The EU on the Threshold of Enlargement: How Well Prepared are the Participants?

The coming enlargement of the European Union is unprecedented in terms of the numbers of new members, the degree of diversity involved, and the high stage of integration reached by most incumbent member states, which makes it harder for newcomers to join in. How well prepared are the existing members on the one hand and the accession countries on the other? When can the new members be expected to enter the euro area?

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May Day! – Mayday? Is the European Union Ready for Enlargement?

Is the Union ready for the "Big Bang" enlargement of 1 May 2004? This is indeed an unprecedented enlargement, given the numbers of new members, the degree of diversity involved, and the high stage of integration reached by most Member States, which makes it harder for newcomers to join in. Moreover the distribution of adaptation costs is new. The burden of adjustment has always been overwhelmingly on incoming countries. There were transition periods and even derogations, but the rule has been essentially that newcomers must adapt to the EU, and live up to its standards and expectations. The existing members, for their part, should extend the same rights and privileges to the new ones. Now, the present Member States must also accept significant changes in their own positions. Beyond this, the troublesome prospect arises that the whole system may have to be re-thought: we can no longer just "stretch" present practices and principles to accommodate the newcomers. Consequently, preparation for enlargement has been more important than ever.

Enlargement has undoubtedly created serious strains on three of the fundamental conditions for the success of deep integration: effective common institutions, solidarity between the Member States, and solidarity in speaking with a single voice to the rest of the world.

The December 2003 summit failed to agree on the draft Constitution mainly because of continued differences over reform of the institutions. Resolution of these questions has been considered an essential prerequisite for enlargement. The 2000 Nice Summit produced a set of agreements which, by their mere existence, made it possible to proceed with the accessions. However, there are still many questions whether these arrangements have prepared the Union effectively. Moreover, it is already too late to introduce any other system in time. The Brussels failure also prompted further statements which indicate strains on internal solidarity.[1] Quite apart from threats of creating core groups, the disagreements over the Constitution were immediately linked to financial questions, as the

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net contributors to the budget issued a letter proposing a reduction in overall spending (which would seem to "punish" the trouble-making Spain and Poland in particular). As for external solidarity, positions over Iraq suggested that enlargement would not increase international weight but exacerbate internal divisions and expose the insufficiency of institutional arrangements.

Indeed, political and public attitudes may be one of the most worrying aspects. The transformation of Europe after the Cold War was never going to be easy. There is an adjustment cost which must be placed against the historical benefits for all concerned of European unification. In 1997, the Commission stressed that: "the consent and support of European public opinion to enlargement is a clear prerequisite for the realisation of the project. This will require, during the pre-accession period, a substantial public information effort in both the present and the acceding Member States."[2] In March 2004, Commissioner Verheugen lamented that Member States had not done enough. Indeed, according to Eurobarometer 60, only 47% of people in the EU as a whole supported enlargement in late 2003, and only 38% of Germans and 34% of the French.

So there are indeed problems. Yet it is not obvious what to make of them. According to what criteria can one assess the EU's state of "readiness"?

In the first place, there can be no objective measure. Since there remain significant differences between Member States as to what the Union should be able to do, it would be hard to define clearly "readiness *for what*?" And even if one could come up with a consensual definition, there would still be differences as to the required institutional arrangements.

Second, we should look at things in historical perspective. The EC/EU has already survived quite a lot of dramas: political "crises" ranging from empty French chairs in the 1960s to UK non-cooperation in the 1990s; institutional failures such as the blocking of the planned move to qualified-majority voting until the early 1980s; financing fights including the wielding of handbags and blackmail over milk quotas. Is the current situation really so much worse?

Third, we should ask the right questions. The issue is not whether there will be problems. Of course there will be, just as there are between the present Member States. The question is whether the Union will retain its ability to function as a problem-solving system.

This article looks at three of the key issues involved: adaptation of the decision-making system; agreement over future finances; and the prospects for external relations. We argue that in each of these cases there are grounds for concern but not for despair. The Union is not going to fall apart, but more needs to be done if it is going to work well.

Institutions and Decision-making

For almost a decade the Union has been talking about how to prepare the institutions for enlargement. So, on the very eve of enlargement, do we have institutions in which the principles of representation are clear and consensual, and a decision-making process which is reasonably efficient and generally seen as fair?

This section looks briefly at three basic institutional questions, which have relevance for all the issues discussed in this contribution: the size and composition of the Commission; decision-making arrangements in the Council; and the principles of representation in the Parliament.

The Composition of the Commission

Discussion of the Commission has been dominated by the question of whether all Member States should have one national in the College of Commissioners. Extrapolating the present system, by which the largest countries have two nationals and the others one, would mean a College of 33 Members in EU 27. This, it has been generally accepted, would be too many.

To have one Commissioner each, however, is widely felt to be important for legitimacy. This is particularly important for small countries, for whom the Commission remains an essential ally in ensuring that their interests are taken into account and that all countries, the big as well as the small, fulfil their commitments. Moreover, just to have a familiar face in the College has been seen as helping make some link between this autonomous institution in Brussels and EU citizens. On the other hand, many influential actors have argued in favour of a smaller Commission, on the grounds that this would be both more efficient and more independent.

It was agreed in principle at Amsterdam that there should be one Commissioner per Member State. At Nice it was eventually accepted that all countries would be represented in the next Commission but that

[1] For an analysis of the various concepts of solidarity and how they apply to the EU, see Ines Hartwig, Phedon Nicolaides: Elusive Solidarity in an Enlarged EU, in: Eipascope, 2003, No.3, pp. 19-25.

[2] Agenda 2000 - Vol. II: The challenge of enlargement, COM/97/2000 final - Vol. II, 15 July 1997, final paragraph.

Table 1
Evolution of the Qualified Majority Threshold

	EU 6	EU 9	EU 10	EU 12	EU 15	"EU27"
QMT	12/17	41/58	45/63	54/76	62/87	96/134
QMT as share of total votes	70.6	70.7	71.4	71.1	71.3	71.6
QMT as share of population	67.7	70.5	70.2	63.4	58.2	50.2

Note: "EU27" is an extrapolation of current arrangements.

one day, when the number of Member States reaches 27, there should be a smaller number of Commissioners. The draft Constitution in the end included a rather unhappy compromise by which there would a Commission of 15 full members – the President, the Vice-President/Foreign Minister and 13 others selected on the basis of rotation among the Member States – accompanied by non-voting members from all the other countries. This does not seem likely to prove either legitimate or effective. The Presidency Note of 11 December 2003[3] indicates that "It is generally acknowledged by all delegations that the Commission has both to satisfy the requirement for legitimacy and to function effectively….a clause could be envisaged which would provide for a reduced Commission with effect from a given date." In other words, we are likely to put off the decision yet again. Meanwhile, more fundamental questions about the nature of the Commission – for example, do we really want the President of this independent body to be elected in the perspective of incipient Euro-party politics? – may continue to receive inadequate political and public attention.

The Council: Voting Arrangements and Working Methods

The proposed changes in voting arrangements were the main reason for the failure to agree on the draft Constitution. From the first adjustment in 1973 until the 1995 enlargement, the system was basically extrapolated, with acceding countries being slotted into their respective "clusters". By this time, however, the situation was entering into crisis. The balance between big and small countries was felt to be slipping too far in favour of the small. The allocation of votes to each of the Big Four countries was raised to 10 votes with the first enlargement, but has stayed there ever since, even as the total number of votes has increased. Moreover, figures now began to be produced explicitly demonstrating the increasing gap between the proportion of votes required for a qualified majority decision and the share of the total population which was represented by a minimum winning coalition under these terms.

The clusters were also called into question – a central political problem which is not, it should be emphasised, directly related to the acceding countries. The Dutch request for an additional vote met with strong Belgian opposition at Amsterdam. In the run-up to the 2000 IGC, Germany made it clear that it wanted recognition of its greater weight, but France was firm in rejecting any change in the parity of votes. Finally, Spain demanded special compensation. The principle of one Commissioner per Member State would mean undoing the accession package by which Spain would have only eight Council votes compared to the ten enjoyed by each of the Big Four, in exchange for having the same number as them (two) of Commissioners. Spain insisted on finding some means to maintain its medium-big status.

The arrangements agreed at Nice do not provide greater efficiency or transparency in decision-making, nor do they correspond to any clear principle of political organisation. There was, to be sure, a preliminary understanding that, however the votes were adjusted, a decision could not be adopted by a minority of states. Beyond this, the Nice provisions were reached through political deals, notably the French insistence on maintaining parity of votes and the consequent compensation package for Germany, including the possibility for a Member State to verify that a qualified majority of votes represents 62% of total population; and the way in which Spain was given a rough equivalence in blocking power to any of the Big Four (resulting in the attribution to Spain and Poland of 27 votes each compared to 29 votes for each of the Big Four, with all the conflicts this has subsequently produced).

The Convention's proposal for a simple majority of states representing 60% of population has, in principle, many advantages compared to Nice. It is likely to be more efficient for decision-making. The double majority is easier to understand and clearly reflects the dual nature of the European Union as both a union of states and a union of citizens. And it offers a simple system of checks and balances: the biggest countries cannot impose a decision based on their demographic weight alone; nor can a coalition of small countries impose a decision based only on their numerical majority as states. Independently of Spanish and Polish interests in preserving the Nice system, there are grounds for reflecting about the move from a system

[3] CIG 60/03 ADD 2, Brussels, 11 December 2003.

of weighted votes among clusters of states to one in which relative populations are measured so clearly.[4] Yet the draft Constitution does provide, on balance, a better alternative. Even if it had been adopted in December 2003, however, it would still have been too late to ratify in time for enlargement.

It must be added that the challenges for decision-making in the Council do not concern only the politics of voting but the practice of managing business at 25 – and with 20 official languages. In this respect, there have been further preparations recently. A Code of Conduct provides a set of guidelines for the Presidency and for delegations. For example, full table rounds are proscribed in principle; time limits for interventions (usually 2 minutes) should be imposed; like-minded delegations are encouraged to consult with a view to presentation of a common position by a single spokesperson; delegations should avoid repeating points, make concrete drafting proposals rather than simply disagreeing, and say nothing if they simply agree. As for the linguistic regime, full 20/20 interpreting will be limited to the Council, European Council and a maximum of 20 preparatory bodies. COREPER will continue in English, French and German. For most preparatory bodies, delegations will be able to request in advance active or passive interpreting at particular meetings, set against annual envelopes of EUR 2 million per language. No interpretation would be requested in an agreed number of preparatory bodies. It remains to be seen how all this will actually work.

Representation in the Parliament

Are there at least clear principles regarding how citizens are represented in the Parliament? There is a principle, known as "degressive proportionality", underlying the current system. There is a "democratic minimum" of six, meaning that any country, however small, should have the possibility of having six different parties represented at European level. Beyond this, population difference should be reflected in progressively smaller increases in additional seats. Moreover, the idea that the distribution of seats should be fairly directly proportional to population was not disputed following German unification, when Germany therefore received extra representation in the Parliament, even as its quota of Council votes remained unchanged.

With the 1995 enlargement, the number of MEPs was raised to 626. With enlargement to EU 27 promising to bring a bit of a "democratic surplus" if nothing was changed, a ceiling of 700 was agreed at Amsterdam. The 2000 IGC was then supposed to decide how to implement this. The Parliament proposed a generalised reduction in numbers. The "democratic minimum" would go down to four, and the "gradient" by which additional representation was granted would be flattened. Everyone would lose, but the bigger countries more than the smaller ones. The re-distribution at Nice, however, was primarily determined by the bargaining over Council votes, leading Euro-parliamentarians to lament that they had been used as loose change, or poker chips, in the diplomatic game. Germany would uniquely retain 99 Members, while every other country would go down compared to its present quota. This in fact means that the resulting distribution is more evenly proportional in terms of representativeness of MEPs. Politics accidentally favoured principle. Not so with other deals. As part of its package, Belgium was offered a raise in the number of MEPs from 20 to 22; Greece and Portugal pressed for the same allocation on the grounds that they had always enjoyed equal representation and had very similar populations; but the Czech Republic and Hungary, which also have very similar populations, were not included in the deal and were left with 20. This was a clear breach of principle and an apparent discrimination against the incoming countries, but it was to be nearly two years before it was corrected, in the context of the discussions of what to do with the seats left unfilled by the Bulgarians and Romanians. The minimum was reduced to five at Nice – but only for the smallest of the incoming states, Malta, while Luxembourg, with its almost identical population, retained six.

