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The Eastern Enlargement of the EU – An Initial Assessment: Growing Imports to the New Member States from the Euro Zone

Timo Baas and Mechthild Schrooten

On 1 May 2004 eight former socialist countries – Estonia, Latvia, Lithuania, Poland, the Czech Republic, the Republic of Slovakia, Hungary and Slovenia[1] – joined the European Union.[2] In the accession year the new EU member states have experienced powerful macroeconomic dynamics, and convergence of per capita income within the new EU-25 was progressing. However, it is remarkable that the eastern enlargement of the EU had not the particularly strong impact on growth for the accession countries that many had expected – macroeconomic growth decreased in many of the new member states in the period after entry, although it is still high. This is probably due to stronger trade links which developed between the euro-zone countries and the new member states after their accession. Whereas the new member states were confronted with relatively weak demand from the euro zone, the euro-zone countries in turn could profit from the dynamic development in the new member states, and from the effects of accession in redirecting trade flows. The share of imports from the euro zone has risen, while trade between the accession countries and non-EU states has fallen noticeably.

The accession treaties entail for the new member states to introduce the euro in time, but an exact timetable has not been fixed. Pre-condition for joining is the fulfilment of the Maastricht or convergence criteria. Therefore considerable efforts have to be made by many of the new member states, in particular in regard to the situation of their public budgets, and in combating inflation.

[1] For the sake of simplicity these countries are referred to here as the new EU member states; Malta and Cyprus, which joined on the same day, are not included.

[2] The EU now consists of 25 economies.

High macroeconomic growth rates in new member states

Growth in the new member states remained powerful in 2004, the year they joined the European Union (cf. table 1)[3]; according to present data real growth of around 5% was achieved. Thus these economies performed much stronger than the EU-15 and the euro zone.[4]

The macroeconomic dynamics in the new member states are still due to strong domestic demand.[5] Private consumption in particular has been growing strongly, as real wages have clearly risen. Investment has also shown a strong increase, after falling noticeably, in the years before EU accession.[6] Both private investment in fixed assets and public investment in the infrastructure increased – helped by EU funds. In some countries a positive stimulus may also have come from the relatively high foreign direct investment, as investment in supplier branches appears attractive in many cases.

A contributory factor could be that the wage level is still relatively low compared with that in the EU-15, despite the rapid increasing real wages. However, it is striking that the unemployment rate remains on a high level in nearly all the new member states regardless of the high growth rates.[7] Finally, the new EU member states must be regarded as small economies with a high degree of openness: exports and imports have a big impact on the macro economy. Exports by these countries increased strongly in 2004, especially in the first half of the year when they were able to profit from the favorable conditions in the world economy. Imports also grew remarkably in many cases.

However, the analysis of macroeconomic activities in the course of 2004 shows down-turning growth rates. It is clear that in the second half-year of 2004 – which by the way was after the EU accession – macroeconomic dynamic reduced, especially in the fourth quarter. This also reflects the cooling in the euro zone, which affected economic development in the new member states through close trade links.

Table 1
Gross Domestic Product and Unemployment Rates in New EU Member States

	GDP		Unemployment rates	
	Change on the previous year (%)		%	
	2003	2004	2003	2004
Estonia	5.1	6.1	10.0	10.0
Latvia	7.5	8.5	8.6	8.7
Lithuania	9.7	6.7	12.4	11.4
Poland	3.8	5.4	19.9	19.6
Slovakia	4.5	5.5	17.4	18.1
Slovenia	2.5	4.6	6.7	6.3
Czech Republic	3.7	4.0	7.8	8.3
Hungary	2.9	4.0	5.9	6.1
Memo item:				
EU-25	1.0	2.3	9.1	9.0
EU-15	0.9	2.2	8.0	8.0
Germany	–0.1	1.6	9.1	9.5

Sources: National statistics; DIW Berlin calculations.

