

EU MEMBERSHIP, *fast lane to prosperity?*

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1. *Using membership for catch-up growth*

A decade or so ago the talk in Central European capitals was about transition, the Europe Agreements, and the new security architecture of Europe. With the security architecture in place, the Europe Agreements completely overtaken by enlargement and pre-accession, and transition largely over, the central focus of candidate countries – and surely of Romania – should be on *secular catch-up growth*. With democracy, a free press, human rights and NATO membership all accomplished, EU membership is really about prosperity. We all know that, other than China, and possibly Vietnam, the 26 countries in transition from command to market economies can be split into two groups: EU candidates doing *relatively* well and the rest, stuck in a myriad of transition problems and with a dramatic fall in the standard of living. However, China and Vietnam are not democracies.

For a democracy, pursuing transition and subsequently catch-up growth for decades is a very tall order indeed. And although the candidates, including Romania, have a headstart over many medium-income developing countries in terms of literacy and industrial history, if not human capital at large, this is a far cry from a safe bet on your future sustained trend growth. You need to design and firmly stick to a very long-run high-growth strategy which, in its core, ought to be politically supported by all major political parties. Easier said than done. Many medium-developed countries have tried and few have succeeded. And amongst the few which did, some were not democracies or turned into democracies only late in the day.

For Romania, and other candidates, the predicament is not exactly the same as for the medium-income developing countries. The critical difference is EU membership. Again, EU membership is not a guarantee for catch-up growth, not even the transfers that make euro-signs glow in the eyes of many politicians in Central Europe. Nonetheless, EU membership exerts a (highly) positive effect on two central prerequisites of long-run growth and holds tremendous opportunities for exploiting a steady development strategy. It is not exaggerated to regard EU membership as an asset for you. Assets can be well managed and may lead to prosperity over the fast lane of the development highway. If you so wish. Because Brussels will not and cannot do it for you.

I feel privileged to be given this occasion of the Special Lecture series of the European Institute of Romania, so as to develop this key theme for Romania's future. Using membership for catch-up growth is something else than the impact of the Europe Agreements or the impact of enlargement as usually discussed. These impacts are routinely studied in a short-to-medium term framework and directly linked to important elements of the *acquis*. Today we discuss long-run dynamics, in an economic environment in which factors of production, structures, institutions, are all subject to change, including what Schumpeter calls 'creative destruction'. The focus is on fundamentals for growth, and political, social or institutional taboos will, sooner or later, have to be mellowed and overcome. It is about strategic focus and deep societal investment in development, not about marginal shifts in emphasis between one government and the next.

I shall first address the question of prioritizing growth in Europe, not only to set the stage, but also because there are conflicting signals that need to be properly understood. Subsequently, I survey the confusing economics of convergence in the hope that this might provide a little bit of clarity for policy makers, bombarded with divergent

conclusions. In the three following sections I shall then attempt to link growth strategy to EU membership, zooming in on prerequisites, fundamentals and the microeconomics of growth. I hope to end with a few notes about a strategy for catch-up in terms of the Union's role and, above all, your own.

2. *Prioritizing growth in Europe*

2.1 The growth bias in the Rome treaty

It is good to remember that the original EEC-6 were very keen on economic growth. Once post-war reconstruction was over, the need was quickly felt to exploit market incentives for competition and market size for scale, as the analysis in the OEEC productivity centers confirmed time and again. Reading the 1956 Spaak report – akin to the Federalist Papers of the US founding fathers, in laying the foundation for the Rome treaty – it is all about growth, scale and market size. A careful study of the Rome treaty confirms the pro-growth bias of the EEC although a veil of somewhat ambivalent objectives and treaty elements mask this bias on first sight. A case can be made to characterize the EEC treaty as pursuing “growth under conditionalities”. The idea sometimes found in the political science literature that the Rome treaty was basically a French/German deal about German market access for its industrial products in France, and French access for its agro-products in Germany, is at best misleading because very incomplete, and more probably, a failure to grasp the acceptance by policymakers and indeed industry that exposure to competition and market size was the key for change and growth. And just as much in Italy and Benelux as in France or Germany. A common competition policy and explicit links to GATT rounds complemented this, incomparably more pro-market than the ECSC. Moreover, the treaty contained several crucial automaticities on its way to the customs union and only few options for safe-guards or special funds. The Community was about growth and prosperity.