A Very Mixed Record

While the political difficulties and sensitivities involved cannot be underestimated, the fact remains that EU 25 will start to work with an institutional system which is almost certainly less effective in decision-making than alternative arrangements which could have been adopted in time. Moreover, the system is not based on relatively simple and clear principles which enjoy political consensus and can be explained to citizens. Quite the contrary, the last rounds of the debate have exacerbated, rather than eased, underlying tensions – most notably between big and small countries – and have given the appearance of simply reducing the constitutional debate to distributional bargaining over shares of money and quotas of power. Finally, the Nice summit and its aftermath have been tinged with an unprecedented discrimination against

[4] For a broader discussion of the issues involved, see Edward Best: What is Really at Stake in the Debate over Votes?, in: Eipascope, 2004, No.1, pp. 14-23.

the acceding countries in decisions over representation.

The Union's Finances

It has been accepted for some time that the Union's finances cannot be "stretched" indefinitely in the face of enlargement. The ten countries that will enter the Union on 1 May 2004 will increase the economy of the EU (in terms of GDP) by 5%, its population by 20% and its agricultural land by 25%. Their per capita income, however, is about 1/3 of that of the EU while their average wages are only 1/5 of those in the EU. To go on applying all the same rules and ways to both old and new Member States would mean that the total amount of spending would reach an overall level which the Union is apparently not willing to support – although it should be added that in several respects, reform is not only desirable in itself for the Union, but is also determined by consideration of the consequences for third countries and the development of multilateral trade negotiations. How, then, has the EU been preparing for enlargement?

Preparing for Enlargement ... Half-Heartedly

There have been three milestones in this preparation. Each solved some problems but also created new ones. The first was the Berlin European Council agreement on the financial perspective 2000-2006 in March 1999. It set ceilings for expenditure per policy area, introduced policy reforms in agriculture and structural funds, determined budgetary allocations to new Member States and ring-fenced expenditure in the new members. New Member States could not ask for more during the 2000-2006 period, nor could existing Member States lay claim to any unspent money earmarked for the new members.

However, the Berlin agreement left a number of issues unresolved. Agricultural policy was not completely reformed and in particular the issue of milk and sugar quotas still remains open. Farmers from the new Member States were not supposed to receive any direct income support, but this position soon became untenable. In the final stages of the accession negotiations in Copenhagen in December 2002, the EU conceded to make direct payments, starting from 25% of what existing farmers get in 2004 and gradually reaching 100% in 2013.

Berlin also patched up, but only temporarily, the issue of budgetary imbalances. Since the UK vehemently refused to give up its rebate, the only relief the other net payers could obtain was an ad hoc arrangement whereby their contribution to the UK rebate was reduced by 75%. The shortfall had to be made up by other Member States. No long-term formula for fixing imbalances was adopted. Ironically, the new, poorer Member States will also pay into the UK rebate.

The Commission's proposal for the next financial perspective that was published in early February 2004 raises this issue and suggests that in an expanded Union it will be imperative to find a permanent solution to budgetary imbalances.[5] Any Member State with an excessive budgetary burden should be able to obtain some relief. Yet the Commission does not suggest any solution. This is one more contentious item that will complicate financial negotiations.

The second milestone was the conclusion of the accession negotiations. The Copenhagen European Council raised the amount that would go to the agricultural sector of new Member States from EUR 8.8 billion to EUR 9.7 bn (in 2004-2006), but lowered the amount for structural actions from EUR 30 billion to EUR 22 billion. New Member States did not object too much to the reduction in structural funds because they knew that they would have to try very hard to match EU money with national money on the principle of co-financing. By contrast, most of the increase in agricultural money came from the channelling of extra resources to rural development where national contributions could be as low as 15% of total costs.

The main achievement in Copenhagen was agreement to prevent new members from becoming net contributors. This was a compensation for the delays that new members would experience in absorbing EU funds. The agreed amounts for 2004-2006 were EUR 2.4 billion in a special cash-flow facility and EUR 1 billion in temporary budget compensation. These arrangements are not unusual. Similar transitional measures were adopted in every previous enlargement of the EC/EU. The difference was that in the past they lasted for five years while in the present enlargement they were fixed for only two and a half years. Yet, the Commission proposal for the financial perspective 2007-2013 makes no mention of any extension of these arrangements for another two and a half years. This means that some of the new Member States such as Cyprus and Slovenia may become net payers soon after their accession to the EU. Budgetary imbalances are not only a problem for large or wealthy countries.

The third milestone came in February 2004 with the publication of the Commission proposals on the forth-

[5] Commission Communication on Policy Challenges and Budgetary Means of the Enlarged Union, COM(2004) 101 final, 10 February 2004.

coming financial perspective and reform of structural policy.[6] Since these documents present only the Commission's own views and their contents are bound to be modified later on in the negotiations among Member States, they are only indicative of likely developments. The Third Cohesion Report suggests that structural funds should be shared equally between old and new Member States, and that those regions in the EU15 that will lose their Objective 1 status should still benefit from transitional aid. Eighteen regions with about 20 million inhabitants, whose per capita income is currently below the threshold of 75% of EU average income, will become "statistically" richer because the average EU income will drop by 12% after enlargement. The Commission considers that it is unfair and politically untenable to deprive them of structural aid. That is why it proposes that they continue to receive (declining) structural support until 2013. This, however, has financial implications.

It means that the EU budget has to support more regions and therefore total structural expenditure has to increase. Otherwise, sharing more widely the same amount of structural money would spread it too thinly for it to be effective.

It also means that on the revenue side, the EU budget will have to be increased as well. Although the Commission Communication of 10 February 2004 proposes that the ceiling for the 2007-2013 financial perspective is kept at its present level of 1.24% of the EU's gross national income (GNI), the average payments in the next seven-year period will amount to 1.14% of GNI, which is about 15% more than at present.

Conflicting Demands by the Member States

Both Commission documents strike a balance between the demands of the net recipients and the net payers. In principle, any budgetary problem can be eliminated if the net recipients accept a bit less and the net payers offer a bit more. At this point however, compromise seems remote between the two groups.

Indeed, the net payers fired their first salvo immediately after the failure of the discussions on the draft Constitution in December 2003. In a letter to the Commission President, the Prime Ministers of Austria, France, Germany, the Netherlands, Sweden and the UK demanded that the EU budget should not exceed 1% of the EU's GNP. That letter was seen as a rebuke and a warning to Spain and Poland for being intransigent on the issue of votes in the Council. It was a warning that they would be "punished" by the six, who would withhold money from the budget. Spain and Poland are the two largest budgetary recipients among the old and new members, respectively.

The second salvo came with the much talked about meeting of the "Big Three" in Berlin on 18 February 2004. In a joint communiqué, France, Germany and the UK insisted, among other things, that the EU budget should not exceed 1% of the EU GNP.

It is worth noting that as of 2002 the budgetary ceiling has been expressed in terms of Gross National Income (GNI) as 1.24%, but when expressed as Gross National Product (GNP) it is 1.27%. Since the GNI is larger than the GNP, 1% of GNP corresponds to less than 1% of GNI. It could be that the gulf between the Commission proposals and the net payers is greater than 0.24% of GNI or GNP (the Commission set the ceiling at 1.24% of GNI). However, the Member States in their statements do not clarify whether they mean ceilings, commitments or payments. The ceiling is the maximum possible expenditure. Commitments are the earmarked money in any given year while payments are the money actually paid out in that year. Since spending is often associated with multi-year programmes, commitments are always larger than payments in any annual budget. However, neither commitments, nor payments may exceed the budgetary ceiling.

Disagreements on the draft Constitution have spilled over into the budget deliberations. Yet even if the Constitution had been approved in December 2003, it would not have made things much easier. Articles 53, 54 and 318 of the Constitution still provide that the EU's own resources, its first multi-annual financial perspective after the coming into force of the constitution and the budget until 2007, respectively, must be adopted on the basis of unanimity; not an easy task for 25 countries.

Moderately Optimistic or Definitely Pessimistic?

It would appear, therefore, that the EU is not ready yet for enlargement, at least as far as its future financial framework is concerned. Enlargement will intensify pressure on financial resources and has already polarised the positions of Member States. Since enlargement is taking place just when the EU has to determine its next multi-annual financial perspective, the situation is even worse, because the EU has not been able to adopt any simplified decision-making procedures that could facilitate agreement.

[6] On the financial perspective see the previous footnote. On reform of structural policy see the Third Economic and Social Cohesion Report, 18 February 2004.

This conclusion must be put in perspective. There will always be tough negotiations on the budget. It is not possible to eliminate budgetary deliberations by determining now and for ever afterwards the level of EU spending or the policies that the EU should support. The objectives of the Union change and so should its spending.

On the other hand, some disputes, such as those over the UK rebate and budgetary imbalances more broadly, need to be resolved once and for all. The contribution of each Member State should be determined by a simple formula based on ability to pay. In some cases, the shares of Member States in EU expenditure may also be objectively fixed as, for example, with eligibility for Objective 1 structural aid. Introduction of qualified-majority voting on budgetary issues will also facilitate decision making. All these issues should be enshrined in the future Constitution so that they are removed from budgetary bargaining.

Accession of new Member States will make the Union more diverse. As a consequence, the interests of members may also differ more sharply. Perhaps it is only realistic to expect that budgetary discussions will inevitably rise to a new level of difficulty in the future and that, although some remedial measures may be taken, the situation will never be quiet on this front.

External Relations

The extent to which the EU is ready for enlargement with regard to external relations can be seen in quite different ways.[7] The reasons for concern stem from the well-publicised difficulties in working at 15, most notably in the Iraq context, which will only be complicated by working at 25 or more. The disputes over Iraq suggest that the possible alignments are unlikely to be along existing/new member lines. Instead alignments are more likely to depend upon a particular issue which may reflect individual geographic, political, or economic interests; in short, the internal politics of external relations are likely to be a good deal more complicated.

On the positive side the acceding countries (and indeed the candidates) have demonstrated a reasonably consistent pattern of alignment with the CFSP *acquis politique* and, more generally, the EU's positions in international fora, even if the pattern of alignment suggests that "homogeneity is more likely to be achieved on positions regarding distant countries and regions; the closer the addressees of CFSP policies are, the deeper the dividing lines between the Fifteen and the future members".[8] Although alignment since April 2003 has shown encouraging congruence between existing and future members, it is clear that enlargement will offer challenges as well as benefits.

Moreover, the enlargement of the EU will take place without a Constitution. Many of the innovations suggested by the Convention in external relations, such as the Union Minister for Foreign Affairs, the European External Action Service or the Foreign Affairs Council, will therefore have to wait. The Union will therefore have to deal with increasingly complex realities in the near future with the current set of largely improvised institutions and mechanisms.

Impact on Priorities and Interests

The very location of the eight central or southern European accession countries will bring their specific concerns regarding their immediate non-EU neighbours to the fore. The EU already has a "New Neighbourhood" policy towards many of these countries. The preponderance of new countries from the east opens the possibility of tension between the eastward and southern (especially Mediterranean) dimensions in EU external relations. It is of course broadly recognised that positive relations with Belarus, the Ukraine and Russia, as well as others, are desirable. It is less obvious whether positions towards the EU's new neighbours may not generate significant differences of perspective between the existing EU members, who are primarily interested in engagement, and the newer members who, for reasons of history and proximity, may be more interested in containment in various forms.

Moreover, the eight can generally be expected to reinforce the importance of the Atlantic bridge, especially in ESDP. It is important, however, to caution against the impression that the new Member States will *ipso facto* create an Atlanticist-European divide within the EU, as is sometimes suggested as a result of the strong support by the eight for the US position regarding Iraq in the Aznar-Blair letter of January 2003.[9] Membership may well mollify some of the Atlanticist tendencies of the new members as they become aware that the shifting strategic priorities of the US away from "old Europe" mean that their foreign and security policy interests are more likely to coincide

[7] See Simon Duke: Beyond the Chapter: Enlargement Challenges for CFSP and ESDP, Maastricht 2003, European Institute of Public Administration.

