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**TRADE AND INVESTMENT  
IMPLICATIONS OF  
EU ENLARGEMENT**

APRIL 2004



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# **Trade and Investment Implications of EU Enlargement**

**Europe and World Trade Directorate  
UK Department of Trade and Industry**

**April 2004**

# Trade and Investment Implications of EU Enlargement

## Preface

The EU will gain ten new members on 1 May 2004, when Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia accede. Enlargement will reunify Europe in peace and stability after the divisions of the last century. It will entrench democracy, the rule of law and human rights across the continent. There are real gains in boosting the fight against international crime, and in driving up environmental standards. And the resulting stability will provide a European climate that is generally more conducive to trade and investment, as well as political and environmental co-operation.

Enlargement brings increased and improved trade and investment opportunities. Enlargement will increase the population of the EU by 20% to 455m creating the largest multi-country single market in the world - bigger than the US and Japan combined. And while the new member states are less affluent than the current EU, their rates of growth are consistently higher than those in the current EU, and should remain so in the immediate future, provided they continue to liberalise and operate effectively in the global market.

The UK has already been able to benefit from enlargement and the liberalisation of the former socialist economies through the Europe agreements of the 1990s - trade between the new member states and the EU15 is already tariff-free in the majority of sectors. The effects of this are clear. While trade with the new member states only represents 2% of total UK trade, it is growing fast. Since 1993, UK trade with the ten new member states has increased by 208% compared with 73% for our trade with the world as a whole.

But accession itself should bring further benefits. As members of the European Internal Market, the new member states will have to comply with all of the EU acquis, subject only to a limited number of transition arrangements. Compliance with EU technical standards and the acquis on, for example, state aids, will contribute to the final removal of the non-tariff barriers to trade. And the larger Internal Market means that firms can expand production, and take advantage of economies of scale. More competition will also lead to more choice and lower prices for consumers. And, just as with previous waves of accession, income levels in the accession states move towards the EU average, the purchasing power of consumers will grow, creating new opportunities for UK exporters.

There are many attractions for UK business for investment in the ten new member states, and EU accession will tend to enhance these:

- they offer political and macro-economic stability and a skilled and educated workforce compared to many other emerging markets;

- they are geographically close to the UK and offer free access to EU markets; and
- while their labour costs are not especially low in global terms they are competitive compared with much of the current EU.

Potentially larger than the gains from trade are the possible longer term gains from the continuation of the reform and liberalisation process which should lead to higher productivity and GDP growth. Most of the new member states have spent the last ten years rapidly liberalising their economies and their arrival should provide impetus for the rest of the EU in the process of economic reform and liberalisation that forms the wider Lisbon Agenda. These effects have the potential to raise the productive capacity of the enlarged EU as well as leading to a more efficient allocation of resources. They are potentially much more significant than the benefits flowing from increased trade, and provide the most promise of gains in the long run.

It is difficult to quantify the precise scale of the benefits. However, research for the CEPR\* suggests that accession could add 1.5% to the GDP of the new member states. GDP of the existing member states will also be increased by an estimated 0.2% or €11bn, of which the UK's share is estimated to be worth £1.75bn per year in 1999 prices.

Fears have been expressed about UK firms losing markets to more cheaply produced goods from the new member states. In reality a sudden flood of cheap imports is unlikely because the new member states already enjoy tariff-free access to EU markets, and much of the impact of increased competition in lower value goods has already been felt. Accession will of course also mean fairer competition.

There have also been worries that the UK will lose out to the new member states in attracting foreign direct investment (FDI). In fact the UK, EU15 and new member states are all competing for FDI in a world market where many factors other than labour costs are important: infrastructure, skills, and access to finance are examples of other aspects investors will consider.

We cannot stop the inevitable shift of low value, labour intensive production to lower wage economies including, sometimes, the new EU member states. In any case the UK cannot look to compete on the basis of reducing costs to the lowest possible level, but instead on the basis of high value and high skill.

And of course foreign direct investment flows into and between countries in an expanded EU are not part of a zero-sum game – a high proportion of investment in the new member states will be to take advantage of profitable opportunities or for serving local markets which are additional to those operations based in the UK or other EU15 countries.

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\* "The costs and benefits of eastern enlargement: the impact on the EU and central Europe"  
Richard E. Baldwin, Joseph F. Francois, and Richard Portes, Centre for Economic Policy Research, 1997.

In conclusion, on top of the broader geo-political gains, enlargement should bring economic benefits to the UK as well as to the new member states. While these are limited in scale, they are not insignificant. The new member states are relatively poor at the moment, but their economies have been growing faster on average than existing member states. As the income levels of the new member states move towards the EU average and purchasing power increases, there will be opportunities for further growth in UK exports of goods and services.

# Trade and Investment Implications of EU Enlargement

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## Summary

The **trade and investment implications** of EU enlargement are difficult to predict. Given the relatively small economic size of the new member states, and our currently low levels of trade and investment with them, the effects may be limited for the UK. Indeed, most of the changes in trade patterns may have already occurred. However, enlargement will generate a number of positive economic effects.

