



# The Impact of EU Enlargement on Romania and Other CEE Countries

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*October 19, 2004*

# 10 Countries, 8 from Central and East Europe Entered EU on May 1, 2004

- **Six countries invited to start accession negotiations in first round in 1997, additional six in second in 1999**
  - **First round: Czech Republic, Estonia, Hungary, Poland, Slovenia, and Cyprus**
  - **Second round: Bulgaria, Romania, Latvia, Lithuania, Slovakia, and Malta**
- **Countries had to gain EU approval for legislation, regulations in 31 areas (chapters)**
  - **Ten countries successfully completed chapter negotiations in December 2002; Bulgaria and Romania did not**
- **Central European states all held referenda**
  - **Turnout was modest, in many cases just over 50 percent**
  - **But large majorities of those who voted favored accession**
- **Parliamentary ratification followed referenda**
- **EU Parliament ratified treaty quickly, parliaments of EU-15 states took longer**

# Compromises on Key Remaining Sticking Points Reached at Copenhagen Summit

- **Agriculture was biggest stumbling bloc**
  - EU offered only 25% of equivalent aid given West European farmers
  - At Copenhagen, applicants given permission to move 20% of EU rural development funds to agricultural support
  - National governments also permitted to top up payments from national budgets
  - Adjustment period to EU norms shortened
- **Structural Funds also contentious issue**
  - New entrants to receive proportionally less than EU-15
    - 137 euro per capita compared to 231 for Greece, Ireland, Portugal and Spain
    - Funds capped at 4% of GDP
  - Not clear new entrants can usefully absorb substantially more because of matching criteria, performance during pre-accession period

# Transition Periods for Land Ownership, Labor Mobility

- **Restrictions on land ownership by foreigners to be removed over extended period**
  - Poland received special dispensation to control sales of farmland to citizens of other EU member states with a seven period in western Poland
  - Hungary also permitted to control sales of agricultural land for five years
- **EU-15 can regulate free movement of labor for workers from new Central and East European member states for 2 years, Malta, Cyprus excluded**
  - Review held after 2 years, 3 year extension, followed by another 2 year extension possible
  - Germany, Austria had insisted on 7 year transition period before free labor movement permitted
  - Only United Kingdom, Ireland, Sweden currently allow immediate free movement of labor

# Benefits and Costs of EU Entry

- **New accession countries to receive 42 billion euros in transfers between 2004-2006**
- **But they will pay 12 billion euros in VAT to EU**
- **Tariffs immediately moved to EU levels as of May 1**
  - **Polish, Hungarian tariffs generally falling**
  - **Some Czech tariffs rose**
- **Free trade in agricultural products will benefit some consumers, higher tariffs raising food prices in some countries, but this year's very favorable harvest has helped**
- **Too early to determine effects on labor markets**
  - **Increased competition and higher standards will lead some companies to close down or at least downsize workforce**
  - **Restrictions on labor movement to EU-15 may mean that more West European companies will simply relocate to CEE**

# Adopting the Euro

- **Countries now have to prepare for Economic and Monetary Union (EMU)**
  - Adopt euro, abandon local currency
  - Join European Central Bank
  - Coordinate economic policies
- **Must satisfy Maastricht criteria**
  - Budget deficits < 3% of GDP
  - Government debt < 60% of GDP
  - Inflation within 1.5 percentage points of lowest 3 in Euroland
  - Interest rates within 1.5 percentage points of lowest 3 in Euroland

**New members must operate within constraints of ERM 2 for two years before euro can be adopted**

# EMU Membership: Sooner or Later?

- ◆ **ECB and the EU are trying to convince new members to take their time; the new requirement of “real” convergence**
- ◆ **Setting the date for ERM2 entry and the right parity rate to the euro essential; no devaluation allowed during two years, the “Soros factor”**
- ◆ **Most likely scenario for euro adoption:**
  - ◆ **2007: Estonia, Lithuania, Slovenia**
  - ◆ **2008: Cyprus, Malta, Latvia**
  - ◆ **2009: Slovakia**
  - ◆ **2010-11: Poland, Czech Republic, Hungary**
- ◆ **Slovenia, Estonia and Lithuania entered ERM2 on June 28**

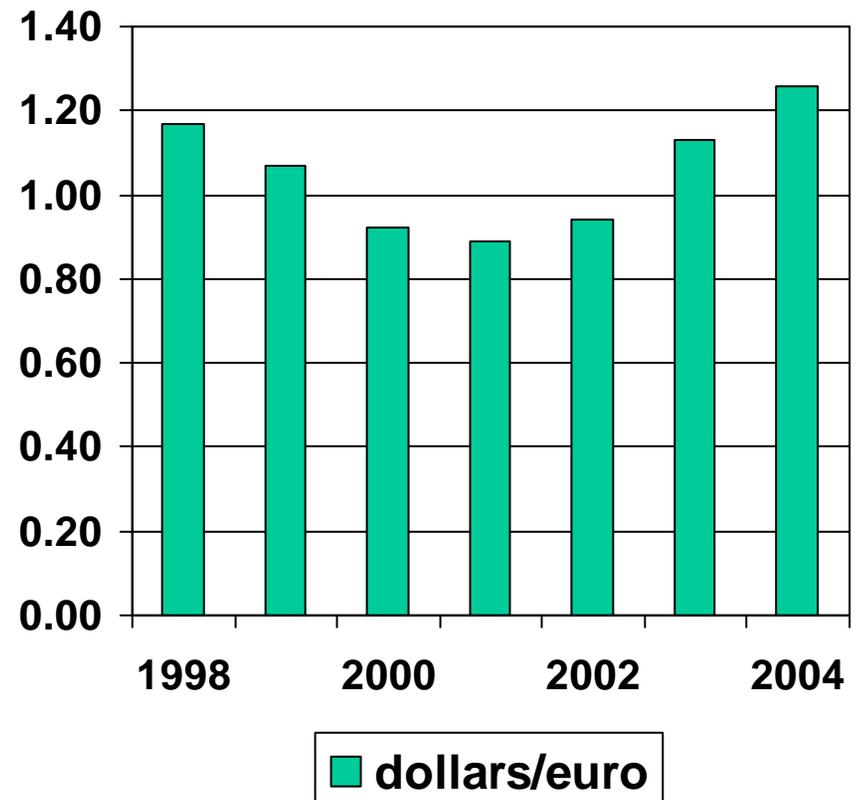
# Debate Currently Ongoing in CEE Countries Regarding Ideal Date to Adopt the Euro

