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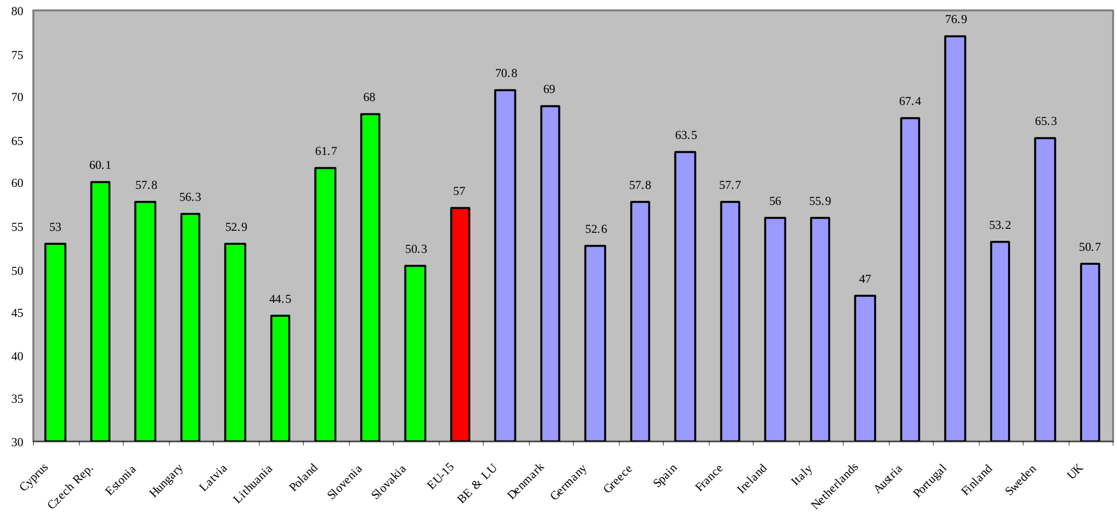
ENLARGEMENT AND BEYOND[1]

The date of May 1, 2004 will bring the biggest enlargement in the history of the European Union. Ten countries, eight of them former Soviet block countries will be admitted as the new members of the EU. This event will be very symbolic in many respects. For the new members it can mark the definite end of a series of unfortunate historical events, which they endured in 20th century being cut off the mainstream of economic development. While Western Europe enjoyed the longest period of growth, prosperity and democracy in its history, Eastern part of the continent stagnated after the World War II under communist regime and Soviet domination. The enlargement of Europe gives the acceding countries the opportunity to definitely anchor the process of democratic and market transition that started in the early 1990s and speed up the catching up process, which should lead to a gradual closing of the development gap between the Eastern and Western parts of our continent. For the incumbent members the enlargement brings more stability to their closest neighborhood and chances to give a new impulse for their development as well.

Table 1: Trade with EU as % of total trade, 2002



Source: Blaszkiewicz, M., and Wozniak, P. “Do Candidate Countries Fit the Optimum-Currency-Area Criteria?”, CASE Studies and Analyzes, No. 267, 2003, Table 3.3, http://www.case.com.pl/upload/publikacja_plik/1661295_267.pdf

[1] Author’s contribution to the “Banque de Luxembourg in 2003 – Annual Report”; see http://www.banquedeluxembourg.lu/pdf/bdl/langue2/rapport_an.pdf.

However, beyond the symbolic feelings and interpretations, one must conclude that May 1, 2004 neither begins nor ends the process of integration. All the new members already went through a series of deep, radical, and sometimes dramatic reforms in the past 15 years that have allowed them to build foundations of democratic capitalism and prepare them for EU membership. This process was accompanied and supported by the series of association and free trade agreements signed between the EU and candidate countries and between the latter themselves (Central European Free Trade Agreement – CEFTA). Six years of accession negotiations brought further economic and institutional adjustment. As a result the new members are already much more closely integrated with the incumbent members than was the case with Greece, Spain or Portugal when they entered the EU in 1980s. Table 1 shows that the level of trade integration of the new members does not differ from that of EU members and in some cases is even greater.

The date of formal EU entry, although very important, will not end the accession process, however either. The new members will not participate to the EMU and Schengen system, and they will have to deal with a number of transitory arrangements (restricted access to incumbents' labor markets being the most important limitation to the four basic freedoms related to the Single European Market). In fact, they will remain 'second' category members for a number of years. Hence, it should be in interest of both new members and incumbents to shorten this transitory period.

With new members aiming to join the Eurozone, the EU will face one of the biggest economic challenges in the next few years. Formally, the new members do not have opt-out clause like the UK or Denmark, and as such they are expected to join the EMU soon. However, the Accession Treaty does not contain any concrete timetable, which will formally depend on meeting the Maastricht criteria of nominal convergence. At the moment, the picture is mixed. While Baltic countries, Cyprus and Slovenia either meet or are very close to meeting the Maastricht criteria, the so-called Visegrad-4 group (Czech Republic, Hungary, Poland and Slovakia) suffers excessive fiscal deficits.

Unfortunately, signals coming from the incumbent side (European Commission, ECB and some central banks of the Eurozone) do not mobilize new members to speed up the EMU accession. The 'Don't rush' advice of the incumbent side is probably due to a number of political and economic concerns. The former relates to a willingness to give new members another 'trial' period before they become full-blown members which will imply, however, an extended period of 'second class' membership. Economic fears refer to the hypothesis (theoretically doubtful) that accession of fast growing countries will increase the inflation pressure and interest rates in the Eurozone which will have an additional recessional impact on slower growing economies of some incumbent members.

