The New Europe (part I)
Challenges and Outlook for Member Countries

Recent developments

On May 1, 2004, the European Union expanded from 15 to 25 members, welcoming seven nations that had rediscovered liberty and their identity after the collapse of communism (Estonia, Hungary, Latvia, Lithuania, Poland, Czech Republic, Slovakia), a former component of the Yugoslav federation (Slovenia) and two Mediterranean islands (Cyprus and Malta). In three years, Bulgaria and Romania should follow suit, while Turkey, an official candidate, had to wait until December 2004 to negotiate membership.

This expansion increased the E.U.'s population by some 75 million to 455 million, making it the third most populous place in the world after China and India. Its gross domestic product is 9,275 billion euros (approximately C$15,200 billion) when the GDP of the new members (448 billion euros) is included.

While significant, the addition of these 10 countries is perhaps not as important as some observers would lead us to believe, since although they represent 20% of the population, they only account for 5% of the European Union's GDP. For example, the population increase is equivalent to Germany's population, while the combined GDP of these countries barely amounts to that of the Netherlands. With 38.6 million people, Poland is the most populous member; however, six countries have less than 5 million inhabitants each.

This bulletin analyzes the current situation of these new members and the adjustments they will have to make to harmonize with the E.U. It will also discuss the anticipated impact on foreign trade and opportunities for Canadian investors and exporters.

Key Figures of the Expanded European Union

	POPULATION (2002 - millions)	Per Capita GDP (2002 - euros)	Hourly Wage (2000 – euros)
Poland	38.64	9,500	4.48
Czech Republic	10.28	14,400	3.9
Hungary	10.19	13,600	3.83
Slovakia	5.40	11,400	3.06
Lithuania	3.48	9,400	2.71
Latvia	2.36	8,500	2.42
Slovenia	1.99	17,700	8.98
Estonia	1.36	10,000	3.03
Cyprus	0.76	17,400	10.74
Malta	0.39	11,700	N/A
15-member E.U. (Total/Average/Average)	380.4	24,010	22.21
25-member E.U. (Total/Average/Average)	454.9	21,910	19.09
USA (Total /Average/Average)	285.9	38,000	17.8

Sources: Eurostat, OECD
1 Canadian dollar = 0.61 euros

Expansion and asymmetry

The new European Union represents the promise of a gigantic domestic market, where customs duties between neighbours will be abolished. Already accounting for 20% of world trade before the expansion, the E.U. will increasingly impose itself as a major trade partner.

The advantage of this expansion is that it will step up the opening of new markets, initially to Europeans, and then to the rest of the world. However, the vast social and economic gaps or asymmetry between the 15 original members and most of the 10 newcomers, which also extend to such important matters as business practices, training of economic agents and regulations, must be taken into account. For example, the social disparities are so marked that a Czech and Pole earns on average seven times less than a Dane.

It will take about 20 years for the 10 new members to reach the economic level of its older counterparts. In fact, 13 years after the collapse of the Berlin Wall, Germany is still having problems integrating the former German Democratic Republic. The economic and social toll of bringing the eastern part of the country into the 20th century has been heavy. Huge investments required to modernize the infrastructures and industrial base of the former GDR have severely weakened the formerly thriving West Germany. The workforce of the former GDR was largely unprepared for a market economy. Managed by the state, this country produced many scientists, civil servants and soldiers, but no merchants or managers. Companies developed based on centralized state decision-making and not according to their performance on an open, competitive market. To a greater or lesser extent, this phenomenon also applies to most of the central and eastern European countries that joined the E.U. in May 2004 despite the fact that their economies have been rapidly changing since the early ‘90s.

A two-tier Europe

The entry of countries considered poor by European standards into the E.U. will initially increase the disparities on the continent and require considerable financial aid to reduce the gaps and finance infrastructure upgrades. However, given their weak growth in recent years, the 15 original members are not prepared to contribute more money to the E.U.

Moreover, the slow conversion of European rules and the multitude of exceptions and transition periods may lead to a two-tier Europe operating at two speeds, as indeed is already the case in the euro zone.

