

Introduction

Stefano Manzocchi*

Università di Perugia

A sound and popular economic argument nowadays is that, in the last two decades, the United States have taken the global lead in product and process innovation with the gestation and birth of the so-called *Information Technology Revolution*, and that this has contributed to the outstanding performance of the American economy in the 1990s *vis-à-vis* other industrial partners, notably the European Union (EU) and Japan (see for instance Schreyer [9]). On different grounds, one can argue that in the past decade the EU has taken the leadership in another sort of innovative activity, namely institution-building and institutional change. First, the creation of a true single market for goods, services and factors, still under way but remarkably advanced today relative to the early 1990s; and second, the launch of the monetary union and the euro, have correctly endorsed the vision of Europe as being «under construction». We can now say that, ten years later, institutional innovation has progressively shaped an Economic and Monetary Union that, although still imperfect, is much closer to the ideal of «one money, one market». The debate is open on whether this is contributing, or will soon contribute, to European growth.

While the completion of the single market is not fully behind us — think for instance of financial integration — the European

* Stefano Manzocchi is Professor of Economics at the Department of Economics.

Union is on the eve of a new step in institutional transformation. After the launch of the euro, it is now time for shifting the Union's border to the East¹. The challenge facing the Union at the start of the Eastern enlargement, whose first wave should be decided at the end of 2002 and implemented in 2004-2006, cannot be underestimated. A region of about 100 million inhabitants will be integrated into the EU; but, given the existing income gap between the two halves of Europe, the Union's GDP will increase by only 5% after enlargement. Populations deeply involved in European history will become again part of the continental *polis*, but ten years ago these same populations emerged from about half a century of Soviet domination and planned economy. A complex net of similarities and differences makes the Eastern enlargement something different from previous episodes of EU expansion.

The last two enlargements of the EU were, first, to the South, and then, to the North. The accession of Greece, Portugal and Spain in the 1980s brought relatively low-income partners in the Union, and this changed the economic geography and the budgetary structure of the EU. However, both the population size and the average income gap of the countries then involved in the Southern enlargement were about half of those of the current candidate countries. The Northern enlargement of the 1990s actually raised the average per capita income of the EU, and the accession of Austria, Finland and Sweden brought a net positive contribution to the Union's budget. This time the picture is completely different. The future members of the EU are, and will be for quite a long time, significantly poorer than the existing members. Their average wages will be lower than those of the incumbents, hence there could be an incentive for workers to move westward, and for capital to go eastward. Their core inflation rates will probably be higher, due to the rise in the relative price of services: productivity in the tertiary sector cannot grow as quickly as in manufacturing, while the demand for services is evolving at a faster-than-average

¹ The current enlargement process concerns ten formerly planned economies of Central Eastern Europe (CEE), plus Malta and Cyprus which will be usually neglected in this volume.

pace. Finally, their net contribution to the EU budget should be persistently negative. All this will impact on a number of EU policies and institutions, in the fields of migration and border flows, financial and budgetary provisions, monetary policy and the working of the European Central Bank (ECB), product and labour market regulations, just listing the economic aspects.

Forced by the prospect of future admission, the Eastern candidates have reformed their societies, and their economies have become more similar to their Western counterparts in the last decade. Future accession has played a role in shaping the expectations of economic agents, both in the candidate countries and on international markets, and has then contributed to shelter the candidates from the financial turmoil following the crises in Russia (1998), Brazil (1999) and Turkey (2001).² It is not surprising that economists have reached different conclusions on the impact of the next enlargement, depending on whether they have put more emphasis on the achievements of CEE's transition, or on the road ahead before reaching Western standards (for a review centred on trade aspects, see Brenton and Manzocchi [4]).

Of course, a number of studies have been released on the feasible effects, costs and benefits of the Eastern Enlargement, and more will be published as its start approaches.³ In this volume, we will not focus on the costs and benefits of the next enlargement, nor on their distribution among incumbents and newcomers. Rather, this volume has a different, twofold aim. First, to introduce and discuss a number of «sensitive» economic chapters along the way to enlargement, for instance real and nominal convergence before accession to the EU and Euroland, or agricultural and structural policies in an enlarged Union. The Eastern Enlargement will necessarily lead to another round of deep political and institutional reform and adjustment within the EU. This was clear at the time the political decision was taken to encourage the countries of Central Eastern Europe to apply for accession to the

² The negative spill-overs of the Argentinian crisis of 2001 have in general been more limited.

³ Among the most quoted works, see BALDWIN R. *et AL.* [1], BOERI T. - BRUECKER H. [3], EUROPEAN COMMISSION [6], GROS D. *et AL.* [7].

