European Integration Enters a New Stage — The Euro Cash Changeover and EU Enlargement to the East

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1. Introduction

The integration process of the European Union originally began with the European Coal and Steel Community (ECSC) in 1952, and subsequently advanced through the stages of customs union, free trade area, and economic and monetary union. At the same time, integration advanced in size as the EU expanded from six to fifteen countries.

In March 2002, when the euro becomes the single legal currency in the euro area, the process of economic and currency integration will be complete. The single currency area is a huge entity of twelve countries and its population of 300 million exceeds that of the U.S., while the economy is 60% as large (Figure 1).

Figure 1 Size Comparison of the Euro Area, U.S., and Japan

	Population		Nominal GDP	
	(million)	U.S. = 100	(billion euros)	U.S. = 100
Euro area	300	107.1%	6,553	61.2%
EU-15	380	135.7%	8,526	79.6%
U.S.	280	100.0%	10,709	100.0%
Japan	130	46.4%	5,145	48.0%

Note: Of the EU-15, the U.K., Sweden, and Denmark do not participate in the euro.

With the successful introduction of the single currency, integration will enter a new stage in both depth and size. This paper outlines developments in European integration in recent years, identifies unresolved issues, and considers the future prospects.

2. The Completion of Economic and Currency Integration

(1) Structural Changes Following the Euro's Introduction

Due to the introduction of the single currency for non-cash transactions between companies in January 1999, various changes were already occurring in the euro area prior to the circulation of euro cash. The major changes are described below.

1. Change in policy framework

At the start of 1999, the most significant change that occurred was in the macroeconomic policy framework for the euro area. Participating states surrendered their individual monetary and foreign exchange competences and adopted a single monetary policy conducted by the Eurosystem.

On the other hand, fiscal policy was not transferred to the EU level but instead remained in the hands of each state. To maintain fiscal discipline, conditions stipulated in the Maastricht Treaty for participation in the single currency — a fiscal deficit limited to 3% of GDP, and government debt not to exceed 60% of GDP — were reiterated in the Stability and Growth Pact, and a system of multilateral monitoring adopted.

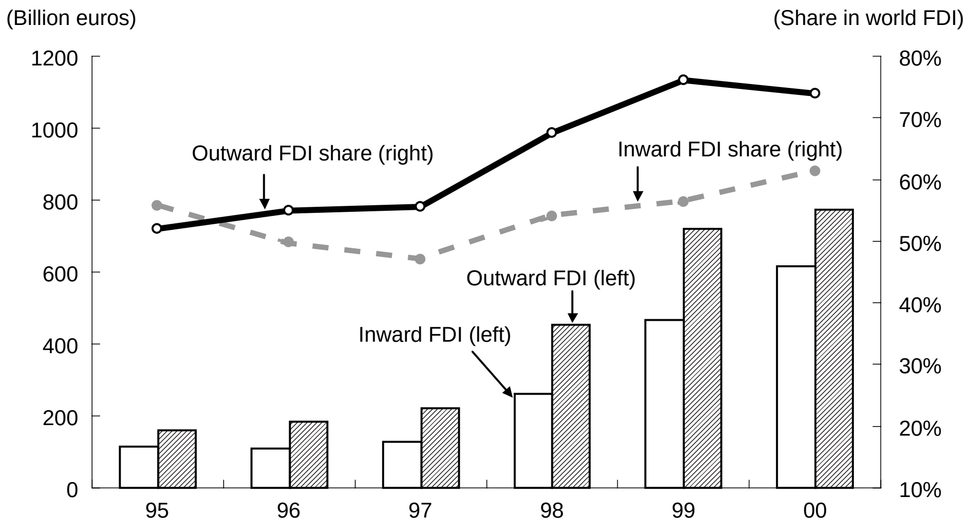
2. Change in corporate sector activity

Even prior to the cash changeover, the euro's introduction caused significant changes in corporate activity, particularly among large companies. While currency integration has reduced uncertainty and costs by eliminating currency risk and foreign exchange fees, it has at the same time intensified cross-border competition.

