THE ECONOMY OF THE EUROPEAN UNION

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Abstract

Ten Central and Eastern European and two small insular countries have negotiated full membership with the EU. At the December 2002 European Council meeting it was decided that the management had been completed with ten of the twelve and that they could join the Union in May 2004. The purpose of this paper is to consider some of the the economic dimensions of the EU enlargement, focusing on the characteristics of the new member states and on the economic implications of enlargement for the EU.

Uneven macroeconomic developments in the new member states can to some extent be attributed to their individual situation at the start of the transformation. However, they also reflect the varying extent to which institutional reform programmes have been implemented in these countries.

Their economies are not yet fully adjusted to the efficient functioning of the market economy. To establish the necessary institutions radical reforms of their financial sectors and their fiscal and financial policies are necessary. Their manufacturing and services sector still remain fragile. The overall economic effects of the enlargement are positive. They are so particularly for the acceding countries, which have the prospect of clear gains, even if the costs are greater and many of the benefits are slower to arrive than they anticipated. For the EU-15, the direct economic gains are relatively modest, with enlargement not expected to bring much extra efficiency or growth, nor to create many new jobs.

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Introduction

The purpose of this paper is to consider some of the key economic dimension of EU enlargement, focusing on the characteristics of the new member states and on the economic implications of enlargement for the EU. Uneven macroeconomic developments in the new member states can to some extent be attributed to their individual situation at the start of the transformation. However, they also reflect the varying extent to which institutional reform programmes have been implemented in these countries. Legal systems, public administration and markets for capital products and services are still under-developed, which will make it very difficult for them to perform effectively in the Single European Market (SEM).

Enlargement promises gains for both the EU-15 and the new member states. However, though economic projections have varied considerably, most empirical analyses have suggested that the expected gains will be relatively small for the EU-15 and may not be as significant for the acceding states as has been commonly supposed. For example, Baldwin *et al.* (1997) have indicated a total real income gain of only 1.5 per cent for CEECs and even less for the EU-15. Better results are reported by Brown *et al.* (1997) and Breuss (2001). Brown estimates overall welfare gains for the CEECs between 3.8 and 7.3 percent, though only around 0.1 per cent for the EU; Breuss anticipates total effects on real GDP between 4 and 9 per cent for the CEECs and about one tenth of that for the EU. Lejour *et al.* (2002) explore the economic implications of enlargement with respect to three dimensions: the move towards a customs union, the enlargement of the internal market, and free movement of labour. Overall they project that the GDP of accession states will increase by more than 8 per cent on average in the long run, but for the EU-15 states increases will be much more modest. For example, the Dutch GDP per capita is projected to increase by a mere 0.15 per cent, whilst in Germany, where the economic effects tend to be dominated by migration, a slight reduction in GDP per capita is anticipated. Lejour *et al.*'s estimates are comparable with those produced by the European Commission (2001).

As well as bringing economic benefits, enlargement also brings economic costs for both EU-15 and acceding states. CEECs still have fragile economies that will be exposed to fierce competition in the SEM. However, they will receive only limited EU financial assistance, it having been decided at the 1999 Berlin summit to limit spending for all EU activities, including enlargement, for the 2000-06 period to a 1.27 per cent limit of total EU GDP. The December 2002 European Council meeting in Copenhagen 2002 confirmed that the Berlin decision must be respected. This means that, whilst enlargement is relatively cheap for

the EU in financial terms, the weaknesses of new member states may be over-exposed and not sufficiently supported.

Other economic concerns arising from enlargement include implications for immigration, jobs and wages. Expected migration flows are likely to be longer than those that followed Mediterranean enlargement. Some EU-15 countries expect large inflows of east European countries and they might put their labour markets under severe pressure. It is generally assumed that Germany and Austria will be the major receiving countries of east-west migration. The estimated number of persons from the CEECs resident in Austria in 1998 is 1.2 per cent of the population. This is almost double the German figure of 0.7 per cent which, in turn, is more than double the figures for Sweden and Finland of 0.3 and 0.2 per cent respectively. These figures may be interpreted as rough indicators of the extent to which countries are exposed to the effects of eastern enlargement on the labour market, and they clearly point to substantial variation among EU-15 countries. Heijdra *et al.* (2002) found that the labour market effects of trade integration are rather modest compared to those of immigration. Their analysis reveals, amongst other things, that low-skilled workers in the EU-15 will find their wages and employment prospects directly impaired by an inflow of low-skilled immigrants, while the high-skilled are likely to gain on both wage and employment counts.