[8] Elfriede Regelsberger: The Impact of EU Enlargement on CFSP: Growing Homogeneity of Views amongst the Twenty-Five in: FORNET, November 2003, Vol. 1, Issue 3, p. 5.

[9] See Quentin Peel, James Harding, Judy Dempsey, Gerard Baker, Robert Graham: The Plot That Split Old and New Europe, in: Financial Times, 27 May 2003.

with those of the EU. The eight are also likely to be sensitive to the need to balance external relations vis-à-vis the US with those towards their east.

Operational Implications

EU enlargement is likely to bring some "soft" security benefits, such as the new members' knowledge of their neighbours, diplomatic expertise and peacekeeping experience. On the "hard" security side, CFSP has suffered from a well publicised capabilities-expectations gap since the early 1990s and the new Member States are unlikely to alleviate this problem, especially as their defence budgets are likely to remain constrained by the competing demands of Union membership (this is a point not only confined to the EU since it applies with equal relevance to NATO enlargement).

The enlargement-related issues that are likely to arise from ESDP will merely exacerbate existing challenges amongst the current EU members. Two in particular stand out. First, the slim defence budgets of the newer members, even when acknowledging recent upgrades carried out with NATO membership in mind, have not substantially enhanced interoperability. Second, enlargement will complicate the complicated debate over funding, especially about how the Community aspects and those aspects having military or defence implications (which are charged to the Member States) are apportioned.

The newer members will also have to learn how to operate in the EU institutions when, at the same time, the existing members are learning how to operate at 25. This may require considerable adjustment when, in cases such as COREPER or the Political and Security Committee, a rather collegial way of working has been the norm. These dynamics, which were already stretched at 15, will require different approaches and working methods when operating at 25. In CFSP generally and ESDP specifically, the often small size of the institutions means that the impact of working at 25 may be more apparent than in many other areas. Some aspects of external relations, such as the rotating Presidency, are clearly unsustainable at 15, let alone 25-plus.

When it comes to the *communautaire* aspects of external relations the main impact of enlargement will probably be reflected in questions over priorities. For instance, the current Community development and assistance programmes reflect the priorities of existing EU members vis-à-vis their former colonies (the African, Caribbean and Pacific countries and the Overseas Territories and Countries). The acceding countries will be anxious to project their own perspectives and priorities into such important areas of external relations. This does not however imply that institutional issues are irrelevant, especially in the context of the discussion surrounding the draft Constitution where the new Member States will presumably be anxious to play an active role, including prominent roles within the *famille* RELEX and the European External Action Service.

The Future Organisation of EU External Policy

It is clear that enlargement runs the risk of exacerbating existing difficulties in external relations merely because of the extra numbers involved in reaching consensus, which remains the norm in CFSP matters. This is not a new factor since the need for various forms of flexible cooperation has been apparent from Amsterdam onwards. The problem with promoting flexibility, including the bewildering types of cooperation suggested in the draft Constitution, is that a balance must be found with coherence – after all, one of the primary objectives of the Union in its founding treaty is that "it shall assert its identity on the international scene".

It is in this aspect that we find perhaps the biggest dilemma facing the EU in the intergovernmental aspects of external relations. Where possible the practice has been consensus but this has been difficult to achieve, especially given the inherently sensitive nature of foreign and security matters. The logical riposte to this is that potential paralysis can be avoided by various flexible schemes, variously called "pioneer groups", the "avant garde" or a "directoire". In the case of the latter, the emergence of an Anglo-French-German directoire (or combinations of any two therein) is likely to provoke extreme sensitivity at the prospect of exclusion from the inner circle.

A number of scenarios are possible. First, the accession countries may be reminded of historical shadows of dominance in external relations (albeit less benevolent) and insist upon consensus as an underlying principle of external relations – or at least full transparency. A reminder of these sensitivities was provided by Chirac's intemperate remarks during the Iraq crisis when the candidate's were reprimanded for missing a chance to "shut up".

The second reaction may be based on the pragmatic realisation that when the "Big Three" work together (as was the case with Iran over weapons of mass destruction or finding a compromise position on the EU planning facilities for crisis management)

the Union may benefit. There are also examples of the same countries not working together, such as Iraq, or various forms of exclusionary behaviour (such as the trilateral meeting immediately prior to the Ghent Summit) which caused needless offence amongst the smaller members. This could either result in a similar reaction to the first one noted above, or a "if you can't beat them, join them" argument where pressure would build for an expanded directoire which might possibly include Italy, Spain and Poland.

Finally, a number of arguments have been forwarded to formally harness the positive aspects noted above in the form of a European Security Council which might comprise four permanent members (the Commission, France, Germany and the United Kingdom) and a number of rotating ones, up to a total of no more than ten.[10] Although the suggestion has its merits and recognises a way of positively harnessing what is fast becoming a reality for the current EU members in the foreign and security aspects of EU external relations, it may nevertheless be unacceptable to the accession countries who have already expressed their concern about the various forms of cooperation discussed in the Convention.

The desire of the accession countries to play a full role in external relations (which is not necessarily the case yet in some aspects of Community policy) may well dampen moves towards a more prominent role (formal or informal) for the directoire. Similarly, it may lead to tougher criteria for the various forms of cooperation mentioned in the draft constitution.

Realities and Challenges

Unlike the other areas examined in this article, the main challenge in external relations is not so much one of adapting rules and procedures, but one of adapting to the realities of intergovernmental cooperation in an enlarged Union. Although there are grounds for optimism, based on the general convergence of interests and positions, it would be unrealistic to expect the accession countries not to defend their own positions and advocate their own interests, especially on matters nearest to home.

Conclusions

The question we have addressed in this contribution is whether enough has been done to prepare the enlargement in terms of the Union's ability to manage its problems. At one level, this refers to procedural changes or policy adaptations which are required to deal with particular issues. At a deeper level, it means the underlying problem-solving capacity of the Union in terms both of mechanisms and of attitudes. Our conclusion is that the record so far is below standard or, at best, behind schedule. There has been a failure to agree on basic principles, and political and public debate has not been adequate to prepare the citizens of the Union for the future.

In the case of decision-making, one can argue that important opportunities have been missed. The problems are largely known. Alternatives have been available which, although not unproblematic, would seem to be better for the Union *as a whole* in terms of efficiency and in transparency, but which could not be agreed between the Member States.

With regard to the Union's finances, it may indeed be unrealistic to expect that this can ever be an area of harmonious integrative negotiations. Nevertheless, it is not reassuring that the Union has failed to agree on basic parameters for its main spending items just when enlargement will place an additional strain on the system. There is no sign of fundamental change in the decision-making procedures to be used in these areas. And linkages have been made with damaging directness between quotas of power and distribution of resources.

Enlargement will also complicate reform efforts in external relations, which currently point towards greater flexibility and various forms of cooperation. Given the recent history of the accession countries, they are unlikely to embrace radical changes to the current decision-making system. Proposals that appear to dilute their full membership, even if apparently supported by a number of existing members, are likely to meet with resistance. The accession countries are likely to have a direct impact on two of the most difficult aspects of EU external relations – future relations with Russia and the United States. Let us hope that the current EU members view this prospect as a case of the glass being half full.

It seems quite clear that the Union is not as "ready" for expansion to 25 members as it could have been, and that Member States could have done more to prepare their institutions, their policies and their publics for the new realities of Europe. Yet there is no obvious danger that the 2004 enlargement will stretch the Union's capacity to breaking point. European integration has proved to be remarkably resilient – as it may need to do again in the coming years.

[10] These arguments are expanded upon in Steven Everts, Antonio Missiroli: To claim a global role, the EU needs its own security council, in: International Herald Tribune, 10 March 2004.

László Csaba*

Ready, Steady, Go?
How Prepared Are the New EU Members for Full Integration?

With the enlargement of the European Union by ten emerging economies on 1 May 2004 a historic era of divisions created by Yalta will come to an end. There is every reason to be optimistic, since the new members will arrive after 10-14 years of preparation. Therefore, unlike in previous enlargements, they can be thought to be better prepared. For instance southern member states needed long transition periods to complete trade liberalisation. By contrast, the new "eastern" member states have all opened up their economies as part and parcel of the transition to the market economy. They established full convertibility of their currencies (on current account items) by the mid-1990s, an achievement not accomplished by Spain and Italy for instance until the early 1990s. Last, but not at all least, opening up their capital account – a subject of extensive controversy in the international literature[1] following the east Asian contagion of 1997-99 – has also been gradually attained by the early 2000s.

Advantages of a Long Preparatory Period

The long preparation in the ante-chamber had further advantages from the point of view of integration maturity. First, the Europe Agreements ensured the orderly and sustained liberalisation of economies followed by institution building. The latter phase has been adjusted by the innovative policies of the EU, including the so-called structured dialogue, launched by the Essen Council of 1994, when cabinet members of the candidates could attend regular meetings of their counterparts, be they responsible for justice and home affairs or the environment. This innovation ensured continuity among the changing governments of the new democracies. As a second innovation, the phase of acquis screening, a kind of pre-entrance examination, took place in l998-99. Then, the implementation deficits of already formally adopted EU pieces of legislation were cross-checked before actual negotiations on full membership could be started. In so doing the EU imposed a degree of discipline perhaps over and above the level intended by the respective candidate countries. For instance in Hungary it took years until the agency managing EU funds for agricultural support could be established outside the framework of the sectoral department. Likewise court practices had to be adjusted according to openly stated requirements in terms of implementing what is in the law books. Finally in the phase of accession negotiations the EU Commission adopted a "take it or leave it" approach. Unlike in cases of previous enlargements, no new items have been put on the EU agenda, (like Trans-Alpine transport at the time of Austrian accession). Following the Treaty of Amsterdam in 1997, the previously widely used opt-outs have been outlawed. Thus the only option the new members had was to ask for a limited period of derogation. In other words, the question is not *if* they are to introduce various common policies, be they the single currency or environmental laws, but rather only *when* the time for implementation has arrived. Therefore such arrangements as the 16-18 years transition period for the implementation of the waste-water directive can be seen as demanding, rather than lax, arrangements.

The new member states have also been trained for full membership much more intensively than any of their predecessors. Selected Members of Parliament could attend the sessions of the European Parliament as observers. Moreover, representatives of the new, not yet member states could participate in the labours of the Convention on the European Constitution. Last but not at all least, pre-accession funds – PHARE, SAPARD, ISPA – to the value of € 45 bn have been earmarked to improve their administrative capacities.

Before agreeing to their membership the Commission of the EU produced regular reports assessing the integration maturity of the candidates. Although these assessments were not void of political considerations, they did reflect detailed professional studies of the state of the art in each of the 31 chapters of the acquis. The political decision of December 2002 to take ten new members on board was thus based on a rather lengthy and detailed process of examination. Moreo-

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[1] J. Caprio, P. Honohan, J. Stiglitz (eds.): Financial Liberalization: How Far? How Fast?, London and New York 2001, Cambridge University Press.

ver, the component of examination has been much more pronounced than the item of give and take that used to be so closely observable in previous cases of enlargement. The fact that such major components of legislation as the law on central bank independence or the abolition of capital punishment had to be tailored to the EU acquis has already produced a considerable degree of systemic congruence. Furthermore, the regular participation of, say, Ministry of Finance officials in meetings of the Ecofin Council, the regular and active cooperation of national banks with the ECB, or the experience gained by proto-MEPs in the workings of the Strasbourg/Brussels organ all helped to smooth what seemed to be a particularly bumpy road from Communism to the EU.

