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**Research Report**

# Delaying Integration. The impact of EU eastern enlargement on individual CEECs not acceding or acceding only later

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# WIIW Research Reports

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*Vladimir Gligorov*

## Delaying Integration

**The impact of EU eastern enlargement on individual CEECs not acceding or acceding only later**

*Vladimir Gligorov*

# Delaying Integration

## The impact of EU eastern enlargement on individual CEECs not acceding or acceding only later

Vladimir Gligorov is research economist at WIIW. – Research for the study was supported by the Austrian Federal Chancellery.

# Contents

*Executive summary*.....*i*

Introduction ..... 1

Integration and diversity ..... 1

*Rationality and diversity* ..... 3

*Free trade, democracy and diversity* ..... 4

*Choice and diversity* ..... 7

*Prices and policies* ..... 8

*Trade and economic sovereignty* ..... 10

*Money and growth* ..... 11

*Diversity after integration* ..... 12

*Diversity and politics* ..... 13

*Fiscal federalism* ..... 15

*How much and whose choice ?* ..... 17

*From Hegel to Herder* ..... 18

A proposition on disintegration ..... 18

Preference for staying out ..... 19

A historical excursus ..... 21

Trying to be in and out at the same time ..... 24

*A sort of classification* ..... 25

*Trade integration* ..... 28

*The money connection* ..... 31

Costs of staying out ..... 35

*Interest rates and convergence* ..... 35

*Westernization* ..... 39

Conclusion ..... 40

Bibliography ..... 41

**List of Tables and Figures**

Table 1 National product per capita in 1910, US dollar (1970 value) .....23

Table 2 Types of integration .....26

Table 3 Trade integration with the EU, selected indicators, 1997 .....29

Table 4 Exchange rate regimes.....32

Table 5 Interest rates in selected countries, end-1997, in % per year .....34

Table 6 Potential growth and interest rates.....38

Figure 1 Prisoner's Dilemma.....4

The study was completed in Spring 1999. While the text was updated, the tables were not.

## *Executive summary*

*The process of European Union (EU) integration proceeds from economic to political integration. The economic integration itself proceeds from trade to financial to complete market integration. The sustainability of the process depends on some causal relation existing between economic and political integration. This causality is captured, in this paper, in the proposition that price-taking leads to policy-taking. This proposition of integration is defended against arguments from diverse sources and fields that maintain that homogeneity is necessary for integration or, in other words, that diversity stands in the way of integration. New developments in political philosophy (Rawls), social choice theory, macroeconomics and new institutional economics are reviewed with respect to their importance for the actual problems that EU integration and enlargement face.*

*In the second part of the paper a converse of the proposition on integration is discussed. This proposition on disintegration states that policy-setters are price-setters too. Assuming the truth of the proposition, it follows that policy divergence, i.e., delayed integration, can be explained in terms of the political economy of the process. The benefits in the delay can be found in the possibility of relying on institutional and policy arrangements the use of which becomes feasible if integration is delayed. These benefits are mainly distributive and not allocative, i.e., they accrue from the use of less-than-democratic and other-than-market instruments of distribution of national resources.*

*These political economy considerations apply mostly to those countries that are, actually or potentially, economically integrated with the EU, but are delaying or postponing their political integration. These are called 'stay-outs'. There are also those that can be classified as 'left-outs', i.e., countries that are not politically integrated with the EU because the EU is not ready to take them in. There are also 'opt-outs', which are countries that decide to stay out of one or the other facet of EU integration (e.g., from the monetary union). Apart from all these 'outs', there are countries that are outsiders. Examples are countries like Ukraine or Russia. These are countries which are, at the minimum, not economically integrated with the EU, temporarily or permanently. It is assumed that it is all but impossible for a country to be politically integrated into the EU and economically disintegrated from it.*

*Given this complex political geography of the EU, the costs of stay-outs are studied. It is first illustrated that their actual or potential trade integration with the EU is quite high. Thus, these are countries that reveal inconsistent preferences: their economic preferences are for integration, while their political preferences are against it. One would expect that their economic policy would be such as to stand in the way of their economic development. This fact is illustrated by looking at the divergence of their money markets from those in the EU. Given that they have significantly higher inflation than the EU and given that their interest rates are also significantly higher, their actual growth rate should be lower than the potential one. This lower than possible growth rate is the main cost of their policy of delaying integration.*

**Keywords:** diversity, transition, integration, EU enlargement, monetary policy

**JEL classification:** F15, F05, P20

*Vladimir Gligorov*

# Delaying Integration

## The impact of EU eastern enlargement on individual CEECs not acceding or acceding only later*

### Introduction

Some countries or whole regions in Europe and even in the Mediterranean are economically and in other ways actually or potentially integrated with the European Union but are for the time being staying out or have been left out of the formal process of European integration. Much of Eastern Europe and of the Balkans are such regions. Trade integration of these countries with the European Union is significant, while formal integration is either lagging or low or even non-existent. In other words, there is at least partial market integration, but not policy integration.

In this paper I want to discuss the reasons and the consequences of the Eastern European and Balkan disintegration, both the regional one and that from the European Union. Given that European integration has proceeded from economic to political integration, while failure of integration, in the past, has gone from political to economic disintegration,[1] I will, first, advance a proposition on integration and discuss the issues of European diversity and how they influence the process of European integration and that of enlargement. Second, I will derive a proposition on disintegration that captures the possible conflict of the two aspects of political and economic integration. Third, I will discuss the reasons that have motivated some of the Eastern European and Balkan countries to diverge from the processes of integration, today and historically. After that, fourth, I will assess some of the costs and benefits of the politics and economics of disintegration, mainly in terms of constraints on economic policy. Finally, fifth, I will conclude with some thoughts about the prospects of the regions that are lagging in integration.

### Integration and diversity

The process of enlargement, as well as of the deepening, of the European Union challenges economists, social scientists, politicians and laymen because, among other reasons, of the manifold increase in diversity that it is bringing about. The enlarged and more integrated Europe is going to be more diverse in culture, development, income and in many other respects. This may create problems because most institutions, be they

* Comments by Professor D. Mueller are gratefully acknowledged.

[1] This is one way to summarize the developments in the so-called first globalization, i.e., the one in the nineteenth century. See on that Bairoch [1993] and Berend [1998].

political, cultural or economic, are believed to require a certain level of homogeneity in order to function efficiently. Indeed, recent advances in political philosophy, political economy, social and public choice theories and in the new institutional economics seem to put even greater stress on social, economic and cultural homogeneity than used to be the case before.

Three or four more recent theoretical developments deserve special mention: (i) Rawls' [1993a, 1993b and 1999] political liberalism, (ii) the new work on integration and break-up of countries and regions (e.g., Alesina, Spolaore and Wacziarg [1997]), (iii) the new results in the theory of social choice (Chichilnisky [1994 and 1997]), and (iv) the increasing distancing of the new institutional economics from methodological individualism (North [1990 and 1994]).

The increasing emphasis on homogeneity is in apparent conflict with at least some of the conclusions stemming from the theories of growth and trade that increasingly highlight the positive role of trade integration on growth and development (Lucas [1993], Romer [1993], Sachs and Warner [1995], Ben-David and Loewy [1998]).[2] In addition, it is not at all clear how applicable these increased stresses on homogeneity are to the case of countries and regions that do not have all that much choice in their economic and social policies. Finally, if all these theories are put together, it becomes more than obvious that essentially no level of economic and political integration is possible in the world with the level of diversity being as it is. This is an unintuitive conclusion not only because the evidence does not support it but because it implies that there are quite significant gains from trade and other types of economic activity that cannot be exploited due to the fact that there can be no institutional contrivances that would facilitate them, i.e., diversity is the cause of pervasive institutional failures, market failures being only one type of these more general failures. For all these reasons, the role of diversity is yet to be clarified both in institutional terms and in terms of economic policy.

The deeper question has to do with the apparent dissolution of the system of nation-states that the continuing integration of Europe leads to and with the sustainability of that process. This development reverses the way Europe has been constituted or has intended to be constituted in the last two centuries or so. The ways in which both security and economy have been based on the notions of political and economic sovereignty, i.e., on the system of nation-states, are being changed in the ongoing process of European integration. The key issue is whether there is an implicit constitution of Europe that could support and

[2] A strong argument for the positive role of diversity could be made from the point of view of financial diversification, but that will be left-out here because these issues deserve a detailed treatment that would be out of place here.

sustain these developments and whether for it to exist a certain level of social homogeneity is necessary.[3]

### *Rationality and diversity*

Originally, Rawls (in Rawls [1971]), developed a theory that was supposed to solve the problem of moral and political pluralism through a rational theory of justice. The theory was based on individual rationality rather than on the exogenous existence of a nation-state, i.e., it was to provide an individually rational justification for the existence of states.[4] Afterwards, he (in Rawls [1993a, 1993b and 1999]) came to recognize that there have to exist certain political constraints on individual rationality, otherwise neither the existence nor the stability of the social order could be guaranteed. These constraints had initially to do with the idea of liberalism being a political rather than a metaphysical doctrine, i.e., a security arrangement rather than a moral doctrine. However, eventually, Rawls seems to have moved towards a position that political liberalism can be accepted and maintained only in certain culturally and institutionally homogenous societies and countries that are in a significant way closed to the rest of the world, though, as will be pointed out below, it is not at all clear what that is supposed to mean (Strncevic and Gligorov [1994]).

This development has led Rawls to supplement the assumption that people are rational by requiring them to be reasonable even to the extent that the latter may have to be substituted for the former. One simple and convenient way to see what that means is to illustrate the distinction by the one-shot Prisoner's Dilemma. The basic case is enough to illustrate the point. There are two persons (or states or any type of agents whatsoever), A and B. They are rational, i.e., they prefer more of whatever they consider to be good (e.g., utility) to less. They can either co-operate with each other (e.g., trade or form firms or become partners or set up a political organization, a state, or engage in any other social relationship) or not. And they have full information about the rules of the game and everything else that is relevant for this game. Let us assume that they face the following pay-offs (outcomes of their decisions; the first is A's pay-off, the second B's):

In this game, it would be better for both if they co-operated because they both get more (2 each) than if they both chose to conflict (1 each). In other words, a joint co-operation strategy is collectively better than a strategy of conflict (i.e., co-operation is Pareto-superior to conflict or conflict is Pareto-inferior to co-operation). However, both do better individually if they fail to co-operate while the other person co-operates (the co-operative person gets 0 and the belligerent gets 3). Therefore, trying to achieve as much as possible, they will both

[3] Another possibility is the drawing-up of an explicit constitution as advocated by Buchanan [1990], but this seems rather unlikely at this point (however, see Fischer [2000]). For a detailed treatment see Bernhloz *et al.* [1993] and Schneider [1998]; for some interesting comments see Vaubel [1995].

[4] This was how it was seen by the early critics too, e.g., by Nozick [1974]

prefer to conflict and the equilibrium outcome of individual rational choice is the Pareto-inferior alternative. Reasonable people, however, would be those who would, for one reason or the other, choose the Pareto-dominant alternative, i.e., they would choose to co-operate.