EU, namely in early 1990s. Since then, however, other priorities have ranked high in the list of European policymakers, first of all the process leading to monetary unification. At the same time, the enlargement countdown has not been stopped, and the need for EU institutional and political reforms has become even clearer. The *Nice Treaty* makes some steps in the direction of adapting the institutional framework to a 27 members EU, but the Treaty falls short of fulfilling the reform requirements of the enlargement.⁴ The *Laeken Council* of 2000 made another step forward with the launch of a *Convention*, whose purpose is to make constitutional reform proposals to be debated in the next Intergovernmental Conference. At the same time, the Commission released a *White Book* on European governance with a number of suggestions to make European institutions more effective. A key issue for the future of the EU is how the Union will accommodate the increasing heterogeneity of its member states.

The second aim of the volume is to offer a representative sample of what can be defined by the *Economics of Transition and Enlargement*. More than ten years ago, the exit from planning towards a market economy in most of Central Eastern Europe and Asia (China only partially excluded) has prompted a wave of economic research on the features of this transformation, and on the problems facing the countries involved in it. This has become known as the *Economics of Transition*, and has been recognised as a specific field of analysis, with scholars and journals devoted to it.⁵ This field has yielded remarkable spill-overs and cross-fertilisation with other branches of the economic profession, and is currently being revitalised by the next enlargement, which adds to the number of open questions and developments therefore requiring more research, and of even more sophisticated nature.

Hence, in this special issue of the *Rivista di Politica Economica* we look at the «economics of enlargement» both as a range of critical themes, open for political assessment and decision, and as new lines of economic thinking stimulated by the

⁴ See BALDWIN R. et AL. [2] for a discussion.

⁵ See CAMPOS N. F., CORICELLI F. [4] for a recent survey, and JOURNAL OF ECONOMIC PERSPECTIVES [8] for a number of recent contributions.

complex process of former planned economies entering the European Union, by itself a unique experiment in contemporary history and possibly the most original innovation in institutional design in the last century. In asking such a distinguished panel of authors to contribute to the volume, my purpose was to accomplish a good balance between the relevance of the topics covered and the novelty of the instruments and methodologies adopted. The reader can judge whether such balance has been reached.

The first two essays provide a broad and insightful analysis of respectively, production and trade aspects, and nominal and financial developments, in Central Eastern Europe (CEE) on the eve of enlargement. Michael Landesmann and Robert Stehrer explore the process of industrial transformation and the evolution of trade competitiveness in CEE. They put forward an original interpretation of the dynamics of comparative advantage, based on the potential for catching-up and the relative evolution of productivity and wage costs at the sectoral level. Applying Gerschenkron's concept of «backwardness' advantage» to the dynamics of sectoral, instead of aggregate, productivity, Landesmann and Stehrer argue that not only price competitiveness, but also foreign investment attractiveness and quality upgrading, are driven by the sectoral potential for catching-up in CEE. The key message of their paper is that trade specialisation changes in CEE according to the potential for catching-up in different industries, and the «social capabilities» available for exploiting such potential. Their paper also discards simple views of CEE as a single backward region. Instead, it shows that a more advanced area whose trade specialisation has evolved towards high and medium tech industries (Central Europe and Slovenia), coexists with a region more oriented towards traditional sectors (the Balkans). Enlargement could trigger, they argue, another step in structural change and real convergence in both the more and the less advanced countries of Central Eastern Europe.

The paper by Daniel Gros tackles the issue of nominal convergence between CEE and the EU. The most advanced among candidate countries, he reminds us, could be only four years away from entering the European Monetary Union (EMU), and in fact

their performance in terms of nominal admittance criteria is good compared to that of Mediterranean countries (Spain, Italy and Portugal) before their accession in the 1990s. However, the recent history of financial and currency distress in Western Europe and emerging countries warns us not to downplay the risk of speculative attacks before CEE enters Euroland. In this respect, Gros suggests that fiscal policies and current accounts must be kept under scrutiny in Eastern Europe, and that careful attention must be paid to the real exchange rate in order to avoid unsustainable appreciation. As noted before, CEE's currencies have shown remarkable resilience during the recent financial turmoil following emerging market crises in Russia, Brazil and Turkey. Nonetheless, the expectation of a devaluation at the time of fixing the conversion rate with the euro could trigger speculative attacks as EMU membership becomes feasible.