The income differentials with new member states, even after over ten years of transition, are still enormous. Enlargement is therefore likely to generate severe strains, given the objective of regional convergence and coherence, which is a cornerstone of the Union and draws fourty per cent of its expenditure. In the run-up to membership, "pre-accession aid" has been extended to candidate countries to support costly institution-building, as required in order to fully adopt the *acquis communautaire***.** Moreover, the agricultural sector in some of the new member countries is very large and its productivity is mostly well below the EU-15 level. This has severe implications for the CAP which accounts for over fourty five per cent of the EU budget.

The costs of enlargement will also affect EU-15 states in quite different ways. The burden for an individual member country depends on the strategy adopted by the EU to achieve a balanced budget. Obviously, there are alternative strategies. For instance, the more Structural Funds one country receives now, the more seriously will be hurt by a financing strategy which relies heavily on adjustments of these funds. It is clear, at this time, that the cost of enlargement will be financed by lower agricultural or/and structural payments to EU-15 countries.

The Economic Structures of the New Member States

GDP

The eventual accession of all 10 + 2 states will increase the EU's population by 28 per cent but its GDP only by 7 per cent at 2001 prices and by 15 per cent in terms of purchasing power standard (PPS) (Eurostat, 2002). In absolute terms, the new member states with the largest GDPs are, in descending order, Poland (€197 billion), the Czech Republic (€63 billion), and Hungary (€58 billion). Those with the smallest GDPs are, in ascending order, Malta (€4 billion), Estonia (€6 billion), and Latvia (€8 billion). See Table 1 for a complete list of the GDPs of all 10 + 2 states.

Table 1. ***GDP per capita, measured at purchasing power standard, and population in EU and accession countries in 2001***

Country	*GDP per capita (in EUROs)*	*Population (in million)*
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
EU-15	23,160	380.5

Source: Eurostat (2002)

* 2000

Measured by GDP per capita in PPS, the 10 + 2 countries are at a significantly lower level of development than the EU-15 average. All of them are eligible candidates for the Cohesion Fund. However, as Table 1 shows, there are significant differences between them. Broadly speaking, the 10 + 2 states can be set in four groupings:

- GDPs of over 60 per cent the EU-15 average: Cyprus and Slovenia;

- GDPs of around half the EU-15 average: the Czech Republic, Malta, Hungary and Slovakia;
- GDPs of around of one-third of the EU-15 average: Estonia, Poland, Lithuania, and Latvia;
- GDPs of around one-quarter of the EU-15 average: Bulgaria and Romania.

Economic sectors

The economic structure of the 10 + 2 states shows that, as in the EU-15, services constitute the predominant economic sector, accounting for over 60 per cent of GDP in all states other than Romania (see Table 2). As GDP has grown the demand for services has increased due to higher income elasticities. However, despite the substantial fall in output in the early 1990s, industrial production still accounts for between 20 and 30 per cent of GDP in most CEECs, which is significantly higher than in most EU-15 countries. This implies the important role of the manufacturing sector in the economies of the CEECs. The long standing tradition in manufacturing along with the relatively low costs of labour and raw materials helps to explain why there has been a rapid inflow of foreign direct investment (FDI) in the CEECs (on FDI, see below).

Table 2. ***Structure of GDP in the 10 + 2 states and the EU-15***

Country	Agriculture[1]	Manufacturing[2]	Services
Bulgaria[3]	13.8	23.0	63.2
Cyprus[4]	4.2	13.3	82.5
Czech Republic	4.2	32.8	63.0
Estonia	5.8	22.7	71.5
Hungary[3]	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
EU-15	2.1	22.3	75.6

Source: Eurostat (2002) ; figures are for 2001.

