

## THE NEW EU MEMBERS

### 1. Introduction

Nearly three years ago, on 1 May 2004, membership in the European Union grew by ten new member countries: the 2004-member countries, as we shall refer to them. In terms of population, the size of the EU increased by over one hundred million people, though in economic terms the increase was much smaller as living standards in most of these countries are significantly lower than in Western EU countries. In the beginning of 2007, a further enlargement of the EU took place when Bulgaria and Romania became full members of the EU. In addition, Slovenia, one of the 2004-member countries, has become a member of the monetary union.

At the time of the 2004 enlargement, it was anticipated that membership in the EU would lead to significant improvements in the economic performance of the new members, especially the ones in Central and Eastern Europe (see, for example Chapters 5 and 6 of EEAG 2004). Our first goal in this chapter is to analyse the most recent macroeconomic performance of the 2004-member countries, discussing foreign trade, economic growth and employment; the criteria for EMU entry; and external and financial aspects.

Our second goal is to provide an overview of the macroeconomic situation of the two most recent entrants Bulgaria and Romania.

### 2. Trade, growth, and employment in the 2004-member countries

Beginning with indicators of economic integration, the share of foreign trade (exports plus imports) in GDP of the 2004-member countries ranged from about 70 percent for Poland to 160 percent for Estonia in 2005.<sup>1</sup> Moreover, the bulk of foreign trade is with other EU countries, with EU-25 trade making up between 60 and 81 percent of total imports of the 2004-member countries and between 52 to 85 percent of total exports.<sup>2</sup>

Another anticipated consequence of the 2004 enlargement was that the ten new member countries would benefit from faster economic growth through exploitation of larger markets and inflow of foreign capital and technologies. On the basis of various studies it was estimated in Chapter 5 of EEAG (2004) that the annual growth gains to the ten countries from EU membership could be around one percentage point for the first ten years of EU membership.

Table 3.1 shows the rates of economic growth since 2001. Economic growth in the 2004 entrants has indeed accelerated since 2004. This observation is true for nearly all of these countries, with Malta and Lithuania being possible exceptions to the pattern.

The growth performance of the three Baltic countries is particularly remarkable, with annual growth rates in the 7 to 11 percent range in 2004 to 2006. The best performers, Estonia and

**Table 3.1**  
Real GDP growth in 2004-member countries, percent, 2001–2006

	2001	2002	2003	2004	2005	2006
<b>Czech Republic</b>	2.5	1.9	3.6	4.2	6.1	6.0
<b>Estonia</b>	7.7	8.0	7.1	8.1	10.5	8.9
<b>Cyprus</b>	4.0	2.0	1.8	4.2	3.9	3.8
<b>Latvia</b>	8.0	6.5	7.2	8.6	10.2	11.0
<b>Lithuania</b>	6.6	6.9	10.3	7.3	7.6	7.8
<b>Hungary</b>	4.1	4.3	4.1	4.9	4.2	4.0
<b>Malta</b>	-0.4	2.2	-2.4	0.0	2.2	2.3
<b>Poland</b>	1.1	1.4	3.8	5.3	3.2	5.2
<b>Slovenia</b>	2.7	3.5	2.7	4.4	4.0	4.8
<b>Slovakia</b>	3.2	4.1	4.2	5.4	6.0	6.7
<b>EU15</b>	1.9	1.1	1.1	2.2	1.5	2.6

Source: Eurostat 2006.

<sup>1</sup> World Development Indicators Online (2006).

<sup>2</sup> European Commission (2006a).

