<u>TOWARDS A LARGE AREA OF SOLIDARITY AND COOPERATION</u>

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THE FACTORS OF INSTABILITY AND INEQUALITY: THE PROBLEMS SEEN FROM THE 15

Dr. Christian Weise

DIW Berlin (German Institute for Economic Research)

From the perspective of the EU-15, the GDP of the twelve applicant countries (AC) is rather small. This is also true for the countries' share of foreign trade of the EU-15; although the latter grew substantially during the 90s – due, among others, to bilateral trade liberalisation - and is not negligible. Not surprisingly, empirical studies of the overall macroeconomic impact of enlargement on the EU-15 tend to come up with positive but quite small effects. In some cases, indirect effects might be larger than direct effects, i.e. Italy might benefit less from increased trade with the applicants themselves, than from the increase in German demand caused by enlargement-induced growth in Germany. However, while the overall effect will probably be small, specific Member States, regions, sectors or parts of the labour force might be more severely affected than others. Therefore, a closer look at the features of economic integration of "old" and "new" Members is justified.

<u>Some characteristic elements of economic integration in Europe</u>

Trade

During the 1990s, the CEECs managed to redirect their exports away from the former CMEA members towards the European Union. The trade volume has increased significantly and the EU has become the most important trading partner of the CEECs. From the point of view of the EU, the AC are much less important partners. Geographical proximity seems to play a key role in determining bilateral trade flows. Main trading partners are Germany and Austria, as well as Finland, Italy and Greece on the EU side and Poland, the Czech Republic and Hungary on the CEE side. Regional trade data available indicate that this pattern also applies at the regional level. However, eastern German, as well as western Polish regions do not account for significant shares in total trade of their respective countries. CEECs have been able to change the commodity structure of their exports from inter-industry to intra-industry trade, i.e. their export structure is now more similar to that of the EU as in the early 1990s; this reduces adjustment pressures in the labour market. However, it is important to note that bilateral exchange is overwhelmingly trade in vertical differentiated products with the CEECs being exporters of product variations with lower unit values. Only Hungary seems to be an exception. There is no indication that the CEECs constitute a severe competition for the EU cohesion countries or other EU members.

FDI

As in the case of trade, recent years have seen a marked increase in FDI flows from the EU to the AC, dominated by the main trading countries but also by France and the Netherlands. While FDI flows are important for the receiving countries (most notably Hungary, the Czech Republic and Poland), Austria is the only EU member where CEE plays a prominent role as a destination for FDI flows. Other than being the case with trade, there are practically no FDI flows from the AC to the EU. The choice of destination seems to be influenced, in general, by proximity and political stability. The motives for investment are not entirely clear. While surveys show a slightly above average importance of wage costs advantages for FDI in CEE (compared with overall FDI outflows from the EU), there are also indications that this is not the dominating influence factor. Market access and first-mover advantages also play a decisive role.

Migration

Migration is often cited as the most important post-enlargement effect with automatically associated negative consequences for EU members. One reason for this is that – contrary to the GDP and the trade volume - the size of the population of the applicants is quite noteworthy. However, diligent analyses do not expect a massive influx of migrants after enlargement and see only minor – and by no means necessarily negative - effects on wage and employment in the EU. Migration flows will be directed mostly into Germany and Austria as these countries are already home to the largest shares of CEEC citizens in the EU. Actual migration flows depend on the income gap, the labour market situation in the destination country and the stock of migrants. The share of citizens of the country of origin that are already living abroad determines, on the one hand, the destination choice of new migrants. More importantly, on the other hand, it dampens the potential for further emigration from a specific country because the propensity to migrate is not distributed evenly among the population. It is, therefore, to be expected that migration flows will rise after enlargement (there are only comparatively few CEECs citizens already living in the EU). However, the inflow will not be as excessively high as sometimes expected and it will slow down over time. The actual labour market effects do not just depend on the number of migrants but also on their qualification. Highly qualified migrants can have positive effects for low qualified domestic workers.

Border regions

Border regions are potentially most affected by enlargement accentuating internal disparities inside these regions. Competitive enterprises, sectors and areas will gain from the proximity of new markets and the supply of a wider selection of inputs. Less competitive ones will suffer from increased competition. Along the EU:CEEC border, the impact will most likely be concentrated on the eastern Austrian regions. The impact is not necessarily negative on balance but the adjustment pressure will be highest here.

The assessment: The economic impact of enlargement and its consequences on welfare, employment and disparities

The direct economic effects of enlargement on the EU-15 will be concentrated, to a significant degree, on Germany and Austria. For these countries, a positive (but small) net-impact of enlargement on welfare and growth is to be expected. Their positive trade balance with the East leads to a net-gain in employment. Easily forgotten, but just as significant are the positive welfare effects for importers of intermediate goods and for consumers that are caused by imports into the EU from the applicants. Adjustment pressures are unavoidable in this process. The pressure concentrates on workers with a comparatively low level of qualifications. They produce goods which compete with imports from the AC. They are affected by FDI outflows, insofar as these flows are determined by labour costs. Thus, regions with a high share of labour-intensive production (and, to some degree, those that depend on traditional industries like coal and steel) face additional challenges. Finally, low-qualified workers tend to compete with migrants in the labour market. However, at the regional level, permanent migration will be directed to centres of economic activity, exactly because their labour markets can absorb the additional supply of labour more easily. Empirical studies on the effects of migration, even those on cases of massive migration, overwhelmingly fail to find a significantly negative impact on the labour market. The border regions will experience an increased number of commuters. This will, on the one hand, put local services under pressure, but is, on the other hand, beneficial for consumers. From a German perspective, it has to be taken into account that the western part of Poland is not the economic centre of Poland and is not very densely populated. This puts a limit on possible adjustment pressures from daily commuters.

