ECONOMIC IMPLICATIONS OF ENLARGEMENT

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BEEP briefing no. 1

October 2002

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Revised from a key-note speech to the
42nd Annual Congress of the
German Association of Agricultural Economics
(GEWISOLA)
30 Sept. – 2 October 2002, Halle, Martin Luther University

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1. Introduction

The Eastern enlargement is about to be decided by the European Council. As expected, the "end game " of the negotiations and assessments is heavily biased by a narrow perspective on net transfers, on income compensations to Central European farmers and on the psychological politics of a single "big bang ". None of these three so-called key items of the end game are of much relevance to appreciate the significance of enlargement. Net transfers have little to do with the costs and benefits of club membership for countries which pay, and can lead to addiction and lethargy rather than extra growth if market integration, macro-economic stability and domestic reforms are not taken serious (as the case of Greece before 1997 has demonstrated). Income compensations for Eastern farmers are crucial for this pressure group, and symbolically of some importance in domestic politics because of the perversity that rich farmers get more, but their absence is likely to serve the public interest in candidate countries far better. And being part of the big bang, as against getting in one or three years later, has assumed a dramatic meaning during this end game, far beyond its true proportions. This hectic European theatre tends to obscure what enlargement is mainly about, now that the stability and values have been secured for the peoples from Central Europe. In a guaranteed setting of peace, freedom and security, enlargement is about greater prosperity.

It is therefore essential that the economic implications of enlargement are better appreciated by policy makers. It is the purpose of this Bruges European Economic Policy (BEEP) briefing to provide an accessible overview of the economic implications of enlargement as a help for advisors and decision makers. The survey is not meant to be exhaustive and avoids technical exposition. Policy implications are drawn throughout the briefing. The presentation shies away from the much discussed reform details of the CAP and from the budgetary aspects, including who pays

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(net) and who receives (net). Similarly, the debate on the transfers related to cohesion after 2006 is not reviewed. The briefing is purposefully focussing on "other " economic effects that tend to get lost in the current debate and which are more fundamental for the secular rise of prosperity.

Section 2 deals with the conventional economic impact analysis of enlargement. This approach is dominated by the trade effects, starting from the idea that enlargement is primarily a customs union issue. This trade-based literature is rich and I shall limit myself to the key conclusions while respecting to some degree the analytical differentiation. A part of this literature is combined with pro-competitive effects or even truly dynamic effects and has frequently been extended to the impact on GDP for the medium-run. Selectively, the shortcomings of these analyses will be mentioned. The greatest weakness, however, is that the starting point should not be the usual one of moving from a tariff-ridden initial situation to a customs union, but from free trade area to a customs union, and indeed one with high tariffs only for agriculture and maximum tariffs in the 9% - 12% range for a few industrial sectors. Other EU tariffs have nuisance value or are zero. Going beyond this trade –driven perspective will therefore require a very different framework.

In this BEEP briefing I shall look at enlargement as '*regime change*' and study its wide-ranging economic implications. In 5 subsequent sections I shall discuss a selection of economic implications of 'regime change': does it help catch-up growth?; does it help the inflow of foreign direct investment?; does it lead to more than trivial migration from East to West?; what are the economic implications of the candidates joining monetary union ? Finally, I shall briefly touch upon three kinds of EU reforms, the need for which is strengthened by enlargement. As noted, this leaves out many other aspects,[1] even the budget and the Zahlmeister issue. An obsession with net payments to the EU forms an unhealthy denial of what economic integration is all about. For readers interested in the economics and estimates of the net-paying vs. net-receiving countries and the shifts therein, I refer to other sources (see Weise, 2002; Pelkmans, Gros & Nunez-Ferrer, 2000; European Commission, 2002). The briefing ends with a summary of the conclusions.

[1] Such as domestic reforms in candidate countries, a range of typical enlargement issues having economic effects (e.g. Schengen frontiers, WTO approval, environment, etc.), institutions in candidates post-transition (key for growth) including 'social capital', and the Convention; one could also include the mere assumption of whether or not Turkey comes in as it is economically bigger than all candidates together and has overlapping structures.

