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"The newer EU states: Maximizing integration"

- This month represents the 10th anniversary of the EU's largest enlargement and the 25th anniversary of the initial dismantling of 'the Wall'. Over the course of two papers, this representing the first, we examine the experience of the newer EU states to date but more importantly the key future policy challenges for continued European integration from both an EU and domestic policy perspective.
- The first decade of EU membership for the newer EU states has been one of two halves. The period up until September 2008 was characterized by a boom in economic activity but the global financial crisis highlighted the extent to which nominal convergence outpaced real convergence in the preceding years in some countries. As we enter the second decade of EU membership for many of the newer EU states, we believe that a more balanced, sustainable recovery is already underway.
- Enthusiasm for EU membership and EMU entry has declined amongst at least some of the newer EU states but the combination of reform efforts within EMU, a recovery in GDP growth and recent geopolitical events between Russia and Ukraine should facilitate some reversal.
- In revising our forecasts for Euro adoption, we consider EMU's willingness to expand, real convergence and domestic political support for the project. Following Lithuania's inclusion, we expect further EMU enlargement only towards 2023/24. Poland, and potentially Czech Republic, should lead the way while those countries with more elevated public debt levels (Hungary, Croatia) are likely to lag.

Editor: Gillian Edgeworth, Chief EEMEA Economist (UniCredit Bank London)

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The newer EU states: Maximizing integration

Gillian Edgeworth,
Chief EEMEA Economist
(UniCredit Bank London)
+44 207 826-1772
gillian.edgeworth@unicredit.eu

Dan Bucşa,
Economist
(UniCredit Bank London)
+44 207 826-7954
dan.bucsa@unicredit.eu

Hrvoje Dolenec,
Chief Economist
(Zagrebačka banka)
+385 1 6006-678
hrvoje.dolenec@
unicreditgroup.zaba.hr

Ľubomír Koršňák,
Analyst (UniCredit Bank
Czech Republic and Slovakia)
+42 12 4950-2427
lubomir.korsnak@unicreditgroup.sk

Marcin Mrowiec,
Head of Macroeconomic
Research Bureau
(Bank Pekao)
+48 22 524-5914
marcin.mrowiec@pekao.com.pl

Carlos Ortiz,
Economist
(UniCredit Bank London)
+44 20 7826-1228
carlos.ortiz@unicredit.eu

Mihai Patrulescu,
Senior Economist
(UniCredit Tiriac)
+40 21 200-1378
mihai.patrulescu@unicredit.ro

Kristofor Pavlov,
Chief Economist
(UniCredit Bulbank)
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg

Pavel Sobisek,
Chief Economist
(UniCredit Bank Czech
Republic and Slovakia)
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

- This month represents the 10th anniversary of the EU's largest enlargement and the 25th anniversary of the initial dismantling of 'the Wall'. Over the course of two papers, this representing the first, we examine the experience of the newer EU states to date but more importantly the key future policy challenges.
- This first paper documents the extent to which nominal convergence outpaced real convergence in the first 5 years of accession, before undergoing a lengthy correction process. Our analysis includes a special focus on the role that the IMF and EU played in aiding Romania during its adjustment process.
- As we enter the second decade of EU membership for many of the newer EU states, we believe that a more balanced, sustainable recovery is already underway, anchored by continued strong trade and financial linkages to EMU. Adjustment in external accounts has been significant and should prove much less of a drag on growth going forward. Much of the hard work in terms of fiscal adjustment has materialized while banking sectors across the region have improved in terms of their ability to support a recovery in activity. We include a focused analysis on FX debt in the region as well as of Slovenia's banking crisis, given that its banking sector is not dominated by foreign owners. Last but not least, recent quarters have also re-inforced Central Europe's key role as part of the European production chain.
- The remainder of this paper focusses on an evolving EMU and the opportunities that presents for the newer EU states. While support for the EU has fallen in some of the newer EU states, we see potential for this to begin to reverse after significant consolidation across the EU. In terms of the changing institutional framework within EMU, banking union is of most importance for the newer EU states. We do not expect any non-EMU members to join at the outset but efforts have been taken to facilitate their inclusion over time.
- We combine our outlook for a more balanced pace of catch-up over the coming decade with EMU's willingness to expand and domestic support for the common currency project within the newer EU states to revise our forecasts for Euro adoption. While our case study of catch-up in Czech Republic and Slovakia suggests that at least to date, Slovakia has managed to compensate for the absence of currency flexibility, we expect further EMU enlargement to be a much more gradual process. Following Lithuania's inclusion, this is likely to materialize only towards 2023/24. Poland, and potentially Czech Republic, should lead the way but those countries with more elevated public debt levels (Hungary, Croatia) are likely to lag. While much lengthier than originally planned, this pace of expansion is likely to prove more beneficial for all over the longer term.
- The paper concludes with a discussion of future EU enlargement. As is the case with EMU, this is set to be a much more gradual process going forward but one that has the potential to act as a crucial policy anchor, particularly in a number of countries in South East Europe. We detail the challenges that Serbia faces in securing EU accession.
- In our upcoming second paper, our focus shifts from European integration and the role that plays in catch-up to the role of domestic policies in determining convergence. Over the first decade, the pace of convergence has varied significantly across countries, irrespective of currency flexibility. Improvements in competitiveness in recent years bode well for the near term but as the newer EU states move from crisis management to recovery management, we will argue that a renewed focus on structural reform is required. More specifically, many of the 'easy gains' from convergence via total factor productivity have already materialized. Going forward labour, as well as capital, will have to play a more important role in generating growth. A reduction in public sector crowding out of the private sector represents another important piece to the puzzle, if living standards are to continue to converge.

Convergence to date: A tale of two halves

2014 marks the 10th anniversary of the EU's largest enlargement

This month represents the 10th anniversary of the EU's largest enlargement. In May 2004, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia became EU members, as did Malta and Cyprus. Bulgaria and Romania followed in 2007, Croatia last year, to bring EU membership to 28 countries. This month is also notable as it represents the 25th anniversary of Hungary's initial dismantling of 'The Wall' running along its Austrian border. The entire period has been one of huge change for the region, albeit differentiated across countries.

Unbalanced catch-up during the first five years….

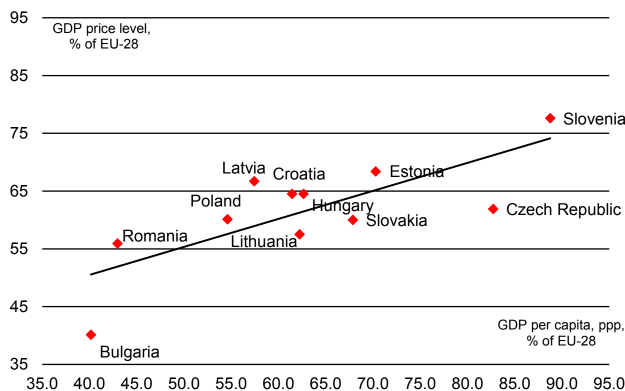
Focusing on the first decade of enlargement, it has been one of two halves for the newer EU states. The period up to September 2008 was characterized by a boom in economic activity. Enthusiasm amongst the EMU member states to draw off the newer EU states as a cheap manufacturing base played an important role, as did widespread reform efforts in the lead up to EU entry. But anchored in part by the prospect of speedy euro adoption, this boom in industry and exports was accompanied by rapid expansion in the non-tradables sectors that in many cases overtook the boom in tradables sectors. This led to excessive credit growth and dangerously large current account deficits.

…pushed nominal convergence ahead of real…

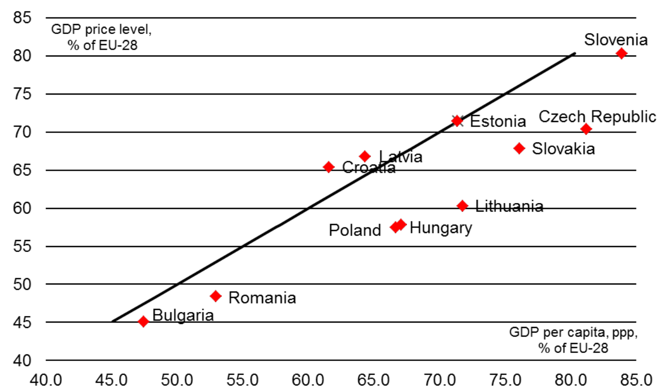
Put differently, nominal convergence overtook real convergence. For the sake of our analysis, nominal convergence refers to a contraction in the gap between metrics such as price levels, interest rates and nominal GDP per capita in a common currency between EMU and the newer EU states. Real convergence is captured by measures of living standards, such as GDP per capita in purchasing power parity terms, driven by factors such as a narrowing of productivity differentials. Taking price levels as a measure of nominal convergence and GDP per capita in ppp terms as a measure of real convergence, our chart below shows how the former had caught up more rapidly than the latter by 2007 in a number of countries.