- There are trade and investment opportunities for the UK arising from enlargement. Although trade between the new member states and EU15 is already tariff-free in the majority of sectors, there are some exceptions: agriculture, coal, steel and textiles. Enlargement will reduce barriers further, especially non-tariff barriers.
- Enlargement will continue a process of economic integration between Eastern and Western Europe, which is leading to more competition, more efficient production, potentially lower prices and more choice for consumers.
- Enlargement will encourage growth in the joining countries and they are expected to achieve high levels of growth over the next decade provided they continue the process of economic reform, liberalisation, and institution building, which EU membership should reinforce.
- Most of the economic benefits will go to the new member states but existing member states will also experience a small positive effect – it is estimated that enlargement will add 1.5% to the new member states' GDP and 0.2% (or €11bn per year) to EU15 GDP.
- UK trade and investment links with the first wave of ten countries are currently minor, but our trade with them has grown faster than that with the world as a whole in recent years, partly reflecting that many barriers to trade have already been removed in preparation for accession.
- The new member states offer opportunities to invest, and their attractions – membership of the Internal Market, skilled labour force etc. – add to their appeal as an option among emerging markets.
- The new member states are competing with the UK for foot-loose foreign investment. However:
  - the UK is competing for foreign direct investment (FDI) in a world market on a variety of factors such as infrastructure, skills, access to finance and labour costs;
  - high inflows of FDI into the joining countries are also linked to privatisations and transition from centrally planned to market economies, and the benefits of that process to the new and existing member states are significant.

# Trade and Investment Implications of EU Enlargement

## Introduction

1. In 1993, in Copenhagen, the European Council launched the process leading to the further enlargement of the European Union. In December 2002, again in Copenhagen, the Council concluded negotiations with Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. The Accession Treaty for the ten new member states was signed in Athens on 16 April 2003, with full membership to follow on 1 May 2004.
2. Negotiations with Bulgaria and Romania are underway. Dependent on their further progress in complying with the membership criteria, a target date of 2007 has been set for their accession. Turkey is a candidate for EU membership but formal negotiations have not yet started. If the European Council in December 2004 decides that Turkey fulfils the Copenhagen political criteria, the European Union will open accession negotiations with Turkey without delay. Pre-accession assistance to all three countries is being increased.

## Benefits of EU enlargement

3. EU enlargement will increase the size of the European Internal Market and lead to increased trade. More trade, specialisation, and access to a larger market will raise welfare by leading to a more efficient allocation of expenditure and resources (known as *allocation effects*) or put another way, production is more efficient, and more competition potentially means lower prices for consumers. The larger market means that firms can expand production, potentially making larger profits, and take advantage of economies of scale. Consumers will also have a greater variety of choice.
4. Many of the benefits are already apparent as association agreements - the "Europe Agreements" - were concluded throughout the 1990s and the ten new member states already have tariff-free access to EU markets for most products.<sup>1</sup> However, accession and full implementation of the "acquis"<sup>2</sup> will further reduce barriers, in particular non-tariff barriers (so-called "frictional" barriers), through, for example, the harmonisation of regulations and standards.
5. Enlargement also has the potential to increase investment (mainly in the new member states), secure the process of economic reform and liberalisation in the new member states, and provide momentum to the Lisbon Agenda<sup>3</sup> in the enlarged EU – the central and Eastern European

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<sup>1</sup> The exceptions are agriculture, coal, steel and textiles.

<sup>2</sup> The "acquis" are the detailed laws and rules adopted on the basis of the EU's founding treaties, mainly the treaties of Rome, Maastricht and Amsterdam  
[http://europa.eu.int/abc/treaties\\_en.htm](http://europa.eu.int/abc/treaties_en.htm)

<sup>3</sup> The Lisbon Agenda is a ten-year strategy, which aims to make the EU the world's most dynamic and competitive economy. See:  
[http://europa.eu.int/comm/lisbon\\_strategy/index\\_en.html](http://europa.eu.int/comm/lisbon_strategy/index_en.html)

countries have spent the last decade or so liberalising their economies at a very rapid rate. These effects (known as *accumulation effects*) have the potential to raise the productive capacity of the enlarged EU rather than just lead to a more efficient allocation of resources, and therefore to lead to higher productivity and GDP growth. They are potentially much more significant than the benefits flowing from increased trade, and provide the most potential for gains in the long run, as the Europe Agreements have already reduced barriers to trade significantly. However, these accumulation effects are also more uncertain.

6. Most of the economic benefits of enlargement are expected to accrue to the new member states. Research for the CEPR<sup>4</sup> suggests that accession could add 1.5% to the new member states' GDP. Current member states also stand to benefit. Enlargement is projected to add up to 0.2% to GDP or about €11bn per year in 1999 prices, and create 300,000 jobs across the existing EU<sup>5</sup>. The UK's share of this (based on the importance of each member state's industry sectors in the EU15 sector totals and share of EU15 GDP) is estimated to be about 14% and worth £1.75bn a year in 1999 prices.
7. Enlargement will also bring important non-economic benefits – the political reunification of Europe, securing peace and prosperity, co-operation on security matters, crime, and the environment etc. These benefits will arguably be the biggest achievement of enlargement and cannot be easily valued in monetary terms. In addition there are other benefits that can only be captured through co-operation between existing and new EU member states e.g. reducing river pollution.

#### Costs of EU enlargement

8. On 11 February 2003, the Commission agreed its proposal for adapting the financial perspective in 2004-2006 to meet the demands of enlargement. The new member states are incorporated into the EU budget within the limits of the financial perspective agreed in Berlin in 1999, but at the same time the proposal ensures that the new member states will be *net beneficiaries* from the day they join. The ceilings for agriculture and the structural funds are to be increased. The ceiling on pre-accession aid is to remain unchanged, but a new heading is to be created for compensatory payments to be made to the acceding countries in the form of a temporary flat-rate cash-flow facility (€1,410m in 2004 shrinking to €1,041m in 2006).
9. Under the Copenhagen deal, the financial cost to the end of the current financial perspective in 2006 is a maximum of €40.8 billion. This sum includes agricultural subsidies, infrastructure and regional aid, as well as funds to help improve nuclear safety, public administration and border

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<sup>4</sup> "The costs and benefits of eastern enlargement: the impact on the EU and central Europe" Richard E. Baldwin, Joseph F. Francois and Richard Portes, Centre for Economic Policy Research, April 1997.

