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Five Years of an Enlarged EU – A Positive Sum Game

Filip Keereman and István Székely, eds.

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There have been a lot of studies about the potential benefits of the 5th round of EU enlargement that took place in 2004 and 2007 (e.g., Breuss 2002; Kohler 2004). Most of these studies have indicated that joining the EU would have numerous benefits for the new member states (NMS), as well as for the EU-15. The results have been very encouraging, especially since this enlargement was dominated by political motives.

A couple of years after the enlargement, the European Commission wanted to show that the enlargement had indeed had a positive effect on the new entrants, as well as on the old members. For that reason, the Directorate General for Economic and Financial Affairs of the European Commission in November 2008 organized a two-day workshop with experts in this area who presented their evaluation of the largest EU enlargement. This book contains articles presented at the workshop. Moreover, this book is a complement to the comprehensive report by the European Commission (2009), which claims that the first five years of enlargement were a huge success.

The chapters in this book were mainly written before the global financial crisis, so the results are probably more enthusiastic than if the crisis period had been taken into account. The crisis has affected growth rates more severely in the NMS than in the EU-15 and may have strong long-term effects on their potential growth. The reason for this is that the relative price of risk in the NMS may considerably increase and the speed of financial integration could slow down as a result of the needed re-regulation of the financial system. However, the editors claim that despite the fact that the publishing of this book coincides with the financial crisis, this does not mitigate the assessment of the enlargement. Rather, it highlights many of the future challenges.

This worth-reading book is edited by Filip Keereman and István Székely. It contains eight independent articles grouped into four parts with comments on each article. The main assessment themes include (1) trade and FDI; (2) migration; (3) financial integration and stability; and (4) integration, openness and growth. The intention of the European Commission as organizers of the workshop and this book was to provide empirical evidence that the enlargement was indeed "a positive sum game". However, despite the fact that the book contains eight very interesting articles, most of them actually do not show the economic effects after the enlargement. Rather, they deal more with the overall problems in Europe, not distinguishing the pre- and post-enlargement period.

In the first chapter, the editors give an overview of the entire book. In addition, they explain the circumstances in which the book was created. Also, they highlight the most important achievements of the enlargement and summarize the results presented in the articles.

Chapter 2, written by Elżbieta Kawecka-Wyrzykowska, analyzes the development of intra-industry trade (IIT) between the NMS and their major trading partners and pays special attention to the old EU members. The crucial issue in this article is the distinction between vertical and horizontal types of IIT. The author explains that vertical IIT involves the exchange of products which differ by quality. On the other hand, horizontal IIT is the exchange of differentiated products with similar quality (this is a more advanced type of trade, allowing for larger trade benefits and lower adjustment costs). Her results are divided in two parts. In the first part, the author analyzes the total IIT in the NMS, and later on she analyzes the changes in intensity of vertical and horizontal IIT in the NMS' total trade, as well as between the NMS and the old EU members. The results for total trade show that for the EU-10 (excluding Romania and Bulgaria), the IIT share of the total share increased from 41 percent in 2000 to 51 percent in 2007, with the highest increases in countries with lower initial positions (e.g., Baltic countries). However, this is still lower than on average in the old EU members. Regarding the vertical and horizontal IIT, the author emphasizes that in the NMS vertical IIT is the dominant type of IIT. More precisely, the author explains that even though vertical IIT was mainly dominated by specialization in the production of low quality products, which means that the NMS export mainly low-quality products and import high-quality products; the share of high-quality vertical IIT increased in all the NMS. At the same time, the horizontal IIT in the EU-10 countries increased from 7 percent in 2000 to 14 percent in 2007. The results for the IIT between the new and old member states show that the increase in high-quality vertical IIT is lower between the new and old member states than in the EU-10 total trade, while the horizontal IIT doubled in both cases. Since horizontal IIT is a more advanced type of trade, its relatively fast increase within the old member states allowed for a smooth adjustment to the internal EU market. Nevertheless, the vertical IIT in 2007 was still much higher than the horizontal IIT.

