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THE ROAD TO ENLARGEMENT

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Since our last meeting, a year ago, important developments have occurred on the road to an enlarged Europe.

I shall organize my remarks along three themes :

- political developments
- economic evolution;
- challenges regarding the future entry of Central European countries into the Euro zone.

1. POLITICAL DEVELOPMENTS HAVE MOVED FAST, BUT SOME UNCERTAINTIES REMAIN:

1. The enlargement process is well engaged :

At a treaty-signing ceremony in Athens, on April 16th, 2003, the fifteen states of the European Union agreed to admit ten new countries as members from May l st ~ 2004. Eight of the "ten accession countries" for this engagement -the three Baltic States, the Czech Republic, Hungary, Poland, Slovakia and Slovenia- are Central European states (the two others being Cyprus and Malta).

As you know, all those eight countries have asked their citizens to, express their views on this issue through referendums. All countries have, over the last months, responded by an overwhelming YES to these referendums. Most of the turnouts as well as the acceptance rates were impressive. So, now, as far as the accession countries are concerned, the route to enlargement has been cleared.

2. But there are two challenges that have to be taken up

a) the accession Treaty will have to be ratified by the members of the European Union. In theory, a referendum or a parliament in one of the EU's 15 existing member states could refuse to endorse the enlargement treaty which must be ratified unanimously ;

b) the issue is complicated by the present process of establishing a new constitution" for Europe. Indeed, adding new members to the EU institution will make it more difficult to avoid gridlock in decision-making, the more so for as long as the EU's most delicate decisions require unanimity among members. It is in this spirit that a "convention" chaired by M. Giscard d'Estaing and featuring political and public figures representing the EU institutions, member states and candidate countries, has been working over the last year. This "convention" has been able to finalize in mid-2003 a draft constitution for Europe. It is on this basis that the governments of the EU and the ten accession countries are negotiating a new treaty for the Union. But the work is not finished and divergences have appeared, in particular, on issues pertaining to voting rights (Poland and Spain are notably in favour of retaining the "overrepresentation" that had been granted to them. and to other smaller states in the Nice Treaty signed in 2002). Hopefully, these divergences will be settled before the end of the year and the new treaty will lead to a more efficient and "workable" institutional setting. Nonetheless, the new constitution will have to be ratified by all the member states, be it through referendum. or parliamentary votes.

I shall add that behind the ten "new" accession countries, other countries are in line to join the EU in future rounds of enlargement. Negotiations are under way with Romania and Bulgaria which could be ready to join in 2007. Croatia may catch up with them (it lodged a membership, application last February which is being reviewed by the Commission). Macedonia and the other countries in the western Balkans have further to go... and Turkey is a special case which will be looked again in December 2004.

II. THE ECONOMIC SITUATION IS CHARACTERIZED BY PROGRESS IN TERMS OF GROWTH BUT FISCAL AND CURRENT ACCOUNT IMBALANCES ARE A REAL CHALLENGE ESPECIALLY FOR SOME LARGE COUNTRIES:

1. Economic growth has fared well in recent years :

If one looks at table I, one observes that the weighted growth of GDP in the region has been strong and continuous over the last decade. The average annual rate of growth has reached almost 4 % in real terms. The estimated level of GDP in 2002 is, on a weighted average, at 113 (versus 100 in 1989).

Although the rate of growth of the region slowed down to 2,5 % in 2001-2002 (due to the sluggishness of the western European economies) signs are positive for 2003 (3,4 % average estimate).

2. Inflation is receding but is still a problem in a few countries :

Table II shows that the levels of inflation (which were around 8 % on a weighted average in 1997/1998) are for the last two years in the range of 2,53%.

But some countries like Hungary (4,4 %), Slovakia (8,8 %) and Slovenia (6 %) have still progress to make.

3. More worrisome, fiscal imbalances are growing :

Table III shows that the unweighted average of general government imbalances for the region has deteriorated since year 2000. In 2002, the figure was around - -4.5%.

But the individual discrepancies are particularly high in this field. Some countries have well mastered their fiscal position (Baltics, Slovenia) while others show significant slippages (Czech Republic 7 %, Hungary 9, Poland: - 6 %).

This is, indeed, a dangerous trend that is pushing up public debt ratios.

Thus, the general government debt ratio to GDP in Poland has risen from 41 % in 2000 to 50 % in 2003. In the Czech Republic, the respective figures are 16 % to 24 %. In Slovakia, 30 % to 42…

This fiscal slippage, if it were not to be reined in, could considerably increase the vulnerabilities of those economies and threaten their future stability and potential growth.

4. Balance of payments deficits are remaining at high levels in most countries :

As shown in table IV, the current deficits of the region are hovering, on an unweighted average, around 5 to 6 % of GDP, per year, for the last eight years.

Of course, countries that are in a transition and catching up process are bound to run into current account deficits. But the trend could be dangerous if it led to a significant increase in foreign indebtedness.

5. FDI is doing well but foreign indebtedness must be kept in check:

As seen in table V, net private flows of capital have increased in the past two years (20,7 Billion $ in 2000, 25,7 Billion in 2001, and 29,1 Billion in 2002). Most of those flows (20,3 out of the 29,1 in 2002, for example) were in the form of foreign direct investment.

This growth of private inflows in the region appears to reflect a significant shift of private financing flows away from Latin America. Actually, for the first time, net private capital flows to the transition economies in 2002 exceeded those to Latin America.