<sup>5</sup> Estimate by Heather Grabbe, Centre for European Reform, for the European Round Table of Industrialists, June 2001.

protection. A report for the Commission<sup>6</sup> estimates that the new member states will contribute some €15 billion to the EU budget and, because they are not expected to make full use of all the funds available to them, the net cost of enlargement for the period to 2006 in terms of cash actually disbursed may only be around €10 billion – about one-thousandth of EU GDP. In the longer term, more investment may be required in building an enlarged Europe. However, when all of the benefits of enlargement - economic *and* non-economic – are considered, it becomes apparent that, whatever the final total, it will be a relatively small price to pay.

#### Current economic conditions in the new member states

10. Accession of the new member states will increase the EU's population by approximately 75 million or 20% to around 455 million – the world's largest multi-country single market (see Annex Table 1). However, the relatively lower levels of GDP in the new member states mean that enlargement will add 4.8% to total EU GDP, equivalent to an economy slightly smaller than that of the Netherlands (see Annex Table 2).
11. The transition process has been economically painful for most of the former centrally planned economies. Whilst the estimated level of real GDP in, for example, Poland and Slovenia, has risen since 1989 (by 40% and 24% respectively), Latvia and Lithuania both had lower real GDP in 2003 than in 1989 (13% and 11% lower respectively) and Estonia's real GDP has increased by only 3% since 1989<sup>7</sup>. However, their progress through the transition process can only be described as rapid and remarkable, from economies which were almost entirely state run in the 1980s, to fully functioning market economies with high levels of private ownership today. And the highest growth rates in the EU25 are forecast for Estonia (4.7%), Latvia (7.5%) and Lithuania (8.9%) in 2003 and growth ranging from 5.5-6.5% forecast for the Baltic States in 2004<sup>7</sup>.
12. While the average GDP per capita *at market rates* in the new member states is about a quarter of that in the current EU15, in *purchasing power standard*<sup>8</sup> terms, the range for the new member states is from just over a third (Latvia) to just over three quarters (Cyprus), with an average just under half the current EU15 average (see Annex Tables 3a and 3b). Growth in most of the new member states has been generally stronger than that in the EU in the face of the global slowdown: according to the IMF, the candidate countries (including Romania and Bulgaria) grew on average by 2.9% in 2002 compared to 1.1% for the EU15<sup>9</sup>. Similar levels of growth are estimated for 2003 (3.3% for the candidate countries

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<sup>6</sup> Wim Kok, European University Institute, "Enlarging the European Union, achievements and challenges", March 2003.

<sup>7</sup> European Bank for Reconstruction and Development, EBRD, Transition Report update 2004.

<sup>8</sup> Purchasing Power Standards are commonly used rather than market exchange rates in making comparisons of GDP per capita across countries. By adjusting for differences in price levels between countries, they provide a better indicator of standards of living.

<sup>9</sup> Source: IMF World Economic Outlook, September 2003.

compared to just 0.8% for the EU15) followed by stronger growth when world economic conditions improve, with growth of 4.1% forecast for the candidate countries for 2004. The EBRD reports growth in central and Eastern Europe as having been a slightly more moderate 2.5% in 2002, and also forecasts 3.7% growth for 2003 and 4.3% for 2004<sup>10</sup>.

13. The resilience of the new member states has been supported by strong domestic demand, exports and investment by foreign companies. However, conditions and prospects vary. For example, the Polish economy has been relatively weak, after strong performance in the 1990s, with growth of only 1.0% in 2001 and 1.4% in 2002. Growth is expected to pick up, but is highly dependent on reduction of the fiscal deficit, in order to maintain investor confidence, and on economic recovery in the euro area. The Czech and Slovak Republics on the other hand posted growth of 3.1% and 3.3% for 2001, after relatively poor performance in the 1990s, and 2.0% and 4.4% respectively for 2002. Again fortunes are strongly linked to the performance of the eurozone economies and to whether policy adjustments can be made to tackle fiscal deficits, but for 2003, growth of 2.9% and 4.2% is forecast for the Czech and Slovak Republics respectively<sup>10</sup>.
14. All the new member states (apart from Slovenia) are running *current account* deficits, and indeed this conforms to the pattern predicted by economic theory: current account deficits are an expected feature of “catch-up” growth. Demand for investment increases rapidly and foreign direct investment (FDI) flows in. These deficits have been sustainable up to now because of expectations that, in the long run, access to the Internal Market, investment and restructuring will put these economies in a better position to finance them. If these changes fail to materialise, the prospects for FDI inflows could be damaged. Fiscal discipline will be an important issue to the new member states both in terms of maintaining investor confidence, and in their moves to join the euro<sup>11</sup> given the rules of the Stability and Growth Pact as it currently stands.
15. Whilst FDI inflows remain vital in this phase they cannot *replace* domestic savings if good growth performance is to be sustained long term. The new member states must also successfully manage the change from attracting FDI inflows based on privatisations to encouraging freestanding FDI from foreign firms. Continued economic reform is also key to continuing to achieve the high levels of productivity growth which have underpinned the strong growth performance of the new member states.

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<sup>10</sup> European Bank for Reconstruction and Development, EBRD, Transition Report update 2004. Central and Eastern Europe and the Baltic States, including Croatia but excluding Romania and Bulgaria. Note: any downward revisions to EU growth forecasts may depress these forecasts.

<sup>11</sup> One of the membership criteria is that new member states must be able to demonstrate “the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union”. The future members are thus expected to adopt the euro when they are ready to do so, but not immediately on accession.

