

EVERYONE WILL GAIN FROM ENLARGEMENT, WON'T THEY?

The next enlargement will be an event of unprecedented political and institutional importance for the European Union. The development gap between the present and future members will also make this an original economic experiment. But trade is already largely liberalised, as investors have anticipated membership. The consequences of enlargement are therefore likely to have less to do with massive competition in a few industries than complex changes in integrating markets. Simulations carried out using the MIRAGE model indicate that belonging to a vast single market will provide substantial gains for the new members which will also benefit from joining the Common Agricultural Policy.

The signing of the membership Treaty for the 10 new members of the European Union, in Athens on 16 April last, marked the end of the negotiating process. In May 2004, these 10 countries will join the Union. This fifth enlargement clearly has a special political dimension as it aims at unifying Europe. By moving from 15 to 25 members, the Union's size will change fundamentally. Institutional issues are primary concerns, bearing little relationship to the modest economic weight of the new members. In reply to worries over enlargement, Wim Kok, the former Dutch Minister, presented a report to the Commission on 26 March, in which the reasons for enlargement are recalled and the reforms necessary to its success identified¹.

In commenting the report, Romano Prodi affirmed that, "the message is clear, everyone will be a winner"². Does this general point of view also apply to the economics of enlargement? Will all countries benefit, will all sectors gain and will the labour market improve as a whole? How will enlargement work economically given that the EU will be positioned on a new scale of activities, a new scale of actions at a continental level which may permit it to work more efficiently?³

■ A Unique Integration

From an economic point of view, the fifth EU enlargement is quite special. The 20% increase in the Union's population is less marked than the 1973 enlargement which brought the United Kingdom, Ireland and Denmark into the Community of Six, raising the population by 34%. But the entry of East European countries into the Union brings in countries whose income per capita is far lower than that of existing members. When Spain and Portugal joined in 1986, their income per capita stood at about 70% of the Community average. In contrast, the future members of the Union currently only have an average income per capita equivalent to 40% of the EU15⁴. This gap in development has frequently led to comparisons between the enlarged EU and NAFTA. But the NAFTA is not an integrated market, nor even a common market and does not rely on common policies. NAFTA has no equivalent to the European budget, nor any redistribution mechanisms aimed to bring about income convergence between its member countries.

Europe's eastward enlargement is therefore unique, raising new questions. The difference in the economic size of present and future members of the EU suggests that the

1. *Enlarging the European Union, Achievements and Challenges, Report of Wim Kok to the European Commission*, <http://europa.eu.int/comm/enlargement/communication/pdf/report_kok_en.pdf>.

2. Quoted in "7 jours Europe", No 509, 1 April 2003.

3. *EFN Spring Report* (2003), Chapter 2, <www.cepii.fr> and H. Bchir, L. Fontagné & P. Zanghieri (2003), "The Impact of Enlargement on the Current and Prospective Member States", *CEPII Working Paper*, forthcoming.

4. The income gaps are calculated at purchasing power parity.

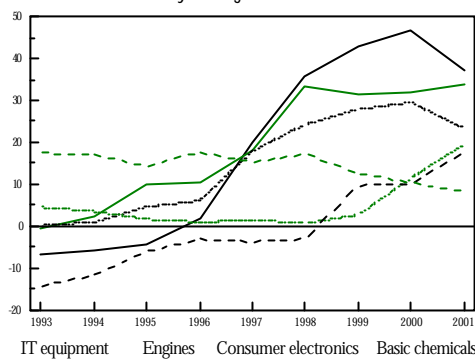
macroeconomic impact on the former will probably be limited⁵. But this development gap with the present Union has several consequences⁶. To begin with, the low income levels of the new members is associated with a large share of agriculture in output. This fact, which is a simple reflection of their overall level of development, is especially important in the European Union, as it allocates a large share of its budget to farm support mechanisms. Secondly, in the wake of economic integration, income differences could have marked sectoral effects. According to classical trade theory, in which comparative advantage plays a key role, present compensation levels in the new members⁷, or indeed technology levels, could lead to a massive re-location of labour-intensive industries to them. It is perhaps from this point of view that the comparison with Mexico's situation with NAFTA is most relevant. The most labour-intensive industries are of course most concerned, but so are the automobile industry, mechanical industry, electrical equipment and information technology, even though by definition countries cannot specialise in all these activities. However, several mechanisms could lead to results that are significantly different to those suggested by classical analysis.