[1] Agriculture, hunting, forestry and fishing; [2] Excluding construction; [3] 2000; [4] 1999

The agriculture sector is a major concern, because of its proportionately large size and its relative inefficiency. Indications of how important agriculture is in many of the 10 + 2 states, and the consequent policy challenges this poses for the EU, are seen in the following:

- The share of agriculture in the GDP of the new member states ranges from 2.4 per cent (Malta) and 3.1 per cent (Slovenia) to 13.8 per cent (Bulgaria) and 14.6 per cent (Romania) (see Table 2). These figures compare with an average of 2.1 per cent for the EU-15, where Greece has the highest percentage with over 6 per cent.
- Labour markets are discussed in the next section, but it merits being noted here that all of the 10 + 2 states apart from Malta have a higher proportion of people engaged in agriculture than the EU average of 4.2 per cent (see Table 3 for a complete list). In three

Table 3. Unemployment rate and share of agriculture in total employment in the EU and accession countries in 2001 (per cent)

Country	*Unemployment rate*	*Agriculture in total employment*
EU	7.6	4.2
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

Source: European Commission for Europe (2002); Eurostat (2002); European Commission (2002).

of the new member states – Poland, Lithuania and Latvia – the figures are significantly higher than the EU-15 average, whilst in the candidate states of Romania and Bulgaria they are very markedly so – at 44.4 per cent and 26.7 per cent respectively.

- When all 10 + 2 states have become members, the Union's agricultural area will increase by 60 million hectares to make a total close to 200 million hectares. Of these

60 millions hectares, two-thirds are arable land, adding 55 per cent to the EU-15's arable area of 77 million hectares.

These figures serve to demonstrate why debates on agricultural reform have featured prominently in the 10 + 2 round and why agriculture will continue to be a key policy issue in the enlarged EU. The fact is that there is a pressing need for structural improvement in the agricultural sectors of most of the 10 + 2 states – most obviously on the farm themselves, but also in the up- and down-stream sectors (Mergos, 1998).

Labour Markets

With the exceptions of Cyprus and Malta, unemployment levels in the new member states present at least as pressing a problem as they do in most EU-15 states. In 2001, the average unemployment rate in the EU-15 was 7.6 per cent. Similar levels were recorded in the Czech Republic, Estonia, Hungary, Latvia, and Romania, but the level was 18.6 per cent in Slovakia, 17.4 per cent in Poland, 17.3 per cent in Bulgaria, 12.9 per cent in Lithuania, and 11.8 per cent in Slovenia (see Table 3).

Labour productivity (real gross value added per worker) in manufacturing has been rising in all CEECs (Podkaminer, 2001). The reasons for productivity growth are, however, quite different across countries. Only in Poland and Slovakia have productivity gains been due to increased output produced by a practically unchanged workforce. In Hungary, Slovenia and the Czech Republic, employment cuts and output increases have contributed positively to productivity improvement, while in Bulgaria and Romania productivity gains have been due to falling employment levels outpacing falling (or stagnant) output.

Significantly, there is no obvious link between changes in unit labour costs and other sets of indicators. Rising labour productivity, for example, is differently "rewarded" in terms of real wages. Strong gains in Hungarian productivity (average annual growth was 11.1 per cent between 1992 and the end of the 1990s) was not rewarded at all (real wage growth was about zero). On the other hand equally strong gains in Poland (11.5 per cent) were rewarded (relatively ungenerously) with a 4.3 per cent real wage growth. Weaker gains in the Czech Republic (4.8 per cent), Slovenia (6.7 per cent) and Slovakia (3.7 per cent) were rewarded more generously (with real wages rising 4, 3.5 and 3.1 per cent respectively). Gains in Romania (7.3 per cent) and Bulgaria (0.2 per cent) were "punished" with falling real wages (-3.3 and –2.4 per cent respectively).

