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to economic and monetary union

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Abstract:

This thesis deals with the currency implications of the eastward enlargement of the European Union. It consists of two parts. The first part is about enlargement, and the second part about the Euro. The European Union, as a strong and powerful community, has an impact on the whole world. Its impact can be felt on the political and the economic levels. Enlargement presents a great opportunity both for the old and the new European Union members. In the course of the past four years the economy in the old and the new member states has developed favorably. However, we could notice that enlargement posed a great challenge to the institutional framework of the European Union and that it caused an increasing degree of friction among the member states. The Union was strong enough to provide mechanisms for the peaceful settlement of all conflicts. The experiences gained in the process, both the positive and the negative ones, could well be of assistance to countries in other parts of the world in their efforts to integrate.

The Enlargement of the EU with regards to economic and monetary union

1. Aims of eastward enlargement

1.1 What is EU enlargement?

Since the foundation of the European Economic Community (EEC) and its successor organisation European Union (EU) all the member states have enjoyed peace and stability for almost 50 years. Later, other European countries like Estonia, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia, Czech Republic, Hungary and Cyprus became members of EU on May 1, 2004. Two other countries, Bulgaria and Romania, joined the EU in the year of 2007, the EU has a total of 27 members.

Now the “EU enlargement” has been a buzzword in the European countries, its potential impacts, which are still not so clear to all, have been discussed by all the politicians and citizens. Actually, the thought that the old EU members just pocketed the new members does not accord to the fact, as in fact the accession countries spare no effort to take part in all the EU activities as well as try to get the support and help from old EU members successfully.



Other countries in western Balkans such as Croatia, Bosnia and Herzegovina, Serbia, Montenegro and Albania which are thought by the old EU members to be potentially ones that will join the EU family in the future still have to wait to be accepted due to their imperfection of political and economic systems.¹

¹ Ambühl, M. and Brunetti, A. (2004), p.35.

1.2 Conditions for membership

In 1993, all the EU member states signed the Maastricht Treaty in which some essential rules of being EU members were strictly confirmed: respect of liberty and democracy, protection of human rights and fundamental freedoms and the principle of rule of law. So if one country is considered by other EU countries not to satisfy any of these regulations, it would not get its accession to EU.

In June 1993, the Heads of EU State and Government specified all the essential conditions for being a member of the EU in Copenhagen as follows:²

- institutional stability as guarantee for democracy
- rule of law, protection of human rights, respect for and protection of minorities
- existence of a functioning market economy
- ability to withstand the market forces and the pressure of competition within the EU
- being able to assume the obligations resulting from membership and from economic and monetary union

1.3 Why EU enlargement?

In principle EU eastward enlargement has been a done deal since the European Council in Copenhagen in June 1993. The start of the first negotiations for accession (1998), the financial agreements from March 1999 regarding the Agenda 2000, and the Treaty of Nice from December 2000 were concrete steps in this direction. On these occasions it was often emphasized that eastward enlargement was not only - and not even primarily - an economic issue but also a political issue.

1.3.1 Political and cultural reasons

It is believed that through EU enlargement the EU values such as democracy, rule of law, protection of human rights and liberty, security and political stability can be realized and

² El-Agraa, A.M. (2006), p.23.

improved in the new EU countries. All the countries who desire to become EU members have to reach the level that is defined by Brussels. EU enlargement is a way to guarantee peace and liberty permanently. Other issues such as security and political stability could be protected as well, so we could see that the division of Europe which existed for almost 50 years after the Cold War would disappear and some so-called “east European countries” (but geographically in central Europe and having long been considered as part of the core of Europe) would regain their opportunities to play a role in the European affairs. All the citizens who belong to the old EU-15 countries also have the chance to familiarize and experience their new neighbours and enjoy a much more colourful and diverse culture in an enlarged family during the integration of EU eastward and southward expansion. The following political aims are frequently mentioned:³

- overcoming of the division of Europe and accession to NATO
- stabilisation of the democratic reforms in Eastern Europe
- reduction of security risks in Europe through the development of relations between states
- containment of organized trans-border criminality
- improved protection of human rights in Eastern Europe
- promotion of the role of the EU as a political player in international power relations.

1.3.2 Economic reasons

As the peace and mutual security have been strengthened during the EU enlargement, the economic development as well as the trade have also benefited. Now the EU economic space contains 450 million inhabitants after the addition of 75 million people, so that EU has become a more powerful international economic market and its influence has been strengthened. Nowadays EU has turned into the largest single market in the whole world and the following table 1 shows the EU in an excellent position so as to meet the challenges of global competition. The new members of the EU do have a considerable economic potential, so that the old EU-15 would find a great deal of chances to invest in such countries and the EU as a whole market would accelerate the growth of its economic integration. Small and medium sized enterprises are thought to have an easier access to involvement in a much larger market. For example, the German foreign trade with the new EU members has grown considerably and even has reached 12% of its trade with all the other foreign countries in the

³ Grauwe, P.D. (2007), p.63.

year 2006. Now the trade between old EU member states and new ones has increased more than three times as compared with what it was in the 1990s.⁴

Table 1: Development of EU between 2003 – 2007

2003(15 member states)	2007(27 member states)
378,5 mio. inhabitants	482 mio. Inhabitants
3,191,000 qkm area	4,278,000 qkm area
8,815 bill. Euro GDP	9,325 bill. Euro GDP

Source: Paul De Grauwe (2007) Economics of Monetary Union

The following economic aims are mentioned most frequently:⁵

- enlargement of the single market and
- securing market economy-based regulatory policies in Eastern Europe
- increase economic growth
- modernize the economy and the administration
- reduce social tension in Eastern Europe
- in addition it is hoped that environmental pollution will be reduced on account of applying the EU environmental standards to the accession states.

2. Enlargement: an economic success

From 1997 to 2006 all the new EU members experienced a strong growth of their national economies, on average 3.75%, while the economic growth of the old EU-15 remained on average 2.5%.⁶ The rising of the incomes of the new EU members was also tremendous: while in 1997 they were only 44% of the old EU-15, in 2006 they already reached approximately 50% of the income level of the old EU-15.⁷ The economic growth was generally closely combined with the planning in these countries and those who developed fast were the ones with the lowest incomes. Since 2005, this phenomenon has had a profound positive influence on the continuously developing labour market.⁸

⁴ Ribhegge, H. (2007), p.45.

⁵ Grauwe, P.D. (2007), p.113.

⁶ Neal, L. (2007), p.64.

⁷ El-Gamal, M. (2006), p.95-p.138.

⁸ Grauwe, P.D. (2007), p.116.

Stability that is more macroeconomic based has evolved thanks to this new growth which has occurred in the new EU member states and which has exerted a beneficial impact on the policies and public finances in these countries. During the integration process and the improvement of coordinating procedures the economic discipline has been boosted and renewed. Meanwhile, the credibility of the economic policies which corresponds with the interest of the old EU-15 has stood the test of time. Furthermore, a great number of reforms in public finances have been introduced as well during the transition period for enlargement. The old EU-15 who had suffered a lot from their excessive budget deficits would also benefit a lot from the new EU countries.⁹

2.1 Welfare Effects

Taken together, the studies of the eastward enlargement do not agree regarding welfare effects: It is true that the majority of the relevant studies assume that the enlargement will increase macroeconomic welfare not only in the accession states but also in the old EU-15. On the one hand considerable welfare gains are possible and likely as a consequence of the expected trade-creating effects. On the other hand the enlargement of the domestic market will tighten the competition and force further rationalisation on the economy of the old EU-15, which will lead to increased welfare for consumers through lower prices and larger supplies.¹⁰

At the same time eastward enlargement will pose big challenges to some sectors, companies and employees as regards their adaptability. Therefore it is to be expected that the countries, regions and sectors of the old EU-15 will be affected by the eastward enlargement to various degrees. The eastern members have considerable comparative advantages in agriculture, labour-intensive products and some raw materials. Capital equipment, however, will face bottlenecks for quite some time. Altogether it may be assumed that the eastern members will follow the classical path according to which at first a large if gradually decreasing share of the domestic national product is generated by agriculture; it is likely, though, that this will lead to controversies about the Common Agricultural Policy.¹¹

Naturally it will be difficult to appraise and quantify the trade gains from the eastward enlargement. Therefore it is no surprise that different studies reach conclusions which differ considerably on some aspects. Generally, it is assumed that Germany, Austria and Italy will

⁹ Ambühl, M. and Brunetti, A. (2004), p.39.

¹⁰ Inotai, A. (1998), p.14-p.41.

¹¹ Inotai, A. (1998), p.14-p.41.

benefit the most from intensified trade with the eastern members as they are their most important trading partners currently. But the other EU members could also benefit from the eastward enlargement, either directly through growing trade with the eastern members, or indirectly by supplying preliminary products to the eastern members' main trading partners.

