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EU enlargement: How to reap the benefits

The overall economic impact of EU enlargement is likely to remain small. The newcomers are tiny compared with the existing EU countries and most economic integration has already taken place. Much depends on the policies in the old and new Member States whether the EU as a whole reaps further benefits from enlargement.

WEST EUROPEANS ARE wary of enlargement. Only 42 per cent of the people in the EU-15 supported the accession of the ten newcomers in May 2004, according to the latest Eurobarometer polls. That is hardly more than the 39 per cent who spoke out against it. Opposition to enlargement is highest in those countries that are doing badly in economic terms. In Germany – often branded the laggard of Europe – a mere 28 per cent of the population is in favour of enlargement. Many people in the 'old' EU countries worry 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 an influx of low-wage workers from the East could push unemployment in the EU even higher.

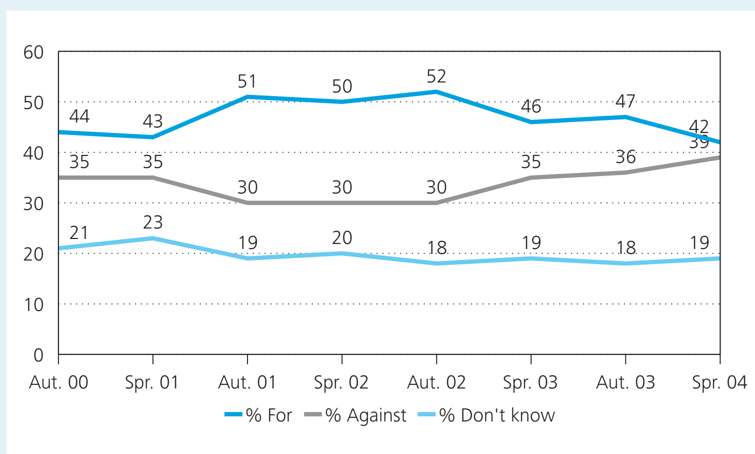
Politicians have responded to these fears by limiting the rights of East Europeans to work in the old EU. They are also wary that the newcomers might be rather too competitive. They have called companies that invest in the East 'unpatriotic'. Germany's chancellor, Gerhard Schröder, has warned that his country could respond to 'unfair' tax competition from Eastern Europe by cutting down regional subsidies for the new members.

Contrast that with the attitude of business, as most West European companies are enthusiastic supporters of EU expansion. They expect enlargement to boost sluggish European growth rate. They think that a larger EU will have a stronger say in global trade negotiations. They point out that enlargement has created the biggest single market in the western world, with GDP that can match the US (more than USD 10 trillion) and a population that, at 450 million, is 50 per cent larger than that of the US. Businesses also value the investment opportunities that come with integrating a bunch of fast-growing, fast-reforming countries into the more sclerotic EU economy. And they are looking forward to employing more highly skilled, motivated and lower-cost East European workers.

Both sides have a point. Enlargement has increased competitive pressures in the old EU, and it will continue to do so. As businesses point out, this is exactly what is needed to shake up the slow-growing eurozone economies. But since these economies are rather inflexible, the adjustment costs could be substantial. However, neither the fears nor the optimism should be overdone.

Support for enlargement

The EU15 Member states

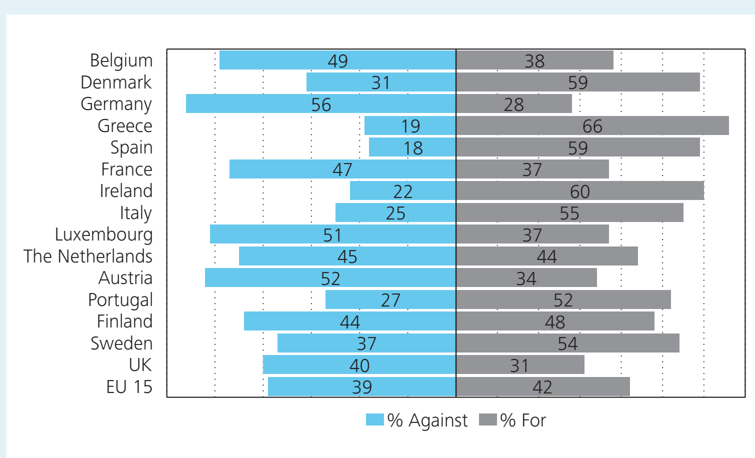


As the greatest enlargement yet of the European Union came closer, the overall support for including ten new countries to EU fell steadily. However, a plurality (42 %) of EU-15 citizens remained in favour of enlargement while 39 % were against it.

