



European integration: The economic dimension of enlargement

**Oxford, 29 April 2005
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Overview

- 1. The 5th enlargement**
- 2. Real convergence**
- 3. Nominal convergence**
- 4. Monetary integration**
- 5. The “accession dividend”**
- 6. Future enlargement**



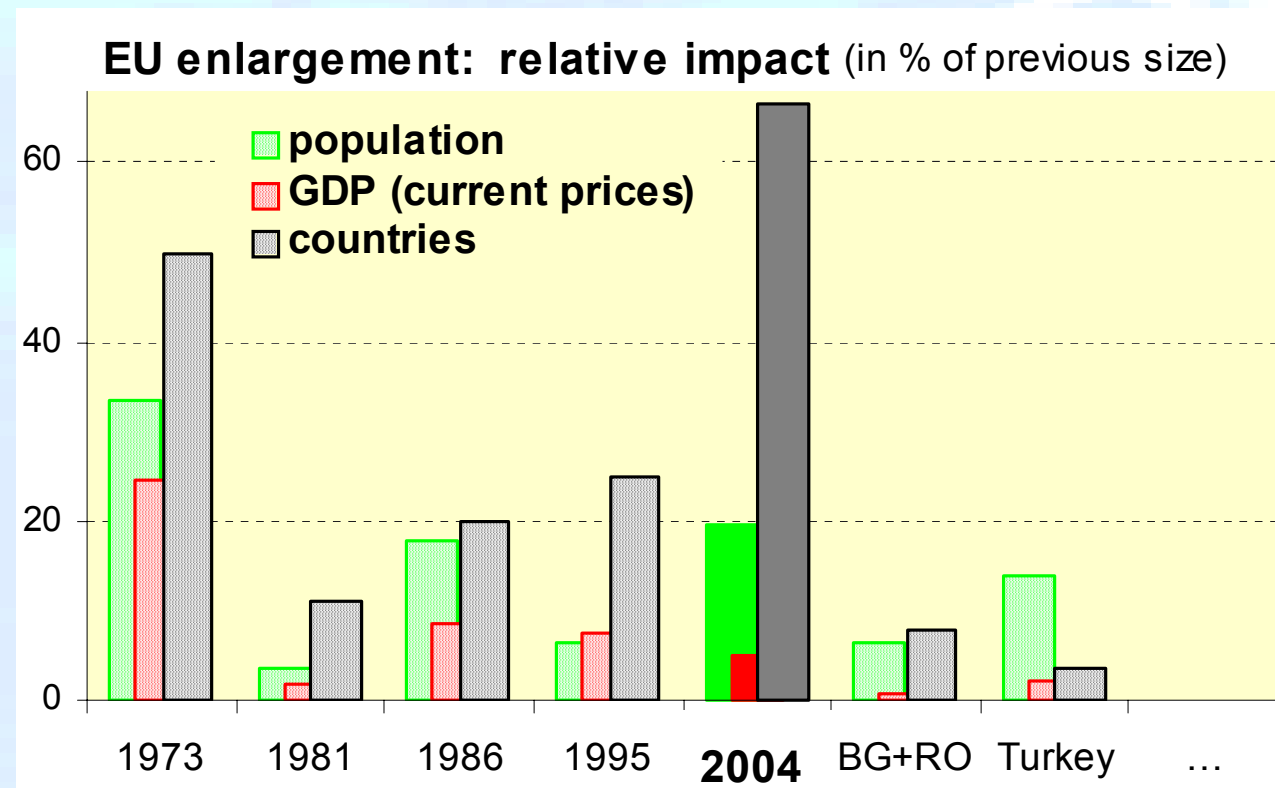
1. The 5th enlargement:

**many countries,
low economic weight,
but large structural
differences and challenges**

The 5th enlargement in 2004 ...

... was important in number of countries and of inhabitants, in widening diversity of the EU

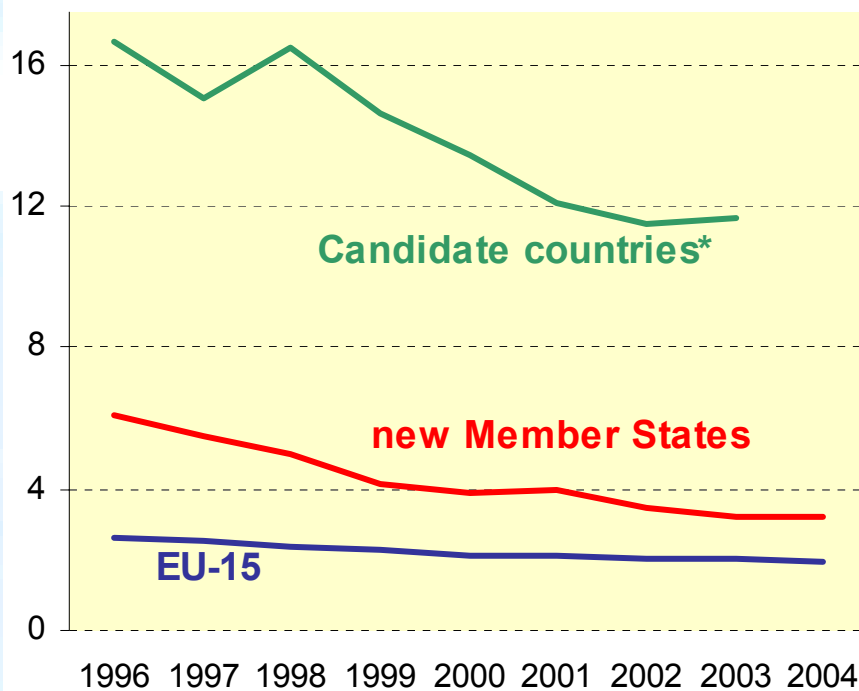
... but less so in terms of income



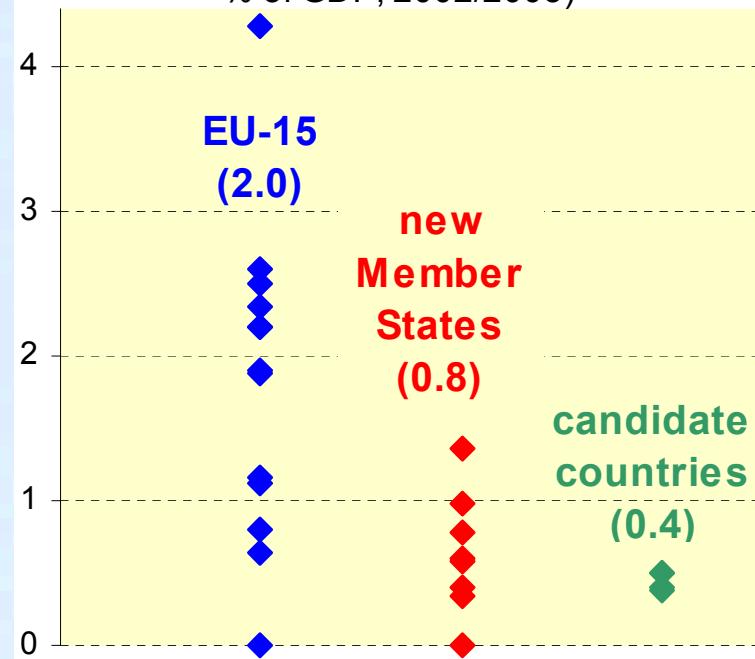
New MS and CC with different production structures ...

- Higher share in agriculture in production (and, more so, in employment)
- Longer way ahead to a knowledge-based economy

Agriculture (Share in total gross value added, %)

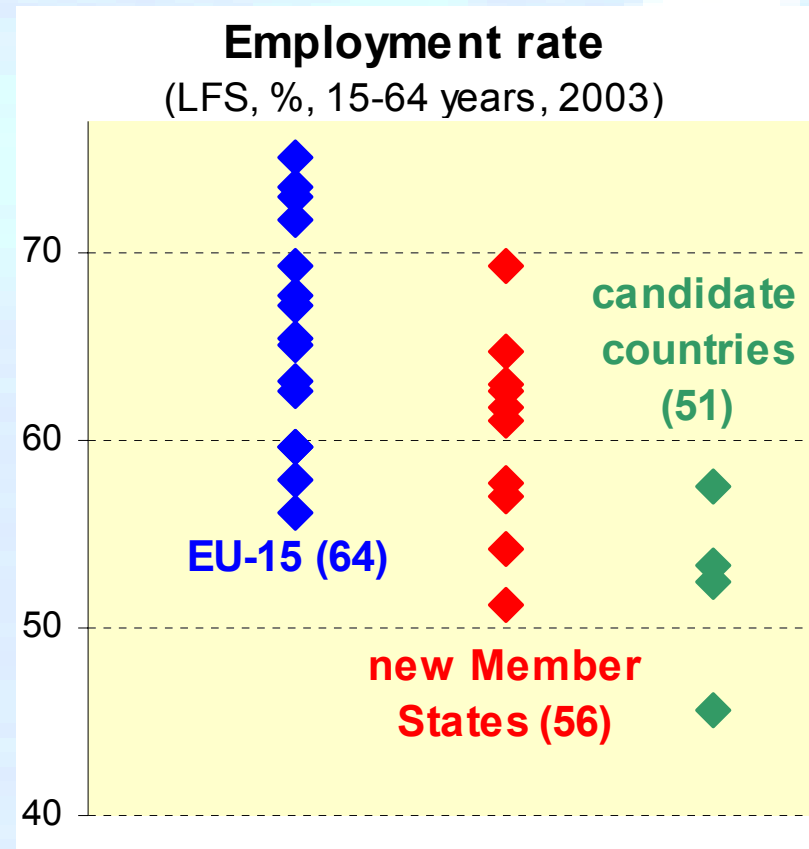


R&D (Gross domestic expenditure, % of GDP, 2002/2003)