For 1998-2002, Estonia and Lithuania averaged 9.2% and 8.7% manufacturing productivity growth, Hungary, 6.5% and Poland, 6.1%<sup>12</sup>.

#### Trade patterns

16. The main trading partner of the new member states is the EU15: in 2002, 68% of their goods exports went to, and 59% of their goods imports came from, the EU15. This is a marked shift of trade following the disintegration of the Soviet Union and the conclusion of the association agreements - so-called "Europe Agreements" - with the candidates which provide for tariff-free trade with the EU15 in most sectors in preparation for accession.
  
17. The main trading partners of the new member states tend to be those which are closer geographically and with whom they have historical ties i.e. Germany and Italy (as well as other new member state neighbours and Russia). In aggregate terms the UK is currently not a major trading partner for the new member states: in 2002, around 5% of their goods exports went to, and around 3% of their imports were from, the UK<sup>13</sup>, and they account for only about 2% of our total imports and exports<sup>14</sup>. However, the UK is an important export market for some new member states: around 15-17% of exports from Cyprus, Latvia and Lithuania go to the UK, and the UK is Latvia's second largest export market after Germany. The most important (European) export market for most of the accession states is Germany, except Estonia (for which it is Finland) and Cyprus (for which it is the UK). The UK's total trade with the new member states has grown at a faster rate than our total trade with the world as a whole. Since 1993, UK trade with the new member states has increased by 208% compared with a 73% increase in our trade with the world as a whole.

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<sup>12</sup> EBRD Transition Report 2003.

<sup>13</sup> UN Comtrade database.

<sup>14</sup> ONS The Pink Book - UK Balance of Payments 2003.

**Table 1 New member state exports and imports of goods in 2001**

2001	New EU10 goods exports		New EU10 goods imports	
	% of exports to EU15	% of total exports	% of imports from EU15	% of total imports
Austria	8	5	7	4
Belgium	4	3	4	2
Denmark	2	1	2	1
Finland	2	1	3	2
France	7	5	10	6
Germany	48	32	42	24
Greece	1	0	1	0
Ireland	1	1	1	1
Italy	9	6	13	8
Luxembourg	0	0	0	0
Netherlands	5	4	4	3
Portugal	1	0	0	0
Spain	2	2	4	2
Sweden	3	2	3	2
UK	8	5	6	4
<b>EU15</b>	-	<b>67</b>	-	<b>59</b>
<b>New EU10</b>	-	<b>13</b>	-	<b>10</b>
<b>ROW</b>	-	<b>19</b>	-	<b>31</b>
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

Source: UN Comtrade database

2001 is shown as data for all countries are not yet available for 2002.

18. In 2001, approximately 14,000 UK firms were exporting to central and Eastern Europe.<sup>15</sup> A further breakdown reveals that manufactures dominate goods trade, with another significant minority proportion of the UK's imports from the new member states being oil, gas and materials, especially from the Baltic States. Services account for about 16% of UK exports to the new member states and 11% of imports.
19. Accession itself will remove the final trade barriers, both tariff and non-tariff, which remain under the Europe Agreements. The new member states will apply the EU acquis in full and will be subject to Commission oversight for the first time. Various transition periods will be in place, which will allow, for example, for the new member states to delay meeting some EU environmental standards, because of the very high investment needed to do so. However, these arrangements have been carefully negotiated, their implications considered, and are time-limited. They are not expected to have a significant effect on the functioning of the Internal Market. There are no transitional arrangements on the tariff or other trade parts of the acquis. There is the potential for trade creation and diversion as the new member states become more open to third country imports, as the EU's common external tariff is on average lower than those which the

<sup>15</sup> Source: ONS. Note this includes Russia and CIS which will give a slightly higher figure than for just the new member states.

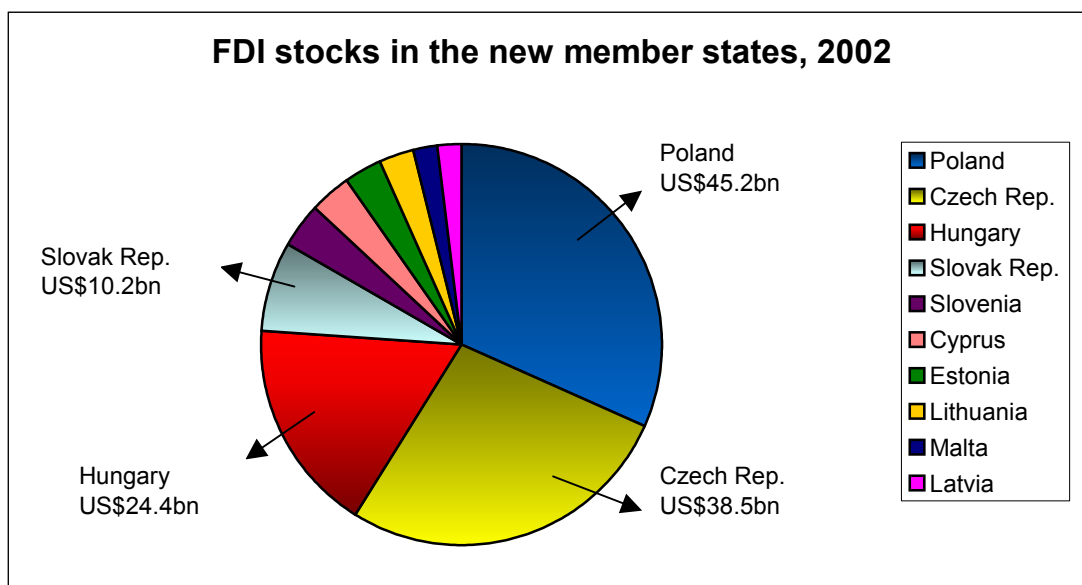
new member states have historically applied to third country goods. So, some EU exports to the new member states could be displaced by those from third countries, but the effect is not expected to be significant.