Table 2: A well-received study reaches the following conclusions for the distribution of likely trade gains (real income growths) from eastern enlargement among the EU-15¹²

	Mrd.ECU (at the price of 1992)	Share of the total real income growth of the EU-15 in %	Share of EU-GDP in % (1998)
Germany	3.8	33.8	25.31
France	2.2	19.3	17.08
UK	1.6	14.1	16.51
Italy	1.0	8.5	13.94
Spain	0.8	7.0	6.85
Netherlands	0.5	4.6	4.6
Sweden	0.4	3.9	2.79
Belgium/Luxemburg	0.3	2.6	3.15
Austria	0.3	2.6	2.48
Denmark	0.2	1.9	2.05
Finnland	0.2	1.4	1.51
Ireland	0.0	0.3	1.00
Greece	0.0	0.3	1.43
Portugal	0.0	-0.4	1.29
EU-15	11.2	100	100

Source: Baldwin R E, Francois JF, Portes R (1997). The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe, Economic Policy

This would mean that Germany, France and Sweden in particular would enjoy disproportionately large benefits from eastern enlargement. Roughly, proportional real income growth would be experienced by UK, Spain, the Netherlands, Austria, Denmark and Finland. Disproportionately small growth effects would be seen by Italy, Ireland, Greece and Belgium while Portugal would even have to deal with negative welfare effects.

2.2 Increasing economic integration

Early in the 1990s the integration of the trade sectors in the new member states started and through bilateral agreements 85% of bilateral trade were liberalised.¹³ Thanks to the opening

¹² Baldwin, R.E. et al. (1997), p.127-p.176.

¹³ Ribhegge, H. (2007), p.52.

of the national economies of the new EU-10, the trade between old EU members and new members increased a lot, during which period the importance of the old member states as trading partners of the new EU-10 grew by 6%. The imports of the old EU-15 from the new members also increased by 13%.¹⁴ This trade is characterised by the fact that most labour-intensive products were exported from the new EU-10 while most products with high technology were exported from old EU-15.

There is no doubt that specialisation effects and a reallocation of the factors capital and labour will come out because of the integration of merchandise markets (free trade), which will play an important role especially in Germany, the largest trading partner of the new EU-10. Germany is a traditional industrial country which stays competitive in vehicle and machine production, chemical and pharmaceutical products and electro-technical products, but such comparative advantages are already declining in the trade with some new EU-10 such as Hungary or Slovenia.¹⁵

The distribution of comparative production advantages that exists in the eastern new EU-10 would become the reason for the extension of trade-diverting effects that may occur besides trade-creating effects. More diversification of comparative advantages among the eastern members will lead to enhanced trade-creating effects. However, the convergence process between old and new EU members would become slower in the course of a trade diversion resulting from largely identical comparative advantages. The new EU members, who have relatively more favourable production costs, contributed a lot to the continuous trade balance surplus of the old member states. During the latest 10 years, it has been seen that the trade balance deficit of the new EU-10 has kept decreasing but it is not considered as startling in view of the economic backwardness of these countries. Furthermore, close political supervision, especially in those countries where a high rate of inflation exists, has been strictly required by the EU Commission in the trade balances.

The new EU-10 have attracted more and more foreign companies to invest after their accession to the EU. Since the mid-90s, this increase has become more evident especially after these new EU countries had opened their markets and executed new economic reforms. In 2006, direct investments with a total amount of more than 190 million euro have been

¹⁴ Ribhegge, H. (2007), p.181.

¹⁵ Mallossek, J. (1999), p.60.

made in the new EU-10, most of which were financed by the old EU-15. For example, as the biggest partner in the field of foreign trade to many eastern European countries, Germany remains the main investor that operates in Hungary, Poland and Slovakia, while for the Baltic countries; the main investors are from Scandinavia.¹⁶

The first motive that led the old EU-15 to invest in the new member states was to improve their market access. In the new EU countries located in the East of Europe, production of non-tradable goods has received nearly 50% of the foreign direct investments, the trend that such investments are not just directed to the centres but also to the peripheral regions will become more evident in the future.¹⁷

It was considered that if the new EU countries could join the European currency union as early as possible, the investment conditions would have benefited maximally without any exchange rate risk. Before these new countries get their accession to the European Currency System (ECS II), the risks of fluctuations of foreign exchange rates would still exist for a certain time, yet would decrease as the time goes by, so that the investment in the new EU countries will go on increasing.

Notable progress in the sector of finance has been seen in the new member states, especially in those who are located in Central- and Eastern Europe. The fact that the level of circulating loans and stock exchange capitalization in these countries is still below the average level of the whole Euro-space can not deny the progress achieved by the new EU members, because the credit growth has been considerable.¹⁸ The old EU-15 have more experience in trans-border participations and the share of foreign banks. As the competition became more intense, the credit (especially real estate loans) would be cheaper, and net interest margins would also be reduced. Having more chances to get into the new markets and to diversify their portfolios thanks to the accession of the new EU-10, the banks of the old EU-15 would benefit the most.

The Euro now would have a much more important meaning in the world currency system in comparison with the US dollar that has had to go through a relatively long period full of difficulties, so Euro does not only mean the sum total of the parts that has created it. Once the Euro zone turns into a currency space which is much larger than it is at present, a new

¹⁶ Ribhegge, H. (2007), p.197.

¹⁷ El-Agraa, A. M. (2006), p.153.

¹⁸ Vobruba, G. (2007), p.26.

currency relation with more stability will surely promote trade, investment and economic growth. It is certain that small countries like Slovakia will be protected in this euro zone against financial crises or some other kind of risks in the world.¹⁹

2.3 Challenges

2.3.1 Single European market

Free traffic in goods, services, people and capital has been principally guaranteed in all member states within EU by a single market without borders. Even to the new EU members, this single market requires them to fully participate without any exceptions lately.

The European single market, now comprising 27 members and more than 450 million consumers, is considered now as the greatest achievement of the European Union. Now a great number of advantages have been brought out, trade and customs barriers have disappeared, more companies have been involved actively in this single market, more goods have been offered to consumers and the currency has been unified. But these successes are still not able to meet all the challenges in this new century due to the lack of sufficient market integration of some sectors of the economy. Only if this single European market turns into an open, competitive and functioning market, can Europe itself confront the challenges brought by globalisation.

Here as follows are some of the changes in this single European Market that have entered into force with the EU enlargement to eastern European countries:

Free movement of goods:

Free movement of goods has become a reality, which means that all customs inspections on the borders just like the issuance of customs papers for goods within the sphere of free circulation of the Union have been abolished. The rules for taxation of incomes and their statistical compilation have been effected.²⁰

¹⁹ Vobruha, G. (2007), p.26.

²⁰ Neal, L. (2007), p.64.

Free movement of capital:

Free movement of capital now became the norm for and in the new member states after the accession of the 10 new EU members, with the exception that the problem of the acquisition of agriculture and forestry lands in all new EU member states (except Malta, Slovenia and Cyprus) remains to be solved according to their national laws in a seven year period of transition (twelve years in Poland).²¹

Free movement of people:

Since the accession, people have been able to move freely within the enlarged EU, which means no matter if the citizens are from old member states or new member states, they can travel from one EU country to another without visa or border control. There is an exception in the area of free movement of labour due to staggered transition periods which gives the member states possibilities to keep their national rules for the time being. However, it will be a must to examine the necessity of such restrictions after two years. Except Malta and Cyprus, this rule is valid for all the members.²²

The identity checks at internal borders between old and new member states were still in force before 2008, and now such checks are not necessary any more in most of the 27 EU countries.²³

Free movement of services:

In all of the new EU member states, it has been realised that services can move freely, too. Only the employees who belong to transnational service delivery have to face the restrictions on free movement of services.

2.3.2 Agriculture

Since the enlargement of the EU, considerable improvements have taken place in all the EU members thanks to facilitating the flow of trade within EU and promoting the modernization of agriculture in the new EU member states. The new EU countries' agricultural contribution in relation to the farmable land area has made the European agriculture more important. There is no evidence that shows whether the agricultural sector would be influenced negatively

²¹ Pinder, J. and Usherwood, S. (2007), p.65.

²² El-Agraa, A. M. (2006), p.165.

²³ El-Agraa, A. M. (2006), p.310.

during the process of the EU enlargement. The fact is that the new EU members are still less productive than the old EU-15, the share of agriculture in the overall workforce in different countries is not the same: 4% of the population in the Czech Republic and in Slovakia, while it is 16% in Poland.²⁴

Since about ten years, the farmers in the new EU countries have experienced more and more direct payments. In 2004, they were paid directly at 25% of the EU level and by the year of 2013, they will be paid entirely directly.²⁵ In this common agricultural market, the new EU members will be treated fairly for crops and animal husbandry instead of facing the risk of an overproduction. Furthermore, funds will be offered to these countries to help with their rural development, which are almost 50% more than those in the old EU members.

2.3.3. Employment and social cohesion

In 2000, the European Council agreed on the Lisbon Strategy in the capital of Portugal, with the initiative for more growth, employment and competition. This was a mandatory strategy to secure permanent competitiveness and dynamics of Europe. In the spring summit of the year 2005, all the EU member states were asked to introduce so-called national reform programs after an interim evaluation. For a social cohesion within the EU that is much larger, the main objectives were ecologically sustainable growth, and enduring employment with more and better jobs.²⁶

The legal rules for employment policies and social policies have been adapted in the new EU member states to the *acquis communautaire* easily, at issue were labour law, health and safety in the workplace, equality of opportunity and anti-discrimination. But some other challenges like fighting against unemployment or promoting social protections and dialogue still exist in the new EU countries. As such problems seem to be different in different countries, the rate of unemployment in these countries still remains high at about 13.4% although this situation has been improved since the year 1990.²⁷ The Lisbon Strategy for development and employment has determined that the systems of the new EU countries with the support of the European Social Fund have to make good efforts so as to reach the objectives.

²⁴ Neal, L. (2007), p.64.

²⁵ El-Agraa, A.M. (2006), p.373.

²⁶ Pinder, J. and Usherwood, S. (2007), p.65.

