EU Enlargement and Finland

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1. Introduction

The integration of the central and eastern European (CEE) countries in the European Union has been on the agenda of the Union since the political upheaval and collapse of communism in the late 1980s and early 1990s. This led to a determinate process of promoting the build up of well-performing market economies and the reduction of trade barriers between the EU and CEE countries through the so-called Europe Agreements. All of the CEE countries applied for EU membership in the early 1990s. The political and economic basis of the enlargement was delineated in the EU summit in Copenhagen in 1993. In 1998, the Union started the accession negotiations with the first wave of candidate countries: the Czech Republic, Estonia, Hungary, Poland and Slovenia. In Helsinki, in December 1999, the European Council decided to start the accession negotiations with the remaining five CEE countries: Bulgaria, Latvia, Lithuania, Romania and Slovakia.[1)]

The eastern enlargement has political, institutional and economic dimensions. The fundamental political desire to create a unified Europe open to all willing countries is the basic driving force of the process. Finland has consistently given its warm political support to enlargement. Enlargement has a major impact on the institutions of the Union, as the population of the Union will rise markedly. In the economic arena, the key issue is the establishment of well-functioning market economies, their legal and economic institutions, which are able to manage competitively in the internal market of the Union. The major economic impacts are related to joining the customs union of the EU with free internal trade and common external tariffs.[2)] This means that the four basic freedoms of free movement of goods, services, capital and labour of the internal market of the EU will be extended to cover the CEE countries as well. The candidate countries may, in the future, also join the Monetary Union (EMU) of the EU. The most difficult issues in the accession negotiations are related to joining the Common Agricultural Policy (CAP) of the EU and the free movement of labour, which some EU countries and interest organisations – right or wrong – consider as a threat to the proper functioning of their labour markets. It may be possible that some transition periods will be applied in this connection.

The main aim of this article is to shed light on the impacts of the enlargement on the Finnish economy, especially its production structure. There are likely to be effects on the level of production, possibly on its growth rate and on the structure of production, both in the CEE and EU countries. The effect on the scale of production (the so called level effect) is derived

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1) In addition to the CEE countries, Cyprus and Malta have also initiated accession negotiations and Turkey has been accepted as a candidate country. These three countries are, however, omitted from the analysis in the following due to their small economic significance (the first two) or the remoteness of membership in regard to its timing and likelihood (the last of them).

2) As the CEE countries join the customs union of the EU, they will have to harmonise their external customs tariffs to those of the Union. The customs systems of the CEECs have differed from that in the EU. The average external tariff rate is 6 per cent in contrast to 3 per cent of the EU. The tariff structures also differ markedly from that of the EU (Baldwin et al. 1997). In the CEE countries the protection of agriculture is quite insignificant when compared to that in the EU. Tariffs on other goods also vary significantly.

from the fact that the remaining trade barriers will be dismantled, boosting production in the competitive sectors in the EU countries. The enlargement will offer a stabilising factor and improvement of the business climate in the CEECs, which will raise the investment activity in these countries, both as regards their own investment and the inward FDIs, which will spur their growth rate, at least in the medium term. The effects on the structure of production can be derived from the fact that integration treats differently the various production sectors, as the existing barriers to trade are different at the outset.

The eastern enlargement may involve various stages in practice. In the following, we simply take as the starting point that those countries which are the most important from the Finnish point of view, namely the three Baltic countries, Estonia, Latvia and Lithuania, and the big country Poland, will be included in the first wave of enlargement. This means that we allow for the biggest effects to be realised from enlargement from the point of view of the Finnish economy and its clusters of production.

In the following, in Section 2, the integration of the CEE countries towards the EU, in particular Finland, is briefly summarised. In Section 3, the effects of the enlargement on foreign trade and foreign direct investment (FDI) are analysed. In Section 4, the effects from the point of view of clusters of Finnish economy are evaluated and Section 5 concludes.

2. The Integration of the CEECs towards the EU

Next table below we depict the situation of the CEECs in 1999 in comparison to the EU.

