Chapter 8

EU Enlargement: Challenges and Opportunities

Jean-Claude Trichet

I will focus on the economic aspects of EU enlargement and the main challenges and opportunities that the new member states are likely to face on their way to the euro. In many respects, the experience of Portugal appears to be of relevance when thinking about the implications of joining the European Union and later on the euro area. Portugal's accession to the EU in 1986 was a major step for the country, probably similar to the experience that the new member states from central and eastern Europe and the Mediterranean currently make. Portugal clearly benefited from joining the EU, as this promoted macroeconomic stability and facilitated structural changes that the country had to undertake. Thus, EU membership was a decisive factor for economic growth and a higher standard of living in Portugal, and consequently for Europe as a whole.

The accession of ten new countries to the European Union on May 1, 2004 was in many respects the largest enlargement round in European history. Let me illustrate this with some figures. In geographical terms, Europe's territory expanded by around 23% following accession. With 75 million people living in the new member states, the population of the EU increased by about one fifth to 455 million people in total. The enlarged EU has consolidated its position in the first league of the world's biggest unified markets, accounting for about one fourth of world trade and global income.

In some respects, the 2004 enlargement should not be over-dramatized. The economic weight of the new member states in particular is still rather limited, amounting to only 4.6% of the GDP of the enlarged EU. Just for comparison, this is well below the increase in the EU's total GDP following the accession of Spain and Portugal in 1986, which amounted to more than 8%. The small economic weight of the new member states is mainly a consequence of the low per-capita income levels that most of the countries had at the beginning of the transition process to a market economy. This, however, will change gradually in the future as the catching-up process progresses.

I will concentrate on three main aspects that are of particular relevance for the European Central Bank. First, I will focus on the main implications of EU enlargement for growth and welfare in the European Union as a whole. Then, I will address the perspectives of monetary integration of the new member states. Finally, I will touch upon the challenges facing the new member states as they seek to follow and adhere to stability-oriented policies.

Enlargement will have Positive Implications for EU Growth

What are the main economic implications of EU enlargement for Europe? In the public debate, there seems to be widespread agreement that the enlargement of the EU will be particularly beneficial for the new member states, while the implications for the "previous" Member States are expected to be less positive. In fact, some people seem to be afraid of mass migration, abuse of western European welfare systems or wage and tax dumping. Most of these concerns remind me of the discussions we were confronted with in the past when there were similar reservations against the southern European countries joining the EU. I strongly believe that the concerns regarding the most recent enlargement round are largely exaggerated, and not only because of the very positive experience we made after the southern enlargements of the EU in the 1980s. More generally, I believe that the benefits of enlargement are often ignored in such discussions. I am convinced that EU enlargement has created a win-win situation, with positive implications for economic growth and welfare in both the new and the previous member states. Of course the benefits to be expected by the new entrants will be very substantial, given their low starting point in per-capita income. But for the European economy as a whole, EU enlargement will not only foster economic and financial integration. It will increase competition, promote structural reforms and lead to higher productivity and potential growth. Such economic benefits of EU enlargement are confirmed by several studies estimating that over the long term EU enlargement will improve real GDP in the previous member states by up to 0.8 percentage points.

When identifying the main benefits of EU enlargement for the EU as a whole, it is important to stress that the prospect of EU accession has already had positive implications. This becomes especially apparent when looking at the degree of trade integration between the previous and new member states, which increased significantly during the past decade. Trade integration was largely supported by the removal of tariffs and quantitative restrictions for some industrial products well before accession. Consequently, the new member states re-oriented their trade flows to the existing EU member states. At the same time the previous member states were attracted by the potentially large markets in the new member states, given the size of the population and the ongoing catching-up in living standards in these countries. Currently the new member states' share of export to the EU on average amounts to 67% of their total exports, while the share of imports coming from the previous member states is about 60% of total imports. In comparison, ten years ago the respective shares of imports and exports were below 50%. With respect to the euro area countries, their export and import shares with the new member states also increased significantly, standing currently at around 11% of total exports and imports, respectively, compared to 7% ten years ago. It is not sufficiently known that the new member states as a group are now one of the main trading partners of the previous EU countries. The trade shares of the euro area with the new member states are only slightly lower than those with the United States (11% versus 14%) and are significantly higher than euro area trade with Japan (8%).