Also, the author wanted to deepen her analysis by investigating IIT in the automotive industry and the role of FDI in the NMS. The author stresses that more sophisticated production (e.g., cars) is often correlated with FDI inflows. She finds a positive relationship between FDI and IIT in the automotive sector and argues that this sector is not mainly of vertical character.

The discussant of this paper, Sándor Richter, criticises the differentiation of IIT into vertical ("bad") and horizontal ("good") IIT, since in the case of the NMS the poor image inherited from the communist era may lead to misinterpretations. He also argues that in trade and FDI there were no dramatic changes due to accession itself and that is not surprising that the NMS achieved a "smooth landing" in those areas after accession.

In Chapter 3, Juraj Stančík aims to analyze the horizontal and vertical spillover effects of FDI on the sales growth rate of domestic companies in the Czech Republic. The author studies two types of FDI – takeovers and greenfield investments – and uses the firm-level data. His in-the-end, unanswered research question is whether there is a type of investment that should be supported more. The author describes horizontal spillovers as spillovers in the same sectors and vertical spillovers as spillovers in other sectors than those of the foreign company. In order to obtain the results, six spillover variables are created and varieties of regressions are estimated. The results show that domestic Czech companies are mostly negatively affected by foreign investors, which means that they are not profiting from their presence. More precisely, regarding vertical spillovers, the author suggests that the sales growth rates of domestic companies mostly decrease in the presence of foreign companies. The impact of takeovers on domestic companies within the same sector (horizontal spillovers) is small but positive (implying that domestic companies are gaining in the presence of foreign takeovers), and the impact of greenfield investments is negative. The article also analyzes the time aspects of FDI spillovers, since domestic companies need some time to adjust to the foreign presence. The results reveal that, already after one year, the positive and negative effects of takeovers and greenfield investments disappear.

In Chapter 4, the discussant Sándor Richter argues that the author actually analyzes the adjustment process to increased overall competition and not only to increased foreign competition after takeovers and greenfield investments. Therefore, the real research question should be if the number of companies in a certain sector increases, does the sales growth of existing companies decrease? This means that the central issue should be investigating the lack of competition of any kind.

In Chapter 5, Martin Kahanec and Klaus F. Zimmermann study migration in the enlarged EU. This is an extensive literature survey of migration in the EU, including the relatively scarce literature on the effects of migration after enlargement. Using the existing literature, case studies and descriptive statistics, the authors evaluate (post) enlargement migration flows in three specific areas: labor markets, welfare systems and economic growth. However, a comprehensive analysis of the actual migration flows after enlargement is relatively difficult, mainly due to the scarcity of data on migration. Migration in the enlarged EU was a very sensitive topic for the old EU members because of the fear of mass migration from new to old member states. For that reason, transitional agreements were specified in the Accession Treaties; although the U.K., Ireland and Sweden opened their labor markets immediately. The authors imply that the U.K. and Ireland most probably experienced increased immigration due to the EU enlargement, together with Austria, which retained restrictions on labor mobility. They conclude, in general, that most of the post-enlargement migration from new to old member states has been economically motivated, while welfare does not seem to be an important aspect in determining the nature of migration flows. Regarding economic growth, it seems that in the long-run migrations from new to old member states could bring substantial gains for the GDP of the enlarged EU.

Discussants Filip Keereman and Karl Pichelmann in Chapter 7 give their own interpretation of migration flows in the enlarged EU, but express broad agreement with the article's main conclusions.