Trade with the euro zone: export shares stagnate while import shares are dynamic

The start of the political and economic transition process[8] brought a far-reaching geographic reorientation of foreign trade for all the former socialist countries. Where before trade within the group of socialist economies played the central role, after the socialist system collapsed trade with western countries increased in importance.

Since the end of the 1990s more than 80% of exports by the new member states has gone to the EU. The European Union also accounts for the lion's share of these countries' imports (about 70%), with trade with the euro zone playing an important part.[9] Before acces-

[3] DIW Berlin presented a detailed analysis of the Eastern enlargement of the EU last year, cf. Tilman Brück, Herbert Brücker, Hella Engerer, Christian von Hirschhausen, Mechthild Schrooten, Dieter Schumacher, Ulrich Thiessen and Harald Trabold: 'The Eastern Enlargement of the European Union: Clear Challenges, Unjustified Fears', in: *DIW Economic Bulletin,* vol. 41, no. 6, June 2004

[4] By GDP comparison the new central and eastern European member states are small: in total they have about 4.5% of the present EU-25 GDP; however, in relation to population the figure is over 20%.

[5] Cf. the most recent diagnosis by the Economic Research Institutes: 'The World Economy and the German Economy in the Spring of 2005', in: *DIW Berlin Weekly Report,* no. 14/2005.

[6] Mechthild Schrooten: 'Ökonomische Perspektiven der EU-Osterweiterung', in: *Der Bürger im Staat,* vol. 54, no. 1/2004, pp. 17-19.

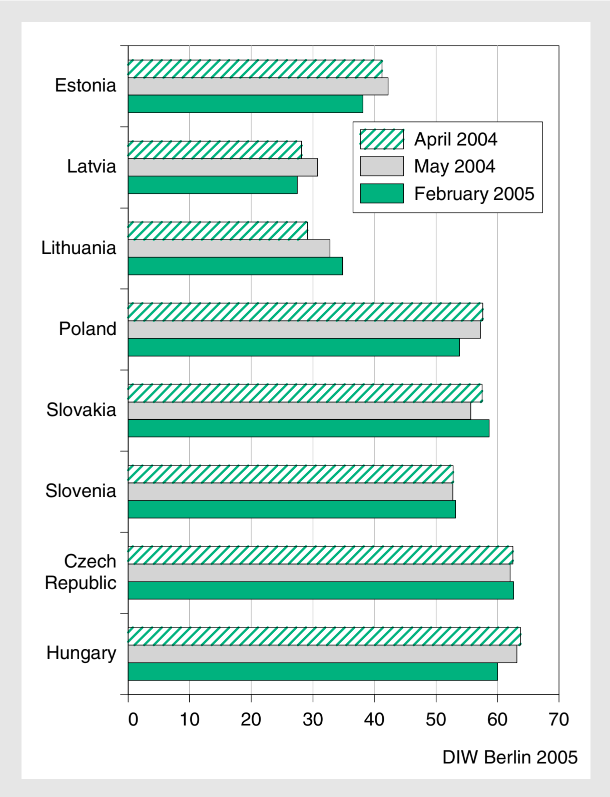
[7] Slovenia and Hungary are exceptions, both with unemployment at around 6%, so below the average of the EU-15 (8% in 2004).

[8] The transition from a socialist economic system to a market economy began at different times in the individual central and eastern European economies. Poland was one of the first (1989), while the social and economic transformation process started relatively late in Estonia, Latvia and Lithuania (1992).

