<u>Discussion</u>

Real convergence, FDI drivers and the question of EU-induced growth

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LSEE
Research on South Eastern Europe

The two papers

Real convergence in CESEE
(Zuk and Savelin)

➢ **What the paper does**
- ➢ **Patterns of convergence (and comparative performance)**
- ➢ **Sources of growth – Challenges for growth**
- ➢ **Descriptives – growth accounting – growth regressions**

➢ **Why is it important**
- ➢ **Nature of the problem**
  - ➢ **Integration => inflation (Balassa-Samuelson; "end of Feldstein–Horioka puzzle")**
    - ➢ **Fixed currency: low real i-rates => bubbles / volatility**
    - ➢ **Fixed pegs: high nominal i-rates => constrained investment**
- ➢ **The wider relevance**
  - ➢ **Convergence per se**
  - ➢ **Political legitimacy**
  - ➢ **Functioning of SEM/EMU**
  - ➢ **Middle-income trap**

Real convergence in CESEE
(Zuk and Savelin)

➤ **General empirics**

  ➤ **An optimistic pic of convergence, albeit with group variation**

  ➤ **Convergence slower post-crisis / slower for non-EU countries**

    → *Shows relevance of EU market / anchor / association*

    → *Useful exercise for when convergence may be achieved*

➤ **Growth accounting**

  ➤ **Mainly TFP, then capital, then labour**

    → *'Intensive' margin: hence, no middle-income trap?*

  ➤ **But subsiding with crisis in non-EU**

    → *K as main driver, but still low – and low savings*

  ➤ **Raises role of FDI (for accumulation – K; and spillovers – TFP)**

    → *But also possible costs of speculative FDI for volatility*

Real convergence in CESEE
(Zuk and Savelin)

➢ **Growth drivers – review**

    ➢ **Capital/investment and demographics/migration**

    ➢ **TFP**

➢ **Economic structure**	**– agriculture; reallocation**
➢ **Human capital**	**– formal high; but skill gaps / low quality**
➢ **Openness/competitiveness/innovation**	**– below capacity (esp. non-EU)**
➢ **Institutional quality**	**– some back-tracking post-accession**

➢ **Growth drivers – regressions**

    ➢ **Convergence confirmed & unit elasticity for EZ growth**

        → *Shows importance of EU anchor / market size / demand*

    ➢ **Positive for FDI and investment**

    ➢ **Negative for debt and credit**

    ➢ **Weak for innovation and institutions**

        → *Calls for shift in growth model; but also questions Inno & Inst??*

FDI drivers in Europe
(Stojkov and Warin)

➢ **What the paper does**
- ➢ **A useful review of theoretical arguments on gravity**
- ➢ **Useful discussion about effects/types of FDI**
  - ➢ **But distinctions (e.g., horizontal-vertical) not followed in the empirics**
- ➢ **Utilisation of a range of estimation methods**
  - ➢ **Adds credibility and helps address known problems**
- ➢ **Examines the role of 'core' (global/trade) variables as well as**
  - ➢ **variables relating to EMU / Maasstricht (debt, deficits, i-rates)**
  - ➢ **variables relating to institutional quality/convergence**
- ➢ **Looks at variations between pre- / post-crisis periods**
  - ➢ **Did the crisis annul the benefits from EMU?**

➢ **Why is it important**
- ➢ **FDI as a key driver of growth (see Zuk and Savelin)**
- ➢ **Integration / EU as a key 'anchor' (see also later)**

FDI drivers in Europe
(Stojkov and Warin)

- ➤ **Overall results**
  - ➤ **'Gravity' effects confirmed – market size and distance**
  - ➤ **Importance of market similarity (+) and relative endowment (-)**
    - → *'Global' variables matter; but endowment is counter-intuitive?*
  - ➤ **'Maastricht' variables less robust/strong**
    - → *But generally monet convergence boosting bilateral FDI flows*
  - ➤ **EMU effect is significant**
    - → *Approx. 25% boost to FDI flows – robust to 'selection'*
    - → *But note: mitigated by market size / similarity and debt*