In spite of this positive trend, foreign indebtedness (favoured by low spreads in the region : see charts VI to IX), has grown significantly.

For example, the Hungarian external debt/GDP has gone up from 53 % in 1997 to 68 % in 2002 (the corresponding figures are 22 % and 38 % in the case of Slovenia, 48 % and 53 % in the case of Slovakia, while in Poland they are 36 % and 40 %).

These figures and the debt service burden that are related to them are still manageable. But if exchange rate vulnerability is to be kept at a minimum, vigilance is required.

III. THE ENTRY INTO THE EURO OF THE ACCESSION COUNTRIES IS A COMPLEX ISSUE:

As you know, the accession countries do not have the choice to opt out of the European Monetary Union. But, they will have to meet the Maastricht criteria before they join.

The issue can be described under the following items.

1. The four relevant Maastricht criteria :

a) achievement of a high degree of price stability : (Le. an average rate of inflation that does not exceed, over a period of one year before the examination, by more than 1 1/2 point that of the three best performing member states) :

b) sustainability of the government financial position : this test includes two criteria :

- not more than 3 % of GDP in terms of fiscal deficit,

- not more than 60 % of GDP in terms of government debt.

c) exchange rate stability :

This requires that the currencies of the accession countries remain, for at least two years, within the normal fluctuation band of the European exchange rate mechanism, without devaluing against the currency of any other member states.

d) convergence of long term interest rates :

The average long term interest rates must not exceed by more than 2 percentage points that of the three best performing member states in terms of price stability.

2. How far are the accession countries from these criteria ?

. **On inflation :** the following five countries are already meeting the Maastricht criteria :

Czech Republic
Estonia
Latvia
Lithuania
Poland

Hungary is still behind the target albeit by 1 percentage point only. Slovakia and Slovenia are further away (by 5,2 % and 2,7 % respectively).

. **On fiscal indicators :**

* Four countries are already meeting the maximum deficit targets : Estonia Latvia Lithuania Slovenia

But the others were exceeding in 2002 the 3 % limit (Hungary by 6 %, Poland by 2,7 %, Slovakia by 2,5 % , Czech Republic by 4 %).

* On the public debt indicators, all accession countries are meeting the target.

. **On long -term interest rates :** all countries -except Hungary by a small margin- are meeting the target.

3. The issue of how early can accession countries join the Monetary Union cannot receive a single answer :

. The answer depends first on the way countries will meet the fiscal and inflation targets. Fiscal discipline is of the essence here. We observe that countries like Poland, Hungary and the Czech Republic are behind target. With the "acquis communautaire" and co-financing requirements stemming from EU accession - and which compound budgetary deficits- , tackling the fiscal issue will require strong political. drive, which is presently difficult to achieve.

. The answer depends also on the stability of the exchange rate of the accession countries.

For a period of two consecutive years, the currencies of the accession countries must show stability -although it is not absolutely clear how that stability will be measured, Le. will exchange rates have to remain within the "old" 2,25 % band or within the "new" 15 % margins of fluctuations established in 1993 (ERM II)?

In this respect one can distinguish two categories of countries :

a) the three Baltic states who have pegged their currency (either though a

Currency Board linked to the euro in the case of Estonia and Lithuania, or a conventional peg to the SDR in the case of Latvia) ;

b) those who float. Some float freely (Czech Republic, Poland), Hungary floats

within a +/- 15 % band with an inflation target and some manage their float with different types of indicators (Slovakia, Slovenia).

Although the timing of each country's entry into the European Monetary Union is still uncertain and will be influenced by a number of factors, one can make, in a tentative way, the following remarks :

1. The three Baltic countries which all abide by the Maastricht criteria and have all achieved exchange rate stability through their fixed exchange regime should normally join the Monetary Union as soon as possible (2006 or even before if the two year exchange rate stability is interpreted as already been met).

2. For the "floaters", much will depend on the way they will meet their fiscal targets. If they are met in 2 or 3 years, one can envisage entry dates in 2007-2008 at the earliest.

In that group, some countries may indeed be tempted to enter the EW "as soon as possible" after the Maastricht criteria are met in order to avoid too long a period of exchange rate uncertainty that could be detrimental to, monetary stability and also in order to encourage governments to accelerate structural reforms (since nominal adjustments will no more be possible after the entry in EMU).

Some others might be inclined to wait longer and to reach complex political consensus on sensitive subjects like privatization, loss making state owned enterprises, social security gaps.... Those could think of 20 10 or beyond.

One should note, in this respect, that most currencies (except for the Baltics and Slovenia) have significantly appreciated in real effective terms since January 19993 (see chart X) in part because of strong inflows of capital which have influenced the exchange markets. Such real appreciation has also been pushed by the relatively high rate of inflation of some of those countries which are, in particular, affected by the Belassa-Samuelson effect. If higher inflation is not counter balanced by a corresponding depreciation of the currency, the exchange rate tends to appreciate in real terms. But, appreciation of the exchange rate, if it is combined with excessive fiscal deficits can lead to exchange rate vulnerability capital outflows and future downward currency moves. That is why fiscal discipline is very much at the heart of the answer on the probable timing of EMU entry. The outcome will, of course, have consequences on the value of foreign investments made in those countries.

In sum, since last year, we can observe :

- considerable progress on the enlargement process ;
- continuous growth and FDI attraction, associated in some countries with serious fiscal imbalances ;
- some uncertainty on the timing of the euro-accession.

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