### Foreign Direct Investment

20. The new member states account for a small proportion of the world's FDI inflows but have been bucking the recent downward trend. While world FDI inflows fell by 21% in 2002 to US\$651bn (and UK inflows fell by 60% to US\$25bn), those into the new member states increased by 20% to US\$21.5bn. The new member states' share of world FDI flows increased from 2.2% to 3.3%. These figures mask a variation in performance however, with large falls in flows into Estonia, Hungary and Poland and increases of a similar magnitude into the Czech Republic and Lithuania, and much larger increases in flows into Latvia, the Slovak Republic and Slovenia. UNCTAD<sup>16</sup> forecasts that, despite the slowdown in privatisation programmes and in GDP growth in some states, the central and Eastern European countries are likely to have continued their resilient performance in 2003.
21. The new member states are therefore taking a larger share of a shrinking global FDI pie (albeit on a small scale relative to world flows) and all, with the exception of Slovenia, have UNCTAD FDI performance index values greater than one, indicating that they are attracting more FDI than could be expected based on their economic size. FDI flows are falling as a result of the global economic slowdown and uncertainties aggravated by corporate financial scandals. In comparison, the growth of flows into the new member states has on average has been strong and the accession process has reinforced restructuring, establishment of institutions and liberalisation of markets: the transition process.
22. The new member states represent opportunities for investors both in terms of greenfield investment and privatisations, but FDI flows are volatile, both in the aggregate and to and from particular countries. Poland, the largest recipient of FDI to the new member states had falling flows in 2002, down to under US\$4bn as its economy struggled. In contrast, Slovenia saw its flows increase by 271% to just under US\$2bn and the Czech Republic's increased by 65% to over US\$9bn. The "lumpiness" of privatisation investments can affect trends e.g. inflows to the Slovak Republic increased from US\$400m to US\$2bn in 2000, an increase of nearly 400%, associated with the advancement of the privatisation programme.
23. FDI stocks, which also include additions to foreign investment stocks financed locally, are perhaps a more meaningful indicator of the long term attractiveness of the new member states to foreign investors, and all (apart from Malta) increased their FDI stocks in 2002.

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<sup>16</sup> United Nations Conference on Trade and Development, World Investment Report, September 2003.



Source: UNCTAD World Investment Report, 2003

24. The UK currently invests very small amounts in the new member states: fractions of one per cent of our total FDI outward investment stocks. Of the £572bn stock of UK outward investment only £5.4bn<sup>17</sup> or just 0.9% went to the new member states in 2002. This compares with 57% to the EU15 and 21% to the US.

#### Future accession waves

25. Bulgaria and Romania are expected to join in 2007, provided they continue to make progress on the economic criteria. Their GDP per capita are currently only 8% and 9% of the EU15 average<sup>18</sup> respectively (a quarter in purchasing power parity terms<sup>19</sup>), but they will add another 30m consumers to the EU Internal Market.

26. Turkey also has low per capita GDP at nearly 12% of the EU15 average (a quarter in purchasing power parity terms<sup>19</sup>) but accession of Turkey would mean an extra 65 million consumers – almost as large as the total population of the new member states. The export and investment opportunities if Turkey joins the EU are potentially as significant as those for the current accession of ten countries.

#### **Opportunities**

27. Enlargement will lead to the removal of the remaining trade barriers and consequently to increased trade between EU15 and new member state economies. There may be opportunities for further growth in UK exports to the new member states, and they are likely to increase their exports to the UK. There may be more scope for the latter, as the new member

<sup>17</sup> Source: Office for National Statistics – UK outward investment by country.

<sup>18</sup> IMF Economic Outlook September 2003, at market rates.

<sup>19</sup> Eurostat.

states are starting from a lower base in terms of exploring export opportunities, and, as FDI is increasing, the competitive position of the new member states and their market development capabilities will potentially improve.

28. On accession, the new member states will have to comply with EU standards and regulations making them a more attractive trade and investment environment for UK firms. But the incremental opportunities arising from the removal of these “frictional” barriers are likely to be less (for trade) than those which have already arisen through the removal of tariffs (under the Europe Agreements). The exception to this might be in trade in services where these frictional barriers can significantly impede trade<sup>20</sup>. In other sectors, many of the short term trade effects of enlargement may have already been realised. For investment however, the removal of frictional barriers may be more important and most of the impacts may be yet to come.
29. In the long term, as the income levels of the new member states rise towards the EU average, there will be greater opportunities for UK exports to grow. A Commission Report on real income convergence<sup>21</sup> shows that although some countries already have GDP per capita levels similar to that of Portugal and Greece, some of the new member states are expected to take several decades to catch up to EU15 levels. They predict that countries such as Poland may take over 30 years to reach 75% of the EU15 average GDP per capita (in purchasing power parity terms). On the other hand, Cyprus is already at over 75% of EU15 average GDP per capita and Slovenia is expected to achieve a similar level within the next few years. Enlargement does not guarantee high growth rates, but the new member states are forecast to record them, provided they continue a process of economic reform, liberalisation and institution building.
30. Growth of trade is likely to be accompanied by a change in trade patterns over time. Although they have changed a great deal, the central European economies still retain some of the legacy of central planning, retaining capacity in sectors where they are not internationally competitive and not having fully developed those sectors where they are competitive. Joining the EU limits their freedom to provide distortive subsidies. It therefore seems likely that continued exposure to market forces and the opportunities presented by the larger EU Internal Market will significantly reduce excess capacity and encourage other sectors to develop.

