Allianz Group

Economic Trend Report

Perspectives of EU Enlargement

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Perspectives of EU Enlargement

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1 Introduction

The division of continental Europe is a thing of the past. In May 2004, some 15 years after the fall of the Iron Curtain, eight central and east European countries are set to join the European Union, alongside Cyprus and Malta. The candidate countries have made enormous efforts to satisfy the accession criteria, and together with the Union they have pushed ahead negotiations on accession at breathtaking speed. Although the European Commission still sees shortcomings in compliance with the accession criteria, it assumes that the countries concerned will be able to redress these ahead of their admission. The way is thus paved for more peace, stability and prosperity in Europe. But successfully as European integration may have been pursued thus far, the future of the "EU-25+" project remains uncertain. Various determinants of the enlargement process suggest that matters may take a less positive course than in the past.

Many transitional arrangements from the current round of enlargement, some of which will apply for long periods, make the inner workings of the Union less transparent and run counter to the spirit of the internal market. The Union will shortly see the limits of its capacity to absorb new members put to the test, particularly since various attempts at reform have so far done little to help create efficient institutional and financial structures. The current round of enlargement is already confronting the EU with a financial challenge which, while fundamentally manageable, does lend acute urgency to the issue of more equitable sharing in the provision of EU own resources.

That the prospect of admission to the EU has spurred the transformation process in the candidate countries, in terms of both their political and economic systems, is beyond doubt. The GDP growth that the transformation countries have succeeded in generating during their candidacy has far outstripped that in the existing EU member states. Of course this has essentially been driven by a catch-up effect powered in particular by a very marked export dynamic and an extremely high influx of foreign direct investment. But the process of structural change in the accession countries is still far from complete. EU development aid can certainly support this process, but only to the extent that the funds made available to the individual countries are actually put to efficient use.

Some of the necessary investment in the central and east European countries is also being funded by private savings. Reforms of the pension systems there have placed greater emphasis on fully-funded provision. But the build-up of private and company pension systems is not yet at an end, further steps will follow. Moreover, the state branches of retirement provision need further overhauling to prevent demographic trends from placing a huge burden on the pay-as-you-go pension systems.

On May 1, 2004 the ten new member states will have covered but one stage on the road to Europe, because membership of the European Union does not

automatically mean membership of the European Monetary Union as well. For this, the Maastricht criteria must first be satisfied. But there is no question that the acceding countries wish to, and will, exchange their national currencies for euros at the earliest possible date. A twin-track accession process is conceivable for this, with the Baltic states and Slovenia joining the euro area at the beginning of 2007, the earliest possible date. They are then likely to be followed in 2009 by the Czech and Slovak Republics, Hungary and Poland, countries that continue to wrestle at present with grave budgetary problems.

2 From the EU-15 to the EU-25

2.1 EVOLVEMENT AND OUTCOME OF THE ACCESSION NEGOTIATIONS

In June 1993 the European Council in Copenhagen paved the way for enlargement of the European Union. EU leaders agreed in principle that the associated countries of central and eastern Europe could join the Union. But before admission they must satisfy the "Copenhagen criteria".

ACCESSION CRITERIA ("COPENHAGEN CRITERIA")

A country wishing to join must

- guarantee stability of institutions ensuring democracy, the rule of law, human rights and respect for and protection of minorities (political criterion);
- demonstrate the existence of a functioning market economy as well as the capacity to cope with competitive pressure within the Union (economic criterion);
- assume the obligations arising from EU membership, including adherence to the aims of economic, monetary and political union (criterion of adoption of the *acquis communautaire).*

With reference to these accession criteria the EU Commission has, since 1997, made an annual assessment of the transformation process in the 13 countries applying to join the EU. In its last "Strategy Paper" dated October 2002 the Commission affirmed that Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia meet the political criterion. It still identified deficits in respect of the economic criterion and adoption and implementation of the *acquis communautaire.* However, the Commission concluded that the countries concerned could redress these shortcomings by the beginning of 2004. It therefore recommended closing negotiations on accession with these countries at the end of 2002, even if it did intend to continue monitoring their progress on adjustment.

The heads of state or government of the EU member states followed this recommendation. Negotiations on the then still unsettled and particularly critical chapters Agriculture, Financial and Budgetary Provisions, Regional Policy as well as Institutions and Other were concluded in December 2002. That month the European Council in Copenhagen, barely ten years after it had launched the enlargement process at the same location, declared the successful completion of accession negotiations with ten countries.

DATES IN THE ENLARGEMENT PROCESS

Country	Date of membership application	Beginning of negotiations	Conclusion of negotiations	Date of referendum
Bulgaria	December 1995	February 2000	ongoing	/
Cyprus	July 1990	March 1998	December 2002	no referendum
Czech Rep.	January 1996	March 1998	December 2002	June 2003
Estonia	November 1995	March 1998	December 2002	September 2003
Hungary	March 1994	March 1998	December 2002	April 2003
Latvia	October 1995	February 2000	December 2002	September 2003
Lithuania	December 1995	February 2000	December 2002	May 2003
Malta	July 1990	February 2000	December 2002	March 2003
Poland	April 1994	March 1998	December 2002	June 2003
Romania	June 1995	February 2000	ongoing	/
Slovak Rep.	June 1995	February 2000	December 2002	May 2003
Slovenia	June 1996	March 1998	December 2002	March 2003
Turkey	April 1987	probably 2005	/	/

Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia are to be admitted to the European Union on May 1, 2004. Bulgaria and Romania have been given a clear accession perspective for 2007. Moreover, the European Council has offered Turkey, which has held official candidate status since 1999, the prospect of beginning accession negotiations "without delay" following the December 2004 summit. Before that, however, the Commission must establish that Turkey satisfies the political criterion.

TEN COUNTRIES WILL JOIN THE EU ON MAY 1, 2004

The time frame for this round of enlargement is extremely ambitious. The heads of state or government of the EU countries and the new members signed the accession treaty on April 16, 2003 at the Athens summit. Ratification in the present and future EU member states is to take place in time to permit accession on May 1, 2004. The future member states have already held referenda, all of them with a positive outcome. Cyprus, which had made no plans for a plebiscite, has already ratified the accession treaty. The "old" member states are not conducting referenda either; there the accession agreement will go through the ratification process as provided for under national legislation.

2.2 TRANSITIONAL ARRANGEMENTS ON THE WAY INTO THE UNION

The *acquis communautaire* represents a considerable stumbling block to accession. So far no applicant country has succeeded completely in adopting and implementing the common body of EU laws and regulations. Nor will the accession countries achieve this objective by 2004. The EU has therefore agreed transitional arrangements with the future member states in various areas enabling them to retain for a limited period national rules that do not basically harmonize with EU law.

SOME 250 TRANSITIONAL ARRANGEMENTS PERMIT DEPARTURES FROM THE ACQUIS COMMUNAUTAIRE

Originally there were only supposed to be transitional arrangements in valid individual cases, because of their market-distorting effects and intransparency. But ultimately, a total of some 250 transitional arrangements were negotiated. **These regulations are clearly defined in content and limited in time, although in some cases very long periods of up to 12 years have been conceded.** Most agreements refer to the environment, taxation, agriculture and transport policy. The majority of these transitional regulations were introduced in response to demands from the acceding countries. For example, the new members have been given up to 2015 to comply with environmental emission rules. Various countries have been given extended deadlines to adjust their value added tax rates and also granted temporarily higher agricultural production quotas.

FREE MOVEMENT OF LABOR CAN BE RULED OUT FOR UP TO SEVEN YEARS

Germany and Austria demanded transitional arrangement to protect their labor markets.

But some transitional regulations were implemented at the insistence of the present EU members. Particularly important in this context is the **restriction on free movement of labor,** urged by Germany and Austria for fear of the pressure that immigration from the new member states would exert on their labor markets.

TRANSITIONAL PERIODS FOR THE FREE MOVEMENT OF LABOR

- A two-year transitional period applies to all new member states, with the exception of Cyprus and Malta, during which the previous EU member states may continue to apply their national regulations. Depending on how liberal these are, this may already mean free access to the jobs market.
- After these two years the need to continue the transitional arrangement is automatically reviewed. Each new member state concerned may also request a review of this kind. The findings will flow into a Commission report, although the previous member states alone will have the power to decide whether they wish to grant full freedom of movement for workers.
- As a general rule the transitional arrangement is scheduled to expire after five years. However, the present EU-15 countries may prolong it for a maximum of another two years if they identify or fear a sustained disturbance of their labor market. The “old” members may adopt safeguards for their labor market up to the end of the seventh year.
- The restrictions on access to the current EU member states’ labor markets may not be tighter than at the time of signing the accession treaty. Moreover, job-seekers from the new member states must be given preference over job-seekers from non-EU countries.
- Germany and Austria further have the right to apply additional safeguards if cross-border trade in certain services threatens to cause serious disturbances.

All in all, the EU will have to devote considerable resources to securing implementation and transposition of the *acquis communautaire.*
This is because in future the central and east European countries will no longer have the prospect of admission to the EU as a spur to this adjustment process.

2.3 OUTLOOK: WHERE DO EUROPE'S BORDERS LIE?

Of the altogether 13 official candidates for accession three are not participating in the current round of enlargement. However, the admission of Bulgaria and Romania in 2007 is practically a done deal, and Turkey has been given a definite prospect for the assumption of accession negotiations. **But even this does not bring enlargement of the European Union to an end; the Community will continue to grow.** The Union concluded stabilization and association agreements in 2001 with Macedonia and Croatia, giving these countries a definite outlook for membership. Croatia applied for membership on February 21, 2003. Serbia and Montenegro, and Albania, are likewise integrated into the stabilization and association process, with 2004 as the probable time frame for signing the relevant agreements. And the process of European integration extends even beyond the borders of those countries. Already, EU Partnership and Cooperation Agreements exist with Russia, Ukraine and other "New Independent States". While these should not be interpreted as a direct run-up to EU membership, they do signal those countries' fundamental alignment towards the Union.

TURKEY AS A MEMBER OF THE EU

Before accession negotiations begin the country must satisfy the political accession criterion.

The European Union is basically designed as an open organization. Article 49 of the Treaty on European Union states: **"Any European State (…) may apply to become a member of the Union".** In the light of this, there has been intensive debate for some time on Turkish membership of the EU. Turkey signed an association agreement with the Union back in September 1963 and applied for EU membership in April 1987. In its application assessment the Union focused less on whether Turkey really is a European country – a question that is hard to answer with the aid of an atlas alone. The main obstacle to launching accession negotiations was the fact that up to now Turkey comes nowhere near to satisfying the political accession criterion. That said, the country's past political and economic decisions have been shaped by the desire to achieve full membership of the community of European states. It is therefore probable that the Union will commence accession negotiations with Turkey in 2005. But the country is unlikely to be admitted before the middle of the next decade at the earliest. It is by all means possible that the Balkan states will satisfy the membership criteria ahead of Turkey.

INSTITUTIONAL REFORM URGENTLY REQUIRED

Positive approaches in EU draft constitution.

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Past enlargement rounds, however – like the present one – suggest that ultimately EU boundaries will be determined by institutional factors. **An "accession criterion" not usually mentioned stipulates that the Union must be capable of absorbing new members while maintaining the "momentum of European integration".** Yet already, a question mark hangs over the Community's capacity for action, precisely because of its forthcoming admission of ten new members. So far, none of the reforms of Community treaties has succeeded in reorganizing EU institutions to set them on course for the future. Certainly, the draft EU Constitution does contain ambitious proposals on revamping Union institutions, but it is doubtful whether these will actually be implemented.

COOPERATION WITHOUT MEMBERSHIP

New forms of cooperation beyond EU borders.

In these circumstances thought should be given to whether countries such as Belarus or Ukraine can in fact aspire to full membership of the Union. Assuming their political integration capabilities do not suffice for such a step for some considerable time to come, different forms of cooperation outside the framework of the EU treaty could be considered instead. This, too, could generate stabilizing effects equally beneficial to the Union and the associated countries. For example, closer cooperation beyond the confines of a strictly

customs union would be quite conceivable in areas such as the environment, education, energy or infrastructure policy. A coordinated foreign policy or a common approach on justice and home affairs would not be ruled out either as the transformation process advances in these countries. In the very long term – a timescale that will certainly be longer than a generation – the possibility of admission to the EU might not be unrealistic.

3 Prospects for a political Union

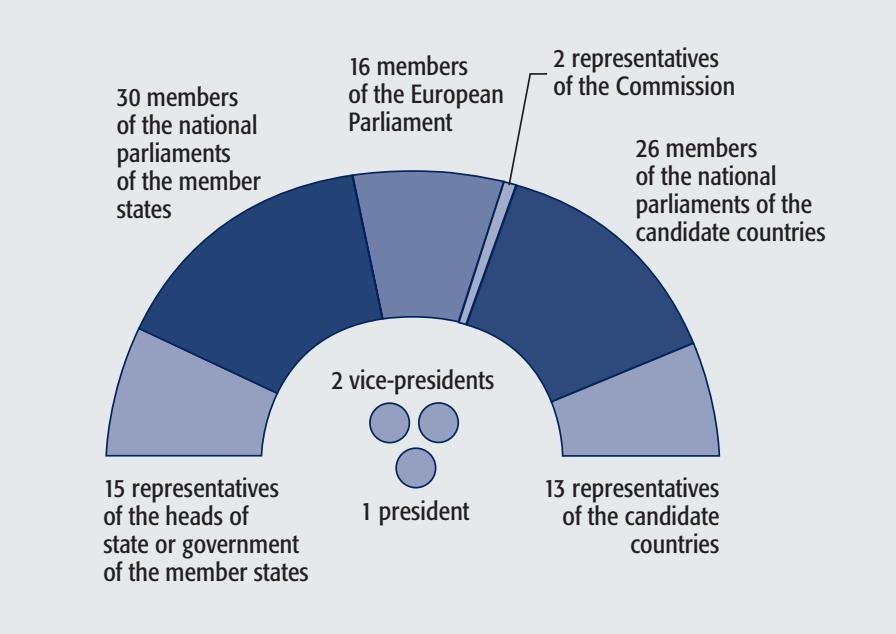
3.1 ON THE WAY TO A WORKABLE EU-27

With the Treaty of Nice, which came into force on February 1, 2003, the EU leaders were aiming to create the institutional foundations for enlargement of the European Union. The main elements of the Treaty are changes to the composition of the EU Commission, re-weighting of the votes in the Council of Ministers and the introduction of a new distribution of seats in the European Parliament.

WORKABILITY OF AN ENLARGED EU IS IN DOUBT

The Treaty of Nice has – if at all – created only a very limited basis for the workability of an enlarged Union. The Treaty's shortcomings are evident for all to see: retention of the unanimity principle in numerous "sensitive" political areas, a complicated majority decision procedure in the Council of Ministers, postponement of reform of the EU Commission. Not least because of this, in December 2001 in Laeken the EU leaders initiated a "Convention on the future of Europe". The Convention consisting of altogether 105 representatives of the EU member states and accession countries was tasked with preparing the next Intergovernmental Conference as comprehensively and transparently as possible. This IGC began on October 4, 2003 and will probably end in April 2004. The outcome is supposed to be reform of the EU treaties.

THE EU CONVENTION



Source: Own depiction.

ONE OF THE CONVENTION'S OBJECTIVES WAS A CONSTITUTION FOR EUROPE

The **objectives set for the Convention** were extremely ambitious. They consisted of **laying the foundations for enlargement of the EU, redressing the democratic deficit in the Union and enhancing the EU's international importance.**

The agenda comprised such items as:

- better distribution and delimitation of powers in the European Union (e.g. application of the principle of subsidiarity, common foreign and defense policy),
- simplification of instruments (e.g. legislative and implementing procedures),
- more democracy, transparency and efficiency in the Union (e.g. democratic legitimization and position of the EU institutions, procedure for elections to the European Parliament, decision-making in the Council of Ministers) and
- a European Constitution.

3.2 RESULTS OF THE CONVENTION ON THE FUTURE OF EUROPE

3.2.1 A CONSTITUTION FOR EUROPE

The Convention agreed, on June 13, 2003, on an initially still incomplete draft constitution, which Convention president Valéry Giscard d´Estaing submitted to the EU leaders at the summit in Thessaloniki. The Convention completed its discussion of the missing sections, including such hotly debated issues as the transition to decision-making by qualified majority on foreign and security policy, on asylum and immigration and on tax policy, at additional plenary sessions. The Convention president presented the complete **"Draft Treaty establishing a Constitution for Europe"** to the president of the European Council on July 18, 2003 in Rome.

The draft constitution builds on the existing European treaties, the EURATOM Treaty being dealt with separately. The Convention has revised and reorganized these treaties, augmenting the previous 414 articles to 462. The constitution is to consist of a preface and four parts, followed by protocols and declarations.

Particularly noteworthy in Part I of the constitution is that the draft attributes legal personality to the Union. This is a vital prerequisite for a constitution. What is more, it strengthens the Union's international negotiating power and position. So far only the European Communities were recognized as having their own legal personality.

ATTEMPT AT A CLEAR DELIMITATION OF POWERS HAS FAILED

The constitutional draft broadly writes previous practice into law.

In this legal code the Convention members have, moreover, sought clearly to ring-fence EU competences. For this they have broadly followed previous common practice, in which, however, definition of the scope of competences had to be deduced from the treaties. Now the areas in which the EU has sole competence, the competences it shares with the member states, and when it may support actions by its members states are to be circumscribed by law.

CLASSIFICATION OF THE DRAFT CONSTITUTION

Preface

Part I

Title I – Definition and objectives of the Union
Title II – Fundamental rights and citizenship of the Union
Title III – Union competences
Title IV – The Union's Institutions
Title V – Exercise of Union competences
Title VI – The democratic life of the Union
Title VII – The Union's finances
Title VIII – The Union and its immediate environment
Title IX – Union membership

Part II: The Charter of fundamental rights of the Union

Title I – Dignity
Title II – Freedoms
Title III – Equality
Title IV – Solidarity
Title V – Citizens' rights
Title VI – Justice
Title VII – General provisions governing the interpretation and application of the Charter

Part III: The policies and functioning of the Union

Title I – Clauses of general application
Title II – Non-discrimination and citizenship
Title III – Internal policies and action
Title IV – Association of the overseas countries and territories
Title V – The Union's external action
Title VI – The functioning of the Union
Title VII – Common provisions

Part VII: General and final provisions

Protocol on the role of national parliaments in the European Union
Protocol on the application of the principles of subsidiarity and proportionality
Protocol on the representation of citizens in the European Parliament and the weighting of votes in the European Council and the Council of Ministers
Protocol on the Euro Group
Protocol amending the EURATOM Treaty
Declaration attached to the Protocol on the representation of citizens in the European Parliament and the weighting of votes in the European Council and the Council of Ministers
Declaration on the creation of a European external action service
Declaration on the final act of signature of the Treaty establishing the Constitution

Source: Draft Treaty establishing a Constitution for Europe.

Explicit regulations are, however, set out only for the coordination of economic and employment policies, the common foreign and security policy, the common security and defense policy and the area of freedom, security and justice. **No clear distinction is made for the other categories of competence, nor does the wording of the constitution abide strictly throughout by the classification chosen.**

Article 9 of the constitution explicitly describes subsidiarity as a fundamental principle of the Union, with very little alteration to the wording of the treaties currently in force. It is striking that, as in the past, the application of subsidiarity is laid down in a protocol. But this principle should represent the essence of the European Union; its implementation ought therefore to be enshrined and defined in the main body of the constitution. Its separation into a protocol robs it of its importance and necessary weight, even if only symbolically.

CATEGORIES OF COMPETENCE ACCORDING TO THE DRAFT CONSTITUTION

Exclusive competence	Areas of shared competence	Supporting action
Monetary policy for the member states that have adopted the euro; common commercial policy; customs union; conservation of marine biological resources under the common fisheries policy	Internal market; area of freedom, security and justice; agriculture and fisheries, excluding the conservation of marine biological resources; transport and trans-European networks; energy; social policy (for aspects defined in Part III); economic, social and territorial cohesion; environment; consumer protection; common safety concerns in public health matters	Industry; protection and improvement of human health; education and vocational training; youth and sport; culture; civil protection

Source: Draft Treaty establishing a Constitution for Europe.

Finally, an article has been included on a country's voluntary withdrawal from the EU – an option already open to the EU member states in strictly legal terms. **For practical purposes, however, withdrawal would be extremely difficult given the advanced integration of the legal and economic system.**

DOES THE CONSTITUTION GUARANTEE A RIGHT TO WORK?

A legally enforceable right would run contrary to greater flexibility of the EU member states' labor markets.

Part II of the constitution consists of the Charter of Fundamental Rights, drafted in 2000 by a separate convention. Here, too, the lack of transparency in the structuring of the draft clearly emerges, with much overlapping with the first part, which also sets out fundamental rights, Union citizenship and democratic life. The fact that the Charter is intended to be legally binding gives rise to the question as to what extent social entitlements will be enforceable at law. This could have undesirable side effects for economic policy. **With regard to the labor market, the draft constitution contains a provision pointing in quite the wrong direction.** The Union's Charter of Fundamental Rights apparently concedes the citizens of the Union a right to work (Article II-15, paragraph 1: *"Everyone has the right to engage in work and to pursue a freely chosen or accepted occupation."*). The problems this approach involves are evident. Quite apart from the fact that a legally enforceable right of this kind would thwart all necessary attempts to make the labor market more flexible in the EU member states, it would quite simply be impossible to implement.

