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How Enlargement Will Change the EU Economy

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1. Introduction

Admitting a new wave of member countries in 2004 the EU faces a difficult challenge. The troubles arisen within the 2003 inter-government conference concerning the reform of the decision mechanisms of the Union could be only a foretaste of what could currently happen in the aftermath of enlargement, reducing the EU to a state of institutional paralysis. At the same time the economic governance of a wider European market could prove more difficult than in the present conditions, putting in jeopardy the results so far achieved, above all in the field of monetary integration.

In order to draw the state of affairs of the enlargement perspectives on the eve of the accession, in this paper an effort is made with a view at singling out the different relevant issues, stressing in particular on the possible instability of EMU in the aftermath of its future extension to the new member countries.

The paper has the following structure. Next section presents some lines of the political economy approach to enlargement, a useful interpretation tool based on the consideration of the interest and strategies of the different players in the game of joining new member countries to the current Union. Section 3 offers an overall description of the economic features of the candidate countries, while Section 4 deals with the impact of enlargement on the Common Agricultural Policy (CAP) and on the structural policies. Section 5 studies the effects of enlargement on the EMU stability, with the help of a couple of exercises aimed at finding evidence of possible structural links among crucial economic variables of EMU and applicant countries. Section 6 draw a synthetic pictures of the acceding countries economic condition at the eve on enlargement, and the last Section concludes the paper with some provisional conclusions.

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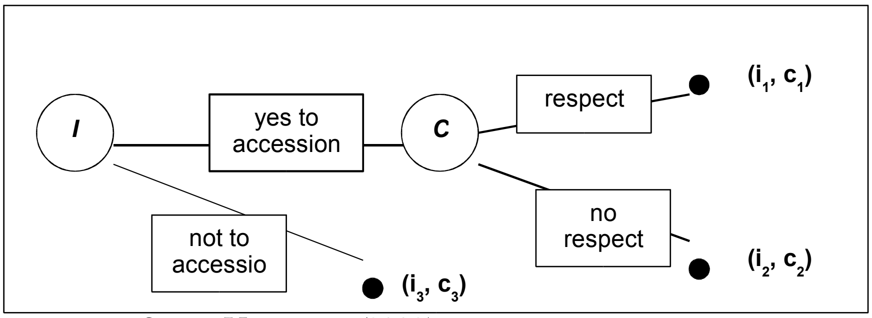
2. The political economy of enlargement

A useful criterion to be used in order to better understanding the ongoing process of enlargement is to adopt the standpoint of political economy, considering in an explicit way the interests, the prospective pay off and the strategies of the different players involved in the game of joining new member countries to the current EU. In such a way it is possible to highlight the conditions for a successful outcome of the enlargement game, explaining at the same time some specific features of the bargaining that has thoroughly accompanied the entry negotiations, and that will be concluded only at the moment of the new member countries accession in May 2004. In particular this approach allows to deal with the issues of time inconsistency, that frequently arise in the strategic relationship between players. A standard case in point happens when one player takes an obligation, that subsequently he has an interest to renege. In such a case the counterpart can consider as non credible the promised future course of action and anticipating the violation of commitment tends to ask for a guarantee or a compensation, in order to avoid a future breach of the explicit or implicit contract passed between the two players.
In our case the mentioned scheme describes the strategic constellation in which the enlargement negotiations have been cast. Following Heinemann (2002), an important character of the accession process is that ex- ante a candidate has a bargaining power lower that that enjoyed ex-post, in the aftermath of joining. Once the admission barrier has been overcome, the new member country is fully entitled to try to change the conditions and to heighten its claims. Therefore a possible promise not to act against the interests of the current or incumbent member countries (for instance to accept the existing distribution of structural aids to the different regions) is subject to the time inconsistency issue already described.

Fig. 1 – Extensive form of the accession game



Source: Heinemann (2002).