2. Trade-induced impact

The pure trade effects of enlargement are first of all the result of a change from an industrial free trade area towards a customs union including agriculture. However, beyond this textbook case, the candidates enter the internal market and this introduces additional potential benefits which are hard to model properly. If tariff differentials in a free trade area are modest and tariffs are absolutely low, the change-over to a low-CET customs union should not be expected to cause large changes. Thus, for industry, most of the adjustment driven by the free access to the EU goods market will be over before 2004. What then follows might be characterised by further deepening of specialisation and vertical intra-industry trade, stimulated by foreign direct investment and sub-contracting. This is best demonstrated by the textile & clothing industry, the biggest sector of the candidate countries in EU imports and showing double digit growth rates for over a decade now, with no sign of abating. With the end of MFA quotas nearing (2005) German and Italian industry have developed strategies for relocation and expansion in Central Europe for as long as a decade ahead (EPPA/CEPS, 2002). The impact is more complicated in the car sector, the only major sector where the candidates' protection is strong, hence where current EU-CEEC trade incorporates significant trade diversion. Thus, the restored trade balance in cars in what will be EU-25 is only sustainable if technical efficiency and/or improvements in technology have important cost-reducing effects, at the required level of quality for sales in Western Europe. In Poland and later, Romania, this will require impressive improvements in applied technology, the quality of supplier networks and other aspects of cost minimisation as well as quality. The trade effects will be by far the most important in agriculture. In agriculture the initial protection by the EU was very high, with only limited exceptions and minimal quotas, whereas the candidates' agro-protection turned out to be much lower but, more often than not, not low absolutely. This spells complex and sizeable trade diversion effects. Of course such effects should not be studied in a static context because the sector, already plagued by cumbersome land privatisation and dual systems of tiny, unproductive and very large farms, is up for drastic restructuring and technological change. Moreover, the nature of the CAP which the EU-15 will "export" to the candidates is not yet known. The present briefing does not deal with agriculture although occasional references cannot entirely be avoided (for readers interested in the expected trade effects in agriculture can consult e.g. Fuller et. al, 2002; Weyerbrock, 1998; Frandsen, Jensen & Vanzetti, 2000; Swinnen, 2002; European Commission, 2002a; idem, 2002b).

The empirical literature on trade effects generally deals with the impact of today's free trade area (the Europe Agreements) and much less with the post-2004 customs union. Some of the more telling inferences about the CECs

(Central European Candidates) include that, after the massive shift towards trade with the EU (up to 1994), the initial dominance of labour-intensive final goods has reduced, and the share of technology and skilled-labour intensive products moved up from 37% in 1993 to 50% in 1997 (Kaminsky, 2001). Quality upgrading is also found by Nielsen (2001), at a very high level of disaggregation, but the CEEC quality levels still lag greatly behind those of the EU. Vertical intra-industry trade dominates East-West industrial trade (Aturupane, Djankov & Hoekman, 1999), with the CEECs invariably supplying the low unit-cost goods. The impact side of Central Europe is extremely dynamic for capital goods (not including motor vehicles and their parts), nearly a tripling between 1993 and 1998. These and other studies, combined with the flows of foreign direct investment, point to ongoing forceful restructuring and upgrading. It is guesswork to make inferences about the quality of factor endowments and applied technology in 2004 but there are good reasons to expect the starting position in the larger customs union to be radically different from the empirical basis of most of the meanwhile published literature on trade effects. If correct, it is good news for competitiveness, and ultimately catch-up growth. In any event, a reasonable guess would be that the candidates' share in EU-15 imports (already gone up from 3.4% in 1992 to 9.8% in 1999) would rise to 13% - 14% by the time of entry. Central Europe will begin to matter in EU trade.

It is far from obvious how to connect this combination of trade growth and structural change with the static theory of preferential trading. It would seem much more attractive to assume a richer approach in which the so-called pro-competitive effects, in models with scale (hence, restructuring via exit of firms) and product differentiation, and possibly capital movements, are accounted for. An example is in Francois (1998) who also allows for (re-) location effects of footloose industries and endogenous capital stocks, so that accumulation effects can be included in a computable general equilibrium model. As is to be expected, the economic impact on the EU is slight but positive. For the candidates, the static efficiency gains are positive but completely overwhelmed by the procompetitive and accumulation effects, on the basis of drastic restructuring in Central Europe and some relocation from West to East. In actual reality, this will take place against the backdrop of considerable, structural unemployment and inevitably large adjustment costs at least in the short-run, reducing the initial net gains appreciably. In such richer approaches, sectoral shifts tend to get lost or evened out. In Lejour, de Mooij & Nahuis (2001), a brave attempt, with a complex CGE model, is made to estimate effects for 16 sectors. This paper is one of the very few in which the post-2004 regime is stylised by (largely) ignoring tariffs. The authors identify, with a gravity approach, the tariff equivalents of regulatory barriers in the internal market (which can only fade away after adaptation, quality upgrading and

recognised conformity assessment). With this ingenious, though problematic procedure, the authors can show pronounced output increases (after 2004) for sectors such as textiles & leather (between 34 % and 52%), electronic equipment (between 8% and 70%) and transport equipment (between 30% and 68%). The implied regulatory barriers (between 10% and 17% for the key sectors) should be related to 'regime change' in the framework of the PECA agreements with the candidates, the industrial equivalent of the infrastructural capacity to conform to sanitary and phyto-sanitary requirements. However, it is one-sided to regard regulatory barriers only as costs, since, broadly speaking, these requirements accord well with quality indicators for competitiveness.

How these trade effects translate into welfare gains, or GDP gains for the initial period has been actively studied. There are essentially three approaches here. One is the use of CGE models (aimed at welfare gains) which tend to be theoretically well-founded, yet more often than not based on highly unrealistic assumptions, and many parameters are given arbitrary values for the calibration to fit (e.g. Keuschnigg & Kohler (1999); Baldwin, Francois & Porter (1997)). A second one is to impute basic trade findings into a macroeconomic model and calculate GDP effects (e.g. Rosati (2000); Breuss (1999)). A third way is a more strategic approach for development, which emphasises gradual improvements of value-added in vertical intra-industry trade, the attraction of foreign direct investment to accelerate just that or to widen the competitive product base and raising productivity more generally via competitive exposure, steady investment and skill-upgrading. Trade then allows candidates to climb the ladder of dynamic comparative advantages, eventually spurred by wage increases and currency appreciation (e.g. OECD (1998); Porter & Christensen (1999); Brenton (1999)).