2.2 Union membership as an impetus for growth

The first 15 years of the EEC are remembered as the golden era of growth. It is exceedingly hard to “prove” to what extent the Union contributed to this growth. The static studies of customs union effects were not at all reflecting the relevant growth dynamics of the time. But there are good reasons to believe that the Union was a powerful help; the extreme intra-EEC industrial trade growth rates between 1958-1964 inclusive being a central indicator, among other ones. One can also take an inductive approach. One illustration is a little noticed but insightful book, published in 1957, by Tibor Scitovsky, about how European markets worked, how inefficient industrial and distributive practices had remained and how the lack of dynamism and business strategy seemed to be the result of a total lack of new entry and challenge. As Mueller and Owen and others have later shown in detail, the microeconomic shockwaves prompted by exposure to (foreign) competition were a splendid confirmation of the Scitovsky view. And of course, they were the source of powerful pro-growth efficiency changes.

The static and dynamic effects of market integration eventually peter out, unless and until the growth fundamentals themselves are subject to change. The link between economic integration and growth fundamentals is more indirect and partly macroeconomic. But with every enlargement, pressures arising from market integration exerted a healthy

impact, if – and that is a key condition – domestic institutions, public finance and policies do not soften, let alone, offset these changes. Britain’s industry got its expected ‘cold shower’ from EU membership, but in a less than receptive policy environment (to put it mildly, remember the 1975 referendum), and problematic macroeconomic policies. It took Ireland about 10 years before it had its act together on a long-run development strategy. Its harvest in the 1990s was phenomenal, with annual growth rates varying from 5% to more than 8%. Greece entered in 1981 but failed, between 1982 and 1996 to exploit the potential for market integration, while pursuing bad macroeconomic and structural policies at home. It is only since 1997 that Greece has begun to exploit its membership as an economic asset, and today it enjoys the highest growth in the EU-15. The saga of Portugal and Spain is well-known – both are on a stable trend growth with slow but steady convergence. East Germany in fact slipped in through the back door in October 1990. With a set of “heavenly” conditions to start a dream-transition, the result has nevertheless been the very opposite. Market integration, first with West Germany and then with the Union, and later with Central Europe, cannot compensate for dramatic policy failures, such as real wages far above actual and initially even potential labour productivity as well a Treuhand sell-out without any ownership for the East Germans themselves. It is too often forgotten that almost NO FDI has moved in to East Germany during the post-Treuhand period, worse than any candidate country.

2.3 Growth paradise lost?

For the oldest Community members EU-induced growth had of course petered out after 15 years. In the early 1980s Western Europe had stagflation – so no growth – and eurosclerosis. The response has been a profound “deepening” of the EU, in two impressive steps: first the single market (a good deal of which, candidates find on their pre-accession menu of the *acquis*) and next the EMU with the euro as the single money. Both can be regarded as further pro-growth shocks, be it with adjustment costs lowering the net welfare benefits. I shall not discuss the difficulties and merits of the 1988 Cecchini report (which I co-authored), with its *ex-ante* estimates of the temporary growth impact, and the *ex-post* Monti report of 1996/97. I shall also refrain from assessing the benefits of the euro, except (later) for the growth fundamentals.