The accession game can be pictured as in Fig. 1, in its extensive form. The players are the incumbent country I and the candidate country C, with payoffs respectively expressed by i and c. The first move is made by the incumbent, who has to decide whether to open negotiations or no. The second move is taken by the candidate, who has two options: to respect the promise not to act against the incumbent's in-

terest (case 1), or not (case 2). Given that the candidate has an interest not to respect the promise (in the sense that his payoffs are: c2>c1), the incumbent anticipates his defection and stops the accession (case 3). So, the only means to produce accession for the candidate is to offer a credible commitment to follow the respect path.
With the help of such a scheme, the Treaty of Nice can be deemed as the tool that has offered the members of the Council (the incumbent states) and of the European Parliament (the incumbent MPs) with their individual specific interests the institutional innovations necessary to guarantee in a credible way the respect of their interests, paving the way for their assent to the accession (Heinemann, 2002).
Nevertheless the outcome that has emerged from the Treaty of Nice is sub-optimal since the Union as a whole has reduced its capability to act. Indeed, in contrast with official statements, in the Nice framework the decision mechanisms of the Union have not been improved and the probability that any proposal can be adopted with the cumbersome procedures introduced has decreased to 2 %.

3. The economic background of enlargement

In general terms the candidate countries display a level of economic development far enough from the UE's. Considering the GDP per capita at purchasing power standard they have levels of income which on average barely reach the 40 % of the EU-15, ranging from values of 5,200 for Turkey to 18,500 for Cyprus, against a EU benchmark of 23,150 (see Tab. 1 and 2). More in detail, in the two groups of Luxembourg and Helsinki, we can distinguish a first subset of more advanced countries, with per capita GDPs going from 60 to 90% of the EU-15 average (Cyprus, Slovenia and the Czech Republic), a second subset of middle income economies (Malta, Hungary and the Slovakia Republic, with 50-60%) a and a last subset of backward countries, whose GDPs are comprised in the range 20-40% (Poland, Estonia, Lithuania, Latvia, Bulgaria and Romania). In addition Tab. 1 informs us that in the year 2000 only Poland, Slovenia, Hungary, Slovakia and the Czech Republic had completed the economic transition, in the sense that their income had climbed to the levels preceding the disruption of the command economy, before the 1989 fall of the Berlin wall.

Tab. 1 – Candidate countries, selected indicators (2000)

	Population in million	Nominal GDP (euro billion)	PPS GDP (euro billion)	Per capita PPS GDP (EU-15 = 100)	GDP 2000 (GDP 1989 = 100)
Luxembourg group					
Cyprus	0.8	9.5	12.9	86	--
Estonia	1.4	5.5	12.4	38	83
Poland	38.7	171.0	342.1	39	127
Czech Rep.	10.3	55.0	135.5	59	98
Slovenia	2.0	19.5	31.0	69	114
Hungary	10.0	50.3	115.1	51	104
Tot. 1st group	63.2	310.8	649.0	46	--
Helsinki group					
Bulgaria	8.2	13.0	51.4	28	71
Latvia	2.4	7.7	15.9	30	64
Lithuania	3.7	12.2	27.6	33	65
Malta	0.4	3.9	4.9	56	--
Slovakia	5.4	20.9	58.1	48	103
Romania	22.5	40.0	117.3	23	77
Tot. 2nd group	42.6	97.7	275.2	29	--
Tot. candidates	105.7	408.5	924.2	39	--
In % EU-15	28.1	4.8	--	--	--
EU-15	**376.5**	**8523.1**	**8523.1**	**100**	**--**

PPS = Purchasing Power Standard. Sources: EBRD (2001); ISAE (2002).

At the same time, even though their economies are characterised by a heavy presence of the service sectors, followed by manufacturing, with a magnitude order not too different from that prevailing in the EU, the weight of agriculture, both in the GDP structure (Tab. 3) and in the total employment (Tab. 4) exceeds by large the EU-15 figures. Remarking that all the levels of agriculture in the candidate countries are higher than in the EU, in the first case some countries record a weight six-seven times more important than that of the present EU (Turkey, Bulgaria and Romania), whereas in the second the divergence is much more worrying, with a share of agriculture in total employment, that compared with the present EU situation for Romania and Turkey is ten, seven-fold.

