide a further significant boost to economic development [in the CEE countries – BG] through increased trade and financial flows by lowering transaction costs and eliminating market risks. But this is not the time to relax. The gains from adopting the euro will not accrue automatically.

Some external observers add that certain difficulties and sacrifices are to be expected from fulfilment of the Maastricht criteria, but that they will be compensated by euro adoption. Lower risks and higher trade and investment are expected and a surplus growth rate is also assumed (European Policy Centre 2004; IMF 2004).

On this interpretation, the question merely concerns how governments will be able to ease the bitter pill of fiscal and monetary adjustment for their citizenries. A World Bank report (World Bank 2004)

states that 'the Visegrad countries (in particular the Czech Republic, Hungary and Poland) will need a longer period to bring fiscal deficits – and in some cases inflation (Hungary and the Slovak Republic) – under control, and will not be in a position to adopt the euro until 2008–10', then adds 'Weak popular support for governments and political instability in some countries is complicating economic policy-making and reform implementation'. Zsigmond Járai, President of the Hungarian National Bank, stated in an interview that 'the introduction of the euro is a question of power: while it is an advantage for enterprises, it has costs for politics, as the budget deficit must be pushed down' (Napi 2004).

Even the title of government plans on the timetable of eurozone accession is telling, namely 'convergence plans', often incorporating the term 'meeting the convergence criteria', as if the fiscal and monetary convergence involved in meeting the Maastricht criteria were part and parcel of achieving the overarching aim of all new Member States, namely economic and social convergence with the core countries of Europe (referred to more precisely as 'real convergence'). Moreover, the political climate of the national approaches is peculiar. After the lengthy process of EU accession with its culminating period marked by 'a rush into the EU' with all the technicalities of transposition of the acquis, now the new Member States find themselves 'rushing into the eurozone' under the same momentum. And while meeting the Copenhagen accession criteria was seen as a race, with countries closely monitoring one another's performance, the same pattern can be seen in relation to eurozone accession.

Peter Papánek, spokesman of the Slovak Finance Ministry, stated: 'We have a realistic chance of fulfilling the Maastricht criteria on time. For a small and open economy like Slovakia it is of the greatest interest to join the developed economies as soon as possible'. He added: 'Even so, Slovakia will not be the frontrunner, as Estonia, Lithuania and Slovenia will be quicker' (Népszabadság 2005).

The framework of EMU accession appears more in a context of 'managing' and 'fulfilling' than of a conscious policy choice based on weighing up the pros and cons of the process in terms of national development priorities and discussions with the social partners.

Evaluations of the impact of euro adoption on real convergence, social welfare and employment have not been carried out in any of the countries concerned and the topic has not been addressed in publications or debates.

If we examine the situations of the individual countries we must emphasise that the new Member States cannot be handled as an homogenous group when assessing the potential benefits and drawbacks of EMU entry and its timing.

First, there is a fundamental difference between countries according to currency regime. For the Baltic States with their currency board arrangements (or hard peg in the case of Latvia), their abandonment of an independent monetary policy means that there would not seem to be substantial benefits to be gained from a long transition period. For the countries with floating currencies and individual monetary policies, however, it is a much more complex issue in relation to which national characteristics and country priorities become decisive.

At the same time, the CEE countries have important common features that distinguish them from the current eurozone countries.

In this context, three major considerations arise:

1. Their different macroeconomic profile, characterised by substantially lower GDP levels, with more dynamism (for example, close to 10% nominal growth rates, high but uneven productivity growth), ongoing transformation and convergence (catch-up process).
2. Higher social risks in the form of a 'welfare deficit' accumulated during the transformation, with severe labour market tensions (low employment and/or high unemployment) and an increase in

poverty and inequalities which need special attention, especially if the European Social Model is taken as reference.

3. Economic backwardness, implying a need for greater investment. Public investments in infrastructure, health care, education, research and development and environmental protection are badly needed for these countries in order to induce convergence with their more developed EU counterparts and to comply with their commitments related to adoption of the *acquis communautaire*.

Our thesis is thus twofold:

1. Due to their different macroeconomic profile and transformational character, the SGP criteria in their present form are not appropriate for the CEE new Member States.
2. On the other hand, due to their specific post-transition character, higher social risks and economic backwardness, higher public investment, welfare spending and employment growth are required, as a result of which the inadequate monetary and fiscal criteria will result in unnecessary constraints and thus harm their development prospects. This also clashes with the objectives of the Lisbon strategy and the principles of the European Social Model.

2. Macroeconomic framework in the new Member States

The new Member States of Central and Eastern Europe have important common features that distinguish them from the current eurozone countries. In this section, we shall present the most striking differences in terms of macroeconomic development.

2.1 Economic dynamism and transformation

CEE countries are substantially poorer than their Western counterparts (Figure 1). Their GDP per capita is roughly 50% of the EU-25 average, taking differences in purchasing power into account (without this correction – at exchange rate parities – it would be less than a quarter).

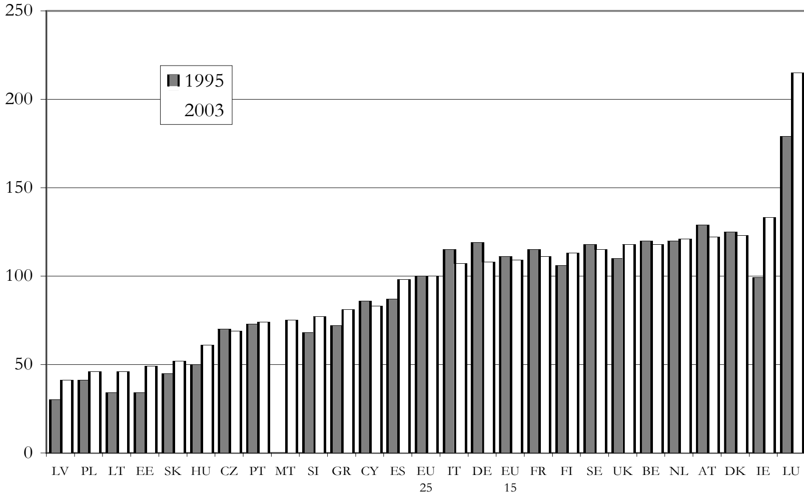

Figure 1: GDP per capita 1995–2003 in PPS (EU-25=100)

Source: ETUI/ETUC (2005) Benchmarking Working Europe, Brussels.

Real convergence, the major objective of these countries, is well under way. Figure 2 shows this in more detail in the case of three countries. In the period 1995–2004 GDP per capita rose substantially compared to the EU-15 average (PPP), from 30.8% to 44.0% in Estonia, from 40.2% to 51.4% in Slovakia and from 44.8% to 56.8% in Hungary.

The second important feature is greater dynamism and their 'transformational character'. National economies still under transformation are characterised by dynamic growth, including extraordinary and uneven productivity increases. Their 'transformational character' also manifests itself in terms of distortions (different price and cost structures) as an inheritance of the previous economic model and disproportionalities (wage and productivity relations) due to turbulent transformation processes. The fundamental restructuring required by their reintegration into the world economy and the transition to a market economy remains incomplete in these countries (large and inefficient

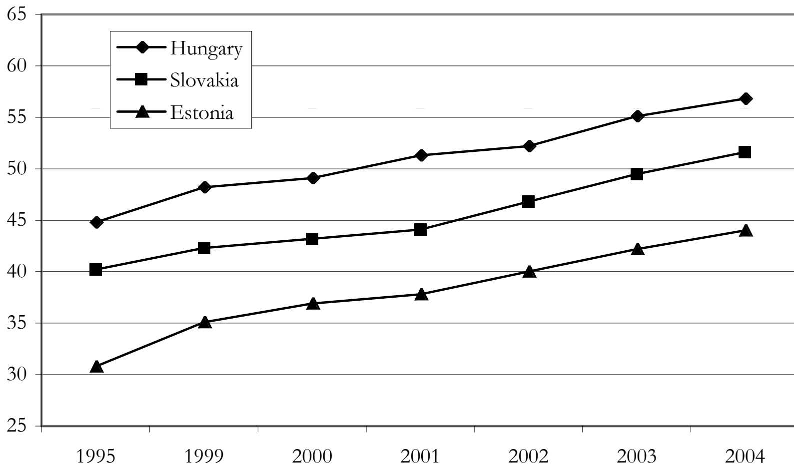

Figure 2: GDP per capita as % of EU15 average at PPP, 1995–2004

Source: Podkaminer, L. et. Al., WIIW Research Reports 303, 2004.

agricultural sectors in some countries, as well as unresolved problems related to steel, coal and mining). These factors have consequences for future development.

Real GDP growth in the new Member States is around 5% on average, twice as high as the EU-15, with nominal growth rates close to 10% in most cases.

Productivity improvements have also been spectacular showing steady catch-up towards the EU-15 average. Figure 3 presents average productivity at PPP (in terms of exchange rates, catch-up is much more spectacular, although the levels are lower). It is also a feature of transformation (catching up) economies that productivity developments are uneven among sectors. The dynamism of industrial productivity and in general in the tradable sector of the economy is much greater than in the non-tradable sector. This phenomenon will have a major impact on future development (see section 2.2).

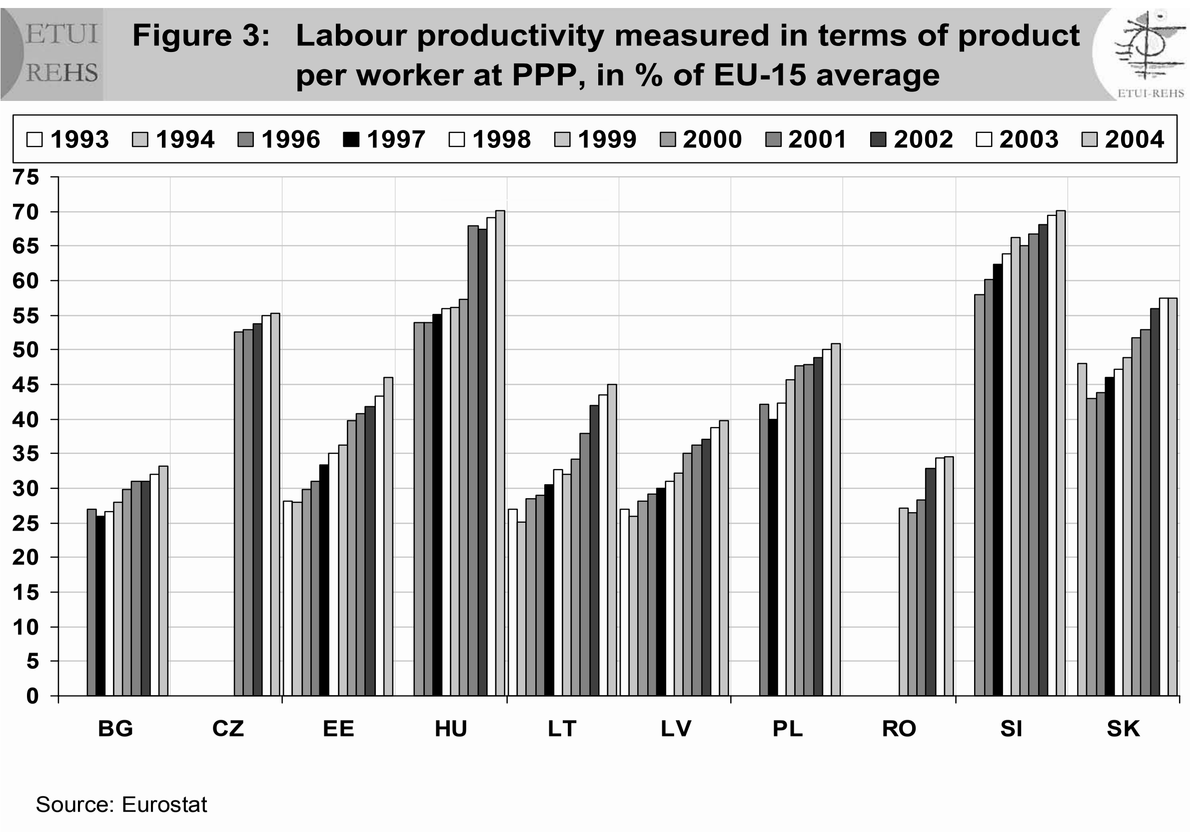

Figure 3: Labour productivity measured in terms of product per worker at PPP, in % of EU-15 average

Source: Eurostat

The ‘transformational character’ of these countries also appears in other forms. If we look at some of their development characteristics in the past decade, turbulent processes can be observed, which we can demonstrate here with the example of Hungary. Figure 4 does not depict a balanced development pattern. What is most striking is how the GDP growth trend diverges from the development of employment (this is a common feature of all CEE countries, labelled ‘jobless growth’). Wage developments did not keep pace with productivity developments, leading to corrections in the most recent period. These imbalances will probably result in further corrections in the future, requiring a certain macroeconomic flexibility.

Price and cost structures are also quite different in the new Member States in comparison with the EU-15, manifesting themselves in terms of a substantial gap between exchange rate and purchasing power parities.

Table 1: Relative price levels of household final consumption, including VAT, 2002

EU-25	96
EU-15	100
Euro-area	**97**
Czech Republic	53
Estonia	56
Cyprus	83
Lithuania	51
Latvia	50
Hungary	55
Malta	72
Poland	57
Portugal	74
Slovakia	44
Slovenia	73

Source: Eurostat (based on the Czech Republic chapter).

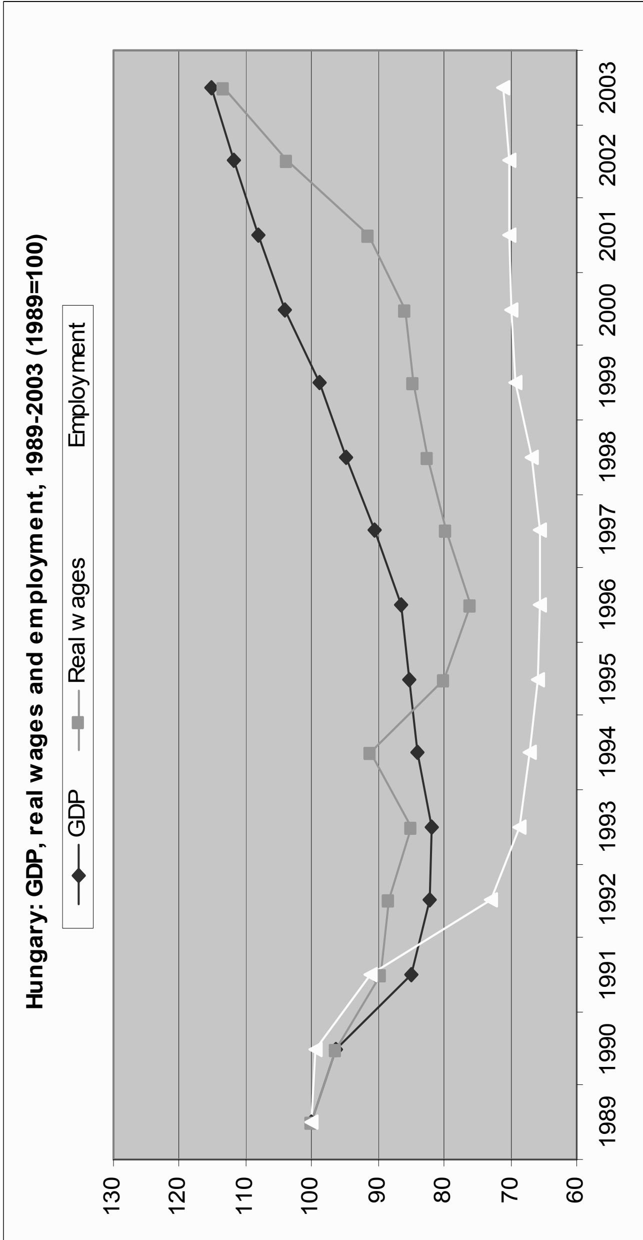

Figure 4: Hungary - GDP, real wages and employment, 1989-2003 (1989=100)

Source: Benchmarking Labour Europe (ETUI 2005).

It is also decisive that wage and productivity levels are much lower compared to the EU-15.

Table 2 clearly shows that the wage gap between the CEE new Member States and the EU-15 (here represented by Austria) is substantially greater than the gap in productivity. This indicates that wages are not only low in absolute terms, but also lagging in relation to economic performance (productivity level). In some countries, such as Hungary, Slovakia and the Czech Republic, this wage/productivity gap is quite substantial.

All this must be seen in the context of recent dynamic wage increases. As Figure 5 indicates, real wage increases in most CEE new Member States in 2000–2003 substantially outperformed wage developments in the eurozone members. In some countries, such as the Czech Republic,

Table 2: Labour productivity and wage levels in CEE-8 compared with Austria (2003)

	Labour productivity (GDP per worker, PPP)	Wages (PPP)
Czech Rep.	64	43
Hungary	65	42
Poland	51	44
Slovakia	56	31
Slovenia	73	61
Estonia	45	37
Latvia	42	29
Lithuania	46	29
Austria	100	100

Note: Austria = 100.

Source: Podkaminer and al. (2004), based on the Czech report of this publication.

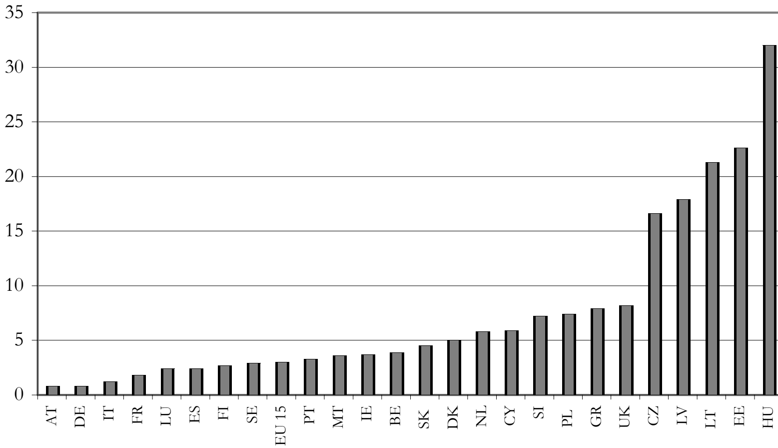

Figure 5: Real wage growth 2001–2003 (2000=100)

Source: ETUI/ETUC (2005) Benchmarking Working Europe, Brussels.

the Baltic States and, especially, Hungary it was seen as unsustainable.[1] It can also be seen as an adjustment building on previously accumulated productivity reserves. As we have seen, wage levels are still far behind productivity levels. There is still a long way to go, although the Maastricht criteria cast doubt on further corrections for the time being.[2]

Figure 6 also shows on the examples of the Czech Republic and Hungary how wages (expressed in euros) have increased over the last decade. (Here it may be noted that the 32% real wage increase indicated for Hungary in Figure 5 for 2000–2003 appears as an increase of 60% in euro terms!).

1 Excessive wage increases (beyond productivity increases) were criticised by economic analysts, European institutions and international investors. The process was seen not only as jeopardising competitiveness, but also as generating inflation and thus endangering economic stability and monetary convergence. On the other hand, exports were not affected.

2 Primarily because the inflation target would be threatened by such 'corrections'.

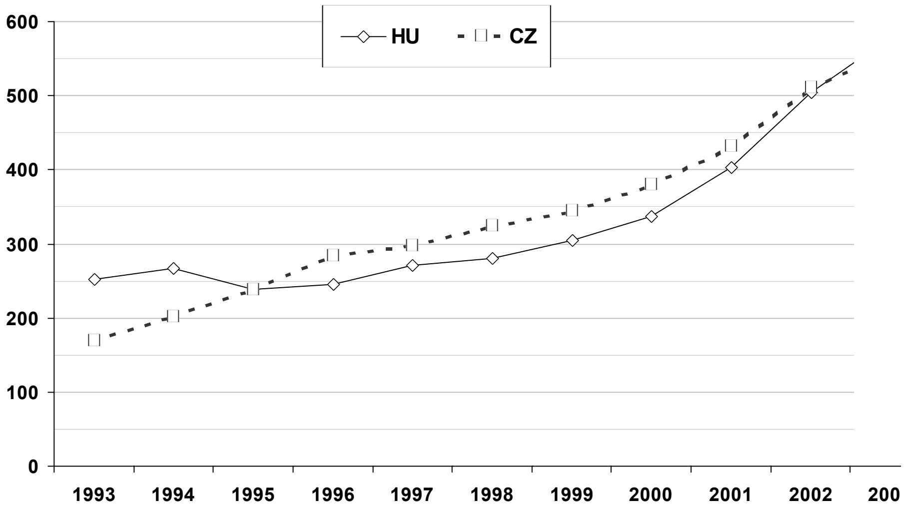

Figure 6: Wage development dynamics in the Czech Republic and Hungary in euros (for average wages, 1990=100)

Source: WIIW database 2003, ETUI 2004.

Figure 6 also presents the impact of the appreciation of CEE currencies against the euro. Such an adjustment (a combination of high real wage increases and currency appreciation) will also not be possible under the SGP criteria.

Another important factor should also be emphasised here. The case of Hungary with its 'wage correction' provided an important lesson. Although it did not cause a setback in terms of economic performance (especially export performance and foreign investment), it did result in a setback in terms of monetary and fiscal convergence through which Hungary found itself at the end of the queue in terms of EMU accession. Interestingly, however, this process has triggered important qualitative changes in the structure of the economy and brought about an upgrading of foreign investments, shifting towards higher value added and less labour intensive activities.

There is a broad consensus that a 'low wage profile' does not represent the future for these countries. It will be an important challenge to break out of the low wage profile while at the same time not endangering EMU accession or, once inside EMU, the 'upgrade' process.

The figures and tables we have presented demonstrate the turbulent economic processes and unbalanced character of transformation and catch-up economies. The bottom-line is that further corrections are still to come, requiring macroeconomic flexibility.

2.2 The Balassa-Samuelson effect

A number of characteristics of transformation economies are expressed by the Balassa–Samuelson effect.

The Balassa–Samuelson effect (Balassa 1964; Samuelson 1964) may be considered crucial in determining suitable exchange rate policies for the accession countries before joining EMU.

In a developing economy catching up with income levels in more economically advanced countries, productivity in tradable goods sectors will tend to rise faster than in non-tradable sectors (United Nations 2001, 1). Since wage increases tend to be more or less the same in all sectors, relatively faster productivity growth in the tradable sector of accession countries will convert into a higher inflation rate if the exchange rate remains constant (Buiter and Grafe 2002).

The Balassa–Samuelson effect is due to the productivity growth differential which results in an equilibrium appreciation of the real exchange rate in a catch-up economy (Szapári 2004).

Simulation results show that the effects could be quite different in individual countries (Egert 2002). The findings show that in the Czech Republic, Slovakia and Slovenia the impact of productivity growth on the inflation differential relative to Germany ranged from 0.9% to 1.3%. In Poland and Hungary, the impact of the Balassa–Samuelson

effect is greater than in other countries, ranging from 2.6% to 3.5% in Hungary and from 1.5% to about 3.3% in Poland. Doyle et al. estimate the size of the Balassa–Samuelson effect to be on average 1% to 3% a year (Doyle et al. 2001, 10).

Over the last couple of years all CEE currencies have experienced strong real appreciation against the euro.

The Balassa–Samuelson effect means on average that in the case of fixed exchange rates inflation will be higher by 1% to 3% compared to the EU average. In other words, the equilibrium level of inflation is 1 to 3 percentage points higher in the CEE new Member States than in the EU-15 (de Grauwe 2004).

György Surányi, former president of the Hungarian National Bank, sums up the contradictory impact of the SGP criteria in a recent publication, as follows: 'As the potential growth rates of the CEE new Member States are higher, productivity is improving at higher speed as well, so their currencies will appreciate in real terms. Under these circumstances, there is no way of meeting the exchange rate stability criteria and the inflation criteria simultaneously' (Surányi 2005).

2.3 Consequences: stricter SGP criteria for the CEE countries than for current EMU members

Nominal growth rates in the new Member States fluctuate between 7% and 11%, as a result of real growth rates of 4–5% and consumer price indexes 2–4 percentage points higher than in the eurozone. Assuming that a sustainable fiscal situation is based on a GDP/debt ratio not exceeding 60%, the maximum tolerable fiscal deficit is 4–5% a year for the CEE countries. The nominal criterion must therefore be stricter when applied to the CEE candidates for EMU (Surányi 2005).

The same nominal criteria of the SGP when applied to the CEE new Member States are stricter and less appropriate than for the present

members of the eurozone. This is clearly the case with inflation and the fiscal criterion (it is also well known that most CEE countries have government debt levels well below the 60% mark).

We have also mentioned that the transformation character and inherited 'disproportionalities' (for example, price, cost and wage levels) of these countries make corrective adjustments necessary. These cannot be made in the 'straitjacket' of Maastricht.

The result is that applying the SGP criteria in the same nominal manner hampers growth potential, employment growth and real convergence.

3. Welfare challenges and investment needs

CEE new Member States are also different because they have higher social risks and badly need public investment (infrastructure, education, employment, research and development).

As economies in transformation that have successfully managed a fundamental structural change in the past decade, most of them face serious social and welfare challenges, differing from country to country. Even the World Bank has warned of the welfare risks of eurozone accession in one of its recent reports, pointing to unemployment, poverty and high and growing regional differences (World Bank 2004). It is widely known that employment rates are characteristically low, with the exception of Slovenia and the Czech Republic, in some countries aggravated by high unemployment (especially Poland and Slovakia), poverty and social exclusion. Health care and education spending has declined in the last decade and labour market policies are under chronic budgetary constraints. András Inotai, a Hungarian economist, characterises this situation as the conversion of an initial 'modernisation deficit' into a 'social deficit' (Inotai 1999). The analogy refers to the fact that besides foreign direct investment, the other major source of structural change and modernisation in these countries in the last decade has been social protection cuts. A substantial redirection of income has

taken place from the population to the business sphere. This also explains why in critical phases of restructuring, wage development lagged substantially behind productivity increases (for example, Hungary in the mid 1990s, Slovakia in 2000–2003).

If we look at employment issues and objectives, the National Action Plans for Employment (NAPE) of most countries have formulated ambitious goals to improve the situation, with particular attention to the employment rate, youth unemployment, long-term unemployment and at-risk groups.[3]

Figure 7 shows that labour market policy expenditure is very low and in some cases declining. It is worth adding that expenditure on active measures makes up a tiny – and in most cases declining – proportion of total spending (for more on this issue see Galgoczi, Lafoucriere and Magnusson 2004).

NAPE provisions on upgrading active labour market policies were often pushed into the background, as budgets were insufficient to cover even the passive measures.

It is worth asking how the ambitious NAPE objectives of the new Member States match up to their monetary and fiscal convergence plans in the run-up to the euro.

Keune and Rhodes (Keune and Rhodes 2005) examined the EMU candidates in two dimensions: (i) 'public expenditure pressures' and (ii) 'welfare stress'. The 'social risk index' was made up of three components: unemployment, risk of poverty and old-age dependency ratio. By combining these factors, they identified different social risk levels among the EMU candidates and assessed the social challenges facing these countries in their run-up to the euro.

3 For more details on the NAPEs of individual countries, see the country chapters of this publication

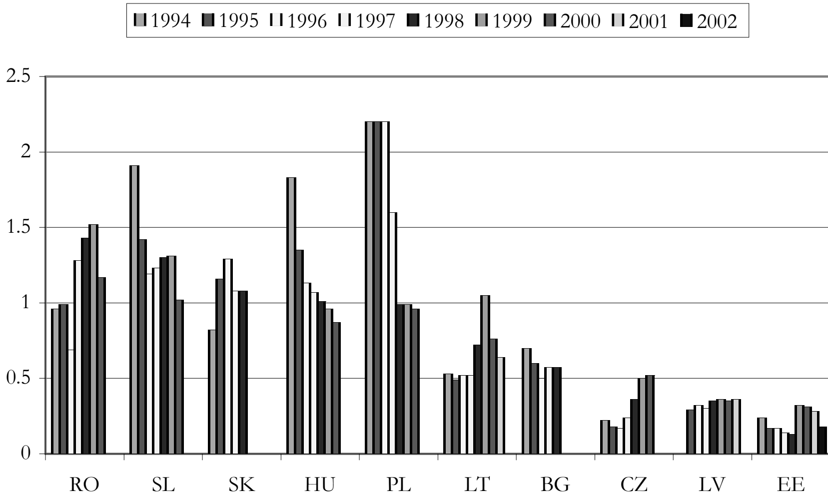

Figure 7: Labour policy expenditure (% of GDP)

Source: Estonian chapter of this publication, based on Eurostat date, 2003.

Slovenia is the best performer in the CEE group, with low welfare stress, high social spending and relatively low debt.

The Czech Republic, while suffering from low-to-moderate debt and high deficits, has a low level of social expenditure, a high employment rate and a low level of 'welfare stress'.

These two countries are not facing serious social welfare problems in the process of euro adoption.

The Baltic States have a medium employment level, low deficits and low social spending, but a high level of 'welfare stress'; they need not fear a further deterioration of their welfare situation due to fast-track entry into the eurozone, but they will have to address their welfare problems within EMU.

Hungary is in an intermediate situation, with high debt, high deficit levels and a medium level of social spending. With a relatively low 'social stress index', EMU, while being a constraining factor, is not likely to threaten the social situation.

Slovakia and Poland can be seen as risk countries, where the public expenditure constraints of EMU could result in serious social tensions. With low employment rates and high unemployment, as well as high welfare stress, these countries face substantial social challenges and difficult policy choices in the course of EMU accession.

On the other hand, public investment in education, health care, research and development, infrastructure and environmental protection are of primary importance for the future development of all these countries. Moreover, substantial investment (for example, in infrastructure and the environment) are obligatory under the acquis communautaire. It should be noted that even if financial transfers from the EU regional and cohesion funds will help with these objectives, the net impact on fiscal positions will be negative. While national contributions (a precondition of EU transfers) are paid from central budgets, subsidies go directly to the economy (for example, agricultural producers) or into investments.

Such investment is urgently needed if these countries are to develop from 'low wage subcontractor' status towards knowledge based societies. Paradoxically, ongoing developments in some new Member States aimed at abandoning the low wage profile and strengthening the 'knowledge based profile' may well come under constraint if the SGP criteria are interpreted rigidly and on a short-term basis.

4. Different monetary policy approaches

The basic thesis is that open economies with close trade links to the eurozone countries will benefit from fixed exchange rates as the transaction costs for international trade decline. With the cost of foreign

exchange risk eliminated, more division of labour within the enlarged euro area is expected to increase welfare. Frankel and Rose (2002) have suggested that the merits of monetary union membership are quite significant – trade with other currency union members is expected to triple, thereby boosting real growth and welfare gains. IMF experts also argue the trade generation effect of currency union, with gains also in terms of foreign direct investment.

4.1 The theory of 'optimum currency area'

The EMU accession of the CEE countries has been widely discussed within the framework of the theory of optimum currency area (OCA), as put forward by Mundell (1961) and McKinnon (1963). The main criteria applied are openness and asymmetric shocks. Within the OCA framework, countries considering joining a monetary union will weigh the potential benefits of exchange rate stability for international trade against the costs of giving up monetary policy independence.

The trade of the CEE accession candidates with the EU-15 as a percentage of GDP is about as high as for the present EMU members after more than four years' EMU membership. Exports to the EU as a percentage of GDP average 28.7% for the CEE countries in comparison with 26.8% for the EMU member states (2001). Economic integration with the EU is much stronger for the CEE countries than for the Member States outside EMU – Denmark, Sweden and the UK (16.5% on average) – which would undoubtedly qualify them for joining the currency union (De Grauwe and Schnabl 2004).

Another important aspect is the synchronisation of economic cycles, resilience to asymmetric shocks, flexibility of prices and wages and international labour force mobility. Some of these criteria are not fulfilled by the present members of the euro area. In future, and considering possible divergent developments, this could produce high costs related to the maintenance of monetary union.

Given that economic structures and business cycles in Central and Eastern Europe are quite different from those in the EU-15, in combination with the assumption that labour mobility and wage flexibility are restricted, the CEE countries probably do not qualify for EMU accession, at least if the OCA criteria are applied. De Grauwe also adds, 'nevertheless, EMU accession seems to be tempting as most CEE countries have expressed their strong intention to join the EMU as soon as possible' (De Grauwe and Schnabl 2004).

4.2 Exchange rate regimes in CEE new Member States

The choice of monetary regime and exchange rate policy have been crucial for the transition countries as small open economies (with the exception of Poland) vulnerable to external developments. Developments of the exchange rate systems of CEE countries are summarised in Table 3.

Estonia, Lithuania and Bulgaria, through a currency board arrangement, and Latvia through a conventional hard peg have maintained a hard peg in relation to a single anchor currency, the euro, while at the same time other countries have either remained with floating pegs or moved towards more flexible systems, like Slovakia or Poland.

Experience shows that the currency board arrangement has been very successful in curbing inflation within a short period (especially above the 10% mark), while differences in growth performance cannot be clearly attributed to currency regimes. As Raul Eamets and Katrin Olenko state in the chapter on Estonia, the success of the currency board arrangement lies to a great extent in fiscal discipline, which has been maintained in all the Baltic States. There is a second crucial element in relation to a currency board arrangement, namely choosing the right entry exchange rate (with undervalued currencies) leaving enough room for maintaining competitiveness later on due to inflationary differences. The currency board arrangement combined with financial discipline has helped to restore credibility and provide protection from currency speculation.

Table 3: Evolution of exchange rate regimes in the new Member States

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bulgaria	8	8	8	2	2	2	2	2	2	2
Estonia	2	2	2	2	2	2	2	2	2	2
Lithuania	2	2	2	2	2	2	2	2	2	2
Latvia	3	3	3	3	3	3	3	3	3	3
Malta	3	3	3	3	3	3	3	3	3	3
Hungary	7	5	5	5	5	5	5	4	4	4
Cyprus	4	4	4	4	4	4	4	4	4	4
Czech Rep.	3	3	6	7	7	7	7	7	7	7
Poland	5	6	6	6	6	6	7	7	7	7
Romania	7	7	7	7	7	7	7	7	7	7
Slovenia	7	7	7	7	7	7	7	7	7	7
Slovakia	3	3	6	6	8	8	8	8	8	8

Notes: 1 – Dollarisation/euroisation, 2 – currency board, 3 – conventional fixed pegs, 4 – horizontal bands +/– 15%, 5 – crawling pegs, 6 – crawling bands, 7 – managed float (with ER path), 8 – independent float.

Source: DG ECFIN, National Banks (Raul Eamets).

The ERM II period

Special risks are attached to the ERM II period, as several experts have pointed out. Charles Wyplosz argued in the *Financial Times* (Wyplosz 2003) that EMU accession countries within the ERM II system are especially vulnerable to speculative attacks, with eventual destabilising effects. He argues that the ERM II system is not an appropriate framework for the fiscal and monetary convergence of the CEE countries (see Table 4). The transitional period of two years does not seem well founded. Looking at exchange rate volatility over the last five years, no movements have exceeded the 15% band.

Table 4: Fiscal and monetary convergence, planned EMU accession

Country	Inflation			Budget balance**			State debt			EMU entry
	2004 average	2004 Dec.	2005 average	2003	2004	2005*	2003	2004	2005*	
Slovenia	3.6	3.3	2.9	–2.0	–2.3	–2.2	29.5	30.9	30.8	1.1.2007
Estonia	3.0	4.8	2.6	3.1	0.5	0.2	5.3	4.8	4.4	1.1.2007
Lithuania	1.1	2.8	2.8	–1.9	–2.6	–2.5	21.6	21.2	21.7	1.1.2007
Latvia	6.2	7.4	3.4	–1.5	–2.0	–2.8	14.4	14.6	15.4	1.1.2008
Cyprus	1.9	3.9	2.1	–6.4	–5.2	–2.9	70.9	74.9	71.4	2007
Malta	2.7	1.9	2.7	–9.6	–5.2	–3.7	70.4	73.2	72.0	1.1.2008
Slovakia	7.4	5.8	4.0	–3.7	–3.8	–3.8	42.6	43.0	44.2	2009
Poland	3.6	4.4	3.2	–3.9	–5.4	–4.1	45.4	45.9	47.6	2010
Czech Republic	2.6	2.5	2.8	–12.8	–5.2	–4.7	37.8	38.6	39.4	2010
Hungary	6.8	3.6	3.3	–6.2	–5.5	–5.2	59.1	59.9	59.5	2010

Notes: * prognosis; ** without private pension funds (otherwise in the case of Poland and Hungary ca. 1% points less).

Source: EC, ECB, prognosis based on national sources, EC and Ecosoc (2005).

5. Conclusion: benefits and risks of eurozone accession

5.1 The 'mainstream' approach

Mainstream economists, including the IMF, most experts, financial institutions, and the majority of policy-makers in the corresponding countries see the positive and negative aspects of EMU membership in rather technical terms (European Policy Centre 2004; IMF 2004).

Positive factors

- The small size of the new Member States compared to the eurozone (5–6%) in GDP terms should facilitate its enlargement.
- Most new Member States can show a solid overall performance in terms of stability and nominal economic convergence criteria.
- Catch-up – real economic convergence – is well under way.

Negative factors

- In some of the new Member States strong efforts are still needed to meet the Maastricht convergence criteria, notably in bringing inflation and public deficits down (which might give rise to political difficulties in some countries).
- Some countries are still experiencing very high levels of unemployment.
- Huge current account deficits are often the 'downside' of high levels of FDI, especially in the Baltic States, Hungary and the Czech Republic.

Seen from the perspective of the EMU candidates, the following mainstream arguments are most often raised:

Positive impact

It is expected that EMU accession will result in an increase in growth rates, thus boosting real convergence of GDP with the EU average. Estimates count on temporary growth-rate falls of between 0.3 and 0.8

percentage points, followed by gains of 0.2 to 0.4 percentage points in the coming years (European Policy Centre 2004). According to the IMF (IMF 2004), 'over the long term, euro adoption could raise GDP by an additional 20–25 percent in most Central European countries'. This would be a result of the following factors:

- Lower interest rates, leading to higher investment accompanied by lower costs of public debt servicing.
- Elimination of exchange rate risks and lower foreign trade transaction costs (Oblath 2003).
- Better environment for FDI due to increased credibility.
- Possible stimulus for structural reforms through the disciplining impact of ERM II participation on domestic policies.
- Increased macroeconomic stability and further convergence of business cycles.
- Once inside EMU, the option of influencing the monetary policy of the ECB to a greater extent than these countries' relative economic weight might otherwise allow.

5.2 A critical approach

As already mentioned, the different macroeconomic profile, in relation to the EU-15, of the new Member States calls into question any rigid application of the SGP criteria to them. As is well known, the SGP criteria in their present form have also been heavily criticised within the EMU, and the performance of the EMU countries, especially Germany and France, in contrast with the UK and some Nordic countries that are not EMU members provides no encouragement.

The Balassa–Samuelson effect due to high and uneven productivity developments results in a higher equilibrium inflation rate (at a constant exchange rate) than in the EMU countries and in accordance with the SGP criteria. A higher inflation rate could result from other things too, however. Two factors in particular are often neglected in discussions of the issue.

1. Cost and price structures in the CEE new Member States are still substantially different due to historical reasons (for example, regulated prices, suppressed inflationary pressures, and so on) as expressed in the gap between purchasing power parity and market exchange rates (ratios range from around 1.3 in Slovenia to 3 in some of the Baltic States and Bulgaria, with an average value of around 2). The current gap, together with its distortions, is likely to be fixed within the EMU 'straitjacket'.
2. The imbalance between wage and productivity levels (mentioned above). For historical reasons and due to the nature of the transformation, current wage levels are substantially behind productivity levels if the wage/productivity ratio of the EU-15 is taken as reference. This means that there is a 'productivity reserve' in these economies, which would theoretically allow wage increases beyond productivity growth, as seen in Hungary in the last three years. Due to application of the SGP inflation constraint in these countries wage convergence is coming under pressure.

However, it is an objective of most CEE new Member States to abandon their low wage profile and promote the development of a knowledge-based economy. Forcing inflation rates to meet the SGP level could hamper productivity development, growth and real convergence.

There are also problems with the fiscal criteria.

The aim behind the SGP criteria was sustainable public finances by maintaining an appropriate public debt/GDP ratio. The rigid SGP criteria – including a 3% public deficit/GDP ratio – were tailored to the growth rates of the current EMU countries and to the debt levels of the most indebted countries, such as Belgium and Italy. EMU candidates with public debt levels well below the 60% mark and nominal growth levels close to 10% could well maintain annual deficits of 4–4.5% without increasing public debt (Surányi 2005).

Given that the 'straitjacket' of the current SGP rules is unlikely to fit the specifics of these countries, growth, employment and real convergence would seem to be in real danger.

Further arguments refer to welfare risks and public investment, as already mentioned. Most transformation countries are afflicted by a 'welfare deficit' and are in desperate need of well targeted public investment.

Here the principles of the European Social Model and the Lisbon agenda are indicative. It should also be seen that there is a clear contradiction between the objectives of the Lisbon agenda and the current SGP criteria in relation to the CEE new Member States. The relation between the SGP criteria and the principles of the European Social Model can also be seen as 'ambiguous'.

The clash of objectives is apparent if the principles of the European Social Model are considered. While on the one hand the EU-15 countries are becoming increasingly concerned about what they call 'social dumping' from the East, rigid application of the SGP criteria imposes serious constraints on CEE countries, preserving distortions in price and cost structures, and disproportionalities between wage and productivity levels.

There is also a contradiction in relation to different levels of integration with the EU. An absurd situation will arise when new Member States enter EMU but still do not enjoy one of the basic EU freedoms, freedom of labour. This will represent a serious asymmetry, particularly given the fact that with less monetary and fiscal freedom, member states would need more mobility and flexibility in other areas to absorb eventual shocks. This is why the ECOSOC working document advises new Member States not to enter EMU before the end of the transition period for the free movement of labour (ECOSOC 2005).

It seems therefore that the main story in relation to EMU accession

and its timing is not the ability of these countries to cope with the SGP criteria (as is almost universally declared) but rather its rationale and impact. Naturally, the timing of the process is most amenable to rational action. The main issue in policy terms is how the agenda of EMU accession suits the national priorities of the new Member States.

5.3 Lack of social dialogue

It depends very much on the specific circumstances of individual countries and also on national priorities, what the optimal trajectory of EMU accession would be. Unfortunately, public debates and social dialogue have not been held in most of the countries concerned. The general public, but also the social partners are not fully aware of the risks, since they have not yet been properly informed.

A comparative study by the European Foundation for the Improvement of Living and Working Conditions (EIRO 2004) examined the role that national-level 'social pacts' between governments and social partners might play in paving the way for the new Member States and candidate countries to join Economic and Monetary Union (EMU). National tripartite institutions might be seen as an advantage as regards the successful coordination of a macroeconomic issue of this kind. The fundamental issue in the new Member States and candidate countries (as the study put it) was 'to what extent the existing national-level institutions are prepared to cope with the socio-economic challenges stemming from adhering to the Maastricht criteria' and take an active role in the development of the EMU accession agenda.

In fact, as our national reports reveal, the social partners (with some exceptions) have not been involved in discussions about the eurozone accession agenda or in the elaboration of national monetary and convergence plans.

One exception is Slovenia, where the genuine involvement of the social partners from the beginning culminated in a Social Pact. Some social

dialogue took place in the Czech Republic, where the trade unions contributed to a decision to put aside the first version of the EMU accession plan that aimed at early entry. In the other countries, however, the role of social dialogue has ranged from merely formal to marginal.

Paradoxically, the social partners in most countries have been involved in the elaboration of the National Action Plans on Employment with their ambitious employment policy targets. No one was really aware of the potential contradictions between these policy targets and the consequences of rapid eurozone accession.

It is even more peculiar that in its progress reports the European Commission put pressure on the – at that time – candidate countries to strengthen social dialogue and, within the European Employment Strategy, urged the involvement of the social partners in the drafting of the National Action Plans for Employment. This pressure bore fruit, as year after year social dialogue, at least in the context of the NAPEs, has made progress. This has been much less the case in relation to the monetary and fiscal convergence plans laying down the agenda of eurozone accession.

5.4 Country-specific features

As we mentioned at the beginning, the CEE new Member States cannot be treated as an homogenous group. There are two main groups of countries: (i) the Baltic States with their currency board arrangements (or hard peg) and (ii) the rest.

For the Baltic States staying outside EMU or choosing a longer transitional period would not offer any more benefits, as the currency board arrangement already limits the scope of independent monetary policy. Their philosophy (as the Estonian report describes) has been that 'the rigidities of monetary and fiscal policies had to be offset by social and labour flexibility'. As we shall see in relation to the country reports, tight fiscal policies are a prerequisite of the successful maintenance of

a currency board arrangement. For these countries it is a logical choice to adopt the euro as soon as possible. This does not mean, however, that the mismatches that appear in the context of the other countries would not have an impact on these countries. Constraints on social spending and public investments, such as the lower than potentially sustainable inflation rates, are also relevant here. Moreover, these countries have the lowest public debt and the highest growth, meaning that higher deficit ratios would not undermine the basic stability of public debt.

Even so, their policy options do not offer a viable alternative to an 'earliest possible' eurozone accession scenario. There is also broad consensus about fast-track adoption of the euro. It is another matter that the social partners were not involved in policy debates and macroeconomic policy formulation. The impact of this, however, was more limited in case of the Baltic States, as their room to manoeuvre and policy options were much tighter than elsewhere.

However, if the Baltic States would like to get closer to the principles of the European Social Model, they will have to increase their low levels of social spending. Furthermore, if they would also like to abandon the low wage profile of their economies, a somewhat higher inflation rate would offer them more room to manoeuvre.

Slovenia is a special case, having taken a gradualist approach and with a social pact underpinning its fast-track adoption of the euro. Slovenia represents best practice among the EMU candidates, although it is true that its level of economic development and starting position were much more favourable than those of the other countries. Still, Slovenia's practice of wide social dialogue should be an example to the others. (Slovenia is probably the only country which can manage fast-track EMU accession without substantial side effects on growth, employment and future convergence prospects.)

For the rest of the new Member States from Central and Eastern Europe, the situation is more complicated. Problematic cases are the

'Visegrad Four' countries that make up roughly 85% of the GDP of the current EMU candidates.

Among these countries, as we will see, a number of different practices can be identified. Even so, it is a common feature that public awareness of the issues is at a very low level. The population, including the social partners, is almost entirely unaware that eurozone accession is not simply a technical matter, but something that will have a direct impact on development prospects and living standards. This is the responsibility of all political actors and the media. No systematic debate has been conducted on the policy options, the alternatives or the consequences. Although a number of documents and development strategy papers are being circulated, from national development plans through action plans on employment to monetary and fiscal convergence plans, debate on how these things are interrelated has not been on the agenda.

Against this background, the four countries have different strategies, but ironically will probably end up in the eurozone in the same year, likely to be 2010. (To the appeal of the Polish finance minister to V4 colleagues to coordinate EMU entry and aim for 2010, the Slovak finance minister issued a flat rejection: 'we are not going to wait for the others, in *Népszabadság* 2005).

The most systematic approach among these countries, accompanied by partial social dialogue, was that of the Czech Republic, where trade union views influenced decision-makers to abandon the initial 'fast-track approach' of the EMU accession agenda.

In Hungary the political disagreement between the Finance Ministry and the National Bank injected unnecessary tension into the process. Instead of a deliberate strategy based on the country's characteristics and national priorities, a number of corrections and unrealistic commitments have undermined the credibility of both fiscal and monetary policy, resulting in a loss of confidence among (mostly short-term financial) investors.

All these countries would have benefited greatly from clarifying how euro adoption will fit into their medium- and long-term development strategy, including the national priorities outlined in their National Development Plans.

