Vysoká škola ekonomická v Praze
Recenzované studie

Working Papers
Fakulty mezinárodních vztahů

8/2008

# Economic Growth, Convergence and Effects of the Integration Process

Josef Abrhám

**Faculty of International Relations**
**Working Papers**

8/2008

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Volume II

Vysoká škola ekonomická v Praze
Working Papers Fakulty mezinárodních vztahů
**Výzkumný záměr MSM6138439909**

Tato studie byla vypracována v rámci Výzkumného záměru Fakulty mezinárodních vztahů Vysoké školy ekonomické v Praze MSM6138439909 „Governance v kontextu globalizované ekonomiky a společnosti". Studie procházejí recenzním řízením.

| | |
|---|---|
| **Název:** | Working Papers Fakulty mezinárodních vztahů |
| **Četnost vydávání:** | Vychází minimálně desetkrát ročně |
| **Vydavatel:** | Vysoká škola ekonomická v Praze<br>Nakladatelství Oeconomica<br>Náměstí Winstona Churchilla 4, 130 67 Praha 3, IČO: 61 38 43 99 |
| **Evidenční číslo MK ČR:** | E 17794 |
| **ISSN tištěné verze:** | 1802-6591 |
| **ISSN on-line verze:** | 1802-6583 |
| **ISBN tištěné verze:** | |
| **Vedoucí projektu:** | Prof. Ing. Eva Cihelková, CSc.<br>Vysoká škola ekonomická v Praze, Fakulta mezinárodních vztahů<br>Náměstí Winstona Churchilla 4, 130 67 Praha 3<br>+420 224 095 270, +420 224 095 248, +420 224 095 230<br>**http://vz.fmv.vse.cz/** |

**Economic Growth, Convergence and Effects of the Integration Process (An Application Study of the New EU Member States)**
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**Summary:**
The goal of this article is to clarify the main tendencies of economic growth and convergence of the New EU Member States, as well as to evaluate possible implications of EU membership for the acceleration of economic growth both at present and in the long term. Depending on the declared goal, the article is divided into three parts. Within the first part the actual trends of the economic growth in the New Member States are analyzed. The second part evaluates the expected effects of the enlargement upon economic growth and real economic aspects, during the first post enlargement years. The last part analyzes the possible scenarios of economic growth and convergence in the New member States within the long term.

**Keywords:** economic growth, convergence, enlargement process

**Ekonomický růst, konvergence a efekty integračního procesu (aplikační studie nových členských zemí Evropské unie)**
Josef Abrhám (abrham@vse.cz)

**Abstrakt:**
Cílem příspěvku je objasnit hlavní tendence ekonomického růstu a konvergence nových členských zemí Evropské unie a zároveň vyhodnotit implikace členství v Evropské unii na akceleraci ekonomického růstu v krátkodobém a dlouhodobém horizontu. V závislosti na stanovených cílech je studie rozdělena do tří částí. První část se věnuje aktuálním trendům ekonomického růstu nových zemí EU. Druhá část hodnotí na bázi publikovaných studí očekávané a reálné efekty hodnotí očekávané a reálné efekty procesu rozšíření EU v oblasti ekonomického růstu. Poslední část je zaměřena na možné scénáře ekonomického růstu a konvergence nových zemí EU v dlouhodobém horizontu.

