THE EU ECONOMY FOLLOWING THE ACCESSION OF THE NEW MEMBER STATES

On 1 May 2004, the European Union (EU) welcomed ten new countries in what represented its most significant enlargement since its creation. However, compared with previous enlargements, the economic weight of the new Member States is relatively small. As a result, the statistical macroeconomic features of the EU economy as a whole have not changed significantly. In fact, among the most notable changes are a 20% increase in total population and a 5% rise in total GDP. In the longer term, this enlargement is likely to contribute positively to economic growth and welfare in the EU as a whole. By increasing the scope for the 'four freedoms"(the free movement of goods, services, capital and labour), the extension of the Single Market should enhance competition and create economies of scale. However, the extent to which these effects will materialise and the speed at which they do so depend on many factors, not least on the economic policies in both the old and the new Member States.

This article presents a number of key macroeconomic features of the expanded EU. In addition, some potential longer-term implications of enlargement for economic growth and welfare are discussed, focusing on a number of aspects relating to the 'four freedoms"of the Single Market.

1 INTRODUCTION

On 1 May 2004, following several years of extensive preparations, ten countries of central and eastern Europe and the Mediterranean – Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, Slovenia – joined the EU. The accession of these new countries opens up new opportunities for trade and investment for both the existing and the new Member States. This article reviews a number of economic implications of EU enlargement.

Section 2 presents a number of key macroeconomic features of the EU both before and since the accession of the new Member States. Comparisons are also made with the United States and Japan. Section 3 then discusses the implications of enlargement for economic growth and welfare in the EU. Given that a full evaluation of the economic implications of enlargement is beyond the scope of this article, the focus is on a number of aspects relating to the "four freedoms" of the Single Market. Other implications of enlargement, such as the impact on EU Structural and Cohesion Funds and the Common Agricultural Policy, are not discussed.

2 KEY MACROECONOMIC FEATURES OF THE EU INCLUDING THE NEW MEMBER STATES

The enlargement of the EU to include ten countries of central and eastern Europe and the Mediterranean does not fundamentally change the key characteristics of the EU economy, as the economic weight of the new Member States is relatively small. However, economic diversity within the EU has increased, as the institutional and structural features of the new Member States are in many respects still different from those of the old Member States. In the short term, the accession of the new Member States will have an upward impact, in statistical terms, on real GDP growth in the EU, as output growth in the new Member States is higher than in the EU-15. The table contains a number of key macroeconomic features of the enlarged EU (comparing it with the former EU of 15 Member States, the United States and Japan), using the most recent data available from various sources. Where necessary, comparisons between the existing and the enlarged EU, the United States and Japan are based on a conversion of national data into a common currency using the average nominal exchange rates prevailing in the corresponding period, unless otherwise indicated.

Table Key characteristics of the EU economy following the accession of the new Member States

	Reporting period	Unit	EU-15	EU-25	United States	Japan
Population [1]	2004	mln	380.8	454.9	291.4	127.7
GDP (share of world GDP) [2]	2002	%	26.8	28.1	32.5	12.3
GDP	2002	€ bln	9,172	9,615	10,980	4,235
	2002	PPP thousands	8,921	9,741	9,422	3,067
GDP per capita	2002	€ thousands	24.0	21.1	37.7	33.2
	2002	PPP thousands	23.3	21.4	32.7	24.1
Labour productivity per person employed	2002	PPP index EU-15 = 100	100	92.8	118.9	87.9
Exports of goods	2002	% of GDP	10.9	9.5	6.5	9.9
Imports of goods	2002	% of GDP	10.8	9.8	11.1	7.6
Sectors of production [3]						
Agriculture, fishing, forestry	2002	% of GDP	2.0	2.1	1.3	1.3
Industry (including construction)	2002	% of GDP	27.0	27.2	21.6	29.1
Services	2002	% of GDP	71.0	70.7	77.1	69.6
Public expenditure on education	2000	% of GDP	4.9	4.9	4.8	3.6
R&D expenditure	2001	% of GDP	2.0	1.9	2.7	3.1
Unemployment rate	2003	%	8.0	9.0	6.0	5.3
Labour force participation rate [4]	2002	%	69.6	68.9	76.6	75.7
Employment rate [5]	2002	%	64.3	62.9	71.2	65.2
General government [6]						
Surplus (+) or deficit (-)	2002	% of GDP	-2.0	-2.1	-3.4	-6.1
Expenditure	2002	% of GDP	48.0	48.0	32.4	38.7
Revenue	2002	% of GDP	46.0	45.9	29.0	32.6
Gross debt	2002	% of GDP	62.5	61.5	45.7	134.6
Bank deposits [7]	2002	% of GDP	81.5	80.1	44.0	118.8
Stock of loans to the private sector [8]	2002	% of GDP	97.1	94.2	51.2	101.0
Stock market capitalisation	2002	% of GDP	57.8	55.9	94.7	46.8