Euro Area Economic Indicators

	EU-15	CEE-10	CEE/EU (%)
Population, mill.	375.8	104.7	27.9
GDP (PPP, bill. Euro)	7 941	824	10.4
GDP per capita (PPP, Euros)	21 133	7 871	37.2
Growth rate of GDP volume (1994-99, %/y.)	2.3	3.3	1.0[1)]
Price level[2)]	..	..	41.2

[1)] Difference in percentage points.
[2)] In relation to the Euro Area.

Sources: The EU according to Eurostat, the CEE countries the OECD and the World Bank.

The biggest direct impact of enlargement on the incumbent EU countries is derived from the change in population, which has a direct impact on the institutions and decision-making procedures of the EU. In economic terms, the CEE countries are a small factor in comparison to the EU. Their income level is less than two fifths of that of the EU. The transition of the 1990s has proceeded in many key respects, but overall economic convergence towards the EU has been quite slow. Poland and Hungary, and Estonia of the Baltic countries have been the most successful countries of them.

The internal variation of the CEE countries is displayed in the table below.

The CEE countries are clearly more heterogeneous (with the exception of the variation in the price level) than the present EU, which is

The Internal Variation of the CEECs in Contrast to the EU

	EU-15	CEE-10	CEE/EU (%)
GDP per capita (PPP, Euros, coeff. of var. 1999[2)], %)	23.9	39.5	165
GDP growth (1994-99, standard dev., %-points)	1.9	2.5	0.6[1)]
Price level (1999, standard dev., %-points)[3)]	14.8	10.2	-4.6[1)]

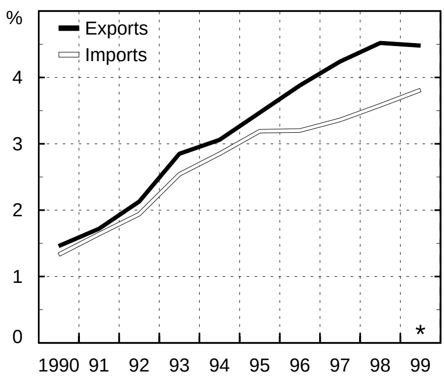
The deviation measures are arithmetically weighted, not weighted by the size of the country.

[1)] Difference in percentage points.
[2)] The coefficient of variation is the relation of the standard deviation to the average multiplied by 100.

[3)] The price levels in relation to the Euro Area.

the most homogeneous of the various trading areas in the world (see Alho 2000). The internal heterogeneity of the CEE countries widened during the 1990s, for instance the coefficient of variation of the income levels widened by more than 10 percentage points. If one of the aims of the Union is to preserve its internal economic homogeneity, the eastern enlargement raises doubts in this respect.

The Share of CEE-10 in the Exports and Imports of EU-15



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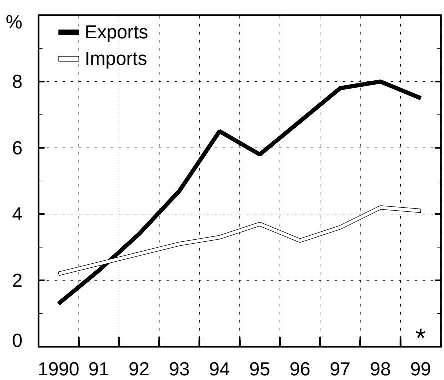
For the EU countries, the markets of the CEECs are relatively small, but have grown in importance. As to Finland, there is a clear difference in this respect when compared to the EU average. In exports, the CEE markets have rapidly grown to become double that of the average situation in the EU, while in imports the situation has levelled off to be roughly the same in Finland and in the EU. Estonia alone accounts for some 40 per cent of Finnish exports to the region.

There is a clear asymmetry between the EU and CEE countries, which is depicted in figure below. The potential importance and gain from the eastern enlargement for the CEECs is much bigger, indeed manifold, in comparison to the potential gain for the EU. This is based on the difference in importance of the mutual trade in these economies. For Finland, the eastern enlargement is potentially of much greater importance than to the EU on average, as the share of mutual trade is twice as big as it is for the EU on average. For the CEECs, conversely, the Finnish markets are quite small, although there are marked differences in this sense (see Section 3). This asymmetry in gains is, of course, one factor which gives the EU a strong position in the accession negotiations.

