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CONTENTS

Contents

FOREWORD

Latin American and Caribbean countries are today at an important juncture in their international economic relations. Since the end of the 1980s the countries of the region have been pursuing a process of economic reform and opening that has brought about a radical change in their domestic economies and in their integration into the world economy. Besides having undertaken a unilateral liberalization of their trade and investment inflows, Latin American countries are in the process of deepening economic integration at the subregional level and negotiating trade liberalization agreements at the regional and hemispheric level. Furthermore, they are also negotiating cooperation and trade agreements with other countries and regions of the world – both developing and industrial ones – and are also engaged in the process of multilateral trade negotiations.

These parallel processes on the integration and trade fronts represent enormous challenges for Latin America. And in facing them, the countries of the region are open to ideas, experiences and good practices that may contribute to their successfully meeting these challenges, and for capturing the opportunities that integration into an increasingly open and competitive international economy offers. In this regard, the rich European experience in the process of regional integration over the last decades that has brought about not only mutual trade liberalization, but also the establishment of joint institutions, a common currency as well as political cooperation and a strong component of solidarity among member countries could be of benefit for the region. Moreover, Latin America is an important market for the EU as it positions itself in global competition and seeks partners for global cooperation.

With this in mind, the Inter-American Development Bank, through the Special Office in Europe and the Integration and Regional Programs Department, through the Institute for the Integration of Latin America and the Caribbean (INTAL), has launched the Euro-Latin Study Network on Integration and Trade (ELSNIT). Established jointly with our partners, leading European research centers in the area of integration and trade, the Network represents a platform for an exchange of ideas between European and Latin American experts, and ultimately a source of support for policy makers on both sides of the Atlantic.

This publication represents a synthesis of the findings of the first cycle of activities of the Network during 2003/2004.

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Contents

INTRODUCTION

In October 2002 the Inter-American Development Bank (IDB), through the Special Office in Europe (SOE) and the Integration and Regional Programs Department (INT), through the Institute for the Integration of Latin America and the Caribbean (INTAL) in Buenos Aires and the Integration, Trade and Hemispheric Issues Division launched the Euro-Latin Study Network on Integration and Trade (ELSNIT). This initiative creates in Europe a forum on integration and trade issues relevant to Latin America and the Caribbean. The main objectives of the Network are to generate research, studies and debate on these issues, draw on a rich European experience and increase interaction between European and Latin American researchers.

Latin America, like much of the world has been opening its economies, while simultaneously pursuing regional integration both of the South–South and North–South variety. European perspectives can provide important policy insights on these processes as well as in areas such as trade; the behavior of investment and FDI; macroeconomic coordination, exchange rate management and monetary cooperation; growth and convergence; labor market dynamics; regional institutions and compensatory mechanisms. Moreover, developments in Latin America are important for Europe in the context of global competition and cooperation.

The Euro-Latin Study Network on Integration and Trade has involved the establishment of a Steering Committee that includes leading European research centers on a rotating basis, and the IDB (represented by SOE and INT). In 2003 the Steering Committee incorporated the Institute for World Economics (IfW), Kiel, Germany; the Center for Research in International Economics (CREI), Barcelona, Spain; and the Robert Schuman Centre for Advanced Studies of the European University Institute (RSC), Florence, Italy. In 2004 the Steering Committee was expanded to incorporate the Centre d'Etudes Prospectives et d'Informations Internationales (CEPII), Paris, France.

The first cycle of ELSNIT was launched in January 2003 with a call for papers on three topics: macroeconomic dimensions of regional integration, European Union enlargement and adjustment policies during the transition, and the impact of regional integration on economic convergence and growth. Close to fifty submissions were received, and the Steering Committee selected a total of twelve papers – four on each topic – that were presented at the Annual Conference.[1]

The first Annual Conference of the Network was held in Barcelona in November 2003. The event was hosted by the Center for Research in International Economics (CREI), under the sponsorship of and in coorganization with the IDB. The conference was organized in three sessions, corresponding to the three topics in the call for papers, and chaired respectively by the representatives of the research centers members of the Steering Committee. Each paper was commented on by an organized discussant from Latin America.

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[1] The papers presented at the first Annual Conference, as well as the discussants' comments, can be viewed at the Network's webpage *at* www.iadb.org/europe or http://www.iadb.org/intal/foros/foro23_2003.htm.

The findings of the conference, together with policy indications for Latin America and future research agenda proposals, were discussed at a follow-up seminar in April 2004 in Buenos Aires.

The coordinators of the sessions of the Annual Conference each prepared an issue paper for this occasion. Some of the main points raised in these papers, and in the comments of Latin American experts, are presented below.

The topic of the First Session of the Annual Conference covered macroeconomic dimensions of regional integration; Jaume Ventura of CREI and Pompeu Fabra University coordinated it. Four papers were presented at this session (see agenda in Appendix) focusing on two basic issues: the role of constraints on fiscal policies, and the effects of nominal devaluations. These issues, as discussed in the papers and during the conference are reviewed by Ventura (First Session in this publication). He also analyzes them from a broader point of view, in the context of the process of integration in Europe, and looks at their relevance for Latin America.

The process of establishing the Economic and Monetary Union in Europe, leading to the introduction of the euro as a common currency, was accompanied by the adoption of the Stability and Growth Pact. This agreement imposed a three percent limit on the budget deficits of the European Union member countries. Ventura discusses the rationale behind this decision, looking into how economic integration affects the desirability and feasibility of budget limits. His first observation is that economic integration can make the problem of "bad" fiscal policy worse. In conditions of a high degree of integration, these costs – manifested in higher interest rates, lower investment and growth, and increased aggregate volatility – can in part be shifted abroad. In this regard, economic integration raises the temptation for implementing "bad" fiscal policies, at the expense of other countries. By adopting "good" policies all sides could benefit from cooperation, but provided other countries reciprocate. This explains why an agreement might be needed to adopt budget limits. A substantial degree of economic integration is necessary for an agreement to be successful, as countries stand to gain more from cooperation. Such an agreement can also increase the government's ability to commit to budget limits.

Nominal devaluations have different effects in industrial countries, where they have an expansionary effect on exports, investment and economic growth (evidence in devaluations in Italy and Spain in the European Exchange Rate Mechanism), and in emerging countries, where they are contractionary, raising interest rates and leading to a fall in investment and growth (e.g. the Mexican crisis in 1994). Nominal exchange rates affect the economy through nominal rigidities or balance-sheet effects. Ventura discusses these two effects presented in two papers at the conference, on one side related to monetary expansion with nominal rigidities in the presence of trade costs and agglomeration effects, and on the other to an empirical investigation of the importance of balance-sheet effects for a country's risk premium.

José María Fanelli (CEDES, Buenos Aires) in his comments on the Ventura paper notes that the empirical findings of the paper are highly relevant for Latin America, but that – when studying South-South integration processes – two additional issues need to be included in the analysis: the role of risk and uncertainty, and the structural features of developing countries, which differentiate these regional initiatives from the European and North-North integration processes. He focuses on cyclical fluctuations to illustrate the problems facing Latin America, and more specifically MERCOSUR, noting the presence of volatility, financial imperfections, regional

cycle comovement, and of idiosyncratic cycles (in Europe the common cycle is more important). With the further problem of monetary credibility, a key question is determining the best exchange rate regime for a country participating in a regional agreement, as well as whether coordination increases the policymakers' number of tools to reduce macroeconomic fluctuations. An additional issue would be whether setting the rules at the regional level represents an opportunity to make policy commitments more credible.

The second topic discussed at the Barcelona conference dealt with European Union (EU) enlargement and adjustment policies during transition (session coordinated by Rolf Langhammer of the Kiel Institute for World Economics). The analysis of these policies that new members must undertake as they join the EU could provide relevant experiences and lessons for the process of economic integration involving developing countries, including Latin America, in particular in the context of North-South schemes.

The papers selected on this topic – see agenda in Appendix – covered two basic issues: first, locational aspects of integration, focusing on the areas of migration, foreign direct investment (FDI) and geographical concentration, and second, monetary integration, analyzing the interaction between exchange rate volatility and employment growth in transition towards monetary union. A detailed overview of the issues raised, and their analysis, are presented by Rolf Langhammer and Rainer Schweickert (Third Session of this publication).

We will point out here some of the salient points raised in the papers and discussion. The migration of workers has been traditionally low within the EU (due to rigid labor markets, strong social and cultural ties to local environment, generous welfare provisions etc.). Given the very high wage differential between new members from central European countries and the EU, the incentive for migration will be high; nevertheless, most analyses do not point to a massive flow taking place. Nevertheless, cross-border mobility could well increase, and the services sector could be most affected. Economic integration has brought about a strong increase in intra-EU trade, and in this regard free trade and the lowering of trade costs are seen as weakening, to an important degree, the demand for migration in the EU. A further factor seen as weakening migration is greenfield FDI and the relocation of production supported by FDI.

Market size and labor costs are an important factor in the attraction of FDI in the accession countries. These countries tend to specialize in labor and resource intensive sectors; an intensification of outward processing activities has also taken place, contributing to an important increase in exports to existing EU members. A parallel could be drawn here with Latin America, particularly Mexico, where in the context of NAFTA export-oriented production activities are concentrating in the border areas with the United States. A similar concentration can be seen in the EU-neighboring countries as the Czech Republic, Slovakia, and Hungary.

The reduction in exchange rate variability (volatility) and the process of euroization are seen as having a small but positive impact on employment growth in the central and eastern countries. In general, the potential beneficial effects of the creation of a currency union – not only through trade but also through stabilization and credibility gains – are corroborated by other studies, and have also been noted above in relation to the macroeconomic dimensions of integration.

A question that Langhammer and Schweickert raise in conclusion relates to what emerging countries - including Latin America - can do to avoid loss of high-skilled labor by attracting FDI that will provide job opportunities either directly or indirectly by supporting technological progress. FDI motivated by market access and low labor costs may provide opportunities for unskilled labor but may not prevent high-skill labor from migrating. Future research should focus more on the integration of factor markets and the relationship between factor flows, particularly between FDI and migration.

In the monetary area, two points of interest for future research, of relevance both for Latin America and the accession countries, emerge: the impact of macroeconomic stability on factor market integration, and monetary management in flexible exchange rate regimes (transition to EMU in the case of the eastern European countries). An additional research area that Langhammer and Schweickert bring up is that of institution building (both formal and informal). Institution building needs to be looked at from both the national and regional perspectives, and as regards the latter in the context of shallow or deep integration schemes. And finally, third country effects of EU enlargement – a topic that was included in the call for papers, but for which no submissions were received – would also need to be the subject of future research.

In commenting on the relevance of these issues for Latin America, Pablo Sanguinetti (Torcuato Di Tella University, Buenos Aires) notes that in the case of migration, North-South regional integration agreements negotiated in the region (such as NAFTA) do not foresee the integration of labor markets. The existing – and high – level of migration in first place to the United States, due to very large differences in wages and job opportunities, is mostly illegal (and relating to unskilled labor). In this respect, a key question that is raised is whether N-S agreements can create the conditions for income convergence and thus contribute to the reduction in the outflow of both unskilled and skilled labor. Again looking at NAFTA, evidence points out to a convergence in the level of wages, but only in the Mexican area bordering the United States, and not at the national level. This convergence is associated with the high level of FDI in production facilities across the border. Further evidence suggests that N-S, and to a certain extent also S-S regional integration agreements, can be very important for expanding foreign investment. FDI is thus seen as an instrument that can foster income convergence and reduce migration flows. The question is what kind of FDI – vertical or horizontal - and what kind of spillover effects the flows have on the host economy.

The third topic discussed at the Barcelona conference covered the impact of regional integration on economic convergence and growth (session coordinated by Omar Licandro of the European University Institute). Three themes were specified in the call for papers – the role of institutions, the role of adoption and diffusion of new technologies, and issues related to economic geography and the role of economic integration for development strategies. The four papers presented at this session – see agenda in Appendix – covered the impact of protection of intellectual property rights in conditions of trade openness, the political economy of voters' decisions to opt for integration in view of the welfare effects of integration, regional convergence in the cases of MERCOSUR and NAFTA, and the agglomeration aspect of economic geography. The papers and the comments on the papers are reviewed in the Second Session of this publication.

In his overview of the issues raised by the papers and the discussion at the conference, Licandro notes that there is evidence of a significant correlation between growth and trade, openness, quality of institutions, and geography. While the establishment of causal relationships is still

subject to debate, it is important to understand what relevant conditions lead to the pursuit of a successful growth strategy in some regional integration agreements, and in some not. This issue has great relevance for Latin America as well. In the case of the European Union, its success – as well as benefits for acceding South or East countries – are based on trade creation and microeconomic integration, the existence of efficient and stable common institutions, and on regional redistributive policies. Furthermore, entry into the EU gives the governments of acceding countries the possibility of undertaking vast reforms without facing important political or social resistance (acceptance of the *aquis communautaires*).

A key consequence of regional integration is that economic activities go across national borders and are reorganized. The process of microeconomic integration, as in the case of the EU, is based on a simultaneous process of agglomeration and decentralization of sectorial activities with an important increase in both intersectorial and intrasectorial trade. In this context, economic geography is an important instrument that can help – with free movement of goods, labor and capital – to better understand the locational decisions of firms (including FDI). And understanding the factors that lead to the agglomeration and dispersion of economic activities can also help design policies to address undesirable side effects of agglomeration and dispersion, or represent a basis for carrying out redistributive policies (such as in the case of the structural and cohesion funds of the EU).

Looking at possible lessons for Latin America, which has been carrying out orthodox reforms and policies over a long period, but with largely unsatisfactory economic benefits, a major question – and challenge for future research – as posed by Licandro is whether regional integration could represent a growth strategy for the region (or a subregion such as the MERCOSUR). This immediately brings to the fore the discussion of the presence of adequate political commitment (equivalent to the Franco-German axis) and common institutions (as the European Commission) that would promote and protect the process of integration in the face of inevitable frictions. And it also raises the issue of monetary union (as compared to EMU in the EU), the credibility of monetary and fiscal discipline and the feasibility of setting up redistributive mechanisms across countries and regions.

Federico Sturzenegger (Torcuato Di Tella University, Buenos Aires) in his comments on Licandro's paper brings forward the dilemma whether increased trade in an integration grouping, such as the EU, stems from a common currency in association with credible institutions linked to political integration, or rather from the relevance of the reduction in transaction costs. A key aspect of the European experience has been its provision of an anchor for expectations on macroeconomic variables and institutional reform for the accession countries. He believes this structure could be emulated in the context of the FTAA with larger concessions from the rich countries in the north as the rest of Latin American countries achieve certain standards in macroeconomic stability and institutional reform. This raises the issue of the political economy of integration. Whereas in Europe this crucial role was taken up by Germany (as a capital abundant and stable country manifesting solidarity towards other members), he does not see a similar interest on the side of the United States. In this context, Latin American countries face the dilemma of how to build a growth strategy and to determine what should be the role of regional integration in such a strategy. He advocates a continuous pursuit of the FTAA, pointing out that the process of integration in Europe needed a number of years to reach significant results, and that a similar process is not unthinkable in the Americas.

Contents

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FIRST SESSION: MACROECONOMIC DIMENSIONS OF REGIONAL INTEGRATION

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MACROECONOMIC DIMENSIONS OF REGIONAL INTEGRATION

Jaume Ventura*

I. INTRODUCTION

The First Annual Conference of the Euro-Latin Study Network on Integration and Trade (ELSNIT) took place at the *Centre de Recerca en Economia Internacional* (CREI) located in the campus of Universitat Pompeu Fabra, Barcelona, on November 6-7 of 2003. The first session was entitled "Macroeconomic Dimensions of Regional Integration," and analyzed the effects of economic integration on the conduct of fiscal and monetary policies. The goal of this paper is to provide a structured overview of the main issues that were raised in this session, and also some others that were not discussed for a lack of time. I have organized the presentation around the two main topics of the session: (i) the role of constraints on fiscal policies; and (ii) the effects of nominal devaluations.[1]

As is well known, constraints on fiscal policy have played a central role in the European Union starting with the Maastricht criteria and the subsequent signing of the Stability and Growth Pact (SGP) imposing a three percent limit on the budget deficits of member countries. Interestingly, the need for such constraints in Europe has not been perceived as arising from increased trade and factor mobility. Instead, the SGP has been justified as a necessary pre-condition for a successful monetary union.[2] Since this is less than an obvious proposition, the SGP has become the subject of hot debate within Europe. The conference reflected this and included a lively discussion on the need and effects of the SGP. In particular, we concentrated on the following questions: What is the rationale for imposing a binding legal limit on the budget deficit? What is the empirical evidence on the effects of such limits? How does economic integration affect the desirability and feasibility of budget limits? How is it possible to create political support for budget limits? Throughout the session, the focus was not only on the European experience *per se*, but also on how one would draw lessons that could be useful to guide the process of economic integration in Latin America.

In industrial countries, nominal devaluations tend to increase exports, investment and economic growth. For instance, the 1992 ERM crises generated an expansion in economic activity in those countries that devalued their currency, i.e. Italy, Spain and the United Kingdom. In emerging markets however, devaluations tend to choke credit and raise interest rates leading to a collapse in investment and growth. The Mexican crises of 1994 and the East Asian crises of 1997 are canonical examples of this. This discrepancy between the effects of nominal devaluations in

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1 The Appendix contains the agenda with the program of this session. This presentation was prepared for the Euro-Latin Forum of IDB-INTAL that took place in Buenos Aires on April 27-28, 2004.

2 At least, this is the point of view adopted by official documents. Even the European Central Bank discussion of its monetary policy in its monthly bulletin, includes always a section on fiscal developments and the application of the SGP.

industrial countries and emerging markets has naturally drawn the attention of academic economists and policymakers alike. The Barcelona conference devoted a fair amount of time to this important issue. In particular, the session focused on the following questions: What is the role of nominal rigidities in determining the effects of nominal devaluations? What is the role of balance-sheet effects? How do these effects vary across countries? Can we identify these effects empirically? How does economic integration influence the effects of nominal devaluations on investment and economic growth? Since this topic is much wider than the previous one, the discussion necessarily had to focus on some specific or narrow aspects of the answers to these questions. I shall try here to place this discussion in a broader context.

In the presentation that follows, more space is devoted to the first topic than the second one. In part, this choice reflects that the discussion of fiscal policy constraints was broader and less technical than the discussion of the effects of nominal devaluations. In part, this choice also reflects my own preferences.

II. THE ROLE OF CONSTRAINTS ON FISCAL POLICY

It is somewhat of a paradox that European policymakers have justified the introduction of legal limits on the budget deficit as a necessary pre-condition for a successful monetary integration. At first sight, this seems to go against some long-standing views about the connection between fiscal policy and stable currencies. These views, based on robust theoretical analysis and numerous country experiences, suggest that the adoption of a single currency in Europe not only weakens the case for restricting national fiscal policies but also strengthens the case for making them more flexible.

The view that restricting fiscal policy is a pre-condition for a stable currency rests on the need to free the central bank from the pressure to finance budget deficits. This need is most acute in situations where the central bank is dependent on the government, and the latter gives precedence to the fiscal authority over the monetary authority. Not surprisingly, there is substantial evidence showing that countries that grant a large degree of independence to their central banks tend to have more stable currencies (Alesina and Summers [1993], and Cukierman, Webb and Neyapti [1992]). It is therefore surprising that European countries did not adopt budget limits when they had domestic central banks and many currencies, but instead have decided to adopt them once there is a supranational central bank and a single currency. The European Central Bank has more independence from national governments than any of the national central banks had before the creation of EMU. In fact, the European Central Bank has neither the obligation nor the possibility of financing the budget deficit of any of the member countries. Based on this observation, one would have expected that the move from national (and more dependent) central banks to a supranational (and more independent) central bank would have lowered the need or value of instituting budget limits.

The standard case for having a flexible fiscal policy arises from the need to stabilize the economy in the face of macroeconomic shocks. To the extent that budget deficits create a positive wealth effect they help alleviate the costs of recessions. These deficits need not lead to excessive debt, if they are financed by budget surpluses during booms. In this way, fiscal policy plays a useful stabilization role that lowers aggregate volatility and can be understood as providing some insurance against aggregate shocks. Typically, this stabilizing role of fiscal policy is complemented with an active role for monetary policy. After all, easing credit and lowering interest rates is another way to help alleviate the costs of recessions and reduce aggregate volatility. But monetary integration precisely forces countries to give up their independent monetary policies and therefore eliminates an important tool for stabilization policy. Therefore, in a monetary union the value of a flexible fiscal policy increases. This has been long recognized in the theory of optimum currency areas. It is therefore surprising that European countries choose to impose budget limits just at the same time in which they are giving up their monetary policies and the importance of having a flexible fiscal policy is higher than ever before.

Despite these classic arguments, European policymakers conceived the SGP as an integral component of EMU. This raises some questions: Why does economic integration (and, more precisely, monetary integration) raise the need for fiscal policy constraints? Or, perhaps, could it be instead that economic integration creates the conditions under which these constraints (which were always needed) can be adopted? The Barcelona conference included two papers on these issues. The Fatás-Mihov paper discusses the motivations for imposing budget limits and presents some evidence of their empirical effects. The Niepelt paper analyzes how to create political

support for budget limits. These papers sparked a lively discussion on the need for budget limits and the connection between budget limits and economic integration.

A. The Case for Budget Limits

As the Fatás-Mihov paper emphasized, the arguments for establishing legal limits to budget deficits are based on the idea that governments have temptations to adopt "bad" fiscal policies. By this, it is meant that political systems have built-in biases that create excessive deficits, too volatile and too pro-cyclical fiscal policies. Most observers will agree that there is substantial evidence of fiscal mismanagement of this sort in Europe and, to perhaps even a greater extent, in Latin America. In principle, budget limits could act as a restraint that either reduces government temptations to implement "bad" fiscal policy or impedes governments to act on them.

Excessive deficits are the natural result of a power asymmetry that is embedded in all political systems. Governments decide public spending and how to finance it. At the same time, governments need the support and votes of their constituencies which value spending but dislike paying taxes. Governments have an incentive to cater to the preferences of current taxpayers, which form their constituencies. Budget deficits shift the tax burden from current to future taxpayers, and allow governments to provide their constituencies with higher spending and lower taxes. To the extent that current taxpayers are selfish and value more their welfare than that of future taxpayers, the political system creates a bias towards excessive deficits and debt accumulation. High levels of debt are translated into high interest rates, depressed investment and low rates of economic growth. The size and importance of this bias towards excessive deficits depends on the nature of the political process, demographic factors and other (Tabellini and Alesina [1990]).