**Klíčová slova:** ekonomický růst, konvergence, proces rozšíření

**JEL:** F15, F43, O11

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## Introduction

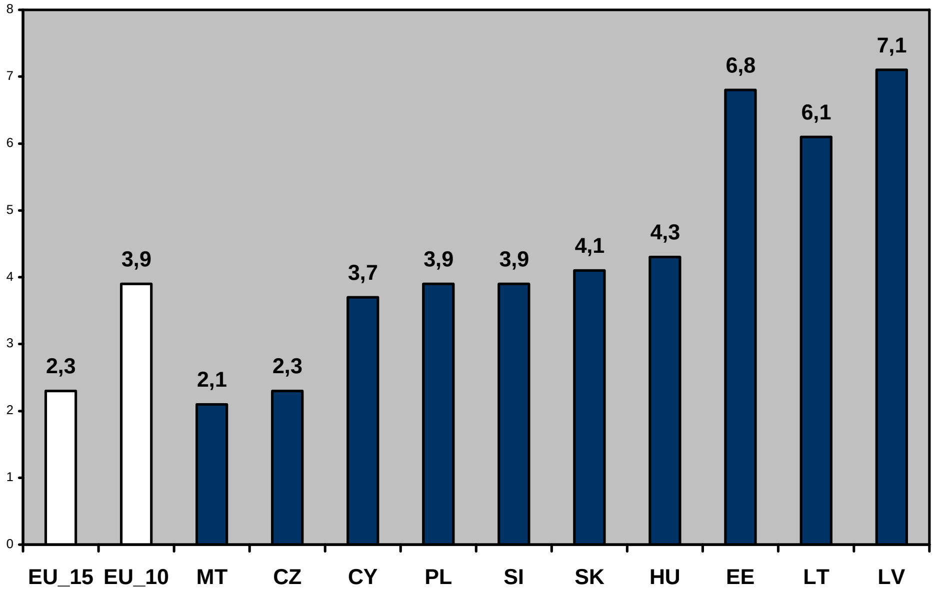
Membership of the EU has expanded on May1, 2004, by the accession of ten new countries (the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia). This was a unique step in the history of the EU; mainly from the point of view of the number of new members; in previous waves of enlargement only a maximum of three states joined during any decade; as well as in view of their level of economic development. GDP per capita of the New EU Members (EU-10) reaches some 50 % of the EU-15 average. The economic divergence of the New and the Old Members can be shown by the fact that this wave of enlargement led to an increase in the number of the EU population by 20 %, but in the case of GDP, only by 8 % (in purchasing power parity), or, by 5 % respectively if we consider GDP in terms of market prices. Economic growth and the catching-up process in the New Member States belongs therefore, among the most discussed economic aspects of the enlargement.

## 1. Economic Growth and Convergence

Preparations for the Eastern enlargement of the EU took almost fifteen years to complete in the course of which, the new EU countries (EU-10) successfully transformed their economies from centrally planned to market-oriented ones, and at the same time thrived on reaching relatively solid growth dynamics. Consequently, after overcoming the initial transformation slump in the first half of the 90s the growth rate of real GDP in the majority of the New EU Member States (EU-10) consistently exceeded the level in the Old EU Member States (EU-15). Specifically within 1997-2005, lower economic growth, compared to the EU-15 average, was achieved only by Malta and the Czech Republic, which unlike the other countries of Central Europe has been achieving bigger growth of GDP only since the year 2000. The growth rates of individual Member States and the average dynamics both of the New and Old Member States within 1997-2005 are shown in Graph 1.

If we wish evaluate the main determinants of economic growth in the New EU Member States during the last decade, we do so on the basis of the growth accounting, and declare that the main sources of the long-term economic growth in the EU-10 are the increased accumulation of capital and their technological progress (the so-called Total Factor Productivity-TFP). These components stimulate a significant growth of productivity despite the low contribution of labour input. The contribution of the labour force to the growth of product unity has been within recent years, in the studied sample of the countries (EU-10), minimal or even negative. That is caused both by a low level of participation in the labour market and a constantly high level of structural unemployment (European Commission 2006a: 44-47.).