- **Applicant countries would immediately benefit from adopting the euro**
  - Decline in interest premia from elimination of exchange rate risk
  - Elimination of pressure on exchange rates because of short-term capital inflows
- **Adopting the euro means an end to independent monetary policy**
  - If current pegged at wrong rate, could contribute to economic imbalances
  - Some governments believe that firms need more time to adjust before joining Eurozone
- **Regardless of accession date, meeting Maastricht criteria means more competitiveness for local economy**

# Adoption of Euro May Contribute to Dollar Slide

- ◆ Accession country traders will continue to shift invoices from dollars to euros
- ◆ Household sector shifting to euros for savings
- ◆ Corporate, government sector shifting to euro liabilities
- ◆ Neighboring countries (Morocco, Russia, Ukraine) also shifting from dollars to euros
- ◆ More vibrant EU growth may make euro look more attractive

## Dollar/Euro Exchange Rate



# Romania and Bulgaria Expected to Join EU in January 2007

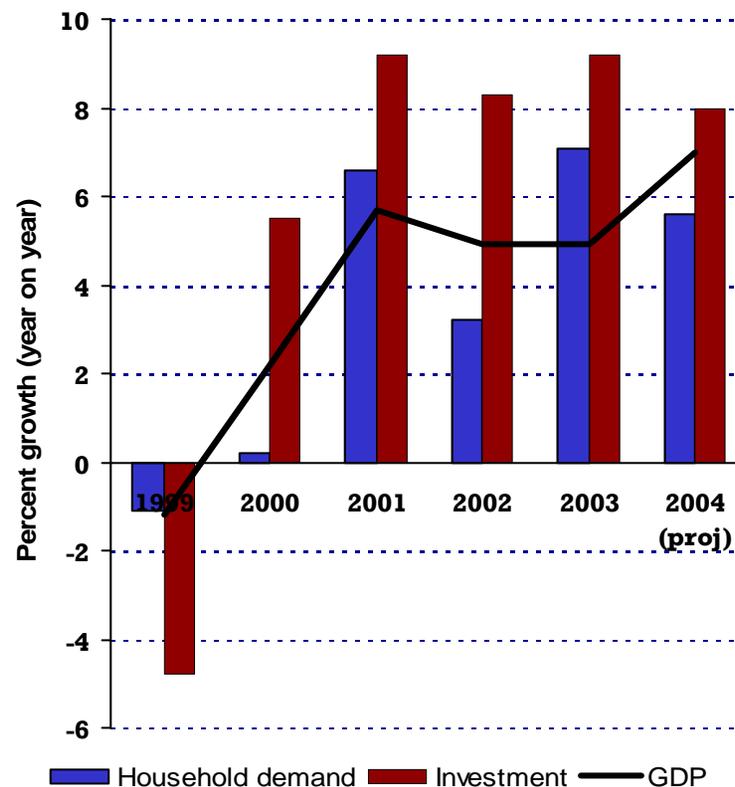
- ◆ Recently-issued evaluation by European Commission put accession on track
- ◆ Bulgaria closed all 31 chapters of *acquis communautaire* in June
- ◆ Romania still has several chapters to go
  - ◆ In October, 4 chapters remained open: competition, environment, justice and home affairs, and miscellaneous
- ◆ EC progress reports in February and October 2004 pointed to limited progress in judicial reforms and fighting corruption
- ◆ Romania finally declared “functioning market economy” for first time in October 2004 report by EC
- ◆ Accession process could be delayed for a year if it appears that the countries will not be ready by 2007
- ◆ Romania’s progress may depend in part on results of November parliamentary and presidential elections (current government has done more than expected to move country forward)
- ◆ Croatia is only starting accession negotiations in 2005, meaning that it will not be ready by 2007

# Economic Situation: Can Romania and Bulgaria Catch Up?

- ◆ **Expanding gap in per capita GDP**
- ◆ **Ways to spur growth:**
  - ◆ More handouts from EU (but funds focused on agriculture may create distortions)
  - ◆ Stronger exports
  - ◆ More foreign direct investment (FDI)
- ◆ **Attracting more FDI requires good investment climate**
  - ◆ Lower tax rates
  - ◆ Lower bureaucratic barriers
  - ◆ Availability of skilled labor
  - ◆ Lower levels of clientelism and corruption
  - ◆ Low wages also help, at least in medium term