Sources: Eurostat, European Commission, IMF, BIS, ECB, World Federation of Exchanges, Bank of Japan and US Federal Reserve.
1) 1 January 2004; Japan: 1 April 2004.
2) GDP shares are based on country GDPs in current US dollars.
3) Based on gross value added at current prices.
4) Defined as the ratio of the labour force to the working age population (those aged between 15 and 64).
5) Defined as the ratio of the number of employed persons to the working age population (those aged between 15 and 64; for Japan, those aged between 15 and 70).
6) Revenue, expenditure and deficit based on ESA95. Gross debt is calculated as defined in the excessive deficit procedure. Japan: data for 2001.
7) EU-15 and EU-25: total deposits with MFIs; United States: demand, time and savings deposits with banking institutions; Japan: demand and time deposits with deposit money banks.
8) EU-15 and EU-25: MFI loans to residents other than general government; United States: loans by commercial banks, savings institutions and credit unions; Japan: loans to the private sector.

POPULATION AND ECONOMIC ACTIVITY

The latest enlargement has increased the population of the EU by approximately 20% to a total of 455 million people. In terms of population this is the biggest enlargement since the EU's creation in 1957 (at that time it was referred to as the European Economic Community). Measured in terms of population, the EU-25 is the largest economic entity among the industrial countries. By way of comparison, the populations of the United States and Japan are less than two-thirds and one-third respectively of the population of the EU-25.

Economic activity in the countries forming the EU-25, as measured by GDP, was just above €9,600 billion in 2002, to which, on the basis of current exchange rates, the new Member States contributed 4.8%. From a historical perspective, the economic size of this enlargement is relatively limited. For example, the accession of Spain and Portugal to the European Community in 1986 (which at the time consisted of ten countries) raised the EU's total GDP by slightly more than 8%, and the enlargement to Austria, Finland and Sweden in 1995 increased total GDP by a little more than 7%. On the basis of GDP data and exchange

rates for 2002, the accession of the new Member States would lead to a rise in the EU's share of world GDP from 26.8% to 28.1%. It should be noted, however, that these international comparisons are heavily influenced by developments in exchange rates, although a way to circumvent this is to make a comparison on the basis of purchasing power parities (PPPs). Purchasing power parity is a currency conversion rate that converts economic indicators expressed in a national currency into an artificial common currency that equalises the purchasing power of different national currencies. In PPP terms and on the basis of 2002 data, the most recent enlargement increases the EU's GDP by 9.2%, so the size of the EU-25 economy is larger than that of the United States.

As the new Member States have a relatively large population in relation to their level of economic activity, their accession implies a decline in the average level of GDP per capita in the EU. In PPP terms, however, the level of GDP per capita in the new Member States is higher than on the basis of current exchange rates, as the price level in the new Member States is lower than in the EU-15. Therefore, in PPP terms, the decline in the EU's GDP per capita associated with the accession of the new Member States is less pronounced. Compared with the United States and Japan, GDP per capita in the EU-25 is relatively low, though the difference, especially with Japan, is much more limited in PPP terms (on the basis of figures for 2002).

EXTERNAL POSITION

The key characteristics of the EU, as described in this section, are generally a weighted average of the individual Member States. One notable exception to this is that since enlargement, EU-15 trade with and among the new Member States has now become intra-EU trade. As a result, it is no longer recorded as international trade. By contrast, trade between the new Member States and the rest of the world excluding the EU-15 countries now counts as extra-EU-25 trade. The accession of the new Member States decreases slightly the trade openness of the EU, as EU-15 trade with the new Member States is larger in magnitude than new Member States' trade with countries outside the EU-15. According to data for 2002, the expanded EU's exports of goods represented 9.5% of the EU's GDP, compared with 6.5% and 9.9% for the United States and Japan, respectively.

