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The European Studies and Education Centre of Corvinus University and the Hungarian European Community Studies Association organised a Conference on 5–6 March 2010 on the theme of “Evaluation of EU membership of New Member States”. The Conference tried to draw the balance of cost and benefits of EU membership in the framework of analysing integration-maturity.

By Eastern enlargements, integration maturity has become an important issue of the economics of integration. Earlier, in the process of European integration, the question was largely ignored (at the level of customs union or common market) for a number of reasons. Particularly in the first period, the economic development and structure of countries entering the European integration were basically similar, and all were deemed to be mature for integration. The Treaty of Rome only stipulated for participation in the European Communities that the country in question be European and democratic. Although it left some uncertainties in terms of geographical definition (for Turkey, for example), it was general enough to open up a possibility of accession as wide as possible. For the enlargements of the 1980s, political considerations were clearly dominant.

The necessity of defining and formalizing integration maturity criteria in the EC/EU became obvious in the context of the higher stages of integration (the single market and the EMU) and the Eastern enlargements.

As far as the Eastern enlargements are concerned, the question was raised by setting accession criteria for new candidates. The so-called Copenhagen criteria were accepted in June 1993, then further specified and completed.

1. Stability of institutions, guaranteeing democracy (rule of law, human rights, respect for and protection of minorities);
2. A functioning market economy;
3. Capacity to cope with competitive pressure and market forces within the Union;
4. Ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union;
5. The Union’s capacity to absorb new members.

In Madrid in 1995 the notion of “functioning institutions” and “stability of economies” were added.

A particularity of the Copenhagen accession criteria is that they equally stipulate political, economic and institutional conditions for new members.

Later, the theoretical analysis was extended to integration maturity. Integration maturity can be defined as a capability to exploit the benefits of the given form of integration to the maximum, while the costs and drawbacks can be minimised. Integration maturity can be measured by comparing costs and benefits. A country is mature for integration if membership on the whole is advantageous for it. Integration maturity, therefore, is a broader concept than meeting accession criteria, but the main points are close to each other. The economic aspects of integration maturity are particularly relevant:
In Copenhagen, creation of a “functioning market economy” was set as a basic condition for accession. Normal operation of the market economy is a starting condition for all forms of integration. The whole theoretical and analytical system of the economics of integration is based on assuming these. Liberalization eliminates precisely the obstacles to these in terms of trade or economic policy. The advantages of internal free trade can only be utilised alongside properly operating market mechanisms. The issue of a functioning market economy was added to the agenda as an official membership criterion pertaining to the accession of Central and Eastern European countries; however, it does not mean that it had no relevance earlier. It is obvious that this issue is assigned various emphases at the various levels of integration, and cannot be avoided in case of closer forms of integration (EMU), not even for the most developed countries. It is a different question that the requirement of a functioning market economy (flexible factor markets and factor prices) was not set as a membership criterion for the EMU, but was only analysed in informal theoretical debates (for example, related to the theory of the optimal currency area). Central and Eastern European countries in the early 1990s were still in the middle of the transition, and what was formulated in June 1993 in Copenhagen was practically no other than the completion of transition from a centrally planned economy to a market economy.

Competitiveness must be considered an important indicator (probably one of the most important ones) of integration maturity. No doubt, the candidate countries are unable to exploit the benefits of integration unless they have companies and products capable of withstanding market competition. Competitiveness needs to be analysed in a complex way. Micro and macro approaches are both relevant, but it is not simply a case of adding up producers’ and companies’ competitiveness at a national or international level, they have independent factors and effect mechanisms. Countries do not only compete by their structures of production, technical and economic management (products, technologies, innovations, corporate governance) or the development of their infrastructure, but also by their social, economic and institutional systems. And, in a given situation, the latter may be more important.

Stability of an economy is also an important factor in integration maturity. This is valid for both normal market operation and the utilisation of market integration benefits. Certainly, macroeconomic stability and successful integration are mutually dependent on each other: stability may be a prerequisite to integration, on the one hand, and an indicator of its success, on the other hand.

When the six countries signed the Treaty of Rome, their level of development and economic structures were very similar, with differences limited to certain regions only (southern Italy). Later, with consecutive enlargements – especially with the accession of Mediterranean countries – differences in development grew. The development level of these countries was 40–45 per cent lower than the
Community average. Their accession – although with varying success – accelerated their economic development, and they achieved a remarkable level of convergence with more developed member states in less than two decades.

With Eastern enlargements, a radically new situation evolved. The average difference of development levels has increased to a great extent (from an average of 20–30 per cent to 60–70 per cent), and the order of magnitude of the differences between the two extremes (Latvia or Lithuania and Denmark) reaches three-fold (and four-fold for Bulgaria).

Convergence in terms of the development levels and structures of the economy necessitates serious efforts, which requires significant resources. Similarly, the issue of compensation provided to the weak and the losers is raised, due to an uneven distribution of trade benefits. Tensions and conflicts generated from growing differences are not in the interest of more developed partners either; consequently, some form of solidarity and compensation has been on the agenda right from the beginning, what is more, the majority of integration organisations have assumed political obligations to equalise these.

Main topics of analysis of the conference were: functioning of market economy, competitiveness (adjustment of SMEs to integration, “structural reforms”, complex analysis of convergence, and macro-stability), challenges of introduction of the Euro (“Euro-maturity” of Hungary), questions of financing membership (impact of supports on economic development, utilisation of resources) and the consequences of the present financial crisis.

We can state that the ten Central and Eastern country’s last five years performance proved that they were mature for integration by the early 2000s when they joined the European Union as full members. They were able to use and exploit the opportunities given by EU integration, both in terms of rapid economic growth and improved competitiveness. Particularly, the growth performance could be considered as robust, and it led to remarkable convergence in a relatively short time. The integration was a positive sum game, gains in growth and employment can be demonstrated for both sides. The latter should be particularly stressed, because it contradicts to the earlier fears about the free movement of labour and to the assumptions of “dislocation”. At the same time, there was an agreement that the current global economic crisis created a new situation, and there are many uncertainties about the future of EU integration.

Separate section dealt with comparative regional integration studies. The Economics of Global and Regional Integration was introduced at Corvinus University as a new course, and the aim was to study the international experiences in the field. The Lisbon Civic Forum also met during the Conference.

The Conference was supported by “Mecenatura” Program of the National Office of Research and Technology, the Hungarian Scientific Research Fund (OTKA) and the Jean Monnet Program.
## Academic Programmes at the Faculty of Economics at Corvinus University of Budapest

### In Hungarian

**Bachelor programmes**
- BSc in Economic Analysis
- BA in Applied Economics
- BA in Human Resources
- BA in Public Administration

**Master's programmes**
- MSc in Finance
- MA in Public Administration and Policy
- MA in International Economy and Business

**Doctoral programmes**
- PhD in Economics
- PhD in International Relations

### In English

- MA in International Economy and Business (IEB)
- International MA in Economy, State and Society (IMESS)
- European Master's in Public Administration (EMPA)

### Special Courses in English (Non-Degree Programs)

- Master Certificate Programme in Economic and Public Policy in Central and Eastern Europe
- Master Certificate Programme in Public Administration
When analysing the impacts of EU membership on NMCs, and in particular on the Hungarian economy, we consider integration maturity as a theoretical framework. Integration maturity can be defined as a capability to exploit the benefits of the given form of integration to the maximum, while the costs and drawbacks can be minimised. Integration maturity can be measured by comparing costs and benefits. A country is mature for integration if membership on the whole is advantageous for it.

INTRODUCTION

In the EC/EU, specific accession criteria were defined first in 1991, related to the transition to the economic and monetary union. The so-called Maastricht convergence criteria set requirements of the monetary integration which the member countries assumed to meet as specific indicators of monetary and fiscal stability conditioning their participation in the EMU. Accession criteria related to Eastern enlargements have been defined for new candidates. The so-called Copenhagen criteria were accepted in June 1993, later further specified and completed.

Integration maturity can be analysed in terms of four main dimensions: compliance with

- economic,
- social,
- political and
- institutional aspects and criteria.

In our analysis, we focused basically on economic integration maturity. Basic criteria of integration maturity concerning the economics of integration are as follows:

- functioning market economy;
- competitiveness (structural and development requirements);
- macroeconomic stabilisation/stability;
- convergence;
- financing and financiability (capability of being financed).

The parameters of integration maturity are more complex than the ones generally used for accession and membership criteria. These criteria constitute the general frameworks for normal operation of the given form of integration; these form the conditions of successful integration.

1. FUNCTIONING MARKET ECONOMY

In Copenhagen, the creation a “functioning market economy” was set as a basic condition for accession. Normal operation of the market economy is a starting con-
dition for all forms of integration. The whole theoretical and analytical system of the economics of integration is based on assuming this. Liberalization eliminates the obstacles to these in terms of trade or economic policy. The advantages of internal free trade can only be utilised alongside properly operating market mechanisms. The issue of a functioning market economy was added to the agenda as an official membership criterion pertaining to the accession of Central and Eastern European countries (CEECs); however, it does not mean that it had no relevance earlier. It is obvious that this issue is assigned various emphases at the various levels of integration, and cannot be avoided in case of closer forms of integration (such as the EMU), not even for the most developed countries. It is a different question that the requirement of a functioning market economy (flexible factor markets and factor prices) was not set as a membership criterion for the EMU, either, but was only analysed in informal theoretical debates (for example, related to the theory of the optimal currency area). Central and Eastern European countries in the early 1990s were still in the middle of the transformation, and what was formulated in June 1993 in Copenhagen was practically no other than the completion of transformation from a centrally planned economy to a market economy.

“Ability to function” presupposes the free movement, without artificial barriers, of market participants and prices. The main actors in an economy, in a given economic situation and economic policy environment respond appropriately and rationally to the influences of the market. Company profit becomes profit in the true sense of the word, a measure of the company’s contribution to the efficiency of the whole economy. The creation of a market economy demands the use of policies, institutions and economic policy instruments that are in harmony with the functioning of the market, and attempt to harmonize the broader interests of society, taking these all into account. In circumstances of globalization, particularly in small, open economies all this applies in relation to external markets as well.

In the professional literature dealing with this transformation, surveys soon appeared analyzing the viability of their markets (EBRD Transition Reports; World Bank, World Development Report). For the interpretation of market conditions several systems of analysis and indices were designed to measure and demonstrate the degree and level of development of market maturity. These, together with the relatively meager EU literature on membership maturity, and the country reports, are from this point of view also very useful.

Analyses of transformation, together with the EU’s Annual Country Reports, concluded that the candidate countries of Central and Eastern Europe, already by the end of the 1990s satisfied the “functioning market economy” requirement. In Hungary, about 97% of prices had been liberalized, free market-access was assured, foreign trade had been liberalized, the Hungarian forint had been convertible since 1996 (fully since 2001), interest rates and exchange rates reflected market conditions, privatisation had not merely been completed but had been accompanied by widespread company restructuring unique in the region, and the capital and money markets were expanding and being modernized. Market-conform forms of taxation had been consolidated, for example, the VAT-type turnover tax and progressive income tax were introduced in 1987. It is worth mentioning that introduction of a VAT-type turnover tax took place only at the beginning of the 1990s in the other CEE
countries. The 1995 White Paper offered a program of implementing the Single Market, and the related measures and approximation legislations to European norms were completed by the time of their entry. Apart from the Central European countries this also applies to the Baltic States.

It was, therefore, not by chance that the new Eastern members in 2004 joined the single market “upon their entry” without general transition period or any substantial derogations. The derogations that did apply were mostly technical, and were limited only to 4 main fields:

- Free movement of labour (postponed all together 7 years), but basically implemented by now,
- Selling of arable land (9 years),
- Full direct payments under CAP postponed till 2013,
- Joining the Euro Zone – no deadline.

Still there are shortcomings of “functioning market economy” and further measures are needed in several fields. Some most important are:

- Modern market infrastructure still has to be further developed (credit cards, forms of financial services, the logistical structures of participation in global networks),
- Further development of financial markets and modernization of the banking sector, creation of real competitive conditions,
- Reform of the public service and public finance,
- Suppression of the black or grey economy, the excessive scale of which, in addition to its criminalizing and demoralizing effects, have broad negative impacts on performance,
- Competition policies should be upgraded,
- Elimination of chain debt, which is undermining stability,
- Increased fight against corruption.

Through liberalizing foreign trade (“negative integration”), and particularly by signing the Europe Agreement, Hungary made important step towards reintegration of its economy to the world and Europe. The Europe Agreement meant free trade association to the EU (by 2000), and it greatly contributed to rapid re-orientation and expansion of Hungarian external trade towards EU as main partner. In 1989, about 25–30% of trade of the candidates was with EC, by 1993 this share was 50%, and by 2004, the share of the EU increased in new member’s export to 67%, and in their import to 64%. The reorientation was particularly rapid already by 1993, but later the Europe Agreements played a major role. The trade integration reached high level, characteristic of the EU member countries. Trade integration of CEE was the major factor in the rapid export-led growth and from 2000s real economic convergence (1.5–3% growth “surplus”) of the CEE region.

2. COMPETITIVENESS

The competitiveness must be considered an important indicator (probably one of the most important ones) of integration maturity. It was also an accession criterion, as it was formulated, the new members should be able to cope “with competitive
pressures" of the EU markets. No doubt, the candidate countries would be unable to exploit the benefits of integration unless they have companies and products capable of withstanding market competition. The competitiveness needs to be analysed in a complex way. Micro and macro approaches are both relevant, but it is not simply a case of adding up producers' and companies' competitiveness at a national or international level, they have independent factors and effect mechanisms. Countries do not only compete by their structures of production, technical and economic management (products, technologies, innovations, corporate governance) or the development of their infrastructure, but also by their social, economic and institutional systems. And, in a given situation, the latter may be more important.

As far as enlargement was concerned, similarly to the concrete parameters of the “functioning market economy”, those of “response to competitive pressure” were not defined clearly and unambiguously either. Thereby many details were left to ample scope for interpretation. The requirements were more vaguely formulated as far as the macro-structural reforms were concerned, which in many respect have equal importance (reform of such public services and social systems as health, education, pensions, or reduction of excessive tax burdens) than in the old member states.

The EU emphasized several aspects of competitiveness, and these turned up whenever fulfilment of the accession criteria was examined.

- The Copenhagen competition criterion definitely implies that the country seeking admission is capable of adopting the EU's rules on competition and its competition policy (acquis communautaires). This presupposes not just their application in law (which is formulated in the association agreements, and in the White Book), but also the ability of the given country in the long term to meet the standards of competitiveness. It is vital to create new institutions and regulatory systems that are in harmony with and conform to the institutional frameworks and competition regulation systems of the EU member countries.

- Competitiveness is closely and mutually dependent on stable macroeconomic policy conditions, especially budgetary and monetary policies. A proper harmony is absolutely essential from the point of view of creating competition-friendly economic policy and a stable economic environment. There is thus a need for consistent industrial, trade and subsidy policies that will ensure the development of healthy competition in the economy.

- In the EU literature and documents the manifestation and demonstration of competitiveness is linked strongly with balance of trade and exchange rate development.

Full and rapid opening from the beginning of 1990s and then the EU association attracted investors, and created (global) competitive environment. Improvement in competitiveness on a great extent was due to FDI and high globalisation of CEE economies.

The accession and integration maturity of the CEECs in terms of competitiveness improved considerably already by the early 2000s. In some sense, it improved quite substantially. The CEE countries have climbed up spectacularly on competitiveness lists, probably we can say that from the upper class of developing countries to the lower class of the developed countries. Now they rank in the upper middle field on
the global economy (25–35\textsuperscript{th} places) according to such institutions as World Economic Forum, IMD World, UNIDO, etc. These analyses indicate that CEE economies have a good chance to close the gap with developed EU members in 15–20 years.

As the main source of the competitiveness of CEE economies, the level of productivity and its relatively rapid increase (comparative advantages) were important, as were the relatively good quality and low cost of their human capital (table 1).

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Source: Eurostat 2008

The closing productivity gap was accelerated in recent years as result of integration of these countries with the EU. The Hungarian productivity level was roughly half of that of Germany in 1997. In ten years the lagging behind shrank to less than 1/3 [European Economy 2009].

It can be added, the fact that labour was under-priced and it was (is still) a substantial source of comparative advantage. As the ITDH study entitled ‘Competitiveness 2000’ states, in Hungary, productivity calculated on the basis of output per worker employed in manufacturing industry rose by 2000 to 2.2 times its 1991 level. In contrast, real wages rose only moderately, by about 30%. The real wages fell during the transformation crisis, and they started to recover only after the mid-1990s. Between 1997 and 2000, in Hungary the real incomes grew annually by 3.1%, but the productivity growth by 4.7% was still far ahead. On this basis, the competitiveness and comparative wage-cost advantages of Hungarian industry grew considerably.\(^1\) The Hungarian productivity is 58\% of the EU average, while the wages are only 40\% of it.\(^2\) These significant comparative wage-cost advantages characterize the whole region.

After 2004, with full membership new competitive conditions were created:

- By entering the single market, ‘asymmetry’ in non-tariff, informal trade barriers disappeared. It opened new business and investment opportunities to the companies of both old and new members. In certain service sectors (health, technical design, education, etc.) new members will be able to use their cost advan-

\(^1\) Published in the daily \textit{Napi Világgazdaság}, July 27, 2001.
\(^2\) Published in the daily \textit{Világgazdaság}, February 15, 2002.
tages, in which in some cases create tensions (“Polish plumber”). The trade impacts of the single market were particularly strong among the new members.

- The trade liberalization was extended to agriculture, which produced contradictory results. In the mutual market opening, agriculture proved to be a weak point, and disadvantages in competitiveness of new members became apparent. Many of these countries formerly had export surpluses with the EU, but recently they have become net importers. In the early 1990s, Hungary exported 6 times more to the EU than it imported from there. By 2008, even Hungary has become a net importer.

- The taking over the Common External Tariffs (CET) meant opening to global markets. The new members had about 6–8% tariff levels, which were replaced by the CET, meaning halving the former national tariffs (to 3–4%). The reduction of tariffs, and taking over of large number of trade agreements of the EU, increase the external competition substantially.

- Greater budget transfers from structural funds, mean new resources for improving competitiveness, particularly in terms of infrastructural investments. The improved competitiveness of new member states is indicated by the knowledge intensity of their export (figure 1).

![Figure 1. The Knowledge Intensity of EU trade](image)

Hungary is particularly well performing. The share of high-tech products in total Hungarian export has increased from practically nothing to 28% by 2006 (it was 25% in 1999). The same share in 2006, for the old members is 17%, for the new ones 14%, for Estonia 17%, for Czech Republic 16% and for Slovakia 15%.

Although, the quality of labour is good, and they produce rapid productivity growth, the countries of CEE are still far away of the knowledge-based society. In most of the CEE countries, the R&D expenditures were the main losers of transformation crisis, as the share of these expenditures in GDP fell from about 2% to 0.5% in the years of early 1990s. Since, a recovery started, but with an about 1% level, they are still far behind to the EU average (1.80%), not to speak about that EU itself is sub-
stantially behind Japan (2.90%) and US (2.80%). Some TNCs set up research bases in CEE (such as Nokia) or pharmaceutical companies in Hungary. Hungary is still behind in use of Internet, with relatively high communication costs (in Hungary about 25–30% above EU average), relatively lagging behind in infrastructure, and in high costs of local capital. In term of innovation – Hungary is on half of EU27 average (according to the Innovation Score Board.) Number of technical students is 1/3 of the old members states’ average (per 1000 habitants).

Table 2. Access to High Speed Internet per 100 population

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Source: European Innovation Scoreboard 2007

By recent years, Hungary achieved a high level of global integration. According to the KOF Globalization Index of 2009, Hungary ranks 10th among the 189 countries of the world (11th Czech Republic, 13th Finland, 16th France, 17th Estonia, 22nd Germany, 27th U.K. 32nd Greece, 34th Latvia, 38th US.)

The ranking is impressive, but it does not indicate some of the disproportions and quality of the integration process. The high globalization is based on massive inflow of foreign direct investments, but it is only one-way process, the outgoing investments from NMCs just started in recent years. In 2008, the outward investment stock of Hungary reached €12bn, and it is close to 15–20% of incoming FDI, which proportion is highest in the region. But the average of developed countries is somewhat around 150%. The transnationalisation process in NMS is external, and also asymmetric. Hungary has only few TNCs of its own (OTP, MOL, Magyar Telekom), and they operate and expand only on regional markets of neighbour countries.

The unevenness of the integration process is reflected also in a certain duality of local SME sector. Only their smaller part integrates into global economy (TNCs), while most of them remain outside, and still mainly oriented to local economy. As result of EU membership, large number of small and medium firms, inefficient small

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3 The analysis is based on 24 variables (economic, social and political globalization). Economic: flows, cooperation intensity, restrictions. Social: personal contacts, information flows, cultural proximity. Political: diplomatic relations, membership in international organisations, UN Security Council participation.
farms (hundred thousands of semi-subsistence farms), and the capital-intensive service sectors seems to be at the loosing end, as result of increased competition.

The enlargement contributed to further reorientation of foreign trade of NMS, as it is shown in the data bellow:


The internal trade intensity of EU members remained high after enlargement, but it did not increase further. In fact, the old members' (EU15) share in the new members' trade decreased relatively quite substantially in the last ten years, from 68.6% in 1999 to 59.7% in 2008. At the same time, the NMS's trade to NMS increased quite dynamically, and they basically regained the proportions before 1990. They had free trade frameworks already before (CEFTA), but the mutual extension of single market regulation due to their EU membership seemingly boosted their cooperation. Increase of trade shares of Hungary since 1999–2000 was with the OMS 1.3 times, with the NMS 2.2 times, and with the rest of the world (RoW) 2 times. It was not surprising that the trade with the RoW increased relatively also rapidly, as far as the former national tariffs (for Hungary about 8%) were replaced by the common external tariffs of EU (about 3–4%). The EU membership meant a certain opening towards the global economy, also in terms of automatically taking over of EU's former association agreements (Cotonou, Mediterranean associations etc.).

The Hungarian trade integration shows very high regional concentration. The share of internal trade to rest of the world is about 67:33% for the EU15, while for Hungary it is 78:22%. About more than half of Hungarian EU trade is with Germany, and nearly 80% with the neighbour countries (Central Europe, Austria and Italy).

Enlargement is extremely important for the EU as well. It must be particularly emphasized that one main benefit of enlargement will be that the Union's competitiveness in global markets is likely to improve significantly.

3. STABILIZATION OF ECONOMIES

*Stability of an economy* is also an important factor in integration maturity. This is valid for both normal market operation and the utilisation of market integration benefits. Certainly, macroeconomic stability and successful integration are mutually dependent on each other: stability may be a prerequisite to integration, on the one hand, and an indicator of its success, on the other hand.

Most of the CEE countries suffered from stagnation of their economies from the 1970s, and many had negative growth already from the second half of the 1980s (*table 3*).

From early 1970s to end of 1980s, Hungarian economy was in a “stop-go” cycle. It meant deterioration of budget and balance of payments during rapid growth, and stagnation of economy due to the necessary restrictions. Economic growth was around 1–2%, and it was effectively stagnating during the 1980s. When growth was
above 3% (1987 and 1994), the indebtedness of the country doubled in one year. Growth was unsustainable.

From early 1990’s, the “transformation recession” (Kornai’s term) hit the region, with unprecedented worsening of economic performance (even in terms of 1929–33, when Hungary lost 10% of its GDP). Between 1991 and 1993, Central European countries, including Hungary were relatively “moderately” hit by the “transformation recession” (loss of 20% of their GDP), while other regions (Southern-Europe or former Soviet Union) suffered 40–50% losses.4

The “transformation recession” produced high unemployment, which was a relatively new phenomenon in the region. Before 1989, it was unknown in CEE, except Yugoslavia. Unemployment increased in all these countries, it was one of the costs of transformation crisis. In many countries (Bulgaria, Poland, Slovakia, Lithuania and Latvia) unemployment peaked around 20%, while Czech Republic, Hungary, Slovenia and Romania remained below comparable EU averages. Poland, Slovakia and Croatia had to cope with high (15–18%) unemployment till early 2000s. High unemployment proved to be one of the constraints of enlargement.

Inflation did not exist before 1990, in most of CEE, except the reform countries (Yugoslavia, Poland and Hungary). The transformation crisis, however, was accompanied by hyper-inflation (3–4 digit), in most of the countries (Bulgaria, Estonia, Latvia around 1000%, Croatia 1500%, Poland, Slovenia, Lithuania around 500%). Hyper-inflation was avoided by Czech Republic and Slovakia (58%), and Hungary (35%) in 1991 as peak year. Hyper-inflation re-emerged later in slowly transforming and stabilizing countries in 1997 (Bulgaria and Romania).

In Central Europe (Czech Republic, Hungary, Poland, Slovakia) the recovery started after 1993–4, and these countries returned to pre-1990 levels by the end of 1990s. The others followed with some delays, and in the second half of the 1990s, some countries (Bulgaria, Czech Republic, and Romania) suffered a new recession.

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4 All data are from Eurostat.
CEE countries have produced diverging performance in stabilization of their economies (*tables 4 and 5*).

**Table 4. Annual growth of new members 1996–2005**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>1.5</td>
<td>3.6</td>
</tr>
<tr>
<td>Slovakia</td>
<td>3.8</td>
<td>4.6</td>
</tr>
<tr>
<td>Poland</td>
<td>5.4</td>
<td>2.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>4.0</td>
<td>4.2</td>
</tr>
<tr>
<td>Croatia</td>
<td>3.4</td>
<td>4.7</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>-0.8</td>
<td>4.9</td>
</tr>
<tr>
<td>Romania</td>
<td>-1.3</td>
<td>5.7</td>
</tr>
<tr>
<td>Estonia</td>
<td>6.1</td>
<td>8.5</td>
</tr>
<tr>
<td>Latvia</td>
<td>5.7</td>
<td>8.1</td>
</tr>
<tr>
<td>Lithuania</td>
<td>4.2</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: Eurostat

**Table 5. Average growth of new and old members 1999–2008**

<table>
<thead>
<tr>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>OMS</td>
<td>2.2</td>
<td>2.2</td>
</tr>
<tr>
<td>NMS</td>
<td>3.4</td>
<td>5.6</td>
</tr>
</tbody>
</table>

Source: Eurostat

From the middle of the 1990s till 2007, most of the new members were characterised by rapid growth, and some countries, particularly as a result of their EU membership produced impressive growth rates. The world economic slow down of 2001–2002 has not been felt in CEE (in some countries only moderate slow down), mostly due to continued inflow of FDI into the region. From the end of 1990s, the strong growth meant an accelerated catching up. The growth "surplus" of NMS's was 3.4% over OMS's in the period of 2001–2005.

All analysis proves that the years following joining the EU as full members, brought substantial gains in their economic performance. NMS's produced rapid growth after 2004, with around 6–7% annual increase of their GDP. In Baltic countries, Romania and Slovakia growth was close or above 10% (certain overheating). Hungary’s growth fell from the 4% to 1% after 2006, due to restrictions. According the EU Commission analysis, accession process boosted economic growth in the new Member States by about 1.75 percentage points per year over 2000–08, when growth increased from 3.5%, on average, in 1999–2003 to 5.5% in 2004–08. Growth in the old Member States also benefited from enlargement (adding up to a cumulative increase in output of around 0.5% over the same period [European Economy 2009]).

After dynamic the growth period, from 2008 all countries were negatively affected by the world economic crisis, and except Poland, all countries produced negative
growth rates. For some countries, particularly for Baltics, the recession was very severe, and the fall back this time was much more substantial than in the OMS's. The structural weaknesses and the high external dependence of the NMS's was particularly demonstrated.

The economic growth in CEE was based mostly on productivity, and as result of restructuring till 2003, the contribution of labour to growth was rather negative. After 2004, the growth was accompanied by reduction of unemployment in NMSs, and till 2008, it fell below the OMS average (to about 5-6%). Since 2004, we can experience robust growth in employment of about 1.5% annually in the new Member States. There was strong employment creation in the old Member States (about 1% per year since enlargement) as well [European Economy 2009]. This contradicts assumptions on “dislocation”, according to which in terms of employment the OMS’s were on the losing end.

By 2002–2003, most of the countries brought down their inflation to a desirable level, and met requirements for joining the Euro Zone (around 2–3%). The exceptions were: Romania, Slovakia, Slovenia and Hungary (with 5–7% inflation). Except Poland, Slovakia and Croatia (with around 20% unemployment), the other countries have brought down their unemployment to or below EU levels (9–10%). The Phillips curve seems to be validated for the Baltics (and Bulgaria), where low inflation was achieved at the expense of high unemployment. Hungary and Slovenia is an opposite case: they produced parallel improvements in inflation and unemployment at the same time, mainly due to their successful restructuring. By the time of 2004, when joining the EU, the NMC's consolidated their economies. Due to rapid growth, particularly overheating, there was an acceleration of prices in recent years, except Slovenia and Slovakia, which at least due to joining the euro-zone, managed to keep down their price increases.

The NMSs produced varying budget deficits after 2004. Estonia posted a budgetary surplus since 2004, while Lithuania and Latvia reported small deficits. In Poland, the deficit decreased from an initially high level, and by 2007 had fallen below 3% of GDP. In the Czech Republic and Slovakia it exceeded the 3% threshold

**Table 6. Growth of GDP of new members in 2005–2009**

<table>
<thead>
<tr>
<th>Country</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Czech Republic</td>
<td>6.3</td>
<td>6.8</td>
<td>6.1</td>
<td>2.5</td>
<td>-4.8</td>
</tr>
<tr>
<td>Slovakia</td>
<td>5.0</td>
<td>6.7</td>
<td>8.5</td>
<td>6.2</td>
<td>-5.8</td>
</tr>
<tr>
<td>Poland</td>
<td>3.6</td>
<td>6.2</td>
<td>6.8</td>
<td>5.0</td>
<td>1.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.5</td>
<td>4.0</td>
<td>1.0</td>
<td>0.6</td>
<td>-6.5</td>
</tr>
<tr>
<td>Croatia</td>
<td>4.3</td>
<td>4.8</td>
<td>5.5</td>
<td>2.4</td>
<td>-6.0</td>
</tr>
<tr>
<td>Slovenia</td>
<td>4.5</td>
<td>5.8</td>
<td>6.8</td>
<td>3.5</td>
<td>-7.4</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>6.2</td>
<td>6.3</td>
<td>6.2</td>
<td>6.0</td>
<td>-5.9</td>
</tr>
<tr>
<td>Romania</td>
<td>4.2</td>
<td>7.8</td>
<td>6.3</td>
<td>7.3</td>
<td>-8.0</td>
</tr>
<tr>
<td>Estonia</td>
<td>9.4</td>
<td>10.0</td>
<td>7.2</td>
<td>-3.6</td>
<td>-13.7</td>
</tr>
<tr>
<td>Latvia</td>
<td>10.6</td>
<td>12.2</td>
<td>10.0</td>
<td>-4.6</td>
<td>-18.0</td>
</tr>
<tr>
<td>Lithuania</td>
<td>7.8</td>
<td>7.8</td>
<td>9.8</td>
<td>2.0</td>
<td>-15.0</td>
</tr>
<tr>
<td>EU 15</td>
<td>1.8</td>
<td>3.0</td>
<td>2.6</td>
<td>0.5</td>
<td>-4.1</td>
</tr>
</tbody>
</table>

Source: Eurostat
only intermittently. Slovenia ran small deficits throughout the period. Hungary’s headline deficit peaked at 9.2% of GDP in 2006, and followed by a considerable improvement (by 2009 brought down to 3.9%). Due to crisis, after 2008, the budgets seriously deteriorated.

The NMS successfully stabilized their economies, and they proved to be mature for integration in the EU. They have produced, however, diverging performance in stabilization of their economies, and in this respect, CEE countries achieved the best progress, while the others followed somewhat later. The full membership further improved their performance, and they have good chances to meet the Maastricht criteria, in order to comply with the requirements for entering the Euro Zone. On the other hand, by the financial crisis most of the NMS’s got more far from euro-zone membership.

4. CONVERGENCE

When the six countries signed the Treaty of Rome, their level of development and economic structures were very similar, with differences limited to certain regions only (southern Italy). Later, with consecutive enlargements – especially with the accession of Mediterranean countries – differences of development grew. The development level of these countries was 40–45 per cent lower than the Community average. Their accession – although with varying success – accelerated their economic development, and they achieved a remarkable level of convergence with more developed member states in less than two decades.

With eastern enlargements, a radically new situation evolved. The average difference of development levels has been increasing to a great extent (from an average of 20–30 per cent to 60–70 per cent), and the order of magnitude of the differences between the two extremes (Latvia or Lithuania and Denmark) reaches four-fold (and five-fold for Bulgaria).

Convergence is a condition for efficient and successful integration. But integration does not necessarily bring convergence. Convergence is dependent on policies both on integration and on national levels. Globalisation (global integration) is accompanied by increasing inequities, but on the other hand, one of the main attraction of European integration has been that it contributed to the catching up of its several new members (Ireland, Mediterranean countries).

While the Soviet Bloc countries suffered serious losses in the so called “peaceful competition” with the West during the 1970s–1980s, their integration with the EU, particularly from the end of 1990s, brought substantial convergence. In 1999, the per capita GDP of NMS’s was about 40% of the OMS's average, it increased to 52% by 2008. Hungary’s per capita incomes in the 1960s were around 60% of the European average. By early 1990, due to structural crisis of Soviet system, and then the “transformation recession” it fell back to around 43%. Per capita GDP of Hungary now is around 62% of that of EU27 (of course above data are not comparable with 1960s, but show the trend). Now, Portugal and Greece is still about 50% above the Hungarian level. Re-convergence had an encouraging start, but it was broken by the 2008–2009 recession.
There is an agreement, that per capita GDP is not a satisfactory index of convergence. Composite convergence indices give a more reliable picture. The Deutsche Bank Research convergence web, for example, is computed by 5 groups of indicators, based on a composite of 16 variables. According to them, the new Central European members (Czech Republic, Hungary, Slovakia and Slovenia) are on about 75% of EU average, and they are in the same group with Portugal and Greece.

Convergence in terms of the development levels and structures of the economy necessitates serious efforts, which requires significant resources. Similarly, the issue of compensation provided to the weak and the losers is raised, due to an uneven distribution of trade benefits. Tensions and conflicts generated from growing differences are not in the interest of more developed partners, either; consequently, some form of solidarity and compensation has been on the agenda right from the beginning. For the future, the question remains, how far the NMS's can secure the sustainability of their convergence.

5. FINANCEABILTY

As by accession of the CEECs, differences in terms of economic development and structure have significantly intensified, the issue of providing financing and the capability of being financed become one of the most critical issues of enlargement. Financing is a strategic issue of integration maturity, and an important indicator of it. The main questions at stake are:

- Availability of domestic capital resources. How capable is the economy in question of producing the resources for its own development? This, among others, points out the relation between national capital accumulation and efficiency. With an obsolete economic structure and deficit-producing sectors, the options of internal savings can become restricted.
- The existence of operating capital markets, which are able to mobilise internal and external resources, and allocate resources rationally. The economy’s ability to minimise capital losses (devaluation of savings due to high inflation, freezing resources by way of the sauration, prestige consumption, transferring capital abroad) is of utmost importance.
- The state of budgets in the acceding countries, the ability of governments to reach or maintain budgetary balance, and to fund the costs related to accession.
- The ability of a particular country to absorb capital, both in terms of external investments of private capital and the intake of budgetary transfers.

In order to reach integration maturity and to implement a successful integration, the new member states need considerable resources for various reasons.

- A starting condition is to improve and maintain the competitiveness of their respective economies. The modernisation and structural reorganisation of the economies of new members have relied on foreign investments of private capital; consequently, their stimulation is of great importance. (Of course, the role of local private capital should not be neglected, either.)
- Development of the region’s infrastructure. In this area, new members may rely on more significant EU funds – the large part of development costs, however, is left for the given countries to pay (programmes implemented through co-financing or purely from the member state’s resources).
- Improving the condition of the environment. Compliance with environmental requirements and expectations in the new member states would necessitate thousands of billions of Euros.
- Building institutions, harmonising legislation and policies.
- Compensating for losses. No doubt, adaptation to membership criteria involves costs, and certain sectors incur losses. This is a natural process, a part of the structural reorganisation related to integration. This, for instance, is expected in agriculture.
- Payment obligations to the European Union must be complied with. Financing or being capable of receiving financing is a key issue of integration maturity and membership adaptation. Difficulties begin with the underdevelopment of capital markets and credit rating, which for a number of countries raise the expenses of involving external resources. In the worst case, rating may as well avert all kinds of reasonable investments, as it has occurred to a number of countries in the past 10–15 years. Still, a major limitation of Eastern enlargements was their budget. It equally applies to the budgets of old and new members, as well as that of the European Union. Despite the restricted nature of the EU’s financing capability, substantial amounts of resources are at stake. It is up to the country’s ability to absorb supports and the reasonable application of funds how these resources are actually utilised.

Hungary enjoyed growing financial transfers from the EU, particularly after 2004 (see figure 2).

![Figure 2. Capital Transfers from the EU to Hungary](image-url)
In the 2007–2013 financial perspective there is €347 billion assigned for Structural Funds, which is 35% of the €975 billion EU budget. In the period of 2007–2009, so far only €93 billion have been allocated, which is 27% of the available funds. From this budget, Hungary is eligible for nearly €25 billion, and the allocation is a little more than €11.5 billion, 46.3% of the total available. By this proportion Hungary is 7th among the 27 members, but in terms of amount of allocation, the country is second after Poland (€12.7 billion). Beyond the absolute amounts, from point of integration maturity the efficient and optimal use of the funds is particularly important. This question is addressed in the paper of Sandor Gyula Nagy and Christopher Maroshegyi in this volume.

CONCLUSIONS

The NMS produced an exceptionally rapid integration in the last 15–20 years, some become one of the most globalised economies of the world. This integration is still uneven, based on a large extent of foreign companies, and large sectors of SMEs and the agriculture remained outside. After joining, both old and new members enjoyed robust gains and the integration of CEE to the EU proved to be a positive sum game. Enlargement exerted positive impacts on integration process, it may promote further reforms. Recent world economic crisis demonstrated advantages of EU membership and enlargement. At the same time, the gains are hardly felt by the majority of society that explains growing negative attitudes, and diminishing support for EU integration. The Lisbon Program offers a development model, which combines and creates a compromise between global competitiveness and ecological sustainability as well as social integration. The future transformation and success of the Europe 2020 Program is critical from points of view of meeting global challenges and parallel the further integration of NMSs. They have the capacities (integration maturity for that), but future policies both on Union and on national levels will be crucial.

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5 Published in the daily Világgazdaság, April 1, 2010.
International M.A. in Economy, State and Society (IMESS)

International M.A. in Economy, State and Society (IMESS) is a highly competitive, two-year, English-language master’s program that is offered by University College London, England (UCL) and the consortium of Corvinus University of Budapest, Hungary (CUB) and five European universities. European Union sponsored scholarships are available.

Program Description

IMESS wishes to attract the brightest international students who would like to gain an in-depth understanding of the economies, states and societies of the expanding European region. The program is specifically designed for students who, besides the aim of completing their academic work at a professional level, believe it is essential to develop personally in their studies and expand their horizons by gaining first-hand experience with societies and cultures abroad.

Besides giving students the chance to develop cultural and linguistic knowledge about the wider European region, the main objective of the program is to provide a combination of discipline-based area studies and rigorous research methodology training. One of the great advantages of the program is that it not only guarantees high-quality tuition but it also gives students the rare opportunity to gain first-hand experience both in Western and in Central or Eastern Europe. Although the program specifically focuses on the Central and Eastern European region, the discipline-based skills it helps to acquire are generic. Therefore, IMESS gives students a global skill set suitable for entering a career in the private or public sector or for developing a research career in the academia.

The Structure of IMESS

IMESS is a consortium of University College London, Corvinus University of Budapest, Charles University, Jagiellonian University, University- Higher School of Economics, University of Helsinki, and University of Tartu. Recognized for its excellence by the European Union’s Erasmus Mundus Program, it offers the following three distinct study tracks that reflect the unique multidisciplinary expertise of IMESS institutions: Economics and Business; Politics and Security; Nation, History and Society.

Each track combines specialist electives (in economics, politics, society or history) and research methodology training (in social sciences or humanities). Students take courses of both types at UCL in the first year and at CUB in the second year of the program. Since the IMESS consortium believes that students can gain full understanding of the economies, states and societies of the region only if they have knowledge of the language of the country of the second year, students are further provided language tuition in Hungarian in the two years of IMESS. The advanced research dissertation is conducted in the final part of the program. Students are required to earn a total of 120 credits (ECTS) in each track and, upon successful completion, earn a double degree from UCL and CUB.

For more information about the IMESS Program, please visit the official IMESS website at http://www.imess.eu and http://economics.uni-corvinus.hu.
INTRODUCTION

The commencement of the official relations between the European Union and Turkey dates back to July 1959, when Turkey applied for association following the establishment of the European Economic Community. The relations were shaped in accordance with the provisions of Ankara Agreement signed in 1963. As stated in article 28 of the Ankara Agreement, the road to full membership was open, based on Turkey's capacity to fulfill its obligations. The Customs Union, which was envisaged as the final period of the Association, took effect on 1 January 1996 and was perceived in big business circles as a cure-all. On the other hand, small and medium sized companies have been critical of this process. With the Customs Union, Turkey had already become part of the European internal market and was required to adopt large parts of the acquis regardless of the membership process. The 1999 Helsinki Summit marked a turning point in Turkey-EU relations, followed by a positive atmosphere till the accession negotiations started in 2005. As Turkey started negotiations, conditionality rather than incentives were perceived to dominate the negotiation process. The absorption capacity of the Union was also an issue, which basically meant that Turkish accession has the risk of overburdening the EU in budgetary, political and/or institutional terms. Although the progress in accession negotiations constitutes an important anchor for the implementation of political reforms, it was only the economic perspective of Turkish accession which has been looked upon more favourably, while the rest became intertwined with the questions of identity and the future of Europe, a larger question. Turkey's road to EU membership is distinct from the previous enlargements, due to the combined impact of population, size, geographical location, economics and energy security. Given these features, despite the deep impact of the current global crisis on the economies of some member states, Turkey continues to be a functioning market economy in line with the Copenhagen criteria. The paper tries to assess and shed an insight into Turkey's economic convergence and argues that Turkey's EU membership is a challenging but a “win-win” case.
advanced far enough to justify envisaging full acceptance by Turkey of the obligations arising out of the Treaty establishing the Community, the Contracting Parties shall examine the possibility of the accession of Turkey to the Community.” Thus the road to full membership was open based on Turkey’s capacity to fulfil its obligations.

The three stages comprised a five-year preparatory period, a transition period and a final period. A Customs Union (CU) was designed to be completed by the end of the transition period. With the ending of the preparatory period, the responsibilities of the two sides during the transition period were determined in the Additional Protocol, which took effect in 1973. The timetable of the transitional stage was upset by the oil crisis and the following global recession in the mid 1970s, which affected labour recruitment from Turkey, a signal pertaining to the Community’s failure to comply with the provisions concerning the free circulation of labour. Another major problem bounced from the extension of concessions by the Community to many developing countries under the General System of Preferences and the Lomé Convention, and also under the Global Mediterranean Policy, which eroded to a large extent the preferences granted to Turkey. Finally, the imposition of quotas under “voluntary export restraint” framework on Turkish textile exports was another factor which strained the relationship. On the other hand, Turkey hit by the oil crisis and the recession was able to reduce tariffs only twice, in 1973 and 1976, and had to delay further tariff reductions on EC manufactured products. It could not even commence the adjustment to the Common External Tariff (CET). Faced with grave economic and balance of payments problems, Turkey presented a plan to revise the stipulations of the Association Agreement and also requested an aid package to revitalize its economy. However, this was not met by a favourable response from the Community and finally in 1978, Turkey took the step of freezing the terms of the Association Agreement under Article 60, which allowed both parties to take the necessary protective measures in case of fundamental sectoral or a regional disruption or disturbance in external financial stability.

The relations of Turkey with the Community came to a standstill after the military intervention in 1980. The fourth financial protocol was suspended, and the volume of trade between the partners began to decrease. The free circulation of Turkish workers in the Community was put off as of 1986. The decline in economic relations was also accompanied by the emergence of diverging views on political issues. The EC’s insistence on democracy and the promotion of human rights was interpreted as interference in Turkey’s internal affairs. Turkey insisted of identifying the EC solely as an economic entity.

At the beginning of the second half of the 1980s circumstances changed. Turkey’s 1980 stabilization and structural adjustment programme brought radical changes in its economic structure. The Community had also reversed its stance, by reactivating the Association Agreement. The Western-oriented business community had already begun voicing the full membership application. This demand was also backed up in

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1 From the Ankara Agreement to the 1999 Helsinki granting candidate status, 35 years passed and 6 more years were needed to open the accession negotiations in October 2005. Thus Turkey faces the most extended waiting period in enlargement history.
other circles, not only for economic reasons but also to guard the recaptured democracy. However, it was the economic considerations at the forefront of the domestic discourse when on 14th April 1987 Turkey applied for membership. The Commission, in its reply in 1989, stated that along with the economic and political drawbacks concerning Turkey, the Community would not be able to accept a new member until the completion of the internal market; and suggested the reactivation of the Association Agreement and proposed a set of measures towards increasing cooperation between the partners, including the completion of the CU. This “let’s talk about it later” approach from the EC had left no other viable option to Turkey but to take the necessary steps towards finalizing the CU. After two years of negotiations, the Customs Union between Turkey and the EU took effect as of 1st January 1996, based on the Association Council decision 1/95.

The CU between Turkey and the EU signifies much more than a customs union in the technical sense. Apart from the elimination of custom duties, quantitative restrictions and alignment with the Common External Tariff, Turkey had to harmonize its legislation with the Community legislation in relevant trade-related fields such as technical barriers to trade and competition policy, as well as negotiating trade agreements with third parties on the same terms as those concluded by the EU. Thus, the CU implied a considerable degree of “policy dependency” [Misrahi 2006: 2].

“The discussions on the issue of CU were clear enough to show the divergent approaches of the two sides in defining the CU. According to the provisions of the Ankara Agreement, the CU is the end product of the transitional stage during which both parties fulfil their reciprocal obligations. Thus it was supposed to be the first step of an irreversible chain of events leading to full membership.” On the other hand, the European side considered the CU nothing more than a way of developing close economic ties with Turkey and consistently refrained from making any reference to a link between the CU and the membership prospect. The EU’s ex-Ambassador to Turkey, Michael Lake, explained the situation as follows: “The customs union created misconceptions on both sides. The European side felt that Turkey would be preoccupied with making it work and not press for full membership for the time being, while Turkey had the misconception that the customs union was a stepping stone towards full membership in the next year or two” [Arikan 2003: 82].

Assessing closer relations with the EU as a counter-weight to the inward-looking etatist economic policy, the business community controlled by large enterprises around Istanbul supported the CU. They perceived it as a cure-all that would impose discipline on the domestic market, correct the trade imbalance, and promote foreign investment. On the other hand, the small and medium sized companies, whose demands were pronounced by the Eskisehir Chamber of Industry, were against the CU claiming that tariff dismantling beyond a critical point would eradicate domestic producers [Uğur 1992: 91–92].

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2 For further discussion see Balkir [1998].
3 In compliance with its obligations, Turkey adopted the Law on the Protection of Competition before the entry into force of the CU and established the Competition Authority in 1997.
4 For a detailed evaluation of the Customs Union issue see Balkir–Eylemer–Tas [2008]
The CU is one of the many respects, which make the Turkish case of accession quite distinct from previous enlargements. Through the CU, Turkey has already become part of the internal market for goods and was scheduled to adapt large parts of the acquis regardless of what happens to the accession process. The drafters of the Customs Union Agreements had realized that the liberalization of trade would entail painful adaptations and in order to counterbalance the adverse impact of such implementations, financial assistance schemes were to be devised together. However, as these financial assistance mechanisms were designed for members, Turkey, being a non-member country concluding a customs union, was deprived of the adequate financial support mechanism.

The CU did not cover agriculture and services. The free movement of the agricultural goods was to be realized after Turkey’s adoption of Common Agricultural Policy. From the beginning, the Community granted tariff concessions on agricultural imports and eliminated duties on primary agricultural products by January 1987. Concerning the manufactured agricultural goods, the taxes applied to were separated into agricultural and industrial shares; of which the industrial taxes were removed, while the agricultural share was set to the tax rate applied in the Community. As for the exclusion of the service sector, it still continues in spite of the fact that at present, Turkey has a strong competitive position in a number of service sectors but there is a need for finding a solution to the freedom of establishment which is a crucial condition for cross-border provision of labour-intensive services [Derviş et al 2004: 76].

The trade volume between the two partners has almost doubled since the CU. The opening up of the economy has made Turkey more attractive to foreign direct investment and thus further integrated it into the international division of labour. It has been claimed that unilateral obligations undertaken under the CU would create a barrier for Turkey to enter to the third country markets. However, the data indicates just the opposite and the Turkish experience shows less trade dependency compared to the experience of some member countries after accession, mostly due to its geographical location which facilitates trading with the neighbouring countries. Imports from low cost third countries have partly replaced the imports from high cost EU countries. Thus, the tariff reduction to third countries due to the application of CET has been an important factor in reducing the trade diversion costs of the CU for Turkey.