Conversion to the euro is also expected to be very gradual. Some countries are taking steps to speed up the process, while others are taking things more slowly. The 10 new members must first participate in the BIS European Monetary System for two years and fulfill the criteria of the Maastricht Treaty, requiring first a drastic reduction in public deficits, before truly belonging to the euro zone. At this time, the smaller countries seem much more anxious to join than the larger ones.

According to experts, the best-prepared members will not join the euro zone before early 2007. For instance, the Czech Republic has committed to eliminating its deficit sometime this decade and does not plan to adopt the euro before 2009. At any rate, joining the European exchange mechanism too early would severely limit currency fluctuations and would rattle the still fragile economies of the new members. In order to trim their inflation and deficit, these countries will have no choice but to raise interest rates and cut spending at the risk of curbing growth and aggravating endemic unemployment, which in the case of Poland and Slovakia stands at more than 15%. To date, most of the new members are far from meeting the financial criteria required to join the euro zone, with inflation rates running much higher than the 15 other members and deficits sometimes twice the 3% limit set by the Stability Pact.

Despite their achievements to date, the troubles of the new member states are not over. They will have to truly apply the European legislation, continue restructuring their industries and agriculture, confront the ruthless competition of a single market, and finally, accept the fact that the most important decisions will be made jointly in Brussels.

The economic structure of the 10 new members is generally different from the 15 older ones. In these former communist countries, which make up most of the new entries, the power of the state remains quite strong, and the production of wealth is broken down quite differently from the older members. Indeed, more emphasis is placed on primary (agriculture and mining) and secondary (heavy industry) sectors, to the detriment of the service sector, which in 2001 accounted for 71% of the wealth production in the 15 member states, compared to only 63% for the 10 newcomers.

Production breakdown in the 15-member E.U. (2001)
Services: 71% - Industry: 22% - Construction: 5% - Agriculture: 2%

Production breakdown in the new E.U. nations (2001)
Services: 63% - Industry: 26% - Construction: 7% - Agriculture: 4%

Improving the business climate and competitiveness is a priority

Noticeable differences can be observed between the business practices in North America and Western Europe, and most of the new entries. The transition from a socialist to a liberal economy was made over a very short period, resulting in situations similar to those observed in the former U.S.S.R. Corruption is endemic in countries where civil servants are poorly paid and the mafia is powerful, especially in Poland and Lithuania. Indeed, the E.U. has repeatedly asked Poland to put an end to its rampant corruption and reform its environmental laws and legal system.

On June 13, 2004, a little more than one month after the expansion of the E.U., elections to the European Parliament were held in 25 countries. Voter turnout was extremely high for the new member countries (nearly 80% in Poland and Lithuania), in contrast to 50% for most of the original members, which generally view New Europe as an elitist project that has little to do with the masses.

While very real gaps exist between old and new Europe, it bears mentioning that some of the new members are doing quite well in certain spheres. First, the growth rates of the new members, particularly former communist countries, are much higher than those recorded in the 15-member E.U., particularly in the euro zone. Excluding the Czech Republic and Slovenia, whose GDP grew moderately, all the new members recorded growth of more than 3% in 2003. Hungary's GDP reached 3%, Poland's 3.5% and Slovakia's 4%. The Baltic States fared even better, with Lithuania surging to 6.5% for example. This contrasts with an anemic 0.5% for the euro zone.

Although many European observers consider the new members, with the exception of Cyprus and Slovenia, to be way behind the 15 original members, it turns out that they are more competitive than expected in certain sectors. Indeed, some are already more competitive than the four "older," less performing countries (Greece, Spain, Portugal and Italy). They are also outperforming some of the 15 original members in specific areas such as research and development, infrastructures (in relation to Ireland) or work flexibility (in relation to Germany). It should also be added that many of these new members have implemented numerous reforms in the last decade to catch up. Estonia, for instance, has surpassed the average of the 15 original members in terms of access to information technology and improvement in its business climate.