Real convergence from the accession countries perspective

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Presentation Outline:

I. EU accession and economic growth.

II. EMU entry and economic growth.

EU membership would foster long-term economic growth of the present accession countries, through:

1. Higher FDI inflows due to good policies and credibility stemming from EU membership.

2. Structural funds (e.g. supporting institution building, infrastructural investment, environmental protection).

3. Positive impact on domestic economic policy:

- Stability and Growth Pact - fiscal discipline (general government deficit not exceeding 3% of GDP and targeting balanced budget);
- Single market policies - free movement of goods and services, capital and labour force;
- Limits on public aid.

Ad. 1 There is substantial empirical literature that confirms positive impact of FDI inflows on growth.

Borensztein Eduardo, De Gregorio Jose, Lee Jong-Wha	*How Does Foreign Direct Investment Affect Economic Growth?*, NBER Working Paper no. 5057, 1995	FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment. However, the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. In addition, FDI has the effect of increasing total investment in the economy more than one for one, which suggests the predominance of complementarity effects with domestic firms.
De Gregoria Jose	*Economic Growth in Latin America*, Journal of Development Economics, 39, 1992	The author shows, in a panel data of 12 Latin American countries, that FDI is about three times more efficient than domestic investment.
Blomstrom Magnus, Lipsey Robert, Zejan Mario	*What Explains Developing Countries Growth?*, NBER Working Paper No. 4132, 1992	There is a strong effect of Foreign Direct Investment on economic growth in higher-income developing countries through the acquisition of technology.
Hecht Joel, Razin Assaf, Shinar Nitsan	*Capital Inflows and Domestic Investment: New Econometric Look*, Bank of Israel, 2002	The effect of FDI inflows on domestic investment is significant. The authors provide also evidence that FDI inflows promote efficiency.

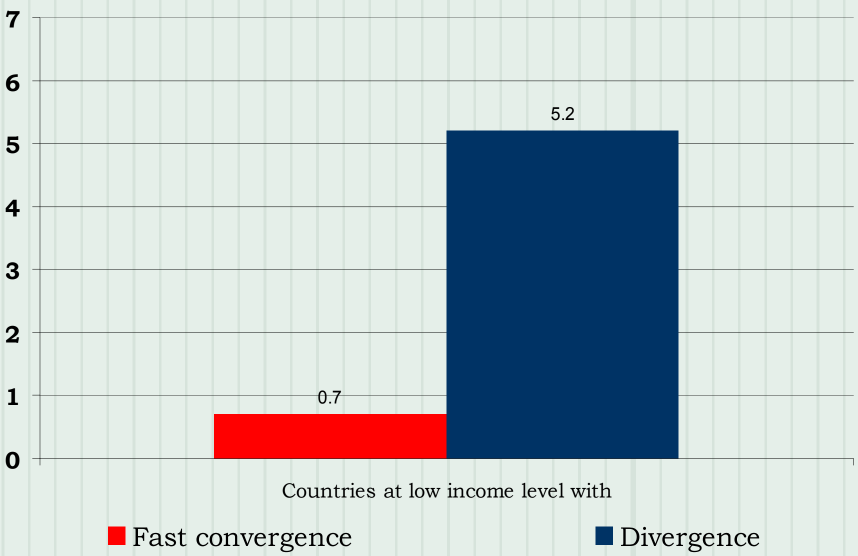
Ad. 2. There is substantial empirical literature that confirms positive impact of Structural Funds on growth.