Latvia, are assessed to have very good business environments among transition economies (EBRD 2006). The situation in Lithuania is not as good in this respect. Domestic demand and, to some extent, very good export performance are behind the rapid growth in the Baltic countries. In some cases there are signs of overheating indicated by worsening external positions (to be discussed below), buoyant asset and housing prices, rapid growth in domestic credit (especially in Latvia) and high rates of capacity utilisation (especially in Lithuania).<sup>3</sup>

Growth in the Czech Republic and Slovakia has also speeded up considerably since 2004. In both countries strong domestic demand – both private consumption and investment – appears to be the key component in GDP growth, though export performance is also solid. Both the Czech Republic and Slovakia are carrying or have carried out important structural reforms, including an ongoing pension reform in the Czech and a tax reform introducing a flat tax in Slovakia. It has, however, been suggested that further reforms are needed to support growth and broaden the base for economic improvements.<sup>4</sup>

Table 3.2 shows that unemployment developments are diverse among the 2004-member countries. Unem-

<sup>3</sup> For further discussion, see IMF (2005a, b) and EBRD (2006).

<sup>4</sup> See OECD (2005, 2006), IMF (2005c, d) and EBRD (2006) for further discussion of economic developments in the Czech and Slovakia.

**Table 3.2**  
Unemployment, percent of labour force, 2003–2006

	2003	2004	2005	2006
<b>Czech Republic</b>	7.8	8.3	7.9	7.4
<b>Estonia</b>	10.0	9.7	7.9	5.4
<b>Cyprus</b>	4.1	4.6	5.3	5.4
<b>Latvia</b>	10.5	10.4	8.9	7.4
<b>Lithuania</b>	12.4	11.4	8.3	5.9
<b>Hungary</b>	5.9	6.1	7.2	7.3
<b>Malta</b>	7.6	7.4	7.3	7.0
<b>Poland</b>	19.6	19.0	17.7	13.9
<b>Slovenia</b>	6.7	6.3	6.5	6.1
<b>Slovakia</b>	17.6	18.2	16.3	14.3
<b>Euro area</b>	8.7	8.9	8.6	8.0

Source: European Commission (2006b).

#### Box 3.1

##### Criteria for EMU entry

- The deficit of the general government must be below three percent of GDP. Gross debt of the general government must be below 60 percent of GDP or declining toward 60 percent of GDP at a satisfactory rate.
- Inflation must not exceed the average rate of inflation in the three EU countries with the lowest inflation rate by more than 1.5 percentage points.
- The long-term interest rate must not exceed the average rate in the three EU countries with the lowest interest rate by more than two percentage points.
- Two years of participation in the Exchange Rate Mechanism II (ERM II)<sup>a)</sup> without major tensions in the foreign exchange market are required.

<sup>a)</sup> ERM II replaced the earlier ERM when the euro was introduced. It is a multilateral exchange rate arrangement with a fixed, but adjustable, central parity for the exchange rate of the currency of a member country to the euro and a fluctuation band around the parity.

ployment has fallen in the Baltic countries, Poland, Slovenia and Slovakia, whereas the picture for the rest is not clear-cut. The same tendencies are reflected in employment rates.

### 3. Fulfilling the EMU criteria for macroeconomic stability

EMU membership is a longer-term goal for the 2004-member countries. Membership requires fulfilment of several criteria of macroeconomic stability. These include price stability, low fiscal deficits and debt, a low long-term interest rate, and stability of the currency exchange rate. Box 3.1 gives details.

Table 3.3 gives information about the current exchange rate regimes of the 2004-member countries.

The Baltic countries, Cyprus, Malta and Slovakia are currently in the ERM II and these countries are evidently planning to adopt the euro relatively soon. Last year Lithuania's application for euro membership was turned down and Estonia was advised not to apply because of concerns about inflation. We return to the inflation situation and the failed attempts to enter below. Presently, Estonia plans to enter EMU in the beginning of 2008 and Cyprus and Slovakia in the beginning of 2009. Latvia, Lithuania and Malta do not have definite planned dates of entry into the monetary union. As the

**Table 3.3**  
Exchange rate regimes of 2004-member countries (beginning of 2007)

<b>Czech Republic</b>	Managed floating with no pre-determined path for the exchange rate
<b>Estonia</b>	ERM II (currency board with fixed peg to euro)
<b>Cyprus</b>	ERM II (pegged exchange rate with $\pm 15\%$ fluctuation band)
<b>Latvia</b>	ERM II (fixed peg to euro)
<b>Lithuania</b>	ERM II (currency board with fixed peg to euro)
<b>Hungary</b>	Pegged exchange rate with $\pm 15\%$ fluctuation band)
<b>Malta</b>	ERM II (fixed peg to euro)
<b>Poland</b>	Free float with inflation target
<b>Slovenia</b>	Member of the monetary union with the euro as currency
<b>Slovakia</b>	ERM II (pegged exchange rate with $\pm 15\%$ fluctuation band)

Source: ECB (2006b), web pages of central banks.