²⁷ Ribhegge, H. (2007), p.197.

2.4 Employment and wages.

The impact of eastward enlargement on employment and wages in the old EU-15 is mostly defined by two factors:

- the effects of enlargement on the international competitiveness of the EU,
- and
- the effects of migration on the level and the structure of wages.

2.4.1 Impact on the international competitiveness of the EU

In the global comparison the eastern members offer clear location economies for labour intensive production because of lower wages for an equally qualified workforce. This could have a positive impact on the international competitiveness of the EU on several levels:²⁸

- Enlargement gives rise to a modified intra-industrial division of labour within the EU which will create comparative advantages to the Union in the global competition. Setting up cost-saving production locations in eastern Europe might thus contribute to securing jobs with companies in western Europe.
- At the same time eastward enlargement will bring about the transition to higher-quality and more technology-intensive production which in turn will result in improved competitiveness.
- Advantages of location will also result from the high level of education and the large number of skilled and highly-qualified expert workers in eastern Europe. This constitutes an important potential for research and development.²⁹
- Additionally the improved location conditions attract not only capital from the old EU-15 but also international capital to the new EU members. In case of EU enlargement this capital remains in Europe and is not shifted to distant low-wage countries. This will contribute to securing jobs in western Europe.
- EU members such as Germany which already have close contacts with eastern Europe or have a favourable geographic location are likely to benefit more in this regard from eastward enlargement than other EU members such as Spain, Portugal and Ireland which still need to develop such relations.

²⁸ Neal, L. (2007), p.143.

²⁹ Inotai, A. (1998), p.14-p.41.

2.4.2 Basic effects of labour migration

As long as the marginal product of labour in western Europe is bigger than the one in eastern Europe, migrations will lead to welfare gains via improved factor allocations. This means that immigration can be beneficial to the target country provided that the labour market there is sufficiently flexible, that a sufficient degree of wage differentials and wage flexibility exists.³⁰

Additionally, east-west migrations could contribute to eliminating labour shortages in the target country. In particular this is true for highly-specialized labour. However, a need for additional manpower could also occur in low wage sectors if domestic manpower is not available for such jobs – possibly because the gap between low wages and public assistance benefits is not big enough. In this case the cause is to be found in the specific incentive effects of the respective social system (with corresponding macroeconomic costs).

2.4.3 Impact of enlargement on labour market and wages

As it is true for potential welfare gains and the volume of migration flows, there are manifold hypotheses also with regard to labour market effects and wage effects which are valid under certain assumptions only:

It remains unclear to what extent the different factor endowments of the old EU-15 and the new EU members will lead to an increased wage differential:

- In principle it might be assumed that wages will decline for unskilled labour and increase for skilled labour in the old EU-15 because the old EU-15 export capital-intensive goods and human capital-intensive goods to the new EU countries and import labour-intensive goods from there.
- However, it might be argued against a strong impact of trade and capital movements on wages that on the one hand the additional trade and capital flows will be too weak to influence the factor prices. On the other hand many producers in the new EU countries do not operate in the same price and quality segments as the producers in the old EU-15.³¹

³⁰ Booker, R. (2007), p.41-p.134.

³¹ Ribhegge, H. (2007), p.215.

- Altogether the growing trade is more likely to lead to a general wage increase than to a differentiation of income distribution. In any case, on the aggregate level no bigger tensions are to be expected in the EU labour markets.
- On the disaggregate level, however, sizable effects of migration are conceivable for specific regions and sectors. Thus noticeable effects on wages and employment will occur mostly in areas adjoining the new EU members (Germany, Austria, Greece, Italy and Finland).
- Additionally, intersectoral distribution effects are to be expected. Tendentially they will come with losses for industrial workers and the unskilled workforce in the services sector because they show a substitutional relationship to migrants on account of their qualification (e.g. clothing, footwear, construction). In contrast, that part of the workforce which shows a complementary relationship to the migrants might benefit from wage increases.
- However, differentiating effects will probably be softened because immigrants frequently settle in prosperous regions and sectors.

2.5 Low Taxes

The importance of the tax that a company has effectively paid after deduction of discounts and allowances is much greater than a tax with absolute highest rate. The EU commission has compared this “effective tax rate” with what it was in the old EU countries, which has been used in the development preview of the Organisation of Economic Cooperation and Development (OECD), too.

In Europe, an actual calculation of these adjusted tax rates was published by the Centre for European Economic Research in 2006, which showed that companies in the new EU countries only paid half of the tax comparing with the old 15 members of EU.

Table 3: effective tax rates in EU Member States 2006 (%)

States	Effective tax rates 2006 (%)
Litauen	13.4
Cyprus	14.5
Lettland	17.8
Hungary	19.7
Slowenia	21.6
Slowakia	22.1
Estland	22.5
Czech Republic	24.23
UK	29.1
Netherlands	32.4
Malta	32.8
France	34.9
Germany	37.2

Source: European Economy 2007

The companies in the new EU countries only have to afford an average tax at 21.3% of their income, while those in the old EU-15 have to give 29.4% of their income as tax to the government. Moreover, most of the new EU countries have even decided to reduce their substantial tax in the following years, which would mean that the tax burden for the companies would decrease further. With the effective tax rate of only about 14% in Hungary, 17% in the Czech Republic, and 18% in Poland, these countries were likely to be real low-tax countries, which might mean that the old EU-15 would have more disadvantages.³²

People would feel exactly this kind of pressure in adjoining areas: a company in southern Germany would have to pay the tax at 37% of its income, while one of its competitors in the Czech Republic which is only several miles away only has a tax burden of 24%.

These tremendous cost advantages will draw the companies from the old EU-15 to the new ones in order to get more profit because of the low tax in the new EU countries, so these companies even don't need a complete relocation and through the way of setting up subsidiary companies they are also able to make a good fortune. If a German company sets up a subsidiary company in Lithuania, it only has to afford a tax burden of 15.4%, and 24.9% in Hungary, 29.8% in Poland.

³² El-Gamal, M. (2006), p.95-p.138.

2.6 Economic situation of the new member states one year after accession

Poland:

The political strife has somehow overshadowed the accession to the EU of Poland, this country still remains the most important one for EU's foreign policy. In Poland, the farmers were the first who received large gains and higher incomes in 2004. The good development in the raw material markets has given the Polish industry a lot of benefits too. Due to the increasing oil price the Polish currency Zloty has suffered some negative influences in terms of the Polish economy as well. The EU has given Poland many opportunities which have been favourable to the transport companies in Poland. From the next privatisation wave that has already begun the foreign investors could profit a lot. The Polish economy kept on developing dramatically, the rate of the economic development in 2007 was at 6.5% and it has been expected that this rate will reach 5.5% by the end of 2008.³³

Slovenia

Since the accession to the EU this country with its 2 million population has been very pleased with the EU organisation and has become a new member of the Euro Space in 2007. Since it became an EU member, the jobs in the food and textile industries in this country have been eliminated without any high protections of trade but this has not resulted the economic depression. However, Slovenia has promoted the development of its economy thanks to the rising exports and has become one of the most important investors in the Baltic countries. In all these South Eastern European countries, Slovenia now has become a good example in terms of development and potential of the economy.

Slovakia:

Slovakia is located in the centre of Europe and has now turned out to be the most favourable location of investment for other countries because of its flat tax and economic reforms. At the same time, known as the Passage to the East, this country has acquired quite a lot of automobile enterprises with a great production of cars which has drawn the attention of many auto suppliers from abroad. Due to the imperfections of its transportation and infrastructure this country still has to face the problem of a high unemployment in its eastern part.

³³ El-Gamal, M. (2006), p.95-p.138.

Czech Republic:

The Czech Republic is a country with highly developed industry, and it now has achieved a high standard of living, it still holds sceptic opinions to join the Euro currency system. As a country in the heart of Europe, the Czech Republic always is an attractive place for foreign investors. It also offers good travel conditions and highly qualified workforce to its investors. Now it is trying its best to be the logistic centre and head office of international enterprises of Central Europe in competition with its neighbours Hungary and Austria.³⁴

Hungary:

After its accession to the EU, the export industry in Hungary has experienced a dynamic development. As one of the favourable investment areas for a long time, this country has exported nearly 50% of its products to foreign countries,³⁵ especially to the EU countries. In comparison with other EU new member states, Hungary has the highest technology share in its exports, so Hungary is meanwhile a location where the foreign countries do their research of development. Few negative consequences have been seen in the economy caused by its political polarisation but its financial policy still risks much.

Baltic countries:

In terms of the economic development, all of the three small countries have achieved the highest growth rate in the new EU countries, and therefore it will be fairly easy for them to join the Euro currency system.

3. EU Enlargement Problems

3.1 Institutional Problem

The EU has big tasks to accomplish, because the institutional structures which were created originally to satisfy the needs of the European Economic Community when it had only six members, do not serve the needs of the current 27 members. To make decisions with the existing structures in the capital of Europe is sometimes difficult in an enlarged family with 27 or more members, thus this situation is not easy to be remedied.³⁶ The authority and decision making power, the EU Commission, forced the heads of states and government to

³⁴ Rita Booker, R. (2007), p.179.

³⁵ El-Gamal, M. (2006), p.95-p.138.

³⁶ Husain, I. (2006), p.16.

yield, so no expectation has been met at the EU-Summit in Nice in 2002 as well as the European Council in Goteborg in 2001. In 2004, several reforms were decided in a conference held by EU governments. A basic direction was clearly fixed in spite of some disagreements: the EU was on the way to receive a constitution for its more than 450 million population, to which France and the Netherlands said “no!” in 2005.