The Share of CEE-10 in Finnish Exports and Imports



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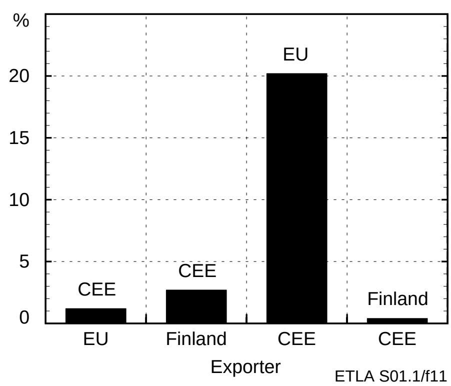
The Importance of Trade with CEECs, Exports/GDP in the Source Region, 1998



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3. Trade, FDI and Location Effects of the Enlargement

After opening up to trade with the Western European countries applicant countries' trade structure has changed significantly. Hungary and Czech Republic, the countries with the strongest industrial heritage, experienced the most rapid change but more recently the development in Poland and the Baltic states has followed the same pattern. On average, the relative importance of the EU as a trading partner is approximately at the same level in the applicant and EU countries.

The major part of the trade between the applicant countries and the EU is based on comparative advantage and hence country differences. However, one of the key elements in recent structural change has been a surprisingly rapid increase in intra-industry trade (IIT), i.e. exports and imports of similar products. Intra-industry trade is usually observed in trade between countries that are relatively similar in terms of their income levels and economic structure. Contrary to this usual picture, IIT between the applicant countries and the EU stems from re-organisation of the production process where for example labour intensive phases of the process have been shifted to countries having cheaper labour. Typically this also means that the unit-values of exported and imported goods differ significantly from each other and usually it consists of transactions within one single firm. To large extent, intra-firm trade also contributes to the recent increase in World trade in general.

Next table shows the shares of intra-industry trade of applicant countries' total trade and in their EU trade. When intra-firm trade is a consequence of re-organisation of production process it usually means that this has substantial implications on foreign investment flows and, thus firm location. The third and fourth column, therefore, show inward foreign direct investment flows to the applicant countries as percentages of GDP.

The table also shows that the relative shares of IIT in applicant countries' trade are not generally very high: between 25 and 45 per cent. The highest shares have, however, reached the level of what the respective numbers are in EU countries with the lowest shares of IIT in their EU trade. A more significant feature is that intra-industry trade tends to be more intense in trade between two countries that are located close to each other. Despite the fact that Germany has a dominant role in both IIT and as

The Share of Intra-industry Trade of Total Trade and Foreign Direct Investments Made in the Applicant Countries

	The share of intra-industry trade of total trade	The share of intra-industry trade in EU trade of total EU trade	Inward foreign direct investments, % of GDP in 1995	Inward foreign direct investments, % of GDP in 1998
Czech Republic	43.6	56.6	4.9	4.5
Slovakia	29.4	..	1.2	2.5
Hungary	33.1	44.5	10.0	3.1
Poland	29.7	33.9	0.9	4.2
Slovenia	37.4	..	0.9	0.8
Estonia	28.8	34.8	5.6	11.0
Latvia	29.1	19.3	5.5	3.4
Lithuania	28.1	16.9	1.2	8.6
Bulgaria	24.5	..	0.6	3.3
Romania	25.7	..	1.2	5.4

Sources: Aturupane et al. (1997), Kaitila & Widgrén (1999), Kaitila (1999) and European Commission (2000).

an investor to the applicant countries, proximity and IIT go hand in hand in Europe also confirming the link between IIT and FDI.

Deeper integration between the EU and applicant countries re-shapes production in Europe and full-membership of the applicant countries strengthens this process. The applicant countries can be roughly divided into three groups according to their location and IIT-FDI pattern. First, there are the Baltic states (and to some extent Poland) that belong to the Northern Dimension. Second there are Central European countries Poland, Czech Republic, Slovakia, Hungary and Slovenia having the closest ties to the EU core, and, third there are Romania and Bulgaria that form a group of South-Eastern countries a little separately located and having the weakest IIT-FDI link with the EU. These groups differ significantly in their economic size and, moreover, the location favour the biggest group of Central European applicant countries. In the near future, this might have, and it already has, substantial effects on location. From the viewpoint of the Finnish economy this may also be bad news since concentration to the core may shift economic activity from the North closer to the markets to Central Europe.