... and lower employment

- **Employment rates are lower than in EU-15, and unemployment is higher**
- **Employment rates have in most new MS fallen over past years, reflecting restructuring and skills mismatch**



2. Real convergence

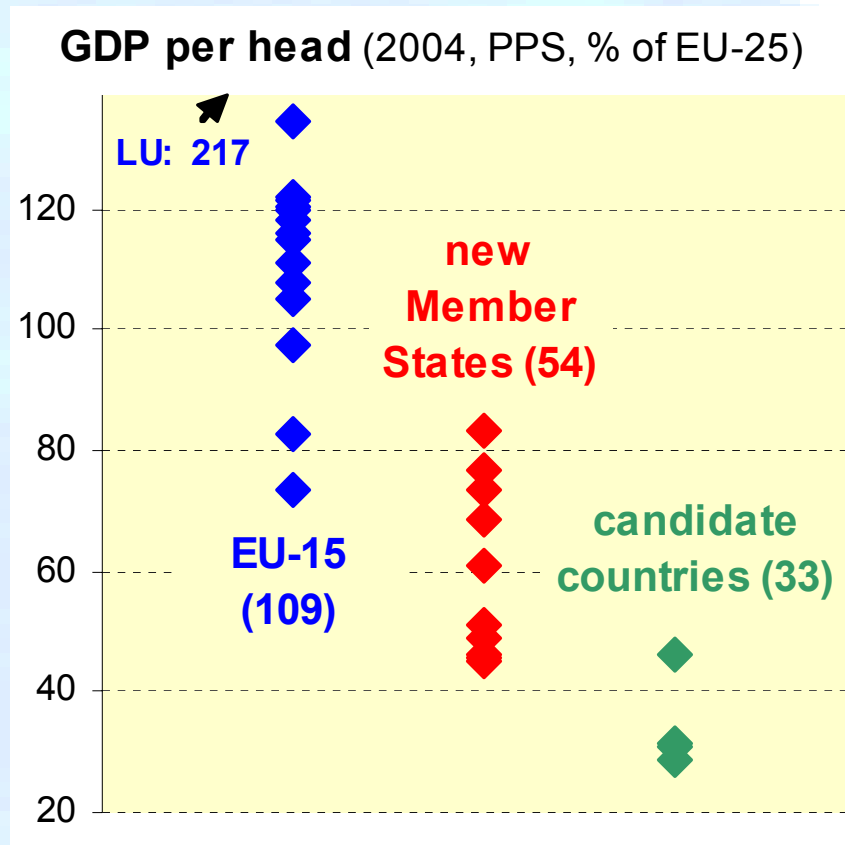
**is on track:
successful catching up,
economic integration and
synchronisation;
but still long way to go**

New Member States (MS): largely accomplished transition

- **Eight of the ten new Member States are/were transition economies**
- **Transition to a functioning market economy had sufficiently advanced** before joining the EU (accession criterion!)
 - *Market and price liberalisation, property ownership and rights, market entry and exit, overall at comparable levels to that of Member States*

New MS and CC: lower income

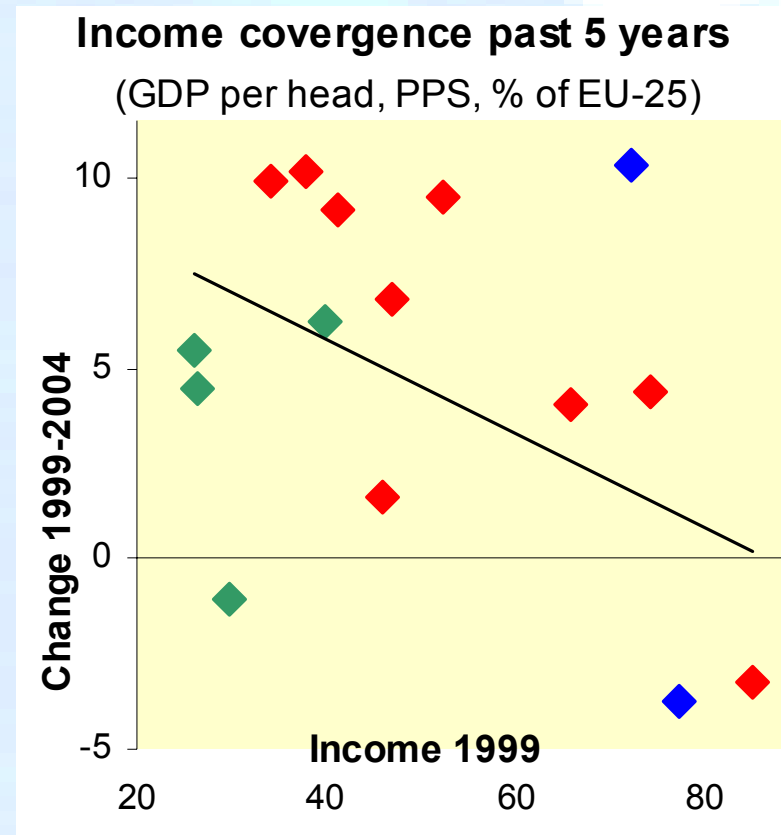
- average per capita income around half of that of other Member States
- But slowly catching up



... but catching up

Main determinants of past medium-term growth performance over medium term:

- **Macroeconomic stability**
- **Starting level of income**
- **Reform of corporate sector**
- **Financial intermediation**