Differences in employment patterns are particularly pronounced in respect of agriculture. As was noted above, Romania 'heads' the list, with 44 per cent of the labour force employed in agriculture, which is more than ten times the EU-15 average (see Table 3). In Bulgaria around one-quarter of the labour force is employed in agriculture and in Poland just under one- fifth. An indication of the challenge this poses not only for the new member states but also for the enlarged EU is seen in the fact that the near 20 per cent of the Polish population engaged in agriculture contribute little more than 3 per cent to Poland's GDP. This compares with figures of 4.2 and 2.1 per cent, respectively, for the EU-15. Labour migration to the cities should increase agricultural productivity in Poland and other CEECs, but if there are no new jobs in the manufacturing and services sectors to absorb such an inflow there may be a significant rise in social tensions (Jovanovic, 2002).

Macroeconomic Developments in the New Member States

Growth rates

As indicated by the evolution of key macroeconomic indicators, stabilisation policies have been implemented in most of the CEECs since the mid-1990's most of them have been experiencing satisfactory growth rates (see Table 4).

Table 4. ***Annual growth rate of GDP in the EU and theEU-15: 1997-2002***

Country	1997	1998	1999	2000	2001	2002*
Bulgaria	-5.6	4.0	2.3	5.4	4.0	4.0
Cyprus	2.4	5.0	4.5	5.1	4.0	2.5
Czech Republic	-0.8	-1.0	0.5	3.2	3.6	3.6
Estonia	9.8	4.6	-0.6	7.1	5.0	3.5
Hungary	4.6	4.9	4.1	5.2	3.8	3.5
Latvia	8.4	4.8	2.8	6.8	7.7	5.0
Lithuania	7.3	5.1	-3.9	3.8	5.9	4.0
Malta	4.8	3.4	4.0	5.5	-0.8	-0.3
Poland	6.8	4.8	4.0	4.0	1.1	1.4
Romania	-6.0	-4.8	-1.1	1.8	5.2	4.5
Slovakia	5.6	4.0	1.3	2.2	3.3	3.6
Slovenia	4.6	3.8	5.2	4.6	3.0	3.0
EU-15	2.5	2.9	2.8	3.4	1.5	1.5

Source: European Commission for Europe (2002); Eurostat (2002). All figures are percentages.

*Estimate

Some of the CEECs had particular problems in the mid-to-late 1990s, but these have been largely overcome. For example, the Bulgarian and Romanian economies experienced major crises in 1996, which had a negative impact for some time. The Baltic states were affected by the Russian economic crisis of the late 1990s, which damaged their growth rates at the end of the decade. However, with the exception of Malta, there has been consistent economic growth in all of the 10 + 2 states since 2000. The challenge is to maintain this positive differential growth rate over and (well) above the EU rate for a long period of time in order to catch up with the EU level of development. Long-run growth projections predict that it may take around 30 years (one generation) for most of the CEECs to catch up with the income levels in "low income" EU-15 countries (Fisher *et al*., 1998: 28; European Commission., 2002c: 183).

The stabilization policies in many of the new member states started with tight monetary and fiscal policies in mid-1990s. But as their economies went into recession and political pressures rose, fiscal and monetary discipline could not in many cases be maintained. Inflation rates in most CEECs have been brought down sharply from their peaks in 1991 to 1993, the first years of price liberalization. But as compared to the average EU-15 level (of 2.6 per cent in 2001) they remain very high. (See Table 5).

Table 5. ***Annual rate of inflation in the 10 +2 states and the EU-15: 1997-2001***

Country	1997	1998	1999	2000	2001
Bulgaria	1,082.6	18.7	2.6	10.3	7.4
Cyprus	3.3	2.3	1.1	4.9	2.0
Czech Republic	8.0	9.7	1.8	3.9	4.5
Estonia	9.3	8.8	3.1	3.9	5.6
Hungary	18.5	14.2	10.0	10.0	9.1
Latvia	8.1	4.3	2.1	2.6	2.5
Lithuania	8.8	5.0	0.7	0.9	1.3
Malta	2.6	2.3	2.3	3.1	3.0
Poland	15.0	11.8	7.2	10.1	5.3
Romania	154.9	59.1	45.8	45.7	34.5
Slovakia	6.1	6.7	10.5	12.0	7.3
Slovenia	8.3	7.9	6.1	8.9	8.6
EU-15	2.1	1.8	1.3	2.5	2.6

Source: European Commission for Europe (2002); Eurostat (2002).All figures are percentages.

