What does a larger EU mean for the European economy? Looking at 2005 and beyond

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The paper assesses the impact on the European economy of this year's EU enlargement, focusing on the short-term outlook and highlighting some of the challenges ahead. Part 1 looks at the outlook for the European economy in 2005. Activity should remain rather dynamic, but it would be weaker than in 2004. Inflationary pressures should continue to be rather subdued. Part 2 argues that the eastern enlargement, in terms of contribution to GDP growth, is unlikely to make any significant difference to the economy of the EU15 as a whole. Part 3 estimates the number of years necessary to close the income gap for the four major economies of eastern Europe and then compares long-term growth projections with those of the four largest developing countries – Brazil, Russia, India and China – and discusses Ireland's economic miracle in the 1990s. We conclude that east European economies lack either the size or the favourable geographical location to speed their convergence process. Being part of a more integrated Europe is certainly important in fuelling development, but sound macroeconomic policies are crucial and will make a real difference to both the real term outlook and the sustainability of successes over the long run.

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Summary

This year's enlargement marks an important and symbolic milestone in the history of the European Union (EU). After long negotiations, ten new member states have joined the Union, taking its composition from 15 to 25. Never before have so many countries joined at one time. Moreover, and more importantly, with the accession of eight of them – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia – the EU has expanded to eastern Europe. This has turned the EU into a truly pan-European union, rather than just a western club. It has also substantially reshaped Europe's political and economic outlook. With other candidates, in particular Bulgaria and Romania, likely to join in the next three to five years – accession talks are due to start in January 2005 – the EU is clearly set on a path that will considerably increase its spatial economic diversity.

Despite its large political significance – the eastern enlargement is the last step in the reunification of Europe that started in 1989 with the fall of the Berlin Wall[1] – the impact of this enlargement on the EU economy in the short and medium term is marginal. In contrast to the large number of member countries, the population, economic and trade figures show that the accession of ten new countries does not significantly differ in size from previous accessions. The EU10 are poised to be the most dynamic part of the EU economy and their GDP is set to grow strongly in the next five to ten years. Their weight of their economies on the EU as a whole, however, is modest, as is their contribution to the EU's overall economic growth.

In this paper we look first at the outlook for the European economy in 2005. Activity should remain rather dynamic, but it would weaker than in 2004. Inflationary pressures, on the other hand, should remain rather subdued. We then argue that in terms of contribution to GDP growth the eastern enlargement[2] is unlikely to make any significant difference to the whole EU15 economy. Net benefits, however, should be greater for eastern economies than for western ones. Even assuming that benefits accrued over the transition period prior to the current enlargement, the gap in development between western and eastern Europe is such that inevitably the latter seems to gain more. It is, however, in the

[1] As Václav Klaus, President of the Czech Republic, declared in a recent speech at the Ifo Institute for Economic Research, University of Munich: "Through EU membership they [eastern European countries] are again counted among the normal European countries after half a century of abnormality, after half a century under communism. This recognition is very important for these countries and their citizens. That is also the major benefit derived from EU membership, although not everyone knows that there is such a benefit that is rather symbolic and without concrete effects", (Klaus, 2004, p.61).

[2] For simplicity we call it eastern enlargement even though it includes the Mediterranean countries Malta and Cyprus. However, their size in economic terms is so marginal that we can ignore them and focus on eastern Europe.

long period that the EU10 face the challenge of narrowing and eventually closing the gap in living standards with the rest of the EU and putting their economies on a sustainable path.

Setting some broad assumptions, we estimate the number of years necessary to close the income gap for the four major economies of eastern Europe. We then compare long-term growth projections with those of the four largest developing countries – Brazil, Russia, India and China (the BRICs) – and discuss Ireland's economic miracle in the 1990s. We conclude that eastern European economies lack either the size of the BRICs or the geo-cultural advantages of Ireland that would enable them to speed their convergence process. Being part of a more integrated Europe is certainly important in fuelling development, but sound macroeconomic policies are crucial and they are needed to make a real difference.

1. Europe in 2005: economic overview

Strong fluctuations in oil prices have finally begun to bite into the European economy and GDP growth is due to decelerate slightly in the last months of 2004 and in the first half of 2005. As a result, we expect real GDP to grow by around 2.4% this year in the enlarged European Union (EU), and to slow down to 2.2% in 2005. These rates compare with the modest growth rate of 1.0% in 2003.

The rather favourable outlook for the EU economy, though, is still quite poor in comparison with the US and even Japan. As a result, economic activity continues to be marked by pronounced differences among the major economies and regions (Table 1). The euro area's economies, for instance, in the past twelve months have expanded at the average rate of 2% – their fastest rate for more than three years. This, however, is less than half the growth rate of America or Japan. The US economy grew at a healthy 3.1% in 2003 and is expected to continue its acceleration this year, but to slow down in 2005 on the back of a less accommodative monetary policy.

Table 1: Global Overview: Annual Changes in Real GDP, 2001-2005

	2001	2002	2003	2004	2005
European Union	1.8	1.1	1.0	2.4	2.2
EU15	1.7	1.1	0.9	2.2	2.1
EU10	2.4	2.4	3.6	4.5	4.3
Euro area	1.6	0.9	0.6	1.9	2.0
United States	0.8	1.9	3.1	4.3	3.2
Japan	0.4	-0.3	2.4	4.0	2.2
China	7.5	8.0	9.0	9.2	7.8
Russia	5.1	4.7	7.3	6.5	5.2

Source: Eurostat, OECD, CH forecasts

In contrast the euro area, despite posting an acceleration in growth in both 2004 and 2005, after the poor performance of 2002 and 2003, remains the principal 'weak spot' of the global economy, with projected growth rates consistently lower. Real GDP in the euro area is expected to increase by 1.9% and 2.0% in 2004 and 2005 respectively, after a sluggish growth rate of 0.6% in 2003. The euro area's relatively modest growth reflects the slow activity in two of its largest economies, Germany and Italy (Table 2).