There are at least four potential sources that affect firms' location. First, concentration of demand tends to explain concentration of production. The bigger the markets the more industries tend to locate close to them. Second, comparative advantage has an important influence. Since comparative advantage plays the main role in trade between the incumbent countries and the applicant countries within the Northern Dimension this seems to be potentially important source of specialisation within the area. Third, input-output linkages within industries tend to have an impact as industries generate their own demand through them. Fourth, the higher the non-tariff trade barriers, the more concentrated is production as firms find it advantageous to locate production close to the EU core.

The Northern Dimension of Eastern enlargement, especially when interpreted in narrow sense, i.e. without Poland, is located in a relatively large area and far from the centre of the EU. One could thus expect that geographical concentration of production works against the area as production shifts towards the demand. Recent empirical evidence finds that concentration of demand is – by far – the most important explanatory variable behind concentration.

Comparative advantage may, however, work as a counter-force against concentration towards the centre. Then economic integration may or may not lead to more concentrated production since when trade is liberalised location becomes more dependent on comparative advantage. Finland's and the Baltic states' trade with the EU is more of inter-industry than intra-industry trade indicating differences in their patterns of the area's comparative advantage from the centre. This suggests that economic integration would strengthen specialisation in industries where they have comparative advantage.

Firms with strong ties tend to locate close to each other. Thus the more of its own production an industry uses the more concentrated it should be. In the case of the Northern Dimension – and Central and Eastern Europe in general – relatively high degrees of IIT between close neighbour countries suggest that input-output linkages may occur on a cross-border basis. Good examples are Finland and Estonia and Germany and Poland. This may decrease country-based concentration but increase area-based concentration.

The Baltic Sea area can be seen as a natural trading area within the EU where countries have closer economic ties together than they have with other EU countries on average. This can be confirmed by using IIT and FDI data as above. Although the economic size of this area is small enlargement and positive development in the Baltic Sea region make Finland and Sweden less peripheral than as EU members today. The relative size of the area is not necessarily the most important issue as also peripheral areas may benefit from deeper integration when there are forces like comparative advantage that works against agglomeration. For peripheral areas integration is the more beneficial the lower trade costs are.

As a sub-region in Europe the Baltic Sea region changes the patterns of comparative advantage and may, therefore, affect industrial location in Europe. Trade data suggest that there are considerable input-output linkages emerging, on the other hand, between firms in Germany and Poland or Lithuania and further North between firms in Finland or Sweden and Estonia or Latvia. In terms of comparative advantage these pairs of countries are very different but at the same time a surprisingly high share of their trade is IIT going together with foreign direct investments from Finland, Sweden and Germany to the Baltic countries and Poland. Deeper integration within the area is having complementary effects on industrial production in the area.

4. The Impacts of Eastern Enlargement on the Finnish Clusters and Sectors of Industry

The eastern enlargement of the European Union will complete the process of liberation of trade in goods – through the free trade in agricultural products and food. The free trade in services and the free movement of labour will also commence on this occasion, although certain transitional periods may be implemented. Many barriers will, however, be dismantled, including border formalities and heterogeneous standards, and all of these factors will contribute to lower costs of trading. Finally, a common currency will be used throughout the Union, eliminating currency exchange costs. The ensuing transparency of prices and costs will have an intensifying impact on competition.

The eastern enlargement of the EU will also affect the Finnish production structure. The impact will be greatly dependent on the international competitiveness of the individual lines of industry. Among the Finnish economy, a major challenge induced by the eastern enlargement will be faced by the food industry, while the Finnish textile and clothing industry will continue to lose out to the applicant countries. New companies from the applicant countries will enter the Finnish market to compete for construction and transportation contracts. The strong Finnish clusters, such as the forest cluster and the ICT cluster, will conquer new markets and will either take over companies in the new Member States, or involve these companies in their own production networks. The international competitiveness of the wholesale and retail sectors, as well as that of the banking and insurance sectors, will be of medium level. In practice, the new Members States will constitute almost the only potential direction of internationalisation for these sectors.