Figure 1

New EU Member States Exports

Share of deliveries to the euro zone in %[1]

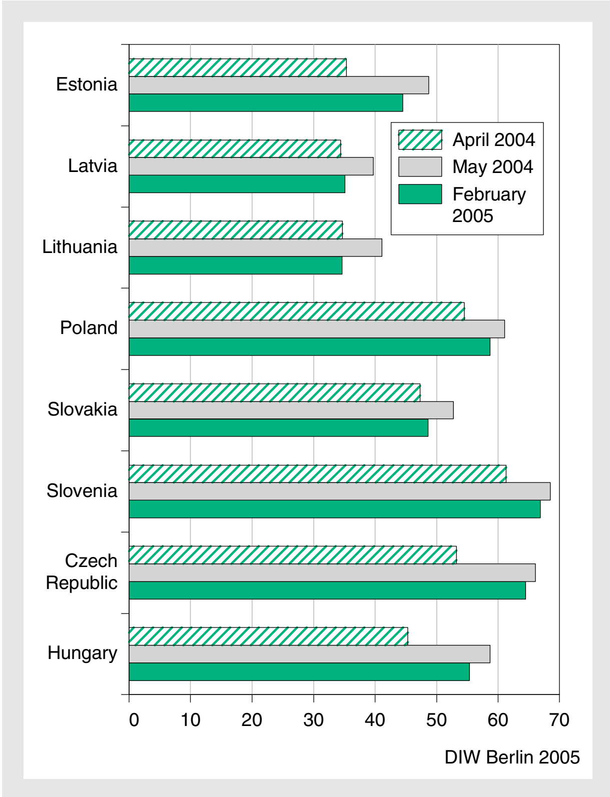


1 Adjusted for seasonal fluctuations and trading days.
Sources: Eurostat; DIW Berlin calculations.

Figure 2

New EU Member States Imports

Share of deliveries from the euro zone in %[1]



1 Adjusted for seasonal fluctuations and trading days.
Sources: Eurostat; DIW Berlin calculations.

sion about 58% of these countries' total exports went to the euro zone, and the euro-zone states accounted for a considerable share, about 50%, of their total imports. The Czech Republic is the most important exporter to the euro zone, followed by Poland and at some distance by Hungary. These three economies are also the most important customers for products from the euro zone among the new member states.

There were already considerable differences between the individual new member states in the degree of trade with the euro zone before they joined the EU, and these differences evidently still persist. In other words, the new member states are not a homogeneous block in regard to their trade links and their real economic integration in the euro zone. Geographical factors, historical business ties and the importance and origin of foreign direct investment in the individual new member states are no doubt playing a part here. Before accession, Lithuania and Latvia, for example, did not send as much as 30% of their exports to the euro zone, whereas the figures for Hungary and the Czech Republic were over 60% (cf. figure 1).[10] There are similar geographic patterns in imports, with the euro zone the dominant region for Poland, the Czech Republic and Slovenia (cf. figure 2).

More than half of the new member states' total exports go to the euro zone now. This share has been stagnating since 1999, nor did it rise after they joined the European Union, although the share of imports from the euro zone leapt up after accession. Before accession, the goods imported by Lithuania and Latvia from the euro zone, for example, accounted for about 35% of their total imports; the Czech Republic and Poland were clearly above the 50% mark, and Slovenia was in the lead with a share of more than 60%. In the month of accession these shares increased markedly, to around 40% for Lithuania and Latvia, and more than 60% for Poland. The Czech Republic and Hungary showed the

[9] This review is based on the Eurostat data on the development of the new member states' foreign trade with the euro zone.

[10] This paper focuses on trends, as the consistency of the time series given by Eurostat is still uncertain.

Box

The eastern enlargement of the EU: statistical and methodological effects on foreign trade data

Different techniques are used to obtain data on EU foreign trade and trade within the EU. The EU foreign trade data is obtained from customs reports while the data on the internal trade is taken by company polls. So with the accession the new members had to change the method of obtaining data on their trade in goods,[1] as the method used to collect data on EU internal trade now applies to them as well. This, and especially the change in the handling of transit goods, inevitably distorted the data base, moreover, parts of trade in goods are no longer covered by data collection. That has resulted in a methodological break.

Beside the statistical and methodological changes the conversion in itself has caused further problems, as companies that are obliged to collect data may not yet have complied with the reporting requirement.[2] However, that problem should be solved by autumn 2005 at the latest, as all the ex post reports for the previous year have generally been received by autumn.