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Czech Republic: pros and cons of adopting the euro

Helena Čornejová and Martin Fassman

1. Macroeconomic situation in the Czech Republic at end of 2004

Czech economic growth has exceeded three percentage points in the last five quarters. Starting from the second quarter of 2004 there has been a further acceleration: growth exceeded the 4% mark and this rate is expected to continue in 2005. It is assumed that strong investment coupled with stable growth of household consumption will continue. Due to planned government savings (public finance reform) government consumption should decline moderately.

After Slovenia, the Czech Republic enjoys the highest standard of living (per capita GDP in real terms) of all post-communist accession countries. Polish GDP is less than two-thirds (63%) of Czech GDP and Slovak GDP 70%. This means that, in absolute figures, 1% GDP growth in the Czech Republic is equivalent, in real terms, to 1.6% growth in Poland and 1.3% growth in Slovakia.[1]

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1 In recent years the registered unemployment levels reported by labour offices have been more than 2% higher than general unemployment rates computed in accordance with the ILO methodology. (A similar situation can be found in Germany, whereas in the Baltic countries general unemployment rates tend to be higher.) In 2003, the unemployment rate registered by labour offices was 9.9% on average and 10.3% by the end of 2003. During 2004 it fluctuated around 10.5%. Unemployment rates are clearly increasing (annual figures for (*cont. on next page*)

Table 1: Living standards, employment and unemployment in the Czech Republic, 2001–2005

	2001	2002	2003	2004	2005
GDP growth in real terms (%)	2.6	1.5	3.1	4.0	4.0
Per capita GDP growth (PPP, EU 15=100)	60.3	61.8	63	64.2	65.6
Per capita GDP growth (PPP, EU 25=100)	66.1	67.8	68.8	69.9	71.2
Compound tax rate**	33.8	34.5	35.3	35.1	35.5
Employment rates*	65	65.4	64.7	64.5	64.4
Unemployment rates (ILO, %)	8.1	7.3	7.8	8.3	8.5
Long-term unemployment (%)	4.1	3.7	–	–	–

Notes:
* Percentage share of employed persons in age group 15–64.
** Percentage share of all taxes and social security contributions in GDP.

Sources: CSO, Eurostat, MF the Czech Republic, CMKOS own estimates.

The continuing decline of total employment in the Czech Republic is due to profound restructuring processes in the economy which are putting strong upward pressure on productivity growth. Factors contributing to this trend are a sustained decline in manufacturing employment and personnel cuts in public administration, defence and in certain types of services. This trend was previously offset by increasing numbers of self-employed, but more recently this effect has been less evident due to less favourable tax incentives.

2003 were up 0.5% for both measurement methods). Also, absolute numbers of unemployed differ considerably on the basis of the two yardsticks: in accordance with the ILO methodology, the annual average number of unemployed was 399,000 in 2003, whereas the corresponding figure for labour office registrations was 522,000 persons (542,000 by end of 2003). Higher figurers of registered unemployment can be partly explained by the impact of the shadow economy. Some persons register at labour offices as unemployed while performing part-time work in the black market. The statistics based on the ILO methodology deal with this problem better.

Employment levels in the Czech Republic are higher than the EU average (64.3% in 2002) and are close to the Lisbon target (67% for 2005 – the Czech Republic attained this target in 1998). Given the continuing above-average proportion of industry in total employment, compared to both old and new EU Member States, it can be expected than industrial employment will continue to decline. However, due to long traditions in the Czech Republic, one can expect that industrial employment will stabilise at a higher level than in comparable countries. In order to maintain – and even increase – total employment, it will be important to develop an appropriate mix of industry and services, provided in particular by small and medium-sized enterprises.

Admittedly, the unemployment rate of the Czech Republic corresponds to the European average, but its high social impact means that substantially reducing it must become the foremost economic policy priority. This unemployment reduction should be targeted at 5% or less in terms of internationally comparable unemployment rates.[2] The sustained increase in long-term unemployment is the most serious problem. The proportion of the long-term unemployed in total unemployment has already reached 50%. Finding jobs for these persons is difficult due to their low educational and skill levels. In percentage terms, most can be found in the 20–29 and 50–59 age groups. Relatively large differences prevail in terms of regional unemployment rates. This is mainly due to low flexibility of supply and limited demand for unskilled labour. High unemployment regions are characterised by substantial unskilled labour – those afflicted by structural adaptation and decline of output in heavy industry and mineral extraction.

2 Section 23 of the Labour Code: Central government authorities which issue labour-law provisions (regulations) on the basis of this Code (for example, those dealing with matters which substantially affect workers‘ interests, in particular economic, production, wage, cultural and social conditions) shall consult the central trade union body and the competent employers‘ association (organisation).

Major structural adaptation of the economy and rapid productivity growth can be expected to continue in the years to come. In this situation it will be difficult to offset the decline of jobs in traditional sectors by job creation in growth sectors, in particular in the service sector. This is why a marked decline in unemployment cannot be expected over the next few years, notwithstanding the expected economic growth in excess of 4%. The reasons for this lie mainly in the structural nature of unemployment, which is due to rapid structural adaptation. However, the target of lower unemployment rates can be attained in the more distant future. It is realistic to expect that further unemployment increases will be prevented and a moderate decline achieved.

After more than two years of relative stability, consumer prices embarked on a path of moderate growth at the beginning of 2004. The change in previous trends was caused by a number of factors related to costs. The first contributory factor was the impact of value added tax increases related to public finance reform and harmonisation changes

Table 2: Labour productivity, inflation, wage trends and poverty-risk rates in the Czech Republic (2001–2005)

	2001	2002	2003	2004	2005
Real productivity growth	2.2	0.7	3.8	4.2	4.2
Labour productivity (PPP, EU 15=100)	56.5	57	58.1	59.8	61.4
Average inflation rate (%)	4.7	1.8	0.1	2.8	3.3–3.5
Average wage (CZK/employee)	14 793	15 866	16 920	18 035	19 500*
Average wage increases in real terms (%)	3.8	5.4	6.7	3.7	4.6
Poverty risk rates (%)	8	–	8	–	–

Note: * CMKOS estimate.

Source: CSO, Eurostat, MF the Czech Republic, own estimates.

related to EU accession. In spite of these developments, the Czech Republic has had the lowest inflation rates (based on CPI) of all the new EU Member States during the whole transition period. In 2003, using the harmonised index (internationally comparable, as used in the EU), inflation rates in the Czech Republic even fell below zero – the price index declined by 0.1 percentage points. However, the long-term zero-inflation policy has resulted in the continuation of a relatively marked difference between Czech and EU-15 price levels, which is not compatible with the level of economic performance achieved by the Czech Republic.

The relatively modest increases in business sector wages in real terms in 2004 are in line with the results achieved by collective bargaining. Essentially, wage increases are following a stable trend and correspond both to economic conditions and to the decline in overall employment. The introduction of a new system of wage rates in the remuneration of public service employees, combined with the reduction of so-called 13th and 14th month wages, means overall wage increases, albeit greatly differentiated for different groups of employees. Certain groups will even experience an annual decline in earnings in both nominal and real terms. This lower increase in the total volume of wages is accompanied by higher growth of average wages and continued decline in staffing levels, which has started to adversely affect even better paid groups of employees.

Despite positive wage developments, international comparisons reveal that there is a wide gap between wage levels in the Czech Republic (as well as in other new EU Member States) and EU-15 states. The size of this difference is much greater than in any previous EU enlargement. For the sake of comparison, the average gross monthly wage in Austria is EUR 2,500, as against gross wages in nominal terms (converted on the basis of official exchange rates) of EUR 300–350 in the countries with the lowest wages (Slovakia, Lithuania, Latvia) and around EUR 500 in other countries (Poland, Hungary, the Czech Republic). Only

Slovenia, with an average wage of EUR 1,100, even comes close to half average wages in the old EU Member States (all data refer to 2003). Indeed, the wages of one worker in Austria would be sufficient to hire 5–8 workers in neighbouring countries.

Looking at wages in real terms, the gap narrows substantially due to lower price levels in accession countries: for example, real wages in the Czech Republic are just under one half of those in the EU-15 (43% compared with Austria, for example). The lowest real wages are in Lithuania, Latvia and Slovakia.

CEE-8 labour productivity is significantly lower than productivity in most EU-15 countries, for example Austria. This is why wages related to a production unit vary less than wages paid to workers. Nevertheless, in CEE-8 countries wages related to a production unit represent only a fraction of the cost in old Member States. The same is true of unit labour costs (ULC), which include, in addition to wages, social securi-

Table 3: Average monthly gross wages in the Czech Republic and CEE-8 countries in 2003 (EUR)

Country	Exchange rate conversion		Purchasing power parity	
	EUR	Austria = 100	EUR/PPP	Austria = 100
Czech Republic	532	21	1 047	43
Hungary	544	22	1 022	42
Poland	499	20	1 065	44
Slovakia	346	14	757	31
Slovenia	1 085	43	1 476	61
Estonia	431	17	897	37
Latvia	299	12	711	29
Lithuania	311	12	696	29
Austria	2 496	100	2 429	100

Source: Authors‘ calculations based on data from L. Podkaminer et. al., WIIW Research Reports 303, 2004.

Table 4: Labour productivity and unit labour costs in CEE-8 compared with Austria (2003)

Country	Labour productivity (GDP per worker)	Wages (PPP)	ULC[1]
	(Austria = 100)		
Czech Republic	64	43	32
Hungary	65	42	35
Poland	51	44	39
Slovakia	56	31	27
Slovenia	73	61	62
Estonia	45	37	39
Latvia	42	29	29
Lithuania	46	29	28
Austria	100	100	–

Note: [1] Wage and non-wage costs (on the basis of exchange rates) divided by GDP per worker on the basis of purchasing power parity (EUR).

Source: Authors' calculations on the basis of EUROSTAT data, structural Indicators and L. Podkaminer et. al., WIIW Research Reports 303, 2004.

ty contributions and other 'non-wage' labour costs. Compared with Austria, CEE unit labour costs ranged from 27% in Slovakia to 62% in Slovenia (data for 2003). In the Czech Republic unit labour costs were less than one-third of those in Austria.

2. Macroeconomic dialogue in the Czech Republic

Social dialogue in the Czech Republic is conducted on the basis of an agreement concluded between the government and the social partners and pays due respect to the social partners' status, significance and role in society.

The main platform for macroeconomic dialogue is the Council for Economic and Social Agreement (hereafter, CESA). CESA discussions are always preceded by deliberations in expert tripartite teams, which are part of the CESA structure. CESA conclusions are submitted, together with the respective ministerial reports, to the Czech government, sometimes also to the Parliament. Discussed at this level are primarily strategic documents concerning the government's economic and social policies, such as public finance reform, the National Employment Plans, the strategy to promote small and medium-sized enterprises, and so on.

The scope of social partner involvement in labour legislation is regulated by section 23 of the Labour Code.[3]

When considering the scope for social partner involvement in employment policy we can refer, by way of example, to the Committee on the Development of the National Action Plan on Employment (NAPE) 2004–2006 and on Combating Unemployment. The Committee was established in order to facilitate preparatory work on the NAPE and with a view to monitoring its implementation and analysing the results. The Committee (which included social partner representatives) participated in the formulation of the document's text and discussed the final version, which was subsequently dealt with under the monitoring procedure referred to above. In accordance with standard procedure, the proposal was also discussed by CESA. We should add that the NAPE was not officially signed by social partner representatives and, following standard procedure, was finally adopted by the government. We might also mention the Committee on Foreigners established by

3 These activities consist, for example, of programmes to promote stability and development of regional industrial activities, including services provided to these activities, development of integrated industrial areas and regeneration of industrial areas, assistance provided to industrial undertakings in situations of structural adaptation, support towards optimising the production process, support for the development of industries based on domestic raw materials. and so on.

MoLSA and an inter-ministerial body on combating illegal employment of foreigners, both with social partner participation.

Six parts of the NAPE 2004–2006 include provisions directly formulated by the social partners, dealing in particular with their respective roles in the implementation of the measures concerned, including CESA mechanisms and collective bargaining. The social partners are committed to implementing the following within the framework of collective bargaining at all levels:

Further education and training: promotion of lifelong learning to maintain existing jobs and increasing workers' labour market competitiveness.

Support for older workers: the social partners will create conditions for the elaboration of social programmes covering older employees. These programmes will promote acquisition of advanced knowledge and skills, thus avoiding redundancies and enabling older workers to be transferred to other jobs.

Combating illegal employment: social partners will conclude collective agreements which provide equal conditions to all employees, including migrant workers and asylum seekers.

Flexibility and mobility: the social partners will conclude collective agreements with a view to facilitating the introduction of flexible working time schemes in accordance with the respective provisions of the Labour Code. These arrangements would contribute towards maintaining employment levels and increased competitiveness of both businesses and employees in the labour market.

In order to promote cooperation in the labour market labour offices have created advisory bodies comprising representatives of trade unions, employer organisations, cooperatives, organisations of the disabled and regional public authorities. The purpose of consultations within these bodies is to coordinate implementation of employment policies and human resource development in the relevant administrative district.

3. Results of social dialogue – problems and conclusions

The social partners' involvement in the solution of labour market problems in the Czech Republic and in the formulation and implementation of specific employment policy measures is most visible in the following three areas:

3.1 Search for new tools which could contribute to sustainable employment increases in the Czech Republic

These tools include programmes directed at revitalising industry, promoting small and medium-sized enterprises, introducing and assessing investment incentives, promoting projects to strengthen competitiveness,[4] assessing the tax burden, coordinating social protection systems and their reconciliation with employment income with a view to making work pay.

The social partners play an active role in the formulation and introduction of specific legislative and organisational measures related to protection of the domestic market against illegal imports and protection of the domestic labour market against illegal employment.

4 The Confederation of Industry and Transport summarised its recommendations on economic policy in the document 'Proposals on economic policy' in autumn 2002. This includes a summary assessment of problems encountered in the Czech labour market and tentative proposals on how to deal with them (more on this in the next section). A number of these suggestions, including those dealing with the labour market problems, were taken up by the government and included in the government document entitled 'Proposals towards improving the business environment', which was approved in the first quarter of 2003. As regards the labour market these proposals dealt with changes in the social benefit system with a view to relating benefits more closely to active job search. Other proposals related to providing employers and employees with more room to negotiate conditions of employment, as well as to changes in the funding system for further training (subsidies provided to employers and workers). Detailed CMKOS proposals concerning the directions of Czech economic policy are included in two position papers (January 2003; June 2003) on public finance reform.

The social partners have actively participated in the discussion on public finance reform and on the directions to be pursued by government economic policy. The Confederation of Industry and Transport and the Czech-Moravian Trade Union Confederation were particularly involved. Both institutions developed and submitted to the government extensive documents containing views and recommendations concerning the development of Czech economic policy. These documents also include specific labour market recommendations.[5]

Understandably, the social partners emphasise different issues but they agree in their understanding that government economic policies will have to aim at achieving high growth rates (higher than those achieved by the EU-15) and strengthening the competitiveness of the economy as a whole. This is a prerequisite for achieving real convergence in the areas of wages, social systems and general living standards. Unfortunately, the government's work on the final version of its economic policy documents is proceeding very slowly, despite growing pressure from the social partners.

Repeated delays in adopting a comprehensive economic policy have been repeatedly criticised by both social partners. The absence of a strategic document covering this area has been felt on many occasions, for example when adopting key decisions on public finance reform or formulating and implementing the National Action Plan on Employment. The social partners have expressed their appreciation of the NAPE because it gave greater prominence to employment and labour market problems and made it easier to formulate appropriate policies in a medium-term perspective and in the context of an overall economic policy. On the other hand, due to the absence of a strategic

5 In 2002 the Czech tourist industry provided 121,000 jobs or 2.6% of total employment. Added to this should be a further 576,400 jobs (12.2% of total employment) created indirectly. This means that every eighth person is employed in the tourist sector or in related industries.

document on a comprehensive economic policy, the NAPE 2004–2006 reflects the joint position of the Ministry of Labour and Social Affairs and the Ministry of Education. Individual tasks and measures are not sufficiently linked to the aims of other ministries. Lacking in particular are links with the policies of the Ministry of Industry and Trade and the Ministry of Finance. There appears to be insufficient funding for measures planned within the scope of active employment policies.

When discussing this document within CESA, the social partners agreed that the programme primarily served the purpose of 'maintaining the status quo', and falls short of more effective measures towards reducing unemployment. They strongly insisted on increased support for active labour market policy measures and the introduction of a meaningful system of lifelong learning through changes in the tax system. Maintenance of the status quo would mean that no substantive improvement takes place in the labour market and that the goals of the Lisbon strategy will probably not be met. The NAPE includes a number of planned measures whose contents and impact were not foreseeable at the time the document was adopted. It can be expected that some of these measures and their implementation will be subject to new controversy. One might mention in this context the new Labour Code and proposed acts on poverty and the subsistence minimum. This is why the trade unions demanded an extraordinary meeting of CESA to deal specifically with employment and unemployment problems. The meeting took place in April 2004 and resulted in adoption of the following:

- *The need to develop a comprehensive economic strategy*, an integral part of which would be measures ensuring coordination of all activities affecting the labour market.
- *The need to address the creation of new jobs and the maintenance of existing jobs through improvements in the business environment* (for example, by simplification of tax laws, support for small and medium-sized enterprises, advice and training for small entrepreneurs and trades-

men, and so on). It is important to mention that a special high-level discussion group was established in mid 2004. This body is expected to provide directions for work on streamlining income tax laws in two areas: (i) preparation of strategic reform (a new income tax act, expected to come into effect in January 2008); and (ii) partial amendments to existing laws and regulations to be adopted by 1 January 2006.

- *A review of the social benefit system to make it more consistent with active job seeking.* The positions of both social partners concur in that neither exclude discussion of long-term problems related to the sustainability of certain social systems and possible reforms. However, the unions have pointed out that these reforms must take into account the time horizons inherent in these systems. They have argued that one-off measures seeking immediate savings would not constitute substantive reforms or solve substantive systemic problems. Such measures would be little more than primitive attempts to discontinue the payment of certain benefits with the simple aim of producing savings at any price. Any such immediate savings would probably result in a long-term increase in expenditure in other parts of the social protection system, as well as in growing social unrest and erosion of social cohesion. (Abolition of social benefits solely for the purpose of achieving savings would not help to solve inherent material problems related to unemployment, poverty and 'social exclusion'.)
- *Formulation of a strategy on developing and strengthening the service sector.* This is not a new requirement. Several important documents dealing with service sector development have been discussed by CESA in recent years (2003–2004), for example 'Prerequisites for development of the tourist industry', a sector which could significantly contribute to job creation. The paper identified barriers to more effective development of the tourist industry and sought to bring about better ministerial cooperation. The social partners praised the document and recommended its adoption.[6]

Also discussed was a document entitled 'Partnership between the public and private sectors'. The paper sought to provide a basis and suitable conditions for implementation of this partnership and to enable the government to provide methodical advice to various public administrative authorities to promote partnership. The necessary regulations were identified for public–private partnership. The social partners conditionally supported the proposed text and expressed some reservations. They agreed that public resources could not satisfy existing demands on public services. The problem lies in decentralisation within the framework of which part of the available resources was transferred to the regions and, in some instances, to municipalities. The state should maintain certain regulatory instruments and stipulate the conditions under which services are to be provided in order to avoid situations in which provision of public services might be impaired. Taking into consideration the importance of the service sector the social partners called for the elaboration of a comprehensive strategy on the development of and support for activities in this sector.

- *More funding for science and research*. The proposals for the state budget 2004 include a relatively high increase in funding (approximately 12%). However, even this increase is not commensurable with the objectives of the Lisbon strategy.
- To direct efforts towards ensuring, in close coordination with *the EU, the sustainability of the Czech textile industry* and, in this context, to combat illegal imports more consistently.

6 The subsistence minimum is a socially recognised income level *below which a person is considered to be in poverty*. The amount of the subsistence minimum is construed as the total amount of money required for subsistence and other basic personal needs of household members with an additional amount to cover essential expenditure (see Subsistence Minimum Act No. 463/1991, as amended).

3.2 Measures to make work pay and not undermine competitiveness

The social partners have concentrated their attention on wage levels, minimum wages and reducing the tax burden, particularly on low-income earners.

The trends in average nominal and real wages in the business sector are roughly consistent with economic development. Current annual growth of average nominal wages (by 6.5% in 2002, 5.9% in 2003 and an estimated 6.2% in 2004) does not put jobs at risk. However, this is a very complex subject and views on wage trends, including determination of minimum wages, are far from homogenous. CMKOS (the most important trade union confederation in the Czech Republic) has instituted an annual meeting with representatives of the Czech National Bank. The meeting generally takes place in November and covers assessment of the labour market situation and wage trends on the eve of the new round of collective bargaining. The most recent meeting took place on 19 October 2004. Both sides agreed that wage trends in the business sector were in line with the present stage of the business cycle. CMKOS's intention to recommend to its affiliates a 7% wage increase in the business sector within the framework of collective bargaining for 2005 was positively assessed. This increase was considered to be in line with economic realities.

In respect of wages in public administration and public services, opinions are more heterogeneous. There are two particularly serious problems:

1. Average levels of nominal wages in the non-business sector have fluctuated substantially in recent years. Annual wage increases in individual years between 1999 and 2003 ranged widely from CZK 260 to 1,500. As far as real wages are concerned, there was even a decline in 2000. Similar declines occurred in subsequent years. The highest increase in real wages in the non-business sector (9.8%) was registered in 2003.

2. In 2004 a new wage rate system was introduced. Due to the fact, notwithstanding trade union protests, that the new system was put in place without proper funding, the result will be a decline of average nominal earnings amounting to as much as 40% for some categories of employees (estimate of the public employees' unions).

Trends in minimum wages

The category of minimum wage was introduced in 1991. Between 1994 and 1999 (due to its very low initial level and minimum valorisation) the minimum wage represented only a formal instrument because it did not fulfil any of its normal functions. The situation started to change in 1998 when the new government made a commitment in its programme 'to gradually increase the minimum wage over and above the subsistence minimum'. Practical implementation of this commitment required adoption of a systemic solution. During some periods it was necessary to increase minimum wage levels more rapidly and at shorter intervals than the subsistence minimum or other wage categories. A new timetable for minimum wage increases was agreed and tentatively approved by the Council of Economic and Social Agreement in February 1999.

So far, this has been fulfilled. At the end of 2004 the minimum wage (after tax and social insurance contributions) was approximately 33% higher than the subsistence minimum for a single person.[7] The minimum wage is now 39% of the average nominal wage in the Czech Republic. In recent years, negotiations on minimum wage increases have tended to be difficult and the same was true of 2004. The trade unions wanted to maintain the agreed growth (in the spirit of the 1999 agreement), proposing an increase of 8–9% and arguing that the min-

7 If adopted these proposals will result in tax reductions in the amount of CZK 3.6 billion for the families covered by the tax allowance and tax bonus and where joint assessment of married couples is applicable.

imum wage must protect from poverty not only individuals but also employees with dependents. The employers, on contrast, proposed an increase of 3–4% which, taking inflation into account, would mean merely maintenance of the status quo.

Reduced tax burden

After consultation with the social partners the government has proposed tax reductions for families with children. The Parliament is now considering a two-part proposal: (i) joint taxation of married couples with children: subject to approval by the Parliament, the combined tax paid by husband and wife will be reduced where there is at least one dependent child in the household; (ii) introduction of a tax allowance and tax bonus to replace the present tax-free part of the assessment base due to each child. This measure would help to reduce the tax burden on low-income persons and so contribute to social cohesion.[8]

3.3 Promoting the labour market participation of groups at increased risk of unemployment

These vulnerable groups include persons with disabilities, single mothers, older persons, school leavers without work experience and the long-term unemployed. At present, there are *detailed discussions between the social partners in the context of public finance reform concerning school leavers*. The social partners aim to achieve a more appropriate mix of skills (in particular among graduates from training centres and secondary schools) and thus improve their chances of entering the labour market. The current education and training systems have been criticised, particularly by employers, who argue that they are not compatible with labour market needs. The Czech education system is heavily structured

8 This is a more general notion than real convergence of exchange rates. After joining the euro area real appreciation of the rate of exchange will no longer be possible whereas real appreciation in general will continue, affecting domestic economic assets in relation to foreign assets. The result of this appreciation will be an increase of relative prices related to average prices in other EU countries..

according to occupations and branches. This means that the chance of finding a job very much depends on the type of education and skills acquired and the level of these skills. In 2002, the National Institute of Professional Education submitted an analysis of the labour market prospects of secondary school leavers ('Correlation between educational levels and job requirements'). This analysis explores the extent to which skills are utilised in practice, that is, whether graduates are employed in the occupations for which they were trained or in related occupations.

The study concluded that the greatest variations in skill utilisation could be found among the following groups:

- Graduates from training centres specialising in electromechanical work. Young people seeking a job do not meet the requirement of work experience but the findings can also mean that the mix and content of the acquired skills are not sufficient or not compatible with job requirements.
- Training for work in the chemical industry is not considered appropriate and this has been highlighted as a longer-term problem.
- Other problem branches are textiles, clothing and leather, where as a consequence job vacancies coexist with substantial unemployment. This shows that there is substantial inconsistency between skills and job requirements. Approximately 40% of those with an apprentice diploma in textiles and clothing (especially young workers) work in other occupations. The situation is still worse in the leather industry – 63% of graduates work in other occupations.

The main goal of training system reform should be to make training less dependent on immediate demand, making it more flexible and oriented towards future labour market needs.

Substantial changes in education were made immediately after the 1989 revolution. However, they were introduced in a rather chaotic manner.

The first systemic and significant step in this area was the adoption of a standard for secondary technical schools in 1998, which defined a common educational base for all newly introduced programmes. This was followed by the introduction of core educational branches (KKOV – since 1 September 1998) linked to labour market needs. Framework educational programmes for these core educational branches are being submitted for discussion.

4. Economic and social aspects of euro adoption

4.1 Pros and cons of rapid euro adoption – the theoretical background

The most important point for discussion – vital for all new Member States – is the relationship between membership of the euro and real convergence trends. Will the meeting of the Maastricht criteria support real convergence of economic efficiency, labour productivity, money incomes (including wages), public and private consumption and, in the final analysis, living standards, or will it put a brake on convergence? Similarly, would the monetary policies applied by the European Central Bank help new Member States to narrow the gap?

In general terms, the criteria for evaluating monetary union are studied by the theory of optimum currency areas. They concern synchronisation of cycles, resilience to asymmetric shocks, flexibility of prices and wages and international labour force mobility. The present criteria are not even fulfilled by the present members of the eurozone. In future, and taking into consideration possible divergent developments, this could lead to high costs related to maintenance of monetary union. As far as meeting the relevant criteria is concerned, the underdeveloped economies of the new EU Member States are very vulnerable. Their situation is not relieved by the current restrictions on free movement of labour and of services imposed by most old EU Member States.

The Czech Republic and other new Member States will find it difficult to reconcile eurozone membership with convergence problems, that is, catching up with per capita GDP levels. There are potential benefits of eurozone membership for real convergence, but there are also dangers related to the conflicts which may be generated by the fact that real convergence will require a certain pace of real appreciation of domestic economic assets in relation to foreign assets.[9]

Real appreciation can manifest itself in higher domestic inflation (inflation differential) or nominal appreciation of the exchange rate. However, nominal convergence criteria and monetary stability criteria in the eurozone impose certain limits on these processes. This means a de facto limitation on the pace of real convergence. In respect of the exchange rate this will be felt within around two years of ERM II membership – with full impact after euro accession. In addition, after euro accession the inflation differential will be affected by ECB monetary policies.

Assuming a situation in which new EU Member States were potentially able to achieve productivity increases and real convergence more rapidly than under the conditions and limitations imposed by the Maastricht criteria, the ERM II system, and later on by ECB monetary policies, it would seem that premature joining of the eurozone would constitute a barrier or a brake to real convergence. For this reason it will be necessary to consider the timetable for euro accession carefully – this is also the only degree of choice made available by the present EU rules. Economists in the Czech Republic tend to line up alongside two main positions: the first can be characterised by the slogan 'the sooner the better', the second by 'no reason to hurry'. Both have their pros and cons.

9 The European Commission (1990) estimated that these savings would amount to 0.4% of GDP a year for an average Member State.

4.1.1 Pros of rapid adoption of euro

No risk of monetary crises. A strong argument for rapid adoption of the euro is the world-wide experience of recurrent financial and monetary crises, which can start or be heightened by transmission from one country to another (international contagion). The enormous global capital flows constitute a permanent risk for individual candidate and new member countries and for the whole programme of EU enlargement.

Reduced transaction costs. After joining, lower transaction costs would be a definite advantage for all businesses engaged in trade within the eurozone. It is also assumed that total macroeconomic benefits would be higher than potential losses for banks through loss of exchange rate operations. Benefits related to reduced transaction costs would be higher for open economies like the Czech Republic, where tradable goods represent a large part of total domestic output. The higher the ratio of flows of money payments connected with monetary conversion to GDP at current prices, the higher the potential savings on transaction costs expressed as a percentage of GDP.[10]

Reduced exchange rate volatility. Euro membership would exclude the possibility of substantial exchange rate fluctuations in relation to our main trading partners. The sole remaining source of volatility would be in relation to other currencies, which might be felt by domestic economies in terms, for example, of oil imports and other commodities whose prices are expressed in US dollars. Major exchange rate fluctuations can put the stability of any economy at risk and volatility always produces risks for both trade and investment. Absence of exchange rate fluctuation in the eurozone would thus be a factor pro-

10 We are referring to the theory of the optimum currency area developed by Mundell (1961) and McKinnon (1963).

moting real convergence for the Czech Republic. The level of the resulting benefits would be warranted by the high proportion of eurozone countries in Czech trade and the likelihood that EMU membership would increase this proportion. The non-existence of exchange rate risk would also exert a favourable influence on potential investors from the eurozone.

Lower interest rates. The proponents of rapid euro accession tend to maintain that it would lead to lower interest rates and that these would, in turn, produce more rapid economic growth. They maintain that lower interest rates over the long term would have a favourable impact on currency risk and even remove it. However, the advantage derived from this particularly concerns countries at higher risk (and with a higher interest rate differential) than the Czech Republic.

4.1.2 Cons of rapid adoption of the euro

There are risks attached to rapid euro membership even if monetary union continues to run smoothly and the international credibility of the euro strengthens further. We shall now look at the risks related to common monetary policies. These risks are generally defined by the theory of optimum currency areas but there are other and more specific risks related to the relatively low economic level of the Czech Republic and the catch-up process. The related economic costs can be very high and can exceed the benefits of early joining.

The theory of the optimum currency area[11] is closely related to the issue of appropriate timing for joining the euro. A number of important points must be considered, such as synchronisation of the Czech economic cycle and the eurozone cycle and the symmetry of impact of these cycles and economic shocks on both the Czech economy and

11 Similar decision points are related to monetary union between countries at a similar economic level (for example, the United Kingdom has grounded its reluctance to join the euro area on among other things the asymmetry of its economic cycle).

other EMU members.[12] If synchronisation of economic cycles is not achieved and the impact of possible shocks is different, the ECB's economic policies would be partly or even wholly inappropriate for the Czech economy. For example, the course of the domestic cycle might deepen and the recession might worsen. In such a situation the theory of the optimum currency area prescribes emergency adaptation mechanisms to mitigate the impact of an asynchronous cycle or asymmetric shocks. These emergency adaptation mechanisms include high flexibility of both prices and wages (including downward movements) and high labour force mobility and mobility of business activities across borders in both directions. The weaker these adaptation mechanisms are, the stronger the adverse impact of a situation in which the common monetary policy is unable to take account of the specific needs of the Czech economy. Fiscal policy, an additional potential adaptation tool, would also have only a limited impact, being restricted by the Fiscal Stability Pact which already appears to be too narrow for some larger Member States.

Loose alignment of the Czech economic cycle with the eurozone. One might expect that in a situation of strong trade relations with eurozone countries, synchronisation of the cycle has already been achieved, or that it would be achieved following introduction of the euro. However, existing experience in this respect does not provide clear indications to this effect. In relation to our main economic partner, Germany, Czech GDP appears to be correlated with German industrial output rather than with German GDP. A study produced by the Czech National Bank[13] gives some indications of growing synchronisation of the Czech cycle with Germany and the European Union, but pointed out that the data on the Czech cycle did not cover a sufficiently long period to allow for valid conclusions. Other available studies provided sim-

12 M. Cincibuch and D. Vávra (2001).

13 See, for example, J. Fidrmus and R. Schardax (2000).

ilarly inconsistent results.[14] Thus the question remains how long the reconciliation of economic cycles will take. In other words, for how long after euro entry will the Czech economy be subject to risks derived from insufficient synchronisation? It should be noted that none of the present eurozone members have managed to achieve full synchronisation despite strong trade relations and long years of membership of the free trade area.

Likelihood of future asymmetric shocks. Individual members of monetary areas can be afflicted by asymmetric shocks even if the condition of similar economic levels is attained. Such countries can differ in their structural characteristics which may prove to be decisive in respect of the impact of economic shocks. However, most studies have concluded that the markedly lower economic level of the new member countries, compared with the EU average, would contribute greatly towards increasing the impact of these shocks. The likelihood of future asymmetric shocks could also be increased by specific post-transformation features encountered in the new Members' economies, including the Czech Republic. The scope of risk will be strongly affected by further development of the structure of mutual trade. Strong specialisation would tend to increase the risk of asymmetric shocks. Conversely, this

14 Where, during the catch-up process, productivity in the trade sector grows more rapidly than abroad, then as a rule, productivity growth in the non-trade sector will be unable to keep pace. Nevertheless, wage increases in the non-trade sector tend to be nearly the same as those in the trade sector. Thus a gap is generated in the non-trade sector between relative increases of wages and productivity, and this becomes a source of inflation. The result is higher inflation in the whole economy compared with other countries. This is also the reason why catch-up countries have, as a rule, a positive inflation differential compared with technological leaders. Within this process, economic, productivity and price levels in the catch-up countries tend to converge towards levels experienced in more developed countries. For a more sophisticated explanation see, for example, ECB (1999), p. 40. There is empirical confirmation that the Balassa–Samuelson effect was actually present within the euro area in the past and the ECB believes that this will continue to be the case in the future (ibid.).

risk would be greatly reduced in a situation of a wide spectrum of trade activities and high levels of trade within sectors.

Insufficient labour market flexibility. The Czech labour market is insufficiently flexible and has little capacity to withstand the effects of asynchronic cycles and asymmetric shocks. Labour mobility is low and wages are insufficiently flexible – there is hardly room for downward movement. Also, there is no real single labour market in the eurozone which would allow high labour force mobility – language barriers appear to be a strong obstacle. Efforts made in the EU to harmonise legislation and social systems will further contribute to reduced flexibility of labour markets in poorer EU countries.

Barriers to early adoption of the euro related to current EU rules. Given the insufficient synchronisation of cycles, substantial risks of asymmetric shocks and insufficiently flexible labour markets, new EU Member States would face many risks when opting for euro membership. Their situation would be further impaired by the impact of certain measures and rules adopted by the EU. Among the most important barriers are the restrictions imposed on free movement of labour and on business activities (services). Thus the European Union has created barriers for its new Member States in relation to mobility of production factors across borders and these countries are effectively deprived of the possibility of compensating for and mitigating the impact of cycle disparities or asymmetric shocks. The restrictions on free movement of labour will be in place for a considerable number of years. In addition, there are restrictions which will make it impossible for Czech businesses to engage in certain activities in the old EU Member States (transport, construction). During the period in which the new Member States are still unable to enjoy all the freedoms guaranteed by the EU Constitution – including free movement of labour and services – they should not seriously consider joining the euro. This is not only a matter of principle (equal rights). The fact is that these restrictions entail major risks, making the eurozone a

somewhat inhospitable monetary environment for new EU Member States.

The Fiscal Stability Pact will deprive new euro members of a potential tool for solving imminent crises. As such, a policy of maintaining balanced budgets is based on a sound principle. However, in specific situations – as, for example, during the first years after joining the eurozone – the Pact would restrict room for manoeuvre in the last remaining area in which independent economic policy decisions are still possible. Indeed, higher budgetary deficits would represent the last area for independent decision making when accession countries relinquish their independent monetary and exchange rate policies. The Fiscal Stability Pact would have a still greater impact if the European Commission's plans to harmonise tax and social systems materialised.

One could hardly expect the EU budget to allow for extraordinary fiscal transfers to assist new eurozone members, covering the potential impact of the divergence of cycles and/or asymmetric shocks. This could only become reality if the fiscal federalisation being promoted by some politicians were established – a rather remote prospect.

Specific risks related to economic and price differentials. The real convergence of the Czech economy will tend to produce real currency appreciation which, after joining the eurozone, will manifest itself in real appreciation of domestic assets. This will be a long-term process, lasting throughout the catch-up period. This will not be a matter of a few years: this goal will certainly not be achieved within the horizon for entry of the new member countries into the eurozone tentatively planned by the EU. On the one hand, real appreciation would impose the task of maintaining competitiveness; on the other hand, it strategies uncertain whether the economy could achieve growth while maintaining low inflation rates which would not undermine the monetary targets set by the European Central Bank.

A number of causes will help bring about real appreciation of domestic assets. In transition economies such as the Czech Republic slightly higher inflation rates are needed to facilitate the process of changing the price structure. Most changes in relative prices were made in the first stage of transition, following initial price deregulation. However, price deregulation is still ongoing and the impact on relative prices has not yet fully materialised. Changes in relative prices in the new EU countries will still be unavoidable even after full price deregulation. They will be generated by the integration process and by the process of catching up with Western technological and economic levels. As a rule, frequent changes in relative prices tend to produce higher inflation rates because most prices are not flexible downward. The low starting levels of relative prices in the new EU countries (see the section 'Macroeconomic framework') will be a further source of real appreciation of assets.

The present price differentials can be explained by the lower quality and lower technological levels of products or rather by the fact that consumers in the old EU Member States tend to perceive these products as being inferior, less reliable, and so on. Introduction of new products (product innovation), quality improvement and boosting the reputation of trademarks, coupled with wider penetration of these products in EU markets, will create room for increasing relative price levels. One should consider that price increases related to product innovation and quality improvement are not de facto inflation, rather a fictitious inflation. It is only because of imperfect price indexes that price increases due to higher quality and product innovation cannot be distinguished from inflationary price increases.

A very important long-term source of real appreciation is the so-called Balassa–Samuelson effect, produced by labour productivity increases.[15]

15 P. Doyle et al. (2001); C. Nayer (2001). For an attempt to calculate the impact of the Balassa–Samuelson effect on real appreciation in the Czech Republic, Poland, Hungary and Slovenia, see Fidrmus and Schardax (2000), pp. 42–44.

Begg and others have produced estimates that real appreciation stemming from the Balassa–Samuelson effect could be in the range of 1.5–2.5% a year for countries like the Czech Republic, Poland and Hungary. The European Central Bank estimated this effect to be between 1% and 3%.[16] However, all these and similar estimates are based on adoption of certain a priori assumptions concerning future developments and trends.

As experienced in recent years in the Czech Republic real appreciation of currency is frequently caused, in addition to productivity and quality improvements, by foreign capital inflows. If real appreciation is accelerated by capital flows, it can jeopardise the competitiveness of domestically produced goods. As a rule, the Czech National Bank has worked towards slowing down the process of real appreciation, if this process appeared to be too rapid. This has been achieved by interventions and more stringent anti-inflation policies. However, excessive emphasis on brakes on real appreciation can produce a reaction in reducing productivity increases.

On average, it is expected that the whole group of new EU member and candidate countries will experience a slowdown of real appreciation rates in the next few years. This is due to plans in all these countries to reduce inflation differentials before and immediately after EU accession. This could also mean slowing down the required process of price reviews and adaptation and also produce lower productivity increases compared with recent years.

Safe limits for real appreciation will be defined by labour productivity growth in the trade sector and by quality improvements, including the product innovation effect. Management of this process will have to

16 Average inflation in the euro area in this context means a harmonised price index (weights of individual countries to be compatible with the relative volumes of their GDP).

take into account the development of the current account deficit of the balance of payments. Real appreciation does not undermine domestic competitiveness if it is accompanied by corresponding increases in labour productivity, which must be higher than those achieved by competing countries. For this condition to be met, it is sufficient to achieve a corresponding increase in the tradable sector of the economy. Similarly, competitive strength would not be put at risk by price increases produced by quality improvements and product innovation.

A particular problem worth mentioning in this connection is assessment of the right time for stabilisation of exchange rates in catch-up countries. One natural effect produced by real appreciation of domestic assets is nominal appreciation of currency rates. The second path for a real appreciation of domestic assets is linked to the inflation differential. During the period in which exchange rate intervention is available as a policy tool, inflation differentials can be maintained at lower levels. Potential entry into the eurozone would freeze currency rates and, as a result, could produce higher inflation rates and higher inflation differentials in all new members.

There are other reasons why joining a monetary union is risky for countries at a lower economic level. To the extent that inflation differentials in new eurozone members are derived only from more rapid productivity increases in the tradable sector, quality improvements and rapid product innovation, this process would not undermine the competitiveness of domestic producers. However, a different scenario would prevail in the event of wage contagion caused by imports and external pressures. This would lead to a situation in which wage increases would not be sufficiently based on productivity improvements. After adoption of the common currency, wage differentials will tend to become more transparent. The eurozone would also increase the risks entailed by harmonisation of social and wage legislation with wage increases tending towards the levels of rich countries.

The risk of lower real convergence caused by stringent ECB anti-inflation policies. Following entry into the eurozone convergence of price levels will proceed only through inflation differentials. If the catch-up and convergence rates of price levels are slow, they will not necessarily imply much greater inflation differentials than those experienced by developed EU countries. However, should the Czech Republic and other new eurozone members demonstrate a potential for rapid productivity and quality improvements and rapid real convergence (as, for example, was the case with Ireland in the recent past) this would enable them to achieve a rapid real appreciation of their domestic assets. This assumption is not necessarily unrealistic given the productivity improvements achieved by Poland and Hungary between 1995 and 2000. However, following entry into the eurozone, this appreciation would have to embark on the path of inflation and would cause a relatively big inflation differential of at least 2 percentage points compared with the eurozone average.[17]

Given the impossibility of exchange rate interventions by the new EU countries after eurozone entry, rapid real appreciation would be fully reflected in their inflation differentials. Despite the low weight of the new members in the eurozone harmonised price index (given their low share of total EU GDP), compound high inflation differentials might become incompatible with ECB objectives. As a result, the ECB might impose measures whose effect would jeopardise the catch-up process. In this situation, efforts made by the ECB to maintain low inflation in the eurozone as a whole would slow down economic growth in new member countries and depress their inflation rates below the levels necessary for rapid real convergence. Should this occur, membership of the eurozone would run counter to the fundamental interests of the new member countries, namely their effort to achieve rapid increases in economic performance and to come closer to the EU average.

17 For example, C. Noyer (2001), *Handelsblatt* (2 December 2002).

The principle that new EU countries will not have an opt-out from EMU membership was probably a result of a political decision related to the disappointment caused by the unwillingness of the UK, Sweden and Denmark to sign up to monetary union. The European Central Bank started to seriously consider the practical impact of this decision immediately after fully assuming its role. As a result, a cautious approach was recommended and the ECB issued a clear warning to new member countries not to be too hasty in their efforts to join the eurozone.[18]

4.2 Czech government strategy for joining the eurozone

In September 2002 the Governor of the Czech National Bank submitted to the government a document entitled 'The Czech Republic and strategic proposals for entry into the eurozone' (CNB 2000). This prompted a dialogue between the government and the CNB. The title of the document does not accurately characterise its contents, however. The introduction includes an explanation of the rules and conditions of entry and the second part contains a concise statement of potential positive effects and possible barriers and weaknesses, the conclusion being a recommendation in favour of rapid entry because of the alleged preponderance of benefits. This recommendation was not supported by any convincing evidence, however. The answer to the key question of the extent to which rapid adoption of the euro would effect economic growth and the speed of real convergence was that real convergence would be achieved more rapidly within EMU. This statement by the CNB clearly contradicted the warnings issued by the European Commission and the ECB in which attention is drawn to possible adverse effects (see above). The CNB document included a recommendation for euro adoption as early as 2007. This was accom-

18 Among other things, the adopted strategy invites the minister of finance regularly to submit evaluations to the government concerning the meeting of the Maastricht criteria and economic harmonisation with the euro area.

panied by another recommendation, namely adoption of the ERM II exchange rate regime simultaneously with EU accession.

In response to a number of flaws in this document and its one-sided recommendations a new and more comprehensive document was prepared by the CNB in cooperation with the Ministry of Finance and the Ministry of Industry and Transport and submitted to the Government in September 2003. Discussion of the problem was more restrained, balanced and realistic. The document included a more detailed analysis of both potential benefits and potential risks, which had been deliberately suppressed in the former document. The simplistic and unfounded statements concerning the automatic positive impact on economic growth accompanied by growing prosperity were no longer in evidence. The new document also included a recommendation that the Czech currency not join the ERM II mechanism on EU accession. The new strategy assumes that joining the eurozone might be feasible around 2009–2010 but no explicit deadline is mentioned. The basic recommendation is to join the eurozone as soon as appropriate economic conditions are created. A close link was also established with public finance reform.[19] The public deficit is to be reduced to 3.5% by 2006. This would make it possible to meet the Maastricht criteria around 2007–2008.

4.3 The CMKOS position on joining the eurozone and adoption of the euro

CMKOS has consistently based its positions on the theoretical and empirical background referred to in section 1 of this paper. This was also the basis for its evaluation of the government's strategy. Although, in contrast with the previous CNB document, the new strategy is much

19 In general, countries with lower living standards tend to have higher economic growth compared to more economically developed countries. This is the so-called 'catch-up effect'.

more in line with the realities of the Czech economy, the reasoning continues to be rather one-sided. The conclusions suggest that rapid adoption of the euro is desirable but difficult to achieve because of the impossibility of reducing the deficit and so meeting the Maastricht criteria. CMKOS believes that such reasoning completely misses the core of the problem, namely how to manage the process of adjustment of a transitional economy and bring it closer to the status of a developed economy on the basis of a single currency. (The related risks are described in section 1.)

Due to the fact that the deadline for joining ERM II is approaching, entailing the beginning of complex negotiations concerning the initial exchange rate level, CMKOS felt that it was opportune to produce a position concerning the adoption of a single currency. For this reason it submitted a detailed paper entitled 'An analysis of risks related to the entry of the Czech Republic in the eurozone' (CMKOS 2004). The document focused on a balanced assessment of the strengths and weaknesses of rapid adoption of the euro (see above). This analysis led to the following conclusion: 'Joining the eurozone is desirable for the Czech Republic only after attaining a sufficient degree of real convergence with the EU-15 average. Only in such circumstances can the economic conditions of the new and old EU countries be truly reconciled and the nominal criteria of the eurozone be fulfilled. These conditions will also generate more benefits than problems.'

In the coming years the Czech Republic will have to make full use of its potential for rapid real convergence. To achieve this it will have to take advantage of all opportunities related to EU accession. During this period it will be desirable for the economy to develop under conditions of "flexible nominal quantities", by which it could adapt more flexibly to dynamically developing economic realities.

Given the high level of development of financial and banking services in the Czech Republic one would hardly expect the benefits of mone-

tary union, such as reduced transaction costs and elimination of currency risk, to be particularly high. In addition, full absorption of these benefits by the Czech economy, even given rapid accession to ERM II, would be felt no sooner than around 2010. Until that time, the economy would be burdened by a number of handicaps and limitations, whereas benefits deriving from membership of a monetary union would be postponed to an uncertain future due to difficulties in generating GDP increases and due to the fiscal problems mentioned above.

