

Is Slovakia the Next Portugal?
A Comment on “Is Poland the Next Spain?”
by Francesco Caselli and Silvana Tenreyo

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Jeffrey A. Frankel

Is Poland the next Spain? In this title, Poland stands for all the countries of Central and Eastern Europe that are joining the European Union, and Spain stands for countries in Southern Europe that joined in the 1970s and early 1980s. The authors look at the successful economic convergence of the Southerners, as a guide to the current prospects of the Easterners. Although they are not the first to make the analogy, their updated perspective on the numbers is indeed a useful contribution.

The first question that occurred to me when I saw the title was: why Poland, in particular, and why Spain? Perhaps it is because they are both Catholic. After all, the authors pronounce Ireland an honorary member of the latter group (“a Southerner in spirit”). Or is that they both have provinces named Galicia? More likely, Poland and Spain are singled out in the title merely because they are the representatives of their respective groups that have the largest populations. It could as easily have been “Is Slovakia the next Portugal?” Country size is a topic to which I will return below.

European convergence over the last half-century is indeed a remarkable phenomenon, compared to the experience of other continents, most dramatically Africa, and compared to the conspicuous absence of unconditional global convergence. Ideally, one’s explanation for how the southerners closed much of the gap with the northerners – or explanations, because a multiplicity of causes is likely – would include an explanation as to why similar convergence has failed to take place elsewhere.

The paper is built around four possible theories.

1. *Solow neoclassical theory*. The driving force here is accumulation of capital: both physical capital and human capital. The argument is that poor countries have low capital/labor ratios, which – in a well-functioning market system -- implies high marginal product of capital; the high return to capital stimulates high investment, and thus leads to catch-up. The investment can be funded by either domestic saving (if the saving rate responds positively to the return on capital) or borrowing from abroad (under conditions of capital mobility).
2. *Endogenous growth theory*. The driving force here is technical catch-up as measured by Total Factor Productivity. One would think it would be easier for the followers to emulate technological innovations and management practices among the frontier leaders, say the United Kingdom and Germany, than it was for the latter to develop the new techniques and best practices in the first place.

3. *Classical trade theory.* The driving force here is international integration allowing each country to exploit its comparative advantage. All participants should reap gains from trade, so one might ask why the Southern or Eastern latecomers would benefit more than the Northern leaders. The authors have a good answer. The southerners and easterners initially had higher levels of protection and smaller economies. Those are actually two reasons to expect that the gains in their real incomes from the process of economic integration would be greater than the gains among the northerners – though classical trade theory (which is implicitly what the authors have in mind) has little to say about the role that size plays in gains from trade.
4. *Structural transformation.* The driving force here is re-allocation of resources from low-productivity sectors to high-productivity sectors. The authors give agriculture as the leading example of a low-productivity sector. If I were writing this paper, I might have given the point even more emphasis by specifying that the fourth theory is specifically rural-urban migration, which has played such a large role in the growth experiences of so many developing countries. China today is the biggest example. The economic development literature includes among the explanations for low rural productivity the following factors: hidden unemployment in the countryside, a relatively low share of economic activity that is monetized and marketized, high transportation costs, and absence of economies of scale, scope and agglomeration (almost by definition: agglomeration is a city).

After a lot of intensive work decomposing productivity, Caselli and Tenreyo find that capital accumulation, TFP and structural transformation all played major roles in the convergence of the Southern European countries toward Northern income levels, and are likely to do so again in the case of Eastern Europe. There are only two losers on the list of hypothesized factors. Human capital does not play a big role in their convergence calculations, in the case of the Southerners because there has been no decline over time in the gap vis-a-vis the Northerners, and in the case of the Easterners because there isn't a large gap to start with. The other big loser in the authors' telling is trade. They largely write off trade. But I am not sure this is an option.

If I were writing the paper, I would also make a fundamental change in the list of theories for continental convergence. I would replace trade in the number 3 slot on the list with the role of size, and would instead put trade in an over-arching fifth (or first) category called economic integration. To see why, let us pause to consider why we are asking these questions about European convergence in the first place. Is it just a coincidence if convergence takes place within a particular geographical area, rather than among a random selection of countries? And why Europe; why not other parts of the world? Perhaps the topic is simply the sources of growth, and it is a matter of data availability or the traditional European focus of the International Seminar of Macroeconomics. But I don't think so. I think the main reason why the question of European convergence arises is that the southern European countries emerged from relative isolation in the 1970s, first by political revolutions that removed right-wing dictatorships and then by accession to the European Union (which was then the European Economic Community). That is the reason for the analogy with the Central and Eastern

Europeans. They similarly escaped from the Soviet bloc, that is to say, left-wing dictatorships, 15 years ago, and are now joining the European Union (8 of them on May 1, 2004, along with the two Mediterranean island countries).