Trade-induced simulations typically show that the EU gains trivially and that the candidates as a group gain anywhere from 1 ½% to 8% or even 10% of GDP in the short to medium run. The lower bound is usually the result of explicit deduction of adjustment costs. This range hides large analytical differences of approaches and should at best be considered as a rough approximation. One example can illustrate this. Several articles (e.g. Baldwin, Francois & Porter, 1997) have included an arbitrary reduction of the risk premium in the interest rate for capital movements and this tends to enlarge the gains considerably.

Another warning is that a number of simulations in the literature come with GDP-related gains but not primarily trade-induced. Thus, the much quoted paper by the European Commission (2001) stipulating extra *annual* GDP growth of 1.3% to 2.1% for the 8 accession countries joining in 2004, critically depends on growth accounting in a Solow-type framework. It assumed, on the basis of a

perhaps plausible but largely intuitive reasoning that pro-growth policies in a steady reform strategy in Central Europe will boost total factor productivity and the capital stock.

This rapid excursion into trade-induced effects is silent about services. Although we live in a service economy, with nearly 70% of GDP arising from service activities, studies only deal with agriculture and industry. Services have swiftly risen in importance in Central Europe, yet, East-West services trade under the Europe Agreements is very small. The internal market will imply at least two shocks: first, some degree of cross-border services will emerge, with opportunities for selected service providers in the candidates; second, in regulated services sectors such as road haulage and financial services, home country control will have to be applied, which may increase competitive exposure to local services. In network services the uncertainty is even greater, with monopolies in telecoms only being phased out now, and e.g. energy prices still regulated at the retail level.

3. Catch-up or catch-22?

The appreciation of fundamental values such as respect for human rights, democracy and security against tyranny does not imply that the peoples of Central Europe were not aspiring to achieve the prosperity levels of Western Europe. Indeed, for most Central Europeans and their governments, catch-up growth and EU membership are more or less synonymous, certainly once the attainment of values seems secured. It is therefore far more important to offer reliable advice about strategies for steady catch-up growth in Central Europe than to produce yet another study on the trade –related impact of enlargement (except for agriculture where the actual policy regime matters so much). Can economists be helpful guides to get candidates on a trendpath of catch-up growth?

Let us first celebrate the good news. After the large output falls of the beginning of transition, the candidates have shown that rather basic recommendations about sound economic policy, combined with the gradual introduction of the acquis communautaire and the access to the EU markets, does bring catch-up growth. Between 1995 and 2000, 7 of the 10 CECs were catching up despite Russian turbulence and lingering transition problems. And the cases of retrogression were clearly countries paying the price of half-baked reforms and/or very sloppy macro-economic policies (Bulgaria, Romania and the Czech Republic). All three are in the process of overcoming these setbacks, with Romania and Bulgaria currently on a catch-up rate of 2 % - 3 % points or more (if the EU remains trapped at a miserable 1 % this year). However, the

real issue is a long-run one: does the Union welcome the growth dynamo's of the near future or must it face the risk of getting stuck with a bunch of new Mezzogiorno's? In other words: how to escape from catch-22 and foster catch-up with the West ? Recent extrapolations of the post – 1995 experience suggests that catch-up to only 75 % of the GDP per capita of the EU-15 will take one, two or three decades dependent on the country and ignoring the relatively high income case of Slovenia.

The Commission and many other policy makers are already enmeshed in the domestic micro and macro economic policy debates of the candidates, at first via so-called Joint Assessments, subsequently via Pre-accession Economic Programmes (aimed at fiscal sustainability) and soon via the various economic coordination mechanisms of EMU, especially the formulation of the Broad Economic Policy Guidelines where candidates will act as if they are members. In addition, general principles of the treaty (what in Germany is called "Ordnungspolitik ") and the obligation to enter monetary union sooner or later, hence the compliance with the Maastricht criteria and the overall stability culture of Euroland, are important beacons for the fundamentals. The acquis is already constraining politicians in not regulating markets the wrong way. Support programmes and the structural funds after 2004 are widely expected to help infrastructure and the costly environmental investment directives, even if the efficiency of these programmes is below standard. This mighty combination of "lock in " and policy stimulus, not to speak of the dynamic benefits of market access and competitive exposure in an EU – 25, generates a pro-growth environment. It is not comparable to East Germany where irresponsible wage increases far ahead of productivity and a lack of local ownership, combined with what Rudy Dornbusch called both the 'good' and 'bad' institutions of Germany, have prolonged structural unemployment and deterred investors. It is not comparable to industrializing developing countries in general as they cannot hope to enjoy such forceful 'lock in ' (not even Mexico in NAFTA), such strong guidance in economic policy, such powerful and long term assistance and such market access, indeed free movement (implying a *right* to access).