**Table 3.4**  
Fiscal balance, percent of GDP, 2003–2006

	2003	2004	2005	2006	EMU deficit criterion
<b>Czech Republic</b>	-6.6	-2.9	-3.6	-3.5	Not fulfilled
<b>Estonia</b>	2.0	2.3	2.3	2.5	Fulfilled
<b>Cyprus</b>	-6.3	-4.1	-2.3	-1.9	Fulfilled
<b>Latvia</b>	-1.2	-0.9	0.1	-1.0	Fulfilled
<b>Lithuania</b>	-1.3	-1.5	-0.5	-1.0	Fulfilled
<b>Hungary</b>	-7.2	-6.5	-7.8	-10.1	Not fulfilled
<b>Malta</b>	-10.0	-5.0	-3.2	-2.9	Fulfilled
<b>Poland</b>	-4.7	-3.9	-2.5	-2.2	Fulfilled
<b>Slovenia</b>	-2.8	-2.3	-1.4	-1.6	Fulfilled
<b>Slovakia</b>	-3.7	-3.0	-3.1	-3.4	Not fulfilled

Source: European Commission (2006b).

**Table 3.5**  
General government debt, percent of GDP, 2003–2006<sup>a)</sup>

	2003	2004	2005	2006	EMU debt criterion
<b>Czech Republic</b>	30.1	30.7	30.4	30.9	Fulfilled
<b>Estonia</b>	5.7	5.2	4.5	4.0	Fulfilled
<b>Cyprus</b>	69.1	70.3	69.2	64.8	Fulfilled
<b>Latvia</b>	14.4	14.5	12.1	11.1	Fulfilled
<b>Lithuania</b>	21.2	19.4	18.7	18.9	Fulfilled
<b>Hungary</b>	58.0	59.4	61.7	67.6	Not fulfilled
<b>Malta</b>	70.2	74.9	74.2	69.6	Fulfilled
<b>Poland</b>	43.9	41.8	42.0	42.4	Fulfilled
<b>Slovenia</b>	28.5	28.7	28.0	28.4	Fulfilled
<b>Slovakia</b>	42.7	41.6	34.5	33.0	Fulfilled

<sup>a)</sup> The debt–GDP ratios of Cyprus and Malta are above the 60 percent limit, but government indebtedness of these countries is falling. Thus, these countries can be said to meet the debt criterion, though this depends on the interpretation of what is a satisfactory pace of reduction.

Source: European Commission (2006b).

other countries do not seem even to have any definite plans to enter the ERM II, their membership in the monetary union will remain an open issue for several years into the future.<sup>5</sup>

Public-sector fiscal balances and debt levels for the 2004-member countries are shown in Tables 3.4 and 3.5.

All the 2004-member countries with the exception of Cyprus, Hungary and Malta have public debt levels below 60 percent of GDP and hence fulfil the EMU criterion with respect to the level of public debt. Since debt levels are falling strongly in Cyprus and Malta, too, also these two countries probably qualify on this count. Looking at the best countries according to the fiscal criteria, Estonia has a sustained fiscal surplus and almost no public debt. Also Latvia and Lithuania have good public sector positions: they seem to be moving into surplus positions and their debt levels are quite low. Only the Czech Republic, Hungary and Slovakia do not satisfy the three percent limit set for entry into the monetary union. The country furthest away from membership in the monetary union is Hungary, where fiscal deficits have been increasing and amounted to 10.1 percent of GDP in 2006. In addition, government debt is above the 60 percent limit and increasing rapidly.