The dynamics of the real exchange rate is at the core of the paper by Fabrizio Coricelli and Bostjan Jazbec. They model the so-called *Balassa-Samuelson effect* of real appreciation under productivity growth in the tradable sector: when productivity gains are lower in the non-tradable service sector, but wages are equalised, the price of services tends to increase leading to inflation and real appreciation. The value added of their contribution stands in the special way the dynamics of the real exchange rate is modelled. Coricelli and Jazbec take into account the distortions inherent in Soviet economies, especially the excessive output of industrial goods and the insufficient amount of services, relative to demand, under central planning. A key point of Coricelli and Jazbec is that, even once such distortions are removed, equilibrium real exchange rate appreciation can yield large inflation differentials between CEE and Euroland. The reason is that growth and catching up in the most advanced among CEE countries are mainly driven by productivity gains in the tradable industrial sectors (see Landesmann and Stehrer), and this could foster inflation according to the Balassa-Samuelson effect. In a word, *real convergence* may come along with *nominal divergence* in an enlarged Europe. Coricelli and Jazbec argue that an early adoption of the euro in CEE could reduce inflation differentials, but not eliminate

them. In order to adjust for an increasing heterogeneity of core inflation rates in the enlarged Union, new arrangements within the ECB and new frameworks for monetary policy will have to be conceived.

Tito Boeri and Joaquim Oliveira Martins provide another essay in what we have defined as the *Economics of Transition and Enlargement*. They set up a theoretical model that relates the output collapse at the beginning of the post-communist age, with the mismatch between an increasing «love for variety» in consumer's preferences and a rigid supply structure in CEE. Here, similarly to the Coricelli-Jazbec model, central planning distortions, namely the bias towards heavy industry producing standardised goods, leave a heavy heritage for the transition process. Boeri and Oliveira Martins convincingly argue that successful transition is conditional on the creation of new enterprises, which can gradually match the excess demand for differentiated goods without incurring balance-of-payments problems. Unemployment benefits can support this process by providing seed capital for self-employment choices; if they are too high, however, job search can be discouraged. Boeri and Oliveira Martins also observe that, compared with the EU, the economic environment in CEE is still unfavourable to enterprise creation due to the weakness of the financial and infrastructure systems. As enlargement is approaching, they suggest that EU structural programs towards CEE should be focused on the removal of these bottlenecks.

The paper by Cinzia Alcidi, Gianmarco Ottaviano and Stefano Manzocchi emphasises another element of economic disadvantage of Eastern vis-i-vis Western Europe, namely the different size of their respective «internal» markets. Despite the Association Agreements of the early 1990s that lowered tariff barriers between the two halves of Europe, the exclusion of CEE from the Internal Market and the Monetary Union has raised the relative cost of making business in Eastern Europe. Enterprise location on the Western side has become more profitable because a larger market has become available at ever lower trade and foreign exchange costs. Alcidi and others run numerical simulations showing that the welfare cost of EU exclusion might have been quite high for CEE,

and that it might not have been fully counterbalanced by the progress in economic transition. From this perspective, the Eastern Enlargement (and the adoption of the euro) will level the competition field, as a single internal market will be available for firms located on both sides of Europe. In the medium run, this could provide an incentive for enterprise delocalisation from the EU towards CEE, and therefore trigger some political opposition in Western Europe.

However, one has to recall that the process of industrial integration between CEE and the EU will not start after enlargement, but has been under way for a more than a decade and is now reality. Salvatore Baldone, Fabio Sdogati and Lucia Tajoli analyse the pattern of productive integration from an original perspective, namely that of the competitiveness gains attainable by EU companies through a so-called «fragmentation» process. Fragmentation stands for the vertical re-organisation of the industrial chain on a multinational scale: in the case of pan-European relations, it is usually aimed at a reduction in global costs obtained by moving the more labour-intensive phases to Eastern Europe. The empirical results of Baldone and others are surprising: they find that — in a so-called «traditional» sector like textiles and apparel — EU-CEE industrial fragmentation has led to cost savings of the order of 40-50 % for Italian firms, and even more for German firms. This has allowed these companies to face the competition coming from low-cost regions like Southern and Eastern Asia. An important message one gets from the paper by Baldone and others is that East-West industrial competitiveness cannot be simply assessed on the basis of bilateral trade balances, or the dynamics of export shares: more complex industrial strategies, including «fragmentation», require new types of conceptual and empirical analysis.