Tab. 2 – GDP per capita at purchasing power standard and population in the EU and accession countries in 2001

Country	GDP per capita, PPS	Population in million
EU-15	23,160	380.5
Cyprus	18,460	0.7
Slovenia	15,970	2.0
Czech Republic	13,280	10.3
Malta	11,900*	0.4
Hungary	11,880	10.2
Slovakia	10,780	5.4
Estonia	9,820	1.4
Poland	9,210	38.6
Lithuania	8,730	3.5
Latvia	7,710	2.4
Bulgaria	6,510	7.9
Romania	5,860	22.4
Turkey	5,210	68.6

*Note: *) 2000. Source: Eurostat (2002), quoted in Jovanovic (2002).*

Tab. 3 - Structure of GDP in accession countries and the EU in 2001 (%)

	Structure of GDP in %		
Country	**Agriculture**[a]	**Manufacturing**[b]	**Services**
EU	2.1	22.3	75.6
Bulgariac	13.8	23.0	63.2
Cyprusd	4.2	13.3	82.5
Czech Republic	4.2	32.8	63.0
Estonia	5.8	22.7	71.5
Hungaryc	4.2	28.3	67.5
Latvia	4.7	18.7	76.6
Lithuania	7.0	28.3	64.7
Malta	2.4	24.5	73.1
Poland	3.4	25.4	71.2
Romania	14.6	28.5	56.9
Slovakia	4.6	27.5	67.9
Slovenia	3.1	31.0	65.9
Turkey	12.1	23.8	64.1

Note: a) Agriculture, hunting, forestry and fishing; b) Excluding construction; c) 2000; d) 1999.
Source: Eurostat (2002), quoted in Jovanovic (2002).

Such an economic structure implies that enlargement is set to change in a dramatic way the framework of the EU economy and policies. The increased weight of agriculture and the deepened differences between the most advanced and the backward regions in the Europe-wide market, in particular, posed a difficult challenge to the Union. And indeed these structural issues have not only be considered for long as stumbling blocks in the accession negotiations, but have induced the EU to accelerate the reform of the PAC and extend to the prospective member countries the structural policies only in a progressive manner, during a transition period, as

we shall see in next sections.
Despite the difficulties arisen during the negotiation period, now that the joining has be decided to occur in May 2004, enlargement is presently considered as being a positive sum game, i. e. with net benefits for all involved players, improving their welfare.
Concerning the candidate countries, the following gains from accession have been singled out (Jovanovic, 2002):

1. First of all the free entry into the vast EU market for goods such as (agricultural products, textile, steel, chemicals), for which they enjoy of remarkable comparative advantages,
2. Secondly the reduction of the high levels of unemployment through the freedom of migration into the EU market after the transition period, even if on the basis of experience following previous enlargement, the migration flows will possibly be lower than someone could expect;

To these, we can add the static and dynamic pro-growth effects linked to the participation to a big and dynamic market such as the EU one, with the ensuing possible acceleration of the catching up process with the higher levels of development prevailing in the EU.

Tab. 4 – Unemployment rate and share of agriculture in total employment in the EU and accession countries in 2001 (%)

Country	**Unemployment rate**	**Agriculture in total employment**
EU	7.6	4.3
Bulgaria	17.3	26.7
Cyprus	3.5	4.9
Czech Republic	8.9	4.6
Estonia	7.2	7.1
Hungary	8.0	6.1
Latvia	7.7	15.1
Lithuania	12.9	16.5
Malta	4.9	2.2
Poland	17.4	19.2
Romania	8.6	44.4
Slovakia	18.6	6.3
Slovenia	11.8	9.9
Turkey	7.9	35.4

Source: UNECE (2002); Eurostat (2002); European Commission (2002), quoted in Jovanovic (2002).