NOMINAL V REAL CONVERGENCE: AN ADJUSTMENT IN COMPETITIVENESS

From overvaluation in 2007…



….to under-valuation for many in 2012



Source: Eurostat, UniCredit Research

…and forced adjustment in the second five

The last five years have been characterized by adjustment, forcing a reduction in the size of non-tradables sectors relative to tradables sectors within the newer EU states. There was large differentiation across countries but growth over the past five years have been uniformly slower than in the first. GDP per capita in ppp terms, as % of EMU, gained on average 4.4% per annum over 2004-08 but 1.4% per annum over 2009-12. And the same comparison for nominal versus real convergence suggests that by 2012 the former lagged the latter, rather than visa versa.

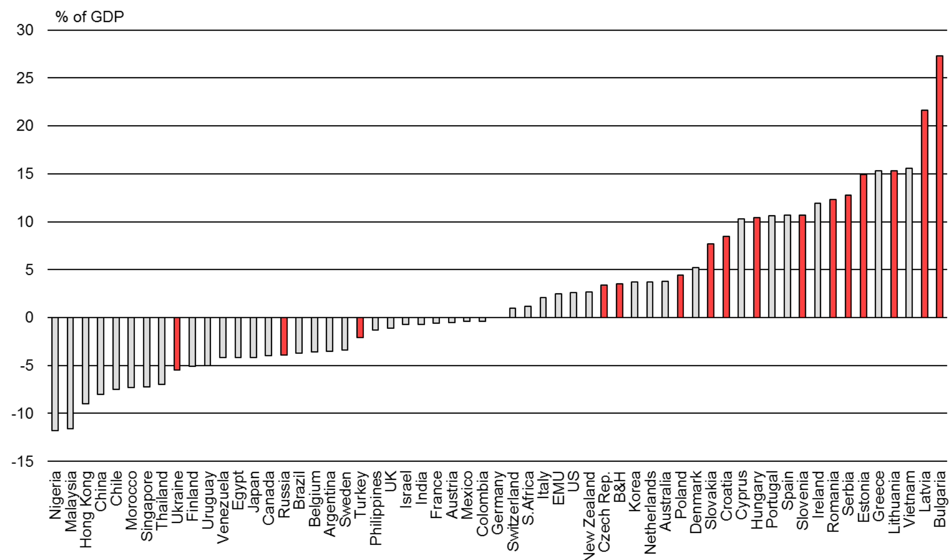
New decade, new (more balanced) recovery

External adjustment has been significant…

As we enter the second decade of EU membership, the adjustment in the non-tradables sectors is visible across external, fiscal and banking metrics but in many cases should now be sufficient to support a more balanced, sustainable recovery. C/A balance improvement across the newer EU states suggests that countries have (been forced) to adjust to a slower pace of nominal convergence. By last year, C/A balances in the newer EU states were on average 10.7pp of GDP higher than in 2007 while at a global level the newer EU states dominate C/A balance improvements at a time when many other EMs have posted deterioration. Within the newer EU states, six countries ran C/A surpluses (Bulgaria, Croatia, Hungary, Lithuania, Slovenia, Slovakia) last year, most of whom do not have currency flexibility. FDI to the region has fallen below the EM average over the past couple of years (1.2% of GDP per annum over 2012-13 v 1.7% for EM as a whole) but this follows a multi-year boom (2.8% of GDP over 2000-11 v 2.2% of GDP for EM as a whole). Inclusive of EU funds, all countries in the region ran basic balance surpluses last year.

THE NEWER EU STATES HAVE SEEN LARGE C/A ADJUSTMENT

A global sample: Change in C/A balances between 2007 and 2013

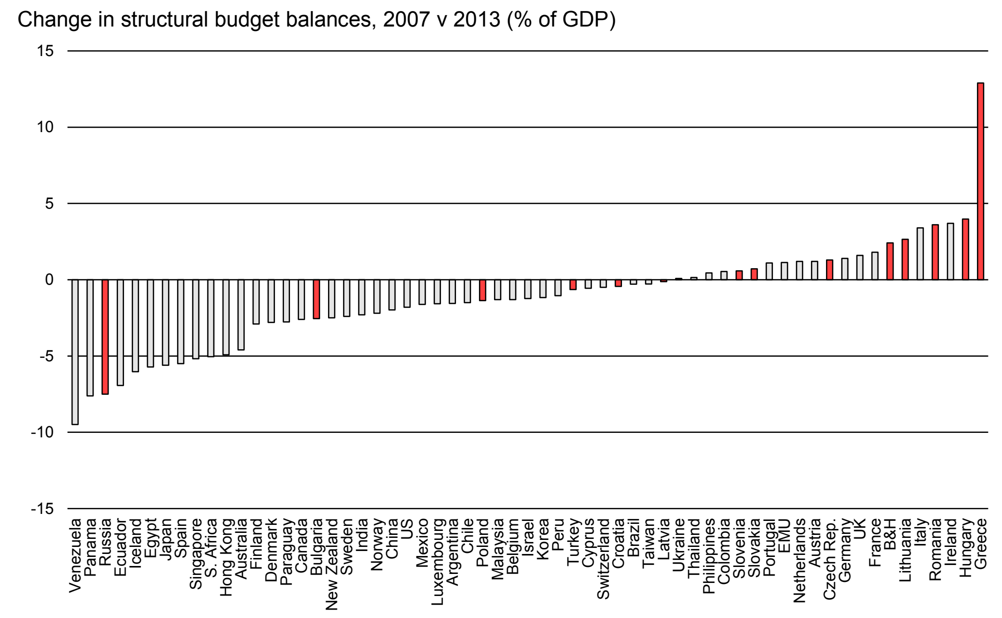


Source: IMF, UniCredit Research

…while much of the hard work on fiscal consolidation has been done…

This improvement in external accounts has been accompanied by considerable fiscal adjustment but just as is the case with external balances, much of the hard work has now been done and should act as less of a drag on growth going forward. Many of the newer EU states are amongst the world's top consolidators, as measured by the change in structural budget balances, over the past 5-6 years, capturing the fact that governments were forced to adjust fiscal plans to a slower pace of convergence. EC estimates show structural budget deficits at an average of 2.1% of GDP this year (4.7% of GDP in 2008) while all newer EU states with the exception of Croatia stand within 3% of GDP. Romania and Hungary lead the pack, having narrowed its structural budget deficit by over 6pp of GDP since 2008. As we discuss in our first box, cooperation between the EU, IMF and some member states, in particular at the early stages of adjustment, played an important role and in the case of Romania continue to do so.

THE NEWER EU STATES ARE AMONGST THE WORLD'S TOP CONSOLIDATORS



Source: IMF, UniCredit Research

The EU, IMF and consolidation in the newer EU states: Focus on Romania

Romania was one of 3 newer EU states to request an IMF/EU programme in 2008/09 (Hungary and Latvia also requested stand-by arrangements) and is today the only country in CEE (including other CEE states such as Serbia and Ukraine) to maintain constant engagement with the 'Troika'. EU involvement in the programme materialised via the re-emergence of its balance of payments facility in 2008, which was increased from EUR12bn to EUR25bn and then to EUR50bn within a number of months to distribute funds to three of the newer EU states. The EU made a financial contribution to Romania's first programme while also adapting to pledge funding for its two precautionary programmes since then.

There has been some significant successes over the course of this engagement, concentrated primarily within fiscal policy. The first programme set strict fiscal targets, including a ceiling on public sector spending and arrears, though high taxes played a dominant role in consolidation. The authorities introduced a new wage bill for public sector employees, revised social benefits, increased the flexibility of the labour market and enacted a new fiscal responsibility law, which included the setup of a fiscal council, limits on intra-year budget revisions and multi-year budgeting procedures. From a structural budget deficit of 8.5% of GDP in 2008, the authorities target a headline deficit of 2.2% of GDP this year. At less than 40% of GDP last year, public debt is less than half the EU average (85%), though it has increased from less than 15% of GDP since before the global financial crisis.

As focus shifted in the second and third programmes to structural reforms, progress slowed. There has been reform of the tax system (reduction of the number of taxes from 113 in 2009 to 39 in 2013), an increase in EU fund absorption and some modest progress on privatization. But in general all have fallen short of target. Tax collection has not improved, SOE governance reform has been at least partially reversed while there is still scope for considerable progress on EU fund absorption.

