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Some remarks on the impact of European Union membership on the economies of Austria and Finland – some lessons for Croatia

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# **Some remarks on the impact of European Union membership on the economies of Austria and Finland – some lessons for Croatia**

*Oxana Charushina*<sup>1</sup>

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**CONTENTS**

ABSTRACT.....	2
1. INTRODUCTION .....	3
2. THE ECONOMIC DEVELOPMENT OF AUSTRIA AND FINLAND WITHIN THE SINGLE MARKET .....	5
3. CONCLUSION .....	12
4. THE EU-ENLARGEMENT ON CROATIA: SOME EXPECTATIONS OF ECONOMIC DEVELOPMENT .....	14
REFERENCES .....	16

**TABLES AND FIGURES**

TABLE 1 OVERVIEW OF AUSTRIAN TRADE IN GOODS .....	8
FIGURE 1 GDP GROWTH BEFORE AND AFTER EU ACCESSION.....	6
FIGURE 2 GDP PER CAPITA IN AUSTRIA AND FINLAND, 1995-2008.....	6
FIGURE 3 INFLATION RATE IN AUSTRIA AND FINLAND, 1995-2008 .....	9
FIGURE 4 TOTAL ASSETS AND LIABILITIES, % OF GDP .....	11

**Abstract**

The article is devoted to the problems of the Austrian and Finland membership in the EU. It analyses the economic development of the countries in the context of the European integration. The author focuses on the Austrian and Finland economic models as one of the most successful examples of reorganization of the economy. This article focuses also on economic consequences facing the accession of Croatia into the European Union.

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## 1. Introduction

The establishment of the European Monetary Union (EMU) is an important step toward further integration within the European Union. Several of the Central European countries can be expected to join EMU in a short period of time and the Austrian and Finland experience in financial integration may be applicable to other countries due to the geographic proximity, the close historical and economic links with Eastern Europe.

Through a review of primary documents and interviews, I hope to uncover recent developments in economic policy of Austria and Finland.

The proposed article pursues a theoretical and an empirical interest. The theoretical interest is to further develop and test the consequences of integration on the economy of small countries. Enlargement of the EU with Balkan Countries is a major item on the EU's policy agenda, however assessing the economic consequences of the accession to the EMU in these countries is not obvious. The empirical interest is to explain the processes of Austrian and Finland economic politics in European integration. Both interests are linked.

This study is both process- and result-oriented. The process-oriented analysis entails evaluating institutional and intergovernmentalist theories concerning the roles of integration processes on Austria and Finland's economy across stages of each of the economic reforms. The results-oriented analyses entail evaluating institutional and intergovernmentalist theories concerning: the relationship between Commission and Austrian and Finland preferences and tactics (independent variables) and the integrative value of a reform (dependent variable) and their hypotheses concerning Commission influence.

There are two approaches, stemming mainly from the theoretical frameworks of political science or international relations, devoted to international and, more especially, European integration. Theory by Bela Balassa (1961) argues that "trade follows financial", namely increase in trade will be followed by an increase in the financial sector<sup>2</sup>. On the other hand, Herber Dieter (2000) implies the other way: "financial follow trade", i.e. financial integration will increase regional trade intensity<sup>3</sup>.

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<sup>2</sup> Balassa B. (1961). *The "Theory of Economic Integration*. L., 1961

<sup>3</sup> Dieter H. (2000). *Monetary Regionalism: Regional Integration without Financial Crises*. Institute for Development and Peace, Duisberg University, May 2000.

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The following comparative analysis examines in which way the two different integration strategies are being reflected by economic developments, namely financial politics. The integration effects are always difficult considering the fact that the complex economic developments of countries are the result not only of integration effects. In order to assess effects of EU membership in the case of Austria and Finland, the study will also be based on model-based analysis.

Many literatures (mainly published in Austria and Finland) have discussed the consequences of Austrian and Finland's membership in the EU.

The most interesting materials, devoted to problems of the European economic integration, are presented on a site of the Austrian institute of economic researches (Österreichisches Institut für Wirtschaftsforschung).