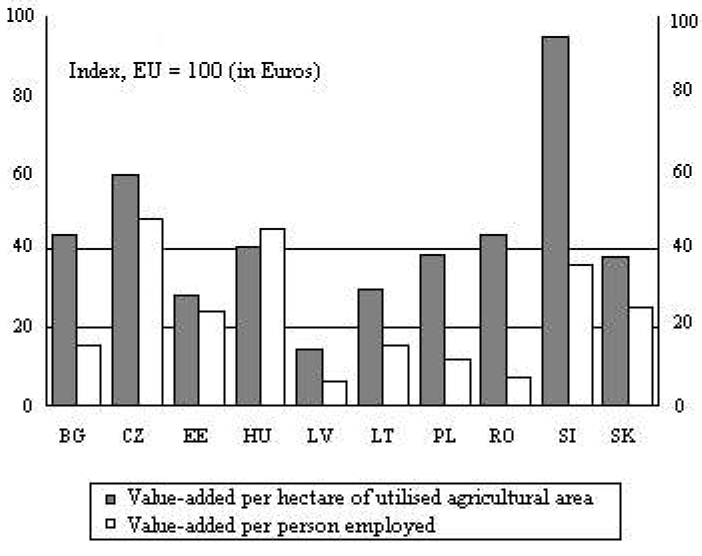
As to the latter, the gains could be represented above all by geo- political assets such as the stabilisation of the central European area with positive consequences for the EU security, but also by economic advantages, above all in the form of availability of a generally young and good trained workforce and more than 100 new consumers, endowed with prospective growing income, even though the present economic weight of the accession country is comparable to that of the

Dutch economy.
In particular the growing consumption in the new member countries could ignite for the Union as a whole a fresh growth engine, alike but possibly less powerful than that working at the heart of the integration process during the first phase of trade liberalisation and the setting up of the customs union, during the Sixties (Praussello, 2003, a).

4. Impact on the Common Agricultural Policy and on the structural policies

As already hinted, the agriculture sector has played a major role within the accession negotiations, inducing the EU to strengthen the reform effort of the CAP, not the least in order to avoid the huge financial burden that would have been associated to the extension of the unreformed CAP rules to newcomers.
Following the adhesion of the 10 Central European acceding countries the workforce employed in agriculture will more than double, rising from 7 million workers to 17 million, with an improvement of only 13% of the sectoral value-added, due to the low productivity of the Eastern farming (see Fig. 2). Indeed, according to the Second Report on Economic and Social Cohesion (EC, 2001), the latter in terms of value-added per worker is only 9% of the EU figure.

Fig. 2 - Value-added in agriculture in Central European countries (1998)



Source: EC (2001).

Despite the common feature of general backward conditions of the sector, agriculture in those countries displays three different models. Some countries such as Poland, Romania and Bulgaria have a semi-subsistence farming; others such as Hungary, the Czech Republic and Slovakia are characterised by large farms market oriented; and between the two the Baltic countries suffer from low productivity

