ARTICLES

THE ENLARGED EU AND EURO AREA ECONOMIES

On 1 January 2007, Bulgaria and Romania joined the European Union, which now comprises 27 Member States. At the same time, Slovenia adopted the euro, increasing the number of euro area countries from 12 to 13. As the economic weight of these new member countries is relatively small compared with the group of countries they join, the statistical macroeconomic features of the EU and euro area economies do not change significantly as a result of these enlargements. That said, EU enlargement opens up new opportunities for trade and investment for both the existing and new EU Member States. However, in order to fully exploit these opportunities, it is important that the Single Market for goods, services, capital and labour is fully implemented across all 27 Member States.

Adopting the euro implies for Slovenia that the benefits of the Single Market are further enhanced by the single currency, which offers a credible framework for monetary policy and price stability in an environment characterised by the absence of exchange rate uncertainty within the euro area. In order to fully reap the advantages of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, all remaining barriers between Slovenia and the rest of the euro area should be removed as soon as possible, including those related to labour mobility.

1 INTRODUCTION

Following several years of extensive preparations, Bulgaria and Romania joined the EU on 1 January 2007. The accession of these two countries raises the number of EU Member States to 27 and adds almost 30 million inhabitants. At the same time, Slovenia is the first country of those that entered the EU in May 2004 to adopt the euro, increasing the number of euro area countries from 12 to 13. This article first focuses on the economic aspects of enlargement by reviewing a number of key economic features of Bulgaria and Romania and the enlarged EU. The article subsequently looks at key features of Slovenia and the enlarged euro area. In addition, it briefly reviews the completion of the Slovenian convergence process towards the euro area during the second half of 2006.

2 THE ENLARGEMENT OF THE EU

The accession of Bulgaria and Romania constitutes the second enlargement of the EU to include countries in central and eastern Europe, following the enlargement of May 2004, when eight countries in this region together with Cyprus and Malta joined the EU.[1] The accession negotiations with Bulgaria and Romania were concluded in December 2004 and a Treaty of Accession was signed in April 2005. In September 2006, the European Commission announced that, in the light of the overall progress made by the two countries, Bulgaria and Romania should be prepared for membership by 1 January 2007, provided that a number of outstanding issues in areas such as judicial reform, and the fight against corruption and organised crime were addressed.

The latest enlargement does not fundamentally change the key characteristics of the EU economy, as the economic weight of the new Member States is relatively small. At the same time, the economic diversity within the EU increases further, as the institutional and structural features of the new Member States are in many respects still different from those of the other Member States. Table 1 contains a number of key macroeconomic features of the enlarged EU.

1 See the article entitled "The EU economy following the accession of the new Member States" in the May 2004 issue of the Monthly Bulletin.

Table 1 Key economic characteristics of the enlarged EU

	Reporting period	Unit	EU25	EU27	Bulgaria	Romania
Population and economic activity						
Total population 1)	2005	millions	462.3	491.7	7.7	21.6
GDP	2005	EUR billions	10,847	10,948	21	79
GDP per capita	2005	EUR thousands	23.5	23.3	2.8	3.7
GDP per capita (PPP)	2005	EU25=100	100	98.7	32.1	34.7
GDP (share of world GDP) 2)	2005	%	20.3	20.8	0.1	0.3
Sectors of production 3)						
Agriculture, fishing, forestry	2005	% of total	1.9	2.0	10.9	14.3
Industry (including construction)	2005	% of total	26.2	26.3	29.8	36.8
Services (including non-market services)	2005	% of total	71.9	71.7	58.3	48.1
External trade						
Exports of goods and services 4)	2005	% of GDP	13.4	-	60.8	33.0
Imports of goods and services 4)	2005	% of GDP	13.8	-	77.4	43.4
Current account balance 4)	2005	% of GDP	-0.6	-0.7	-11.3	-8.7
Labour market						
Labour force participation rate 5)	2005	%	70.2	69.7	62.1	62.3
Unemployment rate	2005	%	8.8	8.8	10.1	7.9
Employment rate 5)	2005	%	63.8	63.4	55.8	57.6
General government						
Surplus (+) or deficit (-)	2005	% of GDP	-2.3	-2.3	2.4	-1.5
Revenue	2005	% of GDP	44.8	44.7	41.1	36.8
Expenditure	2005	% of GDP	47.1	47.0	38.7	38.2
Gross debt outstanding	2005	% of GDP	63.2	62.8	29.8	15.9
Monetary and financial indicators						
Credit to the private sector	2005	% of GDP	127.0	126.1	44.5	20.8
Stock market capitalisation	2005	% of GDP	77.0	76.4	5.1	19.2