**Graph 1: Average GDP growth rate within 1997-2005 (in %)**




Source: EUROSTAT – Database

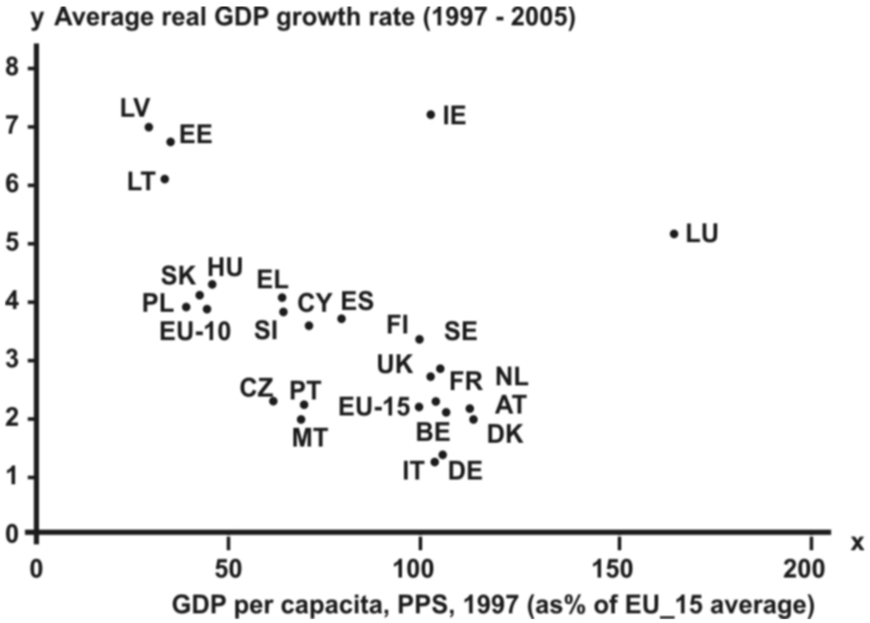
Employment rates of all New Member States (EU-10) are well below the 70% Lisbon target and, also with the notable exceptions of the Czech Republic and Cyprus, below the EU-15 average today. In 2004 the rate of employment in the studied sample of countries (EU-10) ranged from 52% (in Poland) and 69% (in Cyprus)[1].

Relatively fast economic growth has caused in recent years a significant convergence of the economic levels of the Old (EU-15) and New (EU-10) Member States of the EU. In figures relative to the level of the Old (EU-15) EU Member States; GDP per capita increased in the New EU Member States from 44% in 1997 to 52% in 2005. This pace of convergence however differs according to individual countries. Extraordinarily high convergence can be seen predominantly in the Baltic States but also in Slovakia or Hungary. GDP per capita in Estonia approached within 1997-2005 the Old EU Member States

1 In the Lisbon strategy 70 % employment was stated as the goal for the EU Member countries

(EU-15) average by more than 15 percentage points and the ones in Latvia and Lithuania nearly by 14 percentage points[3]. On the other hand Malta as the only state of the New EU Member States worsened its position compared to the EU average from 69% to 64% of the average GDP per capita in the EU (measured in PPP – purchasing power parity)[2].

**Graph 3: Convergence of the EU economies within 1997-2005**




Source: EUROSTAT

The convergent process of the economic level within the EU can be exemplified on basis of the relation between the initial level of GDP per capita (PPP) and the average dynamics of the growth of GDP. This relation in the period 1995-2007 is shown in Graph 3, where on x axis there are stated the initial levels of GDP per capita (PPP) in individual EU member states at the beginning of the studied period and on y axis there are the average growth rates of real GDP within the period 1997-2005. The Graph shows that the mutual relation of the both economic indicators can be, except for Ireland and Luxembourg, proved within the stipulated period. States with the lower economic level showed mostly higher rates of growth and during the period 1997-2005 there were examples of convergence both between Old and New EU Member States as well as within the frame of New Member States as a whole (higher growth rates were achieved by the Baltic states slower development on the contrary was obvious in the case of Cyprus, Malta and the Czech Republic).

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2 Based on EUROSTAT data

In spite of the fact, that the results of convergent process in New EU Member States have been relatively successful for the recent years, there is still a distinct gap remaining between the economic standard of the Old and New EU Member States. GDP per capita (PPP) in 2005 was in all the New EU Member States lower by comparison with the average of the Old EU Member States (EU-15). Among the New EU Member States opposite disproportions can be found. The poorest states are Lithuania (44% of the EU-15 average), Poland and Latvia whereas Cyprus (98% of the EU-15 average) achieves higher GDP per capita than two of the Old States of the EU (Greece and Portugal). In 2005 also Slovenia and the Czech Republic went beyond the economic level of Portugal.

The convergence of New EU Member States (EU-10) to the economic level of the Old EU Member States (EU-15) will thus definitely be a long-term process and probably an uneven one from the viewpoint of individual countries. Currently published studies of the European Commission, which forecast a possible development of GDP until 2050[6], estimate that at the growth rate of New EU Member States (EU-10) by 2 percentage points faster than the growth rate of Old EU Member States (EU-15) the economic level of both units would even out roughly in 2040. Economic development projections are in more detail addressed in Part 3 of this article.