For the long-run view on growth other aspects are more critical. The EU-15 has gradually developed symptoms of a slow grower. The single market and the euro are excellent initiatives, in my view, but they cannot be fully exploited in terms of secular economic growth if national policies and domestic rules and institutions do not allow such “usage”. The present EU member countries have an ambivalent perspective on growth. They accept far-reaching market and macro integration, yet they do not tolerate (too) deep changes in domestic (economic) institutions, vested interests (e.g. labour markets) and local policies. Getting around this, but only in 2000, they have engaged in the Lisbon process. In 2010 the EU would be the most competitive economy in the world. Whatever that means !! Let us be straight about this process : it is not taken sufficiently serious, vested interests control too much the “coordination” (Luxembourg ; Cardiff) and the EU BEPG process has thus far had too few consequences on the domestic politics of the Member States. The Sapir report of July 2003 hits the nail on the head – growth in Western Europe is no longer accepted in terms of prerequisites and consequences. The report deals solely with the EU side and hence can remain relatively friendly (except for Commissioners Barnier and Fischler) but it ignores the genuine culprit : the Member States’ intolerance of deep change. Europe’s growth paradise is getting lost. This would

be bad news for Central Europe. The EU must reconsider, not talk but act about deep reforms as well as deep investments in innovation and R & D incentives. It is in the Central European interest that the EU-15 does not become a “European Japan”. Accomplishing your convergence with a stagnant Europe might be swifter yet far from desirable. Please reflect on the following proposition: though going against simple arithmetics, the probability of you catching up faster is enhanced, not reduced, by secular growth in the West.

2.4. Catch-up growth and cohesion

Convergence inside the EU-15 has typically occurred between “countries” while – more often than not – divergence remained or sharpened inside some countries. The new-economic-geography, a more rigorous follow-up of Myrdal, can explain such “unbalanced growth”. In bigger countries like Poland and Romania the risk of these divergences occurring is considerable. And the policy dilemma’s are painful : spending on infrastructure in regions is key, yet has a low social return as compared to spending on infrastructure in agglomerations ; spending on infrastructure connecting agglomerations with low-income regions tends to accentuate spatial concentration; etc. And the numerous practical problems of generating good projects, without corruption or incompetence, have proved to be tough in the EU-15. The Irish have shown the greatest effectiveness and their ‘best practices’ have gradually penetrated Spanish and Greek implementation. It is controversial among empirical economists whether cohesion spending delivers convergence. The Irish success story inside the EU, let alone the Singaporean performance for decades without ever having seen a dollar of subsidy, cannot be attributed to “cohesion” transfers. Enjoying the transfers can coincide with a failure of secular catch-up growth (Mezzogiorno) and not receiving transfers is perfectly compatible with a successful long-run growth strategy ! Your politicians may hate me say this but they better focus on growth fundamentals above anything else.

2.5. The wavering doctrine of today’s enlargement

Enlargement towards the East has been dominated by a very strong emphasis on accomplishing the introduction of the *acquis* in domestic law and institutions *before* accession. One can understand this position in the early days in and immediately after Copenhagen, December 1993. Reaching out to the transition countries was one thing, weakening the golden asset on which the EU is based (the internal market, broadly defined) would be self-defeating. In the PHARE work explaining, in excruciating detail, the internal market *acquis* menu for the candidate countries I quickly realized that the *acquis* could serve as ‘*mana* from heaven’. No normal bilateral programme or the IMF & the World Bank could ever even remotely approach the intrusiveness and width of the *acquis*, and often its quality too, for purposes of transition to a market economy in a democracy. And the absolutist condition of the Essen and Madrid European Councils of 1994 and 1995 [the *acquis* and nothing less] created an almost a-political drive in all candidate countries to fulfil the requirements, thereby overcoming one of the greatest dangers of transition. In other words, although I was far from happy with this absolutist approach for entrants – which had no historical precedent – I started defending it with gusto for the benefit of Central Europe. And I still do. But not across the board.