Beugelsdijk Maaike, Eijffinger Sylvester	*The Effectiveness of Structural Policy in the European Union: An Empirical Analysis for the EU-15 during the Period 1995-2001*, CEPR Discussion Paper No. 3879, 2003	Convergence of the current EU countries is empirically tested, for the period 1995-2002, and the effect of the Structural Funds in this context is identified. Structural Funds seem to have had a positive impact and poorer countries (like Greece) seem to have caught up with the richer countries.
European Commission	*Sixth Periodic Report on the Social and Economic Situation And Development of the Regions of the Community*, European Commission, 1999	EU structural assistance has increased the rate of GDP growth, on average, by 0.4-0.9 percentage points in Greece, Portugal and Ireland, and by 0.3 to 0.5 percentage points in Spain.
Barry Frank, Bradley John, Hannan Aoife	*The Single Market, The Structural Funds and Ireland's Recent Economic Growth*, Journal of Common Market Studies, 39/3,2001	Estimates of the direct effects of structural funds on Irish national income appear small relative to the phenomenon to be explained; indirect effects arising from structural funds could also be significant, however.
European Commission	*The Impact of Structural Policies on Economic and Social Cohesion in the Union 1989-99*, European Commission, 1997	The EC analysed the allocation of Structural Funds and their main impacts on each assisted region and country by broad categories of funds. Its general conclusion was that the Funds have had a significant effect on reducing disparities in economic performance across the Union.

Ad 3. The importance of the institutional system and the economic policy.

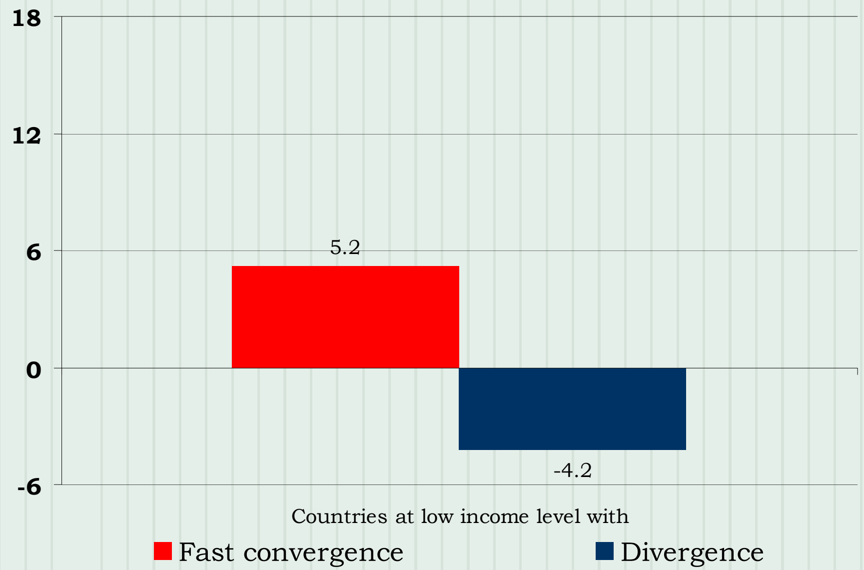
In the long-term high budget deficit leads either to a crisis or at least to a slower economic growth.

General government deficit in years 1970 - 98 (as % of GDP)



Open economies have developed, on average, much faster than their closed counterparts.

Increase in foreign trade to GDP ratio between 1970-74 and 1994-98 (in percentage points)



Fast convergence: average annual Income per-capita growth rate above 3.75%.
Divergence: negative annual Income per-capita growth rate.

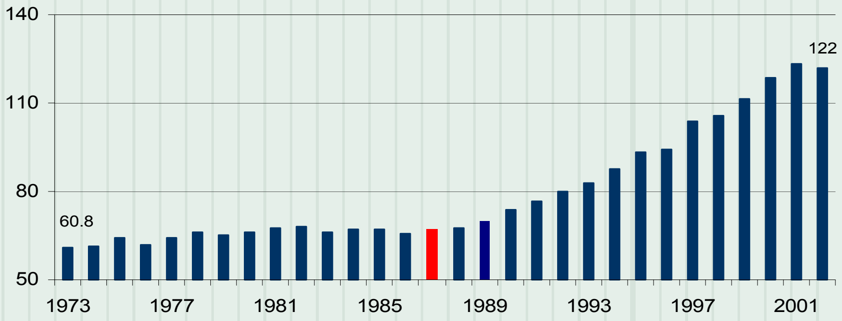
Source: World Economic Outlook, May 2000, International Monetary Fund.