Let us note: not only have the new members been effective in taking over EU legislation (in the case of Malta and Cyprus the British institutional heritage has not called for major changes) but, in terms of several macroeconomic indicators such as gross government debt, and even inflation, and in several years also in terms of deficit and interest rates, several new members have been outperforming the incumbents, such as Greece, or Italy, or Portugal. This is a clear indication that the process of institutional and nominal convergence has indeed materialised. Also in terms of economic growth – real convergence – the transition economies emerging from the transformational recession[2] have shown impressive signs of long-term catching up. True, this process started from a low level, the average of the EU-10 still being below 50 per cent of the EU-15. However, as long as this growth is based on improved allocation of resources, the dynamically growing role of foreign direct investment and wage restraint (relating net wages to productivity growth), this is both healthy and sustainable.[3] But as could be forecast in the paper just quoted, as long as wage restraint is given up, and fiscal positions become expansionary, the dynamics of growth are bound to slow down. Moreover, if sources of endogenous growth, be they R+D or a generally business-friendly climate (rule of law in the economy) are neglected, there is no reason why a lower level of development *per se* could translate into higher growth rates. *Convergence in economic theory is known to be a conditional process* that is likely to materialise only if the complex set of pre-conditions, in terms of policies and institutions, is delivered in reality. In the following I shall investigate if and to what degree these conditions are given in the new member states. It is a relevant research question, both in terms of theory and policy, since membership in the European Union *per se* has not resulted in automatic catch-up, especially not at the level of regions, nor at the level of national economies. EU is a chance though, a window of opportunity, but it is not a panacea. The mere fact that EU members spend a mere 0.97 per cent of their GDP on financing EU related matters in 2004 is already a clear indication that those seeing the advantage of EU membership in massive official transfers (once capped at 4 per cent of the recipient country's GDP) are likely to be severely disenchanted soon.

Ambiguities on the Substance of Policies: Institutional Issues

It would be blue-eyed to be surprised to observe that newly established institutions – or ones re-introduced after a hiatus of four to five decades, like competition law – do not deliver the same way as they do in advanced economies.[4] This has to do with the lack of experience, as well as with the role of historical context and other factors, subsumed in economic theory under the name of informal institutions. It takes time and experience, for instance, until independent regulatory organisations, say in the banking sector, learn how to act and how not to act. Likewise, competition law is, for the time being, much more widely used by transnationals than by local businesses.

Similarly to advanced economies, institutional innovations need time to be familiarised. It is by no means easy for a government the members of which have been socialised in the era of the planned economy to learn that an independent central bank may not be accommodating any fiscal deficits. Likewise it may take time to realise that governmental pronouncements, even of intentions, may carry weighty consequences through the reaction of capital markets. “Fundamentals” no longer explain macroeconomic outcomes, while pronouncements and changes in perceptions do change variables that matter for the real sector, such as the rate of interest or the exchange rate.

It may be no less difficult to learn that EU funds are allocated according to principles adopted by incumbents that may or may not overlap with the priorities followed by the new members' national ministries. In the case of agriculture there is a clear drift between local initiatives to boost production and EU policies

[2] J. Kornai: Transformational recession: the main causes, in: The Journal of Comparative Economics, Vol. 19, 1994, No. 1.

[3] More on that in: L. Csaba: Convergence and divergence in transition and integration, in: D. Schorkowitz (ed.): Transition – Erosion – Reaktion, Bern-Frankfurt-New York 2002, P. Lang, pp. 41-69.

[4] Let us note that following the series of accounting scandals, from Enron to Parmalat, it is hard to come up with the conventional proposition of anybody possessing the stone of wisdom.

derived from WTO and environmental considerations as well as from the Fischler reforms.[5]

Limited Administrative Capacity

Administrative capacity has been notoriously limited. The improvement of this factor, vital for success in intra-EU bargains, has long been recognised as necessary. Much of the pre-accession funds have been directed to improving these, and rightly so. The countries themselves have invested in it. Moreover, the substantially increased number of university graduates, many of whom have spent several semesters, even years, in western universities (not least thanks to the Erasmus and Socrates programmes), the ongoing exchange programmes among regional organs and the like have already produced substantial numbers of properly trained civil servants. Also the practice of outsourcing, the enhanced reliance, also by central governments, on public-private partnerships, may bring about a much larger increase in this area than it may appear.

However it would be wrong to deny that administrative capacity of the regions in the new members lags significantly behind that of the old members. Experience with the Nordic enlargement has already shown that municipalities and regions of more advanced countries stand a fair chance of out-competing those which, in the solidarity-oriented language of EU regional policies, should have enjoyed priority. If for no other reason – such as the February 2004 initiative of the Commission to re-tailor regional spending – this experience may well foreshadow that new members are unlikely to capitalise in full upon all the funds earmarked for them in Copenhagen. As is well known, the smaller amount of agricultural support was to be compensated by a larger amount from the structural funds. However, the latter are not entitlements, and thus insufficient administrative capacity may cross the preliminary calculations of diplomats and bureaucrats. Anybody familiar with the practice of research funding by the EU could testify that sums earmarked for competitive bidding have relatively little in common with targeted entitlements received on citizens' rights.

Return to Economic Populism

One of the more surprising developments of the early 2000s has been the return to economic populism in the front-runner countries of transition that will shortly be EU member states. This holds for the Visegrad countries, not for the Baltics. Parties on the left and right have been engaged in a rehash of old-fashioned competition over redistributory promises.

It is hard to develop a political economy model in line with the broad literature on fiscal sustainability that could offer a conceivable explanation for the fiscal derailment. Unlike in eastern Germany, where the exodus of the population has been going on ever since reunification, and unlike in France, where any major attempt at structural reforms has led to mass demonstrations, signs of measurable social pressure cannot be invoked to explain the softening up of governmental policies. By contrast the slow but steady erosion of governing parties, themselves broad coalitions of interest, could perhaps be invoked. If this is the explanatory factor, the conventional political economy modelling, invoking the weak position of the minister of finance and the fragmentation of the process of fiscal planning[6] could be relied upon.

However, strong doubts may be had about the viability of this explanation in countries like Hungary, where the constructive vote of no confidence cements any government to power. This circumstance allows Premiers to conduct any policy they wish to. Furthermore, if a country has attained a level of inflation below 5 per cent, social consensus favouring low inflation does not need to be created from scratch. Furthermore, the evidence from both incumbent and new EU members clearly shows that low inflation is a key precondition for growth to be sustained, while fiscal expansion produces only very short-term remedies in a globalised environment.

Interestingly enough, participation in the rituals of EMU, like elaboration of the Broad Economic Policy Guidelines (this time called Programmes for European Partnerships) as well as of the Convergence Programmes has done little to stop the central European governments from gross derailments. While domestic economic theory, increasingly influenced by standard mainstream concepts due to the modernisation of higher education, does not provide much room for populism, and the warnings coming, increasingly publicly, from the Commission and the ECB all point in the opposite direction, the disintegration of ruling coalitions has allowed for a policy drift that does not follow from "exigencies".

It would be hard to answer the question whether this unwelcome turn is a sign of institutional or policy weakness. The more we attribute it to institutional performance and design, the more we can follow

[5] A. Kay: Path dependency and the CAP, in: Journal of European Public Policy, Vol. 10, No. 3, 2003, pp. 405-420. Cf. also the Forum discussion in: INTERECONOMICS, Vol. 37, No. 2, 2002, pp. 232-243.

[6] J. von Hagen, E. Perotti, K. Strauch: Fiscal Sustainability, London 1997, Centre for Economic Policy Research.

the arguments of the chief economist of the EBRD[7] that the idea of euro-zone membership is premature, an idea that is to be given up, the sooner the better. This approach, however, provides too easy an exit. It abstracts away from the more general insights[8] calling for the limitation of discretion in fiscal policy-making, on grounds of smoothing activity and of empirical findings supportive of higher growth in countries with less discretion. Alternatively, once we accept that the single currency has been a political economy tool, in the incumbents too, to orchestrate reforms that are needed for solid finances and sustaining growth anyway, the more we believe that the Stability and Growth Pact is a next to ideal point of orientation for the new members in specifying measures and the trajectory they need to follow if they wish to benefit the most from joining the stability club of the EU.[9]

It remains to be seen – as part of a more general European policy issue – if and to what degree public discourse and the related public perceptions can deviate from what is established insight in economic theory. Experience suggests that there is no “inevitability”, let alone shortcuts from theoretical insights to broader policy changes. However, global experience with economic policy reform over the past quarter of a century is indicative of the *potential, though by no means the necessity* of changes for the better. Whatever way it may be, unless these changes are forthcoming new members’ ability to make full use of the potentials of their EU membership, starting with the advantages of stable money and a calculable framework, as a major component of choosing investment localities, will remain constrained. Differently put, their preparedness for an EU based on a single currency is limited at best.

Level of Long-term Interest Rates

It may seem to be a formal criterion, but it is not: the level of (long-term) interest rates. From a legal point of view this is one of the Maastricht criteria that need to be met. Given that the new members joined *not only the EU but also EMU*, though with a derogation for a limited time, meeting the criteria is also just a matter of time, and no longer a matter of debate. But there is more to it. From the point of view of investors in general and of capital markets in particular, the level of the rate of interest is among other things an indicator of trust. This is not an absolute maxim (the smaller the better), but if a country operates, in the long run, with interest rates way above the level customary at the time in global capital markets, it sends a signal equal to a profit warning of a corporation. On the one hand, the ability of the local government and of local corporations to finance their activities (expansion by reliance on external/additional funds) will be constrained. On the other hand, the level of the interest rate is a reflection of the expected risk premium, that is of the overall assessment of the country by the markets. Moreover, this is by no means a spot phenomenon, since we are talking about long-term interest rates.

From a formal perspective it is an encouraging sign that papers with a maturity of 7-10 years have become customarily traded in the central European emerging economies. It also is a promising sign that stock market capitalisation in some of the new members is above that of the old ones. However, as long as the debt of new members, with the exception of the Czech Republic, trades at a very high risk premium, and furthermore that central banks are pushed to sustaining high real rates of interests, this is a sign that the ability of these countries to attract foreign investment, over and above the one-shot opportunity of privatisation,[10] is limited. This is much more of a problem from the point of view of financing long-term, sustainable growth, than the outcome of bargains over the structural and agricultural funds of the European Union. Still, it could be precisely the full membership in the EU that might deliver the required bonus in terms of credibility and reputation that could improve the market standing of central Europe. The latter would translate into the numbers on the capital markets, that is smaller spreads and especially to significantly lower long-term interest rates than the ones prevailing at present.

Reforms in the Making

Available evidence is indicative of a grave danger that may lead to disenchantment and euro-sceptical backlash in the second half of the decade. Namely that new member states are not properly prepared (often not prepared at all) for the changes and reforms that are already in the making in the European Union. One indicator for this has been the telling silence of

[7] W. Buiter: Regional integration and globalization: implications for transition countries – keynote delivered to the 3rd annual conference of the Munk Center for International Studies, Trinity College, University of Ontario, entitled “Canada and the New Europe”, 26-27 February 2004.

[8] A. Fatas, I. Mihov: The case for restricting fiscal policy discretion, in: The Quarterly Journal of Economics, Vol. 118, No. 4, 2003, pp. 1419-1448.

[9] L. Csaba: A non-stability and anti-growth pact for Europe?, in: L. Csaba: The New Political Economy of Emerging Europe, Kluwer/Akademiai, forthcoming.

[10] This one-shot option is of course not exhausted, since new privatisation in the areas of physical infrastructure, welfare services and network industries, as well as the opening up of previously closed markets such as air transport, provide sizeable opportunities for new investments in new areas in the foreseeable period of time.

the representatives of new member states (then candidates) in the Convention on the European Constitution. True, there has been a good reason to keep silent. Incumbents have long been deeply split, and ever since the unlawful boycott of Austria in 2000, followed by the divisions following 9/11 and even more the war on Iraq, an atmosphere of distrust emerged among the incumbents. Sensing this, the new members – called also "new Europe" by their American allies – felt it more rational to keep their opinions to themselves and not to antagonise anyone too early. This did work insofar as the accession negotiations could be concluded according to the road map, adopted in the Nice Council, that had looked quite ambitious at the time of its adoption. On the other hand, their behaviour contributed to "sweeping problems under the carpet", i.e. to avoiding any issue of controversy.[11] This did allow the adoption of the draft document but as evidenced already in the December 2003 Brussels Council, these problems did crop up at a later stage. The non-adoption of the Constitution is not a catastrophe *per se*, however. But the Polish-Spanish axis has already foreshadowed that new members may be much less docile than they may have seemed. Quite in line with game theory, the very fact that the number of agents has significantly increased, while the mechanism of decision-making has not been changed fundamentally, means that it is easy to forecast the possibility of ad hoc coalitions emerging, quite unrelated to the substance of the subject-matter.

