The new EU enlargement

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EDITORS' INTRODUCTION
THE NEW EU ENLARGEMENT

On 1st May 2004, ten countries will have joined the European Union (EU): Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovenia, and Slovakia. The presence of eight Central and Eastern European countries (CEECs hereafter) among the ten newcomers is particularly striking: these countries have had to make a giant step from centrally planned to market economies over an incredibly short time period. Accession to EU may thus be seen as a legitimate reward for countries which have undertaken a profound change in their political and economic structures.

EU accession has been conditional on countries fully respecting the so-called "Copenhagen criteria", i.e. (i) "stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities"; (ii) "the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union"; (iii) "ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union". The political agenda for successful accession was therefore really demanding for countries where the "markets" were formerly almost inexistent, administered price setting was the rule, trade and financial relations were highly centralised and regulated, and incentives were generally geared towards meeting the "plan" targets.

Although major improvements have occurred, most of the CEECs are still in a transition phase towards a market economy. For instance, administered prices, despite a steep reduction, always represent a non negligible share of the consumer price index in countries like Hungary. Moreover, notwithstanding recent good performances as regards GDP growth rates, most notably in comparison with the EU average, the CEECs are substantially lagging behind EU-15 in terms of GDP per capita. In Estonia, Hungary, Latvia, Lithuania, Poland and Slovakia, the PPP-adjusted GDP per capita in 2001 was lower than Portugal's and Greece's at the time of their EU accession.

Hence, this fifth enlargement since the creation of the European Community differs from the previous ones in some important respects. First, this new accession round occurs on a very large scale: it is the widest enlargement up to now, especially in terms of population and land area. The EU-25 population and land area are being respectively increased by 20% and 25%. Sharply contrasting with these features, the EU-25 GDP is only being increased by 5% (at current exchange rates).

Second, the aforementioned gap of the average GDP per capita between the new accession countries and the EU-15 challenges the capacity of the former to catch-up rapidly on the latter.

Third, abiding by the whole EU legislation (the *acquis communautaire*) is a very difficult task and was not required at the same level of complexity when countries like Ireland, Greece, Spain and Portugal were preparing themselves for accession. Complying with the EU legislation may also be costly: some industries should not only be restructured in order to gain competitiveness, but they should also participate in the improvement of the environment, through less polluting activities or production technologies. Also important in the present *acquis communautaire*, EU accession entails planning EMU accession, which means that the new accession countries will have to satisfy the so-called Maastricht criteria sooner or later, including participation in the ERM II. This will impose constraints on the conduct of their economic policies.

Fourth, this new enlargement will not automatically and immediately give these countries the rights their compliance with the whole *acquis communautaire* should entail: free movements of the labour force from the East to the West will intervene only gradually, beginning at best in 2007, and being fully efficient in 2010. Consequently, migration is not a short-term issue. The number of residents and workers from the CEECs in the EU-15 corresponds to a share of 0.2% of the workforce and population in the EU-15 and 0.8 % of the workforce and population of the CEECs. Most studies converge to predict a long-term migration potential of at most 3% of the current CEECs' population (i.e. about 3 million individuals).

Finally, full liberalisation of capital accounts is a prerequisite for entering the EU, here again in sharp contrast with the experience of past newcomers. In the present case, substantial short term capital inflows towards and outflows from the CEECs might endanger the sustainability of ERM II and cause financial instability.

In this Special Issue, we have aimed at focusing on the most important challenges at head for the new Central and Eastern European accession countries. So-called structural issues like the flexibility of the labour markets or the adoption of fully-funded pension schemes, as well as economic policy issues like proposals for reforming the Stability and Growth Pact or the early adoption of the euro, are given peculiar attention. Economic geography and political economy are also present in two contributions which emphasise, on the one hand, the dynamics of trade and FDI relations between the CEECs and the EU-15 and, on the other hand, the optimality of different reforms for the European system of central banks. The Special Issue also has a contribution which tries to assess the ability of the Turkish economy to cope with some of the economic Copenhagen criteria (point (ii) upward), relating public finances, inflation and banking deregulation issues.