EU membership gives the opportunity to catch up, but the actual economic outcomes depend on the quality of domestic policies.

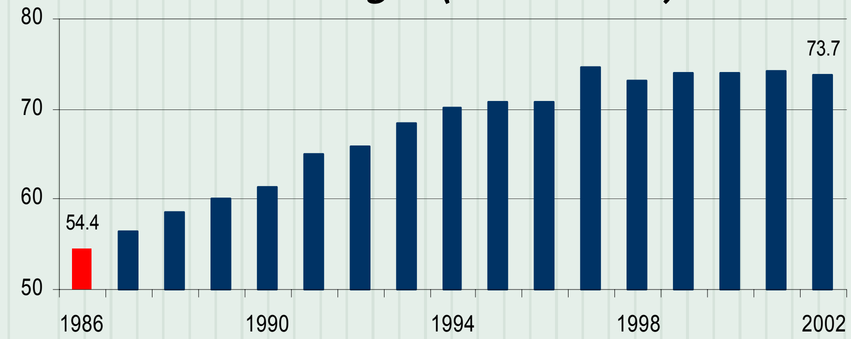
The period of EU membership as a whole has been the most successful in the case of Ireland and the least in the case of Greece.

Per-capita GDP (PPS, EU-15=100)

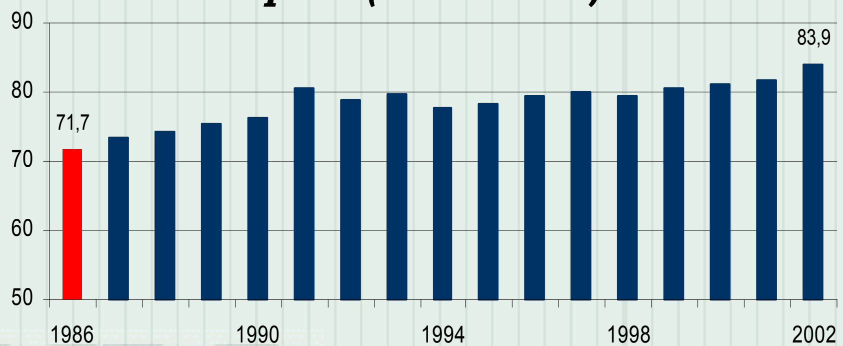
Ireland (1973-2002)



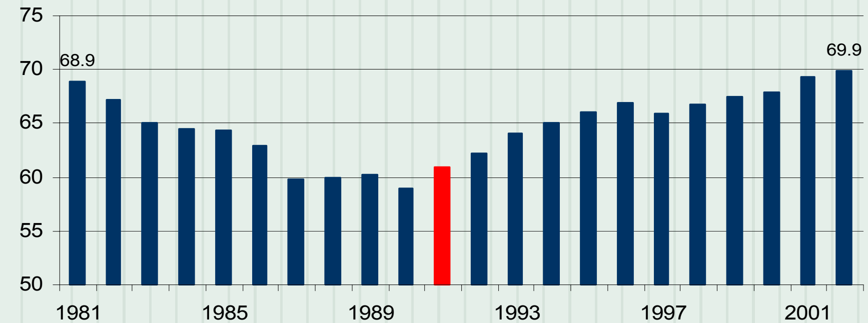
Portugal (1986-2002)



Spain (1986-2002)



Greece (1986-2002)



Red bar represents the first year of catching- up following the EU accession.
Source: European Economy no. 72, European Commission 2001, Eurostat.

It is fundamentally important that the EU policies that are the most conducive to economic growth, i.e.:

1. Stability and Growth Pact,
2. Single Market Policies,
3. Integrated financial market,
4. Limits on public aid.

should be strengthened and not weakened.

Ad. 1. Stability and Growth Pact.