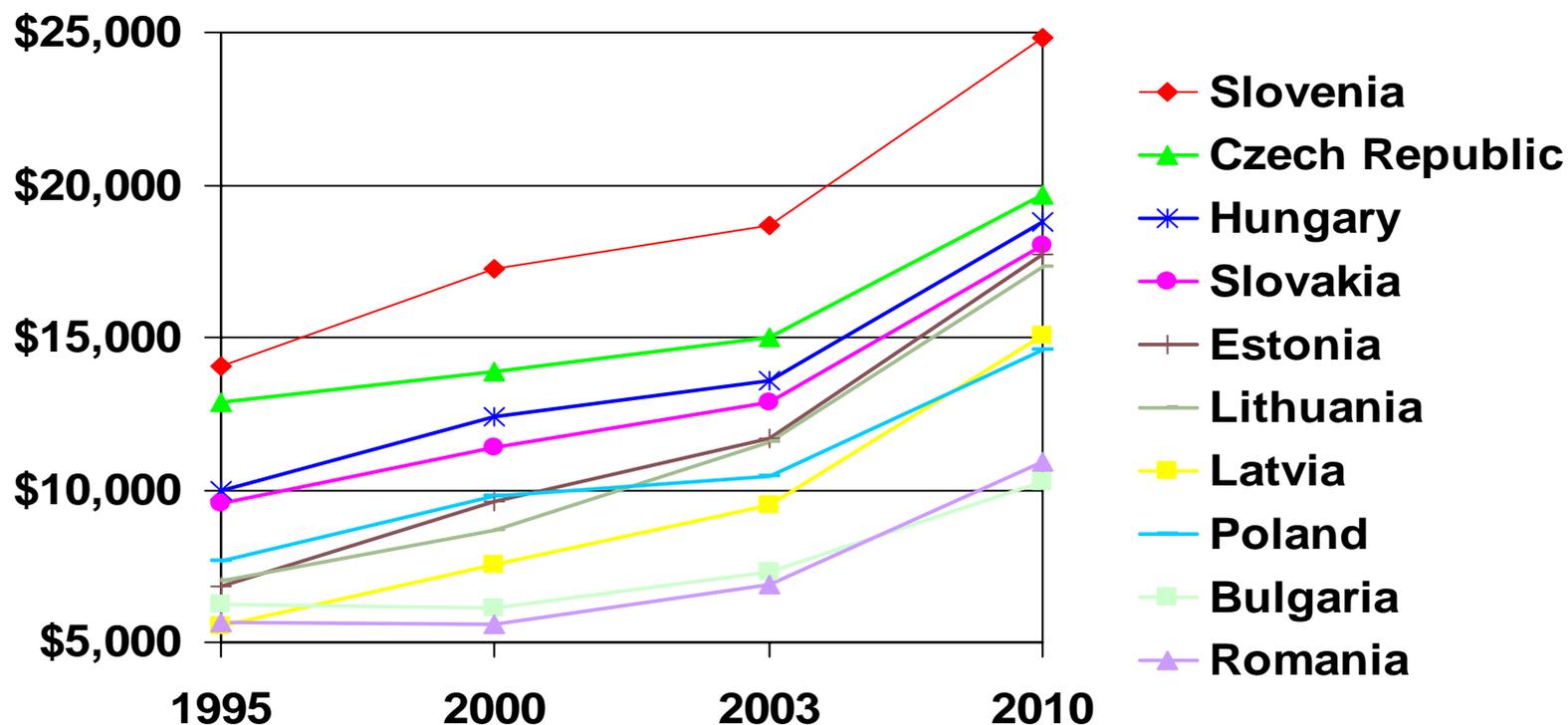
# Romanian Economy Growing Strong

- ◆ After growth of 4.9% in 2003, GDP surged by 6.6% in H1 2004, the highest rate in 10 years, again driven by gross fixed investment and household demand
- ◆ Net exports having negative impact on GDP, with jump in external balances last year (c/a deficit at 5.8% of GDP, trade gap at 11.1%) and continued worsening in H1 2004