PRODUCTION STRUCTURE

The structure of production in the new Member States is characterised by a slightly larger share of agriculture and industry and a somewhat smaller share of services in GDP than the average of the EU-15 countries. Consequently, the accession of the new Member States has only resulted in slight changes in the shares of these broad sectors in the EU's GDP. Sectoral differences compared with the EU-15 tend to be more pronounced in terms of the distribution of employment across these sectors. The new Member States each display notable differences with regard to sector shares and employment distribution. This diversity is even more pronounced within the broad sectors of industry and services. In comparison with the United States and Japan, the agricultural sector in the EU is relatively large, whereas the size of the EU's industrial sector is larger than that of the United States but smaller than that of Japan. The EU's services sector is larger than that of Japan but smaller than that of the United States.

LABOUR MARKET

As the average unemployment rate in the new Member States is higher than that in the EU-15 countries, the accession of the new Member States has led to a somewhat higher average unemployment rate in the EU-25. Despite a fall during the late 1990s, unemployment in the EU-15 and the EU-25 remains significantly higher than in the United States and Japan. In the new central and eastern European Member States, unemployment rates have risen and regional unemployment differences have grown during the past decade, owing to structural adjustments associated with the transition to a market economy. However, prospects for

employment could improve in the years ahead, as labour shedding associated with the business restructuring process may come to an end. In the longer run, the new Member States' potential for catching-up in terms of GDP per capita may also contribute to favourable employment trends and lower unemployment.

The accession of the new Member States lowers the employment rate in the EU by 1.4 percentage points to 62.9%. A breakdown of the employment rates in the new Member States suggests that the participation rate of males in particular is considerably below the level of the EU-15 countries, whereas the gap for females is less considerable. The employment rate of older workers (i.e. those aged between 55 and 64) is also substantially lower in the new Member States than in the EU-15. Even more efforts in both the existing and the new Member States are therefore needed to achieve the Lisbon employment target of 70% by 2010. In comparison with the United States and Japan, the EU labour force participation rate is low. The combination of a lower participation rate and the higher unemployment rate in the EU is reflected in an employment rate which is below that of the United States and Japan.

FISCAL POSITION AND THE SIZE OF THE GOVERNMENT SECTOR

The accession of the new Member States does not substantially change the weighted average government deficit ratio in the EU, despite the fact that public deficits in the new Member States are generally high. The public expenditure and revenue shares in GDP are somewhat smaller in the new EU countries, thus reducing the share of the general government sector in the EU-25 slightly compared with the EU-15. As the public debt ratio in the new Member States is generally significantly below the level in the existing EU countries, the average EU debt-to-GDP ratio has become somewhat lower since enlargement.

In 2002 the general government deficit in the EU-25 was, at 2.1%, lower than in the United States and Japan. Also in 2002, the general government sector in the EU-25, where the expenditure ratio stood at 48% and the revenue ratio at almost 46%, made up a larger share of the economy than in the United States and Japan. In the United States, the general government sector accounted for just over 32% of GDP in terms of expenditure and 29% of GDP in terms of revenue. In Japan, the large public deficit can be accounted for by a government expenditure ratio of almost 39% of GDP and a government revenue ratio of slightly below 33%. The accumulation of public deficits in the past is reflected in comparable public debt ratios in the EU and the United States, which are significantly lower than in Japan.

FINANCIAL STRUCTURE

The accession of the new Member States does not imply significant changes to the financial structure of the EU as a whole. Although the level of financial intermediation is relatively low in most new Member States and is more strongly focused on banks than in the EU-15, enlargement does not materially affect the EU aggregate given the relatively small size of the financial sectors in most new Member States. Financial markets in the new Member States are generally less developed than in the EU-15. In comparison with the United States, the EU's financial sector continues to be more oriented towards the banking sector, whereas the role of stock markets in financial intermediation is less important. The opposite is true for the EU's financial sector vis-à-vis Japan.

3 THE IMPACT OF EU ENLARGEMENT ON GROWTH AND WELFARE

The previous section focused on the statistical impact of the accession of the new Member States on a number of aggregate macroeconomic figures for the EU. In addition to this statistical impact, the enlargement of the EU also affects incentives for and impediments to the flow of goods, services, capital and labour between the EU-15 and the new Member States. Although the degree of economic integration between the EU-15 and the new Member States that was

achieved prior to enlargement is substantial and many effects are already visible, enlargement is likely to have further integration effects. However, the extent to which these effects will materialise and the speed at which they do so depend on many factors, such as future economic developments and policies in Member States. This section reviews some channels through which enlargement could affect economic growth and welfare in the longer term, focusing on the "four freedoms" of the Single Market.