- **Empirical literature confirms positive impact of balanced fiscal policy on growth**

Fischer Stanley	The role of macroeconomic factors in growth, NBER Working Paper No. 4565, December 1993	The author argues that there is a negative correlation between the economic growth, high budget deficit, inflation and a distorted FX market. Additional studies indicate that macroeconomic policy has an influence on growth: both general government deficit, and inflation reduce investment and limit increases in productivity.
Pedro de Lima, Alain de Serres and Mike Kennedy	Macroeconomic Policy And Economic Performance, Economics Department Working Papers No. 353, OECD, April 2003	'Another potential benefit from fiscal consolidation is the support it provides to the credibility of the price stability objective pursed in most countries.'

- **In the long-term high budget deficit leads either to a crisis or at least to a slower economic growth.**

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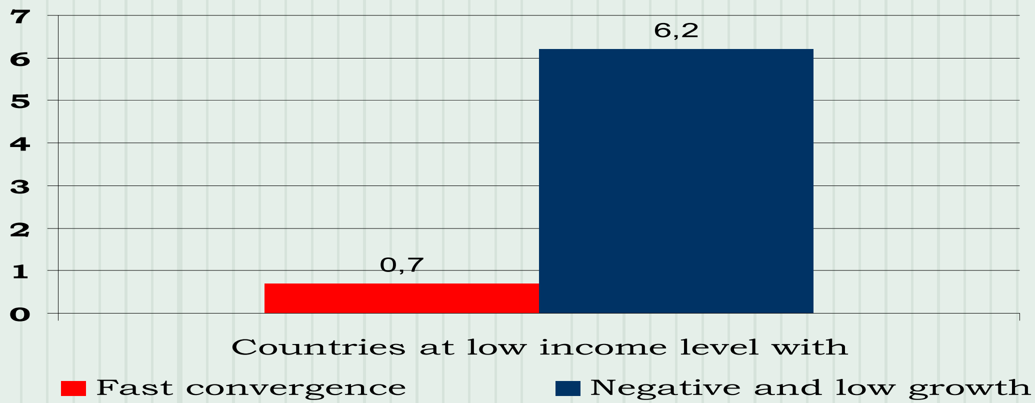


Source: European Commission, The Internal Market – Ten Years without Frontiers, 2002, World Economic Outlook, May 2000, International Monetary Fund.

Ad. 2. Single Market Policies.

The Lisbon Strategy, aiming at making the European Union "the most dynamic and knowledge-based economy of the world, capable of sustainable economic growth while providing more and better jobs and greater social cohesion", is a commitment to the integration of goods, services, labour, and capital markets under the Single Market scheme.

Goods.

- **Cross-border trade in goods has grown by around a third since the creation of the Internal Market in 1992.**

Examples of eliminating trade barriers	Examples of remaining trade barriers
In order to overcome problems connected with national technical regulations* two basic solutions were devised: (1) Mutual recognition meaning that companies can apply their own national rules. (2) EU technical harmonisation meaning harmonisation of national rules through EU directives.	(1) Mutual recognition principle is not working well where relatively more complex products are concerned. (2) There are problems in implementing EU directives in sectors such as construction products, machinery or pressure equipment.
Elimination of cars block exemption allows dealers to market their services freely across the Single Market.	Pre-tax prices of new cars can differ up to 70%. Half of the difference results from the regulations suppressing the competition.

** Technical regulations are regulations concerning health, safety, the protection of consumers or environment.*

Source: European Commission, The Internal Market – Ten Years without Frontiers, 2002.

Services.

- **Services are much more susceptible to Internal Market barriers than goods and are harder hit by their incidence.**

Examples of eliminating trade barriers	Examples of remaining trade barriers
The electricity market in some Member Countries has been opened. The Energy Council agreed a new Directive requiring non-household customers to be able to choose freely their supplier by July 2004 and gas electricity customers by July 2007.	The directive does not concern household customers. In 2001 household customers were able to choose their electricity and gas suppliers only in five and three EU States, respectively.
Airline carriers have equal rights of access to all the Community's markets and equal responsibilities under the law. The result is that any EU airline can now operate on any route within the Community.	Air traffic suffers from the existence of several different and incompatible management systems, which is the source of congestion, extra expenses and safety risks.