The CU has given impetus for the modernization of the economic structure resulting in an increased international competitiveness. Turkey’s exports both to the EU and non-EU countries have been reoriented from consumption goods to higher value-added goods. Although the export growth of Turkey has been astounding during 2001-2008 (13.9% compared to 4.4% for Euro area [Republic of Turkey Prime Ministry Undersecretariat of Treasury 2010]), the share of the EU in Turkey’s exports has decreased. At the year of the CU, EC’s share in imports was 55.7% and its share in exports was 54.1%, while the respective figures were 40.2% and 46.0% for 2009 (see table 1).

The openness of the Turkish economy, as measured by the total value of exports of goods and services as a percentage of Gross Domestic Product (GDP), amounted to about 48% of GDP in 2008 [Commission of the European Communities 2009].
The EU's share in Turkey's trade varies from year to year, depending on numerous factors, including international commodity price trends and exchange rate movements. Although Turkey diversified its trade towards new markets, on the whole, trade and economic integration with the EU remains high.

Currently a discussion has been initiated in Turkey to re-negotiate the conditions of the CU since not being in the decision mechanism, Turkey has no voice in the free trade agreements (FTA) concluded by the EU with the third countries, some of which are trade competitors of Turkey, although disappointingly the EU fails to consider the sensitivities of Turkish industry. Once a FTA is concluded, it opens the entire customs union area of the EU, which also includes Turkey. However, the concession by the third country concerns only the exports originating from EU countries, and not Turkey, which is not a full member. The EU continues to increase the FTAs within the context of its strategy introduced by a communication titled “Global Europe-Competing in the World” dated October 2006 [European Commission 2006].

It has been discussed previously, that the financial assistance mechanisms to counterbalance the negative impact of CU was designed for members and Turkey, not being a member, received very little. The EU has always been reluctant to fulfil its financial obligations which caused frustration on the Turkish side. One must admit that the situation has changed for the better after the candidacy. Table 2 gives the implementation rate for loans and grants prior to the CU and following the CU.

The EU allocated €21 billion 840 million to the Central and Eastern European Countries under SAPARD, ISPA and PHARE Programmes for the period between 2000 and 2006, while the fund allocated to Turkey was only €1 billion 748 million for the same period. In 2000, the amount of funding per capita was €2.7 for Turkey, while the amount per capita for Estonia was €46 and €17 for Czech Republic. Overall, the average financial assistance per capita was 9 times more for Central and

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6 The current financial framework runs until 2013; the following one will run until 2018. Assuming accession by 2015, this would mean that the financial framework for the first three years would be decided by the EU-27 or most probably EU-28. Therefore, Turkey will be fully part of the financial framework in the 2018-2024 Round [for details see Derviş et al. 2004].
Table 2. EU Financial Commitments to Turkey

| Commitments | Prior to the Customs Union (1964–1995) | € 1 605 million (€ 1 152 million loans and € 453 million grants) |
| Payments    | € 1 005 million (€ 927 million loans and € 78 million grants) |
| Implementation Rate | Loans | % 63 |
|             | Grants | % 80 |
|             |        | % 17 |

| Commitments | Following the Customs Union (1996–1999) | € 2 275 million (€ 1 507 million loans and € 768 million grants) |
| Payments    | € 755.3 million (€ 557 million loans and € 52 million grants) |
| Implementation Rate | Loans | % 33 |
|             | Grants | % 37 |
|             |        | % 7 |

Candidacy Process Commitments

| Loans  | 2004–2006: € 1 050 million |

Instrument for Pre-Accession Assistance (IPA)

| 2007–2010 : € 2 256 million |
| 2011–2013 : € 3 000 million |


Eastern European Countries [Gençkol 2003]. Although the EU financial assistance to Turkey has increased gradually in time, the amount per capita is still low compared to the amount allocated to the other candidate and potential candidate countries (see table 3).

Table 3: Allocation of Pre-Accession Assistance among Candidate and Potential Candidate Countries

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Croatia</td>
<td>589 900 000</td>
<td>132.95</td>
</tr>
<tr>
<td>The former Yugoslav Republic of Macedonia</td>
<td>302 800 000</td>
<td>149.70</td>
</tr>
<tr>
<td>Serbia</td>
<td>771 100 000</td>
<td>102.80</td>
</tr>
<tr>
<td>Montenegro</td>
<td>131 300 000</td>
<td>211.70</td>
</tr>
<tr>
<td>Albania</td>
<td>306 100 000</td>
<td>95.60</td>
</tr>
<tr>
<td>Bosnia and Herzegovina</td>
<td>352 000 000</td>
<td>83.00</td>
</tr>
<tr>
<td>Turkey</td>
<td>2 256 000 000</td>
<td>31.30</td>
</tr>
</tbody>
</table>

Source: European Commission Enlargement Website,
*Balkir–Eylemer–Tas [2008: 9]

Screening meetings on the chapter of customs union took place at the beginning of 2006 and the report issued on 9 March 2007 highlights the considerable level of alignment of the Turkish customs law on the acquis in the field of CU. On the other hand, the accession of Cyprus in 2004 to the EU has raised a politically sensitive issue and CU became one of the controversial issues on the agenda of accession negotiations. According to the screening report “as long as restrictions on free
movement of goods carried by vessels and airplanes registered in Cyprus or where the last port of call was Cyprus remain, Turkey will not be in a position to fully implement the acquis relating to the EU-Turkey customs union" [Screening report Turkey 2007]. Following the Commission's recommendation on 29 November 2006 to partially suspend Turkey's EU membership negotiations, EU foreign Ministers decided, on 11 December 2006, to partially suspend negotiations with Turkey for eight chapters including the chapter on CU.7

AFTERMATH OF HELSINKI SUMMIT

The Helsinki Summit marked a breakthrough in Turkey-EU relations, at which the membership perspective overcame the long-lasting ambiguity surrounding the Turkish case and ending the debate over whether Turkey is a European country. This was enough to embark the reform process, although it started with the cautious steps taken by the three-party coalition government. The reform process further accelerated after the 2002 Copenhagen Summit, when it was decided that “if Turkey meets the political Copenhagen criteria in 2004, the accession negotiations will be launched without unnecessary delay” [Copenhagen European Council 2002]. Issues previously considered taboo, such as Kurdish rights, civilian control of the military, reinforcing the legal guarantees on freedom of expression, abolition of the death penalty, elimination of State Security Courts, broadcasting in mother tongues other than Turkish in both public and private channels, amendment of the National Security Council were some of the important achievements.

The optimistic environment created by membership perspective, a definite external incentive, reached a peak when the EU decided to open accession negotiations with Turkey on 3rd October 2005.8 Achieving the EU candidacy status had significantly strengthened the political commitment to economic and political reforms and the commencing of the accession negotiations was expected to be an anchor for implementing them.

However, as Turkey started negotiations, conditionality rather than incentives were perceived to dominate the negotiation process. The EU stated that the negotiations are an open-ended process, the outcome of which can not be guaranteed beforehand. It was also indicated that in the case of Turkish accession “long transitional periods, derogations, specific arrangements or permanent safeguard clauses” was to be expected. The absorption capacity of the Union was also an issue, which basically meant that Turkish accession has the risk of overburdening the EU in budgetary, political and/or institutional terms. As membership perspective got blurred, the accession process lost its attractiveness for the Turkish public, leading to a

7 Chapter 1: free movement of goods, Chapter 3: Right of establishment and freedom to provide services, Chapter 9: Financial services, Chapter 11: agriculture and rural development, Chapter 13: fisheries, Chapter 14: transport policy, Chapter 29: customs union and Chapter 30: external relations.
8 Up to December 2009, 12 out of the 35 chapters of the acquis have been opened, and 8 chapters suspended due to Cyprus conditionality. Croatia, for which the negotiations began on the same date, has already 28 chapters opened out of 35.
decline of support for EU membership. Kramer [2009: 4] rightly points that “fundamental disruption of the logic of conditionality-compliance mainly brought about by the EU's credibility gap, Turkey's accession process has entered a vicious circle, with negative factors and opposing forces on each side reinforcing each other”.

From the EU perspective the accession of Turkey was controversial for many reasons. According to Tsoukalis [2006], “Turkey forms a category of its own. Big, poor and different, Turkey presents the biggest challenge for all.” It is the largest single country to be included since the UK, with a young and growing population and a GDP per capita below EU average. It is not considered as a genuinely European country by many Europeans and the debate on membership is framed in geopolitical terms and around the politics of identity. Discussion in Europe is marked by fear on one side, the fear of Turkey diluting the Union, fear of mass immigration, fear of cultural clash,9 and fear of eventual predominance of large ethnic group in EU.10 On the other hand, there is the fear of missed opportunity by excluding Turkey, a historic chance for Europe to prove its capacity for diversity. Thus the question of Turkey's accession became intertwined with the questions of identity and direction of Europe, a larger question. Opposition to Turkey shifted from measurable variables to ambiguous, abstract debates and discourses on Turkey.

It was only the economic perspective of Turkish accession which has been looked upon more favourable, as a case of “win-win game”, because the country is an important market for EU goods and services, it is the seventh biggest trade partner and the EU firms have invested significantly in Turkey. Even considering only the economic criteria the Turkish case is distinct from previous enlargements. The rest of the paper will try to assess and shed an insight into the economic convergence of Turkey to Copenhagen economic criteria and moreover, the Maastricht criteria.

WHAT MAKES TURKISH ACCESSION DISTINCT FROM PREVIOUS ENLARGEMENTS?

As the paper will concentrate only on the economic perspective, one can say that Turkey's distinction lies in the combined impact of population, size, and GDP. Table 4 gives us the contribution of Turkey to the EU27 with respect to area, population and GDP. However concerning the change in the average per capita, the figure will be different at present as Turkey's GDP per capita increased greatly during the last five years.

With over three million, Turks constitute by far the largest group of third-country nationals legally residing in the EU. Although the impact of Turkey's accession on migratory flows into the EU is a major issue, according to Ugur [2008: 19], the high-

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9 The question of Turkey's accession became intertwined with the questions of identity and direction of Europe.
10 According to French President Sarkozy, Turkey is not European in its geography, culture, and history. And therefore it has no place in Europe. In Germany, Angela Merkel's Christian Democratic Union (CDU) was elected in 2005 on a pledge to block Turkish accession and propose "privileged partnership".
est estimates of Turkish migration suggest that the Turkish migrant stock will constitute only 0.7 per cent of EU-15 population, which is equivalent to 1.1 per cent of the labour force. President of the European Commission J. M. Barroso [2010: 4] in his speech on 11 February 2010 stated that due to accelerated ageing, the working age population will be reduced by about 2 million by 2020, and the number of those aged 60+ is increasing twice as fast as before 2007. BusinessEurope [2010: 8], the Confederation of European Business, also emphasizes the demographic ageing as one of the five key challenges facing the EU. “As the European population ages, it creates a demand for new products and services in Europe. But from 2010, it will also result in a decline of the working-age population, with a loss of over 3 million potential workers by 2020 and over 50 million by 2060. If the EU continues to ignore this trend, the EU will not only undermine its social protection systems, but also lose business opportunities and the related jobs and growth”. Turkey’s relatively young population with an average age around 27 years and with an annual growth of 1.3% can be a valuable contribution to tackle this problem. The new generation is also quite different from 1960’s Gastarbeiter profile who moved to Germany seeking work as part of a formal guest worker programme. The quality of education has improved enormously11 and high labour productivity increases have been accomplished both in industry and service sector since 2002.

Improving the effectiveness of public services, restructuring the health and social security systems, improving energy infrastructure, increasing R&D activities and innovative capacity and increasing productivity in agriculture are some of the main structural challenges ahead. The agricultural sector remains relatively inefficient and highly labour intensive, characterised by unpaid family workers, which leads to a statistically lower rate of unemployment, and requires structural measures to bring into line with Common Agricultural Policy.

There is also the issue of EU’s absorption capacity, meaning the institutional and budgetary impact of Turkey. First, the concerns regarding the institutional impact in the decision making mechanisms has been somewhat alleviated by the Lisbon Treaty, through double majority voting. Secondly, estimating the impact of Turkish membership on the EU budget is quite difficult, depending not only on the struc-

\[\text{Table 4. Comparing the impact of Turkey with the previous enlargements (\%)}\]

<table>
<thead>
<tr>
<th>Increase in surface area</th>
<th>Increase in population</th>
<th>Increase in total GDP</th>
<th>Change in average per capita GDP</th>
<th>Average per capita GDP (EU15 =100)</th>
</tr>
</thead>
<tbody>
<tr>
<td>From EU-15 to EU-25</td>
<td>23</td>
<td>20</td>
<td>4.7</td>
<td>-8.8</td>
</tr>
<tr>
<td>From EU-25 to EU-27</td>
<td>9</td>
<td>6</td>
<td>0.7</td>
<td>-4.3</td>
</tr>
<tr>
<td>From EU-27 to EU-27+TR</td>
<td>18</td>
<td>15</td>
<td>2.2</td>
<td>-9.1</td>
</tr>
</tbody>
</table>

Source: European Commission [2004].

11 The net enrolment rate in compulsory education (8 years) increased by almost 10% to over 97%. The net enrolment rate in secondary education also increased, from 56% to 58% [Commission of the European Communities 2009].
ture of the future budget allocations, but also on the structural change in the Turkish economy.  

FROM MACROECONOMIC INSTABILITY TO FULFILLING THE MAASTRICHT CRITERIA

This section will try to analyse the present position of the Turkish economy, its transformation into a functioning market economy. Turkey was a closed economy with an import substituting industrialization strategy under high state intervention. Starting with the 1980s, under an IMF programme, the country changed its strategy to an export oriented growth model, which suffered from chronic macroeconomic instability in the 1990s and early 2000s, due to lack of adequate regulatory and institutional framework.

In an attempt to stabilise the economy, Turkey entered into an IMF stand-by agreement in December 1999, which was initially successful but as fiscal consolidation and structural reforms lagged behind, in October 2000, Demirbank, a major investor in government securities reached the point where it could no longer refinance itself on the market. The financial turmoil had disastrous consequences for the real economy, including GDP decline of 5.7% in 2001 and the increase in public debt following the depreciation of the lira. The resulting banking crisis affected about one quarter of the country’s 81 banks and the external position weakened as foreign debt rose to almost 60% of GDP in 2000. This was exacerbated by the rise in short-term borrowing. To cope with the crisis, macroeconomic stabilisation and structural reforms were implemented under the 2002 IMF stand-by agreement and the National Programme for Convergence with the EU acquis. Thus the economy recovered via two external anchors; namely, the IMF programme and the prospect of EU membership.

The Turkish economy in the post-2001 era witnessed a successful transformation with an ambitious reform agenda to strengthen the financial sector, banking sector and social sector. The structural reforms implemented since 200113 can be grouped as: fiscal policy, monetary policy and incomes policy. The main target of fiscal policy was to implement fiscal discipline, formulating the budget and debt structure in line with the Maastricht criteria.14 The main objective of monetary policy was to ensure price stability. The incomes policy was to support fiscal and monetary policies in harmony with inflation target. This resulted in a significant decline in the inflation rate. The average inflation rate was 62.7% per annum between 1983 and 1994, 71.6% per annum between 1995 and 2001. It declined to 12.5% per annum

12 Uğur [2008: 16] states that "estimates of net budgetary transfers to Turkey range between 5.6–24.6 billion Euros per year. This sum is a significant amount, but relative to the GDP of the Union, it represents a very small percentage, between 0.05–0.2 per cent".

13 The main economic reforms took place in fiscal and monetary policy, tax policy, financial sector prudential regulations, product market regulations, labour market regulations, capital markets, foreign direct investment, and privatisation of state-owned enterprises, infrastructure and agriculture.

14 The tight fiscal policy implemented since the 2001 crisis based on yielding large primary surpluses in order to reduce the public debt stock is being relaxed in the context of the economic crisis.
during 2002 to 2009. Annual inflation fell to 5.3% in August 2009 in line with the inflation targets but also due to lower energy prices and falling domestic demand. Six zeros were dropped from the Turkish lira and the New Turkish Lira was introduced on the 1st January 2005. Dropping six zeros from the Turkish lira was a clear indicator of the determination in bringing inflation to single-digit figures. The exchange rate was also successfully used for achieving price stability under the inflation targeting floating exchange rate regime.15

Political stability, fiscal discipline and stable growth, in addition to privatisation, resulted in reduced Public Sector Borrowing Requirement (PSBR) which led to a decrease in interest rates. With the increase of confidence levels in the markets, Treasury was able to raise the average maturity of domestic borrowing. The market mechanism and the efficiency in the private sector were strengthened,16 the share of the public sector was reduced by privatisation17 and public administration was restructured.18 Market regulatory bodies were set up.19 All these structural reforms improved the competitiveness of the Turkish economy, getting its macroeconomic indicators more in line with the Maastricht criteria. A concrete example is public sector borrowing requirement (PSBR) decrease from 12.1% in 2001 to 1.6% in 2008.

The banking sector reform20 and measures taken to enhance the autonomy of the Central Bank were critical to the success of the programme. The reforms in the banking sector also resulted in attracting foreign capital into the sector. Turkish banking sector had a strong position against the 2008 global financial crisis, as many announced profit on their balance sheet both in 2008 and 2009.

As the result of structural reforms implemented; Turkey entered a high growth phase, which outperformed most of the European countries. On average, the Turkish economy managed to grow at a rate of 5.9% per annum during 2002-08 and has become the sixth biggest economy in Europe (see figures 1 and 2).

GDP per capita also rose from 2 500 US$ in 2000 to over 10 000 US$ in 2008, though still under the EU-27 average.

15 Foreign exchange rates will be determined by supply and demand conditions in the market and the Central Bank will not set any target for exchange rates. However, the Central Bank may directly intervene in the foreign Exchange market via buying or selling interventions on its own initiative, in order to prevent excess volatility in the foreign exchange rates.
16 The private sector’s share of GDP was around 89% in 2009.
17 The total volume of privatisation revenue reached 4.92 billion in 2008 (about 1.5% of GDP).
18 Restructuring of Public Administration: Public Financial Management and Control Law; extending the scope of budget; Budget Accounting Code System and Fiscal Transparency; Strengthening the Supervision and Auditing Base; Strategic Planning in public institutions; Local Administration Reform; Public Procurement Law / Public Procurement Authority; strengthening the statistical infrastructure; Enhancing the Administrative and Institutional Capacities of ISKUR and Turkish Patent Institute; Regional Development Agencies.
19 Banking Regulation and Supervision Agency; Telecommunications Authority; Energy Market Regulatory Authority; Tobacco, Tobacco Products and Alcoholic Beverages Market Regulation Authority; Sugar Authority.
20 Banking Regulation and Supervision Agency (BRSA) has the authority to take and implement all types of measures for the purpose of protecting the rights and interests of depositors, maintaining confidence and stability in the financial markets, ensuring that the credit system operates efficiently.
The country's commitment to fiscal discipline in the post-crisis era constitutes another important component of macroeconomic stability. In the post-2001 era, budget deficit / GDP and public total debt stock/ GDP ratios have declined in line with the Maastricht criteria. Turkey outperforms many Euro-zone countries in terms of public debt management, as the country managed to reduce its stock of public debt from 73.7% of GDP in 2001 to 39.5% of GDP in 2008. The economic performance under the current economic crisis, in a way, validates the achievement of Turkey's structural reform process.

Figure 1. GDP Growth Rate in Turkey (Annual Average, %)

Figure 2. Europe's Largest Economies

Source: Republic of Turkey Prime Ministry Under secretariat of Treasury [2010]
Competition Law, SME Strategy and Action Plan, legislation on telecommunication\textsuperscript{21} and energy sector\textsuperscript{22}, all contributed to improving competitiveness of the economy. The contribution of the private sector fixed investment to GDP growth has increased gradually, from 0.6\% during 1993-2002 to 2.3\% during 2003-2008. As the business environment improved, Turkey’s ranking in the World Bank’s Doing Business reports improved from 84\textsuperscript{th} out of 155 countries in 2005 to 73\textsuperscript{rd} out of 183 in 2009, and its ranking in the Economic Freedom Index compiled by the Heritage Foundation from 112\textsuperscript{th} out of 161 countries in 2005 to 75\textsuperscript{th} out of 179 in 2009.

Although the CU was not a big impetus, the decision of December 2004 for the opening of negotiations on 3\textsuperscript{rd} October 2005 had a definite positive impact on the FDI inflow, largely driven by inflows from privatisation. The International Finance Institute has announced Turkey as one of the main recipient countries for the inflow of FDI in 2005. Turkey ranked 22\textsuperscript{nd} among top FDI attracting countries in 2005, up from 53\textsuperscript{rd} in 2003 and 37\textsuperscript{th} in 2004 [Republic of Turkey Prime Ministry Undersecretariat of Treasury 2006: 5]. The amount of FDI inflows\textsuperscript{23} to Turkey after 2005 reached the level of 20 billion USD per annum, higher than the total recorded for the period between 1980 and 2000 as a whole. The help of an ambitious privatisation programme also had a major impact on the FDI inflow during 2002-2008. The amount of accumulated FDI reached about 76 billion USD, though compared with the FDI boom of central and eastern European countries during their accession process, it is very modest. Around 78\% of FDI inflow to Turkey originated from EU member states, which illustrate the keen economic interest in the Turkish market. See Figure 3 for more details.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{Figure3.png}
\caption{Foreign Direct Investment Inflows (Billion USD)}
\end{figure}

Source: Republic of Turkey Prime Ministry Undersecretariat of Treasury [2010]

21 Legislation on Telecommunications Sector: Arrangements in Information and Communication Technologies; National Roaming Regulation and Regulation on Access and Interconnection.
22 Legislation on Energy Sector: The Law on Electricity Market; the Law on Natural Gas Market; the Law on Oil Markets; the Liquefied Petroleum Gas (LPG).
23 The amount of portfolio investments is much less, which reduces the risk of speculative movements.
To conclude, one can assert that EU demands on “reducing inflation and fiscal sustainability” and reforms necessary to attain these has collided with Turkey’s priority to ensure a sustainable growth while reducing inflationary pressures and bringing public sector deficit and debt ratios to EU averages. Therefore, the Progress report 2009 states “As regards the economic criteria, Turkey is a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its comprehensive reform programme in order to address structural weaknesses” [Commission of the European Communities 2009: 33].

IMPACT OF THE GLOBAL CRISIS ON THE TURKISH ECONOMY

The negative effects of the global crisis on Turkey became apparent as the economy contracted in the last quarter of 2008 and in the first quarter of 2009. This was mainly the result of a severe drop in domestic and international demand. Due to the economic contraction, the unemployment rate rose sharply to 13% by mid-2009 and the sectoral shift from agriculture to industry and service sectors came to a standstill if not even temporarily reversed. The Progress Report 2009 points to the fact that “the share of agriculture in overall employment increased from 24.0% to 24.6% between December 2007 and December 2008” [Commission of the European Communities 2009: 33].

Macroeconomic stability has been largely preserved in spite of the severe global economic recession. The impact of the crisis was largely limited to the real sector of the economy. The banking sector has shown outstanding resilience to the global financial crisis, basically due to the prior reforms in the regulatory framework. The government has also adopted a number of measures to mitigate the potential shocks that may arise from the financial crisis. In total, stimulus measures amounted to about 5.1% of GDP.24 The stimulus packages included the provision of zero-interest loans for SMEs, a tax break for local investors in equities, inducements for Turkish citizens to repatriate savings held offshore, package supporting domestic demand by cutting taxes on the sale of cars, office furniture, IT, houses and machinery used by SMEs for a certain period. The Central Bank maintained the formal inflation targeting regime, and took several measures to ease foreign exchange liquidity in the banking sector, by re-opening the inter-bank foreign exchange deposit market, extended maturities and volumes for the deposits that it places on this market, and other necessary measures. “Overall, the unfolding of the crisis did not jeopardise the functioning of market mechanisms and Turkey continues to be a functioning market economy” [Commission of the European Communities 2009: 37].

CONCLUSION

Trade and investment have been the two key factors in Turkey’s relations with the EU from the beginning. And moreover, it was only the economic perspective of Turkish accession which has been looked upon more favourable, because the country is an important market for EU goods, services and its investment. However, the country's atypical position as being the only country to conclude a customs union with the EU without being a full member has brought about both opportunities and challenges. Practically, Turkey became part of the internal market for industrial goods and took over substantial parts of the acquis regardless of what happens on the accession front. The CU has facilitated the transformation of Turkish industry and modernisation of Turkey's economic legislation, thus contributed to its competitiveness and integration with the global economy. On the other hand, the CU has been far from fulfilling the country’s expectations in vital aspects such as adequate financial assistance and the eventual inclusion of agriculture and services. Besides, not being in the decision-making mechanisms of the EU concerning external economic relations, Turkey does not have a voice in the free trade agreement negotiations with the third countries, some of which are trade competitors of Turkey. Therefore, such an asymmetrical relationship is unsustainable in the long term if the country's full membership is not realized.

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This essay addresses four major issues confronting the Central and Eastern European new members of the European Union in the decade to come. First: what to think of the financial meltdown of 2008-2009. Second, what have they learned from the tremors, having shaken the previous star performers of the EU? Third we ask if we can expect a return to ‘normalcy’ as forecast by most models of financial rating agencies and international financial institutions? Fourth the question is raised what did the new members benefit from their EU membership? Some conclusions on the future of EU reforms and policies close the overview.

INTRODUCTION

2008–2009 witnessed a largely unexpected derailment in the catching-up process of the new member-states (NMS) of the European Union. Convergence to EU-15 levels has come to a halt already by 2008 with the slowdown of economic activity, and has been positively reverted in 2009. The contraction of GDP in most NMS exceeded that of the Euro Zone by 2.1 per cent, with Hungary registering a drop of 6.3 per cent and the previous envy of the rest, the Baltic States registering double digit drops, unprecedented in peace time development [more on that in: WIIW 2010]. Since recovery in 2010 is modest and also in 2011 likely to be mediocre, at least an election cycle- but perhaps more – is wasted in terms of real convergence, conventionally postulated in theories of economic integration. Also this development stands in stark contrast with the generally upbeat mood, strongly represented in the literature [Kolodko 2009] seeing a fast and continuous catching up as a baseline scenario, provided rather innocent, commonsensical maxims of economic policy making – such as avoidance of excessive deficits and disregard for externalities – are being observed.

These developments took by surprise most observers of the regions as well as central banks, fiscal authorities and international institutions. The vulnerability of the NMS to external disturbances was though a subject of some theorizing, however the intensity and imminent occurrence of the spillover of global financial crisis has called for some reflection, both among policy-makers and academics. In short, while some envision a return to normalcy, and that relatively soon, others [Myant and Drahokoupil, eds 2010] interpret the financial crisis as the final verdict on transition, one that has finally uncovered the long lasting unilateral dependence and unilateral, asymmetric integration of Central and Eastern Europe in the global hegemonic system of capitalism.
ON THE GLOBAL FINANCIAL CRISIS

A. With the passage of time we learn more data about the size and scope of the meltdown. First, while the crisis indeed wiped out entire industries, such as most investment banking, it has not wiped out the entire financial sector. Moreover the more we learn about the balance sheets of banks around the globe, the more we might be surprised to see, that many of the big financial institutions are in pretty good shape. Profits are slightly below the levels of the previous year, but all in all business seems to have been as usual. And while the press was preoccupied with cases of major public bailouts, several other institutions were in no need of public money, and far not only Barclays with its conspicuous overseas takeovers. Major banks in a number of EU states, including those in Spain, Poland and Hungary did not require public action, contrary to their Irish or German counterparts. In short, while some financial institutions collapsed, others flourished. We can by no means talk about the crisis of the entire financial sector of the globe, not even of that in all advanced economies. Interestingly, major collapses occurred not in the relatively unregulated areas like hedge funds, but in the fields where the visible hand and yes, the so frequently required regulator was more than marginally present, such as in mortgage lending. The subprime crisis was therefore clearly one of state failure, rather than market failure [Dimsky 2010]. The role of over the counter deals, structured products and financial innovation with its related lack of transparency was clearly overrated in the popular reaction.

Likewise more detailed analyses of the causes and the mechanisms of the crisis [Reinhart and Rogoff 2009] were able to demonstrate the fundamental differences to those of the Great Depression, not least owing to differences in the workings of global capital markets and owing to the presence of major automatic stabilizers, primarily public transfers and coordinated action by the public authorities in the global scale, avoiding thus the beggar thy neighbor policies of the interwar period. The much criticized disciplines of the WTO as well as the mechanisms of the EU single market, most importantly competition policies and the joint fiscal framework, helped avoid a relapse into old fashioned protectionism. Likewise the survival of the institutional and policy framework allowed to start working on what is euphemistically called as an exit strategy, implying the discontinuation of pumping indiscriminate amounts of money into the economy, and reverting the mostly improvised proliferation of interventions into the workings of the market.

In short, a return from exceptional, ‘war-time’ management practices of the panic phase of 2008-2009 a certain ‘return to normalcy’ is already in the making. Governments declared their schedules to return to the numerical limits of the Stability and Growth Pact, and ECB calls to revive solid operations, typical of ‘peace times’ are being heeded. The wrestling over Greece in early 2010 is a clear indication that in most of Europe the inclination to take wartime as normalcy, and peace-time as exceptional is no longer given.

B. What should we think about the real economy in terms of usual activity indicators that characterize macroeconomic performance of EU nations? First and foremost, it is important to recall, that global output in 2009 contracted by a mere 1.2
per cent, Euro Zone output by 2.1 per cent, EU output by 4.3 per cent, while several economies managed to grow, like China, India but also Poland. This is exactly the opposite pattern to the ones observed during the Great Depression, when core economies contracted much more than those in the periphery. According to the consensus view of analysts, from the OECD to the IMF and the EU Commission, the global and the European economies are to grow in 2010 and 2011, even if recovery is fragile and thus its robustness may well be less than mechanistic modeling would have it. Thus, at the bottom line, we registered a single year of contraction, which is though unpleasant, but not without parallels.

In terms of inflation the good news is that it has not been extinct. While many analysts feared of a deflation, the overall contraction of price levels has not materialized in the sense of ECB, implying four- rather than just two-quarters of consecutive decreases in the overall price levels. On the contrary, in some cases - as Hungary and the Baltics - inflation already flared up, and in other cases, as in Britain and Ireland, Spain and Greece, the question whether governmental spending translates into inflation is a matter of 'when', rather than of 'if'.

In terms of unemployment the situation is equally sobering, but by no means extreme or catastrophic. The unemployment rate of the EU has climbed close to the double digit levels by early 2010, which is certainly bad news. But this overall number is hardly above the customary rate of the 1990s. True, this had been, already then a major social and economic challenge for the Union. Still, 9.9 per cent for the Euro Zone and 9.5 for the entire EU at the end of 2009 is not a severe overshooting over 9.8 per cent of the 1996-2000 average, or 8.6 per cent for the 2001-2005 average, even if in certain countries and regions, especially in Spain, reaching 20 per cent by spring 2010 and Latvia, exceeding the 25 per cent level, which is devastating. By contrast, and defying the bad track record of the 1995-2005 period, unemployment has not soared in traditionally weak Slovak and Polish labor markets. Their respective 12.9 and 11.9 per cent, but remain way below the 18 to 18.5 per cent that featured the preceding period. This observation should not be read in terms of complacency, as governments must surely act, but the macroeconomic impact must be put in proper numerical perspective. Even in the Czech Republic, the 2009 figure of 9.2 per cent is surprising by traditional standards, rather than extremely high in EU standards.

C., What has been summarized above translates in economic theory as a clear case of a cyclical slump as contrasted to a structural crisis, a difference the world has known to appreciate in the 1973 and 1979 global downturn. If the recession is cyclical, it usually does not call for structural measures, let alone rethinking the economic theories and the fundamentals of the market system, as several commentators,

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1 While the US economy contracted by about 50 per cent in the seven years between 1929-36, the Hungarian economy contracted by only 10 per cent in 1930-31 and grew from 1932,
2 Throughout the paper, the source of data, unless otherwise indicated is the ECB's Statistics Pocket Book, February, 2010.
and not just in the press, have called for. Rather what we observe is a *return to normalcy*, a point to be elaborated below.

First and foremost, what we observe is a corrective phase, when previous overvaluation of assets, especially on the stock markets, were cut back to size, i.e. brought in line with the realistic ability of those assets to generate revenues in the medium run. Certainly, following two decades of what Alan Greenspan termed already in 1996 as ‘irrational exuberance’ it takes a longer period of trial and error until the new terms of exchange emerge, thus there is nothing surprising in the relatively slow and tumbling recovery of financial markets.

Second, as previously privately hold toxic assets have been transferred to public hands, authorities will have a tough time in figuring out what to do with those. In other words, the crisis of private banking has been transformed into a severe disequilibrium in public finances, with no clear cut strategy to overcome the new challenge. What is clear however is that private markets are unwilling to finance any levels of debt, and a relapse into inflationary finance in the open manners of the 1970s is no longer an option. Under this angle it is a welcome development that the EU institutions in general and the ECB in particular continues to act in defense of solid finances and do not make allowances coming from the political sphere to ‘bridge’ fiscal disequilibria at any cost and through any means, irrespective of costs and consequences.4

Third, as it can be elaborated at greater length, the improvised set of state interventions created a situation where unintended side effects dominate the intended ones, therefore the exit strategy can by no means be found in the direction of further state intervention and the revival of Keynesian recipes, that were elaborated under different conditions, especially different conditions pertaining to the transmission mechanisms of money markets [Leijonhufvoud 2009; Csaba 2009]. From this it follows that the way out will be in the discontinuation of conditions of an economic martial law and a return to established peace time practices, with significant improvement in terms of regulation.

NEW MEMBER STATES IN THE MELTDOWN

A., The new member states could gather a series of experiences during the 2008-2010 period. First, as can be shown prior to the out brake of the crisis, simplistic policy options aiming at shortcut solutions - and aiming at saving the pains of slow ad complex institution building - enhanced the external vulnerability of the star performers, primarily the Baltics and Bulgaria, to an unprecedented degree [Csaba 2008]. This vulnerability translated into immediate external shocks when quick adoption of the single currency proved impossible, and when the currency mismatch, between earnings in local currency and debts accumulated in foreign currency, primarily of households and the corporate sector, exploded as a side effect of

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the global financial panic that ensued from the collapse of Lehman Brothers in September 2008.

But the fragility of economic development has become manifest in all other states. Czech GDP declined by 4.2 per cent and unemployment rose to 9.2 per cent. The previous growth champion of central Europe, Slovakia also experienced a steep decline in her GDP, reaching a drop of over 5 per cent against the impressive growth of 6.2 per cent in 2008 and 10.2 per cent in 2007.5 While Poland managed to grow by nearly 2 per cent in 2009 (after the upward revisions of the last quarter), Hungary experienced a drop of 6.3 per cent, and the currency crisis could only be averted by resorting to a jumbo IMF-EU-World Bank loan, a unique arrangement of its kind orchestrated in October 2008. The experience of the Visegrad countries less Poland reflect that doing nothing over years is not an innocent lapse that would run without costs in the short and medium runs.

The deepest decline hit the previous star performers, the Baltic States, where the decline of GDP was double digit, and unemployment rates soared accordingly. The crux of the problem here was lack of institutions and lack of will, on the side of the authorities, to cool down the economy when unsustainable current account deficits surfaced already in the middle of the decade. While the currency board regime does exclude devaluation and limits severely the possibilities of setting interest rates at will, however it does not mean a lack of any policy instrument. For instance banking supervision is at the hand of authorities and borrowing, especially in foreign currency, can be limited e.g. by imposing a compulsory deposit requirement or taxing the profits accruing from this form of lending. Likewise tax policy has been around and so are many other policies, provided higher tax revenues are spent on a variety of items with public goods character, such as improving the physical and institutional infrastructure, protecting the environment or building up stabilization funds along the Norwegian or Russian lines. But authorities have refrained from acting, as the naive belief in growth as a panacea for any social ills, along the ‘bigger the better’ lines, was universal. Also the steep fall of output and living standards, that followed Soviet disintegration propelled expectations.

B., What has been described above is a set of policy mistakes, that revolve around the notion of populism. This implies a propensity of decision-makers to follow the immediate preferences of their electorate, irrespective of their longer term ramifications. Procrastinating with long overdue reforms in the central Europeans (save Slovakia), or staying idle when faced for longish years of overheating is certainly not attributable to broader systemic factors, to institutional structure or long term historical path dependence. On the contrary: these are prime examples of policy omissions/mistakes, which recall in elder observers the Latin American experience with recurring currency crises, i.e. the inability to learn the lessons of the past. While these may, and indeed do, have deeper social, historic and other roots, the mistakes themselves should not be identified with the former. For this reason it seems premature to consider the crisis as ‘the final verdict on transition’, as the insightful collec-

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5 Data from the website of the National Bank of Slovakia, accessed on 15 March 2010.
tion by Myant and Drahokoupil [eds, 2010] does. For the structural and institutional weaknesses they list, including the insufficient upgrading of export patterns and the one-sided integration of the transition economies to the global financial markets, together do not explain the specifics of the crisis. Neither its timing, nor its mechanism, let alone the differences in scope by the country.

Should we accept the view that asset bubbles are by and large inevitable byproducts of the workings of free markets, as we have observed over the past two centuries or so, it were difficult to see the Spanish or Irish burst of the real estate bubble as systemic rather than cyclical crises. Likewise it would be hard to draw such broad, theory-shaping conclusions as the above cited authors do, joining the choir of many voices deploring the allegedly incurable ills of market capitalism. Be what those ills might be, it is certainly a non sequitur to infer them from a cyclical downturn whose length is neither unprecedented nor its depth is unparalleled in postwar economic history.

C., What NMS experienced in the 2008-2010 years was, in terms of European policies, the limits to solidarity. If one compares the unprecedented – and of course more than justified – efforts of the EU to forestall the collapse of the Greek domino/not least in fear of its spillover to Spain, Italy and Ireland/ in the spring of 2010, to the hesitant and regularly belated reaction to the deep crises in the Baltics, Hungary, Romania and their neighbors, Ukraine and Serbia, all turning to the IMF for rescue, the picture becomes sobering. Moreover, while public authorities, including the Commission, did finally act to assist the countries listed, private agents, especially headquarters of financial institutions were not slow in using their affiliations in NMS as milking cows for covering the losses suffered by themselves from adventuresome investments, primarily in overseas markets.

It is important to put the events in perspective. For one, it is beyond doubt that registered capital flows have not followed calls from President Sarkozy and other leaders for patriotic economic policies and relocate their activities in the home countries. On the other hand, the credit crunch in the region was exacerbated by the freeze on lending decisions, not justified by local market conditions. This was certainly not an outcome of ‘concerted action’ orchestrated by some dark forces. But the consequence of having outsourced the centers of decision making abroad, following the microeconomic considerations and neglecting macro repercussions has also become manifest for the policymakers in and outside the NMS.

AFTER THE CRISIS – BACK TO NORMALCY?

A., Seeing the end of the crisis phenomena, the recovery of output and financial market indicators, it is indeed tempting to offer the convenient assumption: after rainy days sunny ones must be coming. However, reality might be more complex. Recovery in the global economy might turn more fragile and less evenly distributed as most models customarily would have it. If there is any lesson commonly distilled from the experience of previous crises [Eichengreen 2001; Stiglitz 2009] is that after a crisis ‘normalcy’ does not mean a return of the status quo ante. On the con-
trary, the only item we know for sure that new players, new rules of the game, new modalities of conducting business and new forms of regulation are bound to emerge. One of the obviously foreseeable outcomes is that surviving actors will be even bigger to fail, than the traditional ones. Efforts of the US administration, to tackle those by way of the Volcker rules, go in the right direction, however the problem will be hard to tackle. It is not only the size, it might be other, and often hard to delineate broader considerations, such as regional relevance, or professional significance that may prompt governments to intervene, in a chain, quite in line with the bleak forecast of Ludwig von Mises before World War One [v. Mises 1929(1996)].

B., Coming to the NMS we may revive the insight, summarizing the first decade of systemic change: institutions matter but so do policies [Havylyshyn–van Roden 2003]. Comparing the experiences of Hungary to Poland in the 2002–2010 period speaks for itself already at the elementary level. Instituting measures of solid public finance, avoiding adventuresome external funding for consumptive purposes, sustaining price stability and conducting policies generally converging to EMU criteria allows saving the country from vulnerability and externally imposed discipline.

On the other hand, Bulgarian, Romanian and the Baltic experience seem to suggest that shortcut solutions, often advocated by policymakers and businessmen as well as the media, do not work in the longer run. Sound macro policies though do create growth, which is good. But without creating the institutional memory in the form of setting up institutions capable of sustaining the results of social learning previously experienced problems may revive, and avoidable mistakes might be repeated. The relevance of regulation, especially in the financial sector, counts by today among the platitudes, thus is in no need of elaboration. Implementing rules of prudent banking is certainly a must, especially if the already observable return of malpractices is to be avoided and social explosion - or alternatively even more costly future bailouts - to be avoided.

C., One of the truly strategic debates in and on the NMS is if they should/can return to the previous path of export-led growth, or a more ‘balanced’ path, i.e. more reliance on the domestic markets is the way to sustainable growth. On the base of what we know from economic theory and history, we do not know of a single case in the postwar period, where growth based on domestic markets could have been sustainable, especially in small open economies. While outward orientation – a concept much broader than export-led growth – does carry a cost, the experience of the past three decades is overwhelming in terms of the efficiency of outward orientation. True, more recent literature [e.g. Pitlik 2008; Baitagi et al 2009] calls attention to the relevance of institutional and policy complementarities. In short, it is not a sectoral approach, but a broad set of coordinated policy and institution building measures that deliver results in the long run.

D., Finally mention should be made of the erosion of the European growth potential, which is particularly observable in the NMS [Halmai 2009]. By dodging most of the structural reforms by most member states, the EU has maneuvered itself into a dead alley. Structural changes that should have revived the labor markets remained
fragmentary. The crisis also called attention to the procrastination in terms of capital market reforms and their regulation at the EU level. What was called the Lisbon Agenda, i.e. to try to balance flexibility and competitiveness [Palánkai 2006] was to a large degree watered down and implementation remained partial.

The erosion of European growth potential has also been exacerbated by the insufficient attention to long term challenges, such as ageing and the research and development potential. It is not just the amount of spending which is inadequate, but its composition and relation to business practices, where ‘embodied technological progress’ is being generated remained lukewarm. The explosion of public debt in a number of core EU economies is itself a factor of slowdown owing to the inevitable crowding out effects.

The foreseeable slowdown in the core EU implies that the external environment of the NMS will not be particularly strongly conducive to growth. Mistaken hopes on the EU as a major factor fostering growth, which used to figure high in the pro-EU political discourse in the NMS is likely to produce disenchantment only. The farther is the perspective of joining the Euro Zone, the graver is the risk of aggravating myopia in the policy conduct of the NMS, further delaying painful but necessary changes if the growth potential is to be revived. The drift between formal qualifications, which exploded, and actual marketable skills, social and professional alike, is likely to develop into a major factor of social discontent, reflected in the lastingly low levels of labor market participation in all NMS. In turn, their ability to cope with expanding health and pension costs will remain structurally constrained - an issue demonstrated also for a historically vibrant and much less aging US economy [Rogoff and Bertelsman 2010].

While the global discourse, influenced to a large degree by environmental considerations, often calls for a zero growth scenario in order to avoid the climate catastrophe, from the point of view of NMS zero growth is a non starter. The level of their per capita GDP is between 40.5 per cent of the EU average (Bulgaria) and 88.2 per cent (Cyprus), that is for the majority the catching up process will take generations, even under the best of circumstances. Furthermore, as we argued above, catching up is by no means an automatic process triggered by EU membership. Rather the question marks behind any scenario of relatively fast and steady real convergence continue to multiply, not least due to the structural and institutional weaknesses uncovered by the impacts of the global financial meltdown.

WHAT TO THINK OF EU MEMBERSHIP?

A. Accession to the EU tended to be over politicized from the very outset. As a consequence, there were both inflated expectations in terms of immediate welfare improvements, and conversely, skeptical voices aired before any of the joint European policies could take effect. The latter is the case in terms of cohesion, in terms of the single currency as well as in terms of environmental protection.

In a way the process of Europeanization has progressed considerably, insofar as the paradoxes typical of old member states could be seen replicated. The median voter does not seem to be very well informed about the complexities of the Union.
Therefore if his concern is joblessness, he/she can blame the EU, although the Community has next to no competences in terms of labor markets. If democratic controls, or the judiciary for that matter, do not work perfectly in a member state, the tendency to blame the EU is there even if it is not justified on material grounds. For this reason the Hungarian public tends to be fairly Eurosceptic according to recent surveys.\(^6\)

However, if we take the proper historical perspective, EU accession is surely a major success story in any area we care to mention. First and foremost, NMS ceased to be on the borderline of competing empires, threatened by constant insecurity and being treated as sources/triggers of insoluble interethnic conflicts. While nobody would doubt the presence of ethnic strains, this is by no means constrained to NMS, as the recent attacks on French police by Basque terrorists indicate. In short, being a member of the European architecture constructed in the spirit and practice of postwar reconciliation has ruled out many options, which were indeed on the cards, should the EU not have played its anchor role for the NMS. Therefore it seems simplistic to ‘try to put numbers on EU membership’ and try to assess costs and benefits exclusively or even mainly in terms of transfer balances, or in terms of additional trade or FDI flows. Important as these might be, they surely remain subordinate to the fundamental historic rearrangement discussed above.

But if we take the narrower, financial perspective, the beneficial impact of the EU is still beyond doubt, despite the well known methodological problems of assessing the macroeconomic impacts of EU cohesion funds properly [Sirehej 2008]. First and foremost, the ‘convergence game’ has been at play ever since 2002, i.e. when the political decision on eastward enlargement was taken. This implied more stable exchange rates and lower external costs of funding, for public and private investments alike. Second, from the point of view of capital investors, direct and portfolio managers, the NMS ceased to be a part of some murky emerging market economies and were requalified as secure European investment spots protected by a supranationally imposed Community legislation. Third, the revision of the post-2007 financial guidelines decreased the co-financing requirements to EU sponsored projects to as low as 15 per cent, which of course allowed for more projects to be implemented than under the traditional arrangements, when 50 per cent co-financing was the rule. It is a different cup of tea if we were to ask, whether the priorities set by the NMS, or more precisely the outcome of what many observers consider as an outcome of ad-hoc political bargains on the spot, indeed produce those growth accelerating and multiplier effects, or more broadly speaking any externalities that figure high in the official justification of cohesion spending.\(^7\)

Finally in terms of institution building we might be upbeat. Whatever may the weaknesses of EU practices be, introducing a degree of Community-wide trans-

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6 Eurobarometer survey, published on 18 September, 2009, available on the website of the Commission. 7 As a fan of classical music I can only welcome the long overdue renovation of the Liszt Music Academy in Budapest, wherever the funding is coming from. Likewise constructing funeral houses where the number of deaths exceeds that of births, or building fountains in the center of small towns are all welcome, without however being anywhere close to the theories justifying why these expenditures should be Community funded, rather than locally financed.
perenity, accountability and even-handedness, including regular external checks on the way money had been spent, are welcome additions in countries which are in the middle of setting up new and in theory, internationally competitive institutions of their own. Under this heading the administrative and material expenses on setting up specialized agencies and introducing the practice of competitive bidding in a number of areas might well be seen as a benefit rather than a sacrifice in the NMS concerned.

B., One of the more important insights in assessing the overall impact of the Union on the NMS is that the EU, with its policies and institutions, surely constitutes a framework for, rather than a guarantee of, economic success. Joining the Euro Zone, for one, does entail a number of straightforward advantages widely appreciated in all strands of the literature. Meanwhile experiences of countries like Portugal and Greece clearly indicate that being within the fences is though clearly a plus over being left out in the cold, but is a long way from being the panacea for all economic ills, be that low productivity or profligate public finances.

The broader is the perspective of assessment, the more important is to underscore this point, which might sound as a truism for the economist. For if we recall the political atmosphere that lead to the rejection of the Constitutional Treaty in France and the Netherlands, or the one that surrounded the ratification of the Lisbon Treaty in Ireland, Poland, Britain and the Czech Republic, the relevance of the argument increases. Those opposing any deepening tend to underscore - often very real - shortcomings of the existing arrangements. They express often very profound doubts that improvised policy options could be indeed beneficial. And it is common experience in old and new members, that the public opinion tends to blame the EU for a number of issues the Community has no competences over, such as taxation or public education.

The discourse in the NMS has switched from bad to worse in the past few years. Initially the tendency to overrate the benefits from Union membership reached ironic points. By now the shuttle moved to the other extreme, and the Union tends to be blamed for most of the local illnesses, from corruption to lack of fiscal discipline, from the insufficient support for small businesses to the lack of willingness of commercial banks to lend.

