# Master's Thesis

# *European Economic Integration and Countries in Transition: Lessons from Portugal*

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*This Master's thesis is dedicated to the memory of Václav Havel (1936 – 2011).*

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## ABSTRACT

Portugal was the least developed country to join the European Communities before the Eastern enlargement. Its economy was characterized by weak commercial ties to Europe, a large agricultural sector employing more than one fourth of the labor force, lacking infrastructure and capital-intensive industries, and having a high illiteracy rate. Integration into the Communities influenced the transformation of Portugal into a modern market economy through three different channels. Firstly, the liberalization brought about by the common market attracted important foreign investments, induced domestic investment activity, promoted the competitiveness of light industries, and consolidated trade relations with Spain. Secondly, the modernization of sectors governed by the specific national or European policies (agriculture, fisheries, banking), was largely affected by the capabilities of the Portuguese administration. Thirdly, the EC Cohesion Policy contributed largely to the convergence with other Member States, but did not eliminate the regional disparities inside of Portugal. Most of the findings regarding the effects of the European economic integration prove to be applicable also in case of the Czech Republic and Hungary, undergoing their transformation and Europeanization two decades later.

Keywords: Portugal, Czech Republic, Hungary, European integration, economic transformations, Europeanization, EU enlargement.

JEL Classification: F11, F15, F21, N14, P20.

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| CAP | Common Agriculture Policy |
| CEEC | Central and Eastern European Countries |
| CFP | Common Fisheries Policy |
| COMECOM | Council for Mutual Economic Assistance |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Communities |
| ECU | European Currency Unit |
| EEC | European Economic Community |
| EFTA | European Free Trade Area |
| EU | European Union |
| EU15 | European Union with 15 Member States (1995 – 2004) |
| EU28 | European Union with 28 Member States (after 2013) |
| EUR | Euro |
| FAO | Food and Agriculture Organization of the United Nations |
| FDI | Foreign Direct Investment |
| GDP | Gross Domestic Product |
| GNI | Gross National Income |
| INP | Instituto Nacional de Estatística |
| NATO | North Atlantic Treaty Organization |
| NGO | Non-governmental organization |
| OECD | Organization for Economic Co-operation and Development |
| OSCE | Organization for Security and Co-operation in Europe |
| PIGS | countries in sovereign debt crisis of the late 2000s (Portugal, Italy, Ireland, Greece, Spain) |
| UNCTAD | United Nations Conference on Trade and Development |

# INTRODUCTION

Portugal, a millennium-old nation state known throughout its modern history as the poorhouse of Western Europe, was for a long time considered to be a part of Europe by virtue of its geographical position at the westernmost tip of the continent, and because of its devotion to the Roman church, rather than for an intensive political, economic, or cultural adherence to the rest of the continent. The colonies scattered around the southern hemisphere provided the small European country with an illusion of being a global power, independent on the rest of the world. The country avoided the horrors of the two World Wars which ruined most of the continent, yet did not profit from the dynamics of the Enlightenment, Industrial Revolution, or the post-war European integration. The historical isolation gradually shaped a backward economic system with a large and inefficient agricultural sector and with a high illiteracy rate which ruled out any major technological or societal progress. Only after a democratic regime had been restored in the mid-1970s, the new elite gradually understood that an accession to the European Communities[1] would bring about more promising prospects than the colonialist political discourse.

The revolutions in Southern Europe raised similar dilemmas and questions regarding the upcoming integration of the new democracies inside the European Communities, where developed market economies profited from their advanced industrialization. Portugal, Greece, and Spain had approximately 55 million inhabitants in total, but their economies were based on obsolete foundations, and lacked some principles of the free market. Although the rift between the northern and southern economic models rested on a number of aspects, such as different legislation, the quality of the labor force, and the geographical conditions, this thesis is based on the premise that the major sources of economic underdevelopment of Southern Europe were a lack of accumulated capital and a low investment activity.

The accession of the new democracies into the European Communities therefore changed both the EC and the countries themselves. The new Member States underwent a process of Europeanization on a political, economic, legal, and a social level. Contrary to the first enlargement round, this process took place during their transition from authoritarian regimes

[1] I refer to the European Communities (EC) or to the European Economic Community (EEC) for historical events and processes commenced before 1993. The European Union is referred to only in the context of the Eastern enlargement.

into modern democratic states with open free market economies. Particularly interesting is the process of Europeanization in Portugal, the least economically advanced of the three candidate countries. This thesis therefore aims to provide an answer to the question: *what was the impact of the EC accession on the transformation of the Portuguese economy?*

The accumulation of capital, crucial for the necessary investments and the launching a qualitative economic growth, played a key role in this transformation. The economic capital, and the way it was used for the modernization of the entire Portuguese economy, therefore represents the independent variable that is analyzed in this thesis. Section 2.1.4 is an exception in this thesis because it does not focus on the main independent variable. However, the changes in the economic relations to Spain represent one of the main outcomes of the EC accession in the free trade perspective applied in the chapter 2.1., and as such need to be mentioned. Furthermore, parallels to the developments in Portugal are sought in the transformations in Central and Eastern Europe, one decade later, aiming to identify common economic patterns related to the European economic integration. The dependent variable of the case study is the successful transformation of Portugal into a modern European economy.

