



## **CEPS POLICY BRIEF No. 2**

**APRIL 2001**

### **HEALTH NOT WEALTH**

**DANIEL GROS**

#### **ABSTRACT**

Health, and not wealth, should be the decisive criterion when considering the prospects of the Central and Eastern European candidates for EU membership and the capacity of the EU to enlarge. Viewed from this perspective, the outlook is promising. The CEECs are still very poor, compared to most of the existing EU members, but they are also much more dynamic. Their growth rates are generally expected to remain around 4-5% for the foreseeable future, compared to about 2-3% for the EU. This still implies that full catch-up in terms of GDP per capita will take decades, rather than years, but full catch-up is not the relevant goal if one is concerned about enlargement. Experience in the EU has shown that problems are much more likely to arise from established rich member countries with stagnant economies (Belgium in the 1980s and part of the 1990s) than poor, but more dynamic states (e.g. Portugal and Ireland today). The fact that most of the so-called 'periphery' is now experiencing stronger growth than the 'core' confirms that EU integration benefits poorer countries even more.



# HEALTH NOT WEALTH

DANIEL GROS\*

## CEPS Policy Brief No. 2/April 2001

---

This policy brief aims to serve as a basis for a useful discussion about the economic prospects of the candidate countries and how they would fit into the EU (and EMU). It concentrates on two specific aspects: Section I discusses the extent to which this enlargement is 'specific' in terms of its size, the economic structures of the applicants and their past as socialist economies. Section II then attempts to estimate the economic benefits of EU and euro area membership. Tentative conclusions are offered at the end.

### I. The specificity of this enlargement

#### 1. The relative size of the candidate countries

It is often argued that this coming enlargement is unprecedented in terms of the increase in population and other measures. This is not the case, however, if one considers the size of the countries that joined during previous enlargements, relative to the size of the EC they joined.

*Table 1. Size of the next enlargement compared with the previous ones*

	Population	GDP in euro	Trade
UK+DK+IRL as % of EC-6	33.5	27.9	13.1
E+P as % of EC-10	17.5	8.3	4.7
CEEC-10 as % of EU-15	28.0	4.1	10.9
Turkey as % of EU-15	17	2.4	7
Turkey as % of EU-25	13.2	2.3	6

*Source:* Own calculations based on EU and EBRD data.

This enlargement is thus significant in terms of population because all 10 Central and Eastern European candidate countries (CEEC-10) would increase the population of the EU by over one-quarter (the increase is equivalent to the increase in the German population due to unification). By most economic measures, however, the candidate countries are negligible, even if one assumes that their economies will grow rapidly.

---

\* Daniel Gros is Director of the Centre for European Policy Studies in Brussels.

Table 2. Indicators of relative size in the accession countries (1998 data)

	Population in millions	GDP at current exchange rates (% of euro area GDP)	GDP in PPS (% of euro area GDP)	Money			Deposits	
				M0: Cash (% of euro area total)	M1 (% of euro area total)	M2 (% of euro area total)	Demand deposits (% of euro area total)	Time, Savings, Foreign Currency Deposits (% of euro area total)
Czech Republic	10.3	0.9	2.1	1.75	0.82	1.13	0.69	1.38
Estonia	1.5	0.1	0.2	0.12	0.06	0.04	0.05	0.03
Hungary	10.1	0.7	1.7	1.24	0.55	0.90	0.08	0.83
Poland	38.7	2.4	4.7	3.11	1.35	1.90	0.96	2.36
Slovenia	2	0.3	0.5	0.21	0.11	0.27	0.09	0.39
Latvia	2.4	0.1	0.2	0.22	0.07	0.05	0.04	0.03
Lithuania	3.7	0.2	0.4	0.25	0.09	0.06	0.06	0.04
Slovak Republic	5.4	0.3	0.8	0.57	0.27	0.40	0.22	0.50
<b>CEEC-8 (total)</b>	74.1	5	10.6	7.47	3.32	4.75	2.19	5.56
<b>CEEC-3 (total)</b>	59.1	4	8.5	6.1	2.72	3.93	1.73	4.57
Bulgaria	8.3	0.2	0.6	0.38	0.11	0.11	0.05	0.11
Romania	22.5	0.6	2.1	0.38	0.16	0.31	0.09	0.25
Turkey	63.5	2.5	7	1.18	0.51	1.95	0.35	1.6
<b>1990-91 data</b>								
Portugal	9.9	1.3	2.2	1.94	2.2	2.51	2.5	3.9
Spain	38.9	9.8	11.0	21.31	11.64	8.53	9.4	14
Italy	56.8	21.0	21.4	27.2		17.68	29.2	9.6
Greece	10.2	1.7	2.3	2.91	1.29	1.77	0.8	2.2
<b>Club Med (total)</b>	116	34	37	53.36	15.3	30.49	41.9	29.7

Source: ECB, *Monthly Report*, February 2000; IMF, *International Finance Statistics*, April 1999. The data on money and deposits for the Club-Med countries is for 1998.

