HOW CAN THE NEW MEMBERS CATCH UP? [1]

Since the early 1990's, the prospect of eventual admission to the EU led to important economic progress in the 10 new EU member states. The author outlines this progress as well as the positive effects that membership itself will have on the mentioned economies. However, there are challenges involved in these countries catching up with the EU's leaders. According to the author, good domestic policies as well as strong and well-targeted EU policies are necessary for the gap to be closed.

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Of the ten new EU member states, eight have undergone a transformation whose speed and scope has been unprecedented. Wherever one looks in the post-communist accession countries – at money, markets, ownership structures, banking sectors, foreign trade, health care, environmental protection, and education – one sees institutions that have been reconstructed from the ground up.

In many of the transition countries, inflation was brought down from majestic heights – 251 percent in Poland in 1989 – and all now have fully convertible currencies. Private enterprise dominates production and employment, whereas it accounted for only 23.1 percent of GDP in Poland in 1989 and just 4 percent in the Czech Republic and Slovakia.

Similarly, after the collapse of the Council for Mutual Economic Assistance (COMECON) in 1991, the transition countries quickly redirected their foreign trade to the West. Educational opportunities have multiplied, air and water pollution have plummeted, and life expectancy has increased almost to West European levels across the region.

Since the early 1990's, the prospect of eventual admission to the EU has helped spur these institutional changes. But now the task for the new member states – which account for 20 percent of the enlarged EU's population but only 5 percent of its GDP – is no less difficult: to achieve the rapid catch-up growth rates needed to close the economic gap with the EU's leaders.

Membership itself will certainly help. Increased policy credibility will boost inflows of foreign direct investment (FDI), while EU structural funds will support further institution building, infrastructure investment, and environmental protection.

There is little empirical doubt about the positive impact of FDI inflows. FDI promotes technology transfer and contributes relatively more to economic growth than domestic investment, because it increases total investment in the economy more than one for one, owing to complementarities with domestic firms.

Empirical research also confirms the positive impact of EU structural funds on growth. EU structural assistance has increased annual GDP growth, on average, by 0.4-0.9 percentage points in Greece, Portugal and Ireland, and by 0.3 to 0.5 percentage points in Spain, thereby helping poorer countries catch up with richer member states.

EU membership provides the opportunity to catch up, but the actual economic outcomes will depend on the quality of domestic policies – and whether the EU policies most conducive to economic growth are strengthened, not weakened. This implies several imperatives for the EU and the new member countries alike.

Defend the Stability and Growth Pact

In the long term, large budget deficits lead either to a crisis or to slower economic growth. But even in the short term, there is a negative correlation between large budget deficits, slow economic growth, high inflation, and a distorted foreign exchange market. Moreover, fiscal deficits and inflation squeeze out investment and limit productivity gains.

Strengthen Single Market Policies

The benefits of the single market are evident, not least by creating a much more attractive location for foreign investors. Surveys indicate that the internal market has helped more than 60 percent of companies that export to more than five EU countries boost their cross-border sales, and that 80 percent of consumers believe that the range of goods has increased, while 67 percent say that their quality has improved.

Cross-border trade in goods has grown by around a third since the creation of the Internal Market in 1992 due to two principles: mutual recognition, which allows companies to apply their own national rules, and EU directives that harmonize national rules.

But mutual recognition does not work well for relatively more complex products, and EU directives affecting items like construction products, machinery, and pressure equipment have been problematic to implement. Pre-tax prices of new cars can differ up to 70 percent between member states due in large part to regulations that suppress competition.

Services are even more susceptible than goods to internal market barriers. For example, a new directive requires non-household customers to be able to choose their electricity supplier by July 2004 and their gas supplier by July 2007. But the directive ignores household customers, who in 2001 were able to choose their electricity supplier in only five EU States and their gas supplier in only three.

As for labor mobility, practice has yet to catch up with theory. In 1992-2002, only 4 percent of the total EU population moved across borders either to work or to retire. During this period, only 8 percent of EU students completed part of their studies in another member state.

Integration of EU financial markets – launched in 1999 with the adoption of the Financial Services Action Plan (FSAP) – also needs to accelerate. According to the European Commission, creating a single European capital market would reduce the cost of equity capital for EU businesses by 0.5 percent and lower the cost of corporate debt financing by 0.4 percent. It would also boost GDP in the EU-15 over ten years by about 1.1 percent and raise employment by 0.5 percent. But, by 2002, only 31 of the FSAP's 42 provisions had been implemented.

Target Early EMU Entry

Targeting the euro entry as soon as possible is the best strategy for the accession countries, because it will mobilize them to complete structural reforms in order to meet the Maastricht criteria for inflation, interest rates, fiscal deficits, and public debt. This would have obvious benefits for long-term economic growth, as would elimination of exchange rate risks, hedging costs, and transaction costs in foreign trade.

The accession countries are already highly integrated with the EU economy, with pronounced cyclical convergence between the accession countries and the EMU countries. Continuing EU integration is likely to align the business cycles of these countries in a manner similar to the synchronization of supply and demand shocks in the EU in the 1990's. Thus, costs associated

with giving up an independent monetary policy and a flexible exchange rate would not be significant.

In each of these areas, the accession countries' still face a difficult path to full integration. In many of them, so does the EU.