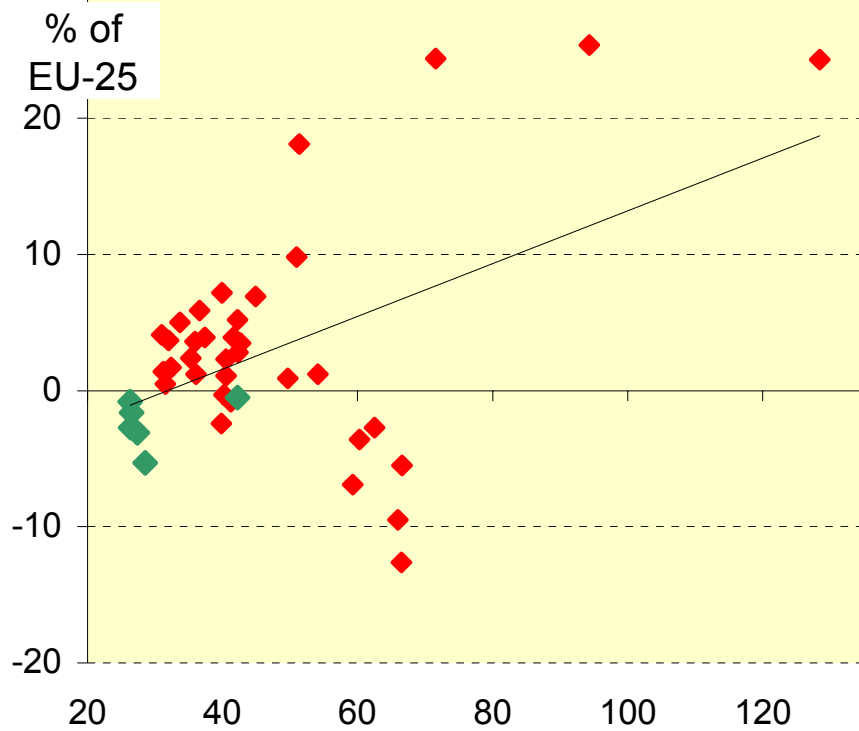


... though not evenly across regions

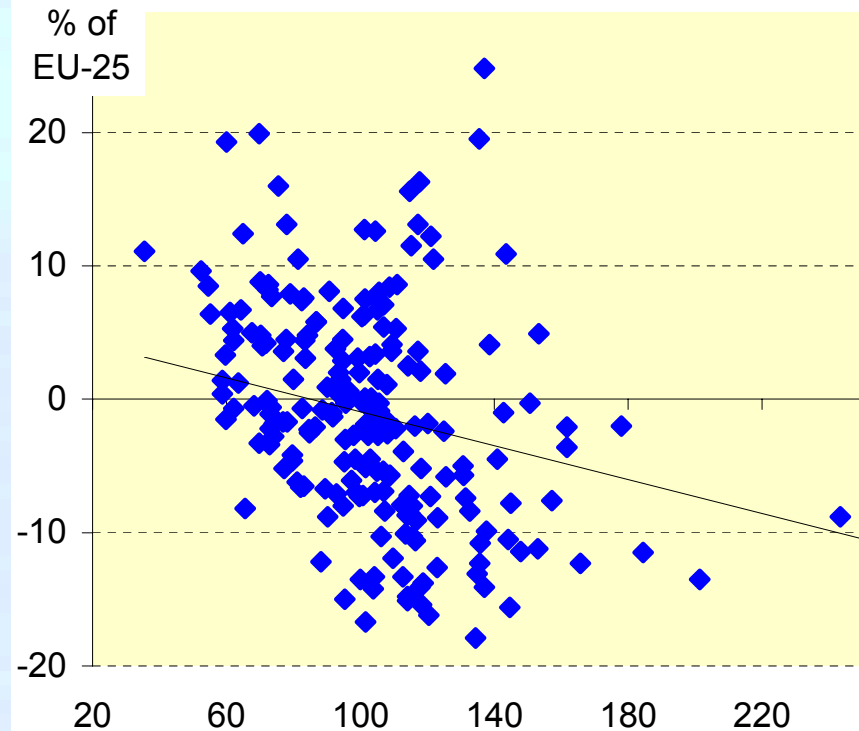
- **Catching up process has reduced income differences between countries, but raised differences within countries**
- **Emergence of “growth poles” in the countries, typically service-intensive centres, mostly capitals**

Regional income development

new MS/BG: GDP per head (NUTS 2, PPS)

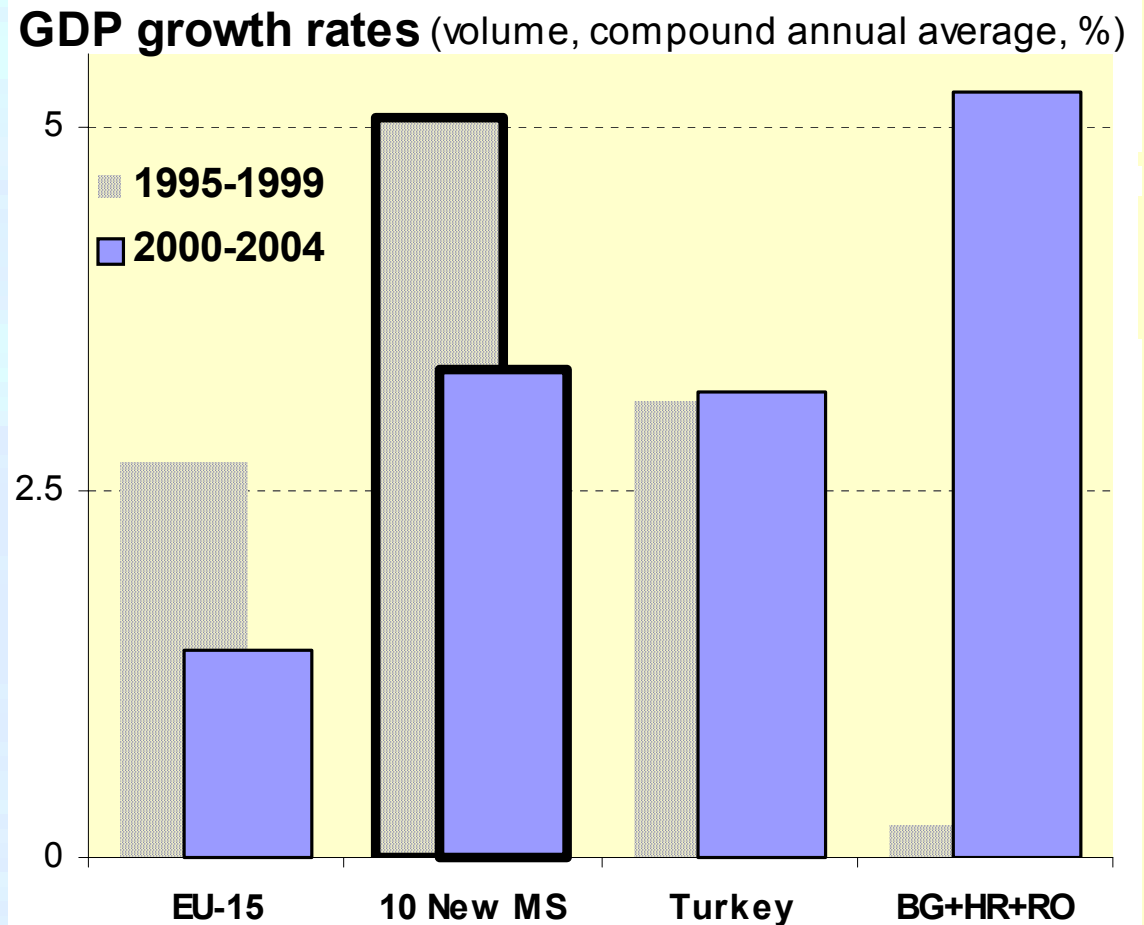


EU-15: GDP per head (NUTS 2, PPS)



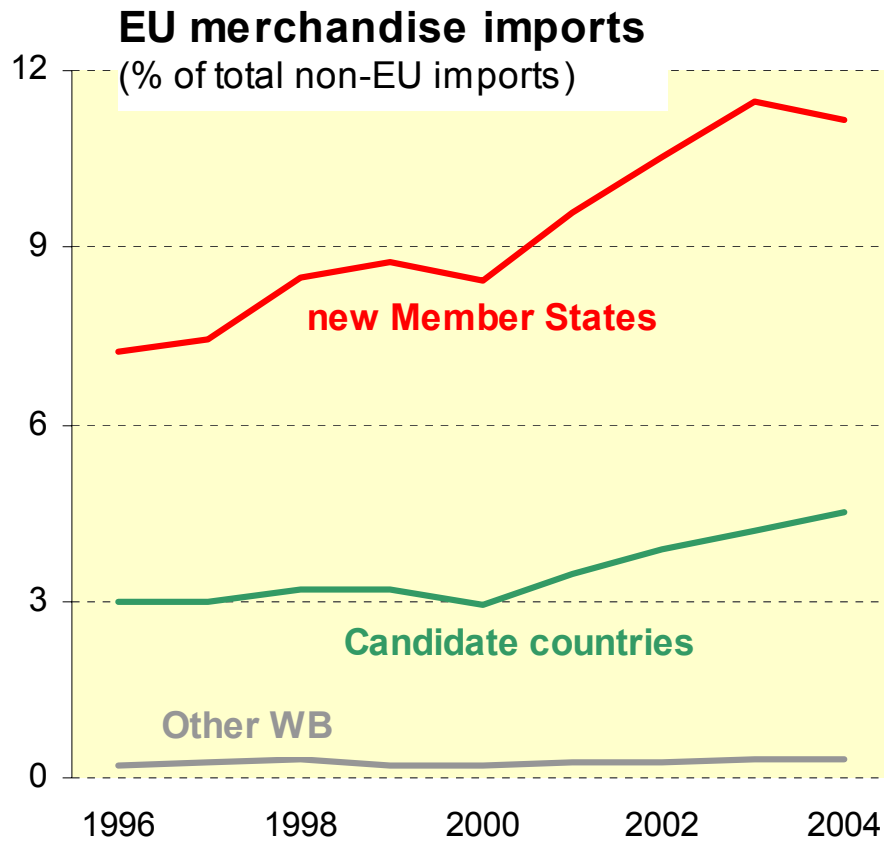
New MS and CC: solid growth

- **Initial stabilisation crises in many countries**
- **Thereafter, consistently higher growth, on average, than EU average**

