Integration of Emerging Eastern Europe and the EU: Challenges and Opportunities

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Challenges to the European Union (EU)

The European Economic-Social Dream:

A Model of Socialized Democracy that includes:

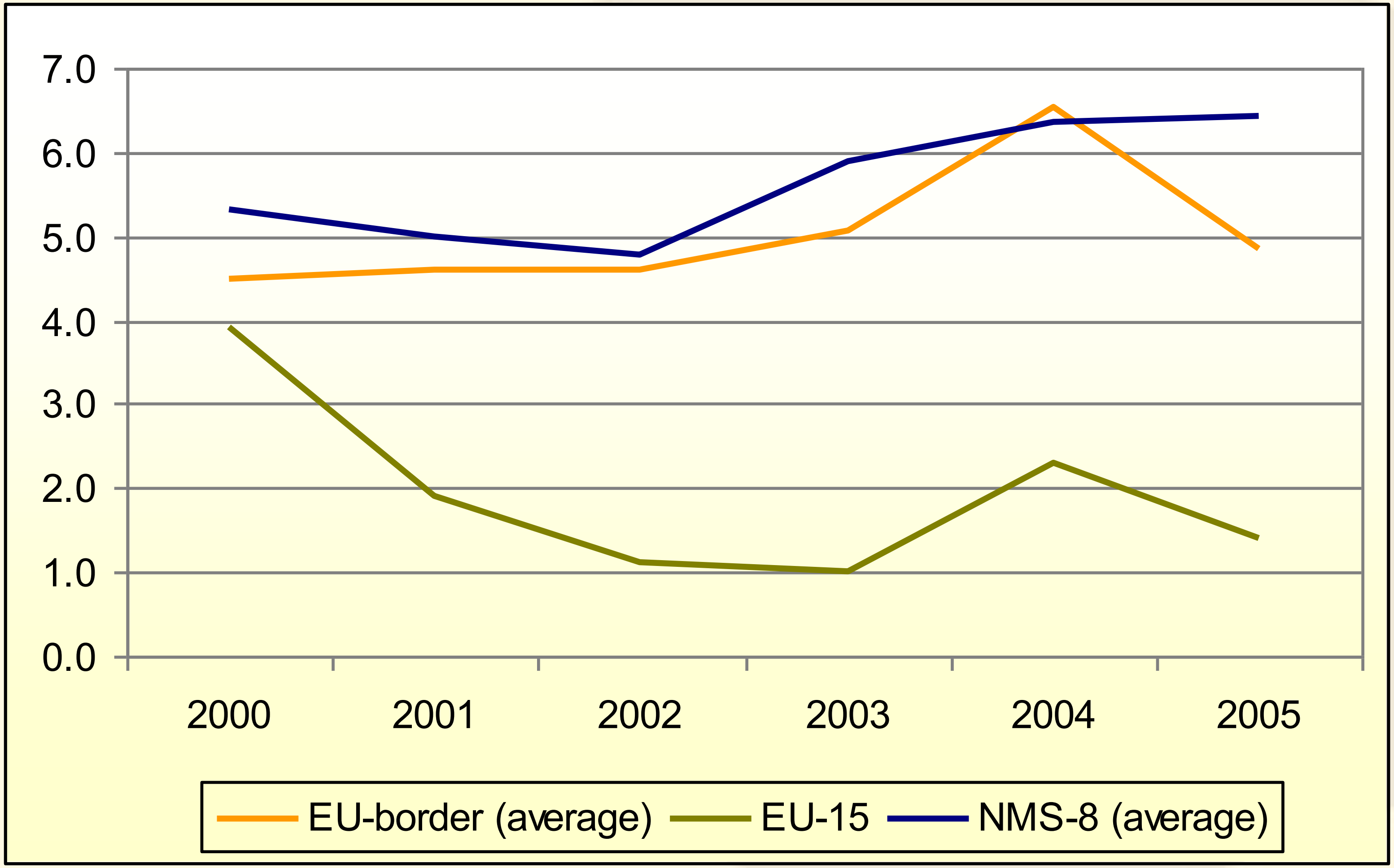
- Low Unemployment with ample jobs for everybody
- High Wages that generate high living standards
- Generous Social Safety Nets for the jobless & substantial health and education benefits

BUT this European Dream is in jeopardy due to very low economic growth rates of about 1.4% pa in EU-15, compared to 4%-5% for the New Eastern EU Member States (NMS-8), the EU border countries and the world as a whole (2005 numbers).

Emerging Eastern European Countries (EEEC)

New Eastern EU Member States (NMS-8)	EU Border Countries
Czech Republic	Romania
Estonia	Bulgaria
Hungary	Croatia
Latvia	Albania
Lithuania	Bosnia and Herzegovina
Poland	Macedonia
Slovakia	Moldova
Slovenia	Serbia
	Ukraine

GDP growth rates in EU-15, NMS-8, and EU-border countries, % yoy



Source: Eurostat, EBRD

Low EU Economic Growth

Low Economic growth in the EU is due principally to:

- Excessive government regulations of businesses with large public sectors and bureaucratic policymaking
- Excessive labor-market rigidities with powerful labor unions that generate low labor mobility and high labor costs
- Low number of working hours and long vacations
- Lack of innovation, entrepreneurship and risk-taking

The Lisbon Agenda of 2000 set a program to deal with these issues and convert the EU into the most competitive and dynamic knowledge-based region in the world.

But EU governments have made little progress in implementation, except for the Scandinavian countries.

Challenges to the European Union (EU)

- As a result of low economic growth, many countries in the region suffer from:
  - High Unemployment (youth unemployment reaches almost 20% in Belgium, France, Spain)
  - High fiscal budget deficits (in excess of 3% of GDP in Germany, Italy, France, Portugal, Greece) that put in jeopardy social benefits.
  - High public debt as a percentage of GDP (in excess of 60% in many countries)
- **What can be done to revive growth in the EU?**
  - The four major economic issues of excessive government regulations, excessive labor rigidities, low working hours and low level of innovation need to be addressed.
  - This will require a change in the EU budget priorities away from agricultural subsidies and more into growth strategies.
  - **In this effort:** the closer integration of Emerging Eastern European Countries (EEEC) into the EU can assist in addressing these issues.