Badinger – Breuss (2005), in a sectoral analysis for Austria (46 sectors, 1978- 2001), investigate whether competitive pressure has increased as a consequence of EU membership. It is interesting, that the result does not confirm earlier expectations<sup>4</sup>.

A study conducted by Spohn, W. (2004) contains the detailed analysis of changes in various branches of Austrian economy after accession to the EU<sup>5</sup>.

Significant differences in developmental stages among countries (Austria, Sweden, Finland) have been found by Roeger – Sekkat (2002) in the study "10 years of Internal Market". It is interesting, that arising partly from structural uniqueness of individual countries, they might affect the prioritization of their policy objectives<sup>6</sup>.

The consequences of monetary policy on economic development have been discussed in previous literature. However, this article focuses more specifically on a European framework and namely within a single monetary policy framework.

The author has used the data information from the sites of the Ministry of Finance of Austria and Finland, the Statistical department of Austria and Finland, the National banks of Austria and Finland, ECB, IMF.

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<sup>4</sup> Badinger, H., Breuss, F. (2005) "Has Austria's Accession to the EU Triggered an Increase in Competition? A Sectoral Markup Study". *Empirica*. 2005. No.32(2).

<sup>5</sup> Spohn, W. (2004) Austria: The Comprehensive Country Report, EURONAT Article Report, Robert Schuman Centre for Advanced Studies, EUI, Italy.

<sup>6</sup> Roeger, W., Sekkat, K. (2002) Macroeconomic Effects of the Single Market Program after 10 Years, Background Paper of the European Commission, Brussels, 2002, II-A-1/W D

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## 2. The economic development of Austria and Finland within the single market

Austria and Finland, using their positions of full economic integration, are able to take advantage of the potential integration effects of the single market and euro zone, but, being EU - and euro members, are subjects to the economic policy constraints connected with such membership.

As small open economies, generating a sizeable portion of added value from exports and largely dependent on imports as well, Austria and Finland have traditionally been closely associated with other industrialized countries. The last non-tariff trade barriers (NTB) were eliminated with accession to the EU (the free trade agreement from 1972 had already provided for a free trade area between the EU and EFTA from 1977 – for industrial goods, but not agricultural products). Austria and Finland became a member of the EU's customs union (Common Commercial Policy), and thereby had to cut their tariffs to the lower EU external customs tariff (5.7%)<sup>7</sup>.

Economic structures are different between two countries: Austria is still marked by medium- and small-scale enterprises, Finland can boast of multinationals of global standing.

Since 1995, real GDP has grown faster in Finland than in Austria. The Figure 1 shows a graphical representation of this difference in economic development. Finland could increase its GDP growth since 1995 on average compared to the decade before by 2.4%, whereas in Austria GDP growth was lower by 0.8% on average in the period since 1995. Austria's development was even worse than those of EU-15 on average (-0.2%)<sup>8</sup>.

Favored by Nokia's success in particular, the rate of Finland's exports has increased, taking GDP along with them; Finland's current account surplus (5% of GDP in 1998) continued to grow, reaching 10% in 2001 and 8–10% in 2003–2004<sup>9</sup>.

