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SPEAKING NOTES

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EUROPE RE-UNITED: FIVE YEARS ON

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THE EU OF 27: ECONOMIC BOOM OR SOCIAL BUST?

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Ladies and Gentlemen,

First of all, I would like to thank you for inviting BUSINESSEUROPE to participate in this timely and important seminar.

Five years after the historical reunification of Europe, we can only assess it as a success. The challenge of the 2004 and 2007 enlargements was unprecedented: the new Member States represented around 28% of the EU population but less than 5% of its GDP. Naturally, this raised concerns in the EU15. A massive flow of labour migration and a severe institutional gridlock were among the clearest fears. However, these concerns proved largely unfounded.

The last two waves of enlargement were a decisive step towards a more unified Europe, while also improving security and stability in the region.

- For the Central and Eastern European countries, the prospect of joining the EU accelerated their transition process, helping them to consolidate their new democracies and to advance towards a real market economy.
- For the EU 15, enlargement represented a great opportunity for investment and an enlarged market for its exports.
- Overall, an enlarged EU also meant a stronger Europe in the world.

For companies in both catching-up and more mature markets, enlargement represented first and foremost a wider single market providing new development opportunities. Also, the harmonisation of rules and standards, and a more stable environment in the region represented less costs and risks for EU companies. BUSINESSEUROPE's membership has also enlarged and our member federations in new member states have played an active role in helping business development in the region.

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1. Benefits of Enlargement

The achievements of enlargement have been immense and have led to an improvement in living standards. Data from the recent Commission report on the 5 years of enlargement provides clear evidence in this direction.

1. The income gap has narrowed between old and new Member States. After enlargement, new Member States grew 5.5% a year on average against 3.5% before, while old member states grew by 2.25% a year.

2. Trade openness in new Member States also increased from 47% before enlargement to 56% after, being significantly higher than in the rest of Europe (38%). Trade integration in the EU has been rapid, with almost 80% of the new Member States exports going to the rest of the EU. What we can see is trade creation rather than trade diversion. Moreover, new Member States have rapidly moved up the technological ladder, developing capital- and technology-intensive products instead of relying on a cheap labour force. Services and knowledge economy have also progressed.

3. Foreign direct investment (FDI) increased sharply, in particular in the banking sector, and interest spreads decreased – which is estimated by the Commission as having a profound impact in the development of these countries.

4. Finally, 3 million jobs were created from 2003 to 2007 and the unemployment rate decreased to the levels of the old Member States (around 7%).

How can this economic growth witnessed in the new Member States be explained? Certainly, the catching-up process from low levels of development played a role. Yet, this explanation is clearly insufficient. In fact, EU accession policy has been the key element. This can be easily proven when we compare the development of the new Member States with those countries left outside the EU.

In fact, not only has the EU provided a stable environment and new opportunities in an enlarged Single Market, it also helped these countries to build on their institutional capacity. The EU regional policy invested the biggest share of its funds in developing basic infrastructures in the new Member States while also providing them with technical assistance. Finally, the Lisbon Strategy provided the right framework for development by directing efforts towards clearly defined structural reforms.

2. Social Impacts of Enlargement

From a labour market perspective, enlargement also brought about massive transformations.

As a result of the enlargement, the allocation of labour became more efficient. Migration inflows from the new Member States into EU-15 helped tackle labour shortages and alleviate skills bottlenecks. Thereby, they contributed to the continued expansion of certain sectors and to the creation of new jobs. Today, worker mobility in the enlarged EU is a key element to better match labour demand and supply across the EU. This is of particular significance in times of an economic crisis and will become increasingly important in the face of a declining working-age population.

The EU enlargement came with strong concerns that the important differences in wages and living standards between new and the old Member States combined with the high level of unemployment in new Member States would lead to a massive flow of workers into EU-15.

From today's perspective, it seems fair to conclude that the feared large inflows of people from these new countries into the EU-15 never materialised. Furthermore, labour migration from new Member States has not led to unfair competition on wages and working conditions and thus has not lowered the level of income for EU-15 workers.

In fact, the worry about wage competition does not take into account the highly regulated nature of EU-15 labour markets. Moreover, differences in wages and living standards are a function of economic development and of productivity. They must not be considered distortions of competition.

Particularly in times of economic crisis, when people are – understandably – concerned about losing their job, it is of utmost importance to clear up misconceptions. Unfounded fears should not lead to unjustified policy measures that restrict fundamental freedoms. There is now a need for strong leadership from all of us to explain the benefits of unrestricted labour mobility within the EU.

Having said this, we strongly hope that on the basis of the evidence collected over the past few years, Member States will now decide to fully open their labour markets by removing remaining obstacles to the labour mobility of citizens from the new Member States.

In this context, we are greatly concerned about recent actions aimed at preventing legal employment of foreign European workers in some Member States. Protectionist reactions are unacceptable and counter-productive. A well-functioning single market is key for the creation of more growth and jobs. We need a clear signal that violations of fundamental treaty freedoms cannot be tolerated in Member States.

3. IMPACT OF FINANCIAL CRISIS IN THE CENTRAL AND EASTERN COUNTRIES

But all that glitters is not gold and the current economic crisis has exposed the vulnerability of the Central and Eastern European economies. These countries have gone through a transitional period towards democracy and market-based economy which is not yet finished. And although the fundamentals underlying the economies of these countries are strong, the new model is still in its infancy and therefore fragile. Moreover, some policy mistakes in recent years have came to light with the current downturn.