However, the 'don't rush' will lead to undesirable consequences for both sides. It will disband the EMU candidates from undertaking painful fiscal adjustments and adopting a discipline of monetary policy. (The experience of Mediterranean members of the EMU shows how the clear accession timetable can discipline domestic macroeconomic policy and help achieve political consensus). Delayed EMU entry can also tempt policymakers in the new member states to resort to competitive devaluation as a tool to boost their economies in the short term.

As result, the new members can suffer costly nominal deconvergence instead of convergence which is already observed in countries such as Hungary or Poland. If we add the European Commission/ ECB view that a narrow corridor of +/- 2.25 percent around the central parity is the preferred ERM-II mechanism (conflicting with free movement of capital) it can easily lead to currency crises or other kinds of macroeconomic turbulence on the periphery of the enlarged EU. I do not believe that this kind of outcome would be particularly welcomed by the incumbent EMU members. So the proper response would be to offer countries, which meet the Maastricht criteria and have had their currencies solidly pegged to the Euro for a longer period of time (Estonia and Lithuania with their Euro-denominated currency boards) a fast track EMU entry what would create a positive demonstration effect for other new members. In relation to remaining EMU candidates, the European Commission and ECB should replace their 'don't rush' approach by actively encouraging their fast nominal convergence and adjust the ERM-II mechanism to the new realities of international financial markets dominated by unrestricted capital movements. Generally, vast international experience (including that of Mediterranean members of the EMU) demonstrates that the so-called real convergence (usually understood as the catching up GDP per capita level of richer countries by the poorer ones) is going hand-in-hand with the nominal convergence and there is synergy rather than trade-offs between these two processes.

Enlargement also creates a lot of other challenges for the new and incumbent members and the EU institutions and policies. The new members must quickly graduate from an applicant status and mentality, and start to think and act in 'community terms' instead of trying to make the most of individual transfers and privileges. The incumbent members must realize that the EU will not be longer an exclusive club of the rich nations and that future EU policies (for example, in the spheres of trade, agriculture, social and migration) cannot continue to focus on defending narrow special interests in the high-income member states. Free market and pressures coming from international competition are much more important for closing a development gap than financial transfers from rich to poor countries.

This is again a very important issue from a catching-up perspective. Accession gives the new member various opportunities to speed up their economic and social development: opening new markets, encouraging inflow of foreign investments in high-tech and high-value-added sectors, importing good institutions and anchoring domestic economic policies in EU standards determined by *acquis communautaire*. All these factors should lead to a serious improvement of business and investment climate, facilitating a sustainable long-term growth. On the other hand, however, various components of EU policies and standards may be harmful to growth prospects of new members. This relates, in first instance to the Common Agriculture Policy, high labor protection and social standards as well as overregulation of certain important sectoral markets.

Thus, the economic policy and regulatory regimes of the enlarged EU must take into consideration the realities of middle- and lower-middle income new members and their need to catch up. This can be also beneficial for incumbents as the current EU lost competition to the US and some other regions (South-East Asia) during the last two decades. Maybe surprisingly for some politicians, both old and new members face many similar development challenges and, therefore, their economic reform agenda is, to some extent, similar. It relates, for example, to reduction of an excessive welfare state, dealing with the consequences of rapid population aging in the area of health care, pension systems, employment and migration, labor market flexibility, excessive tax burden, overregulation of good and services markets, particularly in the agriculture sector, large fiscal deficits, etc. Although many of these spheres are not regulated by *acquis communautaire* (they formally remain in the national domain), close reform coordination and learning from best practices would be very helpful for making the entire enlarged EU more competitive.

The EU must also continue to reform its institutions to make them more efficient, in terms of decision-making process, and more transparent and democratic. The history of the Nice Treaty and the recent failure of the EU summit in Brussels to adopt the European constitution have demonstrated that overcoming individual countries' egoism and short-term political interests of their leaders (both in the West and the East) in favor of an effective community solution will not be an easy and fast process. However, it must be continued to avoid the danger of decision-making paralysis in the EU of 25, 27 or maybe even 30 plus members.

The admission of ten new members also changes dramatically European geopolitics and perspective of Europe's 'widening'. As the EU frontiers will now move to the East and South East, the Union's relations with the remaining part of geographic Europe will have to be reassessed to avoid building the new iron (or even velvet) curtain. The Balkan and CIS countries have the similar development problems and the same historical background as most of the new members and remaining outside the European integration process for good will have a disastrous effect both for them and the enlarged EU. It will not be in interest of the EU, particularly of its new members, to have economically underdeveloped and politically unstable neighbors.

This danger seems to be manageable in the case of Balkans, in spite of a dramatic history of ethnic conflicts in this region of the 1990s. The expected EU accession of Bulgaria and Romania (2007), followed by Croatia and probably Turkey, as well as a clear integration road map offered to other Balkan nations under the series of stability and association agreements should help to stabilize this region. Unfortunately, there is no road map for the CIS yet apart from a loose concept of the Common European Economic Space between EU and Russia and unclear 'neighborhood' idea in relation to Ukraine and Moldova.

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