Nevertheless, the favourable environment notwithstanding, there are lingering doubts about catch-up growth. They have both practical and deep analytical grounds. Practical arguments include the egalitarian inclination in the domestic politics of the transition countries, which has caused intolerably high social mark-ups on wages (not seldomly higher than in Western Europe, which used to be the highest in the OECD) and considerable deficits in the pensions systems today (i.e. before ageing is beginning to hit). Other worrying observations include the hesitation to go all the way in restructuring of ailing sectors in the presence of high structural unemployment, the deep skill mismatches of many long-term unemployed in a rapidly changing labour market

and the expected exit from agriculture with a questionable absorption capacity of industry and services, the alternative being a too generous CAP keeping far too many human resources in subsistence agriculture, dragging down growth. Last but not least, one could add the weaknesses in financial services and capital markets in actually serving the needs of local investors at low interest rates and the overall fear that implementation and market related institutions in Central Europe are so feeble that markets suffer from uncertainty, hence less growth.

The analytical reasons boil down to the controversies in economics about the long term determinants of growth. The empirical convergence literature has brought quite some confusion (see for a rich survey in the context of enlargement, UN-ECE, 2001). A careful application with parameters taken directly from Central Europe shows that these empirical models are not at all robust (e.g. Campos, 2000). In any event these determinants are rather rough, such as simple enrolment rates as a measure of human capital and (as a negative) the share of government consumption in GDP. Broader development strategies a la Porter (Porter & Chistensen (1999)) may be more insightful, yet tend to have a less rigorous basis. Also the debate on the East Asian miracle has ended in controversy on several major determinants (IBRD (1993); Eggleton (1997); Morrisey & Nelson (1998); ADB (1997; ADB (1999, part III)) such as the nature and degree of government intervention (including the quality of economic institutions) and the relevance of intensive versus extensive (i.e. based on volume expansion of factor input) growth. The consensus on a strong emphasis on human capital development and macro-economic stability is not particularly helpful because this is a widespread conviction anyway in Europe. Finally, the recent analytical underpinnings of the convergence /divergence debate for the reform of cohesion policy in the Union have led to great theoretical advances in the new economic geography (see Fujita, Krugman & Venables (1999) and Neary (2001)) but significant difficulties remain in translating it into policy recommendations as the authors themselves admit. In other words, as the Romanian economist (and former finance minister) Daniel Daianu (2002) has put it, should we rely on "an apparent mythical belief " in EU circles that a well functioning competitive market economy will ensure a catch-up growth trajectory ? Can Ireland be imitated by all or will many mimick the Greek tragedy before 1997 or are they capable of pursuing the reasonable Iberian middle-road? It seems obvious to this author that the EU can simply no longer tolerate the pre-1997 Greek underperformance combined with opportunism and bad implementation. EMU is a huge improvement in that respect and Greece has responded in kind.

4. Investment inflows after privatisation

Foreign direct investment (= FDI) has several positive effects on the economic performance of the candidates such as a direct contribution to growth, an indirect one via interfirm spill-overs especially where supplier networks are largely regional and have to be upgraded, a direct competitive exposure which (after allowing for exit) will stimulate higher productivity, the transfer of technology and other worldclass practices and, at the macro level, the reduction of the balance of payments constraint for constant levels of savings in Central Europe. As Brenton & di Mauro (1999) have shown, FDI in the more advanced candidates was greater than one should expect given the actual level of income, market size and relative proximity. The determinants of future FDI flows into Central Europe are perhaps even more difficult to establish than elsewhere. Bevan & Estrin (2000) find as key determinants country risk, unit labour cost, host country size and other gravity factors. In turn, country risk is influenced by private sector development, industrial development, budget (im)balance, reserves and the degree of corruption. They show that more FDI boosts credit ratings with a lag, which in turn boost FDI again. This suggests virtuous circles but also rivalry in attracting FDI between the lagging and advanced candidates. Thus, it raises the possibility of vicious circles for the former which would increase the difficulties of attaining catch-up growth.

One can query, however, whether empirical analysis about the 1990s is a good guide to understand future FDI under EU membership. First, the infamous "business climate" is in a state of flux although broadly in the right direction. Second, the past is no guide since the bulk of the larger acquisitions were part and parcel of the privatisation process. To a limited extent one should expect 'vertical FDI ' responding to the different relative factor endowments than Western Europe (or other OECD countries) such as in clothing, leather, metal working and household equipment. Horizontal FDI however responds strongly to market size and density (indeed, high income consumers and proximity to clients and suppliers) and therefore interacts with catch-up growth. The perception or expectation that chances for long-run catch-up growth are good will act as a major stimulus for FDI which in turn will contribute to the realisation of that economic growth. It is for this reason that business attaches so much significance to actual, not possible, EU membership (ERT (1999); ERT (2001)). They regard the EU as a credible – even when far from perfect - enforcer and stabiliser of the regime change and wish to see the seal of approval. The Spanish and Portuguese accession led to a true explosion of FDI inflows for about four years, before returning to 1986 levels. Note that the data are seriously deficient here because one ought to incorporate reinvested earnings in the inflows but they were not recorded in those days. It is not improbable that local investments by foreign establishments would improve the picture also after

