**STANLEY FISCHER**

***Doing business in Central and Eastern Europe: Economic challenges and opportunities***

It is a pleasure to be in Warsaw at this time, less than a week after Poland and nine other countries joined the EU. Of those ten countries, seven were formerly in the Soviet bloc, one was in the former Yugoslavia, and two are small Mediterranean islands.

Poland, with its 38 million people, accounts for over half the number of people joining the European Union in this wave. Poland's GDP is about EUR 200 billion, around 45% of the GDP of the accession countries. But the total GDP of the accession countries is only about 5% of the total of the 25. So economically, in terms of current production, this is a relatively small addition to Europe. In terms of population and of potential changes in the European economy, it is much larger.

We have heard Prime Minister-designate Belka describe the challenges facing Poland. Similar, and in many cases more difficult, challenges face the other accession countries, several of which have from time to time stumbled on the transition path.

I will present an overview of the economies of and the business opportunities in the Central and Eastern European accession countries, that is the seven, excluding Slovenia, Malta and Cyprus from the ten. I will briefly mention the next two likely entrants, Bulgaria and Romania, and then talk even more briefly about Turkey, Ukraine and Russia. These countries constitute 'the region' that we are discussing. I will perforce be painting with a broad brush.

GDP per capita of the accession countries, measured in Euros, is about a quarter of the GDP per capita of the 15 countries previously in the EU. The real purchasing power value of per capita GDP in these countries is about double its value in Euros. In purchasing power terms, average per capita incomes in the ten is thus about half that of the 15. Among the 10, Slovenia with 70% of the purchasing power income of the EU15 is the highest. The Czech Republic is next. Poland's real per capita GDP is only 40% of the EU15 average, with the Baltics being the lowest, somewhere around 30% to 40%. These real incomes are very low relative to those at which other countries entered the European Union.

How have the new entrants done since the start of the transition process? Their transitions typically started somewhere between 1988 and 1992. Their growth since then has on average been higher than that of the EU15, but not stellar. It has averaged less than 4.5% over the past decade for all the countries. Poland did much better in the period 1991-2000, when its growth averaged about 5%. It then went through a period of some difficulty, from which it is now beginning to emerge. Since the start of the transition, Romania and Bulgaria have grown more slowly than the countries currently entering the EU. In most countries, growth is expected to increase in the coming years, with Poland in particular expected to grow at about 5% in the medium term.

Inflation has reached very low levels in almost every European accession country. This is an impressive performance, for getting inflation under control was one of the most difficult parts of the transition process.

Unemployment experience in the accession countries varies widely. Unemployment rates in the EU15 are high, averaging about 8%. In the accession countries, they average about 14%

with Poland at 19% the highest by far. Polish unemployment is a major political problem, even though there is some uncertainty about its nature, particularly whether there is a lot of hidden or informal employment, for the low level of social unrest is inconsistent with the reportedly high numbers of unemployment.

The fiscal situation is a crucial determinant of whether countries can enter EMU. The budget has been difficult for many countries among the seven. The Baltics have managed their budgets best. Others have had large deficits at various times, particularly as subsidies and liabilities that were not on budget have been brought on budget. Budget deficits among the non-Baltic seven were high in 2003, and will be high again in 2004. Behind some of the larger budget deficits lie populist policies, which have had surprising traction in Eastern Europe.

The budgetary inflows that the accession countries will receive from Brussels will provide a significant but not major contribution to the financing of the budget in the early years after accession. The contribution is smaller than it had been for the earlier accession countries, but is likely to contribute to improving infrastructure in the area.

There is full freedom of capital flows inside the European Union, and this is an important determinant of the business climate in the region. Most current accounts of the balance of payments have been in large deficit, in Estonia as large as 13-14% of GDP in some years. That sounds terrible, but is not, because foreign investment inflows have more than financed the current account deficit. The average rate of foreign direct investment for the seven has been around 5% of GDP. The share exceeded 8% of GDP for the Czech Republic and Estonia over a sustained period. These are very high rates of investment inflows by international standards, and they signal the attraction of these countries for foreign investors. Most of the investment comes from Europe. In dollar terms, Poland, by far the largest economy, has attracted the largest amount of foreign investment, around 4% of GDP per annum.

All the accession countries will have the opportunity to join the monetary union and to adopt the euro within two years of joining. But they have to meet certain tests in order to join. By joining, a country adopts the Euro as its currency, thereby losing the exchange rate as an adjustment tool. Almost every accession country has decided it is perfectly willing to lose that adjustment tool, and will join when it can.

When will that be? Estonia will be the first in. It is ready to join now. That means it has to go into a two-year waiting period during which it has to demonstrate good behaviour: during that period the country is in ERM II, and is required to experience no major strains on the currency for two years. This waiting period is justified by the argument that it provides a test of whether the exchange rate at which the country plans to join the Euro area is appropriate.

Several other counties, possibly including Poland, will enter the waiting room of ERMII in 2005. We discussed Poland's entry yesterday with the Governor of the central bank of Poland. Asked when Poland would join, he said that it would seek to enter ERM II as soon as there was credible evidence of a credible beginning of Poland meeting the fiscal criteria for entry, which is to say heading towards a 3% of GDP fiscal deficit. So, the central banks will likely argue for waiting until it is clear that their countries can meet the fiscal and other criteria before entering.