- ➤ **Consistency checks**
  - ➤ **Significant subsiding of EMU effect post-crisis**
    - → *But not fully annulled*
  - ➤ **FDI premium strongest for GRE, GER, CY, NL, ESP, IRE…**
  - ➤ **Result survives when controlling for 'institutional convergence'**

Discussion

Discussion

Process	Convergence / growth	Integration / FDI premium
The EU anchor	EU 'causes' convergence	EMU 'causes' FDI
Heterogeneity	Slower for SEE / non-EU	Stronger for PIGS + GER(?)
Crisis / post-accession	Slowdown of convergence?	Subsiding of FDI premium?

➢ **Some further points**
- ➢ **External sustainability (CA) and vulnerabilities (NFA)**
  - ➢ **Monastiriotis and Tunali (2016), LEQS**
- ➢ **Institutional approximation and FDI spillovers**
  - ➢ **Monastiriotis (2016), Env & Planning C**
- ➢ **Accession and (regional) growth**
  - ➢ **Monastiriotis et al (2017), Reg'l Studies**

➢ **On the question of institutions and EU-induced growth**

Further points – external sustainability

Table 5. Unit root and error-correction results, full period

Country	Variable	Unit root analysis			Error correction model	
		Optimal Break Point	Break point coefficient	Clemente-Montanes-Reyes test	Long-run coefficient	Error-correction coefficient
Belarus	NFA	2009q2	-1.0862***	-2.060	0.06514	-0.73576**
	CA	2007q3	-0.0641***	-4.538**	(0.0583)	(0.3124)
Bulgaria	NFA	2010q3	-1.4287***	-1.169	0.34761*	-0.16632**
	CA	2010q1	0.1052***	-1.843	(0.1898)	(0.0780)
Croatia	NFA	2005q4	-2.1050***	-2.769	-0.00158	-0.88285***
	CA	2009q2	0.0424***	-5.757**	(0.0045)	(0.1408)
Cyprus	NFA	2009q2	-2.6444***	-1.524	0.01259	-0.62364**
	CA	2008q4	0.0066	-4.410**	(0.0077)	(0.2256)
Czech Rep.	NFA	2007q3	-0.9263***	-3.153	0.02420**	-0.51311***
	CA	2004q1	0.0264***	-4.206**	(0.0099)	(0.1358)
Greece	NFA	2005q3	-1.5240***	-2.533	-0.00117	-0.17675
	CA	2011q3	0.0569***	-1.870	(0.0226)	(0.1840)
Hungary	NFA	2004q4	-1.1556***	-3.759**	0.04345	-0.15784
	CA	2009q2	0.08270***	-4.328**	(0.0363)	(0.1195)
Moldova	NFA	2003q3	1.6188***	-3.825**	0.19096***	-0.37667***
	CA	2005q2	-0.0827***	-1.893	(0.0689)	(0.1049)
Poland	NFA	2009q2	-0.7785***	-1.551	0.01036	-0.36622*
	CA	2005q4	-0.01608***	-3.087	(0.0201)	(0.1850)
Romania	NFA	2009q2	-1.3588***	-1.128	0.03511	-0.10719
	CA	2009q3	0.0280**	-2.463	(0.1149)	(0.1019)
Slovakia	NFA	2006q2	-0.8823***	-2.826	0.03373	-0.35238**
	CA	2011q1	0.05602***	-4.145**	(0.0268)	(0.1584)
Slovenia	NFA	2009q2	-1.1041***	-2.174	0.01197	-0.34817**
	CA	2011q3	0.0445***	-2.663	(0.0097)	(0.1582)
Turkey	NFA	2010q3	-0.3480***	-3.511	-0.03750**	-0.52150***
	CA	2004q2	-0.0326***	-2.585	(0.0162)	(0.1683)
Ukraine	NFA	2009q2	-0.4684**	-3.700**	0.03988	-0.36808**
	CA	2005q4	-0.1113***	-2.756	(0.0378)	(0.1442)

Notes: All series are seasonally adjusted by using Census X12 additive method. ***, **, * denotes the significance at 1%, 5% and 10% levels respectively. Standard errors are in parentheses.