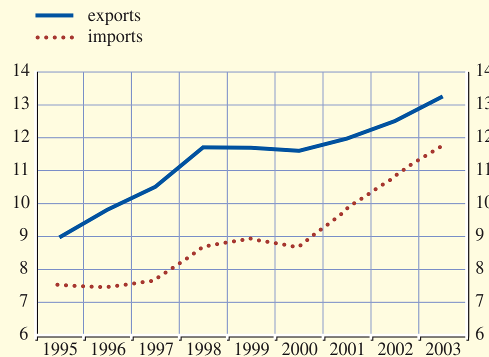
Existing studies have generally suggested that enlargement-related integration effects are likely to produce economic benefits for both the EU-15 and the new Member States, provided that suitable national economic policies are pursued. Estimates of the potential benefits of enlargement in terms of cumulative increases of GDP are generally positive – though rather small – for the existing EU as a whole, but are substantially higher for the new Member States given their relatively small size.[1] In addition, progress with nominal convergence in the new Member States (including a reduction of inflation) can help to speed up the catching-up process in real terms, as the experience of some EU countries during the 1990s has demonstrated. The benefits of enlargement will not be distributed evenly across countries, regions and sectors. For example, some economic sectors may benefit more than others because of an increased demand for their products from the new Member States, whereas others may face increased competition from suppliers in the new Member States.

TRADE AND COMPETITION

The traditional theory of international trade predicts that economic integration has two broad effects on trade patterns. Trade creation arises when economic integration leads to the movement of trade from a high-cost to a low-cost producer, thereby raising the volume of cross-border exchanges. Trade diversion occurs by favouring trade among countries in a free trade area at the expense of lower cost producers outside this free-trade area.

Chart 1 EU-15 trade with the new Member States

(as a share of total extra-EU15 trade)



Source: Eurostat.

It is clear that the implementation of the so-called Europe Agreements has led to a significant increase in trade. These bilateral agreements between the EU-15 and the current new Member States were concluded in the early and mid-1990s and established a free trade area for many industrial products by removing tariffs and quantitative restrictions. As a result of these agreements and the profound structural changes taking place in the new Member States, EU trade with this group of countries grew relatively strongly during the 1990s and, hence, the new Member States as a group became a main trading partner of the EU-15 countries (see Chart 1). Although the Europe Agreements implied the abolition of formal barriers (i.e. tariffs and quantitative restrictions) to trade in industrial products, restrictions on agricultural and so-called sensitive products (including chemicals, textiles and clothing, footwear, iron and steel and furniture) continued to exist until enlargement. EU accession has finally and irreversibly liberalised trade between the new and the existing Member States for these products as well.

1 These are only very rough estimates and only give an idea of the magnitude of the potential effects. For a recent overview of the new Member States' economies, see "The acceding countries' economies on the threshold of the European Union", in the ECB's *Monthly Bulletin,* February 2004.

In addition to the integration effects described above, the expansion of the Single Market has enhanced the degree of competition and the scope for economies of scale. The degree of competition is likely to rise as the accession of the new Member States has increased the number of suppliers within the Single Market. Economies of scale may occur as the expansion of the Single Market has increased the size of the market available to suppliers. A rise in competition and economies of scale should lower prices and increase productivity, thereby contributing to an increase in the potential growth rate. Furthermore, the expansion of the Single Market should increase the range and varieties of products available to producers and consumers.

The scope for an enhancement of competition and economies of scale is reinforced by the reduction of so-called technical barriers to trade that existed prior to enlargement. Technical barriers can arise owing to differences in the way that products are regulated across countries vis-à-vis requirements such as health, safety, environmental and consumer protection standards. The Single Market aims to abolish these technical barriers between Member States, inter alia by setting harmonisation standards or by enforcing the principle of mutual recognition of each Member State's rules and regulations. Although some technical barriers were removed during the adoption of the *acquis communautaire* in the run-up to EU membership, the further removal of technical barriers is likely to have had an additional positive effect on trade flows since enlargement. The size of this effect depends on the actual implementation of the Single Market, including the full transposition of EU Directives into the national legislation of both the old and the new Member States.

