The International Spectator 2/2002

The Potential Macroeconomic Impact of EU Enlargement

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Although the European Union's decision to enlarge is mainly political, the process has important implications in a number of fields, the most significant of which is the institutional, for both the Union and the candidate countries. For the Union, which has reached a high degree of integration, the increase in the number of member countries could pose serious problems for decision-making and could slow down or even block many decisions unless reforms are undertaken. In this respect, the results of the Convention on the Future of Europe, established by the Laeken European Council in December 2001 to work out reform proposals to be submitted subsequently to the 2004 Intergovernmental Conference, will be of the utmost importance. As for the Central and Eastern European countries (CEECs) that are candidates for membership, it must be recalled that they only started their transition towards a market economy in the early nineties and that one of the most complex aspects of such a transition – and the one that takes the longest time to achieve – is the construction of adequately functioning institutions. For example, weaknesses in the banking sector have been found in a number of candidate countries.[1] More generally, a consensus developed in the nineties

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[1] With reference to the stability of the financial sector, not all countries have been completely evaluated. In a recent report on macroeconomic developments and the financial

that one of the central elements for the candidate countries' integration into Europe is the establishment of appropriate institutions. This concept has been reiterated numerous times in the conclusions of the European summits of the heads of state and government and was also repeated in the latest European Commission annual report on the progress of the candidate countries, underlining the importance of an adequate administrative capacity to implement the *acquis comunautaire*.[2]

Initially, attention concerning the consequences of the integration of Eastern European countries into the European economic space was concentrated on the effects of potential trade deriving from the opening up of these countries to the international market. With the signing of the Europe Agreements, aimed at establishing a free trade area between the individual Eastern European countries and the European Union, the focus inevitably shifted to the possible increases in wealth deriving from the entry into operation of the provisions for trade liberalisation and the possible risks deriving from competition with countries with particularly low labour costs and specialised in production sectors that are "sensitive" for EU industries. In this regard, considering the light economic "weight" of the Eastern European countries and the fact that their trade specialisations have been diversifying since the early nineties, it is generally felt that the effects of greater trade integration will be positive for the Union, but rather small.[3]

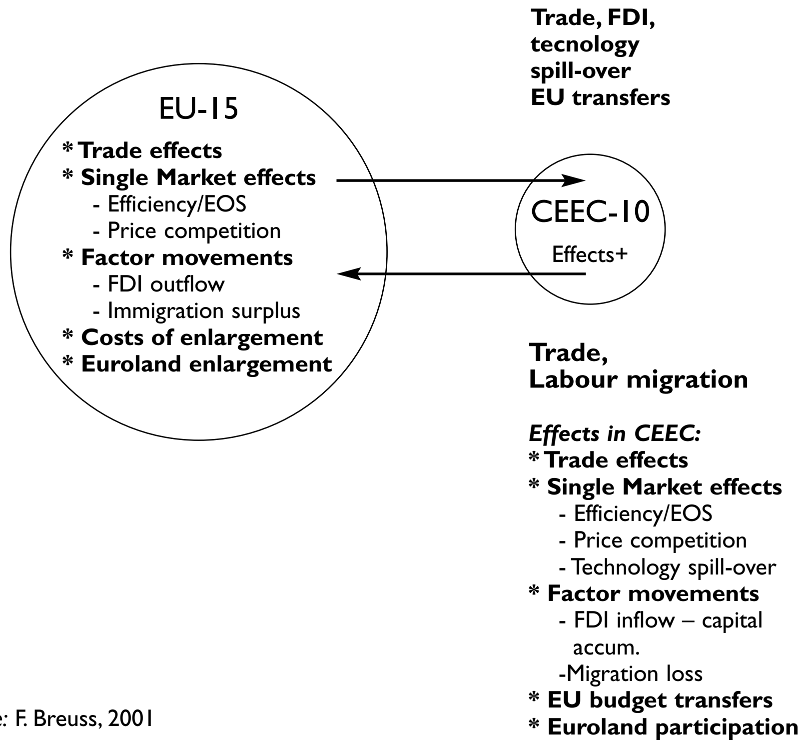
With the application for entry into the Union, recognition of candidate status, and the beginning of negotiations, attention has turned to the effects of enlargement of the single market and the free movement of factors (labour and capital) and, more recently, to the financial costs of enlargement. In synthesis, the *status quo* after enlargement will undergo the following effects (see Figure 1):

system, the Commission acknowledged the progress made by most countries, even if the role of the financial sector in sustaining growth is still relatively small. Furthermore, despite the improvements in the regulatory sphere, a more effective surveillance system is still needed. European Commission, "Report on Macroeconomic and Financial Sector Stability Developments in Candidate Countries, European Economy", *Enlargement Papers no. 8*, April 2002.