Closer integration of EEEC affects economic growth in the EU through:

- **Increased Competition Effects:**
  - Lower price pressures via reductions in profit margins
  - Enhanced productivity
- **Migration Effects:**
  - Freer movement of labor will contributes to more efficient allocation of resources and will add to the EU labor force.
- **Trade Effects:**
  - Acceleration of growth in EEEC results in an increase in their demand for EU products

Direct Effect on EU GDP growth of Integration

- The direct effects of closer integration of EEEC on the "old Europe" (EU-15) is likely to be small, but positive
- The positive economic impact will be necessarily limited since potential members are rather small compared to the EU (in 2003 the sum of these countries' GDP in PPP terms was 13% of EU-25)
- According to the European Commission study, accession of eight Central European countries (out of ten that joined the EU in 2004) could push EU-15 GDP by 0.7 percentage points cumulatively in the 10-year period following accession

Other Indirect Effects on growth from the integration of EEEC

- But the greatest impact of a closer integration of EEEC on EU’s GDP growth will come indirectly:
  - The challenge from closer integration of EEEC will stimulate changes in the EU’s own policies on business regulations, public administration and EU labor laws, helping in the implementation of the Lisbon Agenda. This is already happening: e.g., Germany agreed to extend labor working hours in return for new investments in Germany and not in EEEC.
  - The enlarged EU will benefit from the “new blood and agility” brought in by new members and neighbors, as a large pool of energetic and well-educated (though poor) individuals will join the EU
- The likely impact of these factors are likely to be quite significant for economic growth in the European Union.

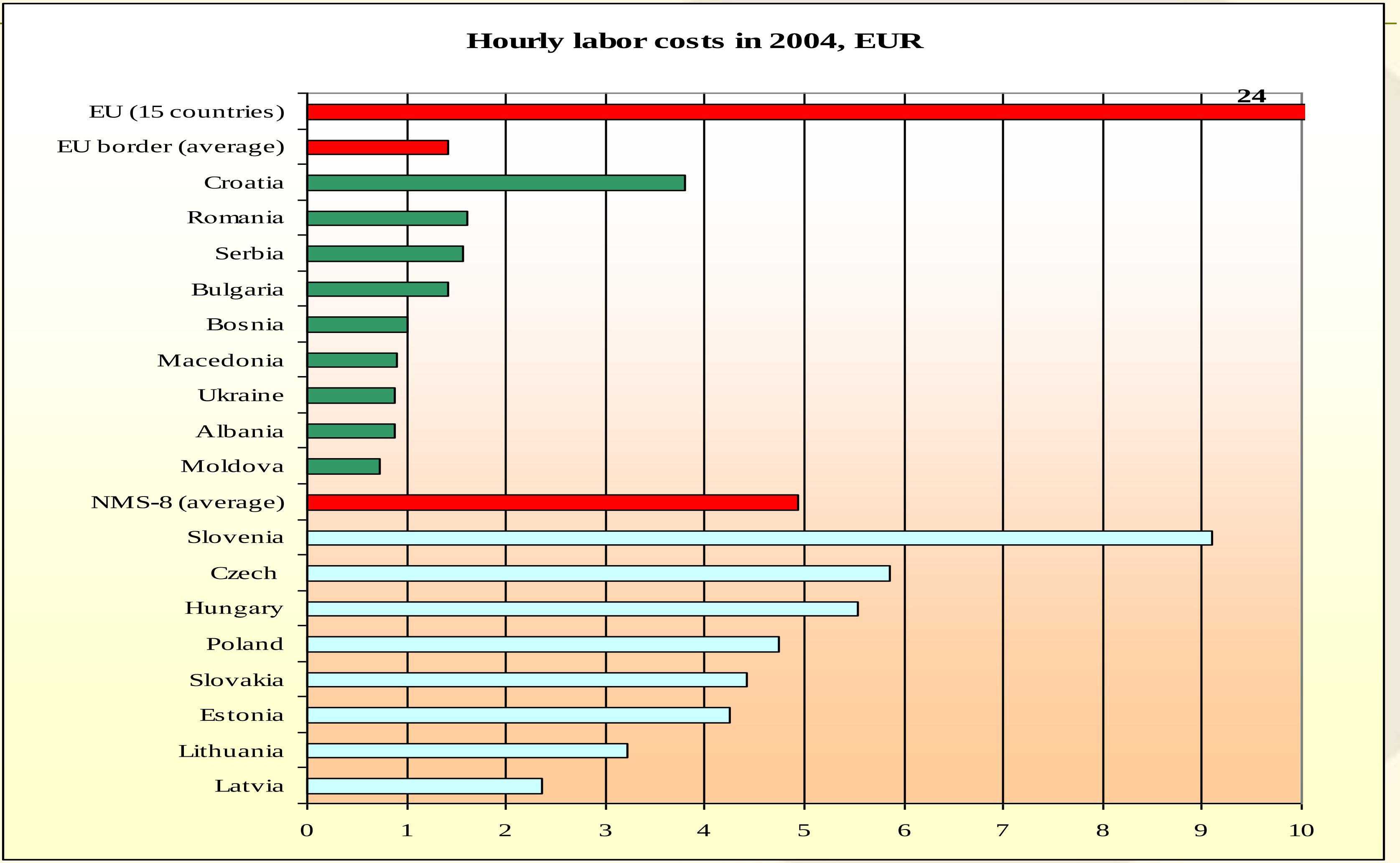
Effect on Growth and Stability in EEEC

- Regardless of the effects of closer integration on the EU, it is clear that the impact on EEEC growth will be substantial.
- Enlargement could boost GDP growth in some of the EEEC countries by more than 2 percentage points annually (EC estimates).
- To a great extent, higher growth rates in EEEC are the result of major improvements in the Investment Environments of these countries, entrepreneurial hunger and access to new funding.
- Higher economic growth in EEEC and their closer integration to the EU will contribute to enhanced ***political and economic stability*** in Eastern Europe.
- This will increase security of the whole Europe

A more powerful European Zone: Enhancing Europe as an Investment Destination

- Including Eastern Europe, the enlarged European Zone constitutes an attractive region that can compete with other world regions (e.g., Asia)
- In fact, the EEEC have a number of unique characteristics that enhances the attractiveness of Europe as a whole:
  - High economic growth potential
  - Highly educated and skilled labor force (with high university enrollment)
  - Low workers' wages and lower production costs
  - Improved economic, business and investment environment
  - Inefficiently run companies provide significant opportunity for value creation through improved operations, marketing, finances, customer and quality focus – bottom line growth.
- These positive elements in EEEC offer European businesses a unique opportunity to increase production levels, achieve economies of scale, and enhance their competitiveness on world markets.