Let us be clear: an organization in charge of redistributing a mere 1 per cent of GNI is by definition in no position to work miracles. On the other hand, if such framework arrangements as the Stability and Growth Pact, or the European Social Charter are made use of, these may allow for a more professional and more pragmatic streamlining of local arrangements, than a free experimentation along any initiative in a perfect democracy would.

C., Finally one should rethink the position of the new member-states on issues of the fundamental reform of the EU. Both the decision-making/organizational structure and the major common policies [Kengyel, ed. 2010] are known to have evolved as an outcome of ad-hoc policy bargains rather than following any theoretical maxim, let alone constructivist design. The numbers in the Stability and Growth Pact, the relative share of farm related spending or the entitlements in cohesion spending
count among the best known and most widely analyzed items in the literature on Europe.

Thus there are two basic ways one might approach these complex issues, intensively discussed at the official level in the preparation for the Financial Guidelines for the post-2014 period. In one, traditional way we may adopt a static approach. If we take things as given, it is in the interest of the NMS to stick to present arrangements, since these contain references to and potentials for solidarity, in terms of sustaining substantial spending on rural areas and on physical infrastructure development, two fields where the Communist heritage of negligence is certainly strongly felt. By contrast, if prioritizing R&D and competitiveness related spending, the edge of the UK and the Scandinavians, which is quite significant anyway, is only to be further increased. Under this angle the status quo is the best of all conceivable worlds.

The alternative approach calls attention to the fact that net contributors have already found ways of attaining a de facto equalization of net contributions and benefits in most areas [Richter 2008]. Furthermore by sustaining expenditure priorities which clearly do not reflect the changed perceptions of European electorates, favoring such items as environmental protection, energy security and inward migration, will be next to impossible to legislate and sell domestically. From the economic perspective, narrow as it may be, it is hard to justify the public finance sense of the expenditure items I listed in the preceding section, from funeral houses to city fountains. The more serious we get about the agenda of competitiveness – or Europe 2020 – the less grandfatherish our position on sustaining spending items unrelated to either demonstrable common gain or competitiveness we may be. Furthermore it is already foreseeable that global trade talks and domestic pressures will translate into a major trimming of agriculture related expenditure [Elekes–Halmay 2009].

Under this angle a fundamental rethinking of the way priorities are set is in order. For one, if the EU is not, in the future, about big and often wasteful investment projects, the ‘maximization of drawable funds’ should no longer be seen as the interest of any NMS. The more we appreciate that expenditure priorities often follow a logic alien to them, such as the priority to the development of sparsely populated and arctic areas, or the focus on animal welfare, the less we shall see it as a sensible and axiomatic requirement that those funds should be drawn, just because of their availability.

Such a reassessment of priority setting would be in line with more recent insights of broader development economics [Szakolczai 2006] stressing the relevance of institutional and generally broader social considerations at the expense of mere quantitative expansion. Under this angle the quality of growth, just as much the quality of life, is the real success indicator. In order to improve that, it is a Community spending focusing on externalities and common value added, creating a framework for sustainable development, a category much broader than growth, is becoming the focus. And this is in line with the long term interests of the population of the NMS as well.
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M. A. IN INTERNATIONAL ECONOMY AND BUSINESS

M.A. in International Economy and Business (IEB) is a two-year, English-language master's program that is offered by the Faculty of Economics of Corvinus University of Budapest, Hungary (CUB) since 2008 as the first English programme of the faculty.

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The paper focuses on the economic and structural policy trends in Latvia as a new member state of the EU, and before accession to the EU. The role of international financial institutions during the first and second-generation reforms is discussed. The general economic development after the EU membership in 2004 is analysed, when high economic growth was combined with out-migration that calls for policies to promote human capital development in the country. Particular considerations will be given to regional and human dimensions at this time of the current global financial and economic crisis.

1. ECONOMIC AND STRUCTURAL POLICY TRENDS BEFORE THE ACCESSION TO THE EU: INFLUENTIAL FACTORS

In 1991 the Republic of Latvia became an independent country as result of a structural crisis in the socialist system and following the disintegration of the Soviet Union of which Latvia was a part since 1940. Immediately after independence was regained, the process of setting up a market economy system was started. It was based on a liberal economic policy, chosen by the Government that followed the recommendations of the international financial institutions. Institutional reforms, privatization and restructuring of large enterprises in all branches of national economy have been done according to a “policy package” suggested by the “Washington Consensus” and represented “shock therapy” policy [Williamson 1990; Kolodko 2002]. The key fundamental suggestions received from the International Monetary Fund (IMF), related to the establishment of a rigorous macroeconomic framework. Technical assistance, provided by the IMF and the World Bank, allowed to complete the first-generation reforms by the mid of 1990s. During the period of implementation these reforms, the economy has undergone three major downturns. First, in the period of 1991–1994, when the economy in 1992 shrunk by almost 35% with a dramatic decline of production and living standards. However in 1994 the rapid decline of GDP in Latvia was stopped. The second downturn, in 1995, started when the internal banking and financial crisis damaged the economic system in the country. Economic development was especially successful between 1996 and the middle of 1998 when average annual growth rates of GDP reached 6% and by the 1997 growth in the Baltic States was amongst the fastest in transition economies. However another, third downturn, happened in 1998 as the result of the negative impact on the economy of the Russian economic and financial crisis of 1998. Producers in Latvia experienced difficulties in selling their products on Russian market due to the weakening demand and strong Latvian currency. The Russian crisis of mid-1998 reduced Latvian exports to Russia and resulted in decline of production outputs. The impact of the Russian crisis on Latvia strongly influenced trade patterns and forced to reorient trade flows to the countries of the European Union. From a position in 1991
where virtually 100% of trade was with the CIS countries, by the time of accession, the EU accounted for approximately 50% of Latvian exports.

The reorientation of exports, from Russia and the CIS mostly towards the EU countries after the 1998 rouble devaluation, served to abandon what was once Latvia’s main export market; the EU-bound exports growing 16–17 percent per year [Bank of Latvia 2009]. Steadily a trend of inter trade with the EU as changed to an intra trade; the pre World War II trade pattern has been re-established. Structural policies have been based on the previously recognized comparative advantages of the country, particularly as far as the product composition of trade is concerned: wood and wood products dominated in the exports and the production of these also made a decisive contribution to the growth of GDP. Another important industry was textile. Exports to the EU were in general advantaged by cheap labour costs in an industry, which is relatively labour intensive. However, this advantage has eroded over the following years as Latvian wage rates moved to catch up to Western Europe.

In general the first-generation reforms in the beginning of 1990s, that helped establish strong macroeconomic fundamentals resulted in high GDP growth rates. The second-generation reforms have been implemented in the second half of 1990s with the prospect of for Latvia to become a member of the European Union. ¹ The country has followed a set of preconditions for accession to the EU according to the criteria introduced by the Copenhagen summit of the European Council. Convergence in indicators of standard of living started with the prospects of EU enlargement and continued since after convergence was viewed in two ways: as the outcome of EU integration, but also as a precondition to it, because each country had to reach a certain level of development before becoming a member of the European Union.

Economic progress of the country required understanding that the emerging composition of production has to be complementary or competitive to the struc-

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¹ In 1999 the Government of Latvia signed the Joint Assessment with the European Commission on economic policy priorities for the country.
tures prevailing in the European Union. Support of the sectors of the economy that should be developed in order to benefit the most from EU membership, was of crucial importance Latvia’s National Development Plan for 2007–2013 [Ministry of Regional Development and Local Government 2006] already in 2006 put the emphasis on the development of knowledge-based industries to stress in the future comparative advantages in those sectors, which Latvia has. This complements the traditional timber industry with such sectors as biotechnology, timber chemistry, pharmaceutics all of which require high technology.

Latvia has been generally following a set of monetary and fiscal policies demanded by the international market. Free convertibility and the liberal foreign exchange policy have secured competitiveness on the foreign exchange market. The national currency (LVL) was pegged to the SDR and shortly after was changed to a Euro peg.2 It has been quite stable since its introduction and the domestic money supply has 100% foreign exchange coverage. Exchange rate pegs in Latvia have provided currency stability and significant progress with disinflation. However, when the exchange rate is fixed, the burden of adjustment in response to external shocks, or shifts in relative competitiveness, falls elsewhere on the economy. To the extent that prices or wages are not flexible enough, the real economy has to adjust. As a result of comparatively stable and liberal economic policies, the Latvian economy had been successful in attracting foreign direct investments (FDI)3, which have had a positive influence on the rapid development of the foreign trade relations (see figure 2). However there have been substantial changes in the foreign direct investments over time; the modest investments in 1992–1996 increased considerable in 1997. Largest gains of FDI were experienced after the accession to the EU as the result of combination of political and economic factors. Major part of FDI has been in transport and communications, port facilities, industrial sector food and wood processing textiles chemicals, base metals, metal products and machinery. Investments have also been significant in real estate and construction business.

Since accession to the EU Latvia was considered as a capital-attracting country. The FDI stock more than doubled in both, goods and services.4 However, the majority of FDI were financial transactions that are not included in direct and portfolio

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2 Since the beginning of 1994 when the Latvian currency was pegged to the SDR, the unit of accounting of the Internationally Monetary Fund (1 XDR = 0.7997 LVL). The Bank of Latvia on December 30, 2004, has fixed the peg rate of the lats and the euro at 1 EUR = 0.702804 LVL, which took effect on January 1, 2005 in line with the government approved plan for Latvia’s preparation for full-fledged membership in the Economic and Monetary Union (EMU). See http://www.bank.lv/eng/main/all/monpolicy/ls-euro/cmp1/ for more information.

3 Foreign investors get national treatment, and they are free to engage in any activity, convert and transfer their earnings. Companies established before 1995 received 4-8 years tax holidays. Since 2001, large investments – both domestic and foreign – are eligible for corporate income tax holiday of up to 40 percent of the invested amount, in line with the limit set by EU competition rules. Companies manufacturing high-tech products enjoy a tax holiday of 30 percent of the investment; in the case of small and medium-sized enterprises it amounts to 20 percent. The corporate income tax rate has fallen gradually, reaching 15 percent in 2004. The withholding tax on dividends amounts to 10 percent.

4 As concerns production of goods, a particularly rapid increase of the FDI has been observed in the energy sector (by almost 5 times), and more than 5 times in the construction sector. The dynamics of FDI was not so rapid in the manufacturing sector and has increased only by 1.5 times.
investment, but represented trade loans, other credits and borrowings, cash and deposits, etc. The biggest share of financial inflows belonged to commercial banks. This trend was stimulated by the open regime of the financial account and the fixed currency exchange rate. Mainly Nordic and German banks (Skandinaviska Enskilda Banken, Swedbank, Nordea, DnBNORD) have increased their stake in ownerships and new acquisitions in the financial sector.

![Figure 2. FDI Inflow to Latvia in million USD](image)

In 2000 Latvia became an integral part of the European banking system. The real time gross settlement system was introduced, which strengthened the motivation of financial capital to settle in Latvia. And since 2005 the leading position in FDI belonged to financial services (see Table 1).

Table 1. FDI by Sectors of Economy in 2004–2008 (end of period, million LVL)

<table>
<thead>
<tr>
<th>Sectors</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>3rd quarter of 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary sectors</td>
<td>49.8</td>
<td>59.5</td>
<td>71.6</td>
<td>112.9</td>
<td>146.1</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>276.1</td>
<td>376.0</td>
<td>395.3</td>
<td>465.2</td>
<td>501.9</td>
</tr>
<tr>
<td>Energy</td>
<td>164.7</td>
<td>327.6</td>
<td>348.1</td>
<td>270.7</td>
<td>278.5</td>
</tr>
<tr>
<td>Construction</td>
<td>36.5</td>
<td>49.7</td>
<td>67.6</td>
<td>86.0</td>
<td>112.5</td>
</tr>
<tr>
<td>Trade</td>
<td>395.7</td>
<td>437.8</td>
<td>562.3</td>
<td>681.9</td>
<td>900.3</td>
</tr>
<tr>
<td>Transport and communications</td>
<td>333.3</td>
<td>336.4</td>
<td>347.0</td>
<td>398.0</td>
<td>454.5</td>
</tr>
<tr>
<td>Financial mediation</td>
<td>375.9</td>
<td>625.4</td>
<td>964.6</td>
<td>1434.7</td>
<td>1610.6</td>
</tr>
<tr>
<td>Other services</td>
<td>439.2</td>
<td>529.0</td>
<td>795.3</td>
<td>1214.5</td>
<td>1352.6</td>
</tr>
</tbody>
</table>

Source: Republic of Latvia Ministry of Economy

Inflow of FDI as percent of GDP was the highest in 2006 ~8% and then was reduced to 3% in 2009. The high level of investments was stimulated by the intensified inflow of foreign financial resources in the national economy after accession to
the EU while domestic savings were too low and cannot be considered as sufficient source of investments. However, a number of potential risks for future real convergence existed and associated with the scale of the current account deficit and inflationary pressures. Stable financing of the current account deficit due to strong flows of FDI plus cross-border credit transfers from Nordic banks to their subsidiaries in Latvia helped to sustainable economic development in pre-crisis period. Inflation increased in 2004, rising to 7.3 percent (according to the LR CSB), due in part to rises in administratively regulated prices, the harmonization of indirect tax rates in the context of EU accession, and high world oil prices. Negative factor in stimulating inflation in the next years that put significant demand pressures was the growth of private sector credit and real estate.

2. EU MEMBERSHIP AND REGIONAL DIMENSION

Accession to the EU provided for Latvia access to the EU Structural Funds (SF). The total accessible financing for Latvia from 2004–2006 was EUR 625 million in the framework of Structural Funds programs and the total Cohesion Fund (CF) financing accessible to Latvia within the period from 2000–2006 amounts to EUR 710 million. In the period of 2007–2013, distribution of the SF and CF financing in the amount of EUR 4.53 billion is available to Latvia. This amounts to about 500 million per year as compared with 1000 million FDI in 2008. As a response to critical economic conditions in the country, temporarily no co-financing is required by the European Commission from the national budget. Successful implementation of this external source of financial resources was aimed at increasing standards of living and reducing gap in GDP per capita in Latvia with the old Member States and increasingly at securing internal cohesion and diminishing regional disparities inside the country. In terms of the EU Cohesion policy, Latvia is one region according to NUTS I, and NUTS II classification, but there are 6 regions at NUTS III level, which are further divided in (self local governments defined by law, being administrative territorial units for municipal elections, governed by “Councils”). The country is also one of the poorest Member State with GDP per capita in purchasing power standards at only 43.7 per cent of the EU-27 (see Eurostat website for more data) average in the recent years. The scale of the gap requires continuing the implementation of a comprehensive catching-up development strategy.

The geographical distribution of population and migration shows a strong urbanization trend in Latvia like in the rest of Europe. In terms of population concentration in capital cities Latvia ranks second, after Portugal at the EU level. Over forty per cent of the population is located in the capital city of Riga, which produced in 2007-mid 2008 around sixty per cent of the domestic GDP. The central part of the country, where Riga is situated concentrates most of the economic activities and population. The next cities in terms of their contribution to GDP are

5 For more information see the National Strategic Framework Document (NSFD) for the period of 2007–2013.
Daugavpils, Liepaja and Ventspils, which each produce around three per cent of national GDP. In the pre-crisis period, regional trends represented metropolisation of the economic development; Riga and area that is called Pieriga significantly contributed to the GDP and employment. The latest pre crisis data shows that the biggest part of Latvian GDP (57.3%) was produced in Riga. The second biggest region by contribution to GDP was Pieriga (11.1%). Following EU accession, in 2005, GDP per capita in Riga was 1.8 times greater than in the country on average. The continued concentration of economic activities in Riga and Pieriga significantly reduce the importance of the other regions in the country. These disparities are in part due to differences in the residential and working locations of some citizens i.e. the level of GDP per capita in Riga partly reflects the effects of commuting from other areas [Muravska et al 2004]. Major efforts are still needed to improve the transport and communication system throughout the country. The whole road sector in Latvia, including the TEN network, primary roads and secondary roads needs substantial improvements; the latest data show that 44 per cent of the State’s roads are in very poor condition. However, it will be of prime importance to make the correct policy choices when allocating funds between potential infrastructure investment projects. There are four special economic zones across the country, three of which are located in the free ports of Ventspils, Riga and Liepaja – the fourth being an inland zone in the city of Rezekne (in Eastern Latvia, close to the Russian and Belarusian borders). As the result of negotiations with the European Commission these zones are allowed to operate until 2017. Latvian authorities consider this a big achievement that would attract FDI. Special Economic Zones were established with the object to develop trade, industries, international freight flow, shipping and air traffic, implement modern technologies and create additional workplaces for the population of these regions. Regional and local authorities can also provide and sell land as well as real estate under favourable conditions to companies intending to create employment. Before the economic downturn local governments suggested to grant up to 90 percent property tax reduction for investment projects conforming to their local/regional development strategies. Despite of the above incentives, the gap between Riga and the rest of the country is still increasing. The highest registered unemployment rate was in Latgale area (17.8 percent in 2003) and the lowest is the Riga area (5.1 per cent in 2003), while the unemployment rates of the other three areas were around 10 per cent. Regional disparities are strong with the registered unemployment rate in 2003 ranging from 4.5 percent in Riga capital to over 25 percent in several districts in the Latgale region (see LR CSB website for more details). Labour migration was always limited between regions and cities due to transport infrastructure, public transport services that are not advanced enough. Lack of jobs and employment opportunities in Riga as well as in other major towns in the country reduces commuting and keeps disparities in employment. Another trend that influenced the labour market is migration as the result of Latvia joined the Common market of the EU and its freedom of movement of persons. A comparison of population and out-migration patterns in Latvia before and after accession to the EU show a significant population decline and out-migration [Muravska–King 2008]. Higher migration abroad was in Riga and Latgale – 1.6 and 1.4 persons per 1000 inhabitants respectively (1 per 1000 on average in Latvia). According to the LR
CSB, higher long-term migration within Latvia was observed in Vidzeme (5.2 persons per 1000 inhabitants). It is typical that inhabitants from Vidzeme more willingly migrate to Riga or Pieriga, not abroad. Out-migration from Vidzeme to foreign countries is two times lower than in the country on average (0.4 persons per 1000 inhabitants). Higher positive balance of migration was only observed in Pieriga region. There is also a need to consider whether the likelihood of further restructuring in the agriculture sector implies the need for Cohesion policy intervention in rural areas, particularly those with high rates of unemployment and social inclusion. Efforts will be needed to improve the skills and flexibility of the labor force in these areas, particularly among people in long-term unemployment. Measures to enhance the overall context for job creation in rural areas with low levels of entrepreneurship and a low density of firms have been in focus of Structural Funds projects. In order to develop the long-term structural potential of such areas, intervention may be needed to upgrade the quality of transport and communication linkages with nearby towns that could become a focus for business activities further development of SMEs and investments. One of the other main problems that Latvia is facing is insufficient administrative capacity at national, regional and local levels. At national level one of the main challenges is to build an effective and modern public administration, to ensure the efficient management of public funds. There is still a need for far-reaching changes in the practices and operations of all levels of the public administration.

3. GLOBAL CRISES AND ITS IMPACT ON LATVIA

The Baltic States had shown positive and strong economic development until mid-2008. The most impressive growth rate among the Baltic States was experienced by Latvia, which was also the fastest in the EU until recently. Latvia’s GDP growth was more than 10% per year during 2004–2007. Latvia has followed an ambition reform strategy in recent years after the EU accession. This strategy was based on the twin pillars of fiscal consolidation and structural reform.

The recession started in the first half of 2008 [European Commission 2009]. Economic downturn originated in the reversal of the domestic real estate boom, worsened rapidly and affected GDP growth rates, which dropped to 4.6% in 2008. The hardest downturn was in retail, real estate and construction. Large domestic consumption as the result of a liberal credit policy by banks (majority of them are Scandinavian credit institutions) in Latvia was one of the reasons for loan boom in the country, where foreign currency loans dominated. Experts and government leaders prior to the crisis had stressed the danger of this situation. Unfortunately government’s decision to limit housing loans through request to buyers to provide co-funding in the value of at least ten per cent of the value of the purchase and the proof of taxed income from the State Revenue Service, was introduced too late.

The catalysis of the rapid economic downturn was the fact that in November 2008 the second largest bank (measured by total assets) and the only Latvian-owned

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6 10.4% in 2004; 11.9% in 2006; 10.2% in 2007 – see the Eurostat website for more details.
commercial bank, Parex Bank announced insolvency. Despite nationalisation of the bank, rapid capital outflows continued and the government introduced deposit withdrawal restrictions. Consequently non-resident deposits had in general diminished by 19.2% compared to the end of last year in December of 2008 in Latvia. In general, the global financial turmoil put a blockage on credit channels, and investment flows into Latvia drained off. The Parex Bank case very seriously affected this process. The outflow of FDI according to the Central Statistical Bureau amounted of 16.5 million LVL in Q1 of 2009, down almost 94% from 260.8 million LVL in Q1 2008. In the coming years Latvia is still facing economic downturn, through unstable financial sector situation, crash of real estate markets, fall in production and growing unemployment.

The adjusted GDP figure for the first quarter of 2009 was –8.0%. International experience shows that economic growth was not just a symptom of economic overheating. So called overheating of the Latvian economy was and is continued to be discussed by experts. However, no forecasts have been made for such deep downturn as in Latvia and the other Baltic States are experiencing now.

The GDP expenditure data suggest that both the persisting decline in domestic demand and the fall in exports, which began in the second half of 2008, have con-
tributed to the intensification of the slowdown. Slowdown in the economic activity caused a sharp decline in inflation: in 2009, the average annual inflation forecast of 2.5%–3.5% was substantiated, but at the close of the year inflation turned into deflation.

The price decline was supported by the persistently low demand and a decrease in the energy prices. Furthermore, on the backdrop of declining natural gas prices for businesses, heating tariffs recorded a notable reduction of 8.9%. However, the rising global oil prices curbed the fall in consumer prices.

Raising unemployment escorted the economic downturn. According to the State Employment Agency, the unemployment level was 11.8% in July 2009, and it reached 22% in 2010. According to the Ministry of Economy, the government further reduced public spending and the budget deficit by 500 million LVL in 2009. Currently the budget deficit is 8.5% (see LR CSB website for more details). Additional cuts of public spending are foreseen in 2010 and 2011, this will increase
the number of unemployed people and the followed reduction in demand will result in further staff cuts in private sectors. According the EU Lisbon Strategy “Europe2020”, the aim should be to reach an employment level of 75% for age group 20 to 64; currently in Latvia this percentage is only around 58%.

Most enterprises are currently trying to reduce wages instead of reducing staff. With the deterioration of the economic situation, there is also a risk that small companies could cross into illegal employment and the grey economy.

In 2008 Latvian exports to the EU started to decelerate, while foreign trade with the Community of Independent States (CIS) remained active. Exports changes over the previous year, show decrease of 6.4% in 2008. Import decrease was 13.8% in 2008. In 2008 Q4 the most serious decline in export was to the EU 15 by 18%, and to the EU 27 by 11.5%, but exports to the CIS showed an increase of 6.7%. Imports in 2008 Q4 decreased by 15% from the EU15, 17.6% from the EU27 and increased 7.5 from the CIS. According to the forecast of the Ministry of Economy, decreases in export and import could reach 8.4% and 21.2% in 2009. Over 2009 as the whole foreign trade turnover totalled annually about 12 billion euros, a drop of 31% when compared to 2008.

The latest CSB data showed that in June 2009 the share of the EU countries in Latvia’s export was 69%, while the CIS had 14% share. Comparative advantages of the economy are significantly damaged especially by decrease in wood products and textile. Considerable decline was due to the lower external market demand. Consequently production of these goods was seriously reduced as local demand for wood products and textile also declined.

Due to the requirements of the EC and IMF to cut the budget expenditure, the government must reduce the number of employees in the public sector, which resulted in high unemployment of public servants and other groups of employees in different areas of the public sector located in Riga and major cities in the country.
The current account worsened considerably over recent years (see Figure 6). The current economic crisis in Latvia represents major threats for the further development of the country. Capital outflows are already taken place and the country’s economy is facing a new wave of emigration and “brain drain”.

4. POLICY RESPONSES OF THE GOVERNMENT, THE EU AND THE INTERNATIONAL COMMUNITY WITH SPECIAL REFERENCE TO THE HUMAN DIMENSION

A program to restore confidence and stabilize the economy has been initiated in accordance with an agreement with the IMF. This program involves a 7.5 billion euro injection of liquidity into Latvia, including contributions from the EU, the IMF the Nordic countries, the World Bank, and other European countries. The main issue concerning the currency peg is for how long the Bank of Latvia will be able to maintain the existing exchange rate. Devaluation of a national currency of Latvia, which is hardly debated by policy makers and experts in the international, European Union and national financial and government institutions, could have positive and negative effects that will impact trade and investment flows. It will seriously damage the real income of the population as most of the resident credits have been taken in euro. Devaluation of the LVL could also negatively affect the economies of the other Baltic States by the so called “domino effect”. However an internal devaluation took place already in 2009 by deep cuts in wages and public spending.

Currently the government of Latvia continues to be occupied with reforms of the management system of the country, and follows the path of so called internal devaluation:

- 20% salary cuts in public institutions and overall expenditure of ministries;
- Tax-exempt minimum of natural person’s remuneration is to be reduced from 90 to 35 LVL and possible increase of VAT;
- 10% reduction in all kinds of pensions; extra benefits remain unchanged;
- Pensions for working retirees are to be reduced by 70%;
- 10% cut is planned in maternity allowance;

Figure 7. Programme to restore confidence and stabilise the economy of Latvia
The internal devaluation measures resulted in dramatic budget cuts with bad news every day: severe salary reductions in the public sector, including the health and education system, decrease in number of places for students and researchers and almost total elimination of the research budgets. Unfortunately, under the pressure of Washington institutions, short-term thinking dominated. Despite the severity of the crisis a number of constraining factors could still prevent fast recovery:

1. Disagreements between major political parties have prevented public sector structural reforms;

2. Government expenditure rose by 9.3% year-on-year in the first six month of 2009;

3. Fiscal deficit reached 9% of GDP in 2009 and is unlikely to improve in 2010;

4. Risk of the erosion of the public sector, loss of country’s competitiveness and appeal for investors.

Nevertheless, it would be particularly important to coordinate business support measures with active labor market policies, in order to mitigate structural long-term unemployment.

From the point of view of stemming the flow of out-migration from Latvia to foreign countries, reduction of internal disparities as well as increasing overall economic performance are important. That most out-migration from Latvia originates from Riga and Pieriga as well as in the geographically more peripheral Latvian regions of Latgale and Kurzeme. Overall economic decline, coupled with decreases in salaries and wages give people a more pessimistic outlook about their potential career in their own country and induce them to emigrate. On the other hand diminishing regional disparities would presumably reduce the incentives for residents of the regions outside commuting distance from Riga to migrate to foreign lands – either directly or indirectly, with a first temporary stay in or near Riga.

Current global financial and economic crisis has influenced economies of the EU and employment level. Cohesion policy could provide means for long term stabilisation of EU economy, in order to reduce long term impact of the financial crisis. Still, the current crisis should not impact the future Cohesion policy’s direction of development. The Cohesion policy cannot become a primary compensation mechanism. In order to address the consequences of financial and economic crisis, the Cohesion policy is slightly adjusted to provide urgent support, as, for example, no need for national contributions, but this does not mean long term changes and does not make changes in main political targets.

This puts strong pressure on the government regarding effective policy choices for sustainable development and cohesion policy implementation; given that the country’s human resources for successful economic restructuring are limited.

**CONCLUSIONS**

When the financial crisis hit, Latvia suffered an exceptional slump. GDP has fallen, unemployment has increased and exports to the EU have decelerated. The economic crisis and fall in growth of GDP could be explained by the following factors: rapid growth of domestic demand generated by loans from foreign banks, low interest rates,
real estate boom, positive growth expectations of foreign investors, FDI and export growth oriented on cheap labour. Latvia's service and construction sectors grew rapidly, but manufacturing was left lagging behind. Strong domestic demand and a disproportionate current account balance pushed inflation beyond the 10% threshold. But, at some point, the process spiralled out of control. In just a year, the economic boom was replaced by a crisis, which made foreign borrowing unavoidable.

The previously widespread policy of lending without any in-depth research into a loan applicant's credit history was suddenly replaced by a much more cautious approach. Together with an increase in value-added tax, this has profoundly influenced consumer trends. Unemployment will continue to increase and there is possible development of social unrest with further GDP decline: a looming social crisis.

The Latvian government has been stabilising exports and promoting exports guarantees and partial import substitution with locally manufactured goods. It is well positioned between the West and East; it has a coastal infrastructure near the Baltic Sea; and it can still provide a well-educated and skilled workforce. These factors will certainly help to maintain the appeal of the Latvian economy in the long term. The key factors for conducting successful national policies are targeted and coordinated innovation policies, flexible labour markets, systematic investments into human capital, proper migration policies etc.

REFERENCES

EUROPEAN MASTER'S IN PUBLIC ADMINISTRATION

European Master's in Public Administration (EMPA) is a one-year Master Certificate programme provided by the Centre for Public Affairs Studies (CPAS) of the Faculty of Economics at the Corvinus University of Budapest.

Students enrolled to the MA in Public Policy and Management offered by the Faculty of Economics can complete the EMPA-Budapest programme taking equivalent courses in English during the four semesters of the MA programme, since equivalency between EMPA and selected MA courses is given. It means that graduating students get an MA in Public Policy and Management from the Corvinus University and a Certificate jointly signed by these EMPA partners. The certificate is issued provided student writes and defends his/her thesis work also in English and studies one semester at one of the partner universities.

The EMPA programme is offered by a network of twelve different universities. Besides CPAS the following institutions are involved:
- Katholieke Universiteit Leuven (Belgium),
- Deutsche Hochschule für Verwaltungswissenschaften, Speyer (Germany),
- Institut d'Études Politiques de Paris (France),
- Institut d'Études Politiques Lyon (France),
- Tallin University of Technology (Estonia),
- University of Liverpool (the United Kingdom),
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This programme is designed for students enrolling to the MSc in Public Policy and Management at Faculty of Economics or arriving from the universities of the EMPA network.

Graduating students get a Certificate jointly signed by these EMPA partners.

For more information, please visit the website of EMPA: www.empa-network.info
1. SOME EXPERIENCE ON THE CATCHING-UP PROCESS DRIVEN BY EXTERNAL FINANCING

The conventional theory predicts that the international flow of capital from rich to poor countries helps the latter group grow faster thereby allowing for an income convergence between the groups. This process is associated with the higher marginal productivity of capital in the poor economies and with the equalizing capital productivities among countries brought about by capital migration. Due to the inflow of external capital, the catch-up potential, under which poor countries tend to grow systematically faster than the rich ones, is thus better used [Barro–Sala-i-Martin 1992].

The process of the liberalization of capital accounts, which has been gaining momentum across the world towards the end of the 20th and at the beginning of the 21st century, is an important component of the – more or less successful – growth strategies in many catching-up economies.

Outside Europe, towards the end of the previous century several emerging economies in Asia have been increasingly receiving external capital and were visibly outpacing advanced countries in terms of growth. This process of convergence was stopped with the 1997 Asian crisis associated with abrupt and strong capital flow reversals. Albeit painful, the crisis turned out to be relatively short and the affected countries were able to turn back to recovery and growth, achieving growth rates higher than advanced economies. In the 1960/1970's major economies in Latin...
America have been soaring and also hugely borrowing from international creditors. The deteriorating external environment of the 1980’s as well as policy mistakes in Latin American countries have led to an acute external debt accompanied by the capital flight. The losses in terms of economic growth have been much more severe and protracted than in East Asia. Also the recovery in the aftermath of the crisis of the 1980’s has been – on average – weaker and marked with more ups and downs than in Asia.

In Europe, Poland in the 1970’s turned remarkably to a growth strategy driven by external financing. With some cushion in the form of low initial external indebtedness, policymakers decided to heavily borrow on external markets with the objective to modernize industry and to speed up both investment and consumption. This strategy ultimately failed for systemic reasons: an inefficient, centrally planned economy was not able to absorb external funds and to produce the desired growth effects. Similarly to Latin America, over the 1980’s the country has been falling into a serious external debt crisis with the deteriorating GDP growth. In Western Europe, convergence has been occurring along with the deepening and enlarging process of the integration of the EU. In particular, four poorer catching-up economies of Spain, Portugal, Greece and Ireland have been showing a long term convergence with the average EU level between 1960 and 2000. It is remarkable, that growth accelerations in these countries followed – immediately or with some lag – their EU entry which was associated with increased inflows of the intra-EU funds, both private and official [Cuairesma et al. 2008]. Towards the end of the current decade the global crisis has severely affected these four countries and their convergence to the EU average.

2. CAPITAL INFLOWS TO THE EU NEW MEMBER STATES.

Over the last two decades the NMS (referred here as Hungary, Czech Republic, Poland, Slovakia, Slovenia, Lithuania, Latvia, Estonia, Bulgaria and Romania) have implemented two strategic steps: the systemic transformation to a market economy and the accession to the EU. These processes were associated with huge increases of external capital flows to the NMS.

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<td>Total private flows</td>
<td>28.8</td>
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<td>52.3</td>
<td>118.8</td>
<td>185.5</td>
<td>154.7</td>
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<td>Foreign Direct Investment</td>
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<td>17.7</td>
<td>31.7</td>
<td>64.4</td>
<td>77.1</td>
<td>69.3</td>
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<td>2.2</td>
<td>17.0</td>
<td>-0.4</td>
<td>-2.9</td>
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<td>Other</td>
<td>10.9</td>
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<td>Official flows</td>
<td>1.0</td>
<td>-4.2</td>
<td>9.8</td>
<td>3.8</td>
<td>-6.4</td>
<td>21.1</td>
</tr>
</tbody>
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Source: IMF
As shown in table 1, Private flows which – except for 2009 – have dwarfed official ones - were increasingly dominated by foreign direct investments (FDI) and by the bank lending (other flows). The NMS witnessed an increase of capital inflows already in the early 2000’s, in anticipation of their EU accession. This increase was visibly stronger after 2004 when eight out of ten countries joined the EU.

The ratio of FDI to GDP jumped in the NMS from 6% in 2000-2006 to 10% in 2007 and of bank lending – respectively – from 0-3% to 7%; individually – in Latvia to 31%, Estonia to 21%, Lithuania to 12%. Western, mainly European banks control the bulk of total bank assets in the NMS: nearly 90% in Estonia, around 75% in Lithuania, Romania and Slovakia, over or around 50% in Czech Republic, Hungary, Poland, Latvia and Bulgaria [MacFarquhar–Pinder 2009].

Among foreign investors and lenders in the NMS, Western European businesses clearly dominate. Depending upon individual NMS, investors and lenders from Western Europe represent, in terms of total stocks/liabilities/locations: around 90% of FDI; 50–70% of portfolio equity investment; around 90% of portfolio debt investment and over 90% of foreign bank assets [Lane–Milesi-Feretti 2006].

Capital flows form Western to Eastern Europe are fuelled by pull and push factors of structure and policy nature. The NMS represent a catch-up potential, i.e. they have higher potential and actual economic growth which attracts foreign resources. Relatively poor physical capital and relatively good human capital endowments offer high returns from those resources. The NMS have structurally higher, although converging to EU levels, interest rates encouraging investors to shift from Western European safe, low-yield to more risky, high-yield investments in Eastern Europe. The latter group has a potential for real appreciation of local currencies. On the policy side, two major processes in NMS attract capital inflows: strategies of speeding up economic growth and smoothing consumption as well as of opening up and integrating with the global economy. The privatization, particularly of the financial sector, is instrumental in acquiring local banks by Western European financial institutions. The NMS strongly compete for attracting FDI.

Structural characteristics as well as policies pursued in Western Europe help push capital outside, including to the East of the region. Economies of Western Europe are relatively well endowed with physical capital and have relatively high labor costs. Several countries show current account surpluses vis-à-vis the NMS. Relatively low interest rates push Western European investors out to the East.

To these pull and push usual factors fuelling capital flows to the NMS another factor is added: it is the EU integration which helps increase private flows and adds EU official flows. The channels through which EU integration affects capital flows to the NMS, are shown in figure 1.

Basic elements of the EU integration, i.e. single capital market, monetary and financial integration, institutional frameworks as well as EU official funds affect capital flows to the NMS directly or indirectly, through credibility of these economies. Single capital market eliminates formal obstacles to capital flows within the EU. Some NMS, e.g. Poland, Slovakia, have liberalized their capital accounts prior to the EU membership, in compliance with the OECD requirements. For other NMS, it is the EU-related perspective of the single market which has put in motion the liberalization of capital accounts in the pre-accession period and allowed for increased
inflows. Monetary union brings in price transparency and eliminates costs associated with capital transfers such as transaction costs and exchange rate risks. Highly volatile exchange rates usually discourage foreign investors except those, however, whose portfolios are oriented towards exchange rate fluctuations. Among the NMS, Slovenia and Slovakia have so far progressed in monetary integration adopting the euro. Financial integration is expected to significantly expand the supply of capital available for the whole integrating area, including for the NMS. Along with increasing financial integration, geographic segmentation of markets tends to become less important. The banks of the OMS can increase their cross-border loans to the firms in the NMS. The latter group can access capital markets of the former one more easily by listing shares on foreign stock exchanges. The process of EU financial integration is not yet completed and it differs from market segment to market segment [ECB 2007]. It is worth emphasizing, that under two major integration programs, i.e. Financial Sector Action Plan and the Lamfalussy Process, the NMS score increasingly closely to the OMS.

Figure 1. EU integration “adds” to capital flows to NMS
The credibility of the NMS in the eyes of risk and yield sensitive investors is a significant factor affecting capital inflows. Compliance - actual or prospective - with the procedures of the single market, with monetary and financial integration and with other EU institutional frameworks helps raise the international credibility of the NMS. In particular, EU integration implies strengthened macroeconomic discipline due to a single monetary policy and common fiscal rules. International capital markets promptly and strongly reward good policies but also promptly and severely punish bad policies. Markets also believe that EU institutional, legal and regulatory frameworks linked to the acceptance of the acquis communautaire reduce the risk of the discretionary and poor policies in the future.

The increased international credibility of the NMS remains instrumental in attracting more and cheaper external funds. In 2004–2008, as compared to other economies with similar fundamentals, the NMS have been enjoying the advantage on spreads of sovereign bonds issued internationally. In parallel to sovereign bonds, the NMS – to varying degrees – have been outperforming other emerging economies also on other asset markets, such as equities or currencies [Luengnaruemitchai– Schadler 2007]. Advancing monetary integration may help increase sovereign credit ratings of the NMS by rating agencies towards the level enjoyed by the whole euro area and therefore lead to an increased access to foreign capital by companies from the NMS.

The spread advantages related to EU integration enjoyed by the NMS have been reduced, and almost disappeared, due to the global financial crisis in 2008-2009 as investors turned out to put more emerging economies in one basket. These developments led some authors to view the earlier advantages of the NMS as temporary rather than permanent issue [IMF 2009].

Although dwarfed by private flows, EU official capital flows to the NMS remain significant in relative terms. Total EU funds amounted to 3–3.5% of GDP of the NMS in 2000–2006, and increased slightly to 3.5–4% under the new financial perspective in 2007–2013. Out of that, structural and cohesion funds increase respectively from 40% to 60–70% of total EU funds (except for Bulgaria and Romania), mainly at the costs of funds for agriculture [Sierhej 2007]. Apart from long term capital flows in the form of the structural and cohesion funds, the EU provides non-euro NMS with short and medium term financial assistance for balance of payments support: either precautionary – designed for crisis prevention – or non-precautionary – for crisis resolution. In 2009 the total amount appropriated for balance of payments support was doubled to 50 billion Euros. By improving long term growth perspectives of the NMS and making these economies more crisis-resilient, the EU official flows help also strengthen their credibility and therefore attract private capital.

3. CAPITAL INFLOWS, ECONOMIC GROWTH AND CONVERGENCE OF THE NMS

Theoretical considerations regarding the impact of international capital flows on economic growth go, generally, in three directions [Ostry 2007]:

- emphasizing that international capital flows bring a number of benefits associated with the improved allocation of funds between market participants; in par-
ticular, economic growth is enhanced when external capital is used to finance efficient projects, implies transfer of technology (e.g. through FDI), or capital flows lead to larger international risk sharing;

- emphasizing the volatility of international capital flows. Large capital inflows amplify vulnerability of the country to abrupt and strong reversals, to a possible contagion, with the effects disrupting economic growth. The wave of financial crises in capital-receiving emerging economies in 1995–2001 as well as recessions in many financially open economies during the global crisis of 2007–2009 are examined to provide support for the negative growth effects;

- recognizing thresholds needed to achieve benefits from capital inflows and to reduce associated costs referred to above. These thresholds include: development of the domestic financial sector; macroeconomic discipline; quality of institutions and of governance.

Empirical studies on the subject bring no consensus. On the one end, no correlation between capital inflows and economic growth is found. On the other, there is significant correlation as well as, both direct and indirect, impact of capital inflows on growth, controlling for other variables affecting growth and discriminating between particular types of flows. Finally, some studies conclude that positive effects of capital inflows depend on “collateral benefits” or “thresholds” which in turn have been found growth-enhancing [Arvai 2005]. Mixed empirical results are due not only to differences in theories but also to varying methodologies (including variables and their measurements, timeframes, country samples etc.).

In the current decade, until 2008 the EU NMS have been enjoying - on average - robust economic growth and receiving large amounts of capital in many different forms. They have been able to converge with the OMS; in PPP terms, on average the NMS have reduced the gap to the OMS in GDP per capita by around 10 percentage points. In 2009 and probably in 2010, the convergence in broad groups of countries slowed down but did not stop. There is, however, some discontinuation on the individual level. Among the NMS, the Baltic countries are very severely affected by the global crisis and record recession over 17% in 2009. Among the OMS, in 2009 Ireland fell into a recession of 7.5%. Perspectives for 2010 are very pessimistic for Greece, Portugal, Spain and Italy. The convergence process for individual EU member states is illustrated in table 2.

It is remarkable that until 2008 the fastest progress in convergence has been observed in the Baltic countries, Romania and Bulgaria. Those economies were also experiencing strongest and fastest capital inflows as well as largest current account deficits. These developments reversed in 2009 and, most likely, in 2010. The Baltic countries and the Eastern Balkans are particularly strongly affected by the sudden stop in external capital inflows turning even into capital flight and by recession. Towards the end of the decade the convergence of these countries and of Hungary to the EU average is reversing.

It is argued that a certain portion of the convergence between the NMS and the OMS can be attributed to capital flows and, in particular, to flows enhanced by the EU integration. A number of studies go beyond simple correlations and try to assign more precisely shifts in convergence to shifts in capital flows to the NMS.
Behms and Schellekens [2007] apply a dynamic general equilibrium model of convergence and conclude that for the NMS output and consumption paths in case of capital flows are above the paths for the case without flows. Credit constraints slow down convergence more binding in an economy without capital flows. Several cross-country regressions assign convergence to capital flows to the NMS and to the advancing process of the EU integration. Abiad et al. [2008] found that capital flows speed up convergence in the EU, after controlling for other variables that are typically thought to be robust correlates of growth as well as for the time lag, reverse causality and institutional framework. 20% of total sigma convergence (decline in the dispersion of GDP per capita) can be attributed to capital flows. In case of the beta convergence (towards the level of GDP per capita of Germany) it is around 10% in case of the NMS with relatively small capital inflows and 20-40% in case of economies with relatively large inflows.

Fabrizio et al. [2009] conclude that subsequent stages of the integration of the NMS with the EU (i.e. membership application; negotiation; EU accession; ERM II entry and the Euro adoption) are statistically significant predictors of growth accelerations in these economies. The same holds true for financial openness and the presence of foreign banks. They consider the access to external capital and advancing integration are strong advantages of the NMS.

The progressing convergence driven by external capital inflows may, however, have its reversal. Such a strategy is exposing the NMS to the risk of growing imbalances which may disrupt growth and convergence. Growing imbalances may be caused either by fluctuations on capital markets due to inherent market failures (such as asymmetry of information, herd behavior, irrational exuberances) and/or by policy failures inducing excessively risky decisions on the side of companies and households. A deterioration of the overall external economic and financial environ-

Table 2. GDP per capita based on PPP terms in EU member states, 2001–2009 (EU average = 100)

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<td>Portugal</td>
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Source: author’s calculations based on data from the IMF.
ment as observed since 2007 is – obviously – reinforcing risks to growth of the NMS. These economies have experienced a crisis of investors’ confidence and faced the risk of an abrupt capital withdrawal leading to a vicious circle of recession, losses and further capital outflows.

External imbalances have indeed been growing, although to a different degree, in individual NMS. Excessive current account deficits have been recorded in the Baltic countries, Romania and Bulgaria. In Hungary fiscal balance has strongly deteriorated. The external solvency ratio (i.e. the ratio of the sum of short term debt and the current account balance to reserves) was lowest in the Baltics and in Bulgaria, amounting to the range of 27–50 (the optimum protection level is 100). However, some other NMS, e.g. Poland and Czech Republic turned out to be relatively resilient to a global crisis and were able to continue their convergence to the OMS. Such developments reflect, to a large extent, country-specific factors (like macroeconomic policies) rather than external factors as the major reason for the slowing down convergence across the group of the NMS.

The inflow of official capital to the NMS may also foster their economic growth and convergence. The growth-enhancing effects of EU funds are channeled through following factors:

- like private flows, EU funds add to domestic capital accumulation in the NMS and increase investment and growth opportunities;
- EU funds attract private capital flows to the NMS;
- EU funds mitigate risks to economic growth associated with private flows.

Theoretical works suggest that EU funds positively affect economic growth of the NMS, particularly through their impact on infrastructure and on human capital. Cross-country regressions and model-based simulations assessing growth effects of EU funds make strong case in favor of funds designed to finance infrastructure, either public or private (Allard et al. 2008). Improved infrastructure and increased human capital are critical for attracting external private capital, particularly FDI. Unlike private flows, EU funds represent a stable and predictable source of financing. Regarding mitigating impact on volatilities of flows, the EU has created Medium Term Financial Assistance (MTFA) - a vehicle designed to resolve or prevent balance of payment crisis of the non-euro NMS. The financial support under MTFA is provided in a close cooperation with the IMF and in the context of its stand by arrangements (SBA); in this way the amount of funds available to the NMS is amplified. Among the NMS, Latvia, Hungary and Romania have recently called the EU and the IMF for MTFA and SBA. Within the EU short and medium term financial assistance is also provided bilaterally (e.g. by Poland and Czech Republic to Latvia).

4. CONCLUSIONS

In the current decade the NMS have strongly benefited from opportunities offered by their catch-up potential. They experienced high growth rates and were able to visibly converge to the EU average. The process of their convergence has - to a large extent - been driven by external capital inflows, predominantly from the OMS. Capital flows and their growth-enhancing effects were underpinned by the advanc-
ing integration of the NMS with the EU, the process which helped anchor investors' expectations towards macroeconomic discipline, institutional convergence and an improved quality of governance. In parallel to flows of private capital, official EU funds have improved opportunities to finance investment, attract more private investors and strengthen stability of external financing. With “an umbrella” provided by the integration with the EU, the NMS were offered opportunities to grow faster and with larger external imbalances than otherwise.

However, several NMS, mainly those converging most rapidly, found the counterpart to their growth in excessive external imbalances which stopped and reversed growth and convergence. The adverse effects of the volatility of international capital flows have been amplified by the global crisis of 2007-2009. As some NMS were affected less than others, specific policy factors were largely responsible for shifts in growth and convergence. Policy recommendations for the NMS and to the EU candidates that could be useful for their successful convergence underpinned by capital inflows include:

- orderly and prudent liberalization prior to the accession;
- sound macroeconomic policies (designed, among others, to prevent excessive debt and current account deficit accumulation);
- directing capital towards productive investment, mainly to a tradable sector;
- strengthening financial regulation and supervision as well as cross-border cooperation in these areas;
- improving financial transparency;
- improving risk management of financial institutions and of supervisory institutions;
- an active participation in the international initiatives designed to strengthen financial stability.

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LÁSZLÓ AKAR

HUNGARIAN EURO-ZONE ENTRY, AS EARLY OR AS LATE AS POSSIBLE?

Analysing the performance of the Hungarian economy we can say that the distances from reaching the Maastricht criteria are different, but the ongoing tendencies are positive. Latest by 2013 realistically all the criterions can be met. Concerning the policy related to Hungarian euro-zone entry both from the Hungarian and EU institutions sides there are possibilities for an as soon as possible and an as late as possible approach. The new government can decide the appropriate policy. The positive scenario (which is better for the economy): is a 2014 euro-zone entry with crucial reforms in the budgetary system, together with sizable tax reductions. The negative scenario is that there is no entry during the next political cycle for Hungary.

Analysing the performance of Hungary concerning the fulfilment of the Maastricht criteria we can say, that the picture is mixed. The distances from reaching the Maastricht criteria are different, but the ongoing tendencies are positive. Inflation and interest rates are approaching the criteria in coming years. Budget deficit was 3.9% of GDP last year, which is not too far from the 3% limit. The structural budget deficit is below 3% in 2009-2010, which is a good sign concerning the future fulfilment of the criteria.