Further points – FDI spillovers

## Figure 1. Estimated foreign ownership spillovers by region of origin and destination
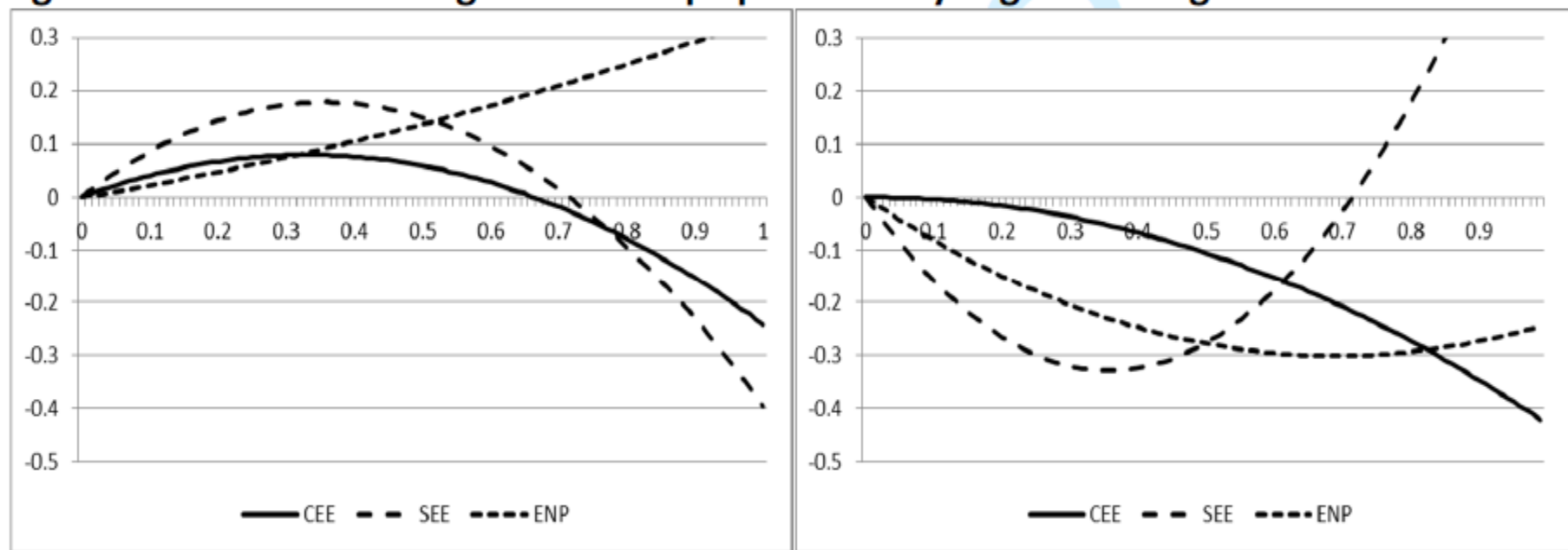
(a) EU ownership (b) Non-EU ownership

Note: Estimated total effects of foreign ownership (sectoral share of foreign-owned firms) on domestic firms' productivity (vertical axis) across different shares of ownership (horizontal axis), by origin of foreign investors and region of destination – derived from cols 7-9 of Table 1.