The level of long-term interest rates is the third criterion for entry into the monetary union. Table 3.6 gives the data for the long-term rates in the 2004-member countries. Long-term interest rates seem to be declining in these

<sup>5</sup> See Table 2.2 and the country assessments in EBRD (2006).

**Table 3.6**  
**Long-term interest rates, percent, 2003–2006<sup>a)</sup>**

	2003	2004	2005	2006
<b>Czech Republic</b>	4.1	4.8	3.5	3.8
<b>Estonia</b>	5.3	4.4	4.0	4.2
<b>Cyprus</b>	4.7	5.8	5.2	4.2
<b>Latvia</b>	4.9	4.9	3.9	4.0
<b>Lithuania</b>	5.3	4.5	3.7	4.1
<b>Hungary</b>	6.8	8.2	6.6	7.3
<b>Malta</b>	5.0	4.7	4.6	4.3
<b>Poland</b>	5.8	6.9	5.2	5.3
<b>Slovenia</b>	6.4	4.7	3.8	3.9
<b>Slovakia</b>	5.0	5.0	3.5	4.5
<b>EMU criterion</b>	6.1	6.1	5.4	5.8

<sup>a)</sup> Long-term interest rates refer to central government bonds issued in national currency with a ten-year maturity; see Annex 1 of ECB (2006b) for further details.

Source: European Commission (2006b).

countries. Slovenia is an exception, but it should be noted that its long-term rate was already quite low in 2004 and it has just entered the EMU. Long-term interest rates vary quite a lot between the other 2004-member countries. The rate is well above six percent in Hungary, which suffers from major fiscal problems as discussed above. Using 2006 data, the EMU criterion is approximately 5.8 percent. Hungary clearly fails this, while Poland is fairly close to this critical value.

Price stability is the remaining criterion for EMU membership. Table 3.7 gives the inflation rates for the countries that joined the EU in 2004. Given that economic growth has speeded up, we would *ceteris paribus* expect some increase in inflationary pressures. These inflation pressures arise because of the Balassa-Samuelson effect: Strong productivity and wage increases in export sectors spill over to the non-tradable sectors resulting in price increases of non-tradable goods. However, the picture for these countries is not one of uniformly higher inflation rates since EU membership. Some countries have indeed experienced increases in the rate of inflation; this is notably the case for the Baltic countries.<sup>6</sup> In the other countries there is no clear picture or inflation has

even declined. Slovenia and Slovakia are examples of countries in which inflation has declined since 2003 simultaneously with increased rates of economic growth.

Of the two Mediterranean countries, inflation is fairly low in Cyprus, whereas inflation in Malta tends to fluctuate. The Baltic countries and Slovakia, which are in ERM II and aiming to join the eurozone, have recently had difficulties with high inflation. As was noted above, problems with inflation have led to postponement of entry by Lithuania and Estonia into the eurozone. Figure 3.1 compares

inflation in Estonia, Lithuania, Slovenia and the eurozone. Due to increased inflation, Lithuania just missed the inflation criterion, which was 2.6 percent in March 2006.<sup>7</sup> The twelve-month moving average for Lithuania was 2.7 percent. Inflation in Estonia has fluctuated around four percent for the past two years, so that Estonia could not meet the price stability criterion. The figure also shows that the disinflation process in Slovenia was successful and the country

<sup>6</sup> See IMF (2006a) for an analysis of inflation in Lithuania suggesting that currently upside inflation risks exist.

<sup>7</sup> European Commission (2006c).