levels, due to recent restructuring and recessions (Marenco, 2003).
In the aftermath of Eastward enlargement the agricultural trade with the newcomers and the EU-15 is expected to increase, owing to the existence of comparative advantages in those countries above all thank to the lower labour costs (Basile and Spampinato, 2003).
In this framework the measure of the pro-trade effect of enlargement will depend on the structural change occurring in Eastern agriculture following the new marketing opportunities offered by the accession and the participation the CAP, with its support mechanisms.
The ongoing CAP reforms, recently approved by the EU member countries in the framework of the mid-term review fostered by the Commissioner Fischler point to decoupling the agriculture subsidies from production by linking them to surfaces and to strengthen rural development programs, promoting a more market oriented and sustainable agriculture (Marenco and Praussello, 2003). For the newcomers, all this is set to increase the speed of transition to a more efficient farming, subduing the protection effects linked to price support measures.
In the same vein, the EU has succeeded in avoiding a big bang approach to the complete ed immediate transfer of CAP rules to the new entrants at the moment of their accession. In fact, for the new member countries a system of gradual phase-in between 2004 and 2013 for agricultural direct payments has been decided: direct payments will start at 25% in 2004, shifting to30% in 2005 and 35% in 2006, with increases by 10 percentage steps to reach 100% in 2013. In addition, new member countries will receive special extra financial aid for rural development during a limited period, namely in the form of a higher proportion of EU co-financing in rural development projects.
Concerning the structural policies, it is widely known that in the aftermath of enlargement the disparities between regions and countries will markedly increase. In regions containing the most rich 10% of EU population in contrast with the regions with the poorest 10%, the ratio of income per head will be 1:6 in a EU-27, up from 1:2.6 in the EU-15 (EC, 2001).
Against this background, according to the Commission the challenges posed by enlargement will be three-fold (EC, 2003, a). On the one hand, divergences among regions will be magnified, as already mentioned. On the other hand the centre of gravity of cohesion policies will shift to Eastern Europe. And thirdly the disparities prevailing in the former EU-15 will persist, requiring further interventions. The Commission has presented specific aid programmes (among them ISPA: Instrument for Structural Policie for Pre-accession, Interreg III) within the budget of €22 billion earmarked for Structural and Cohesion Funds in the period 2004-2006, respecting the general financial EU ceiling. The latter point is a consequence of the budgetary tenet, according to which the present low profile EU budget (not exceeding 1.27 per cent of the EU GDP) cannot be increased in order to finance enlargament. It is nevertheless doubtful that in the future such a limit cannot or has not to be disregarded.

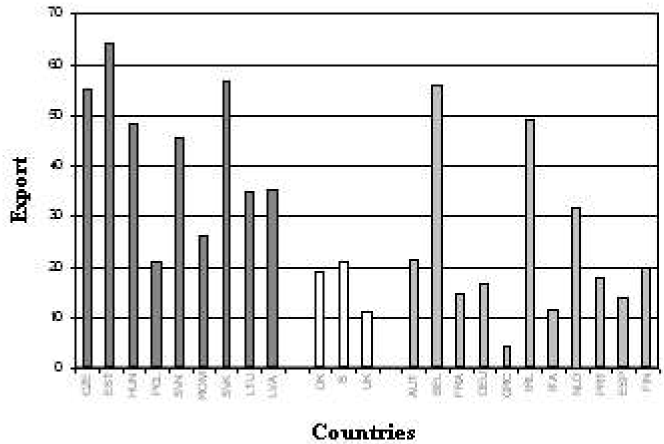
In any case, recent inquiries confirm that Structural Funds contributed to reduce regional disparities within the current 15 European countries, and that a good tool for fostering growth in the acceding countries would be to channel to them a large share of the Funds available in the framework of the future 2007-2013 EU financial agreement (Beugelsdijk and Eijffinger, 2003).