[2] European Commission, *Making a success of enlargement - Strategy Paper and Report on the progress towards accession by each of the candidate countries*, November 2001, Brussels.

[3] J. Rollo and A. Smith, "The Political Economy of EC Trade with Eastern Europe: Why so Sensitive?", *Economic Policy*, vol. 8, no. 16, April 1993, pp. 139-81; European Bank for Reconstruction and Development (EBRD), *Transition Report 1999, Ten years of transition* (London: EBRD, 1999); R. E. Baldwin, J. F. Francois and R. Portes, "The costs and benefits

Figure 1 - Integration effects of EU enlargement



Source: F. Breuss, 2001

- a further increase in trade following the elimination of the last trade barriers (they remain in only a few sectors, particularly agriculture, after the Europe Agreements) and the reduction in the cost of trade (less waiting time at customs, uniform technical standards, etc.);
- greater competition (in particular thanks to the lower price of imports), greater efficiency, greater economies of scale and, at least for the candidate countries, the transfer of technology;
- greater factor movement, in particular, migrant labour flows from the East and capital and direct investment flows from the West (favouring the accumulation of capital);
- costs of enlargement for current members and, conversely, community budget transfers for Eastern countries;

of Eastern Enlargement: the impact on the EU and Central Europe", *Economic Policy*, vol. 12, no. 24, April 1997, pp. 126-76; C. Keuschnigg and W. Kohler, "Eastern Enlargement of the EU: Economic Costs and Benefits for the EU Present Member States? The Case of Austria", European Commission Study XIX/B1/9801.

- in the long term, the participation of the new members in Economic and Monetary Union.[4]

Thus, a number of economic mechanisms must be taken into consideration with respect to new membership in the Union. As concerns trade, above all, it should be observed that most of the "trade creation" deriving from the abolition of tariffs has already been achieved thanks to the Europe Agreements. Signed in the early nineties, they provided for the liberalisation of manufactured goods in view of the setting up of a free trade area between the EU and the Eastern European countries.[5] Nevertheless, there are still protected sectors, in particular agriculture, for which entry into the EU will mean abolishing the remaining tariffs. In addition, entry into the Single Market will allow for a reduction in non-tariff barriers (the application of standards, etc.) and the price of imports, generating further trade. The exact magnitude of this reduction in prices is not easy to estimate. In general, various scenarios are hypothesised: the more generous call for a savings of 10 percent, while others estimate a smaller reduction of around 5 percent.[6] The reduction in import prices should benefit consumers most of all, but if intermediate goods are considered, it will also involve minor costs for producers and investors.

The candidate countries will participate not only in a trade area but also in a customs union with the present members which implies the adoption of common external barriers. From a theoretical point of view, this could lead to costs in terms of trade diversion. That is, the trade flows that previously went to foreign countries outside the Union could be diverted towards members of the Union, where the entry of goods is more convenient given that tariffs have been abolished (which would instead remain or be raised towards other foreign countries). Nevertheless, this possibility is limited in most sectors. In fact, EU tariffs are generally lower than those of candidate countries.[7]

In addition to the repercussions on trade, the effects caused by enlargement of the Single Market will be substantial as concerns supply. In

[4] Entry into the Union does not automatically involve participation in monetary union. Thus, the candidate countries will have to make an effort to satisfy the criteria for subsequent entry into EMU.

[5] The liberalisation was carried out gradually, more slowly in some sensitive sectors, and asymmetrically, with greater initial opening on the part of the Union.

[6] Baldwin, Francois and Portes, "Costs and benefits of Eastern Enlargement"; Keuschnigg and Kohler, "Eastern Enlargement of the EU", respectively.

[7] With the exception of Estonia, which had completely liberalised and therefore had to reintroduce some import tariffs.

particular, entry of the candidates should give rise to an increase in competition and productivity (through economies of scale) and a decrease in mark-up in the sectors characterised by an oligopolistic structure. This will lead to restructuring with relative redistributive effects which can be assessed only by means of extremely detailed analyses taking account of sectoral aspects.