The third part of the constitution is devoted to the policies and functioning of the Union, in other words implementation of what is set out in the first part. **Here, a major weakness of the constitutional instrument is that the system of delimitation of powers in Part I of the constitution is not taken up in the third part of the text.** This strengthens the impression that in future, too, the division of powers will in practice more closely follow the principle of individual authorization than take its legal justification from the constitution. But clear assignment of competences is particularly important for an enlarged Union, as the only way of achieving transparency and efficiency. Also noteworthy about Part III of the constitution is that – in conjunction with a protocol – it formalizes and strengthens the position of the "Euro Group" i.e. the finance ministers of the member states that have adopted the euro. The distinction remains unclear, though, between the duties of the Euro Group president – a post to be newly created – and those of the Commissioner for Economic and Monetary Affairs and the ECOFIN president.

The fourth and last part deals essentially with repeal of the present treaties, legal continuity in relation to the European Community and the European Union and adoption and ratification of the Treaty establishing the Constitution.

Before this constitution can enter into force, which will presumably be in 2006, the Intergovernmental Conference must first deal with the draft. After the heads of state or government of the member states have then agreed on and signed a Treaty establishing the Constitution, the 25 EU member states must ratify the instrument. France, Spain, Italy, Austria, Hungary and Poland have said they will hold a plebiscite on the constitution; in Ireland a referendum is required by law. What happens if a country does not ratify the constitution is an open question.

3.2.2 INSTITUTIONAL STRUCTURES IN AN ENLARGED UNION

The accession treaty creates the institutional framework for EU enlargement for the 2004 – 2009 parliamentary term. This is also set out in the "Protocol on the representation of citizens in the European Parliament and the weighting of votes in the European Council and the Council of Ministers" in the Draft Treaty establishing the Constitution. The provisions in both documents differ in parts from the relevant contents of the Treaty of Nice. The distribution of seats in the European Parliament leaves Germany and the small present and future member states with the same number of seats as stipulated in Nice, while all the other countries have more. All told, the number of seats in the EP is limited to a maximum of 736 in the draft constitution (Nice 732), although it may temporarily exceed this if Romania and Bulgaria join the Union as planned in 2007, i.e. during the 2004 – 2009 parliamentary term. The draft Treaty does not clearly state how many seats these two countries will then have. The number will be geared to the 33 and 17 seats respectively determined in Nice but is to be adjusted using the same formula as for the other member states. This formula is not published in the wording of the Treaty.

SEATS IN THE EUROPEAN PARLIAMENT AND VOTES IN THE COUNCIL OF MINISTERS IN THE 2004 – 2009 PARLIAMENTARY PERIOD, AS SET FORTH IN THE ACCESSION TREATY/DRAFT CONSTITUTION

– THE PROVISIONS IN THE TREATY OF NICE ARE SHOWN IN PARENTHESIS –

Member states	Seats in the European Parliament	Votes in the Council of Ministers	Member states	Seats in the European Parliament	Votes in the Council of Ministers
Germany	99 (99)	29	Bulgaria	–– (17)	–– (10)
United Kingdom	78 (72)	29	Austria	18 (17)	10
France	78 (72)	29	Slovak Republic	14 (13)	7
Italy	78 (72)	29	Denmark	14 (13)	7
Spain	54 (50)	27	Finland	14 (13)	7
Poland	54 (50)	27	Ireland	13 (12)	7
Romania	–– (33)	–– (14)	Lithuania	13 (12)	7
Netherlands	27 (25)	13	Latvia	9 (8)	4
Greece	24 (22)	12	Slovenia	7 (7)	4
Belgium	24 (22)	12	Estonia	6 (6)	4
Portugal	24 (22)	12	Cyprus	6 (6)	4
Czech Republik	24 (20)	12	Luxembourg	6 (6)	4
Hungary	24 (20)	12	Malta	5 (5)	3
Sweden	19 (18)	10	**Total**	**732**	**321**

Source: Draft Treaty establishing a Constitution for Europe.

In respect of the weighting of votes in the Council of Ministers the accession treaty and draft constitution are broadly in line with the Nice Treaty for the period from 2004 to 2009. Decisions that are to be adopted by a qualified majority require at least 232 votes. Decisions to be adopted on a proposal from the Commission additionally require the approval of the majority of member states, otherwise two-thirds of the member states must vote in favor. Moreover, any member state may request a check to ensure that the decision represents 62% of the total population of the Union. Only then does it come into force. If Romania and Bulgaria accede to the European Union by November 1, 2009, they will receive 14 and 10 votes respectively. The Nice Treaty then requires 258 votes for decisions adopted by a qualified majority. After November 1, 2009 the draft constitution proposes that qualified majority decisions will only have to represent three-fifths of the population.

AMBITIOUS PROPOSALS FOR INSTITUTIONAL REFORM BY THE CONVENTION

but the future division of power is still not clear.

With regard to other EU institutions, the Convention has agreed on numerous new arrangements vis-à-vis the existing Treaty. These include plans to strengthen the European Parliament. **In future the co-decision process is to be the rule in the European Union's legislative procedure.** The draft constitutional treaty also contains a provision stating that the heads of state or government of the EU shall elect a president of the European Council. Besides preparing and conducting European Council meetings and reporting to the European Parliament, this president – who may not hold a national office – will also represent the Union outwardly on foreign and security policy at a heads of government level. The other foreign policy tasks will rest with the foreign minister of the European Union, another new position created in the constitution. The exact allocation of responsibilities between the two foreign affairs representatives remains vague, and the actual distribution of power will emerge only in practice. Generally speaking, though, the office of President of the European Council appears to hold little clout or appeal.

PROPOSAL FOR A MARKED DOWNSIZING OF THE COMMISSION

But a rotation principle holds little prospect of political acceptance.

For the Commission, it was decided at the Copenhagen summit to concede the new member states one commissioner each as from May 2004. Then once the European Council has appointed a new Commission president, the newly elected Parliament will review and confirm an enlarged Commission in June 2004. Under the terms of the Treaty of Nice it is to consist of one commissioner per member state[1] and begin work in November 2004. The Convention has demonstrated considerable purposefulness with its proposal on composition of the Commission. This sees a marked reduction in the number of commissioners in 2009, a long overdue step towards guaranteeing that the Commission remains capable of working in future. **The Commission, which is currently composed of 20 members, would then consist of a College comprising the president and the Union foreign minister as vice-president plus 13 commissioners** selected on the basis of a "system of equal rotation" satisfactorily reflecting the "demographic and geographical range of all the member states". The constitutional draft also broadens the powers of the Commission president. He could in future request individual Commission members to resign. It is to be hoped that these plans emerge unscathed from the Intergovernmental Conference. At present, however, it hardly appears conceivable that an EU member state might be prepared voluntarily to renounce its "personal" EU commissioner and waive the political influence attendant on the post. The President of the EU Commission, Romano Prodi, has already criticized the proposal, calling instead for a permanent commissioner for each member state.

[1] The Treaty of Nice foresees, following accession of the 27th country, the introduction of a rotation system with all countries taking equal turns to sit on the Commission, enabling the number of commissioners to be slimmed down to less than the number of member states.

Another positive aspect is that **the constitution envisages the adoption of decisions by qualified majority in the Council of Ministers as the standard procedure**. Areas continuing to require unanimity must be explicitly catalogued. This will be the case for various areas of taxation, amendments to the Stability and Growth Pact, social policy, international association agreements and cultural and audio-visual services. Common foreign and security policy will also remain subject to unanimity. With this approach the constitution will help make decision-making at European level more efficient. That said, the areas in which decisions will have to remain unanimous still contain considerable conflict potential.

3.2.3 PROSPECTS FOR A POLITICAL UNION

From an economic angle, the process of European unification has been very successful in the past. **In political terms, however, it has usually constituted nothing more than agreement on the smallest common denominator.** This is because of the **considerable discrepancy in the EU members' willingness to integrate politically.** The problem is likely to deepen further in an enlarged Union, particularly since the draft Constitution has failed to allocate competences clearly in the various policy areas. As a result, the distribution of power between the Union and its member states also remains hazy. This gives rise to the question of the basis on which a political union can be built up and what shape that union will take.

DIFFERENT DEGREES OF WILLINGNESS TO INTEGRATE WILL LEAD TO A EUROPE OF DIFFERENT SPEEDS

We shall have to set aside the idea of a united Europe in the real sense of the word – not that this need necessarily be a bad thing. There is evidence to suggest that not all members are equally willing and able to share in a deeper European Union. Instead, it is probable that we shall have a multi-speed Europe in future. **Particularly integration-prone member states will work very closely together in individual political areas within the framework of the EU treaties.** A current illustration is the move by Germany and France to coordinate their economic policy more closely. Successful integration projects will presumably then acquire greater appeal for other EU countries, who can come on board at any time. However, the member states involved must be able to end cooperation of this kind if it does not achieve the desired aims. **Differently composed groups of EU members could conceivably opt for a common approach in different political areas. The pace of integration in the various arenas would then be set by the preferences of the states participating in that particular project.**

CLOSER COOPERATION MUST BE MADE MORE FLEXIBLE

The legal basis for this approach was in principle created in the Treaty of Amsterdam, which already provided for the possibility of "closer cooperation". But it was the Nice Treaty that first introduced an element of practicability by at least no longer requiring a unanimous vote by all EU members on more intensive cooperation between individual member states[2]. **However, the EU heads of state or government did not put in place a really flexible tool for heightened cooperation in Nice either, and the draft Constitution also leaves much to be desired in this regard.** The Intergovernmental Conference would therefore be well advised to readdress this item very carefully. For in a Union of 25 or more members no instrument other than closer collaboration appears suited to expediting a targeted and structured process of political integration in the interests of Europe.

[2] Article 43 of the EU Treaty stipulates that cooperation must comprise at least eight member states.

4 The budget for the EU-25

4.1 THE 2004 – 2006 FINANCIAL FRAMEWORK FOR ENLARGEMENT

The Copenhagen European Council in December 2002 agreed on a total of approx. € 37.5bn as the ceiling on enlargement-related appropriations for commitments[3] from 2004 to 2006. In the individual years, enlargement-related appropriations are equivalent to 10.6 %, 13.7 % and 16.3 % of the budget total. They account for between 0.1 % and 0.15 % of EU gross national income for the EU-15.

APPROPRIATIONS FOR ENLARGEMENT

Maximum enlargement-related appropriations for commitments 2004 – 2006 for 10 new member states (€m at 1999 prices)

	2004	2005	2006
Heading 1: Agriculture	**1,897**	**3,747**	**4,147**
of which:			
1a: Common Agricultural Policy	327	2,032	2,322
1b: Rural development	1,570	1,715	1,825
Heading 2: Structural actions, after capping	**6,070**	**6,907**	**8,770**
of which:			
Structural Funds	3,453	4,755	5,948
Cohesion Funds	2,617	2,152	2,822
Heading 3: Internal policies and additional transitional expenditure	**1,457**	**1,428**	**1,372**
of which:			
Existing policies	846	881	916
Transitional nuclear safety measures	125	125	125
Transitional institution-building measures	200	120	60
Transitional Schengen measures	286	302	271
Heading 5: Administration	**503**	**558**	**612**
Total	**9,927**	**12,640**	**14,901**

Source: Presidency Conclusions, European Council (Copenhagen), December 12 and 13, 2002 (revised version).

STAGGERED INTRODUCTION OF DIRECT AGRICULTURAL PAYMENTS FOR NEW EU MEMBERS

The Copenhagen package was based partly on the October 2002 decisions of the Brussels European Council, which laid down a schedule of incremented direct payments to the new EU members within the framework of the Common Agricultural Policy. Under this the accession countries will receive 25 % of the EU level in 2004, rising in five-percent stages to 40 % in 2007 and thereafter in 10 % increments. Finally, in 2013 the new member states will receive 100 % of the support level then applicable in the Union. Furthermore, the enlargement-related commitment appropriations for the Structural and Cohesion Funds for the period 2004 to 2006 were capped at € 23bn.

[3] As a rule the appropriations for commitments represent ceilings on expenditure. But in the case of structural operations (Structural and Cohesion Funds) they define spending targets.

The appropriations for the individual countries are as follows:

APPROPRIATIONS FOR ENLARGEMENT BY COUNTRIES

€m at 1999 prices	Agriculture			Structural operations			Internal policies		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Cyprus	25.1	43.2	46.7	33.5	31.1	36.2	15.8	15.8	16.0
Czech Republic	193.0	439.6	487.5	657.6	733.7	936.2	141.8	139.0	138.1
Estonia	54.6	95.5	103.8	180.3	190.4	247.0	44.4	42.2	40.6
Hungary	227.8	596.2	658.8	788.3	899.6	1,159.3	190.9	185.6	182.9
Poland	916.4	1,760.4	1,959.6	3,113.7	3,607.1	4,647.8	625.9	602.0	588.6
Slovenia	91.6	149.0	160.8	116.4	126.8	162.2	74.8	74.0	73.7
Lithuania	156.6	270.0	298.1	389.9	436.5	539.6	182.8	194.9	160.9
Latvia	98.3	144.4	158.6	324.5	347.9	363.5	61.1	58.0	55.9
Slovak Republic	125.2	239.4	263.1	435.9	495.1	629.0	112.3	109.3	107.7
Malta	8.0	9.9	10.5	20.9	25.3	32.5	6.7	6.7	6.8

Source: European Commission.

COMPENSATION FOR POSSIBLE FINANCIAL DISADVANTAGES FOLLOWING ACCESSION

From the day of their accession the new EU member states must contribute in full to financing the EU budget. This could have turned some states into net contributors, as various EU payments for 2004 will not flow until the following year. To avoid placing these states in a worse position than at present, in addition to the appropriations earmarked a lump-sum cash-flow facility and temporary budgetary compensation for the years 2004 to 2006 have been set[4].

SPECIAL ENLARGEMENT-RELATED APPROPRIATIONS

Heading X (special cash-flow facility and temporary budgetary compensation) 2004 – 2006 for 10 new member states (€m, 1999 prices)			
	2004	2005	2006
Special cash-flow facility	**1,011**	**744**	**644**
of which:			
Czech Republic	174.7	91.55	91.55
Estonia	15.8	2.9	2.9
Cyprus	27.7	5.05	5.05
Latvia	19.5	3.4	3.4
Lithuania	34.8	6.3	6.3
Hungary	155.3	27.95	27.95
Malta	12.2	27.15	27.15
Poland	442.8	550.0	450.0
Slovenia	65.4	17.85	17.85
Slovak Republic	63.2	11.35	11.35
Temporary budgetary compensation	**262**	**429**	**296**
of which:			
Czech Republic	125.4	178.0	85.1
Cyprus	68.9	119.2	112.3
Malta	37.8	65.6	62.9
Slovenia	29.5	66.4	35.5
Total	**1,273**	**1,173**	**940**

Source: Presidency Conclusions, European Council (Copenhagen), December 12 and 13, 2002 (revised version).

[4] From this cash-flow facility € 1 bn for Poland and € 100 m for the Czech Republic have been counted towards the Structural Fund appropriations for 2004 to 2006.

SELECTED EU SUPPORT FOR STRUCTURAL OPERATIONS AND AGRICULTURE

STRUCTURAL POLICY

Objective 1 promotion has as its remit the development and structural adjustment of regions whose development is lagging behind. The EU-15 devote around 70% of their structural support to this. Regions with per capita GDP in purchasing power standards of less than 75% of the Community average are eligible for promotion. With the exception of Prague and Bratislava all regions in the new member states will satisfy this criterion.

With its **Objective 2 promotion** the Union supports the economic and social conversion of regions with structural problems. The crisis regions affected receive 11.5% of the promotion funds.

Objective 3 promotion is concerned with the adaptation and modernization of education, training and work opportunity policies at the national level. All regions throughout the Union are entitled to support unless they come under Objective 1, which already comprises appropriate measures. 12.3% of the funds are used for this.

The **Cohesion Fund** participates in investment to improve the environment and develop the transnational transport infrastructure. It was originally set up in 1993 to prepare the economically weaker countries for membership of the monetary union. The threshold for support is a per capita GDP of less than 90% of the EU average. All the new member states will receive support from this fund.

The EU's co-financing rates range between 50% and 85%, depending on the project supported and the fund. In individual cases the EU will assume 100% of the expenditure.

Spending on structural actions in 2002 totaled roughly € 32.1bn or 33.5% of the total EU budget.

AGRICULTURAL POLICY

The **European Agricultural Guidance and Guarantee Fund (EAGGF)** finances expenditure on the common organization of agricultural markets. This includes direct payments to farmers which were previously tied directly to the production of certain agricultural goods as well as spending on rebates, storage, market withdrawals and other intervention costs. The EAGGF is also tasked with rural development where this does not come under the remit of structural policy.

The agricultural policy spend in 2002 totaled € 44.3bn or 46.3% of the budget.

DISCURSION: REFORM OF EU AGRICULTURAL POLICY

The EU agriculture ministers reached agreement on June 26, 2003 on reform of the Common Agricultural Policy. **Essentially this broadly aims to 'de-couple' subsidies from production.** Admittedly, the EU took this step in response to external pressure to reform, as a means of giving itself greater scope at the negotiations on agriculture in the Doha Round of world trade talks. But the move to overhaul agricultural policy could help bring to an end the decades-long subsidization of surplus agricultural production. That said, the compromise reached by the EU agriculture ministers marks nothing more than a "foot in the door" to a new form of agricultural support. **A host of exemptions, transitional arrangements and 'grandfathering' provisions prevent the reform from being hailed as a really big success.** The package comprises the following key elements:

- conversion of the direct premiums previously linked to acreage and livestock into single farm payments,
- the single farm payments will be tied to compliance with legal standards in respect of environmental protection, animal and plant health, food safety and animal welfare,
- greater promotion of rural development,
- revisions to market support policies.

The single farm payments, which are designed largely to replace production-linked direct subsidies, will be geared as from 2005 to a reference amount for production in the period 2000 to 2002. **Eligibility to the full payment will also depend on whether farms comply with a number of statutory safety and protection standards.** If they breach these regulations it is planned to reduce the subsidies in relation to the damage incurred. As from 2005 the EU will grant farmers financial incentives to promote rural development. These will serve to keep farmland in good condition, to meet safety and protection standards, to improve animal protection and to support young farmers.

A reduction in market support prices is planned for rice, milk powder and butter, among others. The milk quota regulation will be prolonged until 2014/15, with higher milk quotas for Greece. For cereals – the major item of the EU's market support policy – the current intervention price will be maintained, only the seasonal adjustment will be cut by 50%. But rye is being taken out of the intervention system.

To finance the additional rural development measures, direct payments to bigger farms are to be reduced. This arrangement, known as modulation, affects farms that receive annual direct subsidies of more than € 5,000. The accession countries will be exempted from these cuts until, in 2013, the direct payments to them have reached 100 % of the level then applying in the Union. Reduction rates of 3% (2005) to 5% (2007 to 2013) are scheduled. The EU estimates that with a rate of 5% funds totaling € 1.2 bn a year will be freed up. At least 80% of the funds released by modulation are to flow back into the EU countries.

MISSED OPPORTUNITY FOR BOLD AGRICULTURAL REFORM

EU further sealing off its agriculture from the world market.

These fundamental reform moves are watered down by a host of let-out clauses. Some EU countries, foremost among them France, fear that the consistent implementation of reform would mark the abandonment of agricultural production. **There is hardly a clearer way of stating that, through subsidization, the EU is sustaining a sector that would not otherwise be competitive on the world market.** It would make economic sense gradually to scale back the price of farm produce in the EU to world market levels. But this does not appear to be a political option at present. Consequently, even the latest farm reform package permits the EU member states to retain some direct payments – for cultivated plants and beef, for instance – entirely, or at least partly. What is more, it allows member states a transitional period up to 2007 for the introduction of single farm payments "due to specific agricultural conditions". In future, though, only a small proportion of direct payments will be linked outright to production. Estimates put this in the region of 30%.

EU FARM SPENDING WILL REMAIN HIGH

With their reform the EU agriculture ministers have not attempted to lower farm spending, urgently necessary as this may be. They have, however, agreed on a mechanism designed to ensure from 2007 that farm spending does not overshoot the ceilings set at the 2002 summit in Brussels.

4.2 THE FINANCIAL PERSPECTIVE 2007–2013

The current Financial Perspective[5] ends in 2006, when a new financial framework must be approved. Initial EU consultations on the Financial Perspective 2007–2013 are likely to get underway next year, or by 2005 at the latest. The new EU member states will participate in and influence these negotiations. As candidate countries, they had the choice between accepting the financial framework for enlargement presented to them by the EU-15 or opting not to join the Union after all.

25 EU MEMBER STATES WILL NEGOTIATE THE FINANCIAL PERSPECTIVE 2007–2013

But as from next year they will be EU members with equal rights and can thus also bring their influence to bear on the Union's financial planning. We therefore assume that mechanisms to limit the budget, such as budgetary discipline or the agricultural guideline, will be up for discussion at the consultations on the coming Financial Perspective. Added to which, Bulgaria and Romania are expected to join the Union in 2007 and appropriations must also be made in the EU budget for these two countries. The question arises as to how the altered negotiating positions and enlargement of the EU to then 27 members will change the financial situation of the EU. We have estimated what the Financial Perspective 2007–2013 could look like. The following assumptions apply.

- The estimate is based on the Financial Perspective 2000–2006 and the Presidency Conclusions at the Copenhagen European Council (December 2002) and the Brussels summit (October 2002) on appropriations for enlargement.
- The estimate refers to the appropriations for commitments – in other words maximum expenditure by the EU – at the respective years' prices.
- The assumed inflation rate is 1.7% for the EU as a whole.
- The population in the EU member states remains constant.