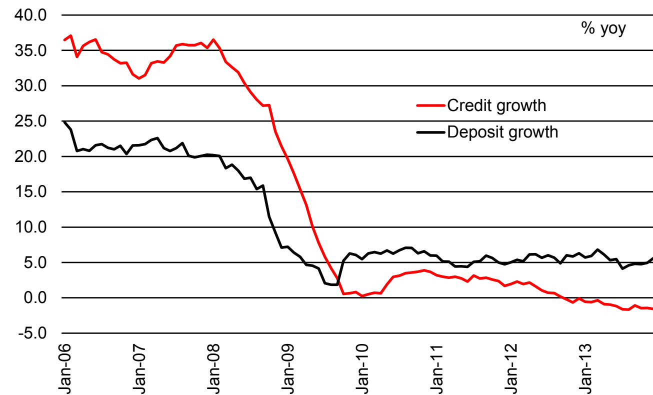
The lack of progress on structural reform re-inforces the challenges that the Troika faces in this sphere across the EU but Romania's interaction with this group has still brought considerable positives. The programmes acted as a credibility anchor, bolstering transparency on fiscal performance and speeding up Romania's return to investment grade. Fitch returned Romania to investment grade in the second half of 2011, providing the sovereign with two investment grade ratings or enough for inclusion in a series of bond indices. This generates a natural buyer of this debt and has allowed the sovereign to repay all IMF and EU loans coming due to date with affordable market debt. Equally importantly, this positive feedback loop has generated favourable momentum in terms of introducing disciplining mechanisms for future fiscal policy. This includes Romania's willingness to sign the fiscal compact and commit itself to a structural budget deficit of 1% of GDP over the medium run.

…and banking sectors are in a better position to renew lending…

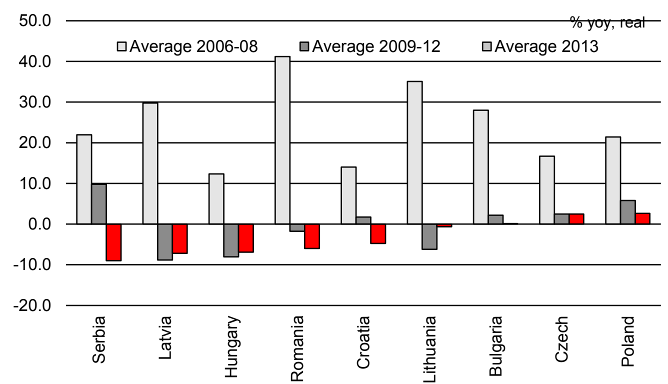
Moreover banking sectors across the region have significantly improved in terms of their ability to support a recovery in activity going forward. Following a period of exuberance in credit in the lead up to the global financial crisis, more recent years have been characterised by 'pay back'. The combination of a re-assessment of growth prospects for the newer EU states post-Lehman and the EMU crisis over 2011-12 has meant that credit growth on average across the region has been below deposit growth since 2010. In many countries credit growth has been negative in real terms for an extended period of time and in a few in nominal terms too.

FIVE YEARS OF CONSOLIDATION IN CREDIT GROWTH

Credit growth has adjusted downwards significantly[1]



Credit growth in real terms varies from weak to negative



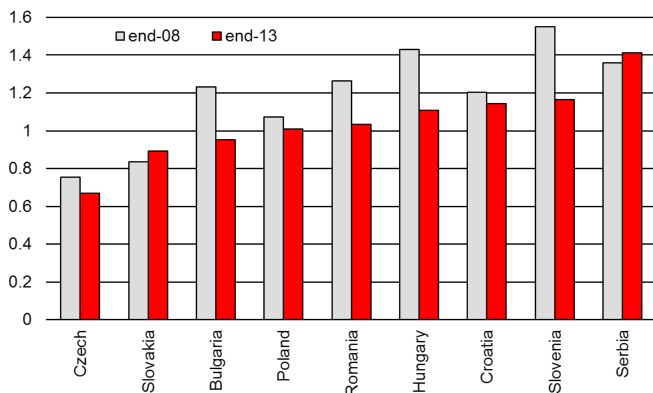
Source: National central banks and statistics agencies, UniCredit Research

…given deleveraging,…

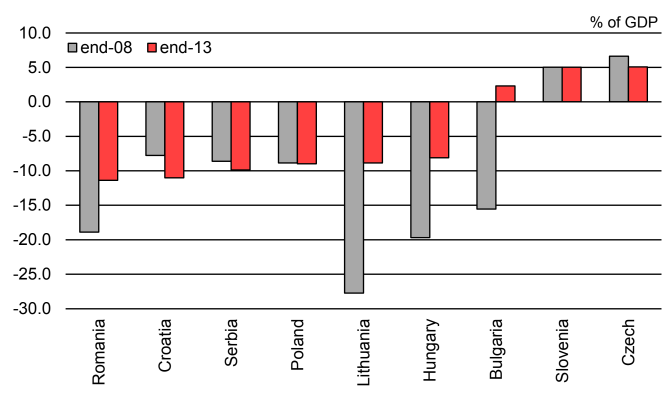
This period of deleveraging has been costly in terms of growth but has returned banking sectors to more viable positions in terms of future lending. This is most obvious in terms of loan to deposit ratios – most of the newer EU states have seen loan to deposit ratios decline considerably, most notably in Slovenia, Hungary, Romania and Bulgaria. There has also been consolidation in the net foreign asset position of banking sectors across the region, particularly in those countries which were most vulnerable.

EVIDENCE OF DELEVERAGING

Loan to deposit ratios have improved in most countries



Banking sector net foreign asset positions have narrowed



Source: National central banks, UniCredit Research

[1] Credit and deposit growth represent a simple average for the following countries: Bulgaria, Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Croatia and Serbia.

…long term commitment from key foreign players,…

The commitment of foreign banks, by and large, to the region has been re-inforced. When the global financial crisis hit in 2008, the willingness of foreign banks to remain present was quickly questioned but also quickly refuted, most visibly in the form of the Vienna Initiative. The timing of the EMU crisis over 2011-12 was unwelcome. Some of the most obvious spillovers to the newer EU states were captured within banking systems in the form of a reduction in funding from mother banks. There have also been divestments by some small foreign owners in the region (Ireland's AIB in Poland, the UK's RBS in Romania, Austria's Volkbank operations across SEE) while as part of its Troika programme Greek banks are also under pressure to divest their subsidiaries in SEE.

Slovenia's experience with banking reform: Different to the rest

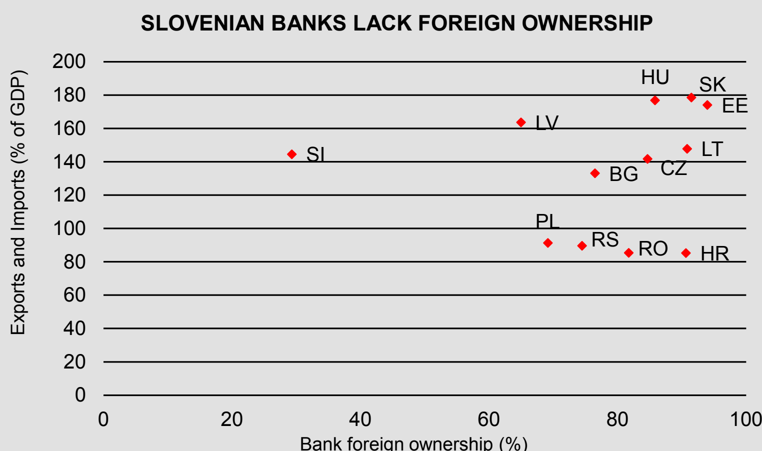
Slovenia enjoys a significant degree of integration into the European economy but not one that extends to foreign ownership of its banking system. With exports and imports standing at 150% of GDP, Slovenia is amongst the most open economies globally in terms of trade but at 29%, foreign ownership of its banking system is the lowest of those countries that progressed to EU accession after the fall of communism.

This did not deter a boom in lending or an increase in reliance on foreign funding in the lead up to 2008, as was also the case in the other newer EU states with a much higher degree of foreign ownership. Between 2004-07, GDP growth in Slovenia averaged 5.3%, fuelled by booming household (+ 99.8%) and corporate credit (+102%). While prior to 2004 bank funding was mostly deposit-based, EU accession and EMU entry accelerated the use of foreign capital by domestic banks. By the end of 2007, the loan to deposit ratio had increased to 1.6 while foreign liabilities of the banking system rose to EUR 16.2bn (or 47% of GDP).

The high share of domestic ownership of the banking system generated structural disadvantages in two forms, however. First, it fostered continued, unhealthy linkages between the domestic banking system and the domestic non-tradables sector, including construction. This is in part because the domestic banking system did not benefit from the import of foreign expertise. Second, the sovereign was burdened with recapitalization costs as boom turned to bust, in contrast with most other newer EU states. To date the sovereign has injected EUR 3.2bn of capital (9% of GDP) into the domestic banking system. ECB liquidity represents 9.5% of all bank funding while system-wide NPLs have increased from 4% in 2008 to 17.3% at the end of 2013. Of these, the biggest NPLs were realised at small (23.7%) and large (21.6%) domestic banks, as these were the major providers of loans to non-financial corporates and SOEs. Between 2008 and 2013 the number of all corporate bankruptcy proceedings increased from 88 to 950 respectively. Of these, 874 proceedings were among non-financial corporates at end-2013.