3.2 Burden for the EU-budget

The “Agenda 2000” is called the forecast of the EU budget, which includes the costs of EU enlargement by the year of 2006. About 80 billion Euros of this budget have become available, of which 22 billion Euros were intended to help with their pre-accession, and 58 billion Euros for expenses after their accession to the EU by the year of 2006.³⁷ In many factors, a huge expense would be intended for these EU new member states as well as during the time when the new EU members would be able to limit the spending on agricultural and structural policies of their own.

Since the economic power of the new EU countries did not reach the average level of the EU, all of them would qualify for financial subsidies from the budget of the old EU members, which is a direct budgetary burden and results in different calculations of fiscal costs, which depend on the kind of the basic scenario that is used or the reforms directed by the EU in fields of agriculture and political structures.

- If the current policies of the EU were simply applied, the EU budget would be doubled roughly, which seems to be unrealistic in the political space.
- The Common Agricultural Policy required further growth. As the CAP kept on triggering production incentives, excess production and concomitant EU subsidies would likely be increased by the inclusion of the new EU countries. So another kind of reform was needed for the reasons of allocation and fiscality.

³⁷ El-Agraa, A. M. (2006), p.310.

3.3 Low-price competition in the market

The further economic development of the old EU-15 is still uncertain, for people have the fear of the flooding of goods from the new EU countries with low prices in their market and of losing their jobs. But such kind of competition would not be stopped, in which most of EU new members would be involved. Rather it is going to rise, especially in the area where a long term economic development existed because of the big market nearby in Eastern Europe. That means a different kind of view which could point out the adverse effects on the old EU-15 markets permanently ought to be taken.

It is clear that the weight of the new EU members would be less significant on the macroeconomic level. The number of the EU-members became 67% more than it was and the population of the EU increased by 20%, adding 75 million people, while the GDP in the EU kept increasing less than 5%.

All the new EU member states have abandoned almost all their old economic structures, and new modern systems have been applied in the transformation process. A huge demand for goods and services has appeared in the market. The growth in the new EU members was faster than that of the old EU-15, so more companies from abroad were attracted and would benefit from the opening of the new market.³⁸ A lot of these companies had laid the foundations even before the EU was enlarged officially. They invested and planned joint-ventures so as to get into the market and gain from their business.

Good prospects do not mean that the new EU countries have already achieved their economic goals and it would still take several decades before they could catch up with the old EU-15 although their economy has grown rapidly. In the future, a lengthy investment would be made during this process. Some old EU countries like Spain or Portugal would suffer a lot from this because of the shortage of important subsidies on account of reallocation of resources for their infrastructures, which have been offered in a considerable amount by the EU. It is certain that these subsidies from the EU would not be enough to guarantee a rapid growth for the new EU countries to catch up with the old EU-15; however, it would lay a solid foundation to avoid that the economy in the new EU countries could be so far behind that of the old EU-15.

³⁸ Lachmann, W. et al. (2006), p.67.

Lately, the development of the common European currency has become a topic that is being discussed frequently. It is still in doubt whether the Euro or the EU enlargement would become stable enough to solidify the exchange rate and to be competitive with the US dollar instead of being threatened. That was just the point at which the experts disagreed. With the opinion that the new member states would have to pay more attention to getting closer to the Maastricht Agreement, the overwhelming majority has recently felt there would be a strengthening instead of a de-stabilisation.

3.4 Relocation of Industry

It has been frequently discussed by commentators on EU Enlargement to what extent the new EU countries should relocate their industry. This kind of development has been going on for a few years and was first noticed by few people, who accused the relocating companies of unpatriotic behaviour, which give rise to more intensive discussions.

This kind of thinking about growth might lead to a failure in the opinion of several research institutes. Lower labour expenses, longer machine running time, labour law conditions benefiting the employers rather than the workers and low tax policy have been realised by the old EU-15. But this favourable condition will not last for ever, the cost structure of the new EU members will become the same as that in the old EU-15 in a long term. Since their accession to the EU, the new EU countries are bound to adopt the EU regulations as regards the environmental protection, product standards, rules of competition etc.

It is necessary to notice another interesting aspect when people asked different companies, that it was not the favourable wage conditions which made the relocation attractive but the establishment of a branch in the new EU countries that offered a market with lots of attractions and good prospects of sales. It has been impossible in the process of the EU integration in terms of tax exemptions, excessive investment subsidies and special agreements. The labour-intensive industry has been too expensive in Poland and the Czech Republic, which means that the relocation would not be a turning away from the home country but would also be an urgent necessity during the globalisation which requires the opening of new markets and the search for raw materials under more favourable conditions. From this the companies will benefit for their exports and they will solidify the economic foundations in their home countries.

The international companies have recently tended to relocate industries away from Spain so that people have worried about the competitiveness of the Spanish industry. It has been announced that companies like Samsung and Philips would have to close their plants in Catalonia in Spain, other companies like Nissan have thought of plans to reduce production recently.

In 2003, this trend still went on, the French company Valeo and the US company Lear closed their plants in Catalonia. The production facilities of these companies have been relocated to the countries where the labour costs are much lower, for example the eastern European countries. People have more concerns about the increasing competition in Spain since the accession of the new EU countries.

People in Spain were worried about being a big loser due to the EU Eastward Enlargement. At the same time, the fear that all the subsidies offered to Spain by the EU would stop quite soon could turn to reality. Before the EU enlargement, it was Spain which received the most subsidies from Brussels, this country received 7.5 billion Euros, which made up 1% of its GDP. Lately, it has been agreed in Berlin that Spain could get about 55 billion Euros as subsidies from Brussels from 2000 to 2006 according to the funding framework.³⁹

The Spanish politicians and the economy had to prepare for an economic development without the subsidies and experts and those people who were directly involved were worried about the competitiveness of the Spanish industry. The problem that the labour market was not flexible enough and the labour cost kept increasing frustrated the businessmen because now Spain is no longer a country with low wages, while in the eastern European countries, the price of the product is much lower.

The Joint-ventures in the old EU-15 and in the new EU countries are quite different. The overall picture has been shaped by ever more intensive commercial contacts and closer interdependence. A few years ago, the EU has been enlarged in the interest of the economy, and then it came true that the economy could expand without barriers. For domestic production locations, it is still necessary to execute more comprehensive reforms in order to strengthen their attractiveness and competitiveness for a long time.

³⁹ Hein, E. (2007), p.195.

3.5 Corruption

The Eastern European countries are the EU members where the problem of corruption is most serious. The ramifications caused by corruption in these countries could be felt even at the highest echelons of power. More co-determination in the Union was resolutely demanded by the new EU member states in the negotiations for the EU constitution, while within these countries, economic and political inefficiency still remained considerable. Some new EU countries were even publicly admonished in the “progress report” of the EU Commission recently. In some parts, the corruption that existed in state and society reached a level of so-called “endemic proportions”, so that billions of euros intended for reconstruction in the new EU member states supported by the EU authorities simply disappeared because of corruption.⁴⁰

According to the research of the Organisation Transparency International in 2005 the situation of corruption in the EU new countries was even worse than it was in the year before. Poland was the worst one, dropping 19 slots in the ranking list and reaching No.64 among all the 133 countries, (the higher the rank is, the more corrupt the country will be), which means that Poland was even more corrupt than Latin American countries like Cuba or Brazil. In the past few years, all these new EU countries still had to face the problems in their political culture, like the lack of transparency or the existence of corruption, which were the main obstacles to their development.

One of the reasons which could explain the serious situation of corruption in these countries is that the civil servants, policemen, teachers, professors as well as hospital doctors were paid quite low wages according to the research from the EU Commission. But after all, the lack of efficient control was the main reason for corruption. In the new EU countries, the executive and judiciary branches were not clearly separated, it was often seen that the politicians themselves, however, appointed the judges, and gave preference to compliant party members, so the institutions which actually ought to fight against corruption would themselves be affected by it, and corruption itself would find a good place to grow.

⁴⁰ Booker, R. (2007), p.179.

3.6 Migration

One central focus of the current discussion about the likely consequences of Eastward Enlargement is the expectation of a considerable migration from the new EU countries to the old EU-15. In particular, the focus is on the following arguments: The determining factors for economic migrations are the differences in wages and social standards, as well as the likelihood to find a job in the target country. It is true there are non-economic factors which would be a counterweight against a massive increase in migrations, such as the social ambience, linguistic and cultural differences and climatic impacts; incentives for migration would be further reduced when the employment conditions in the accession countries improve and the demand for labor in the old EU-15 does not substantially increase.⁴¹ However, considerable migratory incentives are expected because it is felt that for some time palpable differences in wages and welfare will continue to exist between the old EU-15 and the new EU members, and because of the demographic strength of the new EU members. But immigration will be spread over decades.

The incentives to migrate out of the new EU countries are likely to differ substantially among the countries concerned. On the one hand, geographic factors will surely play an important part. On the other hand, institutional framework conditions, which might promote migration, are significant.⁴² The less downward flexibility there is for the wages in the target country and the more developed the social system there is, the stronger will be the country-specific immigration incentives (the more people will want to immigrate). It would be possible to eliminate such incentives rooted in the social system by replacing the country-of-residence principle with the country-of-origin principle in social security.