Excessive deficits also result from an asymmetry in the incentives for fiscal adjustment after positive and negative shocks. Changes in the terms of trade, fluctuations in production, natural disasters and discoveries, and many other events or shocks create the need for changes in public spending and its financing. When the shock is positive, increased spending or lower taxation occurs immediately as the loosening the government’s budget constraint reduces conflict among different groups whose objectives might no longer be incompatible. When the shock is negative, it increases conflict as different groups scramble to ensure that the reduction in public spending does not fall on those items they value most or the increase in taxation does not affect them too much. Typically, this sets up a "war of attrition" among different groups as it takes time to reach consensus. Throughout this period of uncertainty and paralysis, budget deficits are kept high and debt is piling up. This asymmetry between the reaction to positive and negative shocks also creates a bias towards excessive deficits and debt, and its importance depends on the degree of conflict in society and the size and number of shocks the economy receives (Alesina and Drazen [1991]).

Another problem with unconstrained fiscal policy is that it might be too volatile as it responds to changes in the interests of the group or party in power. To the extent that spending helps governments to be re-elected, fiscal policy will tend to be expansive around election time. That is, fiscal policy will be opportunistic and cyclical. To the extent that different governments care about different spending items, incumbent governments will tend to spend too much on those items they prefer in anticipation of lower spending on them by future governments. That is, fiscal policy will be partisan and also cyclical (Persson and Svensson [1989], Rogoff [1990] and Alesina and Roubini [1990]). These opportunistic and partisan cycles in spending do not have to lead to excessive deficits and debt on average. But they not only reduce the power of fiscal policy as a stabilization tool, but might also convert it into an independent source of additional and

unnecessary aggregate volatility in the economy. The negative effects of this increased volatility are compounded or multiplied if financial markets are not well developed. In this case, excess aggregate risk generates excess individual risk that might be orders of larger magnitude.

Fiscal policy can also add to the economy's volatility by magnifying or exacerbating the effects of shocks to the economy. In fact, there is some evidence that fiscal policy might actually be pro-cyclical as a result of a tendency to overspend during booms (Lane [2002]). One reason for this tendency could be excess optimism (or overreaction) during booms and excess pessimism (or under reaction) during recessions. It is often argued that investors tend to overreact to news, and this seems to apply as well to policymakers. Another reason for a tendency to over-spend in booms could be the failure of the political system to control spending during periods of economic bonanza. There are some well-known arguments suggesting that the quality of governance and the transparency of policy decline when resources are plentiful, and this could easily be translated into overspending and waste (Lane and Tornell [1999]).

The argument that there exist biases in fiscal policy that generate excessive deficits and too volatile and pro-cyclical fiscal policies is not only convincing from a theoretical standpoint. There is substantial anecdotal and systematic evidence that suggests the empirical relevance of these biases in real economies. Recognizing this however is not enough to conclude that governments should adopt budget limits. To do this, one must take a couple of extra steps.

The first one is to establish that budget limits can actually help to eliminate these fiscal policy biases. There is some evidence suggesting that budget limits are, in fact, associated with "good" fiscal policies. This evidence uses international and national datasets.[3] There is however an important issue that affects any inference on this issue, namely, how can we disentangle cause and effect. Are budget limits "endogenous", i.e. just a manifestation of the government willingness to be fiscally responsible? Or are budget limits "exogenous", i.e. they are capable of imposing fiscal discipline to governments that otherwise would be fiscally irresponsible? Despite the inherent difficulty of answering these questions, it is fair to say that the SGP has created an environment of increased fiscal discipline.[4]

The second step is to determine that there are no other policy corrections that are superior. Establishing a numerical limit on the budget deficit is certainly a blunt instrument, and it is hard to think of a formal model that will deliver it as the optimal unconstrained policy. Surely, a more flexible constraint on fiscal policy could also eliminate or mitigate the biases while still allowing fiscal policy to play an important role as a stabilization policy. In fact, the recent tendency to re-interpret the SGP in a less strict way should be interpreted from this perspective. But at the same time, it is notorious that formal models are not very satisfactory in the way they treat complexity. The agents in our models tend to have unrealistically large information sets and computing power. In a more realistic world in which agents have difficulties coping with complexity, simple rules have a renewed appeal and might sometimes be preferred over complex rules that work in theory but less so in practice. One could certainly use this argument in favor of adopting simple rules such as a numerical limit on the budget deficit.

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[3] See Fatás and Mihov [forthcoming, 2004].

[4] The recent controversy about the violation of the SGP by France and Germany suggests caution on this point, however.

B. Economic Integration and Budget Limits

Even if one finds the case for budget limits convincing, it is not clear why countries need to sign a treaty to implement them. After all, countries are free to impose budget limits any time they want. Why is it that European countries did not implement these limits unilaterally? Even if there is a reason to implement these limits simultaneously, there is still the issue of timing. Why did European countries waited until the Single Market was in place to agree on budget limits rather than do it earlier instead? To answer these questions, we need to build connections between fiscal policy biases and economic integration.

The first observation is that economic integration makes the problem of "bad" fiscal policy worse. As discussed above, biases in fiscal policies result from the desire of different groups to benefit from higher public spending and lower taxes. The private benefits of this re-distribution are weighted against the costs it imposes. These costs consist of high interest rates, low investment and growth, and increased aggregate volatility. When there is a low degree of economic integration, these costs are born mostly by the residents of the country. The latter include those groups that are in a position to influence fiscal policy and benefit from this. Knowing this, the costs associated with "bad" fiscal policies are partly internalized by the government, and this leads to a certain degree of self-discipline or moderation.

When the degree of economic integration is high, the costs of "bad" policies are in part shifted abroad. Consider first the argument that excessive deficits and debt accumulation leads to high interest rates. In the open economy, this effect is smaller as it is spread around a broader economic area. But it also affects more people, since both domestic and foreign residents suffer from the increased interest rates. The same applies to the argument that "bad" fiscal policy creates volatility or magnifies it. Through interactions in goods and asset markets, this increased volatility is also exported abroad. For these and other reasons, foreign countries now bear part of the costs of "bad" fiscal policy. But the private benefits from "bad" economic policies still remain at home, and in the hands of the same groups as before. A consequence of this is that economic integration shifts the trade-off between the benefits and costs of "bad" fiscal policies shifts, raising the temptations for "bad" fiscal policies. A corollary to this result is that economic integration raises the potential benefits of adopting budget limits. This might be the reason why European countries did not feel the need to adopt these limits until the degree of economic integration was high enough.

The second observation is that economic integration also changes the nature of the fiscal policy problem into a "prisoner's dilemma" type of situation.[5] All groups within the home country would unanimously vote for foreign countries to adopt "good" fiscal policies. This would ensure a world environment with low interests rates, high growth and low volatility. But, holding constant the fiscal policies of other countries, those groups that are in a position of power within a country prefer to distort the country's fiscal policy to their advantage. In such a situation, no country has the incentive to unilaterally adopt budget limits. In other words, the optimal outcome is one in which all countries cooperate and adopt "good" fiscal policies and yet the best response of each individual country is to adopt a "bad" fiscal policy. This means that there exist now gains from cooperation, since countries might be willing to adopt "good" fiscal policies if foreign countries reciprocate. And this explains why an international agreement might be needed to adopt budget limits.

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[5] The situation is analogous to that faced in trade negotiations. See Bagwell and Staiger [2002].

This change in the nature of the problem could also explain why Europeans did not reach an agreement on budget limits before economic integration was high. There was nothing to trade or bargain about. In the open economy, the domestic groups that distort domestic fiscal policy are trading improvements in fiscal policy with foreign groups that distort foreign fiscal policy. In the closed economy, the interactions across countries are inexistent and the groups that distort fiscal policy in the different countries have nothing to trade with each other.

A related point is that an international economic integration might increase the government's ability to commit to budget limits.[6] Despite promises to the contrary, governments have always the temptation to succumb to the demands of powerful groups that want more public spending and lower taxes. Without enough government credibility, budget limits are simply not feasible or believable. The key observation here is that economic integration can help provide this credibility to the government. Assume the benefits from international cooperation are conditional on the country fulfilling its international obligation to keep the budget deficit below a certain limit. When the degree of economic integration is low, the benefits from international cooperation are small. As a result, losing these benefits is not very important deterrent and future governments are likely to succumb to the demands of powerful groups that want more public spending and lower taxes. This undermines the credibility of budget limits. However, when the degree of economic integration is high so are the benefits from international cooperation. Losing these benefits might be enough of a deterrent to future governments temptations to violate budget limits. This argument provides an additional reason why an international agreement might be necessary to adopt budget limits. It also explains why a substantial degree of economic integration is necessary for the agreement to be successful.

C. Building Political Support for Budget Limits

Budget limits have been justified as an attempt to limit the extent to which current taxpayers can extract resources from future taxpayers. Since it is current taxpayers that hold political control, it might seem quite difficult to think of a way to convince them not to adopt "bad" policies. We have seen however that, if the degree of economic integration is high, countries might be willing to cooperate and adopt "good" fiscal policies. Therefore, economic integration is one channel through which support for the adoption of budget limits can be created.

But economic integration is not the only way to create support for budget limits. There might also be different groups within the economy, some of which are against budget limits and some of which are in favor of them. Another way to create support for budget limits is therefore to shift the internal balance of power towards those groups that stand to gain the most from budget limits. This shift would complement the effects of economic integration in building support for budget limits, and could provide an alternative but complementary explanation of why European policymakers decided to sign the SGP. The Niepelt paper is devoted to this issue. Its goal is to identify which are the domestic groups that benefit from budget limits and how to gather their support.

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[6] Cole and Kehoe [1997] develop this argument in the context of sovereign debt.

Support for budget limits might arise among groups that expect increased income in the future. These include the young, the inhabitants of regions that grow faster than average, or the workers in industries that are expected to expand. The argument is, in fact, quite simple. Since income taxation is proportional or progressive, these groups are against shifting the tax burden to a future in which their income will be high. If the size or political power of these groups has increased, this could also explain why the support for budget limits increases. Unfortunately, it is not 'a priori' easy to identify in the European political landscape who these groups might be. Empirical work on this topic is possible and would be quite useful.

Support for budget limits can also be found among those that want low public spending. The argument is quite subtle and is based on the notion that restrictions on fiscal policy raise the cost of government revenue. Typically, it is desirable to collect taxes when the marginal cost of raising them is low. Budget limits might preclude this from happening. For instance, they might force governments to raise the tax rate during recessions where it is especially costly to do so. Faced with a higher average cost of revenues, governments might decide to tax and spend less. And this fits the agenda of those that have a low preference for public spending. According to this argument, there might have been a growing support to budget limits that reflects a decreased preference for high public spending. This explanation is consistent with the observed decline in the support for the welfare state in some European countries and social groups.[7]

D. Summary

So what did we learn about the role of fiscal constraints? Despite the official justification of the SGP as a pre-condition for a stable Euro, it is quite difficult to see the theoretical and empirical support for this assertion. This does not mean that the SGP is a bad idea. There exist biases in fiscal policy that lead to excessive deficits and debt, too volatile and pro-cyclical fiscal policies. The budget limits imposed by the SGP could be a useful way to eliminate or reduce these biases. More research is needed however to determine whether this provides enough of a justification for keeping the SGP in its current form.

We also learned that economic integration creates risks and opportunities for the conduct of fiscal policy. The risks are that, without international cooperation, economic integration lead to a decline in the quality of fiscal policy. This is because economic integration allows countries to shift part of the costs of "bad" fiscal policy abroad. The opportunities are that the gains of international cooperation can be sufficient to sustain a cooperative agreement that increases the quality of fiscal policy.

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[7] Although the support for the welfare state in Europe remains much higher than in the United States.

III. THE EFFECTS OF NOMINAL DEVALUATIONS

While nominal devaluations tend to be expansionary in industrial countries, they also tend to be contractionary in emerging markets. This discrepancy in country experiences has led to the use of different models for the analysis of devaluations. The difference in models reflects the view that the channels through which nominal exchange rates affect the economy are different in both sets of countries. In particular, most of the recent literature has focused on two specific channels: nominal rigidities and balance-sheet effects.[8] Since nominal rigidities tend to make devaluations expansionary, it is not surprising that most of the literature that focuses on industrial countries has emphasized the role of these rigidities. Since balance-sheet effects tend to make devaluations contractionary, it is not surprising either that the literature that focuses on emerging markets has placed these effects at center stage.

The Barcelona conference included two papers on this topic, each within one of the two traditions. The Corsetti-Martin-Pesenti paper provides a theoretical analysis of the effects of a monetary expansion with nominal rigidities in the presence of trade costs and agglomeration effects. The Berganza-Chang-García-Herrero paper contains an empirical investigation of the importance of balance-sheet effects on the risk premium that countries face. Next, I provide a brief (and necessarily incomplete) description of the key elements of each exchange rate model, and then place the contributions of these papers and the discussion that took place in the conference within this context.

A. Nominal Rigidities

In the last decade there has been a renaissance of the old Mundell-Fleming style of thinking in international economics. There is a new set of models that emphasize nominal rigidities and the role of the nominal exchange rate, and which are often referred to as the "New Open Economy Macroeconomics" (Obstfeld [2001] and Lane [1999]). These models are based on optimization techniques and are technically as demanding as the standard macroeconomic models that replaced the Mundell-Fleming model three decades ago. Despite this, and a result of their emphasis on nominal rigidities, the new models tend to deliver the same old results and, with a few notable exceptions, they tend to give the same policy prescriptions. A major advantage of the new models though is that they are based on utility maximization. As a result, and unlike the old Mundell-Fleming model, the new models can be used to perform welfare analysis.

The analysis of nominal devaluations that comes out of these models is quite standard, and goes as follows:

i. Nominal devaluations stimulate aggregate demand by lowering wage costs and the prices of domestic goods relative to foreign ones (They might also lower the interest rate, as expectations for further devaluation are reduced).

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[8] Exchange rates affect economic activity through a variety of channels, and the literature is filled with accounts of how a nominal devaluation can affect economic activity. See Krugman and Taylor [1978] for an early paper that focuses on channels that will not be discussed in what follows.

ii. Since the economy is operating below capacity or full employment, an increase in aggregate demand is satisfied with increased production (This increase in production is temporary since eventually nominal rigidities disappear and prices reflect the new exchange rate).

Naturally, in the context of these models the effects of nominal devaluations depend on details of how the wage and price setting decisions are made. As a result, a large amount of recent work has been devoted to measure the extent to which prices are fixed and, if so, in what currency. Somewhat surprisingly, existing evidence tends to show that consumer prices in industrial countries are not affected much by nominal exchange rates. At first sight, this finding might cast doubts on this research programme. But it need not be so. One possibility is that the evidence is not very good. Datasets on price levels have well-known problems of aggregation and comparability, and one might hope that better future datasets will show a stronger reaction of prices to nominal exchange rates.[9]

Another possibility is that even small changes in consumer prices lead to large changes in demand and production. And this is exactly the theme of the Corsetti-Martin-Pesenti paper, which brings themes and results from the work on the "New Economic Geography" to the "New Open Economy Macroeconomics". As is well known, economic geography models emphasize the role of agglomeration effects on the international distribution of economic activity. They typically show that, if the degree of integration is very low or very high, the location of production is quite insensitive to small differences in policies and economic conditions. However, at intermediate levels of economic integration the location of production is very sensitive to small changes in local conditions. This result is used in the Corsetti-Martin-Pesenti paper to show that small nominal devaluations can lead to very large increases in production.[10]

B. Balance-Sheet Effects

The East Asian crisis did not seem like those that come out of the typical crises models that had been used before. In particular, the financial system reaction to the devaluation played a central role that had not been recognized by earlier models. This prompted a number of authors to work on a new set of models that emphasize the dangers of having financial systems with a currency mismatch. The key distinguishing feature is the central role that borrowing or collateral constraints of various sorts play.[11] These models tell a simple story about the effects of a nominal devaluation that goes as follows:

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[9] The recent literature on this topic is huge. See Engel [2003] for a survey.

[10] The paper contains the stronger claim that, a monetary expansion could lead to a nominal appreciation. For this to be possible, a monetary expansion must stimulate demand through a channel other than a reduction in wages and prices. Only then, a monetary expansion could be expansionary in the face of increases in wages and prices. The paper is not very clear on the nature of this alternative channel.

[11] See Céspedes, Chang and Velasco [2000], Caballero and Krishnamurty [2003, forthcoming] and Aghion, Bachetta and Banerjee [forthcoming].

i. A nominal devaluation leads to an increase in the debt burden of firms and banks that borrowed in foreign currency. This leads to a reduction in profits that lowers their net worth.

ii. The reduction in net worth of financial and non-financial firms raises the interest rates these firms face, and tightens borrowing constraints. The result is a collapse of investment and economic growth.

The Berganza-Chang-García-Herrero paper focuses straight on the second point. It contains an empirical investigation of whether reductions in net worth tend to raise interest rates, as suggested by the theory. It is somewhat surprising that, given the importance of this link in the models, there was basically no empirically evidence of it before this paper. The results are largely positive for the theory. First, reductions in net worth tend to increase the country risk premium. Second, this effect is larger in countries with more imperfect financial markets.

C. Summary

So what did we learn about the effects of nominal devaluations? The evidence shows that devaluations have small effects on consumer prices in industrial countries. The Corsetti-Martin-Pesenti paper says that despite this, nominal devaluations might generate large output effects if trade costs are intermediate and agglomeration effects important. The Berganza-Chang-García-Herrero paper provides strong evidence supporting the notion that credit conditions are sensitive to net worth.

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MACROECONOMIC DIMENSIONS OF REGIONAL INTEGRATION: A COMMENT

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CENTRO DE ESTUDIOS DE ESTADO Y SOCIEDAD - CEDES, 2004

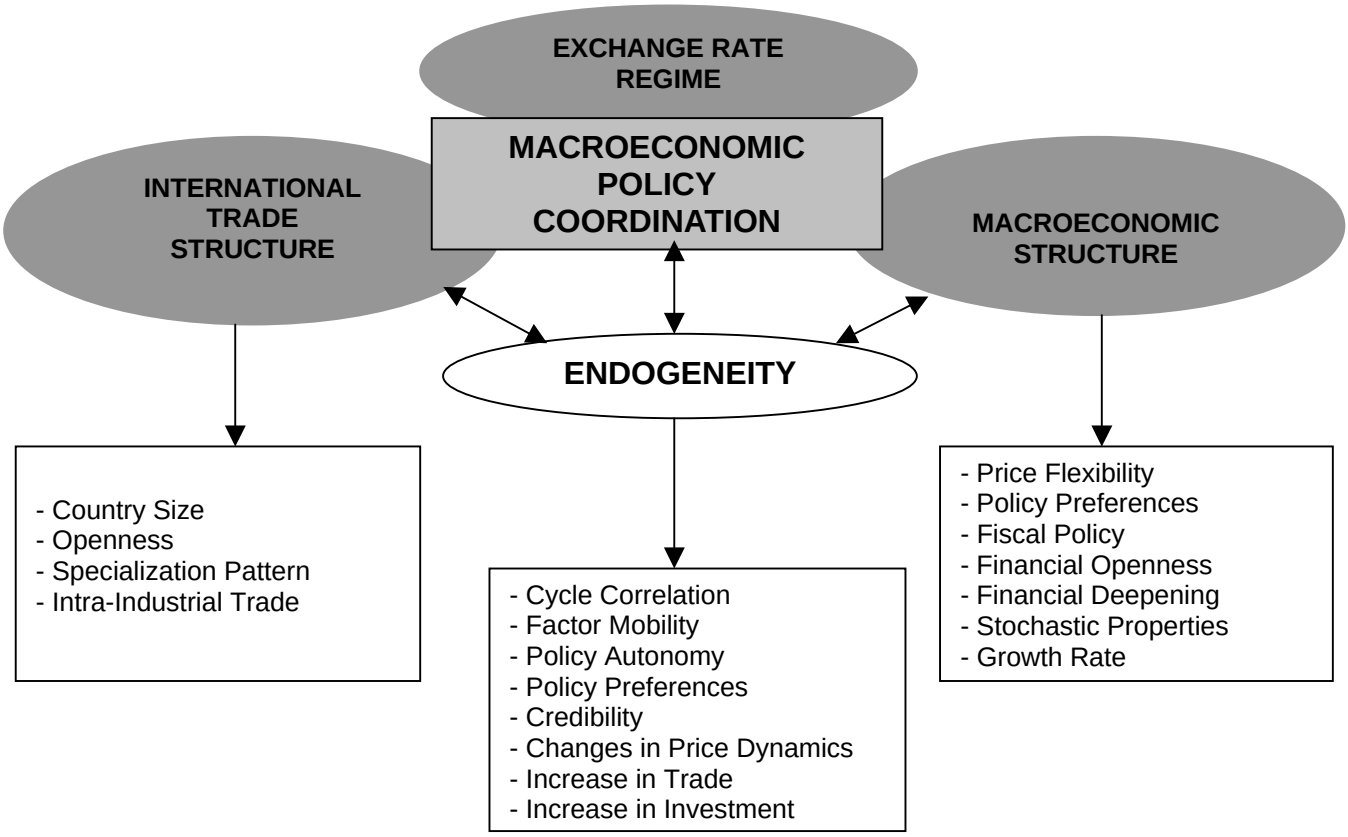
First of all, I would like to thank IDB-INTAL for inviting me to comment on Jaume Ventura's paper. It is quite interesting and I have enjoyed reading it. The main purpose of Ventura's paper is to provide an overview of the most relevant macroeconomic issues that were raised at the First Annual Conference of the Euro-Latin Study Network on Integration and Trade (ELSNIT), which took place at CREI, Barcelona, on November 6-7, 2003.

The paper addresses two main topics: (a) the role of constraints on fiscal policy; and (b) the effects of nominal rigidities. The first topic analyzes the role of budget constraints in the regional integration process and some aspects of political support building. The analysis focuses on the case of European Union countries. The study of the effects of nominal devaluations concentrates on nominal rigidities and balance sheet effects. Although the paper is written from a "European view," there are analytical and empirical findings that are highly relevant to Latin American economies.