The following are some of the particular features of the basic changes resulting from EU enlargement:

– *Transit trade*
  Goods imported into an EU country through a non-EU country are regarded as trade with that non-EU country. Now that customs barriers have been dropped for the new member states these movements of goods are classified as transit trade, and they are no longer included in trade in goods.

– *Free movement of goods*
  The member states of the European Union are reducing the reporting requirements, particularly for small and medium-sized companies[3] in order firstly to ensure the quality of statistical data and secondly to avoid overburdening these companies. By contrast, EU foreign trade of less than 1 tonne or a value of less than 1 000 euros is no longer included. Small and medium-sized firms are not exempt owing to customs duties. Hence the transition from foreign to internal trade classification causes a change in the data base.

[1] Cf. German Bundesbank, *Monthly Report,* March 2005

[2] Cf. German Bundesbank, loc. cit.

[3] Cf. European Commission: 'Statistics on Trade in Goods, User Guide', Luxembourg 2002.

biggest leap in the first month after accession, with their shares of imports from the euro zone rising by 13 percentage points each to 66% and 58% respectively.

Despite a few subsequent fluctuations these new structures have proved to be relatively stable. The development in foreign trade suggests that following the EU eastern enlargement trade flows shifted mainly in favour of imports from the euro zone. Methodological and statistical effects have to be taken into account in interpreting the Eurostat time series, but these affect the figures on exports and imports equally, so they are not sufficient to explain the whole development in imports (cf. box).[11]

Possible causes of the trade shift

Before the accession the former candidate countries signed preferential trade agreements with the EU as a preliminary step to joining, and they adapted EU foreign trade schemes. That caused a shift in trade flows.[12] Exports to the EU, particularly into the euro zone, increased (cf. figure 3), and deliveries to other countries correspondingly lost importance. That development started before the actual accession to the EU.

The situation was different with imports (cf. figure 4). Foreign trade schemes levied by the new member states were not fully adjusted to the EU foreign trade schemes before accession, this was only done on joining. The new regulations came into force on 1 May 2004, replacing at a stroke the national duties that had been in force until then and had, in some cases, been lower. This changed the conditions for foreign trade and probably explains a considerable part of the strong redirection of imports towards the EU, and especially the euro zone, that followed accession.

The Outlook: joining the euro zone

According to the accession treaties the new member states have to join the euro zone and to introduce the

[11] The Eurostat trade data suggest that trade shifts are more likely, as first, the euro zone's share of imports has risen and secondly, the volume of exports remained largely constant, after seasonal adjustment.

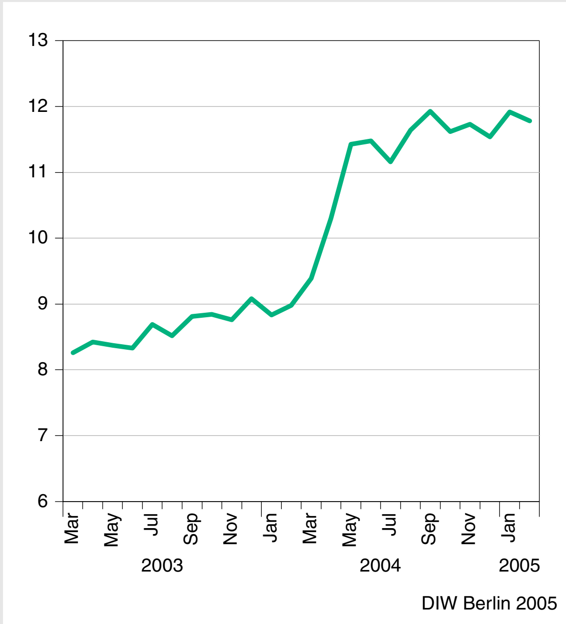
[12] Trade flows are redirected when imports from countries outside a customs union are shifted to countries within that union because of the change in international price structure. While imported goods from the customs union become relatively less expensive, goods from outside become relatively more expensive. And even though the European Union goes far beyond a classical customs union, in which customs duties within the union are zero and duties are levied on goods from outside, the foreign trade effects are likely to be similar.