The EU as a whole is expected to perform slightly better than the euro area thanks to the strength of the UK economy (which also proved to be more resilient to the global downturn in 2002), and to the new member countries (EU10). The disappointing overall performance of most of the EU15 contrasts with the strong economic growth in the EU10, whose real GDP is due to grow by 4.5% and 4.3% in 2004 and 2005 respectively. However, as we demonstrate in this paper, the weight of the EU10's economies on the EU as a whole is modest and therefore their contribution to the EU overall economic growth is marginal. Indeed the EU10 currently account for only 5% of the nominal GDP of the enlarged EU.[3]

Table 2: Changes in Real GDP, 2001-2005

	2001	2002	2003	200	2005
Germany	0.8	0.1	-0.1	1.7	1.6
France	2.1	1.2	0.5	2.3	2.1
Italy	1.8	0.4	0.3	1.2	1.9
Austria	0.7	1.2	0.8	1.8	2.4
Belgium	0.7	0.9	1.3	2.2	2.1
Finland	1.1	2.3	1.9	2.8	3.0
Greece	4.3	3.6	4.5	4.0	3.4
Ireland	6.0	6.1	3.7	4.8	4.4
Luxembourg	1.5	2.5	2.9	3.6	3.2
Netherlands	1.4	0.6	-0.9	1.2	1.6
Portugal	1.6	0.4	-1.2	1.1	2.0
Spain	2.8	2.2	2.5	2.7	2.7
Euro area	1.6	0.9	0.6	1.9	2.0
United Kingdom	2.3	1.8	2.2	3.1	2.7
Denmark	1.6	1.0	0.5	2.1	2.2
Sweden	0.9	2.1	1.6	3.3	2.9
EU15	1.7	1.1	0.9	2.2	2.1
Cyprus	4.0	2.0	2.0	3.4	4.0
Czech Republic	2.6	1.5	3.1	3.7	3.7
Estonia	6.4	7.2	5.1	5.8	6.0
Hungary	3.8	3.5	3.0	3.8	3.6
Latvia	8.0	6.4	7.5	7.2	6.6
Lithuania	6.4	6.8	9.7	6.9	6.5
Malta	-2.2	1.8	0.2	1.1	1.5
Poland	1.0	1.4	3.8	5.3	4.7
Slovakia	3.8	4.6	4.0	4.7	4.4
Slovenia	2.7	3.3	2.5	3.8	3.5
EU10	2.4	2.4	3.6	4.5	4.3
European Union	1.8	1.1	1.0	2.4	2.2

Source: Eurostat, CH forecasts

[3] UN, Economic Commission for Europe (2004), p.1.

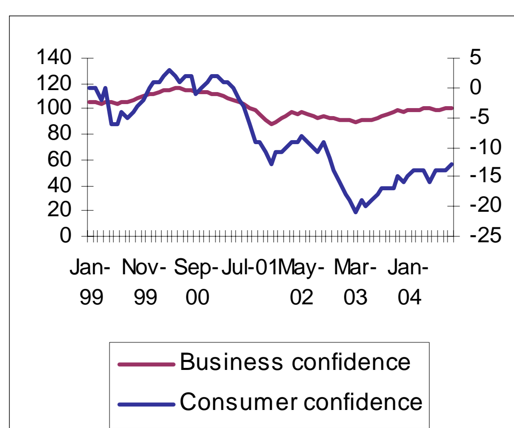
1.1 Drivers of growth

Exports should continue to benefit from strong growth in world trade and therefore to support GDP growth in the main European economies in 2005. However, in 2005 world trade is unlikely to grow more dynamically than this year, providing, therefore, no more impetus to exports.

Domestic demand is expected to gain some momentum thanks to an upturn in business spending on machinery and equipment. Construction investment should also strengthen after the decline in 2002 and 2003.

Particularly in the euro area, businesses have been showing stronger confidence than households (Graph 1). Here, again, there are some remarkable differences. Domestic demand has been growing strongly in France, but it is still stagnant in Germany. In Italy it has lagged behind because of firms' lack of liquidity and households' weak confidence. As a result, Italy's GDP grew only 1.2% in the second quarter of the current year, while France managed 2% and Germany 1.9% (see Box 1).

Graph 1: Businesses are more optimistic than consumers (euro area)



Box 1: A tale of two economies

Since the last downturn, it has become evident that the German economy lags behind the EU average. What it is less evident is that in the last ten years the gap with France has widened. The increase in real consumer spending has been 22% in France and 8% in Germany. In particular, since 2000 consumer spending has stagnated in Germany while capital investment has dropped. Government spending has also given less support to GDP growth. The only GDP component in which Germany has outperformed France since 2000 is exports. Indeed growth has been driven by net exports while in France it has been supported by domestic demand. Germany's domestic demand seems to have picked up in the third quarter of 2004, but it still has a long way to catch up.

Behind stronger consumer spending in France there is stronger job creation and income growth, as well as a drop in the savings rate – from 17% to 14.5% of disposable income since the end of 2000. In Germany, on the other hand, it has risen from 9.6 to 10.9%, reflecting households' concern about the planned economic reforms. Unemployment benefits are to be cut sharply from January 2005. At the same time, several big firms have reached deals with workers to cut

costs by working longer hours for the same pay. In the long term, this should raise profits and investment, increase Germany's growth rate and boost incomes and jobs, but in the short term it has a dampening impact on consumer confidence.

A strong rise in property prices has also helped consumer confidence in France. Here average house prices have risen by 14.5% in the past year while they have dropped by 1.7% in Germany. Moreover, in the past three years prices have fallen in Germany, but climbed by almost 40% in France.

The difference in performance between the euro area's two main economies has some important implications. First of all, Germany is much more vulnerable than France to a deceleration in the growth of the world economy, in particular US and Japan's. Second, monetary policy may not be appropriate for either economy. France may need higher interest rates – and a tighter fiscal policy – to help cool down its housing market. Germany, on the other hand, needs lower interest rates. The ECB's mandate, however, is to set the appropriate rate for the average conditions in the euro area as a whole even if this means that none of the big economies have the correct monetary policy.

A recovery in domestic demand, and especially consumption, is key for the export-led recovery to become self-sustaining in Germany and the euro area as a whole. However, some recent figures on private consumption are not particularly encouraging for a rebound in household consumption. For instance, the September figures on French consumption of manufactured goods show that private consumption, far from picking up, is actually beginning to ease. Not much comfort comes from Italian consumer confidence despite its sharp rise during the month of October. The underlying conditions for a substantial recovery in consumption growth in Italy, which in the last couple of years has been adversely affected by modest wage gains and higher inflation,[4] are not there yet.