In most CEECs, monetary policy is seemingly one of the more successful areas in the reform process. However, the conduct of fiscal policies has not been as successful, not least because in most CEECs large-scale tax evasion and corruption are very common. The dilemma is that stricter enforcement of tax collection and punishment of tax evasion would push many of the chronically financially weak enterprises in these countries over the edge to bankruptcy, while at the same time low tax revenues would make the financing of public expenditure even more difficult and further accentuate the fiscal imbalances observed in most of the CEECs. This in turn transforms into deficits in the balance of payments and thus to increasing foreign debt. As a result, many transition countries have to pay high amounts of interest on debt. Nevertheless, the burden of public debt in all of the new member states apart from Bulgaria and Malta is lower than the EU-15 average (Table 6). This is largely because vigorous efforts have been made in most CEECs to sustain and stabilize public finances by reducing general government spending (Table 7).

Table 6. ***National debt in the 10 + 2 states and the EU-15: 1997-2001***

Country	1997	1998	1999	2000	2001
Bulgaria	105.1	79.6	79.3	73.6	66.3
Cyprus	57.7	60.1	62.1	63.0	..
Czech Republic	13.0	13.7	14.5	17.0	23.7
Estonia	6.9	6.0	6.5	5.1	4.8
Hungary	64.2	61.9	61.0	55.4	53.1
Latvia	12.0	10.6	13.7	13.9	16.0
Lithuania	15.7	17.1	23.0	24.0	23.1
Malta	51.5	64.9	59.9	60.7	65.7
Poland	46.9	41.6	42.7	38.7	39.3
Romania	16.5	18.0	24.0	24.0	23.3
Slovakia	28.8	28.9	40.2	45.2	44.1
Slovenia	23.2	25.1	26.4	27.6	27.5
EU-15	71.0	68.8	67.7	63.8	63.1

Source: Eurostat (2002). All figures are percentages of GDP.

Trade

Thanks to the Europe Agreements of the mid-1990s, non-agricultural trade between the EU-15 and the new member states is largely tariff-free. Enlargement will remove all

remaining tariff-barriers, and will extend the Customs Union as well as the Single Market to new members, leading to increased trade and factor movements.

Following the collapse of the communist trading block – the Council for Mutual Economic Assistance – and then the establishment in the early 1990s of the Europe Agreements between the EU and the CEECs, trade between CEECs and the EU-15 increased significantly.

Table 7. ***Government deficit /surplus in the 10 + 2 states and the EU-15: 1997-2001***

Country	1997	1998	1999	2000	2001
Bulgaria	-0.3	1.3	0.2	-0.6	1.7
Cyprus	-5.3	-5.6	-5.0	-2.7	-3.0
Czech Republic	-2.7	-4.5	-3.2	-3.3	-5.5
Estonia	2.0	-0.4	-4.0	-0.4	0.2
Hungary	-6.8	-8.0	-5.3	-3.0	-4.1
Latvia	-0.2	-0.7	-5.3	-2.7	-1.6
Lithuania	-1.1	-3.1	-5.6	-2.7	-1.9
Malta	-10.7	-10.8	-8.3	-7.0	-7.0
Poland	-4.3	-2.3	-1.5	-1.8	-3.9
Romania	-4.5	-3.2	-4.5	-4.5	-3.4
Slovakia	-5.5	-4.7	-6.4	-12.8	-5.6
Slovenia	-1.9	-2.3	-2.2	-3.2	-2.5
EU-15	-2.4	-1.6	-0.7	1.0	-0.8

Source: Eurostat (2002) *Estimate. All figures are percentages of GDP.

EU tariffs on industrial goods were removed and there was a progressive reduction of quantitative restrictions, though some trade quotas remained on agricultural products. Between 1993 and 2001, the total value of trade increased almost threefold. As can be seen from Table 8, by 2001 virtually all 10 + 2 states were sending at least 50 per cent of their exports to the EU. In the cases of the Czech republic, Estonia, Hungary, Poland and Romania, the figure exceeded or was close to 70 per cent.