Also the atmosphere and the negotiations of the Copenhagen Council of December, 2002[12] have indicated that concerns of re-distribution, bargains about macro-economically insignificant amounts, that later may be presented as a diplomatic victory for the domestic audience, are likely to dominate over broader issues, especially ones relating to long-term matters and institutional reforms. This has two immediate consequences. For one, the new members have demonstrated our claim, elaborated above, that they are quite good at learning the practices of incumbents. Therefore low politics has been dominant over high politics. By the same token the chances of reform are quite dim and diminishing. This is one of the old insights of the literature on policy reform,[13] that at times when concerns over redistribution dominate, no major reforms are feasible in a political sense, irrespective of the severity of the economic situation. The new members therefore may contribute to the lack of actual reforms (as opposed to rhetoric), since they interpret their national interest *exclusively* in terms of net transfer positions.[14]

This situation is dangerous on two planes. First the vested interest politics that contributed to the slowdown and watering down of several reform initiatives of the common agricultural policy as well as of the structural funds over the past 15 years is likely to receive new support from the new member states. An anti-reform alliance – if you wish, the coalition of the nasty – is already in the making and may pre-empt the financial guidelines for 2007-2013 from being elaborated along the lines of new principles and new expenditure priorities, in line with the principles of public finance. Their foot dragging is unlikely to be productive, since the net contributors have made it clear long ago that as long as the questionable efficiency of current EU spending is not revised they do not see any reason to contribute more; actually less contribution should suffice.[15]

Second, and equally importantly, the governments as well as the population of the new member states may be deeply disenchanted seeing that the EU is no longer replicating its policies where major trans-border official transfers assisted countries at the lower level of development. The drift between their (obviously inflated) expectations and foreseeable realities may easily translate into a political backlash. One part of this is the replication of earlier experience, namely that governments which have led their countries to the EU tend to lose out in the subsequent election. More importantly, however, an overall mood of Euro-scepticism is likely to take root. Opinion polls as well as low turnout in the referenda on EU membership have already foreshadowed that this turn may be realistic.

As a consequence, and not least because of their preparing for the past war, the new members may fall short of making use of even those opportunities that present and future – reformed – EU funds and proce-

[11] K. Hänsch: ‚Beschreiben was sein kann': der Verfassungsentwurf der Europäischen Konvents, in: Zeitschrift für Staats- und Europawissenschaften, Vol. 1, No. 3, 2003, pp. 299-312.

[12] P. Gyorkos: A csatlakozasi targyalasok zaro szakasza, legfontosabb esemenyei es eredmenyei, a Koppenhaga utani feladatok (The concluding phase of accession negotiations, its major results and tasks after Copenhagen), in: Europai Tukor, Vol. 8, No. 1, 2003, pp. 139-146. The author was the chief negotiator for the Hungarian delegation at the expert level.

[13] R. Bates, A. Krueger: Generalizations arising from the country studies, in: R. Bates, A. Krueger (eds.): The Political Economy of Economic Policy Reform, Oxford 1993, Basil Blackwell.

[14] Speaking at the congress of the ruling Hungarian Socialist Party, the Prime Minister Peter Medgyessy mentioned as one of his four absolute top priorities the maximisation of transfer payments from the European Union. Reported inter alia in: Nepszava, 13 March 2004, and reiterated in a subsequent cabinet meeting (cf. Vilaggazdasg, 19 March 2004).

[15] J.-J. Hesse: Europa professonalisieren, a study commissioned by the federation of German Taxpayers, Berlin, September 2002.

dures would allow for them. The Scandinavian vicious circle scenario may be replicated in political terms, without however the efficacy of the Scandinavian members in making use of EU funds, or for furthering their own agenda.

Status-quo Assumptions

It may be particularly challenging to see *how little the new members are prepared, at least at the policy-making level, for the foreseeable changes in all major EU policies.* While both in the academic literature and in the policy initiatives, such as reform projects by the Commission or by some of the major net contributors the contours of change have already emerged,[16] the policy-making of the new members continues to build on status-quo assumptions. As far as I am informed no background materials are being prepared for the scenarios should EU agricultural policy or regional support schemes be further changed.

Let us take only those areas where spending may be most sizeable, such as the two areas mentioned above, environmental protection and common foreign and security policy (CFSP)!

Agriculture and rural development have traditionally been the areas which have been least prepared for the new challenges. This has to do with the command economy methods and the insulation of the field from the rest of the economy. In some countries the producer lobby has also been over-represented in the political arena. But across the board there emerged a consensus that new members should replicate the post-war experience of western Europe, that is support farmers via prices so as to allow for rural development. It counts among the commonplaces in the EU to reiterate, ever since the MacSharry reforms of 1992 (extended by Agenda 2000) that there is neither money nor justification to replicate history. Still, given that rural areas have been neglected in most accession countries ever since the l930s (when the depressed farm prices became a factor of the economic re-distribution) the tendency to see investment now as a compensation for historic injustice is widespread even today. The idea of de-coupling rural ways of life from the cultivation of land and animal husbandry still sounds alien to many. Sectoral plans aim either at self-sufficiency, or, as in the case of Hungary, re-establishing the role of this area as a leading export sector. These projects simply disregard the fact that EU policies over the last dozen years has aimed at reducing overproduction, and since this is an outcome of domestic and global challenges there is no way to revert it. Also for considerations of environmental sustainability, rural development de-coupled from farming seems to be in the interest of the new democracies. But the political interpretation remains quite different.

In terms of regional development there still is a faint hope that the major transfers enjoyed by the southern members will be replicated. There is limited if any understanding of the inevitability of following efficiency principles, once the amount to be distributed remains limited or even decreases in relative terms. The fact that most EU supported projects require advance financing and also co-funding by the national and local organs, the diminishing role of national gate-keepers is poorly understood. Given that the backwardness of physical infrastructure has become a bottleneck, spending on this is likely to increase. Funding, however, must come primarily from the private market, if for no other reason than the small macroeconomic significance of EU spending (below 0.4 per cent of GDP). As long as EU structural spending has not been shown to be conducive to regional catching up,[17] not least because of its small size and because of the political determination of objectives, one wonders what role this factor may play in the new member states. The latter are often willing to give in to the pressures[18] to subordinate their territorial modernisation to the needs of structural spending by the EU. This would be a serious mistake, since regional structures are formative in the political set-up of any country, and furthermore they may play important roles in supporting the choice of investments.

As far as the environmental agenda is concerned, in the past couple of years a de-emphasis of this field in terms of shares of total government allotments could be observed. Also the long transition periods "obtained" on accession reflect a limited interest, let alone urgency, in tackling these long-term issues. The green ministries continue to be weak portfolios in the fight for limited resources, and agreeing to the EU acquis has provided only limited and temporary assistance.

Last but not at all least mention should be made of the common foreign and security policy. Slow progress in the transformation of Romania and Croatia, or more recently the re-eruption of ethnic violence in Kosovo, or the close to civil war situation in Macedonia in 2003, are all indicative of a very real need for the EU

[16] Forum: EU cohesion policy: challenges and responses, in: INTERECONOMICS, Vol. 38, No. 6, 2003, pp. 292-311.

[17] H. Midelfart-Kravnik, H. Overmans: Delocation and European integration: is structural spending justified?, in: Economic Policy, 2002, No. 35, pp. 328-358.

[18] M. Ferry: The EU and recent regional reforms in Poland, in: Europe-Asia Studies, Vol. 55, No. 7, 2003, pp. 1097-1116.

to develop an ability to act, at least in its own "backyard". True, the EU has remained a basically civilian institution. Still, the unstable environment, as well as the need to speak with a common voice at least on issues of immediate common concern, such as the western Balkans, need to be addressed. While using force always remains an "*ultima ratio*", being unable to enforce peace, even against small bands of armed people, may seriously undermine the credibility of the EU in international relations. Providing a European perspective should certainly entail more than declarative diplomacy.[19]

Silence on Future Developments

Being unprepared for the EU is most palpable in the new member countries' silence on the future of the Community. Almost nobody asks the fully legitimate question: what sort of EU do we (Hungarians, Poles etc.) need? Even allowing for the (short-term) political expediency of not getting involved in debates on the future at the Convention, one may have to add the regretful fact that such debates are not being conducted in the academic literature either. Sporadic contributions in the daily press and very general statements by political and academic authorities do not substitute for a substantial rethinking. For the time being the political class entertains itself with wishful thinking in terms of the additional growth EU membership creates, of the contribution of EU funds to improving living standards and the like. The question what new members can contribute to the EU is mostly not even raised. Yet if it is raised (mostly in conferences), the answer is general and non-binding, such as references to the cultural heritage, historic aspects, or the growth new members may generate (even if we were to grow by 10 per cent a year, the macro-significance of the latter could be marginal for the EU-15, given that the new members' combined GDP hardly exceeds 5 per cent of that of the EU 15).

Issues such as the need for a well functioning Community, the need to limit the use of official languages, the imminent need to work with a smaller Commission (that works as a team rather than a set of national delegates), the need to deregulate much of the unnecessary EU regulations (the famous chocolate and cucumber regulations for instance) should be considered. But this is a normative statement rather than a forecast on our part.

[19] P. Balazs: Az Europai Unio kulpolitikaja es a magyar-EU kapcsolatok fejlodese (External policies of the European Union and the development of Hungarian-EU relationships), Budapest 2002, Kerszov Uzleti es Jogi Kiado. The author is Hungary's first commissioner in Brussels.

[20] K. Hänsch, op. cit.

Perspectives

Ever since the adoption of the Lisbon Strategy of 2000, as well as following the deliberations of the Convention, there is no doubt that the EU is in need of a fundamental reform. The latter should diminish the role of path dependency in its policies, and make the acquis more forward-looking. Under this angle the rejection of the draft Constitution in December 2003 should not necessarily be counted as destructive. What we do have at hand is more a consolidation of the status quo than a forward-looking document.[20] If this assessment holds, this might not be the time to adopt a Constitution, and the loss of face by those involved is a smaller evil against a bad basic law that could limit further change for a long time to come.

For the time being the text available is redundant on issues that are unrelated to EU policies (cultural heritage etc.) but is silent upon all matters that relate to the fundamentals of the EU in a dynamic perspective (federalism versus inter-governmentalism, simpler decision-making, principles of finance etc.). Very little has been attained to make decision-making suitable for 25 and more members, for avoiding the practice of four-day-and-four-night sessions à la Nice, and introducing real subsidiarity.[21]

Likewise it takes time to realise that new, non-governmental forms of cooperation, such as emerged in the fields of environment or fisheries, may be the model for the future. In these areas – similarly to the CFSP – although there are common goals/policies/norms, there are no common funds. The role of organs other than the Council, the involvement of regions and civil society, may be the name of the game.

If this is the case, a relatively simple measure of EU preparedness can be developed for the new member states. The less they talk about money/net recipient position, the less attention and energy they devote to dodging various pieces of the acquis, be they the Stability and Growth Pact or the environmental acquis, the more they advance propositions of collective rationality, rather than individual rationality, the more they are prepared. True, under this broader angle some of the incumbents of the EU-15 may well want to unlearn the dominance of low politics in their approach to the future of the EU. Then and only then will the Lisbon Strategy, and the ensuing more global competitiveness, sustained growth, and the "ever closer union of European nations" become a reality, not just a normative consideration.

[21] H. Nurmi, M. Hosli: Which decision rule for a future Council?, in: European Union Politics, Vol. 4, No. 1, 2003, pp. 37-50.

Switgard Feuerstein* and Oliver Grimm**

The Road to Adopting the Euro

The ten countries acceding to the European Union in May 2004 will at the same time become members of the Economic and Monetary Union (EMU). Nevertheless, they will not adopt the euro from the very beginning, as they will be member states with derogation. Since the new member countries do not have an opt-out clause, they are committed to participating in the euro area in due course. However, the wish to opt out is not an issue. On the contrary, the accession countries want to adopt the euro as soon as possible. Parallel to preparing their EU membership, the ten accession countries (referred to hereafter as “AC-10”) have aimed at achieving nominal convergence, which is the precondition for joining the euro area, although with varying success. The Bank of Slovenia for instance states explicitly that “preparing the conditions for adoption of the euro at the earliest opportunity remains the Bank’s … basic policy orientation”.[1]

In contrast, the EU has called for a slower timetable and sees the adoption of the euro as the final stage of a long convergence process. The different approaches also become evident in the discussion on the appropriate interpretation of the convergence criteria on exchange-rate and price stability and on the sense of participation in the new Exchange Rate Mechanism (ERM2) prior to joining the euro area. Nonetheless, it can be expected that the first accession countries will enter the euro area in 2007 or 2008.