Note: Estimated total effects of foreign ownership on domestic firms' productivity (vertical axis) across different shares of foreign concentration (horizontal axis), by origin of foreign investors – derived from cols 2-3 of Table 2.
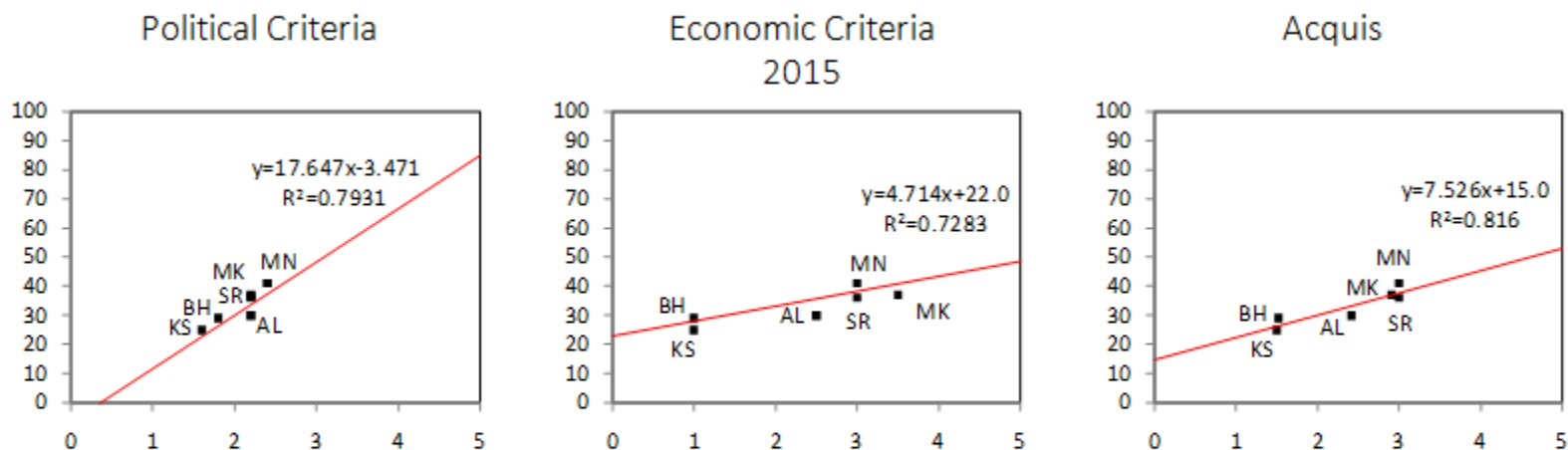
Further points – accession and growth