The labour markets

A prominent issue, as far as the enlarged EU is concerned, is in defining and understanding the most significant features of the new accession countries' labour markets. Beforehand, it is almost astonishing to notice, in sharp contrast with economic policies, that no clear guidance appears in the European legislation as far as domestic labour markets are concerned. The Copenhagen criteria do refer to a market economy, but the precise features of the domestic labour markets seem beyond the scope of European treaties. Active labour market policies (ALMP) and employment protection legislation (EPL) are part of a terminology which is for instance relatively more present in the OECD's literature than in the EU's, Commission's or EP's literature.

Sandrine Cazes and Alena Nesporova[1] start their contribution by defining precisely the various flexible forms of employment in the CEECs and, then, the extent to which their labour markets can be labelled "flexible", as regards the OECD reference in this domain. The authors show that whereas flexibility has actually increased in the CEECs, the forms it has taken are different from one labour market to the other[2] and, more importantly, they are different from the OECD countries. The most striking evidence indeed, though statistics are rare, is that of multiple-jobs: many persons have at least a second job and sometimes even more jobs. Also worth noticing: part-time employment is still scarce in the CEECs in comparison with the OECD countries.

Cazes and Nesporova then evaluate labour market flexibility focusing on labour turnover. They argue that in the OECD countries, new hiring and quits of jobs increase when economic growth is high: labour turnover behaves pro-cyclically. What their econometric evidence shows is that, for the Czech Republic, Estonia and Slovenia, the labour turnover turns out to be counter-cyclical. During "good times", the attractiveness of productive jobs would thus be impaired by the reluctance of workers

1. Longer developments are available in their book (Cazes S., and Nesporova, A. 2003. *Labour markets in transition: Balancing flexibility and security in Central and Eastern Europe*. Geneva: ILO).
2. For instance, the share of temporary contracts in total employment contracts varies from 3% (in Estonia) to 13% (in Slovenia).

to take the risk of quitting their less productive jobs. This behaviour is perceived by the authors as having negative effects on labour productivity for the whole economy.

The shift from enterprise assistance to public institutions assistance in most CEECs during the nineties has also negatively impinged on employment protection and has increased the relative jobs precariousness, i.e. high employment insecurity. Though employment protection legislation strictness in the CEECs is on average very close to that of the EU countries, the percentage of unemployed receiving unemployment insurance benefits is very low in countries like Poland, Slovakia and Slovenia. Cazes and Nesporova therefore argue that this leads to low participation rates. Consequently, more employment protection could contribute to increasing economic activity of population and to attracting workers to the formal, more productive, sector. In their conclusion, Cazes and Nesporova conclude that establishing a "new balance between adjustment flexibility for enterprises and employment and income security for workers" is a major challenge for the CEECs.

The pension systems

Gaël Dupont, in his contribution to the present Issue, discusses the reasons for the reforms of the pension systems and describes the early years of functioning of the newly established systems. Dupont stresses the costs of transition from the pay-as-you-go (PAYG) system to the three-pillar system adopted by most CEECs. The latter system, which incorporates a PAYG tier, a compulsory pension funds and a voluntary pension funds, has had fiscal consequences. Because a part of social contributions has had to be redirected from Social Security to the private pension funds, public balance could not be reached unless taxes were raised and/or public expenditures were reduced. The examples of Hungary and Poland are worth mentioning. In both countries, Dupont argues that the number of people who joined the partially private system exceeded governments' expectations and thus led to higher transition costs than initially thought. In Poland, these costs were only partially met by privatisation, hence higher public borrowing. In Hungary, past accrued rights were cut back and the private pension tier has been phased in gradually in order to smooth the rise in the public deficit.

Rather similarly to Cazes and Nesporova's introductive description of the move from a centrally-planned to a market economy on the labour markets, Dupont shows that the shift from the public pension system to a partly private one has been welcome by the policy-makers and populations. Concerning pension systems, the gloomy prospects of the old systems largely facilitated the transition to a pension funds system: shrinking fertility rates, the anticipated dramatic rise in the share of people over sixty, the very low pre-reform level of pensions and the small incentives to be hired in "risky occupations"[3] went on to boost support for the reforms.

