Integrating countries with different levels of income: Lessons from Europe

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Globalization has integrated formerly "closed" countries into the world economy.

Within Europe, the crucial progress of globalization resulted from the collapse of communism in Central and Eastern Europe. All post-communist countries opened up their economies by , among other measures, signing trade and cooperation or association agreements with the European Union (EU). The latter led to accession in the case of eight transition countries with two more in the final pre-accession phase (Bulgaria, Romania) and several others queuing up for the beginning of negotiations (including Turkey which is of course not a post-communist country).

Within Asia, it is, above all, the policy change in China (and, to a lesser extent, Vietnam) that has given globalization its specific form. North Korea could become a further candidate for transition.

The newcomers have very different income levels from the old market economies

Even fifteen years after the fall of the Berlin wall, the transition countries are generally far poorer than the capitalist OECD economies. Within the EU, the per-capita income of the new member states is about 22% of the EU average, measured at exchange rates, and 46%, measured at purchasing power parities (ppp). The next candidates are even poorer with 8-10% nominally and 25% at ppp (see table 1 in the annex). That is about the same relation as between the per-capita income of China and Korea.

The two income differentials have specific effects on international migration, trade and investment.

Big differences at exchange rates make exports, including tourism, from poor neighbors cheap and investors benefit from the nominally low wages. These low wages have a much higher purchasing power and thus allow workers to survive in their home societies. Even low wages in rich countries translate into high nominal wages in the currencies of the poor countries and even higher real wages and are therefore very attractive to migrant workers who keep their life-centers and families in their home countries. The fact, that national income is very low at exchange rates limits severely the poor countries' capacity to import from rich countries and to invest there.

Five processes have a decisive effect on the distribution of welfare and work between poor and rich countries in the integrated world

1. The productive Ricardo process: All countries increase their productivity by specializing according to their comparative advantage. Without a rise in global demand that process implies less employment.
2. The distributive Ricardo process: Employment and welfare gains are distributed between countries according to the terms of trade (i.e. exchange rates). The country with the weaker exchange rate forgoes welfare gains but wins jobs.
3. The Samuelson process: As Paul Samuelson recently showed, the rich countries' gains are likely to be reversed when the poor countries approach the productivity levels of the rich.
4. The Heckscher-Ohlin process: Integration also redistributes income between different groups within the countries involved and creates losers and winners of integration. In rich countries, unskilled labor will be among the losers; in poor countries, skilled labor and capital should be the losers. In the long run, factor incomes should equalize.
5. The Milberg process: All above processes neglect factor movements which accelerate and modify the same processes. Actually, multinational enterprises locate production steps at lowest-cost locations. They create transnational value chains that substitute high-wage labor by low-wage labor, increase inequality within all countries involved, and might even decrease overall productivity.

By creating the Common Market, the EU has been its own ultimate globalizer.

European integration has established a Common Market with free movement of goods and services, labor, and capital. It has abolished not only custom tariffs and quota but also all technical, fiscal and other barriers to trade by adopting the *acquis communautaire* a 80.000 page body of common regulation. An European competition policy and an active judiciary watch over the market and stop all national measures protecting national producers. On top of that, twelve countries have adopted a common currency, the Euro. However, Europe is nonetheless far from being a perfect market with equal prices for equal goods. In the context of the recent enlargement, some governments, notably Germany and Austria, have asked for and got multi-year transitional periods before the full introduction of the free movement of labor between them and the new member states.

The EU's economic performance confirms the pessimistic view of globalization

With deepening integration and globalization the EU has grown more slowly, while unemployment and inequality have increased (see table 2 in the annex). The causal nexus is not proven but there is a disturbing coincidence. Continental Europe has to a large extent translated

productivity and welfare gains into unemployment or paid leisure such as early retirement. This trend has weakened growth and demand. Contrary to some fears, it has kept social spending at high levels. The challenge for rich countries is to find new employment for those workers displaced by international competition, most probably in the service sector. Welfare state reforms have to continuously re-qualify the unemployed and to correct ill-designed incentives that keep potential workers on the dole or within the shadow economy which has grown dramatically in Europe. But they also have to make sure that there is enough demand.

The EU has aimed at reducing income disparities among its regions and countries, though without much success.

Already after its first enlargement, in 1972, the EU (then EEC) started its regional policy in order to improve social and economic cohesion. In spite of huge expenditures, income disparities between regions could not be reduced. Some regions which received outstandingly high amounts of aid from both, the EU and its own central government, such as the Mezzogiorno (Southern Italy) or Eastern Germany remained poor and with high unemployment. There has been some convergence of income levels between member states while disparities within member states increased. That convergence occurred during the late 1990s and was due to the monetary union (and not to regional policy). Monetary union decreased interest rates in the poorer member states which in turn led to higher investment, consumption and growth.