This said, it is also true that the framework developed in the paper has some weak points when judged from the perspective of the analytical demands posed by the Latin American macroeconomic problems. This is particularly so regarding a South-South integration process like MERCOSUR. More specifically, our research experience suggests that we need to include two additional issues in the analysis: (a) the role of risk and uncertainty; and (b) the structural features of developing countries, which differentiate these countries and their regional initiatives from those of the European Union and their North-North integration process. In fact, I think that some of the issues that I will raise here will also be relevant to the European Union in the near future to the extent that the new members of the EU are basically developing countries, which share some macroeconomic features with countries like Brazil or Argentina.

The sole purpose of Figure 1 is to illustrate the complexity of the macroeconomic dimension of the regional integration process. It is clear that the integration process gives rise to questions that go beyond the problems of nominal rigidities and fiscal policies. To highlight the interactions between the variables that have a bearing on macroeconomic policy coordination we have overlapped the ovals. Another oval represents endogenous effects.

FIGURE 1



Given that time constraints do not allow us to analyze the role each of these elements plays and explain how they relate to the issues Jaume and I raise, I will focus on the problem of characterizing cyclical fluctuations to illustrate the kinds of problems that we are facing in Latin America and, more specifically, in MERCOSUR.

To characterize aggregate fluctuations, we need: to examine cyclical comovements, to identify the sources of shocks, to model volatility, and to study price/quantity interactions.[1] Our hypothesis that the problems of macroeconomic policy coordination that Latin America and Europe face are to a certain extent different implies the additional hypothesis that the structural

[1] Fanelli and Gonzalez Rozada [2003]: "Business Cycles and Macroeconomic Policy Coordination in MERCOSUR," Regional Integration Network, IDB, Uruguay, September.

features of the economies under analysis have a bearing on macroeconomic fluctuations. In this sense, I would like to use the case of MERCOSUR to highlight the following features:

i) MERCOSUR is a young regional integration agreement and it still shows a low degree of integration regarding both trade and institutions.

ii) MERCOSUR is a South-South agreement between "emerging" middle-income economies.

iii) All the members show a low degree of financial deepening. Dollarization is important. There is a marked aggregate volatility, and the countries have recently experienced crises of varying magnitude.

These characteristics are key to understanding macroeconomic dynamics and place severe constraints on the set of policies that can be used to coordinate macroeconomic policies that address macroeconomic fluctuations at the regional level.

Once we have taken these structural features into account, some of the emphases of the optimum currency areas (OCA) literature appear to be misplaced. That is, we need to introduce some issues that are missing in the OCA approach to the analysis of macroeconomic fluctuations. In effect, the basic goal of the OCA literature is to assess the costs and benefits of losing monetary policy autonomy in lieu of establishing a monetary union. Given this goal, the identification of common shocks and the understanding of the asymmetries in the process of macroeconomic adjustment in each of the countries of the monetary union become the highest priority on the research agenda. The basic problem in developing countries, however, is not their loss of a monetary policy. To begin with, monetary policy is never completely autonomous given the "fear of floating" syndrome. The main problem that monetary policy, in particular, and macroeconomic policies, in general, face in the Latin American context is achieving the credibility of their policies. Second, is the problem of smoothing the high degree of aggregate volatility, given the shortage of policy tools at the disposal of the authorities and the pervasive imperfections in international capital markets, which hinders the private sector from diversifying national risks.

Under these circumstances, the most pressing question is not the cost of losing monetary policy (because there is not much autonomy) but the question of determining what the best exchange rate regime is for a country that is participating in a regional agreement, as well as whether coordination could increase the authorities' degrees of freedom by increasing the number of tools to reduce macroeconomic fluctuations. In this regard, a specific issue is whether any opportunity exists to make commitments more credible by setting the rules of the macroeconomic game at the regional level.

From my point of view, to be able to tackle these questions we need to better understand: (a) the determinants of regional volatility; (b) the interactions between idiosyncratic and common regional cycles; and (c) the process of institution building at the regional level, to the extent that good policies seem to be associated with good institutions.

Summing up, while I am not denying that we can learn a lot from the OCA literature and the European experience that Jaume´s paper raises, we should not automatically transfer the lessons to Latin America. In this regard, our research findings in the case of MERCOSUR suggest that:

i) Volatility matters a lot in the case of young and South-South regional agreements. It is interesting to note that this feature appears to be shared both with those countries that were peripheral when the European monetary union was being shaped and with those US regions specializing in the production of commodities.

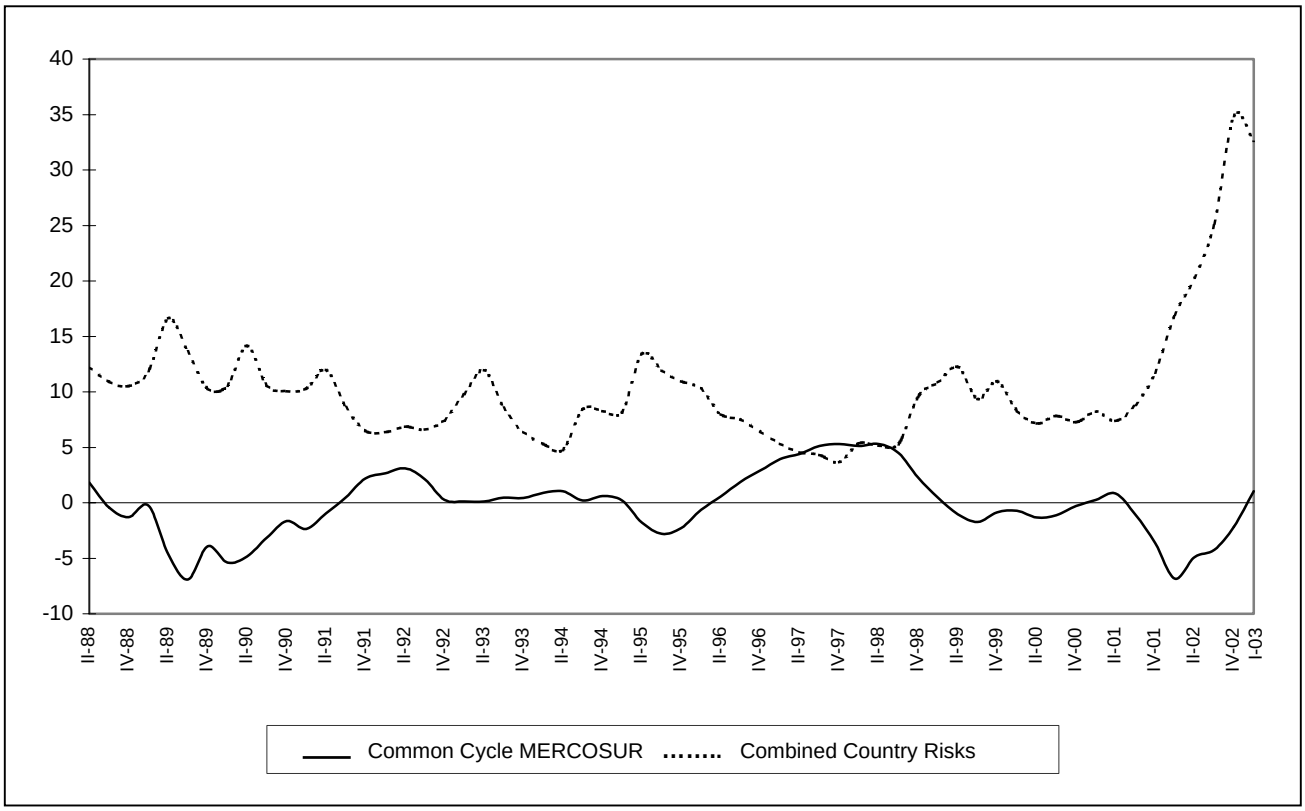
ii) Financial imperfections do matter: (a) for volatility, (b) for fluctuations, and (c) for price-output dynamics.

iii) Common factors originating in the changes of investors' perceptions are relevant to the regional cycle comovement. Figure 2 illustrates this point by showing the negative correlation between the common cycle in MERCOSUR and the evolution of the country risk in the region (Fanelli and Gonzalez Rozada [2003]).

iv) Idiosyncratic cycles still explain a great proportion of the total variance of output. This differs from the cases of Europe and the regions of the US where the common cycle is considerably more important than the idiosyncratic one.

FIGURE 2

MERCOSUR COMMON CYCLE AND COMBINED COUNTRY RISK



Contents

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SECOND SESSION: THE IMPACT OF REGIONAL INTEGRATION ON ECONOMIC CONVERGENCE AND GROWTH

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THE IMPACT OF REGIONAL INTEGRATION ON ECONOMIC CONVERGENCE AND GROWTH

Omar Licandro*

I. INTRODUCTION

The main objective of this paper is to analyze the role of regional integration agreements for growth and convergence, by reviewing some recent contributions in the field and, in particular, by relating it to the papers presented at the First Conference of the Euro-Latin Study Network on Integration and Trade. The past World War II era has been characterized by an increasing international integration of goods markets, with the salient characteristic of developing countries joining the world economy during the last two decades. It has being associated also to the development and expansion of regional integration agreements, covering a larger fraction of international trade. The move towards free trade is the result of an important change on the views of both economists and policymakers concerning trade policies, from supporting import substitution to support *export-oriented outward-looking policies.*

In the last decade, a huge amount of evidence has been accumulated showing a significant correlation between growth and other variables such as trade, openness, quality of institutions, and geography. However, the causal relations are still controversial and case studies tend to show a huge diversity on the relation between economic policies oriented to trade openness and economic performance. This is particularly true for the relation between regional integration agreements and growth. The European Union, for example, has been successful in helping Ireland and South European countries to converge to the living standards in leading countries. EU acceding countries have faced high growth rates in the recent years and they expect to converge to the per capita GDP level of rich European countries in the near future. It is then important to understand what are the relevant conditions under which such integration agreement have played the role of a feasible growth strategy, while other regional integration experiences have not. This could be of a great importance for Latin America, involved in deep processes of regional integration, such as NAFTA and MERCOSUR, and challenged by the creation of the FTAA.

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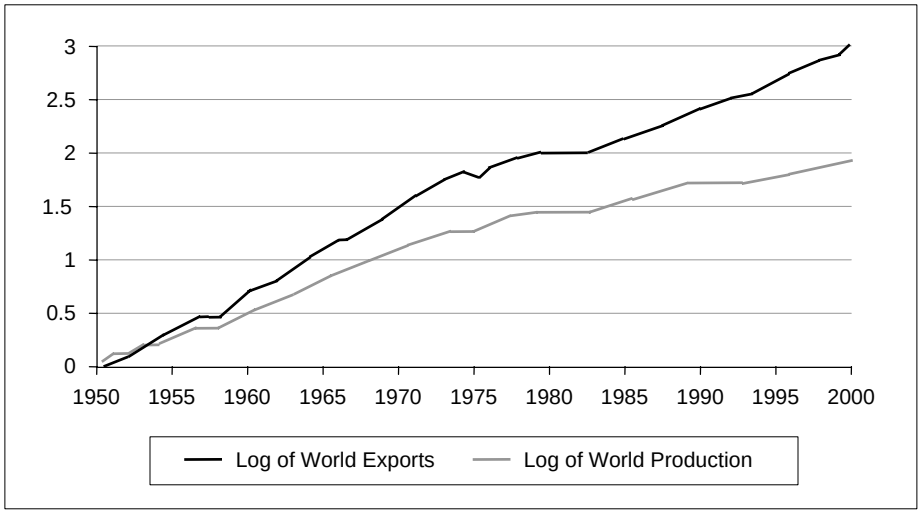
* European University Institute. September 2004. I would like to acknowledge the participants to the First Conference of the Euro-Latin Study Network on Integration and Trade for their comments, in particular the speakers Gino Gancia, Hubert Kempf, Nicole Madariaga and Jacques Thisse, and the discussants Gabriel Felbermayr, Renato Flores, Eduardo Loyo, Pablo Sanguinetti and Cristina Terra for their contributions. A first version of this paper was presented at the Foro *"Aportes académicos de la primera reunión de la red Euro-Latinoamericana de estudios sobre integración y comercio",* that took place in Buenos Aires on April 27-28, 2004. I would like to acknowledge Federico Sturzenegger for his comments. I would also like to thank the precious assistance of Gabriel Felbermayr and Davide Sala.

II. INTEGRATION AND GROWTH: THE EVIDENCE

Global market integration

There is virtually no dispute over the fact that the international integration of goods markets has increased steadily during the entire post World War II era. Figure 1 shows world output and world exports over the last fifty years.

FIGURE 1:
INDICES OF WORLD PRODUCTION AND EXPORTS (RELATIVE TO 1950)



Note: World merchandise production differs from world GDP in that it excludes services and construction.

Source: World Trade Organization, World Trade Statistics, table II.1 *"World Merchandise exports, production and gross domestic product, 1950-01"*, available from *www.wto.org.*

Two things stand out. Firstly, exports have been growing faster than production. While the index of world production has increased 6-fold, the index of world exports has been multiplied by 20 in the 1950-2001 period. Secondly, the evolution was not smooth. We observe two periods during which global integration increased strongly, 1950-1974 and 1986-2001, and one period of relative stagnation. We now use two different indicators of the degree of global integration to understand what events characterize these three subintervals.

The world average of total trade flows (imports and exports) as a share of GDP, from the Penn World Tables, reveals a pattern that looks quite similar to the one described in Figure 1.[1] In

[1] See Heston *et al.* [2002]. In Figure 2, we use openk and openc variables in the Penn World Tables mark 6.1. The sample consists of 107 countries that are observed over the entire time span. While earlier releases of these data (the PWT mark 5.6, for example) only provided an index in constant (1996) prices.

Figure 2, it appears that current and constant price measures of the trade share move very much in line throughout the whole time span, with the exception of a major shift which occurred from 1971 to 1974. This pattern is a direct implication of the oil-price shock which triggered a sharp increase in the price of tradeable goods relative to non-tradeables.

Having attributed the jump in the early seventies to the increase in oil prices, the next question that arises is: what happened around 1985? The answer is that developing countries have joined the world economy. To illustrate this fact, we use the openness index introduced by Sachs and Warner [1995], henceforth SW, and updated by Easterly et al. [2003]. This index classifies an economy as closed if at least one of the following criteria is met: (i) a black market premium larger than 20 percent, (ii) the government has a purchasing monopoly on a major export crop, (iii) the country is socialist, (iv) own-imported-weighted average frequency of non-tariff measures (licenses, prohibitions, and quotas) on capital goods and intermediates is larger than 40 percent, (v) the own-imported-weighted average tariff on capital goods and intermediaries is greater than 40 percent.

FIGURE 2:
EXPORTS PLUS IMPORTS OVER GDP IN CURRENT AND CONSTANT (1996) PRICES
1960 to 1998, cross country averages

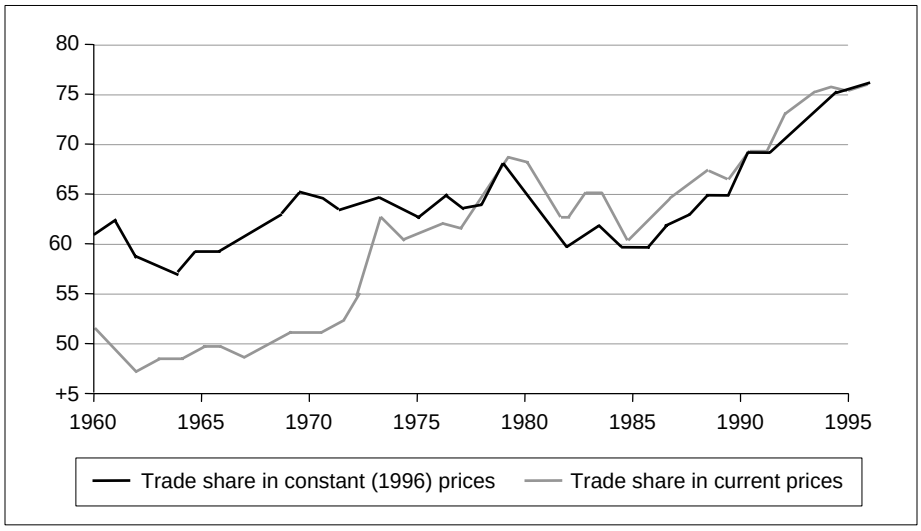
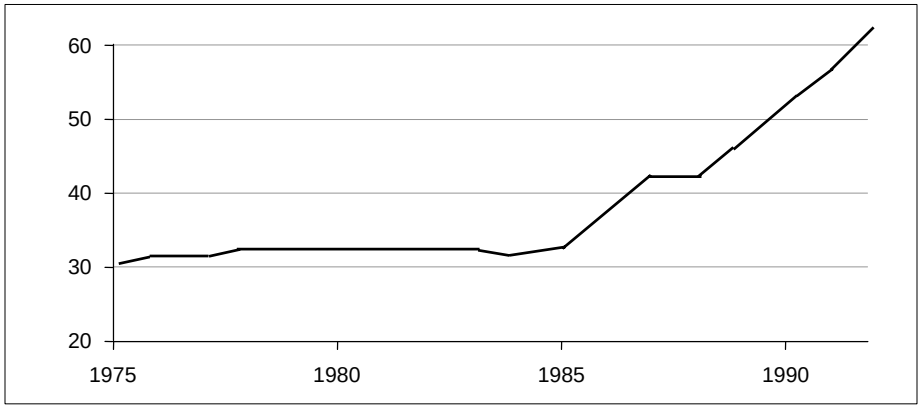


Figure 3 shows how the fraction of countries classified as open evolves over time. This ratio was approximately constant until 1985 and then started to rise. Strikingly, if one looks at the identity of countries, it turns out that almost all open countries up to 1985 are the current, as of 2003, OECD members. Thus, 1985 marks the entry of developing countries into the world economy.

FIGURE 3
THE SHARE OF OPEN ECONOMIES IN A TOTAL OF 101 COUNTRIES
(percentage), 1975-1992



Source: Sachs and Warner [1995].

The increasing importance of RIAs

A regional integration agreement (RIA), or regional trade agreement, is an institutional arrangement, through which two or more countries engage on some common institutions, involving in particular trade and non-trade barriers. It can range from a *Free Trade Area*, designed to reduce or eliminate trade barriers among members, to a *Monetary Union* where independent nations agree on sharing a common currency, on amount of a highly integrated common market with free mobility of production factors.

Regional integration agreements have steadily become more and more important in the post World War II era. Figure 4 tracks the share of total world trade conducted within regional trade agreements since 1958. This share is increasing for two main reasons. Firstly, the number of regional trade agreements has being permanently increasing from the seventies, with an important acceleration at the beginning of the nineties.

Secondly, trade between countries in regional trade agreements has been growing faster than trade between countries outside such agreements. Table 1 below looks at the average growth rate of bilateral trade volumes (in 1996 dollars) of countries that have been part of the same regional trade agreement. Trade between countries, which did not belong to the same RIA was expanding at a rate of 3.70% per year, while trade between countries belonging to the same RIA typically grew at a rate much larger than this.

It is also important to notice in Figure 4 that the share of world trade conducted within RIAs accelerates around 1985, showing the importance of RIAs for the globalization phenomenon described in the previous section.

FIGURE 4:
SHARE OF TRADE CONDUCTED WITHIN REGIONAL TRADE AGREEMENTS, 1958-1999

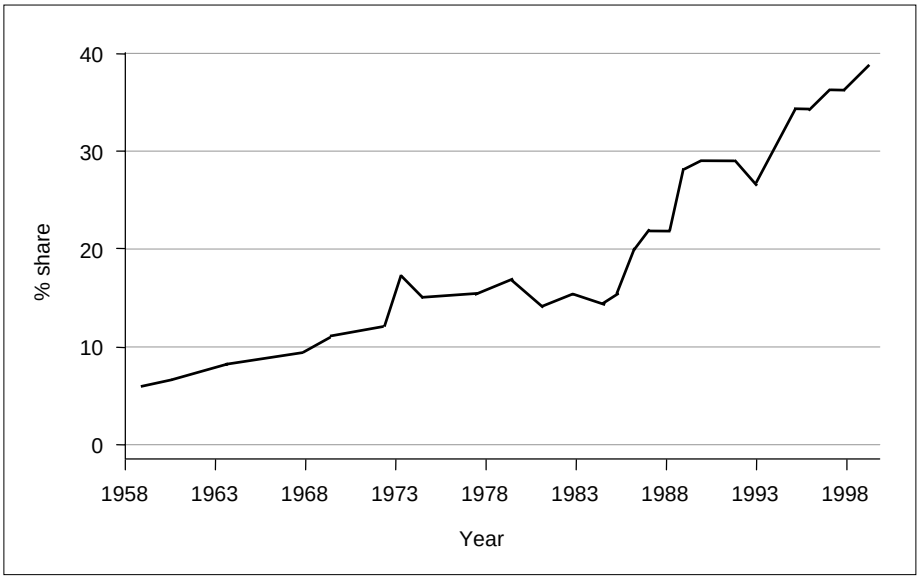


TABLE 1
AVERAGE GROWTH OF BILATERAL TRADE FLOWS

	Average growth of trade
EU/EC	6.50%
USIS	6.81%
NAFTA	8.65%
CARICOM	4.23%
ANZD	4.25%
CACM	7.64%
MERCOSUR	7.48%
ASEAN	14.18%
No RTA	3.71%

Note: USIS: United States - Israel, CARICOM: Caribbean Community, ANZD: Australian - New Zealand Free Trade Agreement, CACM: Central American Common Market.

Source: IMF Direction of trade statistics.

Openness and growth

There is clear evidence on a positive correlation between growth and trade shares in cross-country studies. However, the existence of a causal link is under debate, implying that there is no general agreement on the observed impact on growth of different economic policies oriented to trade openness. Frankel and Romer [1999] support the optimistic view by claiming that increasing the trade share by 1% point, raises GDP per capita by 2.4%.