The fears of a massive immigration of workforce from the neighbour countries into Austria that were found in polls were still far from reality. According to the Austrian reportage the Hungarians who were well paid did not have interest in working in Austria. The assumption of Austrians that most Hungarian employees would leave their country and move across Europe more flexibly would not come true.

⁴¹ Dicke, H. and Foders, F. (2000), p.101-p.145.

⁴² Boeri, T. and Brücker, H. (2000), p.45-p.105.

It has been expected that in neighbouring Bavaria the immigration from the eastern European countries would reach a much higher level. Drastic bottlenecks on the housing market as well as rent increases brought about by the westward opening in the conurbation centres of Munich, Nuremberg-Erlangen, Ratisbone and Ingolstadt, were warned against by the Association of Bavarian Realtors (Vdw) according to the research study of the Munich Info-Institute. Bavaria, being located in the vicinity of several EU new countries, was expected to be the first one that would experience the migration problems. A study published by a research institute predicted that about 600,000 people from Eastern Europe were planning to settle in Bavaria in the following decade, more than 200,000 of whom would choose Munich as their place of residence, so there would be no doubt that the rents would rise.⁴³

3.7 Undermining the welfare state

In addition to the worries about increasing fiscal burdens there are other concerns related to eastward enlargement: those which expect a collapse of the welfare state as a consequence of drastically increasing factor migrations. On the one hand it is argued that extensive migrations might cause problems for the social safety net. Migrations which are not the result of wage differences and other incentive-compatible factors but the result of better welfare benefits in the target country are not only economically inefficient but they even cause increasing funding gaps in the social system. It is assumed that immigrants are mostly employees with less-than-average incomes who are also likely to pay fewer taxes. At the same time they would be fully entitled to all social benefits granted in the target country such as social security, rent subsidies, child allowances, low-cost housing, health insurance, free education for their children etc. Thus, the average low-wage immigrant worker would benefit more from the public social system than he contributes towards it.⁴⁴ In order to contain immigration the states might compete against each other in developing the least attractive welfare system; for this reason some commentators feel that the welfare state might risk being torn apart. A selectively delayed integration of the individual accession countries into the EU social system has been recommended as a solution.

Theoretically an unimpeded tax competition could also develop in the same direction of a “race to the bottom.” At least it is conceivable that the institutional competition of the nation

⁴³Ribhegge, H. (2007), p.109.

⁴⁴ Sinn, H.W. (1994), p.155-p.186.

states for investments and establishment of industries could result in a ruinous competition by lowering taxes to such a degree that the national tax yield is no longer sufficient to make available public goods. Eventually this could be a threat to the welfare state.⁴⁵

4. The European Economic and Currency Union and the Euro

As a public asset the Euro has given the Euro-zone countries so many advantages that the foreign exchange risks could be avoided and the interest rates decreased. All the countries in the Euro Currency Area were able to benefit thanks to price stability, which was the first objective of the European Central Bank. Meanwhile, a deep, liquid and integrated Market in the EU countries appeared. More countries now benefit from such advantages after they joined the EU Currency Area. Moreover, people enjoyed more economic benefits that have increased because of the enlargement of the Euro Currency Union. These countries did not need to face the foreign exchange risks, so that when the people from one country move to another in this Area, they can use the same currency. If one country wants to enjoy all these economic advantages, it has to prepare well for being a euro member at first, its level of readiness will be assessed by the Maastricht convergence criteria.

4.1 Three steps on the path to Economic and Currency Union

When the Werner Plan failed in June 1988 the European Council again focused on realizing an economic union and asked a committee under the chairmanship of Jacques Delors, then the president of the European Commission, to propose concrete steps towards a union. The Delors Report submitted by this panel proposed to achieve the economic and currency union in three consecutive stages, each of which builds upon the preceding one.

⁴⁵ Sinn, H.W. (2000), p.307.

4.1.1 A chronicle of the most important stages⁴⁶

- 10.01.1958: The Treaties of Rome enter into force. The EEC Treaty provides for coordinated economic and currency policies of the member states.
- 08.05.1964: The Committee of the Presidents of the Central Banks of the member states of the European Economic Community is established, and it becomes the driving force for a coordinated European monetary policy.
- 07.10.1970: Luxemburg Prime Minister Pierre Werner submits a proposal for realisation of an economic and currency union in three stages. This “Werner Plan” envisions the first stage for 01.01.1971, the third stage for 1980.
- 21.03.1972: Introduction of the European Currency Snake as a system for minimizing the fluctuation margins among the EC currencies. The exchange rates of the participating countries are to deviate no more than 2.25% from the central rate. After the global economic turbulences as a consequence of the oil price shock of 1973 the Werner Plan is abandoned.
- 13.03.1979: The European Currency System (ECS) enters into force, coinciding with the introduction of the basket currency ECU as the new European currency unit.
- 01.07.1987: When the Single European Act entered into force, the objective of a currency union was stipulated in the EC treaty.
- 14.06.1989: The first stage of the Economic and Currency Union begins. Monetary and capital flows among the member states are liberalized, the economic policies are better coordinated.
- 07.02.1992: Signing of the Maastricht Treaty, according to which the Economic and Monetary Union is to be completed by 1999 at the latest. This includes criteria which are to guarantee the stability of the common currency.
- 01.01.1993: The European Single Market with free movement of goods, people, services and capital enters into force.
- 02.08.1993: In response to monetary turmoil the fluctuation margins among the ECS currencies are broadened to 15% from 2.25%.
- 01.11.1993: The Maastricht Treaty enters into force.

⁴⁶ Scheller, H. L.(2000), p.24.

- 01.01.1994: Start of the second stage of Economic and Currency Union, establishment of the European Monetary Institute (EMI) in Frankfurt on the Main.
- 16.06.1997: The European Council passes the Stability and Growth Pact in Amsterdam in order to guarantee Euro stability from the very beginning.
- 25.03.1998: The EU Commission and the EMI recommend eleven countries for participation in the currency union. Initially UK, Sweden, Denmark and Greece do not participate among the then EU-15.
- 01.07.1998: Official start of the European Central Bank.
- 01.01.1999: start of the third stage of ECU, introduction of the Euro as the common currency.
- 01.01.2001: Greece becomes the 12th member of the economic and currency union.
- 01.01.2002: Introduction of the Euro as a cash currency.
- 01.05.2004: Ten new members accede to the European Union.
- 28.06.2004: The currencies of Estonia, Lithuania and Slovenia accede to the exchange rate mechanism II.
- 02.05.2005: The currencies of Cyprus, Latvia and Malta accede to the exchange rate mechanism II.
- 25.11.2005: The currency of Slovakia accedes to the exchange rate mechanism II.
- 01.01.2007: Slovenia joins the Euro zone as the 13th member.
- 01.01.2008: Malta and Cyprus join the Euro zone as members number 14 and 15.

On the basis of the submitted Delors-report the European Council agreed in June 1989 that the first phase of the establishment of the economic and currency union should start on July 1, 1990. As a consequence as of that day all restrictions on the movement of capital among the member states were eliminated in principle.

In preparation for a higher level of integration the treaty for the establishment of the European Economic Community from 1958 (EEC Treaty) had to be re-designed as a next step in order to create the necessary institutional framework. This was achieved with the treaty on European Union which was agreed upon in December 1991 and signed in Maastricht on February 7, 1992. Because of several delays in the ratification process the treaty entered into force only on 1 November 1993.

The establishment of the European Monetary Institute on 1 January 1994 started the second stage of the economic and monetary union. From the beginning the European Monetary System was designed to be of a temporary nature. Its main task consisted in strengthening the cooperation between the central banks and the coordination of their monetary policies as well as in delivering the necessary organisational preparatory works for the establishment of the European system of central banks, the adherence to a unified monetary policy, and the creation of a unified currency in the third phase.⁴⁷

In December 1995 the European Council decided to call the future European currency unit the “Euro”. It was also confirmed that the third stage of the economic and monetary union would start on January 1, 1999. The EMI had been charged with carrying out the preparatory work for the future monetary and exchange rate relations between the Euro monetary space and other EU countries. In accordance with this mandate the EMI submitted to the European Council its report which became the basis for a decision by the European Council, agreed upon in June 1997, regarding the principles and the essential elements of the new currency exchange rate mechanism. Additionally, in June 1997 the European Council passed the Stability and Growth Pact, whose purpose it was to assure fiscal discipline also in the economic and monetary union. To this agreement later another declaration of the Council was added in May 1998. On May 2, 1998 the Council of the European Union, composed of the heads of state and government, decided unanimously that eleven member states (Belgium, Germany, Finland, Italy, France, Ireland, Luxemburg, the Netherlands, Austria, Portugal and Spain) met the necessary conditions for the introduction of the common currency on January 1, 1999, which meant participation in the third phase of the economic and monetary union. At the same time the heads of state and government also reached agreement on those persons who would be recommended for appointment as members of the directorate of the European Central Bank. At last the ministers of finance of the member states which introduced the common currency, decided together with the presidents of the national central banks of those member states, the European Commission and the EMI to use the current bilateral ERM central rates of the member states introducing the Euro in determining the unalterable exchange rates for the Euro.

⁴⁷ El-Hawary, D. and Grais, W. (1997), p.19-p.27.

