Michael Bolle (ed.)

Eurozone Enlargement

Exploring Uncharted Waters

Editor's note

On 1st May 2004, ten countries joined the European Union (EU). The new members are Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia. Enlargement will increase the EU population to 450 million, making the EU the world's largest single market in population terms. A market of this size can be expected to give a boost to investment and job creation, raising levels of prosperity throughout Europe.

Enlargement will, however, create new challenges: The Central and East European Countries (CEEC) may take decades to catch up economically with their western neighbours unless adequate assistance from the old member countries is being provided. Thus, the success of enlargement depends both on the speed of the process and on the procedure how to implement the right political and economic mechanisms towards sustainable self-financed growth. This process may even be aggravated by the eurozone's eastward enlargement which strips the CEEC of monetary policy independence and the application of traditional economic instruments.

This Final Report summarizes the outcomes of a research project on "The Eastward Enlargement of the Eurozone" that has been, since 2001, conducted by leading research institutions from Estonia, Finland, Italy, Poland, Portugal and Slovenia, coordinated by the Freie Universität Berlin's Jean Monnet Centre of Excellence. The project was generously supported by the European Commission's 5th Framework Programme. The report draws on the research that has been laid down in a set of working papers and several books and analyses impacts on markets and policies, and by assessing the changes that have occurred so far. It also discusses what impact enlargement will have on the eurozone as a whole, its capacity to act, and on institutional consequences.

Under the direction of Hanns-D. Jacobsen, this report has been put together by the Berlin Group (Jochen Blessing, Thilo Bodenstein, Christian Fahrholz, Achim Kemmerling and Thomas Meyer) and the consortium members in Tartu, Helsinki, Bologna, Warsaw, Ljubljana, and Évora. Additional thanks go to our students, Stefan Hohenberger, Philipp Mohl, Oliver Pamp and Till Weber, who helped prepare the print version.

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Abbreviations

BS	Balassa-Samuelson effect
CE8	The 8 new EU members from Central Europe
CEA(C)	Central Applicant (Countries)
CEE(C)	Central Eastern European (Countries)
CET	Common External Tariff
CMEA	Council for Mutual Economic Assistance
ECB	European Central Bank
ECI	Ezoneplus composite indicator
ECOFIN Council	Council of Economics and Finance Ministers of the European Union
EFC	Economic and Financial Committee
EMS	European Monetary System
EMU	European Monetary Union
ERM II	European Exchange-Rate Mechanism (2)
ESCB	European System of Central Banks
EU	European Union
EU 15	The 15 current members of the European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IIT	Intra-Industry Trade
ILD	International Labour Division
IMF	International Monetary Fund
OCA	Optimal Currency Area
PEP	Pre-accession Economic Programme
PPP	Purchasing Power Parity
SGP	Stability and Growth Pact
SME	Small and Medium Sized Firms
TEU	Treaty on European Union (also known as the Maastricht Treaty)
WSE	Warsaw Stock Exchange

The Berlin Group

Economic, political, institutional as well as social risks and opportunities of EMU enlargement

1. Introduction

The inclusion on May 1st, 2004 of eight Central and Eastern European Countries (CEEC) into the European Union (EU), and subsequently into the European Monetary Union (EMU) some years later, will cause deep changes within the political, economic, and social settings of the Union as well as in those of the new member countries. The enlargement forces the EU not only to reform its institutions to accommodate a much larger number of member countries. Enlargement also means deeper economic integration. The new members will get full access to the European single market that allows for free movement of goods, services, labour and capital with their western neighbours. Over the next years, participation in the monetary union will be a further step in including CEEC in the EU's integration process.

The project's underlying idea is that the new EU members in Central and Eastern Europe should continue to pursue an economic strategy of real convergence to the economic levels of the "old" member countries as rapidly as possible by securing sustained growth, e.g. by increasing private savings and by reducing the current account deficit. The attempt to catch up to EU levels has produced considerable progress indeed over the recent years because the new Member States have grown faster than the EU 15 since the mid-1990s (European Commission 2004: 11) by 1.5 per cent above the EU average. The GDP per capita gap, however, still remains considerable: In 2002, only Slovenia and the Czech Republic had a GDP per capita in PPP terms above 60 per cent of the EU average, Hungary above 50 per cent, Poland, Estonia and Lithuania around 40 per cent, and Lithuania just 35 per cent.

This report will discuss the implications of a "catch-up" strategy and have a look at the economic, political, social and institutional consequences for EMU enlargement. A process of CEEC joining the eurozone, implying the reshaping of economic determinants that may lead to efficiency gains, has thus to consider economic adjustment and social costs as well because

real convergence, based on sustainable increased growth, can only be a long-term process, lasting for decades. It comes at a time when all the EU members, old and new, have to adapt to a world experiencing rapid economic and social change and restructuring, as well as trade globalisation. They will also have to come to terms with the particular challenges that derive from an ageing population, growing immigration, labour shortages in key sectors and social inclusion problems. Failure to attain real convergence[1] may jeopardize the benefits arising from EU accession and could even be a source of destabilisation for current members. It will be shown that monetary integration may fail if the CEEC do not succeed in providing rigorous and comprehensive changes in their respective economic, political and institutional environments and provide for appropriate social acceptance.

[1] At this point it should be noted that real convergence is connected with other costly kinds of convergence CEEC have to strive for, e.g., nominal convergence that calls for meeting the Maastricht criteria when entering EMU, or institutional convergence aimed, e.g., at the implementation of EU legislation.