Another appealing aspect in Dupont's contribution is his nice argumentation on the fact that pension reforms have helped to urge a shift from moonlighting to declared and eventually more productive activities. Because pensions are depending on contributions paid or declared earnings, employees now face incentives to officially declare their jobs and jobs' earnings. This may partly participate in the increase in productivity which Cazes and Nesporova consider as a major challenge for the new accession countries.

Finally, Dupont concludes in favour of a balance between, on the one hand, a high rise in contribution rates, to compensate for the transition costs to a private pension system and for the gloomy demographic prospects in the CEECs and, on the other hand, a huge decline in the relative purchasing power of pensions. Such a balance would be attainable more easily the higher employment in the CEECs, he finally notes.

Exchange rate policies

Among the new accession countries, the largest ones– the Czech Republic, Hungary and Poland– have moved recently towards more or less flexible exchange-rate regimes. The entry into ERM II may thus be expected to have substantial consequences on the stance of their economic policies. ERM II may also impinge on their economic growth and inflation path. In their contribution to the present Issue, Jérôme Creel and Sandrine Levasseur propose an assessment of the most likely effects of adopting a relatively fixed-exchange-rate regime in the three above-mentioned countries. Their most significant result points out the specificities of the policy mix in Poland in comparison with that in the other two countries. Creel and Levasseur thus conclude that Poland may suffer more from entering ERM II than the Czech Republic and Hungary.

In a first step, they review the monetary and fiscal policies implemented in the three countries. They argue that capital inflows within formerly fixed exchange rate regimes– which led to real exchange-rate

3. The highest pensions were generally attached to occupational schemes but, Dupont argues, they were not directed to the most productive or the most innovative occupations.

appreciations, to a loss of competitiveness and to a worsening of the current account– might explain the shift to a more flexible exchange rate regime.

In a second step, Creel and Levasseur notably perform a multivariate structural VAR analysis, incorporating the consumer price index (CPI), the real effective exchange rate, industrial production and the nominal short-term interest rate. Within this framework, they are able to distinguish the responses of these key variables to supply shocks, nominal demand shocks, real demand shocks and financial shocks. Large and eventually persistent real exchange rate variations after a shock can thus be evaluated, as are the consequences of fiscal shocks on the CPI, the exchange rate and industrial production.

Impulse response functions show a very high degree of flexibility in the CPI, which reveals the lower importance of administered prices in the Czech Republic and Poland, and the substantial progress made by the three economies towards a market economy. Creel and Levasseur argue that high price flexibility, though a rather new phenomenon, surely puts these three countries in line with the EU-15. Hence, the *real* transmission mechanisms of monetary policy in these countries seem close to the EU standards.

Creel and Levasseur's results also show intriguing responses of the CPI to a supply shock. Their evidence suggests that the Balassa-Samuelson effect should not be overstated and that uncontrolled wage-price spirals may be responsible for inflation trends and for real appreciations. Adopting a fixed exchange-rate regime, like the ERM II, should necessitate that real wage hikes be brought to an end, otherwise competitiveness will be largely impaired, Creel and Levasseur argue.

Finally, and in contrast to the Czech Republic and Hungary, nominal shocks in Poland appear to have a strong and persistent effect on the real effective exchange rate. Creel and Levasseur thus conclude that adopting a firmly fixed exchange-rate regime in Poland seems rather problematic. They also claim that the use of fiscal policy in Poland would be fettered by the dispositions of the SGP: their evidence shows that the impact of a fiscal shock on industrial production is substantial, though it vanishes rather rapidly.

Euroisation

Sandrine Levasseur, in her contribution, reconsiders the issue of unilateral euroisation (i.e. the unilateral adoption of the euro as legal tender) for the accession countries. This issue gained some momentum in these countries on the eve of the new millennium but finally ebbed following the very negative reaction of the EU officials.