Figure 1

**Prisoner's Dilemma**

| | | B | |
|---|---|---|---|
| | | co-operate | conflict |
| A | co-operate | 2, 2 | 0, 3 |
| | conflict | 3, 0 | 1, 1 |

One way to assure that individuals will be reasonable, rather than narrowly rational, is to endow them with the same social or cultural heritage or with some other type of implicit, non-contractual obligations and duties or implicit institutional arrangements. People who share certain social or cultural values (or whose values belong to what Rawls now calls 'reasonable comprehensive doctrines') will be more ready to act as reasonable actors and thus will not fall victim to the Prisoner's Dilemma. One way to see the point is to think of reason being a constraint on rationality, or to think in terms of what is technically known as bounded rationality.

Rawls' political philosophy is of interest because it represents one failed attempt to find a rational solution to the problem of social diversity. The initial idea was that for rational people the moral, cultural, social and all the other differences will not constitute insurmountable obstacles to a political agreement on a just social order. The later development of the theory seems to indicate that political liberalism can be embedded only in a culturally homogenous setting, though it is yet to be made clear what this is supposed to mean. In addition, it is not clear in which way this increased homogeneity is going to increase the reasonableness of the people and what level of homogeneity is in fact required for the social and political choices to lead to the desirable effects and outcomes.

### *Free trade, democracy and diversity*

In a series of papers A. Alesina with a number of collaborators (Alesina and Spolaore [1997]; Alesina, Spolaore and Wacziarg [1997]; Alesina and Wacziarg [1997 and 1999]) has advanced a theory that should help explain the political disintegration of countries and

empires. The core idea is that with enough economic and political diversity the introduction of free trade (or an increase in trade integration), especially if coupled with democratization, favours the disintegration of countries into more homogenous political units. The main supporting evidence is the post-World War II increase in the number of countries and the contemporaneous increase in the level of world trade. More recent supporting evidence is said to be provided by the disintegration of the former socialist countries (Soviet Union, Yugoslavia, Czechoslovakia). The central claim is that economic integration (more trade due to trade liberalization) is accompanied by political disintegration (more countries) and that this process is supported by democratization in cases where the latter is to be found.

There are both empirical and analytical problems with this theory. The empirical support is not very strong. This is especially easy to see when the recent disintegration of former socialist countries is considered. In most cases, there was a trade shift rather than an overall increase in trade. Indeed, in some cases, e.g. in the Balkans, the trade before the disintegration was freer than afterwards (Gligorov [1996 and 1998b]). In fact, the creation of new countries was often justified by the possibility and capability of these new countries to restrict trade (i.e., to have sovereign powers to protect their economies) rather than by the advantages brought about by the possible increase in free trade. The latter observation is supported by evidence from the first globalization when economic liberalization was accompanied by increasing national tensions that led to the creation of new states keen on increasing protectionism in foreign trade and in other economic relations.[5]

From a theoretical point of view the positive influence of democratization on the disintegration of countries is almost completely a consequence of the median voter theorem (that notes that average income will always be higher than the median income and concludes that the political process that gives the power to the median voter, i.e., democracies, will favour tax redistribution).[6] With enough diversity in a country (in the regional distribution of income, for instance), an introduction of democracy may lead more homogenous segments of the population to choose to separate. Thus, the introduction of democracy in the environment of free trade goes together with the disintegration of countries or of other political agglomerations given a high enough level of social diversity in terms of the distribution of local and global medians. However, this is not a theoretically robust result because a more general public choice setting need not lead to the same conclusion (Gligorov [1994]).

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5 See Bairoch [1993] and Dornbusch [1992].

6 This is recognized in Bolton and Roland [1997]; see also Bolton, Roland and Spolaore [1996]. The partial criticism of some of the Alesina *et al.* writings to be found in Collier [1998] also implicitly relies on the assumption of a more general decision-making setting than is allowed by the median-voter theorem.

To see this, let us simply assume that two regions in a country never separately face situations like those described by the Prisoner's Dilemma game. In other words, there are no Prisoner's Dilemmas that are internal to each of the two regions. However, whenever they are put together, they face a Prisoner's Dilemma. Thus, the two regions together always choose collectively inferior outcomes. If they separate, however, they always choose collectively superior outcomes. As a consequence, they may want to separate. This situation can be illustrated by an example from fiscal policy. Let the two regions be one developed and another less developed. They may internally prefer one system of tax rates, but may prefer another one if they are to be one country. For instance, the rich region may prefer a lower common tax rate while the poorer may prefer a higher common tax rate. An outcome may be a tax rate that is worse for both countries than the ones they would have if they were separate countries. Thus, they may prefer to split.

The more general setting is the one that is treated in social choice theory where as a rule there are either multiple equilibria or no solution at all or an imposed solution. Sticking with the Prisoner's Dilemma, the more general setting would be the one where it would not be legitimate to assume that there are to be found regions that do not face the Prisoner's Dilemmas. It would then be illegitimate to assume that the increase in diversity of one characteristic or another would bring in problems of co-ordination of social behaviour. These problems are simply too general to be assumed away at one level and introduced at another. Or, to anticipate somewhat what will be said in the next section, the level of diversity needed for the problems of co-operation to appear is very low or, to put it otherwise, the level of homogeneity needed for them not to appear is extremely high, bordering on the non-existence of diversity altogether.

Still, the importance of the Alesina *et al*. theory is that it highlights, in a formal way, how social diversity can be an obstacle to integration, an idea that has always had significant support in a more informal manner.[7] However, as the authors recognize, the development of the European Union will present a very significant counterexample if indeed it continues to expand and deepen (Alesina, Spolaore and Wacziarg [1997] and Alesina and Wacziarg [1999]). As a matter of fact, the key question that these studies highlight is whether the process of increasing integration of world and regional trade leads to the proliferation of nation-states or rather of regions. They argue for the former, the European integration, if successful, would point to the latter.

[7] See a recent paper by Collier [1998] in which he argues for an opposite conclusion provided that social, in his case ethnic, diversity is a characteristic of a democratic state.

### *Choice and diversity*

The most fundamental treatment of the role of diversity and of the difficulties to be encountered when attempting to cope with it is to be found in social choice theory. It has been recognized from the very beginning that one solution to the social choice impossibility results can be found in the social circumstances where the level of diversity in individual preferences is restricted. Thus, various types of restrictions on preferences have been identified that allow for the social choice paradoxes to be avoided. Recently, a quite general result has been arrived at to the effect that a certain restriction on social diversity is a necessary and sufficient condition not only for the social choice problems to be avoided but for the stability of the competitive equilibrium as well as for the solution to the more fundamental problems in game theory to be found (Chichilnisky [1997]).

The economic meaning of the social choice results is that the usual social institutions such as markets, contracts and political bodies can accommodate only that much diversity in preferences and endowments. In more concrete words, people acting in the usual economic and political institutions should be looking for or facing the possibility of arriving at limited gains in order for the institutions to be able to deliver the efficiency and stability properties for which they are put up and used in the first place. As a consequence, free trade cannot be considered to be applicable to circumstances where the participants are too diverse in either preferences or endowments, i.e., it should not be expected to deliver outcomes that are either determined or efficient or in some welfare sense desirable.[8]

As already mentioned, the level of homogeneity that would be required for social choice problems not to appear, would have to be very high. To illustrate that, I will write the preference structure characteristic of the Prisoner's Dilemma. There are two persons (or regions or states or whatever) and they can choose from four outcomes (as in Figure 1), e.g., $x$, $y$, $z$ and $w$, and they rank these outcomes in the following (descending) order:

A: $w, x, y, z$.
B: $z, x, y, w$.

What one likes the most, the other hates the most, they otherwise agree. If one of the extremely preferred alternatives is removed (for instance, $w$), the following configuration of preferences remains.

A: $x, y, z$.
B: $z, x, y$.

[8] This conclusion has been applied to the different implications of inter-industry trade (i.e., trade based on specialization) and intra-industry trade have for trade policy.

This configuration is typical for the so-called Arrow paradox. The two persons will have either to agree to disagree, i.e., to fail to reach an agreement, or the preferences of one of the persons will have to over-ride the preferences of the other. The latter is a multiple-equilibria type of outcome as the preferences of either one of the persons may in fact prevail.

One way to avoid this problem is to remove the other extreme alternative too (i.e., *z*). In that case, there will be unanimity. Unfortunately, not much more diversity can actually be allowed if the Prisoner's Dilemmas and Arrow-paradoxes are to be avoided. Thus, individuals would essentially have to be the same in order to ensure the more desirable types of co-operation.

A somewhat similar stress on cultural homogeneity can be found in some recent developments in the so-called new institutional economics. In a series of papers Douglas North has argued that institutions develop and are used in order to structure social relations and to decrease the level of uncertainty. In addition, it is argued that the belief systems play a crucial role in the process of the emergence and maintenance of institutions (North [1996]). This idea of the role that the homogeneity of beliefs and values plays for the existence and persistence of institutions is indeed not new. What is new is the stress on the role of homogeneity for the avoidance of market and other failures, i.e., for the emergence and functioning of market institutions as well as of the other social and political institutions. The original idea of course was that the 'invisible hand' of the market works irrespective, and indeed because, of the diversity of interests, beliefs and values of people.[9] In some sense, the stress on culture (and the related stress on history) is one way to give structure to the 'invisible hand' if not to make it visible. In addition, the structure is obviously normative, as institutions are defined in terms not so much of the possibilities they open up or discover but as 'rules of the game', i.e., in terms of what they enforce.

### *Prices and policies*

These three or four theoretical developments seem to point to the limits that the level of social diversity puts on integration. One is tempted to conclude that only relatively homogenous societies, countries, economies and cultures could and should stay together. In contrast to that, there is a growing accent on integration that is connected with both economic growth and with the increase in international trade (Romer [1993], Sachs and Warner [1995] and Ben-David and Loewy [1998]). Indeed, an increasing number of countries are finding that it is useful for them to liberalize their trade and even their financial

[9] At least when it comes to private goods. Diversity in public goods was considered to present problems. However, most problems that arise in game theory and in social choice theory do not depend on the distinction between private and public goods.

markets.[10] Thus, the problems that integration is facing in terms of theory seem to go against what many countries find to be to their advantage to do (Richardson [1997]). The real question is, how are these diverging understandings and developments to be combined and reconciled ? After all, the world is getting increasingly integrated though the level of diversity is not decreasing, at least not in a way that can be clearly connected to the existence or lack of integration.

The theoretical challenge has to do with the question of how economic integration is to be reconciled with political segmentation and with social diversity. Probably the simplest way to approach the problem is to look at the policy choices that a small, open economy faces. One way to characterize such an economy is to say that it is a price-taker in the world economy or in its region. The other way is to say that in terms of foreign trade, if not of policy, it is integrated into the respective segment of the world market. Still another way to state the same problem is to ask what happens with a country whose markets do not diverge too much from the world markets or from the markets that they are integrated into, but is otherwise quite different than the other countries in terms of development, income, growth as well as in the institutional and political characteristics. If these considerations are connected, one can argue for the following proposition.

**PROPOSITION ON INTEGRATION: A price-taker is a policy-taker too.**

In what is to follow I am going to assume that this proposition is true. I do want to argue for it in a number of ways integrating some of the ideas from trade theory, monetary theory, and growth theory but will not attempt to prove it here formally.[11] However, I will give a short informal summary of a possible proof and then argue for some aspects of it in more detail. Once I have done that, I will move on to discuss the implications of this dependency of economic policy on market integration for fiscal considerations, especially for those that are connected with fiscal federalism.