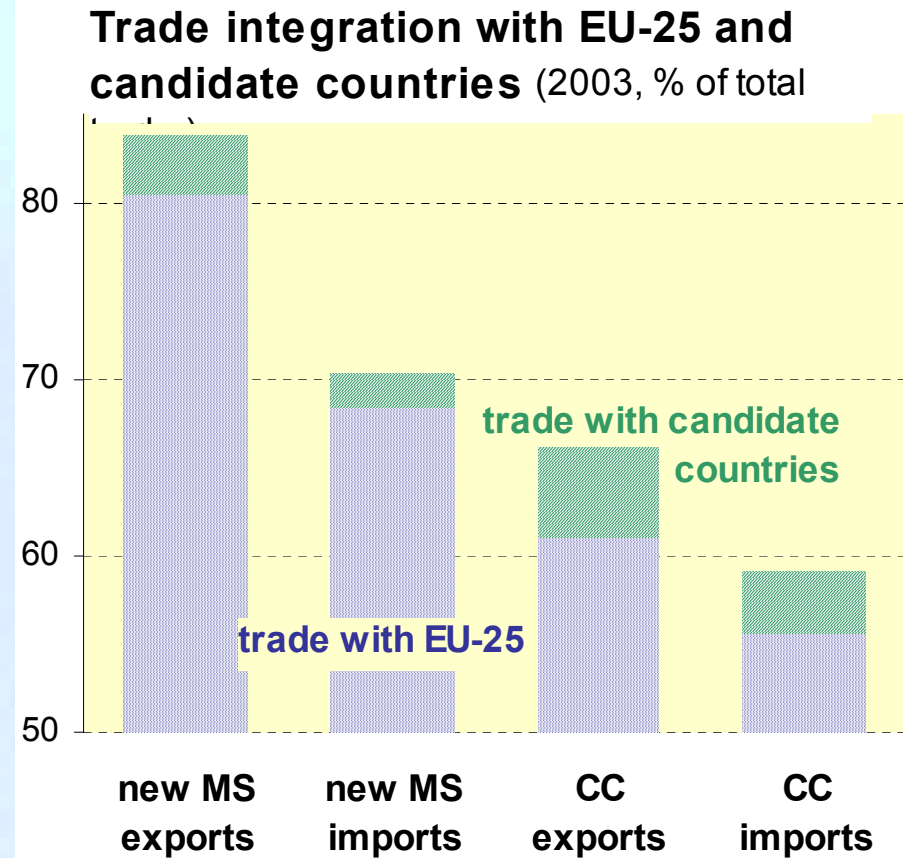


... driven by trade integration

Share of new MS and CC in EU's trade has strongly risen



Share of EU in new MS and CC trade very high, but lately not further rising

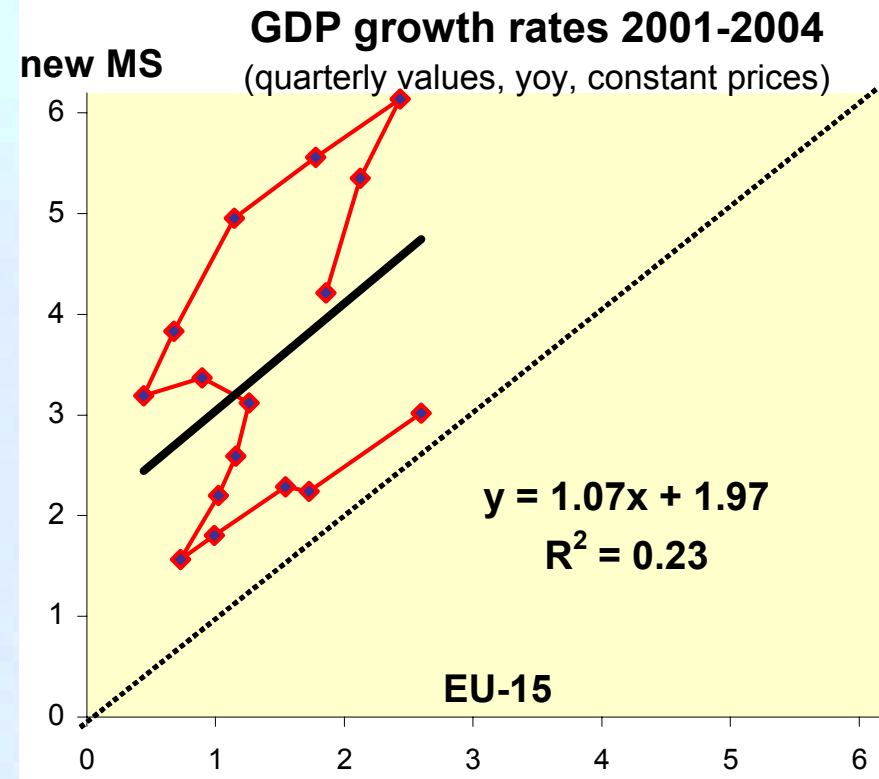
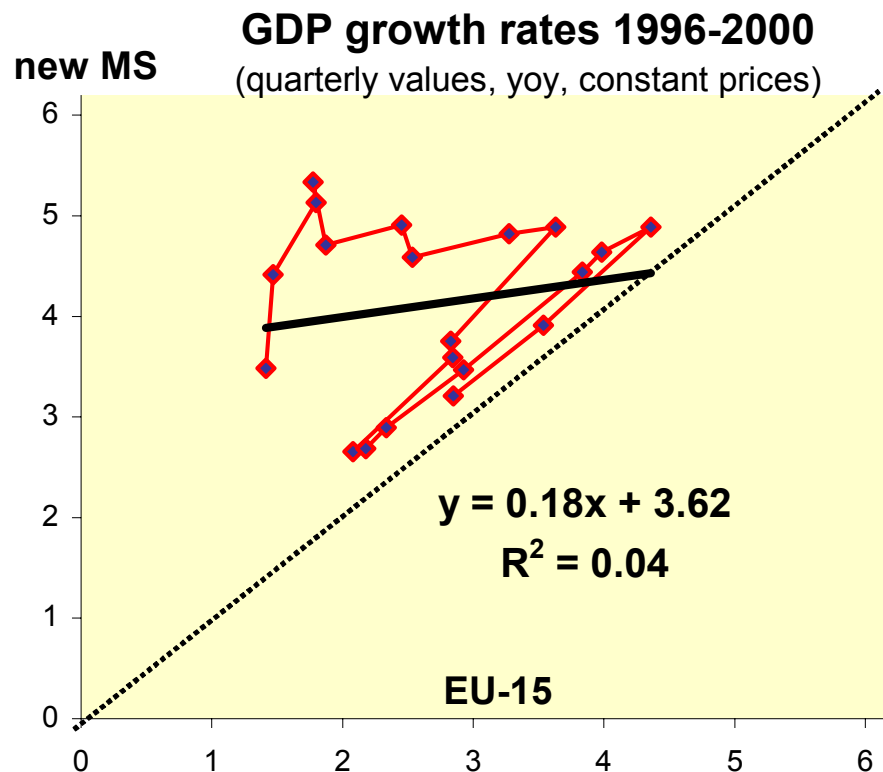


... and financial integration

- **Changing product portfolio towards capital and technology intensive products**
- **Deepening financial integration, driven by FDI**

... and business cycle synchronisation

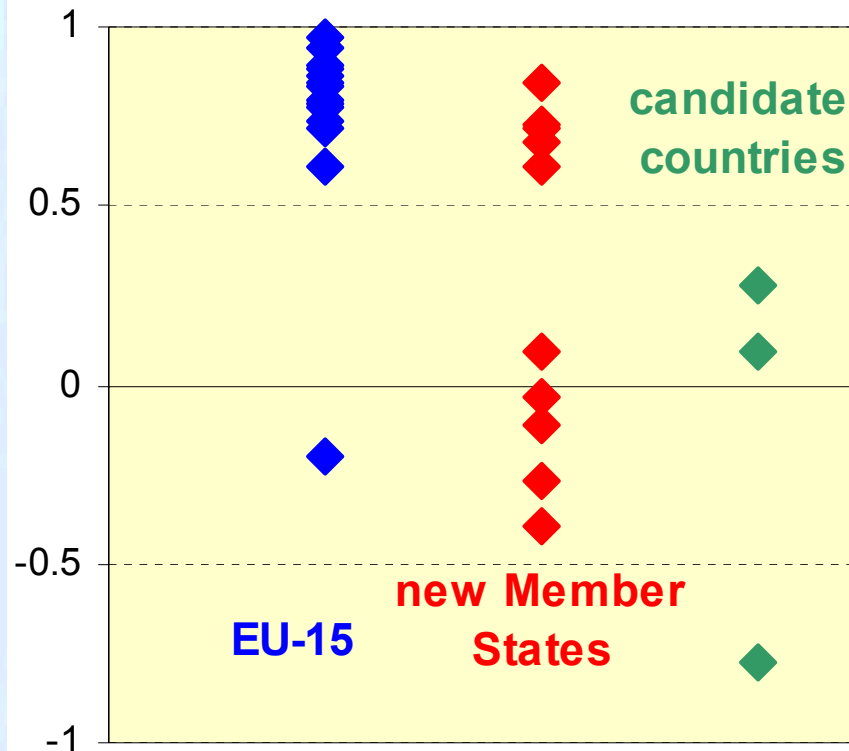
- GDP and industrial production increasingly synchronised with EU economic activity



But business cycle synchronisation still with large country differences

... dependent, among others on relative weight and integration of industrial sector

Growth rates: correlation with EU-25
(quarterly, yoy, constant prices, not s.a.)