Low labor costs in EEEC creates investment opportunities for Europe as a whole



Source: Eurostat, ILO, National Statistical Offices

Net FDI inflows can increase significantly

The potential of EEEC to attract FDI is large.

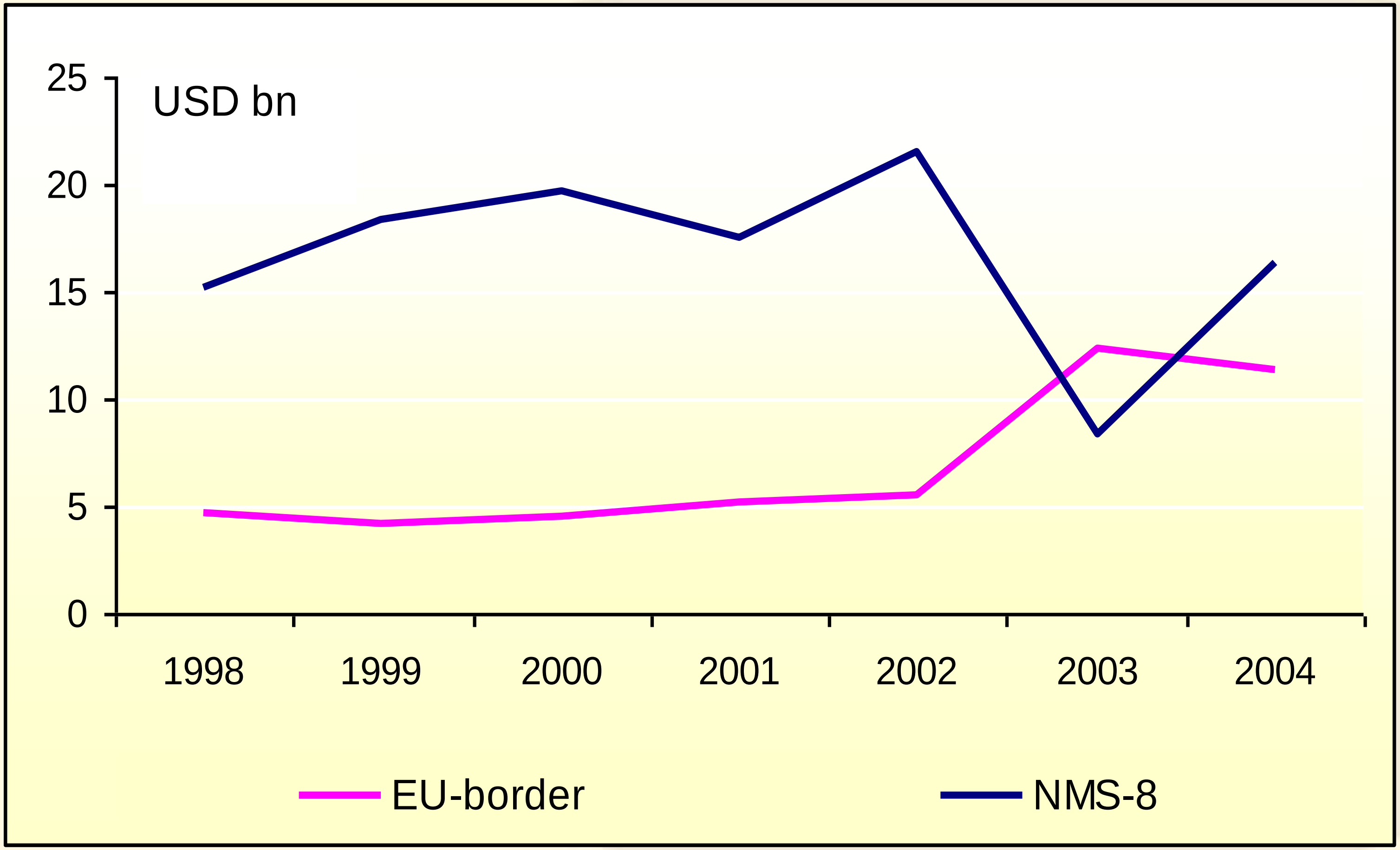
- Though rising, FDI flows to EEEC remain tiny:

  Major FDI destinations in 2004 were as follows:

  - Eastern Europe 15%
  - China 34% of total FDI inflows
  - Brazil, Mexico, Chile 21%
- Even within Europe, the flow of FDI to Eastern Europe is small:
  - FDI from EU-15 to EU-15: Euro 156 billion
  - FDI from EU-15 to EU-10: Euro 14 billion