The *acquis* goes against the short/medium term interests of the candidates in some highly specific, non-trivial instances. Thus, in our WRR report (WRR,2001 ; see also Pelkmans, in the Romanian Journal of European Affairs, 2001) we endeavoured to identify a “core *acquis*” approach which would apply a better sequencing of obligations so as not to hinder catch-up

growth of the accession countries. The shifts in priorities can be found in the very expensive water and air directives , nuclear positioning of the EU-15 (strictly spoken , not even based on the *acquis*) and some social directives e.g. occupational health & safety, for example). The Union had great difficulty with this approach but – de facto, while not formally admitting it – has become more flexible in allowing transition periods here. The flexibility is ad hoc and not based on a strategy that fosters the emergence of a long-term growth strategy in the Central European countries. It is therefore too little , a bit late and shifting burdens on the candidates that makes no sense (e.g. water !). One can , and I certainly concur, also object to the odd phenomenon that the budgetary contributions of the new Member States to the EU immediately are relatively high. Why not phase them in. Stronger , why not make contributions progressive anyway? The EU-15 has been wavering on the hard core of enlargement , without ever taking a strategic view on these aspects.

2.6. The growth imperative of Central Europe

Whether for domestic reasons , after transition , or for reasons of the stability and “health” of the Union, it is imperative that the accession countries swiftly join the ranks of highly developed economies, bringing prosperity to its citizens. The initial conditions are reasonably good, including solid and widespread education, industrial experience, proximity to high income markets and excellent access to those markets as well as neighbouring markets. However, the words “swiftly join “ have to be understood in terms of a generation because that would be quite fast. Imagine your current high growth (5 %) to continue for 35 years – which is a very optimistic assumption – and the EU-15 to enjoy an average annual growth in the same period of 1.5 % (which is lower than recent history) , only then you will surpass the per capita real income level of the western EU.

But there is no reason to despair because “prosperity” comes much sooner.

It is entirely possible to grow secularly without EU membership as the post-war history of EFTA countries has convincingly shown, not to speak of the Singapores and Japans of this world. The point is that secular growth at a high pace requires an enormous discipline (in Singapore , an autocratic form of ‘meritocracy’; in Japan the combination of post-war focus on the economy only, the strict and hierarchical codes in society and the dominance of the LDP) over many successive governments despite the inevitable (re)distributive effects, even if temporary, and the deep transformation of society such growth must imply. For countries coming out of transition , the difficulties are bound to be greater still. So, even though it is conceivable to catch-up alone, it is a very tall order indeed, and it is reckless to expect a completely autonomous process to be predictable over 20 or 30 years. EU membership provides the most stable and “deepest” access-to-markets, by far the strongest and broadest guidance to (proportionate) regulation , liberalisation and institutions, and – most important of all - a very firm “lock-in” of all these accomplishments pre-empting policy reversals. The advantages for your growth imperative are thus potentially enormous. This is not to say that the EU is somehow “perfect” – perfection is best delegated to ‘heaven’. On earth and given your predicament, EU membership would greatly facilitate secular growth towards prosperity and the task of independent thinkers like myself is to try to further improve the Union to have better policies, rules and funding. The way the Union operates today, the debate on how to do better is much more open than ever before. The European Convention has shown this to everybody but it is also the case in economic policy at EU level as well as between member States. The ‘open method of coordination’ can be seen as a great help for countries that have the political and social energy to reform and strive. As a Union strategy I find it too weak, yet

for testing and understanding ‘best practices’ for eager accession countries it is a splendid laboratory.

3 The confusing economics of convergence

3.1 No ‘mythical belief’, please

Daniel Daianu (Romanian Journal of European Affairs, 2002) has rightly called attention to , what he calls, a “mythical belief” in the Brussels circuit that enlargement, given all its conditionalities, will yield “rapid and sustained economic growth” and eventually a catching-up with Western Europe. The critical jargon here is “a well-functioning competitive market economy able to withstand competitive pressures inside the EU”. I share his prudence and concur in warning policy-makers not to fall into the trap of naive beliefs or adhere to purely mechanical expectations about the long-run growth process.