As stressed by Baldwin [2003], economists and policymakers have changed their views concerning trade policies from supporting *import substitution* during the 50s and 60s to support *export-oriented outward-looking* policies from the 70s. Trade liberalization and openness to foreign direct investment are among the recommendations of the Washington Consensus. The large increase in trade openness reported in the section on Global Market Integration, in particular from the middle of the eighties, is a clear implication of this change in policy recommendations. But, are policies addressed to open a country to international trade growth enhancing? As claimed by Wacziarg and Welch [2003], even if trade liberalization has, on average, robust positive effects on growth, there is a considerable amount of heterogeneity in countries' experiences with trade reforms. They claim that successful cases are related to trade reforms that were sustained, i.e., countries continued to deepen trade reform after the time of liberalization, *broad-based*, of which trade liberalization was only a part, and implemented under *political stability.*

Rodrik [2003b] analyzes the recent growth experiences and takes some general lessons for growth and development. His conclusions are close to those by Wacziarg and Welch [2003]. In order to understand the clues of successful economic policies he defines what he calls a *growth strategy*, i.e., "economic policies and institutional arrangements aimed at achieving economic convergence with the living standards prevailing in advanced countries". He claims that growth-promoting policies tend to be context specific, implying that cross-national growth regressions do not provide reliable and unambiguous evidence. Moreover, from the study of national experiences he concludes that first-order economic principles do not map into unique policy packages. To support this argument, he observes that policies undertaken by high performing East Asian countries exhibit significant departures from the Washington Consensus, at the time that Latin America made the most determined attempt at remaking itself in the image of it, but reaping little growth benefits. He points out that a successful growth strategy should be based on "microeconomic policies aim to achieve static and dynamic efficiency in the allocation of resources. Macroeconomic policies aim for macroeconomic and financial stability. Social policies target poverty reduction and social protection".

In particular, concerning trade liberalization, Rodrik claims that it is good for economic performance only if some side conditions are met. Let me refer to some of these conditions:

(i) Liberalization must be *complete*.

(ii) If there are some market imperfections, *second best policies* must be applied.

(iii) The income *redistributive* effects should not be judged undesirable by society at large, otherwise a compensatory scheme must be implemented.

(iv) The liberalization must be politically *sustainable* and *credible*, so that agents do not fear a reversal.

Finally, Rodrik stresses the importance of high-quality institutions for long run growth, a crucial problem for developing countries. As reported by Rodrik [2003a], there is clear evidence on a relationship between the quality of institutions, the degree of integration and geography on one side and economic growth on the other. Rodrik *et al* (2002) claim that there is primacy of institutions over geography and integration in economic growth.

The impact of RIAs on growth

As stated by Venables [2000], the traditional effects of RIA's membership include the benefits and costs of trade creation and trade diversion, its impact on foreign direct investment, and the gains from a large scale and competition. Venables points out that in a world of market failures, the welfare effects of RIAs may be positive or negative, as a direct application of the second best principle. The global reduction of all trade barriers allows firms and consumers to buy from the cheapest sources, which is welfare improving. However, the partial reduction in barriers generated by the creation of a RIA shifts discrimination between sources of supply, which may divert trade from a cheap to a more expensive source.

The recent explosion of RIAs has been extensively analyzed over the last years. Fernandez [1997] classifies the main factors behind it in traditional and non-traditional gains from regionalism. The non-traditional gains include political factors and institutions. Regional integration raises reciprocal trust, contributing to create a peaceful environment. It also avoids the time inconsistency problems typically associated to unilateral trade liberalization, which helps improving the conditions for stable institutions. Finally, it works as an insurance against any form of trade war, which is particularly beneficial for small and poor countries by providing them with a more stable international environment. These are the basic arguments in Venables and Winters [2003] to explain the success of the European Union, as referred below in the last section of this Chapter.

Currency Unions and growth

In the recent years, a bunch of papers have estimated the impact on trade and growth of *currency unions*. Frankel and Rose [2002] claim that currency unions promote trade, by reducing the costs of international transactions, and by eliminating the possibility of exchange rate changes between members of the currency union. In a cross country study, they use a two stage approach to estimate the impact of currency unions (and currency boards) on trade, and then through trade on growth. Data on bilateral trade are used to estimate *gravity models*. They find that belonging to a currency union triples trade with other currency union members, but that sharing both a currency and a political system increases trade by twenty times. They do not find evidence of trade diversion. In a second stage, they find that a one percent increase in a country's trade (relative to GDP) raises income per capita by at least one-third of a percentage point. Consequently, accession to a currency union would have a large impact on *per capita* income through trade creation.

Frankel and Romer's results have been criticized for two fundamental reasons. Firstly, most currency union members in their sample are poor and small countries. Secondly, estimations are affected by endogeneity bias: it may be the case that countries join currency unions constituted by trade partners. In a more recent paper, using panel data estimators to circumvent the possibility of reverse causality in gravity models, Micco *et al* [2003] estimate the impact on bilateral trade of European Monetary Union membership. Controlling for European Union membership, they show that affiliation to the EMU has a positive effect on bilateral trade, even if the estimated effect is much smaller than the one estimated by Frankel and Rose.[2] This result is particularly interesting, since the EMU is an extreme case of regional integration agreement, which goes far beyond trade policies, and in many respects fulfills the side conditions postulated by Rodrik in order for trade liberalization to be growth enhancing.

The European experience

The integration process undertaken initially for some few European countries with the main objective of preventing a future conflict in Europe has converged in our days to the most successful regional integration agreement observed during the last century. In a recent paper, Venables and Winters [2003] stress that the success of the EU is largely based on the following pillars:

(i) In the process of creating the European Union, a *deep microeconomic integration* has been built step by step, making it almost impossible to regress or exit.

(ii) The establishment of *common political institutions* (the European Commission and the European Central Bank, among others), playing the role of the *guardians* of integration, has been crucial to persist on the integration process even in the most difficult periods.

(iii) The Union is based on the principle of generalized *reciprocity*, which entails *redistributive* policies in particular to new acceding countries.

Among the achievements of the EU, I would like to stress its role as a *growth strategy*. Ireland, Portugal and Spain reached the status of developed countries after acceding to the EU. Greece and the new acceding countries have the same hope. South acceding countries benefit from trade creation, at the time that they import good and stable institutions and profit from regional redistributive policies. The accession to the EU gives national governments the unusual possibility of introducing a large number of reforms without facing an important social resistance. This is the key role of the so called *aquis communautaire*, complemented by the use of the Structural and Cohesion Funds. Accession is conditional to a certain number of reforms, which local government can implement because the national society gives a high value to membership and European transfer payments facilitate the use of redistributive policies. More

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[2] Gravity models are in a large extent supported by economic geography arguments. Among the variables included are size, measured in terms of GDP or population, distance, common borders, common language. See Ottaviano and Thisse [2003].

important, these reforms are politically sustainable, given that the reversal is unlikely. Most of the credibility problems faced by economic policy in developing countries are counterbalanced by the prospect of European stable institutions. The Euro is the best example. Since the signature of the Maastricht Treaty, the historical experience of high inflation in some countries does not seem to matter for expectations any more, allowing national inflation rates to converge to very low values. Finally, the prospect of convergence in per capita GDP is supported by transfers to the poor regions, the Structural and Cohesion Funds referred to above.

III. THE ROLE OF INSTITUTIONS

There is a large agreement among economists on the existence of a positive relationship between the quality of institutions and the economic performance of a society. The sense of causality, however, is still controversial. One of our duties, as economists, is to advice policy makers on the efficiency of both existing institutions and alternative reforms. The standard analysis we carry out in order to accomplish this duty is normative. We use economic theory to evaluate the efficiency of different institutional arrangements, and eventually provide a quantitative evaluation of reforms. When we perform this type of analysis, we assume that institutions are exogenous and cause economic performance, and we look for the appropriate formulation of the relevant economic mechanisms associated to the institutions under evaluation.

However, the ways in which societies decide on their own institutions are endogenous and highly related to economic performance itself. A positive theory of institutional change is then required, in which the appropriate mechanisms from growth to institutions needs to be conveniently modeled.

These general principles apply to the evaluation of the relation between RIAs and growth. From the normative point of view, we are interested in understanding the impact of different integration agreements on economic performance and growth. From the positive side, we are interested in understanding the (economic) conditions under which such agreements are a political equilibrium.

Are RIAs good institutions? What is the optimal design of a RIA? How do they affect the economic performance of a society? Under which conditions do we expect countries to decide to become part of a RIA? How economic conditions affect the design of RIAs? Gancia [2003] and Kempf and Rossignole [2003] provide a (partial) answer to these questions. Gancia does it from the normative side and Kempf and Rossignole from the positive side.

The normative role of economic institutions

A good understanding of the normative role of institutions is of a great importance for economists and policymakers. This principle is particularly true for the development problem, where the well functioning of economic institutions is a crucial requirement for growth.

Gancia [2003] is a good example of the joint impact of integration and institutions on economic growth. His paper focuses on one of the most important institutions fostering innovation activities: the protection of intellectual property rights (hereafter IPR). Under the assumption that *South* countries provide in general low protection to IPR, the paper shows that trade openness has two main effects. Firstly, it shifts technical change in favor of *North* countries, since some rents from innovation are lost in Southern industries due to low protection of IPR. As an implication of this reallocation of economic activities, and the associated increase in the relative intensity of R&D in North countries with respect to South countries, between-country income inequality may change in favor of North countries. Secondly, trade openness may reduce growth even in North countries. This result is a direct application of the *second best* principle. The removal of a distortion (trade barriers) is not necessarily good for growth and welfare in a world where IPR are not fully protected. The

most important normative lesson for regional integration is that, if market integration goes with protection of IPR, trade benefits dominate and integration is good for growth.

Gancia's results are based on the following assumptions. Sectorial productivity is decomposed in an exogenous country specific term, determining comparative advantages, and a current state of technology, which results from R&D activities, may be adopted by any country and is subject to IPR protection. North countries provide full protection to IPR, but South countries provide partial protection, which affects negatively patent owners producing in the South country. The world is Ricardian and North and South countries specialize in the production of those goods for which they have comparative advantages.

In his report, Renato Flores makes some interesting suggestions. In particular, he points out that Gancia's framework may be extended to analyze the WTO's Agreement on Trade-Related Aspects of IPRs (TRIPS). One of the two basic principles of the TRIPS Agreement is the *national treatment* condition, establishing that foreign goods must receive the same treatment as national goods. This principle must be recognized by the local legislation, which can be easily monitored. However, another important issue of the TRIPS Agreement is how to deal with *enforcement* of the local legislation. Flores suggests to separate legislation from enforcement, by taking into account that enforcement is costly and difficult to monitor by third parties. This would help to understand the normative implications of the TRIPS Agreement.[3]

The theoretical results in Gancia are consistent with the evidence in Rodrik *et al* [2002] and Easterley and Levine [2002], showing that the correlation between trade and growth disappears after controlling for the quality of institutions and addressing endogeneity issues. Additionally, Gancia provides some empirical evidence on a positive effect on growth of the interaction between IPR protection and openness.

As a general lesson, we should read Gancia's paper as a defense of the simultaneous use of trade liberalization and economic reforms that look for the promotion of good economic institutions. Protection to intellectual property rights is a particular case. As an application to North-South RIAs, it supports the view that trade integration should be followed by a deep integration process helping South countries to import stable, good economic institutions from North countries. This is in line with the side conditions put forward by Rodrik [2003b] and with the pillars of the European Union described by Venables and Winters [2003].

Gancia stresses that free trade needs efficient institutions and that institutional quality has global repercussions (the failure of Southern IPR protection also reduces Northern growth). Thus, countries should have an incentive to adopt common institutions, such as in a RIA. These

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[3] Gancia assumes that the degree of protection depends on industry location. Imports in South countries are fully protected, since they are produced in the North, but exports to the North countries are partially protected, since they are produced in the South. Alternatively, the degree of protection may apply to goods consumed in the local market irrespective of the origin. Under this assumption, the TRIPS Agreement makes sense, since South countries may protect their own industry by imposing different degrees of IPR protection to national and foreign goods, or by having different degrees of enforcement.

institutions are essentially public goods. Kempf and Rossignole [2003] discuss the political economy dimension of this issue.

The political economy of integration

Normative considerations on the welfare gains of RIA membership are not enough to guarantee that countries actually want to integrate. The process of creation of the European Union is a good example. The support to new treaties is voted at the national level, with some well known cases of rejection. To avoid stagnation in the advance of the integration process, the Union has followed in some occasions a two-speed strategy, in which some few countries do not adopt a new treaty. It has been the case of the Maastricht Treaty, the creation of the European Central Bank and the adoption of the Euro. The enlargement of the EU faces a similar difficulty, as it is the case of the creation of the Free Trade Area for the Americas. A deep analysis of the conditions under which countries would like to be part of a RIA is of fundamental relevance.[4]

Kempf and Rossignole [2003] analyze the political economy of integration. In their paper, economic integration yields dynamic benefits, but at the same time it entails distributional outcomes.[5] Consequently, even in a world where integration is efficient, its impact on the distribution of income may create national resistance. Kempf and Rossignole also claim that integration agreements are highly irreversible, implying that when adopted such an institutional reform is stable.

In an endogenous growth framework with scale effects, Kempf and Rossignole take the benefits of integration as granted, and analyze the national decisions to integrate in a two country model of the median voter. Technology is constant returns to scale on capital and labor, and total factor productivity depends on public goods, giving rise to an endogenous growth model of the AK type with scale effects. The government rises income taxes to finance the production of the public good and the political system decides on the magnitude of the tax rate. Individuals have different (initial) non-human wealth, and consequently different preferences on the tax system. Poor agents prefer high taxes, paid mostly by rich individuals, which allow the government to produce a high amount of the public good, increasing labor productivity and wages. In Kempf and Rossignole the world economy is formed by two countries having the possibility of integrating in a Union if both national median voters agree on it. Integration has three effects on the welfare of the national median voters. The first, the *efficiency effect*, is strictly positive since integration has a positive scale effect. The second is called the *status effect*. Integration may remove the key policy-making position of the national median voter, which is unambiguously costly for him. The last is the *position effect*, which is related to the change in the median voter's position on the income distribution, in particular with respect to the Union's median voter. This last effect is ambiguous. Consequently, it may be the case that both national median voters do not agree simultaneously on the creation of a Union, which basically depends on the relative size of

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4 This is related to the recent literature on the number and the size of nations. See Alesina and Spolaore [1997].

5 Kempf and Rossignole [2003] is highly related to the literature on RIAs referred in Chapter II.

countries, on how unequal countries are in terms of initial wealth and on how unequal national median voters are.

Pablo Sanguinetti, in his comments, pointed out that the proposed model applies mainly to problems of *regional economic integration*, where efficiency gains are the result of lower tariffs and extended markets, and redistributive costs are associated to changes in sectorial rents and relative wages. In particular, this theory has some predictions for North-South integration agreements: gains are potentially large for South countries, but relatively small for North countries. In the recent history of the European Union, where most countries voted in referenda whether to support the Maastricht Treaty, major resistance came from rich (North) countries.

A key open question is why the European Union is still interested in enlargement, in particular to the East. The core countries have created the union to render a new war impossible, but they are still promoting enlargement. Are scale effects from enlargement large enough for rich European countries to promote it? On the other side, it seems clear that Eastern European countries are highly interested in acceding, because they expect major gains from converging to the level of welfare in most rich European countries. Differences in wealth with respect to the average EU member are so large that the position effect should be positive and combined with the efficient effect they should dominate the status effect. Similar questions can be raised concerning the creation of the FTAA, taking into account the large asymmetry between the rich and large US and the highly heterogeneous, relatively poor Latin American countries.

IV. THE ROLE OF GEOGRAPHY

In the process of economic integration of independent nations, geography plays a crucial role. Most integration agreements are geographically based, since the interaction of economic activities across national borders tends to be as important as within national borders when countries are relatively open to trade. Over Europe, there are many examples of economic regions overlapping two or more nations. The increasing economic importance of Mexican regions in the US borders, after the signature of NAFTA, is another example. Moreover, one of the main consequences of RIAs is that economic activities shift national borders and are reorganized after the signature of the integration agreement. As pointed out by Venables and Winters [2003], one of the pillars of the European Union is the achievement of a deep microeconomic integration. This is based on a simultaneous process of agglomeration and decentralization of sectorial activities with an important increase in both intersectorial and intrasectorial trade. For these reasons, the analysis of RIAs is highly related to the new developments in economic geography.

Ottaviano and Thisse [2003] is an original survey of the recent literature on the so-called *New Economic Geography* (hereafter NEG), connecting elements of trade theory with the theory of location. The aim being to understand what are the economic forces that emerge as the outcome of human being's actions (the *second nature*) to improve upon the physical characteristics of different geographical sites (the *first nature*). Based on the *Spatial Impossibility Theorem*, establishing that in a spatial economy there is no competitive equilibrium involving transportation, the NEG studies the effects of location externalities and market imperfections on the location of economic activities. In a general equilibrium framework with market failures, the NEG analyzes the interplay between agglomeration and dispersion of economic activities across the space. As an implication of the spatial impossibility theorem, non-trivial allocations of economic activities across the space are inefficient, giving place to public intervention. The design of second-best regional policies requires a good understanding of the main economic forces behind agglomeration and dispersion. This is of a great importance for the analysis of regional integration.

Agglomeration of economic activities is at the heart of the NEG. The home *market effect*, according to Helpman and Krugman [1985], establishes that imperfectly competitive industries tend to concentrate their production in large markets and export to small markets, once transportation costs are taken into account. This is the gravitation force behind the *gravity model* extendedly used in the empirical trade literature, as in Frankel and Romer [1999], where bilateral trade is explained by the size and the distance between countries. The *core-periphery* theory, by assuming that labor is a mobile factor and workers spend their income in the region they work, predicts a stronger agglomeration of economic activities. The mobility of workers multiplies the initial advantage of large markets, amplifying the home market effect.

Finally, Ottaviano and Thisse propose two alternative models to understand the *bell-shaped curve of spatial development*: in the time evolution of the spatial distribution of population and industries "the emergence of a core-periphery structure would be followed by a phase involving interregional convergence". In particular, they argue that heterogeneous preferences on the attachment of workers to the local region may predict a bell-shaped relation between agglomeration and transportation costs. In their theoretical model, Madariaga *et al* [2003] has a similar prediction, but starting from a different assumption. They suppose that the poor region

pays a small salary. Differences in wages introduce a *competitiveness effect* which promotes dispersion of economic activities and may eventually more than counterbalance the tendency to agglomeration of the home market effect. In Ottaviano and Thisse, heterogeneous preferences on the attachment to the local region generates differences in salaries of the type assumed by Madariaga *et al*, since agglomeration forces move to the rich region those workers that are less attached to their own region, implying that the remaining workers would receive a small salary, the difference in wages being related to the difference in local attachments between those emigrating and those remaining.

As stressed by Cristina Terra in her comments to Ottaviano and Thisse's paper, economic geography is a good instrument to analyze regional economic integration. It should help to understand the location decisions of firms, highly related to foreign direct investments, as well as the benefits associated to economies of scale when goods, capital and labor are allowed to move freely across national borders. In particular, it should help to understand the factors promoting agglomeration and dispersion of economic activities, and how to correct them in order to promote an equilibrate and efficient assignment of resources across countries and regions. For example, the design of redistributive policies, as the Structural and Cohesion Funds, may be evaluated from this perspective.

This is a promising research area, which would help policymakers to design good policies addressed to correct the undesirable side effects of agglomeration and dispersion, naturally associated to any process of regional integration.

Agglomeration and regional convergence

As stated in the previous section, the theoretical starting point of Madariaga *et al* [2003] is the bell-shaped relationship between transportation costs and agglomeration of economic activities, in a two country economy -one poorer than the other. On the empirical side of the paper, they build different measures of agglomeration of economic activities across regions in NAFTA and MERCOSUR separately, with the objective of measuring the effect of regional integration on agglomeration and economic convergence.

Madariaga *et al* [2003] measure the trends in agglomeration of economic activities across regions using different concentration measures. In a second step, they use these concentration measures in otherwise standard convergence regressions. Using a Gini index on three different variables (land area, population and sectorial activity) they find some evidence on divergence across regions in NAFTA and agglomeration in MERCOSUR -even if the process in MERCOSUR slowdown after 1991. By including the obtained agglomeration measures in otherwise standard convergence regressions, the authors claim that there is a positive relation between the growth rate and the density of economic activities. Finally, they conclude from these regressions that "NAFTA did not play a significant role in the convergence process between Mexico and the US", at the time they observe convergence across countries in the MERCOSUR over the period 1985-2000, with an acceleration after 1994.

As pointed out by Eduardo Loyo and Gabriel Felbermayr in their comments, the theoretical model in Madariaga *et al* sheds light on agglomeration and dispersion of economic activities

between a poor and a rich country. However, the empirical part of the paper focuses on agglomeration across regions within a RIA. Whether movements in regional agglomeration are due to changes between country or changes within a country is not analyzed, but the proposed model only has predictions concerning the former. An interesting theoretical extension would be a four location model (Northern and Southern regions within both the North and South countries). From the empirical side, it would be interesting to understand if agglomeration forces move economic activities to the borders, as suggested by Hanson [1998].

V. LESSONS FOR LATIN AMERICA

The main challenge faced by Latin American countries is to find a growth strategy, in the sense of Rodrik, allowing them to converge to the living standards in advanced countries. Paradoxically, during the last two decades LA has introduced substantial *orthodox* reforms, but they have not delivered measurable economic benefits.

The main question we would like to answer in the framework of the Euro-Latin Network is whether regional integration would be a growth strategy for LA. In particular, we would like to see if something can be learned from the European integration process. Of course, we must take into account that "Institutional innovations don't travel well," as claimed by Rodrik.

In a recent paper, Venables and Winters [2003] draw out some lessons from European integration experience for the FTAA. On the economic side, they claim that even if the Americas offer a greater potential for trade creation and economic development, they may suffer greater economic divergence due to its initial large differences in economic levels. On the political side, they claim that integration requires a deep political commitment and the existence of institutions aimed to promote and protect integration from the inevitable frictions with national goals. This role is being played in Europe by the Franco-German axis and the Brussels institutions. They claim that it is hard to see what their equivalents in the Americas might be.