Labour.

The international mobility of EU employees is limited.

- **In 1992-2002 only 4% of the total EU population moved across borders either to work or to enjoy retirement.**
- **Only 8% of the EU students have completed part of their studies in another member state within a students exchange programme.**

Source: European Commission, The Internal Market – Ten Years without Frontiers, 2002.

Benefits from the Single Market are evident.

- **Greater diversity and quality of the goods available. 80% of consumers responding to the citizens survey said that the range of goods had increased, while 67% said that their quality had improved.**

- **More competition should be injected into the procurement markets. Vast majority of public tenders in the EU countries is carried out by domestic enterprises (over 90%). The potential for further savings due to more competitive pricing resulting from the application of the EU procurement rules is estimated at around €67 bn annually across the EU.**

- **Over 60% of companies exporting to more than 5 EU countries said that the Internal Market had helped to boost their cross-border sales.**

- **Single Market is a much more attractive location for foreign investors.**

Source: European Commission, The Internal Market – Ten Years without Frontiers, 2002.

Ad. 3. Integrated financial market.

According to the European Commission full integration of the EU financial markets would result in:

- **an 0.5 per cent reduction in the cost of equity capital for EU business;**
- **an 0.4 per cent reduction in the cost of corporate debt financing;**
- **a one-off increase in the EU-15 GDP over ten years of about 1.1 per cent;**
- **an increase in the EU-15 employment of 0.5 per cent.**

The Financial Services Action Plan (FSAP) adopted in 1999 is intended to create a Single European Capital Market by:

- **creating a single wholesale financial market to allow companies to raise capital on an EU-wide basis;**
- **completing a single EU retail market, ensuring consumer choice while maintaining consumer confidence and protection;**
- **underpinning all these actions through state-of-the art prudential rules and supervision.**

The FSAP consists of 42 measures. Untill 2002, 31 out of them have been already enacted.

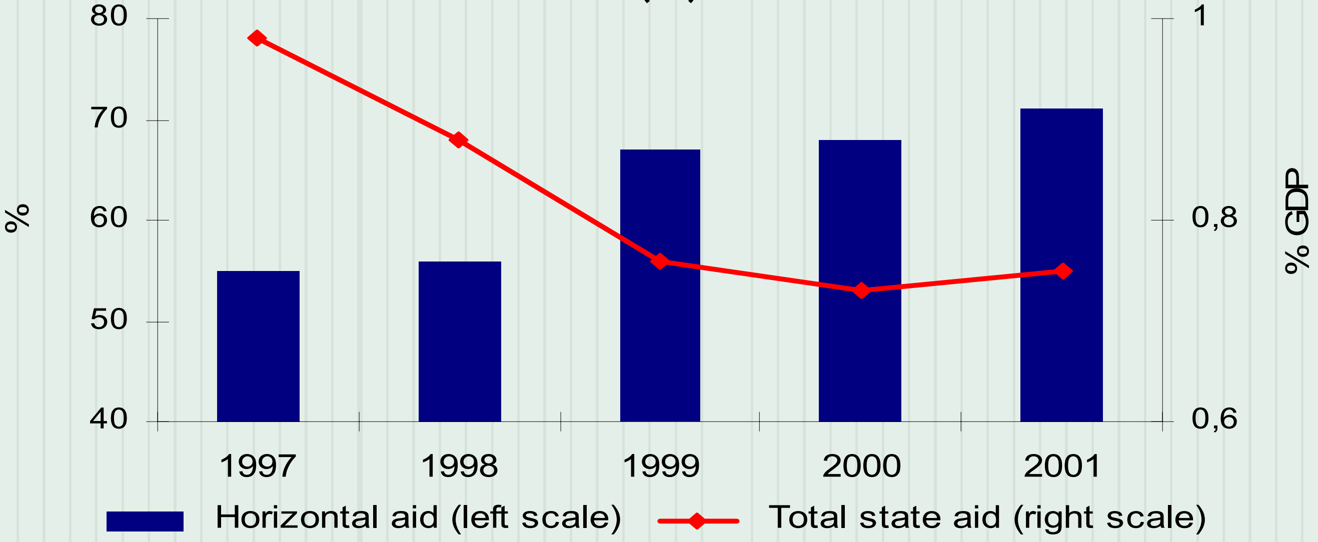
Source: HM Treasury, Meeting the Challenge: Economic Reform in Europe, February 2003.