Source: Eurostat, GKI forecast

Figure 1. Harmonised Hungarian consumer price index and the Maastricht inflation criterion, 2006–2010 (per cent)
General government indebtedness is above 60%, nearly 80% of GDP in 2009. It will peak in 2010, and assuming 3% GDP growth from 2011, a declining tendency is expected. It means, that the modified indebtedness criterion can be met from 2013 (after 2 years of decline and the very likely continuation of such a tendency.)

Interestingly the forint/euro exchange rate is within a not existing ± 15% band. But as the ERM-2 entry did not happen yet, there is no possibility legally to measure the fulfilment of the exchange rate criterion (to spend 2 years without depreciation within the band). It can be a major problem for the euro-zone entry, whenever the ERM-2 entry is delayed further.
From the Hungarian side there are two main policy alternatives concerning the euro-zone entry.

a) The first possible policy is as soon as possible (according to the existing rules). Old arguments for entry are relevant even now (improves growth potential and competitiveness, leads to better fiscal discipline, and so on). The crisis experience demonstrates the stability advantage of euro. The budgetary criterion can be met by 2012, whenever the needed significant tax reductions will be partially financed by savings on the expenditure side of the budget, implementing deep changes, that is reforms in some fields. (Economic growth also can contribute to tax reductions, but it is not enough alone.) A reliable euro introduction program diminishes the interest rate expenditures of the budget soon and improves competitiveness as well. Such a euro policy can be even politically rational, as it follows the classical approach: the burden is at the beginning, and the fruits are coming at the end of the election cycle.

This means, that at Spring 2013 all the existing criterions can be fulfilled realistically (assuming the ERM-2 entry latest till early 2011) and the euro-zone entry can be implemented at January, 2014.

b) The second possible policy is as late as possible. It can be followed only without formal declaration (no euro-zone entry target, or a very late target). Such a policy seems to expand the scope of tax reductions and to help avoiding a part of painful reforms. But with such a policy the interest rates remain higher, the exchange rate weaker, which has effects, very negative on budget. The hoped extra tax reductions coming from such a policy choice can be rather small. The EU excessive deficit procedure and the strength of the money market limit the budget deficit creation, even with such a policy the deficit should go below 4 % from 2011–12.

![Graph: General government balance in per cent of GDP, 2006–2012]

With consolidation expenditures in 2010 and following different policies in 2010–2012
Source: Ministry of Finance, GKI

Figure 4. General government balance in per cent of GDP, 2006–2012
From the European institutions they are also two possible policies towards zone expansion

a) As soon as possible (even changing the rules, for example following the Breugel proposals*). There are good arguments supporting the idea. It might help the crisis management. As only 3 euro-zone countries are fulfilling now the budgetary criterion, it is fair to be flexible at new entries, but there is a need to be tougher towards zone members in the future. The potential new entrants do not make a big difference for the size of the zone's economy.

b) As late as possible. They are mainly hidden arguments supporting such a policy choice. The euro-zone and the ECB face enough problems with the existing members. The sustainability of the fulfilment of the criteria can always be questioned. In case of potential national crisis a non-euro-zone EU country can rely on IMF funds and on depreciation, which favours a delayed euro changeover. The possible outcome concerning Hungary is open. The new government can decide the appropriate policy. The realistic maximum from EU institutions is to accept new candidate countries to the zone, when all criteria are fulfilled. The positive scenario: is a 2014 euro-zone entry with crucial deep changes, that is reforms in the budgetary system, together with sizable tax reductions. The negative scenario is: an as late as possible policy, that is there is no entry during the next political cycle for Hungary. (It might even happen that the Hungarian government and the EU institutions silently agree in practice on such a ground.) Let me hope that the positive scenario will be followed, because it is better for the economy.

* To countries wishing to join the euro, a path to membership should be offered, with clear, economically meaningful benchmarks, instead of atemporal, nowadays largely irrelevant criteria.
The current world economic crisis induced countries to launch wide-scale spending programmes all over the world. Member states of the European Union have not been an exception to this trend. While deficit spending may increase the aggregate demand, it can also accelerate indebtedness and make the required spending cuts politically risky later on. However, deficit financing is not a new phenomenon in the EU; it has been widely practiced in the last couple of decades. As the crisis seems to come to an end, countries with huge deficits should adopt exit strategies now, thereby reducing deficit and debt and reintroducing fiscal discipline, a requirement laid down in the Stability and Growth Pact. Nevertheless, former adjustment processes can provide ample evidence for successful and politically viable fiscal consolidations. In certain cases, even economic activity started to accelerate as a response to the well-designed adjustment measures. Based on the previous experiences of EU states, the aim of this paper is, therefore, to identify the conditions that may determine a fiscal consolidation to be successful in terms of a reduced debt ratio and a positive economic growth.

1. INTRODUCTION

Although the current economic crisis put deficit financing in the centre of attention, it has been a general practice since the early 1970s, carried out on a permanent basis in the majority of European countries. Such behaviour triggered an increase in the debt stock relative to the GDP; that is, the pro-cyclical fiscal policy was hardly ever able to achieve its classical objective to stabilise the national economy (EC 2000). The aim of this paper is to map out what may determine a fiscal consolidation to be successful in terms of a reduced debt ratio and a positive economic growth; to identify those conditions/factors which can be responsible for delivering these desired effects. However, the paper points further since it tries to reconcile the findings of our short data analysis and case studies with the experience of one of the new member states of the EU.

Following the short introduction, Part 2 elaborates on a simple data analysis of a sample of old member states, concentrating on the large fiscal adjustments and their macroeconomic consequences such as the debt-to-GDP ratio and economic activity. A short data analysis can be indicative in several respects; however, country case studies may contribute to a better understanding of how governments were able to implement not just large but also permanent and growth-accelerating fiscal contractions. Accordingly, in Part 3, five cases have been selected for further study: Ireland (1987–89), Denmark (1983–84), Netherlands (1993 and 1996), Great Britain (1997–98) and Sweden (1996). Hopefully, the case study approach makes it possible to concentrate on those conditions/factors that may prove to be indispensable for
success, especially the composition of fiscal adjustment and the institutional environment, such as the reform of the budgetary process. Part 4 concludes.

2. SUCCESSFUL FISCAL CONSOLIDATIONS: A COMPARATIVE DATA ANALYSIS

First of all, we need to specify what is meant by success with respect to a fiscal consolidation. In the following, “successful fiscal adjustment” means that a (i) relatively large fiscal consolidation provides (ii) a permanent recovery in public finances and also (iii) a recovery (or acceleration) in economic activity.\(^1\) Accordingly, by using the relevant literature, three definitions have been adopted for our specific purposes.

(Definition 1) “Relatively large fiscal adjustment”: a fiscal consolidation in which the cyclically adjusted primary balance improves by at least 1.5 percentage points of the GDP.

(Definition 2) “Permanent adjustment”: a fiscal adjustment in year \(t\) is permanent if the gross debt-to-GDP ratio is at least 5 percentage points of the GDP lower in year \(t+3\) than in year \(t\).

(Definition 3) “Growth-accelerating or expansionary permanent consolidation”: a permanent fiscal adjustment in year \(t\) is expansionary if the average real GDP growth rate in years \(t+2\) and \(t+3\) exceeds the average real GDP growth rate measured in years \(t-2\) and \(t-1\).

First, the so-called “relatively large fiscal adjustment” will be identified in the EU-14 between 1980 and 2005. Second, the latter group will be restricted to those episodes where the debt-to-GDP ratio fell substantially, providing a permanent consolidation. Third, the growth-effects of adjustment – as the politically most important consequence – will also be taken into account, while assessing the macroeconomic consequences of fiscal consolidations.

(Ad 1) In the relevant empirical studies, fiscal consolidation is always defined in terms of a given improvement in the specified form of fiscal balance over a given time period. Defining the measure of adjustment is always critical since the results may be sensitive to the chosen concept. A minimum of a 1.5 percentage point improvement in the primary fiscal balance (in cyclically adjusted terms) is usually characterised as a very tight adjustment indeed, which is not undertaken by governments too often.\(^2\) The relatively high threshold applied in our study enables us to

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\(^1\) By focusing on fiscal aggregates and their macroeconomic consequences (such as debt-reduction and economic growth), the data set is comprised of the EU-14 (except Luxembourg) between 1980 and 2005. The data were taken from two sources. Fiscal aggregates are excerpted from the Economic Outlook of the OECD (see OECD 2009), while the data on economic growth were provided by the Statistical Annex of the European Economy, European Commission (1999 and 2009).

\(^2\) The norm in the literature is to define changes in the cyclically adjusted primary balance below +/- 0.5 percentage point as neutral, while changes between +/- 0.5 percentage point and +/- 1.5 (sometimes 2) percentage point as expansionary/tight. Above 1.5 (or sometimes 2) the change is said to be very expansionary or very tight. See especially Alesina and Perotti (1995), Alesina and Ardagna (1998) and Hagen et al. (2001).
select just a few, probably the most robust cases of fiscal adjustments. Moreover, the magnitude itself makes it difficult to achieve such an enormous consolidation by \textit{one-off measures} exclusively – at least not too frequently. As far as the specification of the balance is concerned, the OECD's cyclically adjusted (or structural) balance was chosen in order to filter out the effects of business cycles. With cyclically adjusted terms, the \textit{discretionary} part of fiscal impetus can be detected.\textsuperscript{3} The reason for concentrating on the primary balance is that interest payments are out of the direct competence of decision-makers in the annual budgeting process, where the political decisions are made.

Accordingly, the total number of annual observations in the sample of EU-14 over the period of 1980 and 2005 is 375 (25 x 15), out of which 62 episodes proved to be exceptional adjustments, based on our \textit{Definition 1}.\textsuperscript{4} Each of the 14 countries embarked on at least one large consolidation throughout the scrutinised period, although with a rather different frequency. While France, Germany and Spain reduced its cyclically adjusted primary balance only once, Finland, Greece, Ireland, Italy, Portugal adopted severe measures several times. Nevertheless, the number of exceptional fiscal episodes exclusively cannot say anything about the degree of fiscal discipline or the success of an adjustment. The fact that Germany adopted a severe contraction only once clearly reflects the fact that this country was the ideal-type case of the stability-policy during the eighties and nineties. Intuitively, the more frequent adjustments there are in a country, the less disciplined are public finances.

(\textit{Ad 2}) Following our definition of successful fiscal consolidation, the group of large fiscal episodes (62 in total) will be restricted to those only which proved to be permanent (see \textit{Definition 2}). In our sample, less than one-third of the large fiscal adjustments provided the required 5 percentage point drop in the debt ratio, thereby qualifying for the status of a permanent adjustment (in concrete numbers: 18 out of the total 62 episodes – see Table 1). That is, two-thirds of the attempts to consolidate public finances ended up without the hoped results. Interestingly, the selected 18 episodes gravitated to 10 countries only, out of which Denmark, Ireland and Sweden experienced at least three such successful occasions.

It was also checked in our sample whether the 5 percentage point decline occurred earlier than the maximum three years. The results are surprising: only four out of the 18 episodes required three years to become effective, the rest provided a significant fall in the debt-to-GDP ratio within one or two years already. More impressively, in half of the cases, the decline in debt over the three year period was above 10 percentage points. Ireland for instance produced a staggering cumulated 36.5 percentage point decline between 1986 and 1992. The same country experienced, however, a catastrophic fiscal consolidation just a few years earlier, in 1982–83, when the unsuccessful attempt ended up with a 38.4 percentage point total increase in the debt-to-GDP ratio by 1986. The UK (1998–2001), the Netherlands (1996–99), Belgium (1993–96), Denmark (1984–87), Italy

\textsuperscript{3} Detecting the cyclical component in fiscal variables is not without controversies, however (see especially P. Kiss and Vadas 2005).
\textsuperscript{4} Each episode is enlisted in Table 1.
(1997–2000) and Sweden (1996–99 and 2005–08) also experienced a robust drop in the debt ratio due to fiscal contraction. It is worth noticing, however, that neither the UK nor Sweden belongs to the single currency area, for these countries the ultimate reason for fiscal restructuring was not simply the fulfilment of the Maastricht numerology. On the other hand, Austria, France, Germany, Portugal and Spain – all are members of the euro-zone – never experienced significant drops in their debt ratios between 1980 and 2005, albeit some of them initiated large scale consolidations.\(^5\) *(Further information in Figure 1.)*

![Figure 1 Large-scale adjustments with a significant drop in the debt-to-GDP ratio](image)

Source: own compilation based on the data set of OECD (2006).

Note: 18 episodes proved to be permanent according to our Definition 2, but the Figure displays only eight of them which also provided some acceleration in economic output.

*(Ad 3)* A large fiscal consolidation was said to be successful if not just the debt ratio fell significantly, but economic activity also accelerated due to the adjustment efforts. That growth has been chosen as a part of the definition of success can be rationalised by the fact that without the ultimate growth effects, which can make fiscal contraction more acceptable by the public, it is hard to believe that politicians would be willing to embark on wide-scale consolidations programmes (see especially Benczes 2008). Based on our *Definition 3*, nine episodes out of the total 18 large

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*5* Italy, another EMU member state, provided a rather hectic performance during the nineties by struggling with reducing its debt-ratio. The first attempt proved to be a total failure: the debt ratio increased between 1993 and 1996 by 11 percentage points. The negative trend was broken off only by the 1996-97 consolidation attempt, assuring Italy’s position among the members of the euro-zone.
and permanent adjustments proved to be growth-supporting in our sample. See Table 1.

Table 1 Summary table of successful adjustments in the EU-14 (the year in which fiscal adjustment evolved)

<table>
<thead>
<tr>
<th>Source: own construction.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large fiscal adjustments by Definition 1</td>
</tr>
<tr>
<td>France</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Spain</td>
</tr>
<tr>
<td>Number of total observations</td>
</tr>
</tbody>
</table>

It might be surprising indeed that more than half of the large and permanent adjustments qualified also for being growth-supporting. According to the Keynesian argument, a large and permanent adjustment ends up in a deceleration of economic activity due to the positive fiscal multiplier. However, in our sample it turned out that quite a few episodes do not support this general claim. In fact, except for Italy (1997), these fiscal episodes provided some increase in the level of economic activity in the first year already. Such surprising outcomes are often labelled as the perverse effects of fiscal policy, which also received a new name in modern macro economy: non-Keynesian effects.

6 It is reasonable, however, to reduce the nine episodes to eight only in the further study, because Ireland proved to be successful in two consecutive years (1987–88).
7 The term “non-Keynesian effects” refers by definition to a situation where the fiscal multiplier turns out to be negative: the indirect effects of fiscal impetus on private consumption and/or investment offset the direct effects of government action. Such a surprising outcome is triggered by the changing behaviour of rational, forward-looking private agents, who expect their tax liabilities to decline in the future and/or who work under a more competitive (wage) structure in the international market (see especially Giavazzi and Pagano 1990).
Certainly, the descriptive data analysis of large fiscal adjustments and their macroeconomic consequences is not without doubts. Nevertheless, the international comparative studies on the success of fiscal consolidation have one main point in common: they almost all found some evidence for success.\(^8\) By summarising the main findings of Part 2, two major conclusions can be drawn. First, not every single fiscal consolidation results in improved public finances (that is, in a reduced debt-to-GDP ratio); in fact, a lasting debt-reduction is rather rare. Second, a fiscal contraction is not always accompanied by economic decline; in fact, there are some instances when economic activity does accelerate relatively early on.

3. FIVE SUCCESSFUL EPISODES

A short data analysis can be indicative in several respects; however, country case studies may contribute to a better understanding of how governments were able to implement not just large but also permanent and growth-accelerating fiscal contractions – an unexpected double result that should be achieved now as the current economic crisis is coming to its end. Accordingly, five cases (out of our eight episodes) have been selected from our EU-14 sample for further study. The five case studies will be the following: Ireland (1987–89), Denmark (1983–84), Netherlands (1993 and 1996), Sweden (1996) and Great Britain (1997–98). Belgium (1993) and Italy (1997) have been left out from the further study since their initial conditions (the extremely high level of debt reaching 110–120 per cent of their GDP) can make the lessons not that straightforward. Moreover, Belgium experienced a significant drop in economic growth already in the second year after the adjustment, while Italy's adjustment efforts were strongly supplemented by creative accounting measures in 1997.

3.1 THE COMPOSITION OF ADJUSTMENT

Ireland

After the first failed fiscal consolidation of 1982–83, the newly elected right-wing cabinet initiated an ambitious adjustment programme in 1987, followed by several other supplementing economic measures. The consolidation – started in February 1987 – was based exclusively on expenditure cuts; in fact, taxes even fell slightly between 1987 and 1989 (see Table 2). Throughout these years, the total spending was decreased by 8.5 per cent of the GDP and revenues also declined by a couple of percentage points. The Irish government did not hesitate after a failed adjustment attempt in 1982 to drastically cut back the politically most sensitive items such as the wage bill of the public sector and the cuts in transfers.

More importantly, between 1988 and 1989, the Irish government reduced the number of public servants by 9 per cent, by which 30,000 people were made redundant. This was carried out not simply in the form of dismissals, but rather in the

\(^8\) See for instance Giudice et al. (2003).
form of early retirement and by freezing recruitments. The fiscal consolidation pro-
gramme was supplemented with a wage agreement among social partners and the
state in both the private and the public sector. One of the crucial elements of the
wage agreement between social partners was that the claims on real wage increase
could not exceed improvements in productivity. The significant lay-off proved to be
politically sustainable because it involved a wide-scale tax reduction, and as a corol-
lary, the private sector absorbed so many that unemployment rate even decelerated.
Additionally, the government spent a significant amount of money on re-training
courses.

It is worth mentioning, however, that an increase in employment and an overall
recovery of the economy probably would not have been possible without a
favourable international economic environment, especially in the case of the most
important trading partners of Ireland, which boosted export. Besides, the accelera-
tion of capital inflow via foreign direct investment also contributed to the positive
growth effects. Capital inflow was also supported by the timely liberalisation of cap-
ital accounts and the devaluation of the Irish pound in 1986. In fact, the lowest cor-
porate tax was introduced, which – together with low wages and the devaluated
Irish pound – made Ireland attractive for foreign investors, especially in comparison
to other EU countries. In sum, the restored overall competitiveness of the Irish econ-
omy, along with the accommodative monetary and exchange rate policy were inte-
gral parts of the economic policy package of the right-wing cabinet.

Denmark (1983–84)

The Danish started the consolidation in the first half of the eighties, following a seri-
ous deterioration in fiscal performance, price stability, and economic activity.
Public debt doubled within five years (before the consolidation occurred), and fis-
cal deficit got close to 10 per cent. As opposed to the other four countries, howev-
er, Denmark initiated a revenue-based adjustment (Table 2), although according to
other authors, it is better to say that it embarked on a mixed strategy of both expen-
diture cuts and revenue increase (see especially Perotti et al. 1998).

For sure, besides revenue increase, the spending cut was unavoidable since the
redistribution achieved an extremely high ratio in the country: 60 per cent of the
GDP by 1980. Similarly to Ireland, transfers and compensation to employees were
decreased – although at a more moderate rate. In concrete terms, the earlier prac-
tice of price indexation of welfare spending was given up and maximum ceilings on
some welfare cash benefits (such as sickness) were introduced. Wage-freezing, dras-
tic stop on pension payments and unemployment benefits contributed to the suc-
cess of the consolidation programme, too. The determination of the government
can be touched upon by contrasting current spending cuts with cuts in public
investment: the ratio of current expenditure cuts versus public investment was
around 5. Still, the balance of overall expenditures did not improve due to the steep
increase in the payment of interest. The dramatic recovery in fiscal balance (which
turned into a sufficit as early as 1985) was therefore mostly due to the significant
increase of direct taxes (both on business and households) and social security con-
tributions. Revenues increased by 7 per cent of the GDP between 1981 and 1988, causing a serious increase in the tax burden.

The judgement of the Danish “miracle” is not without doubts, however. On the one hand, the favourable internal and external economic conditions might have played a crucial role in the success story of the early eighties – especially the easing of monetary policy due to the strengthened credibility of macroeconomic policies. On the other hand, in 1987, wage-freezing was abolished and employees pushed the government successfully towards a serious wage increase. The suspension of wage moderation broke the positive growth trend of the economy experienced through the years of adjustment. Significant increase in real costs of labour deteriorated competitiveness and economic growth slowed down from 1988 onwards. That is, Denmark did experience a successful fiscal consolidation which, however, did not prove to be long-lived.

The Netherlands (1993 and 1996)

Seemingly, the Dutch adjustment efforts coincide with the launching of the EMU plan. However, the restructuring of the Holland public finances had already started in the eighties, well before the Maastricht process. By 1997, public spending had decreased by one-third from the peak reached in 1983 (in GDP). The wide-scale reforms of the mid-eighties encompassed the following elements: mutually strengthening measures in fiscal policy and labour incomes policy (along with labour market reform) such as tax cut and the reduction of the real value of minimum wage. Social transfers were cut back significantly too: welfare transfers (especially sickness and disability benefits) were vigorously reduced and restructured. Public sector salaries were cut back and the links between the wages of the public and the private sector were also severed.

Starting in 1993, the Netherlands embarked on a drastic reduction of current expenditures: the level of current expenditure declined from 50.6 per cent (1993) to 42.3 per cent (1998). Savings on final consumption and interest payments contributed significantly to the recovery of the general budget. Interestingly, current revenues fell enormously, too: the decrease was 4.7 points of the GDP between 1992 and 1997 (data can be found in Table 2). The government and the trade unions worked in close cooperation with each other and were able to increase the flexibility of the Dutch labour market substantially, thereby the demand for labour rose, too. The improvement in competitiveness produced a robust growth compared to the neighbouring countries (Watson et al. 1999). In sum, the Dutch success story was not a one-off event, but a result of a long process that had already started in the early eighties. The ultimate aim of the reform was not simply the reduction of deficit and debt but the restoration of competitiveness of the overall economy, thereby promoting sustainability.

The UK (1997–98)

One of the most successful fiscal stabilisations was achieved in the UK in the nineties. Nevertheless, the British experience received attention not just because of
the significant improvement in fiscal stance but also due to the remarkably high level of real growth rate and falling rate of unemployment, stabilising at 5–6 per cent in the second half of the nineties, an outstandingly low level in comparison with other EU countries.9 As far as the fiscal position is concerned, the debt-to-GDP ratio was placed on a downward course: the average ratio between 1991 and 1995 was recorded at 51.8 per cent, while the average of 1996 and 2000 was reduced by 10 percentage points. The same ratios for the deficit were 6.0 per cent versus 0.3 per cent. From 1998 onwards, the general government balance turned into a sufficit which prevailed until 2001. Meanwhile, the growth rate of the country accelerated, providing a spectacular 3.2 per cent annual average in the second half of the nineties, as opposed to 1.7 per cent in the first half of that decade. This certainly raises the issue of causality: it might be easily the case that the recovery in economic performance made it possible for the government to collect more revenues while spending less, thereby experiencing a recovery in the general balance.10

Turning to the composition of adjustment, Table 2 in fact reveals that both the increased revenues (possibly due to the accelerated economic growth) and the reduced expenditures contributed significantly to the recovery in fiscal position. While current expenditures exceeded current revenues by 2 percentage points (in GDP) in 1996, three years later the current revenues were well above current expenditures. The change in the trend can be traced back to several budget items: there was a general decrease in the level of all expenditure-types in the UK. Compensation per employees for instance witnessed a decline of 0.8 percentage points (in GDP), which means a 7.5 per cent decrease (using 1996 the base year). Reductions in public investment and interest payment contributed significantly to the recovery of the general balance, too. The success of the corrections was mainly the result of the increased credibility of policymakers and the improved transparency of the policymaking process (see in section 3.2). Moreover, the commitment of New Labour was also reflected in the fact that several public services were privatised and thereby the number of public sector workers dropped significantly. The status of public sector employees also changed, by which the government was able to reduce the staff of the education sector for instance (OECD 2001).

**Sweden (1994–97)**

The overheated economy of Sweden in the late eighties and early nineties found itself in an unpleasant recession, boosting government spending and dampening revenues. The relatively large size of the public sector in Sweden (two-thirds of the income was centralised) gave birth to a generous welfare state where even the automatic stabilisers could have a devastating effect in times of recession on the fiscal position of the general government. Accordingly, the dramatic increase in the num-

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9 The IMF (1998) in fact warned the country that an overheating might have evolved in 1998 already, due to the strong performance of the economy.

10 According to the IMF (1999: 4), for instance, the strong recovery of the budget was “transient in nature, and hence not grounds to relax policies. The bulk of the gains [of the accelerated economic growth] appears to be cyclical, reflecting the greater buoyancy of the economy.”
ber of unemployed (which peaked at almost 9 per cent in the early nineties from an extremely low level of 1.8 per cent in the eighties) contributed significantly to the undermining of fiscal sustainability in the early nineties. Deficit was higher than 10 per cent for several years before the adjustment was implemented, and the debt ratio was 1.5 times higher than just half a decade before.

The drastic changes in the fiscal course of Sweden were initiated after the crisis from 1994 onwards which were, however, preceded by a strong devaluation of the Swedish koruna and the adoption of a flexible exchange rate regime later on. Revenues were increased dramatically in 1996; while the general level of spending decreased by around 8 percentage points (in GDP) between 1993 and 1998. By decomposing expenditures, it becomes visible that mostly current spending, especially the transfers to households were cut back significantly (see Table 2).

Table 2 The composition of fiscal adjustments

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>General government balance</td>
<td>+6.9</td>
<td>+7.8</td>
<td>+3.0</td>
<td>+13.2</td>
<td>+5.2</td>
</tr>
<tr>
<td>Current revenue</td>
<td>+4.7</td>
<td>-2.5</td>
<td>-4.7</td>
<td>+1.1</td>
<td>+1.9</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>-0.7</td>
<td>-7.7</td>
<td>-7.0</td>
<td>-8.1</td>
<td>-2.8</td>
</tr>
<tr>
<td>Final consumption</td>
<td>-2.8</td>
<td>-2.2</td>
<td>-1.4</td>
<td>-2.0</td>
<td>-0.8</td>
</tr>
<tr>
<td>Compensation of employees</td>
<td>-2.0</td>
<td>-1.2</td>
<td>-0.8</td>
<td>-2.4</td>
<td>-0.8</td>
</tr>
<tr>
<td>Social transfers in kind</td>
<td>-2.0</td>
<td>-1.2</td>
<td>-0.6</td>
<td>-1.0</td>
<td>-0.2</td>
</tr>
<tr>
<td>Subsidies</td>
<td>-0.3</td>
<td>-0.8</td>
<td>-0.8</td>
<td>-2.3</td>
<td>-0.1</td>
</tr>
<tr>
<td>Interest payment</td>
<td>+3.8</td>
<td>-1.2</td>
<td>-1.1</td>
<td>-0.2</td>
<td>-0.5</td>
</tr>
<tr>
<td>Public investment</td>
<td>-0.4</td>
<td>-1.4</td>
<td>-0.3</td>
<td>-0.6</td>
<td>-0.4</td>
</tr>
</tbody>
</table>

Remarks: the data cover the years of the adjustment itself, plus one year before and after the consolidation was initiated.

In Sweden, the government tried to implement a shift from a general, all-encompassing regime to an individual-based, targeting scheme by redistributing sources to those in need. Childcare and family allowances, along with housing support – politically highly sensitive measures – were reduced substantially.11 By restructuring the welfare state, Sweden has introduced a funded pillar in its pension system, thereby reducing the increasing burden of the ageing population. The government achieved a positive primary balance as early as 1996, putting an end to debt accumulation (in 2000 it was already below the Maastricht criterion with its value of 52.8 per cent). Remarkably, the relatively low performance of the economy showing a 0.7 average growth rate per year between 1991 and 1995, showed a steady increase by climbing to 1.3 per cent in 1996, 2.4 in 1997, 3.6 in 1998, and peaking at 4.6 in 1999. In sum, after the crisis years, due to a quick and credible policy and regime change, the Swedish economy bounced back relatively quickly, and its economic performance –

11 The IMF (2003) also added that the decline in current transfers also reflected the privatisation efforts and the reform of the pension system.
regarding growth – can be compared only to the golden ages of the sixties, the heydays of the welfare state.

The case studies nicely illustrated that the composition of fiscal consolidation can have a significant effect on determining whether an adjustment proves to be successful. The short case studies underpinned the idea that expenditure-based fiscal stabilisations have a significantly higher chance of ending up in reduced-cost adjustment than revenue-based adjustments. It has been also revealed that basically two budget elements need to be cut back if the government aims at reducing the debt stock and also producing growth effects relatively early on: (1) compensation of public sector employees and (2) household transfers. Nevertheless, these items are considered to be the politically most sensitive items of the budget, the constitutive elements of any welfare state. Therefore, the cutback of these politically sensitive items may call for political decisiveness which in turn can be backed up by changed institutional conditions, especially a centralised budgeting process and/or a restructuring of the labour market.

3.2 THE PROCESS OF PUBLIC BUDGETING

According to the findings of the political economy literature on deficit bias, the decentralized nature of public budgeting, the lack of a firm-handed finance or prime minister, the lack of a coalition agreement, and the absence of transparency result in a deficit bias which makes it impossible to achieve a close to balanced position of the budget. Reforming the budget process, strengthening transparency and introducing binding fiscal rules (such as the Maastricht fiscal criteria for instance) can induce therefore significant recovery in the budget balance.\textsuperscript{12} Any change in the institutional design of the budgetary process (and/or the adoption of numerical fiscal policy rules) induces automatically a change in political motives. The inefficient allocation of resources can be reduced significantly by the appropriate design of fiscal institutions, which might not be a first best solution for providing socially optimal resource allocation, but still works as a second best scenario. Accordingly, Hagen (1992:54–55) argues: “[o]ur results suggest that institutional reform of the budgeting process is a promising avenue to achieve a large degree of fiscal discipline.”

Among others, Hauptmeier et al. (2006) in their empirical study argue that expenditure reduction is always embedded in a more comprehensive reform package inclusive of the reform of \textit{fiscal institutions} and structural measures. “Virtually all episodes of ambitious reform feature a significant strengthening of national and sub-national budgetary procedures and institutions... one could indeed talk about a major change in the policy regime” (ibid. 9). Fiscal adjustment is therefore initiated with the ultimate aim of achieving long-term macroeconomic stability. The authors' claim can be supported by the experience of several European countries, inclusive of the five states that have been selected for a deeper scrutiny in this study. Besides the widely known fiscal convergence criteria of Maastricht, several EU member

\textsuperscript{12} See especially the monographs of Drazen (2000) and Persson and Tabellini (2000).
states introduced so-called expenditure rules in the nineties. Instead of deficit and debt criteria covering public finances as a whole (such as the Maastricht reference values), these expenditure rules (limits) corresponded to different chapters of the budget, which made them more transparent and reflected personal responsibilities. Generally speaking, the advantage of an expenditure rule is that it guarantees the internalisation of the full costs of public spending, i.e. the rule ensures that policymakers take explicitly into account the budget constraint of the government.

Expenditure rules are usually embedded into a medium-term fiscal framework. The medium-term plan is not simply informative but can be adopted as a law by the national legislation. The essence of medium-term fiscal framework is that the government sends out a clear signal to the market about its commitment on fiscal consolidation, proving that fiscal adjustment is not a one-off measure but part of a coherent long-term economic programme. The framework main contain major economic policy objectives, the assumed macro-economic environment and development path, the programming time span, a list of expenditure items, a definition of exceptional and transitional conditions, the standard exemptions from expenditure limits - especially cyclically sensitive factors, such as unemployment benefit and reserve funds. Such a framework has been adopted earlier in Australia, Canada or New Zealand. Among the EU member states, it was Finland, Sweden, the Netherlands, Denmark and the UK (countries under scrutiny of this paper), and later on Germany and Spain that introduced national medium-term fiscal planning programmes in order to achieve a successful fiscal consolidation.13

One of the most well-known system of expenditure rules has been adopted in Sweden, where starting in 1996, the Act on Public Finances introduced 27 nominal expenditure caps for all of the lines of the central budget and the social security system. The aim has been to achieve a 2 per cent surplus in the cyclically adjusted total balance. The country initiated even constitutional amendments in order to cement the reform steps. The finance minister's position in the cabinet was substantially strengthened and also the strength of the minority government vis-à-vis the opposition forces was increased significantly, thereby making it possible for the incumbents to scale down the politically motivated overspending activity dramatically.

Similar to Sweden, but almost ten years earlier, the Irish right-wing government also secured the position of the finance minister. As a corollary, the government made the claims of spending ministries redundant and guaranteed a tough expenditure-based consolidation. In fact, the whole reform process was executed by the Irish Finance Ministry, which enjoyed the full-hearted support of the prime minister. Interestingly enough, the seemingly over-centralised power of the executive body did not trigger severe attacks from the side of the opposition in the parliament or the wider public, that is, a strong consensus supported the reform programmes.14

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13 Although Finland is not among the selected cases, because it did not fulfil the second requirement of success, it is worth noting that Finland was able to achieve a dramatic drop in its debt ratio and also the economic performance accelerated substantially some years later following the fiscal contraction of 1998.

14 See especially Hallerberg (2004).
As far as the Dutch reform attempts are concerned, they first adopted a medium-term fiscal framework from 1994 onwards and after that a binding coalition agreement in 1998.\textsuperscript{15} The aim was the same in both cases: to reduce public spending in the sphere of the central government and the social security system. The expenditure limits were expressed in real terms and also rainy day funds were created in order to finance temporary overspendings. One of the most important aspects of the Dutch medium-term planning was that the decisions on spending and revenues were clearly distinguished from each other.

Nevertheless, it was probably the UK which developed the most sophisticated system of medium-term planning. The British have adopted a programme, the elements of which have to correspond to five main points: specificity, measurable, adoptability, relevance and timing, or to use the English abbreviation, SMART. Both spending ministries and budget offices have to renew their fiscal framework programmes every two years, in which they must report on the use of discretionary spending that has to be in line with the so-called departmental expenditure limits (no overspending is tolerated). These data are made available for the wider public as well in a document called “public service agreements”. In accordance with the programme-budgeting, the planners do not focus on the inputs (financial sources), but the measurable and controllable outputs (services). Another interesting aspect of the British planning system was that a 4 to 6 per cent of particular expenditures were allocated to a reserve fund which was used up only in extraordinary times. Similarly to Sweden and Ireland, the UK also transposed substantial political power on the Chancellor, who was backed by the prime minister.

Certainly, the crisis of 2008 and 2009 significantly changed the previously established fiscal regimes in each of the analysed countries. Even the most developed British fiscal framework was suspended in 2008. The UK was not able to meet its national fiscal rules established in 1997. Nevertheless, countries have started to negotiate on the main aspects of a future fiscal framework in order to create a credible exit strategy that puts back public finances on the track of sustainability.

\section{4. CONCLUSION}

The ultimate aim of this paper was to provide some lessons about how successful fiscal consolidation can be achieved. As a first step a short statistical analysis made it overt that not every single fiscal consolidation results in improved public finances; in fact, a lasting debt-reduction is rather rare. More surprisingly, however, a fiscal contraction is not always accompanied by economic decline. It has been shown that there were some instances when economic activity did accelerate relatively early on in EU countries between 1980 and 2005.

\textsuperscript{15} In their comparative studies, Perotti et al. (1998) and Hallerberg and Hagen (1999) recommended binding coalition agreements for continental Europe to reduce deficit bias. Such an agreement contains formal objectives and rules - in the form of numerical targets for instance - which can guarantee fiscal discipline in the long run. The contract approach proves to be superior to the delegation one (where the position of finance minister is strengthened vis-a-vis the other ministries) in the case of coalition governments.
Relying on the “successful” episodes of five countries, it was also shown that the consolidations were initiated almost exclusively on the expenditure side. Ireland provided one of the most remarkable fiscal adjustments in the second half of the 1980s. Both the deficit and the debt ratios dropped substantially, while economic activity accelerated to staggering levels. In Great Britain, expenditure cuts played a central role also in the adjustment process. In addition to transfers, the freezing and reduction of government wages proved to be useful in stabilising fiscal position, thereby providing a ground for economic growth even in the short run.16 The Netherlands benefited from the Maastricht process of the nineties, which triggered two adjustment waves in the country. Nevertheless, some corrections had been already initiated in the eighties. The crisis-hit Sweden implemented a drastic consolidation between 1994 and 1997: it cut back primarily the transfers to households, that is, it was ready to reform the Nordic welfare state. Denmark is not a trivial case, however, in the sense that both revenue increase and spending cuts contributed to the short-lived economic recovery during the mid-eighties. Unfortunately for Denmark, a reversal evolved in its fiscal profile as early as 1987, resulting in a deteriorated fiscal balance.

By studying the experiences of EU countries, it has been concluded that the success of a fiscal consolidation is very much dependant on the budgetary decision-making process, its transparency and the power structure within the cabinet. Therefore, it seems to be reasonable to recognise that if the excessive deficit is the result of continuous collisions of interests within the government (or parliament) and/or of insufficient coordination, then the solution is in the discontinuation of political fragmentation and the strengthening of centralisation. Accordingly, besides the composition of adjustment, the redesign of the budgetary process can substantially increase the chance of success. The centralisation of political power, the adoption of a binding coalition agreement possibly supplemented by a medium-term fiscal framework and the strengthening of the position of the finance minister can make it more likely for a consolidation to deliver permanent and growth-supporting results.

16 Nevertheless, both Ireland and the UK failed to maintain fiscal discipline in the last couple of years. Ireland quadrupled its debt ratio, while the UK doubled it in just five years by 2010. That is, even the most successful countries fail to meet fiscal discipline on every occasion. Certainly, the current crisis hit both countries severely, but the magnitude of indebtedness has also revealed serious structural deficiencies in their respective economies.
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Cambridge, Massachusetts.
The global financial crisis has not left the members of the EU untouched. Financial results have significantly dropped, businesses were folded in great numbers, the rate of employment decreased, social tension got fortified, and so did the national deficits in the budget in the majority of the countries. The decisive members of the community reacted fairly quickly to the challenges of the global economic crisis, and among the steps taken there were simultaneously ones to boost the economy and others to lower the expenses of the expenditure. The author examines what role was given to the steps in taxation policy as indirect regulating tools, and that how the decisions brought touch upon the previously issued harmonization strategy.

**TAXATION AND THE CRISIS**

Slowly we are nearing the end of the economic crisis that evolved in 2008, and today we are able to soberly sum up the experiences and draw the consequences. To do this the saying incites: “Who does not learn from history has to live through the events repeatedly.”

The European Union – despite the well palpable prognostics – was surprised by the world economic crisis. At the beginning it was not easy to even diagnose the crisis: some saw the temporary functioning problems of the financial sector in a geographical location, others believed to be able to keep the market tendencies under control by intensified interventions on a governmental level, however in no small number there were those who saw behind the phenomena and identified the malfunction of the international network of institutions as a result of the activity of the multinational companies in contrast to that of the governments, which were limited to operate within national borders. Today we know well that the situation is even more complex and we are the contemporaries of a modernization process, a change resulting in the relocation of economic centre of gravity and one preparing for the reform of the institutional system, in parallel.

The problems at first were referring to the repeated malfunctioning of the monetary system, however, the permanent shakiness of corporate financing did not leave the competitive sector untouched either. As a consequence, the symptoms of over-production crisis became identifiable (see the case of the automotive industry). The contradiction between production and demand were sensed in the fall-back of foreign trade relations, though contradictions between the solvent demand exceeded by product supply also appeared on domestic markets in a short time. Initial steps taken for the recovery of balance were targeted at first to curb production (stopping of conveyor belts, forced holidays, shortened working hours), fol-
lowed by cutbacks, to be followed in a very short time by social tension. All this was topped by – including the Euro – the hectic movement of exchange rates. International organisations – like the European Union – in the beginning were quiet observers of the developments, and, regarding the fact that the effects of the crisis were first appearing within the frames of national economies, these governments were the first to identify the need for immediate action – their solutions being similarly of national character. Several countries – over-censoring the EU regulations for support – saw the solution in the state-level furtherance (see: upgrading of capital stock) and the artificial vivification of demand. In order to achieve this

Source: European Commission - Interim forecast February 2010

**Figure 1. Real GDP growth rate in the EU countries (percentage change on previous year)**

![Real GDP growth rate in the EU countries](image1)

Source: European Commission - Interim forecast February 2010

**Figure 2. State income and expenditure in ratio with GDP in the EU27 countries, in 2008**

![State income and expenditure](image2)

Source: EUROSTAT database, calculations of author
taxes on consumption were toned down (see: UK), or the extension of state support for purchases (see: Germany).

For other countries – due to previously agglomerated indebtedness and various other reasons – this tool was not available, moreover, as a result of the deteriorating financial results and dwindled revenue income they were forced to introduce robust steps in cutting back expenditure as a whole (see figure 2).

As a natural consequence, the relinquishing from taxes, and the increase of the state support against budget, budget deficit and with their accumulation state debts scampered. Relatively quickly it became obvious that the effects on fiscal policy are far from being temporary, and can be handled within national frames for a transitory period only.

The majority of the EU member states launched the modernization of the common charge cost systems a long time before, however, whereas the earlier programmes were based on concepts “rooted in recognition”, those corrections aiming at extenuating the negative effects of the economic crisis can rather be considered as ones based on short term considerations brought under pressure.

The concepts evolving from the second part of the 90s, based on recognition and aiming at the modernization of the taxation system were in the first place serving the idea of giving an impetus to economic outputs, and a more even distribution of burdens (to reorganize tax burden from those with lower incomes onto those within the higher income bracket), and the steps very strongly identical can be put into 6 groups [Sanford 1993]:

a) the depression of increasing tax avoidance (wickets) and tax fraud; and the expectable improvement of tax morals;
b) the *mitigation of the relatively high taxation rates*, which have a counter
effect on justice, regarding that those in the higher income bracket can more
easily avoid taxes through a better knowledge of the regulations;
c) through a revision of the tasks placed on the state the desire was to *limit the size of the public sector* (see the gradual increase of tax and revenue income measured in relation to GDP);
d) it was planned to ensure the distorting effect of *inflation* through the 'maintenance' of the levels of taxes, regarding the fact that inflation, prevailing in a wide range has the objectionable consequence that un-indexed (valorised) tax systems re-group incomes in favour of the state (budget);
e) due to *internationalisation of players in the economy* the individual countries
have to comply with global trends and when formulating the characteristic features of the functioning of their tax system, countries have to consider practices of other states;
f) in the interest of the development of relations within the community and the
minimization of effects curbing the market – besides respecting the national sovereignty – *regulations of common charge costs have to be placed on an identical theoretical basis*, or rather in the case of taxes on international shipments the pace of harmonization has to be speeded up.

The concepts that evolved from the mid-90's were based on the idea that in cases
when major changes take place in the structure of the economy, in the inter-relation
of the branches of production, in the methods of production and marketing and in
consumption, agglomeration and the employment structure of the population, then
the basic components of the central economic regulatory system – within this the focal points of common charge costs, tax bases and measures and the rules of procedure – have also got to be modified.

However, any change taking place in the system of common charges is the source
of endless clashes of interest, regarding that the functioning of taxation systems touches upon several theoretical questions, and it can result in a basic rearrangement in the positions of players in the market. The pros and cons concerning modernisation can be grouped into categories based on their symptoms:

- *Those on the side of social optimum*, who observe the practice of changing the
  common charge cost system from the point of view of all concerned and not
  subdued to partial interest;
- The one *built upon political philosophy* – to vindicate political ambitions
  and/or increasing chances at times of elections;
- *Ambitions concentrating on rent seeking*, which typically represent partial inte-
  rests and are of ad hoc nature – and disregard contexts of the macro economy.

Posteriorly evaluating one has to state that those concepts for the modernisation of
the taxations system that were based on recognition – within them opinions urging
the ones related to community harmonisation – did not receive the necessary sup-
port, and as a result, instead of the sonorous reforms we had to be satisfied with cor-
rectional steps on a much smaller scale, which had far less significant effect on a
social and economic level.

In the lack of social and economic support corrections to a minor scale took
place in the majority of the countries of the EU-27, which, *on the whole did not*
reach the critical mass, and to which the tax burden calculated in ratio of the GDP, or the distribution of the burden could have been modified in merit. The consequences are widely known: the stagnation of economic results, the deterioration of employment rates, stronger social tensions, the existence of deficits in the budget jeopardizing the pact on stability and development and the lurch of the common money.

The world economic crisis in 2008 – comparable to an earthquake (which can be called by various names depending on one’s temperament, as the crisis of financing, monetary crisis, economic crisis, crisis of modernisation, crisis of model) has resulted a basically new situation in public policy, and has not left the common charge cost system untouched either:

1. Decrease of GDP, deteriorated results, termination of companies, cessation of workplaces, decrease in national incomes;
2. The mitigation of the negative influence of the economic crisis on a state level induced intervention on that level – which, in the lack of own resources – went together with the mobilization of external sources. This, however, naturally resulted in the growth of internal and external debts;
3. Debt is protracted tax that has to be paid back following stabilisation, in other words the tax policy in the years following stabilisation and the level of tax burden measured in relation to the GDP move along a pre-determined direction (the tax burden of today, in lack of agreement between the generations – cannot be shifted over to the forthcoming generations).

All in all, in the securing of the balance of the state budget tax and revenue incomes were valorised, and against the hoped mitigation of common charge costs – due to regulations brought under pressure – it is a relatively and permanently high level that will prevail. This does not mean though that a structural modification in the tax and revenue charges cannot take place, on the contrary, this is point-blank desirable, but the burden as a whole – until the catching-up with the growth trend before the economic crisis – can hardly be lessened.

Source: EUROSTAT database, calculations of author

Figure 4. Tax and revenue income in relation with the GDP in 2008
The size of tax and revenue burden is usually measured in a percentage ratio to the GDP, so based on the average of several years – we can differentiate countries with high, average and low tax burden.

a) **Countries in the high revenue bracket**: Denmark (48.0%); Sweden (46.9%); Belgium (43.7%); Finland (43.1%); Austria (42.6%); France (42.5%); Italy (42.5%)

b) **Countries in the average revenue bracket**: Hungary (40.1%); Germany (39.3%); Cyprus (39.0%); Netherlands (38.5%); United Kingdom (38.0%); Slovenia (37.0%); Portugal (36.5%); Czech Republic (35.8%)

c) **Countries in the low revenue bracket**: Poland (34.1%); Malta (34.0%); Bulgaria (32.9%); Spain (32.8%); Greece (32.3%); Estonia (31.8%); Lithuania (29.8%); Ireland (29.0%); Slovakia (28.8%); Latvia (28.6%); Romania (27.9%).

The tax and revenue burden measured in percentage ratio to the GDP is a telling figure, but it does not represent how much each country's budget depends on the realisation of the tax and revenue income. **This area is revealed by the ratio of the tax and revenue income within the budget incomes**, and this also indicates how much a nation – without the changes in the expenditure side – can change the rates of tax and revenue with no consequences to follow.

Based on the figures of 2008 – depending on the ratio of the tax and revenue income within the budget incomes – the EU27 countries can be categorized in several groups:

a) **Countries strongly dependant on tax and revenue income** are those, where within all budget income their ratio is 90% or more (see: Italy, Germany, The United Kingdom, Cyprus, Belgium, Slovakia, Spain);

Figure 5. The ratio of tax and revenue income in all state budget income in the EU27 countries in 2008

Source: EUROSTAT database, calculations of author
b) **Countries dependant on tax and revenue income to a medium level** are those where within all budget income their ratio ranges between 85–90% (see: Austria, Hungary, Czech Republic, Lithuania, Slovenia, Denmark, Romania, France, Poland and Estonia);

c) **Countries relatively less depending on tax and revenue income** are those where their ratio within all budget income does not reach 85% (see: Sweden, Malta, Portugal, Bulgaria, Ireland, the Netherlands, Latvia, Finland and Greece).

The figures in 2008 – as a whole – show that in nearly two thirds of the EU countries the budget execution is strongly related to the tax and revenue income, that is, the effectiveness of the common charge cost system very important* The efficiency of operation depends on a lot on the conditions. Such is, among other things the index of tax and revenue burden in relation to GDP, the quality of services provided by the state, the size of international relationships, the calculability of the legal environment, the practice of voluntary compliance etc.

For handling the deficit in the budget there are more than one methods in theory: one of them is to keep the tax and revenue burden as percent of the GDP on a high level; another – through exploiting the possibilities hidden in international cooperation – is the improvement of the efficiency of common charge systems; the third is the gradual inflating of the budget deficit. None of the methods are perfect, or rather none of them promise a spectacular result in the short run.

* The author deals with the measuring of effectiveness of common charge cost systems in his study published in *Public Finance Quarterly*, 2010/1.

![Figure 6. Shift of Tax to GDP ratio between 2000 and 2008 in the EU-27 countries](image_url)

Source: EUROSTAT database, calculations of author
From the point of view of creating the optimal level of common charge costs the countries of the EU 27 squirm in the trap of “Catch 22”: on one hand, in the interest of improving competitiveness in the market for companies the deductions in ratio with the GDP should be reduced, but it contradicts with the deficit developing in the budget, and the duties in debt service. Naturally, another solution could be the curbing of state expenditure but this would not result in a spectacular cut back of debts and the narrowing down over again of prosperity services (the derogation of acquired rights) could go together with unpredictable social effects.

