CENTRE FOR EUROPEAN REFORM policy brief

Does enlargement matter for the EU economy?

By Katinka Barysch

★ The economies of the new member-states are too small to have much impact on the current EU.

★ The EU as a whole has gained from enlargement and will continue to do so. But labour-intensive industries and border regions will have to cope with increased competition.

★ Germany, Austria and other EU countries can only justify temporary restrictions on the free flow of workers if they use the breathing space provided to reform their labour markets.

The forthcoming enlargement round is the EU's biggest ever: ten new members – eight Central and Eastern European countries plus Malta and Cyprus – are set to join the Union in May 2004. In terms of economics, however, their accession will be of little consequence for most current EU members. First, economic integration between the EU and the East European countries has already progressed to a degree that makes further big gains – and losses – unlikely. Second, the economies of the new member-states are very small compared with the EU.

Nevertheless, many West Europeans are worried that the accession of fast-growing, low-cost economies could create enormous pressure in their countries. In particular, they fear that cheap Polish or Czech exports could price local products out of the market; that financial flows to the new member-states could divert much-needed investment capital from West European businesses; and that a massive influx of low-wage workers from the East could push unemployment in the EU even higher. These fears are largely groundless.

Trade integration is yesterday's news

In terms of economics, eastward enlargement is largely yesterday's news. All East European countries liberalised foreign trade during early economic reforms. As a result, trade with the EU took off even before the Europe Agreements opened the way for the gradual removal of trade barriers over the course of the 1990s. Since then, trade between the candidates and the EU has been growing at double-digit rates every year. By the end of the decade, the candidate countries were trading with the EU just as much as the EU members were trading with each other. On average, the would-be members are now sending two-thirds of their exports to the EU. These shares are unlikely to rise much further. Although there is scope for further integration with some EU countries, including France and the UK, future trade growth will largely depend on overall economic prospects in the enlarged EU.

This rapid trade expansion has helped to boost catch-up growth in most Central and Eastern European countries. But has it come at a cost for the EU? No. First, taken together, imports from the candidate countries amount to no more than 1 per cent of EU GDP. Second, to the extent that these imports have intensified competition for EU producers, they have pushed down prices and benefited European consumers. And third, while the EU has increasingly thrown open its market to East European goods, it has also exploited growing export opportunities in the accession countries. In fact, the EU sells much more to the accession countries than it buys in return. The result has been a large and rising trade surplus. According to estimates from the Osteuropainstitut, a German research institute, this trade surplus has created 114,000 jobs in the EU during the 1990s.

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EU companies have not only sent their goods to the candidate countries, they have also bought existing businesses there and built new ones. The Osteuropainstitut calculates that German foreign direct investment (FDI) alone has created almost 450,000 jobs in the Eastern European countries. But this does not mean that the same number of jobs has been destroyed in Germany or elsewhere in the EU. Most FDI in East Europe has come in addition to, not instead of, investments in the existing EU. By investing abroad, EU companies have mostly sought to access new and fast-growing markets rather than to cut costs at home.

Foreign investment keeps EU companies competitive

Around half of EU investment in the candidate countries has gone into services, such as banks, supermarkets and hotels. A much smaller share has been invested in factories that produce for exports in sectors such as cars, clothing and chemicals. This share, however, is growing. First, much service sector FDI came through the privatisation of banks and telecoms, which is now drawing to a close. Second, with accession around the corner, the East European economies are now starting to look more and more like those in the EU. They now have the same trade policies, competition rules and product standards. As business environments become more alike, differences in wage costs will become a more important factor in companies' decisions on where to produce. Wages are much lower in the Czech Republic, Hungary and Poland than in France or Germany. But this does not mean that West European companies will leave their home markets in droves, partly because productivity in the East is also much lower. The average West European worker produces two to three times more output in an hour of work than his East European colleague, although productivity in some export oriented sectors is now almost at western levels.

Western investment itself will help to boost productivity levels in East European industries. And West European companies will continue to invest in the new member-states, in particular in labour-intensive sectors, such as clothing or cars, as well as in skill-intensive ones, such as electronics. These are industries that are coming under growing competitive pressure from low-cost producers in Asia and elsewhere. By transferring some labour-intensive production to Eastern Europe, EU companies make sure they stay competitive on a global scale and continue to expand in their home market. FDI in the East can therefore help to preserve jobs in places such as Germany, France and the UK.