Attraction of foreign capital to the domestic banking system is the sovereign's primary challenge over the coming quarters. This also extends to a series of state-owned companies in other sectors. The authorities have set up a bad bank (the BAMC) but NPLs within the domestic banking system remain high. In the absence of foreign investment, the state will remain at risk of further capital injections in the future while the resumption of credit flow to viable parts of the economy will also be delayed.

SLOVENIAN BANKS LACK FOREIGN OWNERSHIP

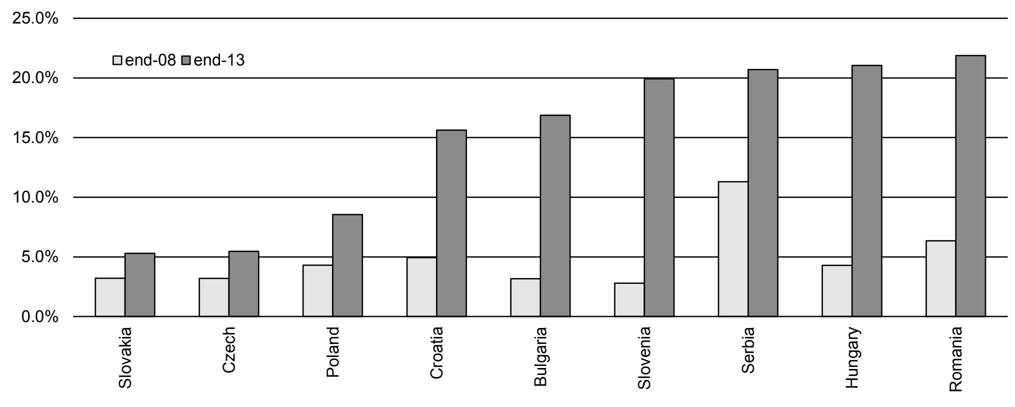


Source: EBRD, National Statistical Offices, UniCredit Research

But benefits from this ownership structure remain. For the newer EU states, this is re-inforced by regulatory structures. As most foreign banks operate subsidiaries rather than branches in the region, domestic regulators exert tight control. This ownership structure has also meant that the cost of capital increases lie with mother banks, protecting sovereign balance sheets. As we detail in Box 2, Slovenia is the only country within our study where the sovereign has faced sizeable bank recapitalization costs.

NON-PERFORMING LOANS REPRESENT A KEY POLICY CHALLENGE

NPLs have increased significantly in many countries

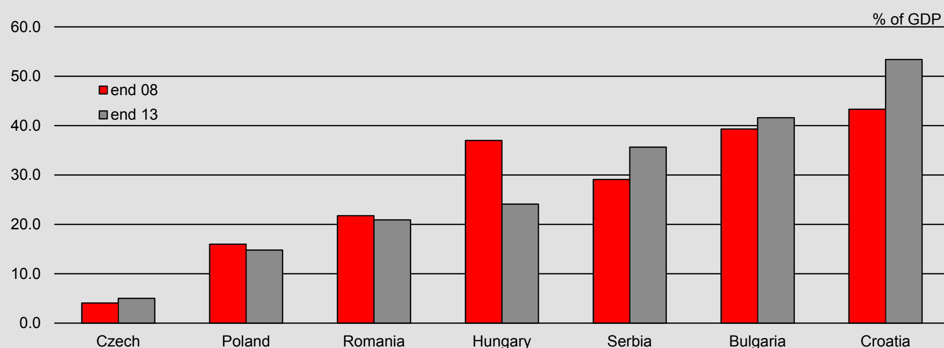


Source: National central banks, UniCredit Research

Sustaining private sector FX debt

The combination of unrealistic expectations surrounding EMU entry, the absence of sufficient convergence between domestic and G7 interest rates, a surge in global cross-border capital flows and increased competition within banking sectors across the region contributed to a sharp increase in lending in FX to households and corporates across the newer EU states in the lead up to 2008, most of which did not enjoy a natural hedge (e.g. hard currency proceeds from exports). Romania and Croatia had limited success in using macro-prudential measures to contain (FX) lending, e.g. larger capital requirements for FX loans, higher reserve requirements on FX borrowing from mother banks, while Poland acted to ensure that access to FX loans was available only to higher earners and even then only low loan to deposit ratios were required. In Bulgaria, verbal intervention was sufficient to curb lending in USD and CHF, though Bulgaria's long-standing currency board meant that the authorities did not act against EUR lending. All that said, by end-08, the stock of household and corporate credit varied from less than 5% of GDP in Czech Republic to in excess of 40% of GDP in Croatia. FX credit stood at in excess of 20% of GDP in Romania, Hungary, Serbia and Bulgaria. As a result, when the global crisis hit, many countries saw the costs of adjustment via currency depreciation as considerably higher than the benefits.

FX CREDIT TO HOUSEHOLDS AND CORPORATES: DIVERGENCE IN INDEBTEDNESS



Source: UniCredit Research, National central banks & statistics offices

The large share of foreign ownership of banking sectors across the region combined with their legal status (subsidiaries rather than branches) means that provisioning against such lending has not been problematic for regulators as NPLs have increased. Moreover in many countries new lending in FX has either fallen significantly or contracted since 2008. In part regulatory measures are at play. In Romania FX borrowers are required to undergo very severe stress tests to access FX credit while Poland has further increased its risk weight on FX lending.

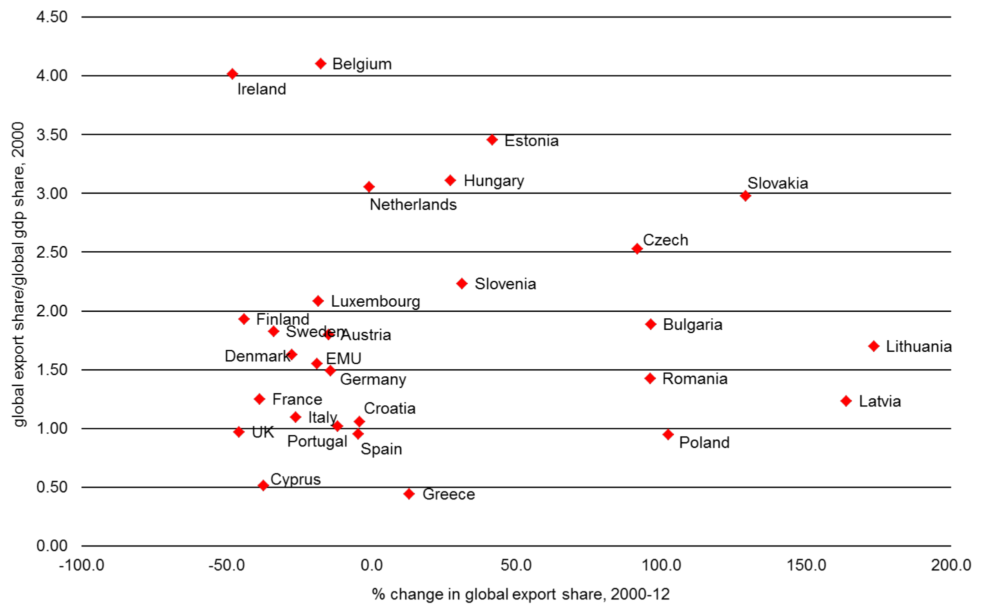
But this debt has dragged on growth and as such has generated increasing political attention over time. For most, resolution of this problem is likely to take the form of loan maturity. At that stage, loans will either expire or be rolled into local currency debt. To date Hungary is the only country to show a meaningful decline in the stock of this debt but this has materialized at a cost to the sovereign and the banking system. Measures taken include the absorption of local government FX debt by the sovereign, an early repayment scheme for households at a favourable FX rate, a fixed FX repayment scheme for households (preferential) and a scheme to allow SMEs to swap FX loans into HUF.

Trade integration: A consistent positive

The newer EU states continue to enjoy increased trade integration

A normalisation of non-tradables sectors in the newer EU states is being accompanied by continued integration of tradables sectors into the EMU and global production chain, a process which remains supportive of both real and nominal convergence. One of the most consistent benefits of EU integration over the past decade has been within industry as cheaper labour costs and other competitive advantages (e.g., tax burdens) prompted foreign investment and expansion of capacities. As shown below, many of the newer EU states have enjoyed more sizeable increases in their share of global trade than EMU member states. In some cases, this is despite the fact that global export shares were already well in excess of global GDP shares. It is three fixed currency countries that lead the pack, namely Latvia, Lithuania and Slovakia. But it is also a fixed currency country which is the most obvious laggard, namely Croatia.