Regions and industries of other EU-15 Members, particularly those in the cohesion countries, are not deeply involved in trade with the applicants. The most important consequences of enlargement on these countries is likely to be more competition from enterprises from the new Members operating in the German or Austrian markets and the increased demand in these markets due to the growth caused by enlargement. Existing empirical studies do not find a significant impact for either case.

Overall, the measurable positive and negative effects of enlargement will both be concentrated on the EU neighbours of the applicants. At the national level, the net balance will be positive and even in the most challenged regions (at the border) positive as well as negative effects will take place. The remaining problems can be dealt with at the Member State level. It is the responsibility of the EU, particularly the EU competition control, to ensure sufficient room for manoeuvre for national measures.

The adjustment pressure has to be put into perspective. Economic relations with the AC are only one part of the international interdependence of the EU economies. Competition from newly-industrialised countries (e.g. textiles), as well as from other EU Members (e.g. the construction sector), is in many aspects more important for lowly qualified German and Austrian workers than is competition from the AC. In addition, technological change exerts similar pressures on these groups of workers and is, most probably, much more relevant than internationalisation.

Problems ahead? Consequences of enlargement-induced changes in EU transfer policies

The effects of the enlargement-induced reforms of EU agricultural and structural policies will most probably cause more serious instability and political problems than the direct economic impact of enlargement will. The issue of CAP reforms cannot be discussed here in depth. However, it should, at least, be noted that reform pressures do not only stem from enlargement, but also from various other sources (WTO, budget, BSE, disapproval of ill-founded subsidies, etc.). Future developments are extremely unclear at the moment, but any meaningful reform would have to include a reduction of income and price support payments. Such reforms would benefit consumers (via lower prices or better quality), taxpayers (less spending or more value for money) and exporters of non-agricultural products (less trouble in WTO). The specific impact on farmers depends on the specific regulations of any reform proposal. A lack of further reform – however likely or recommendable – would mainly result in an additional burden for the net-contributors to the EU budget - most of all for German taxpayers.

The effects on Structural Funds are easier to calculate (if no reform takes place). Today, the most intensely supported regions in the EU-15, i.e. the objective 1 regions, have approx. 83 mill. inhabitants. According to calculations of DIW Berlin, this figure will fall by a quarter after 2006 due to convergence; this will happen even without enlargement. The inclusion of poorer Members lowers the average GDP for the EU. As a consequence, an additional quarter of today's objective 1 population will no longer qualify for support in an EU-25 (i.e. without Bulgaria and Romania). This will mainly affect Germany (Thüringen, Brandenburg and Mecklenburg-Vorpommern who have 6.8 mill. inhabitants), Spain (e.g. La Mancha, Murcia and Asturias; 4 mill.), the UK (e.g. West Wales and Merseyside; 3.8 mill.) and Greece (Kentriki Makedonia and Kriti; 2.3 mill.). This effect gives cause for concern in the case of Greece in particular, because Greece will remain a relatively poor EU Member even after enlargement. Germany, Spain and the UK can support their poor regions at least as well as could be done by the EU. National support as well as generous (and differentiated) compensation payments from EU Structural Funds for the affected regions should be sufficient to cushion any negative impact of enlargement.

Some recent DIW studies on the consequences of Eastern enlargement

To be downloaded from the Institute's homepage:
http://www.diw.de/english/abteilungen/wlt/projekte/

Herbert Brücker, Tito Boeri, et al. (2000): The Impact of Eastern Enlargement on Employment and Labour Markets in the EU Member States. Berlin and Milan: DIW, CEPR, FIEF, IAB, IGIER.

Christian Weise, Martin Banse, Wolfgang Bode, Barbara Lippert, Ferdinand Nölle, Stefan Tangermann (2001): Reformbedarf bei den EU-Politiken im Zuge der Osterweiterung [Necessary Reforms of EU Policies as a Consequence of Eastern Enlargement.], in co-operation with the Institute for Agri-cultural Economics, University Göttingen, and the Institute for European Policy, Berlin, commissioned by the Federal Ministry of Finance. (This does only exist in German language. For a summary in English, cf. Christian Weise, EU Eastern Enlargement Can Be Financed – Increased Need for Reforms, Economic Bulletin of DIW Berlin, October 2001.)

Christian Weise, John Bachtler, Ruth Downes, Irene McMaster, Kathleen Toepel (2001): The Impact of Enlargement on Cohesion, Background Report for the 2nd Cohesion Report, in co-operation with EPRC European Policies Research Centre, Strathclyde/Glasgow, Study commissioned by European Commission DG Regio.