Ad. 4. Limits on public aid.

According to the Treaty establishing the European Union public aid in the EU Member States consists in favouring some enterprises and 'cannot be made compatible with the single market principles'.

The overall amount of state aid declines and is redirected to horizontal objectives of common interest.

Total state aid (% of GDP) and horizontal aid as an average percentage of total state aid in the EU (%).



Horizontal aid is spent on: R&D, Environment, SME, Commerce, Energy Saving, Employment Aid, Training Aid and Other Objectives.

Source: European Commission, State Aid Scoreboard, Spring 2003 update, 2003.

II. EMU entry and economic growth

Targeting the earliest possible date of entry into the EMU is the best strategy for the accession countries, because:

1. **It could mobilize candidate countries to complete structural reforms in order to meet the Maastricht criteria (low inflation and interest rates, limited general government deficit and public debt), which in itself is good for the long-term economic development.**

2. **It could shorten the interim period, which may be turbulent due to volatile short-term capital flows.**

3. **The accession countries are highly integrated with the EU economy, hence costs associated with giving up an independent monetary policy and flexible exchange rate would not be significant.**

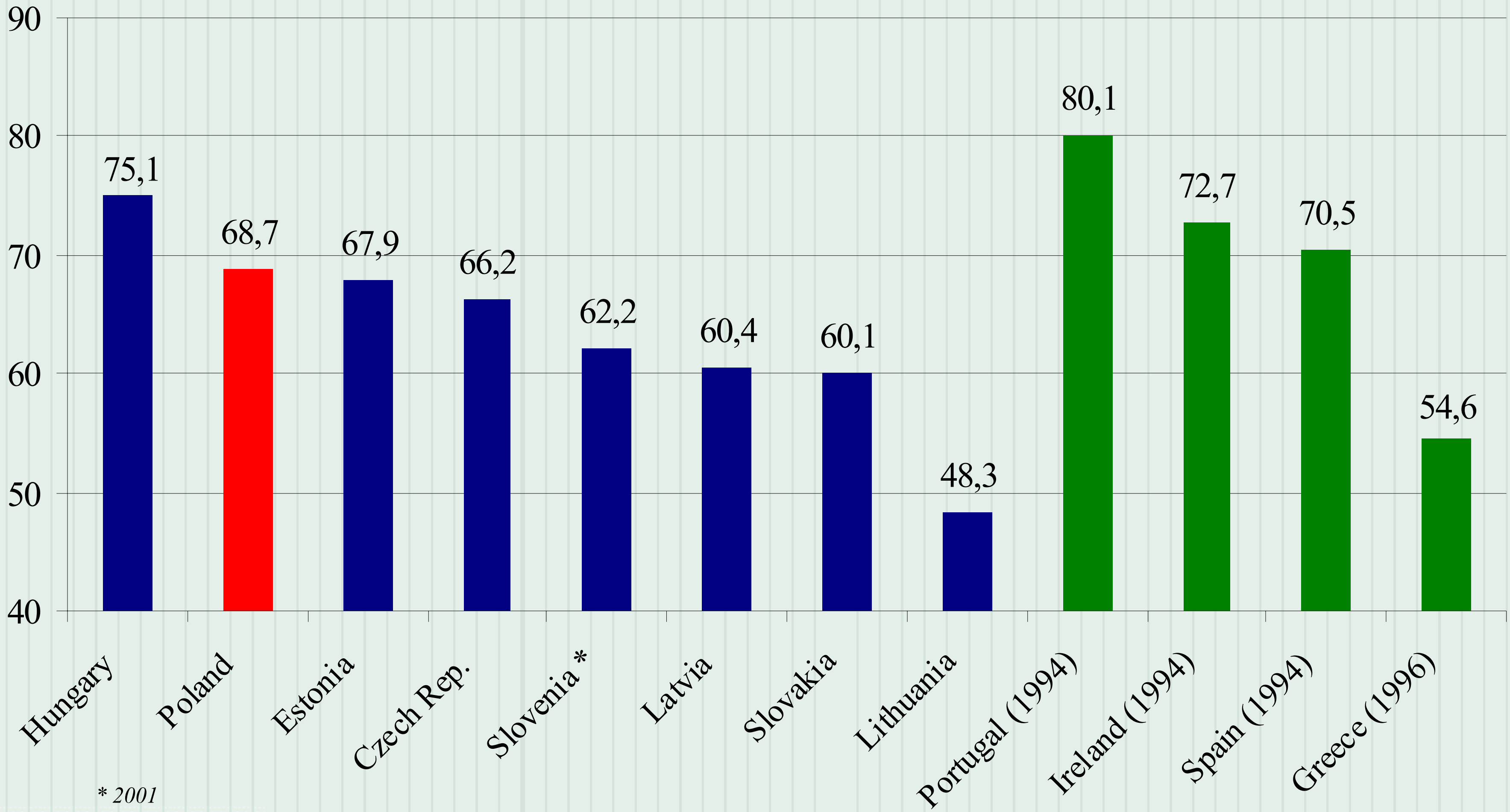
4. Targeting the earliest possible date of entry into the EMU could allow the accession countries to benefit earlier from the advantages of the single currency, i.e. from:

- strengthened framework for fiscal discipline;
- eliminated exchange rate risk and hedging costs;
- reduced transaction costs in foreign trade;
- lowered long-term interest rates.