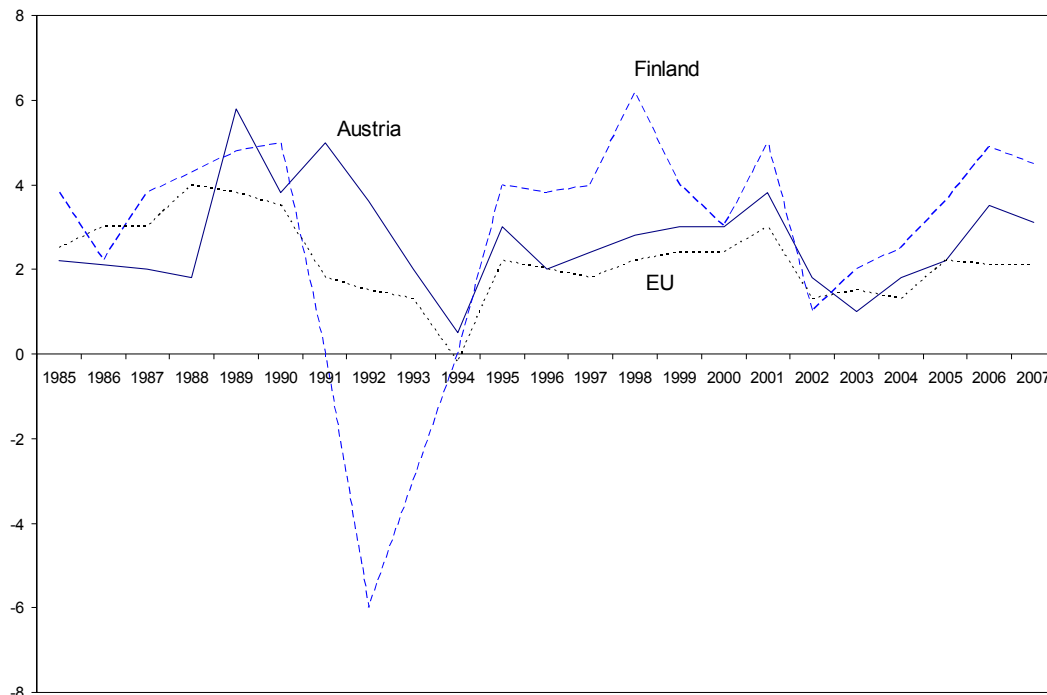
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<sup>7</sup> Breuss, F. (2000) An evaluation of the economic effects of Austria's EU membership. *Austrian economic quarterly*, p. 173

<sup>8</sup> Breuss, F. (2005) Austria, Finland and Sweden after 10 Years in the EU: Expected and Achieved Integration Effects. *EI Working Paper No. 66* (<http://fgr.wu-wien.ac.at/institut/ef/publicat.html>)

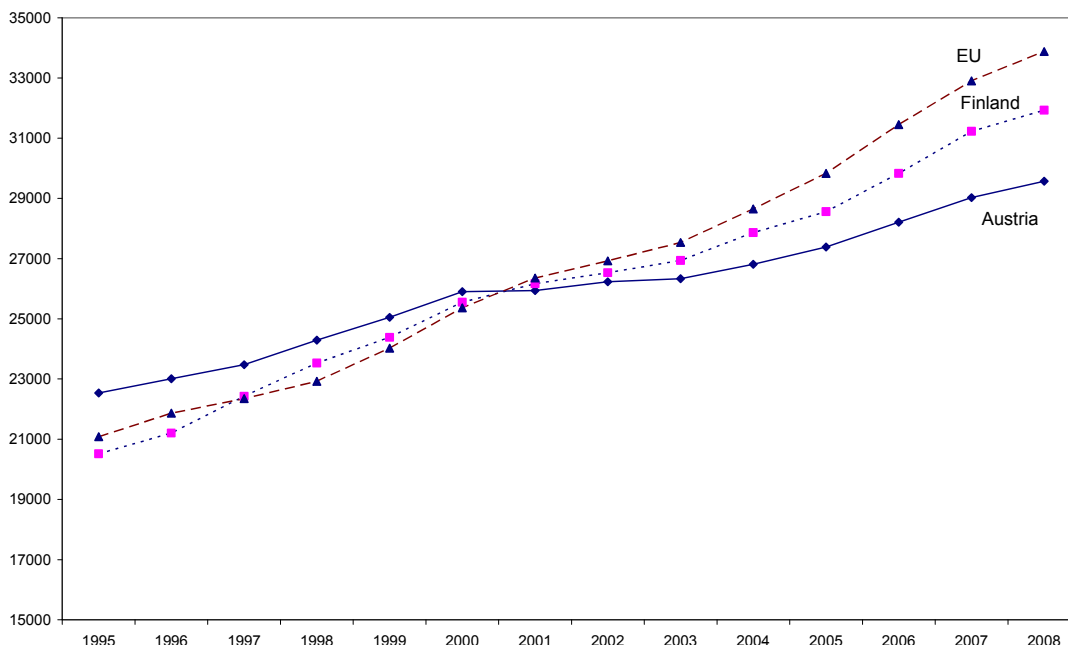
<sup>9</sup> Mayes D. (2004) Finland: the Nordic Insider. In: *Cooperation and Conflict*, p. 189