Source: European Commission, Eurobarometer 60 and Eurobarometer 61

Opinions for and against enlargement

The EU15 Member states



In eight of the EU-15 Member states, a majority of the population supported enlargement while opposition predominated in the seven others. Greece was the country most in favour of enlargement with 66 % of the citizens supporting including new countries to EU. Germany was the country least in favour with 28% against enlargement.

Source: European Commission, Eurobarometer 61

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 what was then the candidates and the EU has been growing at double-digit rates every year. For example, Czech exports (measured in dollars) have grown by 230 per cent since 1993, and Hungarian ones by more than 400 per cent. Export growth remained robust despite the recent slump in the EU's largest economies, which implies that the new members continued to gain market shares in the EU – a clear sign of rising competitiveness.

By the end of the 1990s, the accession countries were trading with the EU just as much as the EU members were trading with each other. On average, the new members are now sending more than two-thirds of their exports to the EU-15. 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. Over the last ten years, the new members have grown by an average of almost four per cent a year, twice as fast as the eurozone.

But has the catch-up come at a cost for the EU-15? No. First, taken together, imports from the new members amount to no more than one per cent of the old EU's GDP. Second, to the extent that these imports have intensified competition for EU producers, they have pushed down prices and benefited European con-

sumers. 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 newcomers 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.

EU companies have not only sent their goods to Central and Eastern Europe, they have also bought existing businesses there and built new ones. Since 1990, the new members have received a staggering USD 160 billion (or EUR 130 billion at today's exchange rate) in foreign direct investment (FDI). Most of this has come from the large eurozone countries.

The Osteuropainstitut calculates that German FDI alone has created almost 450,000 jobs in the East European countries. But this does not mean that the same number of jobs has been destroyed in Germany or elsewhere in the EU. A recent study from Goldman Sachs shows that FDI and domestic investment are positively correlated. In other words, most FDI in Eastern 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 new members 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 of the service sector FDI came through the privatisation of banks and telecoms, which is now drawing to a close. Second, EU accession means that the East European economies are now looking more like those in the old EU. They now have the same trade policies, competition rules and product standards. As business environments have become more alike, differences in wage costs have 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 or her 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 prefer to stay at home

Scare stories that millions of East Europeans would head westwards in search of comfort and prosperity are wide off the mark. Wages are lower in the East, but so are prices and rents, with the result that most East Europeans enjoy a reasonably good standard of living. Surveys show that only very few (perhaps 1% of the population in the new Member States) may be willing 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 are also putting off potential migrants.

Migration flows are fiendishly difficult to forecast. But many researchers think that between 100,000 and 400,000 East Europeans would head West each year if there were no restrictions on labour movements. 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 two to three million people from the new Member States would be living in the old EU countries by, say, 2020. That may sound a lot, but it only amounts to 0.5 to 0.8 per cent of the EU's current population (East Europeans are estimated to make up 0.2 % 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, most EU countries – with the notable exception of Ireland, the UK and Denmark – have decided to resort to a 'transition' clause that allows them to restrict the movement of East European workers until 2009, or possibly 2011.

Calls for restrictions were led by Germany and Austria, which could expect to be the destination of at least two-thirds of all East Europeans coming to settle

in the EU. With unemployment stuck at 4.4 million and the former East Germany still in recession, the German government did not have the political courage to open the borders for the newcomers. The government knows that an influx of low-cost, high-skilled workers is exactly what the economy needs, in particular with a view to rapid population ageing and unsustainable public pension systems. However, since Germany's labour markets and wage-bargaining system are rigid, any influx of low-cost workers would probably just have added to the unemployment queues rather than pushed wages down and encouraged job creation. However, Germany and the other West European countries can only justify the transition periods if they use the interim period to reform their labour markets and prepare their economies for benefiting fully from enlargement.

Overall impact: small but positive

Even under a best-case scenario with faster eurozone reform, enlargement is unlikely to have a big impact on the old EU. Economic studies show that the effect of enlargement on the EU-15 will be negligible, simply because the economies of the new members are so small: taken together, they amount to no more than five per cent of the current EU (if measured at current exchange rates). The share is closer to ten 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 GDP of USD 10 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 be delayed for most EU-15 countries. Similarly, Germany's Friedrich-Ebert Stiftung forecasts an increase in EU GDP of 0.1 to 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 one 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. 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. ◄

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