Participation in the Single Market will involve the free movement of production factors, in addition to that of goods and services. In fact, one of the greatest changes with respect to the present situation is to be expected from the free movement of labour. The broad disparities between contiguous regions in terms of per capita income and even more in terms of wages will induce a net flow of workers from East to West. It has been estimated that there will be a net immigration from the CEECs of approximately 335,000 people immediately after the removal of barriers on freedom of movement.[8] In the long run, despite concerns that the EU will be swamped by migrants from the candidate countries, the foreign population originating in the CEECs is expected to reach no more than about 1 percent of the Union's total population. As a result, there will be an increase in labour supply and therefore in the potential for long-term growth for the EU Fifteen.

The free movement of people in the enlarged Europe is a particularly sensitive subject for public opinion in both the East and the West. In December 2000, Chancellor Schröder put forward a proposal aimed at limiting the freedom of circulation of people for seven years after enlargement; not much later, the Commission proposed a common EU position of compromise allowing the member states that feel the need to adopt transitory periods before ensuring full mobility for the citizens of the new members. Most candidate countries have agreed to close the negotiating chapter relative to these conditions and it is now up to the individual EU countries to decide what stance to take regarding the adoption of such transitory periods (Austria and Germany have already announced that they are in favour).

Given the limited capacity for internal savings and the need to finance growth in the Eastern European countries, the flow of capital from West to East should continue and augment, thanks also to a reduction in the risk

[8] T. Boeri and H. Brücker, *The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States*, Final Report, European Integration Consortium, Berlin and Milan, 2000.

premium for the entering countries. This would favour an increase in investment, capital stock and the growth rate in the candidate countries. On the other hand, additional foreign direct investments (FDIs) in the CEECs may reduce the investment potential in the EU, producing slight increases in the interest rate (that is, raising the cost of capital). However, capital flows towards Eastern European countries represent only a minimal percentage of the EU Fifteen's FDIs, and the latter aspect should therefore be limited.[9]

The main effects of enlargement

With time, the focus of analysis has broadened and studies have started to examine transmission channels and other interdependences. Below is a list of the main effects of greater integration a) at the macro areas level (both EU and Eastern countries), b) at the individual country level and c) in Italy.

At the macro areas level

At the level of macro regions, greater integration will have positive effects on both the Union as a whole and the Eastern European countries.[10] Nevertheless these results will be strongly influenced by the disparity in terms of economic weight between the two areas: essentially, the fact that a large, rich bloc integrates with a small, relatively poor one will cause asymmetrical effects for both areas. The reciprocal importance in trade flows is also very different: about 70 percent of Eastern European trade flows are directed towards the European Union, while the latter directs much less of its trade towards the East (12.6 percent of exports in 2001[11]). Hence the economic effects of enlargement in relative terms with respect to GDP will be small for the EU Fifteen and far more substantial for the entering countries.

Baldwin and colleagues used a simulation model to study the costs and benefits of enlargement, taking account of trade and production in the various sectors of economic activity and in nine macro regions covering the

[9] The European Union's foreign direct investment flows to Eastern European countries account for less than 5 percent of total FDI (Eurostat-Newcronos database, 2002).

[10] F. Breuss, "Macroeconomic Effects of EU Enlargement for Old and New Members", *WIFO Working Papers no. 143* (Vienna: Austrian Institute of Economic Research, 2001).

[11] Eurostat, "External and Intra-European Union Trade", *Monthly Statistics*, no. 5, 2002, Luxembourg.

entire world economy.[12] Table 1 shows the predicted effects of greater integration: the increase in GDP in the EU is small (0.2 percent) while it may vary between 1.5 and 18.8 percent for the Eastern countries, depending on the scenario considered. In particular, the more generous scenario for candidates includes the effects of a substantial reduction in risk premium and therefore the cost of capital, which would trigger a virtuous circle of greater investments and growth in Eastern European countries. Similar results, in terms of the asymmetry between the two areas, can be found in the study carried out by the European Commission (Table 2).[13] It estimates that growth in Eastern European countries could increase by 2 percent annually,

Table 1 - Predicted GDP growth after enlargement

	Billions of ECU 1992	% of GDP
EU-15	11.2	0.2
CEECs (conservative scenario)	2.5	1.5
CEECs (optimistic scenario)	30.1	18.8

Source: R. E. Baldwin, J. F. Francois and R. Portes, "The costs and benefits of Eastern Enlargement: the impact on the EU and Central Europe", *Economic Policy*, vol. 12, no. 24, April 1997.