Table 2 above shows that in terms of GDP, evaluated at current exchange rates, the 10 accession countries combined would be about 1/15<sup>th</sup> (6%) of the euro area. This corresponds roughly to the weight of The Netherlands alone. Most of this, more than two-thirds, is accounted for by the Luxembourg group. In terms of monetary indicators, the story is not much different. Given that the candidate countries have rather small financial sectors their combined monetary supply amounts to generally slightly more than 8% of the corresponding euro area aggregate. This implies immediately that even serious problems with the banking sectors in the CEEC-10 could never materially affect monetary conditions in Euroland. Moreover, in the financial area most of the weight within the CEEC-10 is accounted for by the relatively more advanced Luxembourg group of applicants.

## **2. The economic structures of the candidate countries**

It is often asserted that the candidate countries in this round of enlargement are much poorer and have ‘different’ economic structures. The first half of this assertion is widely known to be true. Applying the most widely used indicator of living standard, GDP per capita at purchasing power standards, the Luxembourg group is on average at about 50% of the EU-15 average. This is somewhat lower than the values for Portugal and Greece at the beginning of the 1990s (several years after their accession to the then EC and eight years before their participation in the euro area). See Table 3.

In terms of broad indicators of economic structures, however, it is difficult to find strong systematic differences between the candidates and the poorer member countries. The share of agriculture in GDP is already rather low in the Luxembourg group, around 5%, and in most of the Helsinki group countries as well. The share of industry in GDP is also not notably different from some current member countries. The fundamental reason why it is so difficult to make any firm judgement about systematic differences in economic structure is that there are large differences even among the present EU members. For example, in terms of the share of industry in GDP, the range is large even only among the so-called ‘Club Med’<sup>1</sup> countries. In both Portugal and Italy, the share of industry is rather high, at around 30% of GDP, but this cannot be considered a sign of high (or low) level of development since Italy’s GDP per capita is slightly above the EU average and Portugal’s is the poorest member country. By contrast, industry is relatively much less important in Spain and Greece, providing only

---

<sup>1</sup> Portugal does not have a coast on the Mediterranean Sea, but it is nevertheless usually counted as an honorary member of Club Med.

around 15% of GDP. As all four of these countries are successful members of the euro area (with Greece having joined in 2001), there is apparently a very large range of economic structures that is compatible with membership in EMU. On the basis of the limited data that are available, it appears that the candidates do not fall outside this range.

In terms of employment the differences in economic structures would appear to be larger, particularly with respect to Romania, Bulgaria and Poland where a huge part of the labour force is officially employed in agriculture. While this will undoubtedly create social problems in these countries and problems for the Common Agricultural Policy, it is less relevant to the issue of EMU membership since value-added in this sector is such a small part of GDP.

Moreover, one cannot avoid questioning the reliability of the data and of the definitions used for identifying farmers, particularly in the case of Poland and Romania. In the former communist countries, many who are classified as farmers actually practice this activity only on a part-time basis, and it appears that their average age is close to 60, so that their numbers will be shrinking rapidly over the next years in any event. A comparison with the Club Med is again instructive. The average here is actually the same as for the Luxembourg group, as most Club Med countries share the characteristic of many applicants that the relative productivity is particularly low in agriculture (the share in GDP is only a fraction of the share in employment). The 1991 data for Portugal shown in Table 3 are actually almost the same as the 1998 data for Poland both for industry and agriculture. Thus the concern over the large share of employment in agriculture in the candidate countries is likely to be overstated.

### **3. Institutional structures**

Is this enlargement different because the CEEC-10 are 'transition' countries, i.e. they have not yet established an institutional infrastructure for a market economy? We would agree that the institutional infrastructure in the accession candidates is weaker than in most current EU members, but it seems that this weakness is just a consequence of low levels of income (per capita).