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<sup>20</sup> The Commission has published a draft Directive on Services in the Internal Market designed to remove remaining barriers to trade in services in the EU.

[http://europa.eu.int/comm/internal\\_market/en/services/services/index.htm](http://europa.eu.int/comm/internal_market/en/services/services/index.htm)

<sup>21</sup> “Real convergence in candidate countries – past performance and scenarios in the pre-accession programmes”, European Commission, DG Economic and Financial Affairs, 16 November 2001.

31. In the CEPR study mentioned earlier<sup>22</sup>, the authors argue that there are some sectors – transport equipment, other machinery, and chemicals, rubber and plastics – in which EU/central European trade has been dominated by existing EU member states. Central European firms already face tariff-free trade and accession will end the scope for subsidies, leading to new member state firms closing uncompetitive capacity (although the pace at which this occurs depends on the speed at which subsidies are phased out). This will result in an even larger potential market for Western European firms.
32. There could be more attractive opportunities for UK firms to invest in the new member states as there will be lower risk premia associated with them compared to other emerging markets. Accession to full EU membership should further reduce risk profiles and “lock-in” the other reasons why the new member states are currently attractive to investors:
- political and macro-economic stability, and a skilled and educated workforce, relative to other emerging markets;
  - close geographical proximity, and free access, to EU markets.
  - favourable investment climates - most countries have set up schemes to attract investors (although the terms of these are being modified to meet the requirements of EU membership) and most have relatively low levels of regulation post-transition.
- There could be more opportunities for UK firms to bid for infrastructure projects, which could flow from structural fund awards, although a higher proportion of projects are likely to be financed by the private sector, national governments or development banks.
33. The new member states have been relatively starved of investment for decades but their highly educated labour force might provide opportunities that some UK firms may be able to exploit. The relative merits of the new member states as investment destinations will be enhanced by full EU membership, and will be another option firms will consider against investing here in the UK or elsewhere in the world.
34. The new member states have come a long way in a relatively short period of time, from centrally planned to market economies, and continue to make steady progress in strengthening the performance of their market-supporting institutions. EU accession has been both a driver for and a facilitator of economic reform: greater growth prospects and stability have helped to demonstrate the benefits of the reform process, and further progress should follow accession. The EBRD reports that the greatest recent advances have been in the financial sector, bringing regulations into line with EU requirements and making investment easier.

### **Threats**

35. There are concerns that UK firms will lose markets to more cheaply produced manufactures from the new member states where labour costs are lower. But a flood of cheap imports is unlikely because:
- the new member states already enjoy tariff-free access to EU markets in most sectors under the Europe Agreements;

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<sup>22</sup> “The costs and benefits of eastern enlargement: the impact on the EU and central Europe” Richard E. Baldwin, Joseph F. Francois and Richard Portes, Centre for Economic Policy Research, 1997.

- subsidies will be limited as the new member states will be bound by the same state-aid rules as the existing member states and EU standards and regulations will be enforced;
  - UK firms are competing in a world market and are therefore likely to encounter tough competition from elsewhere in the world where production/labour costs may be even lower;
  - UK firms do not compete on labour costs alone, instead focusing on maximising productivity and higher value-added activities.
36. There are few analyses of which sectors stand to gain or lose out to new member state competitors in the current EU15, largely because it is difficult to predict how trade patterns will develop and which countries have advantages in which sectors. Competition in low value-added goods has already impacted, but competition in high value-added sectors is expected to intensify as increased investment in the new member states begins to pay off. For most sectors it is important that the new member states will not only enjoy tariff-free access to European markets, but will also face all EU-wide regulations and standards. It is important that standards on employment, environment etc. are adequately enforced in the new member states. The accession states are likely to be under careful scrutiny, as are existing member states.
37. There are concerns that the UK is losing FDI to the new member states and cannot compete with them on labour costs. However, whilst they are in direct competition with existing EU member states for foot-loose foreign investment, particularly in sectors where labour costs are a significant factor:
- the UK, EU15 and new member states are competing for FDI in a world market and factors other than labour costs will be important such as infrastructure, skills, access to finance etc.;
  - a high proportion of investment into the new member states will be to take advantage of profitable opportunities, or for serving local markets, which are additional to those operations based in the UK or other EU15;
  - low wage areas of the EU15 are typically in parts of Spain, Portugal and Greece - the UK as a whole is not a low wage economy - however some poorer, high unemployment rate areas of the UK could be affected;
  - in the long run we can expect to see labour costs rise in the new member states as living standards catch-up with the rest of the EU;
  - high inflows of FDI into the new member states are also linked to privatisations and transition from centrally planned to market economies, the benefits of that process to the new and existing member states are significant, and this trend is likely to decline as the transition process moves into the advanced stages.
38. A longer term issue is whether the new member states will be able to close productivity and quality gaps with the existing member states. If this happens it will intensify competition between the new member states and the EU15 – a positive development. However, as discussed earlier:
- the new member states have a long way to go to catch up but are already becoming competitive in a minority of sectors (e.g. automotive and food processing);
  - there is not a fixed pot of investment funds for the EU – investment leads to growth and more investment opportunities, which in turn lead to more growth and more funds available for investment.

### Conclusion

39. The trade and investment implications of EU enlargement for the UK are difficult to predict but there should be potential for further growth in both export and investment opportunities for UK firms. The new member states are not large countries or rich, although they have good growth prospects. The UK's trade with them is currently small (about 2% of our total trade) but is growing faster than our trade with the world as a whole, reflecting that many barriers to trade have already been removed in preparation for accession. The continued economic growth of the new member states is very dependent on the momentum for economic reform and liberalisation being maintained, sound macro-economic policy, and the effective use of structural funds in ways which are supportive of the reform agenda. These in turn will sustain the trend for increased trade and investment in the new member states.