The new member states were, before their accession in 2004, the EU's second largest trading partner after the USA, with 14.0 per cent of total trade. However, as Table 8 shows, most of them were running trading deficits – and in some cases very large deficits – with the EU. In 2001, the EU's total trade surplus with the candidate countries was €11.4 billion, which though much reduced from the €25.8 billion of 1999 was still very large.

Table 8. ***External trade balances of, and foreign direct investment In, the 10 + 2 states, 2001***

Country	*External trade*				*Foreign Direct Investment*	
	Trade Balance exports/ imports (%)	*Exports to EU (%)*	*Imports From EU (%)*	*Balance of EU with the accession countries (million euro)*	*Stock (euro per capita)*	*Net inflows (As % GDP)*
Bulgaria	76.3	54.8	49.4	380	272	5.1
Cyprus	13.0	49.0	55.5	1,670	na	1.8
Czech Rep.	91.6	68.9	61.8	2,376	2,284	8.7
Estonia	77.0	69.4	56.5	19	2,084	9.7
Hungary	90.5	74.3	57.8	-481	1,790	4.7
Latvia	57.1	61.2	52.6	466	970	2.3
Lithuania	72.1	47.8	44.0	773	720	3.7
Malta	71.8	41.3	63.6	1,304	na	8.8
Poland	71.8	69.2	61.4	83,976	952	3.2
Romania	73.0	67.8	57.3	967	245	2.8
Slovakia	85.5	59.9	49.8	-264	521	6.3
Slovenia	91.2	62.2	67.7	1,819	1,527	1.9

Source: Eurostat, 2003
na: non-available

Foreign direct investment

FDI in the CEECs has increased as their attraction to EU companies has grown as a result of their geographical proximity, the availability of skilled labour, and the ease of access to EU markets through the Europe Agreements. The inflow of investment has served to transfer technology, introduce new management techniques and create jobs. Net inflows were higher that 3 per cent of GDP in most CEECs in 2001 (see Table 8). The Czech Republic, Estonia and Hungary are the biggest recipients. Cyprus and Malta continue to attract high levels of FDI per capita (E.C., 2000).

Between 1992 and 2001, the volume of FDI going to the CEECs relative to the volume received by the southern EU members (defined here as Greece, Spain and Portugal) increased by a factor of six (for more details see www.source.oecd.org). This implies that in the long-run an intensification of the ongoing process of reorientation of FDI away from the Southern EU members toward the new entrants is to be expected.

The financial sector

The financial sectors of CEECs are in need of considerable development. Under the communist regimes, money had only a minor function to play and banking and finance were of little importance. In consequence, the organisational settings and the capacity of financial institutions in the CEECs were quite different from those in market economies. They also varied among CEECs: Hungary, Poland and former Yugoslavia started to reform their banking systems in the second half of the 1980s, whilst Bulgaria, Czechoslovakia and the Baltic States had rather underdeveloped financial structures with a central bank also engaged in financial transfers among firms, a foreign trade bank, savings institutions and a few other specialised banks.

After 1990, a number of new state-owned commercial banks were created through the transfer of existing loans from the portfolio of the central bank. In addition, governments had to re-establish capital markets and their respective institutions (stock exchanges, investment houses, supervisory agencies, etc). Nevertheless, after years of slow and hesitant action, significant progress in the implementation of the EU *acquis* began to occur from 2000 with the adoption of the relevant banking regulations and directives. Moreover, foreign banks were finally allowed to take over troubled CEEC banks as majority shareholders. As a result, the financial sector is more advanced in countries like Hungary and Estonia (and to a lesser extent Poland) which were the first to allow a strong foreign equity involvement in the banking sector. The critical element, however, is not the selling of relative majority stakes to a foreign bank but is rather, the transfer of real management control and responsibility to prudent strategic partners that intend to run the bank as a financial intermediary and not to strip assets like a portfolio manager (Baltas, 2001).