Current Exchange-rate Regimes

The current exchange-rate regimes of the AC-10 range from currency boards to free floating. Estonia has had a currency board with a fixed rate to the DM/EUR since 1992. Lithuania introduced a currency board in 1994; the anchor currency was changed from the US dollar to the euro at the beginning of 2002. Latvia and Malta have pegs to currency baskets with small fluctuation bands of ±1% and ±0.25% respectively. Cyprus closely pegs its pound to the euro (notwithstanding the formal fluctuation band of ±15%). Officially, Slovenia pursues a managed float, although the Bank of Slovenia conducts an active exchange-rate policy. The result looks rather like a crawling peg with a steady devaluation at a falling rate (3% in 2003).

The remaining four accession countries have replaced the (crawling) pegs that they pursued during most of the 1990s by more flexible regimes. The Czech Republic and Slovakia switched to managed float systems in 1997 and 1998 respectively. Since 2000, Poland has let its currency float freely, after widening the fluctuation band of its crawling peg in prior years. In 2001, Hungary widened its fluctuation band from ±2.25% to ±15% and abolished the gradual devaluation of the central parity, thereby mimicking the rules of ERM2. Hungary devalued its central parity from 276 to 282 HUF/EUR in June 2003, but this was not due to a weak forint. On the contrary, the purpose was to shift the margins to avoid a renewed appreciation.[2]

Steps to Adopting the Euro

Upon accession to the EU, the AC-10 can maintain their different exchange-rate regimes. The responsibility for monetary policy will remain in the hands of the respective central banks. Although the new member states will not join the euro area upon accession, the obligation of adopting the acquis communitaire also applies to its EMU related part including central bank independence, the prohibition of direct financing of budget deficits, and the liberalisation of capital movements.

As a next step towards adopting the euro, a new member state can request to join ERM2 at any time after accession. Participation in ERM2 is voluntary, but member states with a derogation can be expected to join the mechanism. Moreover, according to the convergence criterion on exchange-rate stability, participation in ERM2 for at least two years is a precondition for adopting the euro. Finally, the new member states will fully participate in the euro area once they meet the convergence criteria set out in the Maastricht Treaty.

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[1] Bank of Slovenia: Monetary Policy Implementation Report, October 2003, p. 4.

[2] Hungarian National Bank: On the Bank’s Exchange Rate Decision of 4 June 2003, Press Release. The forint appreciated immediately after widening the fluctuation band, and since then it has always nominated more strongly than the central parity. In late 2002, the forint appreciated in response to a loose fiscal policy combined with a tight monetary policy, and in January 2003, the central bank had to intervene at the margin of the fluctuation band. A subsequent cut in interest rates caused a depreciation by a few per cent. In June 2003, the government requested a shift in the central parity to signal to the markets that a renewed appreciation of the forint would not be allowed.

The New Exchange Rate Mechanism ERM2

When the third stage of EMU began in 1999, the European Monetary System (EMS) was replaced by ERM2. According to the respective Resolution of the European Council,[3] the exchange-rate mechanism is based on central rates against the euro with a standard fluctuation band of ±15%. Decisions on central rates are taken by mutual agreement of the ministers of the euro area member states, the ECB and the ministers and central bank governors of the countries participating in ERM2.

Interventions at the margins are in principle automatic and unlimited, unless they conflict with the primary objective of price stability of the ECB or of the central bank concerned. All parties to the mutual agreement, including the ECB, have the right to initiate a confidential procedure aimed at reconsidering central rates.

Finally, fluctuation bands narrower than ±15% may be agreed at the request of a member state, which will be backed by automatic intervention of the country‘s central bank and the ECB. This is the case for Denmark, the only country currently participating in ERM2, with a fluctuation band of ±2.25%.

Although the basic decision of the Eastern enlargement had already been made, the characteristics of the accession countries were not taken into account when the rules of ERM2 were laid down in 1997. Soon afterwards, a discussion emerged as to whether a currency board arrangement (CBA) would be consistent with ERM2, as Estonia wanted to keep its currency board until it adopts the euro.

A CBA may be considered as a peg to the euro with a fluctuation band of zero. In contrast, there was also the opinion that a CBA should be regarded as a completely different regime, as the rules of ERM2 presuppose the possibility of realignments by mutual agreement and some fluctuation around the central parity.[4] However, there do not appear to be any good economic reasons for abolishing a well working CBA to allow for an interim period of exchange-rate flexibility prior to joining the euro zone.[5]

In April 2000, the ECB reached the conclusion that a euro-based currency board will not a priori be considered incompatible with ERM2, if certain conditions are met.[6] To be consistent with ERM2, the CBA must be deemed sustainable, implying that it may not be introduced during participation in ERM2. Moreover, the CBA of a participating country would be understood as a unilateral commitment, meaning that a CBA is not exactly equivalent to ERM2 with a zero fluctuation band. Finally, a mutual agreement must be reached not only on the maintenance of the currency board itself, but also on the central parity. If this is understood literally, it includes the possibility that a country could keep its currency board but would be required to adjust its parity. The substance of this last qualification is not clear, as the requirement that the CBA is deemed sustainable already implies that the central parity does not represent a real misalignment. A rationale for this qualification could be that it prevents a country from unilaterally changing its central parity shortly before or during participation in ERM2. In summary, countries that have had a CBA for a long time may keep it during ERM2. However, a CBA may serve neither as a short-cut to adopting the euro nor to circumvent the principle that in ERM2 decisions must be reached by common accord.

In November 2000, the Council of the EU stated that only the following exchange-rate regimes are clearly incompatible with ERM2: free floating (or managed float without a mutually agreed central rate), crawling pegs and pegs against anchors other than the euro. Compatibility of CBAs with ERM2 will be assessed case-by-case.[7]

Interpretation of the Exchange-rate Criterion

As a precondition for joining the euro area, the accession countries have to fulfil the convergence criteria. According to the Treaty of Maastricht, each country has to achieve a high degree of price stability, convergence in long-term interest rates, sustainability of its fiscal position, and – last but not least – the exchange-rate criterion requires the observance of the normal fluctuation margins of ERM2 for at least two years, without devaluing.

It is not clear exactly what this requirement means. In its resolution on ERM2, the European Council avoided the expression “normal fluctuation band” to refrain from prejudicing the interpretation of the exchange-rate criterion.[8] It was generally assumed that the ±15% margins would be relevant. However, in the Convergence Reports of 1998 and 2000, the

[3] European Council: Resolution on the Establishment of an Exchange-Rate Mechanism in the Third Stage of Economic and Monetary Union, Amsterdam, 16 June 1997.

[4] European Central Bank: Helsinki Seminar on the Accession Process, ECB Press Release, 12 November 1999, http://www.ecb.int/press/pr991112.htm.

[5] A. Gulde, J. Kähkönen, P. Keller: Pros and Cons of Currency Board Arrangements in the Lead-up to EU Accession and Participation in the Euro Zone, IMF Policy Discussion Paper, PDP/00/1, January 2000.

[6] ECB Press Conference, 13 April 2000.

[7] ECOFIN Council Conclusions on Exchange Rate Strategies for Accession Countries, Brussels, 7 November 2000.

European Commission also took the ±2.25% bands into account. In May 2003, Pedro Solbes, Member of the European Commission, drew attention to this stricter interpretation, stating that the narrow fluctuation bands would have to be observed to meet the criterion.[9] This statement has caused confusion among the accession countries.

In its assessment of the EU members in 1998, the Commission retrospectively referred to the narrower margins, that – disregarding Ireland – were exceeded only temporarily and slightly by some currencies during the two years considered. The Irish pound exceeded the ±2.25% fluctuation band most of the time. At the beginning it was 4.2% below the central rate, appreciating to a maximum of 10.9% above parity. Nevertheless, the Commission stated that the exchange-rate criterion was also met using the bands of ±2.25%, because the Irish pound had been strong and the central parity had been revalued in March 1998.[10] During its review period, the Greek drachma also exceeded the narrow margins most of the time up to a maximum of 9.2%. Giving the same reasons as in the case of Ireland, the European Commission stated in 2000 that Greece met the exchange-rate criterion.[11]

Recently, some accession countries have called for full clarity regarding "the rule of the game" and in particular the assessment of the observance of the exchange-rate criterion.[12] The response from the ECB was given by Tomasso Padoa-Schioppa at the Prague Conference on adopting the euro in February 2004, who said that the added precision would be disadvantageous to the AC-10, as it would imply an undue rigidity leading to mechanistic assessments.[13] This indicates that the currencies do not necessarily have to stay within the narrow margins to meet the criterion. Nevertheless, large fluctuations within the wide margins, amounting to a free float, would not comply with exchange-rate stability.[14]

Nominal Convergence and Balassa-Samuelson Effect

The convergence criteria were created with respect to the EU member states in the early 1990s. The issue of an EU enlargement was not taken into account. For the transition countries, a trade-off between exchange-rate stability and low inflation may arise due to relative price adjustments. During their catching-up process, prices of non-tradable goods tend to rise relative to tradable goods, amounting to an appreciation of the equilibrium real exchange rate leading either to nominal appreciation or to higher inflation. The change in relative prices is mainly due to faster productivity growth in the sector of tradable goods – the so-called Balassa-Samuelson effect. Estimates of the real appreciation caused by productivity gains range between 1 and 2.5 percentage points per year.[15] Moreover, further adjustments of administered prices and increases of VAT and excise taxes due to EU harmonisation contribute to higher inflation without causing pressure on the exchange rate. There are further channels that contribute to rising prices of non-tradables in fast growing countries. Bergstrand focuses on the demand side. Increasing productivity leads to a rise in income.[16] If, as usually considered, the income elasticity of demand for non-tradable goods, mainly services, is higher than for tradable goods, the Balassa-Samuelson effect is reinforced.[17] The low average price levels in the acceding countries amounting to only about 50% of the EU-15 average[18] also show that a real appreciation will occur during the catching-up phase. Therefore, it may be difficult for the eight Central and East European Countries (CEECs) to meet the price stability and the exchange-rate criterion at the same time, in particular for the countries with a currency board. Different conclusions can be drawn from this analysis. Keller[19] proposes redefining the inflation criterion to take into account the specific situation of the CEECs. In contrast, Tullio argues for delaying the adoption of the euro as long as a significant tendency for real appreciation remains.[20]

Moreover, according to the EC Treaty, the reference value is not the inflation rate of the euro area plus 1.5 percentage points, but refers to the average of the

[8] ECB: Policy Position of the Governing Council of the European Central Bank on Exchange Rate Issues Relating to the Acceding Countries, December 2003.

[9] P. Kenen, E. Meade: EU Accession and the Euro: Close Together or Far Apart?, International Economics Policy Briefs, No. PB03-9, Institute for International Economics, October 2003.

[10] European Commission, Convergence Report 1998.

[11] European Commission, Convergence Report 2000.

[12] IMF Country Report No. 03/187 (Poland), June 2003, Appendix: Statement by Wieslaw Szczuka.

[13] T. Padoa-Schioppa: Exchange Rate Issues Relating to the Acceding Countries, Prague Conference, February 2004.

[14] IMF Survey, Vol. 33, No. 4, 1 March 2004.

[15] W. Buiter, C. Grafe: Anchor, Float or Abandon Ship: Exchange Rate Regimes for the Accession Countries in: EIB Papers, Vol. 7, pp. 51-71; and Deutsche Bundesbank: Monthly Bulletin, October 2001.

[16] J. Bergstrand: Structural Determinants of Real Exchange Rates and National Price Levels: Some Empirical Evidence, in: American Economic Review, Vol. 81, No.1, 1981, pp. 325-334.

[17] D. Begg, B. Eichengreen, L. Halpern, J. von Hagen, C. Wyplosz: Sustainable Regimes of Capital Movements in Accession Countries, CEPR Policy Paper No. 10, 2003.