During the first years of the euro, economic development in the eurozone was slower than in the EU as a whole and also slower than in the post-communist countries of Central and Eastern Europe. Similar trends can be expected also in the next few years. Thus it would make little sense for the Czech Republic to strive for closer unity with this group of countries, given the fact that the present conditions of EU membership enable us to make full use of free trade and investment. It cannot be excluded that the economic difficulties of the eurozone will continue. This would tend to confirm the concerns and criticisms voiced in the context of introduction of a single European currency, namely that the Member States of the eurozone do not meet the conditions for an optimum monetary area.

In the near future, the main driving force behind improving the competitiveness of the Czech economy will be the good performance of the micro-economy. To achieve this, it is necessary to improve the competitiveness of individual enterprises. Steady growth of real competitiveness and improved labour productivity will provide a solid basis for gradual wage increases and improved living standards. In turn, increased purchasing power will stimulate Czech businesses. Therefore, government economic policies should be primarily focused on improving the competitive strength of Czech enterprises.

Conclusion

It should be constantly kept in mind that the Lisbon strategy is based on three balanced and mutually linked pillars: economic dynamism, higher employment and social cohesion. The trade unions rightly expect that the Czech government will manage its policies accordingly. It is essential that specific policy measures take due account of achieving balanced results in terms of competitiveness, employment flexibility and social protection. Contrary to these expectations, employees' representatives are under permanent and increasing pressure from right-wing political parties (in particular the Civic Democratic Party) and certain employers. These forces are attacking employees' rights and demanding a one-sided revision and dilution of existing labour legislation and of the legal and social protection of employees. Most right-wing deputies and some groups of employers are lobbying for the destruction of the whole system of collective bargaining (in particular, higher level collective bargaining).

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Estonia on the threshold of entering the eurozone

Raul Eamets and Katrin Olenko

1. Introduction

At the beginning of the transition one of the crucial economic policy decisions was the choice of macroeconomic policy framework. The divergent experiences of transition countries provide evidence of the importance of a stable macroeconomic environment and the matching of government priorities with the needs of restructuring.

For the accession countries, the choice of the optimal macroeconomic policy mix is even more complicated as these countries are all engaged in a dynamic movement involving EU membership and gradually also Economic and Monetary Union (EMU). The latter implies a considerable change in the macroeconomic policy environment as well as in the institutional structure of policy making. Many of the countries will have to change their macroeconomic framework in order to meet the strict criteria laid down in the Maastricht Treaty and accompanying legislative acts, especially the Stability and Growth Pact. At the same time, the real convergence of income levels assumes more flexibility concerning policy measures in order to choose the optimal path towards convergence in each country. Issues such as the optimal exchange rate regime for the country that would make it possible both to fulfil the Maastricht criteria and to manage the structural changes needed for adjustment to EU requirements, as well as to ensure further

convergence towards the EU average income level, are being considered by academics and experts, as well as by politicians. This question arises in most accession countries in the context of ongoing structural reform, continuing price convergence and productivity growth.

Estonia is often considered one of the text-book examples of a small, open transition economy, able to cope with transition problems with the help of a liberal and rather passive macroeconomic policy. However, as the currency board arrangement (CBA) and sound government finances have helped to stabilise the economy during the transition, there are still some challenges to be faced upon EU and EMU accession. The aim of this chapter is to evaluate the sustainability of Estonian macroeconomic policy in light of these future developments, especially participation in Economic and Monetary Union.

We shall first review the current macroeconomic policy set-up and compare the macroeconomic performances of transition countries. Particular attention will be paid to productivity developments, as well as inflation and growth performance.

The second part of the chapter will be devoted to exploring how Estonia is meeting the criteria for macroeconomic cooperation in the EU, taking into account both nominal and real conditions. It will provide an overview of nominal convergence according to the rules laid down by the EC Treaty on EMU convergence criteria. However, the convergence criteria are not aimed at ensuring a sufficient level of convergence in economic development and structures. In this context the theory of Optimum Currency Areas provides a set of criteria which are expected to be fulfilled in order to guarantee sustainable and successful participation by the region in monetary union.

2. Macroeconomic performance

2.1 General macroeconomic framework

2.1.1 Currency board arrangement as a cornerstone of the Estonian economy

Like other transition countries the choice of the optimal policy mix for coping with the transition was one of the major challenges for Estonia after regaining independence in 1991.

The most important step in restructuring the economy was to detach the country's financial system from the devastated rouble-based system. The need for rapid monetary reform was also connected with the cash deficit caused by the central bank of Russia and the continually intensifying hyperinflation. Thus monetary reform and introduction of a national currency became a founding pillar of Estonian restructuring.

Various scenarios were suggested for introduction of the currency, but in the end the dominant desire to introduce a stable and credible national currency led to the idea of introducing the currency board arrangement (see also Kukk 1997). IMF experts were initially sceptical about the introduction of national currencies in the Baltic States, especially in Estonia. IMF concerns were related to the emergence of a large fiscal deficit and the lack of a more general and consistent macroeconomic framework (Knöbl et al. 2002). Despite that, the Bank of Estonia and the Monetary Committee, consisting of high-level government representatives and leading experts decided to go ahead with the currency board arrangement.

Since monetary reform in June 1992, Estonian monetary and exchange rate policy have been determined by the currency board arrangement.

The currency board arrangement is one of the strictest forms of hard currency peg. The exchange rate is pegged to a foreign currency (in the Estonian case, the German mark, replaced by the euro in 1999) with the relevant regime and parity enshrined in law. A change in parity or exit from the regime is extremely difficult and costly.

The principal features of the Estonian CBA are 100% backing of base money, fixed exchange rate regime and complete convertibility of the Estonian kroon. Under the terms of the Act on the stability of the Estonian kroon, currency issues are fully backed by the gold and convertible foreign exchange reserves of the Bank of Estonia (Eesti Pank). The Bank may change the amount of Estonian kroons in circulation only in accordance with changes in its gold and foreign exchange reserves (Clauses 1 and 4 of the Act) (Sepp and Randveer 2002).

From 20 June 1992 the exchange rate regime was a fixed rate against the German mark of EEK 8 = DM 1. Since the beginning of 1999, the kroon has been fixed to the euro (EEK 15.6466 = EUR 1).

According to the legislation, the Bank of Estonia has no power to devalue the Estonian kroon. Any change in the exchange rate leading to devaluation against the German mark (euro) must first be approved by the Parliament. Considering convertibility, there are no restrictions on current account transactions. The only valid restriction for capital account transactions is connected with the purchase of land by non-residents (the permission of the government or local authority is needed). There are no further restrictions on capital account transactions (Sepp and Randveer 2002) .

2.1.2 Fiscal policy framework

The lack of a credible macroeconomic environment for introducing the currency board arrangements led to concerns about introducing a rather restrictive fiscal policy, aiming at a balanced budget.

The main goal of the government's fiscal policy was to create conditions for stable economic development by means of efficient government. The main targets of fiscal policy are (PEP 2003):

- keeping the general government budget in balance (exceptions can be made only in the case of financing pension reform);

- reducing the tax burden by cutting taxes on labour;
- stabilising current government expenditure with respect to GDP.

The government has set a target of keeping the budget of the general government sector in balance. Estonia's small and open economy is highly dependent on imported goods (in terms of both consumption and investment), which in some cases (for example, considerable real appreciation of the currency) can worsen the external balance. Excessive government expenditure can only result in increased local demand.

Given the existence of global capital markets sound government finances build up confidence among investors. A conservative budgetary policy makes it possible to avoid accumulation of public debt and also provides for the sustainability of public finances in the long run, including not raising taxes to finance public deficits in the future.

EMU accession will limit Estonian fiscal policy. The government's solid financial situation provides the conditions for price stability and strong and sustainable economic growth. Implementation of this goal allows Member States to cope with normal cyclical swings – if the government usually keeps its budget in balance, revenue reductions during bad years are not expected to result in a budget deficit greater than 3% of GDP. A budget with lower cyclical impact also affects the economic cycle, as letting automatic stabilisers work has a negative effect. The SGP goal is to provide support for financial policy via the national fiscal policies of Member States. As an EU member state, Estonia has to make a contribution now, also taking into consideration that it is easier to proceed with a balanced budget now (which has already proved to be beneficial), than maintaining a higher deficit and making painful adjustments later (PEP 2003).

The government is keeping tax policy simple. The underlying goal is to decrease the tax burden and thus direct more resources to economic development. For this reason, existing tax rates have not been

increased, except for changes related to EU accession, mostly affecting taxation of consumption. In order to improve opportunities for economic growth, the government intends to decrease taxes on labour. Excessive taxation of labour – the effective tax rate on labour exceeds the OECD average – decreases motivation to work. For this reason the income tax rate will be reduced from 26% to 20% (for 2007) and the threshold of monthly tax free income will rise from 1000 to 2000 kroons for the next three years. The decrease in the income tax rate will bring lower growth in government revenues during the first few years, but as the private sector will direct the additional resources which tax cuts will allow them into investment to increase productivity, in the long run the income tax cut will benefit economic development and, thus, national income (PEP 2003).

The task of a fiscal policy is liquidation of market volatility and liquidation of barriers for private sector development. At Estonia's current state of development, plans for implementation of structural reforms and actions to improve the supply side of the private sector have to be developed. Government actions in this field are mostly aimed at improving labour quality and increasing labour supply, which would substantially reduce companies' costs in respect of education and re-education, at the same time preserving the flexibility of the labour market. Government investment in infrastructure and the reduction of transport costs, thus improving the competitiveness of the public sector, are no less important. For this reason it is a complicated task for the state to cope with increased financial demands and social expenditures, which require stable and direct cost planning (PEP 2003).

In reality, a balanced budget principle means that de facto the budget has been in surplus or in some (modest) deficit (see Figure 1).

The role of fiscal policy became crucial in 1997–1998. By spring 1997, the current account deficit exceeded 14% of GDP, and domestic credit growth was over 70%. Under these circumstances the gov-

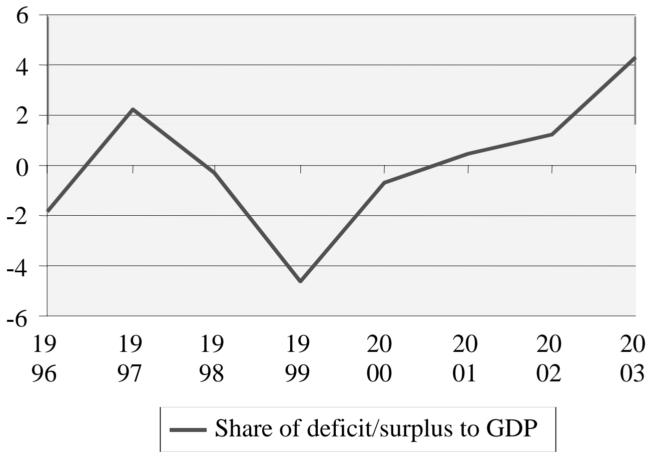

Figure 1: Estonian budget deficit/surplus as a proportion of GDP

ernment made a decision to increase public savings as much as possible. This brought about a drastic change: in the first quarter of 1997 the state budget was practically balanced, reaching a surplus of 5% of GDP in the third quarter and more than 2% of GDP in the fourth quarter. The overall annual surplus of over 2% of GDP was generated in the second half of the year. At that time the government made a crucial decision on fiscal policy: the Stabilisation Reserve Fund was formed. During the period of surplus generating fiscal policy the Stabilisation Reserve Fund served the aim of reducing domestic demand and sustaining foreign investor confidence in economic policy.

Annually balanced budgets have both a positive and a negative influence on the overall macroeconomic environment. On the positive side we see that a balanced budget helps to keep state expenditure under control and, as we shall show later, Estonia already meets the Maastricht criteria. Also, a balanced budget is necessary to maintain the

stability of the currency board arrangement.[1] This gave Estonia a lot of credibility in the course of accession negotiations.

On the other hand, such a restrictive fiscal policy does not enable the government to implement long-run policy planning. This is especially important in relation to long-term planning of social policy issues, such as pension reform.

2.1.3 Inflation

The Estonian government and the Bank of Estonia closely cooperate with the IMF and the framework of economic reform has been worked out with advisors from the IMF and EBRD. Most public sector prices were liberalised in Estonia in 1991–1992 and the monthly inflation rate declined from 20% in the summer of 1992 to 6.6% in September 1992 and to 1.7% in May 1993.

Annual inflation was brought down from the hyperinflation of 1992 (with an annual rate of 1076%) to 19.8% in 1996. In 1997 Estonia reached single digit inflation (9.3%) and according to Eurostat data the annual inflation rate in 2003 was below the EU average.

The persistence of relatively high inflation during most of the transition can be traced to several causes:

a. Money supply was related to the increase of the foreign reserves of the Estonian Central Bank. Due to the currency board system the money supply increases automatically when foreign investments, foreign loans, and so on, increase. Increases in the money supply translate into price increases through demand side factors.
b. Imported inflation via price arbitrage. Because the kroon exchange rate is fixed against the euro (earlier against the DEM) the PPP (Purchasing Power Parity) principle influences price levels. In situ-

1 Argentina represents a good warning of what can happen if the state budget is not balanced and monetary policy is based on a currency board arrangement.

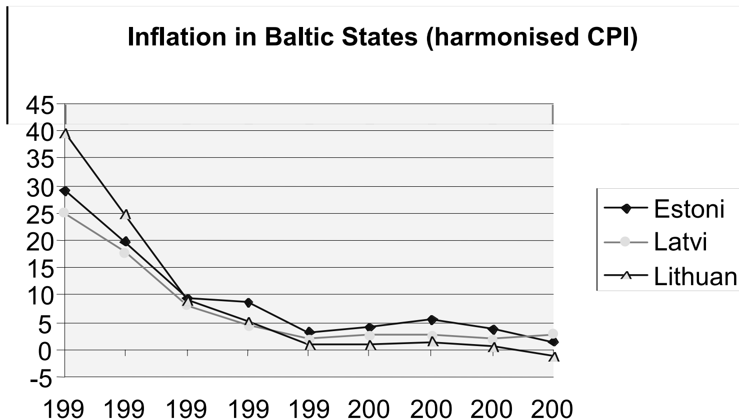

Figure 2: Annual inflation in Baltic countries (%)

Source: Eurostat.

ations where Estonia does not have trade barriers the price level of imported goods (mostly from Finland, Sweden and other Western countries) pushes up the domestic price level.

c. Prices of non-tradable goods are not completely liberalised, while the tradable sectors have been open to foreign competition since the start of currency reform. If we analyse different components of inflation we can see that it is mostly price increases in the non-tradable sectors (electricity, public transport, housing, etc.) that lead to high inflation in Estonia.

Relatively high inflation had little influence on the labour market in the first year of transition, because the currency board system helped to stop hyperinflation quite quickly in 1992. During the currency reform the Estonian currency (Eesti kroon) was undervalued. This provided enough room for price increases under conditions of a fixed exchange rate. The undervaluation of the kroon made Estonian goods competitive in international markets and helped firms to find new markets.

2.1.4 Foreign trade

Estonia adopted a policy of complete free trade with neither import duties nor export tariffs in early 1990. The total openness of the domestic market encouraged a rapid process of identifying Estonia's comparative advantage on world markets. It caused a rapid reallocation of resources in the economy and a strong redirection of trade flows. Table 1 presents the radical changes in the structure of Estonian foreign trade.

Table 1: Estonian imports and exports by main trade partners (%)

	1991	1992	1995	1997	1998	1999	2000	2001
Exports								
Finland	2.3	21.2	21.5	15.7	18.7	19.4	27.0	26.3
Sweden	0.5	7.7	10.9	13.5	16.7	18.8	17.3	15.2
Latvia	7.7	10.6	7.5	8.6	9.4	8.7	7.2	7.7.
Russia	56.5	20.8	17.7	18.8	13.4	9.2	6.8	3.8
Imports								
Finland	2.0	22.6	32.6	23.4	22.6	22.8	23.9	18.2
Russia	45.9	28.4	16.1	14.4	11.1	13.5	14.1	8.1
Germany	0.8	8.3	9.6	10	10.8	9.3	8.8	10.9
Sweden	0.8	5.9	8.5	9.1	9	9.3	8.7	9.2

Source: Estonian Statistical Office (www.stat.ee).

Table 1 shows that in 1991 Estonia's main trade partner was Russia, which accounted for 45.9% of total imports and 56.5% of total exports. The period after the Russian crisis marked another decline in the importance of the CIS countries in Estonian foreign trade.

Foreign direct investments

Estonia has been successful in attracting foreign direct investment. Figure 3 presents an overview of FDI inflows into Estonia on the basis of quarterly data. The first period of intensive FDI inflow into Estonia

ended in the middle of 1994. It was followed by growth in 1995, and starting from the second half of 1996 FDI inflows have grown constantly. The reasons for the irregularity of FDI inflows are various. In the early years of transition the main explanatory factor was the privatisation method used by Estonia.

The main state-owned large enterprises were sold by tenders in the form of large privatisation rounds, and a strong correlation existed between privatisation rounds and FDI inflow until 1996. Starting from that period the structure of FDI inflows changed. After the large privatisation rounds had ended, FDI inflows were in large part the result of the growth in the reinvested earnings of foreign investors and the acquisition of Estonian private firms and banks. The latter form of FDI inflow became evident in 1997 and assumed a leading position in 1998.

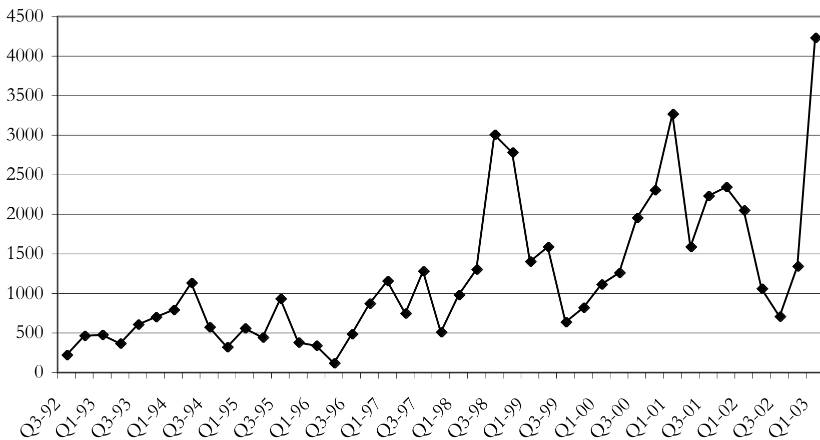

Figure 3: FDI inflows to Estonia during 1992–2003 (EEK million)

Source: Bank of Estonia (http://www.eestipank.info).

The year 2001 was a record year for FDI inflows into Estonia. It was based on the record high level of reinvestments and also the privatisation of the railways and the Tallinn water supply firm. The year 2002 was marked by a strong reduction in FDI inflows compared with the previous year. The majority of FDI inflows were financed from the retained earnings of existing firms and only 25% were investments in share capital.

Since the end of 1999 annual FDI inflows have been growing. These increased inflows have been associated with large privatisation deals involving state-owned infrastructure firms – Estonian Telecom, Estonian Railway and Tallinn Water. Since 2000 an important component of FDI has been reinvested earnings from the stock of FDI and further acquisitions of domestic firms by foreign investors.

FDI has played a major role in the development of the Estonian economy. In our view, the high FDI inflow has been one of the major factors in the recovery of the Estonian economy after the initial transformation shock. FDI can influence employment in different ways. Mickiewicz et al. (2000) have listed several factors characterising FDI influence on employment in transition economies. They found that FDI operates as a buffer by either generating new or maintaining existing employment. Also they support the idea that FDI can contribute to generating employment and recovery but cannot alone lead to growth or generate the bulk of manufacturing employment. Thirdly, they show that the increasing differences in the sectoral distribution of FDI employment across countries are closely related to the relative order of FDI inflows per capita. That means that the more countries receive FDI inflows the more likely it is that various types of FDI will emerge.

All of these things facilitated development of the economic environment so that after the economic reforms and initial stability, average annual growth in the Estonian economy has exceeded 5% for the last ten years.

Estonian macroeconomic policy is rather passive, aiming primarily at providing a liberal market oriented business environment rather than intervening with discretionary policy measures in order to stabilise the economy. At the same time, the country is open to external developments and its passive policy does not promote government interference to provide more stability, which might expose Estonia to the negative aspects of economic development.

2.2 Changes in the Estonian labour market

The period 1990–2000 is of major importance as regards the labour market situation in Estonia. It becomes clear from Table 2 that the emergence and growth of unemployment and the decrease in employment belong to this period. While in 1989–1990 unemployment practically did not exist, in 1991 it became a reality. The first recipients of unemployment benefit were registered in summer 1991.[2] The initial fall in GDP did not lead to high unemployment. Unemployment in Estonia has increased gradually, and there has been no explosion of unemployment, including social disturbances, mass unemployment, and so on. In 1998, the ILO unemployment rate reached 8–9%.

The main reason for the moderate unemployment growth has been a sharp drop in labour force participation (this may be the case: for example, fewer people register as unemployed, but simply withdraw from the labour market). Other factors include the undervalued exchange rate at the launch of the Estonian currency, relatively flexible labour markets, low unemployment benefits and net migration to the Former Soviet Union (FSU). At the beginning of 1999, Estonia suffered from a rapid increase in the unemployment rate. In our opinion it was obvious that this was evidence of increasing structural unemployment. We may assume that part of the cyclical unemployment

2 The first laws regulating unemployment were adopted and the Estonian Labour Market Board was formed in 1990.

Table 2: Estonian labour market indicators

	1990	1993	1996	1999	2000	2001	2002	2003	2004
Total population (15–69)	1101.5	1067.0	1011.9	987.7	986.0	985.3	984.6	985.1	985.1
Labour force	831.2	748.0	687.7	655.8	658.2	655.2	646.5	654.2	652.1
Employed	825.8	698.9	619.3	575.3	568.3	572.2	579.3	588.1	588.6
Unemployed	5.4	49.1	68.4	80.5	89.9	83.0	67.2	66.1	63.5
Inactive	270.4	318.9	324.2	331.9	327.8	330.1	338.1	333.1	333.0
Participation rate, %	75.5	70.1	68.0	66.4	66.8	66.5	65.7	66.4	66.2
Unemployment rate, %	0.6	6.6	10.0	12.3	13.7	12.7	10.4	10.1	9.7
Employment by sector ('000):									
Primary	164.5	111.8	60.2	46.7	40.9	39.5	39.9	36.2	34.5
Secondary	309.6	232.4	208.4	185.7	190.4	189.9	182.4	192.3	206.3
Tertiary	351.8	354.7	350.7	343.0	336.9	342.8	357.0	359.6	347.9

Source: Statistical Office of Estonia.

caused by external shocks (Russian crisis) was also responsible for structural unemployment.

We can conclude that 2000 was turning point for labour market developments in Estonia. Up until 2000 we can observe very clear labour market tendencies: declining employment and increasing unemployment. From 2000 unemployment started to decline and employment increase. Based on empirical data we can assume that major structural changes in the labour market are over and one can expect that employment and unemployment will behave in a more 'regular' way, depending on general economic development.

Although unemployment remains relatively high we can observe a generally declining trend. Especially if we leave aside seasonal effects we

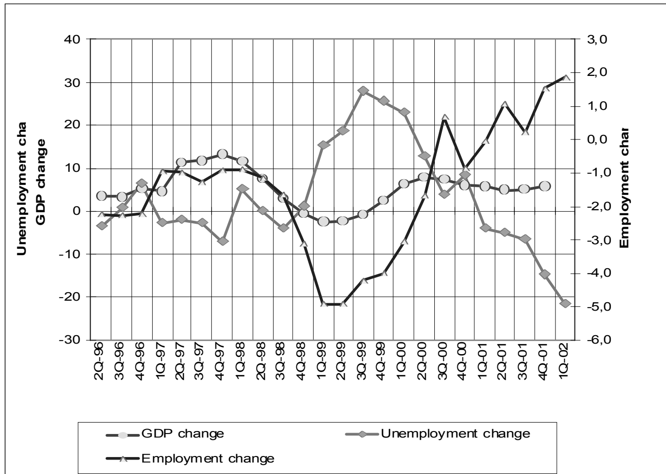

Figure 4: Changes in GDP, unemployment and employment (%, annual changes, compared with same quarter of previous year)

Source: Estonian Statistical Office.

can see that unemployment in general declined in 2001. In Figure 4 we present employment and unemployment changes, comparing annual changes in quarterly data.

For instance, after the Russian crisis in 1998 unemployment started to increase. In Q3 of 1999 unemployment reached its peak, increasing by 30% compared to Q3 of 1998. Unemployment changes are relatively well correlated with employment changes. In 2001 unemployment declined for the first time compared with the previous year. Employment also increased in 2001, also for the first time. These developments also show us the high flexibility of the Estonian labour market, because changes in employment and unemployment are highly correlated, as we can also see from the figure.

If we analyse employment changes by sector, we can see that the worst affected sectors were fishing, agriculture, trade and construction.

2.3 Estonian macroeconomic performance compared to other accession countries

Despite the similar incentives and characteristics of the transition process, the experiences of the various countries in transition have been different. Countries like Estonia have managed to keep the macroeconomic policy framework very stable and have gained credibility due to their non-intervention policy; other countries with a relatively active macroeconomic policy, like Hungary, have gained credibility through successful stabilisation based on interventions and government support measures.

The choice of monetary regime and exchange rate policy have been crucial for the transition countries as small, open economies are vulnerable to external developments. Developments in the exchange rate systems of the candidate countries are summarised in Table 3. Estonia is one of the few countries which is keeping to the currency board arrangement and avoiding moves towards a more flexible system.

Based on this, Estonia, Lithuania and Bulgaria have introduced and maintained a hard peg to a single anchor currency, while other countries have either remained at their floating peg or even moved towards a more flexible system, like Slovakia or Poland.

However, in order to evaluate the performance of one exchange rate system against the others, the performance of macroeconomic indicators should be considered first.

According to Table 4 (overleaf) the inflation performance measured in terms of the consumer price index (CPI) has been quite similar in all the countries, with the exception of Bulgaria and Romania where the inflation rate has topped 40%. During the high inflation period both these countries were operating floating exchange rate regimes. Bulgaria

Table 3: Evolution of exchange rate regimes in the accession countries

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Bulgaria	8	8	8	2	2	2	2	2	2	2
Estonia	2	2	2	2	2	2	2	2	2	2
Lithuania	2	2	2	2	2	2	2	2	2	2
Latvia	3	3	3	3	3	3	3	3	3	3
Malta	3	3	3	3	3	3	3	3	3	3
Hungary	7	5	5	5	5	5	5	4*	4*	4*
Cyprus	4	4	4	4	4	4	4	4*	4*	4*
Czech Rep.	3	3	6	7	7	7	7	7	7	7
Poland	5	6	6	6	6	6	7	7	7	7
Romania	7	7	7	7	7	7	7	7	7	7
Slovenia	7	7	7	7	7	7	7	7	7	7
Slovakia	3	3	6	6	8	8	8	8	8	8

Notes:
1 – Dollarisation/euroisation, 2 – currency board, 3 – conventional fixed pegs, 4 – horizontal bands 5 – crawling pegs, 6 – crawling bands, 7 – managed float (with ER path), 8 – independent float, * – +/–15%.

Source: DG ECFIN, National Banks.

managed to get inflation under the control by introducing a currency board arrangement. In the case of the three Baltic countries the stabilisation of inflation has been relatively rapid compared to other accession countries. This supports the well-accepted notion that fixed exchange rates are suitable for stabilising high inflation, as supported also by the evidence of other countries at the beginning of the 1990s. However, when the inflation rate falls to a single digit, the evidence in favour of fixed exchange rates is less clear.

With respect to real growth rates, there is even less evidence of a correlation between exchange rate regime and growth rates. There have been countries with a fixed exchange rate which have experienced significant growth, such as Estonia and Latvia (4.5–5% annual average, 1994–2002). However, there are relatively high growth rates also

Table 4: Changes in consumer prices (%, Y/Y)

Country	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Bulgaria	82.0	73.0	96.3	62.0	123	1082	18.7	2.6	10.3	7.4	5.8	2.3	6.0
Czech R	11.1	20.8	10	9.1	9.1	8.0	9.7	1.8	3.9	4.5	1.4	-0.1	2.8
Estonia	1076	90	48	29	19.8	9.3	8.8	3.1	3.9	5.6	3.6	1.4	2.8
Hungary	23	22.5	18.8	28.2	23.5	18.5	14.2	10.0	10.0	9.1	5.2	4.7	6.9
Latvia	951.2	109.2	35.9	25	17.6	8.1	4.3	2.1	2.6	2.5	2.0	2.9	4.0
Lithuania	1012	410.2	72.2	39.6	24.7	8.8	5.0	0.7	0.9	1.3	0.4	-1.1	1.0
Poland	38.5	30.5	28.4	27.9	18.7	15	11.8	7.2	10.1	5.3	1.9	0.7	2.3
Romania	210.4	256.1	136.7	32.3	38.8	154.9	59.1	45.8	45.7	34.5	22.7	15.3	12.0
Slovakia	10.1	23.2	13.4	9.9	5.8	6.0	6.7	10.4	12.2	7.2	3.5	8.5	8.2

Source: For earlier period national sources since 1997 Eurostat.

among countries implementing floating regimes, such as Slovenia (4.1% annual average, 1994–2002) or Poland (4.0% annual average 1994–2002). However, countries with hard pegs (Estonia, Latvia, Lithuania, Bulgaria) tend to have more variability in terms of growth rates, which might reflect their inability to stabilise output variations. However, it might also be due to the divergence in the starting points of the transition and therefore needs further investigation.

Analysing labour productivity in accession countries, Estonia and Lithuania seem to have experienced faster convergence than the others. However, this might again reflect the lower starting position of the former Soviet countries.

Thus, although fixed exchange rates could be seen as a useful tool in controlling inflation during the transition phase, and provide a strong incentive for structural reforms and productivity growth, once a country has reached a more stable phase of development no single exchange rate regime stands out as the best choice for promoting economic progress. Also, there is no evidence that Estonia's performance would have been different if another macroeconomic policy mix had been used.

3. EU requirements and conditions for Estonian macroeconomic policy

3.1 Formal requirements for EMU entry

3.1.1 Institutional criteria for EMU membership

Based on the EC Treaty, three distinct phases of macroeconomic policy cooperation are identified in relation to the accession countries. Each of these phases includes specific requirements concerning macroeconomic policy (European Commission 2000, 3):

1. pre-accession phase;
2. accession phase, covering the period from accession to adoption of the single currency;
3. the final phase of euro adoption.

During the pre-accession phase, candidate countries carry out economic reforms and policies needed to meet the Copenhagen economic criteria. As the Treaty does not make any requirement regarding choice of macroeconomic policy instruments, such as exchange rate regime or fiscal policy rules, the accession countries are free to run their macroeconomic polices purely on the basis of national economic policy considerations (European Commission 2000, 2). Thus, the EU requirements are general enough not to cause any changes in Estonia's current macroeconomic policy priorities.

However, a stricter set of formal rules is to be applied in the accession phase, when EMU participation will be decided. Macroeconomic policy cooperation will be intensified when the country is willing to join the euro-area and become a member of monetary union. The process of monetary integration for current as well as future EU Member States is laid down in the EC Treaty and associated lower level legislative acts. The Treaty foresees no opt-out status for new Member States, as stressed during the accession negotiations (European Commission 2000, 2). Thus, new Member States are expected to join monetary union gradually, depending on their own preferences and timetable.

Upon accession, the new Member States will have to show adherence to the aim of economic and monetary union. They will have a derogation and will not adopt the euro or participate in common monetary policy in the first stage. During the accession phase the new Member States have to fulfil several provisions of the acquis. As regards exchange rate policy they are obliged to treat it as a matter of common interest (art. 124). This means that the country is expected to join ERM II, although not necessarily in the immediate post-accession phase (Backe 1999, 59). The requirement also means that competitive devaluations are ruled out, but the choice of exchange rate remains free (United Nations 2001, 3). At the same time, ERM II provides accession countries with a degree of flexibility by means of its broad fluc-

tuation band of +/–15%. This flexibility should also contribute to real convergence. The length of required participation in ERM II will depend upon the country's progress in terms of nominal and real convergence, combined with the possible need to use the exchange rate as an adjustment tool (Solans 2002).

Estonia's position has been that joining ERM II is a logical consequence of the CBA and should be carried out as soon as possible after enlargement (PEP 2003, 15) in order to move towards full EMU membership. However, Estonia is not willing to allow more flexibility to the currency and will continue with the currency board arrangement also within the ERM II framework (PEP 2003, 15), meaning that the fluctuation bands for the Estonian kroon towards the euro will be 0%.

As regards the economic policy framework, countries are expected to follow broad economic policy guidelines (TEC, art. 99) stipulating the macroeconomic policy priorities of the EU. Economic development in each of the Member States, as well as the consistency of economic policies with the broad policy guidelines, is monitored by the Commission. Any deviation may result in recommendations from the Council of Ministers.

However, for Member States with a derogation macroeconomic policy cooperation is characterised by a lack of enforcement instruments, such as fines or charges, and peer pressure remains the only effective measure.

The fiscal policy requirements are as follows:

- Art. 101 prohibits the following financial transactions: Overdraft facilities or any other type of credit facility with the ECB or with the central banks of the Member States in favour of Community institutions or bodies, central governments, regional, local or other public authorities, other bodies governed by public law, or public

undertakings of Member States shall be prohibited, as shall the purchase directly from them by the ECB or national central banks of debt instruments.

- Art 102 prohibits privileged access of Member States to the financial institutions.
- No bailing out of the Member State in financial difficulties is allowed according to art. 103, neither by Community institutions nor by other Member States.

None of these rules causes problems for Estonia as these requirements have been an essential part of Estonia's macroeconomic policy framework (European Commission 2003).

3.1.2 Convergence criteria as a condition for EMU membership

EMU membership will be on the basis of the convergence criteria set by the Treaty (TEC §109, Protocol on the Convergence Criteria, protocol on the Excessive Deficit Procedure).

1. Price stability. Member States should have an average inflation rate – observed over a period of one year – that does not exceed by more than one and a half percentage points that of the three best performing Member States in terms of price stability. Inflation shall be measured by means of the harmonised consumer price index.
2. The state budget position shall be considered on the basis of two sub-criteria:
   a. whether the ratio of the planned or actual budget deficit to GDP exceeds 3%, unless:
      - either the ratio has declined substantially and continuously and reached a level that comes close to the reference value,
      - or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value;

   b. whether the ratio of public debt to GDP exceeds 60%, unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory rate.
3. Exchange rate stability assumes that countries will participate in ERM II. This means that a Member State has to respect the normal fluctuation margins provided for by ERM II without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative for the same period.
4. Convergence of interest rates means that – observed over a period of one year – a Member State has had an average nominal long-term interest rate not exceeding by more than 2 percentage points that of the three best performing Member States in terms of price stability. Interest rates shall be measured on the basis of long-term government bonds or comparable securities, taking into account differences in national definitions.

Estonia seems likely to meet the convergence criteria in a short period.

The price stability criterion is one of the most problematic for Estonia. Until 2003 inflation (see Figure 5) measured in terms of CPI was above the reference value, and in 2003 it even fell below the EU average, but in the coming years it is expected to rise again. Although the liberalisation of administrated prices and the adjustment of relative prices have reached their final stages in almost all the transition countries, the process is not yet complete. There may yet be considerable adjustment in terms of energy prices for private households, which again may put upward pressure on wage claims and on tradable prices. Joining the EU will bring with it stronger price dynamics due to the increase in agricultural and food prices due to the introduction of the common agricultural policy. Bringing tax regulations, especially fuel taxes, into line with EU requirements may also lead to price rises in certain categories of goods and services. Another source of inflation pressure might be

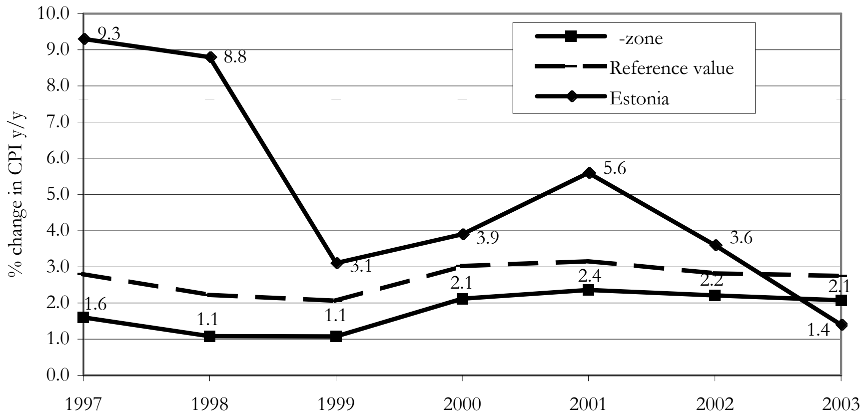

Figure 5: Estonia's inflation performance compared with the EMU price stability criterion

Source: Eurostat, own calculations.

productivity growth differentials, the so-called Balassa-Samuelson effect (Backe et al. 2003, 54–57).

In pursuit of the objective of keeping the budget balanced Estonia's budgetary position is in accordance with the convergence criteria. Compared to the EU average, as well as the average of the 10 new Member States and the two accession countries, Estonia is performing rather well, keeping the budget nearly balanced or even in surplus, except for 1999 when the budget deficit reached 4% of GDP. However, taking into account global developments, especially the Russian crisis in 1998, that year could be considered exceptional.

Estonia is committed to pursuing a conservative fiscal policy and aims to maintain a balanced budget in the coming years too (PEP). However, joining the EU will have a significant impact also on its budgetary stance. The increasing pressure of an ageing population will raise fiscal burdens related to pensions and health care. Also, as the

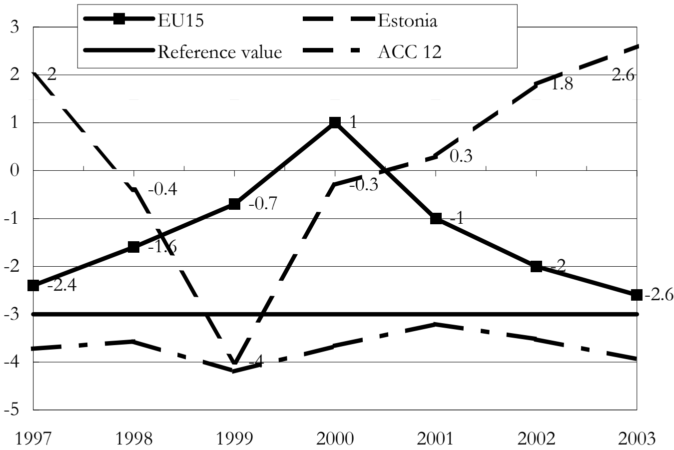

Figure 6: General government net lending as a proportion of GDP

Source: Eurostat.

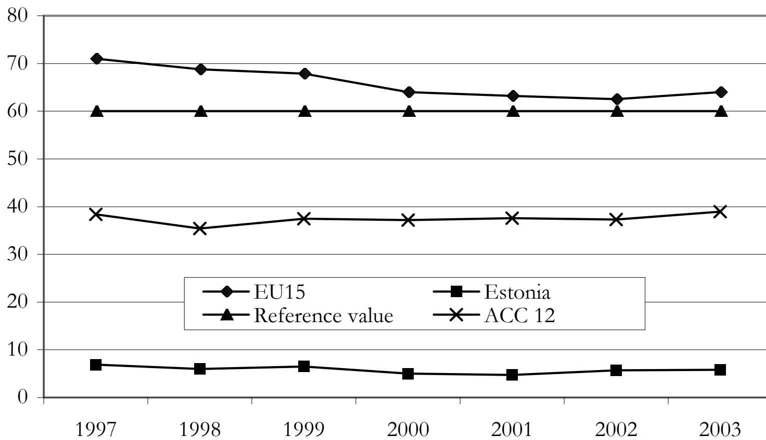

Figure 7: General government debt as a proportion of GDP

Source: Eurostat.

accession countries rely more on consumption taxes and less on progressive income and corporate taxes, the effects of automatic stabilisers in case of economic shocks might be limited (Eichengreen 2002). Thus, EU membership might expose Estonia to additional risks or at least a fiscal burden which will endanger the budget criterion.

As regards the general government debt, the conservative budgetary policy has helped Estonia to keep the debt to GDP ratio below 10%, one of the lowest in Europe. As a result, fulfilling the criterion is ensured.

Estonia lacks a proper indicator for the measurement of long-term government bond rates. However, in order to estimate the level of long-term interest rates for long-term treasury bills, if such existed, commercial bank long-term lending rates are used as proxies.

As shown in Figure 8, in recent years interest rates have been falling considerably. The interest rates of EU Member States have been converging considerably under the EMS and the 2% buffer for the reference value is providing enough flexibility to meet the criterion. In the last five years none of the current Member States have exceeded the reference value. Taking into account enlargement, the current situation and the former experience of Member States, the interest rate criterion is likely to be fulfilled in time.

As regards the exchange rate requirement Estonia has even proposed joining without fulfilling the two-year requirement, as the kroon has been de facto connected to the euro since 1999. Estonia has stated that CBA will be continued until the third phase of monetary integration. The European Council of Ministers has advised that the CBA system with a peg to the euro is compatible with the ERM II requirement. Thus, Estonia has already proven itself able to live with the monetary policy set by the European Central Bank and two-year participation in ERM II will not create any difficulties (European Commission 2003).

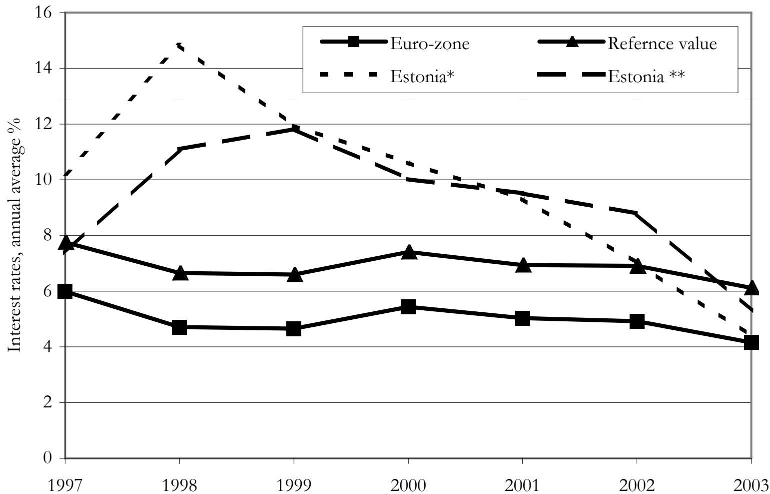

Figure 8: Long-term interest rate criterion in eurozone and Estonia

Notes:
* Commercial banks' long-term lending rate for EEK loans for public sector.
** Commercial banks' lending rate for EEK loans with a maturity of over 10 years.

Source: Eurostat, Bank of Estonia.

4. Social partner involvement

4.1 Social partners and the National Action Plans for Employment (NAPE)

According to the Ministry of Social Affairs, social partner awareness of the European Employment Strategy and of the related national action plans could be better. In order to improve their knowledge in this matter, the Ministry has sent the social partners an explanatory document and the text of the European Employment Strategy. In addition, there is a plan to organise a joint meeting before the preparation of a new NAPE with the drafters of Estonia's National Action Plan on Social Inclusion. The aim of the meeting will be to inform the social partners about the NAPE, the open method of coordination, and so on.

Another objective of this event would be to improve cooperation and mutual understanding. However, any attempt to involve the social partners should take into consideration that they have very limited time and human resources.

According to H. Taliga, chair of EAKL, the NAPE is mainly oriented to an outside audience (EU institutions). It consists mainly of the views of the ruling coalition which are presented as a deliberate and comprehensive labour market policy. In his view, the measures described in the NAPE will have only a marginal effect on employment and a number of measures which are absent could help to solve the basic problems of the labour market.

It must be stressed that there has been no discussion of the relation of the NAPE to the Maastricht criteria.

4.2 Collective bargaining and macroeconomic issues

Estonia is not facing major problems in fulfilling the Maastricht criteria and other requirements, although according to the IMF the high level of unemployment, especially in the north-eastern part of the country, seems to require concentrated action to improve labour market regulations, facilitate labour mobility and increase investment in `human capital' in terms of general education and vocational training. Since 1992, when a first tripartite agreement on social security was concluded, tripartite negotiations have regularly taken place in Estonia. Tripartite agreements and consultations have addressed various issues of social policy, labour market policy, vocational education, and so on. In 2002, a comprehensive agreement was concluded on labour market policy. However, the trade unions and the employers' side have opposing positions on the issue of wage determination. The position of the employers is that, starting from 2005, determination of the minimum wage should take the form of a bipartite agreement, which would ensure more flexibility. According to the employers, minimum wage rises should be related to increased labour productivity, and the remu-

neration systems of manufacturing enterprises exposed to international competition should be taken more into account than at present. It has been decided to continue discussing this matter with the aim of resolving it in 2005. To a certain extent, this initiative calls into question an agreement concluded in August 2001, following a general strike threat by the unions. This bipartite agreement between the central trade union organisations and the employers set out the principles for minimum wage determination until 2008.

4.3 Possible trends towards national agreements on adjustments to meet the Maastricht criteria: social partner involvement

The Estonian government and the Bank of Estonia take the view that Estonia should be one of the first new members of EMU. That would mean joining ERM II as soon as possible, at the present EUR/EEK exchange rate and with the currency board arrangement in place.

Estonia submitted its application for ERM II membership on 28 June 2004. It should also be mentioned that at the present moment Estonia is in a relatively advantageous position among the new Member States as to its ability to meet the Maastricht criteria.

Comparing the level of nominal convergence among the new Member States with the levels of some of the former accession countries five years prior to their EMU accession, it is evident that there should be no serious concerns about most of the new Member States' ability to fulfil the nominal criteria over the medium term. Estonia's choice of a currency board based monetary regime has some inherent advantages in this respect. A balanced state budget is an important prerequisite for a smoothly operating and effective currency board arrangement, and that has had a strong impact on Estonian fiscal policies.

Prior to joining EMU there will be neither a technical nor an economic need for Estonia to change its monetary policy foundations. The exchange rate of the kroon against the euro supports continuous inte-

gration with the European economic space, while the currency board arrangement provides additional guarantees that a consistent economic and monetary policy will be pursued.

As Estonia does not face major problems fulfilling the Maastricht criteria and other requirements, the social partners have not developed a standpoint in this respect; it has not been a topic of social dialogue.

Concerning Estonia and EMU, in our opinion Estonia will probably be technically ready to join the euro area as early as 2006. For practical reasons it will probably happen after January 2007, however. The biggest challenge for the public sector, in this context, would be to avoid a macroeconomic policy mix that would overstimulate domestic demand and result in a significant real appreciation of the kroon. We believe that a balanced fiscal stance, together with a strong financial system, is also the most efficient way of avoiding short-term speculative capital inflows within the context of EU accession. At this point, we expect no great difficulties in meeting the sovereign debt and budget deficit criteria.

The biggest threat to meeting the Growth Pact criteria, in our opinion, is inflation pressure, especially if driven by energy prices. The consequent rise in living costs could put pressure on increases in government expenditure, such as social payments or state pensions, and so on, which might entail the risk of rising budget deficits.

