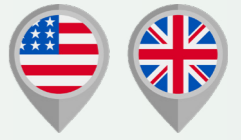




DID EU MEMBERSHIP BRING ECONOMIC BENEFITS FOR CESEE MEMBER STATES?



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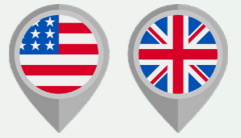
David Lubin is Managing Director and Head of Emerging Markets Economics at Citi, responsible for a team of 30 economists in 15 different locations globally. In the early part of David's career, he was a member of the team that represented Midland Bank in Brady-era sovereign debt restructuring negotiations. He has over 25 years' experience as an economist looking at emerging markets, and joined Citi in 2006, having spent many years at HSBC. He was educated at Oxford University, and is an Associate Fellow at Chatham House, the Royal Institute of International Affairs. His book, 'Dance of the Trillions: Developing Countries and Global Finance' (Brookings Press) was listed in the Financial Times as one of the best economics books of 2018.



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If the EU's new member states of the CESEE region had stayed out of the EU, would their citizens have enjoyed less income growth and fewer economic opportunities than they actually did? Before answering this question with an unambiguous 'yes', bear in mind two key issues. First, the fall of communism in Eastern Europe thirty years ago permitted the replacement of a dysfunctional economic system with more market-friendly, outward-looking and efficient economic systems. This should have boosted growth regardless of whether these Eastern European nations joined the EU. Second, the 30 years since the fall of Communism in Eastern Europe have been an age of economic integration and income convergence across the whole of the emerging and developing world.

It was not only Central, Eastern and South-Eastern European (CESEE) countries whose economies became more open, more skilled, more integrated, healthier, more literate and richer. Since this was an age of globalisation, these opportunities were available not just to the citizens of CESEE, but to those across Latin America, east and south Asia, and parts of Africa too. The expansion of the EU is probably best understood as an instance of globalisation, and neither a substitute for it nor a cause of it. It is also worth bearing in mind that the modern episode of globalisation pre-dates EU accession: global integration of the markets for goods, capital and labour became increasingly

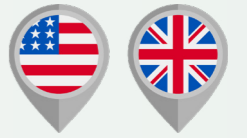
evident in the late 1960s and early 1970s.

To be sure, the income convergence of the new EU members (Bulgaria, Croatia, Cyprus, Czech, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia, Slovenia) has indeed been impressive. Measured at purchasing power parity, the average per capita income of this group rose from a level that was 36.5% of the G7 average in 2000 to 58.1% in 2018. But the fact of income convergence cannot necessarily be attributed to EU membership, since many other emerging economies also enjoyed similar progress.

That said, a meaningful comparison of CESEE's performance with other parts of the emerging world is difficult because CESEE countries were richer to begin with. Emerging Asia, for example, saw its per capita income rise from 10.1% of the G7 average in 2000 to 24.9% in 2018; Latin America's per capita income rose from 30.8% to 33.6%. In addition, many of the CESEE new EU member states are not classic emerging markets that are transiting from a pre-industrial economy to an industrial and modern service economy. Countries like the Czech Republic, Slovakia and Poland are old industrial countries that had the bad luck of having a communist economic system imposed on them for over 40 years. With a highly educated labour force, convergence in living standards with the EU following the



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collapse of communism in Eastern Europe was to be expected with or without EU membership as long as the new economic regime was a material improvement over pre-1989 communism.

It is equally difficult to be precise about what the contribution of EU membership has been to capital accumulation funded from foreign sources. Certainly, net FDI flows to CESEE were large, but three points are relevant. First, plenty of other emerging economies were also on the receiving end of large net FDI inflows. The average net inflow of FDI for the new EU members during the years 2000-2018 was 3.0% GDP, compared to 2.5% for Latin America and 1.6% for emerging Asia. Second, it is possible to argue that for some countries – Hungary and Latvia most obviously – the net inflows of FDI into the financial sector had perverse consequences by creating the conditions for the financial crises that hit these countries in the wake of the great financial crisis in 2008.