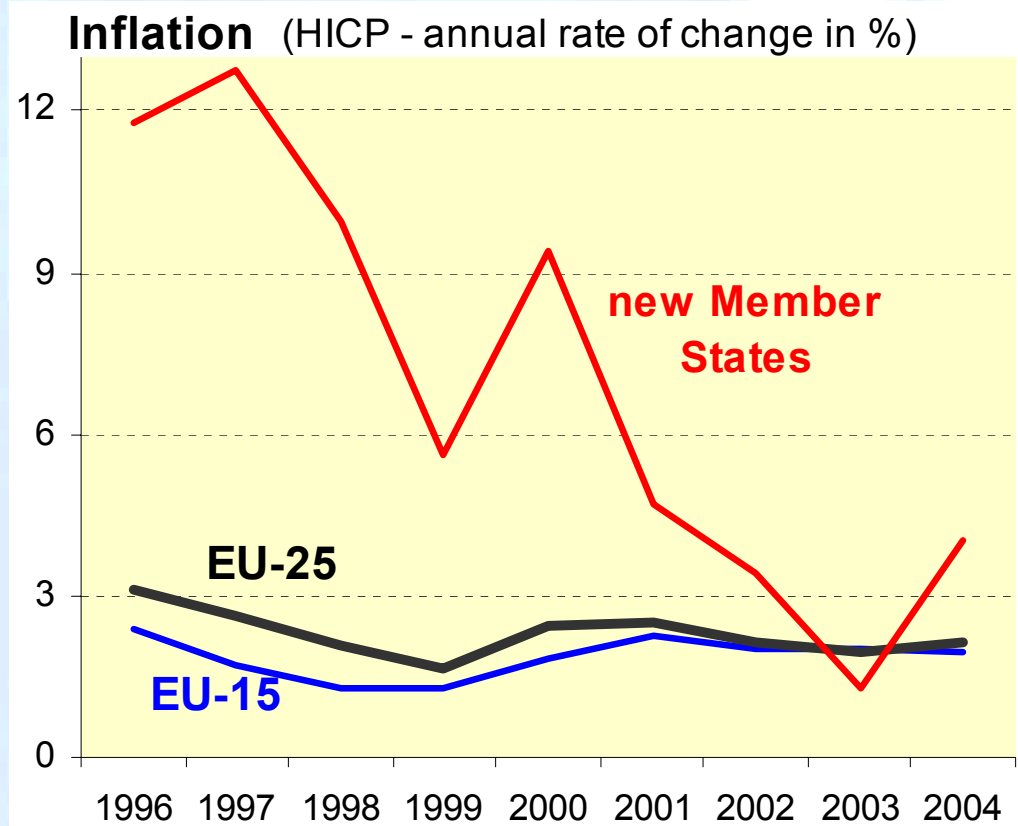


3. Nominal convergence:

**equally advancing;
fostered by real convergence
and vice versa
→ high complementarity**

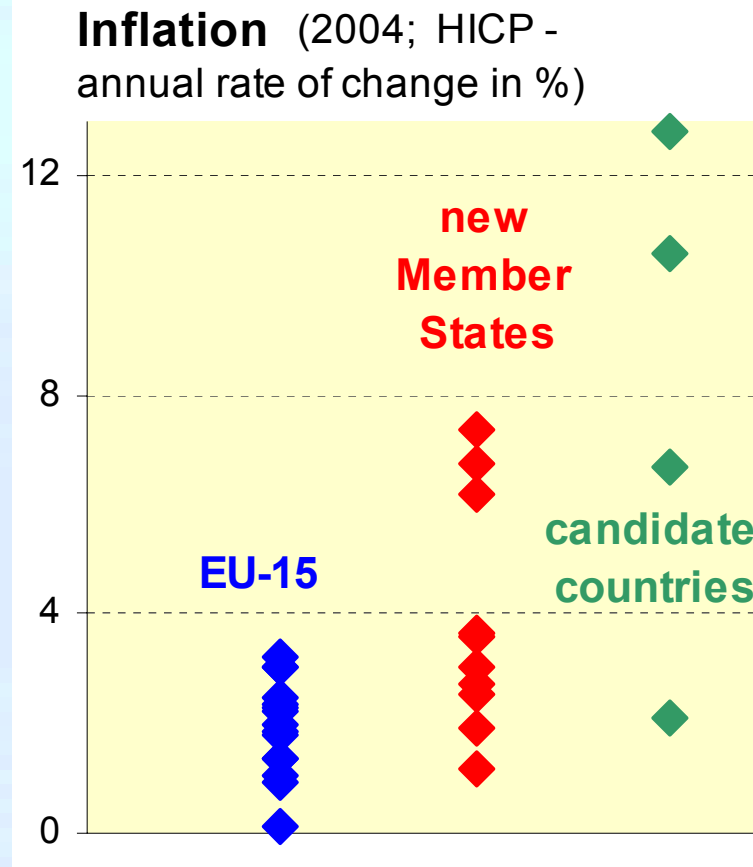
New MS: disinflation advancing

- Disinflation process led to advanced convergence of inflation rates
- More flexible labour markets and exchange rate pass-through were instrumental for this achievement
- Some reacceleration in 2004 (e.g. PL)



...with some outliers

- **Inflation situation not uniform in new Member States**
- **Continuation of relatively high inflationary pressure in some new Member States**

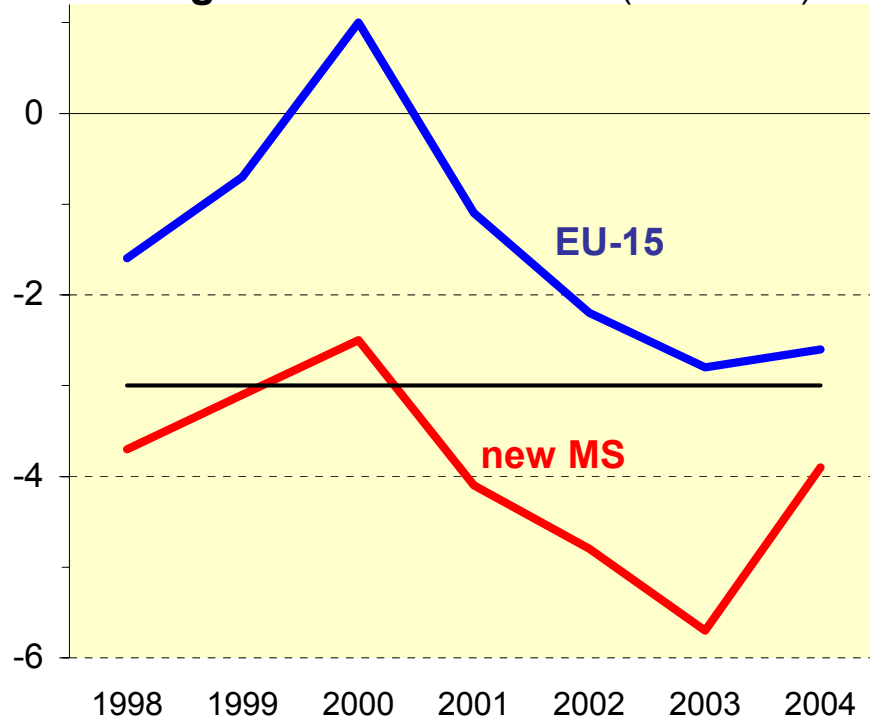


Fiscal policy

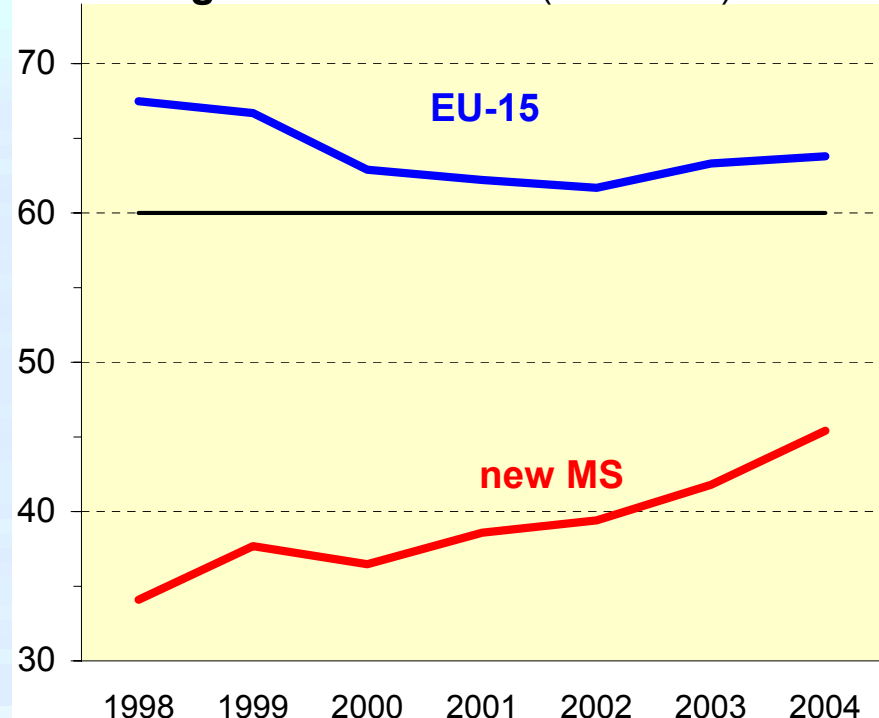
On average, new Member States with

- higher deficits, but lower debt, than EU-15
- rising deficits and debt over past years