FINANCIAL PERSPECTIVE ESTIMATE 2007–2013

in €m	2007	2008	2009	2010	2011	2012	2013
Agriculture	**57,813**	**59,403**	**61,043**	**62,724**	**64,448**	**66,217**	**68,040**
EU-15	48,334	49,301	50,287	51,293	52,318	53,365	54,432
New members	9,479	10,102	10,756	11,431	12,130	12,852	13,608
Structural operations	**48,365**	**49,382**	**50,445**	**51,541**	**52,645**	**53,794**	**54,699**
EU-15	34,513	34,783	35,056	35,331	35,608	35,887	36,168
New members	13,852	14,599	15,389	16,210	17,037	17,907	18,531
Other expenditure (administration, internal and external policies)	**19,633**	**20,222**	**20,777**	**21,348**	**21,934**	**22,536**	**23,155**
Pre-accession aid	**3,618**	**3,680**	**3,743**	**3,806**	**3,871**	**3,937**	**4,004**
Total funds for commitments	**129,429**	**132,687**	**136,008**	**139,419**	**142,898**	**146,484**	**149,898**
As % of GNI[1] of the EU	1.191	1.174	1.156	1.138	1.120	1.102	1.083

[1] Gross national income.

Source: Own calculations.

[5] The Financial Perspective is more than merely indicative financial programming in that the ceilings set are binding. But nor is it tantamount to a multi-year budget plan, because an annual budgetary procedure is required.

Calculation of farm spending is based on a publication by the EU Directorate-General for Agriculture on the "Prospects for agricultural markets in the European Union 2003–2010", which does not, however, take EU agricultural reform into account (see Discursion: Reform of EU Agricultural Policy). Building on this, we have extrapolated agricultural appropriations for the EU-15 from the 2006 data at an assumed nominal rate of growth of 2% p.a. The estimate for the new members rests on the assumption that their share of total agricultural output is consistent with their share of agricultural subsidization. Evidence can be produced to approximately underpin this connection in the past for the EU-15. Consequently, subsidy shares for the new entrants would range from not quite 1% for Estonia to almost 35% for Poland.

22% RISE IN FARM SPENDING
If the assumption of incremental direct payments is set aside, the increase is markedly higher.

The direct payments for the accession countries in 2007 will equal 40% of the EU level, rising to 100% by 2013 – so the Presidency Conclusions of the Brussels European Council in October 2002 say. Were the new members to succeed in pushing through increases in direct payments to 100% as from 2007, their farm subsidies would already reach around € 12.1bn in that year, again advancing to € 13.6bn in 2013. For this estimate we have assumed a constant share of direct payments in total EU agricultural subsidization over time; in 2006 these percentages range between 19.6% in Latvia and 48.0% in Hungary. This assumption appears reasonable, given that the EU farm reform envisaging a shift away from direct payments to the promotion of rural development does not initially affect the new members. **All told, the appropriations for agriculture in 2007 based on the assumption of incremental direct payments would soar by € 10.4bn, or not quite 22%, versus 2006.**

AID PER CAPITA UNDER THE STRUCTURAL AND COHESION FUNDS TO REACH € 176 IN 2013 IN THE NEW MEMBER STATES

Our estimate shows a far steeper rise in the Structural Funds. They would climb between 2006 and 2007 by € 14.1bn, or 41%. For the new EU members we have considered only Objective 1 promotion and Cohesion Fund appropriations, which make up way over 90% of the structural promotion funds. We have assumed that aid per capita in the central and east European countries will increase between 2006 and 2013 at the same annual rates of growth as for Objective 1 appropriations in the previous EU between 1993 and 2006. The new members will receive aid per capita in 2006 amounting to € 117 (at 1999 prices). In the EU, support amounted to € 143 per inhabitant in the first program period 1989 to 1993, growing in the period 2000 to 2006 to € 217 per capita. This is consistent with real average annual growth of 3.3%. For the new members average aid per capita works out at € 132 in 2007, climbing to € 176 in 2013. We have taken into account here the ceiling of 4% of national GDP for annual promotion from Structural and Cohesion Fund appropriations. By our reckoning this would have a capping effect for Latvia, Bulgaria and Romania.

In line with its development in the period from 2000 to 2006, we have reduced the volume of aid for the EU-15 by approx. 1% per annum in real terms. We assume that Objective 1 promotion for all the regions in the "old" EU currently enjoying support will be maintained from 2007 to 2013. Long-range transitional measures or adjustment of the promotion criterion are conceivable here.

Internal and external policies and administrative expenditure are subsumed under the heading "Other Expenditure". Here, we have based our calculation on an enlargement-induced acceleration in nominal growth from previously 2.7% to 3%. The pre-accession aid is extrapolated for Turkey and possible new candidate countries.

DESPITE MASSIVE INCREASE IN EU EXPENDITURE THE BUDGET CEILING IS NOT IN DANGER

In total, we estimate that the appropriations for commitments in 2007 would escalate on the previous year by around € 25.2 bn or 24 %, adding up to € 129.4 bn. That would be equivalent to 1.19 % of the EU gross national income and would still comply with the budget ceiling, because even if the actual payments made were as high as the appropriations for commitments, the ceiling on own resources of 1.24 % of the EU gross national income would not be reached[6]. There would still be a margin for unforeseen expenditure. No constraints would occur in the following years through to 2013 either.

4.3 FINANCING OF THE EU BUDGET

Given this expansion in the EU budget we must consider how the additional expenditure can be financed. Which countries can expect to shoulder a heavier financial burden and which will number among the beneficiaries? To enable us to investigate this, we have made the following assumptions.

- The new EU members will help finance the EU budget with the proportion of own resources relative to their national GDP specified in the preliminary draft budget for 2004.
- The EU-15 countries will finance the remainder with the same proportions of own resources as scheduled for 2004. Allowance has been made for the correction mechanism in favor of the United Kingdom.
- Of the assistance available for the EU-15, the respective countries will receive the same share in 2007 as in 2002.
- Transfers from the Structural and Agricultural Funds only are considered.

THE NEW MEMBERS' BUDGET FINANCING CONTRIBUTION WILL BE VERY MODEST, AT € 6.3 BN

In our estimation the new EU members will be net recipient countries – a state of affairs that will not alter in the medium to long term, even on the assumption of extremely positive growth forecasts. Together, they will contribute only about € 6.3 bn to the EU budget, while receiving EU assistance worth € 23.3 bn. These figures include Malta and Cyprus.

By our calculation all the present recipient countries among the EU-15 will retain this status, although they will receive a markedly lower net volume of assistance in relation to their national GDP. In the case of Spain and Ireland the percentage will shrink by more than half. The current net contributors would in future have to put up a significantly higher share of the funding. For a number of countries, including Germany, Italy and France, as well as the United Kingdom, it would double or jump even more sharply in terms of national GDP. Expressed in absolute figures, Germany would remain by far the biggest net contributor.

All told, our calculations on the 2007 – 2013 Financial Perspective show that enlargement will drive up EU expenditure substantially. But the budget ceilings currently set would not be overrun. Funding could certainly be found for the extra expenditure, although it would severely increase the financial burden for the present net contributor countries. The net budget financing imbalances would remain – a state of affairs that the countries involved will presumably not be prepared to accept on a permanent basis. Already moves are afoot to share the financing burden more equitably. Only recently, EU budget commissioner Michaele Schreyer made a push to extend the correction mechanism beyond the United Kingdom to encompass further net contributors.

[6] The ceiling for appropriations for commitments is 1.31 % of EU gross national income.

EU BUDGET FINANCING (IN €M)

Country	Own resources	EU promotion funds	Net position	Net position as % of national GDP	
	2007	2007	2007	2007	2002
Belgium	4,800	1,260	-3,540	1.12	(-) 0.72
Denmark	2,585	1,354	- 1,231	0.56	(-) 0.23
Germany	27,940	10,783	-17,157	0.72	(-) 0.36
Greece	2,216	4,713	2,497	1.36	(+) 2.39
Spain	10,462	15,597	5,135	0.59	(+) 1.26
France	22,278	11,660	-10,618	0.59	(-) 0.21
Ireland	1,600	2,617	1,017	0.56	(+) 1.28
Italy	17,478	7,923	-9,555	0.63	(-) 0.31
Luxembourg	246	50	-196	0.77	(-) 0.63
Netherlands	7,016	1,300	-5,716	1.09	(-) 0.75
Austria	2,831	1,347	-1,484	0.58	(-) 0.25
Portugal	1,846	3,968	2,122	1.35	(+) 2.09
Finland	1,846	1,119	-727	0.42	(-) 0.09
Sweden	3,446	1,113	-2,333	0.74	(-) 0.42
United Kingdom	16,493	5,616	-10,877	0.64	(-) 0.30
Czech Republic	939	1,807	868	0.89	-
Estonia	101	404	303	3.05	-
Hungary	932	2,509	1,577	1.80	-
Poland	2,271	8,843	6,572	3.06	-
Slovenia	315	445	130	0.43	-
Lithuania	217	940	723	3.50	-
Latvia	115	550	435	4.23	-
Slovak Republic	400	1,099	699	1.95	-
Bulgaria	250	1,818	1,568	6.28	-
Romania	605	4,786	4,181	6.91	-

Source: Own calculations.

Ultimately, however, even if enlargement-related expenditure does appear fundable and a fairer system of providing own resources could be found, this should not blind us to the considerable lack of transparency and inefficiency inherent in the European Union's agricultural and structural assistance. Even before enlargement there was urgent need for reform in this regard, yet so far the EU has failed to deliver a suitable response (see Discursion: Reform of EU agricultural policy). Enlargement is creating added pressure to act. It is, for example, inconceivable how differences in agricultural assistance can, in the long run, be reconciled with the concept of a Common Agricultural Policy.

5 The east European accession countries – the new EU power-house?

"When will the east European countries be admitted to the EU?" In the early 1990s, shortly after the collapse of the Eastern bloc, the answer to this question would presumably have been rather vague and evasive. But in the meantime many countries in the region have revamped both their political and economic regimes, practically in **"fast forward" mode.** Of course they have suffered set-backs in the process, and even now it is not as if there were nothing left to do. But it is an undisputed fact that the progress achieved in eastern Europe is more than remarkable.[7]

For the present EU countries, the new members represent **interesting growth markets,** in terms of both trade and investment. And as well as an expansion in commercial relations, the new EU states are also hoping for a greater transfer of technology, powering **higher economic growth** that will in the long term help narrow the prosperity gap between east and west.

5.1 PROFILES OF THE NEW EU MEMBER STATES

5.1.1 CZECH REPUBLIC

Political situation

- A center-left coalition under Prime Minister Spidla has been in power since summer 2002. Tentative signs of success with urgently needed fiscal reform are emerging. The government has ruled without a parliamentary majority of its own since July 2003.

Domestic economy

- The economy is showing signs of picking up a little at present, fueled by private consumption and public spending. But investment is still very feeble. Given a brighter global economic environment, GDP growth should continue to gather pace in 2004.
- Stability-oriented monetary policy is delivering modest inflation in the lower single-digit range.
- Fiscal consolidation is urgently needed, particularly with regard to future EMU membership. With a deficit equivalent to nearly 9 % of GDP, the budget will slide even deeper into the red this year than last. The program

[7] Besides the eight east European accession countries, in May 2004 Malta and Cyprus will also become members of the EU. But this chapter focuses on the so-called transformation countries among the future EU member states. Malta and Cyprus will not therefore be discussed here.

of spending cuts and tax hikes aimed at reining in the public deficit is by no means undisputed.

- Privatization in the financial sector is complete, but the banks continue to be plagued by a very high proportion of non-performing loans. Among other things, this is causing them to hold back on new lending.

External sector

- The Czech Republic maintains close foreign trade ties with western Europe. Almost 70% of its exports go to the EU, close on 37% to Germany alone. The current account deficit, which turned out between 5 and 6.5% of GDP in recent years, is more than covered by the high annual inflow of foreign direct investment.
- Thanks to healthy capital inflows, the foreign currency liquidity position is comfortable. The rate for the Czech koruna has stabilized significantly against the euro following its heightened latter-year volatility. The low level of domestic interest rates is likely to have been the major factor checking its appreciation.

Czech Republic	2000	2001	2002	2003 e	2004 f
Population (m)	10.3	10.3	10.3	10.3	10.3
GDP (US$ bn)	51.4	57.2	69.5	82.1	96.1
GDP per capita (US$)	5,007	5,558	6,748	7,975	9,329
GDP change in % (real)	3.3	3.1	2.0	2.5	2.8
Inflation in % (annual average)	3.9	4.7	1.8	0.3	2.5
Budget balance as % of GDP	-4.6	-5.3	-7.3	-9.0	-8.3
Merchandise exports (US$ bn)	29.1	33.4	38.2	48.0	55.0
Merchandise imports (US$ bn)	32.2	36.4	40.5	51.0	58.2
Current account balance (US$ bn)	-2.7	-3.3	-4.5	-5.2	-5.3
Current account balance as % of GDP	-5.3	-5.7	-6.5	-6.3	-5.5
Net foreign direct investment (US$ bn)	4.9	5.5	9.0	5.5	6.0
Foreign direct investment as % of GDP	9.6	9.6	13.0	6.7	6.2
Gross foreign debt (US$ bn)	21.4	22.4	26.3	28.6	29.2
Foreign debt as % of exports*	56	52	55	49	45
Foreign exchange reserves year-end excl. gold (US$ bn)	13.0	14.3	23.6	26.0	27.0
Import cover (months)*	3.8	3.7	5.3	4.9	4.5
Exchange rate year-end (Czech koruna per EUR)	35.19	31.95	31.61	32.50	31.00
Exchange rate annual average (Czech koruna per EUR)	35.56	34.04	30.81	31.90	31.30

*Goods, services and income. e = Estimate. f = Forecast.

5.1.2 ESTONIA

Political situation

- Since the parliamentary elections in spring 2003, a conservative coalition led by Prime Minister Parts has been in power. The reform policy is being continued under the new government.

Domestic economy

- Robust economic activity is spearheaded by investment and private consumption. This year, however, the very subdued global economic environment will cause economic growth to slow. In the years ahead, we expect to see annual real GDP growth of around 5%.

- Inflation continues to fall, in 2003 we expect the inflation rate to average less than 3%.
- The government is pursuing a sound fiscal policy with modest budget surpluses.
- The banking sector is stable and dominated by Scandinavian banks. A bancassurance regulator for financial and capital markets was set up two years ago.
- The economy is dominated by the services sector (share of GDP about 65%), with transport and warehousing (16%) and the distributive trades (15%) leading the way.

Estonia	2000	2001	2002	2003 e	2004 f
Population (m)	1.4	1.4	1.4	1.4	1.4
GDP (US$ bn)	5.1	5.6	6.5	8.3	9.9
GDP per capita (US$)	3,759	4,039	4,708	6,030	7,138
GDP change in % (real)	7.3	6.5	6.0	5.0	5.5
Inflation in % (annual average)	4.0	5.8	3.6	2.5	3.0
Budget balance as % of GDP	-0.7	0.4	1.1	0.5	0.5
Merchandise exports (US$ bn)	3.3	3.3	3.5	4.0	4.5
Merchandise imports (US$ bn)	4.1	4.1	4.6	5.6	6.1
Current account balance (US$ bn)	-0.3	-0.3	-0.8	-1.1	-1.0
Current account balance as % of GDP	-5.7	-6.1	-12.4	-13.2	-10.4
Net foreign direct investment (US$ bn)	0.3	0.3	0.2	0.6	0.5
Foreign direct investment as % of GDP	6.3	6.2	2.8	7.2	5.1
Gross foreign debt (US$ bn)	3.0	3.3	4.7	5.7	6.4
Foreign debt as % of exports*	61	64	82	89	90
Foreign exchange reserves year-end excl. gold (US$ bn)	0.9	0.8	1.0	0.9	0.9
Import cover (months)*	2.1	1.7	1.8	1.4	1.3
Exchange rate year-end (Estonian kroon per EUR)	15.65	15.65	15.65	15.65	15.65
Exchange rate annual average (Estonian kroon per EUR)	15.65	15.65	15.65	15.65	15.65

*Goods, services and income. e = Estimate. f = Forecast.

External sector

- Weak export performance combined with brisk import demand pushed up the current account deficit sharply in 2002. This year, too, we are looking for a similarly high deficit owing to very low growth in the EU. The inflow of foreign direct investment is nowhere near enough to cover the financing gap.
- In merchandise trade and capital transactions Estonia benefits from its geographical proximity to Scandinavia as well as from the prospect of EU membership.
- The exchange rate peg to the euro remains stable. The government has signaled that it intends to stick with the currency board until EU accession and introduction of the euro.

5.1.3 HUNGARY

Political situation

- Since April 2002 a socialist-liberal coalition government under Prime Minister Medgyessy has been in power.

Domestic economy

- Economic growth remains dynamic, with the main boost coming from consumer spending, as the lackluster EU economy is still preventing exports from generating any marked growth impetus. We expect average real GDP growth of 4% in the medium term.
- Inflation is beating a retreat, although given buoyant domestic demand the rate of increase in 2003 will be only slightly lower than last year.
- The government's hesitant consolidation efforts mean that no clear inroads can be made into the budget deficit. We expect a shortfall in 2003 equivalent to 6% of GDP. Financing gaps on this scale are not sustainable in the long run.
- Privatization is almost complete.

External sector

- Exports, which make up 45% of GDP, are registering moderate growth. The EU is Hungary's major export market, accounting for 63% of its total foreign trade. Germany is the most important trade partner.
- Robust domestic demand and the anemic EU economy should mean that imports expand more swiftly than exports. We therefore expect the current account deficit to widen in 2003. Just under 14% of the shortfall is covered by foreign direct investment.
- Exchange rate: The forint fluctuates 15% above or below the central rate of its anchor currency, the euro. In the first half of 2003, exchange rate volatility increased as a result of the withdrawal of portfolio investment by foreign investors, following a loss of confidence in Hungary's economic policy.
- Foreign debt is moderate in relation to exports of goods and services. The liquidity situation is relatively comfortable with import cover of almost 3 months.

Hungary	2000	2001	2002	2003 e	2004 f
Population (m)	10.2	10.2	10.2	10.2	10.2
GDP (US$ bn)	46.6	51.9	63.3	77.6	87.8
GDP per capita (US$)	4,569	5,091	6,205	7,611	8,612
GDP change in % (real)	5.3	3.8	3.3	2.6	3.1
Inflation in % (annual average)	9.8	9.3	5.3	5.0	4.2
Budget balance as % of GDP	-3.5	-3.3	-9.6	-6.0	-4.5
Merchandise exports (US$ bn)	29.7	31.1	34.8	39.4	43.5
Merchandise imports (US$ bn)	31.6	33.3	36.9	43.3	47.7
Current account balance (US$ bn)	-1.9	-1.7	-2.7	-4.3	-4.0
Current account balance as % of GDP	-4.1	-3.3	-4.3	-5.5	-4.6
Net foreign direct investment (US$ bn)	1.8	1.0	0.9	0.6	0.7
Foreign direct investment as % of GDP	3.9	1.9	1.4	0.8	0.8
Gross foreign debt (US$ bn)	30.0	32.7	39.7	47.3	50.9
Foreign debt as % of exports*	82	85	93	99	97
Foreign exchange reserves year-end excl. gold (US$ bn)	11.2	10.7	10.4	12.5	12.9
Import cover (months)*	3.5	3.2	2.7	2.9	2.7
Exchange rate year-end (forint per EUR)	265.3	245.1	236.3	254.1	256.0
Exchange rate annual average (forint per EUR)	260.1	256.6	242.9	251.5	260.1

*Goods, services and income. e = Estimate. f = Forecast.

5.1.4 LATVIA

Political situation

- Since the parliamentary elections in autumn 2002 a conservative coalition under Prime Minister Repse has been in power. The market-oriented economic policy is being continued. At the end of September 2003 the government was plunged into deep crisis.

Domestic economy

- In the last three years real GDP has notched up strong growth averaging almost 7%, driven mainly by domestic investment and private consumption. In the medium term, we expect real GDP growth of about 5%.
- The monetary backdrop is favorable. Despite hikes in administered prices and rising energy prices, on average inflation has remained below 3% in recent years.
- Restructuring of the economy is well advanced. However, delays are occurring in the privatization of several big companies. The banking sector is almost completely privatized, with foreign institutions controlling more than 70% of the banking market. An independent watchdog for financial and capital markets was set up two years ago.
- The service sector dominates the economy. Latvia is an important transit country between Russia and western Europe. The value of exports to Russia in 2002 increased by more than 20% on a year earlier; imports from Russia expanded by 8%.