The outlook for business confidence is not particularly encouraging either. The new high in the price of oil and the recent rise in the euro may have an adverse impact on business sentiment. Looking at Germany's IFO index for October, for example, it appears that the economy is loosing momentum although the economic outlook is no longer deteriorating. Indeed in October the IFO index came out stronger than expected, but expectations are at levels that have been associated with stagnation in the past, showing no contraction in the economy as well as no further expansion.

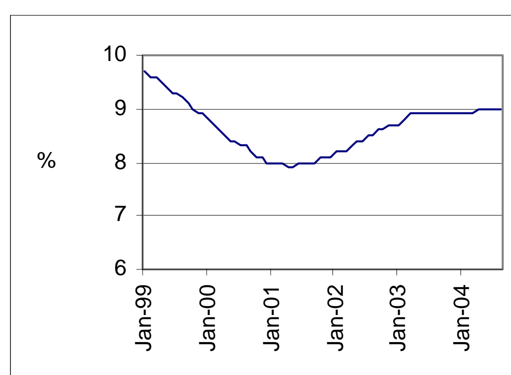
No particularly encouraging signs come from the production side. The October purchasing managers' index (PMI) for the euro area suggests that the economy is loosing additional momentum – somehow in contradiction with national leading indicators and EU Commission Autumn survey. Firm conclusions are certainly premature at this stage, but we see some reasons for concern. First of all, new orders – the most forward-looking components of the survey – point to further deceleration in activity over the coming months. This is a combination of weakening global demand and the lagged impact of the past

[4] Even so, wage gains remain too high given poor productivity. Disposable income, though, is not as weak as consumption, suggesting that a significant portion of income has been allocated to savings.

appreciation of the euro and is likely to slow exports over the coming months. Secondly, the employment component is below the 50 expansion/contraction threshold. This means that the euro area economy is still not expanding strongly enough to create new jobs. As a result, disposable income and consumption are unlikely to receive a significant push, which is worrying for future growth in domestic demand.

Private consumption has been gradually recovering on the back of a better outlook for the economy and for the labour market. Over the last 9-12 months the unemployment rate has stabilised and the overall employment outlook should benefit from some job creation. The impact on the unemployment rate for the euro area as a whole, however, is deemed to be modest; it is predicted to drop to just 8.8% in 2005 from 8.9% in 2004 (Graph 2).

Graph 2: Unemployment in the Euro Area



Source: Eurostat

The EU10 are poised to be the most dynamic part of the EU economy. The process of catching up should continue vigorously as the new EU member states with the lowest per capita GDP are expected to grow the fastest. All the EU10 should also benefit from the strengthening of the west European economy that is their main export market. Unlike in western Europe, growth in the EU10 in 2002 and 2003 was mainly driven by domestic demand – in particular, private consumption – leading in some cases to sizeable macroeconomic imbalances. A shift towards export-led growth – a pattern which prevailed throughout most of the 1990s – would help to reduce these imbalances. Investment inflow, prompted by new export opportunities to the EU as well as growing domestic markets, should be enough to finance the current account deficits caused by rapid restructuring, with imports of capital goods and technical services, and faster growth. With EU pre- and post-accession fund inflows also expanding, there is little danger of unexpected downward currency adjustments. Indeed, current strong growth is partly due to the relaxed monetary policies that most of the region's central banks have been operating as they attempt to prevent capital inflows.

Growth in eastern Europe's largest economy, Poland, has been steadily accelerating throughout 2004 on the back of exports of manufactured goods and a strong revival of private fixed investments even if the central bank has taken pre-emptive action against signs of resurgent inflation and started to tighten

monetary policy again. Supportive policies and the recovery of private consumption should provide further support to activity. All these factors should result in an acceleration of Polish GDP growth to 5.3% in 2004. Growth should slightly decelerate in 2005, but remains robust with a rate of 4.7%.

In Hungary, the expected strengthening of GDP growth in 2004 (to 3.8%) should be driven by exports. This, of course, implies significant gains in competitiveness and profitability which should result from wage moderation and rapid productivity growth. This would lead, in its turn, to a stronger recovery in business investment, a revival in foreign direct investment (FDI) inflows and a sharp upturn in exports. If successful, this adjustment should lead to a large increase in the contribution of net exports to GDP growth that would be sufficient to offset the negative effects of the envisaged tightening of macroeconomic policy – in response to the twin deficit problem and the currency turmoil in 2003 – on private and public consumption.

Similarly, the Czech authorities face difficult policy choices related to the threat of unsustainable twin deficits that are a consequence of earlier expansionary policies. The response to these threats is likely to involve fiscal retrenchment and, possibly, a tightening of monetary policy as well. As a result, GDP growth should be flat next year after acceleration in 2004.

In Slovenia the present policy of wage restraint should strengthen competitiveness and this, together with the recovery of west European demand, should provide a boost to exports. As a result, the recovery in aggregate output should accelerate to 3.8% this year – from 2.5% in 2003 – and be 3.5% in 2005. In Slovakia growth is set to remain strong in both 2004 and 2005, with GDP increasing by 4.7% and by 4.4% in 2004 and 2005 respectively. The export-oriented manufacturing sector should benefit from stronger external demand and the economy as a whole should also gain from the confidence-enhancing effects of EU membership and structural reforms focused on improving the fiscal position and strengthening the incentives for work. In contrast to other central European economies, final domestic absorption can also be expected to increase in Slovakia in 2004, providing further support to domestic economic activity.

Strong GDP growth is expected to continue in all three Baltic states, which should also benefit from macroeconomic stability. The three economies rely heavily on exports to western Europe. A recovery in domestic and import demand in the EU15 will work to their advantage. However, the very large current account deficits in Estonia and Latvia may lead to a tightening of macroeconomic policies which, in turn, may moderate their growth rates.