The intuition behind the above proposition is the following.[12] Take a country that is currently outside the EU, but trades a lot with the EU. If it is an open economy (foreign trade is large as a share of the country's GDP) and if the EU is the dominant trading partner, the country will be a price-taker in the sense that the prices of its tradable goods will be set in the EU markets. That will determine (though not necessarily fix) its exchange rate to the German mark or to the euro (assuming that in the long run the exchange rate is determined in the

[10] This accounts for the increase in international trade that is used as an explanatory variable in the above-mentioned theories of disintegration.

[11] For a thorough discussion of some of the issues central to this proposition, though not of the issue of integration as such, see Mundell [1997].

[12] It is essentially based on the so-called impossible triple in open-economy macroeconomics (i.e., fixed exchange rate, free movements of capital and independent monetary policy are inconsistent; at least one of the three has to give). For a discussion see for instance Wyplosz [1997].

markets for goods). If indeed this is an open economy, the movements in the exchange rate will significantly constrain the country's monetary policy: it will have to be consistent with the inflation not diverging too much from that to be found in the EU countries. As a consequence, the interest rates of this non-EU country will have to converge to those in the EU. For this to happen, the country will have to liberalize its financial and especially its capital markets. These will in turn put pressure on the fiscal policy of the non-EU country in addition to the pressure already being put by the need to keep the competitiveness of the country's tradable sector at an appropriate level. As a consequence, the fact of price-taking leads to the necessity of policy-taking.

It is to be noted, however, that this argument looks at the policy role in the allocation of resources. It does not immediately say much on how the resources, e.g. those that go to the various budgets, are to be distributed or re-distributed. The issue of how much freedom can be left there will be touched upon later.

### *Trade and economic sovereignty*

The key part of the above proposition is the one about a country being a price-taker. This is a consequence of an economy being small and open. For such an economy, the relevant market is the world market or a segment of that market (e.g., Europe) that is large enough to make the economy in question small, which means that the relevant supply and demand functions are those that describe the world or the large enough region of the world and not just the local economy. As a further consequence, the relevant supply and demand shocks are all (or mostly) external to the price-taking economy.[13]

What are the policy choices that such an economy is facing ? As long as it remains open, there are very few choices if any. Some have argued that a small, open economy would have to have a larger public sector precisely because most of the shocks it is experiencing are external to it (Rodrik [1997]). This will mainly apply to its fiscal rather than to its monetary policy. The latter is constrained by the interest rate parity and by the sensitivity of the exchange rate movements to the developments in the capital markets. Thus, the key issue is the level of influence that a price-taker has over its fiscal policy: the key question is whether an economy that is integrated in terms of foreign trade can rely on the counter-cyclical function of its fiscal policy. The answer is that it can, if it stops being a price-taker. The relevant price here is the wage rate. If a small, open economy experiences an adverse price shock it could adjust to it either through a change in its wage rate (or, alternatively, its unemployment rate) or through a change in its fiscal deficit (or in the accompanied

[13] I take it that it is clear that the existing European Union as well as the possibly enlarged one is an economic area with a very significant level of trade integration. For a detailed treatment see Funke and Kennedy [1997]; see also Wyplosz [1997].

adjustment in its exchange rate). In the former case it remains a price-taker, in the latter it does not.

These considerations are relevant primarily for the above summarized theory that connects trade liberalization with country break-ups. If trade liberalization leads to a country becoming a price-taker, the alleged advantages of policy independence disappear. Thus, the idea that the increase in free trade or in trade integration will lead to an increase in the number of sovereign economic entities or states is internally contradictory. Indeed, as already mentioned, empirical evidence tends to underscore this inconsistency. In most cases where the idea of the advantages of economic sovereignty has played a significant role, this has been connected with a rather cautious, not to say selected approach to free trade (for more on that from the historical perspective see Bairoch [1993]). In addition, in many cases the need to introduce trade liberalization measures has led the newly created countries to restrict their economic sovereignty and to look for ways to increase the level of integration of the respective country into the world economy.

### *Money and growth*

The most controversial macroeconomic issue in the case of European integration is that of the introduction of a common currency and what it might mean for the member and non-member countries. From a macroeconomic point of view, the availability of monetary policy is often seen as quite important. It is, however, not altogether clear why and how that is the case. One way to argue for an independent monetary policy is to suggest that a different, usually higher, inflation rate may be justifiable for an economy that is sufficiently different from its foreign trade partners. This is also connected with the theory of optimal currency areas that seems to indicate that a certain homogeneity of the real economy is a precondition for the existence of a currency union.

This is difficult to apply to cases where significant trade and capital market integration exists, i.e., to economies that are price-takers. A simple way to see this is to look at the interest rate behaviour in small open economies. Two things seem important enough to look at:

– First, the issue of inflationary expectations: An economy that is sufficiently integrated with a low-inflation region, like the EU, will experience higher long-term interest rates if it is pursuing an independent monetary policy. It seems to be invariably the case that the expectations of monetary integration with the EU lead to a lowering of long-term interest rates as a consequence of the stabilization of inflationary expectations.[14]

[14] This seems to be the case even for economies that are outside of the present process of monetary integration but have currencies that have been fixed to the German mark in a manner that is credible.

– Second, the relationship between the level of development and monetary integration: Considering the experience of the economies in transition, one could argue that monetary independence leads to lower growth rates than what are the potential ones. This is again the consequence of the level of interest rates. Calculations of the interest rates that would be conducive to these countries achieving the potential output that would enable them to converge to the output levels of the developed countries lead to the conclusion that those would have to be much lower. This, however, could be achieved only in the case that these countries give up their monetary sovereignty.[15]

These considerations lead to the conclusion that the alleged advantages of an independent monetary policy are largely illusory for small, open economies or for economies that are significantly integrated with each other in terms of mutual trade. Indeed, in these cases the markets perceive the insistence on monetary sovereignty as the commitment to higher inflation rates and that implies higher long-term interest rates for these economies and thus a lower long-run growth rate and a slower process of convergence.

***Diversity after integration***

One recently developed argument starts from the Lucas-like idea that homogeneity is endogenous to integration rather than exogenous (Frankel and Rose [1996 and 1997], for some comments see Begg [1997], Wyplosz [1997] and Alesina and Wacziarg [1999]). This idea may help the understanding of the fact that quite a number of countries are looking forward to integrating into the European Union and also that quite a number of countries are trying hard to meet the criteria that will allow them to participate in the monetary union in Europe. The explanation is that the benefits of participation exceed the costs or, to put it the other way around, that the costs of opting or staying out, i.e., of delaying integration, exceed the benefits of independence.

The reason is the one that is contained in the above-formulated proposition. Indeed, as the European Union enlarges to bring in more countries, it makes it more difficult to those that are left out to reap the benefits of their independence or of alternative integration strategies. As the European Union becomes larger, the neighbouring countries become ever more price-takers with respect to the Union and thus become policy-takers too without the benefit of participating in the formulation of that policy.

In addition, the social diversity that characterizes the prospective members of the Union diminishes after the Union is in fact formed. Thus, integration and homogenization become

[15] For more on the monetary rules in transition economies – both those that are to be considered for membership in the first round of enlargement and those that are not – see Gligorov [1998a].

endogenous rather than exogenous. It is not necessary to wait for a region to constitute an optimal currency area and then to integrate.[16] If that is true, then the very possibility of integration could constitute the right kind of expectations that would lead to convergence and homogeneity at least to the extent that this is possible.[17]

### *Diversity and politics*

In most of the treatments of the effects of social diversity on integration the level of diversity is taken in an intuitive sense. In the cases in which measures of diversity are devised, those imply a level of integration that is quite unrealistic. In order to illustrate that, I will quite briefly discuss a number of implicit and explicit ideas of social homogeneity.

One is that of cultural similarity. This idea is used mainly in an intuitive manner.[18] More important than that is the fact that the idea of cultural homogeneity is patently inapplicable to Europe. Though the intuitive idea of the cultural unity of Europe may or may not be clear (it has certainly always been difficult to make it clear), this fact has had few if any repercussions for the economic and political developments and problems in Europe. Indeed, Rawls has emphasized the applicability of his idea of political liberalism to Europe precisely because there is no hope that any idea of value homogeneity will ever be applicable to Europe.

In one sense Rawls is certainly right. Liberalism in Europe is not a moral or metaphysical issue, but a security arrangement. More than that, the process of political integration in Europe has had a distinct security aspect. It was an attempt to solve the problems that the European countries present to each other in a way that is different from the one that was characteristic in the era of nation-building. Rather than externalizing internal problems, Europe has been trying to solve the external problems by internalization. This political approach is in the basis of the European integration.

The same process can be extended to economic integration. Rather than taking the existence of cultural diversity as a problem, economic integration could be a way to internalize those problems that would have to be solved externally otherwise. This indeed was the original idea of Rawls as has already been maintained. In that sense, cultural

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[16] Indeed, the Lucas-type criticism undermines the very idea of optimal currency areas. Mundell, the author of the theory of optimal currency areas, now argues that the whole theory is an *argumentum ad absurdum* rather than a positive statement that it is most often taken to be.

[17] This is of course especially important for the countries seeking to become members, i.e., for the process of enlargement.

[18] This is because of the generally acknowledged ambiguity of the relationship of being 'similar to'. For one, it is not transitive. For another, it is sensitive to a number of dimensions. One formal treatment of the measure of diversity is to be found in Weitzman [1992]. For an interesting treatment see Lazaer [1995 and 1998].

diversity could be defined in a way somewhat similar to Rawls' as the level at which the internalization of external problems does not make political and economic sense.

In an even more narrow economic sense, the process of integration for a small, open economy presents an opportunity to participate in the internalization of external shocks. Much of what is contained in the discussion of the role of asymmetric shocks and the need for monetary and fiscal sovereignty to adjust to those is presumed on the assumption that those will stay asymmetric if they are made internal to a larger economic region or union. However, integration may serve as a vehicle not only of internalization of demand and supply shocks but of increasing their symmetry.

The second measure of diversity is the one to be found in social and public choice theories. As has been mentioned above, social choice theory seems to suggest that institutions are quite sensitive to the level of diversity in preferences. Because of that, there is a feeling that they can accommodate only that much diversity. The question, however, is how much? Most of the results in theories of choice require individuals to have preferences that are very similar, not to say identical. Thus, the level of diversity that the institutions seem to be able to accommodate according to the social choice theory is very low.[19]

This coincides with the requirement often to be found in public choice theory that the legitimacy of public decisions requires that they be taken unanimously (Buchanan and Tullock [1961]). Apart from the fact that this requirement does not really solve the social choice problems, it is, in addition, rather difficult to implement as is well realized in the public choice literature (Gligorov [1994]).

However, it is also often overlooked that social separation is not a solution to social choice problems. Too much social diversity leads to the existence of decision-making mechanisms, as long as decisions have to be made implicitly or explicitly, that are rather less than desirable. Thus, as long as there is a certain level of integration that necessitates that some co-ordinated decisions are made, the social choice theory will support either some kind of complex and less than ideal procedures or will mandate some procedures that will be far from desirable or legitimate.