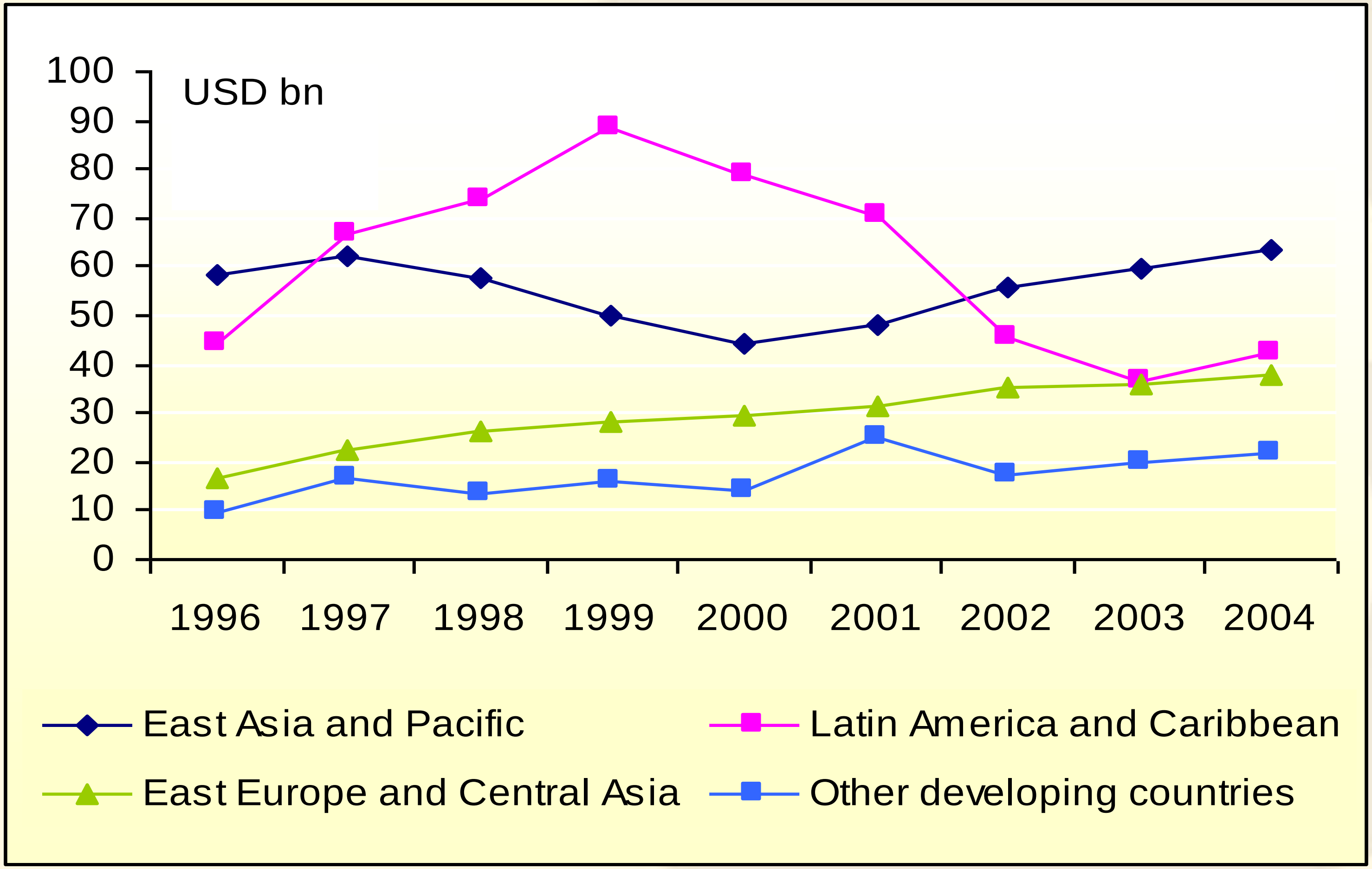
Source: World Bank, Eurostat, SigmaBleyzer's calculations

Net FDI inflows in EEEC



Source: EBRD

Net FDI inflows to developing part of the world



Source: World Bank

Effects of Closer Integration of EEEC in the Stability of the EU

- Many Europeans fear the possible adverse effect of EU enlargement on stability in the EU.

- Main areas of concern include:

  A. Excessive migration into the EU

  B. Excessive penetration of foreign EEEC goods into the EU

  C. Importation into the EU of high inflation

A. Impact from Migration into the EU is not likely to be significant on balance

- **Migration may bring some negative effects:**
  - Partial substitution of the workforce on a hosting labor market
  - Possible increase in the level of unemployment
  - Additional pressure on social insurance/assistance system
  - Need to adopt the existing strict labor regulations to a new standards
- **But they will be overweight by many positive effects**
  - Improving economic prosperity by increasing availability of labor
  - Increasing competition on labor markets
  - Increasing in labor productivity due to economy of scale
  - Saving on costs associated with hiring new-enters and increasing overall economic efficiency
- Finally, labor flows are not likely to be strong enough to adversely affect EU employment due to restrictions imposed by the EU and since increases in living standards will encourage people to stay.

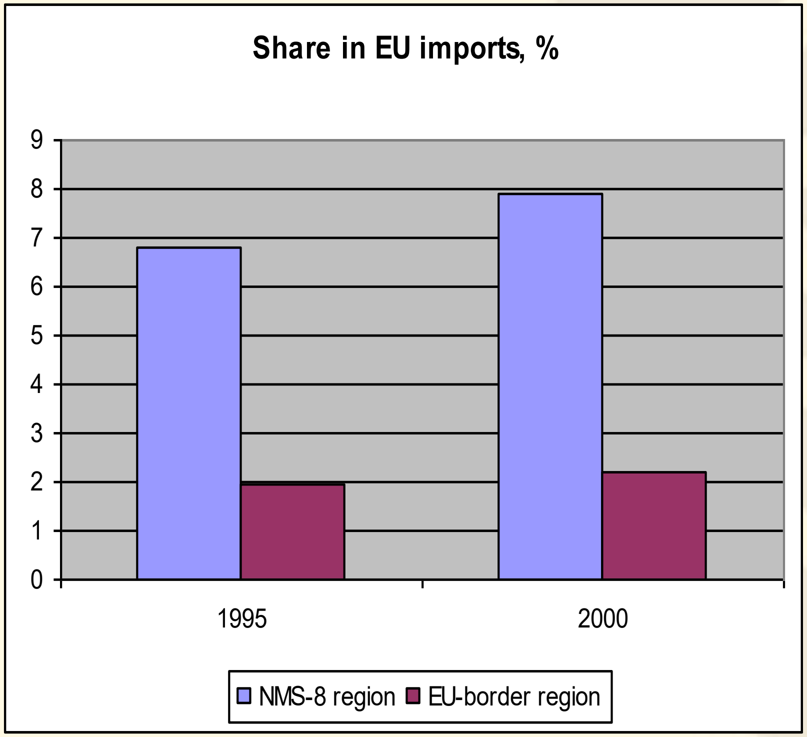
Nevertheless, the greatest influence on EU labor markets is from immigrants other than EEEC