Financial integration also intensified between the previous and new member states prior to accession. All new member states recorded large and increasing capital inflows in recent years, reflecting their limited capital stock, a high marginal return on capital and on average low saving ratios. Financial integration was also supported by the liberalization of most capital movements, which took place well before accession, thus already anticipating the treaty obligations of EU member states. By far the largest component of capital flows was foreign direct investment. Around 80% of FDI in the new member states originated in the previous member states. Looking at it from the perspective of the previous member states, around 12% of their FDI outflows are currently directed towards the new member states, which is three times higher compared to five years ago. Compared to other important FDI recipients from the EU-15, FDI flows to the new member states are still lower than those directed to the United States, but considerably larger than those to Japan. An additional indicator of the advanced degree of financial integration between the new and previous member states is the very substantial level of FDI in the banking sector of the new member states coming from the EU-15.

Moreover, the prospect of the ten countries joining the European Union has anchored the design of economic policies in the new member states and thus also helped to frontload a number of important reform measures. In this way the European Union has served as a catalyst for structural and institutional changes in the new member states. In my view, the most important examples in this respect were the orientation of their monetary policies towards price stability and the willingness to grant their central banks independence long before entering the EU. The statute of the European System of Central Banks was very helpful in this regard.

In addition to these past achievements, economic and financial integration is intensifying further now after accession, contributing to more growth in the EU as a whole. In fact, additional trade and investment opportunities arise in the EU following the removal of remaining technical barriers to trade between the previous and new member states and the extension of the Single Market. In the past, some economic and legal uncertainties in the new member states have apparently prevented in particular small and medium-sized companies of the EU-15 from investing more in these countries. With accession, however, this has been changing. In fact, one can already observe that small and medium-sized companies are becoming significantly more active now in the new member states, as they take advantage of mostly high-skilled labor force and the favorable cost situation.

In addition to more integration, enlargement leads to greater competition in the EU and enhances the scope for economies of scale. The previous member states will also be affected by higher competition in the EU. This consecutively could accelerate structural reforms in the previous EU countries, thereby improving the outlook of potential growth in the EU as a whole and contributing to the implementation of the Lisbon agenda. In fact, overall the new member states seem to be rather competitive and have already made large progress in implementing structural reforms in some areas.

Monetary Integration of New Member States Will be Carefully Prepared

Let me now turn to the process of monetary integration in the new member states, which is also likely to have positive implications for Europe as a whole by fostering economic and financial integration. Accession to the EU is only the beginning of the monetary integration process, which ends with the eventual adoption of the euro, as these countries have fully subscribed to the Maastricht Treaty without asking for an opt-out clause. The path towards euro adoption is embedded in a well-defined multilateral institutional framework and comprises a number of phases. The first phase for the new member states is the period after EU accession and before joining the exchange rate mechanism (ERM II). This mechanism defines a regime characterised by fixed, but adjustable, exchange rates, with a central rate against the euro and a standard fluctuation band of ±15 percent. The second phase is then the period of ERM II participation, which is destined to end with the adoption of the euro.

What is the framework in which monetary and exchange rate policy will evolve in the new member states on their way to the eventual adoption of the euro? Upon accession and before ERM II entry, the new member states are required to treat their exchange rate policies as a matter of common interest and pursue price stability as the primary objective of monetary policy. Yet, the full responsibility for monetary and exchange rate policy is still with the new member states. With respect to ERM II participation, there are no formal criteria to be met prior to the entry. Nevertheless, a successful and smooth participation in the mechanism requires that major policy adjustments—for example relating to a sound fiscal policy framework and price liberalization—are undertaken before joining the mechanism.

Depending on the monetary and exchange rate strategies in place, ERM II can help orient macroeconomic policies to stability and anchor inflation expectations. At the same time, the mechanism allows for a degree of flexibility, if needed, through the wide standard fluctuation band and the possibility of adjusting the central parity. Eventually, the new member states are expected to adopt the euro. Let me stress that joining the euro area is a far-reaching step for any country. To be able to join the euro area each country will be assessed on the basis of a deep and precise analysis of their performance with respect to the Maastricht convergence criteria. At the same time, it has to be ensured that the achievements in terms of nominal convergence are sustainable and can be maintained over the long term.

So far progress towards nominal convergence varies widely across the new member states, which implies that the new member states will join the euro area at different times. Each country's performance in relation to the convergence criteria is examined in "Convergence Reports" regularly prepared by both the European Commission and the ECB.

It is important to keep in mind that the process of monetary integration is based on some general principles that guide the process of euro adoption. They are defined by the Maastricht Treaty and other key documents. One key principle is that there is no single trajectory towards the euro that can be identified and recommended to all new member states at all times. This principle reflects the fact that the new member states differ substantially with respect to the size and structure of their economies, the present state of their fundamentals, and the monetary and exchange rate regimes currently in place. In fact, the new member states currently display a variety of exchange rate regimes, ranging from currency boards to free floating regimes.