Seeking to reduce production costs, acquire new technologies, and establish new profit sources, companies have accelerated their production transfers to low-wage countries and acquisitions of U.S. companies. Such changes have also been helped along by the growth of euro-denominated capital markets within the area.

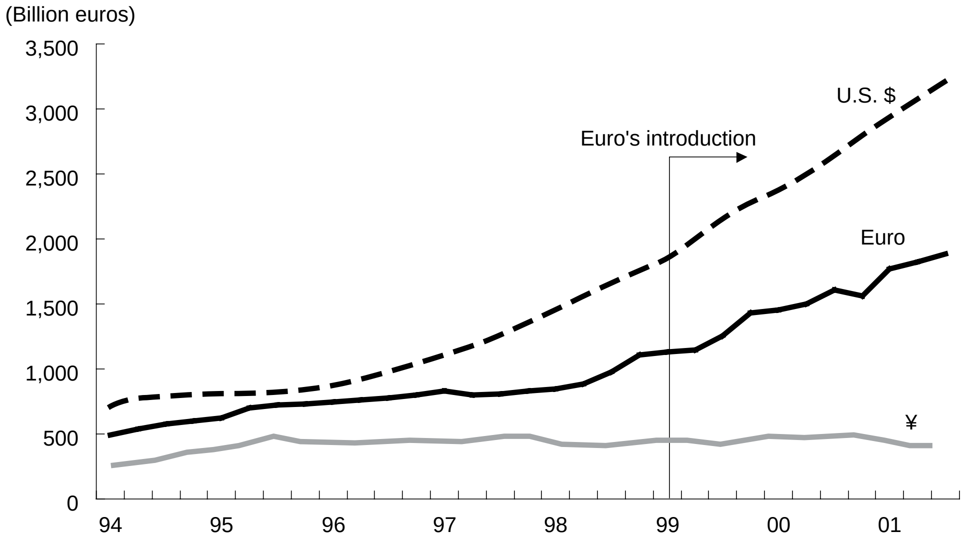
The sharp growth of financing in capital markets through direct investment and euro-denominated bonds has caused structural changes that have enhanced the euro area's presence at the global level (Figures 2 and 3).

Figure 2 Inward and Outward Direct Investment Trends of the EU



Source: UNCTAD, *World Investment Report 2001.*

Figure 3 Global Bond Issuance by Currency Denomination



Source: BIS statistics

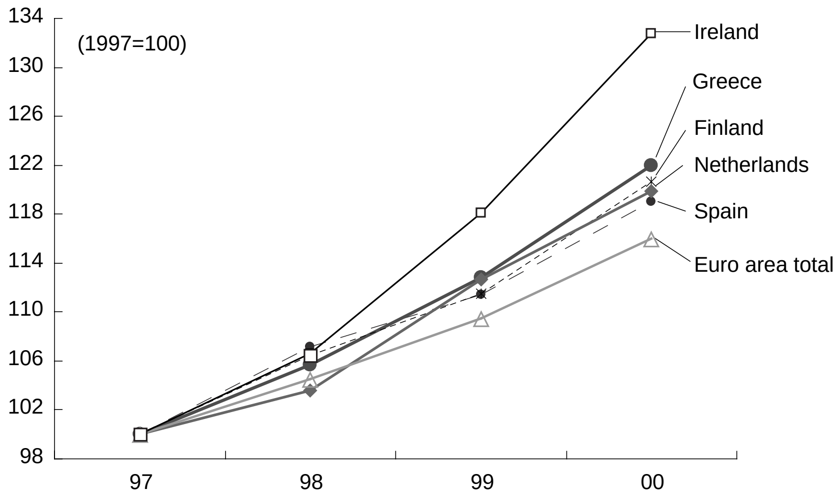
3. Accelerated economic growth in non-core states

In comparing the recent economic performance of individual countries in the euro area, we find that economic growth has accelerated in non-core countries with lower income levels such as Spain, Ireland, and Greece (Figures 4 and 5).