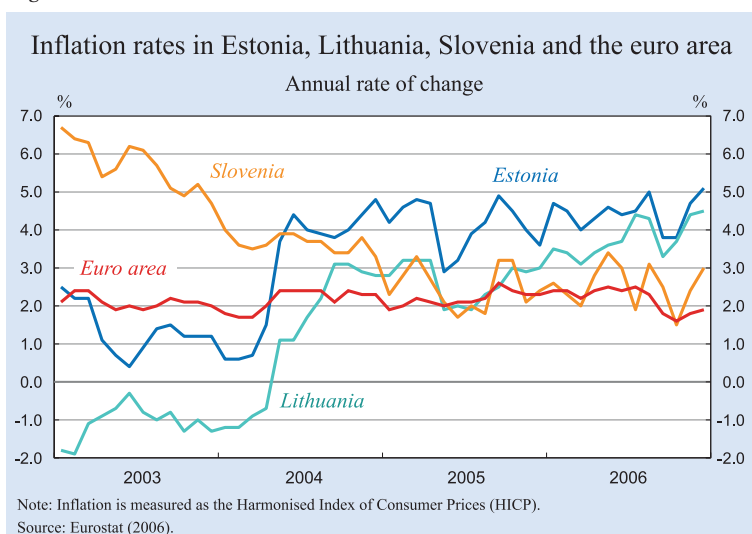
**Table 3.7**  
**Inflation rate (harmonised index of consumer prices), percent, 2003–2006**

	2003	2004	2005	2006
<b>Czech Republic</b>	-0.1	2.6	1.6	2.5
<b>Estonia</b>	1.4	3	4.1	4.4
<b>Cyprus</b>	4	1.9	2	2.4
<b>Latvia</b>	2.9	6.2	6.9	6.7
<b>Lithuania</b>	-1.1	1.2	2.7	3.8
<b>Hungary</b>	4.7	6.8	3.5	3.9
<b>Malta</b>	1.9	2.7	2.5	3.0
<b>Poland</b>	0.7	3.6	2.2	1.4
<b>Slovenia</b>	5.7	3.7	2.5	2.5
<b>Slovakia</b>	8.4	7.5	2.8	4.5
<b>Euro area</b>	2.1	2.1	2.2	2.2
<b>EMU criterion<sup>a)</sup></b>	2.7	2.6	2.9	3.1

<sup>a)</sup> The numerical values of the EMU criterion differ slightly between different publications, as somewhat different twelve-month periods are used to calculate the reference value.

Source: Eurostat and European Commission (2006b).

Figure 3.1



just managed to get its inflation below the critical value.

Strict application of the inflation criterion as a way to postpone EMU entry can have undesirable consequences for the countries in ERM II. The Baltic countries are fulfilling the other criteria for EMU entry and have very strong fiscal positions. The latter are indeed much better than the corresponding positions of several eurozone member countries, so in terms of the fiscal criteria, the Baltic countries, and Estonia in particular, are almost “overqualified” for EMU entry. Cyprus, Malta and Slovakia are having some difficulties with the fiscal criteria, but on the whole meet them or are at least not far from meeting them.

An extended period of ERM II membership due to delayed entry into the monetary union is creating a potentially vulnerable situation for the countries discussed above.<sup>8</sup> These countries have current account deficits and are financing them through inflows of foreign capital, as will be discussed in more detail in Section 3.4.<sup>9</sup> Experiences from other emerging economies suggest that such capital inflows can easily reverse themselves either for reasons that are external to these countries, for example because of a world economic slowdown, or if there is a domestic downturn. This could jeopardise the fixed exchange rate regimes and lead to a serious financial crisis, as we discussed thoroughly in Chapter 6 of our 2004 report. Requiring both exchange rate stability and low inflation is also always problematic as it sets two

simultaneous targets for monetary policy. These targets are usually viewed as alternative, not complementary ways to establish a nominal anchor for the economy.

Moreover, a strict requirement of price stability is particularly problematic for countries that are experiencing rapid growth and face possible inflation pressures through the Balassa-Samuelson effect. The magnitude of the Balassa-Samuelson effect on inflation is difficult to estimate precisely. Estimates in the literature vary from close to zero to

about two and a half percentage points for the Central and Eastern European countries, with larger estimates for poorer countries (see, for example, Sinn and Reuter 2000, Kováč 2002, Mihaljek and Klau 2003, and Buitert and Sibert 2006b). A consensus estimate might be a 1 to 1.5 percentage point increase in the inflation rate per annum.