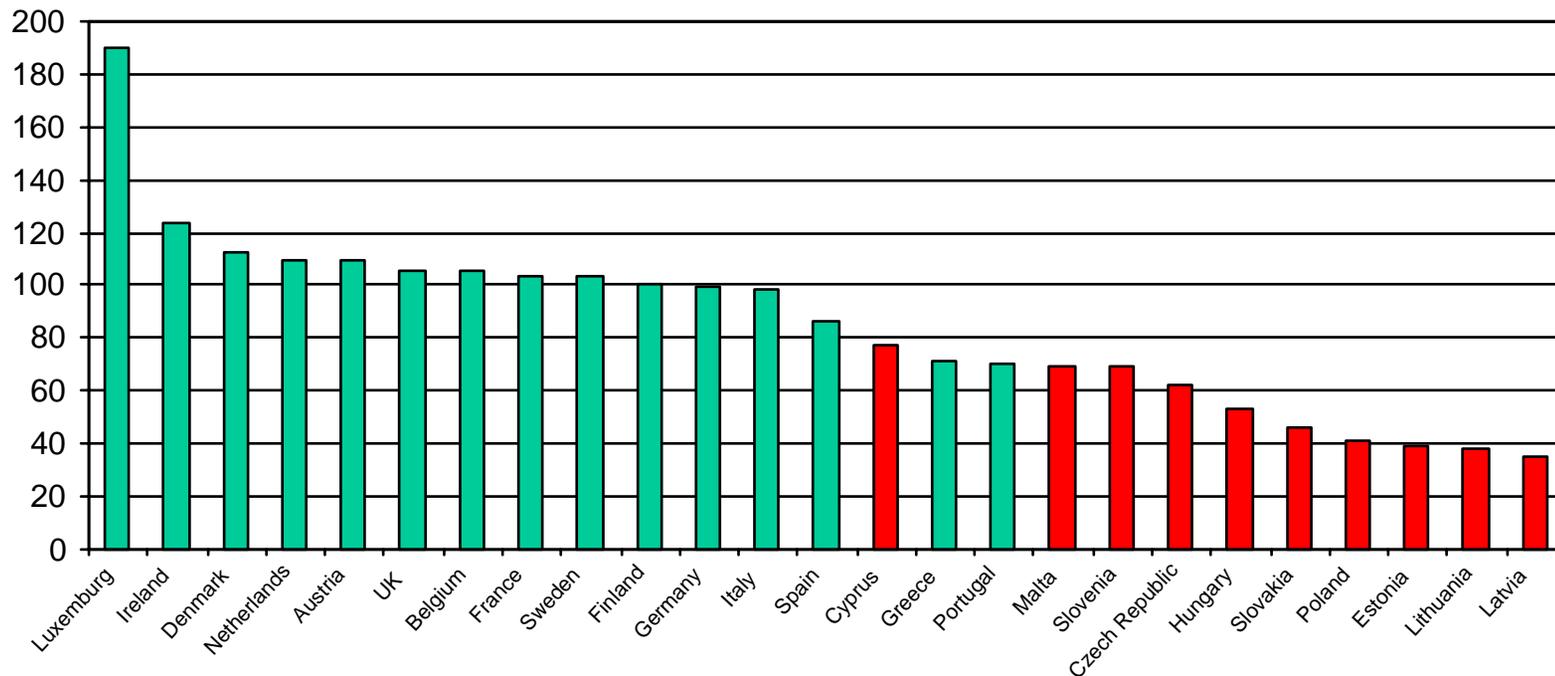
# Growing Disparity Between Incomes of CEE-8 Versus Later EU Entrants

## GDP per capita, PPP terms



# Income Gap Between New EU Members and EU-15 – How Big?....

Per Capita GDP at PPP rates in 2002 (EU-15=100)



Source: European Commission

# How Fast Will the Gap Close?

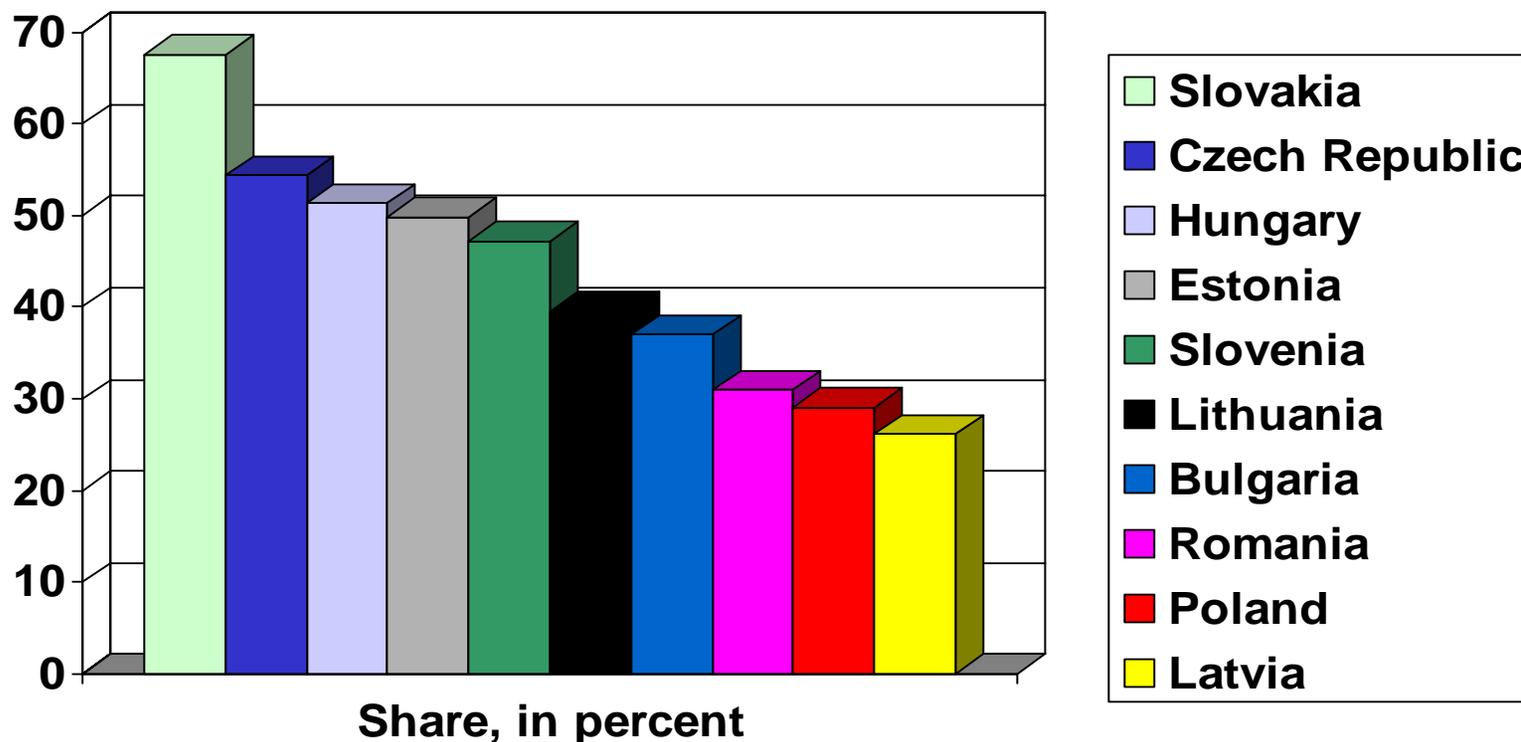
## Average Annual GDP Growth Rates Needed To Achieve 100% and 75% of EU-15 Levels