## 2. Economic Growth and Enlargement

### 2.1 The expected impact of the enlargement and economic growth

The evaluation of macroeconomic effects of the enlargement gained the foreground of the interest of many economic analysts as early as the 90s. At the turn of the century a range of economic studies were published forecasting possible impacts of the prepared enlargement on the future economic development in the EU Member Countries. Those studies differ by forecasting methods being used (e.g. growth accounting analysis, general equilibrium model etc.), by follow-up indicators (economic level, employment rate etc.), territorial focus (all the EU-25 Member States, selected border countries etc.) and of course in term of results achieved. Specific results of the selected studies are to be introduced in the following text.
F. Breuss turned up to very favourable results came in his studies from the years 1999 and 2001 (using the method of OEF – world macroeconomic model). Breuss includes in his analysis three New EU Member States – Poland, Hungary and Slovakia – and the Old EU Member States (EU-15) whereas significantly higher gains in term of the growth dynamics of GDP should be achieved by the New Member States. The GDP growth of Hungary and Poland should reach a level, within 2001-2010 of as much as 8-9 % higher growth compared to their situation prior to joining the EU. The benefits for the Czech Republic should be

during the same period slightly lower (5-6%). The effects on the EU-15 countries should be, in the period 2001 to 2010 a lot more modest (on average 0.5-0.7%), while the gains of the countries with close ties to the New Member States will be higher (namely in the case of Austria, Germany and Italy). For some countries (Spain, Portugal, Sweden or Denmark), however, Breuss calculates higher costs than benefits (Breuss 1999: 19-28).

A study by the Directorate General for Economic and Financial Affairs of the European Commission (the method – growth accounting analysis) estimates when including all economic impact of the enlargement acceleration on the long-term GDP growth rate of the EU-15 countries by as much as 0.5-0.7 % annually, and in the EU-10 countries by even as much as 1.3-2.1% per year (European Commission 2001).

Less optimistic estimates are drawn in a study by M. Maliszewska (using the method of the general equilibrium model) which follows only some selected countries of Central Europe (Poland and Hungary) and the Old EU-15. The author predicts that the New EU Member States will gain, on average, more than the entire European Union. Poland should reach, in the long-term, a cumulative GDP growth of roughly 3.4 %, and Hungary of 7 % while the effect on the Old EU Member States should be relatively negligible (about 0.1 %).

The majority of studies concur, despite some substantial differences in predictions of the main trends of macroeconomic development after enlargement. Generally, it is expected that the benefits from the integration process will be drawn in the long-term by all the EU Member States, though in very different ways. The main beneficiaries should probably be the New EU Member States. This asymmetry is accounted for predominantly by their smaller economic dimension, as well as a lower economic level. The GDP of the New Member States represents only a fraction of the economic base of the EU-15. An analogical situation can be seen also in term of mutual trade. The Old EU states are the main business partners of the EU-10, while the share of those states in the total territorial structure of the EU-15 states is minimal. Within the Old Member States the highest benefits should be reaped by countries geographically close to the territory of the New EU Member States (namely Austria and Germany), and the growing effects on the EU-15 will be relatively low or in some cases they may even be negative.

Published studies generally come to the conclusion that membership in the economic area of the European Union will support improved growth in the

New Member States predominantly through:

- **trade effects** (elimination of tariff and non-tariff barriers, reducing the cost of trading, complementarities resulting from different qualitative and price level of production, stronger competition on the internal market and an increase in efficiency),

**movement of capital and factors of production** (investment flows from the West to the East, migration flows in the opposite direction),

**the impact of financial transfers** executed on the basis of EU Funds.

The process of enlargement however, can also mean significant costs in the short or medium-term, which results from the different endowment of New and Old Member countries. The New Member countries are characterized by relatively low capital endowment, also by many idle labour capacities, while at the same time a lower level of wages compared to the Old EU countries. This creates conditions for the switch of production, namely that which is more labour intensive, to the East, and it can contribute to the migration of the labour force in the opposite direction. Some Old Member States (EU-15) will thus be forced, as a consequence of the new competition to reform their present mechanisms of economic and social policies as well as their labour market structure.