Somewhat less precise are the ideas of value and belief homogeneity that are to be found in some of the studies in new institutional economics. In some sense, these developments represent the abandonment of the postulate of methodological individualism. The slogan seems to be that 'institutions matter' (see North [1994]). If they are to matter for social

[19] The somewhat technical idea of limited arbitrage that has recently been introduced by Chichilinsky [1997] is quite restrictive. It implies that such things as Condorcet triples and Prisoner's Dilemmas do not occur. More on this in Strncevic and Gligorov [1996].

diversity, they would have to act as constraints on the level of diversity that in some social setting can in fact emerge. Thus, with the idea that institutions matter, the starting point is not the individual rationality and diversity but the social homogeneity that keeps the society as an ongoing concern.

Finally, the measures of the acceptable level of social diversity include those that have to do with the difference in the income levels and with some other macroeconomic facts. One of the latter is the already mentioned asymmetry of the demand and supply shocks (Feldstein [1997]).[20] However, as already maintained, for the same reason that security is helped if shocks are internalized, economic integration and especially monetary union lead to a diminishing role of asymmetric external shocks. Indeed, the larger the monetary union, the less significant is the role of the external asymmetric shocks. This is precisely analogous to the internalization process in dealing with the security problems.

In a sense, the European integration as a security arrangement starts from the assumption that the system of nation-states that has existed in Europe has been a failure. Rather than providing for security it has proved to be a destabilizing factor not only in Europe but in the world as a whole. However, the security problems could not be tackled directly in the post-World War II era and have had to be approached via a process of gradual economic and political integration. With hindsight it could be argued that the difference is not one of principle. In both cases the problems that appear as external are being solved through internalization.

Another way to put the same point is to compare the risks implicit in the two globalizations, one in the nineteenth century and the other one in this century. Without leaving Europe, it could be argued that the first globalization coincided with the process of nation-building and ended in rising protectionism and in a world war. The current process continues to widen freedom and to include new countries and regions. It is, of course, yet to be seen how it will end.

### *Fiscal federalism*

With the monetary policy out of reach of the individual member states of the European Union (at least in some simple way), the sole adjustment mechanism that they can rely on is that of fiscal policy. However, the process of integration will transform nation-states into what may be considered to be regions (or provinces). If this turns out to be the case, the fiscal policy that those will be able to conduct will be that which is characteristic of fiscal federalism. Two main outcomes can be expected.

[20] Detail treatment can be found in Obstfeld [1997] and in Obstfeld and Peri [1998].

– On the one hand, local budgets are more often balanced than central budgets. The reason is that local budgets cannot rely on the eventual monetization of their deficits and are thus disciplined by the capital markets (in addition they are more susceptible to a rule of balanced budgets being adopted and enforced).[21]
– On the other hand, a decentralized fiscal system increases the level of competition of the fiscal authorities for the tax base and leads to greater mobility of the factors of production as well as to their greater *ex post* homogeneity.

If both of these tendencies prove to be right for integrated Europe, the European Union will be facing the possibility of multiple equilibria.

The setting-in of fiscal federalism can be expected to support an increase in the movement of both capital and labour. If the local governments cannot react to adverse shocks by relying on fiscal deficits, they will have to compete with the other local governments for capital and labour. This should make these factors of production more foot-loose than they are now and should lead to faster structural adjustments than are characteristic of the individual states in Europe as they are known now. Thus, generalizing on the current situation can be misleading. However, it is not at all certain that these predictions are the only ones that make sense (Frankel and Rose [1996], Begg [1997]).

Another possibility is the increase in the role of the central budget. This is a distinct probability if the process of European integration continues to deepen. That development would lead to the need to increase the legitimacy of the centralized bodies, and that development would transform the European Union into a federal state. Thus, it is conceivable that the *de facto* fiscal federalism that may develop as a consequence of the upcoming monetary integration will lead to the federalization of the European Union (Vaubel [1995]).

Still another possibility is that the European Union may break up. This may happen because of the fact that individual countries may not be happy with playing the role of policy-takers and would indeed want to retrieve some of their influence on relative prices too, i.e., they may want not only not to be policy-takers but not to be price-takers either. However, there is an emerging consensus that the costs of breaking away from the Union, once it is strengthened through the introduction of a common currency, would be prohibitively high. Many of the examples of the recent break-ups of countries involve unions or agglomerations that were not based on free trade or had trade based on 'forced substitution' or were centralized in the wrong way or were empires rather than countries.

[21] This is a vast area and cannot be treated here in any detail. For a discussion see Shah [1998].

Free trade arrangements as well as institutional integration that those bring about more often than not testify to the surprising strength of the 'invisible hand', i.e., of implicit institutions that it fosters. These implicit institutions are most closely connected with the network of contracting and the decentralized ways of their enforcement. One of the challenges that the integration of Europe brings about is the need to a changed perception of the whole aspect of enforcement from a vertical one to a horizontal one.

### *How much and whose choice ?*

Probably one final question that European integration and especially the process of enlargement brings about is that of the political legitimacy of the whole process. From the security point of view, Kant's approach is probably still the basic one and Rawls' recent apparent distancing (in Rawls [1993b] and [1999]) is clearly a development in the wrong direction.[22] Kant thought that the individual, not only the state, should be represented in the confederation of states for peace to be a lasting one.

Given the level of economic integration and of monetary policy centralization, there is a distinct possibility for Europe to federalize in the direction of becoming something like the United States of Europe (on that see Fischer [2000]). That would involve a greater role of the parliament rather than of legal and more implicit institutions. Kant's original idea, however, was more liberal than democratic. The point is to restrict the choices of the individual states but to increase the choices of the individuals. If that is the way things would develop, the European Union cannot be expected to transform into a supra-national state but rather into an arrangement that maximizes the individual opportunities, i.e., into a competitive but stable political system and not into a state.[23] Kant's idea was that this political system would be characterized by homogeneity in terms of its basic characteristic as a regime (i.e., member states would be republics and democracies) but would compete for the allegiance of its citizens with the level of freedom that they provide. That development may be helped rather than hindered by the great diversity that is characteristic of Europe.

This arrangement is not easy to envisage and may look as being by necessity less than stable. This is because the nation-state arrangement seems in many ways so natural. However, the new economic and political realities as well as the security experience point to a different type of solution. Whether it will indeed lead to a liberal Europe or to a federal state does not really depend on the degree of social diversity that will characterize it.

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[22] A similar approach to Kant's in his *The Perpetual Piece*, only much less developed, can be found in Montesquie's *The Spirit of Law*.

[23] The same idea was defended in Hayek's ([1948] last essay on federalism – as was, I think, much of the rest of what I have written in this paper.

### *From Hegel to Herder*

The unexpected development of establishment of a number of independent states in the post-cold war Europe could be seen in some cases as a move from Herder to Hegel (from linguistic and cultural communities to nation-states). The European integration from the point of view of ever increasing social diversity can be seen as the opposite move from Hegel to Herder. Rather than looking to nation-states as the key institutional arrangements in Europe, the more liberal view would see the more implicit institutions as those that would deal with the increasing social diversity. Thus, the key way to cope with diversity cannot be the social homogenization that is supposedly provided by nation-states, but the implicit institutions that spontaneously spring up to co-ordinate the economic and cultural life. This approach does not necessarily rely on individualism, though this is probably the most natural environment for the types of processes that are being considered here. The difference between Hegel and Herder is rather in the level of rationality that is ascribed to institutions and in the role of the state as an enforcement agency. A more diverse Europe will have to rely more on the informal and implicit institutions for enforcement of contracts than on the state. With the increase in trade integration this is natural to expect and with the increasing integration of other business relations, the existing social diversity should not be an obstacle to an increasing homogenization of the more horizontal institutions.

This can be supported by an argument from social choice theory that institutions do not matter for outcomes. In a more general sense, diversity, as long as it is institutional, or micro-diversity, rather than political, or macro-diversity, does not matter for the efficiency of the outcomes. In other words, all those differences that go with culture, beliefs and traditions do not have to be homogenized for a political system to function efficiently and to preserve stability. Indeed, the legal system appropriate for such a system may be more competitive because it will not be centralized in the way as is characteristic of a state and especially of a typical European state.

This argument can be supported from a macroeconomic point of view if it can be shown that local fiscal arrangements can be both competitive and responsive to local needs. In a more precise manner, it would be necessary for taxes to be efficient in terms of business incentives while the revenues may be distributed in a way that responds to the local needs. If this separation of allocation and distribution can be made in the fiscal system, the diversity of needs would not stand in the way of both market and political integration.

### A proposition on disintegration

Integration is a two-way process. Thus, when integration fails, what is a policy of staying out on one side is a policy of leaving out on the other side. One implicit reason for including some countries and leaving out other countries is that of too large diversity. There are a

number of ways in which it can be argued that diversity is a problem for regional integration, though it is not altogether clear, as I argued above, what is in fact meant by diversity. In any case, diversity of one type or another is taken as a major argument for delaying integration. I will discuss the issue in some length taking the process of enlargement of the European Union with the aim at determining, in principle, the costs and benefits of drawing the border temporarily or permanently.

Why is there integration? The basic reasons can be found in the characteristics of geography and history. Given proximity and habitual connections, economic developments will be interdependent. For instance, high levels of trade of all kinds may be expected. Assuming that a particular part of an integrated area is small in comparison to the region as a whole, it may be proposed that the region of potential or actual integration will be a price-taker in respect to the whole. From that and a number of other assumptions, some of which have been discussed above, the proposition on integration formulated at the beginning of this paper, will follow.[24] This proposition implies that economic and political preferences of countries or regions or both are consistent. The proposition on integration leads to a proposition on disintegration. The latter can be stated thus:

**PROPOSITION ON DISINTEGRATION: A policy-setter is a price-setter too.**

Without going into too much theoretical detail, this proposition can be relied on to discern costs and benefits of disintegration. What it essentially states is that trade integration and policy disintegration are impossible to combine. In other words, there is a trade-off between policy independence and trade integration. What this trade-off consists of should be the main subject of the cost-benefit analysis of integration vs. disintegration. The two most general indicators could be stability and development (or, in a more narrowly economic sense, growth). They need not go together, at least as a matter of theory or logic. It may be the case that faster development or higher growth rates require some types of instability or *vice versa*. Because of that, the costs and benefits in terms of stability and growth should be considered separately, at least initially.

### Preference for staying out

If the above-stated proposition on disintegration is accepted, the reasons for disintegration can only be found in the political economy of the process, i.e., in the particular inter-play of economic and political preferences. Given a country or a region that is either potentially or

[24] This is disputed in more ways than one in a series of writings by Alesina and a number of other authors; for the latest see Alesina and Wacziarg [1999]. For a criticism of the consequences of globalization from a position that basically accepts this proposition see Rodriguez and Rodrik [1999]. One precursor of much of the debate on 'markets and nations' in the context of the 'first globalization', i.e., the one in the 19th century is, of course, Polanyi [1944]; for more see Gligorov [1996].

actually integrated with a larger region, the motivation for staying out of formal integration can only be found in political preferences, i.e., in whatever are the interests that require independence in terms of economic policy. Again, if the above proposition is true, it will follow that these reasons can only be those connected with the distribution or re-distribution of whatever goods are deemed to be important. Thus, under these assumptions, disintegration will be motivated by distributive (or re-distributive) interests.