1.2 Inflation

Rising energy prices have certainly put upward pressure on headline inflation, but, so far, they have only marginally fed through to core inflation and wages. In the euro area consumer price inflation is expected to average 2% this year as a result of the lagged impact of the euro appreciation and weak domestic price pressures.

Unlike in 2003, when price developments were influenced by the fall in oil prices, this year's strong fluctuations have not generated yet significant inflationary pressures. There are, however, some risks and we expect to see second-round effects emerging in wage- and price-setting in the first months of 2005. The impact on consumer prices, though, should remain rather moderate thanks to a relatively strong euro and not particularly exuberant consumer demand. As a result, in 2005 inflation should average 1.8%, which is below the European Central Bank (ECB) definition of price stability. As the ECB's governor, Jean-Claude Trichet, noted recently, there are further risks related to "the future evolution of indirect taxes and administered prices". M3 growth remains resilient and "is increasingly driven by developments in its most liquid components". As a result the ECB remains very vigilant, but the odds are in favour of the ECB's keeping an accommodating stance until mid-2005, with interest rates at the current level of 2.0%.[5]

In the new EU member states, inflation is higher than in the western countries. In 2004 inflation is expected to accelerate to 4.2% on average as a result of the increases in indirect taxes since tax rates are adjusted to the EU levels. A subsequent easing of inflation to 3.5% is projected for 2005.

1.3 Risks

Risks to economic activity are broadly balanced. As things stand, they are mainly related to oil price developments which may pose second-round effects in wage- and price-setting. Although the outlook is more favourable than during the summer, on balance, the international environment implies an upside bias. The question, therefore, is how much impact oil prices will have on growth this year and, because of their lagged effect, on next year's growth.

With regard to the euro area we cannot rule out a further appreciation in the euro exchange rate. This could undermine activity, especially in the manufacturing sector, in particular in those member states that have recently depended on external demand to generate economic growth. On the other hand, any further appreciation would ease inflationary pressures and, accordingly, raise real disposable income. Protracted sluggish consumer confidence is another risk to growth in the euro area. Critical budgetary situations in the main economies and the process of reforming the welfare state, as well as the threat of terrorism could adversely influence consumers and persuade them to postpone consumption plans.

Looking at the budgetary positions of several EU member states, the risk here is that budgets bulge further in 2005 if growth turns out to be weaker than expected. Indeed most of the debate so far has tended to assume that deficits can all be brought back in line fairly rapidly as economies improve. This makes improvements in budgetary positions dependent on cyclical upturns rather than structural

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[5] Unlike the Federal Reserve Bank, the ECB did not embrace a vigorously expansionary monetary policy during the recent downturn. Throughout 2004 it has adopted a 'wait and see' policy and assessed GDP growth as well as the impact of oil price fluctuations on inflation.

adjustments. What is clear, though, is that there is no chance of an excessively rapid turnaround in deficit positions posing a risk to growth in the short term.

Credibility has been seriously undermined by some governments' cavalier attitude towards the criteria set in the Stability and Growth Pact, and there is now an urgent need to show good intentions and permanent adjustment measures to restore overall public finance sustainability. New member states (NMS) should reduce their public sector deficits below 3% of GDP in 2006-2008 – a target set by the ECB in view of their intention of entering ERM-II-type exchange rate alignments with the euro and adopting the common currency before 2010. We do not see any risk to short-term growth as a result of too rapid deficit reduction. On the contrary, we are concerned about losing momentum on reforms or further delaying them as well as about adopting inappropriate pro-cyclical fiscal policies.

2. Does the enlargement make any difference to the EU economy?

2.1 When did integration begin?

When applying for EU membership, applicants must meet the Copenhagen criteria that set broad political, economic and administrative requirements. The economic criteria for accession are the existence of a functioning market economy and the ability to cope with competitive pressures and market forces within the EU. In order to meet these requirements and qualify for EU membership, NMS committed themselves to reforms and economic liberalisation. As a result, they have progressively opened their markets and institutions to transparent social and economic governance – a substantial change from previous economic practices in some of these countries. The EU membership certainly acknowledges the progress made by those countries in transforming their economies and moving them from plan to market.

As economic integration is a long process, with net benefits accruing year on year, we take the view that the process of transition and the economic integration between eastern and western Europe began in the early 1990s rather than in May 2004, when the EU10 were officially included in the EU. For instance, trade integration,[6] which is an index of a country's/zone's integration within the international economy, shows that during the transition period, between 1995 and 2003 – years for which figures are available – the EU10 became substantially more open.[7] Trade integration indexes in the three main EU10 economies – Poland, Hungary and the Czech Republic – increased from 19.0 to 30.4 in Poland, from 42.2 to 58.4 in the Czech Republic and from 31.5 to 53.9 in Hungary. Interestingly, west European countries closer to the eastern bloc, such as Germany and Austria, have seen their trade

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[6] Trade integration of goods as a percentage of GDP is the average of imports and exports divided by GDP.

[7] This is consistent with the economic integration theory which predicts an increase in trade after trade barriers are removed. See, for example, Viner, 1950.

integration indexes grow significantly between 1995 and 2003 – from 20.0 to 28.1 in the case of Germany and from 24.8 to 34.8 for Austria. On the other hand, the index for Portugal, which is much further from the new EU10, has grown only marginally in the past ten years – from 26.5 to 27.2.[8]

2.2 Too small to make an impact

Even working on the assumption that the actual enlargement started when the EU10 applied for EU membership, the macroeconomic impact on the EU as whole remains limited in the short and medium term. This is because the new EU countries are considerably poorer than the EU15, have proportionally fewer inhabitants, and represent a marginal market for EU15 exports.

Table 3 shows that with the exception of Poland new member states are relatively small countries. Their combined population is one-fifth that of the EU15. Hungary and the Czech Republic have roughly the same population as Belgium and Portugal. Malta, with about 400,000 people, is smaller than Luxembourg. The combined population of the three Baltic states – Estonia, Latvia and Lithuania – is smaller than that of tiny Austria. On the whole, the NMS contribute about 74 million to the EU's population – less than the total population of Germany.