In the same direction, Levy Yeyati and Sturzenegger [1999] analyze whether it makes sense for MERCOSUR to create a monetary union similar to the EMU. They claim that from the point of view of the theory of optimal currency areas, MERCOSUR is far from achieving the necessary pre-requisites for a monetary union. In particular, trade flows within MERCOSUR countries are relatively low, when compared to EMU members, partially due to the closed nature of MERCOSUR economies. Moreover, countries endowments in MERCOSUR are too similar to obtain much benefits from trade, implying that MERCOSUR will have a limited effect on regional trade. Secondly, they stress that an important lesson from EMU is that Germany has provided the necessary credibility of monetary and fiscal discipline. There is no such candidate for MERCOSUR, implying that a monetary union should generate limited benefits in terms of credibility. A monetary union should include a country like the US, but setting up a monetary block between the US and Latin American countries does not seem to be very realistic.

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THE IMPACT OF REGIONAL INTEGRATION ON ECONOMIC CONVERGENCE AND GROWTH: A COMMENT

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As in many areas of economics, the discussion of the effect of integration on growth and convergence is subject to the principles of second best economics. Obviously, full integration, particularly with developed economies, has to be welfare enhancing. The fifty states in the US, even though with income disparities, show substantial convergence among themselves. The recent experiences of Ireland, Portugal and Spain show that once an economy becomes fully integrated within a rich and capital abundant region it is likely to experience substantial growth. The clues to this result can be supported by the by now well known results of Frankel & Rose, who show that sharing a common currency increases trade between partners three times but, that sharing both a currency and a political system increases trade by twenty times.

What this second increase (from 3 to 20) means is not yet clear. Is it the role of institutions with full credibility being obtained only with political integration? Or is it just showing the relevance of the reduction of transaction costs? I tend to believe that it is the latter but this is an area open to future research.

Yet, why do I say that the discussion is one of second best economics? Because as long as this full integration is not achieved, the trade-off becomes more complex and the welfare effects ambiguous. For example, bilateral trade agreements have trade creation and trade diversion effects (already an example of second best economics), but they also generate effects on third parties. NAFTA, for example, improved the access of Mexican products to the US market but left at a disadvantage the access of other Latin American countries to that market. This, by the way, has finally been understood by the Brazilian authorities, who now realize that an isolated MERCOSUR is bound to lose ground in its access to third markets as other countries negotiate regional trade agreements.

Thus, the discussion tends to be confusing and the implications will depend on the magnitude that we assign to these cross effects.

Licandro's paper surveys some of these channels. An example of these ambiguities can be seen in the discussion of the increasing importance of regional integration agreements. Omar shows that the number of trade agreements has increased steadily since the 1950´s. Likewise, he shows that trade within trade agreements has been growing faster than outside such agreements. I do not know if this is good or bad. Does it imply that RIAs have fostered a higher growth of trade (trade creation) or is it just a reflection of trade diversion with negative effects on growth? Omar provides the fact without elaboration as to how we can read it.

Omar subscribes fully to the second best approach in his discussion on openness and growth, particularly when he comments that trade reform should be sustained, broad based and

implemented under political stability. Here, I want to add two remarks. First, a reference to Calvo´s work on the destabilizing effects of temporary trade liberalizations. Calvo shows that if people anticipate the reversal of a liberalization attempt, they may react significantly to it increasing the volatility of other economic variables, worsening welfare effects.

Secondly, the trade liberalization has to be discussed in close relationship to the openness of the capital account. From my experience of the Argentine economy, I tend to believe that most microeconomic reforms (privatizations, deregulations and trade liberalizations) have been tremendously successful and it is the volatility of capital flows with its sequel of sharp realignments in relative prices and crises what has tarnished the effect of the overall reform process.

The European experience is important in that it has provided an anchor for expectations about macroeconomic variables and institutional reform for accession countries. I believe this structure could be copied in the context of FTAA with larger concessions from the rich countries of the north as the rest of the countries of Latin America achieve certain standards of behavior (both in terms of macroeconomic stability and institutional reform). This takes us to the issue of the political economy of integration in Europe. There was a large rich, capital abundant and stable country (Germany), which was willing to share all that in order to become the center of a new, united Europe. I do not see similar interests from the US (particularly nowadays) that would allow such a carrot to be there.

If such is the prospect, Latin American countries face the dilemma of how to build a growth strategy and to determine what role regional integration should have in that strategy. For this last point, I would suggest that countries continue to pursue so that FTAA happens. As in the case of Europe, where the original treaty grew into something more significant over the years, I also believe that a similar process is not unthinkable in the Americas.

Regarding a growth strategy, the question is whether such a thing can be determined or whether growth is built upon the accumulation of small policy decisions. Again my experience from Argentina biases me in favor of the second hypothesis. For many years we attempted to attain macroeconomic stability either through borrowing institutions that sooner or later turned out to be unsustainable or thinking in the "*gran plan*" which was going to save the country. Now we have realized that macroeconomic stability is earned day after day, one step at a time through consistent fiscal and monetary policies. Why shouldn't a growth strategy be the same? Growth will come as we convince our own citizens on a stable, market based economy, where in spite of potentially substantial government intervention and regulation, the returns to effort are rewarded and reasonably appropriated by whoever creates wealth.

Contents

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THIRD SESSION: EUROPEAN UNION ENLARGEMENT AND ADJUSTMENT POLICIES DURING THE TRANSITION

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EUROPEAN UNION ENLARGEMENT AND ADJUSTMENT POLICIES DURING THE TRANSITION

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I. INTRODUCTION

The analysis of adjustment policies facing new members joining the EU (accession countries) and non-member countries can have important lessons for the process of economic integration in other parts of the world, in particular for integration between industrial and developing economies (North-South schemes). For the Barcelona conference we proposed three themes:

(i) First, the examination of locational advantages in regional and international competition including the role of institution building in community-wide policies, e.g., environmental policies and social security systems. Accession countries have to strike a balance between regional integration and globalization. They have to adjust their real sectors to the increasing competition exerted by the EU countries without forgoing chances offered by globalization in terms of attracting foreign direct investment and improving export performances.

(ii) Second, the discussion of the interaction between monetary regimes and the performance of trade and labor markets in the transition towards monetary union. The choice of the optimal speed of euroization involves trade-offs between monetary stabilization and the adjustment of the real sector as well as between internal (regional) and external stability. Additionally, trade and labor market integration can be a precondition as well as a consequence of monetary integration.

(iii) Third, the analysis of the net effects of European integration for third country groups. Non-member countries like those in Latin America may suffer from discrimination effects (trade and investment diversion) because of effective regional integration. At the same time, positive effects arise from easier access to a larger market, decline of border charges in lowering the external tariffs of the accession countries to the EU level and better investment opportunities.

From the four papers we selected for the conference three papers refer to the first theme, i.e., locational advantages:

(i) A Gravity Study of the Sectoral Trade Impact of Labour Migration in an Enlarged EU (Marques and Metcalf [2003a]);

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* The authors thank both discussants and participants of the Euro-Latin Forum in Buenos Aires, on 27-28 April 2004 for their helpful comments.

(ii) Regional Economic Integration and the Location of Multinational Enterprises (Altomonte [2003]);
(iii) Economic Integration, Specialization of Regions and Concentration of Industries in EU Accession Countries (Traistaru, Nijkamp, and Longhi [2003]).

In Chapter II, we summarize these papers by highlighting the central issue, the relevant literature and the main empirical result and trying to put the three papers into a research perspective. We argue that the missing link, which has to be analyzed by future research, is the integration of factor markets and the relationship between factor flows, especially between foreign direct investment (FDI) and migration.
The fourth paper presented at the conference discusses the second theme, i.e., monetary integration:

(iv) Exchange Rate Volatility and Employment Growth: Empirical Evidence from the CEE Economies (Belke and Setzer [2003]).

In Chapter III, we try to integrate an executive summary of the paper with the general discussion about the effects of exchange rate regimes on real integration and the even broader discussion about the role for the exchange rate policy in the reaction function of emerging markets central banks.

Because we were not able to select a paper, which investigates the third theme, i.e., third country effects, we add our view on this topic in Chapter IV. By doing this we recognize both the obvious (direct) relevance of this theme for Latin America and the fact that all three papers on locational advantages disregard the trade off between (European) regional and global integration.

Chapter V has conclusions for the research agenda.

II. LOCATIONAL ADVANTAGES

Will Migration Affect Trade?

The paper by Marques and Metcalf [2003a] aims to test the trade effects of an Eastern enlargement with or without free migration of Eastern workers at both the sectoral and country group level. The comparison of the two scenarios is done through export and import potentials found by means of a two-step methodology. First, they estimate a sectoral gravity model that accounts for different skilled/unskilled labor ratios and different spatial and non-spatial trade costs. Second, they use the estimated coefficients to predict the potential values of trade between the EU's North, South and East regions in sectors with different degrees of economies of scale and skill-intensity under the migration and the no-migration scenarios.

As summarized by the authors, gravity models became the workhorse for estimating trade potentials for trade between the EU and the Central and Eastern European Countries (CEECs). Earlier papers found that actual EU-CEEC trade was still below potential (Havrylyshyn and Pritchett [1991]; Hamilton and Winters [1992]; Winters and Wang [1992, 1994]; Baldwin [1994]). Later papers, except Buch and Piazolo [2001], found that actual EU-CEECs trade was already above potential, following an "overshooting" reaction to the Europe Agreements (Gros and Gonciarz [1996]; Schumacher [1997]; Festoc [1997]; Vittas and Mauro [1997]; Maurel and Cheikbossian [1998]; Fontagne *et al* [1999]; Nilsson [2000]). The divergence of results represents the use of post-transition data, panel estimation techniques, and the inclusion of economic distance variables but also the sensitivity of results on the basis of gravity models.

Marques and Metcalf use panel data and apply a sectoral approach in order to estimate the gravity equation which builds on a New Economic Geography model with three country groups – EU-North (N = EU-15 – EU-South), EU-South (S = Greece, Portugal, Spain) and EU-East (E = CEECs) – that differ in the skill endowment as well as both spatial and non-spatial trade costs (Marques and Metcalf [2003b]). The latter are compressed to zero when E integrates with N and S, but the former persist and give rise to a hub effect (Krugman [1993]). The basic gravity equation later used for calculating migration effects explains bilateral trade by population, GDP per capita, and human capital per capita, geographical distance and dummy variables for a common border, the implementation of Europe Agreements since 1991, and membership in EMU. In Model 1 the variables for GDP and human capital enter the equation individually for each country; in Model 2 these variables are expressed as economic and human capital distances respectively.

The main results from the gravity equation are that in an enlarged EU, the North would have a surplus in all sectors except in low scale economies, low skill-intensity, and the South would have a deficit in all sectors except in low scale economies, low skill-intensity. The North/South symmetry is broken by the presence of the East, with deficits in high scale economies sectors and surpluses in low scale economies sectors. In the case of the CEECs, it seems that the human capital endowment as a determinant of trade does not prevail over market access. On the contrary, trade between EU-North and EU-South seems to be equally related to endowments and market access.

On the basis of the estimated coefficients, trade potentials are analyzed in a second step by a simulation of two scenarios. In the no migration scenario it is assumed that GDP, population and the human capital endowment will keep following the current trends. Hence migration is not necessarily

equal to zero, but the enlargement does not imply a single labor market, this is, the current restrictions will continue to apply, at least during the next ten years. This scenario is plausible as the current EU members in fear of mass migration have decided to protect their labor markets against Eastern migrants. There is, however, some income convergence, to the extent that growth rates in the East are higher than in the West. In the migration scenario, free mobility of labor is legally allowed and migration is incorporated in the current trends based on the projections for East-West migration provided by Boeri and Brucker [2000] and Weise *et al* [2001], modifying the projected values of population and human capital endowments in the EU-25 accordingly.

Table 1 summarizes the main differences between the migration and the no migration scenario following from the two specifications of the gravity equations. In Model 1, the impact of free

Eastern migration on trade shows a distinct difference between high scale economies, high skill-intensity sectors (Chemicals, Machinery and Transport Equipment) and all the others. Trade in the former three sectors increases very sizeably when Eastern skilled workers can freely move West. As firms and workers agglomerate in EU-North and, to a lesser extent in EU-South, a rise in trade of high-skill goods can be explained if these regions gain skilled workers from the East. However, the South lacks the North's market access advantage and thus it suffers the largest loss, whereas the North has the highest gain. The East is in an intermediate position, with a weak market access but well endowed in skilled labor. Furthermore, with free migration the Southern and Eastern peripheries trade more with the centre and less with each other. Thus EU-North can further consolidate its current hub position if the new members participate in a single market for labor.

The rather strong result shown in the paper by Marques and Metcalf is that East-North migration strengthens the hub position of the North at the cost of the South without a significant net impact on the East. This is likely to stimulate further research on this topic. There are, however, important caveats. As shown in Table 1 the result is not robust. The strong effects of migration almost disappear if the simulations are run on the basis of the alternative gravity equation (Model 2) where income and human capital variables are not estimated separately but expressed as distance variables.

Additionally, the migration scenarios are not discussed in the paper. Table 2 shows an alternative estimation of net migration for the CEECs (Straubhaar [2002]). These results show that net migration strongly depends on the income differentials assumed. Hence, assumptions about convergence have to be discussed in a paper on trade effects of migration. Moreover, Straubhaar argues that, if an income differential of 50–60 percent is plausible, the estimated net migration is large for the East but not for the North. For an immigration region like the EU consisting of 380 million inhabitants, the calculated net migration flows would accrue to about 0.03 percent of the population only, depending on the assumed scenario. Effects of immigration are then likely to be rather small. In contrast, for the CEECs as a net emigration region, a departure of between 0.1–0.13 percent of its population would be significant.

TABLE 1
MIGRATION EFFECTS ON COUNTRY GROUPS (MILLIONS USD)

Model (1)		North		South		East	
		1	2	1	2	1	2
High scale economies and high-skill intensity	Exports	19.027	1.407	–0.795	0.175	–0.174	–0.068
	Imports	–0.411	0.194	19.662	1.432	–1.193	–0.112
	Net exports	19.438	1.213	–20.457	–1.257	1.019	0.044
High scale economies and low-skill intensity	Exports	1.026	0.212	1.643	0.117	0.148	0.004
	Imports	1.937	0.118	1.082	0.230	–0.202	–0.015
	Net exports	–0.912	0.094	0.561	–0.113	0.35	0.019
High scale economies and high-skill intensity	Exports	0.036	0.012	–0.021	0.001	0.322	–0.019
	Imports	0.324	–0.016	–0.053	0.012	0.065	–0.002
	Net exports	–0.289	0.028	0.031	–0.011	0.257	–0.016
High scale economies and low-skill intensity	Exports	–0.585	0.112	–0.539	–0.094	1.352	–0.056
	Imports	0.847	–0.132	–1.044	0.117	0.425	–0.024
	Net exports	–1.432	0.243	0.505	–0.211	0.927	–0.032
All sectors	Exports	19.504	1.743	0.287	0.198	1.649	–0.138
	Imports	2.698	0.165	19.647	1.790	–0.906	–0.153
	Net exports	16.805	1.578	–19.36	–1.593	2.554	0.015

Note: (1) For the definition of the Models, see text.

Source: Marques and Metcalf [2003a].

TABLE 2
MAGNITUDE OF CEEC NET MIGRATION TO EU (INCLUDES RETURN MIGRATION)

Supposed population in CEEC: 99 000 000	
Income differential (%)	**Magnitude of migration**
40	59,400
50	99,000
60	128,700
70	148,500

Source: Straubhaar [2002].

The parameters applied in these calculations were derived from the Southern European experience in the first few years after free labor mobility was permitted. It is possible that migration in these first years was in some way excessive and not really representative for the longer run. The sudden freedom might induce many more migrants to move than would under

normal circumstances do. Martin [1993], analyzing migration effects within NAFTA, calls this kind of migratory pattern the hump effect. Potential migrants do not revise their plans immediately after accession. Nevertheless, following an initial period of strong immigration, net migration flows decrease thereafter. Hence, if labor is legally free to move, this makes people (especially in border areas) more mobile internationally, but it does not in itself induce mass migration from one country to another. People's social and cultural ties to their local environment are an important obstacle to migration, which has not received much attention in theory. It may also be that potential second-round migrants are deterred both because of factor price convergence due to first-round migration and lower skill endowment relative to the first-round migrants. As mobility declines with declining skill endowment for different reasons it is unlikely that first round migration volumes can simply be extrapolated.

Straubhaar shows that in spite of free mobility of labor in the EU, labor has been extremely immobile within the EU. The large majority of people want to live, work and stay immobile where one has one's roots. People usually prefer the status quo to an unfamiliar or insecure change. The simple abolishment of legal impediments to migration is usually insufficient to overcome individual (microeconomic, social and cultural) obstacles to migration and to outweigh the benefits of the status quo. Contrary to what one may expect at first from the theory of international economic integration, European labor has reacted little to the opportunity of free movement within a common labor market since the early days of integration. Given relatively generous unemployment allowances, European workers prefer to stay unemployed at a certain location. The development of national systems of social security and welfare in the EU has contributed immobility even under conditions of long term unemployment. The provision of increasingly comprehensive social security in the EU is one of the most important factors explaining the preference of immobility.

On the macroeconomic level, international labor migration has proved to be mainly demand-determined: it usually depends to a major extent on the needs and employment opportunities in the immigration countries. In the EU, trade has reacted much faster and more elastically to economic integration than labor. The removal of formal and informal protectionist impediments led to a strong increase in intra-community trade. The equalization of good and factor prices expected on the ground of the neo-classic economic theory thus materialized through trade rather than through the increased mobility of labor. To an important degree, free trade within the EU and further lowering of trade costs has strongly weakened the economic demand for migration in the EU.

Migration of qualified labor might follow the Ricardian (or New Growth) dynamic and move to the North as assumed by Marques and Metcalf but this implies to assume that the incentives for qualified labor to migrate is stronger than non-economic incentives to stay and that people from CEECs actually migrate to EU centers and not, e.g., to the US. Even more importantly, Marques and Metcalf ignore that FDI may replace migration at least for some sectors of production. Hence it is important to look at the determinants of foreign direct investment in CEECs as done in the paper by Altomonte [2003] and at spatial effects of integration as done in the paper by Traistaru, Nijkamp and Longhi [2003] in order to identify potential or actual relocations of production as a countervailing force against migration.

Is Relocation to Be Expected?

Altomonte starts with the observation that the economic literature on the relationship between FDI and economic integration is still inconclusive. The theoretical net effect on the relationship between FDI and economic integration is ambiguous depending on the type of FDI (Carr *et al* [2001]); Markusen and Venables [2000]; Dunnning [1992]) and market accessibility (Ethier [1998]; Norman and Motta [1993]). Core-periphery models (Puga and Venables [1997]; Ludema [2002]) tend to conclude that in a 'hub and spokes' arrangement of trade liberalization, like the one between the European Union and each of the CEECs, firms will tend to concentrate in the 'hub', since firms located in 'spoke' countries are penalized from a lower demand by both consumers and firms in other spokes, as compared to that enjoyed by hub firms. This particular result, however, contrasts sharply with the almost exponential increase of European FDI in the CEECs in the last decade unless it accounts for cost differentials between hub and spokes.

Given the non conclusive predictions of the literature, Altomonte [2003] performs an econometric exercise of the relationship between FDI location and regional integration dynamics. In the estimated logit model the dependent variable $\gamma_{j\xi t}$ takes the value 1 if an investment is registered in one of 48 industries (ξ), within one of 8 CEECs (j), in a year from 1990 to 1998 (t). As can be seen in Table 3, the explanatory variables include the (log) market potential $\psi(.)_{jt}$, the (log) degree of competition $\Theta_{\xi t}$, and the (log) comparative advantages γ_{jt}. Industry-, country- and time-specific dummies are included in order to rule out potential problems of spurious correlations between the process of economic integration and FDI Columns (1) to (3) of Table 3 refer to three alternative measures of market potential calculated without including the size of the 'hub' country, i.e., the EU. Columns (4) and (5) report the results when the size of the 'hub' country is included in the calculation of each country's market potential. In order to distinguish the last two measures, the relevant variables have been denoted in Table 3 as ψ_{jt} (*H – RIA*) for the market potential calculated according to the traditional Harris' definition, i.e., discounting neighboring market sizes (this time including the EU 'hub' market size) by geographical distance; and ψ_{jt} (*RIA*) for the market potential calculated discounting neighboring market sizes (always including the EU 'hub') through a measure of transport costs.

The most important result shown in Table 3 is that market size as well as labor costs, which measure comparative advantage, matter for attracting FDI to accession countries. Moreover, investors seem to assume EU market accessibility when locating in the East. This result is obviously driven by the experience of peripheral countries like Ireland attracting FDI after acceding to the EU in 1973. It implies that with EU-enlargement the concentration of production may decrease with multinational enterprises being able to serve the EU market from CEECs thereby benefiting from lower labor costs and providing job opportunities for high-qualified labor. Hence, the relocation of production supported by FDI may influence migration decisions significantly.

TABLE 3
DETERMINANTS OF FDI IN CEECS

Variable	(1)	(2)	(3)	(4)	(5)
ψ (GDP)	1.05***				
	(0.34)				
ψ (H)		1.06***			
		(0.34)			
ψ			1.21***		
			(0.35)		
ψ (H-NIA)				1.41***	
				(0.39)	
ψ (NIA)					2.34***
					(0.84)
Θ	–0.12	–0.12	–0.13	–0.12	–0.14
	(0.10)	(0.10)	(010)	(0.10)	(0.10)
γ	–0.88***	–0.89***	–0.75***	–0.97***	–0.55***
	(0.21)	(0.22)	(0.18)	(0.22)	(0.16)
8 country dummies	*175.1***	*174.81***	*114.11***	*154.27***	*204.09***
48 industry dummies	*126.06***	*126.05***	*126.83***	*125.85***	*127.17***
8 time dummies	*153.38***	*152.51***	*158.52***	*155.93***	*167.82***
constant	–11.58***	–11.77***	–14.00***	–15.33***	–31.59***
	(3.25)	(3.32)	(3.60)	(3.85)	(10.72)
n. obs.	2784	2784	2784	2784	2784
Log-L	–1155.53	–1155.56	–1154.34	–1153.84	–1156.36
Specification test	209.54***	209.48***	211.92***	212.92***	207.88***

Notes: ** significant at the 5 per cent level;

*** significant at the 1 per cent level.

Standard errors in parentheses. The Chi-sq. test of Ho: joint coefficients = 0 is reported for dummy variables. The specification test is a LR test of the restricted (dummies and constant only: Log-L = –1260.30) model vs. the unrestricted model. The test statistic is χ^2 distributed with three degrees of freedom.