MANY NEWER EU STATES ENJOYED A GENEROUS INCREASE IN EXPORT MARKET SHARES



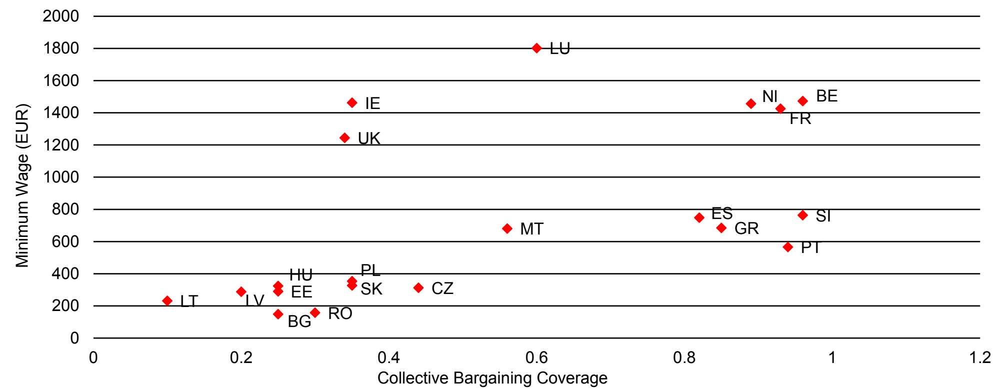
Source: IMF DoTs, UniCredit Research

The newer EU states continue to offer competitive, flexible labour markets compared with EMU…

Many of the drivers that supported this process over the first decade of enlargement remain supportive as the second gets underway. Compared with EMU member states, wages remain competitive while labour markets are often more flexible. This is captured in metrics such as collective bargaining coverage and trade union membership. Despite two shocks to the region over the past five to six years, foreign investment in manufacturing has remained more robust than FDI to non-tradables sectors.

CHEAP, FLEXIBLE LABOUR MARKETS PROVIDE A COMPETITIVE ADVANTAGE

Most of the newer EU states compete on cost and flexibility



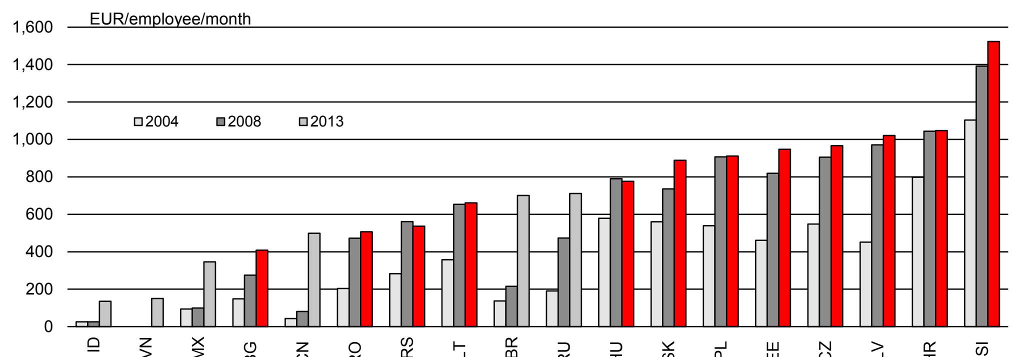
Source: Eurostat, UniCredit Research

…while closing the gap with EMs elsewhere

Moreover unit labour cost adjustment in some of the newer EU states combined with an increasing cost of labour elsewhere in EM means that the newer EU states have significantly narrowed gap in terms of the cost of labour on this front over recent years. Some newer EU states have posted declining unit labour costs, aided by currency weakness (Romania, Poland, Hungary) while in others unit labour cost increases have been modest in recent years (Czech, Estonia, Slovakia, Slovenia). Many other developing regions were characterized by currency appreciation and increasing wage pressure over the same period. As a result the average Chinese wage in 2008 stood at less than 10% of the average for the newer EU states but by 2013 had increased to 57%. In Brazil the average wage was 26% of the average for the newer EU states in 2008 but has now increased to almost 80%.

CLOSING THE GAP WITH EM IN TERMS OF LABOUR COSTS

A cross-country comparison of monthly wages in EUR



Source: Bloomberg, national statistics offices, UniCredit Research

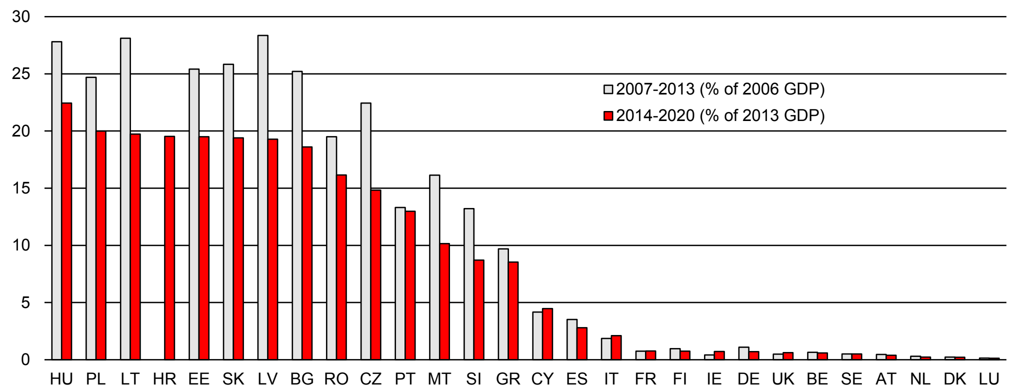
EU funds: Aiding sustainable convergence

EU funds represent a large amount of non-debt creating hard currency inflows designed to foster real convergence…

In terms of economic integration between EMU and the newer EU states, linkages between industry and banking in both regions are most obvious but EU funds have also played a crucial role in supporting convergence in recent years. In line with industry and banking, we expect this to remain the case going forward for EU funds but in contrast with industry and banking, this form of 'integration' does not require countries to service debt or equity injections over time. Instead it represents a source of non-debt-creating foreign inflows that can be directly allocated to boost human and physical capital. While there are many forms of EU funds, our analysis focused on structural and cohesion funds, with amounts varying from between 1.9% (Slovenia) and 4.0% of GDP (Lithuania) per annum over the 2007-13 EU budget period for the newer EU states. These are set to decline to between 1.2% (Slovenia) and 3.2% of GDP (Hungary) per annum over the 2014-20 budget period but remain sizeable and well in excess of other EU countries.

EU FUNDS HAVE PROVIDED A CHEAP SOURCE OF CAPITAL…

EU structural and cohesion fund allocation



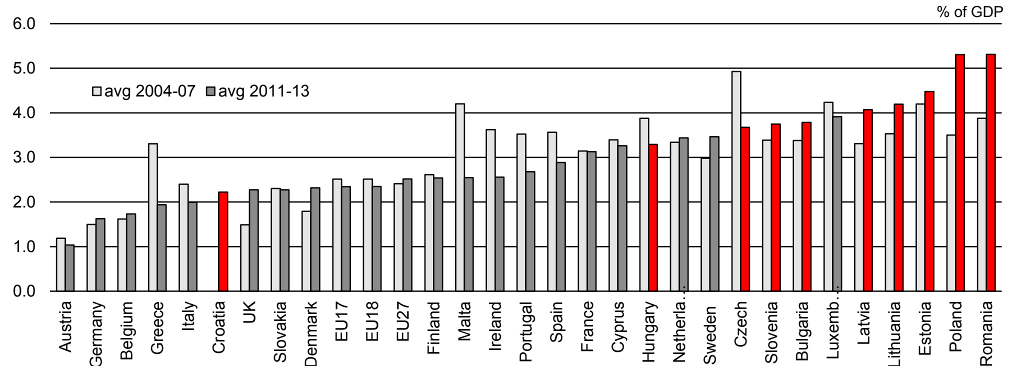
Source: European Commission, UniCredit Research

These funds have already visibly allowed governments in some of the newer EU states to support investment

Following the collapse of Lehman brothers, access to EU funds played a visible role in cushioning the downturn in activity in a number of countries. As shown below, government capital expenditure is higher in almost all of the newer EU states compared with EMU while it has also visibly increased in many countries compared with the boom period of 2004-07. There are many country-specific issues associated with the use of these funds which have generated significant differentiation across countries. We will discuss this in much more detail in our second paper while in the interim noting that these funds essentially represent a source of free capital that is not available to other developing regions globally.