Conclusion

In 1989 the Estonian economy was part of the economy of the Soviet Union and was closely bound up with the latter's raw material and product markets. Thus at the beginning of the transition period the employment structure rather artificially reflected the economic needs of the Soviet Union. The years since 1989 have seen profound changes in the Estonian economy. Between 1989 and 1991 Estonia was still part of the Soviet economy, but it had started initial macroe-

conomic reforms, such as price liberalisation. Drastic changes in the Estonian economy took place in 1991–1992. In June 1992 Estonia introduced its own currency, using a currency board system. At the same time, important decisions were made with a view to establishing complete freedom in foreign trade and a requirement that the state budget be balanced was written into the Estonian constitution. This created a completely new environment for business and is considered the start of serious economic reform in Estonia. As a result of the combination of macroeconomic reforms the Estonian economy was reoriented toward Western partners. The highest GDP growth rate was achieved in 1997. This period in the development of the Estonian economy was marked by relatively steady economic growth up to the middle of 1998, when a banking crisis hit Estonia, followed by the Russian crisis in the same year, which resulted in stagnant economic growth in 1998 and recession in 1999 (–1.1%). One by-product of recession was the second wave of restructuring in the Estonian economy. Growth was restored by the end of 1999. GDP growth in 2000 was 6.4%, 5.1% in 2001 and 5.8% in 2002. Average economic growth was 5.2% in the period 1995–2002 according to the Estonian Statistical Office.

A rapid decline in output in the early years of transition (1990–1992) was not accompanied by a drastic increase in unemployment. There was a moderate increase in unemployment, triggered by a number of other factors.

Relatively high inflation had little influence on the labour market in the first year of transition because the currency board system helped stop hyperinflation quickly in 1992.

The currency board-type monetary system gives credibility to the Estonian economy and helps to prevent speculation in the Estonian currency. Undervaluation of the domestic currency (Eesti kroon) has made Estonian goods competitive in the international market and helped firms to find new markets.

The trade deficit is a permanent problem in the Estonian economy, the worst year being 1997 when it constituted 14% of GDP, enormously high even for a developing country. Fortunately, later years have shown a declining trend. The high trade deficit is balanced by a positive capital account (high inflow of investments).

FDI has played a major role in the development of the Estonian economy. In our view, high FDI inflow has been one of the major factors in the Estonian economy's recovery after the initial transformation shock.

The number of commercial banks has declined to seven and the market is dominated by two larger commercial banks owned by large Scandinavian banks. The stable financial situation enables households and firms to make more long-term plans and the labour market is becoming more stable.

The main reason for the moderate growth registered in unemployment was a sharp drop in labour force participation. Other factors we might mention include initial exchange rate undervaluation (which helped to maintain average enterprise profit rates), flexible labour markets, low unemployment benefits, and net migration to the FSU.

Most of the business sector is privately owned in Estonia. The bottleneck of Estonian privatisation has been the privatisation of land, due to a very slow and complicated registration procedure.

In conclusion, because Estonian monetary and fiscal policy are rigid, social policy and particularly labour policy have been correspondingly flexible (from the employers' standpoint). By flexibility we mean that labour policy has been kept under financial constraints: for example, low unemployment benefit has functioned as a strong disincentive to remain unemployed. Worker turnover between sectors was very high in the early years of transition, although since 2000 the labour market has become more stable and volatility has declined.

EU membership will change the economic environment of Estonia as nominal and real convergence occur. Estonia is able to fulfil all the nominal convergence requirements without problem, except for the most important, price stability criterion. Although price changes in Estonia have converged with EU levels to a significant extent, a number of processes are putting pressure on inflation, such as rising agricultural and food prices, fuel prices, and energy and other administrated prices. Also, the balanced budget requirement may be challenged in the EU in the face of the need to improve social standards, population ageing, environmental investment, and so on.

The real convergence of the Estonian economy towards the EU might be even more complicated. Although recent studies show that the Estonian business cycle and shocks have significantly converged with the EU average, the remaining differences in terms of economic structure may expose the country to possible asymmetric development in future. In this case, Estonia would need macroeconomic policy instruments to stabilise the effects of a shock. The current macroeconomic framework scarcely provides for such discretionary measures.

At the same time, EMU membership will not be more costly for Estonia than the current CBA. As a very open and small economy with a diversified manufacturing structure national monetary policy measures could only have very limited effects.

One of the major hopes of the accession countries is acceleration towards average EU living standards. This expectation brings into focus the issue of real convergence in terms of monetary union. In the new Member States growth rates are expected to be higher than the EU average in order to allow sufficient convergence in income levels and living standards. This might put additional pressure on macroeconomic policy-making as the accompanying developments, such as higher inflationary pressure due to productivity growth, would not fit strict and inflexible EU macroeconomic policy coordination mechanisms.

Appreciation of the real exchange rate accompanied by higher inflation rates and a high current account deficit financed by capital inflows jeopardise the sustainability of Estonia's convergence towards the EU average.

Estonia has proven itself a successful transition country, but challenges remain in designing the proper macroeconomic policy mix and further analysis is required.

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Labour in a trap: the enduring employment crisis in Hungary

László Andor

1. Summary

The new Member States of the European Union have made outstanding progress in terms of macroeconomic development after the crash that followed the collapse of the state socialist political regimes. In recent years, this macroeconomic development has focused on the introduction of the euro. Indirectly, this endeavour means that the employment crisis that emerged with the transitional recession will be prolonged by another decade.

Hungary well illustrates both the achievements and the difficulties of the transition process in terms of the labour market and job creation. The recovery that started to unfold in the late 1990s is still far from restoring pre-crisis levels of employment. Currently, the political elite, policy-makers and the general public take for granted the benefits of meeting the Maastricht criteria and replacing the forint with the euro, while repeated turbulence on the financial markets highlights the fragility of convergence and currency reform. The deflationary consequences of monetary convergence and the latter's connection with the employment problems have only just begun to emerge. This chapter discusses various aspects of the macroeconomic and policy context of this 'labour trap'. The first part outlines the collapse of employment and the transformation of labour relations during the transitional cri-

sis. The second part explains why the macroeconomic framework of the post-transition period has not favoured a high-employment development pattern.

2. Introduction

Having experienced a painful transformation in the early 1990s, the Hungarian economy saw remarkable growth in the late 1990s. GDP growth has remained higher than the EU average in recent years too, but this has not been enough for a major recovery in employment. Although unemployment rates in Hungary have been substantially lower than the EU average – and for that matter lower than the average of the new EU Member States – the low level of participation continues to be a major economic and social problem. Macroeconomic convergence towards the Maastricht criteria seems likely to lock employment into the present level for the rest of the decade. Thus, in addition to more determined labour market policies in Hungary, a different European macroeconomic framework would be needed for visible progress in the area of employment.

3. The transitional labour crisis in Hungary

The collapse of the state socialist regimes in Central and Eastern Europe resulted in the disintegration of the regional economy in the early 1990s. In Hungary, this period was marked by a 20% fall in GDP and the loss of some 1.5 million jobs in various sectors of the economy. Working people and the trade unions have been on the 'receiving end' of capitalist restoration in Hungary. They have faced mass unemployment on a level never experienced before. Wage purchasing power rapidly declined and the unions were unable to do anything to save jobs or real wages. The slow and uneven recovery after 1993 resulted in an improvement in some regions and in some internationally competitive industries, while leaving much of the working class in misery.

3.1 The primary impact of the transition on employment, wages and living standards

The first years of transition brought about a dramatic decline in output. Between 1989 and 1993, GDP declined by some 20%. In the same period, the unemployment rate increased from 0.2% to 13% of the labour force. After 1993, the country experienced more or less steady growth in production, but the unemployment rate only fell to about 10% and remained at that level in the second half of the 1990s.

Table 1: Main macroeconomic indicators

Year	GDP (%)	Inflation (%)	Unemployment (%)	Employment ('000 persons)
1987	+4.1	8.6	0.1	5 371
1988	–0.1	15.5	0.2	5 329
1989	+0.7	17.0	0.3	5 278
1990	–3.5	28.9	0.5	5 251
1991	–11.9	35.0	2.0	5 153
1992	–3.1	23.0	8.2	4 940
1993	–0.6	22.5	13.9	4 753
1994	+2.9	18.8	14.0	4 514
1995	+1.5	28.2	12.0	4 313
1996	+1.3	23.6	11.7	4 240
1997	+4.4	18.3	11.4	4 206
1998	+5.1	14.3	11.0	4 211

Source: Central Statistical Office.

All transition countries in central and eastern Europe were faced with double-digit unemployment in a very short period (1–2 years), with the exception of the Czech Republic.[1] In Hungary, the rise in the number

1 At the end of 1994, about 2.8 million people were jobless in Poland, an unemployment rate of 16%. In Slovakia 370,000 people (14.6%) were registered as unemployed, in Bulgaria around 500,000 (13%), in Romania more than 1.2 million (10.9%), in Hungary 520,000 (10.4%), while in the Czech Republic the number of unemployed remained very low (170,000 people, 3.2%) (Fassmann 1997: 170).

of unemployed from 10,000 to 600,000 in four years came as a shock http://www.epoc.uni-bremen.de/home.htm

Furthermore, the 600,000 newly unemployed were accompanied by another 700,000 who also left the labour force in the first transition years. Altogether, the Hungarian economy employed 1.5 million people fewer in the late 1990s than in the late 1980s. Patterns of labour force exit were distinguished by age and gender characteristics: older workers could seek early retirement, young people could postpone their market entry by extending their studies, and women could go 'back to the household'. For a few years, disability pensions also provided an exit.

In Hungary, half of the unemployed fell into the category of long-term unemployment.[2] The return to employment of unemployed people remained low, and many long-term unemployed just fell out of the statistics. Despite the recovery after the transition shock, there was no significant improvement in long-term unemployment, since the short-term unemployed have always had a better chance of getting new jobs.

The problem of unemployment in transition economies was as much due to institutional causes as to macroeconomic ones. In the state socialist economy, internal labour markets played a much greater role in the allocation of labour than occupational labour markets. The transition broke up the first and thus caused a shift towards the second, but without the proper institutional arrangements for a rapid response to the unemployment shock.

Given that under Kádár ignorance and irresponsibility were aspects of official policy, it was widely believed that 'some' unemployment would help to discipline the labour force. Instead of 'some' unemployment, however, the transition made joblessness familiar to almost every fam-

2 According to ILO standards, the long-term unemployed include persons who have had no work for more than a year.

ily. Nevertheless, one may say that employment and industrial relations remained within 'civilised standards' despite the dramatic developments: withholding wages, which became common in post-communist Russia, did not become a widespread practice in Hungary, apart from some minor examples in largely foreign-owned companies.

Unemployment showed great regional disparities. In Budapest, it hardly ever rose above 3–4%, while in some isolated villages in the North-East the rate reached 40 or 50%. It was particularly in these hard-hit areas that the so-called second economy to some extent relieved the pressure of unemployment, although the emergence of a grey zone between the legal and illegal economies has become a nationwide phenomenon. According to widespread estimates, some 30%[3] of output is accounted for by the unmeasured second economy.

When the first large-scale redundancies occurred in 1989, the prevailing ideology suggested that the vitality of the new market economy would rapidly eliminate the problem. Entrepreneurship would be encouraged and, if necessary, the state would help private entrepreneurs re-employ workers who had been made redundant by bankrupt state industries. The chances of finding new employment would be increased by state financed retraining programmes, and those temporarily unemployed would be assisted by generous benefits.

Indeed, the starting level of unemployment benefits was relatively high in most East European transition countries. After 1992, however, when conditions became tougher, the amount and duration of these benefits were reduced and the requirements for eligibility were increased. In Hungary, the entitlement period was cut from 18 months to one year at the end of 1992, and the replacement ratio (the ratio between unemployment benefit and the last wage) also started to fall.

3 The 30 per cent estimate of the share of the shadow economy in GDP was produced in a totally unscientific way but became a commonplace in economic and political discourse.

Those who lost their unemployment benefits were entitled to local government income support. In 1992, close to half a million Hungarians received unemployment benefits. In the middle of the 1990s, both groups (unemployment benefit and income support receivers) totalled about 200,000 persons.

A minimum wage was introduced as another income protection policy of the new era. In Eastern Europe, the average level of the minimum wage was 60% of the mean wage in the starting period. Like unemployment benefits, minimum wage levels also declined as the transition proceeded and due to high inflation often fell below subsistence level.

Active employment policies in the first period of transition were more rhetorical than actual. All the leading political parties paid lip-service to the need for active labour market policies, while in reality they were waiting for the post-transition recovery to eliminate the mounting problems. Out of the former socialist countries, only the Czech Republic pursued a deliberate, though somewhat hazardous, policy of employment maintenance, through various forms of government intervention. When Poland and Hungary started to treat employment as a more serious issue, they favoured retraining and public works projects instead of tighter labour regulation.

To distinguish between active and passive labour market policies, in the first years of the transition the Hungarian policy was to create two funds to address the problem. The Solidarity Fund was established simply to provide income for the unemployed in the initial period after they were laid off, and the Employment Fund was set up to finance direct job creation. Since any surplus from one fund could not be transferred to the other, however, the two funds were merged in 1996 as the new Labour Fund. This was seen as providing a financial basis for a more comprehensive labour market policy.

Government policy also attempted to involve non-governmental organisations in the process of job creation. To encourage such activ-

ities among NGOs, the Ministry of Labour set up the National Employment Foundation (OFA) in June 1992. OFA gave financial support to foundations devoted to job creation, subsidised local initiatives and other non-profit organisations aimed at reducing unemployment, encouraged research projects on labour-market problems, gave financial support to experimental measures not covered by the Employment Act, and financed the creation of employment agencies in regions with a likelihood of massive redundancies. The OFA started work in 1993, but its funding was cut in 1994 because of the increasing budget deficit. Despite the complications, it has contributed to easing the pressure on certain target groups, such as unemployed young people and Roma (Gypsies).

Public works, like other labour market policies, were widely advertised in certain periods but they only had a marginal effect on the employment picture. In 1993, only 14% of the resources spent on active measures were used to finance public works projects. They mainly involved unskilled and young people, though it was soon realised that public works could not solve the problems of the young unemployed and that their long-term chances could be improved only by better and more competitive training.

Training, however, was also a controversial policy given that the question of what jobs to train people for was hard to answer amidst a deep recession and economic uncertainty. When national economic policy abandoned any attempts to forecast and influence structural tendencies in the economy by leaving decisions to blind market forces, training programmes were left without adequate guidelines. The very nature of the transition and the contemporary technological revolution, however, gave some direction to retraining courses, by making marketing, advertising and computer skills the most popular subjects. Research showed that re-employment among labour-market trainees was relatively high, and a major problem of this policy area was that the most vulnerable and least advantaged groups were largely left outside the

scope of retraining opportunities. Training and retraining has been an area in which public and private cooperation is possible. Due to the import of know-how from Western schools and vast subsidies from the Employment Fund, vocational training became a very profitable sector in Hungary.[4]

Altogether, active labour market policies had only a marginal effect on employment, and successive governments were also unsuccessful in reducing the costs of unemployment. Unemployment, however, did help to reduce the costs of labour. The representation of those employed weakened significantly and the unemployed were left without any institutionalised voice at all. The emerging unemployment rapidly reached a level at which purchasing power also began to decline sharply. When unemployment, or even the threat of lay-offs, started to function as a brake on wage increases, governments could easily abandon central wage regulation (under prime minister József Antall) and make the forint convertible (under prime minister Gyula Horn) without the threat of labour causing any significant imbalance or instability.

A clear macroeconomic impact of mass unemployment was that it helped to curb the wage claims of workers at the micro and macro levels. Though finance ministers always spoke of the threat of a wage–price spiral, such a danger did not really exist after the first years of transition. Even amidst the recovery periods of the 1990s, the threat of wage increases boosting inflation remained negligible.

The emergence of mass unemployment was thus another factor that made the family the primary scene of economic adjustment. In the very first years of the transition, price liberalisation forced families to adjust to rising inflation. As home building was phased out from the

4 It should also be mentioned that, due to the lack of transparency and coherence in the newly emerging sphere of vocational training, an inflation of qualifications of dubious market value occurred in the 1990s, partly due to the lack of proper regulation.

public sector, families had to take over the burden of housing too. As higher and higher costs were charged on health care and education, the family budget had to be restructured again and again. And finally, if someone was made redundant within the narrower or wider family, their support also became a household duty – similarly to those on a pension, since the real value of pensions was (and remains) low.

The categories of 'unemployed' and 'pensioners' were vague not only at the family level but at national level too. To create an easy way out for those facing unemployment, the policies of the early 1990s made it extremely easy to seek early retirement or even disability retirement. Labour market tensions eased as a result but this policy increased the pressure on the national pension fund and thus contributed to a growing campaign for an overall marketisation of the pension system.

The increasing adjustment burden on families manifested itself as a gender problem too. Most of the household duties fell on women, yet it was also women who were more often able to keep their jobs. In Hungary, significantly more men became unemployed than women, not just because women were more likely to leave the labour force and withdraw to the household, but also because among those remaining in the job market women had received more competitive training.

Under the increasing burden of multiple adjustment, the Hungarian household headed towards impoverishment in the second half of the 1990s. Some of the burdens had a delayed or creeping effect on household resources, and the recovery of 1997 meant the survival of many who had been threatened by financial collapse. In the same period, however, rising energy prices started to bite, and the government also cracked down on arrears on home loans. The fairness of the extraordinary austerity measures was widely discussed in parliament, without reaching a proper conclusion before the 1998 elections.

A great majority of Roma families fell into the group that quickly reached the limits of financial adjustability. Far beyond being a labour

problem, the conditions of the Roma population of Hungary became perhaps the most complicated social problem in the post-Communist period. The Roma population combine a whole set of features that has made them the greatest single loser group of the transition. Unskilled workers were hardest hit by unemployment, particularly in the North-Eastern region, while low income workers and large families were over-exposed to the impact of inflation and the erosion of state subsidies: Roma people, the largest single ethnic minority in Hungary, are largely unskilled, low-wage, over-represented in the North-Eastern counties and have relatively large families. They have thus been disproportionately affected by post-Communist economic adjustment.[5]

The Roma population of central and eastern Europe was the only social group that made the news in relation to mass migration towards the West in the post-Communist era. Indeed, contrary to widespread expectations, large-scale migration of redundant East European labour did not take place after the collapse of state socialist employment. Expectations based on neoclassical economic considerations suggested that once the barriers to the movement of people fell between areas of very different income levels, a flow of labour would begin and continue until equilibrium was reached. However, a number of factors prevented the materialisation of this neoclassical scenario (Fassman 1997: 178).[6]

Local unemployment was seen as a temporary phenomenon in the early transition years. Even if expectations were more pessimistic, the

5 As victims of the transition, they had to rely increasingly on state subsidies, for which they were portrayed – by outspoken political commentators – as parasites on the decent working Hungarian nation. It was not difficult to blame the largest victim group for economic hardships and this provided fuel for a new bout of Hungarian racism.

6 Migration is also influenced by expectations regarding wages and living standards as opposed to actual ones. Since people expected a recovery soon, they were less encouraged to move. Various stories about a less than friendly reception also discouraged emigration.

lack of information and particularly the lack of well-established ethnic networks made migration more risky and less attractive. The lack of an efficient housing market is also a significant material constraint on the movement of people in Central Europe. Furthermore, large-scale and long-term unemployment itself is not enough to make people migrate; employed people are more likely to move than unemployed ones simply because they tend to be more employable, and they also move if particular jobs are available. Since the 1990s, however, Western Europe has also been struggling with exceptionally high rates of unemployment and this seriously discouraged East European workers from leaving their own countries. Finally, administrative and political factors have also indicated that East European migrants would not necessarily be welcome in Austria, Germany and other Western countries.

The rise of mass unemployment itself was a dramatic shock to Hungarian society. The impact of the shock was aggravated by the circumstance that many state socialist welfare policies were attached to jobs. Such policies included access to medical and dental treatment, subsidised food, kindergartens and various recreation facilities. When workers lost their jobs by the thousand during the post-Communist transition, they and their families also lost such social entitlements without the possibility of compensation. Thus, the changing pattern of employment resulted not just in increased industrial conflict but also in a widening debate about the system of social policy, and about the role of the state in general.

Price increases and job losses have been interpreted in the past six years as a price well worth paying for EU membership. While the unemployment rate has become stagnant at a level that is considered normal in Western Europe (just above 10% in official statistics), the rate of inflation has remained above 20% in Hungary for seven years, and even higher in most of the 'transition' countries. The runaway inflation has largely been driven by governments, with the deliberate objective of redistributing incomes and wealth on capitalist principles.

The requirements of capitalist accumulation have led governments to wage war on the living standards of the working population. Deliberate choices and the general institutional anarchy of the transition period have made pressure on real wages permanent and inevitable. A typical example of the 'new thinking' was the claim made, six months after a very severe austerity programme was introduced in Hungary in March 1995, by finance minister Lajos Bokros that since real wages had been pushed down by 10%, the competitiveness of the national economy was being restored. This failed to consider any other instrument for increasing international economic competitiveness than the reduction of labour costs. The temporary character of such revivals in competitiveness also remains hidden most of the time.

László Békesi, one of the finance ministers of the Socialist–Liberal government, echoing World Bank rhetoric, often claimed that 'the Hungarian people have been living well beyond their means'. He was mocked even by the managers of some multinationals for his attempts

Table 2: Living standards indicators

Year	1. Car	2. Computer	3. Automatic washing machine	4. Infant mortality	5. Life expectancy at birth	
					male	female
1990	39	5	31	14.8	65.1	73.7
1991	39	6	34	15.6	65.0	73.8
1992	37	6	36	14.1	64.6	73.7
1993	35	6	38	12.5	64.5	73.8
1994	36	6	40	11.5	64.8	74.2
1995	35	6	37	10.7	65.3	74.5
1996	37	8	44	10.9	66.0	74.7
1997	36	9	45	9.9	66.4	75.1

Note: (1–3: percentage of households, 4: number, '000 births, 5: year).

Source: Hungarian Statistical Yearbook.

to impose wage restraints on private foreign companies. Simultaneously, World Bank documents took over a phrase coined by Harvard economist János Kornai declaring that the Hungarian social security system was a 'premature welfare state'. This qualification amounted to a death sentence being issued on this state of affairs.

While both private and social consumption have dropped dramatically over the past six years, official economic slogans justified the permanent austerity in terms of the population's alleged 'overconsumption'. Regardless of its political colour, no government has been able to stop the meltdown of the vast 'middle class' created and maintained by the regulatory and redistributive policies of state socialism. Both the number and the proportion of the population living below the poverty line have increased rapidly.[7] No matter how unattractive were the political systems which ran the countries of Eastern Europe under state socialism, the system did provide a certain level of social stability and the sudden loss of social security has already resulted in demographic breakdown.[8]

While the working classes of Eastern Europe have been experiencing severe attacks on their living standards, anti-social demagoguery has accused them of making excessive demands and threatening the glorious transition to the modern and democratic world.

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7 According to Professor Peter Townsend (1995), the dramatic rise in poverty in Eastern Europe is the latest manifestation of global polarisation. Apparently, the scale of change was different in Russia and in East Central European countries, but the tendencies were largely similar.

8 According to UNICEF figures, in Russia, Ukraine, Bulgaria, Hungary and Poland, excess mortality caused by 'systemic change' reached the shocking total of 800,000 between 1989 and 1993 (Petras and Vieux 1995: 1). The rise in the incidence of heart and circulatory diseases has accounted for a proportion of the mortality increases (32% and 80%, respectively. Life expectancy has fallen in all ex-socialist countries. For Hungarian males this figure is 63 years, one of the lowest in Europe: ironically, it is exactly the retirement age set in the second half of the 1990s.

3.2 Trade unions in decline

The world of labour representation in Hungary went through a fundamental transformation in the 1990s. Following the collapse of state socialist structures, there were some elements of restoration, including trade union relations with party politics.

Throughout the transition years, trade union activity was much more significant at national than at local level. Local organisations were weak and could not obtain the resources and strategies needed for the struggle for better conditions. Examples of successful union activity can be found where certain unions were able to lobby together with the management and influenced government policy towards the companies of particular industries. Such cases include coal mining and also the steel industry to some extent.

The austerity programme instigated by the Socialist-Party-led government in March 1995, which, among other things, resulted in a 10% real wage decrease that year, marked a turning point in the trade union movement, as well.

The austerity package was another blow to union support for the Socialist Party, as well as to popular support for the unions. When the government announced their stabilisation policy together with some degree of marketisation of public services, opinion polls showed that some two-thirds of the population received the news with outrage. The union leaders, however, did not rush to ride the waves of popular sentiment, and most remained loyal to the government line. Slowly, public sector representatives started to mobilise resistance, particularly when it was announced that the government wanted to consolidate the results of stabilisation through fundamental reform of the public sector.[9]

9 There were always suspicions that World Bank policy recommendations lay behind initiatives for public sector reform, which often induced debates between union leaders and World Bank representatives, directly or indirectly.

Consequently, a new division emerged within the union movement. Since industrial recovery had definitely begun in 1993, and perhaps even in 1992, unions in the competitive sector fairly visibly turned their back on any form of militancy. The public sector, on the other hand, was heading towards the decimation of its labour force and this made the union leaders take a stronger stand against the government plans.

Despite occasional conflicts, the unions did not declare any opposition to privatisation, liberalisation and other transformation policies. This situation remained stable, although in some cases the unions had reasons to worry – for instance, some multinational companies did not want to allow trade unions in their factories.

Two German researchers, Rainer Deppe and Melanie Tatur, suggested that Hungary seemed to be heading towards a type of unstable corporatism.[10] One of the main sources of instability was the declining membership and resources of the unions.

After the end of the period of open trade union rivalry – from 1993 – competition between various trade union federations has been at a low ebb, but even the stronger ones face objective constraints on their activities. Later, industrial recovery changed the picture a little. It is not realistic to expect that the power of the trade unions will be restored and the workers have more opportunity to say how the economy should be managed. Recovery in the Hungarian case and the concomitant hope of increasing incomes, after the 1995–1996 stabilisation period, has tended to weaken trade union militancy.[11] Having suffered so much since 1989 due to high inflation, falls in real wages and consumption, the emergence of mass unemployment, as well as the

10 See Deppe and Tatur in Eszmélet No. 28 (Winter 1995).

11 An example of this is the union of railway workers, one of the strongest unions in Hungary. They obtained their 1997 wage demands without the need for a strike threat (in contrast to the previous five years).

collapse of public services, Hungarian workers seem to be grateful for even the slightest improvement in their living and working conditions.

Taking everything into consideration, the weakness of trade union activity can be seen to have several points of origin. According to a widely held assumption, Hungarian trade unions have been strong at the top, weak in the middle and non-existent at the bottom. This description applies to the major conventional unions like MSZOSZ (National Federation of Hungarian Trade Unions) or SZEF (Cooperation Forum of Trade Unions, consisting mostly of teachers).

The degradation of labour representation was accentuated in 1998 by the abolition of the Ministry of Labour by the incoming right-wing government. The competences of the ministry were allocated to three different offices. It was only in 2002, when the Socialists won the elections, that a Ministry of Employment Policy and Labour was re-established, and the status of labour policy was to some extent rebuilt at government level. However, since the membership and power of the trade unions was much lower than ten years before, the change in government structure did not produce a major turn in employment policies and practices.

4. Limits to the recovery of employment in post-transition Hungary

4.1 Macroeconomic framework: from falling unemployment to financial destabilisation

Having gone through a most painful transformation in the early 1990s, the Hungarian economy experienced a remarkable growth period in the late 1990s. GDP growth has also remained higher than the EU average in recent years, but this has not been enough for a major recovery in employment. Though unemployment rates in Hungary have been substantially lower than the EU average – and for that matter

Table 3: Economic indicators 1997–2003 (forecast 2004–2005)

Indicator	1998	1999	2000	2001	2002	2003	2004*	2005*
GDP**	4.9	4.2	5.2	3.8	3.5	2.9	4.0	4.3
Number of employed**	1.4	3.1	1.0	0.3	0.1	1.3	0.4	1.0
Unemployment rate	7.8	7.0	6.4	5.7	5.8	5.9	5.9	5.8
Net real wages**	3.6	2.5	1.5	6.4	13.6	9.2	1.6	4.3
Private consumption**	4.6	4.8	5.0	5.9	9.3	6.5	2.4	3.5
Public consumption**	–0.3	1.8	1.2	5.3	4.8	1.9	0.4	1.0
Current account***	–7.2	–7.8	–8.6	–6.2	–7.1	–8.9	–8.0	–7.0
Fiscal balance***	–9.0	–5.3	–2.6	–4.6	–9.4	–5.9	–4.9	–4.4
Inflation (CPI)	14.3	10.0	9.8	9.2	5.3	4.7	6.8	4.6

Notes:
* Kopint-Datorg forecast; ** percentage change per year; *** percentage of GDP.

Source: Palócz (ed.) (2004): 29.

lower than the average of the new EU Member States – the low level of participation continues to be a major economic and social problem.

Any assessment of macroeconomic policies in Hungary must start by highlighting the fact that, from the late 1990s, there have been successive major improvements in a number of areas. First, the fiscal balance, then GDP growth, and finally the rate of inflation has improved substantially. However, when inflation eventually fell, fiscal disequilibrium emerged, the correction of which caused a slowdown in economic growth in 2003. Throughout the whole period, unemployment fell and remained low, while the enormous problems of low participation and employment were addressed only by means of token policies.

During the reconstruction period of the late 1990s, the rate of inflation fell markedly from the peak of 1995, when the crawling band exchange-rate regime was introduced (i.e. the central bank devalued the forint every month at a rate that was pre-announced but reduced gradually as inflation decreased). However, progress with disinflation in 1999–2001 turned out to be disappointing. Average inflation for 2000 – at 9.8% – barely budged from the 10% recorded for 1999 and was well above the government's target range of 5–7%. The reversal of the disinflationary trend in mid-2000 initially reflected exogenous supply shocks, including higher world oil prices and the weaker euro. At the same time, core inflation was also rising, reflecting in part an increase in unprocessed food prices as a result of growth in external demand, but also the fact that domestic factors have increasingly come into play.

Later, monetary and exchange rate policies have had to cope with the competing challenges of inflationary and capital inflow pressures. Early in 2000, heavy capital inflows kept the Hungarian forint at the strong edge of its narrow band, forcing the central bank to cut interest rates. By mid-2000, interest rates had been cut by more than 300 basis points, while the monthly rate of crawl was cut only once, from 0.4% to 0.3% in April 2000. This loosening of the monetary stance[12] occurred against a background of a rekindling of inflation, a tight labour market and strong economic growth.

In 2000 and 2001, in a surprise move the incumbent right-wing government, which had taken a tough stance against labour in previous

12 When capital market pressures subsequently cooled, and in response to an unforeseen jump in inflation in September 2000 the National Bank of Hungary (NBH) increased its key policy rates by 1 percentage point. In the first two months of 2001, alongside a steady increase in core inflation, capital inflows prompted the central bank to cut rates twice, by a total of 50 basis points. With a view to tightening monetary conditions, the monthly rate of currency devaluation was lowered from 0.3% to 0.2% from 1 April 2001.

years, decided to increase the minimum wage substantially, not once but twice. In a two-year period, the nominal value of the minimum wage was doubled, in real terms constituting an 80% increase. In this way, the minimum wage reached 40% of average gross earnings in 2002, while in 1997–2000 it had remained constantly below 30% (Fazekas et al. 2004: 213).

The decision to raise the minimum wage was based on several considerations. First, it may have been linked to EU requirements. Second, and more importantly, the government intended to increase tax revenues by raising the bottom line of wages which entrepreneurs tended to overexploit for tax-evasion purposes. Third, the right-wing government may have thought that improving wage conditions would improve their electoral chances among workers, while leaving their support unaffected among the business class and small entrepreneurs. Whatever the main reasons for the minimum wage hike, the electoral calculations proved wrong.

At the 2002 elections, the Socialist Party promised to create 400,000 jobs in four years. Most party leaders were fans of Tony Blair and thought that modern social democracy meant being to some extent neoliberal in economics, although they were also affected by Lionel Jospin's example. However, they had made an electoral promise to raise public sector wages by 50% which, by increasing the budget deficit and threatening to increase inflation, was not a good start for an employment boosting trajectory. On the contrary, fiscal disarray meant that the four years of the Socialist-Liberal coalition would be an endless struggle to eliminate the budget deficit.

These developments took place simultaneously with the introduction of a new exchange-rate regime and a massive appreciation of the forint. On 4 May 2001, to allow monetary policy more room for manoeuvre to fight inflation and to take a first step toward conformity with ERM II, the crawling band was widened from ±2.25% to

±15%. At the same time, the NBH proposed to accelerate the capital liberalisation process by relaxing the restrictions on short-term capital flows and derivative transactions between residents and non-residents. A few months later the crawling of the exchange rate was completely eliminated and the forint was fixed against the euro. The wide band, however, allowed the forint to appreciate by about 10–12% over the next year. By the end of 2002, the exchange rate was pushed to the upper limit by the monetary austerity applied by the National Bank to counter fiscal imbalance. The widened exchange-rate band and the appreciation of the currency significantly jeopardised the competitiveness of small and medium-sized companies. Furthermore, a lack of financial knowledge (hedge techniques, futures products, forward markets) on the part of economic actors can cause serious problems if the exchange rate fluctuates widely (for example, the effects of a financial crisis in an emerging country such as Turkey).

The general government deficit was successfully kept under control during the growth period of the late 1990s. By 2000 the deficit came in at 3.5% of GDP, in line with the government's target. Subsequent years, however, brought a progressive loosening in fiscal policy. The right-wing government attempted to disguise the emerging deficit by various techniques, but the new government in 2002 had no choice but to introduce EU standards and attempt to create a clean balance sheet. This resulted in an increase in the budget deficit to more than 9% of GDP in 2002.

The current account showed a similar trend. External competitiveness remained strong, with the external current-account deficit narrowing in 2000. Industrial labour productivity – up by almost 17% in 2000 – far outpaced real wage gains, leading to a depreciation in the real exchange rate (based on unit labour costs) over the year. Rising export market shares and strong corporate profitability in the export sector also support this assessment of solid competitiveness. During most of the year, export growth exceeded that of imports, tourism revenue boosted the

services account, and fiscal policy was tighter than budgeted, contributing to an improved external position. Thus, despite worsening terms of trade, the external current-account deficit narrowed to 3.3% of GDP in 2000, down from 4.4% a year earlier. However, the current-account deficit started to widen again in both 2001 and 2002.

With credit ratings approaching advanced-economy levels, Hungary maintained ready access to external financing, but external debt levels remained high. Spreads on sovereign benchmark bonds were among the lowest in the region and, attracted by Hungary's strong economic fundamentals and convergence prospects, foreign investors' share of holdings of forint-denominated government securities reached record highs. However, in contrast to 1999, strong net foreign direct investment (FDI) inflows were more than offset in 2000 by substantial portfolio equity outflows. Net external debt, as a proportion of GDP, is now almost half its 1995 level, gross external debt has fallen over the same period, and the debt-service burden has shrunk significantly. Nevertheless, external debt, at about 60% of GDP on a gross basis, remained high, although the public sector share has declined substantially, while private sector debt, mostly that of foreign-owned corporations, has increased from low levels.

Fiscal destabilisation is mostly linked to the fact that the 2002 election campaign in Hungary was extremely heated. The left-of-centre coalition narrowly defeated the right and announced a politics of reconciliation.[13] The coalition's position was weakened by a few national institutions in which the right-wing government had appointed chief public servants between 2000 and 2002, with mandates lasting for a number of years ahead. Such offices include that of the attorney general, the

13 The right was not receptive to the reconciliation policy of Péter Medgyessy's government. Street demonstrations challenged the results of the elections, and the new prime minister was attacked on the grounds of his service as a secret agent in the counter-espionage of the state socialist regime between 1978 and 1982.

chairman of the financial inspectorate, and the governor of the National Bank of Hungary. This background is vital for an understanding of the policies of the three institutions. The latter institution is the most important for this analysis. Since 2001, the Bank had operated on an inflation target principle to impose monetary austerity in the face of rising inflation. Following the elections, the Bank twice increased interest rates, despite the constant decline in the rate of inflation.[14]

By the end of spring 2002, it was clear that the state budget deficit would be higher than expected. By the end of the summer, it looked as though it would exceed 6% of GDP. By the end of the autumn, it was made known that, because of book-keeping corrections, the deficit would be between 9% and 10% of GDP. However, at the same time the referendum in Ireland allowed ratification of the Treaty of Nice and the accession treaties were about to be signed in Copenhagen. Confirmation of EU enlargement generated a euphoria of portfolio investment in Hungary and other countries in the region. The wilier central banks responded to this situation by cutting interest rates substantially. The National Bank of Hungary, however, ruled out that option because of its alleged fear of inflation and the consequences of the serious budget deficit of 2002. Thus, while the strong forint and the high interest rates were already strangling the Hungarian economy, the markets expected further appreciation of the forint, and even a revaluation by shifting the band of forint/euro parity downwards. In January, there was a massive inflow of funds, increasing the foreign-exchange reserves of the NBH by 50%, before the bank eventually widened the so-called interest corridor and in effect lowered the rates on deposits.

14 This attitude demonstrated that the Bank was actually aiming to undermine the government's attempts to fulfil its electoral promises. On the other hand, the government did not want to renege on its pledge to the electorate because municipal elections were scheduled for October 2002 and the right was actively challenging the legitimacy of the coalition.

Between January and June 2003, the financial markets went into reverse as regards Hungarian economic policy and financial sustainability. In June, a minor currency crisis – following the shifting of the fluctuation band of the forint[15] – forced the central bank to increase interest rates from 6.5% to 9.5% in order to prevent a dramatic fall in the value of the Hungarian currency. This time, the currency crisis emerged from negative speculation against the forint, stimulated by a package of minor cuts in public expenditure and a small devaluation of the forint. In the first half of 2003, the fundamentals of the Hungarian economy also changed. The slowdown in the economy became apparent and the current-account deficit widened to a disturbing extent. Macroeconomic analysts of the markets and the government realised that the international economic recession[16] was lasting much longer than expected.

However, compared to other countries in the region, the Hungarian growth figures looked unimpressive. Between the first quarters of 2002 and 2003, Russia grew by 6.8%, Slovakia by 4.1%, Lithuania by 9.4%, Latvia by 8.8% and Estonia by 5.2%. Only the Czech and the Polish figures – i.e. those most comparable to the Hungarian case – demonstrated a major slowdown. During the 'golden age' between 1996 and 2000, average annual export growth was about 20%. In the recession period, this figure fell to about 3–4%. In 2003 the deficit on the current account was expected to exceed 5.5% of GDP, i.e. EUR 4 billion.

15 The forint would have fallen slightly anyway in the summer of 2003 since the Bank had completed the sale of the funds that had come in in January 2003. However, the incoherent government measures triggered panic and the outflow of speculative funds was only halted by raising interest rates twice, that is, through another blow to the real economy.

16 Economic growth in the euro area fell below 1%, and Germany, Hungary's most important trading partner, produced virtually zero growth. Through falling demand for imports, the slowdown in Germany determined the growth opportunities for Hungary as well. It is thus a major achievement, if not a miracle, that the Hungarian economy in both 2002 and 2003 produced a growth rate of around 3%.

Following the double shock to wage structures (that is, the minimum wage increase and the public sector wage hike soon afterwards) and the real appreciation of the forint, aggregate demand for labour responded in a sensitive way. At the time of the shocks (2001–2003), wages increased more rapidly than productivity. Manufacturing firms responded by factor substitution and they reduced their employment. This response explains why the minor improvement in employment in 2002–2003 was exclusively the product of the public sector.

During most of the 1990s, labour productivity grew faster than real wages. Administrative measures in 2001–2003 turned this around. Since several other countries in the region managed to implement an opposite turn at the same time, the Hungarian wage-cost advantage was reduced to some extent. One should not forget, however, that Hungarian labour productivity is still one of the highest among the post-transition countries.[17] Its growth rates are among the fastest in the region and the same is expected for the coming years (Scharle 2003: 22).

Despite the recovery of the late 1990s and early 2000s, the participation rate in Hungary has frozen at about 60% of the relevant age group. The propensity to work is particularly low among those between 54 and 64 years of age. This is partly, though not exclusively a product of secondary incomes and their counter-stimulatory effect[18] (Scharle 2003: 33).

Though the post-transition recovery set employment on a slow-growth trajectory and created a low-unemployment environment in a statistical sense, this has not resulted in a convergence of various sub-national

17 Hungarian labour productivity is second to that of Slovenia among the post-transition countries, though it should also be mentioned that labour productivity in Austria is double that of Hungary.

18 This impact is supported by the changes that followed the increase in the retirement age. In the age group affected by retirement-age reform, participation increased at the same time.

Table 4: Unemployment rate (%) by age and gender and percentage of long-term unemployed

Year	Unemployment rate			Of which:	
	Male	Female	Total	Youth*	Long-term
1992	10.7	8.7	9.8	11.5	–
1993	13.2	10.4	11.9	21.3	–
1994	11.8	9.4	10.7	19.4	43.2
1995	11.3	8.7	10.2	18.6	50.6
1996	10.7	8.8	9.9	17.9	54.4
1997	9.5	7.8	8.7	15.9	51.3
1998	8.5	7.0	7.8	13.4	48.8
1999	7.5	6.3	7.0	12.4	49.5
2000	7.0	5.6	6.4	12.1	49.1
2001	6.3	5.0	5.7	10.8	46.7
2002	6.1	5.4	5.8	12.3	44.9

Note: * Aged between 15–24 years.

Source: Fazekas et al. (eds) (2004): 194.

regions in terms of unemployment patterns. The reason for this is that in the early 1990s job losses were a nationwide phenomenon. The impact of the recovery in the late 1990s and the early 2000s was more selective in regional terms. Since foreign direct investment was concentrated in Budapest and the North-Western quarter of Hungary, unemployment was reduced relatively rapidly here, while other quarters, and particularly the North-East, preserved higher unemployment rates. Regional disparities proved problematic particularly because the mobility of Hungarian labour has been low, and it has not increased since the transition began (Fazekas et al. 2004: 96). Lower wages and new motorways have started to exercise a positive effect on the less fortunate, particularly North-East, regions of Hungary in recent years.

4.2 The European framework: pressure for adjustment and the search for an alternative

The emerging macroeconomic instability sharpened the expert debates over future EMU membership and an appropriate convergence strategy towards the Maastricht criteria. While both the government and the NBH insisted on 'accession as soon as possible', György Surányi, former governor of the NBH, voiced the opposite opinion. Surányi had proposed eliminating the budget deficit of 2002 by using inflation as one of the tools and criticised the inflation-targeting policy of the NBH that was supposed to cement the convergence programme. Another prominent expert, Gábor Oblath of Kopint-Datorg research institute, elaborated a scheme to achieve rapid transition to the euro and support it by a social pact with the trade unions. However, the trade unions did not want to be partners in a programme that imposed a long-run constraint on wage increases, and Oblath's proposal remained on paper. Joining ERM II and the length of time to be spent in it has also become a subject of analysis and speculation.[19]

In July 2003 the government launched the financial operations related to the 2004 budget. Because of the slower than expected GDP growth and the larger than expected deficit for 2003, the drafting of the budget and the continuing reduction of the deficit demanded sharper corrections in both spending and revenue than had been previously envisaged. Even the Ministry of Finance was taken by surprise by the gap between expectations and real opportunities. The final draft for the

19 János Kun is one expert proposing that ERM II should be joined as soon as possible but then the introduction of the euro should be delayed, since in that system members can expect the ECB to provide support in periods of currency instability. On the other hand, Judit Neményi and László Antal insist that Hungary should spend as short a time as possible in ERM II by both delaying accession to it and then introducing the euro if the test period provides positive results. In these terms it was less long-term prospects than immediate policies of stabilisation and adjustment which dominated.

budget policies was produced in the run-up to the scheduled government meeting, literally within two or three days.

In order to restore credibility in the face of a number of negative developments, the Hungarian government and the National Bank of Hungary announced in a joint declaration that the country would introduce the euro as the national currency as of 1 January 2008. The agenda attached to this announcement was evaluated as voluntarist by most observers, but the government saw this as an instrument in the debates over the budget and general policy with which to enforce discipline. The joint announcement was also seen as a message to the financial markets about the government's determination to bring the budget back towards balance and to respect the convergence programme which serves as a basis for most portfolio investors in their long-term calculations.

It should be noted that other governments in central and eastern Europe have been largely cautious in making a firm commitment to specific dates for the transition to the euro. What is even more striking is that in Hungary no public assessment of the costs and benefits of monetary reform, comparable to Chancellor Gordon Brown's 'five tests' in the United Kingdom, has taken place. Both the NBH and the Ministry of Finance have produced materials on joining EMU, but the political elites, the policy community and the wider public take it for granted that introduction of the euro would be beneficial.

On the other hand, all parties soon saw that a transition to the euro would demand substantial sacrifices. The budget for 2004 proposed tax increases as well as cuts in expenditure, and the lay-off of some 10,000 public employees was ordered. Even the prime minister had to abandon his position on motorway construction, which he had treated as the only untouchable item in the plans for the 2004 budget. The road to the euro within the framework of national sacrifice had begun. However, the apparent adjustment did not save the country from

another fall in the exchange rate at the end of November, which was halted by a 3 percentage point increase in the base rate by the central bank. This emergency measure looked inevitable, but it also destroyed the chances of accelerating GDP growth in 2004.

Macroeconomic mismanagement and the lack of social and political consensus on the objectives of fiscal and monetary policy created a barely sustainable situation in Hungary. By the end of 2003, an unsustainable exchange rate was replaced by an unsustainable interest rate. In 2004, the National Bank was extremely slow to reduce these ultra-high interest rates, so sending a signal to the markets that the economic problems had not been sorted out despite repeated austerity measures on the fiscal front. The Monetary Council only started significant rate cuts after the elections to the European Parliament, and this timing again fuelled suspicions that their policy was biased in favour of the political opposition against the government and the interests of the economy in general.

The continued monetary austerity of the Bank, explained by the doctrine of inflation targeting, has returned the forint to the euro parity of late 2002. However, this was not sustained by economic performance or a general optimism among foreign investors as in 2002, but purely by a super-high real interest rate that provided a stimulus for speculative investment. The Bank continued this policy, denying that this would harm the competitiveness of the Hungarian economy, while it was clear that Hungarian producers are losing their export share in Europe to their Czech, Slovak and Polish rivals, and the deficit in the current account continued to grow to around 8% of GDP.

The financial problems contributed to the political crisis emerging after the EP elections in summer 2004. This process concluded in the fall of Prime Minister Péter Medgyessy and the rise of his successor Ferenc Gyurcsány. Soon after the new government took office, two Socialist and one Free Democrat members of parliament submitted a bill to

change the regulation of the National Bank.[20] The Socialist-Liberal proposal intended to create a division of power between the governor and the Prime Minister. They also wanted to increase the number of council members in order to balance the situation immediately.

The proposal was rejected by National Bank officials as well as the political opposition, and the European Central Bank also issued a statement that called the initiative problematic and unnecessary. Nevertheless, a somewhat moderated version of the original bill was passed by Parliament on 22 November 2004. Governor Zsigmond Járai announced that he would take the bill to the Constitutional Court and challenge its legality. When, however, the President of the Republic appointed four new members in March 2005, the renewed Monetary Council faced the difficult job of orchestrating a soft landing for the forint instead of a crash that would otherwise have been a logical outcome of the conflicts and mismanagement in previous years.

Eight of the ten countries that joined the EU in 2004 are from the former Soviet bloc. These eight countries underwent a period of decline in the early 1990s, a period of recovery in the late 1990s and some of them have seen outstanding macroeconomic improvements in recent years. However, a number of specific problems remain which raise questions as to these countries' future monetary integration.

