New Europe: What do labor and capital flows hold for its future?

The recent enlargement of the European Union (EU) ushered in not only its largest-ever group of new members but also countries with relatively low per capita incomes. Raising incomes in the new members has therefore taken on new importance within the overall goal of European integration. Indeed, the union of the capital-poor, generally low-employment new members and the higher-employment, capital-rich old members has set in motion forces driving labor migration from east to west and capital flows from west to east. To better understand these trends and the policies that will influence how they play out, the Joint Vienna Institute, the IMF Institute, the IMF's European Department, and the National Bank of Poland gathered academics and policymakers for a conference at the National Bank on January 30–31.

Concerns about potentially large labor and capital flows following EU enlargement have put pressure on policymakers to slow the process. Many old members, concerned about the displacement of domestic workers and downward pressure on wages, have restricted migration from new members. Ireland, Sweden, and the United Kingdom are the exceptions. At the same time, capital has moved to the new members through increased offshoring and other foreign direct investment.

What implications do these developments have for EU policymakers? The conference participants explored the potential size and determinants of labor and capital flows, the composition and likely effect of flows on domestic economies and the basis for concerns about them, and policy measures that could best enhance the benefits and mitigate the costs of these flows.

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At the Warsaw seminar, right to left: Dalia Grybauskaitė (European Commission), Dalia Marin (University of Munich), Karl Pichelmann (European Commission), and Michael Devereux (University of Warwick).

How large is migration likely to be?

Historical episodes of regional migration and the experience to date in the EU suggest that removing all restrictions on migration within the enlarged EU would probably elicit relatively small labor movements—especially in contrast to those flows originating outside the EU. Tito Boeri (Bocconi University) pointed out that labor flows since enlargement have been much smaller than had been projected. Flows to the United Kingdom and Ireland have been larger than to other destinations—perhaps because these countries have fewer restrictions, better labor market conditions, or more flexible institutions that have allowed labor inflows to be used better. Flows to other old members have been small. Boeri estimates that after full adjustment about 3 percent of the population of new members (or less than 1 percent of the population of old members) is likely to work at any one time in the old members. Robert Holzmann (World Bank) noted that, although such migration would have favorable economic effects on old members, it would do little to address their impending demographic problems in Europe.

Drawing on research done on migration into the United States, George Borjas (Harvard University) argued that migration would affect wages in old Europe. In the United States, immigration does not necessarily affect wages at the regional level but may have a significant impact at the national level, especially in the age and experience categories that correspond most closely to migrant inflows.

Surveys of public opinion in Europe, however, suggest that concerns about lower wages are not the dominant reason for opposition to immigration in the old members. Christian Dustmann (University College, London) found that the chief basis for popular antagonism to labor inflows was a perception that migrants would overwhelm domestic welfare systems. Transitional arrangements that limited access to these systems instead of limiting migration therefore made sense.

Capital may substitute for labor

Tim Hatton (University of Essex and Australian National University), considering the North Atlantic migration of the late 1800s and early 1900s, found that for some home countries (for example, Germany, Ireland, Italy, and the United Kingdom) labor and capital moved in the same direction; in others (Sweden and Finland), they moved in opposite directions.

Nevertheless, policy simulations suggested that capital flows to new members could greatly alleviate the need for migration. Antonio Spilimbergo (IMF), presenting the conclusions

of Poonam Gupta and Ashoka Mody (both IMF), described evidence that the lower-productivity, more labor-intensive new members would continue to attract foreign capital. This investment, through production linkages elsewhere in the country, would generate trade. The resulting demand for labor in the new members and the increasing per capita incomes could reduce the incentives for migration.

Capital flows likely to dominate

Converging institutions and substantial differences in capital and labor ratios were bound to attract huge capital inflows to new members, and restrictions on migration would accentuate this response. Substantial flows had already taken place. Philip Lane (Trinity College, Dublin) and Gian Maria Milesi-Ferretti (IMF) noted that some Central European countries had accumulated exceptionally large net external liabilities, especially equity-type flows related to foreign direct investment.

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Lajos Bokros (left, Central European University) and Marek Belka (UN Economic Commission for Europe) at the concluding panel discussion.

Luís Campos e Cunha (New University of Lisbon)—noting that in Europe, where countries have large differences in factor endowments, Mundell's classic equivalence between trade and factor flows does not hold—paved the way for a discussion of the roles of trade and investment flows. Elhanan Helpman (Harvard University) argued persuasively that, given the huge amount of global trade, wage relativities were being established in global markets. Any attempts to protect high reservation wages or reduce wage dispersion would lead to outsourcing and offshoring—whether to new members or to countries outside the EU.

Evidence from German and Austrian firms indicates that they have improved competitiveness (particularly in the face of skill shortages) by using labor inputs from new members. In this emerging "war for talent," Dalia Marin (University of Munich), Claudia Buch (University of Tübingen), and Michael Landesmann (Vienna Institute for International Economic Studies) showed that firms in the capital-rich old members are employing migrants domestically, but, to an even greater extent, they are outsourcing and offshoring intermediate inputs. These changes have been hugely beneficial: rather than precipitating job losses, they have helped firms stay afloat in extremely competitive global markets.

How should policymakers respond?

The forces at play in European integration are a localized version of the broader forces of globalization, Eric Berloff (European Bank for Reconstruction and Development) and André Sapir (Université Libre de Bruxelles) emphasized. Marek Belka (UN Economic Commission for Europe) saw enlargement as a kind of vaccine against the perils of globalization, though he also viewed it, as he did broader globalization, as a force to be welcomed rather than resisted.

The evidence presented at the conference points to the value of policies that support competitiveness in labor and product markets. The more interplay between labor and product markets across the enlarged EU, the better positioned European firms will be to compete in global markets. Michael Devereux (Warwick University) argued that tax policies could influence the amount and location of investment. But there was little enthusiasm for strict tax harmonization and some support for tax competition, which might hasten income-equalizing capital flows.

Another critical question was the potential for vulnerabilities in the new members as they attracted capital inflows. Several participants downplayed the potential volatility of capital inflows, noting that they were driven predominantly by long-term investment decisions. Leslie Lipschitz (IMF), however, argued that substantial capital inflows intrinsically entailed vulnerabilities. Lajos Bokros (Central European University, Budapest) agreed, noting that the legacy of consumer goods shortages during central planning and rapid increases in permanent incomes were likely to make the new members low savers and dependent on foreign savings for some time.

For new member countries with fixed exchange rates, strong capital inflows would mean substantial increases in liquidity, bank credit, external liabilities, foreign exchange exposure, and current account deficits—alongside rapid growth. For the countries with flexible exchange rates, inflows could strengthen currencies, dampen competitiveness, and reduce profitability, investment, and growth. Good policies could lessen but not eliminate these capital flow–related problems. Susan Schadler (IMF) stressed that new members will need to pursue policies that allow them to adopt the euro, which offers substantially improved trade linkages between new and old members and eliminates currency-related vulnerabilities. ■

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