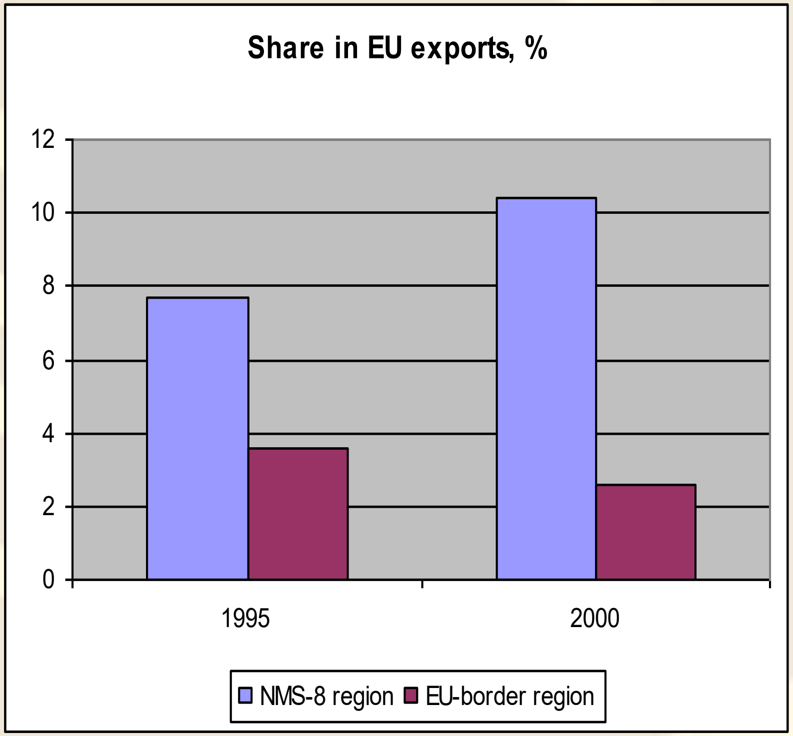
	5 biggest suppliers of immigrants in 2001				
	1	2	3	4	5
Denmark	Iraq	Afghan	Norway	Germany	USA
Finland	Russia	Estonia	Sweden	Yugoslavia	China
Belgium	Netherlands	France	Morocco	Poland	USA
Austria	Germany	Turkey	Yugoslav	Croatia	Bosnia
Germany	Poland	Turkey	Russia	Italy	Yugoslavia
Luxembourg	Portugal	France	Belgium	Germany	Italy
UK	Australia	China	France	Germany	India
Spain	Ecuador	Colombia	Morocco	Romania	Argentina
Portugal	Cape Verde	Angola	G-Bissau	Brazil	Spain
Netherlands	UK Antilles	Germany	Morocco	Turkey	USA
Sweden	Iraq	Finland	Norway	Denmark	Yugoslavia

Source: ILO (EEE countries are in yellow)

B. Imports are unlikely to affect the EU negatively

Trade flows are likely to be relatively small and well-balanced in terms of imports versus exports to the EU.