In its own way, the ECB has recognised the specific problems of the East. In a report issued on 20 October 2004 the European Central Bank said that more than half of the countries that joined the European Union this year, including Poland and Hungary, which want to adopt the common currency by the end of the decade, need to do

20 An earlier amendment in 2001 made the Bank extra-independent. Only the governor had the right to nominate members of the Monetary Council. Thus the council had a tendency to become biased towards the political line which had appointed the governor.

more to trim their deficits to the levels needed for euro membership. However, the ECB views this as a problem of discipline that has recently been aggravated by unsuitable tendencies in France and Germany. 'The behaviour of old members of the European Union in not complying with the Stability and Growth Pact is not sending a good signal to the new member states', said Ottmar Issing, the ECB's chief economist. The president of the ECB, Jean-Claude Trichet, added that it was 'absolutely obvious' that a lack of fiscal discipline among the current 12 members of the euro area set a bad example for the 10 countries who joined the EU in May (Dougherty 2004).

Hungary is a case study of both the achievements and the difficulties of economic development. She also provides an opportunity to demonstrate that satisfying the rules of EMU is not simply a problem of discipline but also a question of social and political cohesion. In July 2003 the Hungarian government and the National Bank of Hungary (NBH) announced in a joint declaration that the country would introduce the euro as national currency as of 1 January 2008. This brave announcement took place at a time when the government was struggling to reduce a serious deficit of the state budget that exceeded 9% of GDP in 2002. The exchange rate has not been stable in recent years, either. Following a period of constant appreciation, the national currency survived three speculative attacks within the space of twelve months which took place in opposite directions. Thus, the actual picture is much more complex than would appear from official statements.

It was not easy to adjust West European economies to the Maastricht criteria but it seems to be several times harder in central and eastern Europe. Hungary is not alone with her problems. The post-transition state of these economies does not provide an easy ground for fiscal and monetary convergence, let alone exchange rate stability. In some countries disinflationary goals have been pursued as part of a balanced economic policy (Czech Republic, Slovenia); in other countries, where

there was an excessive focus on inflation together with a lack of policy coordination, disinflation undermined economic growth either directly (Poland) or indirectly (through unmanageable exchange-rate volatility, in Hungary, where reckless wage policies admittedly have also played a part).

An even more difficult task is that of meeting the fiscal criterion: almost all acceding countries are facing difficulties because of the need for fiscal consolidation as prescribed by the Stability and Growth Pact. An unresolved issue with regard to the fiscal policy of acceding countries is how the completion of transition-related reforms and the adoption of EU standards and regulations will comply with the requirement to meet the EMU's fiscal reference values in the coming years.

In the mid-1990s, it looked as though the monetary criteria – namely inflation and interest rates – would be the most difficult to meet. More recently, the fiscal criteria – that is, budget deficit and public debt – appear to have been the more testing aspects of convergence. Suddenly, however, the difficulties of meeting the exchange-rate criterion became of interest to analysts. The reason is that the adjustment and modernisation process associated with the economic transition has not yet come to an end. On the other hand, the job of the authorities responsible for monetary stability has become harder since the euro was introduced in the West and speculative funds turned their attention towards the East. This factor may have contributed to the decision of the Czech and the Polish authorities to float their currencies instead of pegging them, although they have already faced some repercussions from that decision.

Slower progress in Hungary towards the eurozone is often criticised by various institutions and forums. However, this was partly a conscious choice of the Socialist-Liberal coalition in 2003–2004 to create a more favourable environment for maintaining – or possibly improving – better than average unemployment statistics (see Table 7). Nevertheless,

macroeconomic convergence towards the Maastricht criteria will lock employment at the present level for the rest of the decade. Thus, in addition to more determined labour market policies in Hungary, a different European macroeconomic framework would be needed for visible progress in the area of employment.

In an article for the *Financial Times*, a distinguished expert in this area, Charles Wyplosz, explained the danger posed by speculative flows in the post-transition period. He argued that, along with the freedom of capital flows, ERM II is not an appropriate framework for the fiscal and monetary convergence of central and eastern European countries.[21] These countries should either be allowed to carry out a rapid transition to the euro – provided they comply with the fiscal and monetary criteria – or they should be allowed the same status as the United Kingdom, namely inside the single market without joining the single currency (Wyplosz 2003). The Hungarian currency crisis of 2003 that we discussed earlier in this chapter provides ample arguments to justify Wyplosz's concern, though some draw the conclusion from the same developments that only rapid transition to the euro can save Hungary from similar problems.

Furthermore, the crucial issue of finding the parity at which euro conversion should take place is far from being settled in most cases. It follows that the conditions for a responsible ERM II entry are not in place, not to speak of an early EMU entry. Therefore, the process of joining the euro area should not be hastened. A slower approach should not be viewed as a sign of weakness or lack of political commitment, but rather as a sign of a responsible attitude towards a sustainable and consistent convergence process.

We may expect, however, that in the long run the choice will be not

21 A year later, Wyplosz's concern was echoed by Willem Buiter, chief economist of EBRD.

only between fast or slow transitions to the euro. The longer the transition takes and the more difficulties arise with it, third options may develop. Creating a regional currency that would be pegged to the euro is one theoretical option for the Visegrad states, that would thus be prevented from using competitive devaluations against one another, but allowed to carry out exchange rate adjustments vis-à-vis the euro if necessary. In case the pound area (the UK) and the krona area[22] (Sweden and Denmark) survive in the long run, a central and eastern European currency area will have a constituency too.

In principle, the rules of the transition have been laid down, but with reference to new circumstances and with sufficient political will they should be renegotiable. In this context, it is worth noting that the leaders of the EU must be reminded that they displayed an extreme lack of generosity when the financial framework of the enlargement was elaborated in 2002. This contributed to the falling popularity of the EU in the region (witness the low turnout at referenda on EU accession), and the strengthening of the US orientation of these countries. Wyplosz goes even further in the discussion of the potential consequences of Western European attitudes: he warns that, if the rules do not change, the West will again be responsible for crises in central and eastern Europe (see Wyplosz 2003).

Conclusion

As compared to other EU countries and the group of new members, Hungary has maintained one of the lowest unemployment rates. However, restoration of the pre-transition employment level has been extremely slow and labour market participation has not increased since about 1999 despite the higher than EU average GDP growth. This sit-

22 The non-introduction of the euro may also be attractive to Norway, which may as a consequence join the EU and remain in a sub-region with Denmark and Sweden.

uation is partly a result of the post-communist transition and the market conditions it created, and partly a consequence of the macroeconomic framework imposed by the EU under EMU rules.

The transition from national currencies to the euro is the final phase of economic transformation in post-communist central and eastern Europe. It follows, though not necessarily rapidly, accession to the EU. Notwithstanding declarations to the contrary, the political elites and policy-makers in the Visegrad countries do not view euro membership as a high priority and are not resisting measures that reduce the likelihood of rapid abolition of national currencies. Some of them, like Hungary in 2004, have deliberately slowed down the convergence process in order to maintain greater room to manoeuvre, while in other cases macroeconomic fundamentals prevent governments from implementing rapid currency reform.

In Hungary the policy-making community has converged around the need to introduce the euro, while deteriorating fundamentals and disunity on policies have created an unstable terrain for transition. Impressive developments in the late 1990s were followed by fiscal and monetary disintegration. By 2003, the finances of Hungary had become more fragile than the economy itself, and of course convergence demands a higher level of fiscal discipline and policy coherence, as well as some sort of social contract in the medium term. The Socialist-Liberal government learned this expensive lesson when the 2008 deadline had to be postponed to 2010 as a result of adjustment difficulties. These tendencies constantly make the employment objective a secondary consideration and the solution of long-term labour market problems becomes impossible while short-term financial considerations enjoy priority. However, it still makes sense to consider alternative monetary arrangements for East-West integration within the EU, which would result in a different path or a different outcome for Hungary as well as other countries in the region.

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Latvia's path to the eurozone and its potential effects

Ilze Trapenciere

1. The macroeconomic context

Economic reform and EU membership have positively influenced Latvia's development. Economic growth in Latvia has been increasing since the mid-1990s, although the economic crisis in Russia in 1998 hit Latvia hard from August 1998 to 1999–2000. The Latvian economy is growing significantly: average GDP growth between 1996 and 2003 was about 6.1%, with figures for 2001 and 2003 of 8% and 7.5% respectively. High economic growth is expected also for 2004 (GDP growth in the first nine months of 2004 was 8.5%). The Ministry of the Economy has forecast that annual GDP growth for 2004 will be 8.5%.

The main factors behind this economic growth are high domestic demand and the ability to adapt to changing external conditions. Latvia has one of the highest growth rates in the EU. Economic growth was achieved in a stable macroeconomic environment.

The lat (LVL) has been stable for almost a decade. This has increased economic stability, avoided currency exchange risks and created a basis for corporate planning and price setting. The inflation rate has been very low for many years, at 2–3%: in 2003 the inflation rate was 2.9%. This situation changed at the beginning of 2004 when inflation grew due to the increase in regulated prices, excise taxes and inflationary expectations triggered by EU accession (see Table 1).

Table 1: Main macroeconomic indicators of selected new EU Member States (%)

	GDP growth				Consumer prices				Current account deficit (% against GDP)			
	2002	2003	2004^{f}	2005^{f}	2002	2003	2004^{f}	2005^{f}	2002	2003	2004^{f}	2005^{f}
Estonia	7.2	5.1	5.8	5.4	3.6	1.3	3.0	2.5	–10.2	–13.2	–11.2	–9.5
Latvia	**6.4**	**7.5**	**6.5**	**6.0**	**1.9**	**2.9**	**5.8**	**3.5**	**–6.5**	**–8.6**	**–9.3**	**–8.2**
Lithuania	6.8	9.0	7.0	7.0	0.3	-1.2	0.6	2.5	–5.2	–6.7	–7.1	–6.9

Note: f = forecast.

The Bank of Latvia is implementing a de facto policy of a fixed national currency exchange rate. This reduces uncertainty, eliminates exposure to currency risk and gives entrepreneurs a stable basis for planning and price setting.

From 1 January 2005, Latvia ceased to peg the national currency to the SDR basket and pegged it to the euro instead.[1] At the beginning of 2005 Latvia expects to join the European Exchange Rate Mechanism (ERM II) where it will have to remain for at least two years, fulfilling the Maastricht criterion on exchange rate stability. When the EU Council decides that Latvia is ready to join Economic and Monetary Union (EMU), the lat will be substituted by the euro and the Bank of Latvia will no longer pursue an independent monetary policy. According to Bank of Latvia forecasts, this could happen at the beginning of 2008. Until then the lat will remain the national currency of Latvia.

Higher inflation growth in 2004 was due to a combination of one-off factors, mainly the rise of administratively regulated prices, harmonisation of indirect tax rates, inflationary expectations related to EU accession and higher oil prices.

1 On 30 December 2004 the Bank of Latvia pegged the lat to the euro at EUR 1 = LVL 0.702804, which took effect on 1 January 2005.

The forecast is that inflation will gradually return to its previous level in the coming years. The change of the lat currency peg in 2005 is a measure intended to stabilise exchange rate fluctuations against the euro and diminish inflation due to higher import prices. The world oil price is one inflationary risk factor beyond Latvia's power to control.

In view of growing domestic demand, in March and November 2004 the Bank of Latvia raised the refinancing rate by 0.5 a percentage point to 4% and increased the reserve requirement from 3% to 4% in July. In addition, as of 24 January 2005 the Bank plans to include in the minimum reserve base bank liabilities to foreign banks and foreign central banks with an agreed maturity or redeemable at notice of up to two years in order to ensure equal competition among banks.

The goal of Latvian fiscal policy is to ensure balanced economic growth and financial stability. Since 1996 – with the exception of 1999 when the fiscal situation reflected the Russian financial crisis – the fiscal deficit of the consolidated total state budget has been below the maximum 3% of GDP permitted under the Maastricht Treaty. In the wake of EU accession, Latvia will consistently ensure compliance with the financial criteria of the Maastricht Treaty. The government's goal is to achieve a non-deficit budget in the medium term.

The Saeima (Parliament) approved the state budget for 2004 with a deficit equal to 2.1% of GDP. Revenues to the state budget in the first eleven months of 2004 were 19.5% higher than in the previous year but expenditures increased by 16.2%. The budget had a fiscal surplus of LVL 76 million.

One of the main economic development risks facing Latvia is a relatively high current account deficit caused by high domestic demand and steep investment growth. The negative trade balance is the main reason for the current account deficit. In 2003 the current account deficit was 8.2% of GDP. About one-third of the deficit is covered by the positive balance of services.

With the worsening of the trade balance, the current account deficit in the first six months of 2004 reached 13.6% of GDP, exceeding the same period of the preceding year by 6.6 percentage points. However, after EU accession on 1 May 2004, import growth slowed and the current account deficit started to fall.

Since the current account deficit is basically covered by foreign direct investments and long-term loans, at the moment the deficit level is not considered critical. The net foreign reserves of the Bank of Latvia are growing continuously.

It is anticipated that export growth promoted by structural reforms will bring down the current account deficit in the medium term. However, import demand will remain relatively high due to the further modernisation and growing openness of the economy. After accession to the eurozone risks related to a negative current account deficit (risk of a currency crisis) will almost totally disappear as currency stability and maintenance of foreign currency reserves will become the competence of the European Central Bank.

The fiscal deficit of the consolidated budget has not exceeded the ceiling of 3% from GDP since 1996 (with the exception of 1999). Latvia is therefore meeting the Maastricht criteria. The government's objective is to bring the fiscal deficit of the consolidated budget to within 3% of GDP, and the mid-term objective is to maintain a balanced budget. In 2003, the fiscal budget deficit was 1.6%, while for 2004 the fiscal budget deficit was 2% of GDP. According to official documents, the priorities of the Latvian State Budget for 2004 included the integration of Latvia into the European Union and NATO. Another priority of the Latvian government is a socially responsible policy to improve quality of life. (It is perhaps worth noting that government documents do not emphasise or even mention gender in this connection.)

In recent years the Latvian government has emphasised increasing wages and old-age pensions. The minimum wage has been raised and

the old-age pension is regularly recalculated in accordance with inflation.

Net wages in 2003 were 11% higher than in 2002. However, there is still a gender gap: on average, females receive about 80% of male wages.

2. Real convergence processes

GDP growth per capita is determined by a number of components,[2] mainly productivity growth and, to a lesser extent, employment growth and demographic changes (see Figure 1). In 2003, GDP per employee in Latvia compared to the EU-25 average was a little higher than GDP per capita due to lower employment.

Between 1996 and 2000 employment decreased and average productivity growth (see Table 2) was faster (by an average 5.9% a year) than between 2001 and 2003 (5.4%). Besides, employment has been growing for the last three years.

The average annual impact of falling age dependency on GDP per capita amounts to 0.5 percentage points. Age dependency has decreased due to the rapid decline in the population aged below 14 years, which has exceeded population growth among the over 64s.

2 $$\underbrace{\frac{\text{GDP}}{\text{population}}}_{\text{GDP per capita}} = \underbrace{\frac{\text{GDP}}{\text{employed}}}_{\text{labour productivity}} * \underbrace{\frac{\text{employed}}{\text{population in working age}}}_{\text{employment level}} * \underbrace{\frac{\text{population in working age}}{\text{population}}}_{\text{age dependency (inverse)}}$$

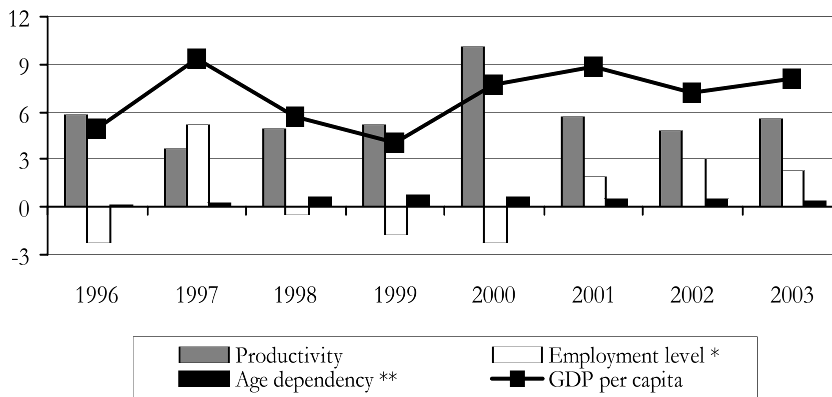

Figure 1: Components of GDP growth per capita (changes, %)

Notes:
* For persons aged 15-64 years.
** Age dependency - indicator characterising change in proportion of non-working age population (under 14, 65 and over) in the total population.

Table 2: Productivity growth by sector – added value per person employed (average annual changes in %)

	1996–2003	1996–2000	2001–2003
Primary sectors	5.0	5.4	4.2
Manufacturing	8.3	8.2	8.6
Electricity, gas and water supply	–1.6	–4.0	2.6
Construction	4.2	6.5	0.5
Trade, hotels and restaurants	7.8	7.0	9.2
Transport and communications	4.5	6.8	0.7
Other services	4.3	5.5	2.2
Public services*	2.3	2.2	2.4
Total national economy	5.7	4.8	5.6

Note: * Public administration with health care and education.

Productivity growth has slowed in recent years but the figures should be treated with some caution since the number of employed used for the calculation of productivity does not always adequately reflect the situation, given the relatively high share of the shadow economy in such sectors as construction. As the shadow economy in these sectors is gradually diminishing, the real rise in productivity is greater: for example, it is likely that in construction productivity growth has been faster during the last three years than the official figures indicate.

Although manufacturing has experienced the fastest productivity increase, it still lags behind several areas of services. For example, productivity in financial services is four times higher than in manufacturing and 3.3 times higher than the national economy on average.

Labour costs

In recent years, as wages have outstripped productivity, unit labour costs have increased. Labour cost growth was especially rapid in 2003 (see Table 3).

This process is not equally rapid in all sectors. Labour costs have increased much more rapidly in services or so-called non-trading sec-

Table 3: Labour costs (percentage changes compared with previous year)

	2001	2002	2003	2004*
Labour costs	5.7	8.5	9.6	9.6
Real labour costs**	3.5	4.9	6.0	2.9
Productivity***	5.7	4.8	5.6	7.0
Unit labour costs****	0	3.5	3.8	2.4

Notes:
* I–III quarters of 2004 compared with I–III quarters of 2003.
** Index of labour cost changes divided by GDP deflator.
*** GDP growth divided by index of employment changes.
**** Index of labour cost changes divided by index of productivity changes.

tors not related to external competition. Unit labour costs in manufacturing have decreased, although it should be noted that provisional data for the first three quarters of 2004 indicate labour cost growth faster than productivity also in manufacturing.

Wages have grown constantly. In 2003, a minimum wage target was adopted of 50% of average gross monthly wages, to be achieved within seven years. In January 2004, the minimum wage was increased from LVL 70 to LVL 80.

Overall productivity is low in Latvia, especially in agriculture and manufacturing. The main competitive advantage of the manufacturing sector is low labour costs. Consequently, the main task of economic policy is to bring about the transition from a labour intensive to a knowledge-based economy by investing in human capital.

3. Employment and labour market

The Latvian labour market is flexible in that employment responds rather quickly to changes in overall macroeconomic conditions (Vanags 2004).

Employment and unemployment indicators are gradually improving. However, it should be noted that this has been achieved mainly at the expense of productivity. By 2003 the number of employed persons in the age group 15–64 years had increased by only 6% compared to 1996. In nearly all sectors of the economy economic growth has had little effect on employment. With the development and strengthening of the private sector, competition is also increasing, forcing companies to look for ways to cut costs. As management improves, one of the main cost items to be reduced is labour costs, which often results in lay-offs. The Latvian economy's generally low level of productivity makes such measures almost inevitable and future growth will mostly be based on increasing productivity rather than employment growth.

Labour market participation in Latvia is slightly lower than the EU average but among women has already exceeded the EU average.

The number of job seekers in the age group 15–64 years has decreased substantially (from 20.5% in 1996 to 10.7% in 2003). However, great differences remain between unemployment rates in different regions and cities. The unemployment rate is highest in eastern Latgale and lowest in Riga region. Measures taken to improve employment and increase economic activity so far have not brought about the expected positive changes in many rural areas. The situation remains most difficult in Latgale where unemployment in several districts exceeds 20% of the economically active population (the average registered unemployment rate in the country at the end of November 2004 was 8.5%, while real unemployment (the share of job seekers) reached 10.7%). Latgale also has the lowest GDP per capita, at half the average.

Table 4 shows recent developments in relation to the 15–64 age group (key indicator 2). Both the number of persons employed and the employment rate have increased over the last three years. However, at 61.8% the employment rate is below the EU-25 average, though above that of the new Member States.

Table 4: Employment developments (1998-2003)

	1998	1999	2000	2001	2002	2003
Employment ('000)	–	–	917.6	937.5	962.5	981.5
Employment rate (15–64)	59.9	58.8	57.5	58.6	60.4	61.8
Employment rate (55–64)	36.3	36.6	36.0	36.9	41.7	44.1

Source: Statistical Yearbook of Latvia, CSB Statistics, 1998–2004, Riga.

In 2003, the economically active population stood at 69.2%. There have been several periods of employment change in Latvia, starting from falling employment in 1992–1993 and the first signs that unemployment was no longer showing any specific gender bias. Another unemployment increase came in 1998–2000 as a consequence of the Russian crisis.

At present, the Latvian labour market is characterised by two important features:

1. It is rather flexible and employment responds rather quickly to changes in overall macroeconomic conditions.
2. Although GDP is showing stable and significant growth, employment growth is much smaller.

Female employment (employment rate 57.9 %; activity rate 64.7%) in Latvia was above the EU average in 2003 (56%) and shows an upward trend. Women's employment rate in Latvia has already exceeded the mid-term target set for 2005 in Stockholm. Although according to LFS women's unemployment is decreasing (2003: 10.7%), it is still higher than the EU-15 average (2003: 8.9%).

Notwithstanding women's relatively high participation rate and educational level, real gender equality remains some way off in Latvia, as indicated by high labour market segregation and the wage gap.

Flexible employment forms and opportunities to work part-time play a significant role in improving family and work–life reconciliation. Given the limited child-care alternatives, the social partners must increase their efforts to provide flexible employment forms, especially for women with children.

Unemployed women are more active than men in registering and participating in active labour market measures. The State Employment Agency (SEA) follows a gender equality principle by considering the male/female balance in involving unemployed persons in active labour

market measures and has identified persons returning from child-care leave as a special target group, providing vocational guidance and career counselling services.

To ensure implementation of gender equality at the highest level, the Gender Equality Council was established. The main task of the Council is to promote the development of a common gender equality policy and ensure the implementation of the Concept on Gender Equality. In 2003, the Gender Equality Affairs Unit was established in the Ministry of Welfare.

In order to facilitate the integration of women in the labour market, reduce the considerable male/female employment rate gap and differences in gender-specific unemployment rates, an integrated approach must be followed in solving gender equality problems. The participation of the social partners will play an important role in ensuring real gender equality in the labour market.

Insufficient attention is paid to improving the work–family life balance, ensuring access to child-care services and other care possibilities for dependant family members with disabilities, as well as facilitating re-integration in the labour market after a period of absence.

According to the Labour Force Survey (LFS), the average educational level of the labour force is relatively high: in 2003, 18.7% of the economically active population had a higher education and 66.5% a secondary education. The proportion of economically active young people is relatively low, comprising 38.6% of the respective age group of young people in 2003. The economically active population aged 55–64 made up 48% of the respective age group.

The employment rate differs significantly by region. In 2003, the highest employment rate was in Riga (capital) region (66%). In Latgale (in the eastern part of Latvia) it is much lower (52%), mainly because of the low level of economic activity there. Low labour force mobility,

influenced also by insufficient transport infrastructure in economically less developed regions, prevents further development.

Compared to the EU average, the Latvian labour force works longer working hours than both the EU-25 and the EU-15, averaging 41.9 hours per week (2002), with men working 44.7 hrs per week in 2003 and women 42.2 hrs.

The vast majority of both men and women work full time. The proportion of people working part time is much smaller than the EU-25 average. Male part-time work is rare (2.7%), while female part-time employment is a little higher at 7.8%.

There is still a serious problem of undeclared employment in Latvia. Employment without a contract or on a 'minimum wage contract' is still widespread: low contractually agreed wages are supplemented by so-called (undeclared) 'envelope wages'.

According to the study 'Employers' and employees' knowledge of their labour rights' (Ministry of Welfare 2001), many employees are unaware of the requirement of an employment contract and of their rights in general. This particularly concerns young people with a low educational level and without previous job experience.

The unemployment rate has exhibited a falling tendency since 2000. However, it is still high (10.7%). Registered unemployment is lower than the LFS data (see Table 5).

Table 5 shows developments in the unemployment rate based on LFS data. It is clear that recent strong economic growth has had an impact, with unemployment falling from 13.7% in 2000 to 10.5% in 2003. However, long-term unemployment remains high (41% of all unemployed). Youth unemployment is 44% of total unemployment, with those young people with a low educational level and a lack of qualifications at particular risk (alongside some graduates of vocational education).

Table 5: Unemployment in Latvia (%)

	1998	1999	2000	2001	2002	2003
Unemployment rate (LFS), 15–64 yrs	14.3	14.0	13.7	12.9	12.6	10.5
Long-term unemployment (LFS)	7.9	7.6	7.9	7.2	5.7	4.3
Share of long-term unemployed	55	54	58	56	45	41

Source: LFS, CSB, Riga.

The unemployment rate of people aged 55–64 is 8%. The employment possibilities for older people largely depend on their education and qualifications.

Another important consideration is the relatively high proportion of economically active people and discouraged persons who have no hope of finding a job. There are more women than men among the inactive who want to start working (10.2% men and 14.5% women).

Data on registered unemployment show that there are more registered unemployed women than men. LFS data do not show significant differences between male and female unemployment. That means that women are more active in looking for new jobs and more active in training and retraining.

4. Main framework and targets of employment policy in Latvia

The main objective of Latvian employment policy is to increase the employment rate, meeting the strategic requirements set by the EU, as well as tackling unemployment on the basis of economic growth. Latvian employment policy takes into account the Lisbon and

Stockholm employment objectives. Measures aimed at implementing national employment policy conform with the Joint Assessment Paper on Employment Policy Priorities of Latvia signed by the government and the European Commission.

Latvian employment policy must help to achieve three overarching and interrelated objectives laid down in the Guidelines for employment policies: full employment, improving quality and productivity at work and strengthening social cohesion and inclusion.

None of the tasks mentions the need for gender mainstreaming in employment policy.

In order to reach the average EU employment rate the government must play an active role in strengthening annual employment growth. The labour market can be reinforced by macroeconomic stability and increases in qualifications and quality of work.

The government understands the need for measures aimed at promoting the development of knowledge based sectors of the economy. It is necessary to improve, develop and continue the structural reforms in the labour market, taxation system and social assistance and social benefit system.

In recent years the government has improved cooperation with the social partners and non-governmental institutions on issues of employment and health and safety at work.

The government has emphasised measures supporting the employment of young and older people, and employment opportunities for the long-term unemployed and the economically inactive population.

The objective 'improving quality and productivity at work' encompasses lifelong learning, work–family life balance, gender equality and health and safety at work. The current level of quality of work in Latvia is significantly lower than in the EU-15.

Strengthening social cohesion and inclusion is based on the full employment of both men and women and the development of a social security system and social assistance for those in need. The Latvian government has developed two important documents, the Joint Inclusion Memorandum and the National Action Plan on Social Inclusion in order to reduce poverty and social exclusion. Social inclusion has three particularly important dimensions in Latvia:

1. The problems facing particular risk groups.
2. Regional/territorial divisions. Latvia has significant regional disparities: for example, in Riga per capita GDP is 170% higher than in Latgale, the poorest region of Latvia. Registered unemployment in Latgale is 3.5 times higher than in the capital.
3. Lack of access to the labour market because of inability to speak Latvian. I cannot agree with the popular thesis that employment disparities are based on ethnicity (non-Latvian). Studies (Asland 2000, Ministry of Welfare, Trapenciere and Rungule 2000) show that access to the labour market is lower for people who lack knowledge of the state language (applying to both ethnic Latvians and ethnic non-Latvians).

The European employment policy context

Recent employment developments for the 15–64 age group show that the employment rate has increased during the last three years. However, the employment level of 61.8% (2003) is still below the EU-25 average, though, as already mentioned, it is above the other new Member States. For women the employment rate is 57.9%, which is higher than both the EU-25 and the new Member States. Women's employment rate has traditionally been high and in 2003 was above the EU average, while men's employment is below the EU average.

The Latvian labour force works longer hours than both the EU-25 and the EU-15, averaging 41.9 hours per week (2002), with men working 44.7 hrs per week in 2003 and women 42.2 hrs.

The vast majority of both men and women work full time. The proportion of people working part time is much smaller than the EU-25 average. Male part-time work is rare (2.7%), while the female part-time employment rate is 7.8%.

The National Action Plan on Employment (NAPE) in Latvia is an important development document. One shortcoming is the neglect of gender mainstreaming in employment policy. Another concerns a more realistic approach to human resource development, lifelong learning, the possibilities offered to young people to integrate them into the labour market, and the lack of a clear vision of the transition to a knowledge-based economy. Moreover, there has been no coordination between NAPE objectives and the national convergence plan for eurozone accession.

5. Latvia's road to the eurozone

The Law on the Bank of Latvia[3] stipulates that the main goal of monetary policy in Latvia is to maintain price stability. The central bank is an independent decision-making institution not subordinated to decisions or orders of the government or governmental institutions. The Bank of Latvia performs its functions under parliamentary supervision.

Since mid-February 1994 the Bank of Latvia has unofficially pegged the exchange rate to the SDR[4] basket of currencies (SDR 1 = LVL 0.7997) thus de facto implementing a policy of a fixed national currency exchange rate. The Bank of Latvia has managed to increase confidence without establishing a formal currency board system and has

3 The Bank of Latvia is the central bank.

4 Special Drawing Rights – currency code according to the classification of currencies under international standard ISO 4217 – XDR. The SDR currency basket from 1 January 2001 consists of: US dollar (45%), euro (29%), Japanese yen (15%) and British pound (11%).

also accumulated experience, at the same time using a wide range of market-oriented monetary tools fully compatible with the monetary policy instruments at the disposal of the European Central Bank (ECB).

At the beginning of 2004, the Latvian National Bank predicted inflation of 4.5%. By the end of November 2004 inflation had increased by 7.25%, with an average inflation rate for 2004 of 5.9%. The Bank also said that in the coming years inflation will return to the level of previous years (2–3% a year). In line with the EU Treaty of Accession the new EU Member States will also join Economic and Monetary Union (EMU) and introduce the euro.[5]

The strategy worked out by the government and the Bank of Latvia foresees replacing the current peg to the SDR basket with the peg to the euro from 1 January 2005 and joining the European currency mechanism, ERM II, at the beginning of 2005. It is planned to set the peg in line with the market rate of 30 December 2004.[6]

Latvia will have to participate in ERM II for at least two years, implementing the Maastricht criterion of exchange rate stability. During this period the Bank of Latvia has to achieve full compliance with the ECB, adjusting monetary policy instruments. The Bank of Latvia plans unilaterally to keep exchange rate fluctuations within the +/–1% corridor instead of the standard fluctuation rate of +/–15% in the ERM II. A narrower exchange rate corridor will provide more stability for prices and fewer possibilities for speculative transactions.

The Bank of Latvia and the government have set a date of 1 January 2007 by which all criteria for introducing the euro should be met.

5 EMU participation is laid down in the EU Accession Treaty but Latvia can select its own timeline for introduction of the euro.

6 On 30 December 2004 the Bank of Latvia pegged the lat at EUR 1 = LVL 0.702804, which took effect on 1 January 2005.

As soon as the EU Council decides on Latvia's readiness to participate in EMU, the lat will be replaced by the euro and the Bank of Latvia will cease to implement an independent monetary policy. According to the estimates of the Bank of Latvia this could happen at the beginning of 2008. Until then the lat will remain the national currency of Latvia.

Both the lat's peg to the euro and the introduction of the euro in Latvia constitute an issue of EU multilateral relations, affecting the common interests of all EU Member States. Official negotiations on this issue with EU Member States and institutions were started only after Latvia's EU entry.

The Bank of Latvia calculates the real exchange rate of the lat[7] against the currencies of Latvia's 13 main trading partners.[8] This shows the relative competitiveness of Latvian exports in world markets (see Figure 2).

In recent years the real exchange rate of the lat has tended to depreciate with regard to the currencies of both developing and developed countries. This decline is favourable for exporters.

President of the Latvian National Bank I. Rimsevics has declared that a future devaluation of the lat cannot be ruled out (press conference, 9 September 2004).

Besides high inflation in 2004 (7%), Rimsevics also emphasised the current account deficit of 13.5%. Both these factors have reduced the strength of the lat. On 31 December, the lat/euro exchange rate was set at EUR 1 = LVL 0.70284.

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7 The real exchange rate of the lat encompasses changes in the nominal rate against the currency of trading partners as well as changes in consumer prices compared with changes in consumer prices in partner states. The real rate is calculated dividing the nominal rate index by the ratio of foreign and domestic price indices.

8 Denmark, Finland, France, Germany, Italy, Netherlands, Sweden, the UK and the USA are included in the group of developed countries, whereas Estonia, Lithuania, Poland and Russia are included in the group of developing countries.

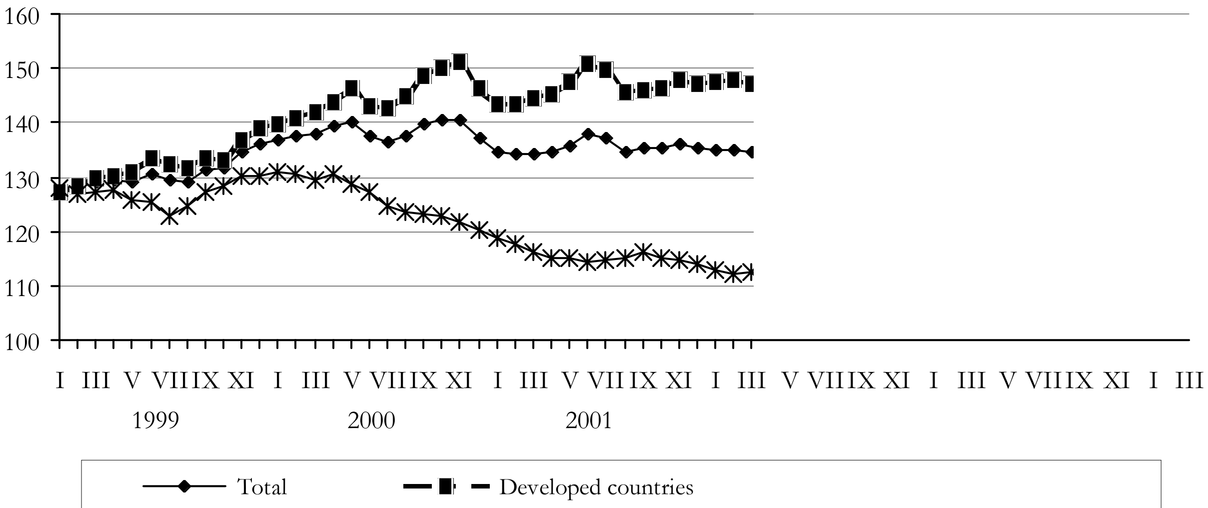

Figure 2: Real exchange rate of the lat (by month)*

Note: * Calculated from average monthly exchange rates – the price of the domestic currency unit in foreign currency (December 1995 = 100).

The President also criticised government fiscal policy and the budget deficit: 'Growing government expenditure is contributing to increasing inflation and that, in turn, neutralises the positive effects of such expenditure'. He emphasises that the government continues to pursue an expansive fiscal policy. In 2004, expenditure increased by LVL 119 million (instead of the planned LVL 66 million). The fact that the original growth target was outperformed is the main reason why Latvia stayed within the planned budget deficit limit of 2.2% of GDP. The President of the National Bank is rather sceptical about the Latvian government's scenario of eurozone membership in 2008.

6. General framework of social dialogue

The concept of 'social dialogue' in Latvia is based on the general idea of an 'institutionalised' exchange of opinions between the social partners and the government, as moderator.

Latvia does not have a long tradition of social dialogue. The Free Trade Union Federation (LBAS) and the Latvian Employers' Confederation (LDDK) were established after independence in 1991. Both LBAS and LDDK took part in the development of new social policy legislation.

The newly created Consultative Council of Social Partners (CCSP) operates at five levels (legislative, executive, professional, enterprise and interest representation).

In some cases local governments organise local tripartite bodies which analyse employment problems, training of the unemployed and labour demand and supply in their territory.

Structure of organisations

Trade unions

Employees are represented by the Free Trade Union Federation of Latvia (LBAS) in dialogue with the government and with the Latvian Employers' Confederation on social, economic and labour legislation

issues. This new independent trade union organisation was established at the beginning of the 1990s. It succeeded the trade unions of the Soviet period, which were founded in May 1945. The new union organisation LBAS redefined its functions and declared its independence of all political parties. Its organisation is fully democratic. LBAS has democratic statutes and is independent of the state.

As regards trade union flexibility (Gruber 2004) there are two main issues: union density and collective agreement coverage. Union density in Latvia is around 25%, while collective agreement coverage is somewhat lower. Both density and coverage differ across sectors. In the state sector, density and coverage are much higher than in the private sector: for example, in education, union density is about 80% and coverage around 66%.

Employers' organisations

One of the main problems of the employers' organisation is that it is almost unknown by the public. This is not surprising since employers independent of the state did not exist before the transformation.

In Latvia, the Latvian Employers' Confederation (LDDK) was founded in 1993 as an umbrella organisation of several branch associations.

In Western Europe one of the main functions of an employers' confederation is to coordinate and organise collective bargaining.

In Latvia the whole machinery and procedures for collective bargaining at branch and national level are still in their infancy. Therefore, one of the tasks of the Confederation (LDDK) is to help establish the collective bargaining system. Specific legislation may be needed for that purpose. This should also facilitate the development of employer organisations at various levels. In contrast to most Central and East European countries, in Latvia there is one employers' confederation which is also a member of the International Organisation of Employers.

The Latvian Chamber of Commerce and Industry (LCCI) is a non-governmental, non-profit organisation that represents the economic interests of entrepreneurs and promotes entrepreneurship. LCCI is a member of the International Chamber of Commerce (ICC). LCCI and the Chamber of Crafts do not conclude collective agreements with trade unions and indeed do not claim to represent their members in their capacity as employers.

LBAS and LCCI are recognised as social partner organisations by the Latvian Cabinet of Ministers (Decree No. 70 of the Cabinet of Ministers, 1993).

7. Public debate and macroeconomic dialogue about euro-zone accession

Macroeconomic dialogue is not a very familiar term among civil servants, employers and trade union experts. To find reliable information on the topic, I searched the web pages of the Latvian National Bank, the Ministry of Economics, the Ministry of Welfare, the main newspapers, as well as NAP Employment and NAP Inclusion, and I interviewed civil servants from the Ministry of Economics, Dept. of Labour, the Ministry of Welfare, Latvian representatives at the EU, and experts from the employers' confederation and the trade unions.

All those interviewed were asked about the existence of macroeconomic dialogue in the field of employment, access to the eurozone and social partner participation in the development of sustainable employment.

No official information on macroeconomic dialogue was available. The term 'macroeconomic dialogue' is not even mentioned in NAPE. The term 'social dialogue' is used in chapters related to the Phare twinning project 'Promotion of bipartite social dialogue'. The project was aimed at facilitating bipartite social dialogue and strengthening the capacity of the social partners. Within the framework of the project, a database

was developed for information on employees, employers and their cooperation schemes at different levels. The project also included such important components as publicity campaigns, developing and distributing printed materials on collective agreements, the importance of social dialogue, and mediation as a peaceful method of resolving labour disputes.

In the chapter on Future Activities, it is mentioned that special attention should be paid to the development of bipartite social dialogue and increasing the number of collective agreements concluded at the sectoral level. It is also mentioned that social dialogue should be one of the objectives of NAPE. However, according to the majority of our interviews with civil servants, social dialogue in the field of employment is mostly formal.

Conclusion: no awareness of and no social dialogue on eurozone accession and its impact

According to the interviews with leading trade union experts (on social and economic issues, the national economy and employment) the trade unions have never been invited to participate in any discussions or decisions concerning eurozone accession. In the Committee of the National Economy, at the Ministry of Economics, trade union experts have emphasised the need to discuss these questions, but with no results.

There has been no public debate on eurozone accession. In late 2004 the Latvian National Bank organised a conference on the issue but the only material from it that has been made publicly available is the presentation of the Bank's president.

So far, the unions have not been involved in any activities related with to eurozone accession, nor have they been actively working on these issues.

The main issues for the trade unions are increasing the minimum wage and raising the basic tax threshold. The unions have tried to make a

contribution to labour law amendments and to have an input in relation to increasing employment in Latvia. However, trade union resources are limited and their contribution to the development of sustainable employment, particularly in respect of the eurozone question, has been almost invisible. At the same time, there have been no serious public debates on eurozone accession or on how the euro might influence employment and the labour market.

Over the last decade the trade unions have officially participated in the Committee on the Joint Inclusion Memorandum (JIM), NAPE and NAPI. However, this participation has been rather formal.

Another trade union objective has been to increase employment in all regions of the country, and they do participate actively in the Committee of the National Economy. The role of the trade unions needs to be improved and made more visible.

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Lithuania: achievements and challenges on the threshold of EMU accession

Tatiana Babrauskiene

1. Overview of the macroeconomic situation

1.1 Stable macroeconomic foundation

Lithuania has put in place a stable macroeconomic foundation from which to approach EMU. During the last decade, Lithuania has achieved macroeconomic stability and positive GDP growth.

Today the Lithuanian economy fulfils all the Maastricht criteria: inflation, interest rates and public deficit (in fact, all are below Maastricht requirements). If the decision were to be taken today, Member States would have to rule that Lithuania meets the requirements for joining the eurozone. The earliest possible date for euro adoption in Lithuania is late 2006 or early 2007. The litas has been pegged to the euro since February 2002 at a rate of LTL 3.4528 to EUR 1.

Table 1: GDP growth (%)

	2000	2001	2002	2003	2004
GDP growth, annual average	3.9	6.4	6.8	9.7*	6.7*

Note: * Provisional data.
Source: Statistics Lithuania; National accounts.

The average inflation rate in 2004 was 1.1% and the projected figure for 2005 is 2.8%. The general budget deficit was 1.9% of GDP in 2003 and 2.6% in 2004, with 2.5% projected for 2005. The government debt figures are 21.6% of GDP (2003), 21.1% (2004) and 21.7% (2005 projection).

Inflation in Lithuania is rather low. It is attributable firstly to the fixed exchange rate upon introduction of the currency board arrangement. The raising of the effective nominal exchange rate of the litas is one of the key factors which has stabilised prices during the past five years. Average annual inflation was reduced from 5.1% in 1998 to 0.4% (on average) in 1999–2003.

A wide range of reforms has made Lithuania's business environment more attractive to investors. Unemployment declined from 10.3% in 2003 to 7.5% in 2004, and the decline continues.

1.2 Major labour market developments

However, macroeconomic stability and GDP growth have not translated noticeably into new employment. On the other hand, the official unemployment level in 2004 was the lowest for the last four years in Lithuania, at 11.4%. The number of unemployed people has been decreasing due to a surge in emigration and the growing production and service sectors.

Emigration is becoming a major threat in Lithuania. The Ministry of Labour announced that as many as 360,000 workers – about one-quarter of the country's working-age population – had left Lithuania by the end of 2004.

In fact, the Lithuanian labour market is quite dynamic, but in the sense that while the job creation rate is quite high, so is the job destruction rate. Since job losses have exceeded job creation, in net terms, the overall outcome has been a decline in total employment. The evidence suggests that small and medium-sized enterprises have created many new

Table 2: Employment rate (%)

	2002 Annual average %	2003 Annual average %	2004 Annual average %
Total employment rate (age group 15–64)	59.6	60.9	61.1
Men	62.3	63.7	64.6
Women	57.1	58.4	57.8

Source: Statistics Lithuania; Labour Force Survey.

jobs, especially in services, trade and some expanding export sectors. However, these have not compensated for the loss of jobs associated with widespread restructuring, or for the stagnation of larger enterprises.

Partly as a result of the high level of restructuring, workers in Lithuania face relatively high job insecurity and difficulties in finding new employment once unemployed. Less skilled workers, in particular, are at a high risk of unemployment, which often is of a long-term nature. Low chances of escaping unemployment are associated with skill mismatches. Some 22% of the unemployed do not find a job because their skills fall short of employer needs. However, wage rigidity at the bottom of the wage distribution scale is another contributory factor. This combination of inadequate skills and a high minimum wage mean that once a low-skilled worker falls into unemployment, the chances of escaping it are low.

Table 3: Employment rate by age group (%)

Age groups	2000	2001	2002	2003
15–24	25.4	22.5	23.6	22.6
25–54	75.0	73.8	76.8	78.8
20–64	65.4	63.9	67.0	68.7

Source: Statistics Lithuania; Labour Force Survey.

Table 4: Employment rate at full-time equivalent (%)

	2001	2002	2003
Total	58.0	60.3	62.0
Men	59.9	64.4	65.8
Women	56.8	65.5	58.4

Source: European Commission data; 2004/2005 compendium.

Table 5: Growth in labour productivity (%)

	2000	2001	2002	2003
Growth in labour productivity	3.9	6.4	6.8	9.0

Source: Statistics Lithuania; National accounts.

Table 6: Real unit labour costs (%)

	2000	2001	2002	2003
Total	–8.3	–6.6	–12.5	1.1

Source: Statistics Lithuania; National accounts.

Table 7: Labour productivity relative to EU-15 (%)

	2001	2002	2003
Per employed person	38.8	43.7	46.9
Per hour worked	–	38.2	41.4

Source: European Commission data; 2004/2005 compendium.

1.3 Major objectives of the National Action Plan for Employment

It is stated in the National Action Plan for Employment of the Republic of Lithuania 2004, which is the first annual report of the Republic of Lithuania to the EU Council and the European Commission, that 'the process of deeper integration of Lithuania's economy into the EU, facilitating integration into the single labour market of the EU, is taking place at high speed'.

The main medium-term goals of Lithuanian economic policy include:

- rapid and sustainable economic growth and a stable macroeconomic environment;
- favourable conditions for business development and successful implementation of structural reforms;
- transparent state governance and political consensus regarding the required reforms;
- a stable and predictable legal environment; and deeper economic integration in the EU.

2. Macroeconomic dialogue in Lithuania

2.1 General overview

The development of macroeconomic dialogue in Lithuania has been attained through continuous improvement of the legal framework and the creation of appropriate institutional structures.

The Labour Code provides the legal framework for social partner involvement in the process of labour legislation through the activities of the tripartite councils and of the bilateral institutions of the social partners and regulates the negotiation, signing and implementing of regional and branch collective agreements. Autonomous social dialogue, especially at sectoral and enterprise level, is promoted and its coverage extended, both in terms of enterprises and percentage of the labour force. However, analysis of the economic situation shows that social dialogue has not been sufficiently exploited for this purpose in Lithuania so far. There exists a relatively long delay (two years) in Lithuania between economic growth and its manifestation in the social and employment sphere, which in fact does not correspond to the aims of social dialogue in an EMU perspective.

The newly adopted provisions on collective labour agreements can be seen as attempts to improve the framework for concluding such agreements at sectoral and enterprise level because collective negotiations which include wages are not very widespread. The social partners are being helped to build up their own research and negotiation capacities. At the tripartite level, ensuring due process within the existing tripartite structures and extending the process to other policy areas contribute to restoring confidence.

However, many observers are sceptical of the impact of the Tripartite Council. Decisions taken by the constituents are rarely reflected in legislation adopted by the Seimas or administrative decisions implemented by the government. The impression is that the government seeks political credit for playing the game of consultation but is not prepared to allow other parties any real influence over the decision-making process.