■ Effects That Are Generally Underestimated

2

It should be remembered that trade between the Central and East European Countries and the European Union has been largely liberalised since 1994. With the notable exception of agricultural products, access to the European market is only presently restricted by the possible use of anti-dumping measures. The European Union is already the main trading partner of the candidate members (68% of exports by the new members are already shipped to the EU)⁸ and the specialisation process is already largely underway. This point is well illustrated by Hungary (see Graph). The country's specialisation in clothing, in the early 1990s, has given way to the spectacular rise of new strengths in IT equipment, engines and consumer electronics. The role of foreign direct investment in this process need not be recalled: private companies have largely anticipated enlargement and so have heavily committed themselves to restructuring their manufacturing operations.

Graph — Hungary's industrial specialisation (1993-2001)
Key strengths in 2001*



* The indicator is expressed in thousandths of GDP. Its definition may be found at: <http://www.cepii.fr/francgraph/bdd/chelem/indicateurs/indicspeit.htm>.
Source: CEPII, CHELEM database.

Moreover, as stressed by contemporary approaches to international trade, product differentiation, the existence of increasing returns to scale in production and imperfect competition are all likely to modify the nature of trade. This tends to lead more to specialisation at a detailed product level, or in certain quality ranges, rather than a broad specialisation in major sectors or industries. This form of specialisation, which has already been largely documented for the Single European Market⁹, is also at work in those candidate countries which benefit from association agreements with the EU. Thus M. Freudenberg and F. Lemoine, and more recently M.A. Landesmann, have shown that the share of intra-industry trade in the overall trade of the Czech Republic is now similar to the European average, when measured at a detailed product-level¹⁰. This reflects the shift of trade based on low labour costs to the type of trade which characterises more diversified, catching-up economies. The benefits of such trade in varieties of differentiated goods are theoretically higher, given increasing returns to scale and greater choice offered to consumers¹¹. Under these conditions, the fear that enlargement will lead to massive competition in a few industries is largely unfounded. Inter-industry specialisation, and hence the shift of resources from one industry to another along with the induced adjustment costs, will no doubt be limited. The impact of enlargement on labour markets will be far more complex than postulated by traditional analyses and will not necessarily be unfavourable to unskilled workers in high-income countries.

5. H. Bchir & M. Maurel (2002), Impacts économiques et sociaux de l'élargissement pour l'Union européenne et la France, *CEPII Working Paper*, No 2002-03, <www.cepii.fr>.

6. Migration issues are not dealt with here. According to T. Boeri & H. Brücker, migration will not peak for a long time, and should not exceed 1.1% of the population: see *The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States*, European Integration consortium, 2000.

7. These currently stand at 15% of the EU's average at current exchange rates, and at 25% in terms of purchasing power parity.

8. Given their difference in economic sizes, only 4% of the EU15's exports are shipped to the future member states.

9. L. Fontagné, M. Freudenberg & N. Péridy (1998), "Intra-Industry Trade and the Single Market: Quality Matters", *CEPR Discussion Paper*, No 1959.

10. M. Freudenberg & F. Lemoine, "Central and Eastern European Countries in the International Division of Labour in Europe", *CEPII Working Paper*, No 1999-05; M.A. Landesmann (2003), "Structural Features of Economic Integration in an Enlarged Europe: Patterns of Catching Up and International Specialisation", *European Commission Economic Papers* 181.

11. T. Boeri & J. Oliveira-Martins (2002), "Transition, variété et intégration économique", *Economie et Prévision*, 152-153.

From a budgetary point of view, enlargement will have two immediate consequences for the present members of the Union. First, a 10 to 15% fall in the average income level of the enlarged Union, with 25 members, will automatically improve the relative position of the 15 present members. If the rules for attributing structural funds are not changed, then such funds are likely to be withdrawn from about half the regions currently benefiting from them¹².