The two following papers are devoted to «hot» issues in the negotiations between candidate countries and the EU, as well as among the current EU members. In his essay on structural policies and enlargement, Giuseppe Mele argues that the time is ripe for a comprehensive debate on the meaning, working and financing of EU structural and regional policies. First of all, a number

of ambiguities concerning the role and effectiveness of structural funds need to be solved. The way Mele summarises the current argument on structural policies is the following: *a)* per capita income dispersion at the EU regional level has not decreased in the past fifteen years; *b)* the Eastern Enlargement will lead to more regional inequality; *c)* hence, structural and regional policies have to be maintained although their impact on the EU budget must be carefully assessed. The alternative, and more convincing, logical sequence suggested by Mele runs as follows: *a)* have EU structural policies been successful in reducing regional inequality in the past? *b)* how should they be modified, provided enlargement will magnify income inequality? *c)* what kind of compromise can be found between the financial expectations of new members, and the need of avoiding a much heavier burden for current members? Behind these alternative ways of thinking at regional policy reform, there is perhaps a more fundamental ambiguity in the nature of EU structural policies, to be intended either as a «common» pool of resources to be managed by the Union, or as a «common» set of rules to be agreed on and respected by member states when implementing their own regional policies.

The impression one gets from the paper by Fabrizio De Filippis and Luca Salvatici is that a similar, possibly even more arduous, set of pending issues is involved in the current debate on the reform of the EU agricultural policy. Here again, the next enlargement is having a disruptive effect on long-standing politico-economic equilibria that for many years prevented the radical reform of an inefficient set of policies. Such politico-economic equilibria were a key element of the founding contract of the European Community, and have afterwards been preserved to avoid political turmoil, at the EU and/or at the individual member state level. For instance, the current system of direct payments to EU farmers was initially justified with the need of compensating them for the lower revenues they would have obtained in the transition to world market prices. Afterwards, it has been maintained despite its huge costs, in order to preserve the politico-economic equilibrium among large EU member countries, on the one hand, and to appease the strong agricultural lobbies inside some of these

countries, on the other hand. Now, as stressed by De Filippis and Salvatici, the Eastern Enlargement calls for a deep reform in the direction of a re-nationalisation of the Common Agricultural Policy (CAP) for at least three reasons. First, the application of the current agricultural policies to the new Eastern members would undermine their incentive for restructuring inefficient farms, as it would immediately raise net farmers' revenues and loosen their budget constraint. Second, in the case of some candidate countries whose agricultural sector is mildly protected, applying current CAP provisions will lead to a de-liberalisation of the CEE markets, clearly at odds with WTO obligations recently subscribed by the EU. Third, if current CAP provisions are extended to newcomers, the enlargement will lead to a jump in the EU agricultural budget and to big distributive conflicts among member states.

The final essay by Friedrich Heinemann takes us more deeply into the realm of bureaucratic interest and lobbying. This enlargement, he argues, threatens the vested interests of politicians and lobbyists in many ways, and a politico-economic perspective is required in order to supplement the conventional view economists offer of this event. Many aspects of the enlargement process can be interpreted in a different light, and what is often presented by economists as a win-win outcome may bring about costs, as well as benefits, for incumbents and entrants. For instance, according to Heinemann the reforms of the EU institutions decided in Nice, or the rules for the participation of candidate countries in the Convention, were clearly designed to protect the interests of EU-15 representatives relative to future members. Similarly, the transition periods envisaged by the EU in the negotiations concerning «sensitive» enlargement chapters such as labour mobility or the extension of direct farm payments to candidate countries, tend to shift the burden of potential conflict beyond the relevant time horizon of EU politicians and bureaucrats — that of the next elections or the next round of appointments — but at the same time tend to postpone essential reforms.

At the beginning of the XIX century, the Prince of Metternich used to say that Asia started just beyond the *Rennweg*, the avenue

that crosses Vienna. The essays collected in this volume prove that, provided it was true at that time, this is no longer the case even after fifty years of separation. Enlargement will make Central Eastern Europe even closer to the European Union, and may have beneficial effects on competitiveness and welfare in the EU as well, but a supplement of institutional change is needed. When the political decision of rejoining the two halves of Europe was taken more than a decade ago, it was implicitly decided that the European Union would have undertaken a deep process of reshaping. This reform process was needed in order to allow the Union to work with 27 or more members, and to employ its resources more effectively to promote growth, convergence and welfare. Institutional and political innovation must now advance, in such diverse fields like the conduct of monetary policy, the working of structural funds or the composition of EU institutions, to adjust for the accession of new members and to make the Union more effective. The Eastern Enlargement is now reality, and new governance solutions must be thought and implemented to the advantage of Easterners and Westerners alike: it is not yet time for Europe to give up its lead in institutional innovation.

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