Central and Eastern European Countries and the European Union *Edited by Michael Artis, Anindya Banerjee and Massimiliano Marcellino* (Cambridge University Press, 2006)

Valentina Ivanić*

The collection of papers focuses the latest EU enlargement (as of 1 May 2004), more precisely eight of the ten new Member States - countries collectively known as Central and Eastern European Countries (CEECs): Hungary, Slovenia, the Czech Republic, Slovakia, Poland and three Baltic countries Estonia, Latvia and Lithuania.

The latest enlargement could induce profound consequences on both the new EU Member States and the pre accession countries, due to the fact that CEECs levels of prosperity and economic development are well bellow the EU average and they had been to a greater or lesser extent subjects to the central planning regimes.

The latest enlargement is unparalleled in terms of the number of countries, which may call for a change in the EU governance structure, but the EU response to the governance issue is not one of the issues addressed by this book. The chapters presented here deal with response to other aspects of the enlargement, the economic situation in CEECs and its likely development, as well as with the nature of impact the EU membership may provoke.

In order to provide answers to a number of relevant questions, this book consists of four themes: the issue of enlargement impact and its distribution, the issue of regional policy and structural funds, macroeconomic trajectories of these economies to date, aiming to predict their likely future development, and finally, the authors develop a debate about the accession to the European Monetary Union (EMU).

1) Overall impact

Bchir, Fontagne and Zanghieri discuss whether the recent EU enlargement is good news for the economies of the old Member States. They notice that the latest enlargement has raised many questions among EU – 15 members: institu-

* Managing Director, Centre for Strategic Economic Studies VOJVODINA-CESS, Novi Sad: v.ivanic@vojvodina-cess.org *Received: 25 October 2007.*

tional, social, political and economic issues. Enlargement has involved a large number of countries which means that institutional questions should be posed. CEECs have GDP p.c. levels lower than the EU-15 countries average, tackling the issue of social competition which means massive reallocation of industries and extensive migrations. Last but not least, the latest enlargement has raised the issue of political sustainability. The authors give the opinion that the EU could be a politically stable project thanks to sizeable transfer payments accompanied with the EU structural policy, whereas they open discussion about the effectiveness of such transfers in enhancing the catching-up process. In other words, the authors are confident that catching up is not an automatic process for CEECs, meaning that these countries should conduct internal reforms.

The CEECs are entering the EU with strong growth dynamics: after the economic slowdown of 2001 and 2002, caused by unfavourable external environment and domestic policy mistakes, the first half of 2004 marks the first period of a very strong growth across most of the region. Emilio Rossi and Zbyszko Tabernacki present reasons, context and key factors which can explain the abovementioned growth recovery, based on the benefits of stronger demand in the traditional Western European export markets, with a steady growth in private consumption and a gradual recovery in domestic capital spending.

Bchir, Fontagne and Zanghieri apply the CGE (Computable General Equilibrium) model to estimates the effects on trade, output and welfare over a period of time. The simulation shows that the enlargement had no effect on the economy of EU-15 as a whole, mainly because of the relatively small economic size of CEECs, while the impact on CEECs was significant and highly positive in the medium run.

By 2015 and relative to the base line, the authors predict large expansionary impacts on the output and welfare of CEECs, amounting to 7-8% of GDP, while old EU members could experience a decline of less than 1% of GDP .

The size of the farming sector (both as a percentage of GDP and number of people employed therein) in CEECs has called for a sizeable transfers of funds under the CAP rules. By rehearsing different scenarios (trade integration, market integration and accession) the authors could point out that further impacts to come from more liberalized trade alone are relatively small. Three scenarios are considered in order to disentangle various effects of the accession. It is worth mentioning that, in the first and second scenarios, CAP (Common Agricultural Policy) remains unchanged and acceding countries do not benefit from it, but it is possible to outline CEECs benefits from CAP and assess impact of the farm support in the third scenario.

CEECs have recorded deep changes in the production structures prior to the accession through redirecting resources towards sectors in which accession countries are granted comparative advantages: Hungary has specialized in com-

puters, consumer electronics and engines, while Poland specialized in labour intensive industries such as clothing, furniture, primary products and consumer electronics.

In other words, the markets had already been open to exports from CEECs prior to the enlargement, except for agriculture and a limited range of sensitive products, but the change in trade volumes could not affect market structures. Old Member States were not be affected when CEECs opened their markets, so it is important to stress that economies of scale could not be achieved as a result of trade liberalization. In other words, trade liberalization may foster trade but microeconomic efficiency gains might be limited. Market integration is more than just trade liberalization because it can cause changes in market structures, primarily under imperfect competition.