Source: Altomonte (2003: Table 4.1).

Traistaru, Nijkamp and Longhi [2003] analyze whether various regions or industries in three first-round accession countries, namely, Estonia, Hungary, and Slovenia and two-second-round accession countries, Bulgaria and Romania, are showing the first signs of a shift in the spatial allocation of economic activities. The prediction of new trade theory regarding the distribution of economic activity between the core and periphery is relevant in the case of the accession of Central and East European countries to the European Union. The current economic integration situation could be seen as one with 'intermediate trade costs'. Further integration could result in the relocation of manufacturing towards these countries due to factor costs differentials (Hallet [1998]). These new economic geography models imply that, in sectors where supply-side and demand-side linkages are important, European integration would bring massive specialization and concentration. Given the extremely low inter-EU labor mobility, this result seems, however,

unrealistic (Eichengreen [1993]; Obstfeld and Peri [1998]). Agglomeration effects might still be present if there is sufficient labor mobility within EU countries. In this case, agglomeration effects would be observed around border regions similar to those identified by Hanson ([1996a, 1996b]) for the case of US-Mexican economic integration.

Empirical literature on the impact of economic integration on production specialization and geographic concentration of industries is still scarce. With respect to accession countries, existing evidence based on trade statistics suggests that these countries tend to specialize in labor- and resource-intensive sectors, following an inter-industry trade pattern (Landesmann [1995]). Despite the dominance of the inter-industry (Heckscher-Ohlin) type of trade, intra-industry trade has also increased, most evidently in the Czech Republic and Hungary (Landesmann [1995]; Dobrinsky [1995]). This increase, however, may be associated with the intensification of outward processing activities. It has been claimed that the processes of internationalization and structural change in transition economies tend to favor metropolitan and western regions close to EU borders, as well as regions with a strong industrial base (Petrakos [1996]). In addition, at a macro-geographical level, the process of transition is expected to increase disparities at the European level, by favoring countries near the East-West frontier (Petrakos [2000]). Increasing core-periphery differences in Estonia are documented in Raagmaa [1996]. Using the ‘new economic geography’ approach, Altomonte and Resmini [1999] have investigated the role of foreign direct investment in shaping regional specialization in accession countries.

Traistaru, Nijkamp, and Longhi use employment data from a specially created data set in order to analyze regional specialization and concentration of manufacturing. The results presented in Table 4 suggest that regional specialization has increased significantly in Bulgaria and Romania, has decreased in Estonia, and has not changed significantly in Hungary or Slovenia. Proximity to the EU is associated with low specialization in advanced accession countries (Estonia, Hungary and Slovenia) and high specialization in countries lagging behind with the accession (Bulgaria). Proximity to other accession countries is associated with low specialization in Bulgaria, Estonia and Romania, and with high specialization in Hungary. Proximity to countries outside the EU enlargement area is associated with high specialization in Hungary, Bulgaria and Slovenia and with low specialization in Romania. Internal regions have high specialization in Romania and Slovenia and low specialization in Hungary and Bulgaria. Geographical concentration of manufacturing has increased significantly in Bulgaria and has not changed significantly in the rest of the accession countries analyzed here.

TABLE 4
SPATIAL EFFECTS IN CEECS

	Bulgaria	Estonia	Hungary	Romania	Slovenia
	Regional specialization(1)				
t	0.0126***	–0.0118	–0.0064	0.0128	–0.0070
	(0.0023)	(0.0084)	(0.0042)	(0.0021)	(0.0115)
Number of obs.	280	50	160	369	48
R^2	0.1094	0.0432	0.0160	0.1018	0.0106
	Geographical concentration of manufacturing(2)				
t	0.0170***	–0.0011	–0.0044	0.0041	0.0007
	(0.0028)	(0.0092)	(0.0053)	(0.0028)	(0.0095)
Number of obs.	120	120	64	108	48
R^2	0.2558	0.0001	0.0124	0.0077	0.0002

Notes: * significant at 10 percent;

** significant at 5 percent;

*** significant at 1 percent

Standard errors in parentheses.

(1) A region *j* is 'specialized' in a specific industry *i* if this industry has a high share in the manufacturing activity of region *j*.

(2) A specific industry *i* is 'concentrated', if a large part of its production is carried out in a small number or regions.

Source: Traistaru, Nijkamp and Longhi (2003: Tables 1 and 2).

The general result is that relocation of industries has been either insignificant or difficult to predict on the basis of data for the 1990s. This may be partly due to the fact that regions within CEECs can be fairly small; it seems difficult to assign centrifuged or centripetal forces to the geographical proximity to EU borders. Additionally, the regional pattern seems to depend on regional as well as sector specific locational advantages. The picture may change, however, as CEECs become members of the EU, but, for the time being, labor market effects and migration decisions are still too difficult to predict in order to justify simplifying assumptions about net migration. It is especially the link between FDI and migration via relocation and labor market effects, which has to be investigated in order to adequately, tackle the impact of integration on the spatial allocation of industries in CEECs.

The Missing Link – FDI and Migration

Despite the obvious relevance of linkages between the different types of factor flows, economic theory provides relatively little guidance for analyzing FDI and migration channels of integration simultaneously (see Buch *et al* [2003]). Theory either disregards market frictions or analyzes different channels of integration separately. If frictions are assumed away, integration and trends towards factor price equalization can equivalently arise through trade or through movements of capital and labor. In contrast, models that assume frictions on capital or labor markets when analyzing a particular channel of integration typically disregard alternative channels of integration.

Theoretical models differ in their predictions or assumptions on whether different types of factor flows are complements or substitutes. Neo-classical open economy models, for instance, often assume different channels of integration to be substitutes. In these models, factor price equalization can be facilitated through trade in goods or through movements of factors (see, e.g., Burda [2002]). Ricardian models, in contrast, yield a complementary relationship. Different factors move to the same region because this region has access to a superior technology (Davis and Weinstein [2002]). Agglomeration effects can lead to complementarities as well. In Gross and Schmitt [2003], for instance, factors of production from one source country cluster in specific destination countries because of labor market imperfections.

At the same time, predictions of the two strands of the literature which focus, on the one hand, on technological differences and differences in factor endowments, and, on the other hand, on cultural and network effects in explaining factor flows are not mutually exclusive. Combining the implications of these models would suggest that cultural proximity and network effects are likely to create clusters of factor migration. These determinants of factor flows interact with the incentives to migrate and to re-locate capital that are being stressed by more standard models of integration.

So far, the joint implications of these models for capital and labor flows have been tested empirically only in a few papers. Bhattacharya and Groznik [2002] explain the regional pattern of US investment abroad and link investment decisions to patterns of immigration into the US. They find that US investments in a foreign country are positively affected by the income of the immigrant group from that country that lives in the US. Including this variable, other variables capturing cultural and geographic proximity become insignificant. This result suggests that patterns of migration and patterns of capital flows are complementary. A link between FDI and migration is also found by Shatz [2003] who studies the importance of FDI for California as compared to the rest of the United States. As one control variable, he uses the stock of the foreign-borne population, and he finds that a high share of the foreign-borne population increases FDI.

Buch *et al* [2003] use data on bilateral inward and outward migration of Germans and foreigners between the 16 German federal states and more than 40 partner countries, and firm-level data on inward and outward FDI into Germany that can be aggregated on a state-level. The evidence points towards a relatively strong link between the stocks of German migrants and stocks of German FDI abroad. For the immigration of foreigners and inward FDI, the evidence is much weaker. In terms of causality between FDI and migration over time, the results remain somewhat inconclusive: while it seems as if outward migration of Germans triggers outward FDI, the reverse direction of causality seems to hold true for inward FDI and inward migration of foreigners. Inward FDI seems to trigger inward migration. This supports the hypothesis coming out of theoretical work by Gross and Schmitt [2003] that migration and FDI are positively related.

The interesting empirical question for the accession countries is whether they will be able to avoid emigration of high-skilled labor by attracting FDI, which provides job opportunities in this segment of the labor market either directly, or indirectly by supporting technological progress. Access to the EU market and low labor costs may provide the basis for attracting cost-oriented FDI but may nevertheless do not prevent high-skilled people from migrating.

III. MONETARY INTEGRATION

A new branch of contributions to the literature on trade integration appeared around the mid-1990s, which presented surprisingly positive results for a trade creation effect of monetary unions. In one of the earlier and most famous result (McCallum [1995]) estimate the "home bias" on trade – i.e., the tendency of agents to trade disproportionately more within a single currency space – to be 2200 percent, or 22 times more, for Canadian provinces, as compared with trade flows with neighbouring US states. Nevertheless, in a more recent work (Anderson and van Wincoop [2001]) re-estimate this "border effect" to be a more credible 44 percent, for the US-Canada, and 30 percent for all industrialized countries. In a widely discussed set of results, Rose ([2000, 2001]; Rose and van Wincoop [2001]) using large panels to estimate gravity equations with a dummy representing a monetary union came up with the conclusion that a monetary union would increase trade between two members by almost 300 percent.

Rose's original estimations were questioned due to, among other reasons, some features of its original dataset, the original econometric specification, and the set of regressors used (Vinhas de Souza [2002]). Papers which performed alternative estimations in most cases came up with results that indicate negative or non-significant trade effects from a monetary union (Nitsch [2002a and 2002b]; Pakko and Wall [2001]; Persson [2001]), while others supported Rose's results, but to different degrees (Alesina *et al* [2003]; Lopez-Cordova and Meissner [2003]; Tenreyo and Barro [2002]). In more recent contributions, Rose tried to address several of the previous critics (Rose [2002]; Rose and Engel [2002]; Frankel and Rose [2002]; Glick and Rose [2002]). With an extended and corrected dataset, the original results were confined. Glick and Rose [2002], e.g., find now that a currency union at least doubles trade.

European monetary integration can provide an interesting case because monetary integration has taken place between mature and already relatively stable economies providing a lower benchmark for trade effects of monetary integration (Vinhas de Souza [2002]). Table 5 shows the results from a gravity model for EU member countries, which explains bilateral trade by distance (D), joint GDP (Y), EU membership (EU; dummy), monetary integration proxied by money market rate differentials (MI) and the bilateral Euro/USD rate (Euro/USD). The coefficient approximating monetary integration is consistently significant and negative, with low coefficients (indicating that reductions in the money market rates differentials of between 7 and 31 basis points would be associated with a 1 percent increase in intra Euroarea trade). Hence, in this case, monetary integration is found to positively impact upon real integration.

The weakness of this strand of research is that it, in the tradition of Rose, treats the transmission mechanism from monetary integration to real effects as a black box, augmenting, e.g., gravity models which explain bilateral trade with dummy variables representing monetary integration. The results of these ad-hoc specifications are highly dependent on the dataset, the sample, the regressors or the econometric technique used. Additionally, even if we accept the empirical observation of positive trade effects of a monetary union to be robust, there is still the fundamental question of what drives such substantial outcomes.

As an obvious candidate, one could assume that the costs associated with having an independent currency could come from the trade costs arising from exchange rate volatility. Yet, to produce

effects like the ones estimated by Rose, volatility would either have to be truly very substantial (and persistent) or highly non-linear, in the sense that even minor levels of instability would have negative effects on trade. Additionally, empirical evidence shows that it is rather misalignment, implying a persistent departure from an equilibrium exchange rate level, which has substantially negative effects on trade (see Sekkat [1998]) while the effects of exchange rate volatility on intra-EU trade are marginal. Recent work (e.g., Péridy [2003]) find significant effects from exchange rate instability for G7 countries' trade, but differentiated by sector: primary, assumed homogeneous goods show negative significant effects, while industrialized goods – assumed as imperfect substitutes, i.e., with significant non-price effects on competitiveness – show positive and significant effects. In contrast, Nowak-Lehmann and Martinez-Zarzoso [2002] who estimate the effects of macro instability on MERCOSUR exports, finds that the *real* exchange rate instability affects negatively and significantly the exports of all MERCOSUR members to the EU. Those results would imply that developed countries (mostly exporters of differentiated industrialized goods) would gain less from monetary integration-induced reduction in exchange rate volatility than developing countries.

TABLE 5
EUROPEAN MONETARY INTEGRATION AND TRADE

Variable	Coeffs. (OLS)	Coeffs. (OLS)	Coeffs. (RE)	Coeffs. (RE)	Coeffs. (FE)	Coeffs. (FE)
C	–38.46*	–42.03*	–36.16*	–109.12*	–23.41*	–155.12*
	(0.30)	(0.62)	(1.52)	(1.61)	(1.82)	(2.02)
D	–0.14*	–0.15*	0.14	0.45*		
	(0.02)	(0.02)	(0.09)	(0.10)		
Y	1.70*	2.06*	1.34*	4.33*	0.97*	6.46*
	(0.01)	(0.01)	(0.04)	(0.05)	(0.06)	(0.06)
EU	–0.04	0.25*	0.90*	3.46*	1.02*	4.46*
	(0.07)	(0.07)	(0.18)	(0.21)	(0.21)	(0.25)
MI	–0.15*	–0.21*	–0.08*	–0.13*	–0.14*	–0.31*
	(0.01)	(0.02)	(0.02)	(0.02)	(0.03)	(0.04)
Euro/USD	0.48*	–1.36*	–0.35	–1.78*	–0.21	–0.94**
	(0.12)	(0.43)	(0.31)	(0.39)	(0.32)	(0.39)
TREND	0.39*		0.50*		0.51*	
	(0.00)		(0.00)		(0.00)	
R^2	0.64	0.41	0.35	0.14	0.33	0.14
F-statistic	17541.37	8285.75	47292.10	9401.16	9341.23	2979.36

Notes: * significant at 1 percent;

** significant at 5 percent.

Source: Vinhas de Souza (2002: Table 6).

Alesina and Barro [2002] propose that the creation of a currency union has potential conditional beneficial effects, not only due to trade, but also to expectations, stabilization and credibility gains (conditional on the degree of co-movements of output between the units that form a currency union – which, on its turn, *may be* related to the degree of trade integration – and on the adequate use of the exchange rate instrument).

Consequently, there is another strand of the literature, which models the underlying transmission mechanism explicitly. It originates from the idea that uncertainty of future earnings raises the 'option value of waiting' with decisions, which concern investment projects in general (Dixit [1989]). Belke and Setzer [2003] develop a model, which illustrates a mechanism that explains a negative relationship between exchange rate uncertainty and job creation.

Earlier studies by Belke and Gros [2001; 2002a; 2002b] on intra-EMS, transatlantic and MERCOSUR exchange rate variability have already indicated that reductions in exchange rate variability could yield substantial benefits for small open economies. Because all employment decisions in the CEECs have a comparable degree of irreversibility, it is to be expected that the same apply for most of the CEECs. Belke and Setzer [2003] investigate both effective and bilateral euro exchanges in order to analyze the costs of exchange rate variability in general (effective volatilities) and in evaluating one partial benefit of euroization – the elimination of the exchange rate risk – in particular (bilateral volatilities vis-à-vis the euro). In order to test empirically for the impact of exchange rate variability on labor-market performance, they employ a panel of ten Central and Eastern European countries, namely Bulgaria (BG), Czech Republic (CZ), Estonia (EE), Hungary (HU), Latvia (LV), Lithuania (LT), Poland (PL), Romania (RO), Slovak Republic (SK), and Slovenia (SL).

The basic result is shown in Table 6. The estimated coefficients measuring the impact of exchange rate volatility on employment growth are significant and display the expected sign. Exchange rate volatility enters the regression equations with at least one lag. However, in most cases, the implementation of even a two-year lag of exchange rate volatility appears superior according to the goodness-of-fit criteria. This corresponds with the usual duration of wage contracts in the investigated countries and serves as first evidence of the absence of a reverse causation of the exchange rate volatility by employment growth. As studies for other regions suggest the economic impact of exchange rate volatility seems to be small but significant.

However, test statistics reveal that the ten CEECs are too heterogeneous to be characterized by a similarly strong impact of euro exchange rate volatility. Heterogeneity might stem from different degrees of labor market rigidities and/or from different levels of volatility experienced in the past. Allowing for different volatility coefficients for each CEEC, it becomes obvious that the Czech Republic, Hungary and Poland, as the economies, which are most open to trade with the eurozone, are among those countries for which the results are most in line with the main hypothesis. These countries are joined by Lithuania and Latvia with four respectively three entries as well. Estonia, Romania and the Slovak Republic display two entries each. Somewhat surprisingly, Bulgaria, an often cited candidate for euroization, reveals only one entry. Only Slovenia, which reveals the lowest degree of exchange volatility in the sample, does not display any evidence of negative employment impacts of exchange rate variability. With the exception of Slovenia, these results closely correspond to different degrees of openness of CEECs.

TABLE 6

IMPACT OF EXCHANGE RATE VARIABILITY ON THE GROWTH OF EMPLOYMENT – SUR ESTIMATES FOR 10 CEECS (FIXED EFFECTS)

Regressors	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
Instrument for the growth of employment (–1)	/	0.06	/	0.09***	/	/	/	0.05	/	0.04
Real GDP growth rate	0.19***	0.11***	0.20***	0.11***	0.06***	0.12***	0.17***	0.10***	0.16***	0.09***
Measures of exchange rate volatility:										
Effective, nominal	–0.20***	–0.16***			–0.29***					
	(–2)	(–2)			(–2)					
Effective, real			–0.08***	–0.08***		–0.13***				
			(–2)	(–2)		(–2)				
Euro (DM), nominal							–0.16***	–0.10***		
							(–2)	(–2)		
Euro (DM), real									–0.35***	–0.08*
									(–2)	(–2)
AR-error assumed					X	X				
Fixed effects:										
Bulgaria	0.60	0.20	0.09	–0.00	1.86	1.40	–0.07	–0.58	0.49	–1.19
Czech Republic	–0.57	0.59	–0.34	–0.41	–0.30	–0.09	–0.70	–0.72	–0.34	–0.73
Estonia	–2.81	–2.35	–2.43	–1.77	–2.06	–1.71	–3.20	–2.70	–2.57	–2.62
Hungary	–0.68	0.45	–0.59	0.73	1.10	0.77	–0.85	0.29	–0.35	0.30
Lithuania	–1.74	–1.47	–0.91	–0.49	–1.55	0.40	–1.93	–1.72	–1.22	–1.79
Latvia	–1.90	–0.46	–1.46	0.27	0.69	0.76	–2.15	–0.72	–1.26	–0.73
Poland	–1.06	–0.52	–1.06	–0.33	–0.08	–0.15	–1.17	–0.67	–0.42	–0.66
Romania	0.54	0.47	0.48	0.68	0.48	0.81	0.25	0.12	1.25	–0.01
Slovak Republic	–0.26	–0.96	–0.05	–0.55	0.08	0.50	–0.39	–1.11	0.02	–1.10
Slovenia	0.62	0.36	0.46	0.35	1.29	0.99	0.48	0.27	0.86	0.31
Unweighted statistics:										
R^2	0.28	0.25	0.24	0.25	0.11	0.23	0.26	0.22	0.28	0.20
Wooldridge - $\hat{t}$ (p-value)	1.99 (0.05)	1.48 (0.15)	3.08 (0.01)	1.22 (0.23)	/	/	2.66 (0.01)	0.49 (0.63)	1.98 (0.05)	0.33 (0.74)
Total panel observations	78	64	79	64	68	69	78	64	78	64
Sample	1993-2001	1994-2001	1993-2001	1994-2001	1993-2001	1993-2001	1993-2001	1994-2001	1993-2001	1994-2001

Source: Belke and Setzer (2003: Table 4)

For Poland, the country that shows the largest impact of exchange rate variability on employment, the estimates imply that a reduction in the variability measure by one percentage point increases employment growth after one year by 0.57 percent. Given a number of about 13,7 millions of employed Polish persons in 2001 this amounts to about 78,000 employed more. This is a quite small, but still non-negligible contribution. The effect would actually be three times as strong if the actual variability was eliminated, given the fact that in 2001 the euro variability of the zloty against the euro was 3.17 percent, or at least twice as high if one eliminates the average variability (2.37 percent).

Generally, the results of this paper suggest that the high degree of exchange rate variability observed from time to time in the CEECs has tangible economic costs. The results are rather strong in that rising exchange rate variability in many cases impact negatively on employment growth. Moreover, the data confirm the expectation that economies with relatively closer ties with the euro zone, such as Hungary or Poland, would show a stronger impact of euro exchange rate variability. The estimated impact coefficients were in most of the cases smaller if pooled for all CEECs. This systematic correlation between openness and the strength of the impact of exchange rate volatility on trade corresponds to the general finding of the literature, which is that for emerging markets with a large exposure to international trade this channel is much more important.

These results could be read as support for the policy conclusion that fixing exchange rates against the euro should bring significant benefits. Belke and Setzer argue that it is now widely considered a stylized fact that exchange rates are disconnected from fundamentals (e.g., Obstfeld and Rogoff [2000]). In this case, exchange variability mainly reflects excess variability. The constant threat of speculative attacks on emerging market currencies can actually cause a co-movement of variables that does not exist for developed economies. It is reasonable to assume that the general disconnect between exchange rates and fundamentals also holds for the CEECs and is even extended to (domestic) interest rates, which for emerging markets are determined by shocks coming from international financial markets. However, it cannot be ruled out that the variability in the exchange rate in the 1990s has been caused by the variability of monetary policy. If this were the case, the cost of exchange rate volatility should be considered as the cost of erratic monetary policy and should fuel the debate on the relation between monetary policy rules and exchange rate variability.

IV. NET EFFECT OF EUROPEAN INTEGRATION FOR THIRD COUNTRY GROUPS

Though not covered by papers in the first Annual Conference, an important issue is the external dimension of the EU enlargement, i.e., the effects of enlargement for non-member countries. Non-member countries share both hopes and concerns, which arise from the two well-known effects of regional integration, the efficiency and the discrimination effect.