The first chapter of this thesis explains the research design of this thesis. At first I introduce the theoretical framework, in which I characterize the applied concepts from economics and international relations. Subsequently, I explain the methodology of my research. Finally, the key studies that influenced my research will be listed in the literature overview.

The second chapter contains the actual case study, which is segmented into three sections according to the channels of the transformative power that are considered in this study. First, I analyze the impact of the membership in the common market, in a perspective of dynamic and static effects of free trade. I also examine the influence of the EC accession on the domestic capital formation, the inflow of foreign direct investments, and the changes in the structure of Portuguese exports. In the second section I focus on the specific sectors governed by comprehensive European and domestic legislation and policies, rather than by the free market mechanisms: agriculture, fisheries, and the banking sector. Finally, I examine the direct transfers and investment enshrined in the EC Cohesion Policy in terms of their contribution to the capitalization and development of the country.

# 1. EUROPEAN TRANSITIONS: AN ANALYTICAL SCHEME

## 1.1 THEORETICAL FRAMEWORK

My research question, dedicated to the history of European integration, is approached from an economic perspective. The theoretical basis for my research employs both classical and neoclassical theories of international economics, as well as more modern concepts such as the economics of transition, and applied economics of European integration. In section 1.1.1, I will introduce the most relevant concepts for this study. Furthermore, since the European integration is a political phenomenon, section 1.1.2 will establish the theoretical framework for the dimension of international relations, based on the concept of the *Transformative Power Europe*.

### 1.1.1 ECONOMIC PERSPECTIVE

According to the *economics of transition*, the Portuguese economy should have experienced a negative growth as a result of the 1974 revolution. Fiscal difficulties, liberalization of trade with more developed countries, political instability, and demanding reforms usually undermine the short-term competitiveness of a transforming country. If elementary reforms are successful, a dynamic growth rate is restored in several years (EBRD 2000, p. 50). In Portugal, where the economy was growing rapidly under the reforms of the Marcelo Caetano government in the years preceding the Revolution of Carnations, the economy recovered as early as 1976[2]. The relatively fast recovery was probably rooted in the existing market economy basis, and the slower reform process in the following politically unstable period. An economic recession hit the country, following the second oil shock in the early 1980s. However, the second half of the decade, when the integration into the EC took place, was characterized by double-digit growth rates. None the less, it is important to bear in mind that, according to the common transition pattern, the Portuguese economy was supposed to grow even without an EC accession in the late 1980s. For this reason, we need to pay special attention to the causality between the Europeanization and the economic growth. The domestically induced investment-led growth is examined in section 2.1.1, where I will also explain the theoretical basis that I did not want to separate from the empirical part and have thus not included it into the theoretical framework.

[2] UNCTAD Statistics (2015)

The analysis of the Portuguese foreign trade employs the logic of the *classical* and *neoclassical theories* of the international economics. The difference in the availability of economic factors should to a certain extent determine the outcome of the full trade liberalization. Portugal was in the early 1980s, in relation to the EC Member States, a country poor on capital yet competitive because of the cheap labor force. According to the *Heckscher-Ohlin model*, Portugal as a member of the EC market should have specialized in the production of labor-intensive goods, while increasing its imports of the capital-intensive ones (Baldwin & Wyplosz 2012, p. 278). The specialization in trade with goods will be analyzed in section 2.1.3 for the manufacturing industry (employing the *Heckscher-Ohlin model*) and in 2.2.2 for the agricultural products (applying the theory of an *absolute advantage*). It is important to highlight the existence of certain conditions needed for the full validity of these theoretical concepts, which are in the practical functioning of the economy never fulfilled. We will therefore have to consider the impact of the foreign investments to apply this concept correctly.

Some principles of the economic geography offer different starting points. Under the *gravity model*, large and relatively nearby markets such as Spain (a special case to be elaborated on in section 2.1.4), France, and Germany, should likely become the essential trading partners. However, as far as the FDI is concerned, Krugman & Obstfeld (2009, p. 148-149) argue that more developed regions have a better chance to attract factors for their further development at the expense of the poorer ones. A comprehensive economic liberalization between the "Blue Banana[3]" countries and the periphery (including Portugal) could therefore further impoverish those standing outside of the economic heart of Europe. The inflow of private capital is examined in section 2.1.2, while 2.2 focuses on the investments related to the EC Cohesion Funds.