Ireland's economic miracle is the main and highly ambiguous exception to the rule.

While most poor member states converged rather slowly, if at all, towards the EU average, Ireland increased its per capita GDP from 79% of the EU average in 1995 to 142% in 2005. It achieved this outstanding performance by the clever use of EU funds to create a good infrastructure and to train the workforce and by attracting large amounts of foreign direct investment (FDI) by offering low corporate taxes. Multinationals have located various activities to Ireland and increased the locally registered value added through transfer pricing in order to save taxes. The Irish success is paid by the Irish people whose national income is 20% lower than its GDP (these 20% are profits transferred abroad) and by workers and treasuries in other countries who lost their jobs and tax revenues.

Europe has achieved peace and democracy but not rapid cohesive growth.

The great success of the EU so far is political rather than economic. The EU has accepted poor countries that emerged from fascist (Portugal, Spain, Greece) or communist (Central and Eastern Europe) dictatorships and supported their transition towards democratic market

economies. But the EU did not succeed to increase rapidly the income per capita in its poor regions and member states. The continuing income disparities are now endangering growth and social stability in the enlarged EU.

The best growth policies are virtually impossible within the EU.

With the exception of the special case of Ireland, the most successful catching-up poor countries have been the economies of East and South East Asia. They have achieved their rapid growth through protected export promotion and politically controlled capital allocation. A developmental state has created the conditions for enterprises to make huge profits on the one hand and has forced them to invest these profits to increase productivity and output. These policies are not allowed to poor countries within the EU. To the contrary, some EU policies are rather preventing the catching-up process such as its common trade policy, strong environmental and labor legislation, and its monetary policy with its strong stability bias.

To close the gap between poor and rich countries, productivity and nominal growth have to be combined.

The real source is of income and wealth is the full employment of available factors of production and, in the end, productivity growth. When growth has been achieved, the gap between exchange rate and ppp should be closed. All catching-up processes consist to a large extent of the appreciation of the national currency, either nominal or through higher inflation (Balassa-Samuelson effect). A too restrictive monetary policy and a fixed exchange rate slow down the catching-up process. In Europe, poor countries should not enter the European Monetary Union too early, although adopting the Euro might lead to lower interest rates.

In East Asia, the main challenge is to adjust to the integration of the emerging China.

China is already exporting about 30% of its GDP and providing 6% of world exports while its exports per capita are less than 3% of German value. These facts indicate a dramatic imbalance between China's domestic economy and its export sector. Theoretically, China could replace all manufacturing jobs in the richer countries by shifting all domestic labor into the export sector. This will not happen, but reality will follow that fundamental trend to some extent. To ease adjustment, global demand, in particular China's own demand, has to grow strongly. To achieve that, China will have to let its currency appreciate and remove some of the brakes to its own growth, in particular in the rural areas. Global growth will strain scarce natural resources and change terms of trade in favor of commodities at the expense of manufactured products. Rich

countries will have to invest substantially in the ecological modernization of their economies.

Annex

Table 1: Per-Capita-income in cohesion* and accession countries (2003)

Country	GDP per capita	GDP per capita	Ratio = ERDI**
Romania	9.3	27.3	2.94
Bulgaria	9.4	27.5	2.93
Turkey	12.7	23.1	1.82
Latvia	15.5	37.1	2.39
Lithuaunia	18.5	42.8	2.31
Poland	19.6	41.2	2.10
Slovakia	22.0	50.9	2.31
Estona	22.5	43.8	1.97
Hungary	29.9	56.2	1.88
Czech Rep.	30.0	61.6	2.05
Malta	43.5	53.1	1.22
Slovenia	50.7	74.0	1.46
Portugal	52.4	67.3	1.28
Greece	57.5	68.9	1.20
Cyprus	68.8	74.3	1.08
Spain	74.9	85.8	1.14
EU-15	100	100	1.00
Ireland	139.1	119.8	0.86

* Greece, Portugal, Spain and – the meanwhile rich – Ireland; ** ERDI = Exchange rate deviation index

Sorce: Eurostat; own calculations

Table 2: Growth, unemployment and the share of wages in GDP in the EU 1961-2004

Year	1961-1970	1971-1980	1981-1990	1991-2000	2001-2005
Growth (in %)	4,8	3,0	2,4	2,1	1,6
Unemployment (in %)	2,0	3,8	8,5	9,4	7,8
Wage share (in % of GDP)	72,3	73,9	72,1	69,2	68,4

Quelle: European Economy 4/2004.