EUROPEAN ECONOMIC PERSPECTIVES

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# Who's Afraid of the Big Enlargement?

**The initial enthusiasm for a 'return to Europe' has turned to anxiety about the potential consequences of enlarging the European Union. The prospect of mass migration, pressures on welfare systems, industrial relocation to the new EU members in response to lower labour costs, and job losses for unskilled natives all give existing EU members cause for great concern.**

Rather than legitimizing the fears, CEPR *Policy Paper* No.7: *Who's Afraid of the Big Enlargement?* recommends that politicians and policy-makers dispel the anxieties associated with them by leading the EU and its members to adopt appropriate measures. The authors argue that EU governments are wary of the budgetary consequences of enlargement since most candidate countries have large agricultural sectors and low per capita incomes. The extension of current agricultural and structural policies to new entrants would therefore imply large positive budget balances with the EU. But the Report finds that treating new EU citizens differently would backfire. Structural Funds are aimed at promoting faster growth and without such policies, income convergence would take too long.

More broadly, *Who's Afraid of the Big Enlargement?* suggests that enlargement offers the EU a window of opportunity to accelerate unavoidable reforms of structural policies, agricultural policies and, indeed, the wider budget. The financing of regional policies should change to a system in which each country pays or receives proportionally to its distance from the average EU per capita income level. Agricultural policies should move further away from price supports towards explicit transfers to agricultural workers.

The Report considers arguments for a delay before lifting all restrictions on migration from East to West. By drawing on the latest estimates of the potential flows of people, as well as the US experience in tackling illegal immigration, the authors argue that there is an option value to waiting. However, current EU members could smooth the adjustment process by beginning to open their labour markets to migration from the CEECs. Furthermore, the study finds that the North American Free Trade Agreement, which has been in place between the US, Canada and Mexico since the early 1990s, can provide the EU with some guidance. Mostly importantly, integration of economies at vastly different levels of development calls for significant inter-industry and geographical labour mobility.

CEPR *Policy Paper* No.7 recommends:

- More mobility-friendly labour market institutions among current EU members - more unemployment insurance of short duration and less employment protection legislation
- A higher level of social welfare standards for candidate members. Accession countries should have minimum guaranteed income schemes similar to those in place in most current EU members
- Minimum guaranteed income schemes coordinated at the EU level, adjusted to take account of differences in the cost of living across countries and regions - with a long-term plan to build up a pan-European social safety net
- A transitional period before migration restrictions on new members are lifted, provided the period is clearly defined from the outset, and

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restrictions are flexibly coordinated at the EU level

• Migration policies adopted across the EU which encompass not only enforcement of border controls, but also on-site controls of illegal employment of migrants

• The maintenance of Structural Funds at current levels and the allocation of regional funds by national governments. Funding schemes should be more transparent but without violating the resources ceiling for the EU budget set at 1.27% of GNP.

The authors conclude that such measures are essential to integrate the new members successfully into the EU. The prize is great - a Europe that fits its historical and cultural boundaries and exploits the tremendous economic benefits of a single market for 500 million people. The risks are also great, and the EU must begin immediately to minimize them. The consequences of failure are only too clear.

## Management Update

CEPR is pleased to announce the appointment of Ms. Hilary Beech to succeed Stephen Yeo as Chief Executive Officer. Ms. Beech brings extensive private sector management experience, along with Masters degrees in International Economics, Business and Engineering. The full press release is available at ww.cepr.org/press/hb.htm

CEPR thanks Stephen Yeo for his many years of outstanding contribution to the Centre from its creation in 1983, and wishes him the very best in his future endeavours.

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# For Richer or for Poorer

**'Globalization' means many things to many people. There is no commonly accepted definition, yet globalization is at the centre of a starkly polarized debate over the major policy issues in the world today. CEPR now makes an important contribution to this debate by separating what is truth and what is fiction in a new Report which analyses the different aspects of the ongoing process of international integration.**

A new CEPR study, *Making Sense of Globalization*, which was written for the European Commission Group of Policy Advisors, and includes an introduction by the President of the European Commission, Romano Prodi. The authors refer to the arguments that have so far been presented for and against globalization. The critics of globalization say that it increases inequality, pollutes the environment, causes economic instability, exploits workers and undermines the ability of governments to raise the taxes that finance public spending and welfare. Yet the authors find there is a wealth of economic evidence demonstrating that globalization brings great benefits as well as imposing costs. It offers the opportunity for a higher rate of sustainable growth - growth that translates into longer, healthier lives and improved living standards. These gains must be weighed against the adverse effects of globalization, and, in particular, the effects of international liberalization on the world's poorest countries. The Report's main conclusion is that the true benefits of globalization strongly outweigh the costs.