[18] S. Stapel: Purchasing Power Parities and Related Economic Indicators for EU, Acceding and Candidate Countries and EFTA, in: Eurostat: Statistics in Focus, Economy and Finance, Theme 2 –56/2002.

Table 1
State of Convergence of the AC-10 as measured by the EMU Criteria

	HICP inflation (annual percentage change)				Long-term bond yields (10 year) (December)			General Government Balance (in per cent of GDP)				General Govenment Debt (in per cent of GDP)			
	2000	2001	2002	2003	2001	2002	2003	2000	2001	2002	2003	2000	2001	2002	2003
Czech Republic	3.9	4.5	**1.4**	**-0.1**	**5.3**	**4.2**	**3.8**	-4.0	-5.0	-6.7	-12.9	**16.6**	**23.3**	**25.6**	**37.6**
Estonia	3.9	5.6	3.6	**1.4**	**6.8**	**3.9**	**2.8**	**-0.4**	**0.2**	**1.3**	**2.6**	**5.1**	**4.8**	**4.4**	**5.8**
Hungary	10.0	9.1	5.2	4.7	**6.9**	**6.2**	8.0	**-3.0**	-4.1	-9.2	-5.9	**55.5**	**53.4**	**56.4**	**59.0**
Latvia	**2.6**	**2.5**	**2.0**	2.9	10.2	7.4	7.4	**-2.7**	**-1.6**	**-3.0**	**-1.8**	**13.9**	**15.7**	**16.8**	**15.6**
Lithuania	**0.9**	**1.3**	**0.4**	**-1.0**	**6.3**	**6.4**	6.4	**-2.6**	**-1.9**	**-1.7**	**-1.7**	**24.3**	**23.4**	**23.6**	**21.9**
Poland	10.1	5.3	**1.9**	**0.7**	9.0	**5.6**	6.6	**-1.8**	-3.5	-3.8	-4.1	**37.2**	**37.3**	**43.3**	**45.4**
Slovakia	12.2	7.0	3.3	8.8	7.7	7.4	**5.0**	-10.4	-5.4	-7.2	-3.6	**46.9**	**48.1**	**41.9**	**42.8**
Slovenia	8.9	8.6	7.5	5.7	na	8.9	**5.1**	**-1.3**	**-2.5**	**-2.4**	**-1.8**	**27.6**	**27.5**	**28.0**	**27.1**
Cyprus	4.9	**2.0**	**2.8**	4.0	7.7	**5.4**	**4.9**	-3.1	**-3.0**	-3.5	-6.3	61.7	64.2	**58.7**	72.2
Malta	3.0	**2.9**	**2.2**	**1.6**	na	**5.8**	**4.7**	-7.0	-7.0	-6.2	-9.7	61.3	66.1	64.9	72.0
Reference value	**2.7**	**3.1**	**2.9**	**2.7**	**6.9**	**7.0**	**6.3**	**-3.0**	**-3.0**	**-3.0**	**-3.0**	**60.0**	**60.0**	**60.0**	**60.0**

Sources: Eurostat, ECB and Deutsche Bundesbank.

Long-term bond yields: Deutsche Bank Research, EU Enlargement Monitor, No. 6, Dec 2001, No. 10, Jan. 2003, EU Monitor, No. 11, Jan. 2004 and National Banks of Cyprus and Malta.

three best performing EU countries – typically those with the lowest growth rates. This definition makes it even more difficult to fulfil the criteria. It is arguable that the assessment should refer to the euro area inflation rate.[21] Alternatively, Buiter and Grafe suggest using the price level based on tradable goods for testing price stability.[22] However, at the Prague Conference in February 2004, Johan Baras, representative of the European Commission, emphasised that alternative benchmarks from which to measure the allowable excess of 1.5 percentage points would not comply with the Maastricht criteria and the principle of equal treatment.[23]

Implications for the Accession Countries

To cope with these difficulties and realise both stable exchange rates and the necessary degree of price stability, the currencies of the CEECs might appreciate within the exchange-rate margins. To stay within the narrow band of ±2.25%, the nominal appreciation can be carried out by a realignment of the central rate, of which Ireland made use in March 1998. For the currency board countries, which do not have that possibility, Buiter and Grafe see the jeopardy of an unnecessary recession to fulfil the conditions for joining the euro. Szapáry considers the problem for all transition countries and calls it the "weighing-in-syndrome": the CEECs may have an incentive for a temporary restrictive monetary policy and for freezing administered prices as well as lowering consumption taxes to squeeze down inflation prior to accession.[24] The resulting pressure on employment and economic growth does not appear to be reconcilable with the intention of the European Commission. In this context, Kenen and Meade point out that a tight monetary policy attracts – potentially volatile – capital inflows and that insufficient exchange-rate flexibility causes vulnerability to that volatility. To avoid the risk of currency crises, they urge the European Commission to use the ±15% standard band of ERM2 to assess the exchange-rate criterion or to allow unilateral euroisation as a substitute for ERM2, which is discussed below.[25]

State of Convergence

Prior to adopting the euro, the AC-10 have to participate in ERM2 for at least two years and have to pass the convergence test. In the following, it is shown how far the macroeconomic indicators of the AC-10 are conform with the convergence criteria today and how they have recently developed.

- *Price stability.* According to the criterion on price stability, a country's inflation rate must not exceed

[19] P. Keller: Recent Experience with Currency Boards and Fixed Exchange Rates in the Baltic Countries and Bulgaria and Some Lessons for the Future, Presentation at the Seminar on "Currency Boards – Experience and Prospects", organised by Eesti Pank, Tallinn, 5-6 May 2000.

[20] G. Tullio: Exchange Rate Policy of Central European Countries and European Monetary Union, in: P. de Grauwe, V. Lavrac (eds.): Inclusion of Central European Countries in the European Monetary Union, Bosten 1999, Kluwer, pp. 63-104.

[21] P. Kenen, E. Meade, op. cit.

[22] W. Buiter, C. Grafe, op. cit.

[23] IMF Survey, Vol. 33, No. 4, 1 March 2004.

[24] G. Szapáry: Maastricht and the Choice of Exchange Rate Regimes in Transition Countries During the Run-Up to EMU, CEPR Working Paper, No. 153, November 2000.

[25] P. Kenen, E. Meade, op. cit.

the average inflation rate of the three best-performing EU member states by more than 1.5 percentage points over the period of one year preceding the examination. In the year 2000, only two of the AC-10 had an inflation rate below the reference value as defined above (see Table 1). However, in the following years all AC-10 with the exception of Slovakia achieved further convergence in price stability. In 2003 five countries – namely the Czech Republic, Estonia, Lithuania, Poland and Malta – met the price stability criterion. In Slovakia, the high inflation reflects one-off effects due to adjustments of utility prices and increases in indirect taxes;[26] a similar effect is expected for Hungary in 2004. From 2000 until 2003, inflation in Hungary was above the reference value but stabilising. Slovenia also did not meet the criterion, but inflation rates were continuously decreasing and the Bank of Slovenia has set the targets of 4% for 2004 and 3% in 2005.[27] If the reference value was based on the euro area inflation rate instead of the average of the three countries with the lowest inflation, it would rise from 2.7% to 3.6%, and Latvia would meet the criterion, too.

- *Long-term interest rates.* Additionally, the AC-10 have to fulfil the condition of (nominal) long-term interest rate convergence. A country's average long-term bond yield (10 years) must not exceed the respective value of the three EU countries with the lowest inflation by more than two percentage points. As the three Baltic countries and Slovenia did not introduce 10 year government bonds until 2003, Table 1 shows yields on bonds with a shorter maturity. It is not clear whether these countries will all have emitted bonds with a maturity of ten years at the time of the convergence test.[28]

  Taking these limitations into account, Table 1 shows that in most countries, long-term bond yields have fallen over time; the exceptions are Hungary and Poland, where yields have increased again recently. Between 2001 and 2003, the number of the AC-10 meeting the interest-rate criterion increased from four to six. This development is due to a continuing fall of inflation rates, lower risk premia based on further legal reforms and the EU accession as well as the global tendency to lower interest-rate levels. Nevertheless, interest rates in Latvia and Hungary still remain noticeably above the reference value.

- *Exchange-rate stability.* As mentioned above, a member state has to observe the "normal fluctuation margins" of ERM2 for at least two years without devaluing to meet the exchange-rate criterion. It would appear that the acceding countries have to maintain their exchange rate within the narrower 2.25% margins, but can temporarily make use of the standard 15% margins without severe tensions.[29] Taking the exchange-rate movements during 2002 and 2003 and assuming the average of 2001–2003 as the central rate, the acceding countries showed remarkably stable exchange rates. Of course, the "best performing" countries are those with a hard peg to the euro, namely Estonia and Lithuania as well as Cyprus, all staying within the narrow margins. Malta and Latvia have pegged their currencies to a basket containing the US dollar and have thus depreciated against the euro since March 2002, but have remained in the standard band of ±15%. Slovakia and Slovenia, which are pursuing managed floats, experienced fluctuations of about 5%, whereas the fluctuation of the Czech koruna was below 3%. The deviation of the Hungarian forint against the hypothetical central rate remained slightly below 10%. Poland has adopted a free float system combined with inflation targeting. In the period considered, the Polish zloty was relatively stable against the US dollar, and thus it depreciated sharply vis-à-vis the euro and exceeded the wide margins of ±15%.[30]

- *Budget deficit and general government debt.* To ensure fiscal soundness, the ratio of the general budget deficit to GDP must not exceed 3% and the ratio of general sovereign debt to GDP must not exceed 60%. There is some flexibility in these criteria, if the particular ratio is diminishing and approaching its reference value. All the CEECs still have debt ratios below 60%. The debt ratios of Cyprus and Malta are somewhat higher. The deficit ratios of most accession countries have worsened in recent years: in 2000, six of the ten countries had a budget deficit below 3% whereas in 2003 only four countries met the criterion. The fiscal deficit was particularly high in the Czech Republic with 12.9% and in Malta with 9.7%. The large fiscal deficit of 9.2% in Hungary in 2002 was significantly influenced by one-off effects;[31] it was reduced to 5.9 % in 2003, which is still far from meeting the criterion.

  The data on general government budget and debt for 2003 were published by Eurostat in March 2004.[32] The budget deficits of some countries are much larger than previous estimates.[33] One reason is that deficit targets were not met. Moreover, the

[26] IMF Staff Visit to the Slovak Republic, 7-15 October 2003.

[27] Bank of Slovenia: Monetary Policy Implementation Report, October 2003.

[28] Deutsche Bank Research: EU Monitor, No. 11, January 2004.

[29] Note that it is difficult to look at the criterion today, as the acceding countries' earliest possible entry to ERM2 is May 2004.

[30] Deutsche Bank Research, op. cit.

AC-10 have for the first time notified their debt and deficit figures under the same reporting conditions as the EU member states. In addition, some new decisions by Eurostat on measuring the deficit have been taken into account. Due to a recent decision by Eurostat regarding pension funds, the data will be subject to further revision.[34]

- *Summary.* In 2003, only Estonia met all convergence criteria. Lithuania fulfilled all criteria with exception of the interest-rate criterion, which was slightly missed. During recent years, the fiscal position of the AC-10 has worsened on average, whereas a higher degree of price stability has been achieved. There are, however, large differences between the new EU members. The Czech Republic, Poland and Malta mainly have budget problems, but meet the inflation criterion. In contrast, Slovenia and Latvia have budget deficits below 3% of GDP, but have not yet achieved sufficient price stability. Cyprus, Hungary and Slovakia violate both the inflation and the deficit criteria. Summarising, with the exception of Estonia all countries of the AC-10 currently fail to meet the nominal convergence conditions. Nevertheless, the degree of convergence is comparable to that of the EU-12 countries in the years before EMU. While eight of the twelve countries fulfilled the inflation criterion in 1995, the fiscal deficit was above the reference value in nine countries.[35]

Exchange-rate Regimes for Accession Countries

Many well-known economists have advocated a hard peg of the currencies of the accession countries or an early adoption of the euro.[36] If the AC-10 are not yet admitted to become full members of EMU, a unilateral euroisation should be possible.[37] The reasoning for these suggestions is that fixed exchange rates are the appropriate regime for small economies that are highly open to trade and financial flows. The problems arising from short and medium term exchange-rate fluctuations caused by capital flows are large, whereas the advantages of adjusting the exchange rate are limited. Dornbusch and Giavazzi start their analysis with the statement that the CEECs lose nothing in giving up their monetary sovereignty.[38] They recommended in 1999 that all the accession countries should introduce a euro-based currency board.