General government balance (% of GDP)



General government debt (% of GDP)

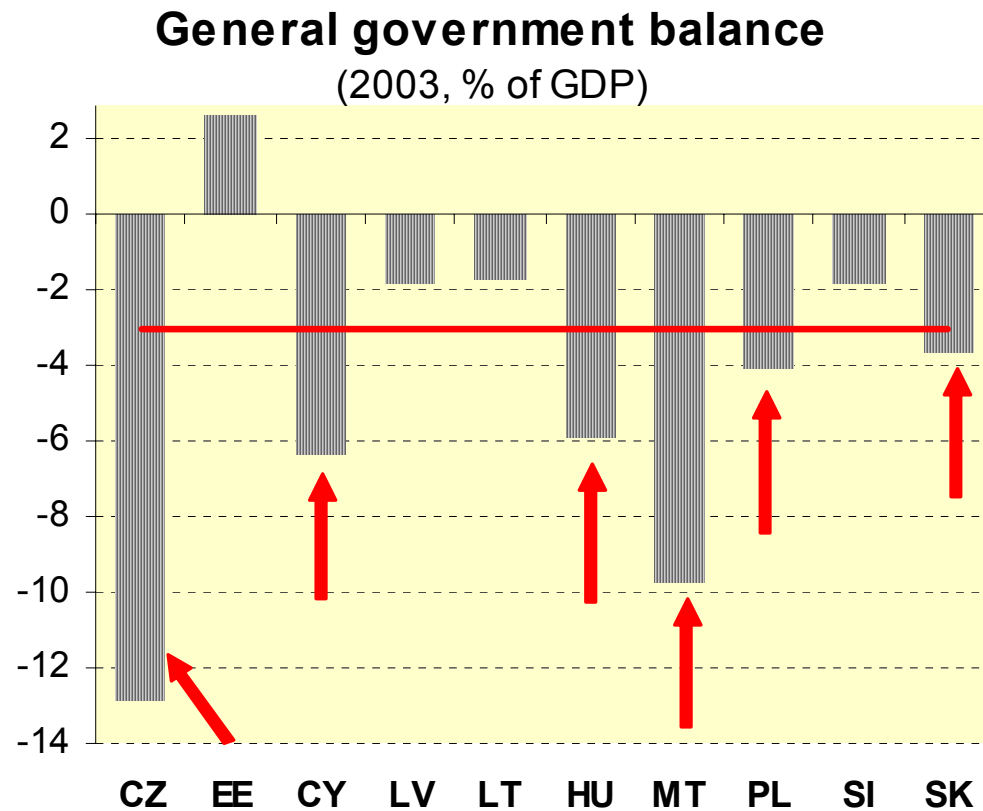


new Member States: Economic policy coordination and budgetary surveillance

- **new Member States were integrated into EU procedures without delay and at equal treatment**
- **Implementation in 2004:**
 - ***Integration in BEPGs***
 - ***Full Integration in Spring Forecast***
 - ***Submission of Convergence Programmes in May 2004***
 - ***Launch of Excessive Deficit Procedure***

Fiscal policy – corrective action

- Six countries with general government deficits above 3% of GDP
- Two countries with debt ratios of more than 60% of GDP

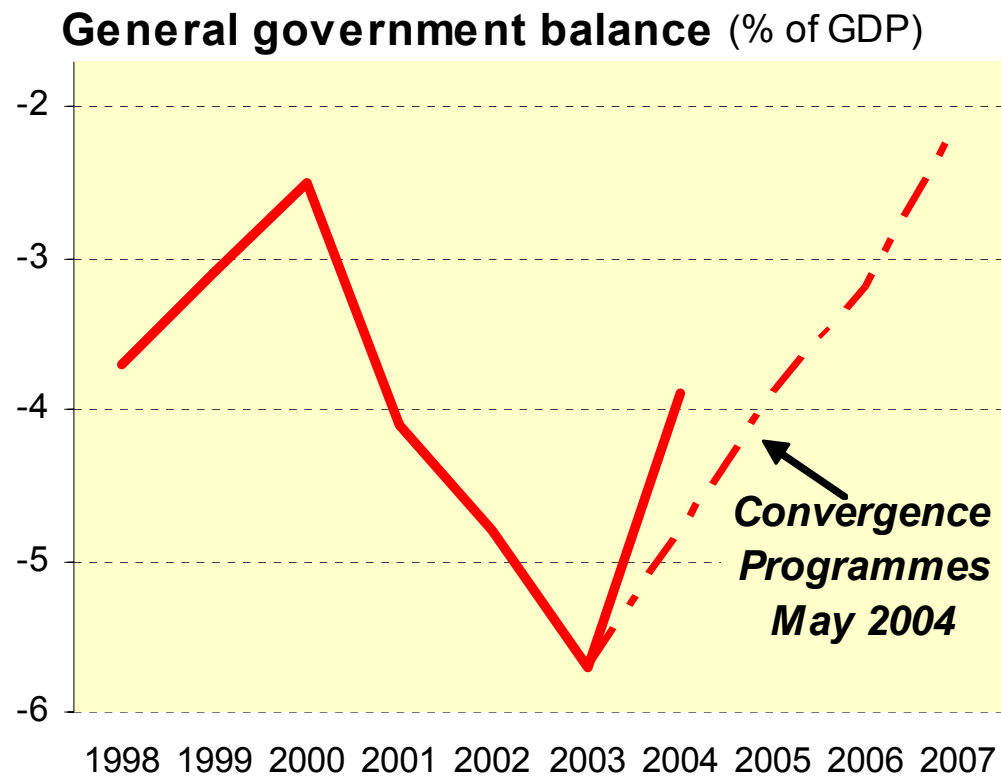


General government debt (2003)

less than 40%	CZ, EE, LV, LT, SI
40 - 60%	HU, PL, SK
60 - 80%	CY, MT
more than 80%	-

Fiscal policy: adjustment path

Convergence Programmes: Correction of excessive deficits is planned to be gradual and to take more than one year



Convergence Programme goals of reaching maximum 3% deficit

Czech Rep.	more than 4 years
Cyprus	2 years
Hungary	more than 4 years
Malta	3 years
Poland	4 years
Slovak Rep.	3 years

Fiscal policy: adjustment path *(cont.)*

This gradual approach was endorsed by Council:

- **In principle Member States are obliged to correct excessive deficits within one year**
- **But: situation in new Member States, although not *exceptional*, is considered due to *special circumstances***
(Council Regulation 1467/97, Article 3, paragraph 4)
- **The Council, therefore, accepted, and committed Member States concerned to, the respective adjustment path laid out in their Convergence Programmes**

4. Monetary integration:

**advancing, based on
“Maastricht criteria”.**

**Ultimately: introduction of
euro.**

**But countries at different
stages**

Financial sector: some stylized facts

new Member States and candidate countries:

- 1. Relatively **small**, reflecting low total intermediation and intermediation via foreign institutions, but recently growing fast in many countries, driven by strong rise in lending**
- 2. largely **bank-based**. Non-bank financial intermediation still small, but partly driven by the growth of funded pension system**
- 3. Relatively **high intermediation costs**, reflecting inefficiencies, limited competition and adverse risk profile of borrowers**

Financial sector: some stylized facts (cont.)

new Member States and candidate countries:

- 4. to a large degree **foreign-owned** institutions. This enhances efficiency and stability of institutions**
- 5. overall **well-regulated and supervised and relatively shock-proof**. Regulatory approach based on EU acquis**
- 6. some **risks of ownership concentration****