EU FUNDS HAVE SUPPORTED CAPITAL EXPENDITURE THROUGH THE DOWNTURN

Government capital expenditure



Source: Eurostat, UniCredit Research

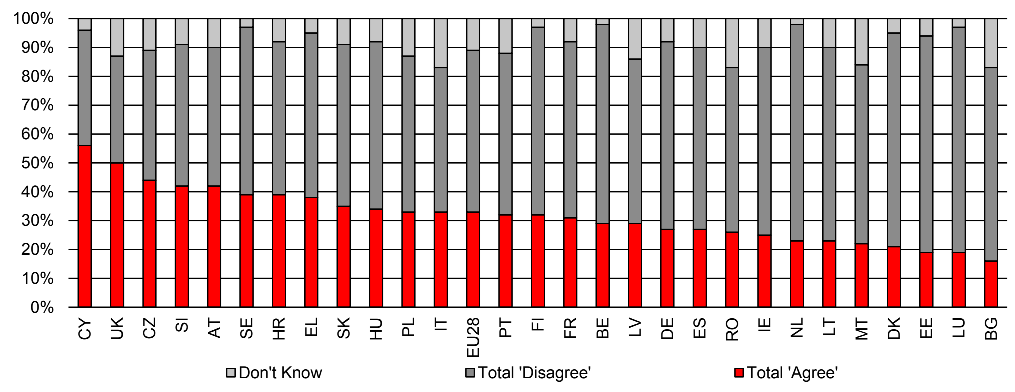
Moving towards increased integration enthusiasm…

Enthusiasm surrounding EU membership has weakened…

As economic integration between the newer EU states and EMU continues and as the recovery in activity in both regions solidifies, we expect a debate on the integration of the newer EU states into EMU's institutional structures to gather pace. To the extent that the impact of the necessary macro adjustment of recent years has outweighed the benefits of membership discussed above, this will take time. More than half of the newer EU states under examination in our papers are more negative on their future as an EU member state than the EU28 average (Czech, Slovenia, Croatia, Slovakia, Hungary and Poland). The Baltics, Bulgaria and Romania are more upbeat than the average. But recent geopolitical events in Ukraine have also generated calls for increased integration, e.g., Poland's PM Tusk has proposed a common EU energy policy.

A MIXED REACTION TO THE EU (H2-13)

To what extent do you agree or disagree: (Our country) would better face the future outside the EU?



Source: Eurobarometer, UniCredit Research

…but within EMU reform efforts have been widespread

Within EMU, efforts to put in place new surveillance and disciplining structures have been widespread over the past 2-3 years, focusing on a combination of fiscal discipline, structural adjustment and banking sector integration. Neither the six nor two pack are binding for non-EMU EU member states, though sound public finances should bring positive spillovers to EU member states outside of the euro area. But banking union carries most immediate and direct spillovers for the newer EU states, as well as future integration prospects.

Banking union is particularly relevant for the newer EU states

We do not expect any of the newer EU states to join banking union upon inception. In contrast with late 2012 and early 2013, enthusiasm amongst the newer EU states that remain outside of EMU to join banking union immediately has eased, for at least three reasons. First, the newer EU states await the outcome of the AQR and resolution of legacy assets. Second, regulators have decided to wait until more clarity is available on the Single Resolution Mechanism and most importantly a common deposit insurance scheme. Third, the ECB's decision to decline a request for an EUR swap line to protect non-EMU member states in return for increased centralization of supervision and regulation was denied. But the newer EU states will still benefit the stability that banking union will deliver within EMU, including via a reduction in deleveraging pressure, lower costs of funding from mother banks and positive spillovers from EMU into the newer EU states from a stronger EMU growth trajectory.

We do not expect immediate integration but over time banking union may incorporate some EU states outside of EMU

Moreover, assuming the project within EMU continues to progress as planned, efforts have been made to address the concerns of the newer EU states which should over time facilitate enlargement. Many of the newer EU states pride themselves in more vigilent banking sector supervision than was the case in EMU pre-crisis. In contrast with initial proposals, the newer EU states that remain outside of EMU but decide to 'opt in' to banking union in the future will have the possibility to apply national regulatory and macro-prudential measures that are more stringent than those imposed by the ECB. This should help in addressing concerns on issues such as an equalization of capital adequacy ratios (implying a flow of capital from the newer EU states to mother banks) and loss of freedom over domestic macro-prudential measures. Under the right conditions, such an enlargement should bring benefits to all involved.

… and a more realistic path for EMU enlargement

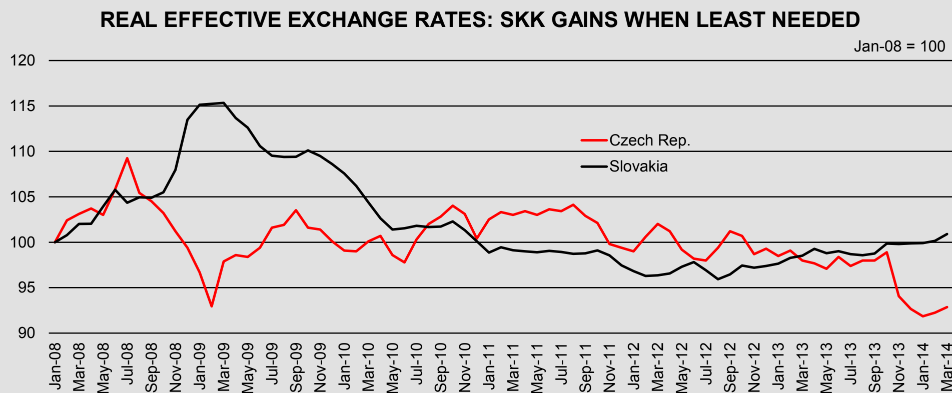
Domestic support for EMU entry has also fallen…

As all of the newer EU states are required to adopt the euro at some stage in the future, the division in support across countries for the single currency is notable. In four of the newer EU states (Bulgaria, Poland, Lithuania, Czech Republic), Eurobaromoter shows that support for the euro is lower than the EU28 average (6 countries in the case of the EU). National surveys show an even higher degree of opposition . But in some of those countries that have joined of late, support is amongst the highest of the EU28. This captures countries such as Slovenia and Estonia that have endured banking sector crises since 2008 but also Slovakia, despite significant domestic opposition to contributions to funds such as the EFSF and the ESM. As per the discussion in our fourth box, Slovakia has outperformed Czech Republic in terms of real convergence since its entry into EMU, in part because of the economy's ability to compensate for the absence of currency flexibility with other policies. Support for the euro in the three countries with the largest stock of private sector FX debt (Croatia, Romania and Hungary) is also above the EU28 average.

Czech Republic v Slovakia: The benefits of 'in' and 'out'

The Slovak and Czech economies run similar business models, anchored by large export sectors with strong links to (the rest of) EMU and Germany in particular. But Slovakia's entry into EMU in 2009 introduced a significant structural difference between the two. Shortly before the eruption of the global crisis and a collapse in global trade, one of the world's most open economies opted to revalue its currency by 21.7% before entering a fixed currency regime. In contrast, five years following the crisis the Czech Republic stepped away from its long standing free float to weaken its currency and reduce deflation risks.

REAL EFFECTIVE EXCHANGE RATES: SKK GAINS WHEN LEAST NEEDED



Source: UniCredit Research

Our analysis indicates that at least to date the absence of currency flexibility as a policy tool has not disadvantaged catch-up in Slovakia. Instead the economy has enjoyed speedier convergence. Over 2008-13, real GDP growth in Slovakia has averaged over 1% per annum compared with a contraction of 0.5% in Czech Republic. Domestic demand was almost identical across the two countries but net exports explains the differential. Upon the onset of the crisis post Lehman, Slovakian exports initially declined by more than in Czech Republic but since 2012 have overtaken Czech. Slovak exports gained a cumulative 29.4% over 2008-13, 42% more than in Czech Republic.

Larger FDI inflows in the lead up to 2008, higher productivity gains and more diversification into knowledge intensive sectors contributed to Slovakia's outperformance:

- Net FDI inflows stood on average 1.4pp of GDP above Czech Republic over 2003-07 per annum. Though the gap has since closed, higher FDI in the lead up to 2008 is likely to have generated positive spillovers in the following years in the form of net production capabilities coming on line. Favourable taxation and a concentration of market reforms over the early noughties contributed to this FDI boom;
- Gains in labour productivity were central to neutralizing the impact of a stronger currency on unit labour costs relative to Czech;
- Slovakia also enjoyed a shift towards more knowledge-intensive services (15.9% of GVA) than Czech Republic (15.4% of GVA), driven mainly by IT, art and entertainment. Slovakia also benefitted from growth in service centers. We estimate that this has added 0.2pp per annum to Slovak GDP in excess of Czech.

Of course, Slovakia has only been a member of EMU for just over 5 years. It continues to enjoy an advantage in the form of a low tax environment but its government has also adopted a series of business-unfriendly policies in the past couple of years. Meanwhile Czech Republic is now using its currency to its advantage. With this in mind, we are aware that past performance is not an accurate indicator of the future but at least to date we have little evidence to suggest that by abandoning the option of currency flexibility, Slovakia has put itself at a disadvantage.

…while target dates have been pushed out significantly

The combination of the crisis in the newer EU states post 2008 and in EMU over 2011-12 has translated in significant revisions to expectations on the timing of EMU entry. Joiner enthusiasm peaked just after Slovakia confirmed its entry FX rate in May-08. Bulgaria, having joined the EU in 2007, was keen to enter ERM II as soon as possible, as its fixed currency peers in the Baltics did upon their EU entry. At that stage, however, rising imbalances in the Baltics acted as a lesson to the ECB. Poland also gave serious consideration to ERM II entry in late 2007 and early 2008 but the global financial crisis forced a re-think, in part because ECB enthusiasm for enlargement waned but also because the PLN adjustment over 2008-09 was viewed as a valuable policy tool amongst the Polish authorities.

