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Changes in the European convergence model

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One of the fundamental goals of European integration is to provide an opportunity to less-developed member states for convergence and strengthening economic and social cohesion. Before 2008 the convergence process was impressive but the crisis is threatening its perspectives. This paper highlights some elements of the European convergence model which require more attention. It focuses on the so-called cohesion countries, the EU member states which receive support from the Cohesion Fund.[1]

Convergence record

To measure the results of the convergence, the GDP per capita is often used. It does not however express the growth in a population's welfare that is central to the meaning of convergence. Another indicator, the actual individual final consumption (including expenditures on the consumption of goods and services by households and non-profit institutions serving households and in-kind social transfers) is a more appropriate measurement for this purpose. Therefore it is worth comparing the convergence of the cohesion countries to the EU average not only in GDP (as usual) but in final consumption as well. In 1995, the contraction resulting from the economic transition came to an end in the post-socialist countries. Choosing this year as a basis for comparison, all of the cohesion countries were catching up with the EU-27 average, although to different degrees. The crisis has affected the cohesion countries' convergence towards the EU-27 average (the position of all cohesion countries worsened in 2010, with the exception of Poland and Slovakia); nevertheless, these countries were able to preserve the bulk of their convergence results. In 2011 the seven lowest-income countries were able to improve their relative position by 1-2 percentage points (Figure 1).

Threats of the global crisis

Although in 2009-2011 the growth rates in most of the new cohesion countries were again higher than the EU-15 average, they are not sufficient to provide a satisfactory pace of convergence in the future. There is a danger that the slowdown of convergence is not temporary but the beginning of a medium-term or even longer trend. The European convergence model was based on foreign capital inflows which made it possible to overcome the lack of savings in the cohesion countries. Europe is the only region where the different forms of private capital – both FDI and portfolio funds – flow from richer to poorer countries and from low-growth to high-growth countries. In the aftermath of the crisis, the external conditions of the European convergence model have been changing unfavourably. The contracting markets of the European Union do not support export-led growth in the cohesion countries, while the management of the European debt crisis and stricter financial regulation decrease the capital available. Financial markets' risk evaluations may remain higher, even for those cohesion countries that are not affected by more severe financial difficulties. Due to the indebtedness of households and governments, the diminishing external resources and markets may not substitute for domestic resources and markets even if the domestic saving rates increase.

The crisis has highlighted the vulnerability of the convergence model implying the dependence on foreign capital. Some experts made several policy suggestions to reorient the European convergence model. They argue that a reduction in the private sector savings-investment gap is unavoidable. This may lead to the repression of domestic demand. A sustained re-launch of growth requires a more efficient use of domestic savings than in the past.

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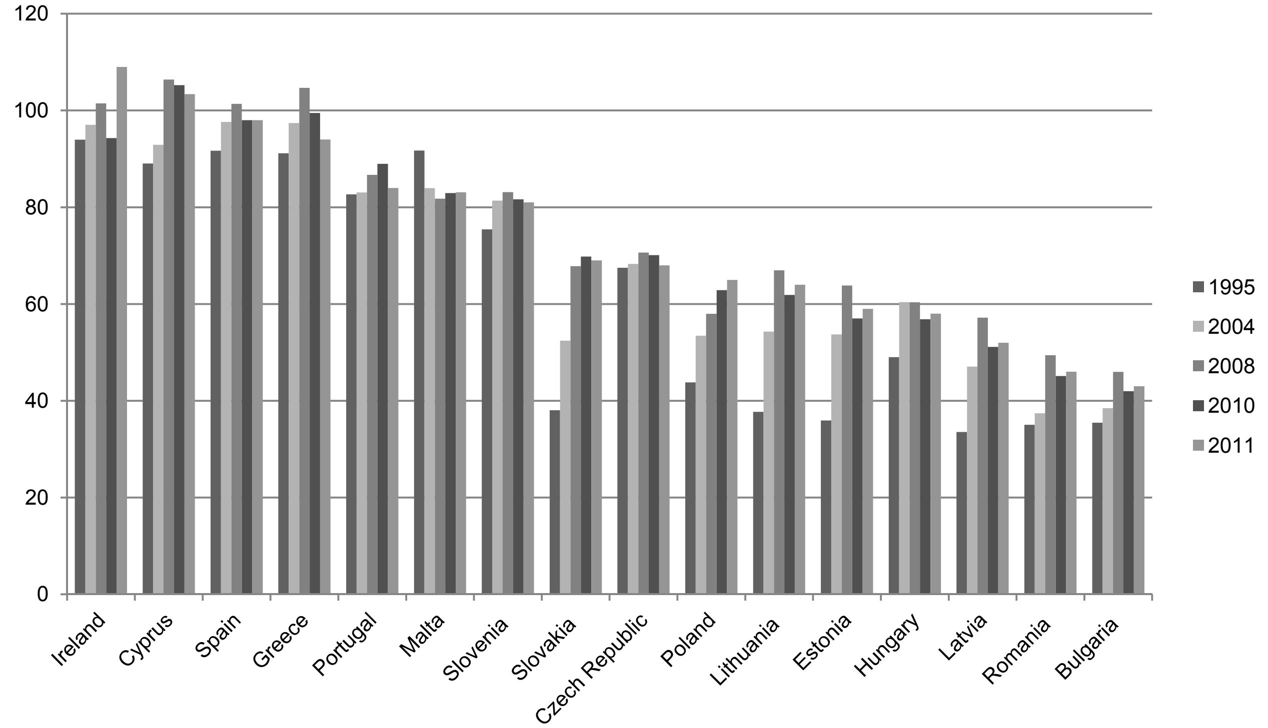
[1] The 'old' cohesion countries are Ireland, Greece, Portugal and Spain, the 'new' ones are Bulgaria, Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovakia and Slovenia.