Path towards €

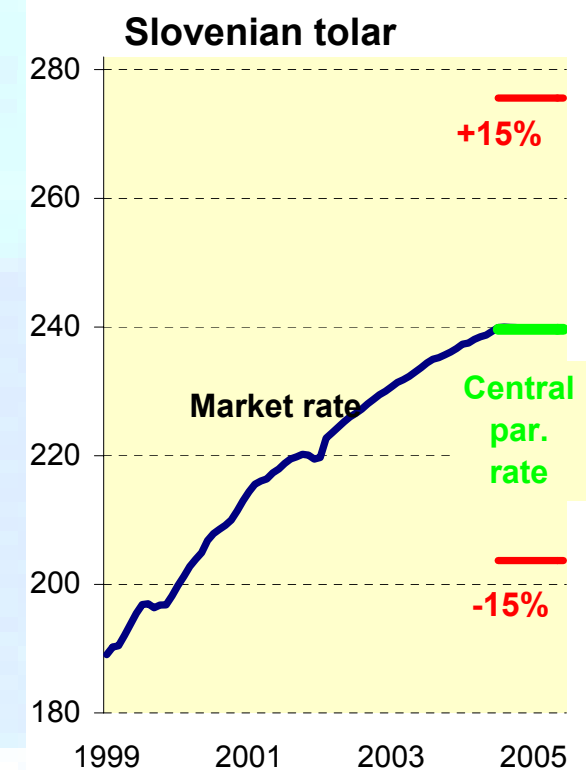
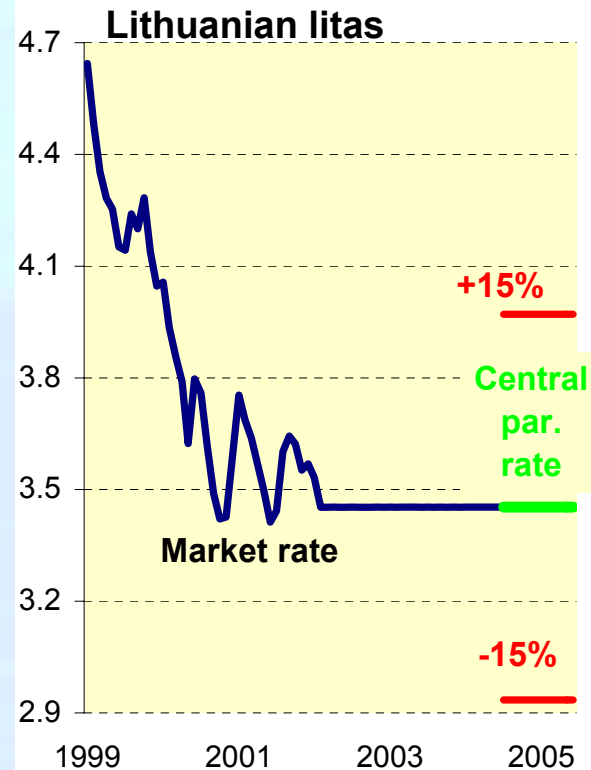
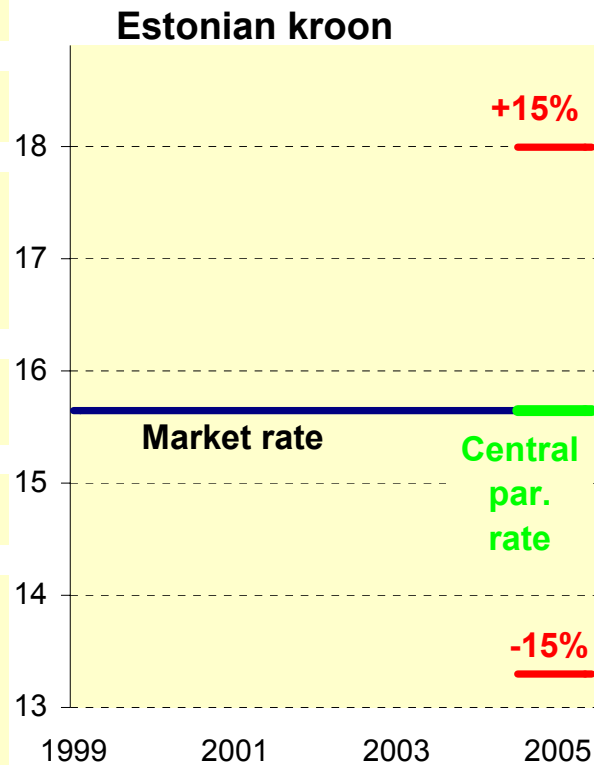
- **New Member States joined EMU with a “derogation”**
- **Introduction of the euro on basis of established Treaty criteria** (“Maastricht criteria”; Art. 121 ECT, Protocol on convergence criteria)
- **One of the criteria: 2-years membership in exchange rate mechanism (ERM II)**
- **First convergence reports (European Commission and ECB) foreseen for later in 2004: overall results are clear**

Participation in ERM II: three new Member States have joined

- **27 June 2004:
Estonia, Lithuania and Slovenia join ERM II**
- **Central parity rates close/identical to previously prevailing market rates**
1 euro = 15.6466 kroon
3.4528 litas
239.64 tolar
- **Standard fluctuation band of +/- 15%**
- **“Firm commitment” by the countries to continue/pursue macroeconomic stabilisation**

... with different histories of exchange rate regimes

- Different (histories of) exchange rate regimes in the three Member States




Further participation

- **Participation of other new Member States, and consequently introduction of euro, will partly take significantly longer**
- **Some countries have put forward intentions pointing to dates of up to 2010**
- **Main determinant: progress in fiscal consolidation**

Current exchange rate regimes of new Member States and candidate countries

<i>CY pound</i>	pegged to EUR; +/-15%
<i>CZ koruna</i>	free/managed float
<i>EE kroon</i>	Currency board EUR - ERM II
<i>HU forint</i>	pegged to EUR; +/-15%
<i>LT litas</i>	Currency board EUR - ERM II
<i>LV lats</i>	pegged to EUR
<i>MT lira</i>	pegged to basket (EUR 70%)
<i>PL zloty</i>	free float
<i>SI tolar</i>	pegged to EUR- ERM II
<i>SK koruna</i>	managed float
<i>BG lev</i>	Currency board EUR
<i>HR kuna</i>	managed float /quasi
<i>RO leu</i>	free float
<i>New TK lira</i>	free float



	Currency board	Peg to EUR		Other peg	Float	
		hard	soft		managed	free
multilateral (ERM II)	EEK LTL		SIT	X	X	X
unilateral	BGN	LVL	CYP HUF	MTL	CZK SKK HRK	PLN ROL TRY

5. The “accession dividend”

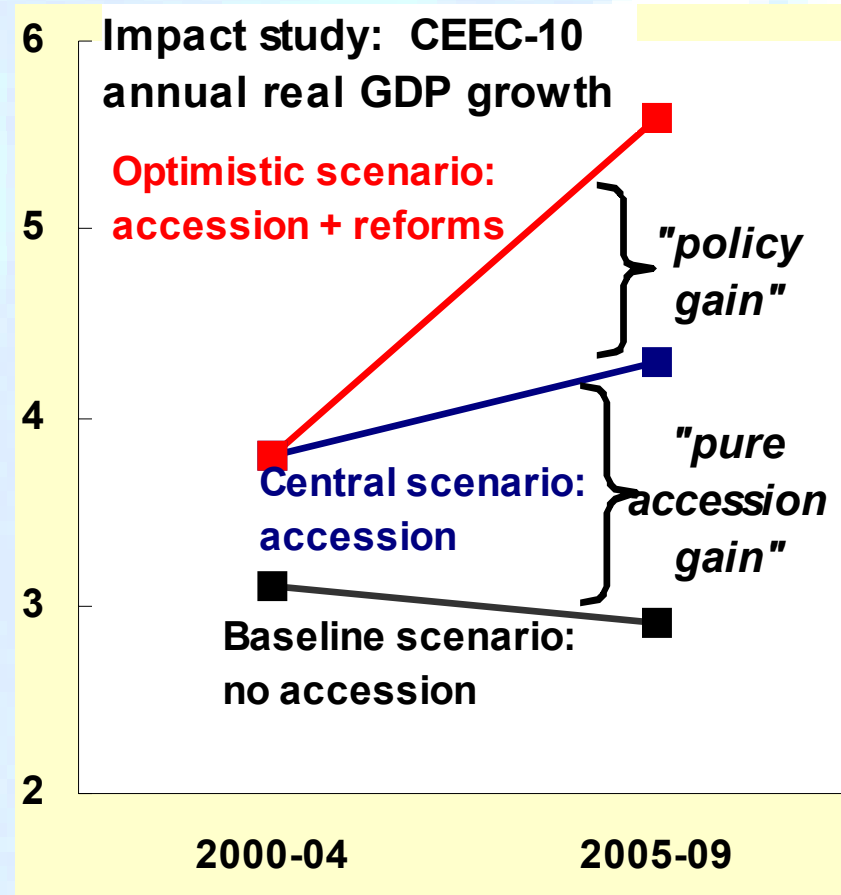
**is (potentially) high for new
Member States / acceding
countries; low for old
Member States**

Impact of accession on candidate countries : example Commission study

- **“Transition economy model”:**
standard Solow type capital accumulation model
 - *linear production technology*
 - *but*
 - *no assumption of common technology*
 - *consumption equation*