These interests will be strong in any case, but they will be especially strong in countries in transition. Indeed, the so-called process of transformation is more or less one of re-distribution of power, property, and of everything else. However, the fact that distributive motives are pronounced does not mean that it will be perceived that those can be realized or secured through disintegration rather than through integration. Indeed, it is evident that some countries in transition are relying on integration while others prefer to stay out (or are being left out for reasons of their political preferences or for other reasons). Thus, though the reasons for preferring disintegration are to be found in the political economy of the whole matter, political economy by itself cannot in general explain why some countries choose integration while others resist it. In other words, political economy can be evoked to explain both integration and disintegration, i.e., political economy is plagued with multiple equilibria.

At this point there is a choice to rely on some kind of descriptive political economy, i.e., on identifying those reasons for disintegration that are specific to a country or to a region. There is, in any case, little else to do in explaining a particular outcome in a multiple-equilibria situation anyway. This is what I will do in the next few brief paragraphs for the case of Eastern Europe and the Balkans and especially for the case of some of the post-Yugoslav states.

Given that preference for disintegration is a preference for policy divergence (given high potential or actual trade integration), the reasons for disintegration should be found in diverging political preferences. In the case of most Eastern European and Balkan countries those are to be found in a number of areas.

– First, and most importantly, there is a divergence in the weight put on *national sovereignty* as opposed to international co-operation. This is a consequence of the way these countries came into being, of their history in the most general sense of that word.[25] In other words, nation-building may take precedence over European integration. This is certainly one of the distinctive aspects of the current post-Yugoslav developments, but it may be observed in other countries too. Nation-building almost invariably brings in security concerns which are a strong argument against integration

[25] On this see Berend [1998].

because the European Union is not well-equipped to deal with security issues, at least not directly.

- Second, there is a divergence in the perception of the basis of *political legitimacy*. In other words, there is no firm commitment to democracy as the way to aggregate political preferences and to acquire political legitimacy for government's ends and means. There is no need here to go into the details of the description of the type of regimes that are to be found in many East European and Balkan countries. It is only to be noted that a member of the European Union cannot rely only on the process of internal political legitimization, but has to accommodate internal legitimacy with the way it is perceived in the European Union. Thus, not only regimes, but political spaces too cannot diverge too much from those in the European Union.
- Third, there is a divergence in terms of *policy of transition* and in *economic policy* in particular. The latter divergence is the one that is most important for this paper and will be dealt with more closely in what follows.

To sum up, disintegration, as opposed to integration in the case of the enlargement of the European Union, is a way to re-distribute the relevant economic and political goods relying on institutions of distribution that diverge from those that are to be found in the European Union, i.e., to disregard certain aspects of market economy, democracy and of the rule of law. In other words, the decision to delay integration is primarily a decision to delay the process of political and institutional transformation.

From this, the problem that both the European Union and the countries that are delaying integration face is how to combine trade and financial integration, actual or potential, in other words the economic preferences of these countries, with the political preference for disintegration that is motivated by the interest in using non-market, non-democratic and non-legalistic means to re-distribute the resources of the respective countries. Some of the costs and benefits of these inconsistency of revealed economic and political preferences will be dealt with in what follows.

**A historical excursus**

It is difficult to resist the interest to draw historical comparisons with the developments in the previous episodes of European integration and disintegration, i.e., in the nineteenth and the first half of the twentieth century. This is a vast topic and cannot be treated extensively here, but some observations could be instructive and possibly useful.

The first thing to notice is that the previous European liberalization, in the nineteenth century, coincided with the process of nation-building as did the process of disintegration at the beginning of the twentieth century. There is a debate going on in macroeconomics

about the influence of trade integration on growth and convergence. From a theoretical point of view, there is no reason to expect that this influence will necessarily be positive. Indeed, some studies seem to show that the nineteenth century integration in terms of trade and finance did not lead to rapid industrialization and growth as well as convergence in income levels in Europe.[26] In fact, in studies in economic history it is pretty much taken for granted that backwardness and divergence are the by-product of the nineteenth century globalization and have been deepened in the periods of both disintegration and new globalization characteristic of the twentieth century.

There is some evidence, however, that this may not have been the case everywhere and in all circumstances. One case that is of particular interest in the context of this paper is the record of Austro-Hungary. Some studies seem to show that there was convergence in income levels not only between Austria and Hungary but between the regions in both Austria and Hungary and across all the regions of the empire at least in the second half of the nineteenth century.[27] This process, as already mentioned, coincided with both internal liberalization in the twin empire and with that of nation-building and so this convergence may not have been perceived vividly enough for the empire to gain the necessary political legitimacy.[28]

One reason that might have given some economic logic to the national resistance to economic integration could have been connected with fiscal considerations.[29] Here a rather complex, but interesting, developmental argument could be made combining some of the ideas developed by Gerschenkron and Rosenstein-Roden.[30] Gerschenkron argued that not every process of industrialization looks the same or can look the same. In particular, he developed a theory of developmental substitutes, the essence of which is that if one agency of industrialization is lacking (e.g., the entrepreneur), another will step in to take up its role (e.g., banks or state). In the case of Austria, he argues, unlike in England where the entrepreneur was the central agent of industrialization, banks were initially these agencies of industrialization (as they were in Germany), but then (after the stock-market crash in the early eighteen-seventies) the state took over or rather tried to take over, especially when it came to railroad building. This story of railroad building is quite instructive irrespective of how accurate it is in every detail. It is clearly relevant to the proposal of Rosenstein-

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[26] See Rodriguez and Rodrik [1999]. A different view is taken by Sachs and Warner (1995) and, in another way, by Ben-David [1993].

[27] See Good [1981 and 1984] and Ranki [1981].

[28] The classical statement on this from the point of view of a historian is in Oscar Jaszi [1929]. In any case, the fact of convergence of regions in Austro-Hungary, if a fact it is, would support the argument that economic integration is presumed on political integration. The same would hold for the fact, if a fact it is, that there is convergence among the member states of the European Economic Community and of the European Union.

[29] This is the basis of the literature on economic integration and political disintegration represented by the work of Alesina and others.

[30] See Gerschenkron [1962 and 1877] and Resenstein-Roden [1943]. For comments on the former see Good [1991].

Roden's for the industrialization of Central and Southern Europe. He suggested that these countries would not industrialize (would remain agricultural) if they did not integrate, in some way, their finances. The reason is straightforward. If there is a need to build a railroad, a long line may be the only one that is potentially profitable. However, that may require that a number of budget centres agree on the railroad project. Otherwise, building it piecemeal may not be profitable for any of the separate budget centres. However, as Gerschenkron's story on the failed Austrian industrialization shows, it proved not to be easy to co-ordinate the different budget centres that had to be involved in, for instance, the building of the railroads. In addition, a railroad will have consequences on distribution as well as on allocation of resources, so that it may meet with approval by some and disapproval by other, all at the same time. The conflicts over distribution will have the same effects, whether they emerge in an otherwise integrated region or in a disintegrated region. Indeed, that seems to have been the case in Austro-Hungary as it seems to be the case in parts of the Eastern Europe and the Balkans that are undergoing transformation.

The conflict between political and economic preferences explain, it seems, much of what are the processes of integration and disintegration that have occurred in the last two centuries in large parts of Central and Eastern Europe and in the Balkans. The consequences of these conflicts are also interesting to look at. There are three areas that may be more interesting than the others.

The first is that of divergence in levels of development or of the emergence and the persistence of backwardness. One way to look at it is to compare the difference in levels of income just before World War I and now. Given that from then on, economic integration was essentially short-lived or non-existent precisely because of the political and security issues that had taken the centre stage, this development neatly illustrates the propositions on integration and disintegration advanced in this paper. Though different estimates of convergence and divergence in some of the sub-periods exist, the overall divergence is unmistakable. Some evidence of the level of development is presented in Table 1.[31]

Table 1

**National product per capita in 1910, US dollar (1970 value)**

| | | | |
|---|---|---|---|
| Germany | 958 | Dalmatia | 650 |
| Austria | 810 | Bosnia | 546 |
| Czech lands | 819 | Croatia | 542 |
| Hungary | 616 | Serbia | 462 |
| Italy | 546 | Transylvania | 542 |
| Greece | 455 | Russia | 398 |

[31] Taken from Palairet [1997], p. 233.

These differences are much smaller than those to be observed now.[32] Though there is a need to take a closer look at the whole period from then to now, the difference in the levels of development at the beginning and at the end of the twentieth century does seem to indicate that the lack of integration of the Eastern European countries with Western Europe has to do something with that.

Another area that is interesting to look into is that of trade integration. In the Rosenstein-Roden [1943] paper it is argued, at least implicitly, that there are regional gains from trade that could be exploited if appropriate financial integration were to be achieved. Historical record goes against that reasoning to a very large extent. In the last two centuries (or little less than that), the dominant destination of Eastern European trade was the more developed West European market. Regional trade was not very developed. This is still the case as will be shown below. Thus, national and regional integration and disintegration reflected political preferences rather than economic preferences. This is another constant feature of European integration.

Finally, an area that is of vital importance, and is much neglected, is that of monetary and fiscal policy. As was pointed out above, at least partly, nation-building was motivated by the belief that fiscal and monetary independence will be conducive to economic development, modernization and industrialization. It is not at all clear that this was indeed the case. In fact, especially fiscal policy was not altogether prudent. New states tended to be chronically bankrupt. This was both the consequence of the lack of democratic legitimacy and of the rejection of democracy and preference for authoritarianism. In any case, a modernizing role of the state was clearly not visible in Eastern Europe and in the Balkans in the twentieth century.

If all of this is taken together, it looks as if the conflict between economic and political preferences that characterized the developments in Eastern Europe has been at least partly resolved in some countries, at least for the time being, while not in others. The persistence of this conflict in the latter set of countries is the subject of this paper.

### Trying to be in and out at the same time

The borders of the future European Union have to be drawn somewhere. Where they are or will eventually end up to be depends on the European Union, but also on the prospective member states, integration being a contractual issue. In addition, the European Union is a complex integration which maintains a number of different types of affiliations. A good example of this complexity can be found in the European Union's relations with the Balkans or with South-eastern Europe. Slovenia is among the countries that have been

[32] On that see Pöschl *et al.* [1999]. Also, Gligorov [1998b].

invited to join the European Union in the first wave of enlargement, Greece is already a member, Turkey has an extensive free-trade agreement with the European Union (a customs union agreement), Romania and Bulgaria have association agreements with the European Union (which in principle entitle them to membership subject to fulfilling the appropriate conditions) and have started the negotiations for full membership, while Macedonia and Albania have co-operation agreements with the European Union. Croatia, Bosnia and Herzegovina and Yugoslavia have no contractual relations with the European Union but still have extensive trade, economic, political and security relations. In some sense, the whole region is integrated with the EU in one way or the other.[33]

Still, these facts can be presented in a different way too. Greece, the only one of the current European Union members, has initially failed to join the EMU (it will join January 1, 2001). Most other countries have been left out of the first round of enlargement and invited to negotiations only later, and even Slovenia – the only first-round candidate of the region – has been warned that it needs to do quite a lot to qualify for European Union membership (especially in terms of liberalization of its financial markets). And Western Balkans is still another distance away from the EU integration. Seen in this way, one can say that it looks as if no country in the Balkans has made an overwhelming case for its membership or participation in the ever widening and deepening process of the European Union's integration.