Poles and Czechs will prefer to stay at home

Once the Central and Eastern European countries are full members of the single European market, their citizens will have the right to settle and seek work in the other EU countries. But predictions that millions of East Europeans will head westwards in search of comfort and prosperity are unlikely to materialise. Wages are lower in the East, but so are prices, with the result that most East Europeans enjoy a reasonably good standard of living. Only very few will want to leave their homes, families and friends to look for new jobs in the West. High unemployment and slow growth in the EU, as well as cultural and linguistic barriers will also put off potential migrants.

Migration flows are fiendishly difficult to forecast. But many researchers think that between 100,000 and 400,000 East Europeans will head West each year once restrictions on labour movements are lifted. Assuming that it will take a decade or two until most of those who want to move have actually done so, they predict that maybe 2-3 million people from the new member-states will be living in the old EU countries by, say, 2020. That may sound a lot, but it only amounts to 0.5-0.8 per cent of the EU's current population (East Europeans are estimated to make up 0.2 per cent of the EU population already).

Some economists think that even these forecasts are too high. They point to the fact that East Europeans do not even like to move around within their own countries despite substantial regional differences in wages and unemployment rates. Moreover, it is highly skilled, well-paid workers who tend to relocate. This implies that East-West labour movements are more likely to take the form of a 'brain drain' than a deluge of unskilled labourers.

Nevertheless, some EU countries, notably Germany and Austria, are so worried about immigration that they insisted on the right to keep restrictions on the movement of workers for up to seven years after the accession date. These restrictions are understandable, but also short-sighted. Some two-thirds of all East European jobseekers coming to the EU-15 are expected to settle in Germany. With unemployment already at 4.6 million, the German government wants to gain time to prepare its labour market and social security system for any future influx. In the medium to long-term, however, Germany will have to adopt a more welcoming attitude towards immigrants. With a low birth rate, a rapidly ageing population and a shrinking labour force, Germany may have to rely on foreign workers (and not only from Eastern Europe) to sustain its generous social standards and avert a looming pensions crisis.

Overall impact: small but positive

On the whole, the impact of enlargement on the current EU will be negligible, simply because the economies of the acceding countries are so small: taken together, they amount to no more than 5 per cent of the current EU (if measured at current exchange rates). The share is closer to 10 per cent if income data are adjusted for exchange rate misalignments. In economic terms, therefore, eastward enlargement is the equivalent of adding an economy the size of the Netherlands to an economic area with 380 million people and a GDP of €9 trillion. Small it may be, but most economists agree that the impact will be marginally positive for the EU. The European Commission, for example, estimates that EU enlargement (defined as a 10-year period of integration from 1995-2005) will push up EU GDP by a cumulative 0.5 per cent. Incidentally, the Commission assumes that half of the benefits would come from immigration, which – as explained above – will probably be delayed for some EU countries. Similarly, Germany's Friedrich-Ebert Stiftung forecasts an increase in EU GDP of 0.1 - 0.4 per cent over several years. However, if the more dynamic economic processes, such as increased competition and higher investment, are taken into account, the gain could exceed 1 per cent of EU GDP.

And who pays?

These gains are obviously positive from an economic perspective. But since most West Europeans will hardly notice this small and steady increase in their wealth, it will not help much in selling EU enlargement to the public. While the benefits are long-term and amorphous, the economic costs of enlargement are immediate and concentrated on a geographical and sectoral basis. Not only has the EU allowed some member-states to restrict immigration, it is also putting in place a number of 'safeguards', designed to protect West European industries and the functioning of the single market after enlargement. Although these safeguards are unlikely to disrupt trade on a large scale, their existence shows that the old member-states are seriously concerned about increasing competition from the East.

As explained above, Eastern Europe has been most competitive in labour-intensive sectors such as clothing or food production, but also in some capital-intensive ones, such as the production of basic metals and chemicals. In these industries, the EU has seen steady job losses throughout the 1990s. But it would be wrong to attribute these entirely to the EU enlargement process. As countries grow richer, they typically progress from labour- and resource-intensive manufacturing to capital- and knowledge-intensive production and services. For the richer EU countries, it makes no sense to cling to the production structures of the past. They should see EU enlargement as an opportunity for economic upgrading. Rather than protecting yesterday's jobs in smokestack industries, they should invest heavily in building up the kind of human-capital intensive industries that will guarantee stable economic growth in the long term.