When we forecast EMU entry dates, we consider EMU's willingness to expand, real convergence and domestic political considerations

In formulating a new set of forecasts for EMU entry, we consider a variety of drivers:

1. EMU willingness to expand: The criteria in the Maastricht Treaty to gain entry to EMU have not been formally re-written but we believe that the ECB has (unofficially) bolstered its entry requirements to ERM II. In particular, countries will be required to show a longer track record of responsible fiscal policy while those posting public debt in excess of 60% of GDP (Croatia, Hungary) will be required to put it on a convincing downward trajectory. Tolerance for any significant C/A deficit has fallen while prior membership of banking union is likely to be a positive;
2. Real convergence: Of the four countries from the former Soviet block that have already entered EMU, GDP per capita in PPP terms on entry to ERM II stood at an average of 64% of the EU28 average (minimum of 50%, maximum of 87%), on entry to EMU at an average of 74% (minimum of 64%, maximum of 87%). Though there is little to no evidence amongst the newer EU states that have entered to date that a lower level of real convergence can prove problematic, we believe that the European authorities have a strong preference for a greater rather than lesser degree of real convergence;
3. Domestic political support: Public support for EMU entry across the newer EU states has trended downwards while in some countries there are technical hurdles to overcome on the political front. Regarding the former, less than 30% support euro adoption in Poland and Czech Republic. But even though support for EMU entry is also low in Lithuania, the domestic authorities are hoping to press ahead next January. Regarding the latter, Poland provides a good example as it must change its constitution prior to EMU entry to allow it to adopt any currency other than the zloty. This requires a two-thirds majority in parliament. In Czech Republic, both the President and parliament are turning less EMU-sceptic but it will be 2017 before a majority on the CNB board can be generated for EMU entry.

After Lithuania, further EU enlargement is only likely towards 2023/24

With all of the above in mind, it is likely that Lithuania will enter EMU in the next couple of years but further enlargement will not materialise until 2023/24. While in contrast with original expectations, such a timeline brings benefits to EMU in the form of a longer 'repair' period while in some of the remaining newer EU states that are outside EMU it provides more policy tools for longer. That said, once one of the remaining newer EU states joins, it will provide a much clearer indication of the pre-conditions, allowing others to follow relatively rapidly.

FORECASTING EMU ENTRY

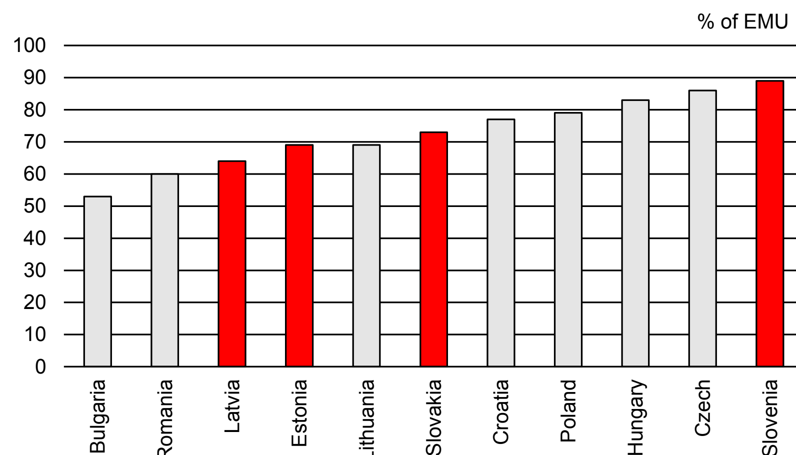
	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015/16	2017/18	2019/20	2021/22	2023/24	2025/26
Bulgaria				EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	ERM II	EMU
Croatia										EU	EU	EU	EU	EU	EU	EU	ERM II
Czech	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	ERM II	EMU	EMU
Estonia	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Hungary	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	ERM II
Latvia	EU	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Lithuania	EU	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU
Poland	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	ERM II	EMU	EMU
Romania				EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	EU	ERM II	EMU
Slovakia	EU	ERM II	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU
Slovenia	ERM II	ERM II	ERM II	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU	EMU

Source: UniCredit Research

We expect Poland and Czech Republic to lead to path to EMU entry…

- We forecast 2023/24 for Poland and Czech Republic. Both should meet all criteria in Maastricht by 2015/16, in theory opening the door to EMU entry in 2017/18 but politics will generate delays. Even assuming no currency gains between now and EU entry, GDP per capita in PPP terms should stand at 80% of the EMU average in Poland at that stage and closer to 90% in Czech Republic;
- By sequencing Bulgaria and Romania next (2025/26), we explicitly assume that the degree of real convergence becomes of lesser concern to the ECB, assuming strong fiscal performance over a multi-year period and positive momentum in terms of real convergence. Romania's willingness to sign the fiscal compact and commit to a structural budget deficit of 1% of GDP over the medium term should help re-inforce this. Assuming no currency appreciation, GDP per capita in ppp terms should stand at 60% of the EMU average in Romania at that stage but closer to 50% in Bulgaria;
- Sequencing for Hungary and Croatia captures to a large extent their weak track records on fiscal performance. Both countries begin with public debt to GDP well in excess of 60% while both will also only be able to show a very gradual decline in this metric. Moreover, European concerns are likely to extend beyond a deficit and public debt ratio and to the inflated nature of public sectors in both countries. This is visibly dragging on potential growth. For entry, we project GDP per capita in PPP terms at 77% and 83% of the EMU average respectively.

DIFFERENCES IN LEVELS OF REAL CONVERGENCE LIKELY TO REMAIN



Source: Eurostat, UniCredit Research

Broader EU integration remains a relevant theme

For some countries in South East Europe, the prospect of EU accession has the potential to act as a crucial anchor for reform

Finally the theme of further EU expansion remains one of relevance. Though at least 6-7 years away, the prospect of EU accession has the potential to act as a significant anchor for policy in South East Europe. This process has already evolved over the past decade. In Croatia, the EU was more forceful in ensuring adherence to the acquis, particularly on corruption and the rule of law. The EU is also now shifting to a strategy of pushing for some of the more difficult reforms at an earlier stage of the process of the accession process, rather than backloading. This has the potential to generate significant benefits in areas such as economic governance. Policies designed to discipline fiscal performance in the lead up to accession, avoiding immediate entry into the excessive deficit procedure, would represent a further step forward. We discuss the case of Serbia in detail in our fourth box.

On a different front, The EU's Deep and Comprehensive Free Trade Agreement, to be signed by Moldova and Georgia, represents the most comprehensive trade agreement that the EU has signed with a non-EU member state to date. Unfortunately in the case of Ukraine, the potential to generate sufficient domestic political support for the DCFTA has faded, though the country stands to benefit significantly from this.

Serbia: Formulating the path for EU entry

In January, a decade after Serbia was identified as a potential EU candidate, the European Commission gave the green light on the start of EU membership negotiations. Screening of the EU acquis is already underway and should be finished by Spring 2015, though the Serbian authorities have indicated that they hope to open the first negotiating chapters by end-June of this year. The Serbian authorities target 2020 as an entry date.

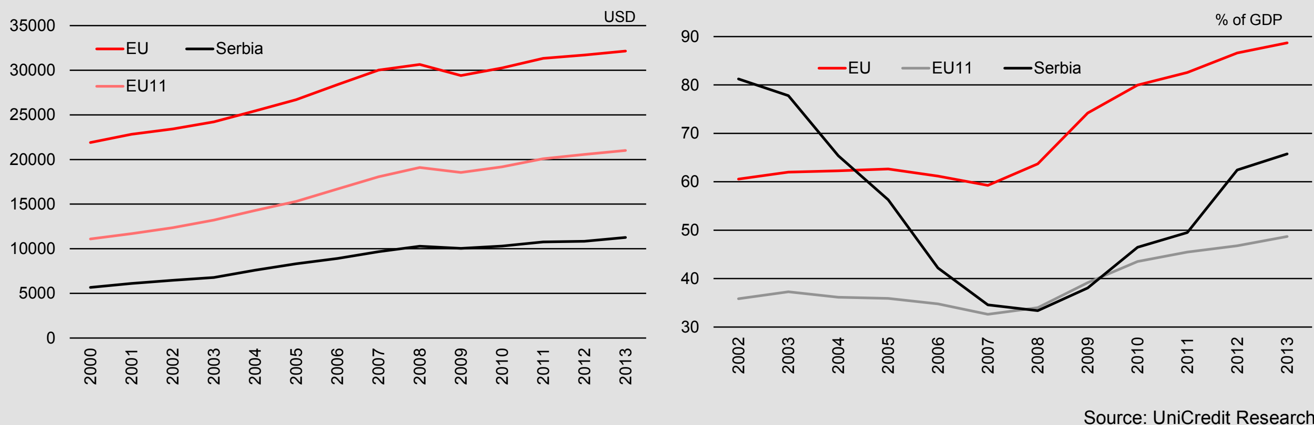
Past experience suggests that the 2020 target will prove too ambitious. Though much is dependent on commitment from the domestic authorities, there was an eight year period between when Bulgaria and Romania started official EU accession talks and entry. This would suggest 2023 as an entry date. We also doubt that EU membership will be possible without some form of official recognition of Kosovo. The 'First agreement on principles governing the normalisation of relations', signed in May 2013, allowed for start of negotiations on EU membership but further progress will be required. The above agreement is designed to guarantee that neither party will block or encourage others to block the other side's progress on their respective EU paths.