Predictive Margins of periods with 95% CIs
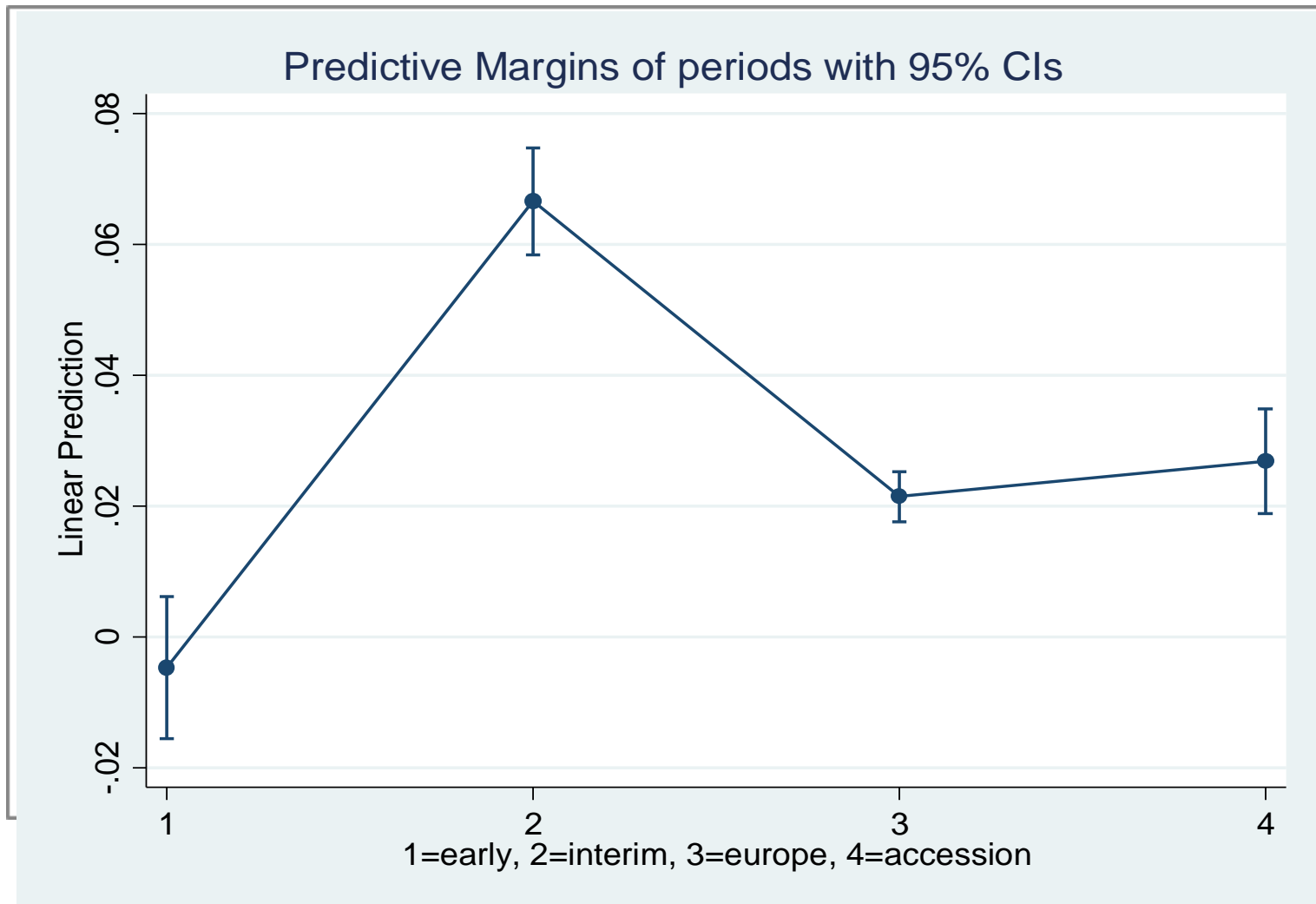
Institutions and EU-induced growth

➢ **Some evidence** (Besimi and Monastiriotis, *in progress*)

Figure 3. Copenhagen convergence criteria and GDP per capita as a share of EU-28 average

Readiness (horizontal axis): 1 –early stage; 2 - satisfactory; 3 - moderate; 4 - good;5 – advanced
GDP per capita (PPS) as a share of EU-28 average (Vertical axis)
Red line represents the simple linear regresion with dependent variable: GDP p.c.as % of EU-28 average

Source: Author's illustration basen on European Commission (2015a, 2015b, 2016a & 2016b) & Eurostat

➢ **Q: if approximation (political, less so economic/institutional) raises devt/growth, what explains the reform slowness?**

Institutions and EU-induced growth

➢ **An explanation (Besimi and Monastiriotis, *in progress*)**

➢ **The government**
- ▪ Reform-neutral government, with pro-accession preferences (no utility from reforms, unless linked to EU – e.g., accession)
- ▪ Agrees EU reforms (r_{EU}), experiences loss if over/under-shooting
- ▪ Enjoys public support around a 'natural' level (s^*)

$$W = -a_1(r_{EU} - r)^2 - a_2(s^* - s) \tag{1}$$

→ *The government wants to set $r=r_{EU}$ and $s=s^*$ (or, $s=s^{max}$)*

➢ **The public**
- ▪ Public pro-EU but negative utility from reforms (else, trivial: infinite reforms)

$$s = s^* - \beta_1 r - \beta_2(r_{EU} - r)^2 \tag{2}$$

- ▪ β_1: intensity of public dislike for reforms (disutility from reforms)
- ▪ β_2: how public values accession (disutility if govt misses EU target)