Latvia	2000	2001	2002	2003 e	2004 f
Population (m)	2.4	2.4	2.4	2.3	2.3
GDP (US$ bn)	7.2	7.7	8.4	9.7	10.4
GDP per capita (US$)	2,948	3,247	3,577	4,149	4,491
GDP change in % (real)	6.8	7.9	6.1	6.0	6.0
Inflation in % (annual average)	2.6	2.5	1.9	2.7	2.8
Budget balance as % of GDP	-3.3	-1.9	-2.5	-3.5	-3.0
Merchandise exports (US$ bn)	2.1	2.2	2.6	3.0	3.2
Merchandise imports (US$ bn)	3.1	3.6	4.0	4.5	4.9
Current account balance (US$ bn)	-0.5	-0.7	-0.7	-0.7	-0.8
Current account balance as % of GDP	-6.9	-9.6	-7.8	-7.2	-7.6
Net foreign direct investment (US$ bn)	0.4	0.2	0.4	0.4	0.4
Foreign direct investment as % of GDP	5.6	2.0	4.6	3.6	3.4
Gross foreign debt (US$ bn)	4.7	5.6	7.0	7.5	8.0
Foreign debt as % of exports*	135	151	169	165	165
Foreign exchange reserves year-end excl. gold (US$ bn)	0.9	1.1	1.2	1.1	1.1
Import cover (months)*	2.5	3.1	3.0	2.4	2.2
Exchange rate year-end (lats per EUR)	0.570	0.561	0.624	0.708	0.750
Exchange rate annual average (lats per EUR)	0.558	0.559	0.581	0.655	0.725

*Goods, services and income. e = Estimate. f = Forecast.

External sector

- More than 60% of total exports are destined for the EU. Germany is the leading importer of Latvian products.
- The current account has been deeply in the red for years. In 2002, the deficit amounted to almost 8% of GDP. Although the deficit will narrow slightly

this year relative to GDP, there is still no question of a turnaround. The inflow of foreign direct investment suffices to cover a good half of the shortfall.

- The lats is pegged to the IMF special drawing right at a rate of 1:1.25. The authorities intend to keep the peg in place at least until Latvia joins the EU.

5.1.5 LITHUANIA

Political situation

- Despite the frequent changes of government there is broad consensus on reform. Since 2001 Prime Minister Brazauskas has ruled a coalition consisting of social democrats, liberals and independents.

Domestic economy

- Following real GDP growth of 6.7% in 2002 driven by buoyant domestic demand and exports, the economy is likely to slow only marginally this year. Over the medium term we expect expansion in the region of around 5%.
- The low inflation rates seen in recent years were helped partly by nominal appreciation of the national currency, which was pegged to the US dollar until the beginning of 2002. On average for 2003 we expect inflation of 0.3%, in line with the previous year's reading.
- The government pursues a sound fiscal policy with relatively small budget deficits.
- Progress has been made on structural reform, although the government has been unable to achieve its ambitious targets for privatization proceeds. It is also likely to miss this year's goals, with privatization in the transport and services sector in particular still outstanding. For example, in a first step it is planned to reduce the government's share in Lithuanian Airlines to 66%. The banks are already fully privatized.

Lithuania	2000	2001	2002	2003 e	2004 f
Population (m)	3.5	3.5	3.5	3.5	3.4
GDP (US$ bn)	11.2	11.9	13.8	17.5	20.5
GDP per capita (US$)	3,205	3,416	3,984	5,008	6,017
GDP change in % (real)	4.0	6.5	6.7	6,3	6.0
Inflation in % (annual average)	1.0	1.3	0.3	0.3	1.0
Budget balance as % of GDP	-2.8	-2.0	-1.2	-1.5	-1.2
Merchandise exports (US$ bn)	4.1	4.9	6.0	7.2	7.9
Merchandise imports (US$ bn)	5.2	6.0	7.3	8.7	9.6
Current account balance (US$ bn)	-0.7	-0.6	-0.7	-0.8	-0.9
Current account balance as % of GDP	-6.0	-4.8	-4.9	-4.8	-4.5
Net foreign direct investment (US$ bn)	0.4	0.4	0.7	0.8	0.8
Foreign direct investment as % of GDP	3.4	3.7	5.3	4.3	3.9
Gross foreign debt (US$ bn)	4.9	5.3	6.2	7.4	7.7
Foreign debt as % of exports*	92	84	81	81	78
Foreign exchange reserves year-end excl. gold (US$ bn)	1.3	1.6	2.4	2.7	2.8
Import cover (months)*	2.5	2.7	3.3	3.2	3.0
Exchange rate year-end (litas per EUR)	3.72	3.52	3.45	3.45	3.45
Exchange rate annual average (litas per EUR)	3.68	3.56	3.45	3.45	3.45

*Goods, services and income. e = Estimate. f = Forecast.

External sector

- The EU share of foreign trade has slipped to just under 50%. At the same time, the volume of trade with Russia has increased sharply in the last two years. The current account deficit in relation to GDP has decreased significantly in latter years. For 2003, we expect a deficit of 4.8%, compared with more than 11% four years ago. The shortfall is almost completely covered by foreign direct investment.
- Last year, the reserve currency within the currency board was switched from the US dollar to the euro. Since then the litas has been pegged to the euro at a rate of 3.4528:1.

5.1.6 POLAND

Political situation

- In March 2003, the Peasants Party PSL left the government coalition with the Democratic Left Alliance SLD and the Union Party UP. Since then, Prime Minister Miller (SLD) has led a minority government. Friction flares up regularly within the government, for example on the question of urgently needed fiscal reforms.

Poland	2000	2001	2002	2003 e	2004 f
Population (m)	38.7	38.6	38.7	38.7	38.7
GDP (US$ bn)	164.1	183.4	189.3	205.5	225.4
GDP per capita (US$)	4,247	4,746	4,891	5,309	5,824
GDP change in % (real)	4.0	1.0	1.4	3.0	3.8
Inflation in % (annual average)	10.1	5.4	1.9	1.0	2.7
Budget balance as % of GDP	-2.6	-5.1	-6.5	-6.9	-8.7
Merchandise exports (US$ bn)	28.3	30.3	33.0	40.5	45.0
Merchandise imports (US$ bn)	41.4	42.0	43.3	50.0	56.0
Current account balance (US$ bn)	-10.0	-5.4	-6.8	-5.9	-7.1
Current account balance as % of GDP	-6.1	-2.9	-3.6	-2.9	-3.2
Net foreign direct investment (US$ bn)	9.3	5.8	3.2	3.5	4.0
Foreign direct investment as % of GDP	5.7	3.2	1.7	1.7	1.8
Gross foreign debt (US$ bn)	69.5	71.8	83.2	89.0	96.0
Foreign debt as % of exports*	182	174	193	172	170
Foreign exchange reserves year-end excl. gold (US$ bn)	26.6	25.6	28.7	30.5	31.0
Import cover (months)*	6.4	6,1	6.6	6.2	5.7
Exchange rate year-end (zloty per EUR)	3.88	3.51	4.03	4.58	4.38
Exchange rate annual average (zloty per EUR)	4.01	3.66	3.84	4.34	4.56

*Goods, services and income. e = Estimate. f = Forecast.

Domestic economy

- After two years of slack economic growth, there are signs of a marked recovery in business activity this year. Retail sales figures suggest a pick-up in private consumption. The trend in industrial production is also encouraging. We expect real GDP growth of 3% in 2003.
- Poland has enjoyed virtual price stability since the beginning of the year. Both the rebound in the economy and the appreciable slide in the zloty against the euro will push up inflation rates in the coming months. The down-cycle in interest rates, now in its third year, will therefore soon

come to an end. We expect the inflation rate to average a little under 1% in 2003.

- Obstinately high unemployment remains one of the country's most pressing problems. Having hit a record high of 18.8% in February 2003, the jobless rate has since eased a little to 17.8%.
- The national budget is running very high deficits. Next year we expect a deficit of almost 9% of GDP.
- Privatization is nearly complete. Companies of strategic importance remain in state hands.

External sector

- External trade has perked up noticeably. Brisker domestic demand is not yet reflected in a marked upturn in imports. The current account deficit is therefore likely to ease below 3% of GDP this year. The inflow of foreign direct investment covers more than half of the shortfall. Given the comfortable level of foreign currency reserves and moderate short-term foreign debt, the foreign currency liquidity situation is good.
- Poland has a flexible exchange rate system. The zloty floats and is subject to substantial volatility.

5.1.7 SLOVAK REPUBLIC

Political situation

- The Dzurinda government was re-elected in autumn 2002. The center-right coalition is following through on reforms.

Slovak Republic	2000	2001	2002	2003 e	2004 f
Population (m)	5.4	5.4	5.4	5.4	5.4
GDP (US$ bn)	19.7	20.0	23.3	31.5	37.3
GDP per capita (US$)	3,656	3,710	4,307	5,836	6,913
GDP change in % (real)	2.7	3.3	4.4	4.0	4.3
Inflation in % (annual average)	12.0	7.3	3.3	8.7	5.5
Budget balance as % of GDP	-6.8	-7.0	-7.2	-5.1	-4.0
Merchandise exports (US$ bn)	11.9	12.6	14.5	20.5	24.0
Merchandise imports (US$ bn)	12.8	14.8	16.6	22.0	26.0
Current account balance (US$ bn)	-0.7	-1.8	-2.0	-1.2	-1.6
Current account balance as % of GDP	-3.5	-9.0	-8.6	-3.8	-4.3
Net foreign direct investment (US$ bn)	2.1	2.3	3.8	1.3	2.0
Foreign direct investment as % of GDP	10.6	11.5	16.3	4.1	5.4
Gross foreign debt (US$ bn)	10.8	11.3	13.2	15.5	15.8
Foreign debt as % of exports*	75	73	86	64	56
Foreign exchange reserves year-end excl. gold (US$ bn)	4.0	4.1	8.8	10.5	10.8
Import cover (months)*	3.2	2.8	5.4	4.9	4.3
Exchange rate year-end (Slovak koruna per EUR)	42.80	42.78	41.50	41.40	42.00
Exchange rate annual average (Slovak koruna per EUR)	43.10	43.30	42.70	42.00	42.50

*Goods, services and income. e = Estimate. f = Forecast.

Domestic economy

- Following slightly weaker performance in 2003 due to a budget squeeze, economic growth should pick up again next year. In the medium term, we see real GDP growth of 4%.

- The yawning budget deficit is not sustainable in the long term. Government aims to trim the shortfall in the current year to 5.1% of GDP by reducing public spending and hiking consumer taxes. Important reforms in the areas of health and pensions are yet to come.
- The increase in administered prices has fueled upward price pressures, with the result that inflation is likely to top 8% this year.
- Restructuring in the banking and corporate sector is making evident progress. The sale of large energy concerns has begun. The stage has been set for privatization of the railway company, which is still state-owned. Foreign credit institutions control 80% of the banking market.

External sector

- The EU is the main market for Slovak products, with Germany the most important merchandise trade partner.
- One of the chief reasons for the country's high current account deficits is strong demand for capital goods in the wake of ongoing privatization. The shortfall is more than covered by foreign direct investment inflows. On the back of an economic rebound in the EU we expect US$-based exports to move up by an average of 7% a year in the medium term. The major exports are motor vehicles, metal products and machinery.
- Exchange rate: managed floating.
- Foreign debt and debt service are moderate in relation to exports of goods and services. With import cover of just under 5 months, the liquidity position is comfortable.

5.1.8 SLOVENIA

Political situation

- The country enjoys political stability, and the government is pursuing a consistent and reform-oriented economic policy.

Domestic economy

- Slovenia can boast the highest per capita income in central and eastern Europe. Owing to its relatively small domestic market, the key impetus to demand comes from exports; in the medium term we expect annual growth of 3.5–4% on the back of more dynamic EU economic activity.
- Slovenia already fulfils two of the five Maastricht criteria. The budget deficit is below 3% of GDP, and government debt, at 40% of GDP, is below the prescribed 60% ceiling.
- The privatization of big enterprises is under way, with the sale of Slovenia's largest pharmaceuticals producer already wrapped up. The restructuring of small and medium-sized firms is complete. But privatization in the banking sector is making slow progress, with foreign investors not allowed to acquire majority holdings. Last year, 34% of the shares in the biggest Slovenian bank, Nova Ljubljanska Banka, were sold.
- The economy is dominated by the service sector, which generates 60% of GDP.

External sector

- The EU is Slovenia's major merchandise export market. Germany absorbs by far the greatest share of exports and is also the most important supplier.

- The current account deficit is moderate; with demand from abroad picking up, in the medium term US$-based exports should be able to notch up annual growth rates of 8 %. Machinery, metal goods and chemical products are the main exports.
- The foreign currency liquidity situation is benign and foreign debt low in relation to exports of goods and services. Import cover of over 6 months is comfortable.
- Slovenia's upcoming EU accession and sound economic framework are encouraging higher foreign direct investment.

Slovenia	2000	2001	2002	2003 e	2004 f
Population (m)	2.0	2.0	2.0	2.0	2.0
GDP (US$ bn)	19.3	19.6	22.3	27.9	32.7
GDP per capita (US$)	9,650	9,810	11,137	13,926	16,352
GDP change in % (real)	4.6	3.4	3.2	3.0	3.6
Inflation in % (annual average)	10.9	9.4	7.5	5.7	4.5
Budget balance as % of GDP	- 1.2	- 1.5	- 2.8	- 1.4	- 1.4
Merchandise exports (US$ bn)	8.8	9.3	10.5	11.9	13.5
Merchandise imports (US$ bn)	9.9	9.9	10.7	12.3	13.9
Current account balance (US$ bn)	- 0.6	0.0	0.4	0.1	0.1
Current account balance as % of GDP	- 3.1	0.0	1.8	0.4	0.3
Net foreign direct investment (US$ bn)	0.1	0.5	1.9	0.6	0.6
Foreign direct investment as % of GDP	0.5	2.5	8.5	2.2	1.8
Gross foreign debt (US$ bn)	6.2	6.7	8.8	10.3	10.7
Foreign debt as % of exports*	56	57	66	71	66
Foreign exchange reserves year-end excl. gold (US$ bn)	3.2	4.3	6.8	7.7	8.0
Import cover (months)*	3.3	4.4	6.3	6.3	5.9
Exchange rate year-end (tolar per EUR)	211.50	221.20	230.20	234.00	235.00
Exchange rate annual average (tolar per EUR)	205.00	217.20	226.00	232.00	233.00

*Goods, services and income. e = Estimate. f = Forecast.

5.2 STRUCTURAL ADJUSTMENT AND THE PART PLAYED BY THE EU

Poland is by far the biggest economy of the accession countries, in terms of both its population and economic prowess. About 50% of GDP in the accession countries making up the first round of enlargement is generated in Poland, followed by the Czech Republic at 16% and Hungary at 15%. Each of the other countries contributes a share of less than 6%. In terms of the accession countries' total population, the ratios are roughly the same as for GDP. Given the size of the Polish economy, the eight new east European EU members' aggregate macroeconomic data are thus clearly dominated by economic developments in Poland.

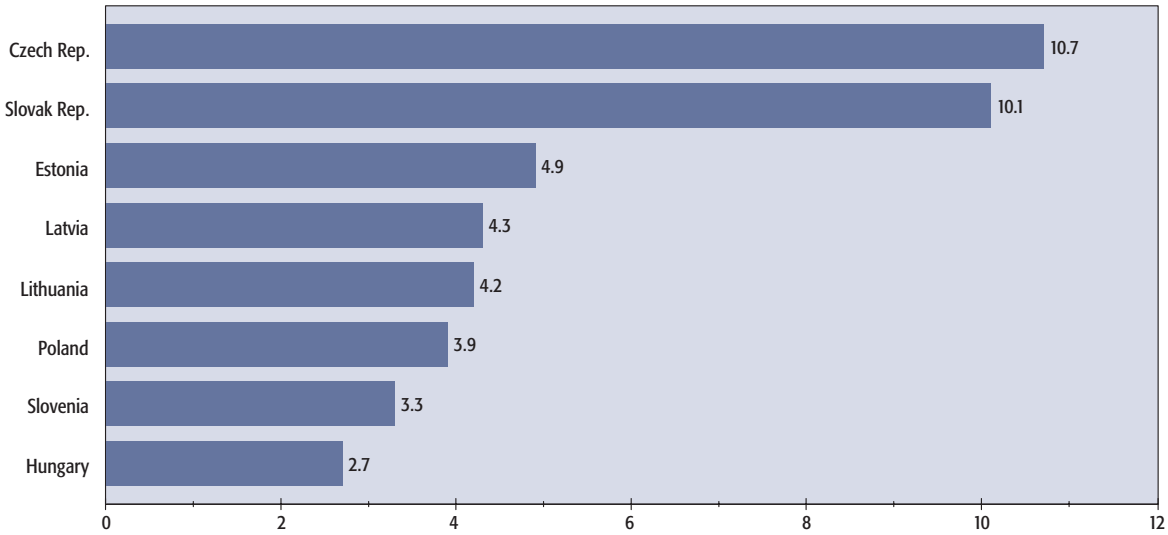
5.2.1 THE DRIVERS OF ECONOMIC GROWTH IN THE 1990s

STEADY CONTRIBUTION FROM PRIVATE CONSUMPTION, INVESTMENT SUBJECT TO CYCLICAL SWINGS

In respect of their GDP components the east European accession countries present a familiar picture, with private consumption making a comparatively constant contribution to economic growth. In contrast, there too the share generated by investment is normally liable to considerably stronger cyclical fluctuation, given that the propensity to invest naturally correlates very closely with the current business situation. This makes the exceptionally buoyant rates of increase notched up in the east European countries towards the end of the last decade in particular all the more impressive. Foreign direct investment played a special part. Although this has no direct impact on economic growth, it usually attracts physical investment in its wake, so that an indirect link does exist after all.

Driven by the privatization process in eastern Europe and in anticipation of EU enlargement, west European companies committed to this region at a very early stage. The inflow of foreign direct investment in recent years sufficed to finance

NET INFLOWS OF FOREIGN DIRECT INVESTMENT
– AS % OF GDP; AVERAGE 1999 – 2002 –



Sources: IMF, Dresdner Bank.

DIRECT INVESTMENT PLUGGED BULK OF CURRENT ACCOUNT DEFICITS

a large part of the current account deficits. Indeed, in the case of the Czech Republic the net inflow was almost twice as high on average as the shortfall on current account, reaching the **record level of almost 13% of GDP** last year. To highlight the scale of this influx, it may help to compare it with China, indisputably the emerging market with the highest inflows of foreign direct investment in absolute terms. Last year, China registered a net inflow of no less than US$ 34bn. But in relation to that country's economic capacity this was just 3.7% of GDP – only a fraction of the proportion in the Czech Republic. A recent Eurostat study puts Poland and the Czech Republic clearly to the forefront of foreign investors' interest in eastern Europe. Those two countries have captured almost 80% of the present total foreign direct investment stock in the ten accession countries.

The global economic lull in the past two years has, of course, not bypassed the east European countries either. As a result, they have seen a **marked slowing in investment.** Poland is a particularly striking example, suffering an average drop in investment of close to 8 % during that period. One consequence of economic stagnation in the EU was that west European companies were less willing to commit themselves to the new accession countries. Hence most of the entrant states saw the influx of foreign direct investment fall off, albeit on a very different scale from country to country. While inflows into the Czech Republic actually continued to increase, their decline was particularly steep in the case of Poland. This was undoubtedly partly due to the latter country's very modest progress with privatization and the government's foot-dragging on reform.

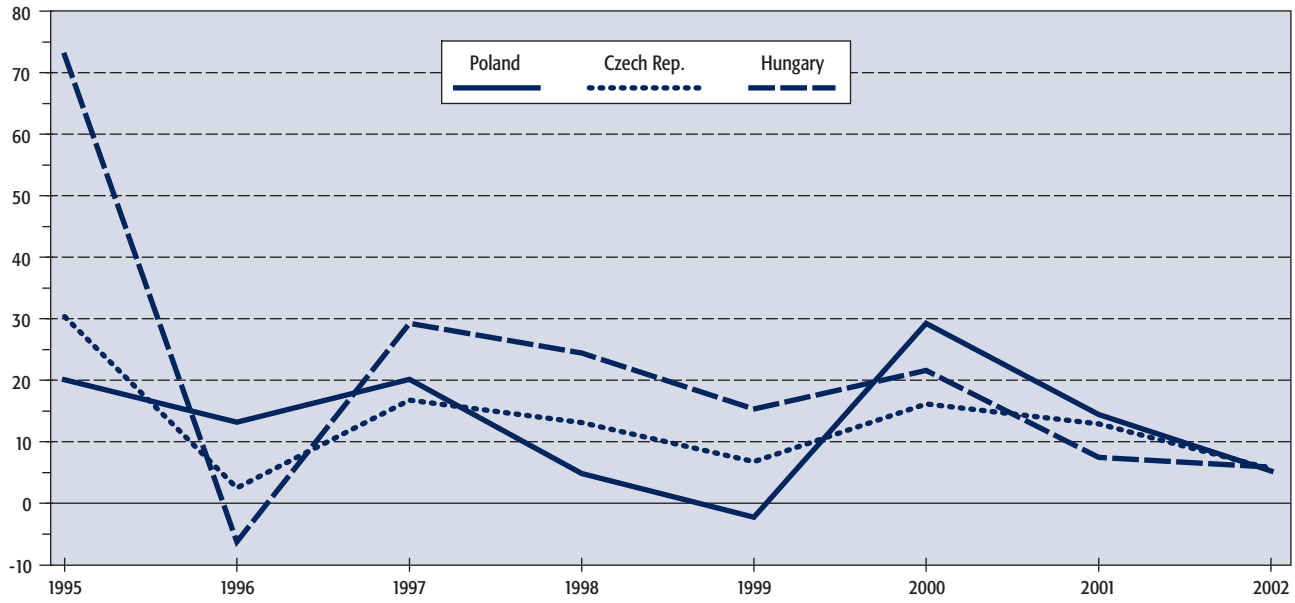
DIRECT INVESTMENT INFLOWS TO EBB AS PRIVATIZATION PROCESS DRAWS TO A CLOSE

In most countries the privatization process will have been wrapped up by and large in a few years' time. Most of the companies that are then still state-owned will presumably be those that as a rule simply fail to find a buyer or that the government is holding on to for strategic reasons. This is very common in the energy sector, for instance. At any rate, it will cause the influx of future foreign direct investment to dwindle on previous levels. Accordingly, the **impetus to growth** of the east European countries' domestic economies from foreign direct investment is likely to be **less powerful** in future. But the recipient countries themselves can be instrumental in keeping FDI inflows high by continuing to improve investment conditions and thus setting the scene for international investors to plough back the profits from their foreign commitments into the respective countries.