1991. One might add that the subsequent entry into Euroland would further boost FDI although little hard empirical work seems to underpin this expectation. Soft indications for this statement include the massive business support for the euro precisely on the grounds of predictability and low long term interest rates. This can be traced to deep-seated business fears for exchange rate volatility before and during ERM 2, given their disillusion caused by the 1992/93 EMS crisis. In so far as FDI is related to a deepening of division of labour between West and East in the EU 25, the fragmentation of the value chain over a range of countries enhances the vulnerability of profits and strategy to currency misalignments or even 'contagion ' in case of a major financial crisis. On the other hand, an important part of FDI actually goes to services in Central Europe and it is not immediately obvious how EU or Euroland membership as distinct from local opportunities would stimulate such investments. An argument that tends to be overlooked is the stability of market access and of currencies *inside* Central Europe. After the collapse of Comecon the initial response was a disinterest in intra-regional trade and a failure of CEFTA as a local instance of regionalism. But this is bound to radically change with EU membership and the more so as candidates' economies stabilize and become more attractive markets as well as reliable suppliers. FDI is known to respond positively to such regional facilitation of market access, since critical mass for scale might now be accomplished by sales to a subset of CECs rather than from Western Europe.

The inflow of FDI is critical and sudden drops (as recently in Poland) can cause strain at the macro level while serving as a negative signal to business. However the annual volatility is not the issue. What matters is to create and promote virtuous circles over several business cycles and independent from the left-overs of privatisation. The overwhelming majority of FDI flows (and stocks) are and remain in the OECD area and there are solid reasons (such as EU membership and sound policies going with it) to expect the CECs to be able to attract a share that would contribute to growth. The candidates should see it as an opportunity, a dividend that comes when investing in growth friendly strategies. The strong business support for enlargement invariably makes the point that FDI flows will remain large if such strategies are followed (ERT (2001); McKinsey (2002)).

5. Migration : perceptions and sobering analysis

European integration has been the source of Angst and false perceptions right from the beginning. It is no different today. French industry in 1956 was against the Spaak report, underlying the Rome treaty, afraid of being flooded by German industrial products. The German coal sector has never been part of the

intra-ECSC market for coal since 1952 and Germany even relied on an escape clause in GATT (art. 19) longer than any other country (namely, since 1958) to prevent non-EC coal imports. British industry was divided about the "cold shower" after the accession in 1973. Austrian farmers were against the CAP because it would offer lower (!) protection for them. All shipbuilding in the EU has frustrated the internal market until a decade ago. Turning to migration, the Greek entry was said to prompt "welfare tourism ", the Iberian enlargement would lead to waves of immigrants into France if not all over the EC, and the fall of communism would send up to 10 million or more to the West of the continent (The Economist spoke on the cover of the "huddled masses"). None of this happened. It is crucial to understand why.

In the confines of this broad survey paper it is not possible to discuss analytically the great debate on migration in the EU 25. As leading authors like Tito Boeri (see CEPR, 2002) are the first to underline, empirical simulations rely on analogies with the past, usually the Mediterranean past, and might turn out to be a poor guide for what happens. The models employ an array of different methodologies. Yet what is striking is that the expected flows, even at current levels of per capita income, are small by any standard. If it is true that Germany - if only because networks of Central Europeans induce path dependency – will receive over 60 % of these flows, the total numbers are still not high. But if unemployment is so high, why Germany ? Why not the five or six EU countries with much tighter labour markets, once migrants are uprooted anyway ? Why is Austria with an unemployment rate of about half of the German one so pre-occupied ?

The reasons clearly lie elsewhere. A few remarks are in place, however, which shed a different light on the debate. First, as recent research has confirmed, much more attention should be paid to the motives of why workers do *not* migrate. They may (rightly) fear to have to compete with non-EU workers for jobs below their skill profile, expect to be discriminated against, value cultural and social attachment more than we are led to believe and, last but not least, appreciate the option value of waiting, in view of the medium term prospects of their countries. Second, relatively little is known about temporary migration, in the framework of worklife strategies. Going to the West only so as to build up working capital for a house or a small business is much preferred and leads to a rather different picture than permanent migration: it would stimulate the sending economies via transfers and entrepreneurship and reduce the brain drain while pre-empting huge inflows into the West of permanent residents with their families. Third, the greatest shortcoming of the research wave on migration is that it ignores a hardcore requirement of cross-border migration in the EU, namely, *host country control*. This is a protectionist principle depriving the poor worker from Central Europe the possibility to exercise his freedom to negotiate

his pecuniary conditions with employers. Host country control means that workers from Member State A (say, Slovakia after 2004) must be paid, and otherwise treated as if (s)he is a worker from the host country (say Germany). This principle matters little between Denmark and Germany or Holland and Belgium and might even provide clarity in the entangled spaghetti bowl of social rules, so different between EU countries (especially when it comes to the agonizing details). But for the poor workers the principle serves as a huge barrier, possibly wiping out any competitive advantage the worker might have compared to local workers speaking German, having a familiar German diploma, knowing the habits and already having shelter and family networks. The principle reduces the discretion for a negative effect on local German wages to practically nil. More important still, it will throttle the potential demand for such workers unless sectoral or regional scarcities force employers to pay premia. Precisely in times of considerable unemployment a faithful application of the principle *cannot* lead to massive demand for migrant workers.