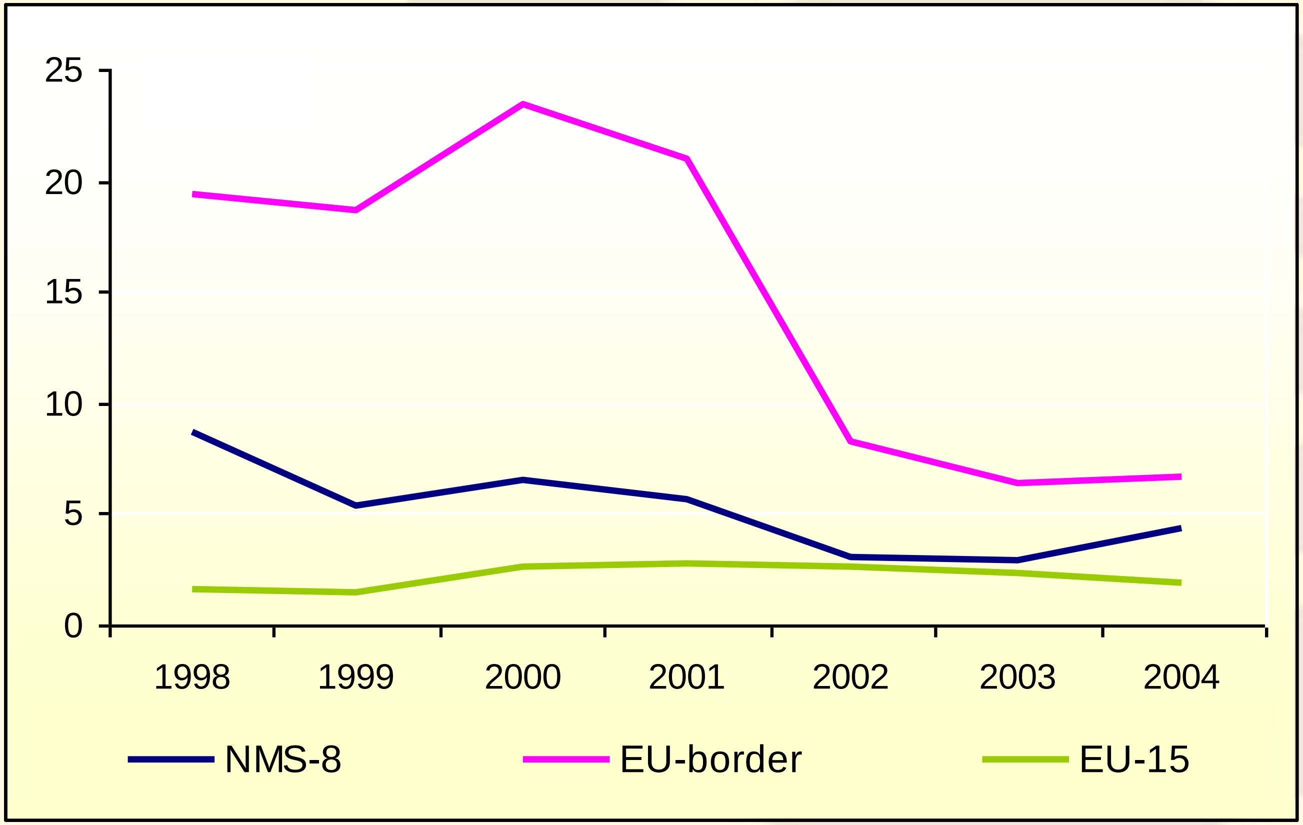




Source: EU trade statistics

C. Inflationary effects should not be of concern.

The Average Annual Inflation in NMS-8 and EU Border Countries is going down to EU levels, % yoy



Source: Eurostat, EBRD

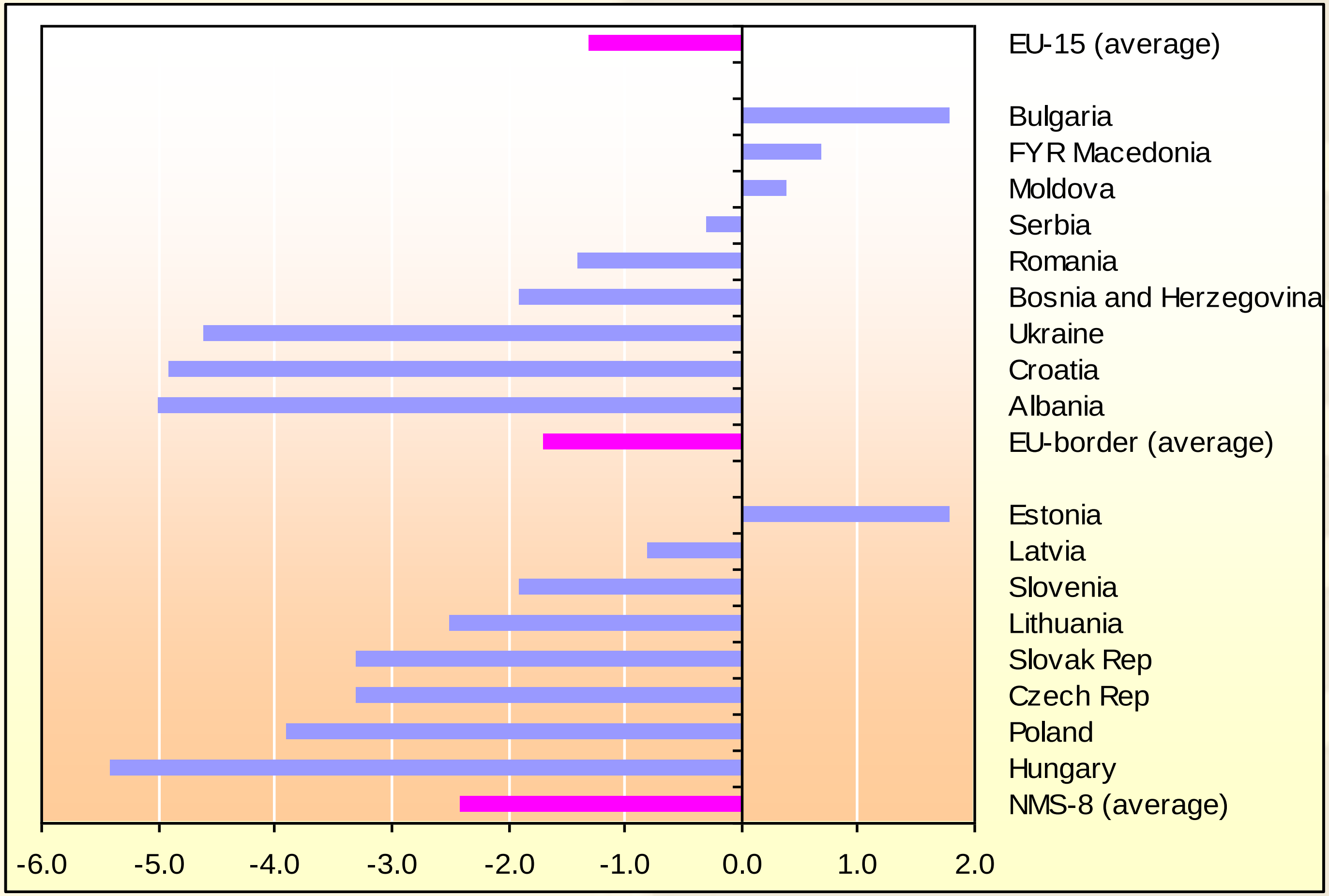
Causes of Inflation in EEEC

- Higher and more volatile inflation in EEEC is driven principally by the ongoing price liberalization with adjustment of administered prices to market ones.
- But the commitment of EEEC to closer EU integration (EMU) confronts these countries with the task to pursue price stability as a major objective of their monetary policies.
- Better access to goods, labor and capital contributes to lower inflationary pressures in EEEC as a result of lower transactions costs and the related decrease in mark-ups.
- Continuation of structural reforms in EEEC will add to enhanced inflation stability in the region

Fiscal situation in EEEC

- Inflation in EEEC is also induced by relatively high fiscal budget deficits that results from the need to undertake government investments to improve infrastructure and catch-up with the EU.
- But fiscal discipline will eventually prevail as EU-members are required to maintain budget balance Maastricht criteria (deficit no more than 3% of GDP).
- Some of the acceding countries (like Bulgaria) already post significant budget surpluses
- So far, fiscal deficits have not been a problem due to plenty foreign financing available from the EU and from foreign direct investments.