2) Regional policy and the structural funds

The continued EU expansion over the last two decades affected both the spatial configuration of economic activity and the regional convergence process. Toni Mora, Esther Vaya and Jordi Surinach try to explain theoretical aspects and empirical evidence using the spatial agglomeration models, in order to discuss whether changes in the distribution were spatially concentrated.

The authors try to identify lessons which could be learnt from the EU enlargement of the mid 1980s, with the aim to calibrate future scenarios after the largest and latest EU enlargement. Toni Mora, Esther Vaya and Jordi Surinach provide us with analysis of the spatial distribution in the period from 1985 to 1995, in order to predict the period to follow the latest enlargement. The authors find out that the changes in specialisation indices were spatially concentrated for certain sectors, giving a positive spatial dependence scheme between nearby regions. Spatial distribution is important and the existence of externalities may account for the presence of regional clusters, with similar patterns in the evolution of specialisation.

Overall specialisation of the EU countries rose during the 1970s. The authors underline an average rise in industrial concentration was 11,4% in the period 1985-1993 and a significant effect of geographical aspects on the evolution of industrial concentration. Dissimilarities in industrial patterns have continued since the 1980s.Emipirical evidence indicates that slow growing and unskilled labour intensive industries became more concentrated whereas industries with large economies of scale became more dispersed. Production specialisation has increased while trade specialisation has decreased.

The changes in the distribution of regional activities seem to show that the entry of eastern regions has increased the gap in specialisation levels between old and new Member States. This might also reveal a European regional map where various groups of economies can be distinguished: regions made up of old Member States recorded a higher stability in their relative specialization

levels; significant number of regions that entered in the mid -1980s have increased their relative specialisation in labour intensive industries and activities of the service sectors, and last but not least eastern regions have seen a rise of uneven distribution of activity at the overall level due to the higher relative specialisation.

Economic integration impacts the spatial location of economic activities. In the first integration stage (characterised by high trade costs), the need to supply markets locally encourages firms to locate in different regions. Further integration (leading to intermediate trade cost values) begins under the hypothesis of increasing returns and weaken the incentives for self sufficiency, thus motivating industries to concentrate in regions with the largest market size. Pecuniary externalities take over, firms and workers cluster together leading regions to differentiate endogenously into an industrialised core and a de-industrialised periphery.

Further reductions in trade costs in the EU would lead to centripetal shifts (centripetal forces are forces that tend to promote geographical concentration, while centrifugal forces work counter wise) in the European industry. In other words, we would expect an increased concentration of scale-intensive production in the EU core, while the periphery would specialize in manufacturing activities (not characterised by economies of scale) and non-manufacturing activities. The existence of the core-periphery scheme or a more equal distribution depends on the strength of both centripetal (backward and forward linkages between firms, the existence of a thick and immobile local labour market and the presence of external economies via information spillovers) and centrifugal forces (presence of immobile factors, high rents on land, notable concentration of economic activity and external diseconomies), and also on the ability of each European region to capitalise on its own advantages.

In another paper, Rosina Moreno, Enrique Lopez-Bazo and Manuel Artis present new evidence concerning the effect of public capital on productivity and economic growth. They analyse the period prior to the accession of Spain to the EU, in order to explore effects of public sector infrastructure investment on regional output and implications for regional policy.

It has to be emphasised that the EU interest in the effects of public capital investments on economic development has grown as a result of the increase in funds created to finance projects to promote growth and convergence and cohesion within the EU.

The latest enlargement of the EU has accentuated regional problems in the Union because the average GDP p.c. of CEECs stands at approximately 40% of the EU average. CEECs economies are characterised by the predominance of primary and secondary sectors, industries highly concentrated at certain locations and insufficient infrastructure endowments. CEECs regions should successfully finish the restructuring process if they aim to create potential for future growth and to catch up with the more developed EU members.

The authors find out that the effects of infrastructure on productivity depend on the type of infrastructure: local infrastructure boosts economic activity in the area, whereas transport and communication infrastructure can create benefits locally and cause positive or negative spill over effects on other regions. In the case of the Spanish regions, negative spill over effects of transport infrastructure prevailed, caused by migration factors. Total output in a region would positively depend on its stock of infrastructure and negatively on the stock of infrastructure in other regions. If negative spillovers prevail, one can assume that such spillovers could be even stronger between the regions which can be substitute production locations.

Spain's experience could provide lessons as to what may happen to CEECs if they attract new investments in the sphere of infrastructure. The evidence point out that infrastructure may play a significant role during the takeoff of a less developed economy, but the impact will decrease over time because after a certain threshold the returns would rapidly decrease.