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.
Note: Comparisons between the economies in the table 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.
1) Annual average.
2) GDP shares are based on a purchasing power parity (PPP) valuation of country GDPs.
3) Based on real value added. Data for Bulgaria and Romania refer to 2004 for agriculture, fishing, forestry and to 2003 for industry (including construction) and services (including non-market services).
4) Balance of payments data. EU data are compiled on the basis of transactions with residents of countries outside the EU (i.e. excluding intra-EU flows). Data for Bulgaria and Romania are compiled on the basis of transactions with the rest of the world (i.e. including intra-EU flows).
5) Share of the working age population (i.e. those aged between 15 and 64).

POPULATION AND ECONOMIC ACTIVITY

The latest enlargement has increased the population of the EU by approximately 6% to a total of 492 million people. In both new Member States, however, the population has been on a declining trend since the start of the transition process towards a market economy, owing to declining net birth rates and emigration.

Economic activity in the countries forming the EU27, as measured by GDP, was approximately €10,900 billion in 2005. On the basis of current exchange rates, the latest enlargement represents an increase of 0.9% in GDP, of which Bulgaria and Romania contributed 0.2 and 0.7 percentage point respectively. This increase is much less than in the case of previous enlargements. The accession of the ten countries in May 2004, for example, raised the total GDP of the EU by around 5%, whereas the enlargement involving Austria, Finland and Sweden in 1995 increased total economic activity of the 12 existing Member States by around 7%. The economies of Bulgaria and Romania are, however, growing rapidly. Over the past five years, real GDP growth in both countries has mostly fluctuated between 4% and 6% per annum. In both countries, domestic demand, fostered by rapid consumption and investment growth, has been the main engine of growth. The level of GDP per capita in purchasing power parity (PPP) terms in Bulgaria and Romania remains low, however, at 32.1% and 34.7% of the EU25 average in 2005.

Beyond this immediate statistical effect of enlargement on EU aggregate figures, the extension of the Single Market will increase the flows of goods, services, capital and labour between the EU25 and the two new Member States, thus leading to gains in welfare and employment in the longer term. Standard theories of international trade and economic integration predict that benefits arise from deeper integration and the creation of a single market, provided that adequate national economic policies are pursued. The integration of different economies brings advantages through increased trade, and, in the Single Market context, through a more efficient allocation of resources, enhanced competition and economies of scale realised through the free movement of goods, services, capital and labour.

PRODUCTION STRUCTURE

The structure of production in the two new Member States is characterised by a larger share of agriculture and industry and a smaller share of services in value added than the average of the EU25 countries. Particularly in Romania, total output is generated to a relatively large degree in agriculture (14.3%) and industry (36.8%, including construction), compared with 1.9% and 26.2% respectively in the EU25. Since the start of the transition process towards a market economy, however, a profound structural reorientation has taken place in both countries from agriculture and industry on the one hand towards services on the other.

EXTERNAL TRADE

After enlargement, EU25 trade with and between Bulgaria and Romania is now intra-EU trade. Consequently, in Table 1 such trade is no longer recorded as international (i.e. extra-EU) trade. Conversely, trade between Bulgaria or Romania and the rest of the world excluding the EU25 countries now counts as extra-EU27 trade. Although official data are not yet available, it is likely that the accession of Bulgaria and Romania slightly reduces the trade openness of the EU as a whole as measured by the share of total extra-EU exports and imports in GDP.

For both Bulgaria and Romania, the rest of the EU accounts for the main share of foreign trade (around 60-65% of the total trade of both countries). Given increasing integration with the EU already before they joined, export growth in both countries has been buoyant but was outpaced by even stronger import growth in recent years. Consequently, in both countries large current account deficits have emerged, which reached 11.3% and 8.7% of GDP in Bulgaria and Romania respectively in 2005. Although these deficits have been largely covered by inflows of foreign direct investment in recent years, they are also associated with strong domestic demand growth and represent an important challenge for the authorities.[2]

LABOUR MARKET

The labour markets in Bulgaria and Romania still bear the legacy of the transition process to a market economy and the above-mentioned significant reorientation in the economic structure over the past 15 years. Following declines in earlier years, labour force participation and employment rates have stabilised, although they are still substantially below the EU27 average. The relatively low employment rates in Bulgaria and Romania are mainly attributable to the low participation rates of males (although female participation rates are also lower than in the rest of the EU, the differences are less pronounced) and older

2 For more details see "Macroeconomic and financial stability challenges for acceding and candidate countries", ECB Occasional Paper No 46, July 2006.

workers (i.e. those aged between 55 and 64). Unemployment rates have been declining in Bulgaria and Romania and stood at 10.1% and 7.9% respectively in 2005.