### 2.2 Economic growth after the EU enlargement

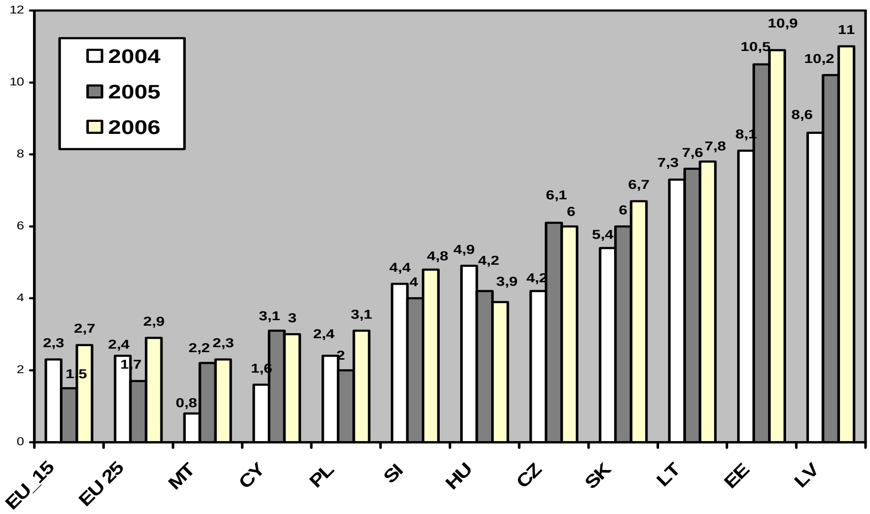
At the time of writing (February 2007) it was not possible, at that time, to judge the tendencies of the development of GDP on the basis of compact time series and thus, compare the expectations before enlargement with economic reality in a reliable way. On the basis of the data available within less than two years of the operation of the enlarged European Union (EU-25); we can however state that the production growth in the New Member States of Central and Eastern Europe (EU-8) confirms expectations and distinctly supports convergent tendencies.

Within the New Member States, and the European Union as a whole, the most dynamic region in recent years has been the Baltic region. The GDP growth rate in the case of Latvia and Estonia reached in 2005; 2006 even double-digit numbers; in the case of Lithuania it was just slightly lower. Likewise, the states of Central Europe managed to profit from the increased inflow of foreign direct investment, primarily due to significantly lower labour cost and favourable tax and investment friendly policies and they achieved by nearly two percentage points faster real GDP growth compared to the EU-15 average (United Nations 2005b: 9-10). The economic level (measured in per capita GDP by PPP) of Slovakia approached, in the within 2004-2005 period the EU average by 5 percentage points, in the case of the Czech Republic by 4 % and as for Slovenia and Hungary; it was by almost 3 percentage points[3]. A relatively lower growth

[3] Based on EUROSTAT data

rate was characteristic only for Poland which is the biggest economy among the New EU Member States. A rather different situation can be seen in the case of Mediterranean economies like Cyprus, and especially, Malta, the growth dynamics of which was, likewise in the 90s, even slower than that in the EU-15. The specific real GDP growth rates in the 2004-2006 periods are illustrated in Graph 4.

**Graph 4: Real GDP growth rate after the accession to the EU**




Source: EUROSTAT - Database

Economic reality confirms also the early predictions concerning the main effects of the integration process on economic growth. The acceleration of mutual cooperation really contributes to the dynamics of both mutual trade and stronger capital flows, as well as to the increased transfer of modern technologies. Foreign trade was already liberalized at the beginning of 90s when the so called European Agreements between the European Union and the candidate states were signed (Krč: 2008). Prior to enlargement, a Customs Union between the Old, and New, EU Member States was put into operation, which at the beginning of the current decade, covered almost 85 % of the total volume of mutual trade. The development of trade bonds are aptly illustrated by the development of the territorial structure of the foreign trade of the Old and mainly of the New EU Member States. The share of the New EU Member states of total trade of the EU-15 states is incomparable though but even here there was between 1993 and 2005 a significant increase (the share in total EU-15 imports increased from 5 to 13 %)[4]. The largest exporter to the EU-15 countries is the Czech Republic followed by Poland and Hungary.