However, I regard it as a duty and the privilege of an advisor to move beyond the preoccupations of , especially, the very recent literature led by Easterly, Stiglitz and Rodrik, by sketching the contours of a strategy which firmly prioritizes growth for a full generation and the potential extra benefits which can be extracted from EU membership in this respect. In any event, Daianu’s reading of the literature is strongly influenced by scholars writing and teaching in the US (and of course by the Washington institutions) and it is worth noting that Europe has long enjoyed a much more diversified perspective on such issues. The clearest example is the work about the East Asian growth miracle where the meeting of minds was less hindered by perhaps somewhat doctrinaire views originating from the Washington consensus. The same for the recent emphasis on economic institutions. The European tradition – the old German/Dutch/Austrian traditions , captured in this German piece of jargon “Ordnungspolitik” , for example - was hardly known or echoed in the english-written literature of prestigious journals. It is the experience of transition which undermined the firm opinions of many economists. Without overstressing the point , it is worth reflecting on it. I have myself been confronted , for decades, with deep skepticism in the OECD, various continental Development Banks, the Washington institutions and in what is called the “economics profession” , about the merits, set-up and positive effects of European integration. Rather than attempting to grasp the strong fundamentals of the pro-market mechanisms of the EU , and criticising the bad exceptions, the uniform attitude was to aggrandize the exceptions (e.g. the CAP and, in the past, old-fashioned industrial and trade policies) and view them as representative of what European integration stands for. As a consequence, EC-1992 was long greeted with disbelief and belittled. The same happened with EMU. During most of the 1990s it was hard to find American economists being in favour of EMU and the euro although the accomplishment of having 12 countries write a strict monetary constitution jointly, that most did not even enjoy at home, coupled with a badly needed fiscal consolidation, is simply inexplicable by any political economy theory in the literature.

It is therefore heartening, but novel, to observe that , since a few years the EU and its enlargement has come to be regarded as the superior framework for transition countries in Central Europe to develop their economies. All international institutions nowadays routinely refer to the EU as the standard, with – and rightly so – some criticism on some aspects, most of which I share. The good news is that the EU can now do likewise as the complementarity

with some of the work of the IMF (e.g. Romania) , the EBRD and the World Bank demonstrates. It is in that spirit that I shall discuss the ‘fast lane to prosperity’ for candidate countries , with some reference to Romania.

3.2 The empirical post-Solow school

[see slides presentation]

3.3 Five other currents

Economics has a lot to offer but certainly not a single recipe. It is also easier to specify what is to be avoided than what exactly ought to be done . So, before going into the specifics of the questions asked , it is useful to elaborate on the overall “state of the art “ in economics on long run growth and its determinants.

Basically , one can usefully distinguish 5 other analytical approaches to long run economic growth. They are (besides the (neo-) classical Solow growth model on which a lot of empirical real convergence literature is based) :

== endogenous economic growth theory , the empirical variant sometimes called the “augmented” Solow model (emphasizing human capital and the ways this is raised over time and aspects such as innovation)

== the so-called new economic geography , focussing on “unbalanced “ growth and attempting to explain the powerful incentives for (growth in and of) agglomerations by various informational and knowledge spill-overs between firms and sectors, in a context of scale and differentiated products and services

== Porter – type competitive (and, to some degree, comparative , indeed sometimes man-made comparative) advantages, culminating in dynamic clusters of policy variables promoting “competitiveness” which propels growth on a secular basis [several new member states have solicited Porter-type consultancy reports as a basis for developing industrial or services strategies]

== transition and post-transition growth literature which combines the growth incentives from the emerging market economies with the role of (market) institutions (including legal regimes, enforcement and its credibility, regulation and regulators) and that of “social capital”