**Figure 1 GDP growth before and after EU accession  
(Real GDP, percentage change from previous year)**



Source: Data from the AMECO database of the European Commission, National Accounts 1998-2007. Statistics Finland

**Figure 2 GDP per capita (at PPS) in Austria and Finland, 1995-2008**



Source: World Economic Outlook Database, October 2008

On the other hand, per capita GDP gets a more accentuated picture, - Austria lost its second rank in GDP per capita (at PPS) and is now the fifth richest EU country,



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following Luxembourg, Ireland, Finland and Belgium, while Finland improved its position from rank 11 to 3.

Finland's good performance has been to large extent due to the increased output of the electronics industry, reflecting development of the telecommunication industry and lately the rapid improvement of the Russian economy<sup>10</sup>.

The EU-enlargement on the Central and Eastern Europe countries was a factor for heightening Austria's attractiveness as a business location, overall exports to Central and Eastern Europe has increased, and exports to neighboring countries (Hungary, the Czech Republic and Slovakia) even increased in 4.5 times<sup>11</sup>. This region was especially in demand by Austrian direct investors, in particular. In 2003, it accounted for 17% of all Austrian trade investment asset positions, i.e. more than three times U.S. volumes (5%)<sup>12</sup>. The degree of economic integration in some sectors even exceeds the figures achieved during the Austro-Hungarian monarchy.

Membership also internationalized the country, by reducing the impact of Germany as its main trading partner and also eliminated Austria's trade deficit, the euro area takes a leading position as a financing region as well (2/3 of all inward FDI and 42% of all loans and deposits by nonresidents in 2003)<sup>13</sup>. As a target region of financial investment, Germany led by a wide margin within the euro area (at the end of 2002 the euro area accounted for some 2/3 of total investments held in Austria, with Germany accounting for 27% alone), this situation may be due to the structure of Austria's economy, which is marked by small and medium-sized enterprises (SMEs), largely preventing investors from investing across a broad front in Austria. All this seriously restricts the number of enterprises that can be considered for public bond issues. Transaction-related growth in cross-border assets in the run-up to the creation of the euro area and valuation effects arising from the world stock market boom have also deepened this trend. At the same time, the innovation of structured financial products

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<sup>10</sup> Kotilainen M. (2006) Finland's experiences and challenges in the Euro zone. In: EFN-EUROFRAME Autumn 2006 report financed by the European Commission (DG ECFIN).

<sup>11</sup> Breuss, F. (1999) Gesamtwirtschaftliche Evaluierung der EU-Mitgliedschaft Österreichs. In: WIFO Monatsberichte 8. 551—575.

<sup>12</sup> Fuchs M. (2005) The Internationalization of Austria's Financial Sector since Accession to the European Union. Monetary Policy & the Economy. Q2/05, pp.130-143

<sup>13</sup> Breuss F. (2006) Warum wächst die Wirtschaft in Österreich rascher als in Deutschland? WIFO Working Papers, Nr. 280. Oktober 2006, p.22

expanded the spectrum of investment opportunities for international investors both in Austria and abroad<sup>14</sup>.

**Table 1 Overview of Austrian trade in goods**

		2005	2006	2007	2008
<b>EXPORTS</b>					
<i>Billion €</i>					
	Values	94.7	103.7	114.7	120.9
<i>Annual %-changes</i>					
	Values	+ 5.4	+ 9.5	+ 10.5	+ 5.5
	Real	+ 3.2	+ 6.8	+ 8.7	+ 4.1
	Prices.	+ 2.1	+ 2.6	+ 1.7	+ 1.3
<b>IMPORTS</b>					
<i>Billion €</i>					
	Values	96.5	104.2	114.3	121.3
<i>Annual %-changes</i>					
	Values	+ 5.9	+ 8.0	+ 9.6	+ 6.2
	Real	+ 3.0	+ 3.0	+ 7.9	+ 3.8
	Prices	+ 2.9	+ 3.7	+ 1.6	+ 2.3
<b>BALANCE</b>					
<i>Billion €</i>					
	Values	- 1.8	- 0.5	0.4	- 0.4
	Change	- 0.6	+ 1.3	+ 0.9	- 0.8
	Terms of Trade	- 0.8	- 1.1	+ 0.1	- 1.0