Given that the Baltic countries, Cyprus, Malta, and Slovakia are growing well, are integrated closely with the EU, and fulfil or are not far from fulfilling the EMU criteria apart from inflation, they should be admitted as quickly as possible to the eurozone. At the moment, these countries seem to be facing an extended period of membership in the ERM II system, which increases the risks of financial shocks. The current inflows of foreign capital may then be reversed and these countries may run into severe difficulties. One should acknowledge that the inflation criterion was originally formulated without any regard for the possibility that fast-growing, catching-up new EU countries would join the monetary union. The ERM II countries should be given a *Balassa-Samuelson rebate* when the inflation criterion is applied. We propose that such a rebate could amount to a maximum of one percentage point. This would mean that the inflation criterion would be reformulated such that the inflation rate is allowed to exceed the average rate of inflation in the three EU countries with the lowest inflation rate by as much as 2.5 percentage points (instead of the current 1.5 percentage points). To qualify for such a rebate, the growth differential between a potential entrant to the eurozone and the average of current members would have to be of a certain magnitude. The price stability criterion for entry into the monetary union is also

<sup>8</sup> See Buitert and Sibert (2006a, b) for a more detailed discussion.

<sup>9</sup> See the data in the next section.



problematic because the reference value for inflation is calculated as the average of the inflation rates of the three countries with lowest inflation. Though perhaps reasonable at the start of the monetary union, this formulation of the reference value is no longer natural. The countries with lowest inflation rates are likely to have experienced undesirable shocks. It would be better to simply use the euro area rate of inflation as the reference value.

#### 4. External and financial situation

Next, we consider external positions and financial situations of the 2004-member countries. These two issues are important for macroeconomic stability even if they are not included in the formal criteria for entry into the monetary union.

Given that these countries have high rates of growth and favourable investment opportunities due to a low capital stock, it is not surprising that they run substantial current account deficits. According to Table 3.8, the external positions of the 2004-member countries vary a lot. According to Table 3.9, the 2004-member countries also exhibit major differences in the inflows of FDI.<sup>10</sup> Most of the FDI, over 80 percent, originates from the euro area and from Denmark and Sweden, while in portfolio investments the rest of the world has a bigger role.<sup>11</sup>

Current account deficits are particularly high in the Baltic countries, Slovakia and Hungary. Rapid growth is the main reason behind the current account deficits in Estonia, Latvia and Lithuania. The current account deficits in the Baltic countries are unlikely to create problems as long as rapid growth can be expected to continue. Estonia relies very strongly on FDI to finance current account

<sup>10</sup> Cyprus and Malta are excluded from Tables 9 and 10 due to lack of comparable data.

<sup>11</sup> See Tables 1A and 1B of Lane and Milesi-Ferretti (2006).

**Table 3.8**  
Current account balance, percent of GDP, 2003–2006

	2003	2004	2005	2006
<b>Czech Republic</b>	-6.3	-6	-2.1	-1.9
<b>Estonia</b>	-12.1	-13	-11	-12
<b>Hungary</b>	-8.7	-8.6	-7.4	-9.1
<b>Latvia</b>	-8.1	-12.9	-12.4	-14
<b>Lithuania</b>	-6.9	-7.7	-6.9	-7.5
<b>Poland</b>	-2.1	-4.2	-1.4	-1.7
<b>Slovakia</b>	-0.8	-3.6	-8.6	-7.7
<b>Slovenia</b>	-0.3	-2.1	-1.1	-2

Source: IMF World Economic Outlook Database September 2006.

deficits, whereas FDI is less important for Latvia and Lithuania. All Baltic countries have significant foreign debts, but special characteristics of these debts limit the vulnerability of the situation, and there do not seem to be significant pressures on the stability of the external positions of these countries (see EBRD 2006). In Slovakia, the increase in current account deficits in 2005 has been argued to depend on increased imports of investment goods and a change in the accounting methodology (EBRD 2006). In Hungary, the current account deficit in the last two to three years has been of the same order of magnitude as the fiscal deficits. Lack of trust in government policies has weakened investor confidence and in 2006 the forint depreciated significantly against the euro.