In addition to largely immature governance structures, the financial sectors in the CEECs are also plagued by other weaknesses. Most notably, financial markets in most of the CEECs are small in relative and absolute terms. They are so for several reasons: a relatively small extent of financial intermediation; a low level of GDP per capita; successive waves of excessive lending followed by credit crunches; and distrust of the financial system after the experience of repeated bank failures. In addition to the small size of the CEECs' financial markets, poor asset quality and serious under-capitalisation continue to be a major problem, with problematic assets in the range of 15-30 per cent of total assets and with estimated

contingent liabilities of 4-10 per cent of GDP, even in the best performing group of Estonia, Hungary and Poland (Fink and Haiss, 2000:1-3; European Commission., 2000a).

Implications of the 10+2 Round for the EU Economy

The traditional model of EU enlargement is based on certain principles linked to the rights and duties of both applicant countries and current members. These principles have been applied successfully in previous enlargement rounds and may yet serve as a sound model for some applicant in the future. At the heart of the traditional model is a requirement that acceding states align with Union laws, practices and guidelines and participate fully in Union policies unless exemptions are granted in the form of derogations or transition periods. This procedure for accession was very much like joining a club with pre-established membership rules (Jovanovic, 2000).

However, the 10 + 2 enlargement round has been different to previous rounds in that it has posed unprecedented challenges for the EU. In economic terms, the challenges arise largely from the fact that the new member states are relatively poor and are still in the process of making the transition to the establishment of efficient and competitive market economies. This raises many questions, not only about how the new member states will cope in the EU's integrated markets for goods and factors, but also about how the EU itself will cope. For enlargement raises many complex issues about virtually all aspects of international market integration and international transfer payments. Established theory of trade integration holds a presumption of gains from trade and thus implies that enlargement will "work" in economic terms, but this does not mean there are not concerns and dangers. For example, will producers in EU-15 states be "under-cut" by cheaper competitors in CEECs; will budgetary transfers between member states be sufficient to promote necessary economic regeneration and acceptable levels of social cohesion; will workers in low-wage CEECs seek to move on a large scale to higher-wage EU-15 states, and will this impose intolerable strains in those countries which receive the largest inflows; and could currently problems arise because the expanded internal market is seen to be not functioning satisfactorily?

For these and related questions, it is argued that whilst enlargement certainly will impose severe strains, most of the challenges are ultimately likely to prove to be, in the customary EU manner, "manageable".

Conclusions

Uneven macroeconomic developments in the new member states can to some extent be attributed to their individual situation at the start of the transformation. However, they also reflect the varying extent to which institutional reform programmes have been implemented in these countries. Their economies are not yet fully adjusted to the efficient functioning of the market economy. To establish the necessary institutions, radical reforms of their financial sectors and their fiscal and financial policies are necessary. Their manufacturing and services sectors still remain fragile. Economic set-backs can easily occur, as was the case in the Balkan countries in 1996 and 1997. Entering the EU without a full macroeconomic stabilization and modernization of the output structure may produce considerable pain. Countries passing through the "transition" may have particular difficulties withstanding the EU's strict competition rules.

Most CEECs have yet to put in place an efficient legal system, public administration has yet to be fully reorganised and markets for products and services are still for the most part in a trial phase. A particular problem is the agricultural sector, which in most CEECs is very significant in terms of both the size of the employed workforce and of the arable surface but is backward in terms of productivity.

The overall economic effects of the 10 + 2 enlargement are positive. They are so particularly for the acceding countries, which have the prospect of clear gains, even if the costs are greater and many of the benefits are slower to arrive than they anticipated. For the EU-15, the direct economic gains are relatively modest, with enlargement not expected to bring much extra efficiency or growth, nor to create many new jobs. However, the final operational adhesion conditions set by the December 2002 Copenhagen European Council mean that the costs for the EU-15 are relatively cheap in budgetary terms. But beyond the "narrow" costs, the EU-15 have achieved their main economic objective in the enlargement process, which was never enlargement for its own sake but was rather to give support to friendly countries undertaking fundamental programmes of economic transformation and stabilization.

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