Old EU Member States Foreign firms` interest to invest in the territory of he EU-10 has been growing sharply from the mid 90s. The reserve of foreign direct investment (FDI) is currently reaching, on average, 40 % of GDP of the New EU Member States compared to about a 10 % proportion in the mid 90s, while almost ¾ of the total volume of FDI has come from the EU-15 countries. The largest part of FDI goes to the Service Sector (55 %) and to the Manufacturing Industry (37 %). Allocations and main investors differ by individual countries. In the countries of Central Europe (the Czech Republic, Hungary, Poland and Slovakia) German investors are most active, and most investment is concentrated namely in the modern branches of the manufacturing industry (automotive industry, machinery, the electrical industry) and in traditional industrial branches such as e.g. food or timber processing industry (which are characteristic namely for Poland) (European Commission 2006a: 58-59). While investors in the Baltic countries actually come from the geographically closer Nordic countries and this also influences the target branches.

The increased inflow of FDI plays a positive role in the New Member countries not only as a factor of growth, but also when adjusting the balance of payments, because all EU-10 Member States have been showing in recent years a deficit in the current account both of the balance of payments and balance of trade. Nor has accession to the EU had a more positive influence on this situation. The only exception within the EU-10 countries is represented by the Czech Republic where, during the first years after the enlargement, there has been a gradual reduction of the deficit in the current account and the balance of trade when it reached a surplus in 2005.

In compliance with the expectations, one of the factors of economic development after enlargement is the support from the EU funds. In the Graph 5 we can see that all the EU-10 countries belong right after accession to the European Union as being among the net beneficiaries of the EU budget. The relatively poorest countries (Latvia and Lithuania) the net position of which exceeded 3 % of their GDP in 2006, of course, profit most. A relatively worse position exists in to the most developed countries such as Slovenia, Cyprus and the Czech Republic (their net benefit was roughly 0.5 % of GDP). Even more substantial volumes of financial aid from the EU funds can be expected in the new programming period (2007-2013), when the New EU Member States become net beneficiaries within the EU-25 (contributions from structural funds and the Cohesion fund should reach in the EU-10 countries approximately 3-4 % share of GDP).

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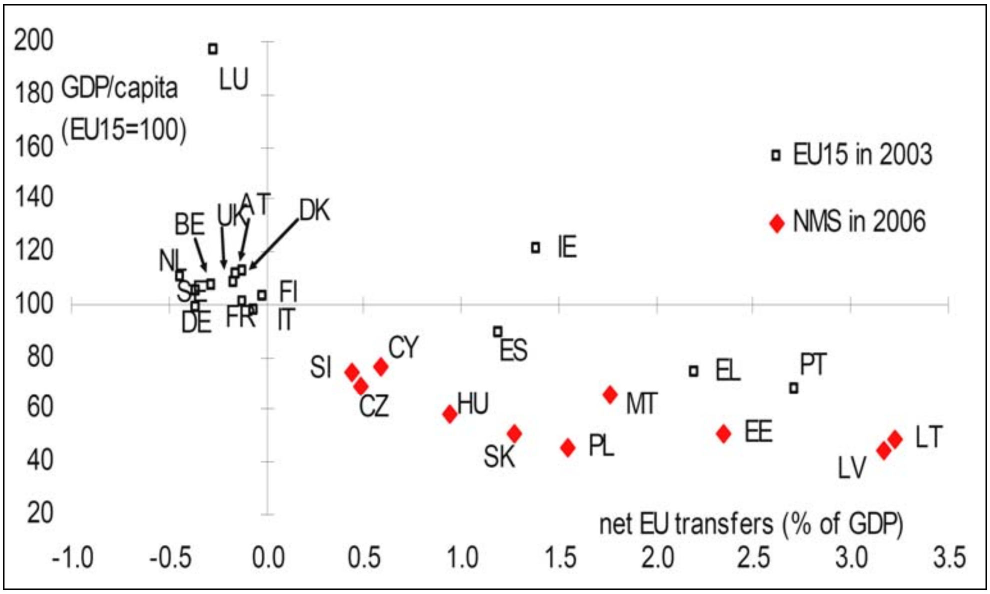
4 Based on EUROSTAT data

**Graph 5: GDP per capita and net EU transfers to Member States**




Source: European Commission (2005), p. 2.

The effects of the EU transfers on the economic growth can still not be accuratelly evaluated. For this, a longer period of time will be needed, but in our opinion the effects on economic growth cannot be overestimated. Probably they will not be of such importance as capital flows or trade effects. But still the New Member States can profit a lot from their position, especially during the period 2007-2013 which represents a unique opportunity that is not probably going to arise again in the near future (we are taking into account further enlargement of the EU and with continually decreasing willingness of the Old EU Member States to finance the common budget). The extent of the effects on economic growth will, however, be influenced not only by the volume of allocated funds, but predominantly by the ability of the Member States both to use those funds efficiently and incorporate them in terms of economic growth strategy.