Should they enter? This is a long-standing argument among economists. I believe that for this group of countries the benefits of belonging to a common currency area outweigh the costs of losing the exchange rate as an adjustment mechanism, particularly since capital flows freely within the area. That is a judgement that has been made by the 12 countries now in the Euro area; the same judgement will likely be made by the new accession countries, some of which, Estonia and Lithuania in particular, have managed with very tightly fixed exchange rates over nearly a decade to produce sustained high growth.

Now what are the opportunities for business in this area?

The main opportunity -- and this is the success of the European Union in economic terms -- is that accession to the European Union puts in place a set of institutions and policy arrangements that are very modern and that provide a degree of certainty and convenience to potential investors and to others potentially doing business in the area, that would almost certainly not be obtainable in the absence of joining the EU. It's the institutional framework and the guarantee that this framework will continue, and of its stability, that is provided by accession and the implementation of the *acquis communautaire* that makes the main difference to business.

Economic agents know what they are going to get if they operate in countries with membership in the European Union. That is an enormously important benefit. Now, you can argue about the institutional structures of Europe: does the *acquis* lead to too big a state, does it lead to too intrusive a state, and all those arguments are very important and well worth having. Nonetheless, in terms of the underlying fact of a strong institutional framework that is widely understood and familiar, that is the key benefit for these countries.

Yet another benefit that I felt very strongly about when I was in the IMF was that the attraction of Europe strengthened the reform process in EU candidate countries. You could talk to the Russians about why they should do various things, like get their budget in shape, get their tax system in shape, they'd say why and you'd say 'well, your economy would behave better'. They would understand that, but it is rather abstract. The candidate countries would say why, and you'd say 'that way you'll get into Europe'. That was and is a much stronger motivating force than the general 'you know, the economy will behave better', which they probably did not quite believe anyway. But getting into Europe was concrete and different.

The second opportunity: the EU is a totally free trade area. You can export and import duty free all over this massive economy, which is the largest economy in the world at the moment. So, you have access to a massive market.

Third: you have access to a very highly educated and skilled labour force in almost every one of these economies, earning on average somewhere between a tenth and a fifth of what labour earns in the rest of the European Union. But it is by no means less skilled by a factor of a fifth or a tenth. So, labour productivity – a reasonable measure of labour productivity -- is about half and wages about a fifth of those factors in the EU 15. That makes the labour very attractive to employ. That is the attraction for foreign producers to come into this part of the world – and by foreign producers I don't mean only Citigroup, I mean also of course producers from the rest of Europe, including Germany, France, etc. The quality of the labour force is visible to the naked eye: when I visit Citigroup's Warsaw operations it is immediately evident how good the labour force is relative to that in most other emerging market economies.

This third factor – the low productivity-adjusted cost of labour – is the main reason there has been so much foreign investment in the current accession countries. Companies have moved production to the East, in order to compete as efficiently as they can. In so doing they tend to raise wages in the countries in which they invest, thereby acting as part of the equilibration mechanism that will eventually bring incomes in these countries up towards the average of the EU.

For the countries now entering, the benefit will also at some point include the rights of migration to the rest of Europe. There has been some controversy over that, and some countries have inferred that there is an agreed limitation on when free migration will begin, in most countries in seven years. But in the meantime there is considerable migration anyway. The natural process will include, as Prime Minister Belka described, labour on average moving gradually to the west, some Polish workers moving out and workers from the east moving in to Poland.

I've talked about these accession countries mainly as places in which to produce for sale in the entire European Union and abroad. There are of course domestic markets in these economies as well. Although they are relatively small, they are a potentially important factor for consideration. For instance, with an institution like mine setting up and buying a bank in Poland, it is the domestic market that is the major interest.

Now let me turn to the non-current accession countries in this region. The next candidates are Bulgaria and Romania. They are further behind: Romania was slow to get on the reform train, but is now there; Bulgaria has been on it longer. It is likely they will enter in a few years. More controversial are the two very big countries: Ukraine, which many want in -- that's 55 million people; and Turkey, a more complicated case. We could sideline the discussion of the accession countries if we talk in detail about Turkey, which is extremely important. I believe it should be allowed in, but I'll keep the topic off the agenda for now. And of course to the east lies Russia, where the economic prospects are excellent, even as the politics become more complicated.

To sum up: these economies have on the whole done well since the start of transition, not as well as hoped for when the process began 10 or 12 years ago, but very well nonetheless. They have been enormously helped by the accession process and if they continue to implement good policies, they have good prospects of growing more rapidly than Europe and seeing their income levels gradually rising towards those of the rest of the Europe.

If their policies are right, you could see the incomes of Poland and the other 9 rising over the next 40 years to around 70% of the European level measured in the common currency. In real terms that would probably amount to 80-85% of the European level, which will itself be higher as a result of growth. So there is a prospect of superior growth over a sustained period.

If the convergence process continues in the way we expect, the Balkan candidates are likely to grow faster, in part because they are further behind. And with better policies, even without accession, Russian, Ukrainian and Belarussian income levels (and Ukraine and Belarus would have to improve their policies significantly) could be somewhere around 50-60% of the EU15 measured in a common currency.

These prospects are impressive, but they do not happen automatically. Countries have to stay on a policy path to make them happen. On the whole, for the past 10 years, despite disappointments, the current accession countries have successfully implemented the right policies, except perhaps in the fiscal area. And there is good reason to hope that within the framework of Europe, they will continue to do so.

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