Similarly, Germany, Austria and others can only justify transition periods for the free movement of workers if they use the intervening years to reform their rigid labour markets. From an economic point of view, the free movement of workers is unambiguously positive. But if labour markets are rigid and wages high and inflexible, such movements can lead to temporary spikes in unemployment and put a heavy burden on public budgets. The natural instinct of a country like Germany – which already suffers from high unemployment – is therefore to shield its workers from low-cost competition. But this is not the way forward. Germany's inability to deregulate its sclerotic labour market has already turned into a drag on the entire European economy. EU enlargement may well be the incentive that Germany needs to get serious about economic and labour-market reform.

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Population and GDP of the new member-states

	Population, million	GDP, € billion	GDP per head as % of EU average
Cyprus	0.7	13	80
Czech Republic	10.2	136	57
Estonia	1.4	13	42
Hungary	10.2	121	51
Latvia	2.4	18	33
Lithuania	3.5	31	37
Malta	0.4	5	55
Poland	38.6	356	40
Slovakia	5.4	60	48
Slovenia	2.0	32	69
EU-15	377	8,830	100

Note: data are from 2001. GDP data are calculated in purchasing power parity, i.e. adjusted for exchange rate misalignments. Source: Eurostat.

Does enlargement matter for...

★ **...the EU budget?** More than 80 per cent of the EU's €100bn annual budget is spent on either farm support or subsidies to countries and regions with income levels below the EU average. Since the accession countries are both poorer and more agricultural than the current EU, some observers have predicted that enlargement will bust the Brussels budget. This is unlikely. For enlargement the EU has earmarked just over €40bn for the period between accession in May 2004 and the end of 2006, when its current budget expires. From 2004, the new members will also pay their dues to the EU budget, which means that net payments are unlikely to exceed €10bn per year, the equivalent of 0.1 per cent of the enlarged Union's GDP.

The EU has not yet determined how much the new members will get during the next budget period (2007-13). But it has already decided that it will take until 2013 before East European farmers are entitled to the same subsidies as their West European counterparts. It has also capped regional aid to the new member-states at 4 per cent of their respective GDPs.

★ **...the Lisbon reform process?** Eastward enlargement will have a mixed impact on the EU's declared goal of becoming the world's most competitive, knowledge-based economy by 2010. On the one hand, the East European economies are more flexible, and their politicians and populations are more accustomed to radical reform, than many current EU members. On the other hand, the relative backwardness of the new members will make it even more difficult for the EU to reach Lisbon targets, for example with regard to education, research and development, employment levels or small business development.

★ **...the internal market?** The EU has declared the completion of the single-market for goods, services, people and capital the cornerstone of the Lisbon process. The EU and the accession countries have removed traditional barriers to trade, such as tariffs and quotas. But national standards, for example for food safety or the provision of financial services, are still hampering market integration. The accession countries have already adopted most internal market legislation. They have also established standard-setting bodies, food inspectorates and other bureaucracies that are needed for the smooth functioning of the single market. The EU has accepted many Czech and Hungarian products as being fully in conformity with EU standards.

However, the EU only sets harmonised product standards in a limited number of sectors. Most intra-EU trade functions on the basis of 'mutual recognition', which means that a product considered safe in one country has to be accepted as such in all other EU member-states. Many people in the current EU ask whether Eastern Europe's inefficient bureaucracies can be relied upon to set and supervise health and safety standards. EU companies may exploit these doubts in an effort to protect their own markets. The European Commission – the EU's internal market watchdog – may be unable to cope with a flood of complaints about allegedly unsafe products coming from the East.

★ **...the euro?** The accession countries are keen to join the eurozone as quickly as possible after EU entry. A country like Estonia, which has fixed its currency to the euro for more than a decade, could join as soon as it has completed the compulsory two years in the ERM II, the EU's revamped exchange rate mechanism. But for many others, relatively high inflation and large budget deficits will make it hard to meet the Maastricht criteria for eurozone entry. To rule out any destabilising impact on the euro, the European Central Bank will insist on a strict interpretation of the convergance criteria before the new members can join the euro. The 2006/07 target date that many accession countries have set for euro entry may turn out to be optimistic.