**Europe and World Trade Directorate  
UK Department of Trade and Industry  
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## Annex

**Table 1 Populations of EU15, new member states and candidates, 2002**

Country	Population (m)
Germany	82.5
Turkey	69.6
France	59.4
UK	58.9
Italy	57.9
Spain	41.2
<b>Poland</b>	<b>38.6</b>
Romania	22.4
Netherlands	16.1
Greece	10.6
Belgium	10.3
<b>Czech Republic</b>	<b>10.2</b>
<b>Hungary</b>	<b>10.2</b>
Portugal	10.0
Sweden	8.9
Austria	8.1
Bulgaria	7.9
<b>Slovak Republic</b>	<b>5.4</b>
Denmark	5.4
Finland	5.2
Ireland	3.9
<b>Lithuania</b>	<b>3.5</b>
<b>Latvia</b>	<b>2.3</b>
<b>Slovenia</b>	<b>2.0</b>
<b>Estonia</b>	<b>1.4</b>
<b>Cyprus</b>	<b>0.8</b>
Luxembourg	0.4
<b>Malta</b>	<b>0.4</b>
<b>New EU10</b>	<b>74.7</b>
<b>EU15</b>	<b>379.0</b>
<b>EU25</b>	<b>453.7</b>
Bulgaria, Romania, Turkey	99.8
<b>Total EU28</b>	<b>553.6</b>

Source: World Development Indicators database, World Bank, 2003.

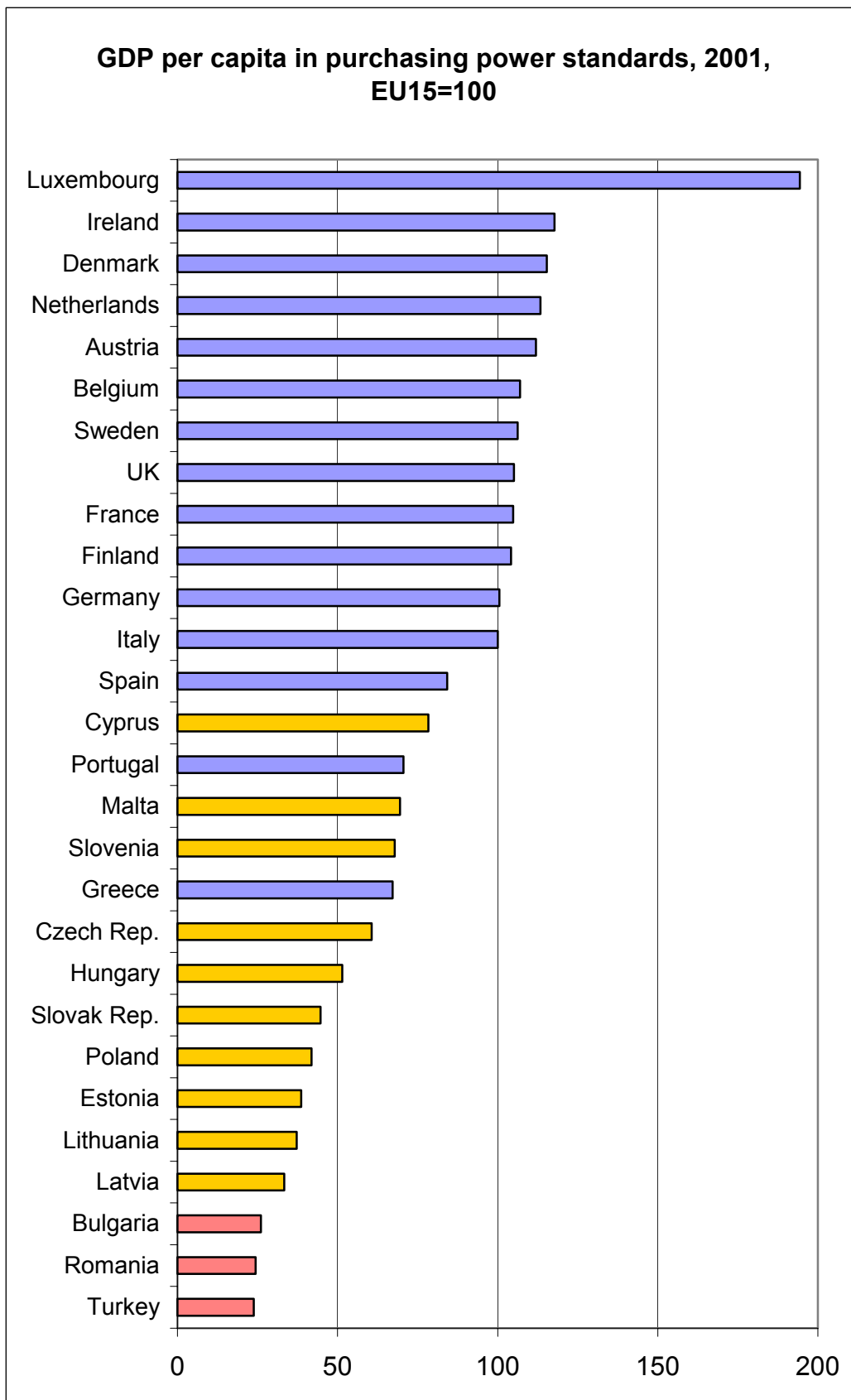
**Table 2 GDP and GDP per capita\* of EU15, new member states and candidates, 2002**