The financial crises in Hungary and Latvia have much in common with the financial crises and banking sector collapses in other EU member states, including Greece, Ireland, Cyprus, Portugal and Spain. Irrational exuberance (partly driven by the excessive sense of security associated with EU membership) combined with inadequate macro-prudential and micro-prudential institutions and interventions drove leverage and asset-liability

mismatch to dangerous and unsustainable levels. Although it is perfectly possible to have a financial crisis without the (excessive) confidence boost provided by EU membership, there is a strong case that the combination of EU membership and inadequate regulation and supervision at the EU and national levels drove the banking crises in the EU during the great financial crisis, including in Hungary and Latvia.

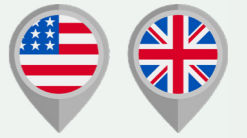
Finally, it may be the case that the logic of geographical proximity might have created a strong magnet for FDI flows into CESEE even in the absence of EU membership.

The logic of geographical proximity may also explain in part one area of economic improvement where CESEE's performance was exceptionally notable, namely an increase in economic openness, thanks to the building out of manufacturing supply chains within the region. The ratio of exports to GDP for the new member states was 40.9% in 2000, but had risen to 65.7% by 2018, an increase that is visibly larger than for other emerging economies. Latin America's openness has barely changed in the past 20 years, and Asia's openness during this period has actually declined on average.

However, being part of the EU single market and customs union no doubt strengthened the economic case for deepening intra-



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EU supply chains. This is supported by the widespread fear that if and when the UK leaves the EU, many intra-EU supply chain-dependent economic activities in the UK will be at risk. The growth of intra-European supply chains – which is the link between FDI inflows into the region and the increase in its export/GDP ratio – has led to a sharp increase in the synchronisation of business cycles between the European core and CESEE periphery. This is especially the case in central and eastern Europe, where the correlation coefficient that links growth in the region and growth in Germany has been 0.7 in the past decade.

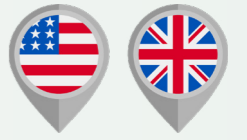
That synchronisation has also been facilitated by the inflow of EU funds, given the contribution these have made to improving infrastructure in CESEE, which in turn has enabled the spread of supply chains in the region. Indeed, the disbursement of EU funds into the region is the one economic aspect of CESEE's position that makes it truly unique within the broad context of emerging markets. That said, the effect of these funds has clearly peaked, and the likely fall in these disbursements is often discussed as a factor that could increase the perception within CESEE that the special benefits of EU membership have diminished. In other words, the one feature of CESEE's economic development during the past 15 years that has been truly unique is about to end.

A key question, which unfortunately cannot be answered with any great degree of confidence, is whether the adoption of the [acquis communautaire](#) by the new EU member states had economic benefits by itself. The answer depends on the counterfactual: what would the new EU member states have adopted instead of the 35 chapters of the [acquis](#), had they not joined the European Union? The [acquis](#) is not exactly a blueprint for a growth-promoting, market-friendly legal and institutional framework (the common agricultural policy, for instance, is a protectionist blot on the economic landscape). However, a plausible case can be made, based on the experience of CESEE and neighbouring countries that did not join the EU and have no reasonable prospect of doing so anytime soon (Ukraine, Moldova, Belarus, Turkey), that the likely alternative to the [acquis](#) would have been something less growth-friendly.

Among the important economic opportunities created by EU membership is the free movement of labour. Many younger workers from the CESEE region have migrated to western Europe. Outward migration from Croatia, for instance (most of it to western Europe) which joined the EU in 2013, went up from 12,877 in 2012 to 36,436 in 2016. While the opening up of the EU-wide labour market to citizens of any EU member state is undoubtedly a positive for those taking advantage of it by moving abroad, the loss of labour (often young and well-



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educated) can be a negative for those remaining in the country of origin. There is some evidence that migrants from the CESEE countries to western Europe may in due course return to their countries of origin, especially if the economic conditions in these countries continue to improve. The combination of remittances while abroad and an ultimate return with new knowledge, skills and socio-economic networks would be a clear positive.

In conclusion, much if not most of the improvement in material conditions of living in the new CESEE EU member states likely would have happened even if these countries had remained outside the EU. There are, however, two main benefits of membership that would not be replicable outside the EU. The first is the deep intra-EU supply chains these countries benefit from as a result of membership in the single market and customs union. The second is the value of the *acquis*, flawed as it is, in providing insurance against the adoption of market-unfriendly and growth threatening policies and institutions at the national level.