Gros and Suhrcke (2000) find that the more advanced candidate countries in Central and Eastern Europe have institutional frameworks that are judged by foreign investors, and in surveys, as being 'normal' for their level of development (or even slightly better than one would expect). There is little reason to believe that progress will not continue as the overall catch-up process continues.

Table 3. Structural indicators of accession countries (1998)

	Per capita GDP in euro (% of euro area per capita GDP)	Per capita GDP in PPS (% of euro area per capita GDP)	Share of industry in GDP (%)	Share of agriculture in GDP (%)	Employment in agriculture (% of total civilian employment)	Employment in industry (% of total civilian employment)	Degree of openness (exports plus imports, as % of GDP)	Exports to EU as % of total exports
Czech Republic	24	60	32	4	6	32	61	62
Hungary	21	48	25	5	8	28	46	71
Poland	18	36	24	4	19	25	26	64
Estonia	16	36	18	6	9	26	85	79
Slovenia	44	68	28	3	12	34	54	63
Latvia	12	27	21	4	19	21	53	86
Lithuania	13	31	21	9	21	21	69	43
Slovak Republic	17	46	27	4	8	30		56
<b>CEEC-8 (average)</b>	21	44	25	5	13	27	56	65
<b>CEEC-3 (average)</b>	21	48	27	5	11	28	43	66
Bulgaria	7	23	22	19	26	26	46	58
Romania	8	27	32	16	40	25	30	70
Turkey	14	40	22	16	42.3	16.8	26	59
<b>1991 data</b>								
Portugal	37.1	61	31	5	18	34	34	80
Spain	68.8	76.5	17	4	11	33	18	65
Italy	101.1	101.9	31	4	9	32	19	53
Greece	43.3	59.4	15	14	21	24	22	62
<b>Club Med (average)</b>	<b>63</b>	<b>75</b>	<b>24</b>	<b>7</b>	<b>15</b>	<b>31</b>	<b>23</b>	<b>65</b>

Source: ECB, *Monthly Report*, February 2000; European Commission, 1999 Regular Reports, Statistical Annex of *European Economy* and "The agricultural situation in the EU: 1994 Report". The data on employment for Estonia are for 1997. For Greece the data are for 1993 (except for the share of agriculture in GDP which is for 1992).

Gros and Suhrcke (2000) also show that the more advanced candidates actually have financial sectors that are appropriate *for their level of development*, and it appears that the transition is over in this area. This does not mean that there won't be any problems, however. The problems that erupted in the Czech banking sector in recent years serve as a reminder that serious corporate governance problems might persist even in systems that are regarded as rather strong. But a number of EU countries faced rather similar problems not so long ago. Moreover, given the rapid pace of bank privatisation and take-overs by institutions from the EU (although this is sometimes still politically controversial), most of these problems should be overcome soon.

At any rate, the screening process should uncover any remaining institutional deficiencies. By the time of their accession, the candidate countries should have an institutional framework that is compatible with a smooth functioning of the EU.

## **II. The benefits of enlargement**

The public discussion in the EU-15 about the budgetary cost of enlargement sometimes obscures the fact that enlargement should bring economic benefits. In the candidate countries, EU membership is often just taken as an economic imperative so that detailed calculations of the economic benefits are not made. However, if one wants to gauge the long-term prospects of Central and Eastern Europe, one has to have an idea of the likely size of these economic benefits. How large will they be? This question is difficult to answer because everything depends on the alternative scenario if they did not accede. For example, if one were to assume that the Czech Republic could become a sort of Switzerland if it did not join the EU, one would conclude that membership would not bring this country any appreciable economic benefit. For its neighbour, the Slovak Republic, one might assume instead that the country would revert back into Russia's orbit and halt its reforms if it did not have the alternative of becoming a member of the EU. These are admittedly extreme examples, but they are useful for highlighting the general problem underlying any attempt to measure the welfare benefits of enlargement.