On May 25, 1998 the governments of the eleven participating member states appointed the president, the vice president and the four additional members of the directorate of the European Central Bank. They were appointed as of June 1, 1998, which marked the establishment of the European Central Bank. With the establishment of the European Central Bank on June 1, 1998, the European Monetary Institute had fulfilled its mission and was closed.⁴⁸

On January 1, 1999, the third and last stage of the European and Monetary Union began with the irrevocable determination of the exchange rates of the currencies of the initially eleven members of the currency union and with the beginning of the implementation of a unified monetary policy of which the European Central Bank was in charge.

The number of participating member states increased to twelve with the accession of Greece to the third stage of EMU on January 1, 2001. As of this date the Bank of Greece became a part of the Euro-system and the Greek drachma became a denomination of the Euro. Greek participation was the result of a decision of the European Council of June 19, 2000 according to which Greece was regarded as having met the convergence criteria. At the same time it was decided that the conversion rate of the Greek drachma in relation to the Euro would be the current central rate of the exchange rate mechanism II.

Among all the new EU members, Slovenia was the first that joined the Euro Currency Union on 1.1.2007. On 1.1.2008 Cyprus and Malta also introduced the Euro. There was no schedule for these countries in which the time of euro introduction was previously determined, for the ECB Council has made a statement in its document with title “Policy position of the Governing Council of the ECB on exchange rate issues relating to the acceding countries” which was published on 18 December 2003. The candidate countries have to achieve a permanent economic convergence at a high level if they want to join the Euro club. The European Council will assess this according to the EU commission’s and the ECB reports and see which country has satisfied the articles of the Maastricht Convergence Criteria. These “convergence reports” come out at least once in two years, which can also be requested by a member state desiring for its Euro dream.

⁴⁸ EG-Vertrags. Artikel 123.

4.1.2 The convergence criteria

As has been mentioned before, compliance with the convergence criteria agreed upon in Maastricht would determine which countries would be eligible for participation in the newly created monetary space. These criteria were intended to determine the level of economic alignment or convergence of the individual countries on the basis of an assessment of several economic key data. The purpose was to check which countries already had a stable and sustainable basis for introducing the Euro.

The criteria included:

- In state of a high degree of price stability. This means if a member state wants to be a Euro-using country, it must guarantee that its prices stay stable permanently and according to the assessment, its inflation should be below 1.5% on average. The countries which could achieve the best success of their price stability would be allowed to have a higher inflation rate up to 3%.⁴⁹
- A long term acceptable financial position of the public sector, which means during the assessment the candidate country has no excessive deficit in opinion of the EU Council judgment.⁵⁰ It will be determined by the EU Council whether the candidate country faces an excessive deficit or not and references will be made as follows:
 1. relationship between the public deficits which were planned and the actual ones, the GDP at market prices that should increase maximally by 3%, and
 2. the relationship between the GDP and the public debt at market prices, which should not be increased over the ratio of 60%.⁵¹

However, other factors will also be thought of in the process of evaluating if the country has satisfied the criteria for fiscal discipline, like the achievement of the reduction of budgetary imbalances, or other temporary special factors which could make a contribution to such kind of imbalances. Meanwhile, if the countries have a debt with the ratio over 60% of their GDP, they will have to try to reduce it under the reference level as soon as they can.

- In cooperation with the normal fluctuation bands of the exchange rate mechanism of the EMS for minimal two years without devaluation of the currency against the

⁴⁹ EG-Vertrags. Artikel 121, Artikel 104.

⁵⁰ Grauwe, P.D. (2007), p.63.

⁵¹ EG-Vertrags. Artikel 121, Artikel 104.

currency of another member state. In evaluating cooperation with this criterion it will play an important role in finding out whether the exchange rate of a currency is close to its euro central rate.

- Factors thought to make good contributions to an appreciation of the exchange rate will also draw a lot of attention, which reflects that the fluctuation bands of the exchange rate mechanism of plus/minus 2.25% was expanded to plus/minus 15% in August 1993, so the interpretation of “normal fluctuation bands of the exchange rate mechanism” has become more difficult.⁵² In addition, people have changed this exchange rate mechanism of the EMS into a new one in the third stage of EMU on 1.1.1999, which gave the participating currencies the disposal Euro central rates of plus/minus 15%. There came later also the questions about “high tensions”.⁵³
- Achievement of the permanent convergence of a member state reflected in the level of the long term interest rates, which means that this country must keep its average long term nominal interest maximally 2% higher than the corresponding rate in time of one year before the EU examination. For those member states which have achieved the biggest success in terms of price stability, they would keep the same interest stay maximally 3% higher than the corresponding ones.⁵⁴ Long term public bonds or similar securities will measure these interest rates, it will also be considered that different member states have different situations, so various definitions will be used.
- Numerous factors of another kind will also be considered in this assessment, like the condition of the integration of markets, the price indicators, the labor costs, and the position of the current account,

The convergence examination was not limited exclusively to examining economic convergence. Additionally, the legal convergence of the member states was examined. In doing so efforts were made to ensure that domestic legal rules and in particular the domestic central bank laws would not violate the EC treaty and the charter of the European System of

⁵² EG-Vertrags. Artikel 121, Artikel 104.

⁵³ Europäisches Währungsinstitut (1998) Konvergenzbericht. p.32.

⁵⁴ EG-Vertrags. Artikel 121, Artikel 104.

Central Banks.⁵⁵ It was especially important to make sure that the independence of the domestic central banks was guaranteed.

4.1.3 The Exchange rate mechanism II

Also at the start of 1999 the exchange rate mechanism II (ERM II) entered into force. This is an exchange rate agreement which exists between different EU member states in the framework of the European Monetary System II (so-called EMS II) and which determines the range of fluctuation of the Euro exchange rate of the currency of an EU state.

The EMS II aims at bringing the non-Euro-member-states closer to monetary union through guaranteeing stable currency relations. This means that the construction of the EMS II is built around the Euro.

Participation in exchange rate mechanism II is optional for the non Euro member states. However, those countries which plan to introduce the Euro should have participated in WRM II for two years without adapting the central rate – according to the convergence criteria.⁵⁶ This means that the new member states are expected to join the exchange rate mechanism sooner or later.

Through WRM II the currencies of the member states are bilaterally linked to the Euro. The exchange rate between currencies which participate in ERM II and the Euro must fluctuate no more than 15% around the central rate.⁵⁷ Narrower margins are possible, too. When upper and lower limits are reached, foreign currency interventions are set in motion automatically. Coordinated intramarginal interventions are possible too. Contrary to the European Currency System both the ECB and the central banks participating in ERM have the right to refuse interventions if they are a hazard for price stability. Also all participating currency authorities are entitled to start a confidential procedure for reexamination of the exchange rates, in consequence of which adaptations of the central rate are possible too. The ECB must

⁵⁵ EG-Vertrags. Artikel 109.

⁵⁶ Khaf, M. and Khan, T. (1999d), p.58-p.69.

⁵⁷ Khaf, M. and Khan, T. (1999d), p.58-p.69.

intervene only when the fluctuation margins are crossed – and in particular only when the target of price stability is not affected. Therefore, sometimes people speak of a certain “asymmetry” in the EMS II concept.

Since 1999 altogether nine countries have participated in ERM II (History members: Greece, Malta, Cyprus, Slovenia and current members: Denmark, Lettland, Estland, Litauen, Slowakia).⁵⁸ Among the first member countries were Denmark and Greece. Both countries had previously participated in the ECS’s exchange rate mechanism, which ceased to exist on 1 January 1999 when the Euro was introduced.

While Greece remained in ERM II only until it met the convergence criteria and introduced the Euro as its currency on 1 January 2001, Denmark is still a member of ERM II. In view of its decision to make use of the opt-out clause it does not seem to intend in the near future to replace the exchange rate peg with the introduction of the Euro. Nonetheless, Denmark – as the only country so far – has made an arrangement with the ECB for a narrower exchange rate peg which permits a fluctuation of the exchange rate between the Danish Krona and the Euro of no more than plus/minus 2.25%.⁵⁹

Out of the 27 EU member states, fifteen have introduced the Euro as their currency, thus only five countries remain as potential candidates for participation in ERM II: United Kingdom, Poland, Sweden, Czech Republic and Hungary. Another seven are now participating in ERM II.

4.2 European Central Bank

4.2.1 The structure of ECB

The European System of Central Banks (ESCB) includes two parts, the ECB and national central banks of all the 27 EU member states. On the other hand, the Euro-system has also been realized by the ECB and national banks of 15 old EU member countries. The national central banks of the member states which do not participate in the euro currency area are also

⁵⁸ Khaf, M. and Khan, T. (1999d), p.58-p.69.

⁵⁹ Europäische Zentralbank, Konvergenzbericht 2000.

members of the ESCB. But these countries enjoy their rights to carry out their respective national monetary policies.⁶⁰ They are also the countries which were not involved in the process of the decision on a unified monetary policy for the Euro area and kept themselves out of the direction of this decision.

In the treaty for the establishment of the European Union and in the charter of the ESCB and the ECB, the mandate of the Euro system has been clearly defined, thus according to this first objective of the Euro system the price stability in the Euro area has been guaranteed, which made it possible that the general economic policy of the Community would be supported and that it would work together with the principles of an open market economy.

The Euro system has the following tasks:⁶¹

- Determination and implementation of the monetary policy of the Euro.
- Execution of foreign currency business.
- Holding and administration of the official currency reserves of the member states.
- Promotion of the smooth functioning of the payments system.

Moreover, the Euro system has the obligation to make contributions to the smooth implementation of measures taken by the competent authorities which supervise banking and the stability of the financial system. Furthermore, The ECB plays an advisory role for the community and the national authorities regarding to questions for which they are competent. Finally, in the fulfillment of tasks of the ESCB the ECB acquires with the support of the national central banks the necessary statistical data either from the competent national authorities or directly from the market participants.