One of the significant findings is the opinion that policies aimed at promoting growth of the less developed regions, particularly regions within CEECs with poorer endowments of public capital, have to focus on the local infrastructure. This opinion is based on the results which show that estimated positive effects of public sector infrastructure investments are not large and the returns seem larger for types of infrastructure (local infrastructure) other than transport, favoured by the EU funded projects.

The estimated returns on local and transport public capital show that returns were higher in more advanced Spanish regions than in the less developed ones. When we talk about CEECs, such investments should be directed to areas with potentially higher returns, better endogenous conditions and higher agglomeration economies. It can cause and increase negative spillovers and regional disparities within each of CEECs. Presence of negative spillovers means that regions can use infrastructure as a competitive tool for attracting production factors. In this way they could increase their own industrial output at the expense of other regions.

The role of public infrastructure in improving productivity is a key policy issue for CEECs. Eliana La Ferrara and Massimiliano Marcellino use the evidence from Italian regions' experience to analyse issues relevant for the form of regional policy. They have conducted a systematic analysis of the impact of public capital on TFP, production and cost, by comparing three existing theoretical approaches (The Total Factor Productivity approach, The production function approach and The cost function approach). The approaches were used to analyse regional data for Italy in the period 1970-1994.

The total factor productivity approach indicates a strong positive effect of public capital accumulation, the production function approach yields a nega-

tive elasticity of production to public capital and the cost function approach indicates almost no effect of public capital on variable costs.
According to all three approaches, the effectiveness of public infrastructure has increased over the years, notably in the 1980s (in comparison to the 1970s). Central and southern Italian regions benefited from the most productive use of public capital.

Many contrasts and differences within CEECs exist also in Italy so one can use the empirical findings for Italy to explain and predict the relations within CEECs.

Many additional factors determine the efficiency of spending infrastructure funds and they could not have been covered by the methods used in this book. Nevertheless, the authors stress that the impact of structural funds spending on the overall growth performance significantly depends on the quality of institutional set-up in the recipient country. In other words, adequate institutions are more important than infrastructure spending itself, in terms of overall productivity effects. These findings are of an utmost importance for decision makers and researchers in drawing conclusions regarding structural and cohesion policies for the CEECs.

On the basis of half a century of experience with southern Italy and more than two decades of experience in southern Spain, one can conclude that the availability of large income support transfer programmes has a negative impact on economic efficiency and long-run growth - they hamper instead of enhancing economic convergence. Mezzogiorno is mentioned as an example of the "dark side" of EU regional economic transfers and serves as a model how we should limit negative political side effects.

Michele Boldrin attempts to draw up a policy which should and could be performed in order to fuel real convergence at the national and regional levels, concentrating on the CEECs economic growth and convergence, after joining the EU.

As the EU economic convergence is a regional issue (regional means NUTS 2 territorial units for which the EU structural policies are designed and evaluated against), Boldrin's analysis provide us with information on the kind of policies that may create an environment most conductive to economic growth at the NUTS 2 territorial level and how Structural and Cohesion Funds, as well as their location, should be modified in order to accomplish that.

Boldrin concludes that the EU regional and structural policies have secondary effects on long-run growth and that transfers taking place under the structural and cohesion policies are just transfers, which can not serve to foster rapid economic growth and convergence.

Theory and evidence show that we can view Structural funds as a pure income transfer with little long term effects. Moreover, availability of such transfers generates two negative effects: they lead to rent-seeking behaviour and

enhance rent-seeking coalitions, and secondly they cause inefficient allocation of resources within recipient regions, resulting in a suboptimal allocation of the resources (labour, capital and entrepreneurial resources). Talking about the long run, we should bear in mind that both of these effects lead to misallocation of resources , corruption and a lack of possibility to create necessary preconditions for sustained growth.

A lack of supply-side incentives played a critical role in the long run regional performances. Pure trade integration does not automatically produce growth effects on participating countries. The overall experience of trade integration, particularly in Europe, points to sizeable improvements in the factor endowments of the poorest partner and in the allocation efficiency. If nevertheless absolute convergence is the objective, we should also respect national policies other than trade liberalisation. Key roles in fostering real convergence are played by measures such as: weakening the fiscal pressure, reductions in public spending and labour and capital mobility, coupled with a competitive level of labour income taxation.

Experiences of Ireland, Portugal and the Italian North East show that key ingredients for the establishment of a growth-friendly environment are FDI incentives, new small firms, risk-taking entrepreneurial behaviour, enhanced labour and capital mobility, low marginal taxes, efficient transportation and communication infrastructures, proper financial facilities, as well as flexible supply of high-quality human capital.