Levasseur argues that one may potentially assist to a renewal of debates on unilateral euroisation in the near future because the political and economic context has now radically changed from that prevailing in the late nineties. Indeed, at that time, introducing the euro against the will of EU officials would have probably deteriorated the prospects of a quick EU accession. And, anyway, the CEECs were kindly converging towards the Maastricht criteria which pave the way towards EMU. Consequently, the political costs of unilateral euroisation were probably prohibitive whereas the net economic gains were perceived as too small or uncertain. Since then, changes have been twofold. First, eight of CEECs candidates are now full members of EU. Second, some of them exhibit a halt in their nominal convergence process towards Maastricht criteria that may delay their entry in EMU. Consequently, the balance between economic gains and costs of a unilateral euroisation has evolved for CEECs while the credibility of (implicit) sanctions by EU officials against a euroising country has become low, even null. Indeed, due to the increasing economic and financial links between the new and old member states, no credible threat (that is a threat which, if carried out, would harm the euroising country but would not hurt the Euro area) can be reasonably defined.

Given this new risk of unilateral euroisation, Levasseur considers that either a consensual euroisation or, at least, a softening in nominal convergence criteria would be a better option from the viewpoint of both new and old member states. In her view, a consensual euroisation (i.e. in accordance with the EU officials) would present the main advantage of keeping the early introduction of the euro within a controlled and structured process, which would reassure financial markets. Indeed, the most uncertain gain related to unilateral euroisation concerns its impact on interest rate. If the removal in the exchange rate risk premium (against the euro) is over-compensated by an increase in the perceived default risk (due to the loss of lender of last resort or, of independent monetary policies), only the costs of euroisation would be basically materialised, mainly the one-time cost of seigniorage income. A consensual euroisation then would increase the success of an early introduction of the euro, even outside the Treaty. Levasseur finally points that, somewhat ironically, such a well-guided euroisation would permit to reach more easily the Maastricht criteria. Hence, a consensual euroisation should permit euroising countries to join EMU and its institutions (including the participation in ECB monetary policy decisions) only when the Maastricht criteria are fulfilled. In that case, euroisation would be consistent with the sequencing and economic rationale underlined in EU treaties to enter EMU: a sustainable nominal convergence should be reached prior to entering EMU institutions.

Turkey

Fiscal issues are prominent for emerging economies. Though the CEECs cannot be labelled "emerging economies", some EU candidate countries can: Turkey is one example. The Turkish transition towards the EU Copenhagen criteria has been slowed down by major currency crises and in 2001, the exchange-rate anchor *vis-à-vis* the US dollar and the euro had to be abandoned for a flexible exchange-rate regime.

In their contribution to the present Issue, Jérôme Creel and Günes Kamber investigate the relationship between fiscal policy, inflation and the 2001 crisis, whose roots are to be found in currency turmoil and banking weaknesses. The huge fiscal cost associated with this recent crisis is understood to have modified fiscal policy at that time and given rise to a deliberate policy of inflating and depreciating the currency in order to provoke a debt deflation– a debt relief to cover the fiscal costs. This economic policy was in sharp contrast with the restrictive fiscal policy and the attachment to a nominal anchor which had been implemented since 1999. Creel and Kamber argue that this shift in the behaviour of fiscal authorities may have had some roots in the Fiscal theory of the price level (hereafter FTPL).

They perform a bivariate VAR incorporating the primary budget surplus and public liabilities and focus on the response of the latter to a shock on the former. Two outcomes are possible: if a positive shock induces a reduction in public liabilities, the fiscal policy is said to be non-inflationary; otherwise, the FTPL interpretation of the data is reliable.

Creel and Kamber's results are mixed. On the entire available sample, a surplus shock provokes a significant positive impact on public liabilities. Fiscal policy, they conclude, is able to drive prices up in order to reduce the real value of public debt. However, excluding the most recent years from their initial sample, hence scrapping the crisis' year, the surplus shock no longer has a positive impact on debt. Creel and Kamber therefore argue that the recent Turkish public management of the banking crisis can be considered as an "exceptional circumstance". The policy implications are as follows: without a substantial improvement in the management of banks, a dramatic economic episode like the 2001 crisis could again occur and the Turkish disinflation efforts could be wasted and lost for a long period. Hence, restructuring the banking sector is a crucial challenge for Turkey. Although market regulations and institutions have improved, financial sector surveillance has been strengthened and FDI legislation have been modernised, the privatisation of state-owned banks should be accelerated. Finally, Creel and Kamber conclude that convergence of Turkey towards the EU standards in terms of financial regulation seems a reasonable condition in order to avoid definitely long years of high deficits and inflation.