The same considerations apply to Slovakia (the only Central European country that was not included in the first round of enlargement) and to a number of other countries in the Baltics, in the rest of the former Soviet Union, and even in the Mediterranean. They define the variety of ways in which the European Union's integration can be approached and also the variety of ways in which countries can be inside and outside of this ever greater integration.

### *A sort of classification*

Given the key conflict of political and economic preferences identified above and implied by the propositions on integration and disintegration, a sort of classification could be sketched out.

Once the borders of the European Union are drawn, they define the *outsiders*. Those are countries that are integrated neither in economic nor in political terms. The most important probable long-term outsider is Russia. The country itself is potentially a separate trading

[33] In 1999 a new type of association agreement has been offered to the countries belonging to the so-called Western Balkans (Croatia, Bosnia and Herzegovina, Yugoslavia, Macedonia and Albania): the Stabilization and Association Agreement. Negotiations with Macedonia started in spring 2000 while those with Croatia should start in autumn 2000. Others are still in the waiting room.

and currency area.[34] Even if it were possible, in theory, for Russia to be somehow politically, or in terms of security, integrated with the EU, it may not tend to be integrated sufficiently in terms of trade and financing. Ukraine, however, presents an ambiguous case, the most important one perhaps. On the one hand, at the moment, its trade and economic integration in general with the EU is quite low, while, on the other hand, this may or may not change in the future.

Table 2

**Types of integration**

| | | Political Integration | |
|---|---|---|---|
| | | Yes | No |
| Economic | Yes | members | outs |
| Integration | No | infeasible | outsiders |

Other countries may be integrated with the European Union in terms of trade and money, but not politically. Thus, apart from political integration (i.e., membership or prospective membership) there may exist an economic integration, or *de facto* integration (i.e., market integration). As a consequence, there are political and market borders of the EU that will in all probability never coincide. Thus, there are and will exist politically integrated European countries (in the sense of membership in the EU) and those countries in Europe and out of Europe that have integrated markets with the EU. This duality is currently often bridged by agreements of different types that are signed between the EU and an ever increasing number of neighbouring countries that may or may not be candidates for membership in the near or even quite distant future.

Among the countries with or without markets integrated with the EU, one finds, apart from full members, three types of outs: opt-outs, left-outs, and stay-outs. *Opt-outs* are countries which could join one or the other type of European integration but choose not to.[35] Given that the EU recognizes (or might recognize, as suggested in Fischer [2000]) the right of its members to opt out in various ways, it is to be expected that the use of this right in the future may increase the overall complexity of the European Union even beyond what is the case today.

The countries that are not considered as candidate members of the EU in one sense or another but are integrated with the EU or would prefer to integrate are *left-outs*. One Balkan country that may be a clear case of a left-out is Turkey. Though Turkey's actual trade integration with the EU is not altogether high (see Table 3 below), Turkey has been

[34] Or what is more ambitiously called an optimal currency area.

[35] E.g., Norway and Switzerland in terms of membership and Great Britain, Denmark and Sweden in terms of participation in the monetary union.

applying for full membership for quite some time now. It argues, among other things, that its market and institutional integration with the EU will increase once it is accepted as a member. Be that as it may, Turkey is a clear case of a country that seeks political integration before it has sufficiently integrated in terms of trade and economic and other policy.

There are other left-out countries in the Mediterranean and also in Central and Eastern Europe. For the former, the Maghreb countries are a good example of a set of countries that are quite integrated with the EU in terms of trade and money, but the prospects for political integration are at present, to a varying degree, dim or uncertain. For the latter, a possibly clear examples were two Baltic countries (Latvia and Lithuania), Slovakia and Ukraine. The Baltic countries are small, very open and increasingly integrated into the European markets. The level of market integration of Latvia and Lithuania with the EU will even increase as soon as Estonia and Poland join the EU. It is to be expected that these two countries will eventually join the EU, possibly together with Estonia, but initially they were left out. Quite similar is the case of Slovakia, though for different, apparently well-known, reasons. Ukraine is a different case as already mentioned. It is conceivable that that country may eventually integrate with the EU in terms of trade, though now it is not, but it may still be left out of the political process of integration for security or other reasons. Or it may indeed choose to stay out.

Most countries in the Balkans are not really left-outs but are *stay-outs*. These are countries that are economically more or less, actually or potentially, integrated with the EU, but are lagging, for one reason or another, in the process of monetary or political integration. The stay-outs can be defined as those countries that are significantly integrated with the EU in terms of trade and financing, but fail to make progress in other areas of integration. Clearly, countries with so-called Europe agreements (Romania and Bulgaria) may be seen as stay-outs in the sense that they are not making enough efforts to converge with the EU in terms of economic and other policies. Because these countries do have agreements with the EU and have thus become part of the process of enlargement of the EU, they can be seen as being a hybrid of left-outs and stay-outs. On the other hand, countries descending from former Yugoslavia can be seen as clear cases of stay-outs because they did not even make the effort to adjust to the extent necessary to conclude the appropriate agreements with the EU. A possible exception is Macedonia, which can also be seen as a hybrid of a country not doing enough, but also as being left out by the EU. In fact, with the exception of Slovenia, all other former-Yugoslavia states have lower levels of formal integration with the EU than former Yugoslavia had with the EEC. This is the only case of formal disintegration from the EU that can be encountered. Trade relations have also suffered, as will be discussed in what follows.

### *Trade integration*

As trade integration is the key starting point for European integration and also for the relevance of the proposition on disintegration advanced above, the first thing to determine is the importance of foreign trade for the countries that are on the borders of the EU. What is of immediate interest here is the level of openness of some Eastern European and Balkan countries and their trade integration with the EU. To measure the latter, one simply takes the trade with the EU as a share of total foreign trade, while to measure the openness one just calculates the total foreign trade as a share of GDP. Table 3 presents the results of a sample of countries classified by their formal, i.e., institutional and contractual relations with the EU.[36]

From this simple table, some of the following things can be observed:[37]

(i) Trade with the EU is significantly or by far larger than with any other group of countries (and often larger than that with the world) for the majority of transition economies. However, there is a clear distinction between those that have been classified as outsiders and all the rest in this respect.

(ii) Most of the transition economies are open or fairly open, foreign trade proving to be large as a share of their GDPs, though, again, there are clear differences between the outsiders and the rest.[38]

(iii) The level of actual trade integration of Eastern European countries with the EU does not necessarily correspond to the level of political integration (for instance, Greece, an EU member, is less integrated with the EU than a number of transition economies).

(iv) The level of trade integration is not enough to distinguish between the left-outs and the stay-outs because both sets of countries may or may not be highly integrated with the EU. This is particularly true if the level of openness is measured not in GDP calculated with the exchange rate but in terms of PPP (purchasing power parity). This would especially affect former-Yugoslavia countries because they have relatively higher levels of prices than all the other transition economies. Measured in that way, the level of openness of countries like Croatia or Macedonia would increase relative to other countries, though the absolute level would of course fall everywhere.

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36) For details on the classification see Gligorov [1998a]. For other interesting comparisons, some data on the trade integration of Southern Mediterranean countries can be found in Abed [1998].

37 Most of the data used in this paper are from 1997. Nothing very much changes if data from later years are taken. It would clearly be desirable to look at the developments, an exercise that is left for another paper.

38) See also *Economic Survey of Europe* No. 1, 1998, New York and Geneva: UN/ECE, p. 139 with comparisons with the openness of some EU countries.

(v) Outsiders, irrespective of their membership prospects, as already pointed out, are rather clearly distinguished by their low level of trade integration. This becomes even more obvious in many cases if a different measure of GDP than that in current prices and at the exchange rate is used because in a number of cases both the level of openness and the share of EU trade diminish significantly (Ukraine and Russia among the transition economies and Turkey among the left-outs).

Table 3

**Trade integration with the EU, selected indicators, 1997**

| | Exports+imports USD mn | Share of EU in total trade in % | Exports+imports in % of GDP | GDP USD mn |
|---|---|---|---|---|
| **EU member** | | | | |
| Greece | 34645.6 | 68.88 | 28.97 | 119585 |
| **First-round candidates** | | | | |
| Czech Republic | 49517.2 | 61.15 | 95.16 | 52035 |
| Hungary | 40138.7 | 66.90 | 89.93 | 44632 |
| Poland | 68058.8 | 63.90 | 50.15 | 135701 |
| Slovenia | 17730.0 | 74.10 | 101.10 | 17534 |
| Estonia | 6324.0 | 65.50 | 138.68 | 4560 |
| Cyprus | 4000.0 | 44.44 | 60.00 | 9000 |
| **Future candidates** | | | | |
| Latvia[1)] | . | 42.52 | 77.00 | 5700 |
| Lithuania | 8785.0 | 38.02 | 97.61 | 9000 |
| Bulgaria | 9799.7 | 40.30 | 96.37 | 10169 |
| Slovakia | 19054.8 | 42.25 | 98.03 | 19438 |
| Romania | 19704.3 | 54.50 | 56.55 | 34843 |
| **Left-outs** | | | | |
| Macedonia | 2941.0 | 42.50 | 88.03 | 3341 |
| Albania | 1300.0 | 79.72 | 55.84 | 2328 |
| **Stay-outs** | | | | |
| Croatia | 13463.0 | 56.83 | 69.63 | 19336 |
| Bosnia and Herzegovina | 2669.0 | 39.26 | 83.41 | 3200 |
| Yugoslavia | 7167.0 | 45.00 | 38.74 | 18500 |
| **Left-outs/outsiders** | | | | |
| Turkey | 73730.0 | 50.79 | 38.89 | 189582 |
| **Outsiders** | | | | |
| Russia | 139020.0 | 34.61 | 30.02 | 462419 |
| Ukraine | 43191.2 | 14.81 | 86.96 | 49670 |

*Note:* 1) EU share imports only; share of exports and imports in the GDP from UN/ECE *Economic Survey of Europe*, Vol. 1, 1998.

*Sources:* WIIW Database, IMF Direction of Trade, OECD Economic Outlook.

Summarizing, trade integration data show that some transition economies in Central Europe, in the Balkans, in the Baltics and elsewhere (in the Mediterranean) are at least

potentially as integrated with the EU in terms of trade as the countries that are already EU members. In addition, a number of countries that are either being left out or are staying out are smaller in terms of their GDP than most EU member countries. Therefore, from the proposition on disintegration presented above it follows that these small countries are facing significant trade and policy costs either because the EU has decided to leave them out or because they have indeed decided to stay out.

The costs of being integrated in terms of trade but not formally become even more clear when the regional trade disintegration is taken into consideration. Without going into details,[39] the following patterns can be discerned and mentioned.

There is little *trade creation* outside of trade with the EU. This is clearly visible in the Balkans. With the exception of Bosnia and Herzegovina, for no Balkan country is another Balkan country the most important trading partner. In many cases, there is almost no trade between a number of Balkan countries. Even neighbouring countries do not trade all that much among themselves.