Table 3: An Overview

	2003 Population (m)	2003 GDP per capita, PPP constant 1995 international US$	2002 Agriculture GDP share (%)
Czech Republic	10.2	14,304	3.8
Hungary	10.1	12,673	4.3
Poland	38.4	10,108	3.2
Slovakia	5.3	11,713	4.1
Slovenia	1.9	16,784	3.1
Baltic states	7.1	10,024	5.7
EU10	74.4		
Bulgaria	7.8	6,789	12.7
Romania	21.7	6,280	13.1
EU12	103.9		
Portugal	10.4	16,039	3.7
Greece	10.7	17,370	7.4
Spain	40.8	19,362	3.4
Italy	58	23,524	2.7
Germany	82.5	24,010	1.2
Finland	5.2	23,700	3.4
France	59.7	23,765	2.8

[8] Brülhart, Crozet, Koenig (2004). For a broad discussion on distance and transition see Fischer, Sahay and Vegh (1998).

Sweden	8.9	23.181	1.8
Belgium	10.3	24.694	1.3
Netherlands	16.2	25.578	2.7
United Kingdom	59.2	23.573	1
Austria	8.1	26.065	2.2
Denmark	5.3	27.507	2.6
Ireland	3.9	31.981	3.4
Luxembourg	0.4	54.652	0.7
EU15	369.2		

Source: Eurostat, World Bank

The contribution to the total GDP of the enlarged EU is even more modest. In 2003 total real GDP in the EU10 was about 4% of that in EU15. With regard to trade, in 2002 the share of western Europe's exports to central and eastern Europe, the Baltic states and CIS was 6.3%. Western Europe, on the other hand, represents a key market for NMS exports, which account for a quarter of the total from all these countries.[9]

Differences between the NMS and the rest of the EU in GDP per capita at purchasing power parities (PPP) are significant and much larger than in previous accession rounds. All NMS lag behind the EU15 average, set to equal 100 (Graph 3).[10] GDP per head in EU10 averages about 38.1 of the current EU level at PPP exchange rates and 48.7 at market exchange rates.[11] Slovenia, which is much closer, in terms of development, to the EU15's poorest members, Greece and Portugal, is the only exception. Poland, despite being the biggest of new member states, is the country with the lowest GDP per head, followed by Latvia, Lithuania and Slovakia.

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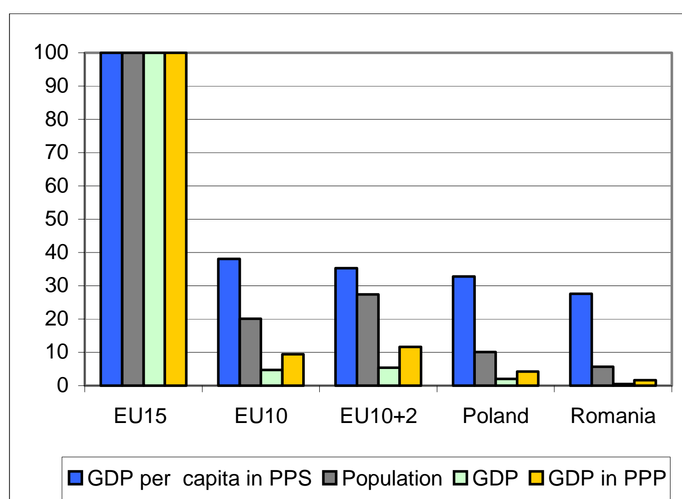
[9] Also, in 2002 EU15's share of the world merchandise exports was 40% compared with 1.4% for central and eastern Europe. EU15's total merchandise exports amounted to US$2,657 billion compared with US$148 billion for central and eastern Europe. See World Trade Organisation (2003).

[10] The graph includes Romania which is not a current member of the EU, but is likely to join it in January 2007.

[11] Eurostat and World Bank figures.

Graph 3: EU15 and EU10: A Comparison



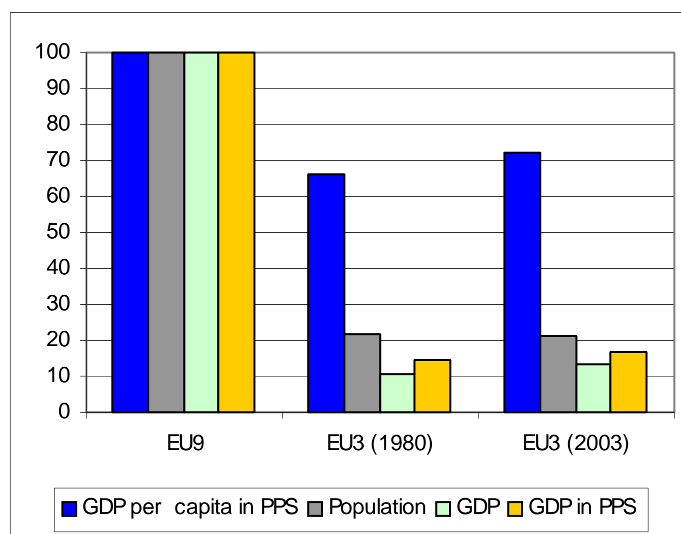
Source: Eurostat, World Bank

2.3 A comparison with the southern enlargement

The challenges imposed by the eastern enlargement of the EU in terms of scope and diversity are huge. The NMS present widely different economic features and have different experiences of running economic policies. However, it is not the first time that the EU is admitting countries with lower levels of economic development than existing members. The southern enlargement, which took place in the 1980s with the accession of Greece, Portugal and Spain, provides a useful comparison for judging the economic challenges posed by the most recent enlargement. In macroeconomic terms, the size of the EU10 *vis-à-vis* the EU15 is broadly the equivalent of the southern member states *vis-à-vis* the EC9.[12] In 1980 the combined population of Greece, Portugal and Spain was about one-fifth of the EU9 (Graph 4), but their aggregate GDP was only 10%. In the case of the EU10's GDP *vis-à-vis* that of the EU15, the proportion is lower – 4%. The difference in terms of GDP per capita is also striking. In the 1980s GDP per capita (in PPP) for Greece, Portugal and Spain was 66% that of the EC9. Poland, the largest of the EU10, is similar in size to Spain which, in its turn, was the largest of the countries joining the EU in the 1980s. In 2003 Poland constituted 10% of the EU15 in terms of population and about 6% in terms of GDP. This compares with 14% and 8% respectively for Spain *vis-à-vis* the EC9 in 1980.