The wide diversity across the new member states implies that the economic situations and strategies of countries will have to be assessed on a case-by-case basis, i.e. on their own individual merits and their particular situation. Given the different situations and strategies of the new member states, it is clear that both the timing of ERM II entry and the preferred length of participation in the mechanism will differ across countries. Some currencies have already entered the mechanism. Following the mutual agreement between the participating parties, three new member states—Estonia, Lithuania and Slovenia—joined ERM II on June 27, 2004.

Another key principle is that of equal treatment. This means that comparable situations and cases will be treated in a comparable manner, both across countries and over time. With respect to the examination of nominal convergence in the ECB Convergence Report 2004, this implies that the same convergence criteria laid down in the Treaty have been applied as was the case in the past. Thus, no new criteria were added, while the existing criteria were not relaxed. With respect to the exchange rate criteria, which requires participation in ERM II for at least two years without severe tensions and without devaluing at the country's own initiative, the assessment of exchange rate stability against the euro is made on the exchange rate being close to the central rate, while also taking into account factors that may have led to an appreciation.

New Member States Need to Maintain Stability-Oriented Policies

To ensure that the process of monetary integration will be successful, it is important for the new member states to conduct generally consistent and stability-oriented economic policies. Moreover, a stable macroeconomic environment and progress in structural and fiscal reforms are also essential to take full advantage of the benefits of EU enlargement and to support the catching-up process in per-capita income levels. Thereby, stability-oriented policies and structural reforms will ensure that real and nominal convergence can be achieved in parallel. I would like to focus on two challenges that I believe are of crucial importance to the new member states in view of monetary integration and real convergence, namely the challenge to ensure price stability and the challenge to foster fiscal consolidation.

Price stability is an essential requirement for a successful monetary integration process. Moreover, by fostering trade and investment, it can contribute to a more rapid catching-up process in real income levels. Where do countries currently stand with respect to price stability? As I mentioned earlier, the new member states have already made considerable progress in terms of disinflation in past years by bringing the average inflation rate in the new member states closer to the one in the euro area. Recently, however, inflation rates have started to pick up again in most of the new member states. The recent increase in inflation was mainly related to supply-side factors such as developments in food and energy prices and indirect tax changes in the context of EU accession. In addition, it should be born in mind that further upward pressures on prices are expected in the context of the catching-up process of the new member states and the liberalization of administered prices.

Against this background, the new member states will be confronted with the task to contain the pick-up in inflation rates in a controlled and moderate fashion, without substantial adverse effects on inflation expectations and future wage developments. Moreover, for those countries that have not yet fully completed the disinflation process the main challenge will be to contain inflationary pressures in a lasting manner. Besides solid macroeconomic policy frameworks and prudent wage policies, progress in structural reforms can be regarded as being conducive to price stability by improving the supply side of the economy and enhancing growth potential. Moreover, sound fiscal policies are also crucial with respect to price stability.

This brings me to the second challenge, namely the need to foster fiscal consolidation and achieve sound fiscal positions. Although the fiscal situation varies across countries, fiscal deficits are on average high and even very high in a number of new member states. It is clear that fiscal consolidation is a major challenge for most of the new member states. Their governments are confronted with competing expenditure demands, including *inter alia* public investment in infrastructure and the need to strengthen the effectiveness of public administration and the judicial systems. Consequently, policymakers have to design and implement a credible consolidation path based on durable and growth-enhancing structural reforms. It is important to bear in mind that fiscal consolidation in the new member states becomes increasingly important in view of their further monetary integration and is particularly essential for smooth participation in ERM II.

Conclusion

First, it is important to stress the historical importance of this enlargement. It proves that the visionary founding fathers of Europe were right in trusting political democracy, human rights, civil liberties and market economies, were right in sticking to their common beliefs during half a century and in inventing a bold, unique and highly successful concept of Union which has no historical precedent. It is a formidable historical achievement.

Second, I want to share a very profound belief that I have acquired progressively over the last fifteen years. Let us not underestimate the rapidity of the present pace of history. When we negotiated the Maastricht Treaty we were still 12. The negotiators did not realize that we were potentially much more numerous. We all had difficulty in understanding that we were experiencing an acceleration in the course of history. In the fall of 2004 a new Constitution was signed in Rome by 25 European governments. And the EU will soon be even more numerous: 28 and even more. Europe—and the entire planet—is advancing, changing, transforming itself much more rapidly now than was the case in the 1950's, 1960's, 1970's and 1980's of the last century. This undoubtedly increases uncertainties and challenges, for uncertainty is the very mark of history in the making. But it also multiplies chances and opportunities, including within the economic sphere. It is up to us to make the best of these opportunities.