We view the path to EU membership of at least as much importance as the end date in determining the economic outlook. Within the 2004 expansion, political enthusiasm overtook compliance with the acquis at stages but this stance was toughened as Bulgaria and Romania joined and even more so in the case of Croatia. The EU has already asked Serbia to intensify its efforts to achieve full compliance with all acquis criteria. Prior to opening the first chapter this summer, the authorities plan to pass 21 reform bills, of which labour reform, bankruptcy and privatisation have greatest importance but Serbia faces challenges, in particular in terms of protection of the rule of law, including reform of the judiciary, corruption and organised crime. Progress has been made on media freedom but more is required in terms of delivering a balanced analysis. The EC has acknowledged Serbia's efforts to improve its business climate but in the Ease of Doing Business Survey, Serbia ranks 93/189 compared with an average for the newer EU states of 47/189. The more widespread the reform effort prior to entry, the speedier and smoother the pace of catch-up should prove thereafter.

But the initiation of negotiations on Serbia's EU entry also warrants debate on whether the EU, potentially in cooperation with the IMF, can play more of a role in ensuring fiscal discipline in the lead up to EU accession. For the first time since the creation of the Republic, a party with sufficient votes to form a majority government without a coalition partner was elected in March. The government's verbal commitment to reform of the public sector, with the aid of the IMF, is encouraging but delivery is urgently required. Public debt to GDP has doubled to 66% since 2008 while in the absence of further measures the budget deficit including contingent liabilities will near 7.0% of GDP. More broadly Serbia runs public expenditure at close to 50% of GDP despite less than one quarter of the population being in employment, underlining the multi-year adjustment process that lies ahead. Financing this has been relatively non-problematic as a global search for yield has allowed the sovereign to issue externally but public sector crowding out of the private sector remains problematic. Moreover Serbia's track record highlights…

1. the risk of slippage and **2.** the risk that, as was the case with Hungary and Croatia, it enters the EU and immediately enters the excessive deficit procedure. With this in mind, increased EU influence over fiscal issues over the course of enlargement negotiations has the potential to act as an anchor for fiscal performance while generating positive spill-overs for the rest of the economy

LAGGING REAL CONVERGENCE (GDP PER CAPITA (PPP)…BUT EXCESSIVE PUBLIC DEBT



Source: UniCredit Research

A welcome turning point

As we enter the second decade of the EU's most significant expansion to date, prospects for convergence have improved. This is not to say that the newer EU states are set to return to the sort of growth rates that were enjoyed in the lead up to the global financial crisis. But it does mean that after a period of adjustment, the combination of reforms within EMU and the newer EU states should increase the likelihood of a continued and more balanced recovery in economic activity from here. Over a multi-year horizon, this should also generate continued EMU expansion.

Of course, a sufficient degree of European integration and in turn real convergence will materialise only if domestic policies are also appropriate. With this in mind, we will follow up this paper with an analysis examining the role of the newer EU states in fostering convergence at a national level. More specifically, many of the 'easy gains' from convergence via total factor productivity have already materialized. Going forward labour, as well as capital, will have to play a more important role in generating growth. A reduction in public sector crowding out of the private sector represents another important piece to the puzzle, if living standards are to continue to converge.

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UniCredit Research*

Michael Baptista
Global Head of CIB Research
+44 207 826-1328
michael.baptista@unicredit.eu

Dr. Ingo Heimig
Head of Research Operations
+49 89 378-13952
ingo.heimig@unicredit.de

Economics & FI/FX Research

Erik F. Nielsen, Global Chief Economist
+44 207 826 1765
erik.nielsen@unicredit.eu

Economics & Commodity Research

European Economics

Marco Valli, Chief Eurozone Economist
+39 02 8862-0537
marco.valli@unicredit.eu

Dr. Andreas Rees, Chief German Economist
+49 69 2717-2074
andreas.rees@unicredit.de

Stefan Bruckbauer, Chief Austrian Economist
+43 50505-41951
stefan.bruckbauer@unicreditgroup.at

Tullia Bucco, Economist
+39 02 8862-0532
tullia.bucco@unicredit.eu

Chiara Corsa, Economist
+39 02 8862-0533
chiara.corsa@unicredit.eu

Dr. Loredana Federico, Economist
+39 02 8862-0534
loredanamaria.federico@unicredit.eu

Chiara Silvestre, Economist
chiara.silvestre@unicredit.eu

Daniel Vernazza, Ph.D., Economist
+44 207 826-7805
daniel.vernazza@unicredit.eu

Dr. Martina von Terzi, Economist
+49 89 378-13013
martina.vonterzi@unicredit.de

US Economics

Dr. Harm Bandholz, CFA, Chief US Economist
+1 212 672-5957
harm.bandholz@unicredit.eu

China Economics

Nikolaus Keis, Economist
+49 89 378-12560
nikolaus.keis@unicredit.de

Commodity Research

Kathrin Goretzki, Economist
+49 89 378-15368
kathrin.goretzki@unicredit.de

Jochen Hitzfeld, Economist
+49 89 378-18709
jochen.hitzfeld@unicredit.de

EEMEA Economics & FI/FX Strategy

Gillian Edgeworth, Chief EEMEA Economist
+44 207 826-1772
gillian.edgeworth@unicredit.eu

Artem Arkhipov, Head, Macroeconomic Analysis and Research, Russia
+7 495 258-7258
artem.arkhipov@unicredit.ru

Anca Maria Aron, Economist, Romania
+40 21 200-1377
anca.aron@unicredit.ro

Anna Bogdyukevich, CFA, Russia
+7 495 258-7258 ext. 11-7562
anna.bogdyukevich@unicredit.ru

Dan Bucşa, Economist
+44 207 826-7954
dan.bucsa@unicredit.eu

Hrvoje Dolenec, Chief Economist, Croatia
+385 1 6006 678
hrvoje.dolenec@unicreditgroup.zaba.hr

Ľubomír Koršňák, Chief Economist, Slovakia
+421 2 4950 2427
lubomir.korsnak@unicreditgroup.sk

Catalina Molnar, Chief Economist, Romania
+40 21 200-1376
catalina.molnar@unicredit.ro

Marcin Mrowiec, Chief Economist, Poland
+48 22 524-5914
marcin.mrowiec@pekao.com.pl

Carlos Ortiz, Economist, EEMEA
+44 207 826-1228
carlos.ortiz@unicredit.eu

Mihai Patrulescu, Senior Economist, Romania
+40 21 200-1378
mihai.patrulescu@unicredit.ro

Kristofor Pavlov, Chief Economist, Bulgaria
+359 2 9269-390
kristofor.pavlov@unicreditgroup.bg

Pavel Sobisek, Chief Economist, Czech Republic
+420 955 960-716
pavel.sobisek@unicreditgroup.cz

Global FI Strategy

Michael Rottmann, Head, FI Strategy
+49 89 378-15121
michael.rottmann1@unicredit.de

Dr. Luca Cazzulani, Deputy Head, FI Strategy
+39 02 8862-0640
luca.cazzulani@unicredit.eu

Chiara Cremonesi, FI Strategy
+44 207 826-1771
chiara.cremonesi@unicredit.eu

Elia Lattuga, FI Strategy
+39 02 8862-0538
elia.lattuga@unicredit.eu

Kornelius Purps, FI Strategy
+49 89 378-12753
kornelius.purps@unicredit.de

Herbert Stocker, Technical Analysis
+49 89 378-14305
herbert.stocker@unicredit.de

Global FX Strategy

Dr. Vasileios Gkionakis, Global Head, FX Strategy
+44 207 826-7951
vasileios.gkionakis@unicredit.eu

Armin Mekelburg, FX Strategy
+49 89 378-14307
armin.mekelburg@unicredit.de

Roberto Mialich, FX Strategy
+39 02 8862-0658
roberto.mialich@unicredit.eu

Publication Address

UniCredit Research
Corporate & Investment Banking
UniCredit Bank AG
Arabellastrasse 12
D-81925 Munich
Tel. +49 89 378-18927

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Internet
www.research.unicreditgroup.eu

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