5. Impact on EMU

As a matter of common knowledge, the economic conditions of the new entrants are quite different from the EU averages. As a consequence, the disparities among the different EU regions are bound to worsen, weakening the future economic fabric of EMU. In this conditions, the degree of heterogeneity following enlargement could increase at a point, where the stability of a wider EMU could be imperilled.
In fact by itself the eurozone can scarcely be considered as an Optimal Currency Area (OCA), i. e. a viable monetary union where the possible shocks are equally distributed among component countries or region without being concentrated in one or in a few number of them (asymmetric shocks). So in principle a further reduction of the optimality conditions, if slight enough, would not necessarily entail the disruption of EMU. It should not be forgotten that since the early 1990s a process of real convergence of the applicant countries is under way that could have progressed enough to render their integration compatible with the stability of an extended EMU. Consider also the fact that in the aftermath of the enlargement the convergence has to continue, as the new entrants have to met the Maastricht nominal criteria before being admitted to the eurozone (Praussello, 2002).
Against this background De Grauwe (2003) argues that, taking into account the openness as optimality criterion, the Central European countries are more open towards the EU than some EU member countries such as Denmark, Sweden and the UK, which have decided not to join the eurozone (see Fig.3). Nevertheless, quoting the exercise by Korhonen and Fidrmuc (2001) on the asymmetry of shocks between each of the acceding countries with those taking place in the euro area, he adds that only for a number of Central European countries the correlations of demand shocks have the right sign, whereas the correlations of the supply shocks are in general low. It seems therefore that they have a limited interest in joining the eurozone, even though they could import monetary and price stability, with a final possible positive net result.
Yet more important is the fact that in an enlarged EMU the present member countries could experiment a worsening of their costs-benefits balance. Following the increased asymmetries of shock, they could more often find themselves in a position of outliers, realising that the European Central Bank (ECB) monetary policy does not take enough into consideration their needs. In a nutshell, this state of affair can be described in the terms shown in Fig. 4, along the axes of divergence and integration. While the present EMU-12 is not far from the optimality condition

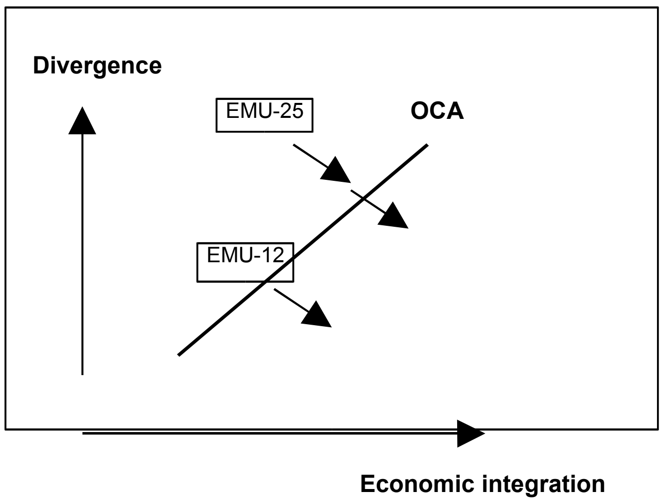
and the increased economic integration is set to shift it beyond the OCA line, the prospective EMU-25 (including also Sweden, UK and Denmark) will be more far from it and placed higher up along the divergence dimension.

Fig.3 – Exports of goods and services towards EU-15 as % of GDP (2000)



Source: De Grauwe (2003).

Fig. 4 – Worsening of the EMU optimality conditions following enlargement



Source: Adapted from De Grauwe (2003).

All this entails a more difficult task for the governance authorities of EMU in stabilising the economy: the ECB and the national governments, which are responsible respectively for the monetary and for the budgetary policies within the eurosystem. The social cost of the monetary rule in order to ensure the price stability could rise (Altomonte and De Pace, 2003), whereas the coordination between the monetary policy and the different budgetary policies as well as the compatibility among the latter would become more elusive. Nevertheless, even though in a more fragile context, the fabrics of an enlarged EMU could be strong enough to avoid a breakdown.

Tab. 5 – Johansen-Juselius (JJ) co-integration test results, 1980-2000 (§)

Number of co-integration equations at 5% significance level					
Eview co-integration assumptions	*i*	*ii*	*iii*	*iv*	*v*
Data trend	None	None	Linear	Linear	Quadratic
Rank or No of Ces	No intercept No trend	Intercept No trend	Intercept No trend	Intercept Trend	Intercept Trend
HM, PM, GM	3	3	3	2	1
HGDP, PGDP, GGDP	1	2	1	2	3

H = Hungary, P = Poland, G = Germany, M = Money stock, GDP = GDP in volume.
Note: (§) Period for HGDP, PGDP, GGDP: 1981-2000. Source: Praussello (2002).