Hopes exist because enlargement removes barriers to trade among the old and the new members, makes the internal market larger, enables to collect scale economies and triggers the relocation of economic activities from the centre to the periphery. One should stress the differences between this view supported by the school of "new regionalism" (Ethier [1998]) and the gravity model approach followed by Marques and Metcalf [2003a]. The new regionalism departs from asymmetric policy reforms: Small countries join a large well-established bloc of countries or large mature countries, respectively. To make accession to such blocs possible, small countries have to liberalise more than the large countries. In accordance with the mainstream finding that own liberalisation offers larger gains than liberalisation of partner countries, it is the smaller countries which collect the lion's share of integration-induced benefits in terms of remaining attractive investment hosts in a globalised world. In contrast, both the US in NAFTA as well as the EU-15 countries in the EU do not make any sizable concession to the smaller countries. Such North-South integration is therefore also expected to enhance income convergence due to the fact that in North-South integration the poorer (smaller countries) are not incurring the costs of trade diversion unlike in South-South integration.

The gravity model approach disregards catching up processes as a result of asymmetric policy reforms between South and North. Instead, it stresses the importance of the hub (the North) as the catalyst for attracting skilled manpower from the South thereby strengthening the competitive base of the North in skill-intensive products. The empirical experience of whether in North-South regional integration there was convergence due to North-South capital flows or, alternatively, divergence due to South-North labor flows, cannot be answered straightforwardly. While labor flows were usually small (and or restricted during a transition period), one can show that North-South integration in Europe has shown both strong North-South capital flows (as in the Spanish case after Spain's accession) as well as capital flow inertia (such as in period after the Greek accession) depending on the reform mindedness of the acceding countries. With low reform mindedness in these countries, the hub can defend its leading position thus yielding the Marques/Metcalf picture.

Both static (trade creation) and dynamic (new investment and productivity gains) effects can help the enlarged EU to rise to medium term growth rate. Third countries are expected to benefit via income effects but also via price effects since higher growth in the EU could lead to higher wage increases relative to goods price increases and thus to real appreciation making imports more competitive against domestic substitutes. Indirect or second-round effects could benefit third countries further if accelerated income growth in the EU would force some industries to outlocate their production beyond EU borders in order to be competitive. Such outlocation could enhance technology transfer, production networking with EU companies and skill formation apart from employment effects.

Concerns on the other hand emerge from the discrimination effect, which is inherent in institutionalized regional integration treating non-members less favorably than members. Old members gain better access to the CEECs relative to non-members giving rise to the well-known static trade diversion effect of replacement of imports from non-member countries by member country trade. As in the positive scenario of the efficiency effect, there are also dynamic effects due to foreign capital inflows into the enlarged grouping to the detriment of locations outside the EU.

Back-on-the-envelope calculations suggest that the size effect of enlargement is within the one-digit range. In 2001, the ten CEECs accounted for 8.2 percent of the EU-25 PPP gross national income in 2001 (World Bank [2003]), not far above the mid-nineties share of 7.4 percent. The size effect has been accepted as a medium-term perspective after both full implementation of the integration process to full membership and finalized transition to a market economy (IRELA [1997]). It has also been argued that catching up growth would be time-consuming. Based on both Barro and Levine-Renelt growth equations which include human and physical capital endowment factors, Fischer *et al* ([1997] Table 9) show how long the "time from Brussels" can be expected. They estimate that convergence to the EU low income level (represented by Greece, Portugal and Spain) would last about thirty years for the average transition country, with the Czech Rep. (11 and 15 years respectively) as the most advanced transition country. This could mean that the positive impact of the size effect on third countries requires a fairly long time span to materialize fully.

Though in absolute terms the pure size effect of enlargement remains small, the effect on third countries should not be underrated. First, in terms of growth rates, the enlargement offers export chances for third countries, as import demand in the CEECs is growing more rapidly than in the old member states. Second, the lower income level in the CEECs opens opportunities for market penetration for standardized mass consumer products which are typically supplied by developing countries and emerging markets, including Latin America. However, the size effect can be viewed differently if one takes into account that in 1995, seven of the ten CEECs (the four Visegrad countries Czech Rep., Hungary, Poland, Slovak Rep., and three Baltic countries Estonia, Latvia and Lithuania) added 41 per cent of labor force employed in agriculture to the EU-15 figure, 35 percent of cropped land and 28 percent of cereal production but only 19 percent of population (Langhammer [2001] pp.105). Hence, the CEECs add an overproportionate share of production to the EU-15 stock just in the most heavily protected and subsidized sector, agriculture. This does not only raise concern about trade policy discrimination against third countries given that vested interests to further protect agriculture may become stronger. It may also hamper the size effects for third countries. A socially and politically acceptable restructuring in the CEECs could be accompanied by substantial North-East fiscal redistribution schemes with potentially negative effects for economic growth for the entire Union and thus fewer impulses both on the supply and the demand side for third countries. To insist on a community preference for CEECs and their supply over third country substitutes could result in the temptation to liberalize sensitive sectors like agriculture (but not only agriculture) less rapidly than without enlargement.

In contrast to the size effect, the discrimination effect is seen as an immediate threat and burden for third countries and thus became subject of empirical enquiries once full membership became an issue (Plummer [1994]; Horne and Huang [1996]; IRELA [1997]). Recent CGE analyses on the impact of EU enlargement on East Asian trade with the EU suggest that while there is some

trade diversion, these effects are small. So are overall macroeconomic effects (Lee, van der Mensbrugghe [2004]). Similar lessons can be drawn from the analysis of EU integration deepening on EU trade with ASEAN (Plummer [2003]).

The bottom line of the discrimination effect was the implementation of the so-called Europe Agreements which envisaged the formation of hub-and-spoke type of bilateral free trade areas (FTAs). Such FTAs give rise to trade policy discrimination as tariffs are removed between the CEECs and the EU while being maintained for trade between the CEECs and third countries. This process of removal will be completed until accession. Currently existing tariff barriers indicate that under a free trade area concept the discrimination effect would be based on an average weighted tariff preference margin of 8.8 percent (Table 7) that is the level of import tariff protection which the EU still maintains against the eight Central European CEECs. The extent of tariff decline that would be necessary to lower all EU tariffs against CEECs at the 15 percent level, i.e., 34 percent on average, indicates the importance of peak tariffs, in particular in agriculture. Overall, the total result is driven by high tariffs levied on agricultural products in CEECs suggesting that the core of discrimination can be expected in agriculture and against third country supplier of agricultural products.

TABLE 7
TARIFF LEVELS OF EU AND CEECS

	Tariff levels imposed by the EU against CEECs			MFN applied tariffs in year 2000/2001					
				Simple average			Maximum tariff		
CEECs	Simple average rate of protection	Weighted average rate of protection (1)	Tariff peaks(2)	All products	Non-agr. products	Agr products	All products	Non-agr. products	Agr. products
Czech Rep.	4.3	6.1	41.8	5.0	4.2	10.0	125.0	30.1	125.0
Estonia	4.9	13.7	32.8	1.7	0.1	12.2	59.0	25.0	59.0
Hungary	4.7	4.1	26.9	9.5	7.0	25.8	127.5	78.0	127.5
Latvia	5.5	10.0	37.9	4.1	2.9	11.9	93.9	30.0	93.9
Lithuania	5.5	7.8	38.0	3.4	2.5	9.8	87.0	33.8	87.0
Poland	4.3	6.5	47.4	13.9	10.1	41.9	676.7	119.2	676.7
Slovak Rep.	4.9	12.8	11.0	5.0	4.2	9.9	125.0	30.1	125.0
Slovenia	5.4	9.9	38.3	9.6	9.3	11.3	45.0	27.0	45.0
Average CEEC	4.9	8.8	34.3	–	–	–	–	–	–
EU	–	–	–	4.4	4.2	5.9	74.9	26.0	74.9

Notes: (1) Weights are the structure of EU imports from a reference group of countries determined by per capita income.

(2)Tariff peaks show the difference in the overall rate of protection if all tariffs and tariff quotas were capped at 15 percent.

Source: EBRD [2003, Table 4.3]; WTO [2003, Tables II.B.4 and II.B.6].

Yet, highlighting the absolute tariff preference margin of CEECs over non-member countries after completion of the bilateral free trade areas is only the first key towards the likely extent of trade discrimination and trade diversion. The second step is the third country effect of forming a customs union between all CEECs and the EU, in other words the harmonization of external

tariffs against non-member countries. Unlike in the early days of the EEC when between 1958 and 1968 the common external tariff was formed by averaging between higher national tariffs of France and Italy on the one hand and Germany and the Benelux countries on the other hand, there will be no averaging between CEECs. Harmonization here means that the CEECs with their external tariffs will adjust to the EU external tariff. The second part of Table 7 showing the MFN applied tariffs of the EU and the eight CEECs for three product groups yield that except for Estonia in non-agricultural products all CEECs maintain higher tariffs than the EU and thus will lower their tariffs to the EU level.

These are potentially goods news for non-member countries as access to the markets of the CEECs is facilitated relative to the FTA scenario both in absolute terms and, more importantly, compared to EU-15 suppliers. The preference margin of the EU-15 suppliers over non-member countries on the CEECs' markets is lower under the customs union than under a FTA scenario. A side-effect of the formation of the EU-25 customs union is the phasing out of the bilateral hub-and-spoke FTA arrangements offering the EU a competitive advantage over the spokes in intra-CEECs' trade. Third country suppliers establishing production facilities within the customs union of EU-25 and trading cross-border within the EU-25 would benefit from the dismantling of bureaucratic and often protectionist red tape associated with hub-and-spoke systems and controls of rules of origin. This is what Altomonte [2003] calls "Network Integration Agreement" (NIAs) due to lowering transaction costs and enhancing FDI. In goods trade, NIAs are just the customs union model. Ultimatively, it cannot be excluded that the high share of the EU in total imports of the CEECs will be redressed somewhat if the customs union is completed.

Empirical studies trying to measure the effects of discrimination on trade flows have focused on the FTA effect and neglected the customs union effect.

The IRELA 1997 study has been the most detailed one so far in terms of specific sectors and with exclusive reference to the Latin American export supply in the enlarged EU market. Based on partial equilibrium analysis (ex-post elasticity analyses) and specific trade indicators (trade similarity and overlap indices), the study concludes that:

(i) trade diversion effects will be marginal in a limited range of products;
(ii) in agriculture the key issue is the reform of the CAP which, under a non-reform scenario, would be most detrimental to Latin American supply;
(iii) continued protection in the EU rather than in the CEECs will be crucial.

Overall, it is estimated that trade diversion in industrial products is unlikely to exceed 1 per cent of Latin American industrial exports to the EU. This magnitude is in line with many partial equilibrium analyses on static price effects from forming an FTA and of discriminating against third country suppliers. What matters is that the similarity between CEECs' export supply and Latin American export supply on the EU is relatively small (about one fourth only). Trade structures are found to be complementary rather than substitutive (Nunnenkamp [2000]). Furthermore, the benefits which Latin American exporters of manufactures and semi-manufactures can collect from the Generalized System of Preferences (GSP) mitigate potential losses due to trade diversion because some exporters can enter the EU market (including the Latin American countries, in future) duty-free.

These partial equilibrium findings reflect the peculiarities of the Latin American export supply which differs between the EU market (more resource-oriented) and the US market (more manufactures-oriented). Plummer [1994] sees more substitutiveness in trade patterns between East Asia and the CEECs' supply and thus sees higher trade diversion risks for East Asia.

Quite a different approach is taken in general equilibrium types of analyses which consider indirect and secondary round effects. In order to assess static effects of different trade policy scenarios of EU enlargement, Horne and Huang [1996] apply an early version of G-TAP model, a conventional multi-region computable general equilibrium model to predict changes in output, exports, household income and welfare between two time points. Welfare changes are approximated by so-called equivalent variation (EV) measuring the amount of income which could be taken away after the policy change to make the agent (the one producer in each sector and the one representative household) as well off as before the policy change. Disaggregation covers ten regions and ten sectors, and the policy changes cover four experiments:

(i) The EU removes tariff on all imports from the CEECs (experiment Ia);
(ii) The EU removes tariff on all imports except "sensitive products" (agriculture, textile and clothing, iron and steel) from the CEECs (experiment Ib);
(iii) The first experiment is complemented by a removal of CEECs' tariffs on all imports from the EU and from within the CEECs (the inter-spoke trade) (experiment II);
(iv) The first experiment is complemented by a removal of CEECs' tariffs on imports from all sources (EU plus non-EU member states) (experiment III).

In experiment Ia (an asymmetric "one-way" free trade area), the discrimination effect affects changes in all four aggregates and throughout all regions (except the core-EU). The biggest loser in terms of welfare is the region "rest of the world" (ROW) which basically represents China and its textile and clothing supply which is particularly substitutive to the CEECs' supply. Yet, the absolute loss would be relatively small, at the maximum 0.32 percentage change for the export volume of South Asia.

Trade diversion and welfare losses are found to be much smaller for all non-member regions (about half of the losses arising from experiment Ia) if experiment Ib is applied which denies sensitive industries from the CEECs free access to the EU market. Like experiment Ia, the symmetric "two-ways" free trade area without hub-and-spoke relations (experiment II) includes sensitive products in the free trade arrangements. In this experiment, the trade diversion losses are found to be the largest for all regions while welfare losses by and large remain at the same level as in experiment Ia. Finally, experiment III offers the best results for third countries. Some regions, South Asia in exports and Japan in welfare, are found to be even beneficiaries from free trade offered by the CEECs to the EU and third countries alike. Thus, not surprisingly, the shift from preferential to non-discriminatory trade liberalization by the CEECs is equivalent to a win-win situation for both the EU and the non-European regions.

What matters in this analysis is that losses are relatively small. There is ground for the assumption that taking into account dynamic effects and the shift from a free trade area to a customs union in Europe which lowers external tariff multilaterally may further reduce the size of the discrimination effect.

Effects of enlargement for third countries are not only confined to trade but also to factor flows and here primarily foreign direct investment (FDI). The key question is whether two host regions, developing countries on the one hand and the CEECs on the other hand, compete for FDI from EU countries and whether full membership gives the latter group a competitive edge over the former. Of the three types of FDI, market-oriented, resource-based, and cost-oriented (or export-oriented), it is primarily the latter type which gives rise to concern. Geographical proximity and the validity of the "acquis communautaire" in the CEECs could lower transaction costs for cost-oriented FDI in these countries relative to FDI in developing countries. In fact, EU FDI in CEECs, in particular in Hungary, Poland and Czech Rep. rose rapidly albeit from a very low level. Yet, this coincided with an even more rapid increase of EU FDI in Asia (from a very low base, too). Latin America, traditionally the most important host of EU FDI among the developing regions, also recorded rising inflows. Nunnenkamp [2000] concludes that until 1996, the empirical result is that FDI creation prevailed rather than FDI diversion. The major reason is that EU FDI in Latin America and Asia has been traditionally domestic market-oriented and that until the Asian and Latin American crises between 1997 and 2000, these markets were rapidly growing. As a result, domestic-oriented FDI did not compete with the more cost-oriented investment in the CEECs. The IRELA [1997] investigations confirm these conclusions based on industry-specific analyses.

These findings complement the empirical pattern of FDI in the CEECs presented by Altomonte [2003]. He shows a rapid growth of FDI inflows in CEECs from EU-15, yet without putting these figures into comparison with extra-EU FDI outflows which were also on the rise during the nineties. It seems that overall locational competition has been less between different foreign hosts of EU capital but more between domestic investment in EU member states and FDI.

To sum up, traditional static trade creation/trade diversion analyses conclude that third countries lose against the new members because of trade policy discrimination. The magnitude is, as always in such sort of analyses, fairly small. Yet, these analyses stop half-way. They concentrate on the free trade area aspect and fail to include the formation of the customs union into the analysis. Full membership, however, is associated with the entry of the CEECs into the EU customs union whose external tariff is almost always lower than that of the CEECs. Therefore, the level of external protection of the CEECs against non-member countries will decline when they enter the EU customs union. This will mitigate the discrimination effect which was inherent in the formation of the bilateral free trade agreement between the EU and the individual CEECs.

In the realm of factor flows, there is wide consensus from empirical studies that non-member countries have had no reasons for concern about investment diversion. Unlike goods producing countries, hosts of FDI either located in CEECs or in non-member states have not proven to be easily substitutable. EU FDI in both areas grew rapidly during the nineties mainly because domestic market expansion induced investors to produce near the consumer in non-member countries while economic proximity between EU and CEECs triggered outlocation of stages or production from the EU home base to the East. Hence, it seems that locational competition in equity capital flows was more and is still more relevant between the EU and the prospective member states than between the latter and third countries.

V. OUTLOOK ON THE RESEARCH AGENDA

In order to determine some research areas of common interest for the discussion of economic integration policies in Europe and Latin America, it is appropriate to start with what determines new in contrast to old regionalism (IDB [2002]; Devlin and Estevadeordal [2001]) regional institution building as a building bloc of global integration, thereby attracting FDI, creating a regional but multilaterally committed market, integrating monetary policy, and developing a strategic partnership. With its southern and eastern enlargement, the EU became a kind of laboratory for new regionalism where integration mechanisms can be observed because policy decisions and structural change are closely linked. While in the case of the southern enlargement, market economies at lower income level experienced rapid sectoral structural change due to full membership, eastern enlargement even implied a transition from socialism and almost closed economies to democracy and full fledged integration with industrialized countries.

The papers presented at the Barcelona conference in the session on 'European Union Enlargment and Adjustment Policies During Transition' offered some insight into the European integration puzzle. They showed that:

(i) migration may change trade patterns (Marques and Metcalf [2003a]),
(ii) regional FDI flows may increase with regional trade (Altomonte [2003]),
(iii) monetary integration may have positive effects on employment growth (Belke and Setzer [2003]), and that
(iv) regional patterns of relocation within acceding countries are difficult to detect and to predict (Traistaru, Nijkamp, and Longhi [2003]).

Clearly, these findings for the CEECs cannot be translated to the situation of Latin American countries one-to-one. It is obvious that the European type of top-down orchestrated 'deep integration' is unrealistic in Latin America even for the medium term perspective. Nevertheless, the papers revealed some common ground with respect to the possibility to analyze economic policies and to draw qualitative conclusions.

With respect to FDI, the experience of Latin American countries suggests that attracting FDI does not necessarily imply that FDI contributes to catching up and thus to discouraging migration:

(i) Market-seeking FDI in industries in which the host country lacks competition reduced potential growth effects (Nunnenkamp and Spatz [2003]).
(ii) The lack of domestic competition had a negative impact on development perspectives (Moran [1999]).
(iii) The lack of complementary factors hindered spillover effects to spread to local enterprises (Kokko [2002]).

By joining the single market and due to a rather good supply of human capital, CEECs have a chance to do better. The interesting empirical question is whether emerging markets will be able to avoid emigration of high-skilled labor by attracting FDI which provides job opportunities in this segment of the labor market either directly or indirectly by supporting technological progress. Access to the EU market and low labor costs may provide the basis for attracting cost-

oriented FDI and job opportunities for unskilled people but may nevertheless not prevent high-skilled people from migrating.

This implies that research should more strongly focus on the role of labor markets in global integration. In order to identify the impact of investment, of government expenditure on education and infrastructure as well as of institution building on labor markets, relocation of production, and migration, partial equilibrium analyses as applied in the papers presented at the conference will have to complemented. To some extent, this can be done in country studies on the basis of CGE approaches (see, e.g., Thiele and Wiebelt [2004]) complemented by microsimulations based on household surveys (see, e.g., Bussolo and Lay [2003]).

With respect to monetary integration, it is discussed for CEECs as well as for Latin American countries that monetary policy has to be tailored to an environment with (temporarily in the case of CEECs) flexible exchange rates. Among the monetary strategies currently debated, inflation targeting and de jure flexible exchange rates figure prominently (Schaechter *et al* [2000]). The proponents of inflation targeting claim that this strategy, which was developed for industrialized countries giving high priority to controlling inflation (see, e.g. Bernanke *et al* [1999]), can be adopted in an emerging market environment as well (see, e.g. Loayza and Soto [2002]). However, inflation targeting faces, at least, two difficulties when adopted by emerging market economies (Mishkin [2000]). The first problem is that for various reasons the transmission mechanism is much more unstable in emerging market economies, which reduces the effectiveness of targeting the inflation rate considerably. The second problem are balance-sheet effects. Because assets as well as liabilities are dollarized (or euroized) to a significant extent, devaluations may cause financial crises (Aghion *et al* [2001]; Céspedes *et al* [2000]). Therefore, emerging markets can hardly ignore exchange rate developments completely (Williamson [2000]; Braga de Macedo *et al* [2001]; Goldstein [2002]).

Empirical studies reveal that the risk of higher debt service due to unforeseen devaluations indeed increases risk premia for emerging market economies (Berganza *et al* [2004]). Furthermore, de jure and de facto exchange rate regimes differ considerably, with de facto regimes showing a higher degree of exchange rate intervention by central banks (Calvo and Reinhart [2002]; Levy-Yeyati and Sturzenegger [2002]). Additionally, the reaction functions of central banks with inflation targets show that either interest rates react to exchange rate movements, as was the case in Poland, or that interventions in the foreign exchange market have been used as a parachute in order to safeguard external equilibrium in cases of global financial crises, as was the case in Chile (Hammermann [2004]).

The CEECs, unlike other countries in similar situations, have the option to choose monetary integration with the euro area as an optimal monetary policy strategy. An indicator analysis revealed that, compared to a reference group of EMU members (Ireland, Portugal, Spain, Greece), the CEECs which enter the EU in 2004 perform quite well with respect to nominal convergence and the optimality of a common currency area (Schweickert [2001]). Hence, the eight CEECs which will join the EU in 2004 will, in all likelihood, become member of EMU until the end of the decade. During this transition period, however, some features are interesting from a Latin American perspective as well.

CEECs have to balance out the trade-off between inflation targeting and smoothing nominal and real exchange rate variability. To neglect exchange rate smoothing can have non-negligible costs. This was shown by the research on monetary integration reviewed in Chapter III.

During transition to full EMU-membership, CEECs markets will be segmented from the EU market because of exchange rate uncertainty. This will negatively affect market accessibility via FDI, and, as argued in Chapter II, migration to the North may be larger than in a fully integrated market.

This points at two research areas of common interest, the impact of macroeconomic stability on factor market integration, and monetary management in flexible exchange rate regimes. It is, of course, the latter which will dominate the public debate in Europe during the transition of CEECs to full membership in the EMU.