There is a significant level of *trade destruction* as a consequence of tariff and fiscal policies in most Balkan countries. Given that fiscal pressures tend to be strong, governments rely on budget revenues from tariffs and thus influence negatively both the level of overall trade and the level of legal trade.

Regional trade liberalization tends to have a small and volatile effect. Thus, CEFTA has not contributed all that much to the trade of its member states and the same goes for other free-trade agreements (e.g., the one between Croatia and Slovenia or between Yugoslavia and Macedonia). To the extent that there is an effect, it proves to be a shock-transmitter. As these countries are undergoing significant policy adjustments, problems in one country are transited to the other countries via the volatility of their trade. This has been noticed in the Balkans, but it is now evident for the CEFTA countries in view of the problems in the Czech Republic and Slovakia and in the region as a whole as a consequence of the Russian crisis.

The fact that regional trade is so low while trade with the EU is significant or high irrespective of whether there are free-trade and other trade agreements among the transition countries and between them and the EU indicates that there is trade specialization that is most probably a consequence of the trade of the transition countries being based mostly on inter-industry rather than intra-industry trade. This pattern of trade is in all probability reinforced by delayed integration because the level of trade with the EU is such that it does not allow for an increased diversification of transition countries' production

[39] I treat the subject in greater detail in Gligorov [1998b].

(characteristic of autarchies) and simply raises the price of foreign trade and thus slows down growth rather than having any other influence on the allocation of local resources.

Trade integration with the EU and the lack of trade integration among the countries in other regions lead to an asymmetric trade relation between the non-EU countries and the EU. While the EU is the dominant trading partner, non-EU countries in Eastern Europe and in the Balkans take very small shares of EU foreign trade. In that sense, these countries are truly price-takers: their prices are determined to a very large extent on the EU markets and they can hardly have any influence on those prices.

On top of that, most of these countries are quite small especially in terms of their GDP but also in terms of population. Thus, they are small, open economies. In other words, they satisfy the key assumption for integration. They cannot hope to be separate trade and currency areas if they want to have stability and aim to grow and develop. Put differently, economic and political independence may prove to be very costly because it can be achieved only if trade is shifted from the EU markets to some other markets, foreign or domestic. Given that regional trade is not very significant and given that other developed economies are distant in terms of transport and other transaction costs, there is little choice but to rely on the larger part being played by the domestic market. In other words, autarchy may turn out to be the only alternative to integration. The cost of autarchy for a small economy, however, are bound to be very high.

### *The money connection*

Given the rather high level of actual trade integration, it is not surprising that when one says money in many transition countries, and especially in post-Yugoslav countries, one means the German mark. In some places the dollar plays that role, but with the advent of the euro, it is to be expected that most of the Central and Eastern European transition economies will integrate even more into the euro monetary area. To see how important the German mark (or euro) is and also to judge how important the monetary connection is, one could look into the extent of German mark indexation and into the level of currency substitution. The former can be surmised from the transition countries' reliance on German-mark-based fixed exchange rates.[40] For the latter, statistical and anecdotal evidence can be used to support the observation that indeed for most purposes the German mark is the currency that is used quite extensively in the whole region. More

[40)] At this moment the following Balkan countries have German-mark-based fixed exchange rates: Croatia, Yugoslavia, Bosnia and Herzegovina, Macedonia, Bulgaria and Greece. Only Slovenia and Romania have some kind of managed floats. Many other transition economies (e.g. Estonia, Latvia, Slovakia) peg their currencies at least in part to the German mark.

reliable evidence can be found in the level of transactions and savings in German marks that have been reported to be quite high.

To illustrate this point by the example of the Balkans, the exchange rate regimes that can be observed can be found in Table 4. Not much difference in exchange rate regimes is found if the Central European and the Baltic countries are added. In both sets of countries one or the other variant of fixed or managed exchange rate regimes prevails. This is clearly the case for the first-round candidates for European Union accession (with Poland, which has starting floating recently, being the chief exception). But, it is also true for the Slovak Republic and for Latvia and Lithuania. Further east, the situation changes. Even in the cases when countries have fixed exchange rate regimes they tend to be based on the dollar rather than on the euro and also, in the longer run, it is not clear whether countries like Russia and Ukraine will become closer to the European Union as they start developing.

Table 4

**Exchange rate regimes**

| | |
|---|---|
| Currency board: | Bosnia and Herzegovina, Bulgaria (DEM based). |
| Fixed exchange rate: | Croatia, Yugoslavia, Macedonia (DEM based). |
| Managed float: | Slovenia, Albania (DEM based). |
| Float: | Romania. |

Data on savings are not comparable and are not altogether reliable. It is safe to say, however, that – if what may be called involuntary savings (mandatory deposits and reserves of different kinds) are excluded – practically in no Balkan country are savings in domestic currency a significant portion of total savings. This is certainly true for Croatia, Bosnia and Herzegovina, Yugoslavia, Macedonia and Albania. Savings in foreign currencies are probably higher than savings in domestic currency in Slovenia, Bulgaria and Romania too. To the extent that there are savings in domestic currency, those are indexed on a foreign currency in one way or another. Indeed, in order to hedge against the exchange rate changes and against inflationary shocks, a significant amount of transactions is conducted in foreign currency. Thus, in most countries, velocity of money is quite high and does not tend to go down to levels that can be found in the EU even when inflation is kept low or very low.

These facts being as they are, the important thing is to see how this monetary connection is reflected in the actual money markets and how those are correlated with the actual monetary policies. One can assume that if the money markets were integrated and if the monetary policies were taking that fact into account, the interest rates in the region would converge to euro interest rates. Indeed, the behaviour of the interest rates is one of the criteria of convergence that indicates the degree of convergence of monetary and of the

exchange rate policies. In some sense, the interest rate differential could be taken as a measure of the adjustment of the respective country's monetary policy to the fact of trade and monetary integration with the EU.

At this moment it is somewhat hard to discuss the interest rate developments in the Balkans, but also in the Central and Eastern European countries. In the transition economies, the experience of normality is very short and very limited. In most cases, the inflation rate was very high in the past or is high even now or, where it is not, the investment level is still quite low. Indeed, the money markets and financial intermediation are still significantly underdeveloped. The same is especially true for countries that belong to the set of the left-outs and stay-outs.

However, even in the candidate countries the long side of the market is practically non-existent or underdeveloped. In that sense, it is difficult and also not altogether significant to look at the long-term interest rates (i.e., those for five-, ten- or thirty-year bonds). However, it can be safely assumed that once this market develops, these interest rates will be higher at least for a certain period of time.

As for the short-term interest rates, i.e., those for loans or bonds with up to one year maturity, one can observe a certain regularity (see Table 5) in the sense that the concerns about the inflationary pressures are connected with the higher nominal and real interest rates. Thus, these may be twice or three times higher in real terms than those that can be found in the EU, on average.

The reason has to do with the following consideration.[41] Transition countries have to fix or observe closely their exchange rates in order to put the inflation down. For the countries that have liberalized their trade with the EU or for those that are *de facto* integrated with the EU in terms of trade, a fixed exchange rate will require that the financial flows are liberalized. Otherwise, there are the following two alternatives: (i) managed float with sustained higher inflation and capital controls and (ii) pegs or crawling pegs with occasional larger devaluation that also keeps the average inflation rate higher than in the EU.

Given these alternatives, it is to be expected that the rather higher real interest differential that is characteristic of most of the transition countries will persist. In addition, it can be observed that the interest rates tend to converge downwards on average along with the financial and monetary integration with the EU. Thus, countries like Greece that intend to join the EMU in the near future tend to implement monetary policies that induce a convergence of their interest rates to those prevailing in the EU. On the other hand, a country like Turkey pursues monetary policies that lead to high inflation and high nominal

41) For a treatment see Branson, de Macedo and von Hagen [1996].

interest rates. It can be assumed that the same difference will characterize a number of countries that will be left out or will choose to stay out.

Table 5

**Interest rates in selected countries, end-1997, in % per year**

| | Discount rate[1)] | Discount rate, real[2)] | 3-month T-bills[3)] |
|---|---|---|---|
| **EU members** | | | |
| Germany | 2.5 | 1.6 | 3.3 |
| Greece | 10.8 | 3.3 | 10.4 |
| **First-round candidates** | | | |
| Czech Republic | 13 | 6.9 | 15.9 |
| Hungary | 20.5 | 0.8 | 20.1 |
| Poland | 24.5 | 11.7 | 21.6 |
| Slovenia | 10 | 3 | 21.3 |
| Estonia | 6.4 | -4.8 | |
| Cyprus | 7 | 3.4 | 5.8 |
| **Future candidates** | | | |
| Latvia | 4 | -4.4 | 4.7 |
| Lithuania | 11 | -2.1 | 8.5 |
| Bulgaria | 6.9 | . | . |
| Slovakia | 8.8 | 4 | |
| Romania | 52.6 | -35.1 | 85.7 |
| **Left-outs** | | | |
| Macedonia | 8.9 | 4.5 | 8.2 |
| Albania | 32 | -1 | 32.5 |
| **Stay-outs** | | | |
| Croatia | 5.9 | 5.3 | 15.5 |
| Bosnia and Herzegovina | . | . | . |
| Yugoslavia | 33.7 | 11.3 | 100 |
| **Left-outs/outsiders** | | | |
| Turkey | 78 | -4 | 100 |
| **Outsiders** | | | |
| Russia | 28 | 19.2 | 26 |
| Ukraine | 34.8 | 19 | 49.1 |

*Notes:* 1) Refinancing rate for Russia, NB lending rate for Romania, NB base rate for Hungary and Bulgaria. – 2) For most countries deflated by PPI, for some GDP or CPI deflators. – 3) Lending rate for Slovenia, Croatia and Ukraine; 12-month TB for Greece; 6-month TB for Turkey; 30-day NB lending rate for Macedonia; inter-bank rate for Yugoslavia.

*Sources:* WIIW Database, IMF Financial Statistics, OECD Economic Outlook.

Now, the monetary situation in the transition economies is quite similar to the one that can be observed in their trade relations. Monetary transactions are, to a very large extent, either done in German marks or are at least partly indexed on that currency. This will, in all probability, only increase with the definite introduction of the euro. Thus, as in the case of trade, the transition economies are financially quite integrated with the EU. And as in the case of trade, *de facto* integration without institutional integration imposes costs on the left-

outs or on the stay-outs. In the case of the money markets, the cost is reflected in higher interest rates.

That cost can also be seen in a different way as a misalignment or wrong integration of the money markets. One way to illustrate that is to observe the existence of a contagion effect from the recent turmoil in the Asian markets and in Russia on the markets in the transition economies.[42] The contagion effect has been largely absent from the EU, but not from transition economies (interest rates went up, in some cases sharply, and the bond and equity markets suffered, in some cases, significant adjustments). Though these economies have thin financial markets and thus the macroeconomic impact can hardly be as important as it has been in Asia, their macroeconomic policies that keep the interest rates high align them generally with the markets in the emerging markets rather than with those in Europe.

In the aftermath of the Russian crisis, a further differentiation among transition countries has been under way. While countries that have been seen as converging to the EU (like Hungary, Poland, the Czech Republic and Slovenia, the latter primarily because it has capital account restrictions) have been able to weather off the contagion, at least so far, most of the other transition countries have for all practical purposes dropped off the financial markets or are struggling to keep their presence and adjust their economic policies accordingly. Indeed, the key test for the costs of disintegration is exactly a global or regional crisis.