EXPORT INDUSTRY AS SECOND GROWTH DRIVER . . .

Another latter-year driver of growth in eastern Europe, besides foreign direct investment, has been the **export industry.** Following the collapse of the former Eastern bloc and with the beginning of transformation in the early 1990s, the east European export industry focused more and more on the west. **Double-digit growth rates** in real export volumes were the rule rather than the exception at that time. This breakneck growth was fostered by favorable exchange rates, low labor costs and a well-trained workforce. Even at times when the global economic environment was muted, real exports nudged up steadily. Meanwhile, the **EU is the biggest market** for east European products. The proportion of exports shipped directly to the old EU member states works out at around 60% on average for all the accession countries.

GROWTH IN REAL EXPORT VOLUME
– % CHANGE ON YEAR EARLIER –



Source: IIF.

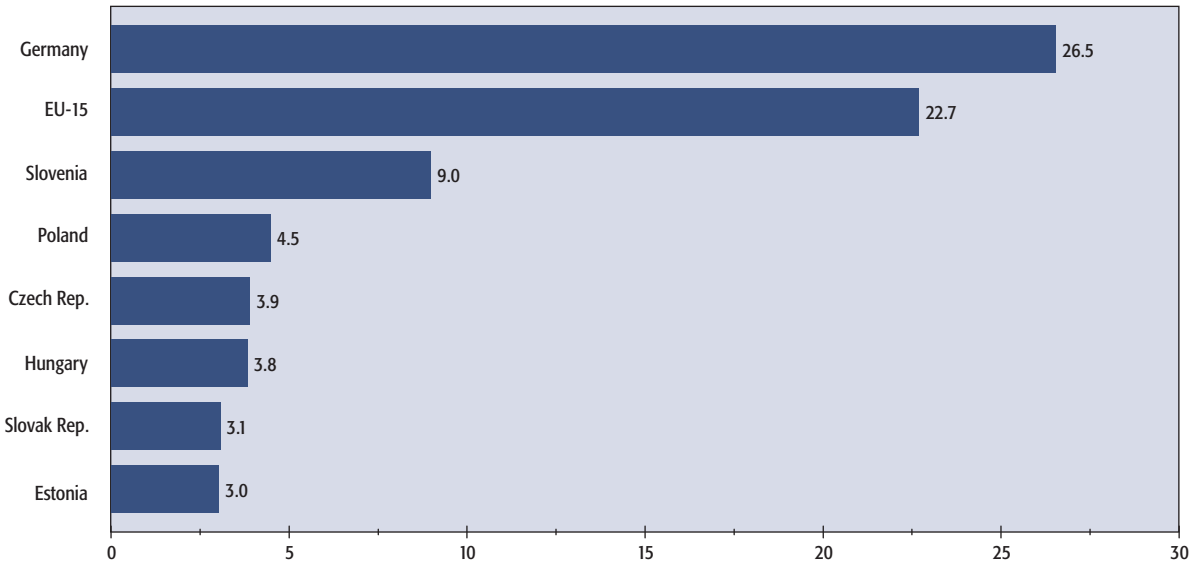
Last year, however, export performance was undermined by slack demand from the EU. In an attempt to boost export volumes and maintain market share, east European exporters were therefore compelled to make extensive price concessions and accept palpably lower profit margins. Export prices in the Czech Republic, for example, plummeted in 2002 by an average of almost 7% on a year earlier.

How will the export industry develop in the years to come? With the exception of Poland, all east European accession countries are **small, open economies** in which exports meanwhile account for between 60 and 80% of GDP. This leaves them **little potential for further development.** In the case of Poland, which constitutes an exception in this respect, exports make up only just over 30%. All in all, while we still expect export activity to be ratcheted up further, the buoyant growth rates of the 1990s will presumably have to be consigned to history. As with foreign direct investment, we therefore expect to see exports providing **less impetus to economic growth** in eastern Europe **in the medium term.**

. . . BUT IMPETUS TO WANE IN MEDIUM TERM

Even if we do not reckon on an export-induced boom in the new EU member states, we do at least expect the **structure of exports** in these countries to change in the medium term. Experience in southeast Asia and Mexico shows that over time the depth of production increases. Up to now, the east European economies have been integrated into the EU division of labor as locations with lower wage costs. At present, for instance, the average gross monthly pay for a Polish worker is only about 25 % that of his EU counterparts' average wage.

LABOR COSTS BY COMPARISON
– COST OF HOUR WORKED IN INDUSTRY, IN EUROS –



Sources: WIFO, Dresdner Bank.

We assume that eastern Europe will gradually be able to disengage from its role as a vertically integrated commission processor. But to do so, it must **push ahead uncompromisingly with structural change.** With the flow of capital from the west and the development of local management structures, the reform countries should succeed in producing a steadily growing proportion of finished articles locally, constantly enhancing their production depth in the process.

5.2.2 THE SOURCES OF FUTURE GROWTH

FUTURE GROWTH WILL INCREASINGLY NEED TO STEM FROM DOMESTIC ECONOMY
Broadening of industrial base needed.

We have seen that **extremely dynamic investment** and the **development of a competitive export industry** were pivotal in recent years to strong economic growth and the impressive catch-up process in the east European countries. But it has also become evident that in the medium term precisely these two driving forces are likely to lose considerable steam. This gives rise to the question of the **sustainability of growth.** What **medium and long-range growth prospects** can eastern Europe look forward to once it has joined the European Union? **And most importantly, where will its growth come from?**

The answer to the second part of the question in particular is really quite obvious. More growth must come from the **domestic economy.** Until now – due in no small measure to the targeted inflow of foreign direct investment – the export sector has generally been at the center of development. It therefore comes as no great surprise that this sector of industry has already reached a comparatively advanced technological level, whereas that part of local industry geared mainly to the domestic economy is still clearly underdeveloped in most of the accession countries, often still leading a rather shadowy existence. But if the east European countries wish to generate notable economic growth in the long range, too, it is vital that they reduce these **disparities in their economic structure.** The **EU** has a vital part to play in this effort, in the context of its structural policy. This aims to reduce regional divergence and strengthen economic and social cohesion in the EU.

EU ENTRY WILL HAVE IMMEDIATE FINANCIAL CONSEQUENCES

Admission to the EU will have immediate financial consequences for the new member states. On the one hand, as from the time of enlargement they must of course pay their contribution to the EU budget, and the pre-accession aid granted ahead of their joining the Union will naturally be terminated. But on the other hand, the east European countries will then participate in the system of financial aid for agriculture and structurally underdeveloped regions.

The following table shows the **agricultural and structural development aid** that the eight east European countries can reckon on in the coming three years. But it also highlights the **own resources**, in other words the contribution to the EU budget, that these countries must put up. Essentially, the contribution level is linked to a country's GDP. For the sake of simplicity, in our calculations we have assumed that each country must pay own resources equivalent to 1% of GDP a year. This roughly corresponds to the average percentage that the present EU countries currently pay into the Community budget each year. At the bottom of the table the individual countries' own resources are netted against the total agricultural subsidies and structural assistance they receive. It is possible for a country to pay more into the EU budget than it receives from the various EU funds. This would be conceivable if, for example, assistance from the Structural Fund was not drawn down in full. To prevent a country becoming a net contributor in such cases, the EU has set up a system of compensatory payments.

AGRICULTURAL SUBSIDIES

The amount a country can expect to receive from the Agricultural Fund depends mainly on the **importance of the farm sector,** both in that country and in comparison to the region. In absolute terms Poland, whose agricultural output alone makes up more than **50% of total farm produce** in the east European accession countries, will garner the bulk of the subsidies in absolute terms. In 2005, the first full year of EU membership and hence the first in which the EU newcomers are entitled to full EU support, EU farm subsidies will kick in at just over € 4bn or not quite 1% of the acceding countries' joint GDP. But this is the average figure. Depending on the country, support will range between 0.6 and 1.8% of GDP.

FOR THE INSTITUTIONAL FRAMEWORK OF AGRICULTURAL POLICY SEE "REFORM OF EU AGRICULTURAL POLICY"
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All told, the farm subsidies will rise appreciably in subsequent years, basically because the **direct agricultural payments** are initially capped at 25% of the EU support level. Thereafter annual adjustments will gradually ratchet up this ceiling until, in 2013, it reaches 100% of the support level then applicable to the old EU member states. Particularly in countries with very high agricultural production – on which the volume of direct aid depends – farm subsidies will escalate significantly up to 2013. Foremost among these are Poland, the Czech Republic and Hungary, whose share of direct payments in total farm subsidies in 2006 will total between 34 and 48%.

IN 2005 FARM SUBSIDIES WILL REACH BETWEEN 14 AND 30% OF OUTPUT

Relative to the size of the farm sector, the subsidies are very substantial. Depending on the country, in 2005 they will reach between 14 and 30% of current agricultural output, hitting almost 38% in the case of Latvia. And this does not even allow for the gradual increase in direct payments. The **subsidies are not conducive** to the creation of incentives to modernize. What is more, guarantee prices which are generally higher than those that can be obtained

FINANCIAL IMPACT OF EU ACCESSION

AGRICULTURAL FUND – at current prices –

	2004		2005		2006	
	€ million	% of GDP	€ million	% of GDP	€ million	% of GDP
Czech Republic	213.6	0.3	494.9	0.6	558.3	0.6
Estonia	60.5	0.8	107.5	1.3	118.9	1.3
Hungary	252.2	0.3	671.4	0.9	754.4	0.9
Latvia	108.8	1.3	162.6	1.8	181.6	1.9
Lithuania	173.4	1.0	304.1	1.7	341.4	1.8
Poland	1,014.7	0.6	1,982.6	1.0	2,244.3	1.1
Slovak Republic	138.5	0.5	269.6	0.8	301.3	0.9
Slovenia	101.4	0.4	167.8	0.6	184.2	0.6

STRUCTURAL AND COHESION FUNDS – at current prices –

	2004		2005		2006	
	€ million	% of GDP	€ million	% of GDP	€ million	% of GDP
Czech Republic	728.2	0.9	826.2	1.0	1,072.2	1.2
Estonia	199.6	2.5	214.4	2.5	282.9	3.1
Hungary	872.9	1.2	1,013.1	1.3	1,327.7	1.6
Latvia	359.3	4.2	391.8	4.3	416.3	4.3
Lithuania	431.7	2.6	491.6	2.7	618.0	3.2
Poland	3,447.8	1.9	4,062.1	2.1	5,323.0	2.6
Slovak Republic	482.7	1.6	557.5	1.7	720.4	2.1
Slovenia	128.9	0.5	142.8	0.5	185.8	0.6

CONTRIBUTION EU BUDGET – at current prices –

	2004		2005		2006	
	€ million	% of GDP	€ million	% of GDP	€ million	% of GDP
Czech Republic	803.7	1.0	856.7	1.0	913.2	1.0
Estonia	79.7	1.0	85.8	1.0	92.4	1.0
Hungary	737.9	1.0	781.9	1.0	828.4	1.0
Latvia	85.9	1.0	91.2	1.0	96.8	1.0
Lithuania	168.1	1.0	180.1	1.0	192.9	1.0
Poland	1,825.9	1.0	1,927.1	1.0	2,033.8	1.0
Slovak Republic	305.4	1.0	323.8	1.0	341.7	1.0
Slovenia	261.7	1.0	274.8	1.0	287.1	1.0

NET – at current prices –

	2004		2005		2006	
	€ million	% of GDP	€ million	% of GDP	€ million	% of GDP
Czech Republic	138.0	0.2	464.5	0.5	717.4	0.8
Estonia	180.4	2.3	236.1	2.8	309.4	3.3
Hungary	387.2	0.5	902.6	1.2	1,253.7	1.5
Latvia	382.3	4.5	463.2	5.1	501.2	5.2
Lithuania	437.1	2.6	615.6	3.4	766.5	4.0
Poland	2,636.6	1.4	4,117.6	2.1	5,533.5	2.7
Slovak Republic	315.8	1.0	503.3	1.6	680.0	2.0
Slovenia	-31.4	-0.1	35.8	0.1	82.8	0.3

Source: Own calculations on the basis of European Commission statistics.

locally enable farmers to boost their output in a market already swamped by surplus production. **The EU subsidization policy has the effect of delaying rather than speeding up the process of agricultural restructuring so urgently needed.** Yet most particularly in Poland, where almost 20% of the working population are employed in agriculture – a sector that generates a meager 3.4 % of overall output – farm reform is absolutely imperative.

FINANCIAL ASSISTANCE FROM STRUCTURAL AND COHESION FUNDS

POSITIVE ECONOMIC STIMULI FROM EU STRUCTURAL AIY
Spain and Portugal benefited substantially in the past.

Whereas the long-range growth effects triggered by farm subsidies can arguably be considered negligible, various studies have repeatedly identified **positive economic stimuli from EU structural aid.** Research conducted last year, for example, concluded that without Objective 1 promotion Spain's GDP would have grown by only 2.4% in 2000, whereas in point of fact it expanded by 4.1%[8]. The results are even more emphatic in the case of Portugal. Of course it is generally difficult to separate entirely the impetus to growth triggered by a structural measure from other determinants. But given the structure and scale of the aid in this case, there can be no question of its positive economic repercussions.

In comparison to the farm subsidies, the financial support from the Structural and Cohesion Funds is considerably higher in relation to GDP. **Average per capita income,** which is pivotal to determining the level of aid from the Structural and Cohesion Funds, is appreciably lower in eastern Europe than in the old member states. In many cases, the inflows that the new entrants can expect will be **more than twice as high** as the agricultural subsidies. Relative to their GDP, the Baltic states can look forward to the highest appropriations. Latvia would receive support amounting to more than 4% of GDP. But what dimension should capital inflows actually be allowed to reach if they are still to be **efficiently absorbed** by an economy? A level of more than 4% is commonly considered critical. In none of the old EU countries has aid surpassed this limit. Of the big east European countries Poland is the one that can look forward to the highest structural assistance relative to GDP; on average for all the acceding countries, maximum aid is likely to be well above 2% in the coming years. Given the scale of this financial assistance, is there not a risk that **the mistakes made with German reunification are repeated?** We do not share this view. The payments to eastern Europe will be nowhere near as high as the sums transferred from west Germany to the new German states in the years following 1990. At that time financial aid totaled more than 50% of east German GDP.

THE FISCAL SITUATION IS DEALT WITH IN DEPTH IN SECTION 5.2.3 "PUBLIC FINANCES IN EASTERN EUROPE UNDER PRESSURE"

An integral element of EU structural policy is that all countries must contribute towards structural operations. **Co-financing** of Objective 1 promotion will probably amount to between 15 and 20% of the total project costs. Given the extremely **precarious budget situation** in some east European countries, we do not expect them to utilize in full the promotion funds available to them. And indeed, in view of their **limited absorption capacity,** this is to be welcomed.

Efficient use of the funds provided will be determined to a large extent by their allocation. In addition to the infrastructure projects that will certainly still be

[8] The study by Prof. Jörg Beutel, Konstanz University, entitled "The economic impact of objective 1 interventions for the period 2000–2006" was published in May 2002.

necessary, attention should focus here on small and medium-sized enterprises (SMEs). Targeted strengthening of the SME sector is sure to broaden the basis for growth of the economy as a whole. If, however, the development aid were used chiefly to keep alive already moribund branches of industry, the growth effects would be in danger of fizzling out in the long run. Particularly in eastern Europe, where many countries still have nothing resembling a healthy SME sector, deliberate and broadscale promotion of small and medium-sized businesses could prove to be the definitive growth engine. In countries like Poland, with unemployment running at almost 18%, financial support for SMEs in conjunction with start-up initiatives could be instrumental in reducing joblessness. This would considerably broaden the scope for structural change and ease the social pressures attendant on the transformation process.

5.2.3 PUBLIC FINANCES IN EASTERN EUROPE UNDER PRESSURE

Public finances in many east European countries are anything but comfortable at the moment. Poland, the Czech Republic and Hungary in particular are running hefty budget deficits this year, in the order of between 7 and 9% of GDP. While the two latter countries look set to trim their shortfalls next year, in Poland the financing gap will widen again quite considerably as public spending continues to climb and the tax take contracts. For 2004 Poland plans, among other measures, to lower the rate of corporation tax and raise personal tax allowances.

VITAL TO PUT PUBLIC FINANCES IN ORDER

All three countries urgently need to consolidate their budgets in the years ahead. Whereas the Czech parliament approved a program of tax reforms in September 2003 designed gradually to roll back the budget deficit to 4% of GDP by 2006, Poland's attempts to sort out its fiscal woes have so far proved rather half-hearted. This is undoubtedly due to its highly fragmented internal political structure, which stands in the way of trenchant measures. Ultimately, though, the new EU countries have no choice but to put their public finances in order – at least, not if they want to set the stage for speedy introduction of the euro. Indeed, the presidency conclusions of the 1993 Copenhagen European Council commit them to put in place the prerequisites for replacing their own national currencies by the euro as soon as possible after their accession to the EU. These preconditions are set out in the Maastricht criteria, which include among others the budget criterion demanding a fiscal deficit below 3% of GDP. But it is not international treaties alone that are exerting an element of pressure to economize on the east European governments. In the coming years Poland's national debt also threatens to breach certain ceilings which its national constitution binds it to observe, and in the event of an overrun the government must take corrective measures.

Budget consolidation in itself will initially have the effect of damping growth in the years ahead. Cutbacks in government consumption and public investment cannot fail to have an impact on the economy, as illustrated by the following example. If in 2002 the increase in public consumption in the Czech Republic had been just one percentage point lower than was actually the case, the Czech economy would have turned in real growth of only 1.8% instead of the 2% realized. In the long term, however, the positive effects of a sound fiscal policy on economic development can be expected clearly to outweigh the downside.

5.2.4 THE ROLE OF THE BANKS

PRIVATIZATION OF BANKING SECTOR LARGELY COMPLETE

In recent years, the east European accession countries have made **remarkable progress with the consolidation of their banking systems and development of their financial markets.** With just a few exceptions, privatization of the banking sector is complete. On average, more than 85% of all bank assets are now held by commercial banks, the majority of which are privately owned. The strategy of bringing foreign expertise and capital into the country has resulted in foreign investors occupying a prominent position among the new shareholders. Much of the east European banking sector has now passed into foreign hands. Due not least to the commitment of these investors, the increase in efficiency of the banking system attendant on the privatization process has been quite outstanding.

Yet in comparison to the existing EU countries there is still **much ground to be made up.** While the commercial banks occupy a very dominant position within the financial sector, their **financial intermediation** is still not comparable to that of the EU area. Many east European banks still shy away from lending to domestic business, daunted by high default costs at private companies. Although insolvency legislation is now broadly in place, it is not yet consistently applied, and the practical liquidation of collateral is scant. Moreover, in many countries a substantial proportion of domestic savings is absorbed by the state to finance its budget deficits, some of which are hefty indeed. This means that companies unable to access foreign loan finance or direct investment are left empty-handed, obliging them to fund investment mainly from retained profits. This is presumably still the norm with small and medium-sized businesses in particular. All in all, the **shortcomings in financial intermediation impose not insignificant restrictions on investment financing** and hence on the economy's growth potential.

5.3 CONCLUSION: CATCH-UP PROCESS WILL GATHER SPEED

We began by asking ourselves what the medium and long-range growth prospects look like for the new EU members and what forces might power their economic development. To summarize, the following aspects have emerged from our review:

- The new EU member states are likely to benefit in particular from the **economic recovery now emerging in the euro area.**
- We expect the CEEC to push ahead with **structural reform** in the coming years. This will be accompanied by more competition and greater market efficiency. The new EU members have no choice but to put their public finances in order, even if this does check growth in the short term.
- Increasing **financial intermediation** by the banks should make it easier for smaller and midsize businesses in particular to fund their investment. More efficient risk management systems will ensure that loans are granted for the investment that promises the greatest benefit. Increased competition in the banking sector will work to the advantage of depositors and borrowers through better interest rates. An efficient banking system will encourage saving and boost the economy's potential for growth.

- An export boom in the east European countries is unlikely in the coming years, although their **export structure** will alter. The depth of production will increase and the differences in technical features between domestically oriented business sectors and those geared more to exports will narrow.
- It will no longer be possible to match the extremely high inflows of foreign **direct investment** achieved in the past, chiefly because the process of privatization in eastern Europe is gradually tapering off. That said, the region will nevertheless remain attractive to direct investment.
- Once the east European countries join the EU in May 2004 they will have **access to the subsidies** from the agriculture budget and the Structural and Cohesion Funds. Possible influxes from these EU appropriations will reach a scale of altogether more than 6% of GDP for some countries. One of the biggest challenges will therefore be to use the funds in such a way that they do not overtax the country's **ability to absorb** them.