The implications of these considerations are less than pleasant. The fear of major inflows must therefore be based on *illegal* migration and the EU rules are irrelevant for this. Additionally, the seven years regime serves little purpose as long as the host country principle is enforced. And illegal immigration can only be countered by effective enforcement of on-site inspections and severe penalties of employers. It is far better to relax the protectionist host country principle, within bounds, and tie this to a temporary quota regime, thereby fighting illegal work much more effectively, yet also having regard to the benefits of the new EU members. A refusal to do so only induces greater incentives for illegal migration, with all the negative externalities for those workers and, at times, others as well.

Finally, the seven years regime for Germany is one of the few exceptions. Several countries will immediately apply free movement (like the Netherlands). It is going to be an interesting laboratory test in the Union, and for Germany, to observe the inflows into these countries. And the candidates are well advised to behave less hypocritically. Neither Greece nor the Iberians got less than seven years (and no derogations for fast moving EU members) despite the fact that the per capita income differentials are now (mostly) larger and, in some regions, the degree of deprivation after transition is much greater. The EU regime is thus better than before. It would have been more useful to insist on derogations from the host country principle – say for ten years - since that would have stimulated a measured demand for their workers that might now hardly arise in the first place.

6. Greater Euroland

CECs must enter Euroland. But there is no date or calendar. There are three interesting implications of the entry into the eurozone: the "passage", the boost to trade and the dividend via interest rates. Given space constraints I shall have to ignore empirical work on optimal currency area applications to Central Europe and several subtleties in the ongoing policy debate (see Hobza (2002) for a comprehensive survey).

The passage to the euro for the CECs gives rise to three problems besides the manifold benefits of the discipline of adhering to the stability culture of Euroland. First, their currencies have to pass through two years of ERM 2 and this could prove to be quite unsettling. Adjustable peg systems are notoriously unstable and, under justified as well as unjustified circumstances, can induce one-way bets and irrational herd behaviour. The search for "the" equilibrium exchange rate before entry into Euroland may thus not only be futile but costly. Better keep the stay much shorter or allow ingenious evasion of the rule via quasi –euroisation (see Buiter & Grafe (2002)). For Estonia and Lithuania (with currency boards) it should simply be bypassed.

Second, a rush into the euro seems unwise because it is costly in terms of fiscal contraction for many CECs. With political will it can be done fast as Italy and Greece have shown. Having no immediate deadline, the CECs should engage in the necessary fiscal reforms of pensions and a stronger revenue base as well as a few other lingering issues (e.g. the social security burden) without the strain of a deficit ceiling of 3 %. This takes time and the short run impact on the budget is not completely certain. The huge investment needs of the CECs do not seem an argument against entry (or the discipline implied) in the light of expected transfers from the EU (up to 3 % of GDP or more) and the possibilities of private initiative for many aspects of hard infrastructure.

Third, the Maastricht criterion of low inflation (1 ½ % above the lowest three in Euroland) is, to a modest degree, a misspecification for the CECs. The reason is the Balassa - Samuelson effect which is an inevitable by-product of catch-up growth (and indeed neither caused by the printing press nor by excessive public spending). Even if the CECs cannot enter at a somewhat higher inflation rate (this would require a unanimous vote to change the protocol) they can, however, let the inflation rise gently in the years after entry. Differential inflation is no problem in a monetary union and also no problem for the entrants as long as their inflation does not surpass the 2 % the ECB has set plus the extra inflation explained by the Balassa – Samuelson effect. Empirical estimates differ (and the effect will fizzle out over time as price levels rise in CECs) but a range of up to 2 % seems entirely reasonable (see e.g. Pelkmans,

Gros & Nunez Ferrer (2000) appendix and Halpern & Wyplosz 2001)) when starting in 2006. Such a differential would not harm the competitiveness of the tradeables sector.

Recent empirical work by Andrew Rose (see Rose (2000), Rose & Wincoop (2001) and Rose (2001)) has suggested that the long run impact of currency unions is a strong increase in internal trade, perhaps up to three times. As yet there is no theoretical underpinning of this stunning finding. A possible link might exist with the so called home bias literature, also very recent, showing that borders remain effective in biasing trade to other home based agents despite free trade. When accounting for distance and language in the EU, home bias might still amount to a factor of 10, perhaps 14 (Head & Mayer (2000)). A monetary union might be pro-trade biased precisely because it does away with a significant border effect, particularly in the longer run. This possibility seems to be of even greater significance for the CECs, less well integrated in the trade networks of the Union and less familiar to buyers, consumers and intermediaries.

Of course, Greater Euroland will reduce the transaction costs for the CECs as for current eurozone members. But in one respect the "borrowing" of reputation will bring a respectable bonus to them: the long run interest rate. The Italian example is instructive. It is said that, had Italy not joined the euro, its current deficit would be around 8 %, merely because of interest payments. The windfall gain for Italy was the sudden substitution of the Italian long interest rate for the eurozone one. A similar effect can be expected for CECs, in various degrees, be it that their degree of indebtedness is much lower. It will also have a beneficial effect on private investment which is exactly what is needed when otherwise the entry might lead to a restrictive fiscal climate. The reputation of the ECB as the hard core of an explicitly codified stability culture might perhaps be endangered if, say by 2008, another 10 countries would have joined its Governing Council, with its one-country-one-vote system. The ten candidates do not have deeply-rooted stability cultures and might have incentives to take a more relaxed view on what "price stability " should mean. Therefore, timely ECB reform, adopting a new decision-making procedure more or less like the Federal Reserve, would be good for credibility. In turn, it would ensure the interest rate bonus to be sizeable.