This has occurred against the backdrop of meeting the Maastricht economic convergence criteria by reducing fiscal deficits and improving confidence in policy, causing long-term interest rates to decline and accelerating the inflow of direct investment. In addition, economic development has been promoted through income transfers at the EU level for regional development such as Structural Funds to assist less-developed parts of the Union, and the Cohesion Fund to assist less-developed countries, which comprised as much as 5% of GDP in some countries.

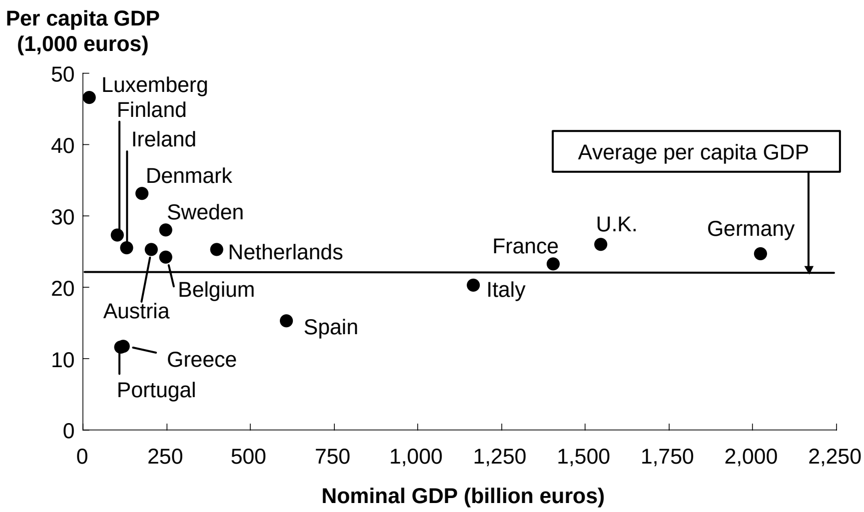
Thus in the initial stage of currency integration, capital movements apparently have helped reduce economic disparities with high-income countries in the area.

Figure 4 Per Capita GDP of Non-Core States in the Euro Area



Source: Eurostat

Figure 5 Economic Size and Income Level of EU Member States (2000)



Source: Eurostat

(2) Impact of Cash Circulation

The cash changeover, which completes the final phase of currency integration, is expected to further reveal structural changes in the euro area.

The greatest change caused by the euro changeover is to make posted prices uniform, making it easy to compare prices in different countries at a glance. While opportunistic price hikes are a strong concern immediately after the changeover, downward pressure on prices should strengthen down the road.

In enabling companies to make cross-border cost comparisons as well, the single currency will accelerate industrial reorganization throughout the euro area by prompting companies to revise production systems, redeploy production bases, and pursue a division of labor based on local competitive advantages.

(3) Issues in Completing the Single Currency Area

While the euro changeover completes the final phase of economic and currency integration, for the euro area to become genuinely integrated as a single currency area, the following issues must be resolved.

1. Institutional harmonization

Sustained efforts are underway to harmonize institutional differences impeding the free flow of people, goods, money, and services in the euro area. Recent developments include the adoption of the European Company Law in October 2001, and agreement on an information exchange system for taxation of non-resident bonds and deposit interest.

In financial and capital markets, progress on the Financial Services Action Plan (FSAP) of May 1999 is being monitored every half year, with the aim of completing integration by 2005. Genuine integration will require harmonization of taxation, laws and regulations, market practices, and regulatory and supervisory systems that still segregate markets despite the single currency.

The resulting price transparency in goods and services from the euro changeover will reveal institutionally derived cost differences. This is expected to heighten the need for institutional harmonization and thereby propel reforms.

Harmonization is still needed in many areas including laws and regulations, taxation, social insurance, and accounting rules. In particular, rapid progress will be difficult in corporate taxation since it is a basic right of nations. However, given the importance of achieving cost reduction and efficient resource allocation, this issue needs to be addressed early on.