Source: Austria's External Economic Relations 2008, published by the centre of excellence "Research centre international economics" (FIW). Vienna, December 2008. p. 19

Table 1 presents overview of Austrian trade in goods. For the second time since World War II, the Austrian trade balance achieved a positive value. We find that Austria's economy appears to react stronger to demand shocks, while in the rest of the Euro Area supply shocks have a stronger impact.

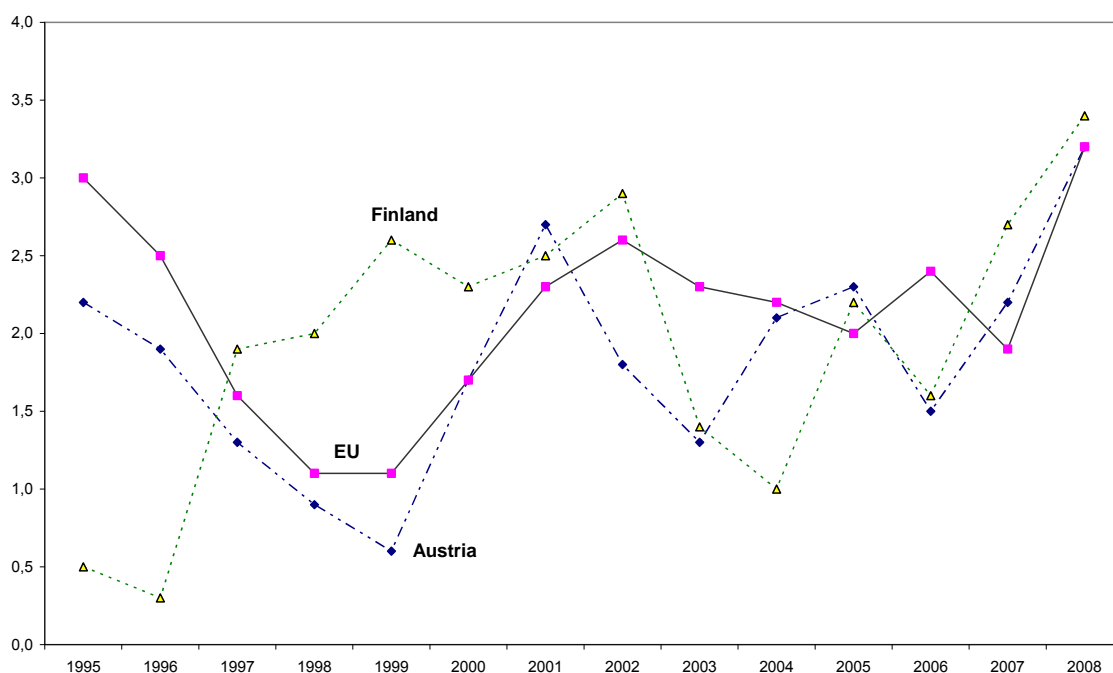
Estimates released at the time (Breuss, 1995) forecasted the increase of consumer prices in Austria to come down (in comparison with a baseline scenario without EU accession) almost 2% during the first two years of EU membership and more than 3% during the next five years<sup>15</sup>. In real world, the inflation rate dropped by half to 1.5% per annum in comparison with 2.7% in period 1987—1994; initial price declines, e.g. in the food sector and later also in some service industries (such as the insurance industry),

<sup>14</sup> Fuchs M. The Internationalization of Austria's Financial Sector since Accession to the European Union. Monetary Policy & the Economy. Q2/05, pp.130-143

<sup>15</sup> Breuss F. (1995) Warum und wie stark sinken die Preise durch den EU Beitritt. In: Wirtschaftspolitische Blätter 6, pp. 482-493

however, turned out to be mostly short-lived. It is obvious, that liberalization entailed price effects in network industries, with prices in the telecommunications sector a case in point: they decreased over extended periods. On the contrary, overall inflation hardly changed following the introduction of euro banknotes and coins at the beginning of 2002; so, prices of some items bought on a day-to-day basis have increased sharply since then.