FISCAL POSITION AND THE SIZE OF THE GOVERNMENT SECTOR

The accession of the two new Member States does not change the weighted average government deficit ratio in the EU in 2005, which was 2.3% of GDP. Bulgaria had a surplus of 2.4% of GDP in 2005 and Romania a deficit of 1.5% of GDP in that year. The public expenditure and revenue shares in GDP are both lower than the EU25 average in the two new EU countries at less than or around 40%. As the public debt ratio in Bulgaria and Romania is substantially below the level in the other EU countries, the average EU debt-to-GDP ratio is slightly lower after enlargement.

FINANCIAL STRUCTURE

Financial markets in Bulgaria and Romania are still at an early stage of development, which is reflected in low ratios of outstanding credit to the private sector to GDP and low levels of stock market capitalisation. The financial sectors in these two countries have been growing rapidly, however, reflecting the transition to a market economy, low starting levels of financial intermediation, the macroeconomic policies pursued and cyclical developments. A key aspect of the development of the financial sector in both countries has been a strong increase in the amount of bank credit to the private sector, particularly to households. Although a rapid expansion of credit is a natural phenomenon associated with the transition and catching-up process, it may also pose some risks to both macroeconomic and financial stability. Macroeconomic risks relate in particular to an overheating economy and an associated worsening of the current account. Regarding financial stability, the speed of credit growth may put strain on banks' risk assessment and risk management capacities, which, in combination with over-optimism about future returns, may lead to a misallocation of credit.[3]

3 THE ENLARGEMENT OF THE EURO AREA

On 11 July 2006, the EU Council adopted a decision allowing Slovenia to join the euro area and adopt the euro as its currency as from 1 January 2007.[4] As Slovenia only adds 0.3% of GDP to the euro area, its inclusion does not lead to noticeable changes in most features of the euro area as a whole (see Table 2).

POPULATION AND ECONOMIC ACTIVITY

Measured in terms of population, the euro area is one of the largest economies in the world, with a total population of 316 million people including the Slovenian population of two million, which represents about 0.6% of the enlarged euro area's population.

Euro area (including Slovenia) economic activity was €8,027 billion in 2005, of which Slovenia contributed around €28 billion, i.e. 0.3% of the euro area's GDP. In turn, the inclusion of Slovenia in the euro area has led to a small rise in the euro area's share of world GDP, from 14.8% to 14.9%. Slovenia's economy is still in a catching-up process relative to the euro area, with GDP per capita in PPP terms standing at 76% of the euro area average in 2005. In recent years, real GDP growth in Slovenia has been robust, averaging 3.4% in the period from 2001 to 2005, compared with 1.4% for the euro area.

PRODUCTION STRUCTURE

The production structure in Slovenia is broadly similar to that of the euro area. In the Slovenian economy the services sector contributes 62.3%

3 For more details see the article entitled "Financial development in central, eastern and south-eastern Europe" in the November 2006 issue of the Monthly Bulletin.

4 See also the box entitled "Adoption of the euro by Slovenia as from 1 January 2007" in the August 2006 issue of the Monthly Bulletin.

Table 2 Key economic characteristics of the enlarged euro area

	Reporting period	Unit	Euro area excl. Slovenia	Euro area incl. Slovenia	Slovenia
Population and economic activity					
Total population [1)]	2005	millions	313.6	315.6	2.0
GDP	2005	EUR billions	7,999	8,027	28
GDP per capita	2005	EUR thousands	25.5	25.4	13.8
GDP per capita (PPP)	2005	EU25=100	106.3	106.2	80.6
GDP (share of world GDP) [2)]	2005	%	14.8	14.9	0.1
Sectors of production [3)]					
Agriculture, fishing, forestry	2005	% of total	2.0	2.0	2.7
Industry (including construction)	2005	% of total	26.5	26.6	36.3
Services (including non-market services)	2005	% of total	71.5	71.5	62.3
External trade					
Exports of goods and services [4)]	2005	% of GDP	20.3	20.2	64.6
Imports of goods and services [4)]	2005	% of GDP	19.3	19.1	65.1
Current account balance [4)]	2005	% of GDP	-0.1	-0.1	-2.0
Labour market					
Labour force participation rate [5)]	2005	%	69.9	69.9	70.7
Unemployment rate	2005	%	8.6	8.6	6.5
Employment rate [5)]	2005	%	64.4	64.4	66.0
General government					
Surplus (+) or deficit (-)	2005	% of GDP	-2.5	-2.5	-1.4
Revenue	2005	% of GDP	45.2	45.2	45.8
Expenditure	2005	% of GDP	47.6	47.6	47.2
Gross debt outstanding	2005	% of GDP	70.8	70.6	28.0
Monetary and financial indicators					
Credit to the private sector	2005	% of GDP	119.4	119.2	58.6
Stock market capitalisation	2005	% of GDP	63.2	63.1	24.2