A further reason why it is difficult to quantify the economic effects of enlargement is that it affects all aspects of the economy. One cannot therefore simply look at the impact of a number of separate markets and total the results. This is why Baldwin et al. (1997) use a so-called 'computable general equilibrium' model taking into account the interactions between trade, labour markets and investment via the capital markets, to mention only the most important



elements of this type of model. They assume in a first 'conservative scenario' that the main effect of EU membership is to reduce the cost of trading between the 10 associated states and the EU by 10% and to eliminate trade barriers for agricultural products.<sup>2</sup> The first element is the key to their results. The 10% reduction in trading costs reduces total costs by 2.5%, since in their model the starting level of the cost of trading across borders is 25% of the transaction value. With membership, this is supposed to go down to 22.5%. They find that under this scenario real income in the candidate states would increase by about 1.5% and only 0.2% in the EU. The small impact on the EU is understandable if one takes into account that exports to the associated states account for about 2% of the GDP of the EU-15. However, one would expect the impact on the CEECs to be much larger because their trade with the EU-15 accounts for up to 25% of their GDP. Moreover, the 10% reduction in trading costs is completely arbitrary. Such an ad hoc assumption is actually not necessary, since, as we will show below, it is straightforward to use existing detailed estimates.

A gain of 1.5% for the candidate states thus seems very conservative, given the estimates that have been made of the benefits from integration within the present group of member states. Enlargement implies essentially an extension of the internal market and monetary union.<sup>3</sup> The benefits of these two integration projects for the present membership have been estimated and could be used as a guide. Recent estimates of the transactions cost savings from the introduction of the euro are in the neighbourhood of 1% of GDP (see also Chapter 7 in Gros and Thygesen, 1998). It is more difficult to estimate the gain from participation in the internal market. Emerson (1998) found that this should yield welfare benefits of between 2.5 and 4.5% of EU GDP. Could one use this estimate for the candidates as well? Several arguments would indicate that the benefits for the CEECs should be at the larger end of this range, or even higher. The key consideration is that all the CEECs are very small economies, which should thus benefit more from the additional competition fostered by the internal market than the larger and more diversified EU economies. Moreover, integration and market opening in the EU has proceeded well beyond the sectors considered in the initial '1992' programme.

---

<sup>2</sup> Membership will also force the Central and East European countries to reduce their tariffs on imports from the rest of the world. But since these imports are small compared to their imports from the EU, this effect is not important for the size of the welfare benefits.

<sup>3</sup> Since agriculture accounts for only a minor fraction (6-10%) of GDP, the gains from freeing trade in this sector cannot be large in relation to GDP.

Even if one does not take into account these elements, any estimate of the welfare gains for the CEECs is bound to be higher than that for the EC-15 since intra-EU trade accounts for about 15% of EU GDP, whereas trade with the EU accounts on average for well over 20% of the GDP of the CEECs. The benefits for the new members should thus be at least one-third higher: 4.4-6.0% of GDP for participation in the internal market and 1.3% for using the common currency. Table 4 provides the details of these back-of-the-envelope calculations, which lead to the result that EU membership should yield a measurable benefit of between 5.4 and 7.3% of GDP for the CEECs.<sup>4</sup>

*Table 4. Measurable benefits to the CEEC-10 from EU membership  
(as % of GDP)*

Common currency	1.0 - 1.3
Internal market	4.4 - 6.0
<b>Total</b>	5.4 - 7.3

*Source:* Own calculations based on estimates for the EU-15 of the gains from a common currency and an internal market.

These measurable gains are already sizeable, but much larger gains can be obtained if one assumes that membership transforms conditions under which the associated countries have access to the world capital market. At the present time, interest rates in the associated countries are much higher than those in the EU, even for countries that have strong reputation for price stability such as the Czech Republic, or operate a currency board, such as Estonia. For other countries, e.g. Poland, the domestic real interest rate is even higher.

Where does this risk premium come from? Baldwin et al. argue that the risk premium that one currently observes on interest rates in the associated states is not due to monetary factors, but to uncertainty about the future of reforms. The crucial assumption then is that only membership can assuage the doubts in the minds of investors and reduce this risk. Countries that are not allowed to become members would not be able to assure investors about the durability of their reform programmes. The size of the reduction in the risk premium that would come with enlargement is difficult to pinpoint. Baldwin et al. use Portugal as an example and argue that accession to the EU would imply a reduction in the risk premium of about 15% (i.e. the real interest rate would drop from e.g. 9 to 7.65%). The result under this

---

<sup>4</sup> Four to five times the amount found by Baldwin et al. Moreover, a large part of the gains in real income found by these authors do not correspond to welfare gains since they result from increased

scenario is that real income in the associated states might increase by 30%! At first sight this result is astonishing, but it actually should not be so surprising given that the models of capital accumulation used by economists imply that the long-term capital stock is extremely sensitive to changes in the real interest rate. (See Gros and Steinherr, 2001, for details.)