General Government Balance*, % GDP in 2004



Source: EBRD

** Including local government and extra-budgetary funds*

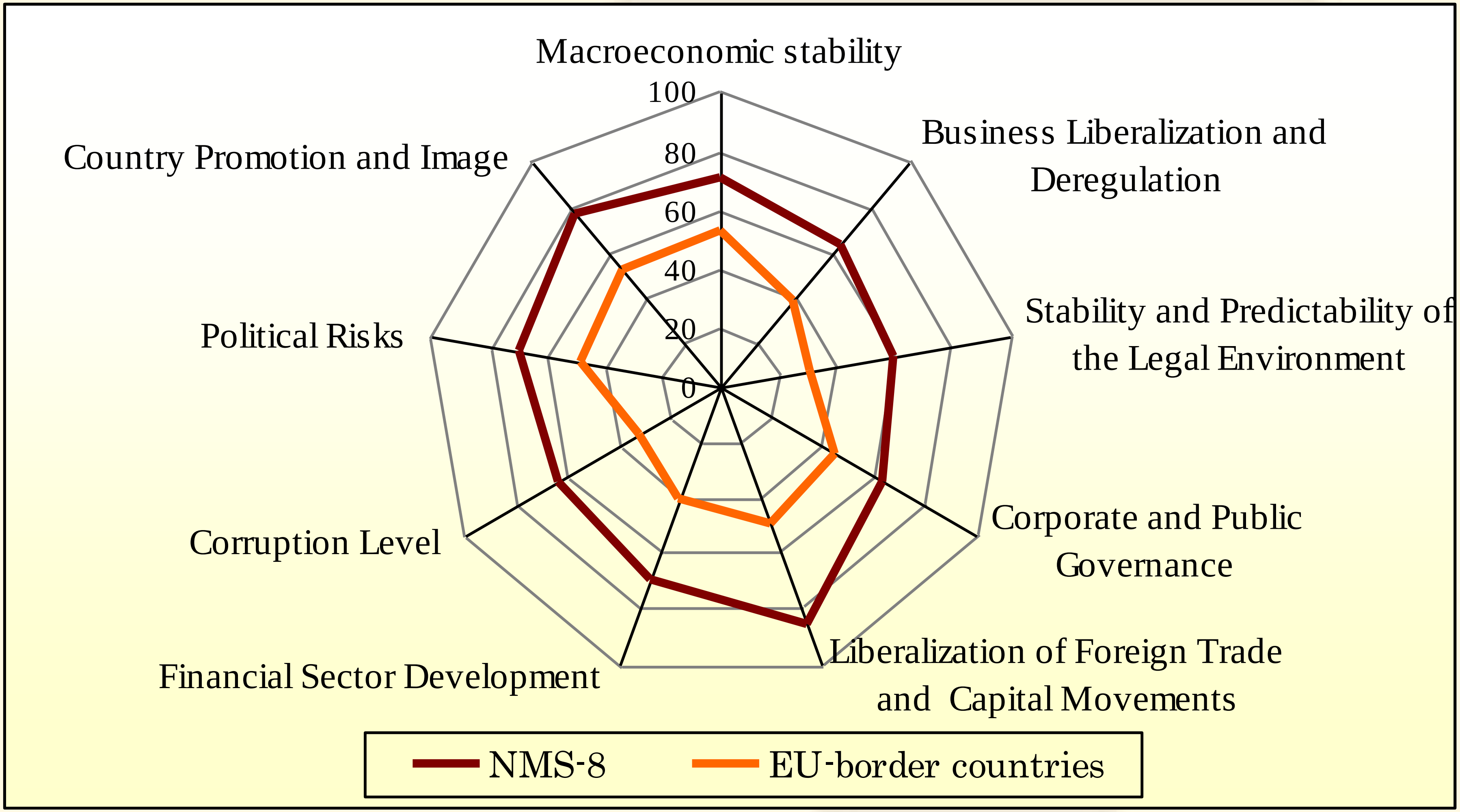
Challenges for EEEC

- The NMS-8 have made remarkable progress in improving their investment climate especially with regard to liberalization of cross-border flows of goods and capital
- But there is still room for improvement, specifically in the field of liberalization and deregulation of business activity
- EU-border region has a large agenda for the nearest future
- Priority areas in the EU-border countries to improve their business environments are identified in studies carried out by The Bleyzer Foundation, as noted in the following slides.