In addition to the tripartite mechanisms there are other institutions, committees and commissions in which, in addition to the public authority concerned, the social partners' representatives and NGOs have the status of regular members.

In developing social partnership, in January 2003 the government approved the Plan on Measures of Social Partnership between the Government of the Republic of Lithuania, Trade Unions and Employers' Organisations for 2003–2004.

Amendments introduced in October 2003 to the Law on public services by the Seimas created the legal preconditions for negotiating and concluding collective agreements in the public services sector.

In October 2004, after more than two years of debate between the social partners, the Lithuanian parliament finally adopted a law introducing works councils. These new employee representative bodies may be established in enterprises with 20 or more employees where there is no trade union present. The legislation lays down the status of works councils and their composition and activities (and the basis for terminating these activities), and regulates the rights and obligations of works councils and their members, as well as guarantees for the members.

2.2 Social partners' involvement in employment policy and in drafting strategic documents

In Lithuania the social partners participate in the development of employment strategies at national, regional and local level. The trade unions actively participate in discussions on the preparation of draft laws or amendments. They present their suggestions, participate in discussions at Seimas committee meetings, and organise public debates with union members in order to explain the benefits and disadvantages of amendments. In many respects, the current legal regulations on employment are already quite liberal.

One of the most important achievements is the new Lithuanian Labour Code which was largely inspired by the need to conform to EU standards. The social partners were involved in its creation and implementation from the very beginning. The Code introduces new forms

of flexible employment contracts, liberalises conditions related to termination of employment, and foresees the possibility of reducing the minimum wage for specific sectors or groups. Most notably, the Labour Code also seeks to promote social partnership in enterprises, and to build a shared commitment to labour standards and labour mobility among employers, workers' organisations and government. The assumption is that only a collective approach can simultaneously achieve the labour market flexibility that Lithuania needs to continue its rapid structural transformation, while ensuring fairness and equity of treatment for workers across all enterprise segments. However, the trade unions unanimously resisted a suggestion in the draft that elected works councils should have the right to represent employees and sign collective agreements. In the opinion of the unions this amendment would prevent the further development of the labour movement, as well as depriving unions of the possibility of representing employees in collective bargaining.

Union representatives took an active part in the task forces drafting the National Action Plan for Employment (NAPE) which was developed by the provisional commission formed by Republic of Lithuania Government Resolution No. 420 of 15 April 2004 from representatives of the ministries, other institutions and governmental bodies. Trade union representatives were involved in its preparation mostly through consultations. The Ministry of Social Security and Labour coordinated the Commission's work and the development of NAPE.

In implementing the Lisbon objectives, Lithuania carries out a wide range of measures in different fields promoting employment, seeking effective use of state and EU structural-fund financing. Social partners and NGOs are also involved in these processes. For this purpose social partnership institutions have been established and function at national, county, municipal and enterprise level.

The social partners actively participated in preparation of the main document defining Lithuania's policy guidelines in the spheres of the economy, social protection, the environment and other fields until 2015, the Long-term Economic Development Strategy of Lithuania approved by the Seimas in November 2002. In line with the Lisbon agenda, the key goal for Lithuania was defined in general as a knowledge-based and secure society, as well as a competitive economy.

The Long-term Economic Development Strategy of Lithuania until 2015, which is a component part of the National Long-term Development Strategy of Lithuania, defines the goals of Lithuanian economic policy: a sound macroeconomic climate, competitive and rapid economic growth, low unemployment and stable prices. The plan is to promote economic activity and increase employment, creating more favourable conditions for new job creation with a VET system focused on market needs. These measures should create the preconditions for increased opportunities in all aspects of life – economic, social, cultural and political. Investments in education, training and health care should enhance individual capacities (human capital). These goals in a broad sense are compatible with the Lisbon strategy.

The government adopted the National Strategy for Sustainable Development in November 2003, which established the following long-term strategic goals in the field of employment: while developing the economy and implementing economic reform and restructuring, to accelerate the development of economic factors stimulating employment growth and reducing differences between regions, to increase labour market flexibility, to reduce unemployment, to ensure the competitiveness and mobility of the labour force and to create the preconditions for a high employment rate.

The social partners are concentrating their attention on wage levels and the minimum wage in particular. High minimum wages limit employment opportunities for low skilled workers. The minimum wage is high

relative to the median wage and to that of low-skilled workers. As a result, it discourages the creation of low-skill jobs.

Although there are few effective constraints on employment adjustment, the scope for wage adjustment is limited due to the relatively high statutory minimum wage. The major item of indirect evidence on the detrimental effects of the high minimum wage in Lithuania is high unemployment concentrated among less productive workers: young people and the low-skilled. At present the national minimum wage in Lithuania is LTL 500 (EUR 145) per month and LTL 2.95 (EUR 0.85) per hour. These minimum wage rates were established after Lithuania joined the EU on 1 May 2004. About 18% of all wage earners and about 10% of full-time employees are paid at or below the minimum wage. Average monthly gross wages in Lithuania rose by 7.9% in 2004 to reach LTL 1,157.8 (EUR 327). Average net monthly wages increased by 7.5%, year-on-year, to LTL 938.5 (EUR 265). Real wages posted a rise of 4.3% during the period.

While limiting the employment chances of less-skilled workers, the high minimum wage in Lithuania has contributed to the fast pace of enterprise restructuring and productivity improvements. By restricting wage adjustments to the fall in demand for low-skilled labour, the high minimum wage in Lithuania has forced employers to terminate low-productivity jobs, implying a rise in average productivity. The high rate of job reallocation provides support for this view. A high minimum wage would thus explain the apparent paradox that high job turnover coexists in Lithuania with a stagnant unemployment pool. Job turnover is high because employers have to terminate low-productivity jobs and replace them with higher productivity jobs. The unemployment pool is stagnant since low-productivity workers are locked out of employment due to a high minimum wage.

3. Economic and social aspects of euro adoption

3.1 Lithuania joined the Exchange Rate Mechanism (ERM II) in June 2004

A central exchange rate for the Lithuanian litas against the euro and a fluctuation band within ERM II were established on 27 June 2004. The rate was fixed at LTL 3.45280 to EUR 1. Under ERM II, the currency must not deviate by more than 15% plus or minus against the euro.

In 2004 the budget deficit was 2.5% of GDP. The government's Convergence Program estimates that the deficit will be 2.5% of GDP in 2005 and 1.8% in 2006. This means that formally the budget deficit criterion will be met. At the same time, the Central Bank would welcome more ambitious fiscal consolidation. It is also worth recalling that under some circumstances such consolidation could be a necessity.

The Bank of Lithuania announced that the general government debt has been relatively low and stable. It will remain so in the next few years. The debt to GDP ratio will remain at around 20%, which is well below the reference value of 60%. Therefore, the general government debt criterion will certainly be met.

Lithuania is complying with the long-term interest rate criterion. The last 11-year Lithuanian government bond denominated in litas was issued at just a 20 basis points spread over the German Federal Bond of similar maturity. The spread is low, even by convergence standards. Since this criterion is largely a reflection of market sentiment as regards the durability of convergence, no problems are seen in fulfilling it, provided that the previously mentioned criteria are within or sufficiently close to the set bands.

Table 8: Key projections from Lithuania's convergence programme

	2003	2004	2005	2006	2007
Real GDP growth (%)	9.1	7.0	7.3	6.6	6.3
Employment growth (%)	2.0	0.7	1.0	0.2	0.2
HICP inflation (%)	–1.2	0.9	2.0	2.1	2.5
Balance of state budget (% of GDP)	–1.7	–2.7	–2.5	–1.8	–1.5
Government gross debt (% of GDP)	21.5	22.4	22.2	21.4	21.0

Table 9: Economic convergence criteria

	Criterion	Current reference value*	Current value in Lithuania
Exchange rate	Normal fluctuation margins (±15%) respected (for at least 2 years) without severe tensions	3.4528 ±15%	3.4528
Price stability	Average inflation over 1 year does not exceed the rate of the three best performing member states +1.5 p.p.	0.7 + 1.5 = 2.2%	1.9%
Budget deficit	Ratio of government deficit to GDP does not exceed the reference value	3%	2.5%
Debt	Ratio of government debt to GDP does not exceed the reference value	60%	19.7%
Long-term interest rate	Average long-term interest rate does not exceed the rate of the three best performing member states +2 p.p.	4.2 + 2 = 6.2%	4.3%

Note: * estimates by the Bank of Lithuania.
Source: Bank of Lithuania.

3.2 Public opinion

According to the survey conducted by the RAIT market analysis and research group, over two-thirds of Lithuanians are in favour of exchanging the national currency for the euro, with slightly more than a quarter saying that it should be done as soon as possible.

In December 2003, when Lithuania was not yet a member of the EU, 43% of Lithuanians said they disapproved of adoption of the single European currency. According to the poll, 25.6% of people are in favour of exchanging the litas for the euro as soon as possible, 32.5% approve of adoption but also think that this should not be done for at least five years, and 11.5% consider that Lithuania could adopt the single European currency but not for at least 10 years. The poll involved 1,053 Lithuanian residents aged between 16 and 74.

According to Candidate Countries Eurobarometer – Baltic Survey 2004.1, as strong supporters of EU membership Lithuanians also support the policies implemented by the European Union. During the last two years the support for every major EU policy initiative demonstrated by Lithuanian citizens has remained stable. A common defence and security policy among the EU Member States is one of the best supported concepts (7 of 10 Lithuanians support this idea).

Lithuanians have constantly supported the idea of a common European currency, as well as a common foreign policy. It is noteworthy that the share of those opposing the common foreign, defence and security policy, as well as EU enlargement, number 10% at most, while the euro is opposed by a quarter of the population.

Lithuanians expect a positive EU impact on economic development and the fight against unemployment, the issues of major interest to ordinary people. These expectations serve to explain the significant number of those supporting EU enlargement and Lithuania's accession to the EU: the EU-related expectations are associated by

Lithuanians not only with international policy developments but also with the resolution of social problems.

Lithuanians consider that domestic issues, such as housing, pensions, health care and education, will not be affected by enlargement. On the other hand, apart from the expected positive impact on economic development in relation to EU enlargement, other economic issues, such as taxes or inflation, received a more neutral or negative evaluation. Two other issues with negative associations relating to EU enlargement are immigration and crime.

Some euro-sceptics (despite their unpopularity in Lithuania so far) particularly emphasise the threat of EU integration to the national culture and identity. However, Lithuanians are not much concerned by this issue. It is not that it is unimportant; rather they believe that if the Soviet Union could not destroy the national culture and identity, nothing could.

Lithuanians consider that the bulk of the EU budget is allocated in three principal areas: employment and social (indicated by 19% of the respondents), agriculture (17%) and foreign policy, as well as support for other countries (15%). In terms of this evaluation, Lithuanians indicated a slightly different attitude compared to citizens of other new Member States who tend to consider that the EU budget is above all allocated to agriculture and administrative costs (19% – in Lithuania administrative expenditure was indicated by only 9%). Lithuanians put more emphasis on EU budget allocations to employment and social needs compared to other new Member State citizens.

Regarding the EU budget, Lithuanians put less emphasis on budget allocations for employment, social needs and agriculture.

It is noteworthy that a quarter of Lithuanians no little about the EU budget structure (in common with one fifth of those in the EU as a whole). Female respondents indicated employment and agriculture,

whereas male respondents indicated employment more frequently as the principal EU budget line. Young people more frequently singled out foreign policy and foreign aid (21% of Lithuanians who indicated this area were under 30 years old). Rural residents indicated agriculture more frequently than the urban population, while urban residents indicated foreign policy more frequently.

3.3 Arguments in favour of rapid euro adoption

Lithuania has a fixed currency rate. This means that in practical terms it has already lost monetary autonomy and has one foot in the eurozone. This means that it has lost the benefits of the former without obtaining those of the latter : this is one of the strongest arguments for faster euro imposition in Lithuania.

Despite the fact that euro adoption would eliminate even the theoretical possibility of implementing monetary policy measures, euro adoption could be very useful for the Lithuanian economy, business and the general public. The full capital market integration is very important for the country in the following respects:

- the economy will become less sensitive to exchange rate fluctuations;
- the risk of financial instability that frequently emerges on small markets will decrease;
- the prospects of additional capital mobilisation will improve;
- currency conversion costs will disappear and transfer costs will decrease (according to preliminary calculations this will save Lithuanian trade enterprises LTL 250–500 million);
- the risk of devaluation will disappear and interest rates fall.

According to the experience of the present members of the eurozone the euro cash changeover in 2002 boosted average inflation by only 0.1–0.3% and was a short-term phenomenon. In the long term, the impact of the euro has become a permanent factor in price reduction

caused by the elimination of exchange costs and greater price transparency.

One more argument for euro adoption in 2006–2007 is current economic growth in Lithuania. Joining the eurozone should noticeably accelerate economic development because inflows of trade and investment will increase. This would make it possible to cope easily with short-term complications related to euro adoption. According to IMF estimates imposition of the euro in Central and Eastern Europe would increase GDP by an average of 20–25%.

Lithuanians tend to mention the following advantages:

- Euro adoption will completely abolish exchange rate risk, and the Lithuanian financial market will become part of the common financial market of the euro area. This will remove the need for foreign exchange transactions in settlements with the main trading partners in Europe, cut borrowing and transfer costs, and encourage investment and trade. Use of the euro by all of Lithuania's main trading partners will make price comparisons easier, which will promote sound competition and abolish price movements determined by exchange rate changes. These and many other factors should contribute to faster economic growth in Lithuania, job creation and the rise of living standards to EU level.
- Early EMU entry would lead to more foreign investment and further improve the Lithuanian economy. One important factor in GDP growth is development of the private sector through rapid privatisation. Privatisation enables more foreign investment, increasing competition in the banking system (all the banks have been privatised), improving domestic business prospects and sustainable fiscal policy.
- Structural Funds can increase GDP growth by raising productivity. New jobs will be created which will affect the development of trade, transport, warehousing and communications.

- Lithuanian participation in EMU would encourage the integration and convergence of Lithuania's economy with the EU, delivering favourable conditions for stable non-inflationary growth. Being part of the EU means lower interest rates, higher investment, wider opportunities in trade and provision of services throughout Europe, acquisition of advanced 'know-how', disciplined fiscal policy and greater economic flexibility through structural reform.

3.4 Arguments against rapid euro adoption

- To meet the eurozone conditions, Lithuania will have to cut public spending over the next few years. This means that the government will have to break promises to create more jobs and improve pensions and health care.
- By definition, the members have to use the euro, hence they have no possibility of having their own foreign exchange policy (this is a continuation of the fourth convergence criterion). If a member has inflation at a higher rate than the other members, it is bound to get into trouble.
- Joining the euro would damage jobs and prosperity because the government would no longer be able to set interest rates to suit the needs of the Lithuanian economy. Unemployment is far higher in the eurozone countries – on average, roughly double. One of the reasons for this is that these countries do not have control over their own economies and sometimes have to put up with decisions that are bad for jobs.
- Introduction of the euro may lead to large price increases for ordinary everyday essentials.

3.5 Government position and strategy for joining the euro area

Lithuania will probably adopt the euro in 2007, just three years after it joined the European Union. Lithuanian Prime Minister Algirdas Brazauskas said in an interview with weekly business newspaper Semanario Economico: 'I do not see big problems on our road to the

eurozone … The conditions for our entry in the eurozone in 2007 are there.' Brazauskas said that Lithuania's deficit stood at 1.2% of GDP and the public debt was roughly 26% of output. He added that Lithuanian GDP should grow by an average of 5% over the next five years. 'If we maintain these indicators, 2007 is a realistic timeline for entry in the euro', he said.

Prime Minister Brazauskas expects that inflation in Lithuania will be below 2% this year and the country will meet the Maastricht inflation condition for joining the euro in 2007. 'We expect a good budget performance and stability, provided that there are no political cataclysms in our country. I think that, at current oil price levels, this level of inflation would be quite normal' (interview with Lithuanian Radio on 15 March). The Prime Minister did not see any major risks but added that inflation should be a focus of attention. 'We will do everything possible to prevent any sharp increases in consumer prices, although there are no direct measures to curb inflation'. According to preliminary estimates, inflation in Lithuania should not exceed 2.1% this year in order for it to qualify to join the euro zone at the beginning of 2007. In order to comply with the Maastricht convergence criteria, Lithuania must keep its budget deficit below 3% of GDP, inflation within 1.5% of the three best-performing EU countries and interest rates within two points of the same three EU countries.

Both European and Lithuanian experts consider that Lithuania is prepared for this step. The Bank of Lithuania has already initiated the necessary preparations. They are certain that joining the eurozone will be yet another incentive for Lithuanian and foreign investors as it will facilitate transactions and cash flow circulation, and reduce business costs because there will no longer be charges for currency exchange.

Dalia Grybauskaite, Lithuania's European commissioner, when asked 'What are Lithuania's plans for adopting the euro and your views on the Stability Pact problems?', answered:

'For small economies such as ours, for small and open economies, we see more pros than cons in introducing the euro, especially for Lithuania because we are already tied to the euro in a currency mechanism. We are not fluctuating at all, our currency is stably fixed to the euro. Practically speaking, for us euro adoption will mean only a change of name. […]

From this point of view, we are already fulfilling all the Maastricht criteria better than any EU-15 country, based on the five or six indicators available, including budget deficit, unemployment, inflation, interest rates. We had GDP growth last year of 8.9%, our deficit is 1.7%, and so on. So these things are very good news. From this point of view Lithuania is eager to join the ERM mechanism as soon as possible. … For us it is a matter of discipline. We would like to see how our economy will behave.

We do not expect any trouble, either serious or minor. From this point of view the troubles that we see in Europe in general, for example, regarding economic growth, are not due to eurozone membership. The Scandinavian countries seem to be in better shape than Germany and France: some of them are in the eurozone and others not. From this point of view we cannot draw a direct parallel, a direct dependency between growth and euro introduction.

The Stability Pact: there was a time about two years ago when we – and also the Commission – needed to think about it more seriously. Not only to call for countries to take stabilisation programmes seriously but to pay more attention to problems, especially on the budget expenditure side, but also regarding structural reforms which all countries needed, especially in pensions, social security and health, which were started too late and were not very radical in most countries.

The Stability Pact which was unanimously adopted was very good in good times, but today the economies are not in very good shape and it seems that the Stability Pact was not flexible enough to react to challenges from outside. Of course, we are now talking about revision. It is not the best time for that after such discomforting conflicts between countries and the Stability Pact rules. Why? As with any law or economic process, it is a living process, you can't have a dogma and it happened that the Stability Pact was constructed as a dogma.

> I myself am in favour of strict fiscal policies but ones which take into account objective circumstances, including political ones such as living standards. We cannot apply laws dogmatically. So, from this point of view, maybe two years ago was the time to think about some kind of revision of the Stability Pact. Now, of course, it is a little confusing and a little too late and of course we have seriously conflicting national theories, laws and policies. This situation is complicating the Commission's job and the Commission's position in discussing the new constitution and possibly the new position of the Commission as a government of Europe. This also concerns me a little and they are not very good signals to the Commission or to Member States'.

3.6 The employers' position on joining the euro area

The majority of Lithuania's corporate leaders favour euro adoption, which, in their opinion, will simplify settlements with EU Member States. Executives of manufacturing and large companies favour eurozone entry the most, as the latest survey commissioned by the Bank of Lithuania from Baltijos Tyrimai has shown. Introduction of the euro is favoured by 66% of corporate leaders in seven major Lithuanian cities. About 78% of executives in companies with a workforce of 50 or more support the shift to a single currency. Moreover, euro introduction is favoured by 66% of mid-scale corporate executives (10–50 employees) and 59% of small business (1–9 employees) leaders. In the opinion of Lithuania's businessmen, euro adoption would also result in easier travel in EU countries and greater stability on financial markets. Moreover, the shift to a single currency should benefit Lithuania's economy and boost exports. Corporate leaders believe that euro introduction would raise living standards and be more advantageous for comparison of prices of goods and services throughout the EU Member States. Baltijos Tyrimai polled 527 company owners, managers, deputy managers or division managers from Vilnius, Kaunas, Klaipeda, Šiauliai, Paneve□ys, Alytus and Marijampole. The Bank of Lithuania sees 1 January 2007 as the most appropriate date to introduce euro banknotes and coins in Lithuania.

The Lithuanian Confederation of Industrialists in its Public Report of mid 2004 analyses the prospects of euro launch and its positive impact on Lithuanian trade and the economy as a whole, and declares strong support for euro adoption.

Early acceptance into EMU would lead to more foreign investment and further improve the Lithuanian economy. One important factor in GDP growth is development of the private sector through rapid privatisation. Privatisation enables more foreign investment:

- Increasing competition in the banking system (all the banks have been privatised).
- Improving domestic business prospects and sustainable fiscal policy.

3.7 Trade union position on joining the euro area

It should be noted that Lithuania's EMU convergence strategy was not discussed with the social partners. Some concerns were raised by trade unionists from the public sector who argued that the convergence criteria for joining the single currency would have an adverse effect on public spending and in particular on jobs, wages and terms and conditions in the public sector. The question some unionists also ask themselves is whether being inside the euro area would produce more growth and economic stability in the long term than keeping the existing currency, and with it control over interest and exchange rates while completing the restructuring of the economy. Nevertheless, the tone of trade union comments on joining the euro has remained positive. Trade union leaders do not pay much attention to topics related to the impact of the single European currency on Lithuania. There are no major differences between unions on this issue.

Given the extremely low living standards in Lithuania, in social dialogue the trade unions pay particular attention to wages. At company and sectoral level, attention is also focused on reducing the phe-

nomenon of double bookkeeping and informal employment. According to the Department of Statistics, the informal economy accounts for about 15% of GDP in Lithuania. In addition to depriving the state of tax revenues this also deprives employees of social guarantees.

Conclusion

The road to EU membership required a major effort but Lithuania finally succeeded. The economic reforms of the past decade and especially in the period of preparation for EU membership have created a flexible market economy in Lithuania. It is expected that introduction of the euro would yield many benefits. Joining the euro, first of all, means that monetary policy would become more predictable and finances less fragile. It would completely eliminate exchange rate risk, abolish the risk premium included in interest rates, eliminate currency exchange transaction costs and make cross-border payments easier, faster and cheaper. A single currency would further integrate the domestic market. Price differentials on goods and services would become more transparent, and this would enhance competition. What is more, it is predicted that the Lithuanian financial market would become an integral part of the second biggest financial market in the world. The banks would be able to participate in the Eurosystem's open market operations. More generally, euro adoption would fundamentally strengthen the Lithuanian financial system, making it more resilient to financial shocks and stimulating investment and trade, thereby laying stronger foundations for macroeconomic stability and growth.

On the other hand, apart from the concern most often expressed by the public that euro adoption would trigger a sudden price jump, the most significant threat would be the loss of autonomy as regards monetary policy – for example, the exchange rate could no longer be used as an instrument for dealing with economic problems. However, any

inflation which might arise would bear little relation to euro adoption. Monetary reform as such creates neither more nor less money, only the redenomination of economic values: prices of goods and services, financial assets and liabilities, wages and social benefits, and so on. Various studies – for example, by Eurostat – indicate that the inflation increase attributable to euro introduction across the eurozone was very moderate, ranging from 0.1 to 0.3 percentage points.

Lithuania's current rapid development with little deficit spending is evidence of the sustainability of its fiscal policy. Lithuania is currently under the 3% maximum and believes it can remain so in the medium term.

Lithuania's level of general government debt (at the end of 2003) was one of the lowest among EU Member States. Given Lithuania's low debt level and deficit spending below 3%, the government plans to remain fiscally responsible, continuing repayment of foreign and domestic debt and budget deficit financing. The planned tax reform would be based on the following:

- reduction of personal income tax;
- increased tax exemptions (family credit, etc.);
- bringing tax policy in line with EU standards;
- shifting the tax burden from labour to capital.

However, it is still uncertain what impact these measures would have on the economy and society. Lithuania also faces serious demographic challenges:

- With its low birth rate Lithuania is also an aging society, which will have a substantial impact on the pension system.
- If the retirement age increases it is estimated that there will be 7 pensioners for every 10 social security contributors in 2025 and 9 in 2050.
- If the increase does not happen it is estimated that there will be 8 pensioners for every 10 contributors in 2025 and 11 in 2050.

How does this affect the convergence programme? An increase in government expenditure to finance the labour and family support programmes and a decrease in tax revenues from tax benefits to families could increase the government deficit in the future (the deficit cannot pass the 3% limit).

Trade union attitudes

All in all, the unions have been active on the road to EU membership in suggesting changes in macroeconomic policy, employment policy, labour legislation, industry and taxation policy, social security and European integration. The biggest Lithuanian trade union LTUC, as well as two other national unions generally support entry to the eurozone. However, their success in influencing policy has been limited because the trade unions have mostly participated in advisory bodies whose responsibilities are rather limited. Perhaps their greatest achievements have been to establish legislation that promotes collective bargaining and a framework for dispute settlement; an institutional mechanism for social dialogue and annual framework agreements; legislation governing health and safety, social security, redundancy, gender equality and employment.

One of the most important tasks of the trade unions in the field of employment is the creation of a policy environment that will preserve existing jobs and generate new employment opportunities. The social partners have still not come to any agreement on issues such as early termination of fixed-term employment contracts, guarantees to trade union officials, calculation of length of service, or additional annual leave. In practice, there are serious problems with implementing legislation in all these fields due to employers' attitudes, the absence of adequate labour inspection and the slow procedures of the Labour Court. In the course of macroeconomic dialogue, ideas are exchanged on how a policy mix can be achieved that is conducive to growth and employment under conditions of price stability.

On the unions' view, with the introduction of the euro it would be easier to compare employment costs across Europe. Employers would therefore be able to monitor employment cost differentials more easily and employees may increasingly be tempted to use this information as a factor in negotiations on pay and conditions.

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Poland: risks of eurozone accession with particular reference to the labour market

Juliusz Gardawski

1. Macroeconomic situation and impact of enlargement

EU enlargement has had a noticeable impact in Poland, with a number of unexpected effects. Prior to May 2004 the Polish domestic market experienced a sudden growth in demand prompted by consumer fears of prices rising rapidly in the wake of enlargement, and for the remaining seven months of the year exports to the EU expanded very rapidly, and Polish enterprise profits increased. Despite favourable economic conditions, however, no improvement in the labour market occurred.

In the first six months of 2004, economists generally remained unenthusiastic in their predictions for the domestic economy. Towards the end of the year, however, expectations were becoming increasingly optimistic. Nonetheless, their optimism is still tempered by sluggish investment as well as stagnation in the labour market. At the end of the year the financial situation of domestic enterprises turned out to be strong: virtually no debts and substantial savings. Net enterprise profits for the first nine months of 2004 were PLN 46 billion, in comparison with net profits of only PLN 18 billion for the whole of 2003. As one market analyst concluded:

> in the third quarter of 2004 the high pace of economic development shows no signs of slowing down [author's emphasis], contrary to the outlooks which stressed out that exploding sales, propelled artificially by EU

> accession, would have to come to an end. All of a sudden, the economic indicators for the third quarter turned out to be superior to the average indicators for the first two quarters. Such outcomes are at odds with most expectations: the pre-accession boom was widely anticipated to diminish. (Maciejewicz 2004a)

Surprisingly, the economy is continuing to grow. Although the Polish złoty (PLN) is strengthening against the euro, the volume of exports has not shrunk. As much as 80% of exporters maintain profitability: 'successful exports would not have been feasible if borders and tariffs had not disappeared, and the złoty remained so strong. Yet despite a strong złoty, the number of exporting operations has been growing' (Maciejewicz 2004a).

What worries economists is that the growing volume of savings accumulated by enterprises has not yet been transformed into material investments. In the first half of 2004, investments rose only slightly (by 3.5% compared to 2003). Bearing in mind that manufacturing was increasing rapidly, the experts counted on an 8% increase in investments in the second half of 2004 and more than 10% in 2005. Concurrently, employment was expected to recover. However, current data do not reveal any improvements in the labour market. According to the experts, all the initial conditions for investment have already been met: enterprises maintain profitability and a high level of demand seems likely to endure. Enterprises are also utilising most of their production capacity (80%). Why have investments and employment then remained stagnant? A number of answers have been proposed. In general, the hypotheses fall into two categories: the first point to political and legal considerations as the major reasons for the failure, and the second focus on economic factors.

The 'political and legal' standpoint mainly concerns the relatively unstable political and social environment and the unpredictable nature of future government policy on the private economy. No one should entirely rule out the possibility of a populist coalition taking power

after the upcoming parliamentary election and then pursuing a campaign against so-called 'klepto-privatisation'. The assets of many private enterprises were acquired from the state in the course of privatisation, and so at least a part of the business community in Poland might feel anxious about possible investigations into the origins of their fortunes. Concerns of that kind could motivate a number of entrepreneurs to secure their capital in banks or the stock market instead of investing in business. Moreover, the instability and unpredictability of the legal environment (tax law, in particular) has also provoked serious criticism. The recent introduction of a new income tax bracket (50% of gross income) for the wealthiest has only reinforced the above-mentioned reservations. New tax regulations are widely perceived by the business community as a political weapon for use in the 2005 parliamentary election campaign.

The 'economic hypothesis' points out widespread concerns about the macroeconomic environment in which Polish enterprises operate. A great deal of concern has been expressed about a likely ending of the 'honeymoon period' with the EU marked with enforced compliance with restrictive regulations, for example concerning 'tax harmonisation' within the Community. Furthermore, small and medium-sized enterprises (SMEs) in Poland are eagerly awaiting structural fund disbursements and subsidies. According to the employers' associations, until SMEs have access to these resources, there will be no new investments on their part.

Experts generally agree that ongoing economic prosperity will eventually trigger new material investments. It remains to be seen, however, whether growing investments will result in any noticeable improvement in the labour market.

2. Labour market trends in relation to economic development

The post-transformation years can be divided into four periods on the basis of the correlation between unemployment and GDP: in some

periods GDP growth led to a decrease in unemployment, while at others no such pattern emerged.

The development of unemployment for the whole transformation period can be seen in Table 1.

Table 1: Total unemployment and unemployment rate (1990–2004)

Years	Number of unemployed ('000)	Unemployment rate at end of year
1990	1 126	6.5
1991	2 156	12.2
1992	2 362	13.5
1993	2 427	14.0
1994	2 474	14.4
1995	2 277	13.3
1996	2 108	12.3
1997	1 923	11.2
1998	1 816	10.6
1999	2 391	13.9
2000	2 785	16.1
2001	3 170	18.2
2002	3 431	19.9
2003	3 329	19.6

Source: BAEL GUS/ Labour Force Survey by the Central Statistical Office (Za: 'Krajowy Plan Działań na Rzecz Zatrudnienia na 2005 rok'/ cited after the National Action Plan for Employment 2005).

2.1 1990–1993: unemployment rate climbs during economic recession

Before transformation Poland's economy was in deep crisis and suffered from high inflation. In 1989 a 'shock therapy' model of economic reforms was adopted, at the expense of incremental change.

The reintroduction of a market economy marked the beginning of restrictive policies directed at state-owned enterprises, which were faced with the need to adapt quickly to a stormy environment. Ultimately, enterprises were forced to take such steps as freezing salaries and laying off employees. Along with the weakening of economic ties with the COMECON countries, the state-owned sector got into extreme difficulties. As a result, Poland had the fastest growing unemployment in Europe. Between 1989 and 1991 the annual increase in unemployment averaged 1 million, which translated into 6% of the working age population.

Facing the prospects of massive unemployment and fearing a potential outbreak of social discontent, the government decided to extend a relatively wide umbrella of social protection over the jobless. In December 1989, in a move to establish the legislative framework enabling implementation of the necessary reforms, the first batch of new laws on social and economic issues was passed by the parliament. This legislative package contained a bill granting the unemployed a number of benefits, including the right to apply for unemployment benefit only seven days after registering with an employment office. For the first three months an unemployed person would receive 70% of their final pay, while for the following six months they would receive an amount equal to 50% of previous earnings, which would later be reduced to 40%. Notably, the period during which unemployment benefit could be claimed was practically unlimited: until the person either found a new job or reached retirement age. Moreover, unemployment benefit could not be lower than the statutory minimum wage. Last but not least, the new legislation also allowed people without any personal history of employment to apply for benefit.

The law of December 1989 proved to be effective in terms of easing the traumatic effects of emerging unemployment. In the following year the government decided to reduce the substantial cover initially offered to the unemployed. This move could not be avoided, not only due to

the heavy burden of social expenditure on the public finances, but also for social reasons: in particular, the right to collect unemployment benefit became temporary (up to 12 months) and a number of further restrictions were introduced. Another aspect of the 1989 legislation should be emphasised: by creating easy access to financial support the law may have boosted unemployment in 1990.

2.2 1994–1997: unemployment falls as the economy recovers

Between 1994 and 1997 the Polish economy recovered and the negative trend in the labour market was reversed as well. Both investment and demand were increasing. In just four years GDP grew by 27.4%. Economic prosperity was reflected in the job market (GDP growth of 1% led to the creation of 41,000 new jobs). Thus employment increased by approximately 1.1 million. The vast majority of new jobs were created by 'traditional industries' such as manufacturing, construction, agriculture and transport, still dominated by out-of-date, labour-intensive technologies. At the same time, employment volume in the service sector did not grow as much as expected. Finally, falling unemployment should also be attributed to the introduction of more restrictive measures on unemployment registration.

2.3 1998–2001: unemployment rate rises again as the economy grows more slowly

In 1998–2001 economic growth slowed down as a result of a restrictive monetary policy combined with other measures intended to prevent the outbreak of a Russian-style financial crisis. Despite these unfavourable circumstances GDP grew by 14.6% but at the same time 1.4 million people lost their jobs. Two major reasons behind this trend could be identified: first, technological modernisation of domestic enterprises, and second, lack of significant development of the service sector. In 1999 the government launched a pensions system and health care reforms and a new rule was introduced: in order to retain the right to public health care the unemployed were required to register with an

employment office. According to an analysis carried out by the Institute of Labour and Social Affairs (Instytut Pracy i Spraw Socjalnych, IPiSS) (Kryńska, 2002), new regulations prompted a number of people employed in the shadow economy to register despite the fact they were no longer entitled to benefits.

2.4 2001–present: accelerating economic growth but continuing high unemployment

In late 2001 a new left-wing government declared that GDP growth would accelerate: in 2002 GDP would increase by 1%, in 2003 by 3% and in 2004 by 5%. Concurrently, the government officially predicted that unemployment would fall provided GDP growth reached 5%.

The economy met these expectations as GDP growth exceeded the forecasted 5% level as early as 2003 and was likely to continue to increase. It is difficult to determine, however, how much credit for the country's economic well-being should be given to the government. On the one hand the government's responsible policy definitely supported economic expansion but on the other hand various external forces (EU accession, global markets, and so on) also boosted growth. Nevertheless, improving economic conditions had no positive impact on the labour market. The government proved to be largely incapable of stimulating employment. The ongoing economic growth thus goes hand in hand with stagnant employment.

3. Major reasons for high unemployment in Poland

The labour market in Poland has three main characteristics:

1. the unemployment rate, at 19%, is one of the highest in the OECD, while the employment rate, at 51.2%, is among the lowest in Europe (as of September 2004, data by Eurostat);
2. Poland belongs among the countries with exceptionally long working time (according to public opinion surveys, the average person

works as many as 45 hours per week, despite labour-law stipulations that the maximum statutory working week is 40 hours);
3. the shadow economy accounts for a relatively large part of the labour market.

This suggests that the government is failing to influence key aspects of the national economy.

The introduction of flexible employment arrangements has not stimulated employment growth. In a report on the labour market published in 2004 (Grotkowska, Socha and Sztanderska 2004) the authors seek to explain why considerable GDP growth combined with labour market liberalisation has not yet altered the level of unemployment. One reason is the labour market liberalisation itself, which is described as random and incomplete. The authors also claim that the social partners, by refraining from mutual cooperation, have deprived themselves of an opportunity to develop a common vision of how to transform labour relations in Poland.

Another assumption made by the authors (and shared by a number of experts: for example, Gadomski 2004) is that the labour market remains overly rigid and the extent of flexible working arrangements currently allowed by law is too narrow. The supposed over-rigidity of the labour market is due to such factors as an excessive statutory minimum wage, overregulated collective agreements and inflated redundancy compensation, as well as complicated fiscal and social security systems. For those reasons, enterprises have been hesitant to hire new employees, choosing instead to build up labour productivity and extend working hours for their current staff.

Overly rigid labour market regulations work in favour of the employed but against the interests of job-seekers, especially unemployed youth. In this regard trade unions are often criticised for defending the interests only of those in a job and ignoring the needs of the jobless.

It appears that allowing flexible working arrangements in the labour market does not automatically result in employment growth. Being aware of difficult conditions in the labour market, employees are willing to work harder, longer and for reduced wages in order to keep their jobs. Consequently, employers are less likely to cut employment, although from their point of view redundancies are less costly now than a few years ago.

In contrast, the trade unions point to the available labour market data and argue that in fact there is a positive correlation between the degree of labour market liberalisation and the unemployment level: the more liberal the regulations, the higher the unemployment (and vice versa). Not surprisingly, the trade unions cherish traditional Keynesian recipes for fighting unemployment by boosting consumers' purchasing power, hence causing domestic demand to expand. In order to achieve that, the statutory minimum wage should be raised.

Shadow economy and unemployment

A number of domestic and international experts and entrepreneurs believe that increasing economic growth will lead to a shrinking of the shadow economy in Poland. According to official estimates by the Central Statistical Office (GUS), Polish GDP for 2001 including the shadow economy would rise by 14.6% of GDP, while the same figure for 2002 would be 13.4% (Rzeczpospolita, 17 April 2004). Data obtained from other sources puts the size of the shadow economy at a higher level than official CSO estimates. For instance, Friedrich Schneider of the University of Linz estimates the shadow economy's contribution to Polish GDP at 27.4% in 2000/2001, 26.3% in 2003 and 25.1% in 2004 (forecasts). The Austrian expert assumes the extent of the shadow economy to be twice as large as the official statistics report. On the other hand, the shadow economy's size in Poland is similar to Italy and slightly lower than in Greece. Thus the Polish shadow economy cannot be branded as excessive when compared to the situation in the EU.

The Annual Labour Force Survey for 2003 carried out by the CSO revealed 924,000 undeclared workers. The Ministry of the Economy goes further in their estimates, assessing the number of shadow-economy workers at 1.4 million (National Action Plan for Employment 2005: 37). Finally, in the late 1990s the Institute of Labour (and Social Issues) estimated the number of illegal migrant workers at no fewer than 1 million (each month around 100,000 foreign workers engaged in undeclared work).

Journalists have also cast some light on the extent of undeclared work: in late 2004 the shadow economy in Warsaw alone employed 200,000 people: 'There are Ukrainian housekeepers and construction workers, and Vietnamese traders. But Poles can be found there too' (Gazeta Wyborcza, 14 December 2004).

As sociological research conducted in April 2004 reveals, 21% of the working population (that is, 12% of the general adult population) admitted to income from the shadow economy within the last 12 months (identified from the response 'I happened to work in the shadow economy') (Sopot Social Research Office (PBS), April 2004).

What are the reasons for the recent shrinkage of the shadow economy? The Polish Confederation of Private Employers (Polska Konfederacja Pracodawców Prywatnych, PKPP) believes there were two major incentives for domestic enterprises to leave the shadow economy in 2003 and 2004: first, the corporate income tax (CIT) rate was reduced substantially (to 19%) and second, liberalization of the Labour Code matching the expectations of small enterprises. PKPP estimates the number of businesses prompted to leave the shadow economy by these favourable developments may be as high as 150,000. In late 2003, PKPP carried out extensive research into private businesses which produced the following results: legally operating companies were hiding 17.4% of their revenues from the tax authorities (the same figure for 2002 was 20.2%), and were employing 15.4% of their staff without

labour contracts (in 2002 – 18.6%). The Institute for Market Economy Studies (Instytut Badań nad Gospodarką Rynkową, IBnGR), a top think-tank in Poland, takes the view that businesses leaving the 'grey' zone could be a significant reason for the leap in official economic growth (Rzeczpospolita, 17 April 2004).

In 2004 a number of phenomena came to the surface which made the public realise how complex unemployment is in Poland. One important feature of Polish unemployment is the fairly high number of formally unemployed who in fact work in the shadow economy. There are various reasons for people engaging in undeclared work. According to press coverage in 2004, two major reasons for doing so are (i) the nature of domestic labour markets (in traditional manufacturing centres with specific industrial monocultures the number of shadow economy workers is high) and (ii) the proximity of the German border. The latter has led to seemingly peculiar consequences: in 2004 there were a number of cases of newly established entities located along the German border (with an official unemployment rate as high as 30% in some districts[1]) experiencing serious problems filling vacancies. The reason behind the reluctance shown by the local unemployed was simple: the wages offered only slightly exceeded the minimum wage and so were far lower than the money the unemployed could make by working illegally in Germany. Notably, the Deputy Director of the Lubuskie Voivodship Employment Office in Zielona Góra (a voivodship with a registered unemployment rate of 27%) has declared that about a third of the 100,000 registered unemployed in the voivodship would not accept any such job offers because of their employment in the shadow economy. The situation in the remaining voivodships in Western Poland is the same. In the same Lubuskie voivodship soon after 1 May a joint Polish–English job agency seeking cooks, nurses, construction workers and cleaners was established. Despite the attractive conditions

1 Hereafter 'powiat'.

offered, including minimal language proficiency requirements, many offers met with no response (Rewiński 2004). In Warsaw large chain-stores struggle to fill vacancies because they are unable to compete with the shadow economy in financial terms: a person can make twice or even two and a half times as much in the shadow economy (Gazeta Wyborcza 15 December 2004).

Other surveys suggest than the estimates presented by the Ministry of Economy and Labour, according to which one third of all the unemployed in Poland perform undeclared work, may not be exaggerated.

4. Employment policy: the National Action Plan for Employment 2005

There were two major drivers behind preparation of the National Action Plan for Employment 2005 (hereafter, NAPE). First, NAPE was drawn up in accordance with the guidelines included in the European Employment Strategy, accepted by the Council of Europe on 22 July 2003 (2003/578/EC), which obliged Member States to implement its objectives at national level. Second, the government was required to prepare the Plan by the Act on Employment Promotion and Labour Market Institutions of 20 April 2004. In previous years subsequent governments had delivered a number of programmes on the labour market but NAPE represents a new qualitative level in terms of its nature and extent. The authors' primary intention was to achieve a synergy of activities beyond ministerial and sectoral divisions (NAPE: 1).

In the course of the preparation of NAPE the social partners played a crucial role. When the initial draft was ready, it was reviewed by the Tripartite Commission. The feedback was substantial. Comments were considered at the next stage of the drafting process. At the meeting of the Tripartite Commission in October 2004 deputy-minister Kulpa

admitted that the comments and remarks provided by the social partners had had an impact on the final document and had also helped the Plan win the support of the major trade unions and employers' associations. In this context, a highly appreciative opinion on NAPE expressed by the All-Poland Trade Union Alliance (Ogólopolskie Porozumienie Związków Zawodowych, OPZZ) is noteworthy.

4.1 The major foci of the National Action Plan for Employment 2005

NAPE was drawn up in line with the list of ten employment guidelines included in the European Employment Strategy and designed as measures to assess key features of employment policies in the EU countries. In Poland NAPE preparation consisted of the following steps: first, each guideline was set against the current situation in Poland to help establish a diagnosis of each area, after which the tasks required to improve the situation were formulated; finally, the expected results were defined.

4.1.1 Active and preventive measures for the unemployed and inactive

Youth activation is a priority task. The youth unemployment rate is expected to fall from 41.1% in the fourth quarter of 2003 to 31.5% at the end of 2006. This should be achieved by involving approximately 500,000 persons a year in various programmes. Combating long-term unemployment is another crucial task. Measures will include vocational guidance and job placement, training in job-seeking skills, vocational and on-the-job training, subsidised employment and lump-sum grants for business start-ups. As a result, the share of the long-term unemployed in total unemployment should fall from 50.3% in 2003 to 44.0–45.0% in 2006. Among the expected results the most important would seem to be raising the number of people taking advantage of vocational guidance services (from 320,000 in 2003 to approximately 400,000 in 2005).

4.1.2 Job creation and entrepreneurship

The SME sector accounts for nearly half of GDP and total exports and employs slightly over 7 million people (68.1% of all those employed outside agriculture, forestry, fishery and aquaculture). The development of SMEs is constrained by such barriers as high general costs and administrative obstacles. As a result, the level of investment is low and opportunities for absorbing the latest technical and technological developments are scarce. It is expected that financial support provided to approximately 5,000 enterprises should result in an increase of investment in SMEs of about 3% and to the creation of roughly 18,000 new jobs by 2006.

4.1.3 Address change and promote adaptability and mobility in the labour market

Despite high unemployment, there is growing demand for highly qualified and educated employees. Under Guideline 3, seven tasks have been identified. The first is personnel development for a modern economy, which is supposed to bring an annual increase in the number of employees undergoing training of at least 60,000. The number of trainees obtaining new vocational qualifications and skills is expected to grow by at least 40,000 every year.

The next task is the promotion of flexible employment. Employers and employees are still unaware of the significant modifications of labour legislation in Poland intended to facilitate flexible forms of employment. Another task listed under Guideline 3 is the vocational reorientation of persons threatened by restructuring. It is assumed that approximately 35,000 people will participate in various projects, of whom 18% will find new employment.

Implementation of the EURES system is another important task. The objective is at least 20 recruitment actions paving the way for Polish citizens to find legal employment in other EEA countries.

4.1.4 Promoting human capital development and lifelong learning

Promotion of lifelong learning in Poland faces the serious obstacle of a society which is already fairly well educated. After 1989 the demand for higher education increased: while in the 1990/1991 academic year the number of students was 403,800, by 2003/2004 the number had more than quadrupled, reaching 1,859,000. In the upcoming academic year of 2005/2006, the number of students is expected to grow once again, climbing to 1,996,000. In Poland, 49% of people aged 25–64 have completed at least secondary education: if the vocational school graduates of the same age cohort were included, the figure would rise to 79%.

4.1.5 Increasing labour supply and promoting active ageing

Rural areas in Poland constitute an enclave of unused labour. In the fourth quarter of 2003, 32.9% of all the unemployed were rural residents. At the same time, the general employment rate for the rural population amounted to 46.8%. Rural residents also made up 36% of the economically inactive population. The other large group pushed out of the labour market is the elderly. Before the mid-1990s favourable conditions existed for leaving the labour market before reaching retirement age. As a result, in the fourth quarter of 2003 the employment rate in the 55–64 age cohort was a mere 27.2%.

In this context, there are two major tasks: (i) promoting economic activity among the rural population and (ii) promoting the economic activity of persons above 50 years of age.

4.1.6 Make work pay through incentives to enhance the attractiveness of work

In Poland tax and similar burdens are relatively heavy and unevenly distributed. In this regard, employees working on the basis of an employment contract and employers of such employees are the most disadvantaged groups. The statutory gross minimum wage amounts to PLN 824, but the net amount paid to the employee is only PLN 603, while

the employer incurs a total cost for such an employee of PLN 1,000. 'It means that persons … not able to generate a product worth at least 1,000 PLN have few opportunities for declared employment. This results in high structural unemployment accompanied by an increase in employment in the "grey sphere"' (NAPE, p. 36). The difference between net earnings and the cost incurred by the employer is referred to as the 'tax wedge'. It is likely that a reduction in the tax and social insurance burden related to persons on the lowest wages would significantly increase their employability.