More generally, all the 2004 EU entrants have significant net foreign liabilities. They ranged from 18 percent of GDP (Slovenia) to nearly 100 percent (Estonia) in 2004. For most countries, the external debt position is not very far from balance. Liabilities take mostly the form of equity liabilities, which

**Table 3.9**  
FDI inflows, 2005

Country	FDI (million Of US\$)	Percent of GDP
<b>Czech Republic</b>	8500	6.9
<b>Estonia</b>	2500	19.1
<b>Latvia</b>	622	3.7
<b>Lithuania</b>	655	2.6
<b>Hungary</b>	3500	3.2
<b>Poland</b>	8177	2.7
<b>Slovenia</b>	346	10.2
<b>Slovakia</b>	1800	3.9

Source: FDI data from EBRD; GDP taken from IMF World Economic Outlook Database April 2006.

**Table 3.10**  
Domestic credit to private sector and stock market capitalisation,  
percent of GDP, 2005<sup>a)</sup>

	Domestic credit	Stock market capital
Czech Republic	37.6	31.8
Estonia	60.0	26.5
Hungary	51.7	31.9
Latvia	60.7	17.4
Lithuania	34.0	31.8
Poland	27.8	31.6
Slovakia	36.2	9.5
Slovenia	53.8	23.8
EU	85.8	67.0

<sup>a)</sup> The Table and the subsequent discussion do not consider Cyprus and Malta.

Source: EBRD (2006).

decreases though does not eliminate the vulnerability to external debt.<sup>12</sup>

Looking at the financial systems, Table 3.10 gives two indicators of the development of financial markets: domestic credit to the private sector and stock market capitalisation as percent of GDP. While the values of both indicators are still well below the average EU level, there has been a rapid increase in the last five years. The domestic credit indicator has risen on average over 60 percent and stock market capitalisation about 55 percent in the period 2000 to 2005. Though financial systems in the 2004-member countries tend to be bank-dominated, other financial services are gradually becoming more important. This is the case with equity markets, which have expanded substantially. Investment in private equity is also becoming an integral part of business financing.

Banking systems in the 2004-member countries have been improving in terms of efficiency and risk management. A major reason for this has been the expanding role of foreign banks in the financial markets of these countries. An indication of the improvement in banking is given by the percentage of non-performing loans in banks' portfolios, which has declined steadily in the last five years. The 2005 figure is close to the corresponding eurozone figure.<sup>13</sup> Overall, the rapid changes in the financial sector are contributing to the fast growth and rising living standards in the 2004-member countries. These rapid changes also mean that risks of new financial crises (suggested in, for example,

<sup>12</sup> See Lane and Milesi-Ferretti (2006) for data and a more detailed analysis.

<sup>13</sup> See Chart 4.2 in EBRD (2006).

Chapter 6 of EEAG 2004) are diminishing. However, financial crisis due to a reversal of capital flows remains a potentially serious risk. As noted above, there are signs of overheating especially in the Baltic countries, and capital flows can be reversed if corrections to overheating or international slowdowns take place.

### 5. Macroeconomic situation of Bulgaria and Romania<sup>14</sup>

Bulgaria and Romania, which joined the EU on 1 January 2007, are relatively undeveloped countries even if the eight central eastern European countries that became members of the EU in 2004 are used as the point of comparison. In 2005, the PPP-adjusted GDP per capita in Bulgaria was 57 percent and in Romania 62 percent of the eight-country average.<sup>15</sup> In 2005, PPP-adjusted unit labour costs in Bulgaria were only 46 percent and in Romania 85 percent of the eight-country average. Trade with the EU25 is fairly extensive for both Bulgaria and Romania; the export shares in 2005 were about 57 and 68 percent, respectively. (The eight-country average was 79 percent in 2005.) Agriculture plays a large role in both Bulgaria and Romania. The share of agriculture in employment was about 25 percent in Bulgaria and 32 percent in Romania. The corresponding eight-country average was about 11.5 percent in 2005.

Looking at economic growth, it is seen from Table 3.11 that both Bulgaria and Romania have been doing well in recent years, though the Romanian growth rate has recently been fluctuating quite a lot.

Table 3.12 shows that inflation is a major concern for both countries. Inflation has been volatile in Bulgaria.