The resources that will accrue to the new EU member states in the coming years are substantial. The inflows of foreign direct investment, together with the monies from the EU structural and agricultural funds, will total between 5 and 10% of GDP, depending on the country concerned. If this is used for investment, it should generate **real growth rates of around 4% over the next ten years.** Greater fluctuation in growth and setbacks cannot, of course, be ruled out. With these rates of expansion the east European countries will easily outstrip economic momentum in the old EU member states. **The catch-up process will thus gather pace.** However, it will still take a **long time for the standard of living to level.** We calculate that by 2013 per capita incomes in the new member states will have nudged up from presently 23% of the "old" EU countries to a scant 29%.

FORECASTS FOR 2003 TO 2013

REAL GDP GROWTH IN %				
	2002	2003	2004	Average 2005 – 2013
Czech Republic	2.0	2.5	2.8	3.5
Estonia	6.0	5.0	5.5	4.0
Hungary	3.3	2.6	3.1	3.5
Latvia	6.1	6.0	6.0	4.0
Lithuania	6.7	6.3	6.0	4.0
Poland	1.4	3.0	3.8	3.5
Slovak Republic	4.4	4.0	4.3	3.5
Slovenia	3.2	3.0	3.6	3.0
EU-15 average	1.1	0.8	2.1	2.2
GDP IN € BILLION				
	2002	2003	2007	2013
Czech Republic	72.3	75.6	97.3	145.6
Estonia	6.8	7.5	9.9	15.5
Hungary	66.9	69.8	87.8	130.8
Latvia	8.9	8.6	10.3	15.3
Lithuania	14.6	16.1	20.7	31.2
Poland	193.3	176.3	214.7	314.8
Slovak Republic	24.6	27.4	35.9	52.1
Slovenia	22.5	24.0	30.2	41.5
Total	**410.0**	**405.4**	**506.7**	**746.9**
EU-15	9,145.7	9,264.8	10,622.3	13,427.0
Grand total	**9,555.7**	**9,670.2**	**11,129.0**	**14,173.9**
Acceding countries' share	4.3	4.2	4.6	5.3
GDP PER CAPITA IN EUROS				
	2002	2003	2007	2013
Czech Republic	7,019	7,340	9,447	14,136
Estonia	4,857	5,357	7,071	11,071
Hungary	6,559	6,843	8,608	12,824
Latvia	3,708	3,583	4,292	6,375
Lithuania	4,171	4,600	5,914	8,914
Poland	4,995	4,556	5,548	8,134
Slovak Republic	4,556	5,074	6,648	9,648
Slovenia	11,250	12,000	15,100	20,750
EU-15 average	24,093	24,407	27,983	35,372

6 Pension systems in the central and east European accession countries

ECONOMIC UNCERTAINTY CAUSED BIRTH RATE TO TUMBLE

For most of the former Comecon member countries the fall of the Iron Curtain at the beginning of the 1990s brought with it a fundamental realignment. In all the central and east European countries (CEEC) the Soviet Union was replaced as the leading political and economic power by the European Union, as the role model to which they aspired to belong. In all those countries the transformation from a planned economy to a free market system was accompanied by setbacks and, on the whole, great economic insecurity for the populace. This led to a marked drop in fertility. **Up to the end of the 1980s the birth rate was approximately two children per woman and enough to hold population figures steady. Just five years later fertility had plummeted to around 1.5 children per woman, a level leading in time to a permanent decline in population numbers.** Even before that, birth rates in the CEECs had generally been heading down, and with life expectancy rising the EU accession countries find themselves faced with comparable demographic challenges to the EU-15.

As in every planned economy the social security systems in the EU accession countries were pay-as-you-go (PAYG) systems. To prevent unemployment, the pension systems also served as a catch basin for older workers no longer fully employable. With the system change in the 1990s, however, the social security systems also had to be revamped. **A dwindling labor force participation rate and high jobless figures were jeopardizing the viability of the existing pension systems.** It was a choice of drastically lowering pensions sooner or later, substantially increasing state subsidies or launching a fundamental reform of retirement provisioning. The fact that pension levels were already comparatively low ruled out pension cuts in most cases. Moves to join the EU, and EMU too in the medium term, and the need to observe the restrictions on government borrowing inherent in this process lent little charm to the option of higher state subsidies for the pension systems. Given the comparatively unfavorable demographic trend and early retirement age, without radical reform the national budgets would have faced deep problems. There was thus no alternative to reform of the pension systems in all candidate countries, as the political powers-that-be were only too aware. Yet for all their insight, the reform process did not go smoothly everywhere. Such fundamental and far-reaching reforms as the reorganization of retirement provision bring a host of different interest groups onto the scene. This can delay the reform process or lead to inconsistencies in its outcome. Poland found it especially difficult to craft a consistent concept,

with the result that in the mid-1990s the World Bank came to its aid as a mediator. With the help of further advisors and by engaging major interest groups such as the trade unions, employers and the government, a coherent blueprint for reform was approved.

HIGHER RETIREMENT AGE IN ALL COUNTRIES

The reforms introduced in the eight central and east European accession countries varied quite considerably, even though they started out from broadly similar situations. **One common element was the changes to the PAYG system designed to ease the burdens on pension insurance funds and national budgets.** To the forefront of the overhaul were measures to raise the retirement age and make early retirement more difficult, such as have already been adopted, or are at least planned, in many of the EU-15 countries. The picture was more mixed with regard to determination of the part that would be played in future by the PAYG state pension scheme – the so-called first pillar of retirement provision – and of the benefits that were to be provided by occupational and private pension schemes, the second and third pillars. Whereas some countries do at least establish occupational pensions by law, others do not provide for them at all, or only on a limited scale.

6.1 THE REFORMS IN THE FIRST PILLAR

WIDE VARIATION IN REFORMED SYSTEMS

There is no generally accepted ideal blueprint for a state pension scheme, although a trend has emerged in recent years toward systems that implicitly take demographic change into account. In particular the recommendations by the OECD and EU Commission on pension reforms, designed to head off dangers to the long-range equilibrium in government finances, helped encourage this reform drive. A rather elegant approach is the introduction of so-called **"notional accounts"**. The contributions paid by each contributor under the PAYG system are credited to a hypothetical account and – as a rule – earn interest at the rate of the development in wages. Then on retirement, the monthly pension payments are calculated on the basis of the accumulated capital in the account. The remaining life expectancy at retirement plays an important part in the calculation, with rising life expectancy leading to lower pension payments under this system. Besides Latvia and Poland, Sweden has also introduced this form of pension computation, and Italy is in the process of doing so. Other accession countries have split pension benefits into a basic pension, intended to provide people in lower income brackets in particular with a modicum of security, and an income-related benefit. Systems of this kind are to be found in Estonia, Lithuania and the Czech Republic. **Most countries have chosen a combination of price and wage indexation for the adjustment of pension payments.** This means that pensioners do not participate fully in productivity gains, as a result of which pension payments fall relative to average incomes in the long term. However, pensioners' standard of living does improve over time, particularly in comparison to a system of strictly price indexing.

In almost all countries the retirement age has been raised to 62 years for men and women. Further increases will presumably be inevitable in the longer term to keep the systems solvent. Contribution rates currently range from just under 20% of gross income in Poland to 34% in Lithuania, although in the latter these contributions also cover other risks such as illness and unemployment. **On the whole, pension payments from the first pillar tend to be low.** As a rule 40% of an average net income is reached as a pension after 35 contribution years. At present Hungary still achieves 74%, but as from 2013 this will be lowered to 69%.

6.2 GROWING IMPORTANCE OF FUNDED PENSION PILLARS

As a rule, benefits under the first pillar are not such as to enable pensioners in the accession countries to maintain the standard of living to which they are accustomed. This makes additional forms of provision very important. **In four countries parts of the pension contribution rate are paid directly into funded plans, as a rule pension funds.** Employees have the choice of different funds. In Slovenia occupational pensions exist only for workers in dangerous professions, which are defined by the state. In Slovakia occupational pension schemes can be set up once the employer has concluded a framework agreement with the responsible agency. The following table gives an overview of the incidence of compulsory funded systems. (Further details on the regulations are to be found in the overviews at the end of this chapter.)

Compulsory contributions to funded systems	No area-wide funded provision
Latvia, Estonia, Poland, Hungary	Lithuania, Slovakia, Czech Republic, Slovenia (only for employees in dangerous professions)

STATE PENSION NEEDS TO BE SUPPLEMENTED WITH PRIVATE PROVISION

Assuming that roughly 70% of previous earnings are required to maintain the standard of living in retirement, further provision needs to be made in addition to the state pension and the payments from compulsory fully-funded systems. Demand will presumably be satisfied first and foremost by life assurers and investment fund managers. In contrast to the old EU member states, there are no statistics on monetary wealth in the accession countries, making it impossible to calculate the need for provision with sufficient accuracy. But some rough estimates can help here. On the assumption that roughly 45% of the average income is replaced by the PAYG pillar and that 70% is aimed for as the target pension, the following amounts must be saved, depending on the return on the funds invested and the savings time horizon:

Return on capital	Capital required as a multiple of the annual net income before retirement	Necessary savings ratios, depending on the time horizon		
		20	30	40
4%	7.6	32.0%	19.8%	13.8%
5%	5.6	21.10%	12.36%	8.12%
6%	4.5	15.40%	8.48%	5.24%

Assumptions: Pension increase 2.25% p.a., income increase 2.5% p.a.
25% of the last net income stems from private provision, 45% from the state pension system.

On the basis of a six percent return on investment and a time horizon of 30 years, roughly 8.5% of annual income would need to be saved. In Latvia, Hungary, Estonia and Poland between 2% and 7.3% of annual income is already paid into funded systems on a mandatory basis. The 2% share in Latvia will be stepped up to 10% in the coming years. Where, as in Estonia and Hungary, compulsory contributions are already set at 6%, on the aforementioned assumptions a gap of around 2½% remains. This would have to be financed additionally to attain pension payments equivalent to 70% in old age. If the return on the funds invested is lower, correspondingly more has to be saved; however, with a time horizon of longer than 30 years lower contributions will suffice. Assuming additional provision amounting to 2% of the gross payroll

were made for all wage and salary earners, in Poland, for example, a pension top-up of approximately € 1.2bn a year would have to be found. In the other countries the comparable amounts would as a rule be lower, given that they have smaller populations or more generous state pension systems.

PENSION PROVISION REDUCES RELIANCE ON IMPORTED CAPITAL

With the exception of the Czech Republic, which is only now considering the introduction of company pension schemes, and Lithuania, where voluntary occupational schemes are to be permitted as from 2004, virtually all candidate countries have built up funded pension pillars to ease the pressure on the PAYG system. A substantial part of the funding accumulated has a very long investment horizon, because funded schemes are frequently compulsory only for young workers. This means that the funds are available long-term for investment in modernization of the capital stock, making the countries concerned less reliant on imported capital. Economic modernization is thus closely linked with retirement nestegging. The countries that have not yet decided on occupational pension schemes are very likely to do so in the near future. What parts of their income people are able to save for their retirement will also depend on the development in incomes and hence on economic progress as a whole. We expect demand for additional third-pillar private provision in the accession countries to pick up appreciably in the coming ten years in the context of a positive incomes trend.

OVERVIEW OF THE PENSION SYSTEMS IN THE ACCESSION COUNTRIES

Country	1st pillar	2nd pillar and compulsory funding	3rd pillar
Czech Rep.	Reforms 1992-97. Contribution rate: employer pays 19.5% of gross wage, employee 6.5%. Retirement age is being increased to 62 for men, 61 for childless women by 2007, subsequent increase to 63 for men/women. Pensions can be drawn early after 25 contribution years, with reductions. Pension level: basic pension (€ 41/month [2002]) and pension depending on income and length of contributions (per contribution year, basis for pension calculation average income in the last 15 years' employment (from 2015 last 30 years). Average replacement ratio 2000: 57% of an average net income. Indexing based on the development in prices.	No statutory basis.	Introduction of incentivised private pension in 1994. Contributions are tax-deductible to a limited extent. The state contributes € 5 a month if private investment totals at least € 16. Employer can also pay into the scheme.
Estonia	Pension consisting of basic pension (€ 37), income-related pension (by contribution years and variable pension value) and an individual insurance component. Average pension amounts to 40% of the average income. Retirement age for men 63, women 58 (from 2016 also 63), contribution rate 20% of gross wage, payable by the employer.	Mandatory since 2002 for all workers up to age 18, voluntary for the rest. Four percentage points of the 20% social tax go to the funded tier, employee pays 2%.	Pension plans, life policies, payments into pension funds are tax-deductible up to 15% of gross income.
Hungary	Reform 1998, combined wage-price-related indexing, from 2013 pensions according to the new system only. Retirement age men 62, women 62 from 2009. Employer pays 16% of gross income, employee 8%. Under the new pension system 6 percentage points of this will go towards mandatory occupational pension plans. Pension amount depends on average net income since 1988 and number of years worked. After 15 contribution years entitlement to pension equivalent to 43% of the average income, after 36 years to 74%. From 2013, pension calculation based on gross incomes and replacement ratio lowered to 69% after 36 contribution years.	Mandatory for workers who took up employment after July 1998, others had to decide by 2002 whether they wanted to pay into a funded system. Funded by mandatory contributions equaling 6% of gross income, funds invested in privately organized pension funds which the employees are at liberty to choose.	Voluntary supplementary provision possible in Voluntary Third Pillar Pension Funds (VPF). Employers may also pay into these funds if an appropriate agreement has been made with the employee and the fund.
Latvia	Reform 1995, introduction of notional defined contribution system. Contribution rate 20% (of which at present 2% for 2nd pillar) shared between employee and employer. Pension consisting of basic pension and income-related pension, indexed to developments in wages and prices. Pension level of a 60 year-old with 36 contribution years 40% of average income. Retirement age officially 60, actually 64.	Since 2001 compulsory for all workers under 30, voluntary for all between 30 und 49. Contributions 2% of income, rising to 10% at the expense of the 1st pillar.	Since 1998 primarily bank deposits and government bonds.

Country	1st pillar	2nd pillar and compulsory funding	3rd pillar
Lithuania	Reform 1995. Contribution rate 31% of gross wage paid by employer, 3% by employee (6 percentage points for maternity, unemployment and sickness benefits). System also mandatory for civil servants and self-employed. Retirement age rising to 62.5/60 for men/women by 2009. Pension breaks down into basic amount (price indexed, at least 110% of subsistence wage) and income-dependent part. Pension level on average 36% of gross income. Pensions are tax-free.	Planned for 2004 on a voluntary basis.	Since 2000 pension funds and life policies for private provision. Contributions up to 25% of annual income are tax-deductible. Pension benefits are taxed. Life insurance contributions and payments are tax-free.
Poland	Reform 1999, introduction of notional accounts (interest rate pegged to wage increases). Joining new system optional from birth-year 1949, compulsory from birth-year 1969. Contribution rate 19.52% of gross wage (up to 250% of average wage), 11.22% of which towards 1st pillar, 7.3% 2nd pillar, 1% reserve fund. Retirement age men/women 65/60, from birth-year 1949 possible from age 62 after 25 contribution years. Pension level from 1st and 2nd pillar at age 62 roughly 62% of average income. Minimum pension after 25 contribution years 28 % of average income. Pensions are price-indexed.	Fully funded, contribution 7.3% of gross income. Compulsory membership. Employees choose between fund managers, balances are paid out as lifelong pensions and are inheritable. Pension benefits are taxed (EET system). Roughly 50% of retirement income is to come from this pillar in the long run.	Variety of investment vehicles, investment funds, insurance contracts or conversion of employee's earnings into direct or group insurance, pension or investment funds. A priori taxation (pension-related expenditure being considered part of taxable income), pension benefits tax-free.
Slovak Rep.	Reform 1994, wage-indexed pension with strong redistribution component, since only incomes up to SKK 10,000 (€ 180/month) are taken into account. Pension replacement ratio approx. 90% of wages for low earners but only about 20% of higher incomes. Contributions 21.6% of gross income for employers, 6.4% for employees. Retirement age for men rising to 62 by 2006 (for women by 2020). Reduction for early retirement 0.5% per month. 2004 reform moving towards basic pension.	Since 1996 voluntary pension system for employees whose employer has concluded a master agreement with a Supplementary Pension Insurance Company. Tax-privileged contributions for both (employees up to 3% of income). Rate of taxation on private pensions was lowered in 2001, around 10% of workforce covered. Further development of 2nd pillar planned from 2004.	
Slovenia	Reform 1999. Retirement age will be raised to 63/61 for men/women by 2008/2022. Reductions for early retirement. A full pension amounts to 72.5% of the average income.	Binding only for workers in dangerous professions.	Voluntary supplementary provision possible. This can be organized by employer. Minimum rate of return prescribed.

7 The road to monetary union

The 2004 accession of the new member states to the EU does not mean that they will simultaneously join European Monetary Union (EMU). To do this, they must meet other criteria. Nonetheless, enlargement will bring the prospect of introducing the euro closer, particularly given that the new EU member states are legally obliged to join EMU as soon as they fulfill the necessary conditions. Unlike the UK and Denmark, the countries of central and eastern Europe cannot choose to opt out.

PROSPECT OF EMU MEMBERSHIP SPURS AMBITIOUS ECONOMIC POLICY

Why is the prospect of EMU so important? Basically, there are two reasons. First, because it will play a key role in both the economic policy of the acceding countries and in their economic growth prior to entry into EMU. Remember the first time when EMU membership became a tangible prospect? Back then, a trend emerged whereby many EU members, who were known for having relatively high budget deficits, inflation rates and interest rates, converged towards lower levels. This did not happen automatically, but rather resulted from the ambitious economic policy these states pursued in order to meet the conditions for EMU membership, the Maastricht criteria. **Secondly, the exchange rate is a critical factor when investing in any of these countries.** In recent years, it is mainly long-term capital that has been flowing into eastern Europe, especially in the form of direct investment. Western European parent companies see substantial fluctuations in exchange rates as a risk that could deter them from making any further commitment to these countries. Once EMU membership appears on the horizon, however, exchange rate volatility will gradually fall, increasing visibility and smoothing the way for closer capital ties.

The prestige of introducing the euro as early as possible is also a reason why, despite their mixed signals, the accession countries have set extremely ambitious economic targets. The most ambitious is the Slovak Republic, where there are calls for koruna to be exchanged for euros as early as 2006. Then comes Slovenia, which plans to follow suit in 2007. Poland, Hungary and the Czech Republic are obviously less ambitious in this regard and are looking at a possible entry as late as 2009. The Baltic states, on the other hand, are likely to want to join as soon as possible. However, political aims can change quickly, not least because the achievable and the desirable are not always easy to reconcile.

7.1 EVERYONE A WINNER?

But is the desirable really what everyone wants? First, some good news for the euro area: **Eastern enlargement will not cause a collapse of confidence in the euro, nor make it into a soft currency.** The economic clout of these candidate countries is simply too low in comparison to that of the current EMU members. Aggregate GDP of the EU-newcomers amounts to a mere 6% of that of the current euro area. Moreover, the stability-driven monetary policy pursued by the central banks of our eastern European neighbors has led to inflation rates in most accession countries that are no longer significantly higher than those of the EMU countries.

EAST AND WEST COULD BENEFIT IN EQUAL MEASURE FROM EXPANDED EMU

Everyone knows, however, that an enlarged Union would lead to increased integration, something very characteristic of a single currency area and from which East and West could benefit in equal measure. For example, trade and capital flows could grow without being disrupted by exchange rate fluctuations, and western European firms would no longer have anything to fear from eastern competition whose competitiveness stemmed from hefty depreciation.

But how would things weigh up for the individual accession countries themselves? **One positive aspect would be the disappearance of currency crises, which have left deep scars in the financial and real economies of other emerging countries.** Yet a crisis of confidence, along with a flight of capital, would of course still be possible in a single currency area. The accompanying dearth of liquidity would then manifest itself in higher insolvency rates and declining investment.

The economic performance of Spain and Ireland is certainly increasing the accession countries' interest in monetary union. The combination of low euro-area interest rates and above-average inflation rates is driving up investment and with it economic growth. The new EU member states are expecting to see a similar development. But if inflation constantly tops that of the other states, international competitiveness will suffer. As such, the price of a short-term economic boom would be long-term structural problems – as a rule a heavy price to pay and something that could also threaten current EMU member states.

EXCHANGE RATE NO PANACEA FOR STRUCTURAL PROBLEMS

Not surprisingly, given their short history as market economies, all the acceding countries are still plagued by major structural problems. The larger among these states have had particular difficulty in fulfilling the EU accession criteria. In these circumstances, is it possible to simply forgo a key economic policy tool, namely the exchange rate? The exchange rate is obviously not a panacea for remedying structural problems, which have to be resolved at some point or another by political or economic measures. **However, in the event of economic upheaval, swelling up within the country or encroaching from outside, a devaluation can help win time and adjust to the new environment.**

Whatever decision is made, EMU entry must be carefully considered because there is no turning back.

7.2 EXCHANGE RATE SYSTEMS: DIFFERENT STARTING POINTS

The road to monetary union will differ from country to country. The exchange rate systems of these states, which vary tremendously at present, are a key determinant of this road map.

The currency boards in Estonia, Latvia and Lithuania represent the strictest exchange rate systems. Central to these systems is the pegging of the exchange rate to an anchor currency, the euro for Estonia and Lithuania, and the IMF's Special Drawing Right (SDR) for Latvia, although the latter is expected to switch its anchor currency to the euro in the foreseeable future. In principle, monetary policy in these countries is based solely on international capital flows, i.e. the respective central bank's currency market interventions.