(assumes growth in the EU-15 at 2% annually)

	100% of EU-15 level		75% of EU-15 level	
	20Y	30Y	20Y	30Y
<b>Czech Rep.</b>	4.6	3.6	3.2	2.8
<b>Estonia</b>	7.1	5.2	5.6	4.4
<b>Hungary</b>	5.4	4.1	3.9	3.3
<b>Latvia</b>	8.5	6.1	6.9	5.2
<b>Lithuania</b>	8.5	6.1	6.9	5.2
<b>Poland</b>	7.0	5.1	5.4	4.3
<b>Slovakia</b>	5.8	4.4	4.3	3.5
<b>Slovenia</b>	3.7	3.0	2.2	2.2

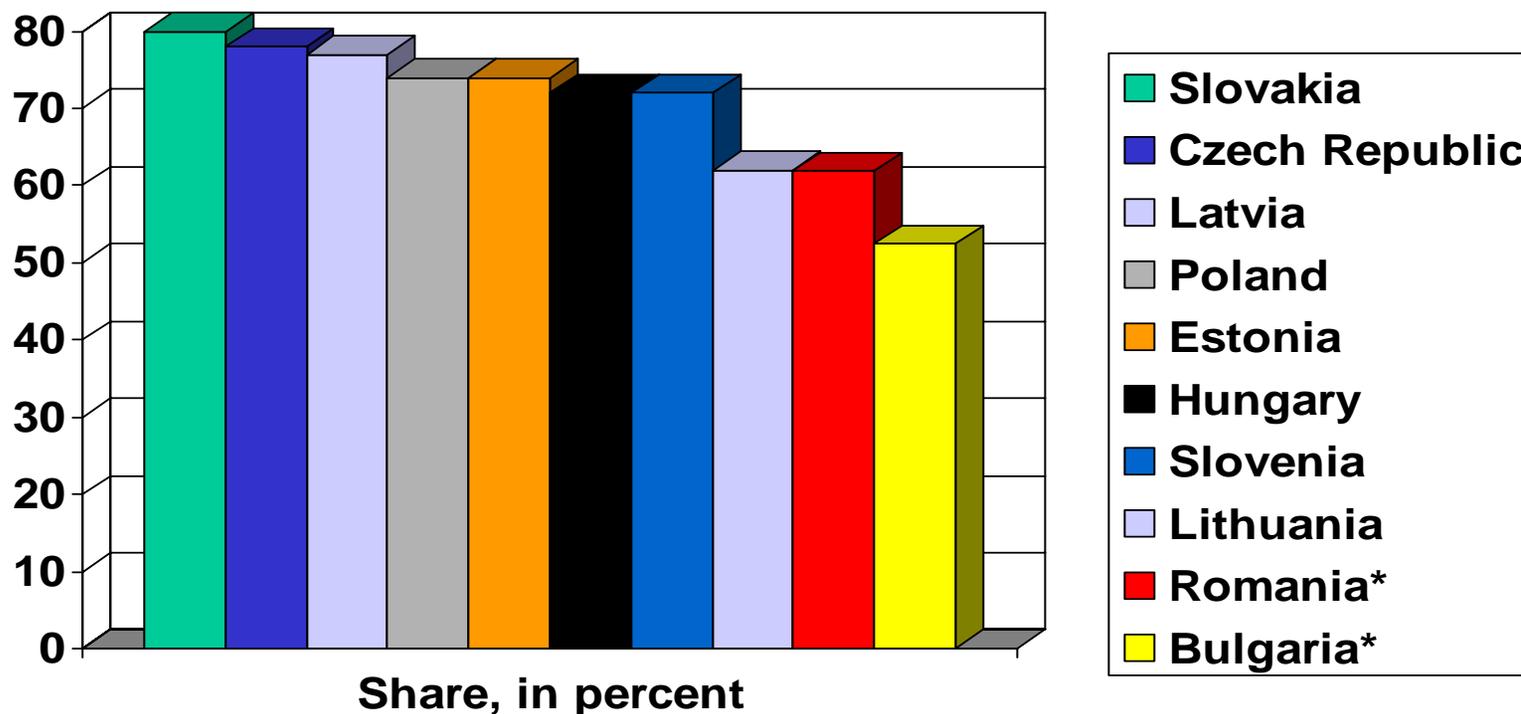
# Bulgaria and Romania More Open Economies Than Some in CEE-8