Table 2 - Predicted GDP growth after enlargement

	2000-09	2000-04	2005-09
EU-15 (basic scenario)	2.5	2.5	2.5
EU-15 (average scenario)			cum. 0.5
EU-15 (optimistic scenario)			cum. 0.7
CEECs (basic scenario)	3.0	3.1	2.9
CEECs (average scenario)	4.0	3.8	4.3
CEECs (optimistic scenario)	4.8	3.8	5.6

Source: European Commission, *Making a success of enlargement - Strategy Paper and Report on the progress towards accession by each of the candidate countries*, November 2001, Brussels.

12 Baldwin, Francois and Portes, "Costs and benefits of Eastern Enlargement". This paper constitutes a point of reference for studies on this subject. In the Eastern European area, seven countries are considered, excluding the Baltic countries.

13 European Commission, "The economic impact of enlargement", *Enlargement Papers no. 4* (Brussels: Directorate General for Economic and Financial Affairs, 2001).

while the European Union would have an overall increase of 0.5-0.7 percent, depending on the scenarios considered.

Although still limited, these estimated increases in terms of GDP for the EU are two to three times previous estimates (see for example the results found by Baldwin and others in Table 1). This is partly due to the fact that the Commission study is more recent and more accurate in considering the different channels of transmission. In particular, it explicitly takes account of the effects of immigrant labour flows, as well as of supply deriving from an extension of the Single Market. Actually, disaggregating the Commission's estimate into the various channels, it turns out that immigration represents the factor that will have the greatest relative positive impact on the EU Fifteen (0.3 percent of GDP out of a total 0.5 in the overall scenario). It follows that the relative importance of this factor should be taken into consideration by current member countries when they decide whether or not to introduce (and the length of) transitory periods for the free movement of people. The manpower coming from the candidate countries, characterised by relatively high levels of education, therefore qualified human capital, will increase the labour supply and the potential growth rates of the receiving economies. This is particularly true of areas such as the northeast of Italy, where there is demand pressure on the labour market.[14] Furthermore, it has been noted that the immigration coming from the Eastern European countries is becoming increasingly temporary,[15] thus reducing the impact in terms of cost for the welfare systems of the host country.[16]

The national level

Since European countries are called upon to take decisions upon such matters as the sharing of the financial costs of enlargement, it is important to estimate what effects enlargement will have on the individual countries. Again, one can turn to the initial, albeit approximate attempt to do so made

[14] For an overview of the effects of the free circulation of people, see R. Balfour, L. Einaudi, F. Pastore, L. Rizzotti, "L'impatto dell'allargamento sui movimenti di popolazione" in Dipartimento per gli Affari Economici della Presidenza del Consiglio dei Ministri, "Allargamento a est dell'Unione europea: sfide e opportunità per l'Italia", Rome, 2001 http://www.palazzochigi.it/sez_dossier_nuovi/allargamento_ue/indice.html.

[15] C. Boswell, "EU Enlargement. What are the Prospects for East-West Migration?", *European Programme Working Paper* (London: Royal Institute of International Affairs, 2000).

[16] G. Amato and J. Blatt, *The Long-term Implications of EU Enlargement: The Nature of the New Border*, final report of a working group set up jointly by the Robert Schuman Centre for Advanced Studies of the European University Institute, Florence, and the Forward Studies Unit of the European Commission, European University Institute, April 1999.

Table 3 - Distribution of the economic benefits of enlargement

	Billions of ECU 1992	% of the EU 15 total
Austria	0.3	2.6
Belgium-Luxembourg	0.3	2.6
Denmark	0.2	1.9
Finland	0.2	1.4
France	2.2	19.3
Germany	3.8	33.8
Greece	0.0	0.3
Ireland	0.0	0.3
Italy	1.0	8.5
Netherlands	0.5	4.6
Portugal	0.0	-0.4
Spain	0.8	7.0
Sweden	0.4	3.9
United Kingdom	1.6	14.1
EU-15	**11.2**	**100.0**

Source: Baldwin, Francois and Portes, "Costs and benefits of Eastern Enlargement".

by Baldwin in the study already mentioned.[17] The results show that the economic benefits of enlargement will be distributed rather irregularly in the current members; in particular, Germany stands to gain the most – more than a third of the total (see Table 3).

Only recently have the effects of enlargement on the single countries been studied in more detail.[18] Breuss considers not only the effects of trade and of enlargement of the Single Market, but also the impact on the economies of the Union and the candidate countries of the changes in migrant and capital flows and of the costs deriving from enlargement. The results in terms of GDP, broken down by country as well as by channel of transmission, are shown in Table 4.