WITH FIXED EXCHANGE RATES, LONG-TERM INFLATION GAP ERODES COMPETITIVENESS

The fixed exchange rate against the euro and the fact that they have dispensed with their own monetary policy instruments mean that, **from an economic point of view, Estonia and Lithuania are already almost a part of EMU.** However, as demonstrated in Argentina, currency boards can also collapse, and so their survival, even in the Baltic states, can never be guaranteed. The advantage of currency boards is not only that the economy and the population quickly gain confidence in the currency but also that the fixed exchange rate encourages international integration – certainly no small argument given the modest scale of these economies. Nevertheless, the inflation gap that builds up over the years against the anchor currency area erodes international competitiveness. This results in high current account deficits, a phenomenon that has since manifested itself in Estonia. Last year's deficit, for example, was a whole 13% of gross domestic product.

KEY EMU PASSAGE FROM THE MAASTRICHT TREATY:

... The report shall also examine the achievement of a high degree of sustainable convergence by reference to the fulfillment by each member state of the following criteria:

- the achievement of a high degree of price stability; this will be apparent from a rate of inflation which is close to that of, at most, the three best performing member states in terms of price stability *(difference of not more than 1.5 percentage points);*
- the sustainability of the government financial position; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104c(6) *(budget deficit and public debt must not exceed 3% and 60% of GDP respectively);*
- the observance of the normal fluctuation margins provided for by the Exchange Rate Mechanism of the European Monetary System, for at least two years, without devaluing against the currency of any other member state *(standard fluctuation band +/– 15%);*
- the durability of convergence achieved by the member state and of its participation in the Exchange Rate Mechanism of the European Monetary System being reflected in the long-term interest rate levels. ...

... The reports ... shall also take account of the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labor costs and other price indices. ...

Source: Official Journal of the European Union, Article 121, C325,85, 24.12.2002, passages in italics own explanations based on publications by the European Central Bank.

In Hungary limited exchange rate flexibility exists. The forint is allowed to fluctuate within an exchange rate band of +/–15 % either side of a fixed (but adjustable) parity rate with the euro. As recently as June 2003, the Hungarian National Bank devalued the forint by 2 percentage points against the euro. The exchange rates of the other accession countries are basically flexible, although the central banks reserve the right to intervene (managed float). Poland made a conscious decision in favor of exchange rate flexibility with a view to joining EMU at a later date and leaving it to the markets themselves to determine the exchange rate at which it enters monetary union. Hardly any restrictions to currency and capital flows remain in any of these countries, i.e. the currencies are, in essence, freely convertible[9].

7.3 PRELIMINARY STAGE: ERM II

WITHIN ERM II EXCHANGE RATES FLUCTUATE BY +/– 15 % AGAINST THE EURO

An important condition of the Maastricht Treaty is that the relevant country must remain within ERM II[10] without severe tensions for a minimum of 2 years, i.e. there must be no devaluation during this period. Under this currency system, the exchange rate against the euro is allowed to fluctuate within a range of +/– 15 % around a central parity rate. At the margins of this range, the respective central bank and the European Central Bank are obliged to intervene. Of course, the candidate countries still have the option of narrowing this range by intervening in the currency market themselves. The central rate may also be adjusted (up or down) if there are particular tensions in the exchange rate mechanism.

If the new EU member states were to join ERM II on the EU accession date i.e. the beginning of May 2004, the earliest point at which the EU would assess their compliance with the conditions for entry into EMU would be two years later, i.e. mid-year 2006. If given the go-ahead, the member states would then still have to meet the organizational requirements for membership of the euro area, e.g. make the necessary arrangements for introducing euro notes and coins, which would again take time. **Therefore, the earliest possible date for EMU membership would be 2007[11].**

Is such a date realistic? Two questions must be answered:

1. Will the states enter ERM II immediately after accession to the EU, and if so, under what criteria?
2. Will the accession countries be in a position to fulfill the remaining criteria of the Maastricht Treaty after 2 years in ERM II?

EXCHANGE RATE SYSTEMS IN MOST ACCESSION COUNTRIES LITTLE DIFFERENT FROM ERM II

The first question is certainly the easier to answer. **There is much to recommend early entry into ERM II.** First, the exchange rate systems used by most of the accession countries are little different from the ERM II mechanism, except that in the latter the European Central Bank is obliged to intervene. Secondly, some states, such as Hungary, have already expressed their desire to join the exchange rate mechanism as soon as possible.

[9] See Dresdner Bank: Investing in Central and Eastern Europe, July 2003.

[10] Exchange Rate Mechanism II.

[11] See Attlila Csajbók-Agnes Cermeli (ed.): Adopting the Euro in Hungary: expected costs, benefits and timing, in: Hungarian National Bank: Occassional Papers 2002/24, especially pg. 149 & 152.

HIGH ENTRY RATE DAMAGES INTERNATIONAL COMPETITIVENESS

But even early entry into ERM II is not a given. **Boosted by heavy capital flows from western Europe, eastern European currencies have tended to gain strength against the euro in recent years.** This uptrend has been supported by high inflows of both direct investment and portfolio capital attracted by handsome yields on the eastern European capital markets. The flip side of these capital inflows, however, has been the erosion of international competitiveness in the accession countries, as reflected in rising imports and only a moderate increase in exports. This in turn has worsened a less than rosy employment situation and left politicians far from happy.

Seen from this angle, lower exchange rates, i.e. currencies falling away from current levels, would therefore be highly desirable, particularly with regard to the ERM II entry rate. Yet although the ERM II parity rate does not necessarily have to be identical to the conversion rate set for EMU entry, devaluation within ERM II would postpone entry into monetary union to a point that may no longer be politically desirable.

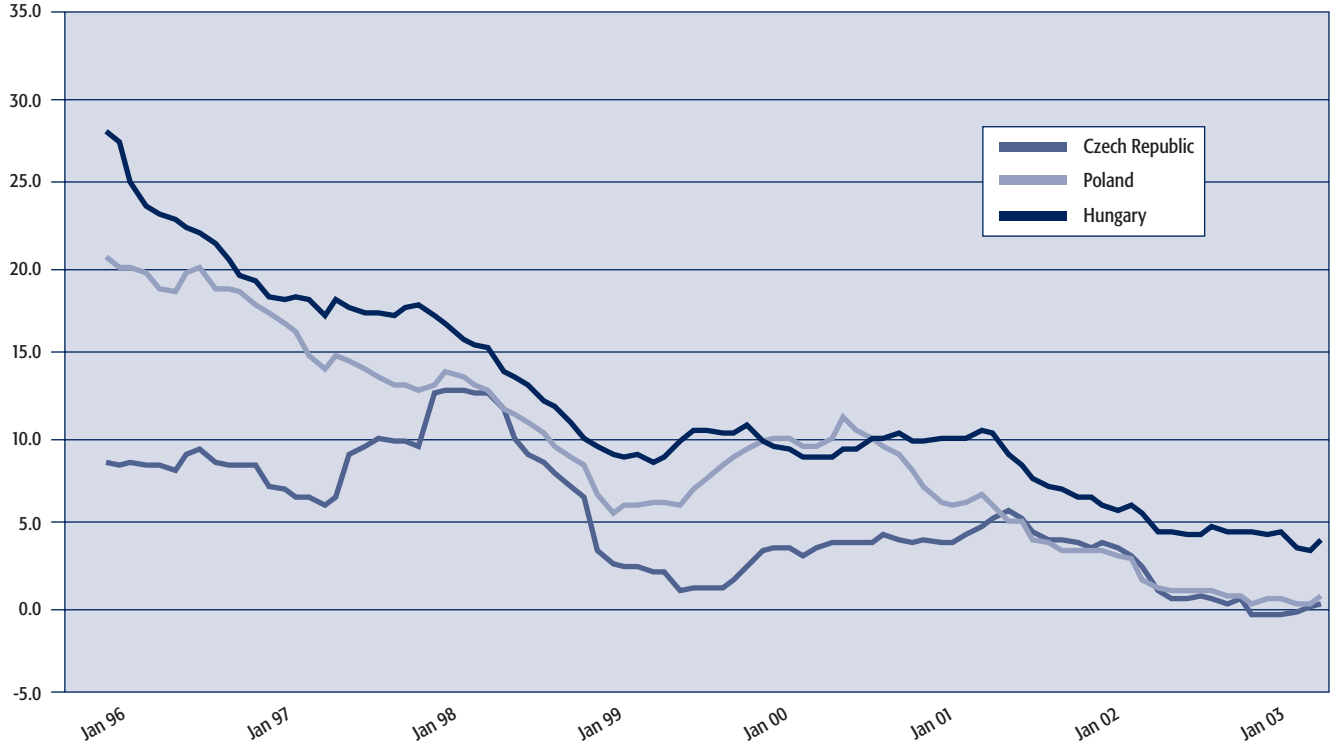
A lower entry rate would, to a certain extent, allow the states to conserve international competitiveness when, as is now the case for most acceding countries, inflation levels exceed those of EMU members. With this strategy, the acceding states would be following in Greece's footsteps. The drachma entered EMU at an extremely low rate in 1999. For one and a half years, the drachma then floated almost without exception below its parity with the euro. In January 2000, in order to bring the subsequent conversion rate more into line with the actual exchange rate, the Greek currency was actually revalued by 3.5% against the euro.

However, in the case of the eastern European countries, bringing down the exchange rate is no easy task. The central banks of the future EU member states have already drastically cut interest rates for all money-market operations, not least in response to the substantial drop in inflation in almost all the countries over recent years. The remaining option would be currency-market interventions by the respective central banks against their own currencies. However, as politically motivated currency interventions in western Europe have shown over the last three decades, these have little influence on longer-term market trends.

Moreover, such a step is not without risk. Once set in motion, expectations of a currency's depreciation tend to snowball, with the result that the ultimate fall in value may be greater than originally intended, as Hungary is currently finding out. Against a backdrop of rising budget and current account deficits, high yields on Hungarian government bonds issued on the domestic capital market, as well as the prospect of a relatively stable exchange rate, have attracted a great deal of capital from western Europe in recent years. Then, in May 2003, investor confidence suddenly collapsed, resulting in substantial capital outflows. Since then, the forint has tended to weaken and the central bank has been forced to raise interest rates substantially. The volume of government bonds currently held by foreign investors is worth more than € 8bn or almost 15% of GDP. An additional massive capital outflow could easily overstretch the foreign currency available to the local currency market. This would probably force the central bank to abandon its current exchange-rate model, which would cause the currency to plummet.

The road to ERM II is therefore not without its pitfalls. In principle, it may well be better that any problems occur before entry into the monetary system than afterwards. Should these difficulties prove extensive, however, it would be entirely plausible to enter after the EU accession date. Nor does it necessarily mean delayed entry into monetary union if it is assumed that the candidate countries will not fulfill all the Maastricht criteria by 2007 anyway, forcing them in any case to aim for a later EMU entry date.

INFLATION RATES
– % INCREASE IN CONSUMER PRICES ON YEAR EARLIER –



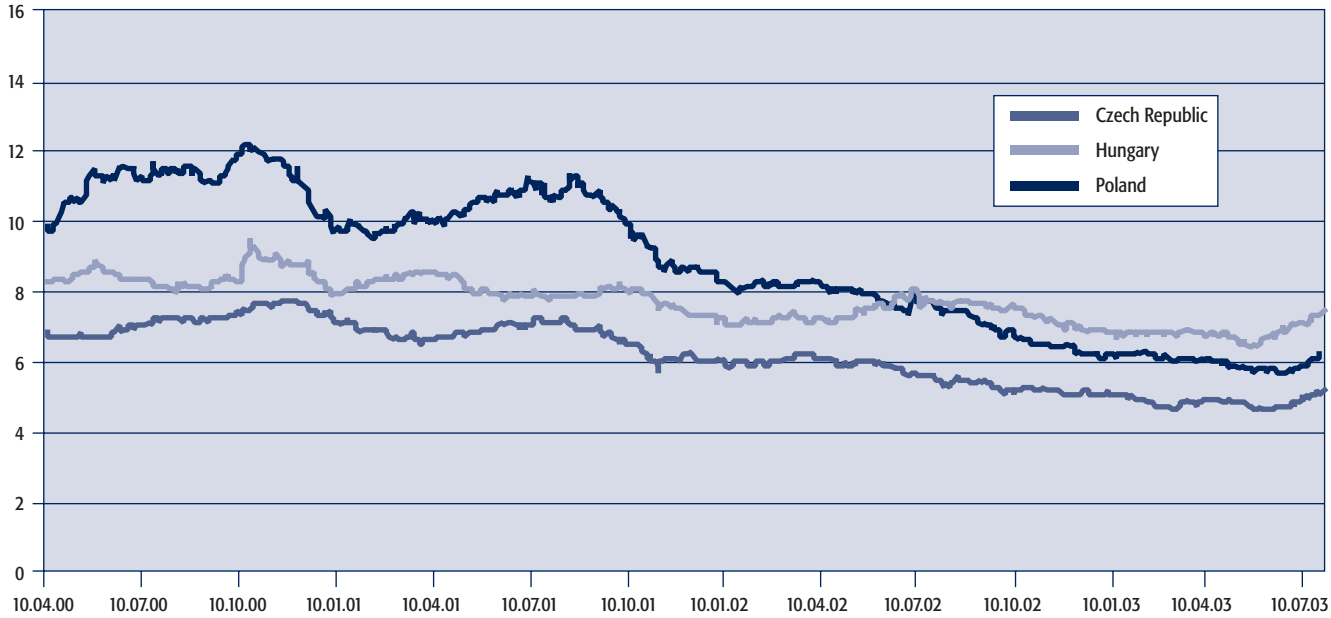
Source: Institute of International Finance.

7.4 NO PROBLEM: INFLATION AND INTEREST-RATE CRITERIA

Meeting the inflation criterion, by contrast, is not likely to be a problem. As the chart shows, inflation rates in Poland, the Czech Republic and Hungary have shown a strong convergence towards extremely low levels in recent years. The Czech Republic and Poland already fulfill the inflation criterion while Hungary will need a couple of years of careful economic management before it manages to bring its inflation rate down to below the reference value. In the Baltic states, consumer price increases have also remained below the 2.5 % mark. At 7.6 % and 5.5 % respectively, the only significantly higher inflation rates recorded were in the Slovak Republic and Slovenia in June of this year. But even in these last two cases, lower inflation rates in the future are a distinct possibility. Poland, whose inflation rate in mid-2002 still ran into double figures, may serve as a role model in this respect. Overall, the central banks of these accession countries have made astounding progress in taming inflation over the past few years. This is a particular achievement given that the inflation rates of our eastern neighbors also reflect the lifting of price controls and the relative lack of competition compared to the West.

The same can be said of long-term interest rates. These have followed the same path as inflation rates, converging to a considerably lower level than in previous years, with the slight increase over the last few months doing little damage. In the other states, too, there is a downtrend in interest rates. Admittedly, the small scale of the economies hardly allows for representative capital market listings for government bonds. What is more, the prevailing budgetary surpluses of the past few years, including Estonia's, for example, have limited the supply of longer-dated government paper.

CAPITAL MARKET YIELDS
– 10YR GOVERNMENT BONDS –



Sources: National Statistics, Ecowin.

INTEREST RATE CRITERION AS EASY TO MEET AS INFLATION CRITERION

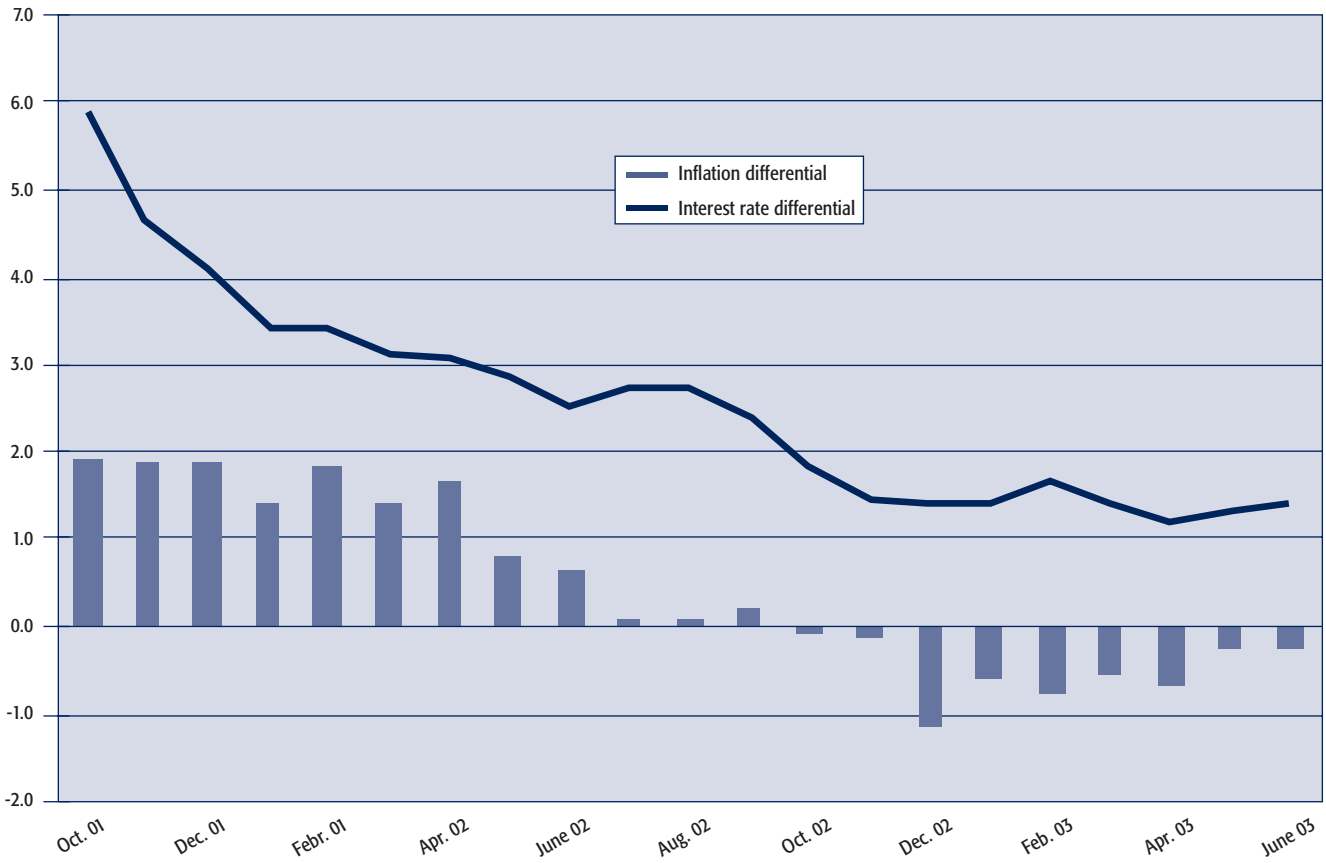
In most cases, the difference between the capital market yields and the corresponding euro-area benchmarks is greater than the inflation gap. Yet this should not lead us to the conclusion that the accession countries will find it more difficult to meet the minimum requirement for interest rates than for inflation. In Poland capital market yields have in fact fallen more quickly over time than the inflation rate. The first point to note is that interest rates began at an initially higher level. Secondly, as EMU entry appears on the horizon, long-term interest rates will experience "complete convergence", mirroring the trend during the run-up to EMU in the second half of the 90s.

7.5 CRITICAL: BUDGET DEFICIT

For most of the accession countries, the budget deficit criterion of the Maastricht Treaty will be a particular bugbear. Weak economic growth in western Europe is weighing on exports from our eastern neighbors, thereby stunting their own economic growth and tearing holes in their budgets. Domestic conditions are also taking their toll. The banking crisis at the end of the 90s is still having a negative effect in the Czech Republic, while in Poland and Hungary, new governments coming to power in 2001 and 2002 have meant vast increases in public spending.

POLAND: INFLATION AND INTEREST RATE DIFFERENTIAL

– % –



Source: Calculations based on IIF/Ecowin figures.

YAWNING BUDGET DEFICITS IN MANY ACCESSION COUNTRIES

Structural changes are also far from complete and still stretching the budget. Poland's unemployment rate is almost 20%, causing the government to shy away from further privatization and instead subsidize state-owned enterprises to keep them afloat. Including all local authorities, Hungary, Poland and the Czech Republic have respective budget deficits of 9.6%, 6.5% and 7.3% of GDP[12]. We estimate that these deficits will grow in 2003, with the exception of Hungary, whose deficit may well shrink but still miss the required target by a long shot. The Slovak Republic is no exception to the rule either, recording a budgetary gap of more than 7% of GDP for 2002. In contrast, Slovenia and the Baltic states are already effortlessly fulfilling the Maastricht criterion, which requires a budget deficit of 3% or less.

HOST OF EMU MEMBERS CURRENTLY BREACHING DEFICIT CRITERION

In the few years remaining, will it be possible to reduce such budget deficits as those of Hungary, Poland and the Czech and Slovak Republics to a level that would satisfy the Maastricht criterion and allow a very early entry? How stringently will this criterion be applied in the all-important assessment? And in this respect, is it even fair to ask accession countries already having to implement structural change at lightning speed to do something that a whole host of EMU members are currently failing to achieve? Does the currently witnessed relaxation of the stability pact not suggest that the criteria will be applied more generously to the accession candidates than originally intended?

[12] Own estimates based on national statistics. They cover public spending as a whole, thus including all government levels. Deviations from these figures are possible depending on the source and definition used.