## Share of Exports in GDP, 2003



# Still, Romania and Bulgaria Have Relatively Low Share of Trade with EU

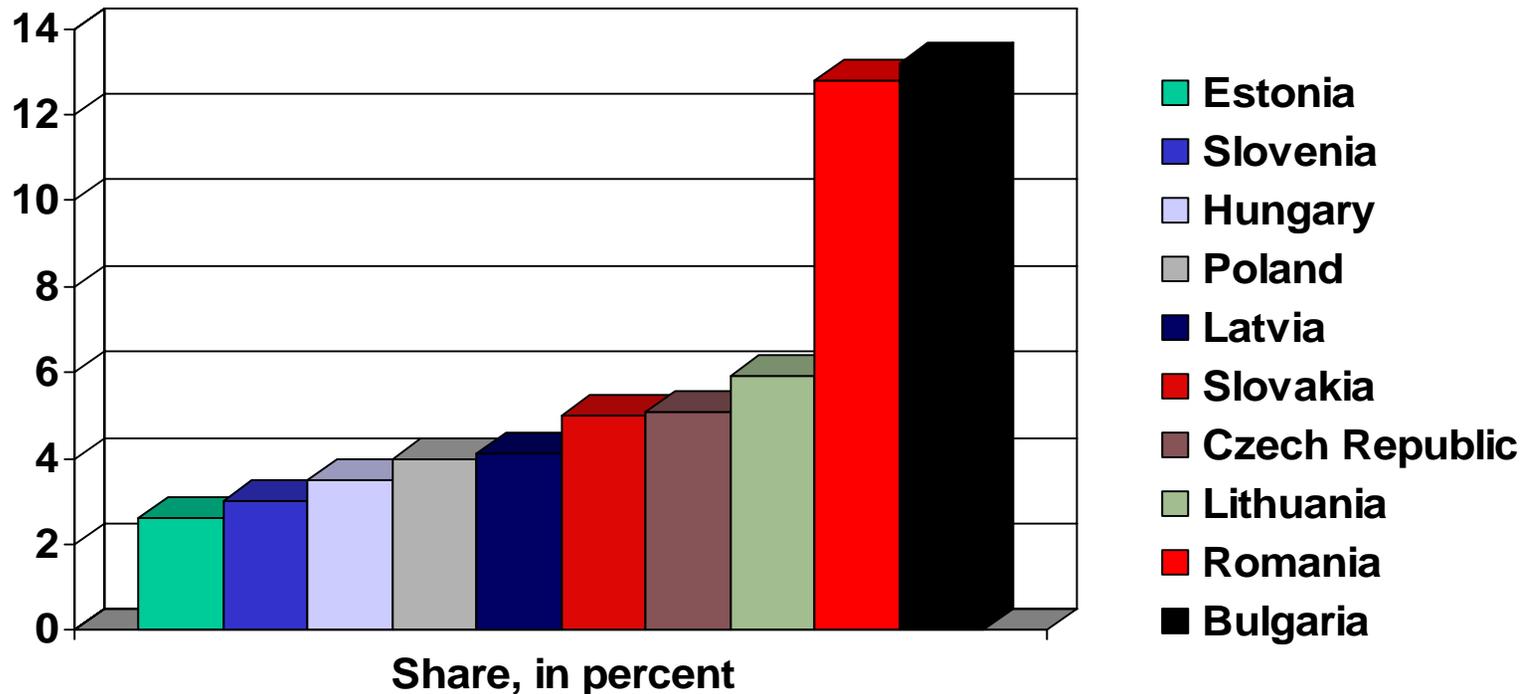
## Share of Trade with EU-25, 2002



\*Figures for Romania and Bulgaria from 2003 and refer only to EU-15.

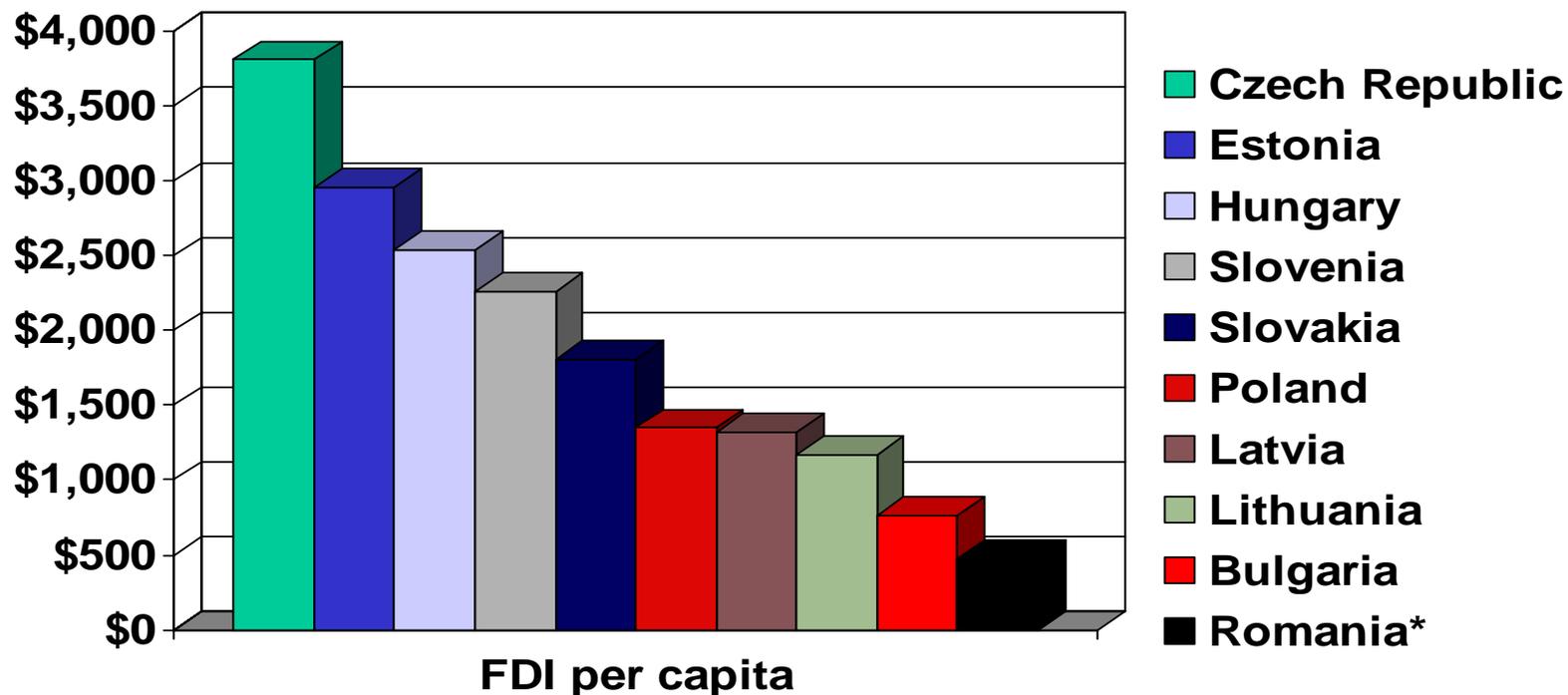
# Agriculture Far More Important in Bulgaria and Romania Than in CEE-8