The big question remains whether early entry is good or bad. Balcerowicz, the president of the central bank of Poland, favours quick entry but his argument is political: it would impose structural reforms and once they are done, disinflation would be less costly and growth might go up more easily. Clearly, this is a gamble and may well fail. The EU favours a go-slow approach and this

seems well – advised. Forcing structural reforms, whether for monetary union or for growth or for employment, is always politically difficult.

7. EU reforms for a healthy enlargement

Enlargement has ignited a reform debate with three pet topics of economists. It looks as if the reformers will not enjoy great harvests on all three fronts: the reform of the CAP before enlargement, the reform of cohesion widely defined also before enlargement, and the reform of labour markets and possibly social policy. Of course there are good arguments to pursue reforms of this kind *without* enlargement. The enlargement adds urgency, at least from a detached economic point of view.

CAP reform is essentially a political game, with economic analysis and the overall public interest at best on the backburner. Since the Berlin European Council in 1999 trivialized the reform process by once again ring-fencing the dairy and sugar sectors for six years, reducing the price proposals and sharply reducing the digression in the income compensations (see Nunez Ferrer & Emerson, 2000, for a detailed analysis), the political game is boiling down to pursuing reform-promises-after-enlargement. Sadly enough, the interaction between the Commission with its seemingly discriminatory proposals for income compensations and the outrage in Central Europe has fueled a political dynamism which completely misses the essential issue for the CAP and its transfers in the larger Union. The pro-reform group of four Member States (Sweden, Germany, the Netherlands, the UK) are all net payers and do not hide this in their advocacy which, again, is not the central issue. The crucial issue is that the export of the conventional CAP, with generous income payments even when somewhat further decoupled from production, will go against long run catch-uo growth for Central Europe. Rather than focussing on the interests of the farmers, the real issue is to focus on two aspects: the overall economic effects (hence, price hikes for consumers, rise in land prices, slow exit from the zero-productivity segments of agriculture, etc.) and the long run. Public choice explains why politicians find these two concerns quite unattractive. The counterpart in the EU-15 is of course that digression in income compensations ought to be restored and that, when sugar and milk reforms are finally tackled, the compensations will be truly digressive over a relatively short time span. This would also take the discriminatory sting out of the negatiations in the end game. Reforms after enlargement are simply not credible, if only because the coalition to preserve as much as possible from the CAP risks to be bolstered. And, lest it be forgotten, two factors weaken the threat effect of the net payers: the extra costs of enlargement are not so large (much lower than estimates of a few years ago) and remain within the 1.27 % of the EU GDP; and the new US farm act

and the aggressive use of it by Washington D.C. remove a good deal of the hard pressure in Geneva. Finally, there is a serious risk that the desire to promote "biological " agriculture by minister Kuenast and others creates a new demand for protectionism which can be cleverly combined with the "old" agro-protection in a political deal that would be presented as a "modernisation". The chances for CAP reform, and better still for CAP reform in the best interests of the candidate countries, therefore are pretty dim.

Is it any different with cohesion and the structural funds? To some degree it is. Cohesion is more self-policing in the long run since catching up (like Ireland and some regions in Spain) ends support. Indeed, cohesion is efficiency based: it is to help catch-up growth until the disparities have been overcome. In this sense it is not a traditional instance of redistribution because that is first of all an expression of solidarity, hence permanent and unconditional. If Spain (and since four years Greece) continues to perform as they have recently, the cohesion issue will shrink to two or three regions of these countries rather soon. However, this favourable medium-run perspective is largely ignored in the political debate. The cohesion debate suffers from double standards: on the one hand, there is political addiction to the transfers; on the other hand, once the transfers have been fixed in the medium-term financial perspective of the Union, the emphasis of policy makers shifts to selected success stories and a sense of pride in achieving real convergence. Spain is reasonably successful but, in the run up to new budget decisions for the EU-25, its campaign is entirely focused on how to keep the same transfers despite its accomplishments.

Irrespective of the genuine effectiveness of these funds, the political salience is such that old cohesion countries are pitted against new cohesion countries as long as the rich EU – 11 intends not to pay more in total. Reforms are needed so as to achieve much better focus (only the truly poor should receive transfers, so no regions from the EU – 11) and greater equity (scaling transfers according to the income gap with the EU average). But, more intrusively, should "Brussels" pay for extra unemployment caused by the refusal of labour unions and social ministers to attune regional wages to regional productivity, which, in weaker regions, can be drastically lower ? The evidence (e.g. Faini (1999) and Mauro, Prasad & Spilimbergo (1999), not to speak of East Germany) is strong that the disparities in unemployment (greater than in per capita income) are largely due to these rigidities. But will these pleas for reform be supported and realized ?