4.2.2 The role of ECB

First of all, determining the central rates of the currencies of the new member states in relation to the Euro ERM II is the main role of the ECB. On June 16th. 1997 the European Council made a resolution in Amsterdam according to which the decisions regarding the central rates

⁶⁰ Neal, L. (2007), p.143.

⁶¹ Grauwe, P.D. (2007), p.63.

within ERM II were made in the framework of a joint procedure, in which the European Commission was also involved. Before these decisions all the central bank presidents and the finance ministers of the ECB, the Euro area member states and those non Euro area member states which are already in the new mechanism had heard the economic and finance committees in mutual agreement.⁶² The finance ministers and the central bank presidents of the member states who have not taken part of the ERM II, could participate in the procedure but they didn't have the right to vote. All participants from the member states as well as the ECB can have a say in the final decision by setting in motion a confidential process in which the central rates could be re-examined.

Additionally, ECB is also helpful in the enlargement process of the ECU.⁶³ For example, convergence reports produced by the ECB and the European Commission appear once in two years regularly, sometimes will also come out exceptionally if requested by a member state. Such kind of reports do the EU Council a lot of help in making decisions of the Euro introduction in a member state, because they can provide essential information, according to which the EU Council would assess whether the member state has satisfied all the necessary conditions.

With the aim to create more conveniences and advantages for the stable integration into the euro-system action frame for the central banks of the new EU countries, the ECB also works together with them according to the convergence report that was submitted in connection with the function of the ECB. There is a contradiction between the Euroisation and the ECU, which was thought to be the first economic idea of the common European currency and aimed to introduce the Euro finally in a multilateral frame for the new member states.

Furthermore, through the enlargement of the EU, there would appear an impact on the structure of the organs of the ECB when it makes decisions. In an enlarged council within the ECB, all the presidents of the national central banks of the new EU countries will become full members, the ECB president and its vice-president are also included. Once the Euro currency is introduced in a new member state, the president of the central bank of this country will be a new member of the ECB Council. The fact is that six of the directorates of the ECB have

⁶² Ribhegge, H. (2007), p.109.

⁶³ El-Agraa, A.M. (2006), p.446.

permanent voting rights, and according to the rotational system the other 15 voting rights would be enjoyed by the other countries. This means the voting is limited to 21 votes. It is certain that one country has one vote.⁶⁴

Besides, the EU new member states have to subscribe to the capital of the ECB which was defined in the ESCB charter. The member country will subscribe to this capital according to the amount of its GDP and population. But for the countries which have not accepted the Euro, they only have to pay 7% of the total ESCB capital.

Lastly, from the new EU countries the ECB can also employ personnel which comes from Estonia, Cyprus, Czech Republic, Latvia, Malta, Hungary, Slovenia, Poland, Slovakia, Romania and Bulgaria.

4.3 Toward the enlargement of the Euro zone

After all new 12 EU member states joined the monetary union they would take their responsibility to satisfy the convergence criteria.⁶⁵ This enlarged monetary union has caused speculation about the disagreements of the inflation rates, the ability of competition and the pressure on the connection with the euro zone. The accession of the new EU members to the monetary union would give rise to more divergences. Instead of an optimal currency area, the idea of monetary union is based on nominal convergence. This means that the options of divergent national economies should exist in the monetary union.

People hope that the monetary union would make contributions to an enhanced integration. Both the old and the new EU member states would benefit from the positive influences by the Euro zone so as to cooperate more closely. Additionally, some successful reforms directed by new members of the EU family who are still waiting for their accession to the euro monetary union would be helpful to the old member states.⁶⁶

⁶⁴ Hermann Ribhegge, H. (2007), p.109.

⁶⁵ Pinder, J. and Usherwood, S. (2007), p.95.

⁶⁶ Moussis, N. (2007), p.23.

Although the economic growth in the Euro zone still remains below the world average level, it can be foreseen that this situation would be improved. However, this kind of economic development is still far from meeting the challenges of this monetary union, especially in solving the problem of unemployment. It is clear that the structural problems lead to the weakness of the European economic argument. There is no doubt that the weakness of the demand within the EU should be considered seriously. It should not be forgotten that people should implement the Lisbon strategy with the aim of economic growth and employment so that the investment in research and development could be encouraged, which might improve the acceleration of the economic growth and employment in the new EU member states by means of the EU Structural Fund. This kind of growth would also be enhanced immediately after the national currencies of the respective countries become invalid.

The advantages in the macro-and micro economy experienced by the present members of the Euro area could also be shared by the new countries which were expecting to accede to this monetary union. Moreover, it is certain that the credibility gained from the early accession of these countries could assure a better defense against speculative attacks and that the budgets would be more consolidated for the currencies.⁶⁷ But the accession to the Euro union was not so rapid as it was expected by the countries with Euro currency because the negotiation with the new members was still hard. There would also be a change of mind of the people in the new members in accession to the Euro union due to the rising prices that might be caused by the Euro introduction. A great number of efforts should be made in most of the new member states for the adaptation weakened by a transition to the Euro currency. Among all the new EU countries, the Baltic states which have reached a high level of trade integration with the Euro zone and achieved significant prosperity and employment have the best chance to join the monetary union recently. Otherwise, some countries like Poland which still suffered much pressure of inflation and excessive deficits could only realise its membership slowly.⁶⁸ Obviously it was not the expansive monetary policy but the productivity growth that constituted the reason for this higher inflation in the new member states, which meant that the accession of these countries to the monetary union could never be as rapid as that to the European Union, but at a much lower speed.

⁶⁷ Grauwe, P.D. (2007), p.113.

⁶⁸ Europäische Zentralbank, Konvergenzbericht (2006).

The successful accession to the Euro monetary union of Malta, Cyprus and Slovenia have brought them a lot of benefits thanks to the disappearance of the currency exchange, to better calculable investments and the economic integration of this area. The Maastricht convergence criteria have defined the preconditions for membership in terms of the Euro enlargement. All the countries which desired to be a member of this monetary union should take the responsibility of keeping the stability of the euro currency.⁶⁹ It is clear that the new member states would not bring any risk of the import of inflation to the old members according to the fact that the GDP of new member states only made up less than 5% of the whole EU area. According to the fair trade principle the new members could get no advantages for the implementation of the convergence criteria.

The argument of the enlargement of the Euro zone was raised again which had disappeared at the beginning of the monetary union. It has been discussed whether Europe needed a unified currency in an enlarged EU family with 27 members which might face the attack of an asymmetrical shock, and a currency unifying at a high speed and more opening might be too fragile to be able to adapt changes from the international price.⁷⁰ In the past few years, the Euro zone has achieved great success in fighting against economic attacks like oil crisis with stable prices. The shocks to the country were much fewer than those to the branches or regions. It meant that the national exchange of one country as well as its interest policies were still far enough from dealing with the economic problems alone than the policies in the Euro zone. There would be fewer options for the countries with a unified currency like Germany to resist the asymmetrical shocks by means of using exchange rates. As an example the increasing oil price crashed various regions and cities in the world. To this attack the economic cycles within the Euro monetary union would react rightly.

Nowadays, comparing costs and their advantages, all the members of the Euro Zone still have to struggle for a positive balance after their accession to this monetary union 7 years ago. The introduction of the Euro has assured the macroeconomic stability for these member states, and all of them that have been combined with a uniform interest rates did not receive any negative impact on their economic integration in future. It can be predicted that once the Euro Zone is enlarged, the economic integration will be continuously strengthened.⁷¹ Although the new

⁶⁹ Moussis, N. (2007), p.23.

⁷⁰ Europäische Zentralbank, Konvergenzbericht (2006).

⁷¹ Rothacher, A. (2005), p.59.

members have a much smaller economic power compared with the old ones, yet they take the same interest as the old members do in these objectives. The real convergence, as in fact a political objective of the Euro Zone, has never constituted a condition for the accession of the new members. The economy in Europe has never caught a fever due to the shortage of real convergence or the expanded credit in the private sector, the monetary policy has no different situation.⁷² Let's take three countries as examples: Estonia, Lithuania and Slovenia are all new EU members who desire to join the Euro Zone, they have to make sure that their policies and prices be stable and be kept coordinated with the strategies of monetary policies of the Euro Union, nevertheless their sovereignty in terms of monetary policies, so it would be more complicated for the new members to predict inflation due to the misgivings according to the enlargement, and it would be difficult to foresee whether there would be more asymmetrical shocks for the countries or not.

On 1 January 1999, the EU introduced the exchange rate mechanism (ERM II) which has continuously made a good contribution to the economic union preparation instead of causing any disadvantages for the European policies. The exchange rate regulations, however, are important factors which could determine the macroeconomic stability, as well as for the investment environment. Meanwhile, the ERM II has kept the exchange rate fluctuations to a minimum quantity in the domestic market so that the further economic integration would be accelerated and the free traffic of capital, services as well as goods is assured. With regard to the exchange rate policies the member states still owned their flexibilities. By means of foreign economic measures the internal adaptation pressures could be reduced so that they would make a good preparation for their accession without a negative impact on the economic development.

5. Conclusion

The analysis has shown that in the course of the integration of the European Union again and again interest constellations reproduce themselves which pushed for EU expansion. So far this expansion has been taking shape by means of EU enlargement rounds. The eastward expansion of 2004 has shown that this political pattern is running its course.