2. The need to improve policy coordination

With regard to macroeconomic policy control, improvements are needed in policymaking capability and policy coordination.

In monetary policy, confidence in the European Central Bank's (ECB) policy management remains low even after three years of operation. More work is needed to improve confidence and stabilize the euro exchange rate.

Income transfers within the euro area are expected to counter imbalances in ways that an integrated monetary policy cannot. However, such EU finances amount to only 1.27% of GDP, and the objectives are limited to regional development and agricultural policy. Revision and reinforcement are needed, particularly in preparation for EU enlargement.

Issues also remain in the regulatory system for financial institutions. With the cash changeover, financial institutions are predicted to step up cross-border activities. But a regulatory system at the EU level has not been established, leaving concerns about the ability to deal with crises.

Since economic globalization has caused repercussions from external shocks to be transmitted more rapidly, macroeconomic policy management and coordination will continue to be put to the test in the future.

3. Goal setting for political integration

Completion of currency integration will focus attention on the need to harmonize taxation and fiscal policy, areas that lie at the core of state sovereignty. In this context, work has begun on setting goals for political integration, the ultimate end of European integration.

A constitutional convention called the Convention on the Future of Europe was convened on March 1, 2002 to produce proposals to further political integration. Over the next year, it will debate issues such as the division of power between the EU and member states, greater legislative authority for the European Parliament, direct election of the European Commission, and plans for political integration. It will then present its proposals to the Intergovernmental Conference (IGC) in 2004.

With regard to conceptions of political integration, Germany advocates a European federation having a constitution, president, government, and parliament. On the other hand, France envisions a confederacy in which member states maintain sovereignty while pursuing integration, and opposes the establishment of a super state to replace sovereign states. In addition to the conflicting stances of these two champions of integration, a third stance represented by the U.K. would limit integration to the economic realm, and is critical of any transfer of state sovereignty.

Building a consensus regarding the ultimate end of integration, and then actually achieving it, will thus take considerably more time.

4. EU enlargement

Enlargement of the euro area is vital to enhancing the euro's stature and clout as a global currency. At present, the countries likely to participate next in the euro at a relatively early date are the EU member states of the U.K., Sweden, and Denmark.

In Sweden and Denmark, due partly to the euro cash changeover, support for the euro has been growing in opinion polls. In early 2002, Prime Minister Goran Persson of Sweden announced plans for a vote on the euro during 2003. Denmark, having voted against euro participation in September 2000, has not announced plans for another national vote. However, the Rasmussen administration, which assumed power in November 2001, favors participation, and is seen as moving toward an early vote following a 57% pro-euro result in a January 2002 opinion poll.

The U.K., the EU's second largest economy and Europe's leading international financial center, euro participation holds a particularly large significance. While Prime Minister Tony Blair favors participation in principle, a specific intention hinges on conformance with the U.K.'s own five economic tests, including convergence between the U.K. and euro area economies.

The Blair administration has maintained a cautious stance consistent with the public's euro skepticism. But it will announce a decision by June 2003, which should stimulate a deeper level of debate in the meantime.

Attention will thus be focused on the mutual interaction of three factors: trends in euro area trends following the cash changeover, developments toward national elections in Sweden and Denmark, and the ongoing debate in the U.K.

3. EU Enlargement — Central and East European Countries

(1) Backdrop to EU Enlargement

With economic and currency integration having been completed on schedule — although room exists for further qualitative improvements — the focus of integration has shifted to EU enlargement and the associated institutional and organizational reforms.

EU membership has grown in four stages from the original six states to fifteen states today (Figure 6). At present, thirteen Central and East European countries have applied for membership, and with the exception of Turkey, twelve are in formal talks. Negotiations began for the first group of six countries in March 1998, and for the second group of six countries in February 2000.