3) EMU accession

Finally, success of the European Monetary Union, measured by benefits which outweight costs, depends on the capacity of European economies to give more flexibility to markets (labour, goods and service markets) and on the degree of symmetry of future shocks. All these findings can be used to create a strategy which should identify main benefits and costs related to a currency area membership.

Upon traditional optimal currency area grounds (OCA), Artis, Marcellino and Proietti find out a lot of evidence against the accession. The authors conclude that shocks among old and new EU Member States have been idiosyncratic, with very few exceptions.

In order to assess whether the recent economic evolution of the new Member States and their expected development in the coming years place CEECs in a better or worse position regarding EMU, authors conclude that the shocks are more asymmetrical in CEECs than in the current Euro area.

The starting point used by the authors for considering the benefits and costs of joining EMU was the theory of Optimum Currency Areas (OCA). It has to be mentioned that most studies of possible effects on the European monetary unification process have focused on the analysis of business cycle synchronicity.

In other words, the costs of participating in the monetary union depend on the similarity of business cycles in the Euro area and CEECs. It is expected for CEECs to benefit from joining the euro zone in the long run but one should keep in mind that the loss of monetary policy discretion can create problems in the short term.

The main cost of joining a currency area would be the loss of monetary policy instruments at national level (the exchange rate) which can serve as a stabilisation mechanism against macroeconomic disturbances, known as asymmetric shocks. The authors stress that positive effects of monetary union at macroeconomic level can be direct and indirect benefits of transaction-cost reductions, less uncertainty and more transparency in price determination mechanisms.

Ramos and Surinach underline that CEECs have significantly better options for creating well adapted stabilization policy if they do not join EMU. Traditional OCA theory suggests that the Euro-area monetary policy would be ill adapted to the needs of CEECs. The authors imply that the attempts of CEECs to conduct autonomous stabilization policies can be disrupted by highly mobile financial capital, as they have small domestic capital markets.

Three countries from the group (Slovenia, Latvia and Lithuania) have already entered the ERM II, which is the antechamber of EMU, while the others have expressed a strong desire to participate. Analysis of the monetary transmission in CEECs is very relevant because, after joining the EU, those states are expected to join the Euro area as well. In this context, it is worth to note that asymmetries in the transmission of monetary policy in the monetary union may destabilise the business cycle and put CEECs out of phase with one another in a way that can not be corrected by deficit-constrained fiscal policies. The authors use structural VAR models to compare CEECs transmission mechanisms with those in the Euro area.

The evidence available for CEECs shows that the monetary transmission may be quite similar to that in other countries of the Euro area while monetary policies have been effective in fighting inflation and stabilising output in all CEECs.

The results obtained using VAR models and conditioning for fiscal deficits show that fiscal policy has adversely affected the efficiency of monetary policy to control inflation in CEECs, which means that independence of central bank is necessary for an effective conduct of monetary policy.

A key policy challenge for the CEECs governments, especially governments of the three largest economies in the group (Poland, the Czech Republic and Hungary), is the need to reduce budget deficits in the next several years in order to meet the Maastricht criteria and enable them to reach their growth potential. CEECs used fiscal policy as a tool to promote growth in their struggling economies, as well as to please the electorate with increased social spending.

One of the major CEECs weaknesses is a high share of fixed expenditures in total budgetary spending, particularly socially related spending. The safest way to reduce expenditures gradually without hampering economic growth can be implementation of a system of medium-term expenditure ceilings. Such system is, usually applied for a period of three to five years to all levels of expenditures. The British experience should be considered as a good example of setting maximum spending targets. Such ceilings apply to spending of all government branches, including off-budgetary funds, and should be reviewed every three to five years.

Conclusion

All CEECs have a greater or lesser degree experienced a recession caused by the transition from the previous centrally planned regime. The period that followed recorded a relatively uninterrupted expansionary path of their economies. The authors suggest that in the medium term (up to 2007) output growth will continue to remain strong and CEECs may grow at modest rates of 3% to 5%.

This book is a contribution towards understanding some of the issues CEECs had to cope with in order to create adequate macroeconomic policy. The short sample period of relevant, post-transition data prevents the use of standard time series methods and limits the opportunity to forecast macroeconomic development of the CEECs. Regarding the Western Balkan countries, one can expect the same problem of data availability. Due to the existing similarities between the two groups, the CEECs experience can be used for predicting and forecasting impacts the EU accession will produce upon the Western Balkans economies.