Based on Figure 6 it can be stated that in years 2000–2008 in nearly two thirds of the EU27 countries the level of tax and revenue burden was remitted, whereas in somewhat more than one third it increased. Regarding the fact that in the “old member countries” providing nearly four fifth of the economic performance the modification in tax and revenue burdens was relatively insignificant, on the whole the average tax burden in the countries of the EU27 was hardly modified. In order to realistically qualify the situation it has to be disclosed that the tax burden in the main competitor countries, the United States and Japan is lower by 10–11 percentage point and that of China, the new competitor that strives to acquire the market positions is 20 percentage points lower than in the countries of the EU27. In other words it means that for the countries in the EU to remain a competitor on the market solutions are a requirement to boost integration performances, and to ease the burdens in general for the competing sector.

CORRECTIONS TOUCHING UPON THE TAX AND REVENUE SYSTEM IN THE COUNTRIES OF THE EU27

The main pursuits of those programmes aiming at correcting the tax and revenue system due to the economic crisis in 2008 as a forcing circumstance (which basically are of structural nature and leave the tax and revenue burden related to the GDP untouched) can be summarized in the following:

- The modification of the structural characteristics of tax and revenue burdens within the taxation system (see VAT, green taxes) and also the expansion of the role of indirect taxes;
- The broadening of the basis for personal and company income tax;
- In the case of private individuals it is for inciting productivity and for companies to fortify the ability to attract and keep capital the lowering of keys in income taxes;
- A gradual decrease in the tax and revenue burdens on labour in order to improve international marketing abilities and indices of employment;
- The simplification of tax procedures and decreasing of administrational burdens;
- The improvement in the efficiency of the operation of the tax administration, to minimize the gap between the taxes collected and achievable.

Above the general characteristics it is worth to present some of the efforts of individual member countries reflecting special features:

a) Germany deserves special attention, as preceding the turn of the millennium a 7-year programme for economic expansion has been elaborated with a sched-
ule to completely modernize the tax system with an annual breakdown of the period. Within this frame the PIT marginal keys are mitigated (from 53% to 42% and from 25.9% to 15%) and those of the social tax (from 40% to 25% and later to 15%), and the cutting back of the burden on labour. The 38% property tax was ceased and the modernization of autonomous taxation was launched. Against the positive changes huge debate was generated on the introduction of taxation on portfolio-investment (10%), that of compulsory minimal tax for companies, the generalisation of tax on capital income, and the increase of the normal key of 16% of VAT to 19%, together with the initiative role in the spreading of green taxes;

b) Spain is widely known as a country with low taxes, and within this the level of direct taxes lower than the EU-average has a decisive role. The changes touching upon the system of common charge costs have two directions: on one side they relate to income taxation (the increase in the number of tax bands, at the same time the widening of the sphere of allowances, in social taxation the lessening of company burdens; on the other side the increasing of the normal 16% VAT key to 18%. As from an international point of view a remarkable step is the decentralisation of state administration, and in harmony with this the modification of the ratio of regional levels in taxes (the local proportion of receiving the income tax rate is 33% out of PIT; 35% out of general income tax and 40% out of VAT); just as well as an also courageous step as it looks is the legal guarantee for these ratios;

c) Ireland – the system of common charge costs – earlier the most dynamically growing and most inventive country in the community – is undergoing an endless transformation. The Irish economy earlier belonged to those with a low taxation (12.5% of social tax, the large preferentialism of the processing industry and the wide application of allowances of offshore nature), however, in parallel with the deterioration of budget indicators strict measures were brought. The normal VAT rate was increased by 0.5%, and the upper rate of PIT was raised from 41% to 46%. In order to improve the budget balance further measures to curb expenditure were brought to light, such as the limitation of expenses in the public sphere by 5–15%, the retirement age was lifted to 66 years and decision was made to stop large scale investment projects;

d) Sweden’s characteristics differ from those of other EU-members in various ways. Due to the 1991 taxation reform upgraded at the turn of the millennium the consumption taxes and those on labour are the highest among the members, and a dynamic growth can be seen in the tax burden on capital incomes in the past few years. As a consequence of all these the welfare society is encumbered with significant tension (the high level service cannot be financed from the income from contributions, however, tax burdens cannot be further increased without risking the competitiveness), meanwhile the securing of conditions for sustainable development require further investments. The now shaping changes in taxation – referring to the need for competitiveness – count on the curbing of burdens on employers and instead compensation will take place by the further lifting of taxation on activities representing environmental hazard and the higher contributions paid by employees.
e) **France** is in the middle of a battle on two fronts, because the improvement of competitiveness would require the mitigation of burdens on companies, however, the increasing deficit in the budget indicates the need for further increasing taxes. In the years between 1995 and 2000 the incomes were more and more drained, social tax received a surtax of 10%, and the VAT rate was lifted temporarily from 18.6% to 20.6%. Within the French economic system a tax modernisation programme expanded for several years was accepted after the millennium. Its major elements are: the normal rate to VAT was reduced to 19.6% (in compensation revenue tax became higher), the tax burden on labour was decreased (with special regard to the low income band and those with the highest qualifications). As a result of the economic crisis new reform programmes have been launched (in the first place to ease the burden on enterprises), burden on live labour has been released, and in order to fortify willingness in enterprises the system of local taxation was corrected.

f) **The Netherlands** has a somewhat lower tax burden in comparison to the countries in the EU15, therefore the changes introduced following 2008 mean smaller corrections as against a comprehensive modernisation scheme. The changing of the PIT and the social contributions was aimed at the easing of tax burden (the lowering of the keys to the highest tax bands and the broadening of the tax-free band), and the lowering of the social tax key from 35% to 30%. An increase of the normal VAT rate from 17.5% to 19%, the increase in the property tax behaving local administrations, and – alike in other countries – the higher environment related taxes however have a counter-effect to the earlier.

g) **Greece** continues with a practice completely different from the previous examples, that is, from the point of view of the functioning of the common charge system can be considered as ‘still waters’. The tax burdening in ratio with the GDP – ranges between 32–33% on an average of the past few years, despite the fact that from among the member countries the deficit in the budget is the highest, or rather the consolidated debt amounts to the value of the annual GDP. One does not need special courage to express that this will not remain tenable in the long run, and the planned steps for 2010 – namely the reduction on health insurance expenses by 10%, the freezing of salaries above 2 000 euros for public servants, the introduction of taxation on capital income and the introduction of tax on property with high value – will be sufficient only for symptomatic treatment.

The overview of national reforms is far from complete, but it characterizes the steps for correction – often even of opposing directions. The hind thoughts remain not questioning the philosophy of a unified market, but it is hardly disputable that the actual steps made are based on short term concepts and serve national interest in the first place.

Meanwhile a growing number of experts give voice to the opinion that without the nearing of tax and contributions systems, operating as a tool for co-operation, the relations among the member states will take unwanted direction, and what is more, without moving towards fiscal federation the monetary federation can be endangered, too. Based on all these and the discretion of strategic interests the
member countries should, in the form of bi- and multilateral adjustments, take steps towards a gradual harmonisation of common charge system regulations.

COMMUNITY LEVEL TAX HARMONISATION – BICKERING APPROACH

The content of the reforms formulating within the national frames are deeply touched upon by the community programmes just as well, despite the many undecided questions. It is by no means all the same whether a federative organisation will be created with the participation of the member states or the other organisational theory, the federation of national communities will operate. Serious changes can derive from the fact how many members the monetary union can enlarge to, or rather whether this union can be followed by a fiscal federation. If yes, then in the interest of the operability of the fiscal federation a fastened tax harmonisation will be unavoidable, moreover, in this case not only the structural composition of the tax systems (the unionisation of the pretences of common charge varying from 42 and 240 at the moment) but the definition of tax bases on identical theoretical background has to be prepared.

Table 1. List of VAT rates applied in the Member States, 2009

<table>
<thead>
<tr>
<th>Member States</th>
<th>Super Reduced Rate</th>
<th>Reduced Rates</th>
<th>Standard Rate</th>
<th>Parking Rate</th>
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<td>United Kingdom</td>
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Source: European Commission (Situation on July 1, 2009)
It is well known that the EU does not have income deriving from direct taxes, or rather the gross value of income rightful for the community, is a fraction in percentage of the gross GDP figure in the EU27 countries. (As indicated earlier, on the level of member countries national budgets can possess 44–46% of the GDP, at the same time the budget of the European Union, in relation to the gross GDP amount of the members remains under 1.00%.) The contradiction is even larger if we consider that the member countries delegate an increasing number of tasks and duties to the EU, and intend to finance them to a lesser extent.

In preparation for the new budgetary cycle (2014–2020) contradicting concepts are being born among the EU member states:

- The representatives of countries being in the position of net payers represent a standpoint where the duty of paying 1.00% of the total GNP value should be reduced;
- At the same time those representing the support for deepening integration would find the increase of the contribution necessary, and they say that the duty of paying 1.00% of the total GNP should be increased by multiplying it with 1.5–to 2 in several stages.

It is almost beyond dispute that the EU has arrived to a crossroads. In case the community considers the Treaty of Lisbon as still prevailing and wishes to close up to the leading countries of the world economy, then it has to speed up economic growth, has to improve the competitiveness of market players, has got to care for increasing the number of workplaces and must not relinquish the gradual falling into line of underdeveloped regions. Within the realisation of community targets a major role has to be played by the operational tax and revenue systems functioning as indirect regulators, and when modernising them attention must be paid to let them serve both community and national interests in parallel.

Source: EUROSTAT database

Figure 7. The changes of corporate tax rates between 2000 and 2008 in the EU-27 countries
The modernisation process of common charge costs formulates serious challenges for the community as well as for the individual members:

- The ratio between tax income as against the GDP is high, and in comparison to other competitors the indices related to the labour force are especially disadvantageous (see: employers’ burden on labour income, or rather the deductions touching on employees);
- If the EU intends to fully validate the principles of freedom then the difficulties curbing the functioning of unified market have to be completely removed (see: the differences of taxation in tax base, tax levels and regulations of proceedings), and instead of fortifying internal competition external competitiveness has to be improved;
- The acclimatisation of Euro as common currency and thus the enlargement of the Euro-zone has created a new situation from a number of aspects, among them the direct commensurability of such indicators as economic performance, profitability indices and tax burdens (see: the strengthening of efforts to minimise the differentiating effect of deviances from average);
- The operation of companies bridging over national borders makes it obvious, that the individual countries are able to protect their interests against globalisation exclusively through the improvement of international co-operation and the unifying approach of regulations on taxation.

The ‘demand for harmonisation’ appeared as early as in the Treaty of Rome for a community level common charging, however, its full implementation can be the result of an organic development alone. Today the vindication of national independence and responsibility are in the forefront of interest, but the first signs of needs for harmonisation have appeared and are being fortified. Proposals concerning changes hardly touch upon the current cycle, however, the preliminary skirmish for the shaping of strategic goals, the prioritised community programmes and the mechanism of financing for the budget period 2014–2020 have already begun.

a) It has to be worded as a demand for the new budget period that the system of goals and appliances be harmonised, in other words a financial background has to be created for the backing of community level programmes – one that is tailor-made for the feasibility requirements. This can partly be implemented by the raising of the membership payment responsibilities, partly by establishing a new type of tax based on a community decision and serving community purposes and partly, through the fortification of international co-operation, by the improvement of the efficiency of common charge systems;

b) The VAT system belongs to the so called harmonised forms of common charging, however, as a result of the “budget interest” of individual member states a final agreement could not be reached. The new harmonisation has to include normal and preferential taxation categories, a more determining approach of taxation rates, the theory of paying VAT (see: switching over to accounting in the country of origin), and the regulations of operation. The fine-tuning of regulation originates from the need that the different VAT rates have different influence on prices, which creates a difference in the competitiveness of the products and services (see Figure 6). A further contradiction is that based on the VAT calculation system of the country of destination the VAT to be paid
after the purchased product/service is calculated with the VAT rate of the country of destination and be paid into that country’s budget. Without a levelling mechanism it is especially disadvantageous for the exporting countries, but at the same time makes the defining of the VAT base of the “consumer country”, serving as the basis for the community payment, also irrelevant.

c) Changes in merit has to be reached in the taxation of companies organised on a network principle, stepping over national borders, with this improving the transparency of common charges, the tax base being calculated on unified principles, lessening the administrative burdens, and with the strengthening of the control-mechanism narrowing down the possibility of income and cost transferring (see Figure 7). The basic principles have been shaped, now it is the turn to put it in practice.

d) Labour force mobility in the EU27 countries has significantly grown, which goes together with the more urging need of community level harmonisation of social security systems. Old regulations are sufficient for the judgement of paying contribution fees and rights for services to an ever smaller degree. It is especially true for the practice of payment of pension contributions (in some countries the pension contribution paid in one’s active working life is exempt from PIT, whereas old age pension is subject to PIT, in other countries the situation is the other way round), which can reach final settlement through the harmonisation of procedural regulations alone.

If we seriously intend to enjoy the benefits stemming in integration, then very consequently we have to stand up against the phenomena jeopardizing the effective operation of the unified market, or rather in order to let the advantages be enforced the operational principles of the tax and contribution system ensuring 90% of the budget incomes have to be harmonised. It has to be identified that safeguarding against the processes of globalisation, or protecting interests successfully against multinational companies developing on a network basis stepping over national borders can only be achieved by strengthening co-operation among member states. It is high time to be confronted by the fact that the fortification of international co-operation is not a sacrifice, on the contrary: it is a national interest.

REFERENCE

1. INTRODUCTION

Employing a great majority of citizens living in the developing world, small and medium sized enterprises (SME) are a key engine of poverty reduction and economic growth. For millions of communities still struggling to develop, SME are often the only source of income and economic activity. These small firms provide far more stable employment and growth than their large and often foreign owned counterparts, providing a source of insulation from the turmoil of a country’s transition and development. The importance of SME is particularly evident in Hungary, where the sector accounts for 99.8% of all enterprises and employs nearly three-quarters of the population.

If SME are the engine of Hungary’s future economic growth, then state of the art technology and the ability to access finance are necessary to fuel this potential. Financial services, ranging from simple bank loans to more complex factoring and leasing mechanisms, allow small entrepreneurs to finance high return investment projects, to pursue costly yet critical research and development activities and ultimately, to expand their businesses. An abundant supply of financial services ensures that sufficient credit is available for the entry of new firms with innovative and growth inducing products and the purchase of the newest technologies to remain competitive.

The authors would like to thank all the SME who participated in this study and all others that contributed. Specifically, Nagy would like to thank his students at Corvinus University of Budapest, who have provided great help. Maroshegyi would like to thank the Hungarian Fulbright Commission for providing the opportunity to conduct this project. Many thanks must also be given to Fr. James Wiess at Boston College, the honorable Hajdu Laszlo, Professor Gabor Kezdi, and Dr. István János Töth.
Given this potential, the European Union and the Hungarian government have thus placed SME near the top of the ambitious Structural Funds development program. Among the many mechanisms established to support the development of Hungarian SME, individual programs to enhance technological development and access to finance are at the core of the government’s SME strategy. Within the Economic Operation Program (ECOP) of the initial 2004–2006 programming period, priority access 2.1 was established to support the technological development of SME. The main objective of priority access 2.1.1, was to “increase competitiveness, to improve SME market positions, to modernise the SME’s technological and infrastructural capability and increase their capacity for innovation.”

In light of Hungary’s chronic financial constraints, the Hungarian government earmarked HUF 200 billion, or USD 1.02 billion for a New Hungary Enterprise Promotion Program in 2007. Nearly a billion of the USD 34 billion allocated to Hungary in the 2007–2013 EU Structural Fund programming period were channeled into JEREMIE, an initiative to “enhance SME finance” JEREMIE works to integrate various credit mechanisms into one development program, and provides low cost loans, credit guarantees and venture capital to SME throughout Hungary. The Structural Fund Program, and in particular its JEREMIE initiative, has had mixed results, sparking a continent wide debate on the effectiveness and impact of EU development efforts.

ECOP 2.1.1 and JEREMIE represent two very distinct and unique mechanisms to promote SME growth. While ECOP 2.1.1 relied upon traditional one off grants distributed by the government, JEREMIE engages and leverages the financial sector, utilizing EU grants to attract and raise private capital through co-financing requirements and provides a number of low cost financial instruments to SMEs.

Given the size of both these programs, and the important role of SME in Hungarian economic growth, it is crucial to investigate the effectiveness and impact of the respective programs. Yet, despite the importance of these programs, very few comprehensive policy evaluations of the Structural Funds are available to the public, especially in English.

Early impact evaluations of the 2004–2006 programming periods fueled skepticism among experts and recipients about the effectiveness of the structural fund program. Two separate evaluations of the SME modernization program conducted by KPMG and the Hungarian government found significant deadweight loss – SME would have implemented nearly 70% of their investments even without EU funds (Béres 2009).

On the other hand, many experts and recipients argue that on the whole, the Structural Funds have boosted the Hungarian economy and its small businesses, particularly during the severe financial crisis that continues to ravage the country into 2010. The same business owners that criticize the EU tender process admit that EU funds have contributed to their firms’ technological development, boosted competitiveness and improved sales.

The EU has established a number of economic indicators to measure effectiveness, both on the program and project level. The analysis of the State Audit Office

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1 ECOP 2.1.1. call for applications is available (in Hungarian) at the NDA’s homepage www.nfu.hu
of Hungary and some other independent researchers, however, show that the
established system of indicators does not function properly, as it cannot reliably
measure the effectiveness and the results of the projects and programs. This weak-
ness and deficiency of the indication system makes clear the necessity of indepen-
dent, academic research, to measure the effectiveness of certain programs or pri-
orities.

To fully understand the dynamics of the Structural Funds, and the impact of
ECOP 2.1.1 and the JEREMIE program in particular, it is crucial to integrate robust
empirical work with detailed qualitative fieldwork.

1.1. METHODOLOGY

This paper aims to determine both the efficiency and impact of the EU Structural
Funds on Hungarian on SME growth and access to finance.

In order to capture the firm level experience with the impact of the Structural
Funds program a survey was distributed to ECOP 2.1.1 recipients from 2004–2006.
Two separate surveys were conducted at different times, the first to examine the
efficiency of ECOP 2.1.1 and the other to measure the impact of EU-funds on SME
access to finance.

Both surveys utilized the same set of 2889 SME recipients of EU funds from ECOP
2.1.1.2 The first survey randomly selected 1275 SME and was conducted by Sándor
Gyula Nagy and a team of Corvinus University professors during the spring of 2009,
the height of the Hungarian financial crisis. The second survey was distributed to
223 randomly selected recipients in the spring of 2010 by Christopher Maroshegyi.

The qualitative portion of this study was conducted with relative success, despite
the hesitancy of many SME to respond to both surveys. Lack of government cooper-
ation and a dearth of data, however, prevented a robust analysis establishing causa-
tion, or even correlation, between increased JEREMIE funds and loans extended to
SME in 2007. The ongoing financial crisis, which began the same year JEREMIE was
announced, paralyzes any effective aggregate level analysis. Instead, this study was
forced to rely on broad, aggregate level data and trend analysis.

Finally, this paper provides a set of recommendations to improve future SME pro-
grams and the effectiveness of JEREMIE.

2 The target group of ECOP 2.1.1 is: micro, small and medium-size enterprises (co-ops, one-person com-
panies, corporations and so on) based in Hungary. The potential financial support ranged from a min-
imum 1 million HUF (~3800 EUR) and a maximum 25 million HUF (~95.000 EUR), depending on
whether the project included infrastructure building, expansion or renovation. The proportion of
financial support (related to the project's total cost) was between 35% and 50%, depending on the
region where the project was implemented. Eligible costs in the application were the acquisition of
technical equipments and appliances (including transport, training and installation), expansion or ren-
ovation of infrastructure, further acquisition of technical know-how and license, some kind of limited
cost of personal, non-refundable VAT and a Hungarian specialty: the non-refundable VAT charged on
that part of project which received financial support from the EU-funds because of the VAT scaling reg-
ulation of the Hungarian Ministry of Finance (till 2006).
2. SURVEY OF ECOP 2.1.1. RECIPIENTS

Empirical data, particularly on the firm level, pertaining to the Structural Funds is notoriously difficult to access in Hungary. Lack of data or the sheer lack of cooperation on the part of the Hungarian government has impeded the efforts of academics and this researcher alike and poses the single great problem to independent program evaluation in Hungary. Initially, then, we were forced to rely solely upon public databases hosted by the National Development Agency and MAG Zrt. This was later supplemented with data from the online database of the Justice Court of Budapest and the Information Service of the Ministry of Justice. We found 2889 SMEs which won EU-money from the ECOP 2.1.1. application, from which we have chosen 1275 on a random basis to contact. In addition, we included every winner with more than one project. We contacted these SME through telephone, fax and/or email, and asked them to participate in our research by filling out an online survey anonymously. Thanks to these methods, we received 148 answers.

In terms of those who responded to the survey, companies from less developed regions were far less willing to respond to the survey. The same tendency can be seen in the case of micro-enterprises, who are less developed than their medium and large company counterparts. Micro-enterprises are underrepresented in relation to their actual proportion of overall grant recipients. In the research, were necessary, we filtered out the distortion of the answers with the method of statistical weighting. So we can say that the results of the research on the target group are statistically relevant regarding the patterns of region of origin, size of the enterprise and amount of money won.

Unfortunately, this study was unable to establish a control group to determine what the ratio among the losers is, but it is still obvious, that the vast majority of the SME have resorted to the service of an application writer or adviser and paid a considerable fee for it (Table 1.).

Table 1. Did you utilize the service of a grant application consultant? If yes, how much did you pay?

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>91.22%</td>
</tr>
<tr>
<td>NO</td>
<td>8.78%</td>
</tr>
<tr>
<td>fee proportional to the amount won</td>
<td>5.57%</td>
</tr>
<tr>
<td>average fee in HUF</td>
<td>616,000</td>
</tr>
<tr>
<td>average fee in EUR</td>
<td>~ 2,200</td>
</tr>
</tbody>
</table>

2.1. IMPLEMENTATION OF THE PROJECT

25.68% of the respondents did not have any kind of difficulty during the project implementation, while three-quarter of SME have experienced some kind of problem (and more than one: in average a recipient experienced 1.2 problems during project implementation, see Table 2.).
Table 2. What kind of difficulties did you encounter during the project implementation?

<table>
<thead>
<tr>
<th>Difficulty</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Preparing the project progress reports</td>
<td>54.55%</td>
</tr>
<tr>
<td>Obeying the environmental standards</td>
<td>3.64%</td>
</tr>
<tr>
<td>Obeying the EU transparency standards</td>
<td>11.82%</td>
</tr>
<tr>
<td>Acquiring the collateral needed to receive the EU-funds</td>
<td>32.73%</td>
</tr>
<tr>
<td>Other</td>
<td>17.27%</td>
</tr>
</tbody>
</table>

The results clearly show that the biggest difficulty was preparing the project progress reports, which requires high administrative efforts. The second biggest problem was acquiring the collateral (bank guarantee) needed for the EU-money. Among the other difficulties, inflexibility, excessive bureaucracy, slow administration, long delays of the intermediate body and their failure to maintain various deadlines were mentioned.

Nearly 30% of the winners could not implement their project according to the originally planned timetable and budget. This could be regarded as a good result, but taking into account that this ratio means more than 850 SME did not implement their project according to original plans, this ratio is not so successful. Amongst the others the continuous delays, bureaucracy and the special Hungarian VAT-reclaim regulations were mentioned (see Table 3.).

Table 3. Were you able to implement the project with the originally planned timetable and budget? If not, why?

<table>
<thead>
<tr>
<th>Problem</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Delay in the signing of the contract</td>
<td>67.44%</td>
</tr>
<tr>
<td>Slowness and difficulties of the construction and the procurement</td>
<td>27.91%</td>
</tr>
<tr>
<td>Slowness and difficulties of acquiring the collateral or the co-financing</td>
<td>11.63%</td>
</tr>
<tr>
<td>Others</td>
<td>11.63%</td>
</tr>
</tbody>
</table>

Among the micro enterprises the number of projects experiencing the above mentioned problems was 25% higher than the average. In the less developed regions (as North- and South-Plain, North-Hungary and South-Transdanubia) the final beneficiaries signalled 20% more difficulties, than the average. This show, that the smaller companies and enterprises in less developed regions can handle the project management problems much harder.

13.51% of the respondents signalled that they couldn't use the entire amount of money awarded for the project. The causes for that were: changing of exchange rates, decline of prices of acquired equipments or modification of the project.

56% of the respondents indicated that they had some kind of transaction cost related to the project which were not eligible to be covered different reasons. On average 6.1% of the project cost had to be financed by the SME, above and beyond the co-financing required. These costs were:

- Cost of administration and management 22.84%
- Non-refundable VAT 57.27%
- Cost of financing the project (e.g. cash-flow credit) 10.46%
- Others 9.43%
54% of the respondents signalled that the transfer of the EU-money did NOT follow the operative legal regulations (by their opinion). The (presumptive) causes are:

- Unjustified completion of documents 32.50%
- Delays caused by the bureaucratic system and mechanism of EU-funds 41.25%
- Both together 22.50%
- Others 3.75%

2.2. THE RESULTS OF THE PROJECT

The results showed clearly, that the global and Hungarian market situation has worsened for all SME, and the EU-money was the only factor, which has (on average) increased its market position against all problems and transition costs. This is a bit surprising but very important finding of this research, however we must note that the answers were based on subjective business sentiments.

After statistically weighting the results we have got the following result: 41.28% of the final beneficiary SME were unsatisfied, and think it was not worth winning and implementing the project, 90% of these respondents do not want to apply to any EU-funds in the future. The other 58.72% of the SME were satisfied, but nearly 50% of them do not want to go through the same bureaucratic and administrative measures to win and implement another EU-project, and are not planning to apply in the foreseeable future.

It is interesting again to highlight the regional differences in the results. SMEs in Central- and Western-Transdanubia and in North-Hungary were more likely to think it was worth applying, as compared to SME in Central Hungary. This result shows that in less developed regions the enterprises regard the possibility of EU-funded project more attractive than in the more developed Central Hungarian Region, even if they have problems and difficulties with the financing and with the administrative procedures. The companies in Central Hungary regard the EU-funds less helpful and can use it less perhaps because they are more developed and because of the lower intensity of financial support (related to the project's total cost).

One third of the winners has applied (or was planning to apply) for new projects since winning EU-money from the ECOP 2.1.1. The average time between the winning and our survey was 4.5 years. The causes for applying again were: need for further development or for maintaining jobs, while some signalled potential loss of competitiveness in the event of not applying (because the competitors were applying for and winning EU-money). Among the motives for NOT applying are the usual: high bureaucracy and administration, problems with co-financing and cash-flow financing, and the falling demand for industrial goods caused by the recession.

52.03% of the SMEs experienced some kind of synergic effect due to the project, for example purchasing new technology or any kind of new construction or renovation works.

To the questions “In your opinion, is the direct influencing of decision makers necessary to win a project?”, the answers are in accordance with Corruption Perceptions Index of the Transparency International. The SME are rating the system
as susceptible to influence, meaning “if one has connections to the decision makers, he has a better chance to win”.

2.3. EXPERIENCES IN NEW HUNGARIAN DEVELOPMENT PLAN

For the 2007–2013 financial period of the EU a new development plan had to be adopted following the EU regulations. The New Hungarian Development Plan (NHDP) is much more complex and has much more funds available than the 2004–2006 period. The entire NDP 2004–2006 had about 3 billion EUR at disposal. The NHDP has about 24 billion EUR, which is about 3 billion per year. It has an Economic-development OP (EDOP), which in aims and means is quite similar to the ECOP of the first NDP. In 2007, it introduced a new application, the EDOP 2.1.1. which is (partly) the continuation of the former ECOP 2.1.1. SME application.

This type of application is the called “automated” application, which requires much less administration, its decision making is fast and mostly automated. How is that possible? To win the application the SME simply has to prove that it followed Hungarian law (paid taxes, employed legally, fulfilled the environmental regulations and so on) for two years, that it has a project within the financial limits of the application, and can account for distributed money with invoices on machines, equipments and so on. The eligible costs are limited to minimize bureaucracy and speed up pay-outs. The whole project evaluation system is quite detached so it keeps out corruption. Next to the apparent advantages, however, there are some disadvantages.

Together with two colleagues (Ms. Lenóra Répássy and Mr. Gábor Somody) we carried out a research based on interviews with application writers and advisers, with EU departments of commercial banks and with final beneficiaries of new EDOP 2.1.1. to highlight the strengths and weaknesses of this new application system, and to see whether the identified problems of the ECOP 2.1.1. of the first NDP were corrected.

Strengths:

- Simplified application procedure: the necessary paperwork can be done in two days. The biggest “challenge” is to acquire a precise price quotation for the equipments, which would be purchased in the project.
- Fast decision-making: the average time needed need to complete a project proposal and receive a decision is 3–4 weeks, making it the fastest application procedure in the whole system.
- Decreased bureaucracy and administration during management: the so-called project progress reports have been simplified, the indicator system is clear and can be fulfilled with reasonable efforts.
- E-application: from the handing in of the project proposal, through the project development reports till the financial monitoring everything is handled online.

Weaknesses:

- Unnecessary data-requirements remained: there are still some kind of data required during the project implementation period, which is regarded as unnecessary by our interviewees. For example paper used for copying, amount
of used water or electricity. Despite this, the data-requirements and administration are on a low, acceptable level.

- Real economic development effects are questionable: following the opinion of some experts the real economic effect of this application system has not been proved yet. Some said it is politically motivated to focus on rapid spending of EU-funds, which can be well communicated.

- Possibilities for evading contracted obligations: there are existing possibilities for evading the contracted obligations by the winners. Without giving ideas, one can identify two main ways of cheating:
  - manipulating the indicators (using legal or mostly legal ways)
  - targeted (sometime organized) theft of EU-funds (exploiting the eased conditions with a through of criminal acts)

These anomalies highlight the dilemma of the application system. Should the system regard all SME as potential criminals, and therefore the whole system should be over bureaucratized in order to avoid possible fraud, but also harden the life of “normal” enterprises OR should the system focus to ease the life of the SME and with it the life of potential criminals? The answers will diverge in different member states of the EU. In Hungary the system is making steps to the second version after failing in the first one.

3. JEREMIE IMPACT EVALUATION

Empirical data, particularly on the firm level, pertaining to the Structural Funds and JEREMIE is notoriously difficult to access in Hungary. Lack of data or the sheer lack of cooperation on the part of the Hungarian government has impeded the efforts of academics and poses the single great problem to independent program evaluation in Hungary.

As per EU stipulations, all recipients of EU-funds in Hungary have been listed on the NDA’s vast and often incomprehensible website. All relevant data is provided in Hungarian only – preventing English speaking researchers from outside of Hungary from conducting any review of the program. The NDA provides a number of quite powerful public databases on their website, include EUTER, a database which details implemented projects and project amounts on an interactive map of Hungary. Another powerful database allows a user to review the recipients of each Operative Program and Priority axis in any of Hungary’s 7 regions. To our dismay however, EDOP 4.1 – 4.3 was not included in the database, and no public records of the final beneficiaries of the JEREMIE funds are provided on the site.

3.1. EMPIRICAL EVALUATION RESULTS

This project has thus been forced to rely on a broad trend analysis examining the effect of JEREMIE’s announcement in 2007 and the level of total and SME loans extended. This broad analysis reveals upward trending levels of loans extended which was sustained through 2007 and 2008 despite the impact of the financial crisis on
monetary institutions. This may indicate that announcement of JEREMIE – and the promise of a massive influx of funds in the near future - provided confidence for financial institutions to continue their lending levels despite increased risks.

Table 4. JEREMIE Timeline

<table>
<thead>
<tr>
<th>Event</th>
<th>Time</th>
<th>Allocation, 2007–2013 (HUF Bn)</th>
<th>Actual Disbursement, as of May 2009 (HUF Bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venture Finance Hungary (MVZrt) is established</td>
<td>August 2007</td>
<td>200*</td>
<td>-</td>
</tr>
<tr>
<td>First Call for Micro Loan Tenders</td>
<td>October 2007</td>
<td>57</td>
<td>6.4</td>
</tr>
<tr>
<td>First call for Loan Portfolio Gaurantees</td>
<td>November 2008</td>
<td>1st micro-loan distributed</td>
<td>-</td>
</tr>
<tr>
<td>Launch of SME Program</td>
<td>November 2008</td>
<td>50</td>
<td>.654</td>
</tr>
<tr>
<td>Notification of Venture Capital Program</td>
<td>December 2008</td>
<td>35</td>
<td>0</td>
</tr>
<tr>
<td>Launch of SME Working Capital Program</td>
<td>January 2009</td>
<td>140</td>
<td>.147</td>
</tr>
</tbody>
</table>

*Start up capital originally allocated. Private and national contributions led to higher actual allocation when the separate programs were announced.

Table 5. JEREMIE Timeline (EDOP 4.1. Call to Tenders)

<table>
<thead>
<tr>
<th>Tender Name</th>
<th>Date Opened</th>
<th>Date Closed</th>
<th>Amount (HUF bn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GOP-2009-4.3</td>
<td>Feb. 23, 2009</td>
<td>April 6, 2009</td>
<td>30.5</td>
</tr>
</tbody>
</table>

Upon review, it is apparent that aggregate loans extended to SME peaked in 2008; the first year JEREMIE began distributing funds (see figures 1 and 2). This may in fact be traced back to the announcement of the JEREMIE fund and its various programs throughout 2007–2008, which totaled well over HUF 200 billion. Anticipating the quick distribution of loans, and especially portfolio guarantees, financial institutions may have been more willing to extend their current stock of capital to SME. The actual distribution of allocated funds has been painstakingly slow, however, and in the Q2 2009, only 9% of funds allocated for micro and SME loans were extended.

Overextended from years of blistering growth in aggregate loans to SME, faced with rising defaults and skeptical over JEREMIE delays, financial institutions significantly cut back on loans to SME in 2009. It is noticeable, however, that loans extended to SME fell at half the rate than for total non-financial corporations in 2009, indicating that JEREMIE funds may have dampened the effect of the crisis for SME.

While the impact of JEREMIE may not be reflected on the aggregate level, one industry expert believes its positive impacts on the financial markets can nonethe-
less be seen as early as 2007. Dr. Jozsef Berecz, Managing Director of DBH Group investment – a recipient of HUF 3.5 billion in JEREMIE venture capital funds – noted that many financial institutions began supporting start-ups in 2007 to prepare for upcoming JEREMIE tenders. In one project, two firms, Inostart and Valdeal, raised HUF 500 million in public and private equity to provide technological and financial support for start-ups with the hope of preparing them for JEREMIE funds in the future.3

![Figure 1. SME Access to Loans](image)

![Figure 2. Aggregate Loans Extended](image)

To Berecz, however, most of the positive impacts of JEREMIE will only be seen after 2013. Berecz considers JEREMIE a 'bell-weather' initiative, and believes that if the program succeeds, it will change the culture of financial institutions in Hungary. Were JEREMIE to succeed in extending affordable credit to SMEs while still affording financial institutions a healthy profit, banks will see a positive track record and

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3 Indeed, the purpose of the following chapter is to empirically test these claims and establish a correlational link between the announcement of JEREMIE and an increased volume of loans to SME.
begin to expand their SME operations. Firms like DBH have a proven track record both abroad and in Hungary, and Berecz predicts that the same profitability and success will be translated to JEREMIE’s venture capital funds.

4. FILLING IN THE DATA GAPS

Current data is inconclusive on the impact of JEREMIE funds on SME access to finance. To fill in the data gaps and gain a deeper insight into the program’s impact on the firm level, it is necessary to turn to qualitative data. This project employed a two-pronged approach in collecting qualitative data to isolate individual firms’ and actors’ experience with the Structural Funds and JEREMIE. First, a survey of SME receiving EU funds was conducted to establish baseline firm-level financial statistics, financial constraints and finally the impact of EU-funded projects. Second, we conducted dozens of interviews with policy makers, members of civil society and academia to gain an insight into the problems of Structural Fund implementation.

It is important to note that survey respondents are not recipients of JEREMIE funds but rather the EDOP 2.1.1 program.\(^4\) The financial survey was distributed to the same as the efficiency survey, a year later, in March, 2010.

4.1. FINANCIAL CHARACTERISTICS OF RESPONDENTS

A great majority, 81%, of SME indicated that they had implemented projects aimed at business development since 2007. Nearly three-quarters of SME relied on either EU-funds or other state subsidized loans, such as JEREMIE, to finance their projects. Most SME utilized more than one source of finance to implement their projects. Nearly a third of SME that claimed they had used EU funds to expand their business also utilized bank loans to carry out their project. This reflects that banks are often unwilling to finance an entire project at terms acceptable to the SME, forcing business owners to look elsewhere to for credit.

![Figure 3. How were your business development projects financed?](image-url)

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\(^4\) The EDOP 2.1.1. application is available (in Hungarian) at the NDA’s homepage, www.nfu.hu. EDOP 2.1.1. falls under the technological development priority access of the EDOP, with the express intent of providing funding to modernize SME technological, infrastructural and innovation capacity.
The most striking aspect of Hungarian SME's financial situation is their overwhelming dependency on external financing for day-to-day operations. Nearly three-quarters of SME indicated that external financing is important or very important simply to maintain their operations. This is a worrying phenomenon that likely reflects the negative impact of the continuing financial crisis, which has eroded sales and assets for many firms. Most importantly, this highlights the critical importance of adequate supplies of credit for Hungarian SME.

Figure 4. How necessary is external finance to the day-to-day operations of your firm?

Strikingly, nearly half, 48%, of SME noted that they experienced difficulties in accessing finance. A number of factors were attributed to their firms' financial constraints, with high financial transaction costs and interest rates most likely cited to be had effected or severely effected firms' access to finance. Half of SME complained that high loan financing costs were negatively affecting their company. Other constraints cited were high bank collateral costs, loan servicing costs and the lack of willingness on the part of banks to lend to SME.

One firm indicated that interest rate costs eat up 15% of their assets and prevents the firm from pursuing further expansion. So high are the costs of borrowing, the firm indicated that interest rate costs were preventing them from hiring two extra employees which would allow the firm to boost sales and productivity. A number of firms expressed concern that the high financing costs would soon bankrupt their business. One had already been forced to lay off 15 employees and is still on the brink of bankruptcy. Another noted that financing costs were siphoning off most of their internal funds, “with no end in sight.”

4.2. SME EXPERIENCES WITH STRUCTURAL FUNDS

Business owners were asked to rate the effect of commonly expressed problems on their own company. These included co-financing requirements, loan collateral requirements, costs of financing projects prior to receiving EU funds, and administrative costs. 75% of respondents stated that securing sufficient co-financing costs was a major impediment in project implementation. Another 54% found it difficult to cover the costs of financing the project. These results clearly show that financing constraints are negatively impacting firms' ability to implement projects.
More alarmingly, the results of the survey reveal that the EU funds have had little effect on firms' access to finance. Less than a quarter of respondents indicated that access to finance has improved, and not one believed that access to finance has greatly improved after the allocation HUF 4 trillion to projects since 2007.

Figure 5. How has your firm's access to finance changed since completion of your EU-funded project?

The EU funds have had significant impact on SME sales however, with 88% of firms reporting stronger sales thanks to the Structural Funds. This is significant given the negative impact of the latest crisis among firms who have not received EU funds. In fact, a recent Flash Eurobarometer revealed that falling demand and sales have been the biggest concerns for Hungarian SME. Improved sales figures to have medium to long-term positive impact on firms' access to finance, as banks will become more willing to lend to SME with stronger sales. In fact, a number of experts interviewed in the financial field have noted that implementing EU-funded projects establishes a positive track record, improves transparency and establishes a credit history, all crucial for SME to access finance to reluctant banks.

4.3 MAIN FINDINGS OF THE SME SURVEY AND INTERVIEWS

The survey reveals a clear need to improve the financial system at the local level for Hungarian SME. Despite increasing levels of funds available for SME lending, the money simply is not reaching those in need. High transaction costs and interest rates – rather than a lack of available funds at financial institutions – constitute SME's largest financial constraints.

SME owners count EU-funds as a mixed blessing. Nearly every SME experienced difficulties in obtaining the EU-funds and successfully implementing the projects. In their follow up notes many have expressed frustration with delays in fund distribution and the red-tape that slows down implementation. SME may receive funding to buy a certain type of computer in 2008, but by the time they receive the funds in 2009, that machine will have been obsolete. Co-financing requirements have put many SME between a rock and a hard place, forcing them to take out high interest loans without guarantee that the EU will release all of the funds for the project in the end.
On the other hand, EU-funded projects have clearly increased firm sales. Most SME have applied for funding more than once, and some even more. Most business owners recognize the potential of EU funds, and many offer only small points of reform. EU-funds have had a strong effect on sales, which is confirmed by the results of the initial survey that show that EU funds have been instrumental in keeping SME afloat during the latest financial crisis.

5. MAIN FINDINGS AND RECOMMENDATIONS

- Interviews conducted with policy officials throughout the year reveal a complex, bureaucratic, non-transparent and top-heavy institutional framework, although survey respondents reveal some improvements in the program's administrative burdens.
- The monitoring system for both ECOP 2.1.1. and JEREMIE is insufficient and non-transparent. Monitoring indicators fail to show the real effects of EU-funds on micro-level.
- Loans extended to SME significantly trended upwards from 2003 to 2009. The impact of the financial crisis reversed this trend in 2009, but a deeper decline may have been prevented by JEREMIE funds.
- Financial constraints continue to persist and hamper SME operations in Hungary, despite the growth in lending since 2003. Less than a quarter of respondents believe that access to finance has improved since they completed their EU-funded projects and nearly half of expressed difficulties in obtaining financing.
- More than 75% of SME experienced difficulties in implementing their EU-funded project, while nearly a third of projects were delayed or over budget.
- EU-funds were cited as the only factor, which has, on average, improved the market position of Hungarian SME during the recent financial crisis.

5.1. RECOMMENDATIONS ON THE PROGRAM LEVEL

1. The Hungarian Government should strengthen laws to ensure dissemination of program data. Contracts with private consulting firms should be announced and the results made public.
2. Increase JEREMIE transparency at the financial intermediary level. Streamline distribution to intermediaries and reduce auditing burden.
3. The pre-financing of any privately owned enterprises without bank guarantee or collateral should be revised, possibly withdrawn.
4. New monitoring methods should be introduced with the aim of further easing the administrative burden of the SMEs.
5. Vigorous academic research should be carried out to examine and analyze the real economic effect of the “automated” application systems. Establish an Institute for Structural Fund Evaluation that centralizes and coordinates research efforts.
5.2. RECOMMENDATIONS ON PROJECT LEVEL

1. Partial rebuilding of the institutional system handling the EU-funds (from managing authorities inside the National Development Agency to several intermediate bodies), with the purpose of “best practice” implementation.
2. Rethinking the priorities and the means for economic development (including JEREMIE, pre-financing – without collateral or other guaranties).
3. Strengthening the monitoring system (new methods, better cooperation and data transfer between authorities).
4. Fighting political and “private” corruption in institutional system handling the EU-funds.

REFERENCES

M.A. IN PUBLIC POLICY AND MANAGEMENT

The Public Policy and Management (PUMA) program prepares graduates for senior leadership positions in nonprofit organizations, government, and the private sector. Students acquire the necessary skills and knowledge to analyze and address contemporary issues of public concern. The program connects academic study with public service in order to strengthen communities and develop effective public leaders.

PUMA includes training in the role of economic and political factors in public decision-making and policy formulation; microeconomic analysis of policy options and issues; resource allocation and decision modeling; cost/benefit analysis; statistical methods; and various applications to specific public policy topics.

The program is meant for students who are working or intending to work in careers that involve the implementation of public policies and the administration of public service and non-profit organizations. It is also a strong match for those who are interested in business, especially where it interacts with government or is subject to significant government regulation.

By the end of this program, students will:

- have an understanding of the different conceptual and theoretical perspectives applied to public policy and management,
- have an understanding of the principles and practices underlying the implementation of public policy and management processes,
- have developed skills in the initial analysis of public policy and management and in communicating their analysis in the form of clearly written and readable documents,
- have a good command of current theory, policy, and practice in relation to some of the following specialized areas: public policy process and methods, public sector economics, development and economic policy, privatization and public enterprise reform, public sector accounting and organizational change,
- have developed basic research skills through a supervised dissertation project.

For more information about the PUMA Programme, please visit the official website of our Faculty at http://economics.uni-corvinus.hu.
The paper has been devoted to drawing a provisional balance of the Italian experience within the Euro Zone in the 11 years elapsed from its inception. We have seen that prior to the setting up of the single currency, Italy has accepted to play the convergence game with the financial conditions prevailing in Germany, the main and the pivot country of the subsequent attempts to create in Europe an area of monetary stability, as a precondition to establish eventually a monetary union within the EU, in order to avoid competitive depreciations or devaluations putting in jeopardy the correct functioning of the single market, on a non discriminatory basis or in levelling out starting points among partners. During the convergence game Italy's monetary constitution underwent a dramatic change, giving up a traditional set of lax policies nurturing the vicious circle of inflation-devaluation-inflation. The transition towards a new stance of monetary stability and anti-inflationary reputation was not without troubles, as it was shown by the withdrawal of the national currency from the ERM in the period 1992-1996, but was made possible by the loyalist choice to accept to tie one's hand within the latter, or by the strong currency option implied in the link between the lira and the German Mark, thus importing credibility in international markets while forsaking to produce inflation by surprise. Once included in the Euro Zone, however, Italy was possibly penalised in terms of decreased growth rates by the mix of monetary and fiscal policies allowed by the Euro Zone framework, with the caveat that the virtual stagnation of the Italian economy could also be due to an outdated international specialisation, challenged by emerging countries in the new division of labour within globalisation. Even worse, also for Italy, as for the rest of the peripheral countries with a past low record of financial stability, some divergences due to high relative unit labour costs compared with the internal devaluation implemented by the policy of wage restraint followed by Germany came to the fore, possibly putting at risk in the future its permanence in the Euro Zone.

1. INTRODUCTORY REMARKS

The participation in the European Monetary System (EMS), dating back to the end of 1970s, and subsequently in the Economic and Monetary Union (EMU), when twenty years later the Euro Zone was launched, represented for Italy a dramatic change in its monetary constitution. Indeed, the country had a long record of unorthodox monetary and exchange rate policies, resorting in a systematic way to devaluation within the different fixed exchange rate regimes where the lira, the national currency, was in sequence pegged, or to its depreciation, during the periods in which it floated, under different circumstances, after the collapse of the Bretton Woods system. The intentional goal of authorities – in fact the government due to the lack of independence suffered in those times by the Bank of Italy – was
to offset the loss of competitiveness following a higher than average inflation, compared with the main partners', driven by cost factors and fostered by an accommodating monetary policy.

Thanks to two main factors, along a bumpy process extended over a time span of about two decades, such a lax monetary stance was progressively abandoned in favour of adopting a German-style monetary policy. As hinted, the change in Italy’s monetary constitution did not take place in a smooth way, but was characterised by an alternation of successes and setbacks along a thorny path. On the one hand a first driver of the convergence process was due to the structural push linked to new directions taken in the framework of the European economic integration process towards monetary stability and in the long run towards monetary unification, after the setting up of the customs union and the Common Agricultural Policy (CAP). On the other hand, as shown by a convincing political economy literature, disinflation in the Italian economy was rendered possible by an increased power in the government sphere and policies of lobbies and parties defending the rentiers’ interests to avoid to be damaged by the inflation tax on their financial investments and assets.

The aim of the present note consists in describing the central experiences gained by Italy in the convergence game that led the country to become part of the first wave of Euro Zone components, as well as the past consequences and perspectives of its membership in the latter. The rest of the paper is organised as follows. In the second and third sections we focus on the path followed by Italy across the EMS, from the initial period in which the European monetary device worked as a crawling peg mechanism to the subsequent time span of the loyalist choice to accept the system constraints. Section 4 describes the policies adopted by Italy in the run up to the EMU, after the lira crisis and floating from 1992 to the re-entry the system in 1996 and the final qualification for joining the Euro Zone. Sections 5 and 6 are devoted to identifying the costs and benefits deriving from the participation in the Euro Area, respectively in the short and in the long run. The following section 7 tries to put into perspective the debate on a possible withdrawal of Italy from the monetary union and the last section concludes with a number of final remarks.

2. THE EMS: THE INITIAL EXPERIENCE

During the collapse of the Bretton Woods system European countries belonging to the European Economic Community (EEC) tried to withstand monetary turbulences generated by the end of the gold exchange standard by linking their currencies within a tunnel of limited exchange rate fluctuations moving freely against the dollar. Such an agreement was in its essence a target zone device aimed at providing a degree of monetary stability deemed to be necessary for the correct functioning of the two main schemes of economic integration achieved by the EEC in that period: the customs union and the CAP. In this respect, monetary instability could put in jeopardy both achievements: the former by allowing competitive devaluations or exchange rate depreciations which were incompatible with the existence of a stable and protected towards the rest of the world internal market for manufactured goods; the latter by rendering exceedingly complicated the operation of the com-
mon price system put at the basis of public management of the market for agricultural produce. By the way, we find here two of the prerequisites for the survival of economic integration in the framework of European general institutions, in that time EEC and subsequently the European Union (EU), which are the same conditions that justify the present monetary integration within the euro area.