common currency. However, an exact timetable for the entry has not been fixed. But it is already evident that they will certainly not join at the same time. As well as implementing the appropriate legal and institutional conditions and two years membership of ERM II, fulfilling the Maastricht or convergence criteria is also a condition for joining the European Monetary Union. Financial indicators are the centerpiece of the Maastricht criteria. There are five points to indicate convergence: price stability, the financial situation of the public budgets – firstly the budget deficit and secondly public debt, exchange rate stability and convergence of long-term interest rates (cf. table 2).

By now only Lithuania fulfils the convergence criteria for joining the euro zone, but it still needs to make the necessary changes to the legal framework. Since Lithuania joined the ERM II exchange rate mechanism on 27 June 2004 (cf. table 3), it could join the euro zone and introduce the common currency in mid-2006.

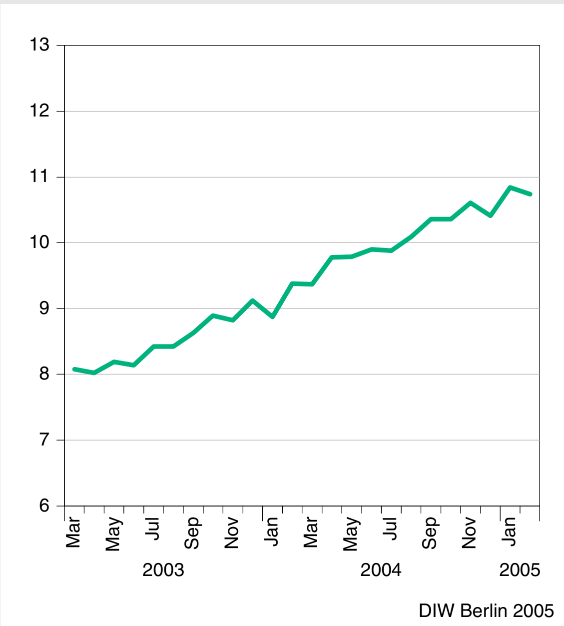
Estonia and Slovenia are two more countries that have joined ERM II already, but they do not fulfil the convergence criteria yet; Estonia was successful with price stability in 2003 but failed to meet this criterion in 2004. Hence it is an open question when it can join the currency union. Slovenia did not fulfil the price stability

Figure 4
New EU Member States Imports from the Euro Zone
In billion euros[1]



1 Adjusted for seasonal fluctuations and trading days.
Sources: Eurostat; DIW Berlin calculations.

Figure 3
New EU Member States Exports to the Euro Zone
In billion euros[1]



1 Adjusted for seasonal fluctuations and trading days.
Sources: Eurostat; DIW Berlin calculations.

criterion in 2004 either, so in this case, it is not yet clear when the euro can be introduced.

Latvia took an important step towards joining ERM II by fixing the lat to the euro in January 2005. In a second step they joined the exchange rate mechanism on 2 May 2005. Hence it could join the European Monetary Union in two years, after two years membership of ERM II, although further efforts are needed, for example to reduce the inflation rate.

All the other countries are planning to join ERM II in 2006/2007, making European Monetary Union membership possible in 2008/2009 at the earliest. However, it must be borne in mind that Hungary and Poland do not yet fulfil three of the convergence criteria, beside legal requirements and membership of the ERM II mechanism.