It can be seen that the total effects for the Union are estimated to be in the same order of magnitude as previous studies. In particular, looking at the different channels of transmission, it is evident that the effects on the Union connected to trade will be very small (equal to 0.07-0.05 percent of GDP),

[17] In particular, the benefits at the EU level for each sector of economic activity were broken down by member country depending on the importance of the sectors in each country; Baldwin, Francois and Portes, "Costs and benefits of Eastern Enlargement".

[18] Breuss, "Macroeconomic Effects of EU Enlargement".

Table 4 – Integration effects deriving from enlargement: real GDP

(Cumulative deviations from the basic scenario, in percent)

	Trade effects		**Single Market**		**FDI flows**		**Immigration**		**Costs of enlargement**		**Total**	
	2005-06	2008-11	2005-06	2008-11	2005-06	2008-11	2005-06	2008-11	2005-06	2008-11	2005-06	2008-11
Germany	0.15	0.01	0.50	0.37	-0.07	-0.12	0.06	0.23	-0.01	-0.01	0.63	0.48
France	0.02	0.12	0.21	0.27	-0.10	-0.21	0.03	-0.03	-0.05	-0.04	0.10	0.11
Italy	0.09	0.16	0.46	0.49	-0.04	-0.09	0.02	-0.03	-0.03	-0.03	0.50	0.50
Great Britain	0.01	-0.06	0.22	0.19	-0.01	0.02	0.03	0.05	-0.02	-0.02	0.24	0.18
Spain	-0.06	-0.11	0.48	0.37	-0.11	-0.41	0.04	0.05	-0.08	-0.07	0.28	-0.18
Netherlands	0.08	0.17	0.72	0.31	-0.08	-0.21	0.05	-0.08	-0.06	-0.04	0.71	0.15
Belgium	0.06	0.09	0.31	0.40	-0.06	-0.21	0.03	-0.02	-0.01	-0.01	0.33	0.26
Sweden	0.04	0.06	0.65	0.04	-0.06	-0.16	0.07	-0.02	0.00	0.00	0.69	-0.07
Austria	0.20	0.14	0.59	0.64	-0.09	-0.29	0.13	0.16	0.00	0.01	0.83	0.66
Denmark	0.07	0.07	0.35	0.10	-0.07	-0.21	0.02	-0.05	-0.01	-0.02	0.35	-0.11
Finland	0.07	0.08	0.52	0.55	-0.09	-0.33	0.05	0.02	-0.02	-0.02	0.53	0.31
Ireland	0.07	0.20	0.64	0.77	-0.14	-0.40	0.05	-0.05	-0.15	-0.13	0.47	0.40
Portugal	0.04	0.12	0.68	-0.12	-0.09	-0.14	0.05	-0.12	-0.05	0.05	0.63	-0.21
EU-13	**0.07**	**0.05**	**0.40**	**0.33**	**-0.07**	**-0.16**	**0.05**	**0.06**	**-0.03**	**-0.03**	**0.42**	**0.26**
Polond	1.95	2.47	1.23	2.07	0.21	0.45	0.02	-0.12	1.87	3.15	5.26	8.02
Hungary	3.95	4.20	1.58	1.25	0.32	0.81	0.03	-0.09	1.45	2.23	7.32	8.40
Czech Rep.	1.79	2.84	1.02	0.54	0.14	0.37	-0.03	-0.08	1.10	1.98	4.03	5.65

Source: F. Breuss, "Macroeconomic Effects of EU Enlargement for Old and New Members", *WIFO Working Papers no. 143* (Vienna: Austrian Institute of Economic Research, 2001).

while the greatest benefits will result from enlargement of the Single Market (0.4-0.33 percent of GDP). For the candidate countries, a much greater order of magnitude in terms of GDP is confirmed. In particular, trade expansion is expected to be the main engine of GDP growth connected to enlargement, along with the benefits deriving from European funds, followed only at some distance by the effects of entry into the Single Market. In the Union, results appear to be rather different for the different countries. Austria and Germany are likely to be the main beneficiaries in terms of growth, but Italy will also be above the European average, along with Finland and Ireland (in spite of the costs deriving from the reduction in structural funds). Spain, Portugal and Denmark may have a net cost in the medium term, due on the one hand to the reduction in the flow of community funds, and on the other hand to a possible outflow of capital and direct investments, which could shift to the new members (see the FDI flows column in Table 4). Therefore, the entry of the new members can be compared to an asymmetrical external shock for the Union countries, with different effects depending on geographic position, economic structure and other factors (for example, their position with respect to major community policies).