Figure 1

Per capita individual final consumption at purchasing power parity in the cohesion countries (EU-27 = 100)



Source: Author's calculation based on AMECO database.

Limits of the European convergence model

There are further aspects of the European convergence model that should be taken into account. In theory, FDI can play an enhancing role in productivity growth directly (through investment) and indirectly (through spill-over effects). Both channels work in the cohesion countries but the experience of two decades suggests that the FDI-based modernization has its limits.

It may be instructive to have a look at the quite recent experience of Continental and Northern Europe. After the collapse of communism, companies located in Continental and Northern Europe successfully adapted to the new conditions. These companies located their assembly activities in Central and Eastern Europe, taking advantage of lower wages. Thus their flexibility in offshoring could strengthen the competitiveness of Central and Eastern Europe. The region could integrate not only within the EU but also within the world economy through increased investment and productivity.[2] However, does this type of FDI-based convergence model ensure long-run convergence? Although there are possibilities of upgrading along the value chain, there is no reason to assume that foreign companies will abandon their key positions in innovation, technology development and strategic decision-making.[3] It seems to be much more

2 In the new cohesion countries, the main form of foreign capital was FDI, while the old cohesion countries attracted portfolio and other capital inflows. According to Gill and Raiser (2012), the reason for the difficult situation in Southern Europe is that these countries did not participate in the value chain reconfiguration from the late 1990s and that they have few global companies. Moreover, the Central European countries were the primary beneficiaries of rapid technology transfer; here the FDI went into manufacturing, which is a tradable sector. In the Baltic states, Bulgaria and Romania, the FDI was biased in favour of banking, real estate and other non-tradable sectors.

3 The European Competitiveness Report points out: "Despite high levels of internalization in the EU-12, the bulk of foreign-owned R&D and innovation activity takes place between EU-15 member states' (European Commission, 2010b).

likely that the current labour and production division will essentially be reproduced.

Another possibility to increase the growth potential through FDI could be that spill-over effects help domestic companies to foster competitiveness that could accelerate the catching-up process. However, the literature on FDI spill-overs suggests unambiguously positive productivity effects in the case of vertical linkages. In these linkages the domestic firms occupy the dependent position in these relationships. The horizontal spill-over effects seem to be weak in the overwhelming majority of empirical investigations (Gorodnichenko et al., 2007; Hanousek et al., 2010).[4]

Due to the low initial GDP levels in the cohesion countries, the European convergence model provided sufficient space for the cohesion countries to develop – as long as growth in the Old EU remained relatively strong. If the crisis had not occurred, the poorer countries could have further developed within the framework of that model, even if the development would have been concentrated in the areas that had attracted foreign capital (typically the capital cities and their agglomerations).

However, it is remarkable that the Czech Republic, which had one of the highest initial GDP levels in Central and Eastern Europe and followed a very balanced fiscal and economic policy, did not converge towards the EU-27 average in final consumption between 1995 and 2011 (Figure 1). Slovenia, with its higher initial GDP level, has achieved greater convergence but it has always chosen different means, focusing on the domestic economy and had in the meantime accumulated imbalances prior to the crisis.