The discussion on the Stability and Growth Pact

In the current discussion it is occasionally assumed that the reform of the Stability and Growth Pact will make it easier for the new member states to join the European

Table 2
New EU Member States Convergence Indicators

	Convergence of inflation rates		Convergence of long-term interest rates		Fluctuation in the exchange rate to the euro[3]		Financial situation of public budgets			
	Change in consumer prices (HICP) in %[1]		Yield on government bonds[2] in %		Change in exchange rate on previous year (%)		Budget deficit as % of GDP		Public debt as % of GDP	
	2003	2004	2003	2004	2003	2004	2003	2004	2003	2004
Convergence criteria of the EU	2.8	2.6	6.2	6.2	15.0	15.0	–3.0	–3.0	60.0	60.0
Estonia	1.4	3.0	5.3	4.4	0.0	0.0	3.1	1.8	5.3	49.0
Latvia	2.9	6.2	4.9	4.9	5.1	1.9	–1.5	–0.8	14.4	14.4
Lithuania	–1.1	1.1	5.3	4.5	–0.1	0.0	–1.9	–2.5	21.4	19.7
Poland	0.7	3.6	5.8	6.9	7.0	1.4	–4.5	–4.8	45.4	43.6
Slovakia	8.5	7.4	5.0	5.0	–1.4	–1.8	–3.7	–3.3	42.6	43.6
Slovenia	5.7	3.6	6.4	4.7	1.7	1.1	–2.0	–1.9	29.4	29.4
Czech Republic	–0.1	2.6	4.1	4.8	1.7	0.1	–11.7	–3.0	38.3	37.4
Hungary	4.7	6.8	6.8	8.2	2.2	–0.4	–6.2	–4.5	56.9	57.6

1 The harmonised index of consumer prices (HICP) is used to assess inflation convergence in accordance with Article 121 of the Amsterdam Treaty. — 2 Government bonds on the secondary market with a remaining term of about ten years. — 3 The exchange rate criterion is regarded as fulfilled after two years membership of ERM II, if the maximum fluctuations during that time are less than 15%.
Sources: Eurostat; DIW Berlin calculations.

Monetary Union. As the Stability and Growth Pact applies only to countries that are already in the euro zone such a statement is questionable. It depends on how the clause stating that a country may not have an excessive public deficit on the date of joining, is interpreted.[13] Entry to the euro zone could only be made easier for the new member states if the reform of the Stability and Growth Pact also leads to a change in the interpretation of the convergence criteria.

However, the latest trade developments have probably stimulated the discussion on the introduction of the common currency. In Latvia, for instance, fixing the national currency to the euro was justified by greater integration in trade with the euro zone.[14] Secondly, the theoretical literature prove that a higher trade integration is a decisive factor for an optimal currency area.[15] So the growing importance of trade between the new EU member states and the euro zone must be regarded as in itself an important step towards joining the European Monetary Union.

[13] If it were possible for the new EU member states to calculate their way out of their deficit by switching to a partly privately financed bond system the Polish deficit, for example, would come down by 1.5 percentage points for 2004 and 0.6 percentage points for 2007. Source: Crédit Suisse First Boston.

[14] Cf. Latvijas Banka: 'Monetary Policy of the Bank of Latvia', Riga 2004, (cf. www.bank.lv/eng/monpolicy/Is-euro/).

[15] Cf. R.I. McKinnon: 'Optimum Currency Areas', in: *American Economic Review,* vol. 53, 1963, pp. 717ff.

Table 3
Exchange Rate Regimes in New EU Member States

	Exchange rate regime	Membership of ERM II
Estonia	Currency board[1]	Yes
Latvia	Currency board[1]	Yes
Lithuania	Fixed with margin[2]	Yes
Poland	Flexible exchange rate	No
Slovakia	Managed floating[3]	No
Slovenia	Fixed with margin[2]	Yes
Czech Republic	Managed floating[3]	No
Hungary	Fixed with margin[2]	No

1 The exchange rate is fixed and in addition a fixed exchange ratio is guaranteed. — 2 The exchange rate is fixed within a permitted fluctuation margin of ± 15%. — 3 The exchange rate is flexible, but the central bank intervenes to smooth fluctuations.
Sources: IMF Country Reports: 'Recent Economic Developments', various issues; IMF International Financial Statistics; national central banks.