The reforms of labour markets are an evergreen amongst European economists. It ranges from Giersch' 'eurosclerose' of 20 years ago until the recent, sensational call by a CEPR team led by prof. Boeri (CEPR (2002)) to

make accession conditional upon the existence of a decent social safety net while at the same time letting the EU contributing to this net via the structural funds. The Boeri group goes even further and argues for a European safety net (!), based on a European minimum guaranteed-income scheme (which would be differentiated, to be sure) so that systems competition would only take place above that level. I shall not go into the merits and financing of those systems nor into the details of all kinds of labour market flexibility proposals floated by many economists, the EU and the OECD. The Luxemburg process, dealing with the so-called European employment strategy since 1998, has attempted to approach it via the so-called 'open method of coordination '. One observes that all the hard reform issues remain excluded from the work. The benchmarking has done little to convince German or Italian vested interests to mend their ways. Would enlargement make the difference ? The answer is that only a combination of three changes might get Europe somewhere: making intra-EU labour mobility across borders easier (a topic carefully neglected until in 2001 the Commission finally came with serious suggestions to remove barriers to cross-border labour mobility - se European Commission, 2001), greater flexibility with the host country control principle, and some acceptance of the fundamental idea that the cumulation of regulatory protection in the labour *and* a generous safety net without any trade – off between the two can be excessive and hence hinder the attainment of goals that the EU (hence its Member States !) have set. If this triptich is not accepted - and it will be an uphill struggle - chances are that, gradually, Central Europe will transform into a copy of Western Europe. The upshot will be sluggish growth in the continent while labour markets will fail to clear. If this agenda could even be partially implemented, as about half of the EU countries are favouring and are already doing to a degree, enlargement might infuse some extra dynamism.

8. Conclusion

The economic implications of enlargement can be divided into the traditional, trade driven effects, whether static or dynamic, and the consequences of what amounts to regime change, both West and East, at national level and for the EU at large. It provides us with a range of tremendous opportunities, yet equally much with a range of strategies for conservation. It is possible to belittle enlargement - after all, the economic weight of the ten CEECs is a mere 5 % of the Union's GDP. The opposite is practised too, that is, to regard enlargement as the trigger to reform the Union, and in one breath some ill-considered national policies and regulations as well. Unfortunately, what is to be reformed covers precisely those areas in an otherwise quite healthy Community which are exceptionally reform-resistent.

The trade effects outside agriculture have largely been realized since industrial free trade is already enjoyed and external tariffs are not very high, indeed often low. However, it is crucial not to focus too much on the static welfare effects. Enlargement is really about a long run to higher prosperity through restructuring, relocation, upgrading of products and skills, development of services as inputs for industry and intersectoral labour mobility. In such a richer view modelling might be less helpful but the trade / FDI nexus can serve as a steady engine of growth. Other beneficial effects such as the reduction of risk premia given macro-economic stability prompted by "lock-in" should not be ignored. Little is known about the future impact of the larger internal market for services but, given the low productivity of services and the absence (as yet) of tradeability, competitive exposure and new opportunities are bound to induce significant positive effects. Also. little attention seems to have been given to the liberalisation of intra- CEEC trade, some one and a half decade after the demise of Comecon. Again, these opportunities ought to be added.

The thrust of enlargement, however, is "regime change ". There is little doubt, and empirical evidence in the transition literature, that the lock-in effects of preparing for EU membership have been and still are extremely positive. The occasional policy reversals are inevitably corrected and relatively strong and gradually more credible market and policy institutions are rapidly developed. The economic implications of enlargement, once studied as aspects following from "regime change ", provide policy makers with a much more relevant and richer picture for the design of long run strategies both in the EU circuit and in the capitals of the candidates.

This BEEP briefing discusses the crucial importance of catch-up growth and both the positive influence the EU acquis exercises as well as the profound difficulties economists have in advising more detailed strategies to "ensure " a steady path of catch-up. It paints a relatively positive picture for the future attractiveness of Central Europe for inflows of FDI, even in a global climate in which overall outflows of FDI have shrunk. The briefing attempts to call attention to a different way of looking at migration which strongly suggests that migration flows in the EU-25 will not be sizeable, at least not the legal ones. The EU principle of host country control is, however, unnecessarily strict, and thereby adds a major incentive for *illegal* flows. The win-win advantages for a flexible approach to this principle have unfortunately been ignored. The entry of the candidates into euroland is seen as relatively unproblematic, if a cool analysis of the risks of a hasty, early entry guides the decision makers and if today's euroland accommodates justified reservations to go through, or to stay too long in, ERM II. The Balassa/ Samuelson effect can be easily accomodated, without any threat to the accomplished stability culture of euroland. The benefits of getting into euroland for the candidate countries are

likely to be considearble. Finally, enlargement is viewed as a leverage for at least three reforms, long on the hitlist of many economists in the EU. Enlargement is not the reason in and by itself for these reforms but it adds urgency. EU policy makers should take these reform pleas much more serious. It is argued, however, that the reform resistence in these areas has deep political roots and indeed may well be rational as suggested by theories of collective action or public choice. Given the limited economic weight, at least still today, of the candidates, it is not easily to be expected that the leverage factor of enlargement for those reforms is high. In the light of the vague but inspiring aim of the Lisbon process of the EU, indeed the larger EU, of becoming a high-performance economy unmatched by any in the world, the reforms may well have a greater prospect over the medium run, not least because accommodation may then be less painful.

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