The Irish economic development is also instructive as regards the FDI-based modernization. A state agency, the Industrial Development Authority, was very successful at identifying emerging sectors and in attracting multinational companies in those sectors to Ireland. Since the Culliton Report in 1992 the Irish government has striven for a 'holistic approach' to industrial development policy, perhaps the most consciously among the cohesion countries. This meant that they tried to eliminate the serious dichotomy that existed between domestic and foreign-owned firms. The Irish economic development policy was successful; many domestic SMEs grew from the foreign-owned firms through linkages and spill-overs, mainly in the software industry (Andreosso-O'Callaghan and Lenihan, 2006; Barry and Bergin, 2012). Despite these results, labour productivity was still higher in foreign-owned enterprises in every manufacturing industry in 2006. In Ireland foreign firms are highly concentrated in large and high-tech manufacturing activities even after a twenty-year catching-up process. In Sweden, foreign firms are more evenly distributed across manufacturing and services and domestic firms control the highly export-oriented and technology-based engineering sector (Andreosso-O'Callaghan and Lenihan, 2010).

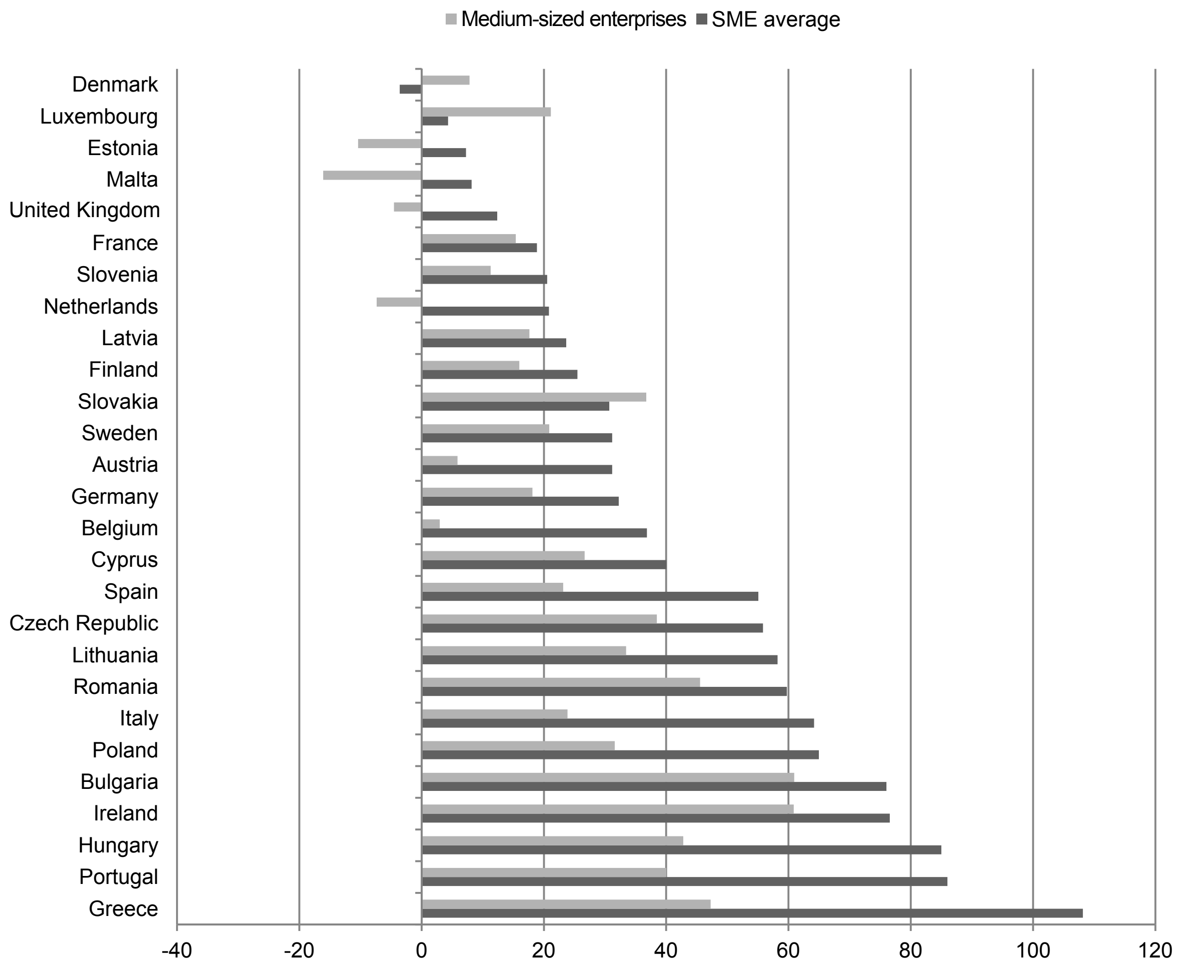
We could not find complete data on the productivity difference between foreign-owned and domestic firms across EU member states. However, the foreign-owned enterprises typically belong to large companies not only in Ireland but in the cohesion countries in general. We can use therefore the labour productivity difference between large companies and SMEs as a rough proxy to the productivity difference between foreign-owned and domestic firms. Figure 2 shows that the difference between large firms and SMEs is small in five cohesion countries: Estonia, Malta, Slovenia, Latvia and Slovakia. In the case of Estonia, Latvia and Malta, the large companies' contribution to GDP is far below the EU average as the FDI went rather to the non-tradable service sector.[5] Slovenia and Slovakia are the only cohesion countries where the large companies and manufacturing contribute to GDP substantially and the productivity difference between the large firms and SMEs is at the level of North-Western EU member states. In the other