Secondly, budgetary commitments to the new members will constitute a cost to the EU15. From this perspective, what will be the impact of the decision reached at the Copenhagen summit in December 2002 to commit €40.85 billion to the new members over three years (2004-2006)? To appreciate the size of these sums, it is useful to start by assessing the respective share of commitments appropriations and payments appropriations in this total planned disbursement. Of the total, the latter comprise €27.88 billion over three years. Next, it should be born in mind that the new members of the Union will also contribute to its budget, so calculations should be made in terms of net transfers. Contributions by the new members (based on VAT, customs duties and the GNP contribution) have been estimated to amount to €14.7 billion for 2004-2006¹³. The transfers to the new members will partly be aimed at projects to be co-financed by the Union's budget and by national budgets. Depending on certain assumptions made about the ability of the new members to mobilise capital for co-financed projects, S. Richter has estimated that the actual net flows to these countries will turn out to be between €5 and 10 billion, over the three years. In annual terms, this represents 0.8% of GDP at best for the new members and 0.04% of GDP for the current EU15. Otherwise, the costs of enlargement will largely depend on possible reforms of the Common Agricultural Policy and on the attribution of structural funds. According to B. Karlsson (quoted in the Kok report), these costs will account for between 0.11% and 0.23% of the enlarged EU's GDP, in 2013.

■ Complex Transmission Mechanisms

The developments discussed above suggest that the economic effects of enlargement will probably be quite different from what is generally assumed. In industry, enlargement is likely to lead to a more complex integration of markets than to a simple "openness shock". For the EU budget, the net effect on transfers may turn out to be generally modest, but extending the CAP to the new members

of the Union will impact significantly on the allocation of resources. The CEPII's model, MIRAGE¹⁴, offers a coherent and dynamic framework for drawing together the integration effects for goods and factor markets, while taking into account country size, market structures (types of competition), the specificity of production factors (which is particularly relevant in the case of agriculture), as well as the degree of substitutability of goods from different sectors and countries of origin.

Three simulations have been carried out successively to illustrate the main components of integration. The first scenario refers to a "customs union", and simulates the suppression of all existing tariff and non-tariff barriers to trade between the 25 countries, along with the adopting of a common external tariff (CET); but European markets remain fragmented. The second "single market" scenario adds market integration to the first scenario. It draws on the framework used by Smith, Venables and Gasiorek¹⁵ in which companies, acting within a completely integrated market, make decisions which consider the market as a whole. This affects the degree of competition, price formation and size of companies. Lastly, the "accession" scenario extends the second by assuming that all new members participate in the CAP.

The impact of trade liberalisation simulated in the first scenario is very limited. Indeed, it is negligible for the eurozone, even for a period running to 2015: GDP does not move significantly from its reference path and the variation in wages is limited to 0.5%. For the new members, which liberalise their own trade with the EU15 and adopt the CET, the impact on GDP becomes positive after a short period of adjustment, but its scale remains modest, reaching 3% for Hungary by 2015, and less than 2% for Poland. In the medium term, the simulation suggests wage movements that are contrary to what would be expected within the classical analysis of trade: wages of skilled labour in the new members benefit from openness whereas wages for unskilled labour remain below the base scenario. This phenomenon may be explained by the reinforcement of the specialisation in activities which are relatively intensive in human capital¹⁶.

In the case of market integration, the impact on the new members is more pronounced. In a 25-member single market, the size of their reference market changes radically. It leads to a fall in the number of firms and a rise in their size, which may reach 20%-25% in certain sectors (Table 1). Overall, as Hungary illustrates (Table 2), the negative effects of short term adjustment disappear and the long term gains are amplified. The negative impact on the wages of unskilled

12. For a detailed analysis see C. Weise (2002), "How to Finance Eastern Enlargement of the EU", *ENEPRI Working Paper 14*, <www.enepri.org>.

13. S. Richter (2003), *Fiscal and Financial Aspects of EU Enlargement: the Issue of Transfers*, *WIIW Spring Seminar*, Vienna.

14. H. Bchir, Y. Decreux, J-L. Guérin & S. Jean (2002), "MIRAGE, a Computable General Equilibrium Model for Trade Policy Analysis", *CEPII Working Paper*, No 2002-17, <www.cepii.fr>.

15. A. Smith, A. Venables & M. Gasiorek (1992), "1992: Trade and Welfare; a General Equilibrium Model", *CEPR Discussion Paper 672*.