What should one think about these very large potential gains from membership arising from a reduction in the risk premium? A first point to note is that this approach assumes that investors will only upgrade the new members and not downgrade the existing ones. While this is possible one could also argue that the new equilibrium of political forces within the enlarged Union will make economically sound policies less likely (see the discussion about 'power politics' in agriculture above). The loss of the EU from a slight increase in its risk-premium could easily exceed the gains of new members on account of a lower risk premium for them. Moreover, the quantification of the gain in the risk premium is totally arbitrary. The assumed alternative (continuing uncertainty about reforms) is not likely for those countries that will actually be able to join first. The countries that will not be able to join because they cannot implement the *acquis* would actually be those with the highest risk premium and thus those that would benefit most from becoming members. For those that have the choice, a reduction in the risk premium might thus not be the first source of advantage from membership.

Nevertheless, these illustrative calculations of the potential gains from membership are useful because they highlight one important aspect. There are certain gains from joining the internal market and EMU that can be quantified. In our view these gains should be in the neighbourhood of 5% for the associated states that are very open economies. But the potentially more important gains are not quantifiable: they come from joining an area that embodies the principles of open competition through the internal market rules in the largest market of the world and that guarantees sound macroeconomic policies within the context of EMU. This framework for sound policies should favour growth through a lot of channels and might ultimately raise income by even more than 30%. But one has to admit that this is not a judgement that can be proven with scientific methods.

Another useful lesson from these estimates is that the welfare gains for the EU are also real, although much smaller in terms of the EU-15's GDP. Expansion to the East would increase

---

capital accumulation, which does not come for free (like the transaction cost savings from a common currency) but require households to postpone consumption.

trading opportunities for the EU-15. The CEECs account for less than 5% of the EU's GDP and about 10-15% of the EU's external trade. As the gain from the internal market is about 4-5% of the EU's GDP, the gain to present EU members from the inclusion of the 10 CEECs in the internal market and in the euro zone should thus be about 0.4-0.5% of GDP, or about 25 billion euro p.a. This alone would be more than the total budgetary cost. Moreover, the gains for the EU can only grow over time as the economies of the associated states grow along with their trade. Their share in the overall external trade of the EU has already doubled since 1990 and on the basis of current trends, it could well double again by 2005-06. At that point, the estimated benefit would be twice as large as it appears from today's perspective, but the budgetary costs would not increase proportionally. By the time the formal decision on enlargement has to be taken, it is thus likely that the economic benefits of enlargement to the EU-15 will even more clearly outweigh the costs than they already do today.

#### **IV. (Tentative) Conclusions**

The main findings of this paper are that the economies of most of the candidates (the CEE-8) are not so different from those of the current EU-15 members that they would not fit into the EU or the euro area and that their legal and institutional frameworks are clearly better than one would expect given their low levels of income. Moreover, the candidates are likely to benefit considerably from EU and EMU membership. This suggests that the long-term economic prospects of the candidates are rather good. They start from a low level of income, but they are likely to have healthy, growing economies, which might be better able to absorb shocks than the more established economies of the richer EU member countries.

A number of studies by investment banks, international financial institutions and independent economists suggest that the combination of low income (and wages), market access and a stable institutional framework for a market economy should lead to growth rates of around 4-5% over the next decade. This is considerably more than the 2-3% growth usually expected for the (core) EU countries. While this would not lead to a quick catch-up, it suggests that the new members are unlikely to cause problems within an enlarged EU or euro area.

## References

- Baldwin, Richard E., Joseph François and Richard Portes (1997), 'The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe', *Economic Policy*, pp. 127-176.
- Emerson, Michael (1998), *Redrawing the Map of Europe*, London: Macmillan.
- Gros, Daniel and Alfred Steinherr (forthcoming 2001), *Winds of Change, Economic Transition in Central and Eastern Europe*, London: Longman and Cambridge, MA: MIT Press, chapter 11.
- Gros, Daniel and Marc Suhrcke (2000), *Ten Years After: What is special about transition countries?*, CEPS Working Document No. 143, Centre for European Policy Studies, Brussels, May.
- Gros, Daniel and Niels Thygesen (1998), *European Monetary Integration from EMS to EMU*, London: Addison-Wesley Longman.
- Pelkmans, Jacques, Daniel Gros and Jorge Núñez Ferrer (2000), *Long-Run Economic Aspects of the European Union's Eastern Enlargement*, WRR Working Document No.109, Scientific Council for Government Policy, The Hague, September.