**Figure 3 Inflation Rate in Austria and Finland, 1995-2008 (HICP, percentage change from previous year)**



Source: Eurostat, ECB, the Statistical departments of Austria and Finland

The Figure 3 also illustrates that in an international comparison, price stability in Austria in the observation period was high, with Austria taking third place within the EU-15. With the adoption of the CAP, Austrian farmers had to adjust their prices to the lower EU level, as a consequence, agricultural prices at the producer level decreased by almost 25%<sup>16</sup>. However, price pressures in the food sector remained subdued in the years up to 2000, which resulted in a downward impact on inflation, this changed in

<sup>16</sup> Breuss, F. (1999) Gesamtwirtschaftliche Evaluierung der EU-Mitgliedschaft Österreichs. In: WIFO Monatsberichte 8. 551—575.

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2000 and 2001, when Europe was hit by severe supply shocks (weather-related crop failures in southern Europe pushed up fruit prices considerably)<sup>17</sup>.

During the changeover to euro banknotes and coins, inflation receded in Austria, observably falling out of step with the EU-12 trend<sup>18</sup>.

However, with oil prices taking off in 2004, energy prices increased again in Austria, which consisted with rising prices in the service sector (especially in housing); as a result, the inflation rate rose again to 2.0%. At the beginning of 2005, inflation remained relatively high, among other things owing to the measures agreed upon during the 2005—2008 fiscal sharing negotiations, for instance, an increase in the tobacco tax and reduced reimbursement of dental services by health insurance funds. The high growth of the global economy in 2004-2006 induced an increase in export demand, a trend which also highly stimulated investment expenditures, especially investment in machinery and equipment. The raise of inflation over the course of 2004-2006 is a result of high global increases in energy and food prices from midyear onward<sup>19</sup>.

Following EU accession, prices in Finland came under high pressure and remained moderate over extended period, the rate of Finnish inflation has been by a higher degree than in other European countries, this did indeed occur between late 1999 and early 2001, but the net effect on the price level over the period as a whole was only 1–2%. This has already been largely compensated by lower inflation than the rest of the euro area since mid-2002<sup>20</sup>.

The Austrian and Finland financial sector's robust focus on Europe has meaningfully increased after the EU-enlargement on these countries and, in particular, after the country's participation in the European monetary union.

The financial market of Finland has taken more advantage than Austria from microeconomic advantages of the introduction of euro, such as reduced costs of

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<sup>17</sup> Fluch M, Price Developments in Austria after EU Accession and in Monetary Union. Monetary Policy & the Economy Q2/05, pp. 69-89