4.1.7 Transforming undeclared work into regular employment

In order to reduce the size of the shadow economy, employment inspection should be strengthened and more favourable conditions created for legal employment. The latter objective is to be achieved through simplification of the tax system, introduction of more flexible conditions of recruitment and dismissal, and regional diversification of the minimum wage.

4.2 Other government unemployment initiatives

In December 2004 the government proposed a scheme under which special grants would be awarded to investors whose enterprises created at least 100 new jobs. Employers criticised the idea, calling instead for general corporate tax cuts. The Ministry of the Economy and Labour presented another project concerning activation of the long-term unemployed no longer entitled to unemployment benefits and collecting welfare (the situation of 86% of all the unemployed in Poland). Under the project, the long-term unemployed whose rights to unemployment benefits have expired will be offered public works (at least 10 hours a week paid at a minimum PLN 6 per hour and co-funded by central and local government). Refusal to accept such employment will result in termination of the person's right to welfare. Another sanction under discussion is removal from the employment register (*Rzeczpospolita* 21 December 2004).

The Ministry has prepared a number of other projects. From the long list, two proposals are especially noteworthy. First, it has been proposed to grant health care insurance to all citizens, regardless of their labour market status. Thus, shadow economy workers will no longer register as unemployed in order to retain the right to public health care. Second, taxes on household help will be radically reduced in the hope that 'informal' work in that sector will be reduced and fewer of the workers concerned register as unemployed.

4.3 The employers' views on NAPE

Employers complain constantly about institutional barriers such as excessive employment protection, long periods of eligibility for unemployment benefits, excessive trade union power, inefficient employment services and excessive tax burdens as major reasons for continuing unemployment. While the business community generally supported the idea of the 'tax wedge' reduction, they were afraid such a reduction could be used as a cover for introducing even more complicated fiscal regulations, leading eventually to further increases in labour costs. Employers have responded enthusiastically to any proposal increasing flexibility of employment and the development of temporary staffing agencies. In the employers' view, any obstacles preventing the expansion of temporary agency work should be removed. They have also suggested reforming employment services by opening up labour market services to non-public entities. The employers have also encouraged decision-makers to follow the leading European economies by increasing investment in research and development, as well as in human capital.

4.4 The trade unions' views on NAPE

In general, Solidarity agrees with the priorities laid down in the EES guidelines, but at the same time expresses reservations concerning the details of NAPE. Two consecutive amendments of the Labour Code intended to stimulate job creation did not match expectations, so why

would further enhancing flexibility in the labour market help? The union stresses that 'Poles work longer hours and increasingly efficiently for less and less money. And everyone suffers: employees, their family, their future pension and also the state budget'. Moreover, according to Solidarity, NAPE lacks clearly defined objectives (both quantitative and qualitative). Last but not least, the alleged vagueness of some NAPE provisions threatens to remove some unemployed from the unemployment register and strip them of their rights to social security or vocational activation. Finally, Solidarity focuses on the issue of quality of work, maintaining that only 'worthwhile jobs' (as opposed to minimum wage posts) guarantee any improvement in the labour market, The other two national trade union centres, Trade Union Forum (Forum Związków Zawodowych, FZZ) and OPZZ, have expressed only minor objections to NAPE. The OPZZ leaders have noted that this is the first time an official document presented by the government has presented specific tasks and objectives.

5. Poland and EMU

Joining EMU (economic and monetary union) became a topic of public debate as early as 1997, when the National Bank of Poland (Narodowy Bank Polski – NBP) first addressed the issue. For seven years, NBP has advocated Poland approaching the eurozone in the shortest possible time. Most Polish economists share this view.

The pro-euro faction argues that the new Member States entering EMU will appear more attractive in the eyes of foreign investors. Staying outside the eurozone will therefore hinder national economic development. Therefore, introduction of the euro should be treated as the top priority, even at the expense of certain social sacrifices. The President of the National Bank has repeatedly voiced the 'euro as soon as possible' idea.

Meeting the Maastricht criteria on acceptable levels of budget deficit, public debt and inflation will require an enormous effort on the part of

Poland and the other new Member States, all of which are troubled by high levels of budget deficit and public debt. Public finance imbalance has been a constant worry for successive governments, prompting tax increases and expenditure cuts. This has brought only temporary relief. By the time the AWS (Akcja Wyborcza Solidarność) government stepped down, the national budget was under significant pressure (the Minister of Finance spoke of a deficit as high as PLN 60–100 billion, in comparison with a total budget of PLN 140 billion). When the new left-wing government took power in 2001, new efforts directed at budget deficit reductions were launched. Grzegorz Kołodko, the Deputy Prime Minister and Minister of Finance in 2002–2003, prepared a programme for reviving the public finances. However, his attempts to force the programme through failed, leading to his resignation in May 2003.

In late 2003 Jerzy Hausner, Deputy Prime Minister and Minister of the Economy, formulated another plan (the so-called 'Hausner Plan'). The plan included a wide range of potential public spending cuts. Due to firm opposition in the parliament, many of the initial proposals had to be sacrificed, but the government managed to secure from MPs sufficient support for the plan's basic provisions. Implementation of basic measures aimed at rationalisation, alongside the revival of the national economy in 2004, may cause the budget deficit to fall below forecasts.

In May 2004, the Ministry of Finance designed a strategy for meeting the Maastricht criteria and joining the Eurozone by 2009, which met with the approval of the EU Ministers of Finance. According to the programme, the budget deficit was to be reduced from 5.7% of GDP in 2004 to 4.2% in 2005, 3.3% in 2006 and 1.5% in 2007, which should allow Poland to enter the ERM II in 2007 and, finally, in 2009 to replace the national currency with the euro. Due to economic growth accelerating beyond expectations, the government decided to update its original targets for combating the budget deficit in September 2004: the deficit is now set to be reduced to 3.7% (instead of 4.2%, as origi-

nally planned) of GDP. Attaining that goal will also allow Poland to maintain public debt below 60% of GDP.

Poland faces another obstacle on the road to the eurozone, namely Open Retirement Funds (Otwarte Fundusze Emerytalne, OFE). In line with the methodology currently employed in Poland, the OFE are seen as part of the public sector. However, the financial means controlled by the OFE are not treated as public in EU statistics. Using the Eurostat methodology, Poland's budget deficit turns out to be 1.5% higher than the official figure announced by the government. In these circumstances, Poland may not be able to fulfil the Maastricht criteria even by 2009. The issue was discussed at the EU Ministers of Finance summit in the second half of 2004, and the current Polish minister Mirosław Gronicki hoped his arguments for including the OFE in the public sector would be taken into account (Sołtyk 2004). There seems little chance of this, as Polish statistics will eventually have to comply with the EU definition.

When discussing the pros and cons of Poland joining EMU, public attitudes to European integration should also be considered. First, EU accession in May 2004 was well received by the majority of Poles. To date, the bright side of EU accession has mostly eclipsed the less favourable aspects of membership. Second, most Poles seem to have crossed a psychological barrier that could otherwise have hindered euro adoption. With the US dollar falling dramatically, Poles have gradually been losing trust in the currency that once dominated the domestic financial market (Bielecki 2004).

However, although the idea of a rapid shift to the euro receives widespread support, opposing voices can also be heard. A number of influential economists have warned of rushing into the eurozone, arguing that despite unquestionable long-term benefits for the country, in the medium term adoption of the euro may cause painful side-effects. As Edmund Pietrzak, an economic advisor to the President of Poland,

claims, Poland should not convert to the euro sooner than 2010–2011, giving way to a number of smaller new Member States such as Slovenia, Estonia, Lithuania, Latvia and Malta. Along with several other experts, Edmund Pietrzak points out that striving to meet the Maastricht criteria may cause such detrimental consequences as a slow-down in GDP growth and a rise in unemployment, which is already very high. There is sound evidence to back up this thesis: as NBP was successfully battling inflation in 2000–2003, GDP growth suffered a setback (Pietrzak 2005).

A lot of attention has also been drawn to the fact that the eurozone countries' economic performance has not been very impressive: GDP indicators have been increasing at a slower rate than in the 'old' Member States outside the eurozone (Denmark, Sweden and the United Kingdom), as well as in the new Member States. Furthermore, the eurozone countries have slowed down economically since adopting the euro.

As a result, government officials appear less enthusiastic about the euro than NBP representatives. In an interview given to *Rzeczpospolita* on 5 November 2004, Minister of Finance Mirosław Gronicki observed:

> NBP maintains the view that the sooner the euro is adopted, the better. We [the government] reply: all right, but not at any cost. The Finance Ministry wants the fairly high pace of economic growth to continue, macroeconomic stability to be sustained and unemployment to gradually decrease. The central bank is preoccupied with keeping inflation low – GDP growth is not a goal of primary importance to them.

A pragmatic, British-style attitude towards the euro has been gaining prominence in the public debate: the 'euro as soon as possible' approach is now counterbalanced by the 'euro at the right time' position.

Conclusion: run-up to EMU without social dialogue?

Meeting the Maastricht criteria for EMU means cutting inflation and keeping the budget deficit below 3%. All these requirements would mean painful cuts in government expenditure. The experiences of all countries show that EMU adoption has major implications for workers' living conditions. In some of the social pacts agreed in different countries, government and business organisations have pressured the working class to accept wage moderation, pension reform, and more flexible labour market rules in return for a commitment to reduce unemployment and promises that moderation now would be repaid in the future, when the improved conditions supposedly resulting from EMU would finally make it possible.

Despite social dialogue making constant progress, no social pacts have been concluded in Poland. There are numerous social dialogue institutions: the Tripartite Commission at the national level, sectoral and regional commissions, and dialogue bodies established at some ministries. However, for various reasons the Tripartite Commission has not evolved into a forum in which social pacts resembling those concluded in Western Europe or in the Czech Republic or Slovenia are signed. Since 1989 the only social pact in Poland has been the Pact for State-Owned Enterprises of 1993, which among other things established the Tripartite Commission. It should be remembered, however, that the primary objective of the pact was to ensure trade union consent for privatisation of state-owned enterprises in exchange for relatively large shares in privatised companies being handed over to the employees. However, no subsequent social pacts emerged.[2]

2 With the sole exception of an unwritten agreement between Solidarity and the government, backed by the AWS (a political body of the union which held power in 1997–2001) regarding four structural reforms (pensions, education, local government and health care). Solidarity unilaterally (without the consent of the other unions) agreed to support the reforms to ensure society's interests were satisfied.

In 2003 the Deputy Prime Minister/Minister of Labour, who is also chairman of the Tripartite Commission, invited the social partners to negotiate a complex pact on sustainable socio-economic growth. The government's proposals regarding public finance revival would also be the subject of a debate within the Commission. The trade unions (Solidarity in particular) remained reluctant and despite long negotiations no agreement was reached.

Labour Ministry officials and some trade union leaders revealed that the issue of EMU accession was not on the agenda of the Polish Tripartite Commission.

No specific position regarding introduction of the euro has been formulated by the trade unions. There is no awareness of the problem in trade union circles. Branch agreements concentrate on problems of restructuring in industrial sectors (such as coal mining, metallurgy, railways). The major purpose of these agreements was to provide social cover for those being laid off.

It is difficult to determine whether the unfavourable climate for social pacts in general (and Polish entry into EMU in particular) will improve. If conditions remain unchanged, Poland is likely to join EMU without any social pact and decision-makers in the trade unions will probably avoid binding themselves to any obligations resulting from a voluntary agreement.

Given the high level of social tensions and the particular problems of the labour market, one might wonder why so little attention is being paid to the potential risks of forced adoption of the euro. One might also wonder how the ambitious targets laid down in NAPE and supported by the social partners can be matched with the current agenda of entering the eurozone.

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Slovakia: run-up to the eurozone

Ludovít Czíria and Ján Košta

1. Macroeconomic overview

It is not only the ambition but also the obligation of the new Member States to enter Economic and Monetary Union (EMU). In this connection it is important to understand the consequences of fulfilment of the Maastricht criteria with regard to employment and other areas of economic and social development, and to focus on whether the process of introducing the euro will be painless or Slovakia will have to pay a high price. What policies should be adopted during the period of fulfilment of the Maastricht criteria so that the consequences of euro introduction will do the least harm in the social sphere? Finally, will the Slovak government be able to choose from a range of policy options in the economic and social areas? And at what price and with what consequences? The aim of the present chapter is to characterise Slovakia's initial state after EU accession in relation to fulfilment of the criteria for eurozone accession.

The state of fulfilment of the Maastricht criteria in the Slovak Republic

Fiscal policy

Fulfilment of the criteria for EMU entry related to fiscal policy will probably be one of the most difficult tasks in the whole process given the possible social consequences. The problem here is the sustainability of the state budget deficit and the national debt.

The state budget deficit, in common with other areas of economic and social policy, has so far been influenced by the four-year political cycle. The political parties forming the government coalitions have not felt able to cut social benefits and to liberalise price controls on some products and services. For example, liberalisation of energy prices and VAT increases on foodstuffs were postponed in 2002. This has influenced inflation and the state budget deficit.

The value of the state budget deficit depends to a great extent on the chosen method of calculation (GFS, the IMF methodology; ESA 95, the methodology of the European System of National Accounts). The difficulty of evaluating the criterion of the state budget deficit as a proportion of GDP results from the fact that fiscal processes have been influenced in recent years by vast extraordinary and occasional revenues and expenditures. Among the most important state budget items of this type belong privatisation revenues, the honouring of privatisation bonds, the costs of restructuring industry and the banks, payment of government warranties and transfers to state funds. The utilisation of different accounting methods leads to different results, but the trends are the same. For simplicity's sake, in Table 1 we use only the ESA 95 method.

Table 1: Ratio of the state budget deficit to GDP

	2000	2001	2002	2003
Deficit	–12.5%	–6.0%	5.7%	–3.5%
Increase in GDP (constant prices)	2.0%	3.8%	4.4%	4.2%

Source: Statistical Annex of the European Economy (spring 2004), Statistical Office of the Slovak Republic.

Foreign debt in 2003 reached USD 18.3 billion or EUR 14.6 billion. The increase in foreign debt against the expectations of the National

Bank of Slovakia (NBS) was caused by two factors. The larger difference between payment and repayment was a consequence of the increased influx of short-term liabilities on the part of commercial banks (transactions between parent and subsidiary banks within the framework of the strategies of foreign bank subsidiaries in connection with more profitable interest rates), and the higher influx – in consequence – of NBS repo operations. The appreciation of the Slovak crown further influenced the level of foreign debt, mainly in USD.

The present government's tax reform has been based on a substantial increase in the bottom rate of VAT. In the transformation period the lower rate of VAT was increased in stages: from 6% to 10% and later from 14% to 19%. The higher rate of VAT has decreased from 23% to 19% and so Slovakia now has no lower rate of VAT by which the state could indirectly support higher consumption. The increase in VAT has had a direct influence on inflation (see below).

In addition to the significant VAT increase, tax reform has been supplemented by tax reductions on corporate profits. In the course of the transformation period this rate has been reduced from 45% to 29%, 25% and finally 19%. Furthermore, there have been increases in consumption taxes on, for example, fuel, tobacco, alcohol, and so on. Another important change in the tax system was the introduction of the so-called flat rate tax of 19% on personal income, signifying the abolition of the principle of solidarity between rich and poor which characterises the taxation systems of all EU-15 countries. The authors of the tax reform have repeatedly stressed that it is a matter of chance that the rate of VAT is the same as the flat tax rate (19%).

The reduced corporate tax rate has attracted criticism, also internationally. Some new EU countries have generally reduced corporate taxes in order to attract foreign capital – making it a form of tax dumping – and giving rise to the relocation of production from Western to Central and Eastern Europe. The negative experience of the EU with

Ireland, for example, which has the lowest rate of corporate tax, has not affected employment in the countries of the EU-15 because the Irish economy is small. The situation changed after the recent EU enlargement, however. French Minister of the Economy N. Sarkozy has suggested that if Slovakia does not need corporate tax revenues for its state budget, assistance from the structural funds should be stopped. The average rate of corporate tax in the EU-15 is 31.4%, but the ten new EU members have an average rate of 21.5% (Le Monde, 2004). The situation is complicated, however, because for example in Germany (and also in other countries) there are many tax exemptions, while in Slovakia tax exemptions have been abolished. In addition, corporate tax revenues represent on average 2.4% of the state budget in the EU-15 countries, but 2.5% in the ten new countries.

Probably the next general election in September 2006 will determine the preservation or modification of this tax policy, unless tax harmonisation is imposed in the meantime by the EU, although it has said that legislative preparation would require two years.

The problem for Slovakia is that the ongoing reforms in the social sphere (health care, education, pensions) have been unable under current state budget revenues and expenditures to bring the state budget deficit under the Maastricht limit of three per cent of GDP.

It is clear that, regardless of differences in calculating the state budget deficit and of relative improvements in the figures, the pressure on the budget from expenditure will increase mainly in connection with the failure to collect the planned tax revenues. In 2003, of the SKK 99.4 billion in planned VAT revenues only SKK 83.8 billion (that is, 84.3%) were collected. In contrast, 95.5% of corporate tax revenues were collected (SKK 31.9 billion as against SKK 33.4 billion). As a consequence, there was a shortfall of SKK 16.1 billion. This could not be made up by consumption taxes, which have been increased. The unfavourable development of tax revenues, that reached 99.0% of the

expected level approved in the state budget for 2003 (according to the data of the Ministry of Finance), caused the state budget deficit.

The criterion of national debt as a proportion of GDP is not precisely defined in the Maastricht treaty. If the deficit is higher than 60% of GDP, the national debt should approach this reference level. Slovakia meets the stated criterion, but only thanks to the situation before the transformation (after the split between the Czech and Slovak Republics) when the national debt was very low. The situation is deteriorating very quickly, however. The ratio of national debt to GDP increased from 32% in 1999 to 43% in 2001. If this development continues, by 2007 the national debt will probably exceed 60% of GDP.

Monetary policy

In the wake of EU accession a debate has got under way concerning the date of Slovakia's entry into EMU. Important issues include which model of introducing the euro would best serve the Slovak economy and whether fast or slow EMU entry would be better.

It is clear that the present four-year political cycle causes a slowdown in economic reform as general elections approach and that this postponing of dealing with problems has resulted in some periods in rising inflation and its perpetuation as well as an increase in public and national debt. The poor functioning of state financial policy made it necessary to restructure the state-owned banks, which were sold to foreign investors.

The price liberalisation introduced at the beginning of 1991 caused inflation that unfavourably influenced overall economic development. The economy needed about four years to recover and inflation fell below 10%. In the period 1995–1996, inflation was curbed by controlling wage growth in the state sector (elimination of inflation). Long-term developments seem to confirm that inflation pressures have come from the rising prices of production inputs (cost-push inflation) and

from increased state social protection expenditure (state administration, education, health care, and so on). In this regard, governments have tried to fill the gaps by increasing VAT and other consumption taxes (petrol, alcohol, cigarettes, and so on).

The next important influence on inflation was the step by step increase in energy and water prices under price deregulation. The highest price increase took place at the beginning of 2003 which took 2003 inflation to a year-end level of 9.3%. The government had not deregulated prices in the election year of 2002 and so total inflation in 2002 was only 3.3%. The development of inflation is presented in Table 2.

In 2003, the growth of hitherto regulated prices and of taxes made up 75% of the overall inflation increase. The greater influence of cost factors on price development was, however, given the absence of demand-side effects, not reflected in more significant secondary effects. The relatively low level of core inflation, which in 2003 reached 3.0%, also documents this.

Despite the fall in domestic demand economic growth reached the relatively high level of 4.2%, although the structure of GDP was different from expectations. The fall in domestic demand was compensated by dynamic export growth. The slower economic growth of the main

Table 2: Development of inflation

	1998	1999	2000	2001	2002	2003**
Slovakia	6.7%	10.6%	12.0%	7.1%	3.3%	9.3%
EU reference value	2.2%	2.1%	2.3%	2.5%	2.2%	2.1%

Notes:
* Since 2002 the EU value has been replaced by the eurozone value.
** Preliminary value.
Source: Economic Monitor 2002 and 2003, Statistical Office of the Slovak Republic.

EU trading partners has not been an impediment: Slovak export growth topped 20%. This development was the result of higher productivity in the automobile industry and a new production programme. Favourable development was similarly recorded in iron and steel exports.

In view of the absence of demand impulses as well as the expected continuation of deregulation effects on demand in 2004, in order to support balanced economic growth and prevent unjustified pressure for a fall in prices, the NBS reduced key interest rates in September and December 2003, on both occasions by 0.25 percentage points. These measures – followed by a further reduction in key interest rates in March 2004 by 0.5 percentage points – were intended to support a recovery in domestic demand and sustainable economic growth alongside the forecast of a lower GDP contribution from exports. Concurrently, the interest rate reductions were intended to support the central bank's struggle to contain pressures for exchange rate appreciation and thereby corresponded to the objective of sustainable growth.

In the next few years economic growth in the eurozone will probably recover slightly. Economic growth should also accelerate in our main trading partners, which should create relatively favourable conditions for Slovak exports and low imported inflation.

As far as price development is concerned, it will be influenced in structural terms by a number of factors (the rate of overall inflation with the mid-interval at 6.4%). The appreciation of the exchange rate will probably be reflected in a slower dynamic in the prices of tradable goods, excluding fuels. Price development in 2004 will again be influenced by administrative measures which should account for approximately 70% of the overall rate of inflation. Likewise, the introduction of the common agricultural policy should not bring about any unexpected pressure for growth in food prices. A more significant recovery may also be expected in investment demand, primarily in connection with the inflow of FDI into the automotive industry.

While Slovakia is a small, open economy (the share of imports and exports of goods and services in GDP was 157.5% in 2003 and 165.1% in 2004), in monetary policy decision-making consideration is also given to the development of the nominal exchange rate, which has an important position in the monetary policy transmission mechanism. With regard to the existing interest rate differential and the 'convergence play' the NBS carefully monitors the effects of the inflow of speculative capital on exchange rate volatility. If significant pressures emerge for revaluing the Slovak crown which are not in accordance with economic fundamentals, the NBS is prepared to use the appropriate instruments. These include primarily interventions on the foreign exchange and money markets, as well as a possible change in base rates. An interest rate reduction with the aim of curbing the exchange rate, however, must take into consideration the main NBS goal, which is price stability. The excessive exchange rate rise against the euro in the first months of 2004, influenced by the inflow of short-term capital taking advantage of the interest rate differential, prompted the NBS to lower key interest rates in April 2004 by 0.5 percentage points. It may be expected that price development in 2005–2007 will be in accordance with NBS objectives with regard to meeting the Maastricht inflation criterion, characterised by a progressive disinflation, supported by the continuing consolidation of public finances, as well as low imported inflation.

One of the significant factors influencing economic development in Slovakia in 2005–2007 will be the inflow of foreign direct investment, primarily into the automotive industry, where, in contrast to the forecasts of the Monetary Programme for 2004, the investment by Hyundai-Kia has been increased. Over the medium term the inflow of FDI should thus create the preconditions for accelerating real convergence, productivity growth and competitiveness.

Some forecasts of GDP growth state that it will gradually accelerate from approximately 4.1% (mid-interval) in 2005 to almost 6.2% in

2007. In view of the expected growth in real wages and a relatively significant recovery in investment demand (in particular as a consequence of FDI inflow), domestic demand over the period should have a beneficial effect on economic growth. In 2005, in connection with investment imports for the automotive industry, we may expect a negative effect of net exports on GDP growth. However, in the following years increasing production can be expected in this sector, benefiting both overall exports and economic growth. As a consequence, the current account balance of payments should gradually move from a deficit of 2.7% of GDP in 2005 (a slight worsening in comparison with 2004) to a surplus in the amount of 1.8% of GDP in 2007.

In order to make the process of Slovakia's integration into the eurozone transparent the NBS, in cooperation with the Ministry of Finance, has prepared the document 'Strategy for adoption of the euro in the Slovak Republic', which was discussed by the government in summer 2003. Both bodies stated that eurozone accession would represent a significant impulse for healthy growth of the Slovak economy, and the advantages of membership outweigh the disadvantages. The Slovak Republic should therefore introduce the euro as soon as possible after having fulfilled the Maastricht criteria in a sustainable manner. The Slovak government and the NBS at the same time declared their interest in creating the comprehensive preconditions for euro introduction in Slovakia in 2008–2009. In terms of the exchange rate regime managed floatation, in the medium term, will be replaced by the ERM II exchange rate mechanism. Slovakia's accession to ERM II can be expected in 2005, or soon after. After ERM II accession the aim of monetary policy, besides tackling inflation, will also be the exchange rate, which should continue to be subordinate to the main goal of price stability. Slovakia's membership of ERM II should not exceed the time necessary for fulfilling the Maastricht exchange rate criterion, given the fact that over the longer term a conflict may emerge between price stability and exchange rate. Even where the NBS's objective is exchange

rate movement close to the central parity, the ongoing process of real convergence, productivity growth and related well-balanced appreciation of the real exchange rate may require more flexible use of this exchange rate regime. ERM II membership and evaluation of fulfilment of the exchange rate criterion should be sufficiently flexible and take into account the process of real convergence.

2. Labour market

2.1 Main tendencies in employment and unemployment

Price liberalisation, the loss of Eastern markets and the primary restructuring of state enterprises meant that as early as the end of 1991 unemployment had reached 302,000 or 11.8%.

Slovakia belongs to a small group of countries in which demographic factors had a substantial influence on the labour market in the 1990s. From 1990 until 1998 working-age population growth was 305,400. Part of this population growth was retained in the education system; however, the increase in the labour supply was still between 140,000 and 150,000. At the same time, there was strong motivation to leave the labour market, especially for women and those of retirement age. Between 1998 and 2002 working-age population growth (up to 55 years for woman and 60 years for men) was 79,400 persons, as a result of which the influence of demographic factors on labour supply slackened. However, during this period the second phase of the restructuring of large enterprises took place (including enterprises sold to foreign investors), increasing unemployment at a time when there were no new jobs to replace the old ones. Unemployment in the second half of the 1990s increased more in the more backward regions. The main labour market indicators are presented in Table 3.

Average employment (according to the Labour Force Survey) in 2003 reached 2,164,600, an increase of 37,600 or 1.8% on 2002. Average employment continued to increase in 2001–2003, mainly among small

Table 3: Labour market indicators

Indicator	1998	1999	2000	2001	2002	2003
Population ('000)	5 393	5 399	5 403	5 379	5 379	5 380
Employment – LFS ('000)	2 198.6	2 132.1	2 101.7	2 1237	2 127.0	2 170.6
Participation rate (%, 15–64 years)	–	–	–	–	–	57.6
Registered unemployed persons (end of year, '000)	428.2	535.2	506.5	533.7	504.0	452.2
– proportion of long-term unemployment	38.2	43.2	43.6	41.2	47.3	46.9
– proportion of young people (15–24 years)	32.2	31.8	31.6	28.2	25.5	21.6
Unemployment rate (%), based on:						
– Labour Force Survey (LFS)	12.5	16.2	18.6	19.2	18.6	17.4
– Registered unemployed persons	14.7	18.4	19.2	19.3	17.9	15.2
Nominal wages						
– in SKK	10 003	10 728	11 430	12 365	13 511	14 365
– in EUR/ECU	253	243	268	286	317	346

Note: Exchange rate in May 2003 was about SKK 41 to EUR 1.

Sources: Statistical Office of the Slovak Republic, National Labour Office and Institute of Slovak and World Economy.

enterprises and the self-employed, and total growth from 2000 onwards represents 62,900 or 2.99%.

The employment rate in Slovakia is very low (57.6% in 2003) in comparison with the Lisbon target, which set the employment rate at 70% for the 15–64 age group. Of the OECD countries only Poland (51.4%) and Hungary (57.0%) have a lower employment rate.

The increase in the number of jobs was insufficient to soak up increased labour supply. According to the Labour Force Survey the unemployment rate remains above 17% (in the first quarter of 2004 it was 19.3% and in the second, 18.5%).

Average registered unemployment fell in 2003 (compared to 2002) by 2.6 percentage points and reached 15.2%. Mainly administrative measures helped to bring down unemployment as a consequence of the amendment to the Act on Employment that tightened up the conditions for registration of job applicants (see also section 1.2.3).

By OECD comparison, Slovakia had the second highest unemployment rate in 2003: Poland 19.2%, Slovakia 17.1% and Spain 11.3% (OECD 2004).

Long-term changes in the structure of the unemployed bear witness to three serious problems.

(i) *High unemployment among the under 25s.* Although it has fallen the proportion of this age group in unemployment is very high. Expected population ageing has necessitated increasing the pensionable age, which may also hit young people. Working age population growth in the period 2004–2007 is forecast at about 53,000. After 2008 the slow shrinking of this age group should begin (Vaňo, Jurčová and Mészáros 2002). However, the pace of population ageing in Slovakia will be lower than in the majority of European countries. The labour market situation will be worsened by the extension of pensionable age. Some amelioration may be expected from expiry of the transitional periods for free movement of labour in the enlarged EU (at present about 80,000 Slovak citizens work abroad, about 65,000 of them in the Czech Republic).

(ii) *Long-term unemployment*. The majority of long-term unemployed are workers with low or no qualifications. The proportion of long-term unemployed is the highest among the OECD countries.

(iii) *Regional unemployment*. In 2003 the difference between the region with the lowest (Bratislava III, 2.55%) and the highest unemployment rate (Rimavská Sobota, 32.79%) decreased by 5.79 percentage points; however, the main reason for this was the tightening up of registration conditions. The majority of unemployed persons have dropped off the unemployment register in backward regions, which also have the highest proportion of ethnic minorities (Roma). According to an OECD study Slovakia has one of the highest levels of public sector employment (21%) and the lowest proportion of self-employed (8.7%).

2.2 Development of wages and labour costs

By international comparison wages and labour costs in Slovakia (in euros) are among the lowest of the Visegrad (V4) countries. Slovakia seems caught in a wage trap in comparison with its neighbours. Detailed comparison of the development of GDP and gross wages in Slovakia and other countries of the region is presented in Table 4.

Table 4: Comparison of GDP and gross wages (2002)

Indicator	Czech Republic	Hungary	Poland	Slovakia
GDP per capita, current prices, PPP, EUR	14 836	12 615	9 805	12 382
Gross monthly wages, EUR	511	502	591	317
GDP, PPP	119.8	101.9	79.2	100
Gross wages, EUR	161.2	158.4	186.4	100
Unemployment rate (%)	7.3	5.8	20.0	19.0

Source: Own calculations based on data from Podkaminer et al. (2003).

In terms of per capita GDP based on purchasing power parity Slovakia lags behind only the Czech Republic, has roughly the same GDP per capita as Hungary, and higher than Poland. However, in terms of gross wages (EUR) it lags significantly behind the other V4 countries. The high unemployment rate – after all, in Poland it is higher – does not explain such a big difference. The wage lag is connected with other economic phenomena (high ERDI = Exchange Rate Deviation Index, low price level, structure of large and small enterprises in the economy, differences in labour productivity among sectors and firms, and so on). However, these factors cannot explain the absolute (by decreasing social contributions) and relative (in comparison with other countries) decrease in total labour costs and the continuation of the low wage policy in Slovakia. The decrease in total labour costs brings Slovakia closer to the Balkan group of countries.

Probably the most important factor in the wage lag is the large differences in labour productivity between foreign and domestic firms. Above all, the foreign firms have a policy of transfer prices that can deform the development of productivity not only in the sector, but also in the economy as a whole. Wages in foreign companies are adjusted to the level in domestic firms (that is, they are pressed downwards) rather than the other way round (Table 5).

In some cases wages in foreign companies are on average 30% higher than in private domestic companies and the difference is persisting.

Table 5: Wages in domestic and foreign companies with more than 20 employees (SKK)

Sector	2001	2002	2003
Domestic private	13 756	14 830	15 931
Foreign	18 056	19 286	20 862

Source: Statistical Office of the Slovak Republic, 2001–2003.

Unit labour costs in the Slovak Republic are now unequivocally the lowest among the Visegrád countries. In 2000 labour costs per hour in industry and services in Poland came to EUR 4.48, in the Czech Republic EUR 3.90, in Hungary EUR 3.83 and in Slovakia EUR 3.06 (Report on Social Situation in Slovakia, 2002). Further labour cost decreases and its low absolute level are likely to trigger a transfer of low-qualified jobs to the Slovak Republic which is likely to become established as a long-term orientation. This manoeuvre is not necessary under conditions in which the productivity of foreign companies in Slovakia does not lag behind that of foreign companies in other V4 countries and the mother companies in EU-15 countries (for example, Volkswagen Slovakia in Bratislava).

Structural reforms in recent years have led to an absolute fall in real wages and to wage development falling behind the development of productivity (Table 6). Productivity has increased constantly in all branches but without much benefit in terms of employment and real wages.

The minimum wage constitutes a separate problem. The government is uncompromising in the face of trade union demands to increase the

Table 6: Development of real wages in comparison with productivity (1989 = 100)

Indicator	1998	1999	2000	2001	2002	2003
Index of real wages	91.6	88.8	84.4	85.2	90.2	88.2
Index of labour productivity (GDP per employee)	117.0	122.4	126.7	130.1	135.7	139.0

Source: Statistical Office of the Slovak Republic.

minimum wage. The trade unions argue that in the EU-15 the level of the minimum wage is higher in comparison with the average wage (on average 50 to 60%). In the Slovak Republic the level of the minimum wage in 2001 varied between 35.6% and 39.8% and in 2002 between 36.4% and 41.2%. The last minimum wage increase was on 1 October 2004, at SKK 6,500 – after tax that represents SKK 5,629 (about EUR 140).

3. Employment and labour market policies

The change of government in 1998 meant a change in employment policy. Until 1998 investment had been directed to the energy sector and generally to large state enterprises with a long-term return. Subsidies to employers to create new jobs had prevailed within the framework of active labour market policy. Apart from this, at that time the state banks extended a lot of consolidated credits, which was followed by the restructuring of banks and their sale to foreign banks. The new government began to favour foreign capital, for example, with generous tax allowances (for example, US Steel in Košice in the eastern part of Slovakia, Volkswagen in Bratislava, PSA Peugeot-Citroën in Trnava, Hyundai-Kia in Žilina).

The reduction of the tax share of labour costs has also formed part of tax reform. The government has transferred financing of the system of unemployment insurance from the National Labour Office (managed by a tripartite board) to the state budget. The high public finance deficit could endanger expenditure on active labour market policy measures in the future. This expenditure is relatively low in view of the high unemployment rate. In 2002 expenditure on active labour market policies represented 0.46% of GDP (in 2000, 0.32% and in 2001, 0.37%). While in 2002 the National Labour Office spent SKK 3,483 billion on active labour market policy measures, in 2003 the figure was only SKK 2,808 billion, representing a decrease of 19.4% (Národný úrad práce, 2004).

The number of long-term unemployed in recent years led to the introduction of a Public Works programme which has increased the number of temporary jobs. Since 2004 this measure has been replaced by paying an activation allowance to unemployed persons who take up such employment. Employment subsidies to employers are paid out solely if they create jobs for disadvantaged unemployed (first of all, the long-term unemployed). For this purpose the resources of the European Social Fund are also to be applied. The levels of subsidies to firms hiring long-term unemployed will vary according to the type of workers hired and the region, and may reach 25–35% of total labour costs in the most disadvantaged areas. These subsidies will be paid for two years following hiring.

Broadly speaking, the problem of unemployment should be tackled to a great extent by reinforcement of an individual's motivation to find and retain a job, by more effective delivery of labour market services and by reforms in the field of social protection. From 2003 onwards, the conditions for remaining on the books of labour offices were tightened. As a result, the difference between the unemployment rate based on Labour Force Surveys (ILO methodology) and the unemployment rate based on the number of registered unemployed has increased considerably (for example, while the difference in the third quarter of 2003 was 3.5, in the second quarter of 2004 it was 4.6 percentage points). An increase in regional mobility should be supported by subsidies for relocating.

3.1 Implementation of new labour market policy measures

In April 2003, the government adopted a 'Strategy for supporting the increase of employment on the basis of changes in the social system and labour market'. This document contains a set of principles to be implemented in order to achieve the government's strategic goal of a system which motivates those of working age to find and keep a job and to support the economic activity and employability of individuals.

At the same time, this system shall provide for the establishment of a flexible labour market and modern social services. In October 2003, the Slovak Parliament adopted Act No. 453/2004 on state administrative bodies in the area of social affairs, family and employment services. Subsequently, in December 2003 the Parliament adopted Act No. 5/2004 on employment services. These acts created the legal framework for the establishment of new institutions in the areas of labour market and social affairs, as well as new and effective employment services better able to implement the European Employment Strategy. The new Act on employment services emphases early indication of the individual needs of the unemployed: during first contact with the unemployed, the public employment services guarantee support and help in the process of job seeking. A very important part of these services is counselling aimed at assessing the client's personal circumstances and their abilities and professional skills in order to ensure identification of their needs and to determine the optimal form of intervention. Intensive support shall be given to those who are unemployed longer than three months in the form of professional guidance and development of an individual action plan.

A new set of active labour market measures has been implemented since 2004 aimed at job creation for disadvantaged groups, especially to support self-employment, employment of young people, labour force mobility and activation of the long-term unemployed. A new feature in this area is regional determination of the intensity of support for the creation of jobs and self-employment. This shall depend on the unemployment rate. The Ministry of Labour, Social Affairs and Family (MPSVR SR) sees the benefit of the new measures in their focus on those at risk of unemployment and variable support for particular regions. This approach allows for greater support for employment development in vulnerable regions.

Sums available under the European Social Fund are also being used to implement the mentioned active measures.

On the labour market, single active measures are being implemented as national projects. The Centre of Labour, Social Affairs and Family (ÚPSVR), an executive body, is responsible for national project implementation. The Centre succeeded the former National Labour Office (NÚP), which was abolished by the Act on employment services (see section 3.2). At present, the ÚPSVR is implementing the following national projects (Hanzelová 2004):

- Employment support for the unemployed with the main focus on the most disadvantaged groups on the labour market.
- Employment support for people with disabilities.
- Labour market training and retraining.
- Activation of unemployed persons, particularly those with low motivation who are dependent on social benefits.
- Graduate placement.
- Increasing the employability of socially excluded groups and groups under threat of social exclusion through social inclusion partnerships.
- Increasing the scope and quality of employment services through counselling and guidance.

In 2004, a process of general reorganisation and rationalisation of public employment services started. New institutions have been established and since January 2004 have provided employment and social services under the coordination of a central body. Consolidation of service implementation provides for the simplification of the whole process and creates conditions for increasing the quality and flexibility of services in reaction to the differing needs of clients. The new ÚPSVR offices are no longer responsible for collecting unemployment insurance contributions (the previous employment fund was abolished) and the payment of unemployment benefits, which have been transferred to the Social Insurance Office.

3.2 Changes in labour legislation and pension reform

The government has also amended the Labour Code with the aim of increasing labour market flexibility. More flexibility has been introduced as regards an employer's right to terminate an employment contract. Employment contracts can be concluded for a fixed term and the employer has been given the right to prolong them without being obliged to provide legal justification for doing so, up to a maximum of three years. Overtime limits have been increased so that employees may work up to 400 overtime hours per year (the former limit was 150). The conditions for part-time work have been simplified. In spite of this simplification part-time work is not favoured by employees because of the high level of living costs in comparison with the minimum wage. According to the Labour Force Survey for the fourth quarter of 2003 the number of part-timers was 56,300, that is, 2.59% of total employees, of whom 16,600 were underemployed.

From 2005 an important change will take place, the introduction of the second, so-called capitalisation pillar into the old-age pension system. The size of this pillar is one of the biggest in Europe (9% of gross wages should go to the mandatory private pension accounts of licensed pension funds). The pay-as-you-go pension reform may sharply reduce public retirement pensions for low-income earners, putting pressure on the social assistance system to provide resources for the elderly. The government wants to use privatisation revenues for the introduction of a new pension system. It has been estimated that the accumulated costs would far exceed the privatisation revenues set aside to finance the transition to a new pension system. The transition could cost the state budget more than 1% of GDP (OECD, 2004). In addition, the pension system includes a voluntary, supplementary pension pillar. Slovakia has not introduced into its pension system partial pension schemes in individual enterprises.

4. The role of social dialogue in dealing with employment issues

4.1 Tripartite social dialogue is changing

As early as 1990 the government of the independent Slovak Republic adopted the tripartism established in the Czechoslovak Federal Republic. The Tripartite Council of Economic and Social Concertation (RHSD) has continued practically unchanged to the present day. The social partners were represented by the Confederation of Slovak Trade Unions (KOZ SR) and the Federation of Employers' Associations (AZZZ SR). Since April 2004 the National Employers' Union (RUZ SR) has also been involved (Cziria 2004a).

According to the rules, the RHSD is entitled to prepare statements regarding all important measures proposed by the government in the area of economic and social policy. The RHSD agreement on the national minimum wage is used in wage bargaining at sectoral and company level. The results of tripartite concertation do not have legal validity, although the General Agreements – the national social pact – played an important role in the transformation process.

The Slovak government signed five General Agreements with the social partners in the years 1993–1996 and for 2000. The adopted measures include mainly government duties and implementation of the necessary economic and social reforms, including the reduction of unemployment. However, implementation did not respond adequately to the rapid increase in unemployment and falling real wages. This contributed to increasing tensions between the social partners. Disagreements culminated in 1996–1997 when the government proposed a new wage regulation and the social partners, especially the trade unions, refused to sign the General Agreement for 1997. They also broke off the usual tripartite negotiations at the RHSD. The RHSD did not function during 1997–1998 but social peace was not disturbed and the transformation continued. In 1999, when a new gov-

ernment came to power, tripartite negotiations at the RHSD restarted and the Parliament approved Act No. 106 of 1999 on economic and social partnership. According to this law the government was obliged to submit to tripartite negotiations at the RHSD all proposals for measures with a substantial impact on living standards.

After a three-year break, the parties signed a new tripartite General Agreement for 2000. The General Agreement for 2000 consisted of four main policy areas: the economy, employment, incomes and social affairs. After an optimistic restart in 1999 tripartism started to run into trouble during 2001 when the outcomes of the General Agreement for 2000 were evaluated. In spring 2001 the parties evaluated the agreed tasks and the trade unions made several criticisms. Some tasks were fulfilled, for example, a reduction in the tax burden. However, two socially sensitive goals – increasing real wages and reducing the high unemployment rate – were not achieved. Therefore, the KOZ SR representatives declared their dissatisfaction with the government and refused to negotiate the General Agreement for 2001 (Cziria 2003). Trade union representatives on the tripartite Council stopped negotiations on the next tripartite general social pact and no tripartite General Agreement has been signed since. Furthermore, neither the employers nor the government seem particularly interested in restarting negotiations on a new tripartite social pact.

Recently, national tripartite concertation was temporarily called into question. Disagreements between the trade unions and the government continued also in tripartite concertation. The government was disappointed by trade union political activities (announcement of a referendum on early parliamentary elections to remove the current government) and announced its wish to abolish the law on tripartism. The parliament discussed the government proposal and abolished the Act on economic and social partnership on 31 December 2004.

The last meeting of the RHSD based on the Act on tripartism took place at the end of November 2004 when KOZ SR submitted a Declaration on ending the current form of tripartism and its continuity based on the new rules. Representatives of the government, AZZZ SR, RUZ SR and KOZ SR passed the Declaration. The views of the social partners on a draft proposal for a statute for the new form of tripartism were also discussed at this RHSD meeting. The participants agreed that tripartism would henceforth take the form of the Economic and Social Partnership Council (RHSP). The Ministry of Labour, Social Affairs and Family issued the Statute for the new tripartism in Slovakia which became valid on 1 December 2004. Under the Statute the outcomes of RHSP discussions are to be considered recommendations to the government. The first meeting of the RHSP was held on 28 January 2005. The RHSP procedural rules, the proposed agenda and dates of meetings in the first half of 2005 were approved. Tripartite meetings also took place in February and March and no major problems in the functioning of the new tripartite consultations have been noticed.

According to Act No. 387/1996 on employment, as amended, the National Labour Office (NÚP) was established as an institution which acts through its tripartite self-governing bodies, such as the Supervisory Board and the Governing Committees of Regional and District Labour Offices. Members of self-governing bodies were elected for four-year terms of office and represent the employers, trade unions and the state. The Supervisory Board consisted of nine members, representing each party equally. It was elected and recalled by the National Council of the Slovak Republic based on proposals submitted by representatives of employees, employers and the government. Tripartite self-governing bodies dealt with the approval of projects for implementing active labour market policy measures in the regions, including decisions on allocation of the necessary financial resources. Recently, the Ministry of Labour, Social Affairs and Family prepared,

and the Parliament adopted, a new Act No. 5/2004 on employment services, which significantly changed the above-mentioned tripartite management in the area of employment services (see section 3.2). New legislation annulled the operation of the National Labour Office as a tripartite institution.

The other area in which steps have been taken is regional tripartism. The National Plan for Regional Development, adopted in 2001, created a new framework for social partner involvement in regional development. They are to participate in the preparation of regional development plans and projects. In late 2001 for the first time regional self-government bodies were elected and took over responsibility for regional development in 2002. These events, together with EU membership, may have a positive impact on the preparation of regional development projects aspiring to support from the EU Social Fund, as well as on the development of regional tripartism in Slovakia.

4.2 Social partner participation in the National Action Plans on Employment

NAPE 2003

The elaboration of NAPE 2003 was based on the EU Lisbon employment policy guidelines, Programme Declarations of the Slovak government and the Support strategy for increasing employment through changes in the social system and labour market. The new employment and labour market policy is part of a wider process, also including reforms and changes in the social system. In this respect, NAPE 2003 was also linked to the Sectoral Operation Programme Human Resources and to priorities resulting from the Common Assessment of Employment Priorities in the Slovak Republic. Some NAPE mechanisms were prepared in the course of 2003 and take effect in 2004. This applies to a number of mechanisms incorporated in the Sectoral Operation Programme Human Resources, which the Slovak Republic has implemented since January 2004 using resources from the

European Social Fund. One of the fundamental objectives of NAPE 2003 was to involve ministries and other state administrative bodies, local self-governments, social partners and other organisations active in employment policy implementation in improving the labour market situation.

The content of NAPE 2003 included 18 guidelines elaborated within a four-pillar structure and may be defined as fundamental and progressive. In comparison with the previous NAPE for 2002–2003, this one involves the implementation of more systemic employment policy measures and close connection with the social system, including changes in legislation (for example, stricter conditions for registration of the unemployed, as well as unemployment benefit claims).

The manner of funding NAPE 2003 also changed. Its activities were more intensively co-financed, also including provisions from the relevant EU funds.

Social partner involvement

Trade unions and employers' representatives were usually involved in the preparatory stages of NAPEs, commenting on the proposals of the Ministry of Labour, Social Affairs and Family and submitting proposals, as well as being cooperative partners in NAPE implementation. As far as NAPE 2003 is concerned the social partners were involved in implementation of the majority of the 18 Guidelines. The trade unions were not involved in implementation of the guidelines under the entrepreneurship pillar, however.

Considering the outcomes, social partner participation in implementation of the guidelines was rather formal. Trade unions and employers' representatives at national and sectoral level declared their willingness to support implementation of the proposed guidelines and measures in practice, but the available information indicates that the social partners' role was more modest than was desirable.

KOZ SR declared their willingness to provide continuous support also for implementation of the guidelines, measures and tasks of the new NAPE 2004–2006. The trade unions will also help to create conditions promoting implementation of the ETUC's Action Programme adopted by its May 2003 Congress in Prague, implementation of goals and guidelines of the European Employment Strategy aimed at full employment, better quality work and good partnership. KOZ SR proposes to make a regular (twice a year) assessment of the implementation of NAPE 2004–2006 guidelines, measures and tasks at the tripartite Economic and Social Concertation Council (since 2005 at the RHSP).