## Agriculture as Share of GDP, 2003



# FDI Per Capita Lowest in Romania and Bulgaria

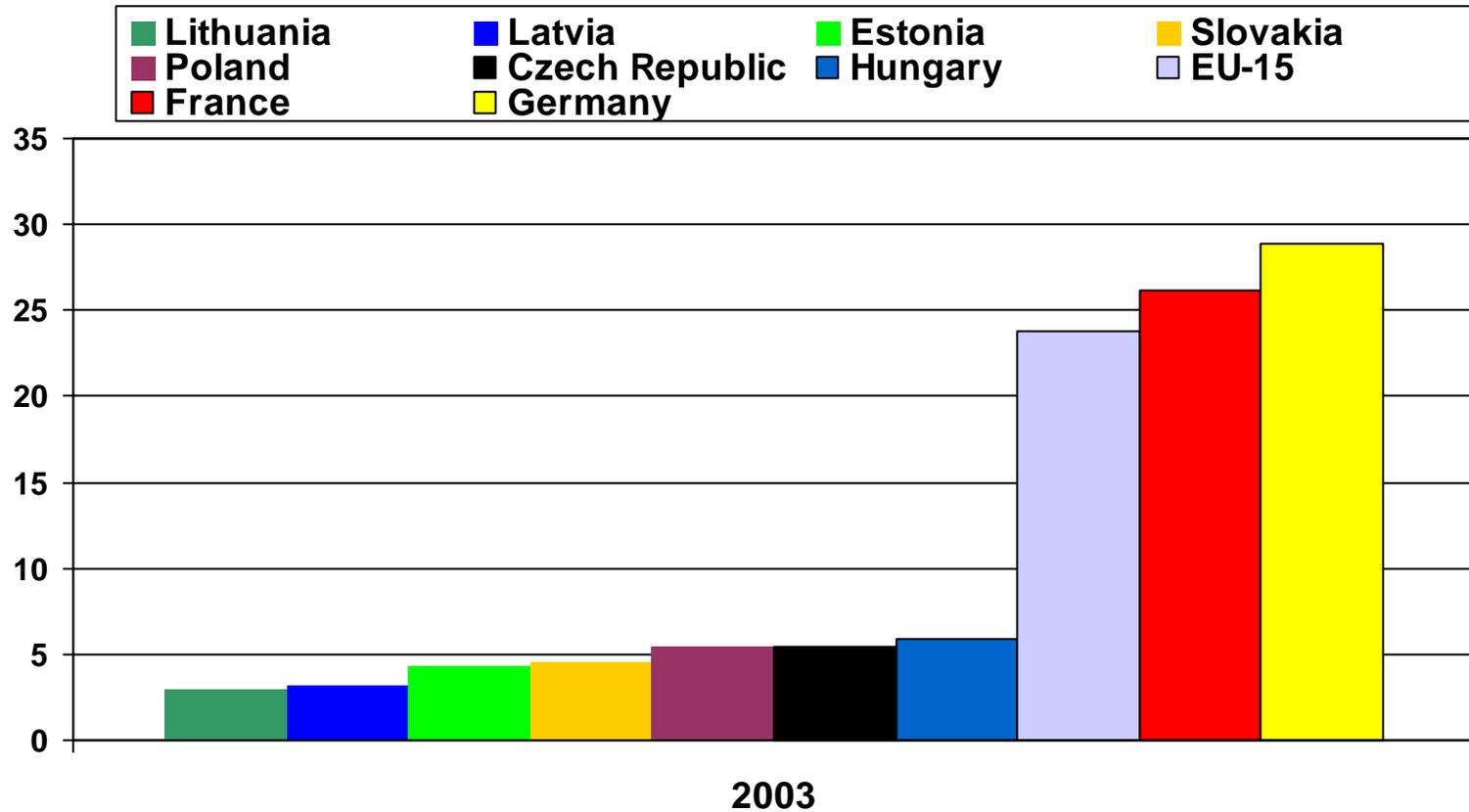
## Cumulative FDI per capita, 2003



\*Most FDI in Romania aimed at low-wage sectors, partly due to high tax rates.