The fifth stage of enlargement will be to the east. The objective is not simply an economic one of expanding the single market; also important are the political goals of establishing democracy and ensuring peace in Central and East Europe, and constructing a new European order in the post-Cold War era. In doing so, the EU aims to increase Europe's political and economic clout in the world.

Figure 6 Stages of European Integration

Year	Event	No. of members
1952	Start of European Coal and Steel Community (ECSC)	6
1973	U.K., Ireland, and Denmark enter	9
1981	Greece enters	10
1986	Spain and Portugal enter	12
1995	Austria, Finland, and Sweden enter	15
1998	Start of EU membership negotiations for Poland, five other countries	
2000	Start of EU membership negotiations for Bulgaria, five other countries	
2002	Front-runners chosen from among 12 candidates in formal talks	
2004	Front-runner countries to enter EU	

(2) Institutional Preparations for Enlargement to the East

The pending enlargement will the number of new member states is large, and a large income disparity with current members. This makes it critical to pursue reforms of EU organizations and finances that have been postponed.

1. Changes in decision-making procedures of EU institutions

In preparation for EU enlargement, proposals for institutional and organizational reform were compiled in the Nice Treaty, which was signed in December 2000.

Proposed changes in the decision making processes of EU institutions include revising the composition of the European Commission (an administrative and executive body), expanding application of the qualified majority vote and re-weighting of votes in the Council of the European Union (legislative and decision making body), and reallocating seats in the European Parliament (an advisory and supervisory body).

Regarding the integration process, a reinforced cooperation method was adopted in which integration can be carried forward with the approval of eight member states on the Council.

Ratification of the Nice Treaty and preparations for organizational reform are scheduled to be completed by the end of 2002, tentatively setting in place the necessary institutional framework. However, many problems remain unresolved. For instance, in the interest of saving time, conflicts among member states caused tax harmonization to be excluded from the scope of the qualified majority vote, while the associated arrangements are complex as well.

Due to these problems, uncertainty remains as to whether decision making processes will function without delay after the actual EU enlargement.

2. Reform of EU budget

In the event of enlargement to the east, a large economic disparity will arise with current members, and since many of the new members are dependent on agriculture, regional development policies and the common agricultural policy (CAP) will need revision.

With regard to income disparity, the entry of the ten frontrunner candidates would expand the EU from fifteen states to 25 states, and double both the land area and population. However, the economic benefit would be limited to a market expansion of only 4.2%, causing the EU's overall per capita GDP to decline (Figure 7).

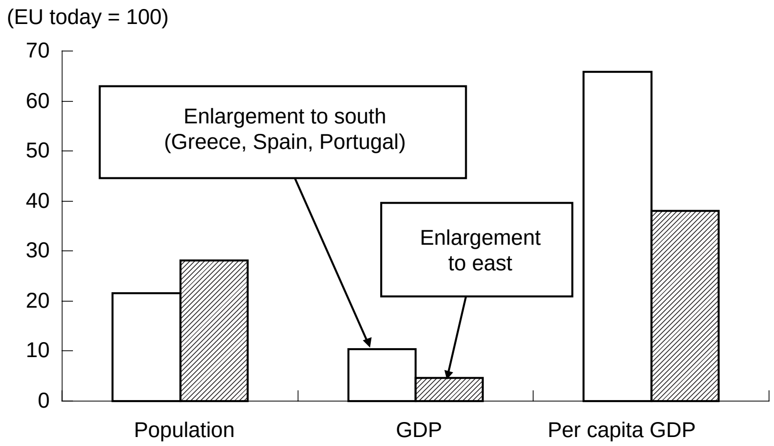
Figure 7 Statistical Profile of EU Candidate and Applicant Countries