One could usefully talk about each of the four influences on real per capita incomes – capital accumulation, TFP, size, and rural-urban migration – even in an autarkic economy. But my suggestion would be that the most interesting question is whether economic integration, i.e., particularly the removal of barriers to cross-border trade and investment, accelerates these four influences, and how much. In the case of capital accumulation, the main channel would be capital inflows, allowing the capital stock to adjust gradually in response to a high rate of return (the evidence on the responsiveness of saving rates being rather meager).

In the case of TFP, the argument that openness to exports and imports speeds the process whereby followers are able to absorb and emulate the frontier technologies and best practices of its more advanced trading partners, as in the writings of Grossman and Helpman (1991). Indeed, one of the many attractions of the New Trade Theory is that it is capable of explaining why opening to trade can boost growth permanently, or at least for a long time, whereas traditional classical trade theory predicts only a one-time increase in real incomes.

In the case of size, trade is the only route other than immigration or territorial expansion available to countries like Slovakia or Portugal to overcome the disadvantages of having been born small and reach larger markets. Here too, it is useful to broaden one's interpretation of trade beyond the classical theory of comparative advantage to include New Trade Theory: the notion of having too small an internal market does not arise until one assumes increasing returns to scale in production and love for variety in consumption. (To be sure, it ought to be possible to fashion a supplement to Heckscher-Ohlin theory in which the geographical distribution of factor endowments, including natural resources, occurs randomly but unevenly, with the result that small countries like Singapore or Luxembourg are highly dependent on trade, while large countries like the United States already have most of what they need within their own borders. I wonder if anyone has done this.)

Finally, in the case of structural transformation, such as from agriculture to manufacturing and services, here again international trade can help drive the process. As the authors point out classical comparative advantage implies structural divergence, as each country specializes in whatever it does best. The authors are held up by the fact that, despite large agricultural sectors, which really large means rural populations, productivity has historically been low in the agriculture of Southern and Eastern Europe. That these countries typically respond to the opening of their economies by importing food rather than exporting it suggests that they probably do not have a comparative advantage in agriculture. For the authors the trade theory is rejected, in favor of what they see as the competing structural transformation theory. But why does comparative advantage have to lie in the sector that was larger before the opening? I suppose a pure form of classical trade theory would suggest that if one country in autarky has a larger agricultural sector than another, it has a comparative advantage. But looking at the size of sectors before trade is not as reliable a guide as looking at relative prices, or looking at the patterns of production and exports after the opening has occurred. On the list of

advantages of international trade is that it helps compete away monopoly power and the rents of politically well-connected sectors. In countries that don't have a comparative advantage in agriculture, trade means shifting away from this sector. The result is to raise overall productivity. For example, if coddled farmers in Korea and India ever give up their subsidies and protection, it will probably be under pressure of the global trading system. Again it may be necessary to take a broader view of trade theory than classical perfect competition. (The authors recognize in footnotes 4 and 16 that they may be leaving out a lot when they limit their use of trade theory to classical comparative advantage.ⁱ)

In the case of Europe, there is an extra twist. Joining the EU does not of course mean free trade in agriculture; rather it means joining the protectionist and distortionary Common Agricultural Policy (CAP). So when Ireland, Denmark and the United Kingdom joined the European Community, it did not imply liberalization of agriculture. Nor Greece, Spain and Portugal. But their unilateral protection of agriculture had been high previously. Three latecomers to the European Union -- Austria, Finland, and Sweden -- were leaving the European Free Trade Association, which is even more protectionist than the CAP. More relevantly for this paper, those who come later do not share equally in the CAP handouts. Poland and other recent joiners in the East will not get proportionately the same transfers that France gets. One reason is that it would be too expensive, busting the budget. Another reason is that in terms of the balance of political power, these small latecomers want to join and are not in a strong enough bargaining position to demand large transfers. The twist is that by denying the newcomers large agricultural subsidies, the European Union is probably doing them a favor. An economy that depends on subsidies is likely to be less dynamic than one that has to figure out how to compete in international markets. More specifically, the pattern of rural-urban migration that has played an important role in stimulating economic development in other countries may be stunted by agricultural subsidies.

The paper reveals a major problem in the otherwise-satisfying story of economic integration accelerating all four channels of convergence in Europe. The timing is rather far off, at least for some of the countries. Most of the catch-up by the Southerners, particularly Greece and Spain came before 1975, even though they did not accede until five and ten years later, respectively. Indeed, the catch-up seems to go into reverse in 1975-2000, which is the period of accession to the EU. Portugal and Ireland fit the expected pattern somewhat better.