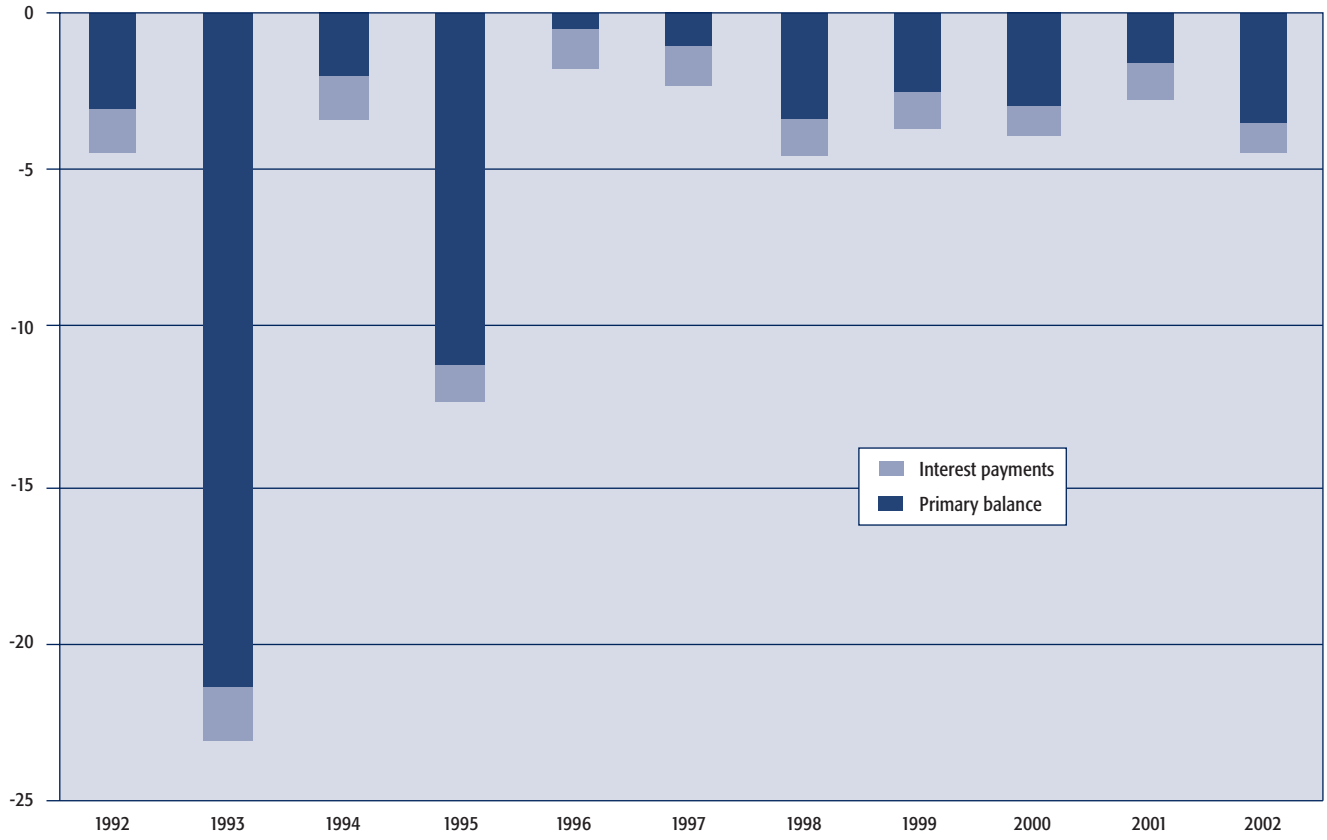
First, let's step back to 1996, i.e. three years before EMU. Of the future member states, only Ireland, Luxembourg and the Netherlands had public sector deficits below the 3% mark. Italy's deficit ran to more than 7% of GDP. Based on these figures, the following years bore witness to an unprecedented budgetary consolidation that smoothed the path into the euro area.

Is similar success to be expected for eastern Europe? The parallels are unmistakable. If economic policy is geared towards this goal, it can generally be reached. **The question is whether an EMU-driven deficit cull will justify the costs it entails.** This point becomes all the more pertinent if the circumstances in which convergence took place before 1999 are compared with those that will apply to the eastern European EU-states over the next few years. Two aspects are particularly important:

First on the list is the strong economic growth that prevailed in the euro area towards the end of the 90s, pumping tax revenues into the public coffers. Real GDP, for example, grew by as much as 2.3% in 1997 and 2.9% in 1998. Figures of this magnitude are not be expected for this, nor next year. **As a result of extensive trade with the EU, eastern Europe mirrors the economic cycle of the West, albeit with a 6-month delay.** Economic growth will firm up here too, but certainly not domino into an economic boom. An additional windfall in tax revenues is certainly not on the cards.

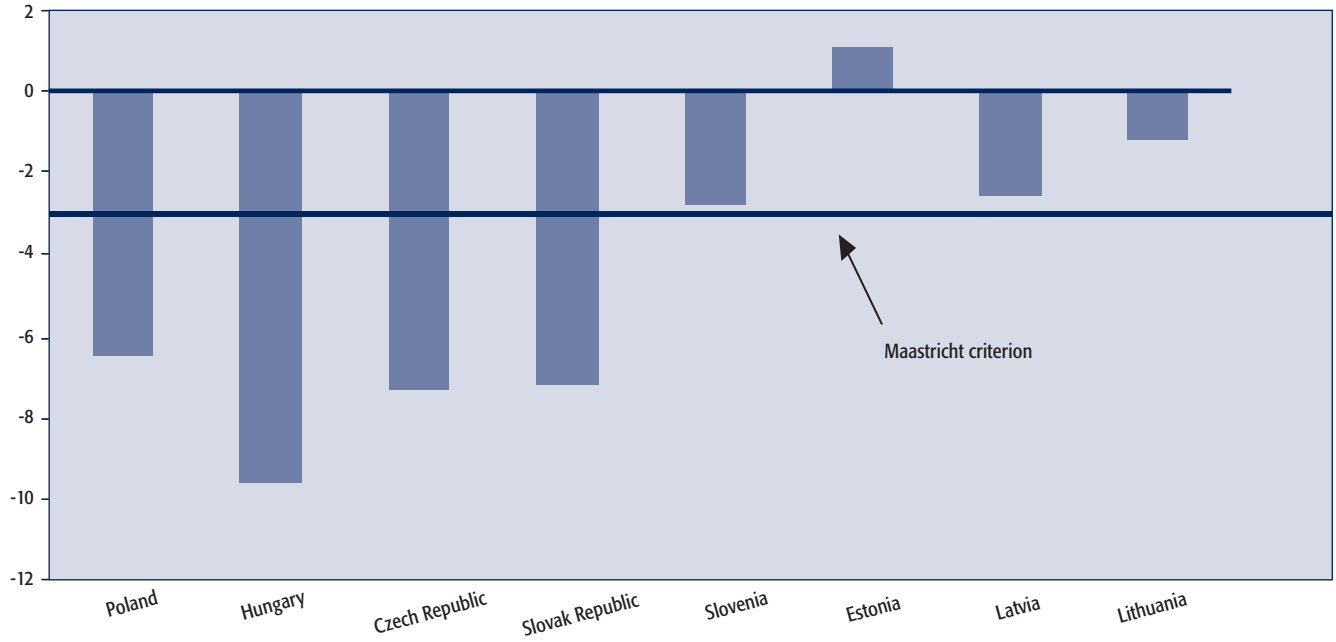
CZECH REPUBLIC: INTEREST PAYMENTS AND PUBLIC SECTOR PRIMARY BALANCE

– AS % OF GDP –



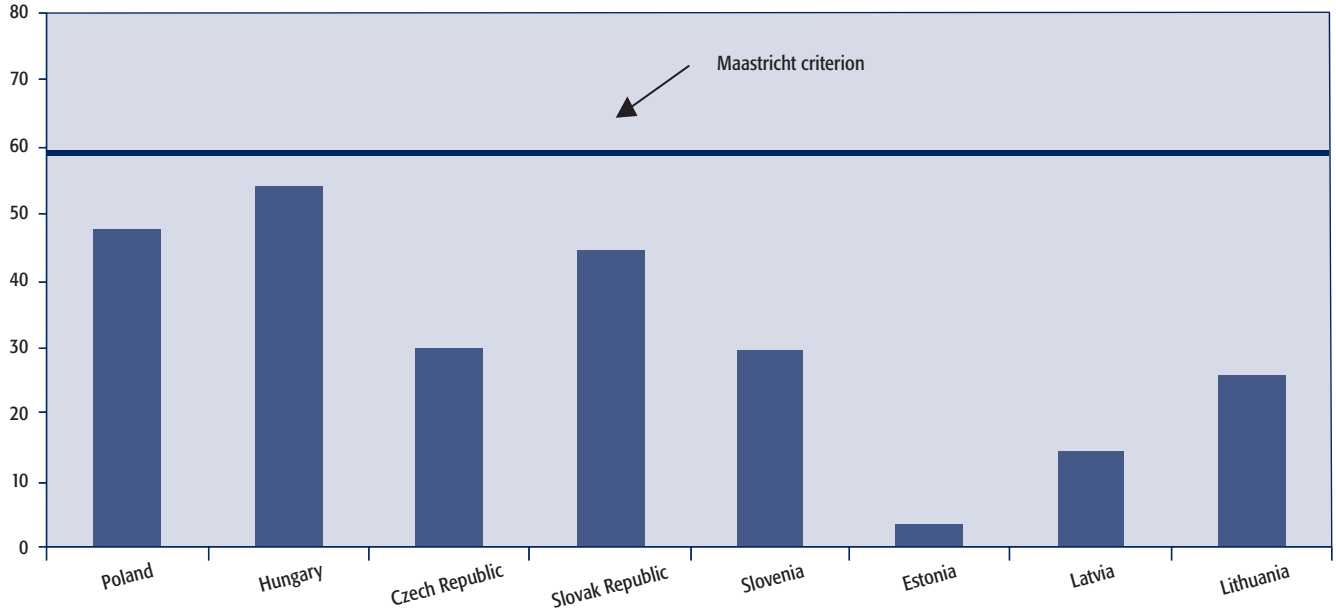
Source: OECD.

BUDGET DEFICIT 2002 AS % OF GDP



NATIONAL DEBT 2002 AS % OF GDP

– OVERALL PUBLIC SECTOR; HUNGARY, SLOVENIA AND ESTONIA: CENTRAL GOVERNMENT ONLY –

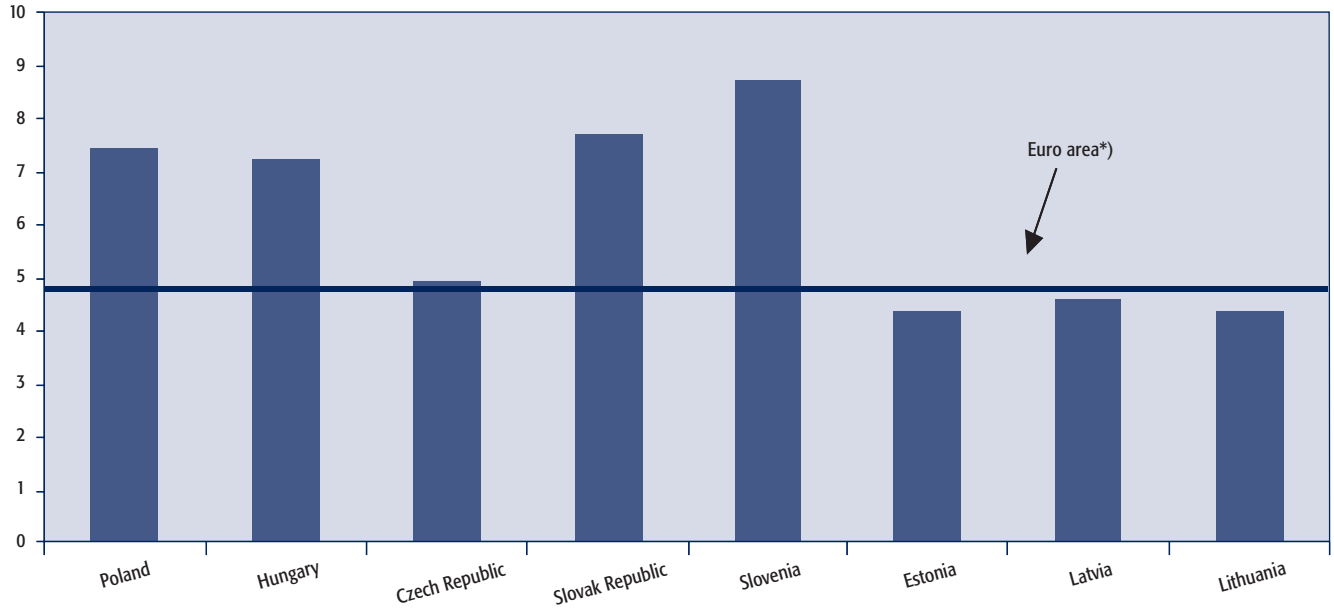


Sources: National statistics, IMF, IIF.

Italy's budgetary consolidation prior to 1999 profited considerably from tumbling interest rates. Given the country's high debt-to-GDP ratio, the plummeting interest rate led to appreciable savings in public expenditure. Public sector interest payments as a percentage of GDP, for example, fell from almost 11% in 1996 to a good 6% in 1999. When Greece entered EMU, almost 2 years later than planned, similar circumstances prevailed.

INTEREST RATES 2002

– POLAND, HUNGARY AND CZECH REPUBLIC: YIELD ON 10YR GOVERNMENT BONDS; OTHERWISE MONEY MARKET RATES –



* = average long-term government bonds.
Sources: IMF, OECD, Ecowin.

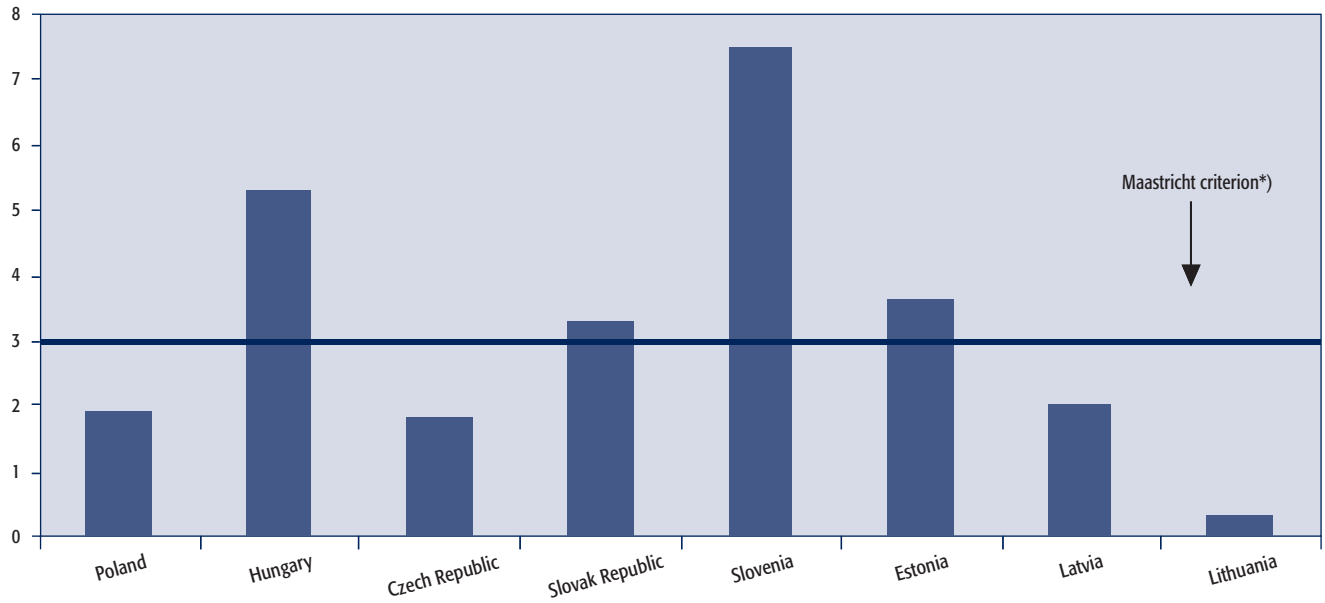
Given their late start as market economies, the public debt of our eastern European neighbors is still far below levels seen in Greece and Italy. Moreover, as already stated, interest rates have already fallen sharply in most of these countries. The chart for the Czech Republic clearly illustrates that the bulk of public sector borrowing can be attributed to the primary deficit, i.e. the budget deficit excluding interest payments. **The positive impact of falling interest rates on budgetary consolidation will therefore not nearly be as strong in the accession countries as it was in Italy and Greece.** Even the generous subsidies being handed out by Brussels will not help in finding a solution to this budgetary mess, since the additional support from the structural and cohesion funds will be offset by correspondingly higher expenditure. In order to substantially reduce the budget deficit, it would be essential to increase taxes and/or curb spending. Since the former can only be achieved to a limited extent, budgetary consolidation must rely on spending cuts.

BUDGETARY CONSOLIDATION VIA TAX INCREASES OR SPENDING CUTS

Would this be politically acceptable? 2004 in Poland and Hungary and 2005 in the Czech and Slovak Republics are parliamentary election years, which, as experience has shown, are not the ideal time for retrenchment. We therefore harbor grave doubts as to whether the governments will take up the gauntlet of budgetary consolidation in order to introduce the euro as early as possible. On the contrary, there is a danger that politicians in the larger accession countries will flinch from the important task of reducing budget deficits, thereby pushing EMU entry further and further back. The best remedy for this is to publish a binding and realistic entry date as soon as possible.

Unlike the budget criterion, the condition that public debt must not rise to above 60% of GDP is one the states are more likely to be able to fulfill. Having only adopted a market economy and corresponding accounting system some 13 years ago, these states still have a relatively low level of national debt. Nevertheless,

INFLATION RATES 2002
– % INCREASE IN CONSUMER PRICES –



* = Average of 3 best performing member states plus 1.5 percentage points.
Source: IMF.

as a result of high budget deficits at a time of comparatively weak economic growth, national debt in the larger accession countries is climbing rapidly. In this respect, the future EU states are in a position diametrically opposed to that of Italy and Belgium in the years leading up to EMU. National debt may have been exorbitantly high in both these countries, but public sector borrowing was abating.

Due to this downward trend, the European Council decided to accept both countries despite their high debt levels. The greater emphasis this approach places on the budget deficit strengthens our belief that those countries with public sector deficits above the target will have to reduce these substantially to be accepted into monetary union. Yet bearing in mind the questions raised earlier, this does not necessarily mean that the deficit must be exactly 3% or less. But the trend in and intensity of budgetary consolidation will need to fit the bill.

The Maastricht Treaty also stipulates that the convergence of each member state must be sustainable. The Deutsche Bundesbank, however, does not consider this to go far enough and considers a "real convergence" to be necessary. This includes structural adjustment and reform[13]. These factors certainly give greater scope for interpretation than the numerically based and therefore "tougher" conditions set out above. In other words, **it will be impossible to exclude a country from EMU if it meets the conditions explicitly cited in the treaty text, even if opinion is divided on the degree of convergence achieved.**

[13] See Deutsche Bundesbank: Die Europäische Wirtschafts- und Währungsunion (Sonderveröffentlichung) (special publication on European economic and monetary union), 2002, especially pg. 86/87. Additionally, Deutsche Bundesbank: Monthly Report, July 2003, p. 15 et seq.

7.6 ENTRY DATES 2007 AND 2009

BALTIC STATES ALREADY FULFIL ALMOST ALL CRITERIA

The Baltic states and Slovenia already fulfil almost all of the "tough" conditions of the Maastricht Treaty. Entering into monetary union will change little for those countries who already have currency boards, i.e. Estonia, Latvia and Lithuania. Moreover, these are all smaller-scale and therefore extremely open economies. Given the large proportion of GDP made up by foreign trade, the euro is already playing a larger role in these as opposed to the other accession countries. **All four states will therefore attempt to enter EMU as soon as possible, i.e. at the beginning of 2007. Malta and Cyprus will also be in the first wave.** This gives monetary policymakers in the euro area the advantage of gaining important experience with a manageable number of new members before the larger states join.

POLAND, HUNGARY AND THE CZECH AND SLOVAK REPUBLICS LIKELY TO JOIN EMU IN 2009

We assume that Poland, Hungary, and the Czech and Slovak Republics will not drag their feet in reducing their budget deficits, but approach the task with verve. Shored up by resurgent economic growth in both western and eastern Europe, budget deficits will fall, allowing entry at the beginning of 2009.

It is unlikely that there will be more than two rounds of EMU enlargement, as this would mean "permanent" institutional upheaval for the respective boards of the ECB, something that would not bode well for a stable monetary policy. There would also be more statistical gaps in data, further hampering the monetary policy analysis that provides the basis for monetary policy measures.

Will individual accession countries attempt to introduce the euro under their own steam? Although this would theoretically be possible, it would be an affront to the Maastricht Treaty and the European Central Bank. After all, the euro should only make an appearance where the right conditions are met. We therefore do not foresee any unilateral euroization. The euro is much less widespread as a means of payment, a unit of account and a store of value than is the case with the US dollar in many other emerging countries. In Croatia, for example, the share of overall bank deposits denominated in euros is substantially higher than in either Estonia or Poland.

Nor do the accession countries really need to introduce the euro unilaterally as i) they will be able to enter EMU soon enough and ii) they are already reaping the benefits before the event. This is something that EMU enlargement to the East will have in common with the very first round of monetary union.

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