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.
1) Annual average.
2) GDP shares are based on a purchasing power parity (PPP) valuation of country GDPs.
3) Based on real value added. Data for Slovenia refer to 2004 for agriculture, fishing, forestry and to 2003 for industry (including construction) and services (including non-market services).
4) Balance of payments data. Euro area data are compiled on the basis of transactions with residents of countries outside the euro area (i.e. excluding intra-euro area flows). For the euro area including Slovenia: ECB estimates based on national data.
5) Share of the working age population (i.e. those aged between 15 and 64).

to total value added, industry (including construction) 36.3% and agriculture 2.7%. The employment shares in the respective sectors are also broadly similar. Compared with the euro area excluding Slovenia, the major difference is the higher share of industry and the lower share of services both in value added and employment.

EXTERNAL TRADE

Slovenia is a small and very open economy, which traded mostly with the euro area already prior to adopting the euro. In 2005 the 12 euro area countries accounted for 67% of Slovenia's imports and 54% of its exports. In turn, Slovenia's inclusion in the euro area has made the enlarged euro area a slightly more closed economy, reducing the degree of openness of the euro area as measured by the share of extra-euro area total exports and imports in GDP by about 0.1 and 0.2 percentage point to 20.2% and 19.1% respectively.

LABOUR MARKET

The labour market in Slovenia has been reformed significantly during the transition process, although further reforms are required to support economic growth over the medium to longer term. In 2005, the labour force participation and employment rates stood slightly above the euro area averages, while Slovenia's unemployment rate was lower, at 6.5%. The relatively high employment rate in Slovenia is mainly attributable to the relatively high participation rate of females.

In this context it should be noted that some countries in the euro area still retain restrictions regarding the free movement of workers from the Member States that joined the EU in May 2004, including Slovenia. Six euro area countries still have restrictions in place, namely Belgium, Germany, France, Luxembourg, the Netherlands and Austria, although some of these countries have announced simplifications of their existing national access regimes to varying degrees. However, now that Slovenia is part of the euro area, it is essential to ensure that all production factors, including labour, can move freely within the single currency area. Removing all remaining barriers, including those related to labour mobility, is a necessary condition for the functioning of Monetary Union and important in order to promote the efficient allocation of factors of production in the euro area. In addition, the free movement of labour should be seen as one, among many, adjustment channels which exist in a monetary union to absorb localised shocks.

FISCAL POSITION AND THE SIZE OF THE GOVERNMENT SECTOR

The general government fiscal deficit in Slovenia has declined in recent years, reaching 1.4% in 2005, which is below the euro area average. The ratio of public debt to GDP has remained below 30% of GDP, which is significantly below the euro area average. The general government sector accounts for a similar share of the Slovenian economy as in the euro area.

FINANCIAL STRUCTURE

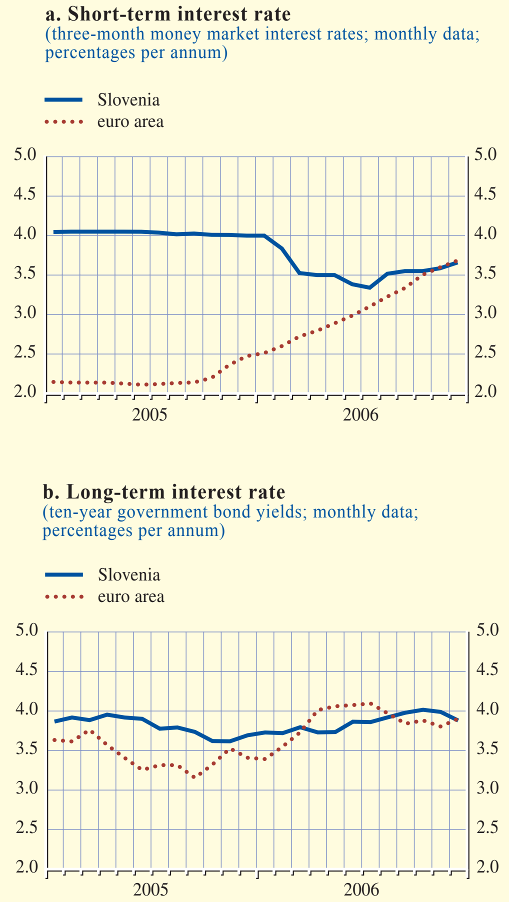
Financial markets in Slovenia are generally less developed than in the euro area, which is also reflected in the significantly lower share of outstanding credit to the private sector in GDP and the lower level of stock market capitalisation. The financial sector has, however, been developing rapidly, with bank credit to the private sector growing at an annual rate of 26% in September 2006.