== demand-based theories of growth ; unlike the other theories which are all supply-side approaches , there is a tradition going back to Kaldor and Kalecki to analyse long run demand issues as the root for unbalanced growth;

It so happens that all six approaches have been surveyed in authoritative reviews in the literature in the years 1999 – 2002. There is no point in attempting to provide a survey of surveys , even less to expect a “cooking book” for economic convergence policies in the framework of a larger EU. Economists have learned a lot about growth but have also made many , sometimes fundamental mistakes when providing policy advice. A degree of prudence, if not modesty, is recommended. At the same time certain key mistakes in policy can be identified and a number of fundamentals have always remained robust throughout decades.

The renewed debate about the determinants of long run growth is not merely fuelled by Easterly ‘s book and its aftermath. All this is not really about esoteric theory or academic ivory tower insulation. The strongest but by no means only catalyst is the implosion of growth in East Asia, the erstwhile darling of the World Bank (be it only after a decade of debate about the "East Asian miracle” and the deviations in East Asian strategies from the

“Washington recipes”, in particular about the interventionist role of governments and the Asian Development Bank. Shortly after a consensus seemed to have been reached (the World Bank in 1993 and the ADB in 1997) about the East Asian model and its “growth tigers”, a totally unexpected and initially inexplicable collapse took place which is comparable with the Great Depression at least for 5 or 6 countries in the region. Moreover, Japan is already stagnant for 13 years and is incapable of reforms needed to re-ignite growth.

In the European context the growth worries might not be so extreme but the sharp contrast between Greece (until 1997, not thereafter) and e.g. Ireland, Spain and Portugal in long run catch-up growth demonstrate that the mere membership of the EU, and the basically healthy exposure to the competition in the internal market under the *acquis*, is a necessary but far from sufficient condition for economic growth and real economic convergence over the next two decades. The worries about growth have now begun to reach the economic powerhouse of the Union, e.g. countries such as Germany and Italy, whilst (confusingly) the EU has solemnly declared that it wishes to become the most dynamic economy in the world.

As noted, I shall limit myself to the contours of a strategy for long-run secular growth, exploiting EU membership. Before doing so it is essential to realize that, ultimately, it is Romania which ought to design and carry through the strategy. It should do this in the light of its specific circumstances and on the basis of domestic political leadership which is supported as legitimate and appropriate, even if the details of the implied change can not possibly always comprise good news for everybody at all times. Political leaders and opinion makers must be conscious of winners and losers but there is a big difference between short-run losers (adjustment; no growth without major re-allocation and new ways-of-doing-things) and permanent losers. In short, the key is a combination of sound economic analysis with *policy ownership*.

The three aspects I distinguish here are: the growth prerequisites, its fundamentals in the framework of EU membership and the micro-economics of growth, the incipient signs of which we can begin to observe also in Romania. I shall end with some propositions for the strategy, divided into the Union’s role and, more importantly, your own. My hope is to encourage an in-depth debate in Romania as the prelude for a credible strategy, not written or pressed by outsiders but developed, “owned”, embraced and pursued with vigour and gusto by the country’s leadership.

4. *Growth prerequisites and EU membership*

4.1 Political stability & democracy

[see slides presentation]

4.2 Macro-economic stability and credibility

[see slides presentation]

5. *Growth fundamentals and EU membership*

5.1 Factor accumulation

[see also slides presentation]

The relevant factors of production are labour , capital (in various forms) and technology. Factor accumulation by adding more labour to the work force can basically happen in two ways : a higher participation rate (the Lisbon target by 2010 is 70 %) and a high fertility rate (or indeed immigration). Higher participation rates are a problem in a number of current EU Member States , much less in Central Europe (a legacy of communism which had even higher participation rates than today). Neither fertility rates (low to very low in Central Europe) nor immigration into Central Europe can be expected to help growth for the foreseeable future.