⁷² El-Agraa, A.M. (2006), p.446.

The inner limits are the result of the large number of member states and the accompanying problems: increasing transnational competition, difficulty in shaping the political will, and exponentially rising costs of integration of every further step towards enlargement. As a result the readjustment of the EU from uniform to staggered integration seems very likely.

This pattern is spreading to the development of the external relations of the EU. There the EU is facing the problem of having to develop projects of pacification and prosperity the countries of the periphery which will have to do without the offer of a future full membership. This will result in a continuation of the pattern of staggered integration beyond the borders of the EU, as different levels of integration within the periphery of the EU.

In view of the multiple possible developments and the related uncertainties it is only possible to make speculative and preliminary comments about the economic chances and risks of an eastward enlargement. There is no doubt that enlargement may produce considerable welfare benefits not only for the accession candidates but also for the current members. As to their scope and distribution widely diverging evaluations exist.

At the same time enlargement also means big risks and challenges which should not be trivialized. This is equally true for the accession countries and for the current members.

- For the accession countries, adopting the *Acquis Communautaire* might turn out to slow down growth and development in many fields. Additionally, in some accession countries there are excessive expectations not only regarding the possible growth effects of accession but also regarding the expected transfers from the Brussels funds. A realistic attitude might be able to prevent disappointments while at the same time it might contribute to stopping the widely spread “rent seeking mentality” with its effects which rather threaten than promote cohesion.
- For the current EU members it will be important initially to connect the solutions to evolving intra-community conflicts with market economy-based concepts, rather than resorting to compromises which involve huge amounts of money but are only geared to the status quo, as has often been the case in the history of European integration. Most of all it will be critical for the balance sheet of eastward enlargement from the

EU point of view to what extent it will be possible to promote the those reforms which have become unavoidable in the framework of enlargement both on the national and community levels more energetically.

In the course of the history of the European economic and currency union it is important to distinguish three phases: the first phase which began on 1 July 1990 mostly dealt with the liberalisation of capital movement between the member states. The second phase which began on 1 January 1994 was mostly marked by the establishment of the European Monetary Institute. On 1 January 1999 the third and last phase of economic and monetary union started with the irrevocable fixing of the exchange rates of the currencies of the eleven founding members of the monetary union, as well as the implementation of a singular monetary policy.

Regarding the convergence criteria it is possible to distinguish the inflation criteria, the interest rate criteria, the exchange rate criteria and the two fiscal crises. On 2 May the Council of the European Union, composed of the heads of state and government, unanimously decided that eleven member states (Belgium, Germany, Finland, France, Ireland, Italy, Luxemburg, the Netherlands, Austria, Portugal and Spain) met the necessary preconditions for the introduction of the singular currency. This meant that those eleven member states participated in the third stage of economic and monetary union. The number of member states participating in the third states of economic and monetary union rose to 12 when Greece joined on 1 January 2001. According to the results of the convergence reports, both the EU Commission and the ECB recommended Slovenia, Malta and Cyprus for membership in the Euro zone.

Also at the start of 1999 the exchange rate mechanism II came into effect. This is an exchange rate agreement existing between various EU member states which defines the fluctuation margin of the exchange rate of the currency of a member state in relation to the Euro. The objective of the EMS II is it to bring the EU members which do not belong to the Euro zone closer to monetary union through guaranteeing stable currency relations. The Euro zone has become one of the most important currency areas in the world through this merger.

If we are honest we must admit: The ECB and the Euro have been amazingly successful so far. Already other regions of the world economy have taken their clues from the European (including monetary) integration. One example is the ASEAN group in South-East Asia, but

also Mercosur in Latin America. Meanwhile the United States, which had long been taking a dismissive attitude towards the Euro, take the development of the Euro-US Dollar exchange rate very seriously. The inflation-adjusted key interest rate of the ECB has been close to zero over quite some time. Therefore it is admissible to blame the ECB for the economic stagnation of the Euro area.

And lastly: it is non-negotiable for the Euro and its future stability that all countries which are doing their job in terms of financial policies don't let those countries such as Germany, France, Italy or Greece get away with flagrant violations of the stability and growth pact. This requires the backing of the EU Commission which has accepted an important task with the supervision of the national budgets.

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Anhang I:

Zusammenfassung

Die Arbeit hat gezeigt, daß im Integrationsprozess der Europäischen Union immer wieder Interessenkonstellationen entstanden sind, die nach einer EU-Erweiterung verlangten. Bisher fand dieses Erweiterungsbestreben Ausdruck in den verschiedenen Runden der EU-Erweiterung.

Dieses Verhaltensmuster greift auf die Entwicklung der auswärtigen Beziehungen der EU über. In diesem Bereich ist die EU mit dem Problem konfrontiert, Befriedungs- und Wohlstandsprojekte für jene Länder der Peripherie zu entwickeln, die ohne ein Angebot zur Vollmitgliedschaft auskommen werden müssen.

Angesichts der vielfältigen Entwicklungsmöglichkeiten und der dazugehörigen Ungewissheiten können die ökonomischen Chancen und Risiken einer Osterweiterung nur spekulativ und präliminär kommentiert werden. Ohne Zweifel könnte eine Erweiterung beträchtliche Wohlstandseffekte nicht nur für die Beitrittskandidaten, sondern auch für die derzeitigen Mitglieder bringen. Bezüglich Umfang und Verteilung dieser Wohlstandseffekte gehen die Einschätzungen weit auseinander.

Gleichzeitig bedeutet die Erweiterung auch große Risiken und Herausforderungen, die nicht unterschätzt werden sollten. Dies gilt gleichermaßen für die Beitrittsländer und die gegenwärtigen Mitglieder.

- Für die Beitrittsstaaten könnte die Übernahme des Acquis Communautaire zu einer Verlangsamung des Wachstums und der Entwicklung in vielen Bereichen führen. Auch gibt es in einigen Beitrittsstaaten überzogene Erwartungen nicht nur betreffend die möglichen Wachstumseffekte des Beitritts, sondern auch betreffend die voraussichtlichen Transferzahlungen aus Brüssel. Eine realistische Einstellung könnte Enttäuschungen verhindern und gleichzeitig dazu beitragen, daß dem weitverbreiteten Streben nach politischen Renten (welche die Kohäsion eher behindern als fördern) Einhalt geboten wird.

- Für die derzeitigen EU-Mitglieder wird es am Anfang wichtig sein, die Lösungen für die entstehenden innergemeinschaftlichen Konflikte mit marktwirtschaftlichen Konzepten in Einklang zu bringen, anstelle von Kompromißlösungen, die enorm viel Geld kosten und nur auf den Status Quo ausgerichtet sind, wie es in der Geschichte der europäischen Integration oftmals der Fall war. Die Bilanzziehung der Osterweiterung wird in der EU-Perspektive entscheidend davon abhängen, wie sehr es möglich sein wird, jene Reformen, die im Rahmen der Erweiterung unentbehrlich sein werden, sowohl auf nationaler wie auch lokaler Ebene voranzubringen.

Betreffend Konvergenzkriterien kann zwischen Inflationskriterien, Zinssatzkriterien, Umwechslungskurskriterien und fiskalischen Kriterien unterschieden werden. Am 2. Mai 1998 hat der Rat der Europäischen Union, bestehend aus den Staats- und Regierungschefs, einstimmig beschlossen, daß elf Mitglieder (Belgien, Deutschland, Finnland, Frankreich, Irland, Italien, Luxemburg, Niederlande, Österreich, Portugal und Spanien) die erforderlichen Bedingungen für die Einführung der gemeinsamen Währung erfüllen. Das bedeutete, daß diese elf Mitgliedstaaten an der dritten Phase der Wirtschafts- und Währungsunion teilnehmen würden. Die Zahl der Mitgliedstaaten, die an der dritten Phase teilnahmen, erhöhte sich auf zwölf, als sich Griechenland am 1. 1.2001 anschloß. Gemäß den Ergebnissen der Konvergenzberichte empfahlen sowohl die EU-Kommission als auch die Europäische Zentralbank die Teilnahme von Slowenien, Malta und Zypern an der gemeinsamen Währung.

Zu Beginn des Jahres 1999 trat auch der Wechselkursmechanismus II in kraft. Dabei handelt es sich um ein Wechselkursübereinkommen zwischen mehreren EU-Mitgliedern, welches die Schwankungsbreite der Währung eines Mitgliedstaats im Verhältnis zum Euro definiert. Zweck von Wechselkursmechanismus II ist es, die nicht zur Euro-Zone gehörenden EU-Mitgliedstaaten näher an die Währungsunion heranzuführen, indem stabile Währungsverhältnisse garantiert werden. Dadurch die die Euro-Zone zu einer der wichtigsten Währungszonen in der Welt geworden.

Wenn wir ehrlich sind, müssen wir zugeben: die Europäische Zentralbank und der Euro sind bislang erstaunlich erfolgreich gewesen. Es wird für den Euro und seine zukünftige Stabilität unentbehrlich sein, daß jene Staaten, die sich an die finanziellen Regeln halten, jenen Länder wie Deutschland, Frankreich, Italien oder Griechenland deren flagrante Verletzungen des Stabilitäts- und Wachstumspakts nicht durchgehen lassen. Das erfordert die Unterstützung

der EU-Kommission, welche mit der Aufsicht über die nationalen Budgets eine wichtige Aufgabe übernommen hat.

Anhang II:

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