Geography will have an influence. Among the candidate states, those with most impact on Finland will be the Baltic countries and Poland, as well as the Czech Republic, Slovakia and Hungary as far as certain industries are concerned. The migration of labour to Finland will most probably take place from the Baltic area – especially from Estonia, considering the Estonian population's widespread proficiency in the Finnish language. Finnish companies see the Baltic countries as a manageable production environment, almost as a domestic market, while Poland is attractive due to the large size of its consumer market. The companies in the Czech Republic, Slovakia and Hungary, with their uninterrupted industrial tradition, are competitive manufacturers.

Food Industry

The eastern enlargement of the Union constitutes a challenge for the Finnish food industry. In the nearby Baltic countries, the level of raw material prices and labour costs is significantly lower than in Finland. Moreover, these countries used to be the "granary" of the former Soviet Union, which is a reason for their considerable surplus in food production.

Due to favourable production costs, the Baltic production of food raw materials and semi-processed products will override some Finnish production. This will not apply to finished products, since the conservative consumers will perhaps not be willing to accept imported finished products. However, the adaptation of the Baltic food industry to the EU market will encounter some difficulties; there is still a lot to do to solve the problems related to the purity and quality level of the food.

The changes in the competitive situation are also visible in the market for production factors. Baltic agriculture will win new markets, and in terms of employment, the Baltic food industry will gain in importance when compared to Finnish companies. However, the enlargement will provide a new opportunity for Finnish agriculture and the food industry to hire cheaper labour.

The Baltic countries and Poland are potential markets in which Finnish food companies might wish to establish themselves. They are closer to the continental European markets and, supported by EU subsidies, exports can be extended to south-west Russia and Belarus. Imports into Finland would probably take place using Finnish brand names, to a much greater extent than under the foreign brands of the applicant country companies.

The resources of the Finnish food sector companies are still sufficient to implement corporate acquisitions in the applicant countries, despite the heavy adaptation process they have undergone due to Finland's own membership of the Union. BBH Holding AB, of which Finnish Hartwall owns half, is a good example of a successful entry to the Baltic markets. The company has developed the acquired breweries into market leaders in Estonia, Latvia and Lithuania.

Textile and Clothing Industry

The Baltic textile and clothing industries play an important role in the countries' economy, accounting for a considerable share of both production and jobs in these countries. So far, the companies subsist mainly by supplying their production on a subcontractor basis to producers in the EU and also in more remote countries. The development of proprietary brands has only started recently. However, leading foreign manufactures are expected to start acquiring factories, imposing rationalisation and improving productivity. Mergers are also to be expected. Gradually, a larger share of the production value chain will be transferred to these countries.

Faced with tough competition, the Finnish clothing industry has also transferred an increasing number of operations to cheaper production countries – recently to the Baltic countries. They constitute a local subcontracting area for the Finnish companies anxious to cut their own production costs. As the border formalities will disappear, the logistics will develop and the efficiency and client service capacity of the subcontractors will improve, these potentials becoming increasingly easy to exploit. However, the problem of the Finnish textile and clothing industry is the limited size of the production run, very small by international standards. Not even the subcontractors are interested in such short runs.

In the context of the division of labour within the enlarged EU, the Baltic countries hold a strong position in the textile and clothing industries. This becomes clearly evident in a comparison between Finland, with its 5 million inhabitants, and Lithuania with a population of 3.9 million. Currently, the Finnish textile and clothing sector employs only 20,000 people whilst the corresponding figure in Lithuania is 63,000. Some jobs in the Finnish industry are likely to be lost, to the benefit of the applicant countries. This trend would continue – although less markedly – even if EU membership of the applicant countries did not materialise.

Construction and Building Materials Industry

For the companies engaged in construction and in the building materials industry, the new applicant countries constitute both a promising potential market and production area as well as a source of cheap labour. EU membership will also make it very much easier for companies in the applicant countries to penetrate the Finnish market. Tougher competition will intensify the operation of the companies in Finland, pushing prices down and levelling off the cyclical changes in the construction business. Labour from the applicant countries will be employed by Finnish construction and refurbishment sites. In manual labour, the levels of wages may start to reconcile at a rapid pace. The level of wages of Estonian professional workers is expected to reach the Finnish level in five years.