4 Both studies provide a comprehensive overview of the literature concerning spill-over effects in emerging Europe.

5 In Estonia and Latvia, the FDI thereby fuelled an unsustainable boom and contributed to the development of housing bubbles.

Figure 2

Labour productivity difference between large enterprises, medium-size enterprises and SMEs in per cent of labour productivity of large enterprises, 2007



Note: Labour productivity is measured by gross value added per employed person.

Source: Author's calculation based on Wymenga et al. (2011).

cohesion countries and Italy the difference is far beyond 40 percentage points. In most cases, the productivity of medium-sized enterprises shows a similar trend but the degree of difference is smaller.[6]

Conclusions

The FDI-based convergence model provided an opportunity for the cohesion countries to develop and catch up with the North-Western countries of the EU. However, this model has some limitations. The concept of a single market presumed that competition forces induce improvements of productivity throughout the economy. Nevertheless experience suggests that much larger differences between foreign-owned/large firms and domestic enterprises/SMEs persisted over decades in the majority of the cohesion countries. Abundant foreign capital inflows – in the form of FDI in Ireland and the post-socialist countries, in the form of portfolio and other investment in the Mediterranean countries – concealed this problem.

The cohesion policy supports SMEs first of all as job creators but also with their technical upgrading. However, it does not address the problems of the duality of developments observed in the cohesion

6 We chose the last year before the crisis to avoid the temporary distortion effects.

countries' economies (see Council Regulation (EC) No. 1083/2006, Regulation (EC) No. 1080/2006). The Europe 2020 strategy also does not pay any attention to this issue (European Commission, 2010a).

If foreign capital becomes scarcer, the productivity gap between foreign and domestic firms could become even wider (and so will the productivity gap between large enterprises and SMEs). In the forthcoming years, it will be even more important to promote the positive spill-over effects through a more active economic policy. The policy measures to develop a competitive domestic economy are essentially in the hands of national governments. The EU policy framework does not make it impossible to foster the domestic economy mainly through the development of SMEs. Slovakia and Slovenia seem to be successful in this field. However, the efforts of the Irish governments over decades show how difficult it is to reach long-lasting results. The support of SMEs is always on the agenda of the Hungarian governments but the results are not impressive. A general European SME support programme cannot replace the targeted approach. The competitiveness deficits of the Mediterranean countries indicate that the obstacles to the development of SMEs (e.g. restricted access to capital, rigidity of regulation etc.) are special not only in the post-socialist countries but in all cohesion countries.

A successful SME development policy is a necessary but not sufficient condition for the reduction of the productivity gap between foreign and domestic firms. We cannot avoid drawing a further conclusion from the lessons of the crisis. The crisis revealed that only countries belonging to the EU's core had internationally competitive domestic companies. Ireland has the better chance to restore its position due to its geographic location, small size and the well-embedded market institutions. But the Mediterranean countries have diverged from the EU-27 average both in GDP and final consumption for some years and they have slipped out of the core countries. Finland was the last country to carry out a modernization which led to an economy based not only on internationally competitive foreign-owned but also domestic companies. However, the recipes of the 1970s and 1980s can no longer be applied either within or outside the EU. The question of an adequate economic development policy in the cohesion countries beyond SME support was not raised in the period of affluent foreign capital inflows. Now, we cannot avoid it anymore.

The modification of the current convergence model is a serious challenge for European integration. We cannot assume that all economies will adapt themselves successfully to the new circumstances and the convergence will return to its former speed. The coming years make some changes in the concept of integration necessary. The European Union must take efforts to maintain cohesion because a certain degree of inequality leads to disintegration. If the speed of convergence remains a measure of the success of integration, as was the case in the past decades, the EU will doom itself. It is a further question how the populations accept this new period because the perspectives of quick convergence was the most attractive element and the main legitimating basis of EU membership in the cohesion countries.

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