[12] Germany, France, Italy, Belgium, the Netherlands, Luxembourg, UK, Ireland and Denmark.

Graph 4: EU9 and EU3, 1980 and 2003



Source: Eurostat, World Bank

From a macroeconomic perspective these comparisons suggest that the eastern enlargement is unlikely to have a more significant impact on the existing EU members, especially in the short term, than the southern enlargement in the 1980s.

2.4 Few gains in the short term for the EU15

In terms of contribution to GDP growth the recent enlargement makes no significant difference to the economies of the EU15. Empirical evidence also supports this conclusion. A report of the European Commission's Directorate General for Economic and Financial Affairs shows that the cumulative impact on GDP growth in the decade 2000-2009 is between 0.5% and 0.7%.[13] Of course, each EU country is likely to be affected in a different way. A number of empirical studies[14] have shown that for countries closer to EU10 and more exposed to trade and immigration potential gains are higher.

Looking at income per capita, however, we see an increase in income disparity in the EU member states and a drop in the average GDP per capita in the EU as a whole. Average income per capita, not adjusted for PPP, is likely to drop from about €20,000 in 2003 to about €18,000 in 2004. Also, the

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[13] DGEFA (2001), Section 3. A simulation in this study indicates that enlargement could boost GDP growth in the eastern countries by more than two percentage points annually, even if the impact on EU15 is very modest.

[14] See Keuschnigg and Kohler (1999), Grassini (2001).

enlargement is likely to lead to more regional inequality, at least in the medium term, with the result that structural and regional policies have to be maintained.

Over the first five to ten years after enlargement the net benefits should be higher for the EU10 than for the EU15. EU membership should help reduce volatility of performance while boosting the average performance. However, it is easier to reduce volatility versus the post-Communist collapse than to improve average performance.

We have calculated (see below) that being part of the EU should boost the annual GDP growth rate of EU10 by between 1 and 2 percentage points in the next decade.[15] The EU10 economies should expect a boost to their growth from mark-up and trade integration effects as well as from migration flows and should also benefit from some EU transfers in the name of economic cohesion, which will have important budgetary implications. These transfers should help income convergence.[16]

3. Taking a longer view: the challenge of closing the income gap

From the discussion above it emerges clearly that converging with the most developed countries in the EU is the biggest task faced by the new member states. Judging from the experience of the southern countries (see Graph 4), closing the income gap with the EU15 is likely to take decades. Twenty years on, indeed, GDP per capita in Greece, Portugal and Spain is about 72% that of EC9, up from about 66% in the 1980s – a significant but not remarkable improvement. Historical evidence from EU integration also supports the view that convergence may take several years. Despite strong growth in the 'golden age' of 1950-73, on the whole GDP grew at an annual average of just 2% in 1950-90. Assuming that east European economies grow at the same rate as the then EU countries in 1950-73, it would take around 30 years just to halve the present income gap with the existing EU member states.[17]

Convergence is likely to be even longer and more difficult for east European countries for a number of reasons. First of all, at the time of their accession the southern countries were and had always been private market economies, even if with a strong state participation. In eastern Europe, on the other hand, the transition from planned socialist economies to private market economies started in 1990. Second,

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[15] Our calculations are broadly in line with DGEFA (2001).

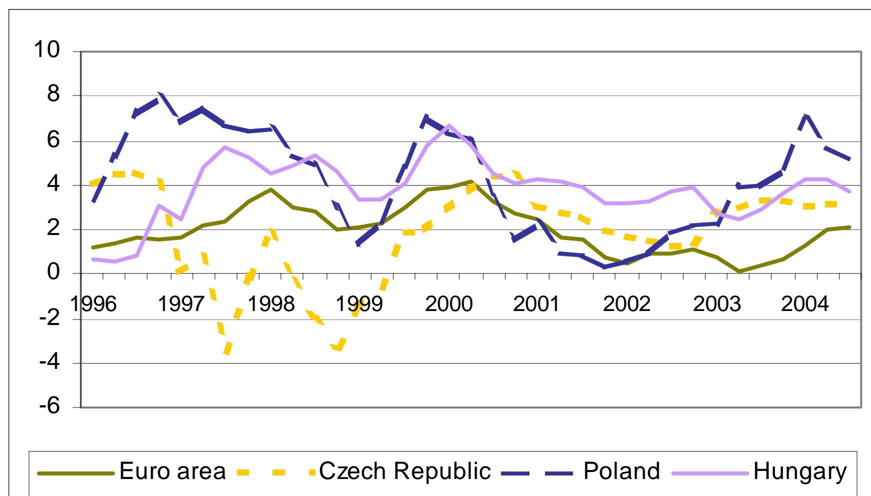
[16] However, due to a re-definition of the relevant rules the NMS should receive less EU funds than was the case for the Southern enlargement and for Ireland.

[17] Kekic (2003).

the income gap between the new member states and the EU15 is wider than in the southern enlargement (see above).[18]

The NMS, therefore, face the challenge of closing the gap in income per head and putting their economies on a sustainable path.[19] Despite doing relatively well in transforming their economies, they have not achieved consistently strong growth rates. Over the past decade, owing to the strong contraction in output that followed the transition from central planning, real GDP growth rates have been on average just slightly above those posted by EU15 economies (Graph 5), while the income gap has actually widened.[20] GDP has been growing relatively strongly since 1996 without, however, making significant improvements in terms of income per head. GDP growth should accelerate in the next decade as a result of EU membership, boosting total output in the NMS and supporting the difficult task of catching up with average EU living standards. There is, however, a catch, which is whether the 'old' EU is sufficiently dynamic to drive the NMS forward faster.

Graph 5: Real GDP Growth, 1996-2004



Source: Eurostat

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[18] On the other hand, as Daniel Gros argues (Gros, 2002), the performance of the most advanced NMS in terms of nominal admittance criteria to the European Monetary Union is good compared with that of the southern countries before their accession.

[19] It can be argued that the 'gap' may never fully close. This is because some of the 'gap' represents regional disparities that could persist in the long term. For a forecast view, this opens up the question over what the future EU 'hierarchy' may be, where the high income spots would be and where the lows.