The Baltic countries, Poland and the Czech Republic constitute the most natural operating area for Finnish construction companies. Further away from the mother country, the management costs of the project would start to become excessive, and the competition from companies operating from less distant EU countries eat up their profitability. The competitiveness of the Finnish companies is stronger the more complicated a building or a project under consideration (e.g., building technology, project development, financial arrangements, etc.). Typically, the practical construction work will be left to local companies. It is not necessarily profitable for Finnish companies to own local construction companies, because they will achieve a better result by having local companies compete for the tender.

The Baltic countries have opened a new, important market for the building materials industry.

Construction of one-family houses has shown a rocket-like increase, and various infrastructure projects and building of business premises for western companies provide a growing source of orders. Depending on production and logistics costs, it may be profitable to transfer production to where the new markets are. Examples of this choice are Rannila (Rautaruukki), a producer of roof materials and Paroc, an insulation producer.

The applicant countries can also boast fairly good building material subcontractors. Short of orders in their traditional line of business, many companies which were earlier involved in the production of more sophisticated products are now willing to work as subcontractors. Through the respective cost benefit, the Finnish industry gets an additional boost for the exports to the EU markets and also to Russia.

Traffic and Transport

In the transport sector, Finnish companies will have to compete not only with their Baltic counterparts, but also with companies from the eastern middle-European countries. The competition will involve the Russian transit transport and export transportation for Finnish industry as well as Finnish imports and domestic transport.

In road traffic, the problem of the Finnish entrepreneurs is the relatively small size of the companies and the take-over of the larger companies by foreign owners. The competitive edge of the Finnish companies, however, is based on good competence in logistics and on reliability. When considering road traffic, the applicant countries will enjoy the following competitive advantages: lower labour costs, lower capital costs and lower fuel prices. Moreover, they are more prone to exploit measures which fall in the area of the grey economy, such as compromising the minimum terms of employment, imposing excessively long shifts on drivers, violating the dispositions concerning the vehicles, and failing to pay their taxes.

In maritime traffic, the Finnish ship owners, as well as those EU shipping companies which operate from Finland, are already competing with the applicant countries' companies for freight, while the passenger ferry traffic between Helsinki and Tallinn is a rough battle between Finnish and Estonian shipping companies. It is probable that the passenger traffic between Sweden and Finland will also become heavily contested after the eventual entrance of the applicant countries into the EU.

As a consequence of the applicant countries entering the EU, the number of employees originating from these countries will increase in Finnish companies. This will lead to a levelling-off of labour costs and competitive positions. Although the cost level of the applicant countries will approach the Finnish level, the process may be too slow for Finnish companies. In road traffic, the technical standards, the levelling-off of the cost through harmonised taxation as well as a better control of working hours and other similar factors would improve the position of Finnish entrepreneurs.