Indeed a number of exercises concerning some crucial variables in the current EMU and within the acceding countries allow to find evidence of the existence of some common structural features between the two kinds of economies. Considering on the one hand two representative countries of the new entrants, Poland and Hungary, and Germany as the core country of the current EMU, on the other hand, in Praussello (2002) a co-integration relation between the monetary stocks and the GDPs is found, showing the existence of a long term stable relationship among the countries under scrutiny, i. e. a necessary condition for the stability of an enlarged EMU (see Tab. 5).

Tab. 6 – Correlations with the EMU cycle (10 acceding countries in 2004)

Positive	**correlations**	**Negative**	**correlations**
Slovenia	0.90	**Estonia**	-0.08
Cyprus	0.63	**Lithuania**	-0.17
Hungary	0.61	**Czech Republic**	-0.53
Poland	0.19	**Slovak Republic**	-0.71
Latvia	0.15		
Malta	0.01		

Source: Authors' calculations based on World Development Indicators database.

In addition a second exercise finds the signs and the levels or correlation between the cycles of each acceding country with the EMU cycle, the assumption being that high correlations can be considered as evidence of low risk of shock asymmetry and hence of optimality conditions. In Tab. 6 we give the results of our calculation, whilst in Fig. 2 the graphs of the most converging country, Slovenia, and of the most divergent one, the Slovak Republic, are plotted, showing the kind of relationships found. In the first case the two cycles are almost coincident, and in the second have opposite links. The outcome of the exercise points to the existence of

low risk of shock asymmetry (Praussello, 2003, b).
The conclusion is therefore that an enlarged EMU has enough optimality conditions to be assessed as viable.

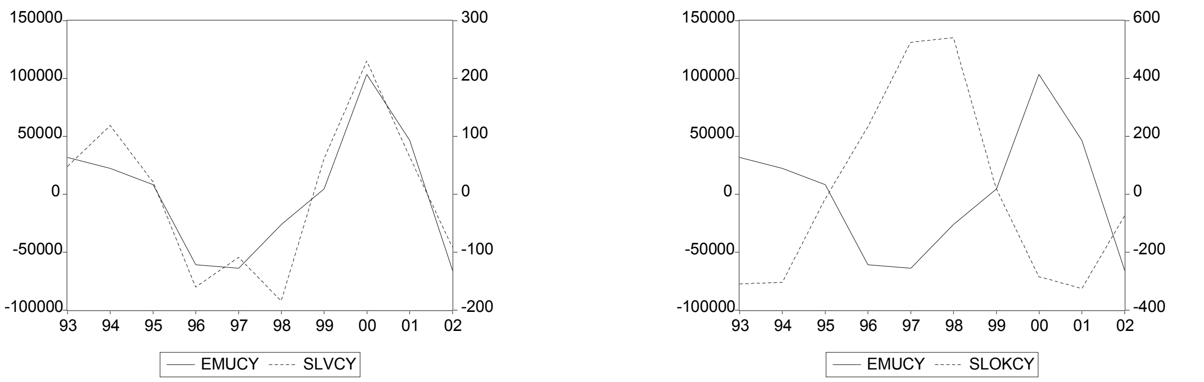
Tab 7 – **Correlations with the EMU cycle (Bulgaria, Romania, Turchia)**

Bulgaria	**0.31**
Turkey	**-0.23**
Romania	**-0.62**

Source: Authors' calculations based on World Development Indicators database

Taking into account a possible further enlargement, this conclusion has to be qualified. A similar exercise carried out with reference to the candidate countries to a further wave of accession makes clear that the correlation matrix contains positive values for Bulgaria and negative values for Turkey and Romania, the latter being the most divergent country in this group of economies (see Tab. 7). The hope is that the shock linked to the possible joining of Turkey and Romania could be reduced by an appropriate transition period.

Fig. 5 – Links between cycles in EMU and in the most convergent (Slovenia) and in the most divergent country (Slovak Republic) (1993-2002)



Source: Tab. 6.