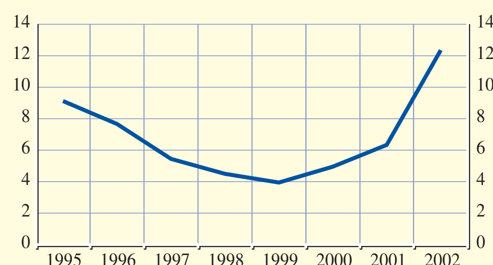
FLOWS OF CAPITAL AND LABOUR

According to economic theory, the establishment of the free movement of capital between the old and the new Member States should lead to a flow of capital from the relatively capital-abundant EU-15 countries towards the new Member States, where the capital stock is smaller and marginal returns on capital are higher. Conversely, labour is likely to flow from the new Member States to the EU-15 countries, where the marginal return on labour (i.e. incomes) is higher. On the basis of this theoretical framework, the free movement of capital and labour should contribute to an increase in growth in the EU as a whole, because factors of production move to those locations where they are most productive. However, this framework is highly simplified. Migration flows, for example, are also influenced by a range of other factors, such as the employment rate in the home and the foreign country, geographical distance and differences between countries in terms of culture and language.

The new Member States largely liberalised capital movements early in the transition process, anticipating the obligations of EU accession. Foreign direct investment (FDI) constitutes by far the largest share of total cumulative net private capital inflows to the new Member States, also reflecting the role of FDI as a source of financing in the privatisation process. The share of FDI flows from the EU-15 countries to the new Member States has increased in recent years, linked to the prospect of joining the EU (see Chart 2). More specifically, some firms from the old Member States have tended to move labour-intensive parts of their production chains to the new

Chart 2 FDI flows from the EU-15 to the new Member States

(as a share of total extra EU-15 FDI flows)



Source: Eurostat.

Member States. The prospects for FDI flows depend on a range of factors, such as factor prices, transport costs as well as labour and product market regulation in the economies concerned. On the one hand, the diminution of risks associated with entry into the EU is expected to support FDI inflows to the new Member States. On the other hand, the end of the privatisation process in most new Member States may reduce the role of FDI.

In contrast to goods, services and capital, limitations on the movement of labour between the new and old Member States remain in place. Member States are allowed to use transitional periods to postpone the free movement of workers and most existing EU countries have maintained restrictions since enlargement. However, several EU-15 Member States grant nationals from the new Member States the right to temporary immigration. Inflows of labour from the new Member States have thus been concentrated in sectors characterised by a high degree of seasonal work, such as agriculture and tourism.

Many studies suggest that future migration flows to the existing EU countries are likely to be small in relation to the size of the workforce in the EU. However, the range of estimates is rather wide, reflecting considerable uncertainty. Studies on the implications of enlargement for migration are based on very different methodologies, such as opinion polls, extrapolations from earlier south-north migrations, and analyses of past migration episodes in econometric models. Most studies predict a long-term migration potential of broadly 1%-4% of the current population in the new Member States. It is important to bear in mind that these projections are often based on ad hoc assumptions regarding the determinants of migration flows, such as future unemployment and income differentials between the new and the old Member States. In addition, it should be noted that these numbers are averages and the distribution of migration inflows into the existing Member States is likely to be uneven across countries and regions.

4 CONCLUDING REMARKS

On 1 May 2004, the EU underwent its most significant enlargement since its creation, increasing from 15 to 25 Member States and from 381 to 455 million people. As the economic weight of the new Member States is relatively small, the statistical aggregate macroeconomic features of the EU economy have not changed fundamentally. In fact, the most notable changes in the EU are the 20% increase in total population and the 5% rise in GDP. In addition, as the new Member States have a large population relative to the level of economic activity, their accession implies a decline in the average level of GDP per capita in the EU.

In the longer term, enlargement is likely to contribute positively to economic growth and welfare in the EU as a whole, although the benefits of enlargement are not likely to be distributed evenly across countries, regions and sectors. The extension of the Single Market, by increasing the scope for the free movement of goods, services, capital and labour, should enhance competition and economies of scale. This should lower prices and increase productivity, thereby contributing to an increase in the sustainable rate of growth in the EU. The extent to which these effects will materialise and the speed at which they do so depend, inter alia, on economic policies in the old and the new Member States. In particular, macroeconomic policies should be aimed at stability and structural reforms should be implemented to enhance the flexibility of markets, including a forceful and prompt completion of the enlarged Single Market. Therefore, enlargement has made it all the more important to fully exploit the potential of the Single Market by dismantling any remaining barriers to the free movement of goods, services, capital and labour and any remaining impediments to competition.