The European budget

The distinction between economic and political issues is impossible when budgetary decisions are concerned. Let us first mention the recent propositions of the European Commission regarding the European budget. Despite political lobbying by the contributors countries, which had called for a decrease in the overall budget ceiling to its present level (1% of the EU GNI, though the ceiling is 1.24%), the Commission has made propositions that would make the budget tend towards its ceiling. Though the amounts at stake are very limited, notably as regards the new EU enlargement, the Commission's position could be labelled "brave". But the adjective is excessive and possibly misleading. Because in February 2004, Commissioners were close to their office term (a new Commission will be appointed at the end of 2004), very ambitious budgetary perspectives at the EU level could have been expected. A debate would have then arisen between the advocates of two different views regarding economic efficiency: some would have stated that solidarity enhances overall efficiency, whereas some others would have favoured a reduction in the financial costs of the EU policy (structural funds, Common agricultural policy (CAP), etc.) leading to improved economic efficiency.

In his contribution to this special Issue, Jacques Le Cacheux presents and discusses the main proposals that have been put forward during the new round of the negotiations over the next multi-annual financial perspectives for the period 2007-2013. Le Cacheux opposes two logics within the European integration process: first, the accounting logic ('I want my money back'); and, second, the convergence logic. Whereas the former logic strongly disapproves any further increase in the European budget and generally associates solidarity to a resource waste, the latter logic strongly refers to the Fathers of the European Economic Community. Between those two 'extremes', another hybrid logic has emerged and contributes to modifying priorities within the EU budget. This logic is generally labelled the 'Frankfurt-Brussels consensus'. In a recent European report (the so-called 'Sapir Report') which draws extensively on this 'consensus', the authors favour a decentralisation of agricultural expenditures (hence, a re-nationalisation) and a deep restructuring of the EU budget along two main principles: a focus on common goals (in order to get rid of the aforementioned accounting logic) and a budget which would target EU priorities. Among these priorities, reorganising expenditures towards growth and convergence would be prominent. Despite reference to the convergence logic, the authors consider that the EU overall budget should not be raised and they thus still stick to a European-wide accounting logic.

Le Cacheux makes an important contribution in evaluating the track record of major common policies, among which the CAP. Hence, he is able to criticise some of the main conclusions arising from the 'Frankfurt-Brussels consensus'. Although, over the years, the CAP lost its common European objective– the European satisfaction of food needs– food security issues, he argues, are at stake and may still legitimise the recourse to the CAP. Moreover, in the food and beverage industries, the United States implement a very active policy which still need a European counterpart. Le Cacheux then extends the analysis to broader considerations about common policies, like the structural and regional policies, and collective goods for the EU. He finally analyses the pros and cons of various alternative sources of financing for the EU budget, including a European tax.

Fiscal policy

As the CEECs enter the EU, they will have to satisfy the Stability and Growth Pact (SGP hereafter)[4]. Currently, countries like the Czech Republic, Hungary, Poland and Slovakia are still heavily burdened by high budget deficits which will have to be reduced by expenditures cuts and/or higher tax revenues. In his contribution to the present Issue, Fabrizio Coricelli reviews the fundamental differences in the determinants of public deficits between the new accession countries and the average EU-15; he thus highlights that good fiscal rules for the EU-15 are not automatically good rules for the EU-25, keeping in mind that fiscal rules in the EU-15 have even proved inefficient for the EU-15 countries themselves…