<sup>18</sup> Ibid

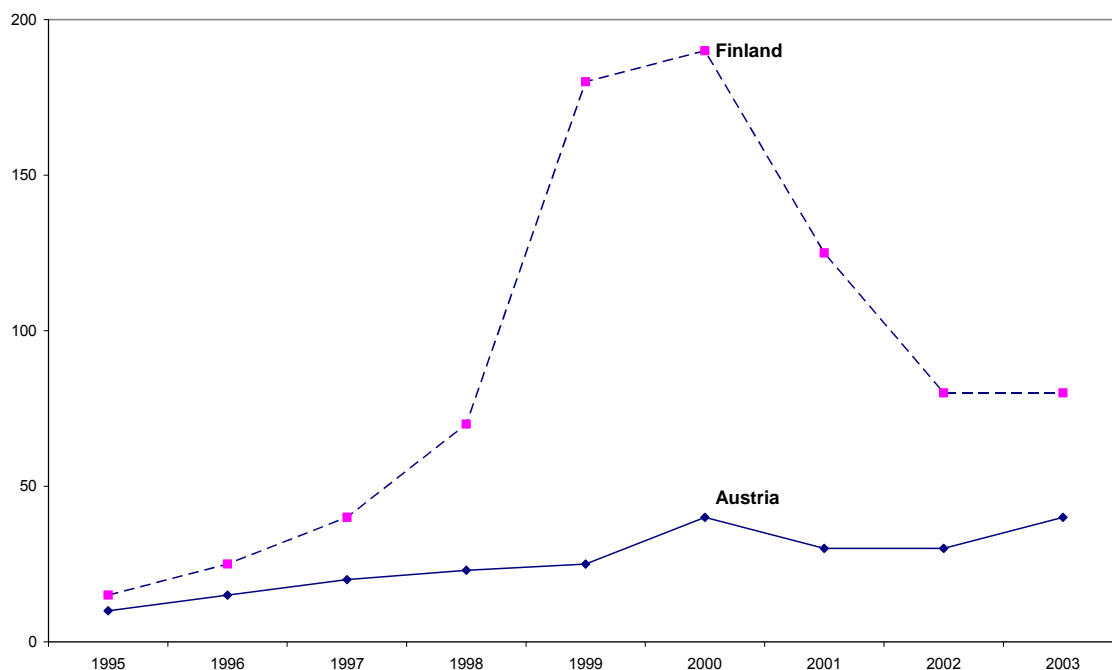
<sup>19</sup> Austria's External Economic Relations 2008, published by the centre of excellence "Research centre international economics" (FIW). Vienna, December 2008. p.17

<sup>20</sup> Mayes D. (2004) Finland: the Nordic Insider. In: Cooperation and Conflict, p. 189

foreign exchange, which might have had a positive effect on investments, and particularly, lower interest rates<sup>21</sup>.

The massive growth in Austria and Finland's cross-border asset and liability positions could be explained by the massive increase in autonomous movements of capital, this development, also visible in most other industrialized countries, is well reflected in global foreign exchange trade.<sup>22</sup>

**Figure 4 Total assets and liabilities, % of GDP**



Source: IMF (International Financial Statistics)

The Figure 5 shows that in terms of GDP, the share of banks' cross-border financial assets and liabilities increased in Austria and Finland in the period from 1993 to 2003<sup>23</sup>. However, when considering the period after the introduction of the single currency, the level of financial integration within non-euro participating Member States and non-EU members has also increased over this period<sup>24</sup>.

<sup>21</sup> Fuchs M. The Internationalization of Austria's Financial Sector since Accession to the European Union. *Monetary Policy & the Economy*. Q2/05, pp.130-143

<sup>22</sup> Ibid

<sup>23</sup> Fuchs M. The Internationalization of Austria's Financial Sector since Accession to the European Union. *Monetary Policy & the Economy*. Q2/05, pp.130-143

<sup>24</sup> Worthington, Andrew and Katsuura, Masaki and Higgs, Helen (2003) Financial integration in European equity markets: The final stage of Economic and Monetary Union (EMU) and its impact on capital markets. *Economia* 54(1):pp. 79-99

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### 3. Conclusion

After fourteen years of membership in the European Union, the results can be drawn as follows:

We find that Finland appears to have profited most from EU membership in economic terms (0.8% greater annual GDP growth since 1995), followed by Austria (+0.4%). Participation in the internal market caused imports from the EU to grow at a faster pace than Austrian and Finland exports into the EU.

The introduction of the euro in 1999 meant for investors the end of exchange rate risks and hedging costs, in addition, financial products were now denominated in a single currency and were thus comparable across countries. All this opened up the Austria and Finland market to foreign banks and fueled domestic banks' cross-border business, rapidly accelerating the internationalization of Austria and Finland's financial sector, at the same time the privatization of most Austria and Finland nationalized banks triggered considerably fiercer competition. In addition, Austria and Finland have profited from the credibility created by the European central banks, which is important, especially in times of international and domestic crises.

Austria's banking sector, which is marked by the high degree of foreign transactions, continues to be guided by risk aversion in the international comparison, however, in the future Austria's external financial assets could be under the influence by international stock market crises to a lesser degree than those of other European countries, whose foreign positions are determined by a riskier profile.