Country	GDP per capita US\$	GDP US\$bn
Luxembourg	46,021	21
Denmark	32,215	173
Ireland	31,334	122
Sweden	26,878	240
UK	26,496	1567
Netherlands	26,077	420
Finland	25,209	131
Austria	25,131	205
Belgium	24,390	246
Germany	24,197	1,992
France	23,475	1,437
Italy	20,465	1,188
Spain	16,253	655
<b>Cyprus</b>	<b>15,766</b>	<b>10</b>
Greece	12,155	133
Portugal	11,974	122
<b>Slovenia</b>	<b>11,031</b>	<b>22</b>
<b>Malta</b>	<b>10,001</b>	<b>4</b>
<b>Czech Republic</b>	<b>6,784</b>	<b>70</b>
<b>Hungary</b>	<b>6,646</b>	<b>66</b>
<b>Poland</b>	<b>4,884</b>	<b>189</b>
<b>Slovak Republic</b>	<b>4,389</b>	<b>24</b>
<b>Estonia</b>	<b>4,380</b>	<b>6</b>
<b>Lithuania</b>	<b>4,015</b>	<b>14</b>
<b>Latvia</b>	<b>3,581</b>	<b>8</b>
Turkey	2,699	178
Romania	2,046	46
Bulgaria	1,932	16
<b>New EU10</b>	<b>5,560</b>	<b>413</b>
<b>EU15</b>	<b>22,740</b>	<b>8,653</b>
<b>EU25</b>	<b>19,910</b>	<b>9,066</b>
Bulgaria, Romania, Turkey	2,492	240
<b>Total EU28</b>	<b>16,769</b>	<b>9,306</b>

Source: IMF World Economic Outlook

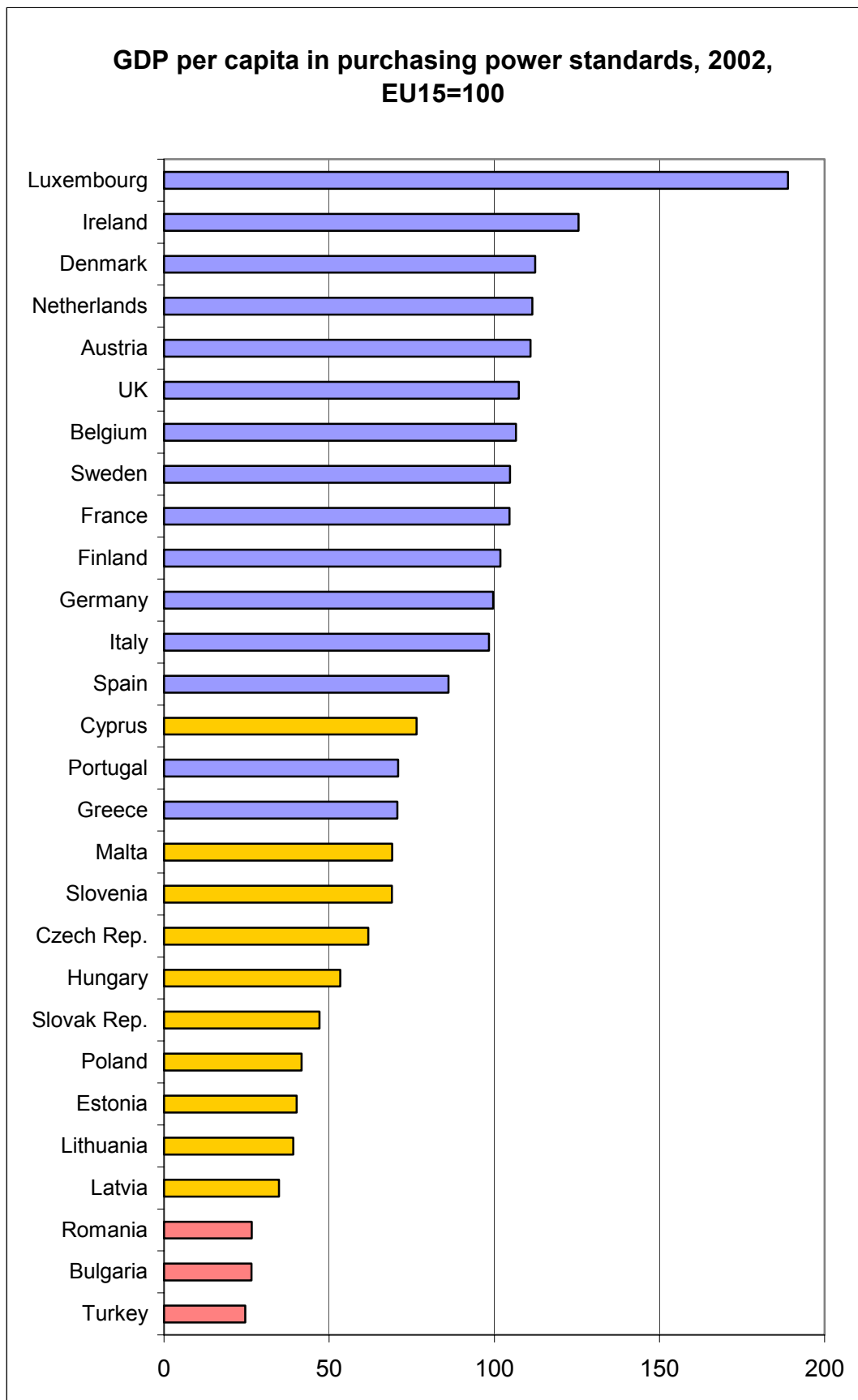
\*Note: at market exchange rates.

**Table 3a**



Source: Eurostat.

**Table 3b**



Source: Eurostat *forecast*.