6. On the eve of enlargement

By the end of 2003, six months before the accession, the Regular Report on the candidates countries focus on the preparedness of the new entrants in comparison with the obligations linked to the EU membership (EC, 2003, b) The principle being that they have to apply the full body of EU legislation or acquis communautaire from the beginning of membership, the Report strikes a balance between the many elements of progress achieved and the limited matters of concerns, requiring addition efforts.
Generally speaking, the accession countries are deemed as ready to take up the obligations of membership, with a number of exceptions. 2003 Report confirms

therefore the judgement contained in previous year's Report stating that the acceding countries fulfil the Copenhagen political criteria and have functioning market economies.
More in detail, improvements have been recorded on the issues of economic policy, with sustained economic growth and reduction of inflation rates, of legislative ad administrative reforms, with wide-ranging adjustment measures, bringing to the conclusion that in most areas of acquis "preparations for membership have been virtually completed".
Yet a number of issues remain unresolved. Among the issues requiring enhanced efforts a list of recommendations is given for each new entrant, ranging from the fields of free movement of goods, services, persons and capitals, to intellectual and industrial property rights, or social policy and employment. Among the areas of serious concern the Commission identifies 39 issues grouped in those affecting the internal market and those affecting the delivery of EU funds. As instances of unresolved issues of the first kind one can quote the delay in improving the control and inspection measures on fisheries fleet for Lithuania and Poland, where in the second area setbacks in setting up procedures for CAP interventions in particular for Cyprus, Hungary, Malta, Poland and Slovakia can be singled out.
Despite these reservations the Commission holds on its opinion that the ten countries "will be ready for membership from beginning of 2004".
In any case the positive judgment expressed by the Commission is supported by the outstanding economic achievements recently recorded in the eastern acceding countries. Compared with the dire growth figures in western Europe, their economic performance can be deemed quite satisfactory, with an increase in the aggregate GDP exceeding 3%, and growth rate ranging from 4.5 to 6.5 for the Baltic states (EBDR, 2003). Even though their macroeconomic outline contains still too high unemployment rates, their dynamism could help the EU to increase its growth perspectives in the aftermath of accession (Beuve-Méry, 2003).

7. Conclusions

The aim of the paper was to describe in a nutshell the possible economic effects of the EU enlargement due to take place in 2004. Even if the accession of the new member countries has been prepared for long their entry is set to change in a significant way the functioning of the EU, both from the institutional and the economic standpoints. The present EU-15 member countries have obtained credible commitments to respect their interests in the aftermath of enlargement, but the institutional reform put forward by the prospective European constitution could change the game rules. What is sure is that should the ongoing 2003 inter-government conference not succeeding in reducing the veto power of the government, the Union could de reduced to a state of institutional paralysis. Indeed, on the basis of the decision mechanisms adopted by the Nice Treaty, any action proposal within the

Union has barely 2% of probability to be approved.
From the economic point of view, the extension of CAP rules and of the support measures provided by the structural funds is set to increase the growth prospective both of the Union and of each acceding country, even though implementation difficulties will possibly be present.
In the paper a particular emphasis has been put not only to assess the impact of enlargement CAP and the structural policies, but also on the EMU stability.
Following their accession, the new entrants will have a formal duty to join the eurozone, albeit after having successfully completed the nominal convergence process with the present member countries required by the Maastricht criteria. During the transition period from EU to EMU they could achieve a degree of flexibility required to adjust their economies to the occurrence of country specific shocks by means of an exchange rate mechanism not too dissimilar from the EMS (Prausello, 2002).
The perspective of an early extension of the eurozone to the new member countries could in principle pose some threats to EMU, because of the increased heterogeneity of the currency union engendered by the admitting of countries whose economic conditions are far-away from the average of the current members. But the results of the exercises presented in the last part of the paper support the hope that enlargement will not be followed by a disruption of the most ambitious goal so far achieved by the Union: the monetary building set up around the euro.

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