According to Coricelli, four substantial differences between the EU-15 and the CEECs should be acknowledged: first, output growth in the CEECs is high and volatile and it can be expected that these two features could well lead to substantial swings in the public deficit to GDP ratios. Consequently, the 3% deficit ceiling may not be sufficient to let automatic stabilisers play fully. Second, within the EU context, the CEECs will apply to the Structural funds, and this will necessitate that a local co-financing be implemented. Third, in their catching up process, the CEECs dramatically need better infrastructures whose financing is expected to come mainly from public institutions. The consequent level of public investment is thus expected to remain higher than in the EU-15. At last, according to Coricelli, the balance between large and small countries as far as the SGP procedures are concerned is expected to keep on being at the advantage of the former ones: relatively small and poor CEE countries may thus only participate in a "second league" within the enlarged EU; knowing this, CEECs may find

4. Only countries in the Euro area can be imposed fines in the case of an excessive deficit. During the first five years of the Euro area, despite excessive deficit procedures, no country has had to pay a financial sanction.

little incentive to curb their fiscal deficits. In fact, this "second league" would already exist: Coricelli notes that EU institutions have had so far a "benign neglect" approach *vis-à-vis* public finances issues related to the CEECs. Quoting Coricelli: "a clear indication that high deficits would not be accepted within the EU fiscal framework, starting from May 2004, would have served as a strong deterrent against loose fiscal policies in CEECs. It is ironic that the paternalistic approach towards acceding countries has contributed to softening the budget constraints for national governments".

To sum up, the first point highlighted by Coricelli assumes that higher fiscal margins for manoeuvre are necessary for the CEECs; the second and third points emphasise the expected future growth in public expenditures in these countries; and the fourth point focuses on the bad enforcement of the current EU fiscal framework. Public deficits in the CEECs are thus intended to grow and this increase is economically largely sensible. Coricelli thus proposes a reform of the SGP in which he promotes an expenditure rule. Instead of planning future public expenditures and deficits *via* projected *real* output growth, Coricelli argues that that they should be planned according to the projected *potential* output growth.

Coricelli shows that the European cyclically-adjusted balances (CAB), computed with projections of *real* output growth, can only be given a very loose interpretation as a discretionary policy. The recent amendments to the SGP proposed by the European Commission are thus at stake: promoting the CAB as a good indicator for the fiscal stance is flawed. In fact, when *real* growth is high, the relative improvement in the CAB cannot be (fully) attributed to discretion, but conversely, when *real* growth is low, the deterioration in the CAB cannot be attributed to discretion: it is therefore very ambiguous to prosecute governments for so-called lax behaviour.

Monetary decision-making in the Euro area

In his contribution to the present Issue, Piotr Stanek suggests an original political economy view on the reforms of the ESCB (European system of central banks). Alongside an '*economic efficiency*' criterion, he also considers the European-wide *political acceptability* and the *perception by the public* as key criteria for judging proposals for reform. Developing his own set of three-stage optimal criteria and his own taxonomy, Stanek evaluates the relevance of the different reform proposals, from status quo to rotation, in the European context. He finally proposes a new reform proposal which suits better the set of optimal criteria.

Stanek recalls that the ECB has proposed a mix of two widely-promoted reforms: rotation and grouping of countries. Rotation means that governors of national central banks participate in votes with a certain frequency and consequently are not allowed to vote during some periods. Representation (or grouping of countries) relies on pooling national central banks in a few constituencies and on allocating a certain number of votes to each group. The ECB's proposal consisted in dividing countries into three groups with weights related to the GDP shares in the Euro area total and to the amount of total assets within each national financial sector. However, no reform should occur before the Euro area exceeds 15 members, and only two groups (rather than three) would be organised so long as current members of the Euro area would be comprised between 16 and 21. In this latter case, Stanek points that the ECB's Governing Council would comprise up to 24 members, which is dramatically excessive and would surely lead to the total paralysis of a key EU institution.

According to Stanek's classification, the ECB reform proposal might be even worse than the status quo: the lack of transparency and precision on the mechanisms defining the rotation scheme, as well as the relative vagueness of the conditions leading to the eventual postponement of the reform, largely hinder its political acceptability and might result in a poor public understanding of the reform.