## 3. Projections of the development of the economic level

Membership of the European Union is often connected with expectations of an increase in living standards of the New EU Member States, as well as with convergence to the economic level of the EU-15. At present one cannot seriously state when, if ever, the New Member States will gain the average level of the EU-15 per capita GDP but we can, based on the long-term forecasts, submit possible scenarios of convergence. In our evaluation, we proceed from two scientific studies, the first worked out by a team of experts for the needs of the European Commission (Carone: 2006), and the second was made by EEAG

(European Advisory Group: 2004). Both studies differ by methods used and date of publication and logically, they come to rather different conclusions. Especially the date of publication is relatively important because every prediction is influenced to a significant extent by previous developments. The recent years which were very successful from the point of view of the growth dynamics of the New Member States thus lead especially in the short or medium-term till 2010; to substantially more optimistic projections.

The key element of the methodical procedure of the study published by the European Commission is the production function (Cobb-Douglass Production Function). The authors predict, on the basis of selected indicators the development of individual inputs of the production function (labour inputs, capital reserve, Total Factor Productivity) and they state the assumed development of the long-term product. The contribution made by the study is the inclusion of the actual forecast of the development of the EU countries` populations. The study presents the comparison of all EU Member countries at the given period (of the current Members, the study does not include Bulgaria and Romania).

The results of the study imply that the main determinants of product growth by 2050 should be rising capital accumulation in all EU Member countries the and the increase in Total Factor Productivity. The contribution of labour input is predicted as a negative as the drop in productive age of the population will exceed the effect of growth of the employment rate. The increase in the economic level should be significantly faster in the New Member States of the EU (EU-10). Average per capita GDP of the EU-10 states should rise from 50 % in 2004 to 78 % in 2050. The fastest pace of convergence is however predicted already in the course of the current and following decade. In Chart 1 we can see that the pace of convergence within the EU-10 will be admittedly very different for individual countries.

The projection of the European Economic Advisory Group is also rather optimistic where the expectations of the convergence of the New EU member countries are concerned. The study envisages the average pace of convergence of the level of per capita GDP between the Eurozone (EU-12) and the New EU Member States by two percentage points annually. The catching-up process should differ by country but not as dramatically as the European Commission study claims. In Chart 1 we can observe that the most developed EU-10 countries (Slovenia and Cyprus) should by 2030 reach roughly the 90 % level of the EU-12 average. On the other hand the Baltic States and Poland should range from 60 to 70 % of the EU average. In our opinion, a more realistic proposition is the projection of the study of the European Commission which calculates with a distinct acceleration of the growth rate of the Baltic countries.
Finally it is necessary to remark that the mentioned projections of economic development are based on high quality data and methodical apparatus, but still it

is imperative to consider their results as some kinds of scenarios which can be, in the fullness of time, modified with respect to economic phenomena and trends arising in the future prospect.

**Table 1: Results taken from the selected studies forecasting the economic level of the EU countries**

| Country | Forecast of European Economic Advisory Group (Year of study 2004) | | | Forecast of the European Commission (Year of study 2006) | | |
|---|---|---|---|---|---|---|
| | 2010 | 2020 | 2030 | 2010 | 2030 | 2050 |
| Czech Republic | 68 | 74 | 79 | 71 | 89 | 86 |
| Estonia | 52 | 61 | 68 | 60 | 88 | 87 |
| Cyprus | 90 | 92 | 94 | 87 | 107 | 110 |
| Latvia | 44 | 54 | 62 | 58 | 93 | 99 |
| Lithuania | 46 | 56 | 64 | 60 | 93 | 94 |
| Hungary | 60 | 67 | 73 | 60 | 76 | 75 |
| Malta | 62 | 69 | 75 | 65 | 73 | 76 |
| Poland | 50 | 59 | 66 | 53 | 75 | 73 |
| Slovenia | 76 | 81 | 84 | 80 | 94 | 94 |
| Slovakia | 58 | 66 | 72 | 57 | 83 | 77 |
| EU-25 | - | - | - | 93 | 97 | 97 |
| EU-15 | - | - | - | 100 | 100 | 100 |
| EU-12 (Eurozone) | 100 | 100 | 100 | - | - | - |