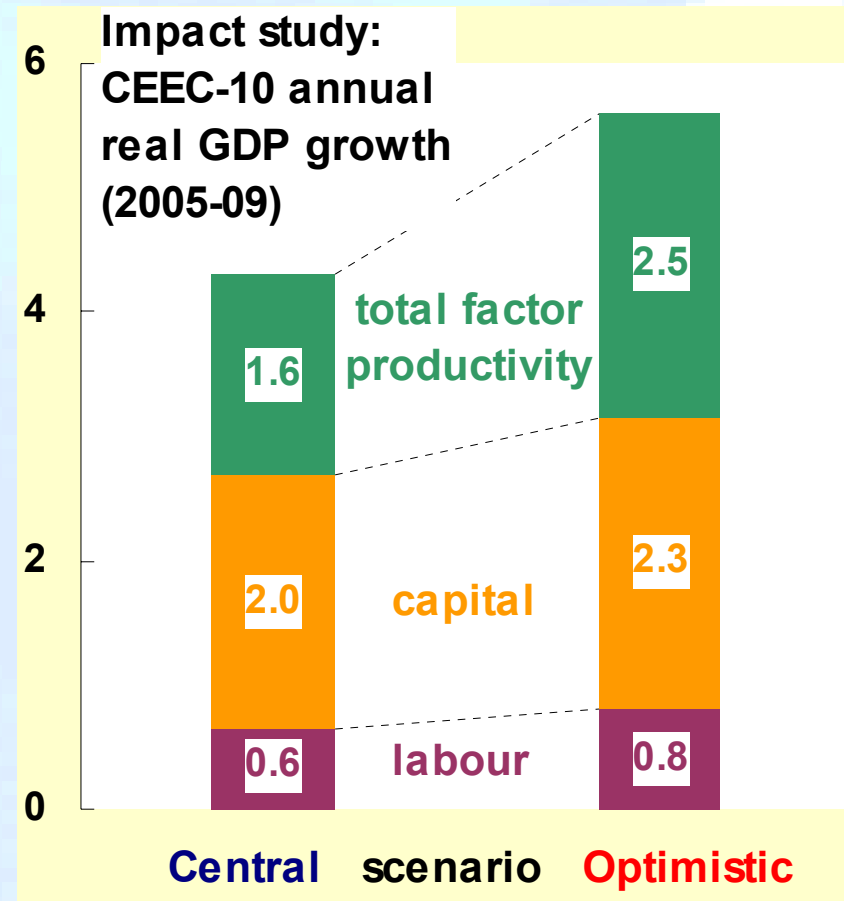
Impact on GDP in candidates / new Member States

- **Effect on GDP growth is sizeable:**
 - 2000-04: 0.7% p.a.
 - 2005-09: 1.4% - 2.7% p.a.
- **Extent depends largely on scope of structural reforms, reaping potential benefits of enlargement**



Sources of growth

- All factors contribute to higher growth due to accession
- Contribution of
 - *labour: moderate*
 - *capital: sizeable*
- Key variable: total factor productivity
 - *high growth contribution*
 - *large differences in different scenarios*



Sustainability of higher growth

- **Higher rates of growth → higher domestic demand (investment, consumption)**
- **Rising deficits in the balance of current account**

Impact on old Member States

- **Economic effects much smaller than for candidate countries**
- **Difference due to relative sizes: share of new Member States in GDP of EU is small**
- **Supply side effects dominate**
- **Trade effects already partly reaped due to trade liberalization**

Impact on old Member States: migration

- **Part of positive effects on current Member States due to east-west migration**
- **Assumption: cumulative net outflow from candidate countries 2.5% over 15 years**
- **Asymmetric effects on Member States (D and A with high net inflow)**

Summary: asymmetric impact

GDP growth rates and accession, effects 2000-09

Cumulative impact on **EU-15**
Central Optim.

Annual impact on **AC-10**
Central Optim.

	scenario			scenario	
Total impact	0.5	0.7	Total impact	1	1.8
<i>of which from</i>			<i>of which from</i>		
trade	0	0.1	employment	0.2	0.3
migration	0.3	0.3	capital stock	0.3	0.4
mark-up	0.2	0.3	TFP	0.5	1.1

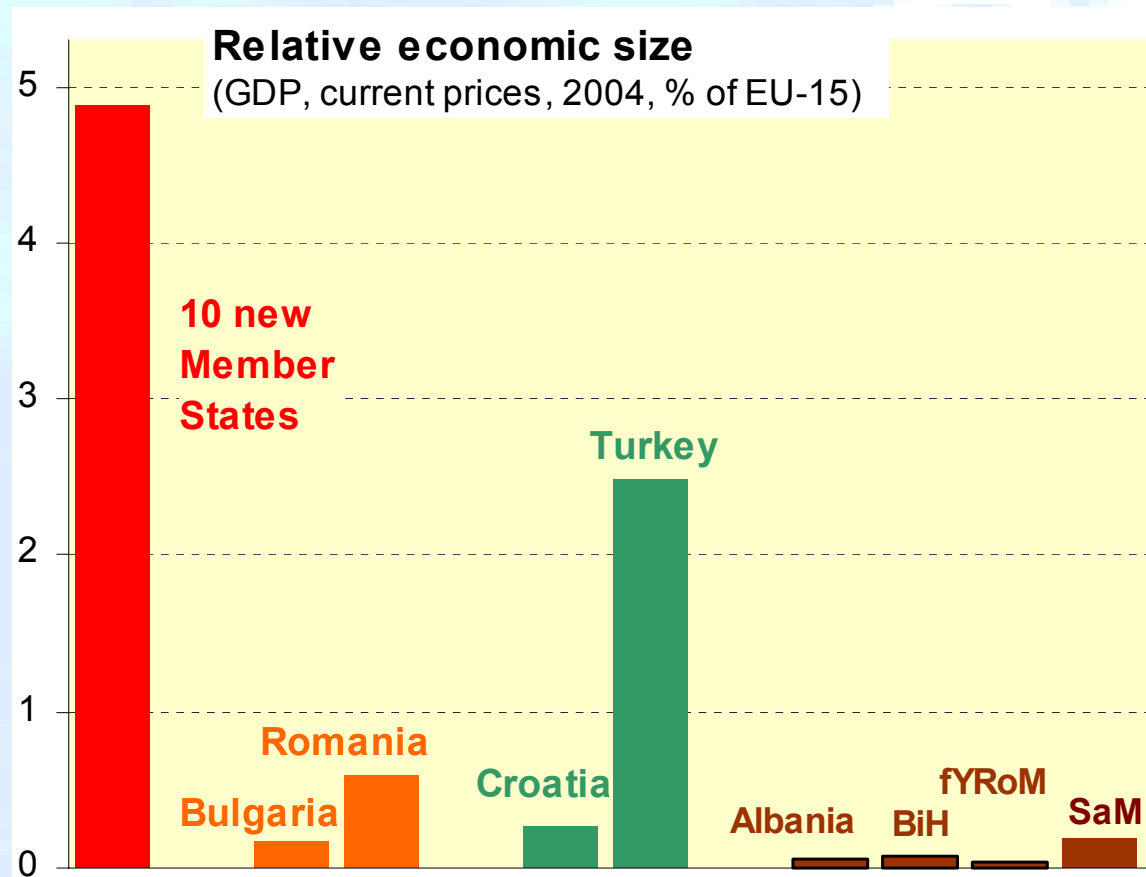
Assumption: 8 countries join EU in 2005

6. Future enlargement:

**more countries in South-East Europe lined up for possible accession;
but with small economic impact on EU as a whole**

Economic weight of “next waves”

- Economic impact of new Member States on EU is, presently, small
- Impact of “next waves” will be even smaller
- But candidate countries have, as new MS, higher potential growth rates than EU-15





Bulgaria - Romania



1995: Europe Agreements entering into force

Dec 1995: Application for EU membership by Bulgaria and Romania

Oct 1999: Commission recommends the opening of negotiations with the countries

Dec 2004: Accession negotiations closed; invitation by EU to BG/RO to sign Accession Treaty

25 Apr 2005: Signature of Accession Treaty: accession on 1 Jan 2007

May 2005 - end 2006: "Interim period" (Partial integration in EU decision making; Monitoring of commitments of BG/RO)

Turkey



1963: EU - Turkey
Association Agreement

1987: **application** for
membership

1989: **Commission opinion** on application,
finding that Turkey
was not ready

1995: **Customs union**
(in framework of
Association agreement)

1999: European Council
recognises Turkey as
candidate country

2004: **Commission Report and recommendation**,
finding that Turkey was
fulfilling political criteria
(precondition for negotiations)
and, thus, **accession negotiations should start**

Dec. 2004: **European Council decides to open negotiations in Oct. 2005**

Croatia: latest candidate



February 2003: Croatia **applies for EU membership**

April 2004: **Commission Opinion** on application, recommends recognition as candidate country and opening of accession negotiations

June 2004: European Council recognises Croatia as “**candidate country**”

Spring 2005: start of **negotiations postponed** due to Croatia’s lack of co-operation with ICTY

Date ??: **Accession**, depending on fulfilling Copenhagen criteria

Balkans: “next wave” ?

- (Member State)
- **Acceding country** (negotiations closed, accession criteria fulfilled, Accession Treaty signed): **Bulgaria, Romania**
- **Candidate country** (negotiations to start in 2005): **Croatia** (subject to co-operation with ICTY), **Turkey**
- **Stabilisation and Association Agreement + Application for membership:** **fYRoM**
- **Stabilisation and Association Process:** **Albania, Bosnia and Herzegovina, Serbia & Montenegro**





End