Impacts on Commerce and the Service Sector

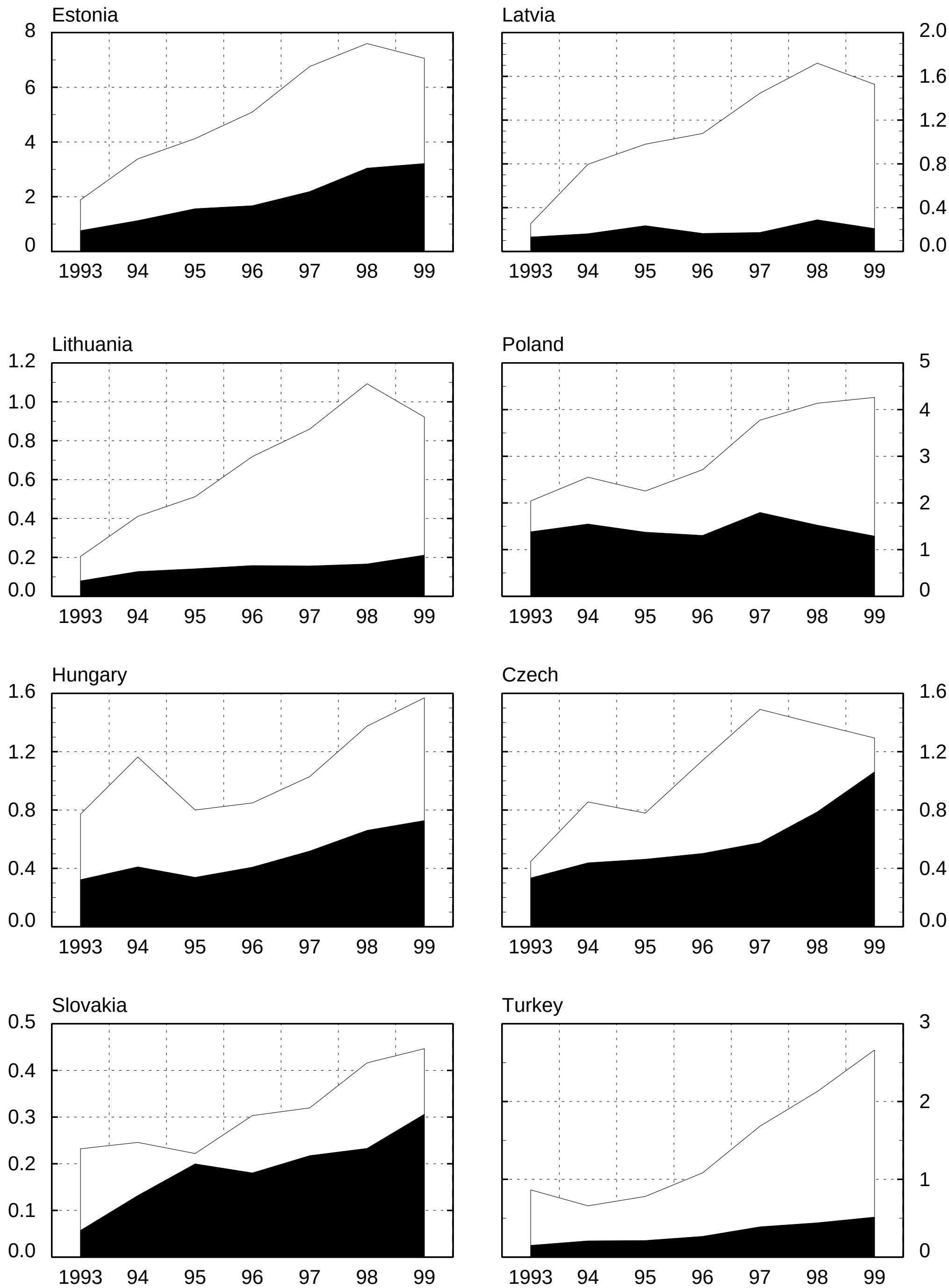
The Finnish service companies have already launched a process to penetrate the new applicant country markets.

- In the Baltic countries and Turkey, Finnish companies are already involved in telecommunications. In fact, the largest individual investments in the applicant countries have been made in the telecommunications sector.

- In wholesale operations, Finnish companies are aiming at an important position – if not at market leadership – in the Baltic countries. Their Swedish competitors share the same objective. The wholesale sector will build its logistic centres *in situ*, because the local products, such as foodstuffs, play an important role in the retail trade. This is also necessary for the trade in imported products, because Finland lies somewhat off the main import arteries.

- Banking and insurance are also sectors in which Finland is looking for a market position in the Baltic countries. The mistrust felt by the consumers vis-à-vis the domestic banks and insurance companies is a factor promoting the success of foreign companies, considered to be more trustworthy.

Finnish Foreign Trade with Selected EU Applicant Countries, Bill. FIM



Export Import

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Finland's Strongest Clusters and the Eastern Enlargement

The mode of operation and the product structure of the Finnish forest cluster – large-scale production of information-use paper – differ clearly from those of the respective industry in the applicant countries. In the latter, the mechanical woodworking industry, and the considerably more labour intensive further processing of the wood, play an important role. In fact, the Finnish forest companies are interested in the raw material resources of the applicant countries, as well as in their geographical vicinity to the Continental European export markets. If willing, the Finnish companies could invest and introduce their own concept in many of these countries. This might mean export income for the applicant countries, but the downside would be a loss of employment if the labour intensive current product suffers from lack of raw materials. The export of forest harvesting and mechanical woodworking technology and competence, as well as the export of "waste-wood"-fuelled energy technology are the types of business in which the Finnish companies could best exploit the applicant countries.