An additional research area, which has not been addressed in the four papers presented in the session, is institution building. As a product of the Post-Washington-Consensus debate, the development economics literature acknowledges the importance of reliable formal institutions, i.e., governance, and informal institutions, i.e., social capital, for economic development (Schweickert and Thiele [2004]). Empirical studies on the basis of the World Bank Governance Indicators identify institutions as an important, or even the most important, determinant of long-term economic development (Acemoglu *et al* [2001]; Easterly and Levine [2002]; Rodrik *et al* [2002]; Rodrik [2003]). For social capital (e.g. norms and traditions), which have recently been assessed for a number of countries in the World Values Surveys and the European Values Surveys, cross-country evidence also confirms the hypothesis of a positive impact on growth (La Porta *et al* [1997]; Knack and Keefer [1997]; Zak and Knack [2001]). The interesting question from a region perspective would be whether institution building usually pursued under a national policy regime can be promoted also (or even alternatively) by deep or shallow regional integration schemes. Again, evidence from the different rounds of European enlargement could provide an interesting data base for empirical research.

Finally, third country effects of EU enlargement are still a subject of future research. Only after the EU-25 customs union is completed, one can gauge the true extent of the discrimination effect which is relevant for third countries such as Latin America. The southern enlargement gave some hints how important political economy arguments are if new members try to shift some part of the adjustment burden to third countries by denying them freer access to EU markets in sensitive products like agriculture and textiles and clothing. As the CEECs are partly specialised in these products, one cannot preclude that their influence in determining the common external trade policy in the multilateral arena will become more targeted toward “community product preferences”. Furthermore, whether EU offers on free trade agreements with Latin American countries will become more restrictive after accession is an open question but should be given due attention in future research.

Should such negative spillovers from European integration to Latin America occur, this would indeed be highly unfortunate. It could easily refuel a deeply rooted export pessimism in Latin America originating from the Cepalismo era and, more generally, serve to legitimate a reform fatigue which has recently been identified to spread over Latin America (IDB [2004]).

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EUROPEAN UNION ENLARGEMENT AND ADJUSTMENT POLICIES DURING THE TRANSITION: A COMMENT

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Introduction

The purpose of the document by Langhammer and Schweickert is to summarize the main findings and lessons that can be derived from the papers presented at the First Annual Conference of the Euro-Latin Study Network on Integration and Trade, held in Barcelona on November 6-7, 2003.

The papers addressed several issues related to the potential consequences of EU enlargement. First: how integration affects migration patterns and how these affect trade flows. Second: the consequences of EU expansion on FDI flows, and in particular whether the acceding countries will benefit. Third: how the economic geography of the countries entering the EU might be affected by firms' location decisions. Fourth: the impact of EU enlargement on third countries. Will other nations and regions such as Latin America lose because of trade (and investment) diversion? No paper in the Barcelona conference addressed this, but the authors developed their views on the matter.

My purpose in these comments is to explore the relevance of the above issues for the integration initiatives currently underway in Latin America. I conclude with some ideas on future research.

Integration and Migration

The key issue raised in by the paper by Marques and Metcalf [2003], which is discussed in Langhammer and Schweickert report is whether the real effects of integration on trade flows and industrial development are sensitive to the assumption of free mobility of labor. One concern that the paper tries to answer is whether, as a consequence of the increased integration of labor markets in the enlarged EU, the East European countries will experience migratory outflows of their most educated workers.

More generally, high labor mobility could affect the pattern of trade between developed and developing countries, further fostering Northern countries' specialization in human capital-intensive products, while the South is obliged to produce low-skilled or natural resource-intensive goods. Thus economic integration might bring about a less diversified trade structure in the Southern economies, undermining productivity and per capita income growth.

To what extent is this concern for the consequences of high labor mobility significant for the North-South integration initiatives currently underway in Latin America? Three issues can be mentioned in this regard:

First, the regional integration agreements (RIAs) that have been or are being negotiated in the region do little in the way of labor market integration. In the case of NAFTA, for example, very substantial constraints on labor mobility across countries persist.

Despite the significant restrictions on labor mobility, developed countries in the region, mainly the United States, are still a magnet for labor because of huge wage differentials. In the case of unskilled labor this migration is often illegal and is documented by the very high level of remittances (see Cox-Edwards and Ureta [2003]). For skilled workers, immigration into developed economies is sometimes channeled through government programs such as work permits for entrepreneurs, student scholarships and so on.

The crucial question is whether the RIAs that developing countries sign with industrialized countries can create the conditions needed for a process of income convergence, thereby reducing outflows of both low-skilled and skilled migrants. In Latin America, an important country to search for evidence of this is Mexico, given its NAFTA membership and its proximity to the United States. Robertson [2000] and Hanson [2002] provide a detailed analysis of the behavior of Mexican wages relative to those in the United States, using a methodology that facilitates control for educational levels, age, sex, and fixed industry-specific components of wages. They found that there is no clear trend of convergence for wages at the national level, but only in those Mexican states that have common borders with the United States. In part, wage convergence in these states is clearly linked to the huge flows of foreign direct investment (FDI) promoted by the cross-border integration of production facilities. The importance of FDI as a channel for income convergence is discussed next.

Integration and FDI Flows

The impact of EU enlargement on FDI flows is discussed in the paper by Altomonte [2003], which seeks to analyze the extent to which the acceding countries will benefit from increased flows of FDI. These new flows are the most significant reward that countries expect in return for meeting all the stringent conditions they have to fulfill in order to join the EU. But are these expectations justified? What is the evidence for the effects of an integration agreement on FDI flows? A recent paper by Levi Yeyati *et al* [2002] provides complementary evidence to that presented in Altomonte [2003] and discussed in the Langhammer and Schweickert report. It also helps put the issue in a Latin America perspective.

In their analysis of the impact of RIAs on FDI, Yeyati *et al* try to capture the various channels through which an integration initiative may foster investment. Besides the classical dummy variable indicating that two countries have signed an agreement, they also include an indicator of the expansion of the recipient country market brought about by the integration initiative. They show that this is an important channel for fostering FDI flows. In Mexico, for example, NAFTA entailed a 100% increase in bilateral FDI from the United States. Completion of the Free Trade Area of the Americas (FTAA) would entail a surge in US FDI in Argentina of about 165%.

The above evidence suggests that North-South RIAs could be very important for southern countries in terms of expanding foreign investment. South-South agreement could also be important in this regard. Nogues *et al* [2001] analyze the case of Mercosur and show how this agreement has played some role in encouraging real capital investment in the region. The new

flows covered all member countries, not only the largest economy (Brazil), and have allowed these countries to diversify their production and trade patterns with a notable increase in intra-industry trade (see Sanguinetti *et al* [2004a].

Linking the analysis presented in this section with the previous one, it can be concluded that RIAs could be an efficient means of fostering FDI flows from developed to developing countries. That in turn may give rise to a certain degree of income convergence and thereby reduce the incentives to emigrate, especially for skilled labor.

The RIAs and the Economic Geography within Countries and Integrating Regions

A related question, already mentioned above, is whether the integration policies may cause a geographically unbalanced development pattern. This issue, for the case of the EU accession countries, is discussed in the paper by Traistaru *et al* [2003]. The concern is whether, as a result of transport cost savings and other locational advantages, economic activity will concentrate in the regions bordering the EU-15.

As indicated above this has been a matter of concern in Mexico. As mentioned earlier, Mexican states bordering the United States have experienced a strong economic surge; this has not spilled over to other regions especially in the south.

What is the evidence in the case of other Latin American RIAs? Sanguinetti *et al* [2004b] provide some evidence for Mercosur, revealing that the initial size of the market *cum* scale economies is an important determinant of industry location. Still, elimination of internal barriers has somehow moderated the effects of these agglomeration forces, allowing smaller countries of the region (say, Argentina and Uruguay) to gain also some industrial employment.

Additional evidence on the effect of trade liberalization on industry location is presented in Sanguinetti and Volpe [2004]. This paper shows Argentine industry de-concentrated In the 1990s. Perhaps more interesting, those sectors facing lower tariff have tended on average to locate far from the main domestic consumer markets (the Greater Buenos Aires area).

Third Country Effects

The consequence of EU enlargement for third countries is an issue of concern for Latin American countries. Europe is an important market for Latin American exports (around 20% of total shipment go to the EU). The Langhammer and Schweickert report discusses two potential and contrary effects. On the positive side, stronger growth and income convergence for the accessing countries may foster import demand from the rest of the world, and from Latin America in particular. On the negative side, because of preferential access to the EU market, Eastern European nations may displace exports from third countries. This is particularly worrisome in the case of agriculture and food products, since the export supply of some of the accessing economies competes with that of some Latin American countries (Poland's crop production, for example).

How justified are fears that EU enlargement might induce sharp losses for third countries through trade diversion? In this regard there is evidence showing that the EU's agricultural policy has diverted trade (Vollrath [1998]). This is unsurprising, given the significant level of protection to which these products are subject, both in terms of tariffs and domestic subsidies. Bianchi *et al* (2004) shows that the average tariff in agriculture (almost 10%) is more than twice that for industrial products. Though equivalent protection through subsidies is also significant (reaching 100% for some products), market access is more important than subsidies when tariffs are eliminated. Hoeckman *et al* [2002] report the same finding.

The problem is not only the level of tariff and other border protection that the EU maintains against third countries which, if they are high, give the acceding countries very substantial competitive advantages over third countries. The extension of free trade treatment to the Eastern European economies might spur an increase in external barriers as a means of compensating domestic producers in the EU countries. This happened in the case of NAFTA. In sugar and orange juice, for example, US external barriers increased when Mexico joined the accord (Sanguinetti and Bianchi [2002].

A way of counteracting these potential negative effects of EU enlargement is for Latin American countries to reach free trade agreements with Europe. Some countries in the region have already taken steps in this direction. Notably, Mexico and Chile have signed FTAs with the EU. On the agriculture side these agreements have brought good news, since the accords have yielded significant market access gains even though some restrictions on agricultural trade persist. This is an important step towards agricultural liberalization in comparison to what was secured in the last multilateral negotiations (the Uruguay Round).

Concluding Remarks

Let me conclude by arguing that the European integration experience is very significant for Latin America. It shows how North-South integration can foster income convergence and thus reduce migration flows. A key channel through which this convergence is achieved is the strong stimulus to FDI flows in the Southern countries. This brings in more diversified patterns of production and trade in the integrating economies.

Further research is needed to assess the impact of integration (both North-South and South-South) on trade and development. For example, there is a need for a better understanding of the relationship between FDI and a recipient country's technological progress; any potential spillover that FDI may have in the host economy needs to be quantified. What kind of investment is more significant in this regard: vertical FDI or horizontal?

As to third country effects, more research is needed on the political economy of regional integration agreements. Under what circumstances (in terms of domestic market structure, industry characteristics and so on) are there incentives to displace part of the adjustment of trade liberalization to third countries? NAFTA and the ongoing process of EU enlargement provide an interesting cases for examination of these issues.

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Contents

APPENDIX

AGENDAS

Barcelona, November 6-7 2003

Buenos Aires, April, 27-28 2004

INTER-AMERICAN DEVELOPMENT BANK

SPECIAL OFFICE IN EUROPE
INTEGRATION AND REGIONAL PROGRAMS DEPARTMENT
INSTITUTE FOR THE INTEGRATION OF LATIN AMERICA AND THE CARIBBEAN

First Annual Conference of the Euro-Latin Study Network on Integration and Trade November 6-7, 2003

Co-organized with the Center for Research in International Economics (CREI) and in cooperation with the Kiel Institute for World Economics (KIEL) and the Robert Schuman Centre for Advanced Studies of the European University Institute (RSCAS)

Building Roger de Llúria, Room 40.213
CREI, Universitat Pompeu Fabra
Ramon Trias Fargas 25
Barcelona

Agenda

Thursday, November 6

8:30 – 9:00 **REGISTRATION**

9:00 – 9:15 **WELCOMING REMARKS**
Andreu Mas-Colell, Minister for Universities, Research and the Information Society, Generalitat de Catalunya, and President of CREI
Carlo Binetti, Special Representative in Europe, IDB
Juan José Taccone, Director INTAL, IDB

9:15 – 10:00 **OPENING SESSION**
(9:15 – 9:40) **André Sapir**, Group of Policy Advisers, European Commission and Free University of Brussels
"Sapir Report: Lessons for Latin America"

(9:40 – 10:00) **Open Discussion**

10:00 – 13:30 **FIRST SESSION. MACROECONOMIC DIMENSIONS OF REGIONAL INTEGRATION**
(Session coordinated by CREI)

Chair/Rapporteur: Jaume Ventura, CREI and UPF

(10:00 – 10:35) **Juan Carlos Berganza, Roberto Chang** and **Alicia García Herrero**, Bank of Spain, Spain
Balance Sheet Effects and the Country Risk Premium: An Empirical Investigation"
Comments by Guillermo Le Fort, Executive Director, Chair of the Southern Cone Countries, IMF

(10:35 – 11:10) **Giancarlo Corsetti,** University of Rome III and Yale University, USA, **Philippe Martin,** University of Paris I and CERAS, Paris, France, and **Paolo Pesenti**, Federal Reserve Bank of New York, USA
"Globalization and the Transmission Mechanism"
Comments by: Sebastían Claro, Instituto de Economía, PUC, Chile

(11:10 – 11:30) **Open Discussion**

11:30 – 11:45 Coffee Break

(11:45 – 12:20) **Antonio Fatás and Ilian Mihov**, INSEAD, Fontainebleau, France
''On Constraining Fiscal Policy Discretion in EMU"
Comments by: José Fanelli, CEDES, Argentina

(12:20 – 12:55) **Dirk Niepelt**, IIES, Stockholm University, Sweden
''Intra-Generational Distributive Conflicts: The Role of a Balance Budget Requirement''
Comments by: Daniel Titelman, ECLAC, Chile

(12:55 – 13:15) **Open Discussion**

(13: 15 – 13:30) **Final Remarks: Jaume Ventura**

13:30 – 15:15 LUNCH

15:15 – 18:45 SECOND SESSION. EUROPEAN UNION ENLARGEMENT AND ADJUSTMENT POLICIES DURING THE TRANSITION (*Session coordinated by KIEL)*

Chair/Rapporteur: Rolf J. Langhammer, KIEL

(15:15 – 15:50) **Carlo Altomonte**, Università Bocconi, Milan, Italy and Katholieke Universiteit Leuven, Belgium
''Regional Economic Integration and the Location of Multinational Enterprises''
Comments by: Fernando Broner, University of Maryland

(15:50 – 16:25) **Ansgar Belke** and **Ralph Setzer**, University of Hohenheim, Germany
"Exchange Rate Volatility and Employment Growth: Empirical Evidence from the CEE Economies"
Comments by: Oscar M. Landerretche, MIT and Universidad de Chile

(16:25 – 16:45) **Open Discussion**

16:45 – 17:00 COFFEE BREAK

(17:00 – 17:35) **Helena Marques,** Loughsborough University and **Hugh Metcalf**, University of Newcastle, United Kingdom
''A Gravity Study of the Sectoral Trade Impact of Labour Migration in an Enlarged EU''
Comments by: Maximo Torero, GRADE, Peru

(17:35 – 18:10) **Iulia Traistaru**, University of Bonn, Germany, **Peter Nijkamp** and **Simonetta Longhi**, Free University of Amsterdam, The Netherlands
''Economic Integration, Specialization of Regions and Concentration of Industries in EU Accession Countries''
Comments by: Felipe Lopez Calva, University of the Americas, Mexico

(18:10 – 18:30) **Open Discussion**

(18:30-18:45) **Final Remarks: Rolf J. Langhammer**

20:30 DINNER

Friday, November 7

9:30 – 13:15 **THIRD SESSION. THE IMPACT OF REGIONAL INTEGRATION ON ECONOMIC CONVERGENCE AND GROWTH (*Session coordinated by RSCAS)***

Chair/Rapporteur: Omar Licandro, RSCAS

(9:30 – 10:05) **Gino A. Gancia**, CREI and UPF, Barcelona
''Globalization, Divergence and Stagnation''
Comments by: Renato Flores, Fundação Getulio Vargas, Brazil

(10:05 – 10:40) **Hubert Kempf**, CNRS and Université Paris I, Panthéon Sorbonne and **Stéphane Rossignol**, Université de Versailles and CNRS, France
''Growth, Inequality and Integration: A Political Economy Analysis''
Comments by: Pablo Sanguinetti, University Torcuato di Tella, Argentina

(10:40 – 11:00) **Open Discussion**

11:00 – 11:15 **COFFEE BREAK**

(11:15 – 11:50) **Nicole Madariaga** and **Sylvie Montout**, University of Paris I, Panthéon Sorbonne – Maison des Sciences Economiques, France and **Patrice Ollivaud,** OECD
"Regional Convergence, Trade Liberalization and Agglomeration of Activities: An Analysis of NAFTA and Mercosur Cases''
Comments by: Gabriel Felbermayr, EUI, Italy and written comments by Eduardo Loyo, Central Bank, Brazil

(11:50 – 12:25)
Gianmarco I. P. Ottaviano, Università di Bologna, Italy and **Jacques-François Thisse**, CERAS, Paris, France and Université Catholique de Louvain, Belgium
''Agglomeration and Economic Geography''
Comments by: Cristina Terra, Fundação Getulio Vargas, Brazil

(12:25 – 12:45)
Open Discussion

(12:45 – 13:00)
Final Remarks: Omar Licandro

13:00-13:15
CLOSING REMARKS: Robert Devlin, Deputy Manager, Integration and Regional Programs Department, IDB and **Antoni Estevadeordal**, Principal Trade Economist, IDB

13:15 – 15:00 **LUNCH**

15:00 – 16:30 **DISCUSSION ON THE FUTURE AGENDA FOR THE NETWORK**
(with the participation of representatives of the Network centers)

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November 6-7, 2003

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INTER-AMERICAN DEVELOPMENT BANK

DEPARTMENT OF INTEGRATION AND REGIONAL PROGRAMS
INSTITUTE FOR THE INTEGRATION OF LATIN AMERICA AND THE CARIBBEAN

SPECIAL OFFICE IN EUROPE

EURO-LATIN STUDY NETWORK ON INTEGRATION AND TRADE (ELSNIT)

ACADEMIC CONTRIBUTIONS OF THE FIRST EURO-LATIN STUDY NETWORK ON INTEGRATION AND TRADE

And

SECOND INTAL AWARD CONTEST

Raúl Prebisch Auditorium
Institute for the Integration of Latin America and the Caribbean IDB/INTAL)
Esmeralda 130, 17th floor
Buenos Aires, Argentina

27 - 28 April 2004

AGENDA

27 April 2004

09:00-10:00 **Opening Session – Background of the Euro-Latin Study Network on Integration and Trade and the Second INTAL Award Contest**

Panelists: Carlo Binetti, Representative, Special Office in Europe, Inter-American Development Bank; and Juan José Taccone, Director, IDB/INTAL.

Euro-Latin Study Network on Integration and Trade – -Overview of works discussed in the framework of the First Annual Conference (6-7 November, 2003, Barcelona, Spain)

Moderator: Antoni Estevadeordal, Integration, Trade and Hemispheric Issues Division, Inter-American Development Bank

10:00-11:00 ***First Panel on Macroeconomic Dimensions of Regional Integration***

Panelist: Jaume Ventura, CREI, Universitat Pompeu Fabra, Barcelona, Spain

Comentator: José María Fanelli, CEDES, Buenos Aires, Argentina

Open discussion

11:00-12:00 ***Second Panel on the Impact of Regional Integration on Economic Convergence and Growth***

Panelist: Omar Licandro, Robert Schuman Centre for Advanced Studies of the European University Institute (RSCAS), Florence, Italy

Comentator: Federico Sturzenegger, Torcuato Di Tella University, Buenos Aires, Argentina

Open Discussion

12:00-12:15 ***Break***

12:15-13:15 ***Third Panel on the European Union Enlargement and Adjustment Policies During Transition***

Panelist: Rolf J. Langhammer, Kiel Institute for World Economics, Kiel, Germany

Comentator: Pablo Sanguinetti, Torcuato Di Tella University, Buenos Aires, Argentina

Open Discussion

13:15-15:30 ***Break***

15:30-16:30 ***Keynote Lecture – The Experience of Macroeconomic Coordination in the European Union: Lessons, Achievements and Challenges***

Moderator: Robert Devlin, Deputy Manager, Department of Integration and Regional Programs

Speaker: Eduard H. Hochreiter, Senior Advisor and Chief of Economic Studies, National Bank, Austria.

16:30-17:30 ***Discussion***

28 April 2004

Second INTAL Award Essay Contest on "Macroeconomic Coordination and Monetary Cooperation: Their Costs, Benefits and Applicability in Regional Integration Agreements"

Moderator: Ziga Vodusek, Economist, Special Office in Europe, Inter-American Development Bank

09:00-10:45 ***Presentation of Works with Special Awards***

Panelist: Louis Bertone, Lawyer, University of Buenos Aires; and PHD in Law, University of Paris, Paris, France

Panelist: Igor Barenboim, Economist, Gávea Investimentos. Bachelor of Arts in Economics, Pontificia Universidad Católica de Rio de Janeiro, Exchange Program with University of California, San Diego, USA, and Rio de Janeiro, Brazil

Panelist: Alejandro Jacobo, Doctor in Economics, University of Cordoba, Cordoba, Argentina

Panelist: James Loveday Laghi, Economist, Researcher from the Research Center at the Universidad del Pacífico, Peru, Lima, Peru

10:45-11:00 ***Break***

11:00-11:40 ***Presentation of the Winning Award***

Panelists: Mauricio de la Cuba, Economist, Universidad del Pacífico, Peru; Chief at the Foreign Sector Analysis Department, Central Bank of Peru, and Diego Winkelried, Economist, Universidad del Pacífico, Peru, Analyst at the Department of Macroeconomic Analysis, Central Bank of Peru

11:40-12:25 ***A European Vision***

Comentators: Jaume Ventura, CREI, Universitat Pompeu Fabra, Barcelona, Spain; Rolf J. Langhammer, Kiel Institute for World Economics, Kiel, Germany; and Omar Licandro, Robert Schuman Centre for Advanced Studies of the European University Institute (RSCAS), Florence, Italy

12:25-13:00 ***Discussion***

13:00-13:30 **Conference Closure**

Robert Devlin, Deputy Manager, Department of Integration and Regional Programs, Inter-American Development Bank.

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