Statistics on bilateral trade, whether in the form of simple shares of trade or more sophisticated gravity models that control for geographical determinants, tend to show that the effects of regional trading arrangements are statistically significant, but they do not arise suddenly in the year that an FTA is formed or that countries of interest join. Rather, trade evolves more gradually. The effects of membership in an FTA or common market develop with long lags.ⁱⁱ Some of the response comes ahead of the date that the arrangement goes into effect, as firms invest in new markets or new production facilities in anticipation of the coming integration. It is worth looking to see if trade patterns in the Southern European countries shifted ahead of formal accession to the EU, and if the same has been happening in Central and Eastern Europe in recent years. Despite the many

econometric studies of the effects of the EU on bilateral trade, the verdict is surprisingly mixed. (In Frankel, 1997, Chapter 5.1, I survey the gravity-based findings of others and of my own research on this topic as well.) Of course European countries trade a lot with each other. But until 1980 this intra-regional trade is fully explained – more-than-fully explained, in some studies – by other standard variables: per capita income, common borders, and common languages. Only in 1985 and thereafter does membership in the EU-15 appear to have a statistically significant independent effect. This is consistent with the accession of the three new members, Spain, Greece and Portugal, during 1981-86. Looking at *changes* in trade give the same message, though the impact on trade flows is a rather weak 30%. Estimates on disaggregated data show that the impact of the EU is stronger, and starts a bit earlier, in the cases of manufactured goods (first significant in 1980) and agriculture (earlier) than for other categories.

The awkwardness remains. Caselli and Tenreyo find that most of the catch-up occurs pre-1975, especially in Greece and Spain, and if anything there is something of a reversal subsequently. So shifts in trade patterns that begin around 1980 are no help at all. Moreover we think of these countries as having been isolated dictatorships until their revolutions, which happened to occur precisely in 1974 [CHECK]. The timing could hardly be worse.

There seems little alternative to trade and other forms of international integration (including investment, emigration, and communication) as the drivers of convergence. Otherwise, why these countries and this half-century, as opposed to some other grouping of countries or some other century?

The trade story for Southern Europe may not be quite that bad. The chronological fit for Portugal and Ireland is considerably better for Spain and Greece. The most intriguing possibility is the hypothesis that when Greece joined the EU in 1980 it was flooded with transfers that may have delayed structural and macroeconomic adjustment. It would be worth extending the authors' sample period to look at 2000-2004, a period when Greece undertook some long-needed economic reforms, with the goal of acceding to European Economic and Monetary Union, and did achieve some pay-off.

The trade story for Central and Eastern Europe is likely to be more straightforward. A substantial reallocation of trade patterns away from the old Soviet bloc partners and toward Western Europe had already taken place before any of these countries acceded in May 2004. Trade links with euroland have risen over the last decade, as trade that had for half a century or more been distorted by enforced dependence on the Soviet Union reverted to more natural patterns. CEE countries now trade roughly as much with euroland as the countries of euroland trade with each other -- even more, in the case of the westernmost countries: Hungary, Poland, Czech Republic, Slovenia and Slovakia.ⁱⁱⁱ This integration is likely to promote convergence of Eastern Europe with western Europe through many or all the channels enumerated by Caselli and Tenreyo. They tend to be more like Slovakia than like Poland or Spain – small, and in half the cases landlocked – so that the spur from policy-driven integration may be necessary to overcome natural barriers to trade.

Furthermore, they are likely to escape some of the possible negative influences of joining the EU. As already noted, they will not receive large transfers to their farmers in the same proportions as earlier joiners. Furthermore, countries like Slovakia are now finding it possible to leap-frog Western institutions, achieving reforms in taxation and

other areas that Western economists can only dream of. This is because politics and institutions are in flux in the East. Brussels is not particularly a spur to these reforms. But the awareness of the need to be able to compete internationally is.

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ⁱ "new trade theories not grounded in comparative advantage...do not necessarily predict that integration leads to structural divergence." Perhaps one would go beyond this and say that some of New Trade Theory could predict that integration leads to structural convergence.

ⁱⁱ E.g., Eichengreen and Irwin (1998).

ⁱⁱⁱ Darvas and Szapary (2003, Fig. 6); Backe and Thimann (2004, Charts 2.1 and 2.2), who find that the CEE countries are now more open *and* more EU-oriented than the traditional members of the EU themselves, which has actually fallen from 1995-2002, especially in Greece; and Boeri (2004, Figure 1).