[20] The outlook is, of course, rather different for each single country. For instance, Estonia and Slovenia in the last decade posted on average GDP growth rates of 5.0% and 4.5% respectively.

3.1 How many years to close the income gap?

To estimate the number of years necessary to close the income gap, we develop a simple model and compare the results with those of the EIU.[21] We work on the assumption that EU membership has an impact on growth through its possible effect on trade and investment, through intra-EU transfers and through effects on policies and institutions.[22] Although the direct effect of improved trade may be limited over the long term, improved entrepreneurship, increased investment and technology generation all count as indirect effects. Also, the impact of aid inflows may be less strong than expected. In 1999 the EU summit decided to give aid totalling €42.6bn to the NMS in the first three years of membership. This is the equivalent of 1% of their collective GDP and is below the 4% threshold set to avoid transferring more money than the newcomers supposedly have the capacity to absorb.[23] In any case, the link between growth and aid is not clear: the case of Greece, which has been unable to catch up with EU average living standards, speaks volumes.[24]

In the model we look at three components of GDP growth – employment growth, capital stock growth, and total-factor productivity (TFP) growth – and model each of them. We use the UN's demographic statistics as a base to forecast employment growth over the long term.[25] We use assumptions about the investment rate to have a long-term projection of capital stock. We model TFP growth as a process of catch-up on the EU15. The assumption here is that the wider the income gap, the greater the potential for catch-up and stronger TFP growth. Finally, we assume a conservative view of GDP per head growth in the EU15, with a 1.5% rate per year. As these are long-term forecasts, we ignore the impact of the economic cycle.[26] We express all our projections in real terms and in 2003 US dollars. We limit the model to the three biggest EU10 economies – Poland, Hungary and the Czech Republic – and the biggest candidate country, Romania. The structure of the model is identical across the four economies.

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[21] Kekic (2003).

[22] There are also indirect effects which come from structural reforms, improved policies and institutions, etc.

[23] With the budget capped at 1.27% of GDP, an increase in aid money is unlikely in the next budget period, 2007-2013.

[24] Kekic (2003), Barysch (2002).

[25] Low population growth, as we assume, means that unemployment rates should fall and help cut social payment costs.

[26] Eastern European economies are subject to wide cyclical fluctuations and are prone to asymmetric shocks. There is widespread concern that the NMS might be subject to country-specific stabilisation crises and asymmetric demand shocks from countries such as Russia.

However, we assume a stronger 'catch-up impact' on Poland and Romania because of the relative size of their economies and the need to upgrade their infrastructure. In the last 15-20 years of the forecast period, all four countries achieve the same convergence speed. We use our forecasts until 2007 and begin the simulation in 2008. The results are summarised in Table 4.

Table 4: Closing the Income Gap: Long-Term Growth in GDP per head (average % change)

	Baseline*	CH		EIU	
		Benign %	Number of years	Benign %	Number of years
Czech Republic	3.1	3.5	44	3.7	39
Hungary	3.0	3.6	39	4.0	34
Poland	2.9	4.0	55	3.8	59
Romania	2.6	4.6	86	3.8	80

** EIU*
Source: EIU; CH projections

For the baseline scenario we use the EIU long-term growth projections.[27] These are estimated using cross-section growth regressions, based on 85 countries for the 1970-2000 period, that link real growth in GDP per head to a large set of growth determinants. The differences between our scenario and the EIU baseline are substantial for Poland and Romania: 1.1 and 2.0 percentage points respectively. Differences between our benign scenario and the EIU benign scenario are less marked, even if we tend to be more bullish about growth in Poland and Romania. In any case, the two scenarios point to broadly the same number of years necessary to catch up. A little more than a generation[28] is necessary for the Czech Republic and Hungary to bring their living standards in line with the EU average, while Poland will need two generations and Romania almost three. It is certainly worth noting that population growth is slow – fertility rates in eastern Europe are similar to those in the west. This contributes to a reduction in the catch-up period. Indeed, when population grows rapidly, income per head tends to rise more slowly as higher investment is needed just to keep up with population growth.

3.2 A comparison with the BRICs

Both our and EIU's projections show robust economic growth throughout the forecasting period. Real GDP growth rates are not substantially different from the projections for the BRICs, the four largest developing countries – Brazil, Russia, India and China (Table 5). According to a recent study, however, in 50 years the BRICs could be the larger economies in the world, having overtaken Germany, France,

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[27] Kekic (2003).

[28] We define 'generation' as the normal time between successive generations.

the UK and Italy.[29] The size of Brazil's economy, for instance, should overtake that of Italy by 2025, France by 2031, and Germany by 2036. China is expected to become the world's largest economy by 2041, while India should outstrip Japan by 2032. Russia, on the other hand, is due to benefit from strong convergence rates and to have the highest GDP per head among the BRICs.

It is certainly debatable whether such forecasts are plausible and whether such a dramatic shift in economic power is possible. However, the key point here is that the BRICs, because of their size, have the potential to overtake the main developed economies.[30] This is certainly not the case for eastern Europe, which is constrained by the size of its internal market and resources. Being part of the EU helps the region to achieve sustainable high growth rates even if membership on its own is no guarantee of success.

Table 5: A Comparison: Real GDP Growth, 5-year period averages

	Czech Republic	Hungary	Poland	Romania	Brazil	China	India	Russia
2001-2005	3.0	3.7	3.3	5.3	2.4	8	5.3	5.1
2006-2010	4.7	4.8	5.0	6.4	4.2	7.1	6.1	4.6
2011-2015	4.7	4.6	5.2	5.9	4	5.8	5.9	3.7
2016-2020	4.4	4.3	4.9	5.6	3.8	5	5.7	3.3
2021-2025	3.9	4.0	4.5	5.2	3.7	4.5	5.7	3.4
2026-2030	3.3	3.7	4.1	4.9	3.8	4	6	3.5
2031-2035	3.3	3.2	3.9	4.4	3.9	3.8	6.2	3
2036-2040	2.8	2.7	3.6	3.7	3.7	3.8	6	2.5
2041-2045	2.1	1.7	3.3	2.9	3.5	3.5	5.6	2.1
2046-2050	1.9	1.4	2.3	2.4	3.4	2.9	5.2	1.9

Source: Wilson-Purushothaman (2003), CH

3.3 The case of Ireland

Despite having joined the European Community in 1973, at the beginning of the 1990s Ireland was still a long way behind its European partners. It had low living standards and a very low employment to population ratio. Nowadays Ireland's GDP per capita at PPP is well above the EU25 average while real GDP growth has consistently outperformed that of the rest of the Union.