Such an arrangement of limited exchange rate fluctuations, dubbed the “Snake”, was launched in April 1972 and Italy took part in it, above all for political reasons. Nevertheless the lira was not able to bear the constraint of a fixed exchange rate pegging and in early 1973 was forced to withdraw, following a deterioration of inflation and external balance conditions [Maes and Quaglia 2003]. In fact Italy in those years was still following a growth- cum- inflation path, that required a progressive depreciation of the lira. With the qualification that such a policy was subsequently exacerbated by the supply shocks in form oil price increases which took place during the 1970s [Giavazzi and Spaventa 1989].

The Snake did not succeed in bringing together the currencies of the EEC member countries, which from time to time joined, left and re-entered the European mechanism, so that in 1977 it had become the equivalent of a German Mark zone. However, not least owing to a reduced pace of economic integration which came to the fore in that period, the quest for monetary stability in the EEC area went on, by devising a new and more structured exchange rate mechanism, the European Monetary System (EMS), that came into force in 1979. In the run up to EMS Italy expressed its preference for a symmetric monetary arrangement, in order to share the burden of adjustment between deficit and surplus countries. And indeed the EMS on paper showed such a character, but Italy’s expectations were soon frustrated since in its real functioning it became an asymmetric device, dominated by the German mark and shifting the whole of adjustment on the debtor countries. Still in present time, within the eurozone such a latter issue has not yet been solved due to unwillingness of creditor countries, and namely the largest of them, Germany, to reflate thus helping debtor countries to reduce their disequilibria and hence their deflationary policies.

Under these circumstances in the first part of its participation in the EMS, covering the period 1979–1986, Italy went on following the cycle devaluation-inflation-devaluation, considering the new arrangement not as a fixed but adjustable exchange rate mechanism, but as a crawling peg device, accompanying the sliding of the exchange rate, or allowing a progressive devaluation of the national currency. Table 1 shows the realignments of the lira during the period under scrutiny, implying a devaluation of the Italian currency by more than 20 per cent during the first half of 1980s.

<table>
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</tr>
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<tr>
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3. THE EMS: THE LOYALIST CHOICE

By 1987 Italy decided to change its monetary stance, giving up its traditional policy to try to offset its competitive loss by decreasing the value of the lira via a realignment of the exchange rate. Whereas in the first part of its experience within the EMS Italy did not fully play the convergence game towards the financial conditions of the leader country of the monetary arrangement, Germany, behaving as a reluctant follower, by that time it entered the group of loyalist countries of the system. Such a choice was influenced probably by two distinct but interlinked factors. On the one hand by a similar shift made in 1983 by President Mitterrand in France, who launched the “franc fort” policy, after having realised that an expansionary policy based on the franc devaluation was unsustainable and that an attempt to reflate in a single country in the context of an asymmetric EMS was bound to fail [Bernard 2002]. On the other hand the Bank of Italy and Italian policymakers were in search of a new monetary constitution, not least in order to strengthen an institutionalised co-ordination among EMS monetary authorities in view of a more symmetric working of the scheme [Quaglia 2003].

As a consequence, the EMS constraint was considered by Italy as a means for importing anti-inflationary credibility. By linking the lira to the Mark, Italy could hope to share the strong currency option adopted by Germany, benefiting from a better anti-inflationary reputation in international financial markets. The mechanism by which such a reputation could accrue has been explained in terms of advantages obtained for countries accepting to “tie one’s hand”.

In general terms, taking part in the EMS for the leader country meant to obtain a big benefit in terms of reduced probability for the EEC partners to be allowed to follow a policy of competitive devaluation, that would translate into lessening its sales in the protected market of the customs union, putting in jeopardy the export led growth model traditionally adopted by it. But what about the follower countries? Since in a fixed exchange rate regime, with free capital mobility, the monetary policy becomes ineffective, what was their interest to give up their monetary sovereignty, by linking their policies to the EMS rules? The explanation has to do with the need to reassure international markets as to their anti-inflationary credentials.

In this respect, the follower countries within the EMS, when trying to realign their currencies in case of past inflation, would be penalised since European partners did not allow to transfer the whole of past inflation on the exchange rate devaluation. It follows that some loss of competitiveness remained as a residual, and that a country generating inflation by surprise was permanently penalised, reducing its interest in adopting a lax monetary policy [Giavazzi and Pagano 1990]. International markets, anticipating such a development, came therefore to the conclusion that Italy had no interest in producing self damaging inflation, thus strengthening its anti-inflationary credentials.

In the aftermath of the loyalist choice towards the disciplining effects of the EMS, Italy follows a path of disinflation and convergence with the core EMS countries and the lira appreciates in real terms.
However, the new co-operative policy decided by Italy towards the EMS came to an abrupt stop five years later. In the meanwhile the EMS had worked with an excess of credibility, since its member countries behaved as if the stage of the monetary union had been already reached. But of course the final and irrevocable locking of the national currencies into the euro was not yet accomplished and when in 1992 the Danish referendum on the Maastricht treaty was rejected such an excess of credibility vanished suddenly. Speculation performed by a group of aggressive hedge funds attacked the weaker monies of the system and the lira was forced to withdraw from the Exchange Rate Mechanism (ERM), alongside with the pound. The Bank of Italy tried unsuccessfully to resist speculation attacks, but when its foreign exchange reserves were virtually depleted and a possible help by the financing facilities of the system proved to be unworkable, abandoning the EMS was inevitable and the Italian government put into being a heavy fiscal plan to keep the country finances afloat.

Amongst the possible culprits of the lira crisis one can quote the loss of competitiveness of Italian goods. On the basis of the “tying one's hands” mechanism just described, the subsequent realignments of the national currency in the form of devaluation by an amount of more than 20 per cent since the inception of the EMS left a significant penalty in terms of extra costs for the Italian tradables, due to the difference of past inflation over the partners’ average not offset by the decline of the exchange rate parity. As a result the worsening of the competitive conditions of Italy represented a signal of weakness, which could be easily challenged by international speculators.

At the same time a second factor was at work when the increase of the German interest rates linked to the country re-unification was transmitted to the partners’ economy via the pegged exchange rate, and hence also to Italy. We find here an additional element of fragility blurring the perspectives of Italian economy.

However, probably the crucial factor precipitating the currency collapse was the lifting of controls on capital movements, that took place after 1989. For a country considering as a penal offence to export capitals abroad to shift to the free capital movement regime was not an easy task. Yet it was deemed to be necessary as a step on the path to monetary unification.

By getting rid of controls on capital movements Italy tied its hands also towards international speculators. And when in 1992 the lira was targeted by a massive speculation attack the Bank of Italy was found to be defenceless, after having sacrificed almost all available exchange rate reserves.

From the technical point of view the crisis of the lira was a reminder of the relevance of the Mundell’s impossibility triangle: the fact that autonomy of monetary policy, fixed exchange rates and capital mobility cannot be attained simultaneously together. Or, how Padoa Schioppa [1988] put it, the triangle could became an inconsistent quartet, adding to the former also the free trade of goods and services.

Thus, for Italy, the removal of controls on capital movements, that had allowed the country to bear the constraint of the EMS, implied also the end of the pegged exchange rate regime, allowing the lira to take a leave from the ERM.
4. THE RUN UP TO EMU

The withdrawal of the lira from the ERM translated in a noteworthy depreciation of the currency, that by 1995 reached the amount of 30 per cent [Bugamelli and Tedeschi 2005]. Italian policymakers decided to take the opportunity offered by the dramatic break with the EMS for restoring the country’s competitiveness previously damaged by the constraints of the latter and stopped adopting the disinflation policy followed since 1987. Hence, after a period of about five years of loyalist behaviour, Italy reverted to the traditional stance of reducing the nominal exchange rate of the lira and over a time span almost equivalent Italian authorities did not take the necessary policy measures for re-entering the European system. The return to the old strategy of competitive devaluation or depreciation was scarcely appreciated by European partners. Not only the German policymakers reinforced their doubts as to the possible admission of Italy in the final step of monetary unification that the Maastricht Treaty had put on the rails, but France too voiced to find itself damaged by the Italian currency floating.

Indeed, Germany insisted for extending two of the Maastricht criteria for joining the future eurozone to the functioning of EMU by a formal agreement stating the obligation for the member countries to fall in line with the limits concerning the public finance, both for the yearly deficit and the outstanding public debt. Later on such provisions were laid down in the Stability Pact, agreed upon in 1997 with the addition of a second name, becoming the Stability and Growth Pact (SGP), for the sake of politically correct speech. Still today it is not clear if the intent of German policymakers was really to set up a control on fiscal policies of member countries in order to ensure the viability of EMU, or to keep out from the latter countries with low fiscal credentials, such as Italy and in general the countries of the so called ‘Med Club’. The latter interpretation is legitimate since the financial crisis of Greece in 2010 shows the limited availability by the German institutions (included the Constitutional Court of Karlsruhe) to pass over the no bail out clause of the Lisbon Treaty for helping a divergent Euro Zone southern member country avert a possible default.

As to France, which went on following the ‘franc fort’ strategy in that period, its reaction to the Italian exchange rate policy was bluntly tough. During a meeting with Italian government members the president in charge Chirac maintained that the free floating of Italian lira gave Italy an unfair competitive advantage, warning that the EU partners could decide as a response to re-introduce customs duties on Italian exports to the single market. Unmistakably an over-reaction since other partners such as the UK did not link their currency either to the ERM, without any precise complaint by the rest of the EU.

In the meanwhile, during the move from the EMS to the project of EMU Italy had changed its mind as to the best method to reach the monetary union. Its positions went back to the early period in which the reflections on monetary integration started, prior to 1970s. Whereas initially Italy shared with Germany the views of the “economist” approach, in the course of time its policymakers accepted the “monetarist” mind-set. The use of the two adjectives surrounded by quotation marks is made here in a particular sense concerning the order of stages leading to monetary
integration. In the debate launched after the setting up of the EEC customs union on how to create the monetary union, considered as the subsequent chief objective to be achieved by the end of 1970s, two schools of thought emerged. According to the “economist” school, headed by German scholars and policymakers, the birth of a single currency had to be the final stage of full economic integration and could be obtained only in so far as all markets and policies, except of course that regarding the monetary regime, had been previously integrated at the European level. So the German-born theory of coronation (Kroenungstheorie) maintained that monetary union, in order to be achieved and remain sustainable, had to be based on the building of economic union, like a roof crowning the latter.

On the other front stood the “monetarist” approach, following to which a common monetary device leading to a single currency could represent a constraint strong enough to push member countries to make progress on the road to economic union. France supported this second stance, confirming the influence exerted in the past by an adviser to General De Gaulle for monetary affairs, the economist Jacques Rueff, who used to argue: “L’Europe se fera par la monnaie ou elle ne se fera pas”.

The choice between these two conflicting views was decided by the need for the EEC to build up, in any case, a monetary agreement with which to fight the currency instability that the imminent break-up of the Bretton Woods was going to generate, as Robert Triffin had famously anticipated, with his dilemma between the need for the US to provide the world economy with dollars via a persistent current account deficit and the commitment to exchange the latter for gold. In 1970, just one year before the declaration of dollar inconvertibility by President Nixon, the EEC countries approved the Werner plan, which foresaw the setting up of a monetary union through a three stages process, following the “monetarist” inspiration.

The choices made at the time of the first attempt to set up the European single currency extended their influence in the run up to EMU. Thus, during the discussions preceding the approval of EMU design Italy was considered to be in the group of “economist” countries, alongside with Germany and the Netherlands, that were opposed to the creation of the European Fund for Monetary Cooperation. But starting in the early 1980s Italian policymakers joined France, Belgium and the Commission in the “monetarist” grouping, under the leadership of Governor Ciampi and his aide Padoa Schioppa [Maes and Quaglia 2003].

Against this background, Italy took an active part in the decisions that led to the setting up of the Maastricht Treaty, which laid the foundations of EMU, displaying a pro-European initiative in a number of crucial choices instrumental in overcoming the resistance of eurosceptic countries such as the UK, which expressed at the start a preference for a system of parallel currencies in competition among them, up to the moment when the market would have selected the preferred one. In particular, Italian policymakers played an outstanding role during the Strasbourg summit in 1989, when the objections of Mrs Thatcher were put aside and the fundamental decision was taken to create not a simple common money, but a single currency.

In such a way Italy reverted to its traditional function of a country that could exploit initiative by the EEC political engine, the French-German couple, in order to make the European integration process move on.
It is clear that in such a framework Italy could not afford to pass over the next grand appointment of the EU: the launch of the single currency. And in fact, after a period of strong depreciation following the withdrawal from the ERM, the lira rejoined the latter in 1996, just in time to qualify Italy to enter the first EMU wave country group. To have one’s currency within the ERM for at least two year, respecting the normal margins of fluctuation and without having carried out devaluations represented indeed one of the Maastricht convergence criteria. It goes without saying that the come back to the full set of EMS rules meant for Italy the resumption of the previously followed disinflationary and convergence policy.

To be honest, in that period the Italian government planned to enter the Euro Zone with some delay since the convergence criteria were not fully attained, despite the lax interpretation of the rule regarding the public debt, whose level of 110 per cent was about the double of the 60 per cent ceiling established by the Maastricht Treaty. A political reading of such a criterion stated namely that it could be considered as respected, when the divergent country reduced the debt proportion at a satisfactory pace. However the public deficit was still too high, and for this measure no escape clause existed.

Thus, when after a meeting with Spain’s government Italian policymakers realised that the Iberian country had a firm intention to qualify for an early entry and was not available to form with Italy a group of loyalist but laggard countries, former prime minister Prodi decided to speed up the transition to EMU. As a consequence, the Italian government asked for a one-off sacrifice by tax payers, whom were charged by an extra “Europe tax” in view of lessening the public deficit. Later on such an extraordinary contribution was largely paid back thank to savings produced by the reduction of the debt service burden, following a fall in interest rates.

The occurrence of the “Europe tax” deserves some attention because it could be a clue of the possible validity of the endogenous currency area theory.

One of the fresher shoots of the theory of Optimum Currency Area (OCA) states that a number of optimality features that are absent among a group of countries wishing to set up a monetary union, can be generated by the monetary zone itself, once the latter has come into being. In other words optimality characters that did not exist ex ante, can be produced ex post. Hence, the stress on endogeneity of some elements of economic integration founding the viability of a monetary union such as a high degree of trade integration put recently by a new strand of literature [Frankel and Rose 1998]. In our case, also some components of financial integration can be taken into account in the same way. So, the “Europe tax” was instrumental in inducing international financial markets to anticipate the admission of Italy into the eurozone, reducing in a short time span its interest rates at levels converging towards the German ones. And when such a fulfilling expectation became true Italy recovered the resources to pay largely back the amount disbursed by tax payers.

5. BENEFITS AND COST OF EMU FOR ITALY: THE SHORT RUN

After more than ten years of the Euro Zone’s working it is possible to draw a provisional balance of the specific cost and benefits that accrued to Italy following
its participation in the monetary union. Here we focus on the specific impact that the launch of euro had on Italian economy, over and above the general costs and benefits of a single currency, that in principle are the same for all partner countries.

In this respect on the microeconomic advantages attached to the presence of a single money for a group of countries, such as reduction of transaction costs, removal of exchange rate risks, increased transparency of prices and the like Italy’s experience was not such different from what happened in other eurozone countries. As to the main macroeconomic cost, traditionally identified in the loss of the monetary and exchange rate policies (the so called Corden’s, 1972, argument on the main cost of monetary integration), possibly in case of Italy the contra argument that the exchange rate tool can have sometimes destabilising effects [Mundell 1973] could be made and expanded on, but not in this note.

The idiomatic advantages and drawbacks of the use of the single currency for Italy concerned two sets of developments. On the one hand a possible euro inflationary effect and a significant decrease of interest rates in the short run; on the other a potential reduction of growth rates and the appearance of divergences towards the EMU core countries in the longer term.

The claim that the euro has been an inflation factor has been levelled in Italy soon after the changeover from the lira to the single currency. In January 2002 the euro was introduced into circulation and after a short period of double pricing the lira ceased to be legal tender. From that time on and for a couple of year a popular sentiment arose, according to which many prices had been changed on the basis of an exchange rate not of 2000 liras per euro (the people’s mental reference for the official rate of 1936.27) but of a much lower rate for the old national currency of around 1000 liras. In such a way in many cases one had the feeling that prices had been doubled. A widespread say in that period was that the introduction of the euro had had a negative impact on people living from their salary or pension since the latter, as to their value, continued to be paid in liras, whereas prices were charged in euros.

A possible, immediate explanation of such a development, that translated into a negative popular judgment on the new currency, has to do with the circumstances that in a large number of markets, above all in those regarding the consumer goods, conditions of imperfect competition prevailed. Thus, in the presence of an information asymmetry in imperfect markets the changeover had been the pretext for price setters to charge new prices well above the level justified by the official rate of exchange between the old and the new currency. As a result, the higher prices generated a major loss of purchase power for consumers to the benefit of sellers, whose initial income and wealth conditions improved. However in the longer term the subsequent fall in aggregate consumption was one of the driver of the stagnation of growth in Italy, with a negative impact also on consumer prices.

Also in other member countries similar effects came to the fore. In Germany, for instance, popular press spoke of “Teuro”, an acronym composed by “euro” and the adjective “teuer”, meaning “expensive”.

Yet, oddly enough, such a one-off surge in inflation was absent from the official statistics, whose figures did not record price spikes.
The difference between the official rate of changes in the price levels and what has been dubbed the “perceived inflation” has been explained in different ways and is still a focus of economic research, with mixed results. For instance, whereas some authors use indirect measures of prices behaviour and do not find evidence of the alleged inflationary effects of the euro [Angelini and Lippi 2007], for others the rise in perceived inflation did materialise and was due in its essence to the existence of large, upward and regularly watched price movements in frequently purchased consumer goods [Del Giovane and Sabbatini 2005].

As already said, in the short run Italy, as all Euro Zone member countries with a low record of fiscal credibility, was benefited by a considerable fall in short and long term interest rates. The long convergence game towards the German rates of interest that took over ten years to be accomplished ceased in the very moment where markets became convinced that Italy was going to be qualified for adopting the euro. For a country with an outstanding debt of 110 per cent of GDP in 1997 benefits in terms of reduction of the debt service happened to be remarkable.

Thus, the experience of Italy in this field confirmed that one of the main advantage to take part in EMU consists of gaining an enhanced access to international liquidity at a low risk premium [Jones 2009].

6. BENEFITS AND COST OF EMU FOR ITALY: THE LONG RUN

Let us turn now to the longer term consequences of the euro adoption. According to some scholars the stagnation of growth that Italy has been recording for a long time can be attributed to the very working of the Euro Zone, where a mix of monetary and fiscal policies followed respectively by the European Central Bank (ECB) and the German policymakers do not create a framework favourable to economic expansion.

As a matter of fact, in the period 1999–2008 the Italian average annual growth rate of income was 0.8 per cent, with a range going from 3.2 to –3.5, the latter figure being recorded in the last year of the time span. In 2009 the global crisis, after the negative result of the previous year, took a heavier toll, with a fall in GDP exceeding 5 per cent. Over the longer term the Italian rate of growth fell from 5 in the 1960s to less than 1 per cent in the last decade.

Among the authors identifying EMU as the culprit of this state of affairs we can quote Canale and Napolitano [2009] on the one hand, and De Cecco [2007] on the other hand. Canale and Napolitano [2009] challenge the theoretical foundations upon which the Maastricht Treaty and the SGP have been built, since the denial of an active role in affecting equilibrium income by central banks and national governments that they take for granted has no sound theoretical and empirical bases. Indeed in their exercise on Italy, which covers the period 1998–2008, they find that government spending has displayed a positive effect and inflation targeting by the ECB has shown to have a negative impact on growth. Hence their conclusion that the two pillars of the EMU, with a monetary policy only finalised to produce stable low inflation and rigid fiscal rules hampering government spending seem to have
reduced Italy’s economic growth, namely in the last five years of the time span under investigation.

As to De Cecco [2007], he maintains that the euro has had a negative impact for Italian industrial companies, whose exports have been penalised in relative terms, and in fact the Italian share of world exports has been reduced from 4.5 per cent in 1995 to less than 3 per cent ten years later.

On the latter point, however, Faini and Sapir [2005] offer a different interpretation. According to them, the decline in the economic performance of Italy cannot be attributed to the choice to enter the Euro Zone, but depends on more structural factors. In particular they argue that the loss of export shares suffered by the Italian economy is a consequence of a traditional model of specialisation adopted by it, which is currently challenged by the less developed and emerging countries’ competition in the framework of globalisation. A factor that is worsened by the growing gap recorded by Italy in the field of human capital formation, compared with other industrialised countries.

Whereas it is debatable that the decline of Italy’s rate of growth is really due to EMU policies, a second negative development involving the Italian economy regards the divergences recorded towards the eurozone core countries, whose origin seems to be the very functioning of the monetary union.

In order to put the argument into perspective we have to remember that in the aftermath of EMU regional cycles within the Euro Zone diverged. In a nutshell, within the latter a number of clusters of countries emerged. On the one hand we had a first group of countries that were characterised by high rates both of growth and inflation, whilst a second one experienced economic stagnation and a low price dynamics. A typical country belonging to the former group of growth-cum-inflation economies was Spain, but in the cluster were also present countries such as France, that experienced an above the average inflation rate. The latter group was led by Germany but included also the Netherlands. Italy and Portugal were in the middle ground, forming a third cluster with slow growth and a rate of inflation just above the ECB’s target [Dullien and Schwarzer 2008].

All that translated into cyclical imbalances among eurozone member countries, which could not be offset owing to the absence of fiscal union, a precondition linked to the existence of a centralised common budget strong enough for exerting significant stabilising effects via inter-regional transfers.

Under these circumstances the eurozone economic fabric came under strain, as it is currently shown by the impact of the global crisis, which displayed the fragility of peripheral EMU countries, dubbed by the popular press with the unflattering acronym PIGS or PIIGS (Portugal, Ireland, Italy, Greece, Spain).

One of the most satisfactory explanations of divergence by peripheral countries towards the core ones has been offered by Blanchard [2006] with his theory of revolving slumps. For countries with low inflationary credentials entering EMU produces a reduction in interest rates, with a subsequent boom often linked to the residential sector development. However, when the capital stock reaches a new equilibrium, the economic expansion comes to a stop. At this point, provided that labour productivity improvements have not been in the meanwhile materialised, a loss of competitiveness comes into view, which cannot be offset through the depreciation
of the exchange rate. In Figure 1 we find a picture of divergences among member countries’ relative unit labour costs dynamics. It appears that whereas labour costs in countries such as Netherlands and the group of peripheral countries including Ireland, Italy, Spain, Greece and Portugal, have increased by 10–15 per cent from the start of the euro area, in Germany and Austria a fall of 5–10 per cent of them has been recorded. All this means that, compared with the situation in Germany, labour costs for peripheral countries moved up by 20–25 per cent. At the same time, as shown in Figure 2, the higher relative unit labour costs were associated with higher public deficits [De Grauwe 2010].

Source: De Grauwe [2010]

**Figure 1. Relative unit labor costs in the Euro Zone**

Source: De Grauwe [2010]

**Figure 2. Relative unit labor costs in (1999–2008) and budget balance**
Blanchard’s [2006] model partially applies also to Italy, with the caveat that both rates of growth and property market boom were quite moderate in its case. Yet, for Italy too the absence of labour costs relative reductions compared with the euro-zone core countries involved a deterioration of its competitive position.

When the lira joined the eurozone, its depreciation that had generated a robust expansion cycle was largely wiped out. After 1999 Italy suffered from the wage deflation systematically carried out by Germany, in order to recover its competitive edge. Such a restrictive stance was quite similar in its economic consequences to a currency depreciation (the so called “internal devaluation”) and this added to Italy’s economic woes: by 2006 the loss of competitiveness of the latter towards Germany reached a level of 15–20 per cent, with a possible worsening in recent times [De Grauwe 2010].

According to De Grauwe [2006a], so large a deterioration of a competitive position could be contrasted only by a decade of inflation at less than 1 per cent, i.e. by a long period of deflation with income losses and high unemployment. The doubt that in such a condition Italy could reconsider the benefits of its participation in the EMU surfaced just by the middle of the present decade. In this respect by 2005–2006 prime minister Berlusconi and the populist party Northern League seemed to call for the reintroduction of the lira. The Italian minister Maroni who belongs to that party in 2005 advocated the secession from the euro area and the reintroduction of the lira, being supported in that by Mr. Berlusconi, who defined the single currency as a disaster.

In the following poll campaign in 2006 the centre-right coalition argued that the one-off perceived inflation surge that accompanied the introduction of the euro was due to a mistake made by centre-left parties led by Mr. Prodi in accepting an undervalued rate of changeover from the lira to the euro, not taking into account that the final rate of entry depended not by the sole will of the Italian government but by the consensus of other partners.

By that time, on the other hand, Roubini [2006], the economist that later on acquired a world reputation for having correctly forecast the imminent global financial crisis, described for Italy an Argentina scenario, with a withdrawal from the euro area and a subsequent default on public debt, launching a debate on a possible secession by Italy from the monetary union [Praussello 2010], that fostered a large number of mixed opinions. Among them some argues that the danger of a withdrawal by Italy was not immediate, but could materialise, should it prove unable to introduce the necessary reforms for complying with the criteria of an OCA.

In recent times such an occurrence has reappeared, but in a completely different context. The Greek crisis has shown that the debate on the withdrawal of a country and a possible break-up of the eurozone concerns a real danger, not an abstract study case. The latter with two schools of thoughts defending opposite views: the optimistic one led by Eichengreen [2007], who maintains that the cost of withdrawal would be so high as to deter any country wishing to secede, and the pessimistic one, inspired by De Grauwe [2006b], believing that without a fiscal union and a European government the euro in the long run is doomed to fail. And among the
possible candidates that could be affected by the lack of a European solution of the
Greek crisis, Italy too is in jeopardy. Considering evaluations of Credit Default
Swaps, not at once, but in a time span of 4–5 years.

In any case a subject of anxiety is the last comment by Mundell on the eurozone
difficulties, stating that in his opinion the real sick man of EMU is not Greece but
Italy. In this respect, whilst for Greece a concerted help by the member countries is
feasible at a low cost, since its economy has a weight not exceeding 3 per cent of the
euro area, for Italy a bail out could prove impossible.

8. CONCLUDING REMARKS

The present note has been devoted to drawing a provisional balance of the
Italian experience within the Euro Zone in the 11 years elapsed from its inception.
We have seen that prior to the setting up of the single currency, Italy has accepted
to play the convergence game with the financial conditions prevailing in Germany,
the main and the pivot country of the subsequent attempts to create in Europe an
area of monetary stability, as a precondition to establish eventually a monetary
union within the EU, in order to avoid competitive depreciations or devaluations
putting in jeopardy the correct functioning of the single market, on a non discrimi-
natory basis or in levelling out starting points among partners.

During the convergence game Italy’s monetary constitution underwent a dra-
matic change, giving up a traditional set of lax policies nurturing the vicious circle
inflation-devaluation-inflation. The transition towards a new stance of monetary sta-
bility and anti inflationary reputation was not without troubles, as it was shown by
the withdrawal of the national currency from the ERM in the period 1992–1996, but
was made possible by the loyalist choice to accept to tie one’s hand within the lat-
ter, or by the strong currency option implied in the link between the lira and the
German Mark, thus importing credibility in international markets while forsaking to
produce inflation by surprise.

By the end of the transition path the convergence game provided the country
with a improved access to international liquidity at a low risk premium, a major
advantage for a country burdened by a high public debt exceeding the yearly GDP.
Compared with such a significant benefit the one-off surge in perceived inflation fol-
lowing the changeover to the euro looks like a minor drawback, even though such a
development contributed to level popular criticism against the single currency.

Once included in the Euro Zone, however, Italy was possibly penalised in terms
of decreased growth rates by the mix of monetary and fiscal policies allowed by the
euro area framework, with the caveat that the virtual stagnation of the Italian econ-
omy could also be due to an outdated international specialisation, challenged by
emerging countries in the new division of labour within globalisation. Even worse,
both for Italy and the other peripheral countries with a past low record of financial
stability, some divergences due to high relative unit labour costs compared with the
internal devaluation implemented by the policy of wage restraint followed by
Germany came to the fore, possibly putting at risk in the future its permanence in
the eurozone.
However if the present financial difficulties experienced by Greece will be contrasted by a European solidarity effort and Italy will be able to go back to a path of decent growth, the nightmare of an Italian economy leaving the euro area in a not too distant future could not materialise.

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Systematically monitoring regional integration processes is a relatively recent activity, but its potential is quite important. From an academic perspective, it allows us to get a more precise idea of the depth and speed of certain regional integration processes, more clarity on the relative importance of regionalization versus globalization processes (and their interaction), and a better understanding of the meaning and significance of the so-called new regionalism. From a policy-making perspective, a better monitoring has the capacity to make integration policies more development effective and integration processes more transparent, involving higher degrees of participation and legitimacy, and therefore, making the processes more sustainable. In this paper the authors present a critical review of recent proposals and experiences with setting up indicator systems for monitoring regional integration processes in different parts of the world. The review covers both conceptual (academic) proposals as well as indicator systems developed by or for regional organizations such as the European Commission, the European Central Bank, the UN Economic Commission for Africa, ASEAN, COMESA, ADB, EDB, etc. A systematic comparison of the different indicator systems (covering both technical and political-economy aspects) makes it possible to evaluate their relative qualities and to identify best practices.

1. INTRODUCTION AND AIMS OF THIS PAPER

In the emerging multi-level governance architecture, the regional level (here understood as: supra-national) has become more important over the last decades and is likely to continue to gain importance in the foreseeable future. At the same time, and in line with the evolution at other governance levels, the variety of institutional arrangements and the types of actors involved are significantly increasing.

Institutionalised regional integration and cooperation includes, for example, ad hoc projects and policy coordination, networking, functional integration, free trade areas, regional economic organizations, etc. Hettne and Söderbaum [2004], for example, presented a typology of regional cooperation mechanisms, where economic integration appears as a special case. Their typology was based on two criteria: whether cooperation is delivered by an organization or network, on the one hand, and whether cooperation is unidimensional or multidimensional, on the other. According to these authors, there is a tendency observable from mainly uni-
lateral forms of cooperation (often at the level of organizations) towards multidimensional and hybrid forms of cooperation (Table 1).

This institutional complexity, in combination with the discourses developed around it, lead to a renewed need for adequate tools for monitoring, assessment and comparison of regional integration processes.

Table 1. Typology of regional cooperation mechanisms

<table>
<thead>
<tr>
<th>Organization</th>
<th>Network</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unidimensional</td>
<td></td>
</tr>
<tr>
<td>Sectoral organizations</td>
<td>Research networks</td>
</tr>
<tr>
<td>Security organizations</td>
<td>Public-private partnerships</td>
</tr>
<tr>
<td>Economic integration</td>
<td>Civil society networks</td>
</tr>
<tr>
<td>arrangements</td>
<td></td>
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<tr>
<td>Regional development banks</td>
<td></td>
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<tr>
<td>Multidimensional</td>
<td></td>
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<tr>
<td>Comprehensive organizations</td>
<td>Growth triangles</td>
</tr>
<tr>
<td>River basin organizations</td>
<td>Cross-border micro-regional organizations</td>
</tr>
<tr>
<td>UN Economic Commissions</td>
<td>Development corridors</td>
</tr>
</tbody>
</table>

Source: Hettne and Söderbaum [2004: 5-6]

Systematically monitoring regional integration processes is a relatively recent activity, though, but its potential is quite important. Different actors have appeared on this emerging scene and have shown that there is a growing interest from the side of policy-makers in such systems. The European Commission, the European Central Bank (ECB), the Inter-American Development Bank (IDB), the Asian Development Bank (ADB), the Eurasian Development Bank (EDB), ALADI, and UNECA, for example, have expressed their intentions to get involved in active monitoring or have developed and/or applied monitoring systems [De Lombaerde and Van Langenhove 2006].

From an academic perspective, systematic monitoring allows to get a more precise idea of the depth and speed of certain regional integration processes, more clarity on the relative importance of regionalization versus globalization processes (and their interaction), and a better understanding of the meaning and significance of the so-called new regionalism, viewed as a multi-dimensional phenomenon. It allows us to explore the future of the international governance architecture, and clarify whether trends may be expected in the direction of multilateralism, (multi-) regionalism or a (new) combination of both [Fratianni and Pattison 2001; Hettne 2005].

From a policy-making perspective, better monitoring has the capacity to make integration policies more effective and integration processes more transparent, involving higher degrees of participation and legitimacy, and therefore, making the processes more sustainable.

On the concept of new regionalism, see e.g. Hettne et al. [1999-2002]; Breslin et al. [2002]; De Lombaerde [2003]; Söderbaum and Shaw [2003]; Gavin and De Lombaerde [2005]; Farrell et al. [2005].
In this paper we present a critical review of recent proposals and experiences with setting up indicator systems for monitoring regional integration processes. The review covers both conceptual (academic) proposals as well as indicator systems developed by or for regional organizations. A systematic comparison of the different indicator systems (covering both technical and political-economy aspects) should make it possible to evaluate their relative qualities and to identify best practices. The exercise presented here aims at contributing to the design of better indicator systems in the future.

Section two presents the aims and methodology of the paper. Section three evaluates the selection of indicator systems. Section four concludes.

2. METHOD OF THIS PAPER

2.1. CHOICE OF THE CASES TO BE EVALUATED

For this study we are interested in indicator systems designed to monitor regional integration processes in a systematic way, involving the use of a ‘significant’ number of indicators and variables. The criteria that are used to select the cases (indicator systems) are rather broad. We considered both academic and institutional initiatives; both conceptual and applied systems; both broad and narrow (specific) systems; both qualitative, quantitative and mixed systems; and both prototype and finalized systems. We have tried to be as inclusive and complete as possible in the identification of relevant cases, but cannot – of course – guarantee exhaustiveness.

We included the following institutional proposals: (i) the ECB proposal to examine regional institutional and economic integration in MERCOSUR (as compared to the EU) [Dorrucci et al. 2002] (further referred to as: ECB-MERCOSUR); (ii) the various schemes proposed and/or implemented by the European Commission and its regional partners, in the framework of interregional relations; (iii) the COMESA proposal as a response to DG DEV’s proposal (COMESA, 2002) (COMESA); (iv) UNECA’s proposal to monitor regional integration in Africa (UNECA) (UNECA, 2001, 2002, 2004); (v) the indicator system proposed for ASEAN [Dennis and Yusof 2003], both in its full (ASEAN) and short (ASEAN-KEY) versions; (vi) the EDB proposal to monitor regional integration within Eurasian economies (EDB) (EDB, 2009); and (vii) the ADB system of indicators to measure economic integration and cooperation in East Asia (ADB) [Capannelli, Lee and Petri 2009].

The schemes proposed by the European Commission include: the EU-MERCOSUR Joint Photography (EU-MERCOSUR) [European Commission 1998]; the EU-CAN Joint Evaluation (EU-CAN) [Grupo de Trabajo UE-CAN 2005a;b]; the EU-Central America Joint Evaluation (EU-CENTRAL) [Grupo de Trabajo Conjunto CA-UE 2005a;b;c]; and the EU-ACP Reviews (EU-ACP) [European Commission 2002; European Commission 2005b; World Bank 2002; COMESA 2002].

2 For the EC we have selected the indicators systems for (mainly) ex ante monitoring purposes. The EC has also a well developed system of ex post monitoring - the Results Oriented Monitoring (ROM) System - that is used for the monitoring of the effectiveness of EC funded programme.
In addition, the following ‘academic’ proposals, were included in our sample: (i) Hufbauer and Schott's proposal to assess regional integration in the Americas [Hufbauer and Schott 1994] (further referred to as ‘H&S’); (ii) its modified version by Feng and Genna [2003; 2004; 2005] (‘F&G’); and (iii) Ruiz's GDRI model [2004] (‘GDRI’). Fourteen indicator systems have thus been selected for the evaluation exercise. A number of other proposals and initiatives have been left out of our analysis.3

2.2. POLITICAL ECONOMY ASPECTS: BY WHOM? FOR WHOM? WHY?

Before tackling and evaluating the technical aspects of indicator systems let us first have a look at their political economy aspects. Indeed, the evaluation of the technical quality of a system cannot be seen independently from the actors involved or concerned (users and producers of the monitoring system), their goals and the goals of the indicator system itself.

Actors possibly interested in the design of indicator systems for regional integration include: regional organisations, individual countries, academia, civil society, and external governmental and non-governmental actors. In line with the shifts suggested by Hettne and Söderbaum [2004] in the direction of networked and multidimensional forms of regional cooperation, as mentioned above, it might be expected that more (and different) actors will be involved in monitoring in the future.

An important distinction that should be made is between uni-regional and pluri-regional (comparative) monitoring and indicator systems. Uni-regional systems refer to the regional integration process in one region. They can be designed by/for regional actors (e.g. regional organisations, regional civil society organisations, ...), by extra-regional actors (e.g. donor governments, international organisations, ...), or by a combination of both. Pluri-regional systems refer to two or more processes and feature a comparative aspect. Again they can be designed by different kinds of actors. Obviously, the comparative aspect implies a number of specific technical issues.

For the, politically more sensitive, comparative systems, a choice is possible between traditional comparative indicators (allowing for a direct comparison of the scores of particular regions on a particular variable) and ‘relative’ (‘reflexive’) indicators (comparing first the performance of each region with its own objectives) [De Lombaerde and Van Langenhove 2006]. The World Bank [2002], for example, favours relative comparisons. A combination of comparative and relative indicators is also possible. A concrete example of a case where both types of indicators are combined is the system of Indices of Economic Integration Effort in Africa [UNECA 2001: 2]. In that system two yardsticks are used: (i) the self-defined pre-determined

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3 For example, DG Internal Market's Internal Market Scoreboard, launched in 1997 and published since then, and the Eurobarometer were left out of the scope of our evaluation because of their high level of specificity, although these tools are obviously interesting in terms of their design and in terms of the communication strategy built around them [European Commission 1997; 2005; Costea et al. 2008] (see, http://europa.eu.int/comm/public_opinion/standard_en.htm).
targets for target-driven indicators (if they exist for particular integration groupings), or (ii) an average of the n best performers.

When designing an indicator system for the monitoring of regional integration processes, a number of ‘political choices’ should further be made. Following De Lombaerde and Van Langenhove [2006], these include: (i) the degree of specificity of the system: referring to the number of aspects of integration (or sectors) that are covered; (ii) the level of assessment: referring to the fact that systems can be designed to monitor the dynamics of a group of (integrating) countries or regions, or otherwise, to monitor the participation of individual countries/regions in the integration schemes; (iii) the treatment of overlapping memberships, relating to the choice of countries to be included in the monitoring exercise and leading to technical problems concerning the disentanglement of effects of regional integration; when, as also observed by the World Bank [2002], the evaluation of a regional arrangement involves ‘rewards’ or ‘sanctions’ from the international (donor) community, should be able to handle asymmetries within the groupings, such as passive or obstructive behaviour by one or a minority of members, caused by e.g. occurrence of a conflict, diverging policy preferences, etc; and (iv) the distinction between policy discourse, effort, implementation and effect.

2.3. CONCEPTUAL FRAMEWORK

Between the political economy aspects and the technical aspects of indicator systems stands the conceptual framework used to build the indicator system, whether it is explicitly presented or implicitly present. Reflecting the fact that there is no unique definition of regional integration, and that it is a phenomenon with evolving characteristics, again a number of options lay open: regional integration conceived as a process or a state [Balassa 1961]; adoption of a uni-dimensional or a pluri-dimensional approach; focus on institutionalised or ‘real’ integration; focus on ‘positive’ or ‘negative’ integration [Tinbergen 1954; Pinder, 1968]; focus on one actor or more

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4 One should be aware that focussing on one level of analysis, say the regional level, might bias the results. Simultaneous policies (be it in different policy areas) in opposite directions might yield a net effect in either direction. A bias might occur if integration policies tend to be common policies, whereas disintegration policies (protectionist reactions) tend to be national, which might well be the case. Theoretically, ideal indicators would be net indicators, showing whether a given set of policies and measures taken during a period of time contribute or not to integration. Such indicators are however difficult to construct.

5 On the issue of overlapping memberships, see for example UNECA [2004]. It is particularly problematic in Africa, and it is becoming more problematic in South America.

6 In this context, the distinction between ‘positive’ and ‘negative’ integration is relevant. The former might suggest more ‘policy effort’ and be captured as such by many indicators, although nothing assures ex ante that ‘positive’ measures have more important effects than ‘negative’ integration [De Lombaerde and Van Langenhove 2006].

7 Low levels of integrative ambition are associated with negative integration, whereas high levels of integrative ambition are associated with positive integration, although it is difficult to conceive negative integration without a minimum amount of positive measures [Best 1997: 56]. Integration should be seen as a varying mixture of both types of measures.
actors; adoption (or not) of a typological approach, like Balassa's well-known stages approach [Balassa 1961] or a new regionalism typology like Hettne and Söderbaum's based on the regionness concept [Hettne and Söderbaum 2000]; etc. The definition of regional integration will usually imply that related concepts like coordination or cooperation are also to be defined.8

Concepts refer to theoretical models of regional integration. These theoretical constructs suppose causal or systemic relationships between variables and suggest ways of interpreting the results of monitoring exercises. Especially relevant within this context is the strong normative tradition in integration studies [Bekemans, Fiorentino and Van Langenhove 2000: 55-7]. This, in turn is explained by the fact that research on regional integration is very much steered by its context and, historically, by the development of European integration. One should be careful not to reduce the evaluation of the facts (actions, decisions, effects), taking place in particular regions, to a mechanical application of a model labelling them as positive or negative, progress or decline, functional or dysfunctional, etc. [De Lombaerde and Van Langenhove 2006].

The Balassa model of economic integration [Balassa 1961], for example, has been extremely influential in academia and lends itself very well for measuring ‘progress’ of a particular integration scheme. However, the model is too often confused with a set of general laws governing integration processes. In the real world, simultaneity, inversion and endogeneity are rather the rule than the exception [De Lombaerde and Van Langenhove 2006].

2.4. VARIABLES AND CATEGORIES

The choice of categories of variables is, on the one hand, linked to the chosen level of specificity of the indicator system and, on the other, to the theoretical framework employed. Alternative ways of classifying variables include: (i) the sectoral approach with a classification by policy areas; (ii) the sectoral approach with a classification by disciplinary fields; and (iii) the input-output approach [De Lombaerde and Van Langenhove 2006]. The first two approaches are straightforward, although border cases will occur.

The input-output approach is theoretically the most attractive because of its analytical focus; however, it is not necessarily the most practical for setting up a monitoring system. In the input-output approach, as ‘inputs’ can be considered: structural characteristics of the integrating area (number of countries, shared borders, etc.), asymmetries, capacities to integrate, commitments, governance structure, overlapping memberships, etc. As ‘outputs’ could be considered: policy implementation (as

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8 Recently, for example, the problem of conceptualisation has been illustrated very well in the context of the discussions about the RCRP proposal of the European Commission. The World Bank [2002], proposed to distinguish between ‘integration’ and ‘cooperation’ on the basis of the degree of sovereignty that countries agree to transfer to supranational institutions, but recognised that the borderline is not clear-cut. The Commission itself proposed a category of inter-state interaction called ‘functional regional cooperation’ (see below).
intermediary output), effects on flows, effects on growth, degree of interdependence, etc. A special category of inputs could be called pre-conditions for integration. Although originally intended to assess (ex ante) the possibilities and potential of (future) integration agreements, the variables involved can also be used in a dynamic manner to evaluate the compatibility of the formal integration process with the pre-conditions. In addition, these pre-conditions are not static, they are often endogenous because of feedback effects of the integration process. H&S and F&G are examples of indicator systems focusing on these pre-conditions. Ex ante studies have not been limited to trade and economic issues. Best [1997], for example, analysed the public-management capacities for regional integration and identified a set of variables that shape the complexity of the implementation of the integration objectives (‘levels of integrative ambition’). The author identified nine key variables, various of these consisting of sets of variables themselves, that shape the complexity of the implementation of the integration objectives. The variables are: (i) number of member states, (ii) relative sizes of the participating countries, (iii) different levels of development, (iv) scope of coverage, (v) type of impact, (vi) time perspectives, (vii) degree of real interdependence, (viii) political framework, (ix) perceptions, values and norms.

In order to have a benchmark against which the indicator systems can be compared and evaluated, we propose to use the conceptual framework as developed in De Lombaerde and van Langenhove [2006]. The different systems that will be evaluated use a different terminology, ways of presenting, and ways of classifying which make it difficult to compare their contents. Our purpose is to screen the existing systems and to consider each individual variable and re-classify them in our pre-established categories. The conceptual framework which will be used here, combines features of the three generic ways of classifying variables, as explained before. In this conceptual framework, the distinction between real and formal integration is considered as not really appropriate; parallel (but interconnected) processes of regional integration are considered: institutional (more or less capturing what is usually called ‘formal’), political, economic, cultural, etc. The effects of integration policies and the evolution of regional interdependence will obviously have feedback effects for the institutionalisation process, thus conceptually restoring its endogenous character.

In principle, variables and indicators are included in the framework on the condition that they inform us on the regional integration process. This seems straightforward, however, one should be aware of the fact that a (large) grey zone exists, consisting of variables that are, as such, purely national indicators but that can easily be transformed into indicators of convergence/divergence. Growth rates and inflation rates for member states illustrate this point very well. Another group of variables that are in a grey area, are the variables that belong to political economy approaches to integration, such as: underlying motivations of integration processes, role of interest groups, and permeability of regional institutions, etc. Without

9 See e.g. the discussion on the endogeneity of OCA criteria [Frankel and Rose 1998].
10 As in the case of the COMESA proposal [COMESA 2002], this can well be only a matter of presentation (i.e. not involving calculations of convergence indicators).
understanding the underlying motivations of a regional integration effort, it is difficult to evaluate.

The conceptual model is shown in figure 1. Six categories of variables are considered: (i) actors, (ii) structural factors, (iii) institutionalisation, (iv) implementation, (v) effects, and (vi) interdependence.

The categories of actors and their structural characteristics (structural factors), contain information about the basic building blocks of the integration effort. The category of actors refers to the number and type of actors involved and their behaviour. The number of countries or regions involved has a direct influence on the dynamics of the decision-making process. From an administrative and political point-of-view, the number and character of the policy-making and implementing levels is also important. In addition to their numbers, within each category of actors a list of attributes can be established to reflect their character and importance. The intensity of their involvement and their importance in the decision-making process can be evaluated through quantitative methods (number of meetings attended, financial contribution, etc.) or qualitative assessments (expert opinion).

The category of structural characteristics, includes all those variables that refer to structural characteristics of the integration grouping and of its members. They should logically be restricted to variables that are directly or indirectly related to the integration process. These variables might relate to the scale of the arrangement, the structure of the grouping and of each component, the nature of the components, etc. Proximity of the actors is obviously a relevant variable to evaluate the potential and sustainability of an integration grouping. Gravity type models of economic interaction have shown significant (negative) relationships between the intensity of economic relations between countries and their distance. It has been shown also that proximity/distance is a typical multi-dimensional variable; physical, economic, political, cultural, linguistic, and historical proximity are all relevant variables. Structural asymmetries play an important role in integration processes although the direction of causalities is not clear. Its measurement can be based on variables of population, the economy, external relations, and so on.

The actors involved in integration processes take steps (measures) that are supposed to contribute towards regional integration and the ‘Institutionalisation’ of the region and its integration effort. These political decisions are implemented to some extent (implementation) and have or have not certain impact (effects) in different areas (social, economic, cultural, etc.). Also relevant is the institutional basis on which the whole integration process rests (for example, constitution-based versus treaty-based integration processes); institutionalisation should thus be analysed on different levels. Obviously, institutional activity has quantitative (for example, number of treaties or ministerial meetings) and qualitative aspects (content of the treaties or decisions). Productivity measures can be applied to the institutional activity, thus linking policy outputs to their resource cost.

Seen from the perspective of citizens and policy makers, the most important category of variables should be the effects of regional integration policies. It is also the most problematic category to include in the system. This is related to the fact that it is difficult to isolate effects of integration from those of other phenomena. Integration is a complex and dynamic process not necessarily adequate for causal
explanation. On top of that, for many aspects of integration, there are no comparable data sets nor standardised research methodologies available. This is certainly true for the analysis of static effects of integration (directly linked to the reallocation of resources among sectors and countries), but even more so for the analysis of the dynamic effects of integration. Although researchers often concentrate on the short term (static) effects of integration measures rather than on the dynamic ones, it should be stressed that the sign (direction) of the effects does not necessarily coincide, so that the former cannot necessarily be used as a proxy for the latter. In practice, it is often explicitly understood and accepted that short term costs (transition costs) are the price to pay for reaping long term benefits.