		Negotiation status—out of 31 chapters	Negotiation status—Front runner	Land area 1,000 km²	Population (million)	Nominal GDP (billion euros)	Per capita GDP PPP std. (euros)	Per capita GDP EU=100
In formal talks								
Central & East European states	Bulgaria	13	×	111	8.2	13.0	6,300	28
	Czech Rep.	24	○	79	10.3	55.0	13,200	59
	Hungary	23	○	93	10.0	50.3	11,500	51
	Poland	19	○	313	38.6	171.0	8,900	40
	Romania	9	×	238	22.4	40.0	5,200	23
	Slovak Rep.	21	○	49	5.4	20.9	10,800	48
	Slovenia	25	○	20	2.0	19.5	15,600	69
3 Baltic states	Estonia	20	○	45	1.4	5.5	8,600	38
	Latvia	22	○	65	2.4	7.7	6,700	30
	Lithuania	21	○	65	3.7	12.2	7,500	33
Mediterr. states	Cyprus	24	○	9	0.8	9.5	19,400	86
	Malta	19	○	0.3	0.4	3.9	12,600	56
Awaiting formal talks								
	Turkey	–	–	775	65.3	217.4	5,900	26
① Grand total				1,862	171	625.9	7,600	34
Total of countries in formal talks				1,087	106	408.5	8,752	39
Total of 10 front-runner states				738	75	355.5	10,073	45
② EU-15				3,191	376	8,525.9	22,530	100
Ratio of 10 front-runner states to EU-15				23.1%	19.9%	4.2%	–	–
Size of enlarged EU (①+②)				5,053	547	9,151.8	17,993	80

Source: Eurostat

The eastern enlargement, which was made possible by the conversion of political systems, is often compared to the southern enlargement, when the low-income agricultural countries of Greece, Spain and Portugal entered. From the perspective of balance between current and new members, the eastern enlargement represents a larger income disparity and smaller economic benefit from market expansion, which will tend to increase inequality within the EU (Figure 8).

Figure 8 Comparison of Eastern and Southern EU Enlargement



Source: Directorate General for Economic and Financial Affairs, “The Economic Impact of Enlargement,” June 2001.

Enlargement will affect the operation of regional development policies, which the EU finances to reduce income disparity across regions and states. Current low-income member states (Spain, Greece, Portugal, and Ireland) are concerned about receiving a smaller share of development funds, while Germany is concerned that enlargement will increase its already substantial burden as a contributor.

Moreover, CAP spending, which comprises 46.1% of EU finances (in the fiscal 2002 budget proposal), is predicted to increase with the entry of less productive agricultural countries, and will thus need to be revised.

Responses to the above problems were adopted by the European Commission in the *Agenda 2000* in March 1999. It stipulates measures from 2000 to 2006 to maintain a ceiling on EU finances at the current level, and restrict spending for regional development policies and for CAP price supports.

However, these measures are at best temporary remedies, and unless structural reforms in the new member states proceed smoothly, substantial revisions could become necessary in the future.

(3) Status of Membership Negotiations

1. Conditions for membership

In the membership negotiations, candidate countries must fulfill a set of conditions called the Copenhagen criteria. These include political criteria such as respect for democracy, the rule of law, and respect for human rights; economic criteria such as a functioning market economy, and sufficient competitiveness to function in the EU after accession; and legal criteria such as the administrative ability to carry out the rights and duties derived from EU treaties, laws and regulations (Community acquis).

At present, candidate countries are implementing institutional changes and revising laws at a rapid pace to conform with the EU criteria.