Jean-Claude Berthélemy and Mathilde Maurel in Chapter 6 investigate whether an increase in the living standard in the CEE countries leads to an increase or decrease in migration flows to the old EU members. They calculate the critical level of GDP above which an increase in transfers and an improvement in the economic situation does not lead to an increase in migration (the assumption is that migration flows are hump-shaped). This means that above this critical level progress in the economic situation or increased European transfers cause a decrease in migration. However, if a country is poor, then potential migrants cannot afford the cost of moving due to liquidity constraints. This is alleviated by supplied aid, which means that in poor countries the improvement in economic conditions leads to an increase in migration. In addition, the authors are interested in whether this critical threshold is the same for skilled and unskilled individuals. Their hypothesis is that the critical income under which skilled individuals who have better opportunities to find a job abroad decide to migrate is higher than for unskilled individuals, who may be better off working in the home country. The results show that the income above which an increase in European aid to the NMS and economic growth does not cause an increase in migration flows is 2,837 US$. In 2007, all the NMS except Bulgaria and Romania had a GDP per capita above this threshold and, hence, there should not have been a fear of mass migration from most of the NMS. The income above which an increase in economic conditions does not increase the migration of individuals with primary education is 4,384 US$; with secondary education, 6,367 US$; and with tertiary education, 15,085 US$ (these results are estimated for the whole world, not just for the NMS). This means that for any income in this range, an increase in GDP per capita will accelerate the migration of skilled workers. The authors conclude that this will happen to the NMS, since in most cases their GDP per capita exceeds 4,384 US$, but is lower than 15,085 US$.

Discussants Filip Keereman and Karl Pichelmann in Chapter 7 question the non-linear relationship between migration and economic development as described by the authors. They argue that the hump-shaped relationship is not the only possible relationship between migration and economic development, which can be seen from the scatter plot in the article. Hence, if the hump-shaped relationship does not correspond to reality, then policy conclusions drawn in the article are not valid.

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Chapter 8, written by Sabine Herrman and Adalbert Winkler, tests for the relevance of financial market characteristics in explaining the divergence in the catching-up process in Europe and Asia. The authors assume divergence in current accounts, since it is recorded that countries in emerging Asia are running sizable current account surpluses, while emerging Europe is faced with large current account deficits. The authors test for the significance of different types and dimensions of financial integration and they employ the concept of the convergence club, with two cores and peripheries (the U.S. is viewed as a core for emerging Asia and the euro area/EU-15 for emerging Europe). Their results show that the degree of financial integration within the convergence clubs and the extent of foreign exchange reserve accumulation explain the divergent patterns of current accounts in those two regions. Deep integration in the EU allowed emerging Europe to follow a growth path driven by domestic demand, which resulted in current account deficits as predicted by standard theory.

The discussant Corina Weidinger Sosdean in Chapter 10 praises the authors' in-depth knowledge. However, she questions the decision that the U.S. is the most appropriate "core country" choice for emerging Asia. The discussant bases her disagreement on the fact that some emerging Asia countries have very close trade and financial ties with Japan.

In Chapter 9, Jan Babetsky, Aleš Bulíř and Kateřina Šmídková analyze whether the macroeconomic performance of the NMS improves through the overall positive impact of FDI on the trade balance or whether FDI actually worsens the situation. The authors argue that the process of catching-up to the EU-15 level of development may have serious implications for the macroeconomic policies of the NMS. It may affect the observed and sustainable real exchange rates. The authors also argue that the real currency appreciations that occurred in the last decade cannot be attributed to the excessive devaluations at the start of the transition process, to the significant rise in total productivity in the tradable sector due to the Balassa-Samuelson effect, or to the hypothesis of external wealth accumulation. They find the explanation for this appreciation in FDI and argue that FDI could be a mixed blessing for some NMS. The authors describe integration gain as a positive impact of FDI on the trade balance if FDI enlarges exports or reduces imports. However, this integration gain is often reflected in the sharp appreciation of the real exchange rate, which could jeopardize the country's chances to fulfill the Maastricht criteria. The authors find that for the Czech Republic this could be mixed blessing. Further, the authors argue that for some NMS that have experienced only mild integration gains, FDI could be a pure blessing because they could face only a moderate appreciation of the real exchange rate, which could be compatible with the Maastricht criteria. According to their results, Hungary and Slovakia fall in this group. The third group of countries are those for which FDI seems to have a deteriorating impact on their trade balances, which means that FDI is considered to be no blessing at all. Their results show that Latvia, Lithuania and Romania are in this group.