Italy

Thanks also to the impulse of the Commission, country studies have now been carried out for Austria, Germany, Denmark and Italy.[19] The econometric analysis in the latter considers various factors: a reduction in trade barriers, the direct and indirect effects on Italy of growth in Eastern European countries, and the tendency towards trade specialisation that has developed in the Eastern European countries in the last decade. In fact, coming out of their planned economies and the communist trade bloc (COMECON), the trade specialisations of these countries in the early nineties did not necessarily reflect their comparative advantages in a free market context. During the decade, however, their trade flows have been reoriented (towards Western Europe) not only from a geographic point of view, but also as concerns commodity sectors. Trade specialisation has been diversifying and this trend will probably continue with their greater integration into the world economy and the restructuring of their economies.

[19] M. Grassini, "Eastern Enlargement of the EU: Economic Costs and Benefits for the Present EU Member States? The Italian Case", European Commission Study BUDG/B1/2001.

Supposing that the Eastern European economies have a growth rate after enlargement that is 2 percent higher than in the industrialised countries, this would lead to an increase in demand in Italy, due both to the greater demand for imports – which would be addressed directly at Italian goods – in Eastern countries, as well as the indirect effect that the growth of the Eastern economies would have on Italy's trade partners. In fact, the increased demand for imports would also be directed at other EU countries, creating an expansive effect which would have indirect repercussions on the Italian economy. For example, as shown above, the country that stands the most to gain from enlargement is Germany, which is the main destination of Italian exports (accounting for approximately 17 percent of the total).

As can be seen from Table 5, the long-term effects for Italy, taking into consideration the dynamic aspects that would appear in the course of the decade following enlargement, are greater than is generally expected. First of all, the direct effects of growth of the Eastern European countries are estimated to lead to an increase in Italian GDP of approximately 0.15-0.2 percent (see Scenario 1 - Italy and Eastern European countries: direct effects). This figure doubles (to 0.35-0.39 percent of GDP) if one considers the indirect effects on the Italian economy of the channel of transmission that passes through the other major European countries (see Scenario 2 - Italy-EU and Eastern European countries: indirect effects).Thus, for Italy, the indirect effects are as important as the direct ones. Considering the trend in trade specialisation of the Eastern European economies, Italy should

Table - 5 Italy: GDP growth rates for the decade (deviations from the base)

	01-02	**02-03**	**03-04**	**04-05**	**05-06**	**06-07**	**07-08**	**08-09**	**09-10**
Basic scenario	3.20	2.43	1.68	1.88	1.67	1.43	1.90	1.85	1.79
Three different scenarios with differences from the basic one									
Scenario 1) Italy and CEECs (direct effects)	0.20	0.18	0.19	0.16	0.13	0.13	0.13	0.15	0.15
Scenario 2) Italy-EU and CEECs (with indirect effects)	0.39	0.34	0.37	0.39	0.35	0.38	0.36	0.38	0.36
Scenario 3) + CEEC specialisations	0.45	0.39	0.43	0.48	0.47	0.51	0.49	0.51	0.42

Source: Grassini, "Eastern Enlargement of the EU".

have an overall increase in growth of almost 0.5 percent of GDP per year for the decade considered (see Scenario 3 - specialisation of the Eastern European countries).

Conclusions

One of the salient characteristics of this enlargement is the asymmetry in terms of economic weight and relative wealth between the two areas in question. On the one hand, this means that the economic benefits for the Union as a whole will be rather small in terms of GDP. Nevertheless, the most recent studies indicate that the advantages are greater than those estimated a few years ago and will probably be sufficient to compensate the costs. On the other hand, the economic wealth of the Union makes it possible, with only a slight effort on the part of the current members, to create substantial benefits for the new members.

The task of economists and national governments is to make accurate calculations, taking all the effects and the transmission channels – which are many – into account in order to determine the economic costs and benefits. As far as costs are concerned, it must be emphasised that the final result will depend on an agreement above all between the current members, and therefore one that is susceptible to the influence of the national governments. Thus, considering that the benefits at the European level will not be distributed evenly among the new and old members, nor even within the latter, the ability of European institutions to manage this process will take on the utmost importance. Their task should be to protect common interests and avoid sub-optimal results caused by inadequate coordination or the predominance of individual national interests.