<sup>14</sup> See ECB (2006) for a detailed discussion.

<sup>15</sup> Source for the data in this paragraph: WIIW (2006).

**Table 3.11**  
Real GDP growth in Bulgaria and Romania, percent, 2001–2006

	2001	2002	2003	2004	2005	2006
Bulgaria	4.4	4.9	4.5	5.7	5.5	6.0
Romania	5.7	5.1	5.2	8.4	4.1	7.2

Source: European Commission (2006b).

**Table 3.12**  
**Inflation in Bulgaria and Romania**  
 (harmonised index of consumer prices), percent, 2002–2006

	2003	2004	2005	2006
<b>Bulgaria</b>	2.3	6.1	5.0	7.0
<b>Romania</b>	15.3	11.9	9.1	6.8

Source: European Commission (2006b).

**Table 3.13**  
**Unemployment and employment in Bulgaria and Romania, 2003–2006**

	Unemployment rate (percentage of labour force)				Employment rate (percentage of working-age population 15–64 years)		
	2003	2004	2005	2006	2003	2004	2005
<b>Bulgaria</b>	13.7	12.0	10.1	8.9	52.5	54.2	55.8
<b>Romania</b>	6.8	7.6	7.7	7.6	57.6	57.7	57.6

Source: Eurostat Yearbook 2005 and European Commission (2006b).

**Table 3.14**  
**Fiscal situation, percent of GDP, 2003–2006**

	Fiscal balance				Public debt			
	2003	2004	2005	2006	2003	2004	2005	2006
<b>Bulgaria</b>	0.3	2.7	2.4	3.3	46.0	38.4	29.8	25.8
<b>Romania</b>	–1.5	–1.5	–1.5	–1.4	21.5	18.8	15.9	13.7

Source: European Commission (2006b).

**Table 3.15**  
**Current account and FDI, percent of GDP, 2003–2005**

	Current account				FDI		
	2003	2004	2005	2006	2003	2004	2005
<b>Bulgaria</b>	–5.5	–5.8	–11.3	–13.9	10.3	11.5	8.7
<b>Romania</b>	–4.8	–12.7	–8.7	–10.3	3.6	8.4	6.6

Source: European Commission (2006b) and ECB (2006).

In Romania, the rate of inflation has been high, though recently there seems to be a declining trend.

Both countries have high unemployment and low employment rates as shown in Table 3.13. In the past, Bulgarian unemployment was at very high levels, but it has fallen rapidly. In Romania, unemployment is at a fairly high level and there is no improving trend.

With respect to public sector balance and debt, both countries are doing reasonably well, as indicated in Table 3.14. Both countries are, however, running significant current account deficits, as shown in the left panel of Table 3.15. Both countries, in particular Bulgaria, have relatively high rates of FDI, as shown by the right panel of the table. FDI is effectively

financing the current account deficits of these two countries. In terms of the financial development indicators used in Table 3.10, the financial sector in Bulgaria appears to be roughly at par with the 2004-member countries. For Romania, the values of these indicators are much lower, which suggests that the financial sector in Romania is lagging behind the other new EU-member countries.

Overall, the medium-term prospects for Bulgaria are assessed to remain favourable (see EBRD 2006). Bulgaria has experienced a boom in domestic credit and it has a high level of private external debt (IMF 2004). These developments can lead to a vulnerable situation, given that Bulgaria is using a currency board arrangement. This is the main macroeconomic risk to the basic medium-term scenario.

The medium-term prospects for Romania are fairly good, given that relatively fast growth is likely to continue. Fast credit growth is also a feature of the recent growth in Romania, which has led to some concerns about potential financial-sector and macroeconomic vulnerability. Romania is

showing signs of deteriorating competitiveness with an appreciation of its real exchange rate due to an appreciation of the nominal exchange rate, strong wage growth and low productivity growth.<sup>16</sup> These concerns imply clear downside risks to the basic medium-term scenario.

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<sup>16</sup> See the discussions in IMF (2006b), ECB (2006a) and EBRD (2006).



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