→ *In the absence of the EU, the public prefers $r=0$ => $s=s^*$*
→ *We treat the EU (its 'desired' level of reforms) as exogenous*

Institutions and EU-induced growth

➢ **An explanation (Besimi and Monastiriotis, *in progress*)**

- ➢ **Equilibrium**
  - ▪ Insert (2) into (1), differentiate with respect to *r* and solve for *r*:

$$r = r_{EU} - \frac{a_2\beta_1}{2(\alpha_1+a_2\beta_2)} \qquad (6)$$

  → *As all parameters are positive (α_1, α_2, β_1, $\beta_2 > 0$), it follows that $r < r_{EU}$*
  → ***The optimal policy choice for the government is to 'defect'***

- ➢ **Specifically: the impossibility of full commitment**
  - ▪ Assuming full reform commitment by the govt ($r = r_{EU}$)...

$$s = s^* - \beta_1 r_{EU} - \beta_2(r_{EU} - r_{EU})^2 \Rightarrow s = s^* - \beta_1 r_{EU} \qquad (3)$$

$$W = -a_1(r_{EU} - r_{EU})^2 - a_2(s^* - s^* + \beta_1 r_{EU}) \Rightarrow W = -a_2(\beta_1 r_{EU}) \qquad (4)$$

  - ▪ ...which implies welfare loss for the govt: **s<s* and W<0**

  → *For any EU negotiations (any $r_{EU} > 0$), no govt will have the incentive to fully comply with the targets agreed with the EU: defection, or lack of commitment, is an **equilibrium outcome** (but defection may increase with EU 'strictness')*

Institutions and EU-induced growth

➢ **An explanation (Besimi and Monastiriotis, *in progress*)**

➢ **Policy predictions / implications**
  ➢ In equilibrium , the level of reforms will
    ▪ increase with α_1 (the weight the govt assigns to the accession process)
    ▪ decline with α_2 (the weight the government assigns to public support);
    ▪ decline with β_1 (the extent to which the public dislikes reforms); and
    ▪ increase with β_2 (the weight the public assigns to the accession process)

➢ **What the EU can do**
  ✓ Increase α_1 – e.g., via **socialisation**
    ▪ But note: this will not achieve full compliance; simply reduce discrepancy of r to r_{EU}
  ✓ Reduce α_2 – e.g., via **elite influence**
    ▪ As above, this will only reduce, rather than eliminate, the discrepancy b/w r and r_{EU}
    ▪ But note: making the govt more responsive to the public is politically undesirable
  ✓ Reduce β_1 – e.g., via **yardstick** and **information-sharing**
    ▪ But note: too much 'intrusion' may backfire / create anti-EU sentiment
  ✓ Increase β_2 – e.g., via better **communication** and **education**
    concerning the benefits from accession (including non-pecuniary ones)

Conclusion

Conclusion

➢ **Zuc and Savelin show that convergence is heterogeneous**
  - ➢ **The EU 'anchor' matters**
  - ➢ **Institutional proximity helps reforms** (at least just before accession)

➢ **Stojkov and Warin show that an E(M)U FDI premium exists**
  - ➢ **The EU 'anchor' matters**
  - ➢ **Beyond 'gravity', EMU matters even besides**
    - **(a) monetary convergence (Maastricht) or**
    - **(b) institutional convergence (quality of government)**

➢ **How to strengthen the 'EU anchor'?**
  - ➢ **Our own work shows that simply 'asking for more' (or for "more for more") may not be sufficient – or even optimal**
  - ➢ **Processes of socialisation, info-sharing, and education are crucial**
    - ➢ **As is the EU's (avail)ability to internalise the domestic SR costs of reforms**

Thank you

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