

Strengthening Ties that Bind in the Enlarged EU

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In the two years since enlargement of the European Union, the new Central European members have proved their mettle. In most, growth has been high, inflation low, exports vibrant and investment strong. Certainly each country has a long way to go to reach Western European living standards. But for most the catch-up is proceeding rapidly, with small costs but also benefits for the 15 old members (EU-15). These trends cannot, however, be taken for granted—strategies for sustaining them are essential.

Successful strategies will build on the basic economic differences between the new and old members. Most importantly, the large gaps between per capita incomes between Old and New Europe provide significant opportunities for mutual benefit.

The new members are short of capital. Scrapping the misallocated investment from central planning has left them with average capital deployed per worker at about 40 percent of the EU15. The scarcity of capital, together with low wages, means that average returns on investment in the new members should be relatively high. The main influence that would dampen very high rates of return is weaker conditions for doing business in the new members than in the EU15: despite much progress during the past decade and a half, legal, administrative, and political institutions, technology, and infrastructure that

determine the productivity of labor and capital (so-called total factor productivity) in the new members remain far short of Western European standards. But with EU membership these conditions should continue to improve, perhaps even more rapidly than during the past decade and a half, and make rates of return on investments in the new members even more attractive..

Countries of the EU15, on the other hand, save, on balance, more than they invest at home and are looking for high-return investments. Capital-poor new members offer excellent opportunities. Large net capital flows to new members—Estonia received 12 percent of GDP in 2005—reveal these attractions. The investment feeds labor productivity in the new members, leading to income gains. Provided fiscal deficits are small, or better yet are in surplus, financial inflows fund private expenditure. Much of the direct investment goes to sourcing inputs for production in the EU-15. Recent evidence suggests that these production networks improve the global competitiveness of industry in the EU15 countries.

Capital outflows are causing some job losses in the EU15 countries. But outsourcing also helps businesses and banks remain viable in the face of global competition. It therefore will result in at least partially offsetting job creation as stronger competitiveness allows expanded production at home. Analysis (by Dalia Marin, University of Munich) of German and Austrian firms' experience with offshoring provides evidence of such win-win outcomes from capital flows. Complementing this process, labor migration from East to West will help relieve any labor or skill shortages that are likely to emerge in the EU15.

Where are the constraints on this process and how can they be alleviated? EU-15 countries could be a drag on the process. Restrictions on labor mobility will slow migration from new members to old. Recent decisions by Finland, Greece, Portugal and Spain to join Ireland, Sweden and the UK in opening their borders will allow East-West migration to complement West-East capital flows. Encumbrances on trade in services or other rigidities in labor and product markets also hurt. But such impediments are unlikely to thwart the underlying incentives for high-saving Western countries to invest in high-return Eastern countries.

New members may create constraints through poor policy choices. The pattern of net capital inflows to the region suggests that long-term investors prefer low budget deficits, stable inflation, and improving business climates over fiscal, monetary and institutional reform policies that are erratic because they have gotten bogged down in politics. Recently growth rates in the Baltic countries, where fiscal and structural policies have for the most part been relatively strong, have significantly outpaced the regional average: if policies continue to diverge, a two-speed catch-up may become entrenched, as the best-performing economies set the bar for attracting investors.

But even for countries that get policies right, rapid income catch-up is not risk-free. The benefits of greater capital market integration go hand in hand with the exchange rate risk inherent in large financial inflows. The Baltic countries, which have been highly attractive to foreign investors, are already showing the familiar signs of emerging market

vulnerabilities. Their external indebtedness is growing, and balance sheet exposures to foreign currencies are increasing. First-class fiscal and structural policies with transparent balance sheets and institutions certainly mitigate these vulnerabilities. But foreign exchange risk is inevitable when countries import foreign savings on a large scale. As long as the inflows do not show the characteristics of “hot money”, the answer to these risks is not to try to limit inflows and thereby forego the benefits they confer. Neither borrowing nor lending countries would be well-served by this course. Rather the right response to manage macroeconomic policies well and take all steps possible to contain risks.

Here, however, Europe has a unique opportunity: it can eliminate exchange rate risk by enlarging the euro area to include new EU members with strong policies. Already the expectation of early euro adoption has attracted large net foreign inflows—particularly in Estonia and Lithuania. As long as separate currencies exist, foreign exchange exposures are a vulnerability. New members that meet the essential conditions to thrive after euro adoption—fiscal positions that meet the Maastricht criterion with a margin to spare and labor and product markets that are flexible enough to adapt quickly to changing conditions—should move expeditiously into the euro area. Both new and old members will benefit from the reduction in risk and therefore from safer integration of financial markets. And the results will motivate laggards to get their policies right and seize this unique opportunity. All countries stand to gain from strengthening the ties that bind in the enlarged EU.