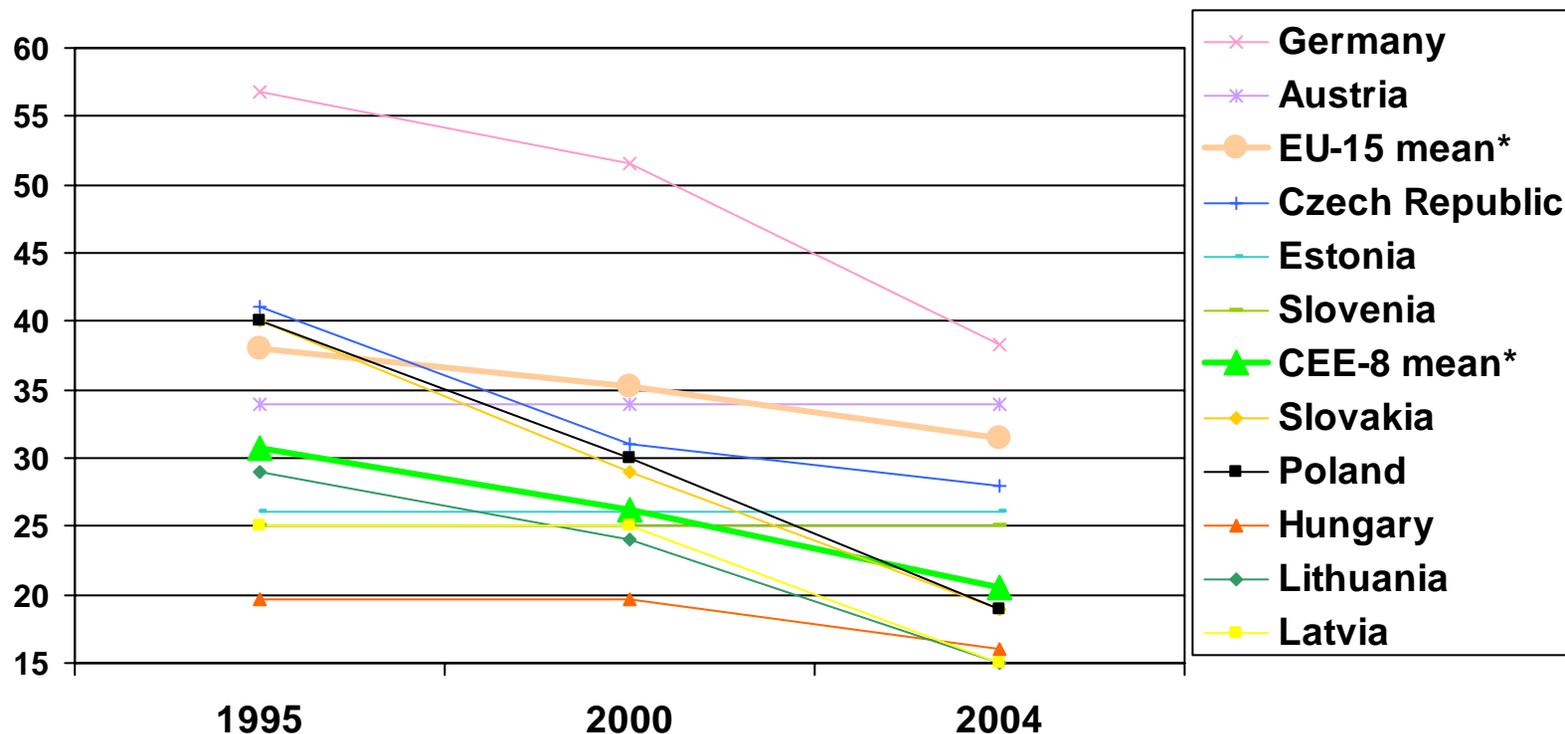
# The Low-Wage Advantage

Hourly Wages in Manufacturing and Services (in euros)



# Tax Dumping: Myth Or Reality?

## Corporate Income Tax Rates (in percent)



**\*EU-15 mean of 31.4% in 2004, versus 20.6% in CEE-8.**

**Bulgarian rate now at 19.5%, versus 25% in Romania.**

# Are Low Wages And Competitive Taxes Everything?

- ◆ **If yes...**
  - ◆ FDI flows would skip New Member Countries and flow directly further East (Balkans, CIS, India, China)
- ◆ **But...**
  - ◆ Advantages of operating in the same legal, regulatory environment
  - ◆ Quality of existing infrastructure
  - ◆ Market proximity, low transportation cost
  - ◆ Lack of barriers for bringing the product back into own markets
- ◆ **Rule No.1!**
  - ◆ Excessive wage growth in short periods of time may force investors to reassess their original investment plan

# If Reforms Continue, Romania and Bulgaria May Attract More FDI in Future

- ◆ Bulgaria and Romania look set to join EU in 2007
- ◆ Thus far, FDI in those 2 countries has mostly been linked with privatization, based on low wages
- ◆ Romania and Bulgaria good locations for FDI, as they are likely to have lowest wages in EU into next decade
- ◆ Still, given location, they are unlikely to serve as manufacturing sites for higher-end products aimed at more developed countries, at least in medium term

Gross Monthly Average Nominal Wage