THE CONVERGENCE PROCESS OF INTEREST RATES IN SLOVENIA IN THE SECOND HALF OF 2006

The convergence of Slovenian short-term interest rates towards comparable euro area levels started well before the ECOFIN Council decision in July 2006 that Slovenia fulfilled the necessary conditions to adopt the euro (for an overview of developments up to March 2006 see the ECB's Convergence Report, May 2006). This notwithstanding, in May 2006 Slovenian short-term interest rates were still above comparable euro area levels, reflecting the monetary and exchange rate policies pursued by Banka Slovenije. By contrast, long-term interest rates were around comparable euro area levels, reflecting market confidence in general economic and fiscal developments in Slovenia and the credible monetary and exchange rate policy (see Chart 1).

Since May 2006, Banka Slovenije has taken three steps to reduce the difference between policy rates in Slovenia and the euro area. First, it cut interest rates on 60-day tolar bills and long-term deposits by 25 basis points in June. Furthermore, Banka Slovenije did not follow the 25-basis-point increases in key ECB interest rates in both October and December. This was in contrast to August, when it increased the main policy rate by 25 basis points in line with the ECB move. These steps contributed to closing the spread between the short-term interest rate in Slovenia and the euro area. In May the Slovenian three-month interest rate was 61 basis points above the three-month euro interbank offered rate (EURIBOR). The spread declined to 40 basis points in June and gradually closed by October. In December 2006 the three-month interest rate in Slovenia stood at 3.7%, which was very close to the euro area average. The spread between the long-term interest rates in Slovenia and the euro area

Chart 1 Short and long-term interest rates in Slovenia and the euro area



Source: ECB.

average, as measured by 10-year benchmark government bond yields, was slightly negative at the end of 2006.

On 11 July 2006, the ECOFIN Council also adopted a regulation fixing the irrevocable conversion rate between the Slovenian tolar and the euro. The conversion rate was set at the central rate agreed on 28 June 2004 when the Slovenian currency entered the exchange rate mechanism II (ERM II). On the day of this decision, the tolar was trading at SIT 239.64 to the euro, i.e. at the parity, while on 29 December it was irrevocably fixed at SIT 239.640 to the euro. The tolar-euro exchange rate stayed close to the parity during the whole period of ERM II participation.

4 CONCLUSION

On 1 January 2007, Bulgaria and Romania joined the EU, which now comprises 27 Member States. At the same time, Slovenia adopted the euro, increasing the size of the euro area from 12 to 13 countries. Given that the economic weight of Bulgaria and Romania is relatively small, the statistical aggregate macroeconomic features of the EU did not change much as a result of this enlargement. In fact, the most notable change in the EU is a 6% increase in total population. Nevertheless, in line with previous expansions of the EU, the latest enlargement round opens up new opportunities for trade and investment for both the existing and new EU Member States. To fully reap the benefits of enlargement, a fully operational Single Market must be implemented, allowing a free flow of goods, services, capital and labour. Removing the remaining barriers within the EU will be an important means to promote the efficient allocation of factors of production as well as deeper economic and financial integration.

Following the decision by the ECOFIN Council that Slovenia could adopt the euro as of 1 January 2007, the country smoothly completed the convergence of its short-term interest rates vis-à-vis the euro area during the second half of 2006. During the same period, the exchange rate against the euro remained stable and was irrevocably fixed at the end of December at the previous ERM II central rate of SIT 239.640 to the euro. Owing to its small size, the entry of Slovenia into the euro area has had only a very limited statistical impact on the aggregate euro area economic characteristics. However, adopting the euro implies for Slovenia that the benefits of the Single Market are further enhanced by the single currency, which offers a credible framework for monetary policy and price stability in an environment characterised by the absence of exchange rate uncertainty within the euro area. In order to fully reap the benefits of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, all remaining barriers between Slovenia and the rest of the euro area should be removed, including those related to labour mobility.