So, it will have to be capital which will serve as a source of accumulation. This means that we talk about domestic savings and investments as well as foreign direct investments (FDI). Saving rates in Central Europe tend to hover a few percentage points above those in the EU-15 but this is unlikely to serve as THE source for a much higher growth rate. Domestic investment will have to exceed domestic savings for decades . This is possible if (a) EU transfers are significant and well spent on investment projects; (b) FDI inflows remain steady and high after the initial first boost following the 2004 EU membership; (c) portfolio capital (which is far more liquid) is not heavily biased towards very short run capital (hot money) induced by market distortions (and without solid collaterals). Incidentally , if all these good things happen, it must mean that new members will run structural deficits on their current accounts and , up to a point , this is not worrying ; quite the contrary , it reflects the net capital inflows required for investments to underpin the high growth rates.

To make these good things happen depends essentially on two things. First, financial markets and institutions ought to become first-class and they aren't yet. They inherit a reputation of instability , partly due to “thin” markets , partly due to a decade of problems, bank failures , weak corporate governance , insufficiently agile supervisors , etc. The acquis and practical standard setting by the Union is critical here. This is greatly helped by the second banking directive and all what it implies (other directives , cooperation of supervisors , etc.) and by similar advances in insurance and capital markets, especially given the ongoing programme in financial services/markets until 2005. Moreover, foreign (mainly EU-15) banks and insurance companies are heavily present in Central Europe, well acquainted with this new acquis and forcing high standards by competitive performance based on trust. In the medium run, therefore, there are reasons to be confident that financial markets and services rise to first-class as badly needed to obtain all kinds of capital for catch-up growth.

Second, the investment climate ought to be attractive. Of course what exactly that means is not carved in stone and can vary between countries and over time. Thus, it is an elusive notion and, moreover, may even differ between sectors and individual enterprises. The annual Competitiveness Reports of the Davos World Economic Forum rely on more than 200 variables, many of which are “soft” and probably subjectively answered. Categorical statements about the investment climate therefore have to be taken with more than a few grains of salt. But a few basics should not be violated in Central Europe. Domestic policies, not determined by the acquis, should broadly be supportive of structural catch-up growth. Criteria such as reliability of commitments , predictability of economic policy over time (especially between successive governments , something that Central Europe finds difficult to do , one hastens to add), solid medium-term commitments and finance for all kinds of infrastructure via public investments and public/private partnerships, a professional public administration at all levels of government [again, public policy reform in Central Europe has been disappointing thus far; too much lip-service and too little “hard” action ; still far too

much politicisation at the top] are certainly valid throughout the region. Other aspects of the investment climate depend more on the level of development of the country, the type of specialisation already achieved, the quality of intermediate and input markets, the level and scope of a range of supportive business services and other business related elements that have a less direct relation with government policies. It simply goes much too far (and would require a more systematic analysis) to even attempt to deal with these issues in the present Note.

Technology is also a factor of production. What we mean here is *existing* technology which can be obtained, in principle, via professional literature, academic and technical training, patents, standards, capital goods and intermediate products (in which it is embodied), joint ventures (know-how connected to agreed specialisation between companies or licensing), business alliances, mergers and takeovers and/or FDI. It is absolutely essential for Central Europe that the inflow of existing technology is facilitated wherever possible. However, for many if not all of these routes it is indispensable to acquire or develop a basic capacity of technological understanding and experience of their own, whether in testing laboratories, technical education, research centres etc. Otherwise countries will be incapable of “absorbing” and putting to proper and effective use the actual or potential inflows, with the consequence that such inflows will reduce or dry up. Reskilling people is one key element of post-transition that needs great attention and deserves resources. Another one is the building up (also for *acquis* purposes) of the entire infrastructure of testing, certification (also for unregulated products), quality assurance and other forms of technical conformance. Finally, something urgent has to be done about the extremely destructive decline of R & D capacity all over Central Europe since the fall of communism; it is true, these centres were, more often than not, misspecialised or engaged in defense – related work or bound to old or lousy technologies but their demise has caused the loss of very considerable human capital. In order to attain sustained high growth rates Central Europe will need a technological skill and infrastructure base which seems to be in shatters or, at best, is reemerging only slowly. These countries cannot converge to high performance levels of the EU-15 by specializing on low-skilled-labour intensive goods and services. They must climb the ladder of higher quality and/or technology input and/or higher skill inputs.