Effects of integration, together with structural conditions and exogenous influences, can explain the degree and evolution of interdependence between the regional actors. Effects are thus attributable to specific integration policies, whereas the degree of interdependence is autonomously measured and reflects the evolution of interdependence in different dimensions. Interdependence is used here as a substitute for what is often called ‘real’ or ‘de facto’ integration. Interdependence tries to capture the degree of ‘regionness’ of the region, or at least some aspects of it. Regionness is also a central concept in the new regionalism approach [Hettne 1999; Hettne and Söderbaum 2000].

Interdependence can be assessed on different dimensions, such as economical, political, cultural, security and infrastructural. These dimensions coincide broadly with those considered in the proposal for a system of indicators of interconnectedness, made by Held and others in the framework of the Global Transformations project [Held et al. 1999]. The following dimensions are being considered in that project: (i) political-legal indicators, (ii) military indicators, (iii) economic indicators, (iv) migration indicators, (v) culture indicators, (vi) environment indicators, (vii) global stratification. Many of the indicators proposed could be transformed into
indicators of regional interconnectedness. The measurement of the degree of interdependence can be approximated via the measurement of the flows (of people, goods, capital, information, etc.) that are interconnecting the actors or via direct measurements of correlations of variables (for example, symmetries in business cycles, interest rate spreads, etc.). For the forms of interdependence that are more difficult to measure, like political interdependence, indirect measurements should be considered. The patterns of voting behaviour in multilateral organisations might, for example, be a possible indicator of regional policy convergence/divergence.

Interdependence through trade flows is probably the most studied kind of interdependence. Its study is usually based on simple indicators as the relative importance of intra-regional trade and its growth, which can easily be calculated. More sophisticated indicators are available, which correct the former for size effects in order to allow for methodologically sound inter-regional comparisons [Iapadre 2006].\(^{11}\) The indicators of the degree of integration can be complemented with indicators of the direction and nature of commercial integration. This is particularly relevant from an analytical point of view. The composition of the flows induced by the integration process are good indicators of the underlying socio-economic changes that take place in the member countries. In the case of trade flows, for example, indicators of intra-industry trade and of the technological content of intra-regional trade can easily be calculated. The ex post analysis of the flows of (public) funds between national governments and the supranational institutions within a group of countries (a region) also permits an evaluation of the degree of their integration, provided that these flows reflect the actual level of organised solidarity, the importance of the supranational institutions, etc.

2.5. AGGREGATION AND WEIGHTING

Indicator systems can be designed as tableaux de bord, consisting of an ordered presentation of the values of the selected relevant variables, permitting - for each variable - cross-country or cross-region comparisons and time series analysis, but without establishing explicit weights for the variables and their categories. The designers can go a step further though and add calculations of aggregate indicators per country, per region and/or per sector. Aggregation procedures ‘pre-process’ the data so that their reading by the users is simplified, but it should be added that this is not necessarily true for its interpretation. Aggregate indicators might become too abstract, especially if they are multi-dimensional.

The index problem can be solved in different ways. The weighting procedure can be based on statistical criteria (based on the statistical contribution of the variables to the variation of a goal variable)\(^{12}\), expert opinion or practical considerations (data availability, lack of knowledge or valid criteria, etc.) [De Lombaerde and Van Langenhove 2006]. In any case, weighting procedures will always be arbitrary.

\(^{11}\) See also, the Regional Integration Knowledge System (RIKS) at: www.cris.unu.edu/riks.

\(^{12}\) For an example of statistical weighting, see e.g. the CSGR Globalisation Index [Lockwood and Redoano 2005]. On methodological aspects, see Nardo et al. [2005].
to some extent. The World Bank [2002], for example, pointed to the problem of combining indicators applying to different topics or different regional arrangements, and suggests to accompany the quantitative data with qualitative assessments.

3. EVALUATION OF THE SELECTED SYSTEMS OF INDICATORS

3.1. BY WHOM, FOR WHOM AND FOR WHAT PURPOSE?

Of our set of 14 indicator systems under evaluation, three proposals are proposed by academics, eleven by regional institutions. Of the latter, five belong to the EU family, thus illustrating the active role the EU is playing in promoting regional integration worldwide.

EU-ACP

The Cotonou agreement places particular emphasis on regional economic integration and the role of regional organisations (see articles 28–30 of the agreement and articles 6–14 of annex IV). Annex IV article 9 sets out some principles for regional resource allocation, which are comparable to those for national resources allocation. The article states that the indicative resources allocation shall be based on an estimate of the need and the progress and prospects in the process of regional cooperation and integration. Regional mid-term reviews (MTRs) and end-of-term reviews are explicitly foreseen in article 11 of the agreement. The Cotonou text is clear on the key principle, i.e., flexibility of financial cooperation to ensure that it is kept constantly in line with the objectives of the Agreement. Therefore MTRs are based on three elements: (i) the review process should provide an update of the regional strategy paper (RSP) analysis, i.e., update on the political, economic and social situation, priorities and objectives of the region concerned, highlighting any changes occurred since the RSP programming; (ii) regional MTRs should in principle not lead to a change in the RSP but should assess the implementation of the regional indicative programme (RIP), ensure its correct implementation and, where appropriate, lead to the formulation of concrete proposals to adapt the RIP to evolving circumstances; (iii) regional MTRs may lead to a revision of the region’s allocation by the Community in the light of current needs and performance. In addition, and following the EU Council conclusions of March 2003, “MTRs should take into

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13 Although external experts were contracted in cases like ASEAN and UNECA.
14 Cotonou Agreement, article 11 of annex IV: “Financial cooperation between each ACP region and the Community shall be sufficiently flexible to ensure that operations are kept constantly in line with the objectives of this Agreement and to take account of any changes occurring in the economic situation, priorities and objectives of the region concerned. A mid-term and end-of-term review of the regional indicative programmes shall be undertaken to adapt the indicative programme to evolving circumstances and to ensure that they are correctly implemented. Following the completion of mid-term and end-of-term reviews, the Community may revise the resource allocation in the light of current needs and performance.”
account and operationalise, as appropriate, EC/EU policy initiatives and commitments taken at the international level, while respecting the principles of subsidiarity, ownership and concentration of aid."

Although the Cotonou agreement does not explicitly require annual operational reviews within regional programming, such reviews were organised in 2003 for each of the programming regions in accordance with the principle of rolling programming and by analogy with the country strategy paper (CSP) review process.

The EU-ACP Reviews were based on reports prepared by DG DEV geographical services, with support from Delegations with a regional responsibility. These reports were discussed by the Commission services in the framework of a region team meeting and were finally formalised in the regional review meeting with the participation of regional authorising officers (RAOs), national authorising officers (NAOs), Heads of Delegation (HoDs), Member States and non-State actors. The 2003 operational reviews have concentrated on a limited number of priorities, such as: (i) 9th EDF programming and the use of old EDF resources; (ii) performance indicators in the intervention framework (9th EDF) to measure results in focal sectors; (iii) preparation of the Economic Partnership Agreements (EPAs); and (iv) preparation of MTRs.

The main weakness of the exercise has been the lack of involvement of the RAOs in the preparation of the operational reviews and the difficulty of ensuring participation of the RAOs, NAOs, HoDs, Member states and non-state actors (NSAs) in the exercise. In the absence of representatives of the region’s member countries, it was not always possible to properly assess the economic integration process and the major constraints of its implementation at national level. In some cases there was no region team meeting but the 2003 draft annual report was only shared with the relevant services in headquarters and Delegations. Therefore, the annual reports cannot always be considered as real joint reports.

**EU-MERCOSUR**

The inter-regional Framework Co-operation Agreement signed by the EU and MERCOSUR in Madrid in 1995 led to the creation of three Technical Working Groups (on Goods, on Services and on Trade Norms and Discipline). The TWGs met for the first time in Brussels in March 1997, and for the second time in Punta del Este, Uruguay, in November 1997. In accordance with the agreed calendar, the TWGs have worked towards preparing a detailed photography of the current status of trade relations between the European Community and MERCOSUR, which has been finalised in April 1998. The assessment served as a background document for the preparation of the interregional association agreement between the European Community and MERCOSUR. In order to prepare each part of this photography, the EC and the MERCOSUR delegations to the Working Groups have conducted a number of comparative analyses of various aspects and areas of EC-MERCOSUR trade relations covering the period from 1990 to 1996. They have also exchanged complete data bases and information bases on all facts and legislation directly relevant to these analyses.

The Joint Photography establishes the final agreed description of the current situation and of its recent evolution as regards trade in goods and in services and trade
standards and disciplines (regulations; technical norms and conformity assessment; commercial defense instruments; competition rules; public procurement; rules of origin and veterinary and phytosanitary rules).

EU-CAN and EU-CENTRAL

In the case of EU-CAN and EU-CENTRAL, the Ad-Hoc Joint Working Groups dealt with the technical aspects of this phase of the joint assessment exercise. These Working Groups reported their conclusions and recommendations to the 9th Joint Committee and met three times per year (usually during the months of April, June/July and October) alternating locations between both regions.

The Madrid Declaration (2002) provided the political mandate to the European Commission for the negotiation of political dialogue and cooperation agreements with CAN and CA. The prospects for an Association Agreement, including FTAs, rest on two preconditions: (i) completion of the Doha Development Agenda; (ii) achievement of a sufficient degree of Regional Integration. An agreement on the Joint Assessment was reached during the EU-LAC Summit in Guadalajara in May 2004 and was formalized in January 2005 during the EU-CAN mixed commission. Under the joint exercise, officials from both sides met on a regular basis to review the state of integration and assessed whether the progress achieved permits to start negotiations. The exercise was conducted in parallel but independently with CAN and CA. The final report of the EU-CAN exercise was published in July 2006 (Joint Working Group EU-CAN, 2006). However, recent developments in the Andean Community, and particularly the abandoning of the common external tariff in July 2007, illustrate the meager impact of the whole exercise on the integration process.

ECB-MERCOSUR

The main goal of the contribution of the European Central Bank was “to test for the hypothesis that institutional integration interacts with economic integration at the regional level” [Dorrucci et al. 2002: 6]. The authors sought to draw lessons from the European integration experience for Mercosur.

COMESA

The COMESA proposal [COMESA 2002] was a response to DG Development’s proposal for the RCRP (EU-ACP). The short-term goal was to identify indicators to measure the effectiveness of COMESA programmes in promoting regional integration. The aim was to build up a time series which could measure the effectiveness over a specific period of time. This would allow COMESA as an organisation to determine which programmes are more effective than others and allow some fine-tuning of programmes which are not performing well. The long-term goal was to develop a regional surveillance mechanism (RSM): (i) to provide a measure of how successful regional policies are in promoting regional integration; (ii) to highlight potential issues which might slow down the regional economic integration and allow the region to develop timely policy responses; (iii) to take the initiative to determine
which parameters the region itself thinks are important in terms of poverty reduction and development rather than relying on preconceptions of outside agencies; (iv) to develop a set of indicators to measure the progress being made in regional integration which can act as both “conditionalities” for the PRSP approach and as a basis for assessing risk for outside investors; (v) to develop a set of regional lock-in mechanisms through a peer pressure system; (vi) to be used as a trigger mechanism for budgetary support in cases where countries need such assistance to continue with the process of liberalization.

UNECA

Progress in regional integration was assessed by UNECA in order to analyse the performance of each regional country (individually and relative to other member countries) in achieving specific objectives set by the treaties as well as to evaluate the overall progress made by the regional economic communities towards realizing the goals and objectives of the African Economic Community. The assessment focused on the progress made after the African Economic Community was established by the Abuja Treaty. The indicators have been based on the eight sectors that are common to the treaties of the regional economic communities. The sectors are: trade, money and finance, transport, communications, energy, agriculture, manufacturing and human development and labour markets. The Composite Integration Index which assesses the ‘relative performance of a regional economic community’ is also developed based on the eight sectoral indices. The main objectives of the indices are listed as follows: (i) “[t]o assess each country’s performance and relate it to the goals and objectives of each regional economic community and that of Africa as a whole, as well as to assess the performance of each economic community to that of Africa; (ii) to compare the contributions of each member country in a regional economic community towards the realization of such goals and objectives, in addition to the contributions that each regional economic community has made towards the realization of goals and objectives of the continent at large; (iii) to monitor the performance of each country, regional economic community, and the continent as a whole for regional integration efforts over time; (iv) to enhance the quality of the analysis by providing indices for scores and rankings at country, regional economic community and continent levels” [ECA 2004: 244].

ASEAN and ASEAN-KEY

The report on Developing Indicators of ASEAN Integration is a technical document prepared for the ASEAN Secretariat and funded by the Australian Regional Economic Policy Support Facility (REPSF). The objective of the ASEAN proposal was to measure “the progress towards economic integration of the 10 ASEAN nations in the context of the aim to move towards an ASEAN Economic Community” [Dennis and Yusof 2003: 1], a comprehensive set of indicators has been identified. These focus on the following areas, trade in goods, investment, trade in financial and other services, infrastructure, customs, standards, mutual recognition agreements and conformity assessment, small and medium enterprises, e-ASEAN and intellectual property. While
a complete set of indicators to monitor the progress of economic integration has been recommended, a limited set of indicators has been selected as key integration indicators to be used in the initial stages of monitoring (ASEAN-KEY).

**EDB**

The Eurasian Development Bank [2009] assesses the level of regional integration in post-Soviet countries through the System of Indicators of Eurasian Integration. The short-term goal is to describe the dynamic of integration between 1999 and 2008 and measure the level of integration after the Bing Bang of 1990. The SIEI proposed is based on the analysis of regional integration and regional co-operation. Regional integration is described in terms of integration of markets and convergence of economic system. The objectives of the indicators are:

1. To evaluate the overall level of regional integration achieved by countries and regions in terms of convergence of economic systems, overall cross-border flows of production factors and critical areas of cooperation, which can become areas of actual solidarity.
2. To assess the performance of the ongoing projects of regional integration and measure the members commitment, the fulfil of the institutional mandate and its role in the regional integration process.

The EDB plans to collect data and compute the integration indicators on an annual basis. The long-term goal is to build a consistent system of regional integration in Eurasia to systematically assess the drivers of regional integration, and how regional integration affects country members.

**ADB**

Regional integration in East Asia is driven by intra-industry production networks and the transmission of economic development from more to less developed areas. In this case market integration is leading regional integration. Nevertheless, regional cooperation is weak and regional institutions are underdeveloped. Capannelli, Lee and Petri [2009] measure regional integration with reflexive and comparative indicators through quantitative indicators of market integration and policy cooperation. Quantitative input indicators of political and cultural similarity are calculated to explain the disequilibrium between institutional and economic integration in East Asia.

**Academic proposals (H&S, F&G, GDRI)**

The integration process of the western hemisphere is rather complex due to the vast differences between the countries of North and South America. Two sets of indicators have been developed by Hufbauer and Schott [1994] to analyse this process of economic integration in the western hemisphere (H&S). One assesses the level of
economic integration achieved by each sub regional group and the other examines the level of readiness of these groups in order to increase the degree of hemispheric integration. The indicator system proposed by Feng and Genna [2004] is directly based on H&S. The F&G system measures the level of regional integration according to six categories associated to regionalism. The integration achievement score was used mainly to test the following hypothesis “a critical condition for the emergence of a successful economic union is that the homogenization of domestic economic institutions and the process of regional integration reinforce each other”. The model has been applied to Africa, Asian and Latin America.

The GDRI model developed by Estrada [2004] enables the process of regional integration to be analysed from a global perspective using a social, political, economic and technological framework. This analytical tool is said to be applicable to examine any form of regional integration based on past and present situations and characteristics. Unlike a majority of indicator system which focus on monitoring one aspect of regional integration, this tool encompasses a multidimensional approach. The GDRI model comprises the Regional Global Development Index which is “an indicator to compare different historical periods of the regional integration process in any region” [Estrada 2004: 13] and the Regional Integration Stage Index “measures the degree or stage of the regional integration development that any region achieves in its different stages of evolution” [Estrada 2004: 15].

In general, it can be observed that only few actors are apparently involved in the monitoring exercises. In addition, communication with the broader public in the region is underdeveloped, if not completely absent. The participation of different actors in the monitoring exercise (regional organizations, national governmental actors, civil society, international organizations, academia), could considerably improve the monitoring exercise. Especially the quality and choice of indicators, transparency and relevance of the process and its sustainability could greatly benefit from higher levels of participation.

Summarising, the following objectives of indicator systems can be identified:
- to measure the level of integration of a given regional grouping (H&S, GDRI, EU-MERCOSUR, EDB, ADB);  
- to measure the pre-conditions for (further) integration (H&S, EDB, F&G, ADB);  
- to assess the performance and contribution of individual countries in regional groupings (UNECA, EDB);  
- to evaluate regional integration policies (ASEAN, ASEAN-KEY, COMESA, EDB);  
- to compare regional integration in different regions (UNECA, H&S, GDRI, EDB, ADB, EU-MERCOSUR, ECB);  
- to evaluate donor-financed support programmes for regional integration (EU-ACP);  
- to assess needs and merits of regional organizations upon which to base future aid decisions (EU-ACP);  
- to be strategically used in the context of a negotiation process (EU-MERCOSUR, EU-CAN, EU-CENTRAL).

15 In theory, EU-CAN and EU-CENTRAL have also this objective.
3.2. CONCEPTUAL FRAMEWORKS USED

The conceptual framework is often not very developed in the proposals under consideration. Most of the cases exclusively focus on economic integration without further elaborating the conceptual framework. Some include also institutional aspects (ECB-MERCOSUR, H&S, F&G, EDB, ADB; three cover also technological variables (GDRI, UNECA, ASEAN). Table 2 shows the policy areas covered by the different indicator systems.

Table 2. Coverage of Policy Areas

<table>
<thead>
<tr>
<th>Indicator System</th>
<th>Economic</th>
<th>Social</th>
<th>Institutional</th>
<th>Political</th>
<th>Monetary</th>
<th>Cultural</th>
<th>Technological</th>
</tr>
</thead>
<tbody>
<tr>
<td>H&amp;S-AS H&amp;S-RI</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU-MERCOSUR</td>
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<td></td>
<td>x</td>
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<td></td>
<td></td>
</tr>
<tr>
<td>ECB-MERCOSUR-INST</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ECB-MERCOSUR-ECO</td>
<td>x</td>
<td></td>
<td></td>
<td>x</td>
<td></td>
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<td></td>
</tr>
<tr>
<td>COMESA</td>
<td>x</td>
<td>x</td>
<td>x</td>
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<td></td>
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<tr>
<td>ASEAN Road Map</td>
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<td>x</td>
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<tr>
<td>ASEAN-KEY</td>
<td>x</td>
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</tr>
<tr>
<td>GDRI</td>
<td>x</td>
<td>x</td>
<td>x</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>UNECA</td>
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<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
<td></td>
<td></td>
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<tr>
<td>EDB</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td></td>
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<tr>
<td>F&amp;G</td>
<td>x</td>
<td>x</td>
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<td></td>
</tr>
<tr>
<td>ADB</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td>x</td>
<td></td>
<td>x</td>
</tr>
<tr>
<td>EU-CAN</td>
<td>x</td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>EU-CA</td>
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<td>x</td>
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<tr>
<td>EU-ACP</td>
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<td>x</td>
<td>x</td>
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</tbody>
</table>

Note: AS = Achievement Scores of Economic Integration; RI = Readiness Indicators; INST = Institutional Index of Regional Integration; ECO = Economic integration measure.

Only a few proposals deal with conceptual issues. In the ASEAN proposals, for example, a distinction is made between integration, openness and interdependence [Dennis and Yusof 2003: 24–25]. In the EU-ACP review process it is stressed that integration and cooperation should both be examined. The European Commission (2002b) further sustained that it favours indicators of inputs and efforts, rather than results and effects.

The EDB Report contains an extensive methodology [EDB 2009]. Regional cooperation, regional economic integration and social integration are defined and discussed. The study also distinguishes between existing approaches measuring regional integration: (i) market integration; (ii) economic convergence; and (iii)
institutional integration. A critical literature review and the technical aspects of monitoring the indicators are also developed.

A few proposals explicitly refer to a theoretical framework. The conceptual framework of GDRI is based on the old (closed) and new (open) regionalism [Bhagwati et al. 1999]. However, in spite of this economic bias in the theoretical framework, the choice of indicators shows a multi-dimensional approach [Ruiz 2004].

To evaluate institutional integration, the ECB developed an institutional index of regional integration based on Balassa’s [1961] conceptual framework. The authors consider four stages of regional integration: (i) free trade area (FTA)/customs union (CU), (ii) common market (CM), (iii) economic union (EUN), and (iv) total economic integration (TEI). The index measures at a specific instance the level of integration attained by a particular regional arrangement. “Institutional integration can be defined as the outcome of joint policy decisions designed to affect the depth and breadth of regional integration over time” [Dorrucci et al. 2002: 6]. Interesting here is that they apply the Balassa model in a flexible way in order to account for different time patterns, instead of sticking to a strict sequencing. Economic integration is evaluated using a set of variables based on the Optimum Currency Area theory and also other measures outside of this framework. Dennis and Yusof [2003] also use a Balassa type conceptual framework.

3.3. VARIABLES AND CATEGORIES

The number of variables in the indicator systems under evaluation varies from one system to the other. It ranges from six variables (F&G) to 145 variables (EDB and ASEAN) (table 3). Cases like ECB’s Economic Integration Measure (ECO), COMESA and ADB feature mainly quantitative measures, whereas H&S, F&G, ECB’s Institutional Index of Regional Integration (INST) are based on ordinal variables.

The fourteen cases classify the variables in different ways, making a direct comparison difficult. The categories are usually based on policy areas. This is the case for EU-MERCOSUR, EU-CAN, EU-CENTRAL, all focusing on trade related variables, and UNECA, featuring eight ‘clusters of activity’ to classify the variables and indicators. These are: (i) trade and market integration, (ii) monetary, fiscal and financial integration, (iii) transport, (iv) communications, (v) industry, (vi) energy, (vii) food and agriculture, and (viii) human development and labour markets [UNECA 2001; 2002].

EDB [2009] distinguished three aspect of regional integration: regional market integration, convergence of economic systems and regional co-operation. The choice of indicators was determined by the availability of data on post-Soviet economies and the importance to particular areas of economic co-operation and modernisation in CIS countries. Integration of markets is divided between general market integration in trade integration and labour migration and indicators of functional integration in electric power, agriculture and education. Convergence of post-Soviet economies is evaluated in four areas: macroeconomics, monetary policy, financial policy and fiscal policy. Three types of indicators were calculated for market integration and economic convergence: (i) integration of country pairs: (ii) inte-
igration of a country with a group of countries; and (iii) integration within a group of countries. Regional co-operation and the potential for further integration is measured through an analysis of an expert poll and indicators of institutional performance.

Table 3. Number and Type of Variables

<table>
<thead>
<tr>
<th>Indicator System</th>
<th>Number of Variables</th>
<th>Type</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Quantitative Measures</td>
</tr>
<tr>
<td>H&amp;S-AS</td>
<td>6</td>
<td>x</td>
</tr>
<tr>
<td>H&amp;S-RI</td>
<td>7</td>
<td>x</td>
</tr>
<tr>
<td>EU-MERCOSUR</td>
<td>52</td>
<td></td>
</tr>
<tr>
<td>ECB-MERCOSUR-INST</td>
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</tr>
<tr>
<td>ECB-MERCOSUR-ECO</td>
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<td>x</td>
</tr>
<tr>
<td>COMESA</td>
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</tr>
<tr>
<td>ASEAN</td>
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</tr>
<tr>
<td>ASEAN-KEY</td>
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<td>x</td>
</tr>
<tr>
<td>GDRI</td>
<td>102</td>
<td>x</td>
</tr>
<tr>
<td>UNECA</td>
<td>20</td>
<td>x</td>
</tr>
<tr>
<td>EDB</td>
<td>145</td>
<td>x</td>
</tr>
<tr>
<td>F&amp;G</td>
<td>6</td>
<td>x</td>
</tr>
<tr>
<td>ADB</td>
<td>21</td>
<td>x</td>
</tr>
<tr>
<td>EU-CAN</td>
<td>21</td>
<td>x</td>
</tr>
<tr>
<td>EU-CENTRAL</td>
<td>21</td>
<td>x</td>
</tr>
<tr>
<td>EU-ACP</td>
<td>35</td>
<td>x</td>
</tr>
</tbody>
</table>

Notes: see Table 2. Quantitative measures are *a priori* not excluded in EU-CAN, EU-CENTRAL and EU-ACP.

More sophisticated classifications of variables, with features of the input-output model are found in ECB and EU-ACP systems. The ECB distinguishes between institutional and economic integration [Dorrucci 2002]. The former is evaluated on the basis of the implementation of decisions in four dimensions, based on Balassa’s stages approach to integration, as mentioned before. Within the latter category, seven subcategories (and 11 variables) are considered: (i) synchronisation of the business cycle, (ii) convergence of inflation rates, (iii) exchange rate variability, (iv) trade openness and integration, (v) financial market integration, (vi) convergence of interest rates, (vii) income convergence.

EU-ACP distinguishes between types of policies. In the 2002 document, the categories were: (i) regional economic integration; (ii) functional regional cooperation; (iii) governance and financial issues; and (iv) implementation of EDF projects and programme. The indicators measure the efforts or inputs into the integration process (they do no attempt to measure results and outputs). In the 2005 document the indicators proposed by the EC are grouped under the following categories: (i) regional trade liberalisation and facilitation, (ii) other regional integration policies
(including EDF implementation), and (iii) institutional structure and governance issues. The distinction is stressed between institutionalisation (reaching agreements and adopting required legislation) and effective implementation. Monitoring should be able to distinguish those cases. However, it is not clearly specified how this should be done.

As a response to DG Development’s proposal, the COMESA Secretariat launched a proposal for a system of indicators with an alternative design. The philosophy of that proposal is different in the sense that inter-regional comparisons are not the main focus, but rather the monitoring of their own integration process. COMESA considers 12 categories of variables: (i) trade liberalisation, (ii) trade facilitation, (iii) trade in services, (iv) transit facilitation, (v) monetary convergence, (vi) domestic payments and settlement systems, (vii) fiscal environment, (viii) government intervention in the economy, (ix) capital flows and foreign investment, (x) governance issues, (xi) regulatory environment, (xii) licensing requirements.

In its discussion of the UNECA methodology, the COMESA Secretariat expressed strong reservations over the methodology used, precisely for the reason that the UNECA indicators do not necessarily reflect the effects of programmes being undertaken by regional organisations [COMESA 2002: 6]. COMESA criticised, for example, the ranking of SADC and ECOWAS as the most successful regional organisations. According to COMESA, these rankings simply reflect the presence of a member with a large economy in each case (South Africa and Nigeria, respectively). One should therefore carefully distinguish between structural characteristics of countries and regional groupings, on the one hand, and integration policies, on the other hand.

In order to better compare the contents of the different indicator systems, we reorganised all the variables of the fourteen systems according to the categories of our conceptual framework, as presented in section 2.4. A summary of this re-classification exercise is shown in table 4.17 The table shows a different picture than the one based on the published results of the indicator systems.

Surprisingly, it appears that one fourth (175 out of 702 = 25%) of the variables do not inform us directly about the regional integration process. And this is not only due to the presence of readiness indicators. COMESA, UNECA, ASEAN, and GDRI illustrate this very well. The categories on which the systems focus are varied. Those that focus on one category are: F&G on Institutionalisation and Policies; EU-MERCOSUR, EU-CAN, EU-CENTRAL and EDB on Implementation; ASEAN-KEY on National Macroeconomic Indicators; and GDRI on Other National Indicators. Those that focus on two categories are: H&S on Institutionalisation and National Macroeconomic Indicators; ECB-MERCOSUR and ASEAN on Implementation and Interdependence; EU-ACP on Institutionalisation and Implementation; and ADB on Institutionalisation and Interdependence. Only EU-CENTRAL, EU-CAN and ASEAN cover all categories (with the exception of structural factors) at the regional level and EDB

16 COMESA also intends to assess the effectiveness of programmes that promote regional integration.
17 In a (limited) number of cases, the re-classification of the variables in our framework was not always straightforward, especially in the border area between the Institutionalisation and Policies category and the Implementation category. We consulted the original documentation to minimize classification errors.
cover all categories without exception. ASEAN (and ASEAN-KEY) is the only case where the criteria to select indicators are made explicit. The criteria chosen by the authors include: policy relevance, simplicity, statistical consistency, validity, data availability and indicator coverage [Dennis and Yusof 2003].

### Table 4: Distribution of variables across categories (%)

<table>
<thead>
<tr>
<th>Indicator System</th>
<th>Actors</th>
<th>Structural Factors</th>
<th>Institutionalisation and policies</th>
<th>Implementation</th>
<th>Effects</th>
<th>Interdependence</th>
<th>Global Integration of the Region</th>
<th>National Macroeconomic Indicators</th>
<th>National Trade Indicators</th>
<th>Governance and Regulations</th>
<th>Externally Financed Regional Development Projects</th>
<th>Other National Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>H&amp;S-AS</td>
<td>16.7</td>
<td>0</td>
<td>83.3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>H&amp;S-RI</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EU-MERCOSUR</td>
<td>0</td>
<td>0</td>
<td>3.8</td>
<td>94.2</td>
<td>0</td>
<td>1.9</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ECB-MERCOSUR-INST</td>
<td>0</td>
<td>0</td>
<td>18.2</td>
<td>81.8</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ECB-MERCOSUR-ECO</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>100</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>COMESA</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>19.3</td>
<td>0</td>
<td>7.0</td>
<td>0</td>
<td>19.3</td>
<td>14.0</td>
<td>40.3</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ASEAN</td>
<td>0.7</td>
<td>0</td>
<td>4.1</td>
<td>43.4</td>
<td>2.1</td>
<td>49.0</td>
<td>0</td>
<td>0.7</td>
<td>0.7</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ASEAN-KEY</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>9.09</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>90.9</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>GDRI</td>
<td>3.9</td>
<td>0</td>
<td>3.9</td>
<td>0</td>
<td>2.9</td>
<td>0</td>
<td>21.6</td>
<td>5.9</td>
<td>9.8</td>
<td>0</td>
<td>52.0</td>
<td>0</td>
</tr>
<tr>
<td>UNECA</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>20.0</td>
<td>0</td>
<td>25.0</td>
<td>20.0</td>
<td>0</td>
<td>0</td>
<td>35.0</td>
</tr>
<tr>
<td>EDB</td>
<td>4.1</td>
<td>5.5</td>
<td>6.2</td>
<td>6.9</td>
<td>16</td>
<td>61.3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>F&amp;G</td>
<td>16.7</td>
<td>0</td>
<td>83.3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>ADB</td>
<td>0</td>
<td>9.5</td>
<td>19</td>
<td>0</td>
<td>0</td>
<td>57.2</td>
<td>14.3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EU-CAN</td>
<td>9.5</td>
<td>0</td>
<td>14.3</td>
<td>61.9</td>
<td>9.5</td>
<td>4.8</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EU-CA</td>
<td>9.5</td>
<td>0</td>
<td>14.3</td>
<td>61.9</td>
<td>9.5</td>
<td>4.8</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>EU-ACP</td>
<td>14.3</td>
<td>0</td>
<td>37.1</td>
<td>34.3</td>
<td>0</td>
<td>5.7</td>
<td>0</td>
<td>2.9</td>
<td>2.9</td>
<td>2.9</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

### 3.4. AGGREGATION AND WEIGHTING PROCEDURES

European Commission indicator systems (EU-CAN, EU-CENTRAL, EU-MERCOSUR, EU-ACP) ADB and COMESA do not feature aggregation procedures. Of the other seven indicator systems, ECB-MERCOSUR, ASEAN, GDRI and UNECA feature two-step aggregation procedures with sub-indices (Table 5).

The weighting procedures are never based on statistical weights or expert opinion. In most cases (H&S, ASEAN, EDB, ASEAN-KEY, F&G), simple unweighted arithmetic averages are used. UNECA calculates unweighted arithmetic averages per country, which are then weighted by GDP figures. ECB-MERCOSUR and GDRI use a combination of ad hoc and equal weights.

The ASEAN Regional Economic Integration Index is calculated as follows:
INTEGAat = (TRADEAat + FDIINTat)/2

TRADEAat refers to the index value of intra-regional trade for the whole region as a percentage of intra-regional GDP for the same year and FDIINTat is the index value of intra-regional FDI for the whole region as a percentage of intra-regional GDP for the same year.

UNECA calculates the weighted composite integration index as the average regional economic community indices multiplied by the corresponding GDP weight of each regional economic community.

EDB calculates two types of consolidated indices based on market integration and economic convergence. The weighted average is calculated as the average of the standardized index of market integration and economic convergence for the country within CIS-12 and for each of the five analyzed regions.

ECB’s Institutional Index of Regional Integration is calculated as follows. Scores ranging from 0–25 are assigned according to the degree of regional integration achieved over time in the development of the four stages. The scores are assigned to the variables based on the year and month when a decision started being implemented. Scores can be assigned in parallel to each of the stages. These scores are then summed up for all months to obtain the Institutional Index of Regional Integration. This index ranges from 0 (no economic integration) to 100 (economic, monetary and financial integration).

In the case of the GDRI, for each of the Regional Global Development Indexes (Xi) the values of the variables are added up under Actual Situation (AS) and the Total Possible Results (TPR) is obtained. Each of the indexes is calculated as follows: Xi = ΣAS (i) x 100 / ΣTPR(i). The Regional Global Development Index is the summation of the four Regional Global Development Indexes (Xi). The Regional Integration Stage index is calculated using the four Regional Global Development Indexes (Xi) and a constant coefficient, Regional Integration Approach Incline (RIAI). The RIAI can be taken as homogenous interest where each RAIA has the same level of importance or it can be taken as an incline with different possibilities of political approach incline, social approach incline, economic approach incline or technological approach incline.

4. CONCLUSIONS: TECHNICAL QUALITY AND POLICY RELEVANCE

The growing importance of the regional level of governance, combined with a growing variety of governance modes in a multi-level governance context, indicate a need for adequate monitoring tools. Both academia and the policy community have recognized this.

In this paper we reviewed fourteen indicator systems that have been developed for the purpose of monitoring regional integration processes. Conclusions that can be drawn from this revision include the following:

First, in general, only few actors seem to be involved in the monitoring exercises. Participation of stakeholders other than the designers of the system is very scarce, if not inexistent. The same holds for communication more in general. In our
view, the participation of other actors in the monitoring exercise (regional organizations, national governmental actors, civil society, international organizations, academia), could considerably improve its technical quality and its policy relevance. Considerable resources are sometimes invested in the design of the systems, but most of these remain one-shot efforts; there is certainly a potential to make the systems more sustained efforts through a better management of the monitoring systems and more openness.

Table 5: Aggregation and weighting procedures

<table>
<thead>
<tr>
<th>Overall/aggregate index</th>
<th>Weighting procedure</th>
<th>Sub indexes included</th>
</tr>
</thead>
<tbody>
<tr>
<td>H&amp;S</td>
<td>YES</td>
<td>Achievement scores on economic integration Readiness Indicators Unweighted arithmetic average NO</td>
</tr>
<tr>
<td>EU-MERCOSUR</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>ECB-MERCOSUR</td>
<td>YES</td>
<td>Institutional Index of Regional Integration Ad hoc weights within categories Unweighted arithmetic average for the overall indicator FTA and CU CM EUN TEI</td>
</tr>
<tr>
<td>COMESA</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>ASEAN</td>
<td>YES</td>
<td>Regional Economic Integration Index Unweighted arithmetic average Regional Trade Index* Regional Investment Index**</td>
</tr>
<tr>
<td>GDRI</td>
<td>YES</td>
<td>Regional Global Development Index Regional Integration Stage Index Unweighted arithmetic average at the level of factors Ad hoc weights for the overall indexes Regional Global Political Development Index (X1) Regional Global Social Development Index (X2) Regional Global Economic Development Index (X3) Regional Global Technological Development Index (X4)</td>
</tr>
<tr>
<td>UNECA</td>
<td>YES</td>
<td>The weighted Composite Integration Index Weighted arithmetic average Sectoral Indices</td>
</tr>
<tr>
<td>EDB</td>
<td>YES</td>
<td>Consolidated convergence index Weighted arithmetic average Index of regional integration calculated as an average of indices</td>
</tr>
<tr>
<td>F&amp;G</td>
<td>YES</td>
<td>IAS Unweighted arithmetic average NO</td>
</tr>
<tr>
<td>C&amp;L&amp;P</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>EU-CAN</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>EU-CENTRAL</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td>EU-ACP</td>
<td>NO</td>
<td>NO</td>
</tr>
</tbody>
</table>

* Value of intra-regional trade for the region as a whole as a percentage of intra-regional GDP in year \( t \) compared to the base year.

** Value of intra- regional foreign direct investment as a percentage of GDP in country \( i \), year \( t \) compared to the base year.
Second, the review also learned that the objectives of indicator systems are diverse. They include the following: (i) to measure the level of integration of a given regional grouping; (ii) to measure the pre-conditions for (further) integration; (iii) to assess the performance and contribution of individual countries in regional groupings; (iv) to evaluate regional integration policies; (v) to compare regional integration in different regions; (vi) to evaluate donor-financed support programmes for regional integration; (vi) to assess needs and merits of regional organizations upon which to base future aid decisions; (vii) to be strategically used in the context of a negotiation process. This explains in part, but not totally, why the different systems focus on different types of variables.

Third, only a few proposals deal with conceptual issues. This, in turn, leads in many cases to a lack of clarity related to the selection of variables and categories and the existence of discrepancies between stated objectives and those that can be realistically and technically achieved with the indicator systems. An illustration of this point was that one fourth of the variables included in the indicator systems do not inform us directly about the regional integration processes they pretend to monitor.

Fourth, technical issues are often linked to political issues. Solutions for technical problems often require political decisions. Examples include: the inclusion of cross-region comparisons, the choice between absolute and relative comparisons, the choice of weights, the inclusion of policy implementation variables, the combination of quantitative measurements with qualitative assessments, and the interpretation of results.

A new initiative, involving national, regional and international organizations, academia and civil society would be welcome in this area in order to improve the design and implementation of tools to monitor regional integration.

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Grupo de Trabajo UE-CAN [2005b]: Resumen Reunión Conjunta CAN-EU, Lima Abril 2005

Guidelines for the MTRs in ACP Regions under the ACP-EC Partnership Agreement [2005]


Master certificate programmes (MCP) provide a one-semester long (14 weeks) education for 30 credits, combining compulsory and elective courses. A certificate will be awarded after the successful completion of any of the two programmes.

The aim of the one-semester programme is to provide students with the most updated and relevant knowledge on the CEE region and its economic and political transformation, and its integration into the European Union and world economy. Besides a strong policy-oriented approach, the course also provides theoretical training, relying on the latest research in International Political Economy and Transformation Economics, and it also builds upon the theoretical tradition that has made Hungarian economic research well-known throughout the world – just to mention Mr. János Kornai or Mr. György Lukács.

Topics cover Integration and Transformation of CEE, Globalisation from the perspective of Central and Eastern Europe, Economic Policy and Public Finance in Transition, Quantitative Methods in Transformation Studies, Public Policy Process in CEE, EU Economic Policies, etc. As the topics reflect, the basic aim of our Faculty is to provide education for foreign students in the field of Hungarian and Central and Eastern European economic policies embedded in a European and global context. The basic techniques and methods that students have learned at their home institutions will be applied to specific problems facing Central and Eastern Europe. Even those students who are absolute beginners in Transformation Economics or Comparative Political Economy will find our courses appealing, since our enthusiastic academic staff educates students on the most important concepts, methods and practical issues of economic and public policy.

To learn more about this programme, please visit the website of the programme at http://economics.uni-corvinus.hu.
The paper shows that Comprehensive Neo-Schumpeterian Economics (CNSE) is an adequate theoretical approach accompanying the enforcement of the aims of the Lisbon Agenda and the recent Growth Strategy 2020. The CNSE approach as well as the Growth Strategy 2020 are based on the principle of innovation as a competitive driving force, and the idea of future orientation penetrating all spheres of economics which can be summarized in three domains of economic life: industry, finance and the public sector (the 3-pillars of CNSE). The CNSE approach is applied to an empirical study of 11 Central Eastern European Economies. The country patterns of pillars are identified in a cluster analysis. This gives a fine-grained picture of institutional and structural set-ups for the countries under study.

INTRODUCTION

In the so-called 5th enlargement in 2004 and 2007 Malta, Cyprus, Estonia, Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Slovenia, Hungary, Romania and Bulgaria joined the European Union. In particular, the former communist economies had to undergo severe structural transformations after the fall of the iron curtain and still when they entered the European Union showed marked differences with respect to the western part. Obviously, these differences also frame their strategies to react to the challenges of the current worldwide financial and economic crisis. After more than five years it is time to ask the question how the new member countries perform in the restructuring of their economies and in their refurbishment with the crisis. The Economist (March 20th–26th 2010, p. 29) writes “The idea of a single ‘ex-communist region’ called Eastern Europe does not bear scrutiny.” In fact the economies of the new member countries show severe structural dissimilarities, which are to be considered in the evaluation of the performance as well as in the design of policy strategies to manage the transformation processes.

In March 2010, the EU Commission renewed the Lisbon Agenda with the so-called Growth Strategy 2020, in which it is outlined: “Europe is recognised the world over for its high quality of life, underpinned by a unique social model. The strategy should ensure that these benefits are sustained and even further enhanced, while employment, productivity and social cohesion are optimised.” Like the Lisbon Goal, this goal is challenging and extraordinarily difficult to be accomplished in particular in the current economic crisis. From the point of view of economics, the following major issues have to be addressed:

1. The decisive economic elements and forces responsible for the achievement of the agenda must be identified.
2. An adequate economic approach should be developed which explicitly includes these elements.
3. For the application of this theoretical approach on the empirical realm the right methodological concept must be found.

4. The fourth major issue is to apply this operationalisation to Europe. A severe difficulty here stems from the fact that Europe is not a unity composed of homogenous components but a collection of heterogeneous countries. Accordingly, the method chosen should focus on detecting patterns of similarities and dissimilarities among the countries under investigation.

5. This discovery of patterns is a necessary step for a further analysis which focuses on the manifestation of success in the sense of the Lisbon Agenda and compares patterns of similarity with patterns of performance.

These five points also structure the content of our paper. In the first section we derive the economic substrate of the Lisbon agenda and Growth Strategy 2020. It can be shown that the Lisbon Agenda as well as the Growth Strategy 2020 is mainly based on innovation and the resulting future orientation. We then elaborate Comprehensive Neo-Schumpeterian Economics (CNSE) as an adequate theoretical framework suitable for the enforcement of the Lisbon agenda. In order to apply CNSE, we develop an indicator based 3-pillar model in the following section, composed of an industry, a financial and a public sector part. This 3-pillar concept is applied to 11 Central and Eastern European countries encompassing the ten new member states of the EU which are on the continent (thus excluding Cyprus and Malta) as well as Croatia as a potential new member in the near future. A study which tried to find clusters for 14 older EU-members (EU-15 excluding Luxemburg) has been conducted in 2006.

We then focus on dissimilarities and similarities of the various economies and their pillars. This analysis allows for the detection of whether there is variety in the composition of the three pillars for the different countries or whether one finds a convergent structure of groups of countries. This allows us to get a first hint on the convergence and divergence of structures in geographic areas in Europe. The study is done by a cluster analysis. Our paper ends with some conclusions and the agenda for future research.

1. THE ECONOMIC SUBSTRATE OF THE LISBON AGENDA

One of the most frequently cited statements of the famous Lisbon agenda claims that *Europe should become the most competitive and dynamic knowledge-based economic region in the world*. What does this mean in economic terms?

Today, economists widely agree that technological progress is the central determinant of growth and dynamics in modern economies. These dynamics are propelled by innovative activities in all parts and spheres of the economy and the society as the main driving force of change and development. Behind innovation understood as a process of unpredictable and discontinuous crowding out of established and appearance of new products, production technologies and organizational solutions, we most importantly find knowledge generation and diffusion processes. As a consequence, looking at the competitiveness of firms, regions, countries or even a union of countries, it is no longer price-competition which plays the central role,
but the competition for innovation which really counts (Saviotti and Pyka 2008). Under this angle, the dynamics which are relevant and have to be observed include not only quantitative features of economic growth but also qualitative features of economic development and structural change. Obviously, dynamic processes understood and analyzed in this vein are fed by multiple sources which also mutually influence each other in a co-evolutionary way. These sources encompass actors like entrepreneurs, firms and households as well as financial actors as banks, venture capitalists and private equity firms. Public actors and institutions like governments, universities, schools, research institutes, patent offices and regulatory authorities also play a role.

Keeping in mind this comprehensive innovation-oriented view of the Lisbon Agenda, which economic approach might be suited for its enforcement?

2. COMPREHENSIVE NEO-SCHUMPETERIAN ECONOMICS

The Lisbon agenda and its successor, the Growth Strategy 2020 formulates a strategy for keeping and even improving the competitiveness of the European Union. Therefore, its overall goal must be seen in securing the welfare for European citizens. Without doubt, economics is the science which focuses on economic welfare and the ability to increase it. This can be stated as a goal for all schools in economics, among the most important being the Neoclassical school, the Neo-Keynesian approach and Neo-Schumpeterian economics. But the angle of analysis differs sharply among these various approaches. Boiling down the Neoclassical approach to its essentials, it can be characterized by rational individuals acting on markets where the price mechanism is responsible for an efficient allocation of resources within a set of given constraints. Neo-Keynesian Economics, briefly characterized, turns out to be a demand-oriented macro approach based primarily on short term processes occurring in non-perfect markets. Accordingly, the knowledge-driven and the ensuing innovation-driven processes characterizing long run development are by far not central to either of these approaches.

One of the decisive differences of Neo-Schumpeterian Economics with respect to other approaches in economics can be found in its emphasis on different levels of economic analysis and their particular interrelatedness. Due to the dominance of the Neoclassical School in the 20th century, the approach of a micro foundation of macroeconomics has wide appeal. The aggregation from micro to macro becomes possible because of the idea of representative households and firms. Although this approach may seem convincing due to its analytical stringency, its mechanistic design may lead to difficulties when it comes to the analysis of dynamic phenomena endogenously caused by the economic system.

Neo-Schumpeterian economics, by contrast, seeks to get a grip on these dynamic phenomena of economic reality. In order to do this, important meso-level aspects between the micro and the macro level of economic analysis are considered (e.g. Dopfer, Foster and Potts 2004). It is the meso-level of an economic system in which the decisive structural and qualitative changes take place and can be observed.
To understand the processes driving the development at the meso-level, Neo-Schumpeterian economics puts a strong emphasis on knowledge, innovation and entrepreneurship at the micro-level. Innovation is identified as the major force propelling economic dynamics. In this emphasis on innovation, the major difference in the Neo-Schumpeterian approach with respect to alternative economic approaches can be identified. Generally, one may say that novelty (i.e., innovation) is the core principle underlying the Neo-Schumpeterian approach. Innovation competition takes the place of price competition as the coordination mechanism of interest. Of course, prices are also of significance, but concerning the driving forces of economic development, they are by far not central. Whereas prices are basic concerning the adjustment to limiting conditions, innovations are responsible for overcoming previous limiting conditions and – as in economic reality, everything except human creativity has an end – setting new ones.

The focus on novelties is thus the most important distinctive mark of Neo-Schumpeterian economics. By its very nature, innovation, and in particular technological innovation, is the most visible form of novelty. Therefore, it is not very surprising that Neo-Schumpeterian economics today is most appealing in studies of innovation and learning behaviour at the micro-level of an economy, in studies of innovation-driven industry dynamics at the meso-level, and in studies of innovation-determined growth and international competitiveness at the macro-level of the economy (e.g. Hanusch and Pyka 2007c).

To summarize, in Neo-Schumpeterian Economics the central actors under investigation are entrepreneurs and entrepreneurial firms, the most important process under investigation is innovation and the underlying knowledge creation and diffusion processes. Here, in sharp contrast to Neoclassical Economics, the notion of innovation focuses on the removal and overcoming of limiting constraints and the setting of new ones.

However, Neo-Schumpeterian Economics, in its present shape, restricts itself to the dynamics of the industry side only. Even with this shortcoming, it seems to be the most adequate approach in tackling the enforcement of the Lisbon Agenda. Nevertheless, to fulfil its extreme challenges, namely to successfully hold ground in global innovation-oriented competition with the aim to enforce a development which makes Europe the most dynamic knowledge-based economic region in the world, the Neo-Schumpeterian approach has to be put on a broader conceptual basis.

For this purpose, we suggest Comprehensive Neo-Schumpeterian Economics (CNSE) as elaborated in Hanusch and Pyka (2007a). CNSE has to offer a consistent theory which encompasses all realms relevant to an improved understanding of economic processes involving change and development. This becomes even more pressing in cases in which the different realms are in close relation, mutually influencing each other, which is very likely the case for economic development. In other words, a comprehensive understanding of economic development must inevitably consider the co-evolutionary processes between the different economic domains.