Stanek proposes instead that monetary decisions be split between two different bodies within the ESCB. Interest-rate setting and exchange-rate policy should be addressed by a Board whose number would be increased from six to nine in order to gain a "larger political representation". Since the Board's members would be appointed by governments' heads, it would be necessary to improve both accountability and transparency through the publications of minutes of the Board's meetings. Finally, the ECB's Governing Council would still be comprised of all national central bankers from the Euro area, plus the Board, and its task would be limited to setting the broad policy guidelines. The Council would also have an advisory power to the Board, so that the Governing Council would retain some control over the new Board. Hence, Stanek stresses the need for centralisation of powers as far as strategic decisions are at stake, but he also points the need for political acceptability: unlike rotation and centralisation, every national central banker would be voting on any non-strategic decision. Though his proposal dramatically depends on the capacity to separate the interest-rate setting from the broad policy guidelines, Stanek puts it right when he emphasises that a prerequisite for an *optimal* enforcement of an *optimal* monetary rule is an *optimal* acceptability of the monetary reform: leave one country aside and you will never gain full support for your actions, though you need it crucially.

International economies

The post-Communist transition of CEECs and their consequent deep trade and financial liberalisation processes have urged fears of a sharp increase in EU-15 firms' relocation towards the CEECs, thanks to a mix of lower wages, relatively highly-skilled workers and lower capital per capita ratios in comparison with the EU-15. Fears also included a capital rush towards the CEECs, where yields on investment should have been higher than in the EU-15, and consequently lower investment in the EU-15 which, in turn, would have led to a decrease in real wages in the EU-15[5]

The question of industrial relocation is at the core of the contribution of Sébastien Dupuch, Hugues Jennequin and El Mouhoub Mouhoud in this Issue, with strong emphasis on the flows of foreign direct investments (FDIs) and on trade specialisation. The three authors insist on two patterns of industrial specialisation whose respective consequences on the EU-15 are very different. First, inter-industry specialisation can be related to the international division of labour: differences in factor endowments drive trade specialisation. Quoting the authors: "this can confine countries whose specialisation is driven by traditional and unskilled labour-intensive industries in a low-development trap." In these countries, FDIs are driven by countries' comparative advantages. In contrast, intra-industry specialisation draws on the quality of the factors involved in the production process: highly-skilled workers coupled with initially well endowed physical capital, transport and telecommunications infrastructures are thus able to attract the whole chain of the production process. Consequently, well-endowed countries do not only produce intermediate goods but also final goods. In these countries, FDIs are driven by the search for higher local market shares.

Dupuch, Jennequin and El Mouhoub Mouhoud consider the theory of the New Economic Geography and argue that a core-periphery equilibrium is expected to occur in the enlarged EU as a result of vertical linkages within industries. Then, they show that the sectoral divergence resulting from agglomeration economies is likely to persist through a high-skilled core attracting increasing intensive activities and a low-skilled periphery. The core would be comprised of Central European countries which would be expected to follow a "Spanish model" based on catching-up industrial diversification and intra-industry trade. Eastern countries, at the periphery, would durably lag behind and would mainly have to compete with Mediterranean countries.

5. A related, more precise, analysis can be found in Fitoussi J.-P. and E.S. Phelps (1990), "Note sur les conséquences globales de la reconstruction de l'Europe de l'Est et l'épargne mondiale", in Fitoussi J.-P. (ed.), *A l'Est, en Europe, des économies en transition*, collection Références, Paris: Presses de la Fondation Nationale des Sciences Politiques.

As far as trade specialisation patterns are concerned, Dupuch, Jennequin and El Mouhoub Mouhoud base their conclusion on two different indices. First, according to the Krugman specialisation index, the trade specialisation of the Czech Republic and Hungary, for instance, is relatively low and similar to that of wide-open European economies like the Netherlands and Sweden. In contrast, trade specialisation of more peripheral CEECs countries like the Baltic States is large and even superior to that of the most peripheral EU-15 countries like Greece, Portugal or Ireland. Second, according to the Finger-Kreinin index, the similarity in export structures is high between Spain and the biggest new accession countries, which indicates some convergence with the "Spanish model". This index also testifies to the high similarity of export structures within the CEECs themselves which leads the authors to the following conclusion: "the main competitors of the candidate countries are still the candidate countries themselves".

Jérôme Creel and Sandrine Levasseur