## Costs of staying out

### *Interest rates and convergence*

Monetary policy in transition countries may be analysed more concretely with the help of the so-called Taylor rule.[43] This rule is one simple version of a large class of rules (that can all be called Taylor-like rules) that determine the optimal monetary policy response to price and output shocks. This rule has a normative and a positive interpretation. In a normative sense, the Taylor rule will suggest an adequate (i.e., optimal or desirable) response by a central bank to the particular shock that the economy is being subjected to. In a positive sense, the Taylor rule will capture the actual behaviour of the central bank thus serving as a basis for formation of expectations and for predictions in an economy.

The normative side of the rule is probably more important for transition economies because their experience with monetary policy is rather short and because most of them have an implicit inflation target given by the inflation developments in their most important trading region, i.e., in the EU. Thus, one can rely on the EU target inflation to evaluate the

[42] More on that in Gligorov and Sundström [1999].

[43] For expositions see Taylor [1993 and 1994].

economic policy response to the price and output shocks brought about by the transition process. The same is true for the output developments in transition economies because the deviation of their actual output from their potential output should be given by the speed of their catching-up with the EU.

One general representation of the Taylor rule can be written as follows:

$$R = p + ay' + b(p - c) + d. \quad (1)$$

R is the nominal short-term bank rate (the main monetary policy instrument of the central bank which may not be the same in every country, but usually refers to something similar to the overnight lending rate). Actual inflation (observed or anticipated, i.e., forecasted), e.g., the one-year average retail price index, GDP deflator or CPI, is p, y' is the deviation of the actual growth rate of GDP, e.g., one-year average (y), from the long-term potential growth rate (y*), while a, b, c and d are parameters. Indeed, c is the target inflation rate and can be written as p* while d is the target real interest rate, that can be written as r*, that the central bank feels is the appropriate one given what it knows about the expectations in the economy. Thus (1) can be written as:

$$R = p + a(y - y^*) + b(p - p^*) + r^*. \quad (2)$$

This general rule gives rise to a number of more specific rules that differ from each other in the way they specify p*, y*, a, b and r* (empirically or normatively). The particular rule that has been found to be a good representation of the monetary policy in both the US and the EU[44] is the following:

$$R = p + 0.5(y') + 0.5(p - 2) + 2. \quad (3)$$

In this case, assuming that the actual growth is equal to the potential and that the actual inflation is equal to target inflation, the rule will suggest an R that is equal to p + r* or, in this case, with the target inflation rate being 2%, the nominal bank rate should be 4% and the real bank rate 2%. If y' deviates by 1%, the nominal bank rate changes by 0.5%. If the inflation rate p changes by 1%, the nominal bank rate changes by 1.5% and the real bank rate by 0.5%. Thus, both in the case of output deviation and of inflation deviation of 1%, the real bank rate increases by 0.5%, i.e., it increases 0.5% for every per cent of inflation or output deviation from their target or potential levels.

[44] Some have found that the rule does not fit the policy of the German central bank, but it does fit some kind of combination of the policies of the euro-zone. This makes it an appropriate rule to anticipate roughly the policy of the European central bank though the history of this bank is so short.

Other rules use different values for target inflation and for output and inflation adjustment parameters. Also, they differ in the way they determine the level of potential output as well as in the concrete measure of inflation that they use. These issues are of paramount importance in countries using inflation targeting in their monetary policy. Some of these issues are not necessarily important in the same way in transition economies. The reasons are the implicit inflation target for transition economies given by the actual inflation in the EU and the level of potential output determined by the reasonable rate of growth convergence. The values left to be determined are those of the parameters a, b and r*. As these can hardly be found by looking at the way transition economies have actually behaved, they can either be determined by some rule of thumb or they can be solved for in the general equation for the Taylor rule. Here these two approaches will be combined in order to just get a feeling for the usefulness of the whole enterprise. Afterwards, this approach can be refined in one direction or in the other.

By way of example, I will use the following assumptions: p* is given by the target EU rate which is 2%; y* is given by the 2 percentage points higher growth rate than that of the EU (this can be changed, as will be done in what follows, into a 2 percentage points convergence rate per year; the potential growth rate of the EU is taken to be 2%); initially a and b are given the values of 0.5, r* is taken to be 2%. For thought experiment purposes I will first take an imagined transition economy with 10% inflation and 5% potential growth rate. It is to be determined what should its nominal bank rate, R*, be. Introducing these values into (3) gives the following:

$$R^* = 10 + 0.5(0) + 0.5(10 - 2) + 2 = 16.$$

In this example, potential output could be given by the 2 percentage points convergence rate. Assuming, for instance, that the GDP per capita of this fictitious transition economy is one third of the EU average, the potential growth rate that ensures an initial 2% convergence is about 8%. If the actual growth rate is, say, 6%, the bank rate consistent with 10% inflation is equal to:

$$R^* = 10 + 0.5(-2) + 0.5(10 - 2) + 2 = 15.$$

Croatia could be used as an actual example. For 1997 its estimated GDP growth rate was around 5% while the estimated inflation rate was 3.6%. Given that Croatia's GDP per capita calculated with the actual exchange rate was about 18% of the EU average, the Croatian initial potential growth rate consistent with 2% convergence would be about 13.5% (which would bring its GDP to 20% of the EU average in one year). If these figures are introduced into (3) the outcome is as follows:

$$R^* = 3.6 + 0.5(-8.5) + 0.5(3.6 - 2) + 2 = 2.15\%.$$

The actual central bank's discount rate was 5.9% on average in 1997. If figures for 1998 were to be used, the discrepancy between the actual and needed discount rate would be even greater because the growth slowed down to at most 3% while inflation ended at 5.7% in 1998. The combined effect would have required the bank rate to be somewhere around 2% while the interest rate in fact increased because of the effect of the Russian crisis in the aftermath of which Croatia was one of the countries identified as being more vulnerable than the others.

The same exercise can be performed for the other Central and East European countries. Slovenia, for instance, had an estimated inflation rate of 9.1% in 1997 and an estimated GDP growth rate of around 3%. The discount rate of the central bank was 10% throughout 1997. If Slovenia's GDP per capita at the exchange rate was about 40% of the EU average, its potential output growth consistent with a 2% convergence rate was about 7%. Introducing that into (3) to get the appropriate discount rate gives the following:

$$R^* = 9.1 + 0.5(-4) + 0.5(9.1 - 2) + 2 = 12.65\%.$$

The first use of Taylor rules could be to evaluate the current monetary policy, i.e., the actual bank rate rather than the parameters a, b and r*. Another exercise would be to evaluate the probable implicit target inflation rate that the monetary policy is pursuing, i.e., to solve for c in (1) or for p* in (2). This is done for Central and East European countries in what follows assuming that a and b are equal to 0.5 and that the convergence rate is 2%.

Table 6

**Potential growth and interest rates**

| | GDP per capita | 1 9 9 7 | | | | | |
|---|---|---|---|---|---|---|---|
| | **1996** | **y*** | **Y** | **P** | **R** | **p*** | **R*** |
| EU | 23000 | 2 | . | 1.9 | . | . | . |
| Bulgaria | 1129 | 50 | -7.5 | 1082.2 | 6.4 | 5340.3 | 1595.5 |
| Croatia | 4243 | 13.5 | 5 | 3.6 | 5.9 | -5.5 | 2.2 |
| Czech Republic | 5231 | 11 | 1.3 | 8.5 | 13 | -3.1 | 8.9 |
| Hungary | 4347 | 13 | 4 | 18.4 | 21.3 | 7.7 | 25.1 |
| Poland | 3479 | 16.5 | 7 | 14.9 | 24.5 | -10 | 18.6 |
| Romania | 1521 | 36.5 | -5 | 150 | 51 | 310.5 | 205.8 |
| Slovakia | 3529 | 16.3 | 5.5 | 6.1 | 8.8 | -6.1 | 4.8 |
| Slovenia | 9362 | 7 | 3 | 9.1 | 10 | 7.3 | 12.7 |
| Russia | 2985 | 20 | 0.4 | 14.6 | 28 | -27.2 | 13.1 |
| Ukraine | 864 | 66 | -3.2 | 17.8 | 35 | -81.8 | -6.9 |

*Note:* y* is the potential growth rate, y is the actual growth rate, p is actual inflation, R is the actual nominal discount rate, p* is the implied target inflation rate and R* is the suggested nominal interest rate. Figures were rounded to one decimal.

*Source:* Author's calculations using the WIIW Database.

It is easy to see that the divergence of practically all the countries in transition is quite significant. In 1998, however, all these countries were subjected to the shock of the financial crisis in Russia and the turbulence it caused in the world financial markets. Because of the fall of import prices and because of the tight monetary policies pursed (as can be seen from Table 6), inflation slowed down significantly in practically the whole region (except for Russia, Romania and Yugoslavia). However, monetary policy eased only in Hungary, the Czech Republic and Poland, i.e., in the convergence countries. Even there the easing was not necessarily so dramatic, given that monetary policy was softened in the EU too. However, in all the other countries, monetary policy had to be tightened in order to keep, in most cases unsuccessfully, the flow of foreign finance in. This certainly does not make the monetary policy and all the other economic policy choices in any way easier. The problems become even more transparent if it is observed that the developed countries, the EU in particular, reacted to the financial crisis and to lower inflation with a lowering of the interest rate in order not to precipitate a recession. Contrary to that, monetary policy had to stay tight or even had to be tightened in most Eastern European countries even in the face of a marked slowdown in their growth.

### *Westernization*

The main reason to delay integration is divergence in politics and in policy. From the point of view of political economy, this is for reasons of relying on different institutions than those that exist in the EU to re-distribute the resources of a country. The major cost is in lower than attainable growth. The more far-reaching cost may be expressed in terms of development. Chances are that, with few exceptions, not only slow growth may become a rule, but regions of backwardness may get established. This may happen for essentially the same reason as in the nineteenth century and during the socialist period. The history of development in Europe has been one of the spread of what has been called the process of westernization. There is no need to go into details here. One aspect may be highlighted, however. The process of westernization is basically one of the spread of knowledge in all its various forms. It has been argued that the role of knowledge is what distinguishes the first (i.e., nineteenth century) globalization from the second (i.e., the current one).[45] Without necessarily endorsing this theory, it can be safely argued that the role of knowledge of all kinds (that is, not only technological but also institutional) has become crucial. This may change the type of backwardness that may be appearing in Europe today. This may have far-reaching consequences in terms of migration and in other social areas that cannot be treated here.

[45] See Baldwin and Martin [1999].

## Conclusion

The disintegration of much of Eastern Europe and particularly of the Balkans from the European Union is the consequence of a policy divergence. The latter implies that some countries or whole regions will delay their integration with the European Union and that the level of diversity implied by this policy leads to them being left out with slow growth and development. The benefits these countries are trying to exploit by delaying integration are to be found in the political economy of disintegration, while the costs are to be found in the higher price of stability and in a slower process of convergence. The key policy issue is whether the policy of delaying integration should be complemented with the decision to leave this region out. This is probably impossible for security reasons, but the appropriate manner of integration is yet to be found.

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