**Source: Carone (2006), p. 42; European Economic Advisory Group (2004), p. 100.**

## Conclusion

The dynamics of the economic growth in the New EU Member States has been, for the last ten years, fairly positive. A slow growth rate is recorded only in Malta compared to the EU-15 average. The main sources of economic growth in the EU-10 countries are the increased capital accumulation and technological progress (the so called Total Factor Productivity – TFP). These components stimulate significant growth in productivity despite the low contribution of the labour input. The contribution of the labour input to the productivity growth has been in the course of recent years in the examined sample selected countries (EU-10) minimal or even negative.

Relatively rapid economic growth is contributing to a substantial convergence of the economic level of the Old (EU-15) and the New (EU-10) Member States of the European Union. Relative to the level of the Old EU Member States (EU-15), per capita GDP of the New EU Member States rose from 44 % in 1997 to

52 % in 2005. The pace of catching-up however differs by individual state. Extraordinarily high convergence can be seen, predominantly, in the case of the Baltic States but also, in Slovakia and, to a significant extent in other countries of Central Europe.

The growth dynamics of the New EU Member States, in compliance with expectations has further accelerated in the first three years after the accession to the EU. The EU-10 states are the main beneficiaries of the integration process. They manage to profit from the development of mutual trade with the EU-15 states (namely: resulting from the complementarities coming from the different price and qualitative level of production) as well as from the increased inflow of FDI which has supported since the mid 90s, the transfer of new technologies and structural change of the economies in a considerable way.

Despite a relatively fast pace of convergence, there is still a considerable gap remaining between the economic standard of the Old and New EU Member States, and the convergence of the new EU Member States (EU-10) will definitely be a long-term, and from the viewpoint of individual countries, also rather uneven process. The crucial aspect will be not only the average pace of convergence but also the initial level of GDP per capita which significantly differs from country to country (e.g. Slovenia versus Poland or Latvia).
According to current long-term economic growth projections the increase in economic level should also be in following years faster in the New EU Member States than in the Old ones. For example, the study by the European Commission estimates that the EU-10 per capita GDP should rise from 50 % of the EU-15 average in 2004 to 78 % by 2050 (Carone 2006: 78). And the fastest pace of convergence is already estimated in the course of this decade and the following one.

The current development and prospects concerning economic growth and the convergence of the New EU Member States are thus, relatively positive, but in our opinion there are also significant risks which will need to be solved within the short and long term by the new EU Member States. Only nowadays maintaining both the internal and external balance of the economy and the preparation of the economies for the accession to the EMU represents a big challenge for the economic policies in the majority of the New EU Member States. The states of Central Europe (Hungary, the Czech Republic and Slovakia) grapple with excessive deficits in their public budgets. For the Baltic States, which without any problem fulfil the Maastricht convergence criteria; in the fiscal area it becomes an unattainable goal to maintain price stability and simultaneously persist in the ERM regime (Maastricht exchange rate criterion). Moreover the external position of all the New EU Member States is characterised by steady deficits in the current account of balance of payments.

From the long-term perspective namely the stimulation of inactive production capacities through raising the amount of participation on the labour market and encouraging a further increase in productivity as well as technological growth. We incline to the opinion that the most developed economies can hardly compete in the price of a production factor nor higher quality of the production (World Economic Forum: 2004). Therefore they are forced to focus on the production of specific goods. That diversity can be obtained on the basis of their own high innovating know-how. Thus they have to develop so called innovating factors – a sophisticated level of business environment and innovating potential. The importance of these factors will increase with raising the economic level and cost characteristics of the economies of the New EU Member States.

From this point of view there is a challenge ahead of the New EU Member States to develop new economic and political instruments of higher quality. The growth enhancing policies should include especially facilitating technology and transfer of innovations, improvement of productivity in industry as well as improved quality of educational policy.

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130 67 Prague 3
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Vydavatel: Vysoká škola ekonomická v Praze
Nakladatelství Oeconomica
Tisk: Vysoká škola ekonomická v Praze
Nakladatelství Oeconomica
Tato publikace neprošla redakční ani jazykovou úpravou

**ISSN 1802-6591**