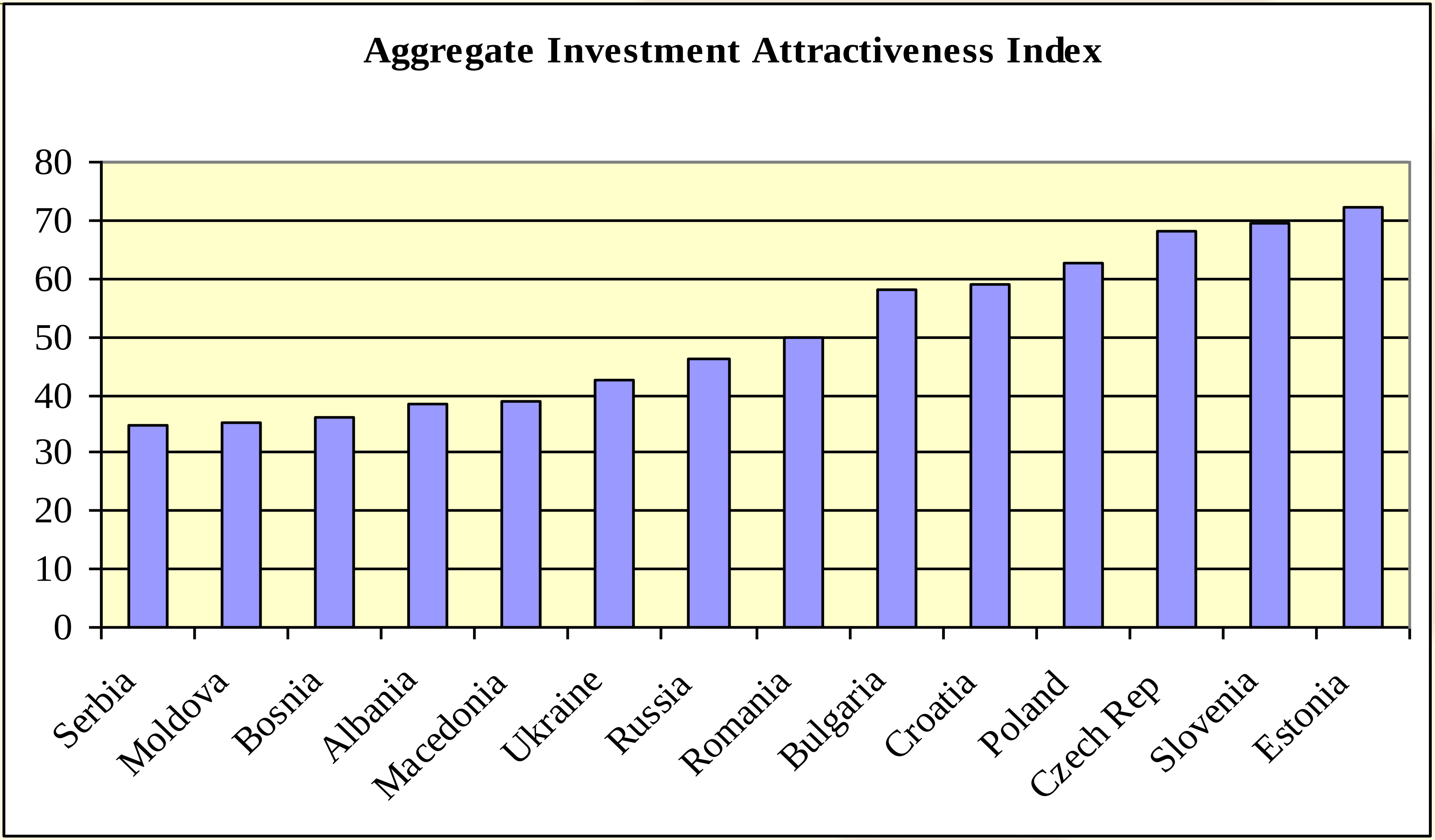
SigmaBleyzer's Drivers to Improve the Business Environment and Investment Attractiveness

1. Macroeconomic Stabilization
2. Liberalization and De-Regulation of Business Activities
3. Stability and Predictability of the Legal Environment
4. Improved Corporate and Public Governance
5. Liberalization of Foreign Trade & International Capital
6. Sound Development of the Financial Sector
7. Dealing with Corruption
8. Addressing Political Risks
9. Improving Country Promotion & Image

SigmaBleyzer's Nonagon for EEEC

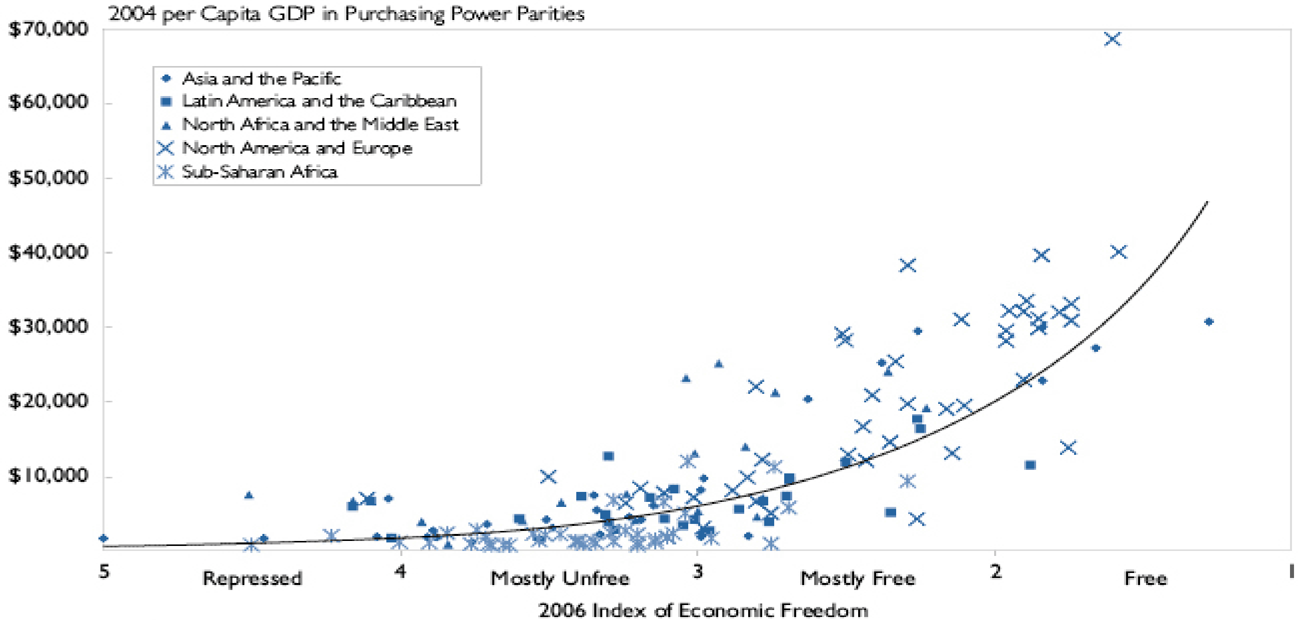


Overall Investment Drivers – Country Ratings



Other studies also show that it pays to have economic freedom!

Economic Freedom and Per Capita Income



Sources: World Bank, *World Development Indicators Online*, available by subscription at *www.worldbank.org/data;* Central Intelligence Agency, *The World Factbook 2005*, available at *www.cia.gov/cia/publications/factbook/index.html*, for the following countries: Bahamas, Bahrain, Barbados, Burma, Cuba, Equatorial Guinea, Iraq, Kuwait, North Korea, Libya, Qatar, Suriname, Taiwan, United Arab Emirates, Zimbabwe; Marc A. Miles, Kim R. Holmes, and Mary Anastasia O'Grady, *2006 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2006), at *www.heritage.org/index*.

Economic Freedom involves "liberalized" policies regarding business regulations, government interventions in the economy, tax burden, international trade and capital, monetary policies, banking and finance, wages, and property rights

The Challenges are great as most of the world is mostly economically unfree