In addition, the Report finds that many of the charges levelled against the globalization process are misguided. An important result presented in the study is that the increasing integration of the world's economies does not inevitably increase the inequality of incomes. The nineteenth century saw an explosion of inequality but by the middle of the twentieth century it had stopped rising. In fact, the proportion of the world's population in absolute poverty is now lower than it has ever been.

The authors recognise that the effects of globalization on inequality are complex. They stress the best response may be complementary policies rather than restrictions that would sacrifice the benefits of globalization. Indeed, a general argument emphasized in the Report is that many of the apparent costs of globalization reflect domestic policy failures, so that they are better tackled through domestic policy reform than through seeking to halt the globalization process. The authors find that the effects of increasing economic openness depend critically on the circumstances of individual countries and the policies they follow. Similarly, they find little evidence that governments are losing power to multinational corporations or other agents of globalization or that there is a 'race to the bottom' in environmental or labour standards or taxation. And where true international policy spillovers exist, such as the regulation of international financial markets, the authors suggest that the EU should take the lead in developing appropriate policy proposals.

The Report argues that the real dangers of globalization and the greater awareness of such dangers due to improved communications make it vital to implement policies to deal with them. The alternative is a backlash that would reverse some of the great progress that has already occurred.

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# As good as Greenspan

**In 2001 a sharp deterioration in the economic outlook, both globally and in the Euro Area, gave the European Central Bank (ECB) its sternest test to date: steeply falling output was accompanied by rising inflation. Critics argued that because the ECB was overly concerned with maintaining price stability, it cut interest rates both too little and too late. Does such criticism stand up to scrutiny?**

Written by a team of distinguished monetary economists, *Monitoring the European Central Bank* 4: *Surviving the Slowdown*, examines the simultaneous slowdown faced by OECD countries and identifies four reasons that made this situation especially challenging for the ECB. First, since all countries experienced simultaneous slowdown, no country was available as an external locomotive of growth to help out the others. Second, over-investment in the tech bubble left an overhang of capital, making new investment potentially unresponsive to interest rate cuts in the short run. Third, the end of the first inflation-less boom for decades raised the remote possibility that subsequent interest rate reductions might hit the zero lower bound before any danger of deflation had been completely averted. Fourth, uncertainty increased, at least temporarily, because of the events of September 11.

The Fed responded by cutting interest rates aggressively. The ECB was slower to start cutting rates, and in total cut only a third as much as the Fed during 2001. Did the Fed cut too much or the ECB too little? Or were both responses entirely appropriate reflections of transatlantic circumstances that had differences as well as commonalities?

The authors of the CEPR Report argue that those calling for the ECB to acknowledge a more active concern for output in the short run must recognize that for half its life to date the ECB has allowed inflation to exceed 2.0%, the upper bound of the target range. As credibility grows, the ECB can in principle, support output without undermining its clear commitment to price stability.

When judged by its past behaviour, the ECB was slow to cut interest rates in the first half of 2001, but by October had largely made up the lost ground. As noted in previous *Monitoring the European Central Bank* reports, however, the authors find the first pillar of the monetary strategy to be flawed beyond repair, both theoretically and empirically. Continuing to give money a special role in inflation forecasting will only serve to undermine ECB credibility unnecessarily.

*Surviving the Slowdown* also argues that the ECB should clarify which circumstances are grounds for international coordination and which are not. The fact that the ECB has already participated in coordinated activities with other leading central banks, notably in the aftermath of September 11, underlines the importance of establishing such a framework.

How would a Fed-in-Frankfurt have behaved? The Report uses the vector autoregressive (VAR) approach to examine how changes in policy that were previously unanticipated are then transmitted to macroeconomic variables. It also extracts information from the term structure of interest rates and estimates Taylor rules for monetary policy. The main finding of this analysis is that US interest rates were cut much further because the US faced a much bigger shock, not because the Fed and the ECB reacted very differently to the same circumstances.

Overall the authors support the view that until it has a longer track record of success, a clearer admission of its multi-dimensional mandate, and spends less time explaining away uninformative or perverse monetary indicators, it will be hard for the ECB to change interest rates much in advance of events, even though monetary policy takes time to work its magic.


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