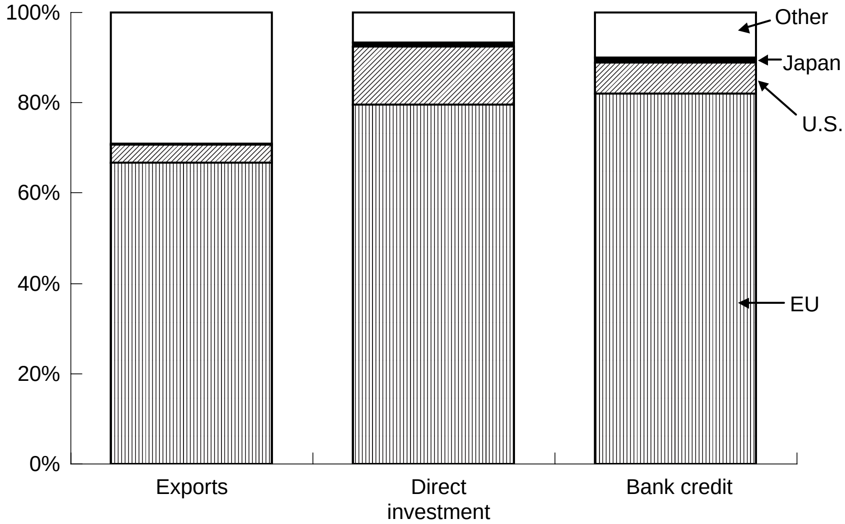
2. Benefits to candidate countries

From the perspective of candidate countries, economic benefits of EU membership include not only income transfer from the EU budget, but the inflow of direct investment (which will spur capital investment, job creation, and technology transfer) and export growth.

Part of these benefits had been received due to continuous support after the collapse of communism in 1989 and 1990 through the trade and economic agreement with the EU, economic aid, and European Agreement premised on EU accession. Thus for Central and East European countries, the EU centered around Germany had already become an important partner in terms of both trade and capital inflow, and the aim of EU accession is to further deepen these ties by integrating into the market (Figure 9).

The benefits of membership are not limited to the economic realm. EU membership has important implications for restoration of relations with Europe, democratic and social stability, and national security.

Figure 9 Exports and Capital Flow into Candidate Countries (by origin)



Note: Direct investment and exports are for 2000, bank credit is for 2001 until September.

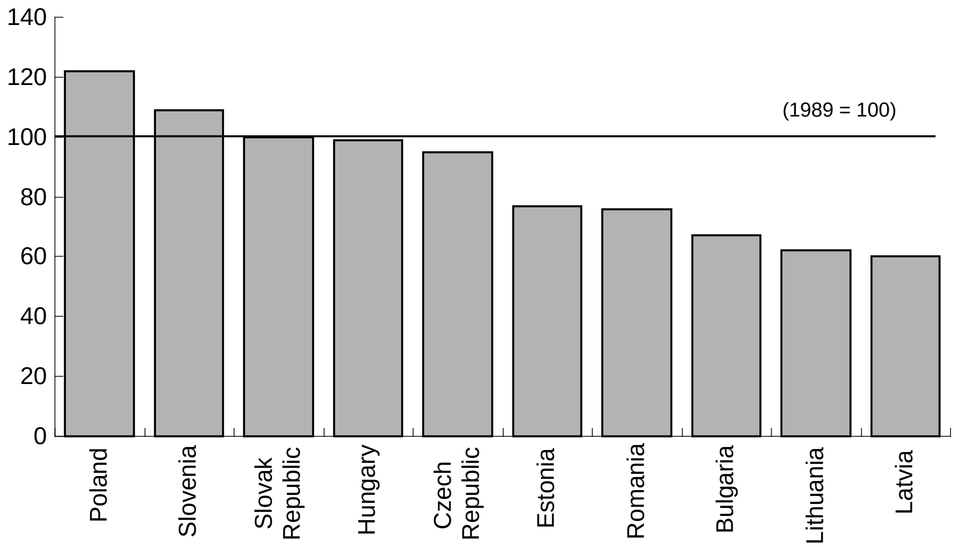
3. Disparities among candidate countries

Disparities exist in the size and absolute levels of economies among the twelve candidate countries conducting membership negotiations. There are also disparities in the status of progress toward democratization and market economies due to differences in historical experience and policy management following the fall of communism.

The Central European countries of Hungary, Poland, Czech Republic, and Slovakia share a common political tradition in that they have all had experience with democracy prior to World War II, unlike Romania and Bulgaria to the southeast. Slovenia, located at the northern edge of former Yugoslavia, has the highest per capita GDP of the former communist countries due to its advanced industrial base. The two Mediterranean countries of Cyprus and Malta are small island nations, and Malta's population of 388,000 is smaller even than Luxemberg, the EU's smallest member. The three Baltic nations of Estonia, Latvia, and Lithuania are former Soviet Republics.