Consequently, we argue that it is high time for Neo-Schumpeterian economics to devote considerable attention to the role of the financial and public sector with respect to economic development. In particular, we introduce the Comprehensive...
Neo-Schumpeterian approach as a theory composed of 3-pillars: one for the real side of an economy, one for the monetary side of an economy, and one for the public sector. Economic development then takes place in a co-evolutionary manner, pushed, hindered and also even eliminated within these 3-pillars (figure 1).

![Figure 1. The three pillars of Comprehensive Neo-Schumpeterian Economics](image)

In order to understand the crucial co-evolutionary relationship, one must explore the bracket encompassing all 3-pillars, namely their orientation towards the future which introduces uncertainty into the analysis. The relationships between the 3-pillars drive or hinder the development of the whole economic system in a non-deterministic way. Consider, for example, the case of the financial sector, exaggerating the developments taking place in the real sector and leading to dangerous bubble effects which might cause a breakdown of the whole economy. Or think of the case in which the public sector cannot cope with the overall economic development, and areas such as infrastructure and education become the bottlenecks of system development.

A comprehensive Neo-Schumpeterian economic theory focusing on innovation driven qualitative development should offer theoretical concepts to analyze the various issues of all 3-pillars: industry dynamics, financial markets, and the public sector. Innovation and, as a consequence thereof, uncertainty, are ubiquitous phenomena characteristic of each of these pillars and are also intrinsically interrelated. An improved understanding of the development processes can only be expected if the co-evolutionary dimensions of the three pillars are taken into account. This is illustrated within the concept of a Neo-Schumpeterian corridor shown in figure 2.

In a CNSE-perspective, there exists only a narrow corridor for a prolific development of socio-economic systems. Profound Neo-Schumpeterian development takes place in a narrow corridor between the extremes of uncontrolled growth and exploding bubbles, on the one hand, and stationarity (i.e., zero growth and stagnancy) on the other hand. Economic policy in the sense of CNSE strives to keep the system in an upside potential including both overheating-protection (i.e., on the macro-level bubble explosions and on the micro-level insane explosive growth) and downside-protection, that is on the macro-level stagnation and on the micro-level bankruptcy.
To summarize, the essence of CNSE is captured by the following definition: CNSE deals with dynamic processes causing qualitative transformation of economies driven by the introduction of novelties in their various and multifaceted forms and the related co-evolutionary processes. These processes are not merely restricted to industry but also include the financial and public sphere of an economy and thereby encompass all spheres of economic and societal issues.

3. THE INDICATOR BASED 3-PILLAR APPROACH

It is a central aim of this empirical study to gain new findings as regards the structural characteristics and the functioning as well as the competitiveness of economies in 11 countries which have just recently joined the EU (or will join in the near future, as in the case of Croatia) from a Neo-Schumpeterian angle.

3.1. DATA

To achieve this objective, our analysis is grounded on a comprehensive set of indicators (Hanusch and Pyka 2007b). In total, more than seventy variables have been collected, reflecting many different activities in the various EU economies which are related to innovation. In dependence of data availability, the indicator sets comprise different years, namely from 2001 to 2006.

Above all, the set of variables reflects structural specifics, yet the data are also comprised of several indicators for the functioning of the economies, including inputs in the innovation process such as R&D related indicators as well as variables on the knowledge base and the institutional structure. To summarize, the data we draw upon must reflect all types of activities for the three pillars introduced above, immediately entailing the future-oriented characteristics.
The utilized indicators originate from various sources, the most important one being Eurostat, the statistical office of the European Union. The central additional data sources are the World Bank, the UNESCO and the European Private Equity and Venture Capital Association (EVCA). From these databases, patent statistics, R&D expenditure data as well as several indicators of national education systems and of qualification structures of national workforces have been extracted.

3.2. THE INDICATORS FOR THE 3-PILLARS

The crucial feature of the industrial pillar in a CNSE conception is its orientation towards the future. In order to comprise this dimension structurally as well as from a process perspective, we divided the pillar in three independent dimensions. In a first step, we considered the knowledge base in the country in order to associate them in educationally comparable groups. Secondly, we considered the openness of the economy through an analysis of the export of high technology. The third step encompasses the integration of the innovativeness and the efforts undertaken in R&D. Altogether, the three categories can enable us to draw a picture of the structural relatedness between the different countries with respect to their real sector.

Concerning the financial pillar, we focus once again on the future orientation, which therefore must be expressed in the selection of indicators. We concentrated on the availability of venture capital as a variable which can both reflect the willingness and the ability to finance innovation in a country. Furthermore, it includes the perspectives which the financial markets attribute to the development in the respective economy.

The future orientation of the public pillar is centred around the institutions and the economic structure in the different countries. The indicators are linked to the public life in general and range from the use of e-government services to the public budget deficit. It also includes aspects relating to the workforce as well as the energy intensity in each country. Taken together, these indicators can offer a comprehensive picture of the structure and the institutional setup of the public role in each of the economies.

4. PATTERN DETECTION: SIMILARITIES AND DISSIMILARITIES

By using the conceptual framework of our Comprehensive Neo-Schumpeterian Approach, the specific targets of the study are to detect and then to analyze cross-national (dis-)similarities in the structure and composition with respect to the future orientation and innovativeness of the economies.²

To meet these objectives, cluster analysis techniques are applied to the data (see, e.g. Jobson, 1992). The general rationale behind this analytical tool is to test a sam-

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1 A complete listing of all utilized data sources can be found in Appendix 1.
2 A similar approach has been applied in Balzat and Pyka (2006) in an analysis of national innovation systems.
ple for the degree of structural commonalities between the units of analysis. Its outcome is a categorization of the analyzed units so that the coherence of each group (or cluster) as well as the heterogeneity across different clusters is maximized. To determine the coherence of a certain cluster and to calculate the existing diversity of different clusters, distance values between the units of analysis need to be determined on the basis of the characteristics of each entity. From the various methods to calculate distances between the entities, the squared Euclidean distance measure is applied, because it is a frequently applied distance measure of metric data. Furthermore, it more strongly accounts for differences between entities than the linear Euclidean distance does. Hence, the distance between two countries \(i\) and \(j\) can be calculated as follows:

\[
d(i, j) = \sum_{k=1}^{m} (a_{ik} - a_{jk})^2
\]

Here, \(a_{ik}\) represents the parameter value of characteristic \(k=1,\ldots,m\) for country \(i=1,\ldots,n\).

Thus, the entire quantitative data matrix is

\[
A = (a_{ik})_{m \times n}
\]

The determination of distances between entities is a crucial but at the same time preliminary step in the entire cluster analysis. It needs to be completed by the application of a classification algorithm. Depending on the quality of the underlying data and on the research target, various classification procedures exist.

The data are characterized by a relatively small number of units of analysis (i.e., eleven countries in total) and at the same time by a relatively large number of variables (more than seventy variables in total) as well as by a cardinal data level.

Given these specifics of the underlying data and the country sample, a hierarchical, two-step cluster method (which rests upon the average-linkage principle of cluster membership) is applied to the sample.

The determination of the inter-cluster diversity between two classes \(K\) and \(L\), \(v(K,L)\), can thus be described formally as follows:

\[
v(K, L) = \frac{1}{|K| \cdot |L|} \sum_{i \in K} \sum_{j \in L} d(i, j)
\]

with both distinctive classes \(K\) and \(L\) (i.e. \(K \neq L\)) belonging to the entire classification \(K\).

Since it is not intended to impose a given, pre-determined classification of countries ex ante, an agglomerative classification method is utilized. This method starts with single-country clusters and entails a step-wise concentration of countries according to their degree of structural similarities. Given that it is intended to attach all countries in the sample to a certain cluster and that cases in which a certain country belongs to several clusters shall be ruled out, the selected clustering
method yields an exhaustive as well as a disjunctive classification. A classification is exhaustiv e if
\[ \bigcup_{K \in \mathcal{K}} K = N, \text{ with } N \text{ being the total amount of analyzed objects. A disjunctive partition meets the condition that } K, L \in \mathcal{K}, K \neq L, \text{ so that } K \cap L = \emptyset. \]

The clustering method is applied to each pillar of the countries under study.

In order to determine the optimal number of clusters, the so-called elbow criterion (see Hanusch and Pyka 2006b) is applied. The elbow-criterion is a commonly employed measure in cluster analysis that guarantees intra-cluster homogeneity and at the same time inter-cluster heterogeneity is maximized. Countries grouped within one cluster show strong similarities concerning the future orientation of the different pillars, whereas countries allocated to different clusters are structurally heterogeneous in this respect.

5. EMPIRICAL RESULTS

The following sections deal with the description of detected clusters and the analysis of their composition. We will discuss each pillar and the overall implications on the comparability and similarity between the analyzed countries.

5.1. CLUSTERS IN FUTURE-ORIENTATION OF CENTRAL AND EASTERN EUROPEAN COUNTRIES

Before we look at the individual pillars and their respective cluster separation, it is worth looking at the global analysis where all variables and indicators are taken into account. This will give us an idea of the overall distribution of the countries in the different clusters and will help in the interpretation of the pillar-related clusters.

In order to represent the country clusters graphically, figure 3 is organized as follows: The upper line includes the country codes (the meaning of the abbreviations for the different countries is explained in Appendix 2). The lower line includes the mapping of the countries to the various clusters which is expressed by numbers and colours.

![Figure 3. Country clusters of the global analysis](image)

The most striking result of this global analysis is that there is one large cluster comprised of the Baltic countries Estonia, Latvia and Lithuania as well as the medium-sized central European countries Czech Republic, Hungary and Slovakia. This hints towards a structural similarity in the future-orientation in these countries during the analyzed time period. The table can also be read in such a way that the countries in cluster 1 are similar enough to be grouped into one cluster and too dissimilar to be compared with the other economies in our sample. This result does, however, not mean that the different countries are characterized by the same quantita-
tive values, rather only the structural composition is similar. Furthermore, we find that the two newest accession states, Bulgaria and Romania, make up their own cluster. Consequently, they are considerably different from all the other countries under observation and they share some similarities. The three countries which are left all form individual clusters implying that they are too different from the other economies to be compared with them. This applies to the largest country in terms of population, Poland, to the only one which has not yet joined the European Union, Croatia, as well as to Slovenia, which became the first of the new member states to adopt the Euro as their currency in 2007.

In the first cluster, we find countries which experienced a growth rate between 1% and 10% in 2007. Consequently, the global analysis does not yet tell us where the most promising starting point or termed negatively the most pressing bottlenecks are to be expected. Therefore, it is important to break the dimensions even further up and look at the different components in order to be able to better differentiate the distinct influences which may help explaining the different developments.

5.1. RESULTS IN THE INDIVIDUAL PILLARS

As explained above, we have analyzed the real sector by looking at the three different dimensions “knowledge base”, “openness” and “innovative efforts”. The first thing we notice is that there is considerable variation in the clusters which were formed according to those three domains. Only Estonia and Croatia, as well as Latvia and Slovakia form pairs of countries which belong to the same cluster (1–1–1 in the first case and 1–2–1 in the second) in each of the three dimensions. This means that those pairs can be considered to have a fairly similar industrial structure. All other countries are comparatively individual in the setup of their real sector. Nevertheless, in each dimension, we have a largest cluster which is made up of seven countries which are relatively close in their structure (see figure 4).

![Figure 4](image)

**Figure 4. Country clusters of the industrial pillar**

When looking at the knowledge base in Central and Eastern Europe, we find that the main cluster has grown compared to the global analysis because Poland and Croatia have joined it and only Lithuania has left this cluster. It now contains seven countries, Bulgaria and Romania form a cluster on their own again. In this analysis, we only find two single-country clusters which are made up of Lithuania on the one hand and Slovenia on the other.

With respect to the openness of the countries, the picture changes considerably. We are only left with three clusters and there is no imminent geographical or historical link between the countries within a cluster. The first cluster has shrunk to three economies and is only comprised of the Czech Republic, Estonia, and Croatia. The
second cluster now counts seven countries. Bulgaria and Romania are now joined by Poland, Slovenia and Slovakia, as well as by the two Baltic States Latvia and Lithuania. It is interesting to note that while Estonia and Latvia shared the same cluster when looking at the knowledge base, it is Latvia and Lithuania in the case of openness. Apparently, similarities and dissimilarities in the Baltic States are not as clear cut as one might expect. Hungary makes up a cluster of its own, which shows that it is different from all the other countries in the sample in this category. This difference can be traced back to Hungary’s historically determined close connection with the Austrian economy.

Our third category in the industrial pillar leads to a separation into five groups again where we find four single-country clusters and have one large cluster made up of seven countries. For the first time, Bulgaria and Romania do not show a similar setup in their innovative efforts, where Bulgaria belongs to the large cluster together with the – once again reunited – three Baltic states, Hungary, Slovakia and Croatia. Romania is too different from all other countries and, consequently, forms its own cluster. The same is true for the Czech Republic, Poland and Slovenia. While Poland and Slovenia already belonged to single-country clusters in the above analyses, it is the first time for Romania and the Czech Republic to be significantly different from all other countries.

Even though we once again find a large cluster made up of six countries, the future-orientation in the financial market differs most strongly from the result of the global analysis (figure 5). For the first time, Bulgaria constitutes a cluster on its own and Romania finds itself in a cluster only together with the Czech Republic. Hungary which has been struck so hard by the current economic crisis is forming a cluster on its own, just like Poland. The six-country cluster is made up of the three Baltic states Estonia, Latvia and Lithuania – even though we found Latvia in considerably larger distress during the financial crisis than the other two countries –, the two countries which by now have introduced the Euro, Slovenia and Slovakia, as well as Croatia as the only country which is not yet a member of the EU.

The pattern of clusters in public pillars (figure 6) shows to be strongly politically determined. We find a large cluster made up of those eight countries in our study which joined the European Union in 2004: the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia. This implies that their institutional setup is somewhat harmonized and comparable.
Obviously different enough to this first group, the clustering algorithm identifies Bulgaria and Romania in one public pillar group. Not surprisingly, these two countries joined the EU together in 2007. Finally, the only candidate country, Croatia, is put in a single-country cluster. There is no causality check in our data, so we cannot imply if the perspective of membership to the European Union has led to a harmonization in the public structure or if the similarity has allowed those countries to fulfil the accession criteria at similar moments. Nevertheless, the correspondence of the clusters to the different accession dates is striking.

6. CONCLUSIONS

Innovativeness and orientation towards the future are central elements of the Lisbon Agenda and the Growth Strategy 2020. CNSE offers an appropriate theoretical approach for the enforcement of the Lisbon Agenda. Our cluster analysis demonstrates that from an empirical point of view, CNSE can be operationalized without major difficulties. It is central to maintain future orientation as a common feature of both the Lisbon Agenda and our 3-pillar approach. This target can be achieved by relying on a comprehensive set of indicators reflecting different activities related to innovation.

Of course, due to its composition of very heterogeneous member countries, Europe will not come up with a simple pattern of pillar compositions. Does this mean that each country needs a specific policy design to achieve the Lisbon strategy? From the results of this analysis, we suggest that this is not the case. Countries can be attributed to clusters according to their similarities and differences. These groups of countries with similar pillar compositions can then be analyzed according to their performances in such areas as patenting, growth, and employment in order to identify bottlenecks as well as catalysts of economic development. This procedure has the advantage that only comparable countries are used for comparisons in the sense of benchmarks concerning their future orientation and innovativeness. This avoids a major problem of all international comparisons, namely neglecting the complex interdependencies and complementarities stemming from two sources: First, countries composed of very different pillars (e.g., the Slovenian vs. the Croatian public pillar) are not used for comparisons and for deviating policy conclusions. Second, within groups of countries with similar structures of pillars, one can analyze the joint functioning of the industrial, the public and the financial pillars. Besides the design of the 3-pillars, one can thus demonstrate that an important dimension of economic development is constituted by the co-evolutionary relations between the 3-pillars.

Our methodology of pattern detection allows for a fine-grained analysis of the composition of the main institutional and structural components of an economy (the 3-pillars: industry, finance and public sector) in the various countries with a particular orientation towards the future. This cluster analysis has provided strong evidence for a pronounced heterogeneity in the structural composition of the eleven observed countries. Only Slovakia and Latvia are found to be in the same cluster for the global analysis as well as all subsectors which we analyzed. Interestingly,
both countries have experienced rather successful economic growth rates before the crisis and their future orientation might serve as a benchmark for other economies in their clusters. Furthermore, we cannot detect a clear geographic pattern in the overall analysis. The Baltic States do show some homogeneity in certain subgroups as do the Black Sea abutters Bulgaria and Romania. Nevertheless, there is no clear and persistent geographical structure visible comparable to the situation for Western European countries.

Future research should concern within-the-cluster analyses in order to show rankings in the specific groups and point to bottlenecks or benchmark situations. With the help of linear programming tools such a ranking can be performed which will allow to evaluate the relative strength of single economies in their clusters concerning their future orientation. A dynamic analysis could further help to detect the changes in these patterns in time. In particular, the current financial and economic crisis very likely will change the current pattern due to different defense strategies. Looking at the shifts produced and the country structures which have proven to be better suited to cope with the crisis might be an insightful goal for future research.

The empirical analysis of the capabilities of the EU countries in achieving the goals of the Lisbon Agenda presented here allows for the design of a sound, well balanced and differentiated policy. This policy design, on the one hand, avoids being too general in the sense of neglecting the heterogeneity of countries in the European Union. On the other hand, it considerably reduces the complexity which stems from this heterogeneity by grouping countries with similar pillar compositions. This allows for a well-adapted design of policy measures according to the specificities of the various country groups identified in Europe and differing according to their innovativeness and future-orientation (i.e., their capabilities to achieve the goal of the Lisbon Agenda). The development of policy designs following CNSE is certainly on the agenda for future research.

**REFERENCES**


Knowledge Base:

- Students' enrolment at the ISCED-levels 5–6 in science, mathematics, and computing, engineering, manufacturing, and construction in per cent of all students, 2003–2004
- Female students' enrolment at the ISCED-levels 5–6 in science, mathematics, and computing, engineering, manufacturing, and construction in per cent of all female students, 2003–2004
- Male students' enrolment at the ISCED-levels 5–6 in science, mathematics, and computing, engineering, manufacturing, and construction in per cent of all male students, 2003–2004
- Graduates (ISCED 5–6) in science and technology in per cent of all fields, 2003–2004
- Female graduates (ISCED 5–6) in mathematics, science and technology in per cent of female graduates in all fields, 2003–2004
- Male graduates (ISCED 5–6) in mathematics, science and technology in per cent of male graduates in all fields, 2003–2004
- Graduates (ISCED 5–6) in science and technology in 1000s, 2003–2004
- Graduates (ISCED 5–6) in mathematics, science and technology per 1000 of population aged 20–29, 2003–2004
- Female graduates (ISCED 5–6) in mathematics, science and technology per 1000 of female population aged 20–29, 2003–2004
- Life-long learning (adult participation in education and training) – Percentage of the population aged 25–64 participating in education and training over the four weeks prior to the survey, 2002–2005
- Life-long learning (adult participation in education and training) – females – Percentage of the female population aged 25–64 participating in education and training over the four weeks prior to the survey, 2002–2005
- Life-long learning (adult participation in education and training) – males – Percentage of the male population aged 25–64 participating in education and training over the four weeks prior to the survey, 2002–2005
- Youth education attainment level – Percentage of the population aged 20 to 24 having completed at least upper secondary education, 2002–2005
- Youth education attainment level – females – Percentage of the female population aged 20 to 24 having completed at least upper secondary education, 2003–2005
- Youth education attainment level – males – Percentage of the male population aged 20 to 24 having completed at least upper secondary education, 2003–2005
Openness:
- High-tech exports: Exports of high technology products as a share of total exports, 2002–2004

Innovative Efforts:
- Gross domestic expenditure on R&D (GERD) – Percentage of GDP, 2002–2004
- Gross domestic expenditure on R&D (GERD) by source of funds – industry – Percentage of GERD financed by industry, 2002–2004
- Gross domestic expenditure on R&D (GERD) by source of funds – government – Percentage of GERD financed by government, 2002–2004
- Gross domestic expenditure on R&D (GERD) by source of funds – abroad – Percentage of GERD financed by abroad, 2002–2004
- Patent applications to the European Patent Office (EPO) – Number of applications per million inhabitants, 2002–2003
- Patents granted by the United States Patent and Trademark Office (USPTO) – Number of patents per million inhabitants, 2000–2003
- Percentage of GERD financed by industry in % of GERD, 2002
- Percentage of GERD performed by the Government Sector in % of GERD, 2002
- Percentage of GERD performed by the Higher Education Sector in % of GERD, 2002
- Personnel in R&D in Full-Time Equivalents (FTE), 2003
- Personnel in R&D in head count (HC), 2003
- Personnel in R&D in the Business Enterprise Sector in FTE, 2003
- Personnel in R&D in the Government and private Non-Profit Sector in FTE, 2003
- Personnel in R&D in the Higher Education Sector in FTE, 2003
- Number of researchers in FTE, 2003
- Number of researchers per million inhabitants in FTE, 2003
- Number of researchers in HC, 2003
- Number of researchers per million inhabitants in HC, 2003
- Number of researchers in the Business Enterprise Sector in FTE, 2003
- Number of researchers in the Government and private Non-Profit Sector in FTE, 2003
- Number of researchers in the Higher Education Sector in FTE, 2003
- Technical personnel in FTE, 2003
- Technical personnel per million inhabitants in FTE, 2003
- Technical personnel in HC, 2003
- Technical personnel per million inhabitants in HC, 2003
- Other R&D personnel in FTE, 2003
- Other R&D personnel in HC, 2003

Financial Sector:
- Total amount of Venture Capital invested in 1000 €, 2004–2005
- Venture Capital as a percentage of GDP, 2004–2005
Public Sector:

- Inequality of income distribution – Ratio of total income received by the 20% of the population with the highest income to that received by the 20% of the population with the lowest income, 2003
- At-risk-of-poverty rate before social transfers – total – Share of persons with an equivalised disposable income, before social transfers, below the risk-of-poverty threshold, 2003
- Early school-leavers – Percentage of the population aged 18–24 with at most lower secondary education and not in further education or training, 2003–2005
- Early school-leavers – females – Percentage of the female population aged 18–24 with at most lower secondary education and not in further education or training, 2002–2004
- Early school-leavers – males – Percentage of the male population aged 18–24 with at most lower secondary education and not in further education or training, 2003–2006
- Comparative price levels – Comparative price levels of final consumption by private households including indirect taxes (EU-25=100), 2002–2005
- Market integration – Trade integration of goods – Average value of imports and exports of goods divided by GDP, multiplied by 100, 2005
- Market integration – Trade integration of services – Average value of imports and exports of services divided by GDP, multiplied by 100, 2005
- Employment rate – total – Employed persons aged 15–64 as a share of the total population of the same age group, 2002–2005
- Employment rate – females – Employed women aged 15–64 as a share of the total female population of the same age group, 2002–2005
- Level of Internet access – households – Percentage of households who have Internet access at home, 2004–2005
- ICT expenditure – IT – Expenditure on Information Technology as a percentage of GDP, 2003–2004
- E-government usage by individuals – total – Percentage of individuals aged 16 to 74 using the Internet for interaction with public authorities, 2004–2006
- E-government usage by individuals – females – Percentage of individuals aged 16 to 74 using the Internet for interaction with public authorities, 2004–2006
- E-government usage by individuals – males – Percentage of individuals aged 16 to 74 using the Internet for interaction with public authorities, 2004–2006
- E-government usage by enterprises – Percentage of enterprises which use the Internet for interaction with public authorities, 2004–2006
- Broadband penetration rate – Number of broadband lines subscribed in percentage of the population, 2004–2006
- Total greenhouse gas emissions – Index of greenhouse gas emissions and targets in CO2 equivalents (Actual base year = 100), 2001–2004
- Energy intensity of the economy – Gross inland consumption of energy divided by GDP (index, 1995=100) Kgoe (kilogram of oil equivalent) per 1 000 Euro, 2001–2004
Share of electricity from renewables to gross electricity generation: Ratio between the electricity produced from renewable energy and the gross national electricity consumption, 2001–2004

GDP per capita in PPS – GDP per capita in Purchasing Power Standards (PPS), (EU-25=100), 2003–2006

Real GDP growth rate – Growth rate of GDP volume – Percentage change on previous year, 2003–2006

Labour productivity per person employed – GDP in PPS per person employed relative to EU-25 (EU-25=100), 2004–2006

Employment growth – total – Annual percentage change in total employed population, 2002–2005

Employment growth – females – Annual percentage change in female employed population, 2003–2005

Employment growth – males – Annual percentage change in male employed population, 2003–2005

Public balance – Net borrowing/lending of consolidated general government sector as a percentage of GDP, 2002–2005

General government debt – General government consolidated gross debt as a percentage of GDP, 2002–2005

APPENDIX 2: COUNTRY ABBREVIATIONS

Bg  Bulgaria
Cz  Czech Republic
Ee  Estonia
Lv  Latvia
Lt  Lithuania
Hu  Hungary
Pl  Poland
Ro  Romania
Si  Slovenia
Sk  Slovakia
Hr  Croatia
EXCHANGE PROGRAMMES

The Faculty of Economics hosts several dozen undergraduate and graduate students every year from all parts of the world, especially from the EU, the USA, Canada, Turkey, Russia and China. Students who choose our University will find themselves in a beautiful city with lively cultural activities, and will also have the chance to follow courses that will enable them with sound knowledge in the field of both theoretical and applied economics. Regarding the applied fields, the main focus is on economic policy (such as public policy, public finance, monetary policy or regional policy) in CEE and the European Union.

Since the ultimate aim of both the ERASMUS and the CEEPUS programmes is that students should also widen their understanding of contemporary world economy and politics, the Faculty also offers courses for those who have not yet heard about the region and its economic and political transformation. The most interesting topics cover Integration and Transformation of Central and Eastern Europe, Economic Policy and Public Finance in Transition, Quantitative Methods in Transformation Studies, Public Policy Process in CEE, EU Economic Policies, etc. As the topics reflect, the basic aim of our Faculty is to provide education for foreign students in the field of Hungarian and Central and Eastern European economic policies embedded in a European and global context. Even those students who are absolute beginners in Transformation Economics or Comparative Political Economy will find our courses appealing, since our enthusiastic academic staff patiently educates students on the most important concepts, methods, and practical issues.

Courses have been selected with the aim of creating English-language applied courses: the basic techniques and methods that students have learned at their home institutions can be applied to specific problems facing our region. Due to its regional determinacy, one of the main assets of our Faculty is its firm commitment to provide a better understanding and perception of CEE, with a special focus on the process of catching up, development, transformation and integration. The wide scope of study makes it possible for foreign students to obtain a relatively broad view and understanding - not just of the region, but also of contemporary world economy.

Foreign students are welcome to select among a wide range of courses in each semester (each course is worth 6 ECTS and is taught in a 2 x 80 minute session every week).

To find more information, please visit the website of the faculty at http://economics.uni-corvinus.hu.
INTRODUCTION

This paper explains and analyses the emergence of the apparent social issues in Southern Europe, connecting them to the overall upcoming recession in the member states and proceeding to evaluations for the Mediterranean countries.

The European Trade Union Confederation (ETUC) gives the following definition to the question what is the European Social Model. “The European Social Model is a vision of society that combines sustainable economic growth with ever-improving living and working conditions. This implies full employment, good quality jobs, equal opportunities, social protection for all, social inclusion, and involving citizens in the decisions that affect them. In the ETUC’s view, social dialogue, collective bargaining and workers’ protection are crucial factors in promoting innovation, productivity and competitiveness. This is what distinguishes Europe, where post-war social progress has matched economic growth, from the US model, where small numbers of individuals have benefited at the expense of the majority. Europe must continue to sustain this social model as an example for other countries around the world.”*

Before the economic crisis it was taken for granted that a single European social model exists, rather than 27 different national social models. The main characteristics of this include: state responsibility for full employment, for providing services of general interest, and for economic and social cohesion; fundamental social rights, including freedom of association, the right to strike, protection against unjustified dismissal, fair working conditions, equality and non-discrimination; social protection, delivered through highly developed universal systems, and wealth redistribution measures such as minimum income or progressive taxation; social dialogue,

* http://www.etuc.org/a/111
with the right to conclude collective agreements, to workers’ representation and consultation and national and European Works Councils.

The plans for reaching a comparative status with the labour market of the US however do not seem achievable. This can be understood from the rates of unemployment per country and region in the 27 EU Member States. We stand in the beginning of the employment crash and far from the Lisbon targets of an overall employment rate of 70% in 2010. The correlation between the unemployment rate and the creation of new jobs is based on more complicated grounds than the social partner’s dialogue. In some countries with very slow growth (e.g. Italy and the UK) the figures reflect the decline of the total population rather than the creation of new jobs.

The evolution of the European idea is related to the construction of the information society, the enhancement of social capital and a more balanced state policy and free market regulation.

THE NEED FOR A EUROPEAN SOCIAL MODEL

Is there a need for a sustainable and balanced social model across Europe? The working hypothesis is whether this model is generic and has the same effect in each country or the model is differential in character.

The European Commission published on 5 March 2009 an annual report on social protection and social inclusion. The European Trade Union Confederation for instance, considers that in today’s context of crisis and in order to organize an economic recovery, it is crucial to build on solidarity and to enable social protection systems to play to their full role of providing stability. The ETUC notes that none of the over-arching objectives of the Lisbon Strategy have been met to date [ETUC 2009].

The uniqueness of the European Labour and Social System and the internal weaknesses of the member states to adopt and initiate vital employment changes forced the Commission to report on social inclusion every year. Most of the decisions of the Commission, which are included in this report, reflect a more realistic attitude through the rights of workers and unions in the past years and have led to new processes within the Union. Reformation of existing legislation is becoming more critical in order to protect employment partnered with an investment in research programs, should bring balance in the labour market and thereby industrial peace. Contrary to this concept are the arguments that the European system of law and labour relations is the product of the interplay of a complex range of historical, economic, political and social factors. Inevitably, what follows is a mix of highly interesting processes, which create substantive rules for the member states and, of course, a great divergence between legal theory and industrial practice. It is expected that the 16% of the European people who live in poverty will increase and as the trade unions stated “the rate of poor workers (8%) proves that not all jobs offer protection against poverty, a risk that is even greater for certain less favoured groups like children (19% exposed to the risk of poverty) or older people (notably women) (19% compared with 16% in 2006)” [ETUC 2009]. The magic word is recession. M.
Vlieghe and P. Vreymans [2006] in their article Europe’s Ailing Social Model: Facts & Fairy-Tales found out that “Europe’s present social model is unable to tackle the modern challenges of globalization, and has left Europe with gigantic problems: an insurmountable public debt, a rapidly ageing population, 19 million unemployed, and an overall youth unemployment rate of 18%. The unemployment figures may easily be doubled to account for hidden unemployment. The untold reality is that Europe’s real unemployment stands at the level of the 1932 depression.” The magic word is recession.

In the end of the 90’s a report for the World Bank suggested that the following topics should be taken into consideration,
1. The standard of living is multidimensional. When analysing poverty and inequality, variables as health and education, vulnerability and risk, crime and violence, integration into the mainstream of society, and other factors highlighted by the poor themselves as being important should be examined and inserted.
2. Poverty exists although economic growth is strong.
3. The evolution of technology creates first choice changes for reduction of poverty and exclusion.

**SUSTAINABLE SOCIAL MODEL IN EUROPE**

The European Social Model is an example for the rest of the world of a society based on social justice and solidarity, where economic and social advancement take equal priority, and where decent work and social protection combat poverty and social exclusion. That is why the success of Social Europe is so important not only for European citizens, but also for developing just and fair political systems in other countries. One basic question is what are the actual powers which are driving the social process? The collapse of growth has a direct impact on social exclusion, which is becoming a central figure in the combat for social inclusion. A special plan should develop in order to give power to local authorities, tackling down the policy measures. Measures, which stop poverty, relight of neighbourhood and in general means, community regeneration are improvements. The Community Strategy is also driving this agenda and has identified “narrowing the inequalities gap” and “building community confidence” as two of the strategy’s four key aims to promote inclusive communities.

**THE CASE OF CYPRUS**

The unemployment rate in Cyprus was over 4.0% in 2008 and in 2010 reached 6.6% and is expected to reach 7.0% by the end of the year (see figure 1). Inflation will remain low, about 2.2% and in general terms speaking, GDP growth will be less than 1%, which is mainly affected by the international economic crisis and diminished from 2007, when growth was 4.4% and the economy was booming. The Cyprus’s economy is characterised by macroeconomic stability. This was accomplished in an
environment of full employment conditions, low inflation and a stable and strong currency. In 2006, Cyprus’s per capita GDP reached about 93.7% of the EU-27 average. Foreign workers are estimated to be 80,000 (approximately 10% of the population). This number refers to the persons living legally in Cyprus.

Figure 1. Unemployment rate in Cyprus

Since the early 1990s, the labour market has been confronted with labour shortages and bottlenecks. The low fertility rate is expected to gradually aggravate the problem. This has led to the need for employment of foreign workers. In 2006 foreign workers, including EU-25 nationals, represented around 13.7% of total employment.

Figure 2. Growth rate in Cyprus

In addition, it should be pointed out that important structural reforms within the context of the Lisbon Strategy are in progress in order to further modernise and liberalise its market-oriented economy, with a view to enhancing its international com-
petitiveness and EU compatibility. These structural reforms, together with macroeconomic stability, provide a strong Cyprus joined the euro area on 1 January 2008 and as a result the setting of interest rates is now the responsibility of the European Central Bank (ECB). The primary objective of the ECB is to ensure price stability, which means keeping inflation rates below, but close to, 2% [Central Bank of Cyprus 2009].

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VISITING PROFESSORS AT THE FACULTY OF ECONOMICS

The Faculty of Economics has established contacts with more than 60 universities all over the world. Co-operation can take the form of student exchange (study semesters, completion of a master's thesis), teaching staff exchange (permanent or short-term lectureships, guest lectures), administrative staff exchange, or double degree programmes.

We welcome visiting teachers, lecturers and experts to enrich our curriculum by teaching in our degree programmes in their own fields of expertise. Teacher exchange is a good opportunity also for the teachers themselves to learn about teaching methods used in another country.

In the past few years the visiting professors of our Faculty were, among others, the following:

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- Ercan Gündogan (Girne American University, TRNC)
- Éva Blénesi (University of Cambridge, UK)
- Gábor Lukács (Oxford Brookes University, UK)
- Gabriele Michalitsch (University of Vienna, Austria)
- Gary Scudder (Champlain College, USA)
- Geert Bouckaert (Catholic University of Leuven, Belgium)
- Grzegorz W. Kolodko (University of Warsaw, Poland)
- Gulshan Sachdeva (Jawaharlal Nehru University, India)
- Havva Caha (Fatih University, Turkey)
- Hina Khan (Northumbria University, UK)
- Jean Cartelier (Paris-Ouest University, France)
- Manfred Bienefeld (Carlton University, Canada and IDEAS, UK)
- Mariusz Niemiec (Wroclaw University, Poland)
- Mihály Fülöp (University Selye János, Komarno, Slovakia)
- Peter Herrmann (Cork University, Ireland)
- Robert Mikecz (Liverpool Hope University, UK)
- Stephan J. Wirtz (University IFM, Switzerland)
- Thierry Warin (Middlebury College, USA)
- Vildan Serin (Fatih University, Turkey)
- Walter Vanthielen (Hasselt University, Belgium)
- Wenzel Heinz-Dieter (Bamberg University, Germany)
- Werner Brouwer (University of Rotterdam, the Netherlands)

If you are interested in participating in teacher exchange with the Faculty of Economics, first consult with your home institution to see if there is an agreement between our respecting institutions (Erasmus or bilateral). This way you can also acquire important information concerning the requirements of your home institution regarding teacher exchange.

For further details, please visit the website of the faculty at http://economics.uni-corvinus.hu.
INTRODUCTION

The present essay aims at comparing the two multilateral partnerships governing EU relations with its periphery: on the one hand, the Euro-Mediterranean Partnership (EMP) branded as the Barcelona process, and recently re-branded Union for the Mediterranean (UfM) and, on the other, the recently launched Eastern Partnership. Both appear to serve the same purpose, i.e. ensuring stability in the EU’s periphery; moreover, they are complementary to the European Neighborhood Policy (ENP) launched in 2003, as well as to bilateral relationships based on Association Agreements with Southern Mediterranean countries and Partnership and Cooperation Agreements with Eastern neighbors. Although the aforementioned multilateral initiatives have been highly promoted by their sponsors, their added value and prospects of success are debatable. The evaluation that follows aims at comparing the limits and possibilities of the two initiatives, by focusing on the attitudes of their participants.

1. THE EUROMED PARTNERSHIP

1.1. REGIONALISM VERSUS BILATERALISM

At regular intervals the EC/EU has reinvented its Mediterranean policy in order to promote the goal of stability in its Mediterranean periphery. It is far from certain, however, that the EC/EU’s policy has helped reduce the main threat to stability, i.e. the economic, social and cultural divide between North and South. The latest attempt at bridging this divide was the Barcelona process launched in 1995. The process was based on the diffusion of norms and standards, such as democracy and human rights from the North to the South, at a time, however, when most Southern regimes had to curtail freedoms in order to combat radical Islam. Moreover, the
The Barcelona process may have been adversely affected by the launching of the European Neighborhood Policy (ENP) in 2003. Karen Smith [2005] noticed the shift from normative regionalism to normative bilateralism reflected in the ENP action plans and the positive conditionalities therein and, similarly, Michelle Pace [2006; 2007] argued that in its role as a norm entrepreneur the EU had shifted from EMP to ENP. In the words, however, of Christian Franck [2006] the ENP seems to be more the continuation of the same trend under a new label than a new stage in the approximation of the two sides of the Mediterranean Sea. On the other hand, and notwithstanding the negative conditionalities therein, the needs of South Mediterranean countries were adequately addressed through existing bilateral relationships, as well as EU financial instruments, including 8.8 billion euros through the MEDA instrument during the period 1995–2006 and 10 billion in loans from the European Investment Bank / FEMIP during the period 1995–2007. In the case of Morocco and Tunisia, successful cooperation under the ENP action plans and progress towards more advanced relationships with the EU entailed reduced interest in the regional approach.

Regionalism was, however, given a new chance with the adoption of the Paris Declaration on the Union for the Mediterranean at a meeting of the Heads of State or Government convened on 13 July 2008 by the French presidency of the European Council. The Union reflected the traditional intergovernmental logic of cooperation, but the Declaration aimed explicitly at redirecting the Euro-med Partnership (EMP) into a Union of Projects. Project-based functional cooperation would thus rely on shared interests rather than shared values. Moreover, the partnership, which until then had been guided by the EU and, essentially, the European Commission, was to be based on the principle of co-ownership by the 43 signatories of the Declaration. It was to be co-driven by the Northern and Southern countries and co-chaired by a minister from each side. For the first time, the Southern countries were given the opportunity to shape the Partnership’s policies and projects, although participation would be on a variable geometry basis. Co-ownership is not, however, synonymous of effectiveness. The output of the first 18 months since the Union’s inception has been disappointing due to delays in the setting-up of the organizational structure. Yet the projects as well are likely to suffer from prolonged negotiations. The central question is whether the Northern and Southern partners will set aside their differences on politically sensitive issues and work together in the new project-oriented framework.

1.2. ATTITUDES OF PARTNERS

1.2.1. Diverging views between Northern and Southern partners

(a) Migration

Demands of Southern Mediterranean countries aimed at the liberalization of migration flows have been continuously ignored. On the other hand, illegal migration remains a serious challenge to Northern Mediterranean countries such as Greece,
Italy and Malta. On its part, Spain has been pushing for progress on legal migration. Actually, a very small number of persons, such as researchers, are eligible under EU law for entry and limited stay in the Union. There are no EU provisions allowing larger categories of persons, such as seasonal and posted workers. Moreover, cyclical migration of professionals has remained an area of academic debate, without practical steps in implementing the concept.

(b) Democracy and human rights

The EU and its partners agree on the need to combat radical Islam but differ on the appropriate policy-mix. Divergences remain on issues such as allowing opposition parties and civil society to flourish. These issues receive some attention at the joint consultative bodies which operate at the parliamentary level and that of local and regional authorities. A consultative status is sought by the network of Economic and Social Councils. Many blame the limited success of the Barcelona process on the lack of involvement by civil society and other non-state actors. There have been, however, some successful civil society projects, not least those sponsored by the Anna Lindh Foundation for Intercultural Dialogue.

Democracy and human rights are relegated to general commitments in the Paris Declaration. Two distinguished colleagues from Barcelona rightly point out that “UfM economism neglects the normative dimension of the Euro-Mediterranean acquis...one can wonder to what extent the UfM fits in the EU Mediterranean policy (Euro-Mediterranean Partnership, European Neighborhood Policy).” [Barbe and Soler I Lecha 2009:99 ]

1.2.2. Rivalries among partners

(a) Rivalries among Northern partners

The Northern Partners pursue their national agendas. They have been competing for political and economic influence; France and Spain have been competing in Morocco, France and Italy in Tunisia etc. Moreover, Franco-Spanish competition on the branding and the seat of the new institutional framework ended in a compromise, with the final branding of the new partnership as Union for the Mediterranean (without reference to the Barcelona process) and the establishment of its seat in Barcelona. Competition is likely to be more open-ended regarding participation and funding of joint-projects. Germany and other EU member States are likely to project their technological capabilities and secure pole positions for their business entities in specific projects.

(b) Rivalries among Southern partners

Leaving aside the Israeli-Arab conflict, the most troublesome relationship among Southern partners is the one between Algeria and Morocco, the former being accused of providing support to the autonomist movement in the territory of
Western Sahara claimed by Morocco. Moreover, Egypt and Algeria have been competing for influence in the Arab world and international bodies, rendering uncertain their cooperation in the Union for the Mediterranean.

1.3. THE STALEMATE IN THE SETTLEMENT OF THE MIDDLE EAST CONFLICT

There is no fundamental disagreement between the EU and its Arab partners regarding the settlement of the Middle East conflict. There is, however, disagreement on the ways and means to reach a settlement and, more specifically, how to deal with the recent radicalization of Israeli policy.

(a) Attitudes towards Israel

Israel enjoys special treatment as an EU partner. The EU has concluded an advanced association agreement with Israel which, upon the latter’s insistence, also applies to illegally occupied territories. The EU’s standard procedures for dealing with ENP countries do not apply to Israel. No political conditionalities are laid down in the ENP action plan for Israel, beyond a vague reference to human rights.

The EU, and the rest of the world for that matter, has been witnessing the radicalization Israel’s policy on the Palestinian issue. The erection of the wall separating Israel from occupied territories and the expansion of Jewish settlements in these territories have generally been perceived as additional impediments to the settlement of the Palestinian issue. In contrast, however, to the wall, which aimed at satisfying Israel’s security needs, the expansion of Jewish settlements lacks any legal or moral justification. The latest move on behalf of Israel to partially freeze the expansion of Jewish settlements is unlikely to attract much sympathy. The vicinity of East Jerusalem is excluded from the freeze and Palestinians will continue to be displaced by force from their homes in this area.

The EU has gradually been losing its credibility in the Arab world. Gone are the times of the Venice declaration (1980) when the ten-member EC was the first major international actor to call for the establishment of a Palestinian state. The Gaza military operation and, more significantly, the continued expansion of Israeli settlements have inflamed Arab public opinion and undermined the credibility of moderate Arab governments in the minds of their citizens. While witnessing the radicalization of Israel’s conduct, the EU has limited itself to condemnations and calls for redress. Steps such as the freezing of the Israel’s association agreement with the EU, recommended after Israel’s military operation in Gaza, carried out in January 2009 would, however, be counterproductive at this point in time and create divisions among EU Member States.

(b) Impact on the Union for the Mediterranean

Due to Arab misgivings, the Union for the Mediterranean launched in July 2008 remained for a time a theoretical exercise. Following the Gaza operation, the intergovernmental meetings were suspended and the organization failed to be staffed.
The procedural deadlock was lifted on July 7, 2009 when Ambassadorial meetings resumed; on March 4, 2010 the appointment of a distinguished Jordanian diplomat as Secretary General finally took effect. Nevertheless, the frustration of Arab countries resulting from Israel’s conduct and the EU’s complacency undermined progress in the implementation of the Union for the Mediterranean.

In view of the above, it seems appropriate for the EU to review its position regarding the participation of Israel in the Union for the Mediterranean. In the past, Arab states maintaining diplomatic relations with Israel were happy to cooperate with it in the Euro-med framework. In the current context, however, these states, not to mention the rest of the Arab world, are unwilling to establish or pursue cooperation with Israel and consider region-building in the EMP context as irrelevant. The EU is losing a lot from the EMP stalemate, while Israel would lose little if its participation in EMP was provisionally suspended. As things stand today, there seems, unfortunately, no other alternative to overcome the impasse and to hold a meaningful Euro-Mediterranean summit during the Spanish Presidency.

2. THE EASTERN PARTNERSHIP

Its origins are very recent. They can be traced back to a meeting of the foreign ministers of Central and Eastern European Members of the EU held in Warsaw on November 24, 2008, upon the joint initiative of Poland and Sweden. The Eastern Partnership was officially launched at a special meeting of Heads of State or Government convened by the Czech presidency of the European Council on May 7, 2009 with the participation of EU members, as well as Ukraine, Moldova and the three Caucasus republics. The initiative was generally perceived as complementing ENP and re-balancing the EU’s relations with its periphery, following the creation of the Union for the Mediterranean. While perceptions and aspirations of EU members and partner countries differed a lot, there was almost unqualified support for the initiative as such. In fact, a further indication of support was the early establishment of the Eastern Partnership Civil Society Forum.

2.1. ATTITUDES OF EU PARTNERS

The EU members behind the original initiative, Poland and Sweden, were major foreign policy players, with experience in regional cooperation – in the case of Poland the Visegrad group and, in the case of Sweden, the Nordic Council. Most other participants were EU members bordering the Eastern partners. At the Prague Summit the common concern of EU members was to enhance stability in the EU’s Eastern neighborhood and to allow for more differentiation in ENP. Attitudes over the longer term prospects of neighboring countries differed a lot. For Poland, the Eastern partnership would serve as an intermediate stage on the road to accession for neighbors such as Ukraine. For other prominent supporters of the partnership, such as Germany, the partnership could serve as a viable substitute to accession. For most EU members the partnership did not in any way prejudge accession.
2.2. ATTITUDES OF EASTERN PARTNERS

The declining American involvement in Ukraine and Georgia and the abandonment of the plans for the accession of these countries to NATO created favorable conditions for deepening relations with the EU. Eastern European countries were still feeling uncomfortable with the big Russian neighbor. Any means of enhancing their relations with the EU, whether bilateral or multilateral, had a direct bearing on their sense of security. Ukraine, on its part, had made known publicly its aspiration to become a member of the EU and viewed the Eastern partnership very much like Poland. At any rate, the Prague Declaration explicitly provided that “The Eastern Partnership builds on and is complementary to existing bilateral contractual relations. It will be developed without prejudice to individual partner countries’ aspirations for their future relationship with the European Union. It will be governed by the principles of differentiation and conditionality.” Actually, differentiation applies to both membership of the partnership and future links to the EU. Interestingly, the Eastern Partnership does not include all ENP members of the former Soviet Union.

CONCLUSION

Adding a regional dimension to EU cooperation with Eastern European countries corresponded to what already existed in the Mediterranean context. The two multilateral designs complement advanced bilateral relationships and bear some resemblances, such as the principle of differentiation, already present in ENP. Nevertheless, their prospects seem to differ. While they are both recent in time, the Union for the Mediterranean aims at resuscitating a process which failed due to the lack of interest and rivalries of its partners – and lack of involvement of civil societies, while the Eastern Partnership is a promising multilateral design, not least because of the almost unqualified support of the interested nations and the early involvement of civil societies.

REFERENCES

SUBMISSION GUIDELINES

Köz-Gazdaság – Economic Theory and Policy is a bilingual quarterly journal, published by the Faculty of Economics of the Corvinus University of Budapest. The editors consider all received papers for publication in the field of economic sciences, which contributes to the development of Hungarian economic thinking.

The following guidelines should be observed when preparing a paper for submission:

- The paper must be written in either Hungarian or English.
- We only accept electronic submissions, sent to balazs.szentivanyi@uni-corvinus.hu in MS Word (doc) format
- The length of a paper should not exceed 40,000 characters (bibliography included).
- We kindly ask our authors to observe this upper limit to the greatest extent possible.
- The paper must have a short abstract (with a maximum of 100 words).
- Chapter headings must be indicated using Arabic numerals. In case of subsections, the number of the main chapter must also be given: 1., 1.1., 1.1.1, 1.2.2, etc.
- Figures and charts must all have titles, and must be numbered with Arabic numerals. The content of a figure or chart should be interpretable without the knowledge of the main text. In all cases the source of the data should be given below the figure or chart.
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- Notes and references:
  - References should be given in the main text in square brackets in the format [author year]. E.g.: [Szentes 1999]
  - In case of full citations or exact data, the page number should also be given in the format [author year: page number]. E.g.: [Szentes 1999: 312]
  - Footnotes are used to supplement the main text, please use as few as possible.
- Bibliography: the paper must contain a complete list of cited works in the following format:
  - Books:
    Author (year of publication): Title in italics. City of publication: Publisher
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