There are some well-known structural factors in the Finnish economy that could lead to problems during the economic crises: the quota of transport and communications, the paper industry and the electronics industry are higher in Finland than in the other European countries. These sectors are traditionally strongly been affected during the stagnation of world economy.

Summing up, in terms of the rate of internationalization, Austria has a higher level of financial integration as Finland. In general, an increase of overall economic productivity in both countries has stimulated economic growth, improving the cost position and pushing down prices. This development has

been favored by the full liberalization of the Austrian and Finland financial sector, as did the country's participation in Economic and Monetary Union.

#### **4. The EU-enlargement on Croatia: some expectations of economic development**

This article focuses also on challenges facing the accession of Croatia into the European Union. Economically, the country is well prepared for EU membership, despite its small domestic market. Per capita GDP stands at about \$14,470 (at PPS), just 2.8% below Poland's; Croatia attract more foreign direct investment - \$1,857 on a per capita basis - than Slovenia or Poland<sup>25</sup>.

The most significant problem remains the large external debt, which peaked 87% in 2007<sup>26</sup>, a level the IMF regards as the upper limit of sustainability.

Croatia has a bigger banking system than many of the new EU members in Eastern Europe, with bank assets amounting to 112% of GDP<sup>27</sup>. Over the past decade the financial system has been modernized by foreign banks that now hold more than 90% of banking assets (Italian and Austrian banks dominate the financial sector), industry has been also largely privatized, what bring the private sector's share of GDP -- currently about 60% - closer to the 75 to 80% average of recent EU accession countries.

The budget deficit has risen from less than 2% in 1999 to 6.3% in 2005 because of increased spending on health care, unemployment insurance and payments to war veterans. Inflation has stayed below 2.5% over the past three years (however, rise to 6.2% in January 2008, the highest rate since the early 1990s.)<sup>28</sup>, and the kuna (the local currency) has traded within a band of plus-or-minus 15% against the euro for the past decade<sup>29</sup>.

Although it is not possible to predict the situation in Croatia after enlargement, it is possible to predict within a range of values the consequences of different scenarios involved with the enlargement.

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<sup>25</sup> Kandell J. (2005) A Balkan rebirth. Institutional Investor-International Edition; May 2005, Vol. 30 Issue 5, pp. 77-82

<sup>26</sup> Data from Central bureau of Statistics of Croatia

<sup>27</sup> Racan, I. (2003) Croatia Pushes For EU Accession. In: Emerging Europe Financial Alert; 6/2/2003, Vol. 2 Issue 3, p. 3

<sup>28</sup> Data from IMF (<http://www.imf.org/external/np/ms/2008/030308.htm> )

<sup>29</sup> Aris B. A gateway to the Balkans. In: Euromoney; Jan. 2005, Vol. 36 Issue 429, pp. 66-70



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*Expectation 1: Restructuring of the new economies leads to an increase in real GDP growth:*

We expect a rise in the external factors determining real GDP growth. The stylized facts are:

- (a) The growth impulse might occur from the restructuring of the economies by privatized firms, generally controlled by foreign investors.
- (b) The productivity growth, broad based in both tradable and non-tradable sectors;

*Expectation 2: The raise of inflation:*

- (a) The transition economies are traditionally marked by a set of natural resource prices considerably below world prices, after the EU-accession the situation in these sectors may be changed.
- (b) The reform of welfare system (pension system, social security) may lead to a wide array of relative price changes.
- (c) Relative prices are explained by productivity differentials.

The growth rates of relative prices of non-traded goods are explained by growth rates of relative labor productivity of traded goods. In well established Balassa-Samuelson model this is the driving force of dual inflation.

*Expectation 3: Investment is diverted from the EU to Croatia*

*Expectation 4: The raise of cross-border financial transactions within the EMU and the capital inflow into the entire EMU rises (FDI inflows)*

Financial transactions, which have grown dramatically as a major form of international capital transfer over the last few decades, are increasingly determining cross-border movements of capital.

\* \* \*

Our recommendation - this small economy should, like Finland, create a national stabilization fund that can be activated in case of a shock before joining the EMU.

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