The discussant Corina Weidinger Sosdean in Chapter 10 asks why the authors did not include other capital flows in their analysis, since those flows were also relatively high, especially in the case of pre-accession and structural funds. Besides that, the discussant calls for additional explanation on why Greece, Portugal and Spain lost competitiveness in attracting FDI after the introduction of the euro.

In Chapter 11, Stefania Fabrizio, Daniel Leigh and Ashoka Mody focus on the second transition in the Central and Eastern Europe countries, which they describe as an "achievement in increasing economic sophistication riding on the wave of globalisation". The authors argue that this achievement was based on a growth model with no recent precedent. In doing so, the authors provide a broad comparative perspective of trade and financial integration as well as institutional development. Using these metrics, they compare Central and Eastern Europe with East Asia and Latin America. The authors reach the conclusion that CEE countries in comparison with East Asia and Latin America were more advanced in trade integration, despite the appreciation of their exchange rates; moved faster with financial integration and were about on par with respect to institutional development. Regarding the growth performance, the authors concluded that the performance of CEE countries was impressive, but still on par with East Asia, with Latin America lagging behind. Moreover, the achievements of CEE countries are more recent than in East Asia, so their ability to deliver sustained development remains to be confirmed.

The discussant Ryszard Rapacki in Chapter 13 suggests including social capital in the analysis, which could provide an additional differentiation between selected regions. Besides that, the discussant suggests including the "EU factor" or "external anchor" as a driver of economic growth.

Chapter 12, written by Fritz Breuss, deals with the evaluation of the EU enlargement. Even though he focuses on Bulgaria and Romania, he discusses the overall achievements of the enlargement. The author argues that the NMS are already benefiting from joining the EU, despite not being fully integrated in the labor markets. Almost all the NMS (except Hungary) grew faster in the first five years after the enlargement than before their integration into the single market. On average, the EU-27 grew faster after the enlargement, while the growth rate of the EU-15 was slightly lower. On the other hand, the NMS were hit harder than the old member states by the international financial crisis, causing the NMS, for the first time, to have a slightly worse overall economic performance. The NMS increased their trade with the old member states, but increased it even more between themselves. Besides presenting the overall achievements of the enlargement, the author develops a generalized, unified theory in order to capture the long-run integration effects which are expected from the enlargement. The author uses Bulgaria and Romania to demonstrate those integration effects. His results suggest that the integration effects had already started in the pre-accession period, with acceleration after accession. Moreover, due to the increased efficiency of the economy, labor productivity should increase, while more competition should decelerate inflation. The income gap between Bulgaria and Romania and the old member states should steadily decrease on average by around 3 percent per year between the years 2007 and 2020. Budget balance as well as the debt-to-GDP ratio should not be affected much by the accession.

The discussant Ryszard Rapacki in Chapter 12 praises the article since it gives a remarkable analytical framework for evaluating the impact of the EU enlargement. However, he regrets that the author did not include other NMS in the analysis in order to see how this would change the results of the model. In addition, the discussant argues that the trade off between the nominal and real convergence may be significantly alleviated if the "golden rule" of public finance is applied.

Even though this book is a worthwhile attempt to discover what happened in the EU-27 after the most important and largest enlargement, the time span is too short to do a relevant empirical analysis, which is probably the reason why most of the authors did not focus on the post-enlargement evaluation. The reason for this is that the workshop in which the articles from the book were presented was in 2008, which means that the authors had at their disposal at most four years of data after the enlargement to evaluate. Even though this time span was too short to make a firm conclusion that the enlargement would be a long-term success, the book still gives us a plenty of evidence that the whole integration process, not just the moment of accession, caused mostly deep positive changes in the NMS.

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