The Central and East European nations who converted to market economies all experienced significant negative growth in the process from 1990 to 1993, but gradually began recovering from 1994. However, differences have emerged in their performance since then. Hungary and Poland have successfully attracted foreign capital and grown exports due to privatization and preferential measures, and are moving smoothly toward market economies. The Czech economy also succeeded in introducing foreign capital, but was battered by a currency and financial crisis in 1997, and finally managed to resume positive growth in 2000. On the other hand, economic restructuring has yet to bear fruit in Bulgaria, Romania, and the three Baltic nations, where real GDP levels in 1999 were lower than in the previous era (Figure 10).

Figure 10 Real GDP in Central and East European Nations (1999)



Source: EBRD, *Transition Report Update 2001*.

4. Status of negotiations

With regard to meeting the Copenhagen criteria for membership, all twelve candidate countries have cleared the political criteria. Cyprus and Malta have cleared the economic criteria, while the former communist countries are near doing so except for Bulgaria and Romania.

As for the legal criteria, negotiations cover the inspection of membership criteria contained in the 31 chapters, and requirements for the transition period following accession. At the end of 2001, negotiations had closed on at least 20 chapters for Hungary, Czech Republic, Slovenia, Slovakia, the three Baltic nations, and Cyprus. By comparison, Poland, whose economy and population are the largest of the candidates, trails at 19 alongside Malta.

In the process of negotiation, conflicts surfaced between neighboring countries on the sensitive issue of cross-border movements of money and people. Current members such as Germany and Austria have concerns about the inflow of immigrants, while candidate countries such as Poland, Czech Republic, and Hungary are concerned about land acquisitions. Negotiations are moving toward imposing a limited transition period after accession.

5. Future schedule

Front-runner candidates are to become members by the end of 2002, and participate in the European Parliament election in June 2004. Because the pace of negotiations accelerated in 2001, it was suggested at the Laeken European Council in December 2001 that the number of front-runners could be as high as ten.

This presumes the successful accession of all candidates currently in formal talks except for Bulgaria and Romania, who lag behind conspicuously in the negotiations. This massive enlargement was prompted by political considerations to include Poland in the first group because it accounts for the largest share of 30% of cumulative direct investment in Central and East Europe, and by the growing political demand for stability in Europe following the Kosovo conflict in 1999.

However, the remaining negotiations, while few in number, are likely to consume more time than before due to their controversial nature. In the first half of 2002, negotiations are scheduled for agriculture, regional policy and coordination, and EU finances. Since these negotiations will also meet resistance from current member states, who have concerns about additional fiscal burdens and violation of vested rights, it is unclear whether the talks will be completed on time.

6. Euro participation by new members

Since conditions for euro participation differ from those for EU membership, EU enlargement will not lead immediately to expansion of the euro area. After EU accession, new members will attempt to stabilize exchange rates by achieving economic convergence criteria and participating for the prescribed two years in the exchange rate mechanism (ERM II).

Even many of the Central European countries transitioning smoothly to market economies need institutional reforms to set up an environment for monetary policy to work through the market mechanism, and to establish central bank independence. Participation in the euro will thus require no less than one to two years after accession.

4. Conclusion

While the euro changeover has completed the Economic and Monetary Union (EMU), many issues need to be resolved before the euro area can achieve sustained and stable growth as a single currency area. Even as economic and currency integration need qualitative improvements to become truly complete, political demands are causing EU enlargement to accelerate.

With enlargement, there has been increasing diversity even among EU member states in the desire and ability to coordinate policy and institutional harmonization accompanying the transfer of sovereignty, and in approaches to political integration. Countries with the desire and ability to pursue further integration may raise new problems such as by creating disparities in rank and reducing cohesiveness.

In the future, while the desire to ensure peace and stability will keep integration moving forward, indications are that the process will not become more smooth and speedy.