Clearly, the AC-10 are small open economies. The GDP of Poland, by far the largest of them, amounts to only 2% of the GDP of the EU-15. The export quota of the AC-10 lies between 30% in Poland and 91% in Estonia.[39] In six of the AC-10, it exceeds 60%, which is only true for three of the members of EU-15. In particular, the three countries with the lowest per capita income in EU-15, Greece, Portugal and Spain, have relatively low export quotas of 24%, 32% and 31% respectively. In addition, the EU is by far the largest trading partner of the AC-10, accounting for more than 60% of most countries' exports.[40]

Thus on average, the AC-10 are more integrated with the EU than the EU-15 countries among themselves. Moreover, the CEECs already have a differentiated export structure. About half of the exports and imports are intermediate goods, indicating a high degree of integration into the international value-added process.[41]

In addition, the recommendation to quickly adopt the euro is based on doubts over whether ERM2 is a suitable system for the AC-10 preparing for euro adoption. The experience of the 1990s has shown that in a world of open capital markets, fixed exchange-rate regimes with some remaining flexibility are highly vulnerable. This applies in particular if the AC-10 are expected to stay within the narrow fluctuation band of ±2.25% to meet the exchange-rate criterion. The supporters of a hard-peg to the euro argue that participating in ERM2 exposes the accession countries to the unnecessary risk of exchange-rate crises that could damage them severely.

Strategies for the Adoption of the Euro

The accession countries want to adopt the euro as soon as possible. Most countries have decided on strategies for the adoption of the euro that include intended time schedules. The earliest possible date for participating in the euro area is the beginning of 2007, requiring entry to ERM2 during the year 2004. The as-

[31] IMF Country Report No. 03/124 (Hungary), May 2003.

[32] I. Kuhnert: An Overview of the Economies of the New Member States, in: Eurostat: Statistics in Focus, Economic and Finance, Theme 2 – 17/2004.

[33] See e.g. ECB: Monthly Bulletin, February 2004.

[34] Eurostat: Euro Indicators, First Notification of Deficit and Debt Data for 2003, News Release No. 38/2004.

[35] Deutsche Bundesbank: Annual Report 1995.

[36] R. Dornbusch, F. Giavazzi: Hard Currency and Sound Credit: A Financial Agenda for Central Europe, EIB Papers, Vol. 4, No. 2, 1999, pp. 24–32; D. Gros: Who Needs an External Anchor?, in: European Commission Seminar on Currency Boards in the Context of EU Accession, Brussels, 25 November 1999: Summary of Proceedings and Papers, Enlargement Papers No. 1, May 2000, pp. 142–159; D. Begg et al., op. cit.

[37] W. Buiter, C. Grafe, op. cit.; P. Kenen, E. Meade, op. cit.

[38] R. Dornbusch, F. Giavazzi, op.cit

[39] The data refer to 2001. Cf. Deutsche Bundesbank: Monthly Report, December 2002; Statistisches Bundesamt: Statistisches Jahrbuch für das Ausland; IMF Financial Statistics.

[40] The exceptions are Lithuania, Malta and Cyprus with shares of 48%, 44% and 55%, respectively. Cf. IMF: Direction of Trade Statistics Yearbook 2002.

[41] Deutsche Bundesbank, December 2002, op. cit.

sessment would then take place in 2006, meaning that the convergence criteria must be met in 2005.

Estonia, Lithuania and Slovenia indeed want to proceed according to this schedule and adopt the euro in 2007. Latvia and Malta currently peg their currencies to currency baskets and intend to switch to a euro peg and join ERM2 at the beginning of 2005; Latvia wants to enter the euro area in 2008. Malta and Cyprus also aim at adopting the euro quickly, without, however, giving exact dates. There are good chances that these six countries, which already have fixed exchange-rate systems, will indeed be able to join the euro area within a few years. The Baltic countries are already very close to meeting all convergence criteria. Slovenia still has to reduce its inflation further by about one per cent per year, but fulfils the fiscal criteria. The latter, however, remain a challenge for Cyprus and Malta.

The four larger CEECs also want to adopt the euro as early as possible. Poland and Hungary have explicitly mentioned the year 2007 as the desired entry date. However, they have now realised that entering the euro area is only possible if they meet the convergence criteria, which – according to the European Commission and the ECB – will be interpreted strictly. All four countries have problems in reducing their budget deficits, there is a risk that they will not meet the narrowly interpreted exchange-rate criterion, and the above-mentioned conflict between the inflation and the exchange-rate criterion applies.

The Czech Republic, Poland and Slovakia have stated that they regard ERM2 merely as a gateway to joining the euro area and that they want to participate in ERM2 only for the minimum of two years.[42] Poland will postpone entry to ERM2 until it can expect to meet the convergence criteria in the second year of membership. Slovakia now expects to adopt the euro between 2008 and 2010, the Czech Republic around 2009–2010.

Until very recently, Hungary adhered to its goal of entering the euro area in 2007 or 2008. However, the new finance minister Tibor Draskovics, who took office in February 2004, stated that this aim was too ambitious. The main challenge is to meet the criterion on the budget deficit. In April 2004, the Hungarian government will publish a new schedule for adopting the euro.[43]

The countries which want to enter ERM2 very soon after EU accession aim at keeping their currently fixed rates as central parities. The Czech Republic, Hungary, Poland and Slovakia, which currently have more flexible exchange rates, will have to negotiate on the central parity with the EU. In view of the precedents of Ireland and Greece, these countries will have an incentive to enter ERM2 with a relatively low central rate, because doing so will make meeting the exchange-rate criterion easier. If their currencies tend to be weak, there will be some range to depreciate moving towards the central rate. In case of a strong currency, the central rate could be revalued, which – according to the EU – does not pose a problem.

The Position of the EU

The EU sees the adoption of the euro as the end-point of a structured convergence process within a multilateral framework. In the first years of EU membership, the AC-10 should focus on achieving real convergence in the sense of ongoing structural, administrative and economic reform, and not yet on joining the euro area.[44]

As the AC-10 differ in their size and structure and in their current exchange-rate regimes, it is acknowledged that the paths towards the euro will be different. The EU will assess the countries case-by-case, taking their specific situations into account. However, the EU also emphasises the principle of equal treatment between the new and the current member states. Referring to this principle, the European Commission justifies for instance the unduly restrictive interpretation of the inflation criterion, that has been discussed above.

Kenen and Meade[45] criticise this approach pointing out that *equal* treatment should not mean *identical* treatment but *equivalent* treatment, taking into account the changes brought about by the creation of EMU. In addition, the situation of the CEECs is also different from that of the old EMU members due to the real appreciation they experience during the catching-up process.

In the opinion of the EU, the AC-10 should not see ERM2 as a mere waiting-room for the adoption of the euro. The EU regards ERM2 as a mechanism fostering real and nominal convergence, while at the same time

[42] The Czech Republic's Euro-area Accession Strategy, Joint Document of the Czech Government and the Czech National Bank, October 2003; National Bank of Poland: Monetary Policy Guidelines for the Year 2004, September 2003; National Bank of Slovakia: Strategy of the Slovak Republic for Adoption of the Euro, in: Banking Journal BIATEC, August 2003.

[43] Beitrittsländer geben raschen Euro-Start auf, in: Financial Times Deutschland, 11 March 2004.

[44] ECB Press Conference, 13 April 2000; T. Padoa-Schioppa, 2004, op. cit.; P. Solbes: Euro Adoption in the Accession Countries – Opportunities and Challenges, Prague Conference, 2 February 2004. The position of the European Commission, the Council and the ECB on EMU enlargement are very similar and are not distinguished in the following.

providing the flexibility that may still be needed. Thus it may be advantageous to participate in the system for more than two years. Moreover, the EU states that ERM2 may help to find the appropriate exchange rate at which to join the euro area.[46] There are, however, doubts whether this reasoning applies. The exchange rate would be determined by market expectations regarding the conversion rate rather than on the basis of fundamentals.

Of course, the heterogeneity within the euro area will increase when the CEECs adopt the euro, making monetary policy more difficult to conduct. However, the economic situation of the AC-10 will have little impact on the ECB's decisions, since the AC-10 are small and thus have little weight in the euro area's average inflation rate, which is the ECB's target. In the case of an asymmetric shock, the AC-10 would have to bear the adjustment costs. As discussed above, there are nevertheless good economic reasons for an early adoption of the euro.

The argument that the accession countries will have only little influence on the monetary policy of the ECB is qualified, as they will be represented in the ECB's Governing Council. To prepare for the EU enlargement, a reform in the structure of the ECB's decision-making bodies has been adopted. As soon as the number of full EMU members exceeds 15, a rotation system for the voting rights of the governors of national central banks will be introduced, increasing the weight of the large countries in the Governing Council.[47]

Unilateral Euroisation

As the EU is reluctant to admit the AC-10 to the euro area, unilateral euroisation was discussed in some of them.[48] However, the EU strictly opposes unilateral euroisation, as it would circumvent the stages foreseen by the EC Treaty for the adoption of the euro and run counter to the multilateral framework.[49] As a practical solution, Buiter and Grafe suggest that the AC-10 should be allowed to euroise at a parity negotiated with the EU in order to be able to benefit from early euro adoption.[50] It would, however, be important for them to keep the prospect of full EMU membership, although euroised countries would have higher inflation rates than the euro area as a whole, as they are expected to have higher growth rates. In this context, Begg et al.[51] argue that within a currency area there is only one inflation rate, which equals the rate at which its money loses value, implying that countries which have adopted the euro unilaterally would meet the inflation criterion by definition.

Conclusion

The AC-10 and the EU have differing views on the appropriate speed of adopting the euro and on the requirement of participation in ERM2 for at least two years. The AC-10 want to join the euro area as soon as possible and focus on meeting the convergence criteria in the near future, whereas the EU calls for a slower timetable. Many economists support the approach of the AC-10 on the ground that a pegged exchange rate is suitable for small open economies and that participation in ERM2 exposes the new member countries to unnecessary risks of currency crises.

Referring to the principle of equal treatment, the EU emphasises that in the assessment prior to full EMU membership, the Maastricht criteria will be strictly applied. In particular, it adheres to an unduly restrictive interpretation of the inflation criterion. Moreover, the EU points out that according to the EC Treaty, the assessment will also consider the development of unit labour costs and other price indices and the situation of the current account. The latter exhibits a large deficit in many accession countries.[52]

There are, however, some indications that the EU will act more flexibly in future assessments than it states today.[53] In some cases, the criteria were interpreted very generously in the past, if this seemed appropriate. For instance, Belgium and Italy were admitted to the euro area with debt ratios above 110%, and Finland and Italy participated in the Exchange Rate Mechanism for less than the two years required prior to the convergence report.

It is difficult to predict how fast the AC-10 will be able to join the euro area. However, it seems likely that the process of integration into EMU will gain momentum after EU accession, and that all acceding countries will have adopted the euro by the end of the decade.

[45] P. Kenen, E. Meade, op. cit., p. 4.

[46] T. Padoa-Schioppa: Trajectories towards the Euro and the Role of ERM2, East-West Conference, Vienna, 4 November 2002.

[47] M. Frenkel, R. Fendel: The New ECB Voting System: Some Room for Improvement, in: INTERECONOMICS, Vol. 38, No. 6, pp. 334-338.

[48] P. Backé, C. Wójcik: Unilateral Euroisation: A Suitable Road Towards Joining the Euro Area for Central and Eastern European EU Accession Countries?, in: U. Sepp, M. Randveer (eds.): Alternative Monetary Regimes in Entry to EMU, Bank of Estonia, Tallinn 2002.

[49] ECOFIN, op. cit.

[50] W. Buiter, C. Grafe, op. cit.

[51] D. Begg et al., op. cit.

[52] In particular, Estonia, which meets all convergence criteria, has a current account deficit exceeding 10%. See ECB: Monthly Bulletin, February 2004.

[53] T. Padoa-Schioppa, 2004, op. cit.