NAPE 2004–2006

The National Action Plan on Employment for 2004–2006 (NAPE 2004–2006) was prepared in accordance with good governance and partnership principles. Partners from central state bodies, Social Insurance Agency regional governments and regional state administrative bodies, social partners (KOZ SR, AZZZ SR and RUZ SR), non-governmental organisations, organisations for the disabled, scientific institutions and the research sector, including ministerial research institutes and universities, were involved in this process.

The social partners had more than two weeks to react. According to the social partners, the deadline was longer than it had been in previous years, although the trade union representatives thought that the deadline was still too short for elaboration of the responses of sectoral trade unions, which were asked for their opinion.

The social partners developed their positions and suggestions for NAPE 2004–2006 and submitted them to MPSVR SR. Their opinions and proposals were partially taken into account in the preparation of NAPE 2004–2006.

The AZZZ SR representatives criticised the lack of new job creation in regions with high unemployment and particularly for disadvantaged

groups on the labour market. They also pointed out the still inadequate stimulation of entrepreneurs and the burdens of current taxation and obligatory contributions to the insurance funds. AZZZ SR also criticised insufficient utilisation of social dialogue in solving employment issues. The trade unions focused on a critical evaluation of the current situation in employment and the procedure adopted by the government for the preparation and implementation of NAPE 2002–2003. Trade union representatives also emphasised the role of social dialogue. The role of the trade unions in dealing with employment issues was reduced compared with previous years.

The RUZ SR position was based on proposals on: improving public counselling services for the unemployed, reduction of employers' taxation and contributions to insurance funds when employing disadvantaged people, supporting mobility of the labour force by considering regional differences in employment conditions, providing tax allowances for employers creating new jobs in regions with high unemployment, punishment not only of the employer but also of employees involved in undeclared work, simplifying the regulations on self-employment and the administrative duties of employers to the Social Insurance Agency.

Nevertheless, NAPE 2004–2006 does not include a separate chapter or part written by the social partners. It is not considered a joint text of the representatives of government and social partners and the social partners have not signed it. Nevertheless, the representatives of all the social partners have declared that they accept the proposals of NAPE 2004–2006. Regarding NAPE implementation, no special tripartite agreements have yet been signed. NAPE 2004–2006 has not been discussed at the tripartite Economic and Social Concertation Council.

According to the available information, the social partners consider the procedure for the preparation of NAPE 2004–2006 as rather formal because they were involved in its preparation mostly in an administra-

tive fashion: the social partners were asked to submit proposals for the preparation of NAPE 2004–2006, after which they were given the draft of NAPE 2004–6 and asked to prepare their comments. According to the trade unions, no real social dialogue has taken place. No working meetings were organised in order to consult on and discuss relevant issues from the social partners' perspective (Cziria 2004b). The trade union representatives proposed that the social partners report on their own activities aimed at implementing NAPE 2004–2006.

5. Potential risks of eurozone accession for Slovakia

EMU membership is obligatory for the new countries joining the EU on 1 May 2004. That is why the risks and disadvantages of membership are being discussed in Slovakia only in terms of the date of euro adoption, that is, should the country hasten to join EMU or should it wait until some degree of convergence has taken place with the EU-15?

Potential problems related to euro adoption were publicly discussed by experts at the seminar 'Slovakia in the EU – when to adopt the euro?', organised in 2003 by the Slovak National Bank, the Ministry of Finance and a number of economic institutes. The seminar was linked to elaboration of the government document 'Strategy for adoption of the euro in the Slovak Republic'. The main idea is to enter the eurozone as soon as possible on condition that Slovakia can ensure sustainable fulfilment of the Maastricht Criteria. The 3% fiscal deficit is considered the main precondition, even for sustainable economic growth in Slovakia. Some analysts have criticised the fact that there has been no cost/benefit analysis of alternative dates for entering the eurozone. Major differences between the Slovak economy and the EU, especially with regard to prices and wages, constitute significant barriers to early entry. The potential devaluation of savings and lower interest rates in the eurozone are just two potential problems.

In general, the main advantage of EMU membership is considered to be long-term monetary stability. The main risk attaching to membership is the possibility of an increasing asymmetry of shocks. After renouncing monetary independence the Slovak Central Bank will not be able to react to shocks specific to Slovakia by means of money market instruments. Joining EMU will also limit fiscal measures despite their usefulness in dealing with the consequences of asymmetric shocks. It is difficult to predict what character asymmetric shocks may take in the course of eurozone entry. Slovak economists regard manufacturing's heavy dependence on expansion of the automotive industry as the most significant risk factor. After expansion of the Volkswagen subsidiary in Bratislava, two large car plants are under construction in Trnava (PSA Peugeot-Citroën) and in Žilina (Hyundai-Kia). As a result, Slovakia is likely to become a world leader in terms of number of cars produced per capita. However, a recession in the world or European car markets would hit the Slovak economy particularly badly. However, this is a long-term problem not solely related to EMU. Another risk is low state support for backward regions (which contrasts strongly with the relatively significant state aid for the automobile industry). Some economists have criticised the government, suggesting that part of the large subsidies given to foreign car producers could be diverted to regional projects which would contribute more to tackling unemployment.

As a next step in preparations for euro adoption in 2004 the Slovak National Bank and the Ministry of Finance developed the document 'Specification of the strategy for adopting the euro in the Slovak Republic' (these central bodies are also working on a national implementation action plan). According to this document an information campaign on the advantages of eurozone membership is planned in the third stage of the implementation process, after ERM II. The above document deals also with the potential risks of non-fulfilment of the Maastricht Criteria by Slovakia. The following risks and their consequences are mentioned in the document:

• Balassa-Samuelson effect	Increase in wages in the non-tradable sector not based on productivity growth.
• Wage indexation	Inertia of current high inflation.
• Rapid growth in loans – credit boom	Impact on the economy of overheating and inflation growth.
• Sudden significant weakening of the exchange rate	Growth in inflation in consequence of the pressures on the exchange rate.
• Conflict between the aim of price stability and the exchange rate criterion following entry to ERM II	Breaching the inflation criterion or in an extreme case disqualification from ERM II.
• Failure of expected disinflation	Reflected in enterprise calcula tions and acceleration of price growth
• Political risk – change in the basic aims of fiscal policy	Failure to collect tax and social insurance revenues, non-receipt of EU funds and the impact of all this, likely to be a deepening of the deficit.
• Reliability of expected budget revenues after implementation of reforms	
• Long-term nature of the effects of reform and the resulting limitations on predictability	Deepening of the planned deficit.
• Decline in economic growth, cyclical fluctuations	Impact on consolidation of public finance.
• Reversal in movements of capital	Impact on exchange rate stability in pre-accession period

• Inappropriately set central parity	Exchange rate instability in ERM II.
• Conflict between the aim of price stability and the exchange rate criterion following ERM II entry.	Failure to maintain the exchange rate within the fluctuation band – in an extreme case.

Appendix 2 of the above document discusses different aspects of policy requirements in relation to overall economic and financial stability within the framework of fiscal policy, monetary policy, financial markets and the labour market.

Risks to the Slovak labour market include the following:

The high unemployment rate is currently suppressing wage inflation. Rapid growth of the economy, however, may gradually exhaust the readily employable workforce in the future. If the forecast growth in employment and a fall in unemployment (according to the Convergence Programme 2004) became a reality, this development could result in inflationary pressure on important regional markets and in certain segments of the labour market (labour shortages in some occupations and surpluses in others are already occurring in some regions and professions). Currently this pressure only contributes to growth in regional wage differentiation, but in the medium to long term wage inflation may be substantial. It is therefore necessary to emphasise activation and training of the unemployed and to develop more sophisticated production that will create room for further productivity growth, wage rises and economic growth.

Investment in education, science and research is especially important. It would also be desirable to increase the share of manufacturing in the economy and to reduce the share of the public sector in total employment. In 2002, the public sector accounted for 21% of total employment, one of the highest proportions among the accession countries.

Moreover, Slovakia was the only country to report an increase in this share (OECD Economic Overviews 2004).

Raising the retirement age will also put pressure on the labour market. According to the Convergence Programme, the elimination of high unemployment should occur through employment growth. In order to continue to reduce unemployment, by the end of 2009 the labour market must in addition be able to absorb the approximately 109,000 persons who will potentially join the ranks of the unemployed due to the raising of the retirement age. This calculation does not cover the option of early retirement, however, which is not expected to be much exercised due to its income-discriminatory nature. Moreover, this would have only a short-term effect (up to 1–2 years) on the expected increase in the working age population: in the medium and long term this effect will be negligible.

Undeclared work continues to be a problem. There is significant demand for this type of employment in regions with high unemployment. Although there is room for more efficient controls under existing legislation, effective measures are still being sought. More flexible forms of employment and self-employment are also necessary, particularly with regard to wages and hiring. Compared to the EU, as well as to other accession countries, the Slovak Republic has not made much progress in this respect. While in the EU-15 the average rate of part-time employment is 18%, in Slovakia it is only around 2%. Following the amendment to the law on part-time work and tax reform, increased use of this form of employment can be expected in Slovakia.

There is another problem relating to the 3% fiscal deficit limit. In 2003 the government reorganised the public employment services, bringing them under the state budget. Expected cuts in the state budget aimed at reducing the fiscal deficit may affect the resources available for active labour market policy. At present, Slovakia spends only 0.46% of GDP on active labour market measures despite its major unemployment

problem by European comparison (according to OECD statistics unemployment is worse only in Poland). With the exception of the Czech Republic, other countries have much higher expenditure on active labour market measures.

However, in 2003 the situation worsened still further. While in 2002 the NÚP spent SKK 3.483 billion on active labour market measures, in 2003 the figure was 19.4% lower (NÚP Report 2004).

It should be noted that the social partners were not even consulted in connection with the convergence programme or planning eurozone accession. None of the risk factors mentioned here were discussed with the social partners and it seems there was no coordination between the National Action Plans for Employment and the Convergence Programme. There appears to be little awareness of the particular employment risks faced by Slovakia in relation to early euro adoption. The same is true of the impact of eurozone accession on wage convergence.

Conclusion

In terms of Slovakia's macroeconomic indicators, high unemployment and low wages are the most important obstacles to future development and economic prosperity. Although a number of positive changes have taken place in economic and employment policy, improvements in terms of unemployment reduction and real wage increases are still inadequate. Active labour market policy itself, even if better linked to social policy measures, cannot solve the employment problems. The creation of new jobs is the only effective way of increasing the participation rate in terms of both collecting the revenues needed to support social welfare and bringing down unemployment. Although a relatively large number of new jobs are being created by new investments, many jobs are still being lost due to restructuring. No progress is being made in increasing employment in small and medium-sized enterprises either.

Nevertheless, foreign investors are becoming increasingly interested in Slovakia because of such recent measures as corporate tax reductions and the implementation of a flat tax rate. The investment boom in Slovakia will most likely continue and the number of new jobs may increase markedly for the next few years. As a result, GDP growth for the next few years is forecast to remain stable at the relatively high level of around 5–6%.

Employers and trade unions evaluate the government's employment policy in different ways. The former are happy that the government has accepted their demands to make employment more flexible and has also reduced taxation. However, the employers would like further changes, including increased labour market flexibility, differentiation of the minimum wage, and reductions in labour costs, all with a view to increasing employment and reducing the high unemployment.

The trade unions, on the other hand, have a number of objections to the government's employment policy, mainly its failure to reduce high unemployment and particularly its regional disparities. According to the trade unions the government has so far been able to reduce unemployment only by administrative measures, such as tightening the conditions for registration: it has not been successful in the creation of new jobs. The unions have also been concerned that real wages had not increased for two or three years until the 2.5% increase in 2004; in any case they are still the lowest in the region.

As far as the contribution of the social partners to implementation of current EU employment guidelines is concerned (especially the following: 'Address change and promote adaptability and mobility in the labour market'; 'Promote development of human capital and lifelong learning'; 'Increase labour supply and promote active ageing and gender equality') it has been limited.

According to KOZ SR, trade unions can contribute to implementation of the abovementioned guidelines at the sectoral and local level only

with the tools they have available, largely collective bargaining. The social partners have negotiated better terms and conditions of employment, including wages and working conditions, at these levels, but the trade unions consider their participation in implementation as inadequate. As far as changes in enterprises are concerned the trade unions regard their implementation as a very important issue, particularly in relation to redundancies. Therefore collective agreements regularly contain agreed general principles concerning how the management should proceed in such cases.

Labour market mobility is an issue in several company collective agreements: for example, various benefits and loans are made available to employees to help them with relocation. Employee services of this kind depend on the employer's circumstances. With regard to human capital development and lifelong learning, a number of company collective agreements contain provisions on education and training. However, according to the trade unions employers often seek to reduce labour costs by skimping on training. This occurs more often in domestic companies than in foreign-owned firms. The issue of gender equality is usually included in collective agreements. According to the trade unions, women's unemployment and the gender wage gap should be reduced in Slovakia. However, there are tradeoffs: flexible forms of work organisation might increase women's employment, but at the cost of reducing the wages of part-time women. The trade unions are committed to better work–family life reconciliation; however, a survey of sectoral and company collective agreements showed that measures supporting the abovementioned employment guidelines were included in collective agreements to a rather limited extent. The social partners are more actively involved in preparation of the legal framework to enable implementation of the EU employment strategy in Slovakia. The most recent changes in labour legislation have increased the role of local collective bargaining also in the civil service.

The social partners consider the specific recommendations of the European Commission for the Slovak Republic ('Increasing adaptability of workers and enterprises'; 'Attracting more people to the labour market and making work a real option for all'; 'More effective investment in human capital and lifelong learning') as important. They wish to contribute to the implementation of these recommendations.

Trade unions and some employers' representatives (AZZZ SR) are concerned by the decline in the importance of social dialogue in respect of solving employment problems: for example, abolition of the tripartite management of the former employment offices and not discussing NAPE 2004–2006 in the tripartite RHSD. According to the trade unions the main weakness of NAPE 2004–2006 is that it does not sufficiently stress new job creation. The Plan is rather general in nature; it does not contain an implementation plan specifying responsible agencies or deadlines. The monitoring and evaluation of implementation is also lacking.

MPSVR SR engaged a wider range of partners in the preparation of NAPE 2004–2006 within the framework of good governance and partnership than in the past. This process was an important political task and was supported accordingly by the authorities. With regard to the importance of employment in Slovakia, it is necessary to pay consistent attention to the NAPEs. If the social partners want to participate in this area more effectively, the issue should occupy a permanent place on their agenda.

As far as the advantages and disadvantages of EMU membership are concerned, the social partners have so far not been invited to take part in discussions. According to the available information the document 'Specification of the strategy for adopting the euro in the Slovak Republic' has not yet been included on the agenda of tripartite concertation. As far as public discussion of eurozone entry is concerned, few articles have appeared in the media. A rare exception was infor-

mation on the results of a 2004 Eurobarometer survey of the Slovak population regarding the risks of adopting the euro. According to the survey Slovak citizens are looking forward to the euro but they are afraid that its introduction may be taken as an excuse for price increases.

Recently the exchange rate of the Slovak crown rose despite the fact that prices in Slovakia are among the lowest in the EU. It is feared that under conditions of high economic growth (low labour costs will probably be the most important factor in economic growth in the foreseeable future in Slovakia), after the exchange rate of the Slovak crown has been fixed against the euro inflationary pressures may appear and Slovakia could have serious problems meeting the inflation criterion.

It seems likely that Slovakia will join EMU after the general election in September 2006. However, this entails the risk that current economic and social policy reforms may not be continued (for example, the strongest opposition party would change the current flat taxation system).

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Slovenian accession to the eurozone: gradualism with social dialogue

Marko Lah

1. The basic framework of eurozone accession

Since 1991, when Slovenia became an independent state and the transition period began, the country has experienced sustainable GDP growth. With the exception of 1992 and 1993 when growth rates were negative, Slovenia has maintained a robust growth rate of about 3–4% per year, generally speaking accompanied by improvements in the other macroeconomic indicators. Comprehensive studies of Slovenia's 'success story' have described its transition policy in various terms: for example, as cautious or predictable (Šušteršič 2004: 404, Vodopivec 2004: 294), while Silva-Jaregui (2004) emphasises the synchronisation of Slovenian monetary and fiscal policy and its execution. However, the most commonly used term for Slovenia's transition macroeconomic policy and the development of its social system is gradualism (Mencinger 2004; Rojec 2004; Stanovnik 2004; Šušteršič 2004).

According to Rojec (2004), who distinguishes two periods of Slovenian gradualist macroeconomic policy – the first being marked by Slovenia's declaration of independence in 1991 and the second by the beginning of Slovenia's accession partnership with the EU in 1997 – the periodisation may be extended. The turning point of the third economic stage was the decision by Slovenia's government in November 2003 to enter the Exchange Rate Mechanism II (ERM II) right after Slovenia became a member of the European Union (in May 2004). The decision on

ERM II should ultimately lead to membership of Economic and Monetary Union and adoption of the euro as the national currency.

Our aim in the present chapter is to present the roles of social dialogue and incomes policy within the three stages of Slovenia's gradualist macroeconomic policy, with the emphasis on the third, ERM period. In section 2 we briefly explain the formation of the gradualist approach at the beginning of transition and the institutional establishment of social dialogue. Section 3 describes the main characteristics of the period during which the framework for the 'Maastricht economic policy' was established, leading to Slovenia's formal decision to enter ERM II and the role of the social partners in it. Section 4 analyses the impact of the current ERM II economic policy, especially on the labour market, and adds some topics illustrating the climate of social dialogue.

2. The beginning of gradualism – economic independence and transition

Slovenia's transition since 1991 corresponds to the country's secession from the former Yugoslavia and its formation as an independent state. The primary goals of the new national economy were to establish a legislative and institutional framework. The economic laws consisted of three groups: the law on privatisation, laws intended to strengthen the operation of market forces (Slovenia was not a purely planned economy as Yugoslav 'self-management socialism' mixed the market and planning) and laws on the liberalisation of foreign trade. Major tasks at the outset of independence were to introduce a new national currency, build a monetary system and establish a solid foreign exchange position by creating foreign exchange reserves (these being virtually zero at independence).

Slovenia's economy was expected to experience a transition depression at first, for two reasons. First, the established business contacts and

networks of Slovenian firms with firms from the former Yugoslavia were severed and there were fears that they would not be able to compete on competitive European markets. Secondly, economic policy would have to be very restrictive in order to cope with the hyperinflation (more than 200%) inherited from the Yugoslav economy.

The Slovenian gradualist approach to transition reform is clearly seen in the debates on privatisation in 1991–1992. Two privatisation scenarios were envisaged: (i) the gradualist approach was based on the idea of decentralised and gradual insider buyouts subsidised by the state, while (ii) the shock therapy approach emphasised centralised privatisation through a voucher scheme and investment funds. The first model favoured enterprise insiders (managers and employees) and implicitly assumed long(er) term ownership. The alternative stressed the importance of rapid establishment of strategic owners (through the secondary share market) in a very short time, assuming that new strategic owners would become the core of the new capitalist market economy. After two years of 'gradual' discussion the Privatisation Act was passed, which was a compromise between two balancing and equally strong proposals (Mencinger 2004: 77, Šušteršič 2004: 403–4), with the gradualist approach dominating. The privatisation process did not produce serious social conflicts. In many cases the identification of managers and workers with 'their new company' was strengthened as they were willing to retain their privatisation shares (Lah 1996: 319).

Another significant manifestation of gradualism concerned whether to impose a fixed or a floating exchange rate, after the new currency – the tolar – was introduced in autumn 1991. The shock therapists proposed a fixed exchange rate believing that a new country needed that as a precondition for a genuine market economy. In contrast, the gradualists proposed a floating exchange rate, which implied a flexible and gradual depreciation of the tolar. The latter would primarily stimulate domestic export-oriented firms, resulting in smaller output losses and lower unemployment. On the other hand, the floating exchange rate

would, through imports, generate inflationary pressures (Mencinger 2004: 78).[1]

Development of the system of social dialogue might also be interpreted as part of the gradualist macroeconomic policy process. During the first two years of transition the labour market was basically left to the free play of market forces. The transition downturn caused growing unemployment but that was understood as a normal by-product of the functioning of the 'new' capitalist system. Generous benefits for the newly unemployed absorbed some social tensions (Stanojevič 2004a: 357) and neutralised the absence of social dialogue. The Economic and Social Council was established in September 1994 with the aim of articulating and channelling the interests of government, employers and workers and coordinating (labour) market forces. The agenda of the Economic and Social Council was broadly defined to cover the following issues:

- wage policy;
- social policy;
- employment policy;
- economic and monetary policy;
- industrial relations;
- EU policy.

In its ten-year history the ESC had 122 meetings – nearly one every month – and discussed about 500 topics, primarily wage policy. Three broad social tripartite agreements and five tripartite agreements on income policies were signed after 1994. Stanojevič argues that the dialogue between left-of-centre governments (Slovenia had left-wing

1 Another reason for a floating exchange rate was the total collapse of the Yugoslav monetary 'shock therapy model' in 1989, which Slovenia experienced while it was a federal unit of the former Yugoslavia. At that time the Yugoslav government and the Bank of Yugoslavia imposed a fixed exchange rate model, which lasted only a few months, resulting in hyperinflation.

coalition governments from 1992 until 2004), trade unions and employers was a permanent feature of the Slovenian transition and that exchanges between them were a key mode of interest concertation (Stanojevič 2004a: 351, 2004b: 109).

The gradualist economic policy measures adopted in the first period of the transition, with the institutionalisation of social dialogue as an integral part of the process, resulted in a smooth transition in Slovenia. Like all transition countries, Slovenia experienced a downturn, but it was short-lived. From 1995, when inflation and unemployment were relatively stabilised, the Slovenian economy experienced sustained growth.

3. Towards fulfilment of the Maastricht criteria and ERM II

3.1 Formation of the Maastricht economic policy

During the transition, the next turning point for Slovenia's economic policy came when, at a meeting in Luxembourg in 1997, the European Council opened accession negotiations. The Accession Partnership dealt with priorities in relation to legislative and institutional measures linked to the adoption and implementation of the *acquis communautaire*.

At that time Slovenian macroeconomic policy was being conducted in line with the guidelines laid down by the Maastricht Treaty, although the Maastricht convergence criteria were not formally mandated for countries seeking membership and adherence to EMU aims was not an explicit accession requirement. The economic part of accession policy was outlined in two documents: the Joint Assessment of the Medium-Term Economic Policy Priorities of Slovenia (1997) and the more comprehensive and detailed Strategy of the Republic of Slovenia for Accession to the European Union: Economic and Social Part (hereafter, Strategy) of 1998. The Strategy perhaps too optimistically and prophetically declared:

> (T)he main objective is to become an EMU member in 2005, a few years after Slovenia joins the EU. (Strategy 1998: 37)

Even at that time Slovenia fulfilled both budget-related Maastricht criteria. Roughly balanced public finance had been achieved by the reform of public financial institutions in 1991, the effectiveness of tax collection was good and budget expenditure was under control. Annual budgets were balanced more or less without deficits. Public debt remained at 25 per cent of GDP (Strategy 1998: 242).

On the other hand, Slovenia was still short of monetary and foreign exchange rate targets. Inflation and interest rates were also high compared to the Maastricht criteria and a floating exchange rate was in place. The Slovenian government, together with the Bank of Slovenia, decided that monetary policy should play a central role in the macroeconomic policy mix, while fiscal and incomes policy should play 'supportive roles'. To quote the Strategy:

> Money supply as the anchor of monetary policy has been effective due to stable monetary demand in the country. Recently, M3 targeting was introduced and publicly announced by the Bank of Slovenia. (Strategy 1998: 34)

The unprecedented transparency of the monetary policy goal had a strong disinflationary impact.

As already mentioned, fiscal policy played a supportive role, which meant that it had to follow the guidelines established at the beginning of the transition.

Income policy and the role of social dialogue were important parts of the Strategy. The government recognised that the trend of wage increases not matched by productivity growth had to be checked. Between 1992 and 1996 aggregate wage levels outstripped (except in 1994) productivity (see Table 1).

Constant increases in average gross wages per employee from 1992 contributed to the deterioration of export competitiveness and profitability in certain parts of the economy, especially in the tradable sector, which faced competition on both domestic and foreign markets.

Table 1: Wage and productivity developments (1992–1997)

	1992	1993	1994	1995	1996	1997
Gross wage per employee	0.7	11.7	4.7	5.1	5.1	2.4
Productivity	–1.4	4.6	5.0	3.2	3.9	3.8

Source: Strategy of the Republic of Slovenia for Accession to the European Union: Economic and Social Part (1998: 242).

Depressed profitability and the slow privatisation process had a negative impact on investment activity, which was low in manufacturing, and on job creation. The fall in employment hit lower skilled workers hardest, automatically pushing up wages. Wage increases were to a large extent integrated in the cost of inputs and therefore in prices, particularly in the non-tradable sector, which did not face competition.

The unbalanced wage increases might be explained in terms of an inverse Ballasa-Samuelson effect. According to the normal Balassa-Samuelson effect (Lojchova 2003) rises in the prices of tradables tend to be equalised across countries, thereby bidding up wages in the tradable sector. Afterwards, with labour mobility, wages rise in the non-tradable sector and in the economy as a whole. In Slovenia, conversely, the increase in wages in the non-tradable sector raised the cost of inputs for the tradable sector. In pre-election periods (1992, 1996) the public sector trade unions took advantage of the 'soft' government bargaining position and obtained wage increases for their members. The tradable sector, on the other hand, was less able to pass on the rising costs (wages and inputs from the non-tradable sector) in the form of prices because this would have harmed its export competitiveness.[2]

2 Another explanation of the wage increases is the 'hump shape hypothesis', according to which either centralised or decentralised collective wage bargaining leads to moderate wage increases, while wage bargaining at the intermediate level stimulates extensive wage increases. In Slovenia, the wage (*cont. on next page*)

At one of the meetings of the Economic and Social Council in 1996 the social partners agreed that wage increases were too high and supported government policy to control wage increases (Ekonomsko socialni svet, 2004: 31). Later, in 1997 and 1998, there were long discussions among the social partners on wage policy but no formal agreement was reached. The government enshrined its incomes policy in law but taking into account the results of unsuccessful collective bargaining (Stanojevič 2004: 354). The tacit approval of the trade union side was the turning point for applying a wage policy based on the doctrine of 'productivity reserve'.

Employment policy was not a primary goal and was left to one side. In the Strategy it was recognised that 'a large fall in unemployment cannot be expected in the medium term' (Strategy, 1998: 10). This was partly due to demographic trends (generations from the 1970s and early 1980s entering the labour force), partly to the restrictive transition monetarist policy and partly to the labour-saving technologies introduced due to enterprise restructuring. Unemployment was therefore treated as a free variable of economic policy, to be reduced by active policy measures.

The 'EMU accession-centred' economic policy mix, taking the Maastricht criteria as its goals, with a central role for monetary policy, and budget and income policy in supporting roles, was the framework for the later decision to enter ERM II. The strategy was discussed at the Economic and Social Council and supported by the social partners, who demanded an opportunity to participate in the process (Ekonomsko socialni svet 2004: 35). Slovenia's relatively favourable macroeconomic results in the next few years led to the conclusion that adopting the Maastricht policy was a good decision.

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bargaining system was at that time (and still is) centralised. The strength of the public sector trade unions 'moved' the bargaining position to the top of the hump, which produced higher wage increases, with further pressures on inflation (Sušjan and Lah 1997).

3.2 The formal decision for ERM II

The Government and the Bank of Slovenia decided in November 2003 that in the new few months Slovenia would prepare to enter the fixed exchange rate system (ERM II), to be followed, in two years, by adoption of the euro. When a fixed exchange rate was agreed, the tolar's exchange rate could fluctuate only within a +/–15% band. It was planned that, after entering the ERM regime in mid 2004 (Slovenia actually entered ERM II on 27 June 2004 with central parity set at SIT 239.640 to EUR 1), the euro should be adopted at the beginning of 2007.

Fulfilment of the Maastricht convergence criteria was taken as a basic orientation for the new economic policy. As shown in Table 2, Slovenia accomplished stability of fiscal criteria from 2001 (and indeed since 1997), while the monetary criteria still had to be met. Inflation rates were higher than the convergence criteria laid down, as were interest rates.

A number of other macroeconomic figures indicated that the economic and social environment was relatively stable and favourable. The Slovenian economy experienced sustained GDP growth (average growth rate in the period 2001–2003 was around 3%), and GDP per capita was constantly increasing, reaching 75% of the EU-15 average in 2003, up from around 69% in 1995 (Eurostat).

The external trade balance became positive in 2001 after a deterioration in 1998–2000 (due to the introduction of value added tax, which prompted a rise in imports in anticipation). In 2002 the surplus widened as a consequence of the large FDI inflow (nearly 9% of GDP) when 34% of the government share of the largest Slovenian bank – Ljubljanska banka – was sold to KBC of Belgium (EUR 435 million) and EBRD (EUR 64 million) and the pharmaceutical company Lek was acquired by the Swiss multinational Novartis (around USD 860 million). In 2003 FDI was modest and outward FDI exceeded the

Table 2: Slovenia's macroeconomic performance and the Maastricht criteria

Maastricht criteria	Slovenia 2001	Converg. criteria	Slovenia 2002	Converg. criteria	Slovenia 2003	Converg. criteria	Slovenia 2004	Converg. criteria	Euro zone
Balance of state budget	–2.7	– 3%	–1.9	– 3%	–1.8	– 3%	–1.9	–3%	–2.7%
General government debt	26.9%	– 60%	– 27.8	– 60%	–27.1%	– 60%	– 29.4	–60%	–71.3%
Inflation rate	7.7	3.00	6.2	2.8	5.6	2.1	4.1	2.4	2.1
Interest rate	12.65	6.98	5.75	6.18	6.16*	4.31*	5.20	6.44	4.27%
ERM	Flexible	Fixed	Flexible	Fixed	Flexible	Fixed	Fixed	Fixed	–

Note: * The interest rate criterion changes on a monthly basis. The data are for October 2003, the month before the Slovenian decision on ERM was taken.
Source: Eurostat (2004, 2005), Bilten Banke Slovenije (2004, 2005).

inflow: in 2003 Slovenia was a net direct investor abroad (IMAD Spring Report 2004: 82–83). The sudden increase of FDI – one of the rare shocks during Slovenia's transition – had substantially increased the foreign exchange reserves (up to 6.8 months of imports compared to 4.5 months in 1996). Silva-Garegui (2004: 122) argues that this was one of the main reasons which gave the government confidence in relation to ERM II.

3.3 Labour market developments

As far as the labour market and unemployment are concerned, the data for 2001–2003 show that:

- the unemployment rate fluctuated between 6.5% and 7% (Eurostat);
- the wage distribution index (ratio between the 10th and the 1st decile of wage earners) was stabilised in the period 2001–2003 at around 3.5 and the Gini coefficient was slightly reduced, from 0.299 in 2001 to 0.292 in 2003 (IMAD 2004, Spring Report: 102).

Vodopivec (2004: 311) asserts that the transition of the Slovenian labour market was completed around 2001. Market forces had been sufficiently strengthened so that the labour market could begin to perform its 'key' function, the reallocation of labour. His arguments are:

- both worker and job flows declined and mostly stabilised at the end of the 1990s;
- unemployment was stabilised at a relatively acceptable level according to international standards;
- the remuneration of more qualified workers increased dramatically, while that of workers with long service declined; remuneration also improved for workers just entering the labour market.

4. Social agreement on entering ERM II

Besides the favourable macroeconomic figures in recent years, the major social precondition for the decision to enter ERM II was the Social Agreement signed between the social partners in April 2003 for the period 2003–2005. The new agreement was a continuation of the process of social dialogue. The agreement recognises and asserts the importance of mutual understanding, trust and good will, as a framework for channelling, preventing and neutralising social conflicts in the short term:

> The partners agree that the model of social dialogue developed in the past ten years has produced satisfactory results. However, we are aware that social dialogue is a mechanism that constantly evolves, improves and adapts to new conditions resulting from changes in both the wider and more immediate environments. In order to create a mechanism that would react promptly and appropriately to the new conditions and serve its purpose, all the participants in the process shall constantly improve their knowledge and the skills required for conducting social dialogue successfully. (Social Agreement 2003–2005: Chapter 30)

The most important parts of the agreement, concerning macroeconomic policy in the ERM II period, are the following:

> The partners are aware that low inflation is not only a condition for joining the EU and EMU but also, even more importantly, a vital condition for achieving the goals of this Agreement. The partners shall take appropriate action to fulfil the Maastricht criteria regarding inflation before Slovenia joins the EU. (Social Agreement 2003–2005: Chapter 30)

The agreement included a policy on wage increases:

> We agree that the real growth of gross wages per employee should be at least one percentage point behind productivity growth, which will enable investment in development, the creation of new workplaces and increased social security. (Social Agreement 2003–2005: Chapter 40)

The productivity reserve wage policy is a continuation of the wage policy of previous periods (see Tables 2 and 3).

Table 3: Productivity and wage developments (1998–2004)

	1998	1999	2000	2001	2002	2003	1999–2003	2004 (est.)
Labour productivity	3.6	4.3	2.8	2.2	3.9	2.5	3.1	3.2
Gross wage per employee (real)	1.6	3.3	1.6	3.2	2.0	1.8	2.4	2.0
Private sector	–	3.2	1.3	2.3	2.3	2.1	2.2	2.5
Public sector	–	3.7	2.1	5.1	1.1	0.7	2.5	0.5

Source: IMAD Spring Report, 2003: 144; IMAD Spring Report 2004: 97.

The new wage agreement also almost completely abolished indexation and therefore alleviated the cost pressure from wages on both public and private enterprises (Šušteršič 2004: 408), which should have a disinflationary impact.

The Social Agreement also included the Lisbon goals on full employment:

> The government will take into account EU guidelines and policies aimed at increasing competitiveness and achieving the Lisbon goals (for the EU to become a more dynamic, competitive, environmentally-friendly and knowledge-based economy by 2010). Consequently, full employment and increased economic and social inclusion are to be achieved. (Social Agreement 2003–2005: Chapter 26)

If the basic tasks of social dialogue are negotiation, information and consultation (Winterton and Strandberg 2004: 22) between the social partners, finally resulting in an agreement, the Social Agreement for 2003–2005 was a definite success. There may be some hesitations in terms of completeness, however. It is always questionable how broad macroeconomic dialogue should be and how deep it should go. Furthermore, should the whole (economic) policy mix and its conse-

quences – assuming that these could be perfectly foreseen – be discussed and negotiated or should negotiations and consultation be limited to topics connected directly with the labour market (unemployment and wage policy).

It should be added that some of the goals in the Social Agreement were rather contradictory. The goal of reducing inflation assumed that employers and trade unions would accept a future restrictive monetary policy of the Bank of Slovenia, which should – seen from the Keynesian perspective and in terms of the Phillips curve – result in lower growth rates and higher unemployment. (The wage policy with a 'productivity reserve' goal, when wages grow more slowly than productivity supports inflation reduction.) If the full employment goal were to be achieved, monetary policy could be less restrictive or even expansive; but this would nullify the ERM II goals. It should also be stressed that the inflation goal and the wage-lagging goal are precisely defined: inflation has a clear anchor for the next two years under ERM II defined by the inflation in the best performing EU countries, while wage increases are to be based on productivity. On the other hand, the Lisbon or Stockholm employment goal, specified at 70% (in 2010) of the active labour force – Slovenia has achieved around 63% since 1998, with negative employment growth since 2002 (Eurostat) – is declarative in nature.[3]

In any case, the Social Agreement 2003–2005 provided the legitimacy the government needed to pursue its ERM II economic policy. The logical consequence was that inflation would be 'public enemy no. 1' during the period of preparation for ERM II and afterwards. As a consequence, the Bank of Slovenia took the following actions:

3 The Agreement could go even deeper and specify intermediate employment goals from the Stockholm declaration such as 67% employment in 2005, or 50% for older workers in 2010, etc. Slovenia already 'fulfils' the female employment goal (57%). In Slovenia it is around 58% (Eurostat).

First, even before Slovenia entered the ERM II mechanism in June 2004, the Bank of Slovenia had decelerated the growth of money supply aggregates targeting lower inflation. This is notable when we observe the broad monetary aggregates. From the beginning of 2004, the growth in M1 was 10.6% at the end of 2003 (11.2% at the end of 2002), growth in M2 fell by 19.8 percentage points to 5.2% and growth in M3 dropped by 13.5 percentage points to 4.9% (IMAD Spring Report 2004: 118). The tightening of the money supply will have a disinflationary effect but will also restrict enterprises' ability to obtain credits, especially those already in difficulties.

Second, interest rates had to be lowered. International comparisons show that Slovenian lending rates were above EMU rates, even when taking into account differences in inflation. The biggest differences can be seen in long-term interest rates on corporate loans, which encouraged domestic firms to borrow from abroad (IMAD Spring Report 2004: 124–125). Both measures are intended to initiate the following 'causal chain' (Watt and Hallwirth 2003): falls in inflation and inflationary expectations › lower interest rates › higher investment › lower unemployment,[4] with favourable effects.

Third, the depreciation of the tolar in the first half of 2004, when the floating exchange rate system was still in operation, was slowed. The euro's monthly appreciation ranged at around 0.2%, which reduced the value of the tolar to the euro. The fixed exchange rate would have a disinflationary effect.

In sum, the Slovenian government's decision to enter ERM II was reasonable and well founded. Slovenia's macroeconomic performance in the period 2001–2003 was relatively favourable, 'not far' from the

4 The original causal chain, analysing the impact of monetary uncertainties on European unemployment, is: inflationary fears › higher interest rates › lower investment › higher unemployment (Watt and Hallwirth 2003: 617).

Maastricht criteria. The Social Agreement (ignoring the abovementioned contradictions and incompleteness) guaranteed future adherence to the Maastricht goals by the social partners. The latest data also show (see Table 2) that Slovenia is closing the gap with the Maastricht criteria.

5. ERM II, labour market and social partner behaviour

The ERM II economic policy was expected to have both positive and negative effects on the Slovenian economy, with, of course, the positive prevailing in the long run.

Among the positive impacts, the most important is the improved transparency and stability of the business and financial environment and the significant lowering of transaction costs. The fixed exchange regime will reduce the uncertainties which were possible during the flexible exchange rate regime, when unpredictable exchange rate variations affected the plans especially of export-oriented firms. Next, the expected reduction in interest rates will, viewed from a Keynesian perspective, stimulate domestic investment and, even more, demand[5] and further increase output and employment.

On the other hand, the most important negative impact is, of course, the loss of an independent monetary policy and the consequent inability to react to external or internal shocks. It may be expected that the monetary policy restrictions will cause liquidity problems in Slovenian firms, in the short run especially affecting the most labour intensive industries and firms already experiencing problems (textiles, footwear, etc.).

5 The extensive stimulation of demand by lowering interest rates is considered to be a ‘risk factor’ (IMAD, Spring Report, 2004: 14) which might have inflationary effects. On the other hand, it is expected that the restrictive wage policy will have the opposite effect and neutralise the risk.

It is difficult to be sure of what kind of impact – positive or negative – will prevail in both the short and longer term (if one takes into account unpredictable external factors such as rising oil prices, predictions become even more dubious). However, the recent performance of the Slovenian economy, since the decision was taken to enter ERM II and join the EU, is promising:

- Real GDP growth in the second quarter of 2004 compared to the same period of 2003 was 4.6%, the highest growth since 2000 (2.7% in 2001, 3.3% in 2002, and 2.1% in 2003 – IMAD Spring Report, 2004: 14).
- Unemployment rates are the lowest since independence: in June 2004 the rate was 6% (according to ILO methodology).
- The level of investment in the first half of 2004 was higher than in the same period in 2003 (7.3% compared to 6.3%) (IMAD Autumn Report, 2004: 5).
- No significant outward or inward migrations of labour have been reported since Slovenia's membership of the EU.
- The Bank of Slovenia has been successful in pursuing a restrictive ERM II monetary policy since the end of 2003. Under the ERM II regime, since the end of June 2004, the Bank of Slovenia has already 'tested' its ability to sustain a fixed parity of the tolar to the euro. The Governor of the Bank of Slovenia explained in an interview that, during the two months under the ERM II regime, the Bank of Slovenia had intervened (though he did not say when) and that the exchange rate had fluctuated no more than +/– 0.2%.
- EU membership did not cause significant changes in terms of external balance and FDI (IMAD, Spring report 2004: 84).
- The inflation rate has been decreasing, although in recent months it has increased slightly, but this is more a consequence of rising world oil prices than the ERM policy.

Among the negative effects of the ERM II policy and Slovenian membership of the EU, unemployment – although decreasing – is the

worst. Structural unemployment is concentrated more and more among the young unemployed (in 2003 those under 26 made up around 26% of the unemployed) and the female unemployed (in 2003 women's unemployment constituted 52.8% of average unemployment) due to retirements, removals from the unemployment register and subsidies given to people with poor employment prospects (IMAD Spring Report 2004: 95–96). Regional disparities in terms of unemployment slightly decreased in 2003 (IMAD, Spring Report 2004: 97).

The National Action Plan on Employment in 2004, prepared in accordance with the European Employment Strategy, uses the 'Danish' strategy to help the unemployed, which means that it will concentrate on targeting unemployed persons in labour intensive industries and in less developed regions.

The abovementioned generally optimistic macroeconomic figures suggest that there is no potential for serious social conflict. The issues discussed recently by the social partners may be summarised under four headings. We present some typical views to illustrate the climate of social dialogue:

1. *Labour costs, competitiveness and management efficiency*

The employers' side emphasises labour costs. Samo Hribar Milič, Secretary General of the Employers' Association of Slovenia, says:

> As in the EU, labour costs are extremely high compared to productivity growth and value added … On average labour costs are too high. The government should lower taxes … and people should work more for the same wage. (Delo, 14.8.2004)

The Trade Union side, on the other hand, replies (Brane Mišič, Secretary General of the most influential trade union, ZSSS):

> Only incapable managers with insufficient knowledge and unable to develop good products or services compete on the basis of lower costs … With more imagination they could achieve a higher market share. (Delo, 14.8.2004)

2. Extension of the working day

The debate on the extension of the working day has been provoked by the new European context.[6] As might be expected, the employers' side and some managers support 'European' practice (but also complain that they would prefer lower taxes). The trade union side asserts the negative impacts of extending the working day, such as higher rates of absenteeism and lowering the quality of life. The government side seems to be indifferent, asserting that the new Labour Code will allow some leeway.

It may be added that 'hidden' extensions of the working week are already significant in Slovenia. Based on an empirical study, Stanojevič reports extreme intensification of labour compared to European averages. This takes a number of different forms, such as weekend work extensions, night shifts and extra working hours, and has become common practice for management especially in export-oriented firms. The workers, under pressure of losing their jobs, have no choice but to 'accept' the extra work. Although trade unions in Slovenia are strong, they have tacitly accepted such practices (Stanojevič, 2004c: 126–127).

3. Strike threats

GDP growth and falling unemployment during the ERM II period and the declining trend as regards strikes since 1992 (Stanojevič, 2004a: 352) might lead to the conclusion that longer strikes should not have happened. The strike threats of casino workers and football players demanding higher wages may be mentioned as curiosities but the jour-

6 The same trend has been observed in Germany and it is assumed that it began in East Germany, where workers agreed to put in more time to compensate lower productivity. Christoph Schroder, an economist at the Cologne Institute of German Statistics, estimated that if everyone worked only one hour a week extra, German growth would hit 3% in 2004, double current projections ('The Lazy Men of Europe No More?', *Business Week*, 7 June 2004).

nalists' strike may have broader consequences. It was a significant example of the confrontation between social partnership on one side and neo-liberal thinking on the other. The Journalists' Trade Union signalled the possibility of strike action several times, demanding that the Collective Agreement, mostly concerning wages and working standards, should apply to all journalists in Slovenia (Slovenia's system of collective bargaining is inclusive). The journalists from the larger media companies (the most influential newspaper in Slovenia, Delo, National TV), which generally implemented the agreement, supported the demands of the journalists from many smaller regional media firms which did not implement the agreement. The Chamber of Commerce, acting as the representative of the employers' side in the dialogue, refused even to meet journalists' trade union representatives. The decision to go on strike was taken during the parliamentary elections and lasted three days.[7] However, journalists from POP TV, the other influential TV company (Slovenia has a duopolistic TV market), which is privately owned, refused to join the strike but took their 'liberal' opportunity to improve market position in the 'hot' electoral period. The strike was called off after the trade union side managed to get the employers' side to agree to negotiations, but with no clear obligations from the latter.[8]

There are signs that the journalists' strike may influence the established framework of social partnership, especially the role of the Chamber of Commerce in negotiations. New prime minister[9] Janša commented on the journalists' strike:

7 The Journalists' Trade Union demands were supported by the most influential Slovenian trade unions and the European Federation of Journalists.

8 The journalists criticised the government side, especially the Ministry for Labour, Family and Social Affairs for their passiveness, demanding that the negotiations be conducted at the tripartite level.

9 After twelve years under a left-wing coalition, a right-wing coalition won the election in Slovenia.

> We are living in a state in which the employers' representative has decided that it will not negotiate. (*Delo*, 8.10.2004)

The problem concerning the inappropriate representation and articulation of employers' interests seems to be deeper. Several complaints have been made about the central role of the Chamber of Commerce:

- Complaints about compulsory membership come mostly from SMEs which find it difficult to pay the fees. According to research, about 80% of the members are against compulsory membership and it is estimated that only 3–5% of the present members would remain if membership was voluntary.
- The representative body of the Chamber of Commerce consists of the representatives of large companies, while the majority of smaller members cannot articulate their demands. It is also stressed that the stance of the Chamber of Commerce in relation to the government is too submissive.
- It is said the Chamber of Commerce covers too wide an area of activities, which are not always even 'demanded' by firms and that the services offered are in many cases useless.

A group of so-called 'young economists' (mostly educated in the USA) who are members of the new Strategic Advisory Board of the prime minister also question compulsory membership of the Chamber of Commerce and the institution of social partnership. Taking Slovakian reforms as a model, they eagerly advocate (using the motto 'Lisbon is dead, Bratislava here we come') neo-liberalist supply-side policy measures, such as lower taxes on capital and (higher) incomes, flat tax rates and the abandonment of the too generous social security system. However, the result is somewhat unclear as the Prime Minister, expressing the Government's commitment to the ERM II policy, in an interview said that the Social Agreement which expires in 2005 should be renewed.

Criticism of the Chamber of Commerce may not only modify the pre-

sent organisation of the Chamber but also change the established institutional structure of social dialogue. If membership of the Chamber of Commerce was voluntary, the radical fall in membership would call into question its central representative role. As already mentioned, there are signs that the policy of the new right-wing government might turn to liberalisation.

Otherwise, the issues discussed among the social partners under the ERM II economic policy may be qualified as normal at bipartite or tripartite level. The fact is that the Social Agreement 2003–2005 is still in place and there are no indications that it will be cancelled.

Conclusion

Slovenia has been pursuing a gradualist and synchronised economic policy during its fourteen years of independence and transition, and, according to macroeconomic data, it has been relatively successful.

The same gradual and synchronised policy was pursued in preparation for the ERM II regime. The Social Agreement 2003–2005, which precisely defines restrictive monetary goals (inflation and wage increases), but is lacking a precise definition of employment goals, was an important precondition for the step into ERM II. The Keynesian fears of falling growth rates and growing unemployment caused by a restrictive monetary policy seem not to have been realised. On the contrary, the macroeconomic data in the preparatory stage and during the first months of ERM II show favourable results with inflation falling and growth rates unaffected. The exception is unemployment which, although generally falling, is structurally threatening particular segments (young people, women). It is expected that active policy measures will address this problem. The issues discussed in the macroeconomic dialogue may be qualified as normal between the social partners.

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