From the point of view of the ITC cluster, the applicant countries provide not only an emerging market area, but also constitute a source of components for the electronics industry, offering software competence, if necessary. The best example is the Estonia-based factory of the Finnish company Elcoteq. The company is Estonia's largest exporter and biggest private employer. In addition to Estonia, the Czech Republic, Slovakia and Hungary are important import markets for the ITC cluster. If necessary, it will be possible to build new contract-based subcontracting capacity in Latvia and Lithuania.

For the power technology industry and boiler producers involved in the energy cluster, the applicant countries offer a certain level of competition. In principle, the considerable foreign ownership share of the Finnish energy technology industry restricts its potential of penetration in the applicant countries. However, the Finnish units of these companies have been assigned business responsibilities in Russia and in certain eastern European countries. The Finnish energy cluster companies could provide environmentally compatible energy technology to suit the circumstances in the applicant countries. In fact, the Baltic applicant countries play an important role in the strategies of the Finnish energy companies.

5. Conclusions

The countries of central and eastern Europe have been able to achieve, in aggregate terms, a relatively favourable economic growth during recent years. On the other hand, they are, however, a much more heterogeneous group of countries than the present 15 EU member states. In this respect, qualifications can be made about the enlargement as the present economic homogeneity of the Union may suffer substantially in this respect.

There is also a clear asymmetry between the Union and the aspirant countries. The gain from membership is manifold for the CEECs when compared to that of the EU. For those countries, which have during the transition period had the most intense economic relations with the CEECs, the enlargement assumes the greatest importance. Finland belongs to this group of countries.

The effects of enlargement can be different for firms and their workers. As the amount of FDI in the CEECs is in some cases already greater than in the inward FDI in the EU countries, the foreign ownership of the key industries is quite high. In this case the elimination of the remaining barriers to trade means a rise in the profitability of those EU firms which have made these investment in the CEECs, while the position of EU workers may, in the short-term, face harmful consequences. In general, deepening integration has the biggest effects on those branches which have been separate from the integration process, these being typically some of the home market industries, while the competitive export industries are likely to gain from the lowering of the barriers in their export markets. This will also hold for the eastern enlargement of the Union.

Much of the public debate on the EU's eastern enlargement is centred on fears of industrial delocation. From the point of view of an incumbent country located far from the core of Europe, such as Finland, this involves fears of the shift of manufacturing activities from that particular country either to the new entrant countries with lower labour costs or to central Europe where the bulk of the enlargement and expansion of the Internal Market will take place.

A simple analysis of trade and foreign direct investments demonstrates, however, that eastern enlargement takes place in three quite distinct regions. The central dimension, dominated by the German presence, is the region where by far the biggest action will take place. This is not, however, bad news for the peripheral Baltic Sea region, where nations' comparative advantages are mostly independent from the core nations. This serves as a counter-force to concentration-increasing specialisation. Moreover, strong complementary effects of trade and FDI suggest that the proximity of low wage countries does not yield massive industrial delocation from the incumbent countries to the new entrant or applicant countries.

The EU applicant countries are important trading partners for Finland. Trade with these countries generates a considerable net export income for Finland (see figure on page 62). In addition to the trade in goods, the Finnish companies have substantial other operations within the countries, including telecommunications services and the manufacture of components for the electronics industry. Currently, the Finnish service companies, including banks and insurance companies, as well as the wholesale sector, are expanding their operations and establishing a strong position in the Baltic countries.

The EU membership of the applicant countries will enhance their position, at least in the food industry, the textile and clothing industry as well as in transport and construction. Compared to Finland, the considerably more advantageous cost level of these sectors will provide the applicant countries with a clear competitive advantage. In the food industry, Finnish companies will be able to defend their position through an increased number of corporate acquisitions in the applicant countries.

The membership of the Union will allow free movement of labour, and cheaper labour will arrive in Finland, at least from Estonia. Increased competition in industrial sectors, such as the food industry, and transfers of labour in other sectors, such as construction, will benefit the Finnish consumer through a decrease in prices.

The eastern European and Baltic countries have already started to adapt themselves in view of their EU membership and the changes brought about by the common market. Likewise, Finland has to prepare itself for the eastern enlargement of the EU, and companies should improve their capacity to exploit the imminent change. If not based on solid argumentation, any restrictions of business involving the four basic freedoms will have a negative impact on the Finnish companies' competitiveness and on domestic employment in the long run.

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