The above would promote the long-term economic growth through increased foreign trade with the EU member states and higher accumulation of capital.

Trade integration with the EU.

Exports to the EU as % of total exports, accession countries in 2002, Spain, Portugal, Ireland in 1994 and Greece in 1996.



** 2001*

Source: 2002 Regular Report on Progress Towards Accession, European Commission 2002 and UNCTAD Handbook of Statistics On-Line, EcoWin.

There is substantial empirical literature proving high cyclical convergence between the accession countries and the EMU countries.

Frenkel Michael, Nickel Christiane, Schmidt Günter	*Some Shocking Aspects of EMU Enlargement*, Research Note No. 99-4, Deutsche Bank, 1999	There is a high correlation between supply and demand shocks in Poland and the biggest economies of the EMU – France and Germany.
Korhonen Iikkan, Fidrmuc Jarko	*The Euro Goes East. Implications of the 2000-2002 Economic Slowdown for Synchronization of Business Cycles between the Euro Area and CEECs*, WUSTL, 2003	Several acceding countries have a quite high correlation of underlying shocks with the euro area. Continuing integration within the EU is likely to align the business cycles of these countries in a manner similar to the synchronization of supply and demand shocks the authors document for the EU in the 1990s.
Bank for International Settlements	*BIS Working Party on Monetary Policy in Central and Eastern Europe*, 2003	Changes of industrial production and export are highly correlated between the accession countries and the euro area countries.
Borowski Jakub	*Susceptibility to assymetric shocks and the process of the EMU accession /in Polish/*, „Bank i Kredyt" Nr 11-12, 2001	Cyclical components of GDP, industrial production, inflation and unemployment in Poland and Germany or euro area are quite highly correlated.