16. The Baltic States, which are specialised in petroleum products, agricultural products and clothing are an exception in this case.

labour is dampened, and the positive consequences for skilled labour increased.

Table 1 — The impact of market integration on firm size, in 2015*

	Euro zone	Other EU15	Hungary	Poland	Baltic States	Other new members
Machinery and equipment	-0.4	-0.1	3.8	-0.7	0.1	-0.9
Automobiles	-2.5	-1.6	12.9	2.4	-	6.8
Textiles, clothing	0.0	-0.1	1.5	-0.9	0.1	1.2
Wood	-0.3	-0.1	23.4	8.3	22.3	32.9
Electronics	-0.3	-0.2	1.0	1.0	-0.0	-1.4
Chemicals	-0.1	-0.2	6.8	1.2	1.2	-4.6
Metal Products	-0.8	-0.2	24.4	15.3	4.1	24.3
Transport	0.8	0.5	1.8	0.5	-2.7	-13.0
Other industries	0.0	-0.0	6.1	1.6	2.3	3.3
Other services	-0.0	-0.0	24.7	25.0	22.5	23.1

*Change in the level of output by firm between the reference scenario and the "single market" scenario, in %.

Source: H. Bchir, L. Fontagné & P. Zanghieri, *op. cit.*

Table 2 — The macroeconomic impact of the three scenarios*, Hungary

	Customs union			Single Market			Accession		
	2005	2010	2015	2005	2010	2015	2005	2010	2015
GDP volume	-0.5	1.2	3.0	0.5	2.4	4.1	3.0	5.8	7.6
Unskilled wage	-7.3	-4.9	-2.7	-4.2	-3.5	-1.5	-4.1	-2.3	-0.2
Skilled wage	-2.1	0.5	3.2	1.3	1.8	4.8	1.8	3.2	6.3

* Change with respect to the reference scenario, in %.

Source: H. Bchir, L. Fontagné & P. Zanghieri, *op. cit.*

The last scenario adds CAP support for the new members to the second scenario. All countries contribute to the CAP in proportion to their GDP, and pay tariffs collected on their agricultural imports into the EU budget. These monies are then distributed among the member countries on a *pro rata* basis, according to their agricultural production. However, under the terms of the Copenhagen agreement, the new members will only receive 30% of the corresponding sums in 2005, and this proportion will rise progressively to 100% by 2012. Following from the political compromise at Copenhagen, this transition period is also a way of avoiding support for agricultural activity which is not competitive and for favouring the modernisation of the sector.

If the CAP is fully extended to the new members, the results change substantially. While the effect on the GDP of the EU15 is slightly negative, the macroeconomic benefits for the new members are far more important: their GDP in 2015 is

estimated to be 7% higher than in the reference scenario, with the exception of the Baltic States, whose resources are redirected towards agriculture, which is a sector with only constant returns to scale.

Overall, the present members of the Union would appear to be little affected by the consequences of economic integration, whereas the new members, apart from the Baltic States, would gain considerably. They will benefit from greater microeconomic efficiencies linked to market size and from the financial transfers made to them. It should also be mentioned that openness and integration could accelerate the productivity gains of the new members of the Union through other channels, which are not modelled here. In this case, their catching-up will be faster than indicated by these simulations¹⁷. This could be especially the case of the Baltic States, where the flexibility of markets is likely to favour adaptation to the Single Market. It should also be noted that integration and convergence will lead to important movements in relative prices and to real exchange rate appreciation. From this point of view, defining the central parity of the new member's currencies against the euro within an ERM Mark II will be of crucial importance. An over-valued parity could lead to a real appreciation that goes beyond that implied by economic catch-up. Conversely, an under-valued exchange rate will reinforce inflationary pressures and lead to a depreciation in the terms of trade¹⁸. The adjustment of productive structures and factor markets that will lead to the gains set out above could then be compromised. The fulfilment of Romano Prodi's statement of faith on enlargement will thus depend largely on the credibility of the parities selected for the ERM.

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17. M. A. Landesmann (2003), *op. cit.*, note 10.

18. A. Lahrière-Révil (2003), "Enlarging European Monetary Union", *La Lettre du CEPIL*, November, <www.cepil.fr>.

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