These economies have been particularly hit by the current crisis and the macro-financial stability of the region is now under stress. The ECB has made €5 and €10 billion available for the Hungarian and Polish central banks respectively to use in repurchase transactions with their commercial banks. The EU together with the IMF is providing financial assistance to alleviate a balance of payments crisis in Hungary and Latvia. Moody's latest report has expressed concerns about the situation in Eastern European countries and *Standard & Poor* has already downgraded the rating of Romania and Latvia, putting Lithuania and Estonia in CreditWatch. Talks about bailout risks all over the region are becoming more vocal.

How did we arrive to this situation?

- Trade and financial liberalisation were at the base of the extraordinary growth observed in the new Member States. The prospect of high returns fuelled foreign capital flows and the expected increase in income led to wild domestic credit. Although this allowed for strong investment in the Central and Eastern countries and an increase in demand, it came with <u>large current account deficits and dependency on foreign savings</u>.

- In addition, the <u>lack of control over public finances</u> despite strong economic growth and the <u>excessive expansion of the construction sector and real estate prices</u> in some countries is a clear source of vulnerability at present.

- To worsen the situation, <u>loans have been mostly denominated in foreign currency, often based on expectations of further appreciation of their domestic currency</u>. This exposed the Central and Eastern countries to the current depreciation of their currency which increased their debt sharply. Moreover, in case of default, those western banks that have heavily invested in these countries will face severe problems. It is the case of Austrian banks, but also Italian, Swedish and to a lesser extent French, Dutch and Belgian ones.

- In addition, the banking system of the Central and Eastern countries is almost all foreign-owned. Although this is not a bad thing *per se*, the <u>risk that their parent banks will stop financing their subsidiaries is increasing</u>, putting the new Member States in a precarious position.

- Finally, many of these countries remain <u>outside the euro area</u> and are therefore more exposed to the current crisis. While some have made the necessary reform steps to adopt of the Euro, many have not progressed and are now paying the price for the evident lack of reforms.

The growth model of these countries is at stake. If the EU wants to preserve the achievements of the last two decades, needs to be able to coordinate the actions of the 27 Member States and to create the necessary mechanisms to protect the economies of the Central and Eastern European countries.

Last week, the World Bank, the EIB and the EBRD have made €24.5 billion available for the Central and Eastern European banking sector. BUSINESSEUROPE welcomes this initiative from these international institutions. On the contrary, we regret that the special EU summit on 1 March did not agree on more concrete pre-emptive measures to assist those Central and Eastern European countries more severely affected by the crisis. The EU needs to act!

- Firstly, <u>prospects of euro area membership must be reinforced</u>. Only in this way will new Member States be able to implement the necessary reforms and undertake credible actions to avoid a currency and current account crisis. A certain flexibility in the application of the convergence criteria could be considered in light of the current context of very low inflation and high exchange rate volatility.

- Moreover, the ceiling of the <u>medium-term financial assistance facility from the EU should be increased</u> significantly above the current €25 billion (€15.4 left after the help provided to Hungary and Latvia) in order to safeguard the financial viability of the Member States outside the euro area.

- Mechanisms should also be put in place to <u>guarantee a continuous flow of financing from parent banks to their subsidiaries</u> in the Central and Eastern countries, in particular when parent banks benefit from state aid. Cross-border banking activities must be closely monitored by the Commission and state aid approval reassessed in case of severe cross-border distortions.

- It is also vital to guarantee the <u>respect for the single market</u> in order for the EU Member States to be able to fully reap the benefits of this enlarged market. Finally, <u>widespread protectionism should be avoided</u> if an even more prolonged economic crisis wants to be avoided and neighbourhood policies should not impose negative externalities in border countries.

4. Future Enlargements

Regarding future enlargements, they should be based on promoting economic and political stability through the strict application of accession commitments. The progressive expansion of the European Single Market offers huge economic potential for both EU and accession country companies and has demonstrated its value in encouraging democratic stability.

Therefore, the EU accession negotiations with Croatia, Macedonia (FYROM) and Turkey should continue based on agreed calendars, with Croatia expected to join soon while negotiations with the other two candidates may take more time. For the future candidate countries of the Western Balkans (Serbia, Bosnia-Herzegovina, Kosovo, Montenegro and Albania), advancing towards accession is an important tool for economic and political stability.

BUSINESSEUROPE is prepared to work closely with the European Commission to help strengthen the role of business organisations in the region through an extension of the Eastern Europe business support programme to the region.

5. Conclusion

After the turmoil at the beginning of the 90s, the process of integration of the new Member States has been smooth in economic terms but has raised fears and misperception in the general public, as reflected in the debate surrounding the services directive, the Laval and Viking cases, and the negative referendum in France and the Netherlands.

We can hope that in times of crisis solidarity and unity will prevail over national and protectionist reflexes. This is vital for the future of the EU, which today faces its biggest challenge since its creation. We need to safeguard the basic principles of European integration and solidarity and take the necessary actions to guarantee that no country is left behind.

In this context, ratifying the Lisbon Treaty will certainly help reinforce leadership and decision-making in the enlarged EU.

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