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[29] Wilson-Purushothaman (2003).

[30] Indeed, the BRICs' size means that they can, in data terms, overtake the EU and US. Size is also a key determinant in sustaining FDI given the attraction of a big growing internal market.

The Irish ‘miracle’[31] has certainly been favoured by the country’s relative geographical and cultural proximity to the United States. This, together with a relatively low initial wage level, has turned Ireland into a profitable location for US companies keen to have a base in Europe. Most of all, in the 1990s the Irish economy benefited from the US boom.

Being a small and open economy has greatly contributed to the development of Ireland – as Paul Krugman pointed out, it resembles a region of a larger economy. Large countries find it more difficult to attract capital and labour on a scale sufficient to make the sort of impact on aggregate supply that immigration and FDI have made on Ireland. Funds from the EU Cohesion, Regional and Social Funds contributed to speeding up change and supported economic growth in the early phase of the boom through a counter-cyclical boost.

Most of all, proactive economic policies managed to turn location and size into real competitive advantages and propelled development. These policies were geared to fiscal adjustments based on the ‘shock therapy’ of expenditure cuts – rather than a gradualist approach of tax increases – and on bargaining and ‘social partnership’. They contributed to stabilise the economy and to increase investor confidence. Favourable economic conditions coupled with low tax rates and grants for fixed assets did the trick of turning Ireland into a particularly attractive location for FDI.

Everything else then lined up. Employment could expand without generating inflationary pressures thanks to the relatively large percentage of the working-age population not in employment. Productivity strongly increased, while a well-educated labour force, even if not itself a condition for economic expansion, played a very positive role. As a result, the Irish economy experienced a steady improvement in competitiveness throughout the 1990s. A virtuous circle was soon established. The growth of clusters in certain sectors (mainly pharmaceuticals, electronics, medical instrumentation, and financial services) and the expansion of specialised labour markets have attracted further investment in these sectors.

4. Conclusion: can policy speed convergence?

For illustrative purposes, if we break down FDI into three components – size of the economy, costs of wages/competitiveness and trade advantages, other factors (Table 6) – it is clear that the BRICs benefit from size and costs of wages/competitiveness and trade advantages. Ireland had a lot of other factors and some costs of wages/competitiveness. EU10 can only offer low wages/competitiveness, and these factors, however, seem running out of steam. In any case, the BRICs still have a long and steep road ahead while Ireland now faces the challenge of consolidating its rapid development.

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[31] For a discussion on Ireland see Walsh (2000).

Table 6: Who scores best?

FDI components	BRICs	Ireland	EU10
Size of the economy	√		
Wages/competitiveness and trade advantages	√	some	√
Other factors		√	

In the case of Ireland, being part of a larger economic area has certainly had a positive impact on the convergence process. But EU membership is not enough on its own to guarantee a rapid narrowing of the gap in living standards. Economic policy plays an equally important role in fostering convergence by stabilising the economy, narrowing current account and public deficits and improving productivity. As TFP is substantially lower in the NMS than in the old EU, a more efficient use of already available resources has the potential to reduce the income gap.

The ultimate goal is to create a favourable business environment and increase investor confidence in order to maintain and boost FDI flows. In the recent past years FDI has been a major driving force behind growth in the NMS as foreign investors have taken advantage of the wave of privatisation opportunities. However, indications point to a decline in FDI as public offerings dry up and competition from locations with cheaper labour in Europe and Asia intensifies. As domestic capital formation is not strong enough to replace FDI, macroeconomic policies are needed to ensure that the FDI flow is maintained or even increased.

Even if some aspects of the Irish model cannot be applied to eastern Europe, there are still some valid lessons. Fast and deep deregulation leading to well-functioning markets and institutions remains one of the best ways to support economic growth. This is certainly encouraged under EU membership. The promotion of entrepreneurship and the development of small and medium-sized companies should also be encouraged, while access to capital has to be improved. At the same time, the size of the black economy should be reduced. More competition is needed in transport, labour, and other markets. Jobs should be created by cutting taxes on labour, reducing labour legislation, and supporting investments in human capital. Labour market participation rates should be increased. More should be spent on infrastructure, education, and research and less on income transfers. As the quality of national policy is the main determinant of economic success, fast convergence very much depends on efforts to promote macro-economic stability and sound investments.

Will an economic miracle happen in eastern Europe? None of the NMS presents the same favourable conditions that have been at the basis of Ireland's recent rapid and strong development. On the other hand, it is certainly true that twenty years ago few would have bet on Ireland. It is equally true that NMS do not have the potential of the BRICs. Being part of a larger EU should boost development,

turning the NMS into prosperous areas with well-developed economies and living standards close to the EU average. The role of policy here is to accelerate the transition and help these developments take place within a shorter time span than the baseline forecasts currently indicate.

But the role of policy is not limited to the east. Structural reforms and sound fiscal policies should take priority on the agenda of western Europe's governments in order to bring Europe out of the current malaise. Europe still has a long way to go before becoming a cohesive economic block. In market terms cross-border trade is somehow difficult and full labour mobility has not been achieved yet – and not only because of language problems. The US demonstrates well the importance of scale. It is a huge integrated market where it is possible to sell to all consumers, businesses (and investors) pretty seamlessly. This gives a power base to those companies (and individuals) operating in this environment, that can be challenged only from a similar power base. As size is going to become more and more crucial, we see a big shift in economic power in the decades ahead. It is plausible to expect the US to be in the driver's seat, but who will be the co-drivers? One of the BRICs – perhaps China or Russia – possibly Japan. Certainly not some of today's economic powers – such as Germany, France, Italy, and the UK, all G7 members and EU constituents. Would the EU as a whole replace them? Only if it manages to become a truly integrated economic block.

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