5.2. Secular technical progress

Technical progress is no longer about existing technology but about its further improvements or entirely new products, services or other innovations. What has been said above about technology applies a fortiori for this fundamental issue. It is neither necessary nor to be expected that Central Europe move immediately to the forefront or frontiers of technological progress in the world. What IS required is the capacity to absorb innovations quickly and adapt or amend them according to market needs at home or for export. And this capacity ought to grow over time both in the private and public sectors.

[see slides presentation, for more]

5.3. Appropriate economic institutions

[see slides presentation, for main items]

We have learned from the transition that economic institutions (for well-functioning markets and good economic policy making) should not be taken for granted. They matter a lot and they require care and firm guidance when designing them. The worst pain and the greatest mistakes are now a thing of the past. And “reversals” back to the bad habits are made very difficult indeed due to the *acquis* and the strong influence of EU membership. Further help can be had from the recent “soft” coordination practiced in the Union in benchmarking all kinds of national economic policy aspects, but even education as well. Soft as it may be, the naming & shaming, and indeed praising in public comparisons, makes these exercises more powerful than any work of a similar nature the OECD has been doing.

The merits of the *acquis* for the (permanent!!) quality of economic institutions are systematically underrated. The width and depth of the *acquis*, its overall quality and underlying high standards, its proven credibility in the EU-15 and the reasonably tough (though perhaps still not tough enough) enforcement by the Commission and ultimately the ECJ provide a unique foundation, completely “locked in” with EU membership. Business realizes this very well and is bound to raise the FDI levels greatly for this reason alone. But one should not make the severe mistake to regard the *acquis* as a set of regulations only. A great contribution to growth, indeed secular growth, consists in the many and tight constraints the *acquis* implies for governments of Member States. Because of the *acquis* all kinds of bad policies, exceptions, forms of protection, discrimination, distortions and the like that usually put a brake on economic growth and new initiatives are outlawed or pre-empted. The *acquis* is therefore fundamentally pro-competitive, an essential condition for economic growth to be high and remain high. Thus, the *acquis* imposes free movement (of competitive goods, services, capital and labour and technology), free establishment, competition (with both national and EU competition policy) and, not to forget, mutual recognition (which avoids EU rules and yet guarantees free market access). Taking this for granted would amount to a dismissal of the importance of 40 years of building the internal market, first and foremost by blocking interventions of Member States and all the pro-competitive forces this unleashes. Regulation comes in where market failures require this and the joint result of liberalisation and regulation amounts to a competitive single market.

It is not sufficient, though. There is still ample scope for purely domestic economic institutions to be wrongly designed or to escape from reform over time. In the EU-15 (too) little in the *acquis* and during the ‘soft’ coordination has had any serious influence in labour markets, especially entry rules and EPL regulation in most countries, notably Germany and Italy. The German *Wirtschaftswunder* has fizzled out a decade ago, if not earlier, and “acquired rights” block badly needed reforms. More generally, the prosperity in Western Europe appears to have instilled into the present generation an attitude of risk aversion and a disinterest in innovation or entrepreneurship. This must imply that the deep incentive structure is flawed and EU membership cannot, of course, impose the desirable changes.

6. *The micro-economics of growth*

6.1 Incentives & tolerance of transformation

[to be drafted]

6.2. How market integration propels your growth

[see slides presentation]

7. A strategy for catching-up

7.1. The Union's role

[see slides presentation]

7.2. Policy ownership and Romania's long-haul

[see slides presentation]

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