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[3] A frequent term in economic geography in Europe, used for the core of the European economy. It comprises a banana-shaped stretched between Northern Italy, Western Germany, and England.

### 1.1.2 INTERNATIONAL RELATIONS PERSPECTIVE

The role of the European Union on the global stage has been a subject to numerous theoretical approaches. The idea of the Union as an *"(...) economic giant, a political dwarf, and a military worm*"[4] pronounced by the late Belgian Foreign Minister Mark Eyskens short before the First Gulf War in 1991, became a renowned basis for research regarding EU's position in international security relations, highlighting the constrained capability of exercising hard power. A decade later, Ian Manners formulated the concept of the *Normative Power Europe*[5], suggesting that Europe exercises a distinct form of soft-power based influence in the global arena. And finally, Mark Leonard (2005, p. 3), a British scholar and journalist, known for his strongly pro-European stances, introduced a similar concept in his essay *Ascent of Europe*: *"Europe's obsession with legal frameworks means that it can completely transform the countries it comes into contact with, instead of just skimming the surface. The US might have changed the regime in Afghanistan, but Europe is changing all of Polish society, from its economic policies and property laws to its treatment of minorities and what gets served on the nation's tables."* The often discussed concept of the *Transformative Power of Europe* was hereby named. This theoretical concept is based exclusively on the soft power, predominantly using economic influence.

The transformative power may function on various levels and through different channels of influence. Transitions of legal systems and governance can be enhanced by interactions with the European Union, OSCE, or the Council of Europe. Social standards and human rights issues can also be considerably influenced by individual European countries or international NGOs. As far as an economic transformation is concerned, the Union plays the prime role, but the influence of multinational enterprises creating commercial ties to the Old Continent should not be ignored either (reflected in chapter 2.1). From all these different fields and channels of transformative power, this thesis focuses exclusively on the economic transition of Portugal, and considers therefore the EC/EU as the key source of this power.

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[4] New York Times (1991): *War in the Gulf: Europe; Gulf Fighting Shatters Europeans' Fragile Unity.* Online: http://www.nytimes.com/1991/01/25/world/war-in-the-gulf-europe-gulf-fighting-shatters-europeans-fragile-unity.html?pagewanted=1

[5] See Manners, I. (2002): *Normative Power Europe: A Contradiction in Terms?* JCMS: Journal of Common Market Studies. Volume 40, Issue 2. p. 235-58. Online: http://onlinelibrary.wiley.com/doi/10.1111/1468-5965.00353/pdf

For the purposes of this thesis, we have to distinguish between the two stages of the Portuguese relation to the EC in the theoretical framework. The first one covers the accession process; that is the period between 1974 and 1985. In this stage, Portugal was subject to the Transformative Power based on the conditionality the EC exercised in respect to the applicants. The second stage considered is the initial decade of the EC/EU membership, where the country's participation on the common market and European policies is scrutinized.

The first stage of the Transformative Power was characterized by large institutional and legal changes driven by the actual EC accession process. This mechanism is defined by Vachudova (2005, p. 63) who developed the concepts of a passive and an active leverage of the pre-accession process *"to separate theoretically the kinds of influence that the EU can have on credible future members. By passive leverage I mean the attraction of EU membership, and by active leverage I mean the deliberate conditionality exercised in the EU's pre-accession process."* The active leverage is based on the existence of a comprehensive enlargement policy, which aims to prepare the candidate countries, in light of the Copenhagen criteria,[6] for the eventual adhesion to the Union. However, before the introduction of these criteria, the whole accession process had lacked the official structure. The conditionality was exercised in a more individual fashion, yet on the same principle. After the revolution, the Communities sent a clear signal to Lisbon that the future support and cooperation was tied to a successful democratic transition. An intensive economic aid was indeed granted only after the first free elections in 1975 (Pinto & Teixeira 2004, p. 120). In order to capture the complexity of the problem, I use the post-Copenhagen definition of the enlargement policy by Sedelmeier (2005, p. 402): "*It is not a policy area in its own right, it is not a single-issue policy, and it does not have a single location in the policy process. Despite this, enlargement affects literally all of the EU's policy areas (...)."* This means that a candidate country must be prepared to become a full member of the Union, apply its primary and secondary legislation, participate in all common policies, and compete on the common market. To ensure an advancement in all these areas, the mechanism popularly known as *carrot and stick* is applied. Opening and closing of each chapter is rewarded by approximation to the actual accession, or by explicit financial incentives. On the other hand, a lasting non-compliance is sanctioned by a blurring prospect for the membership and cuts in economic aid (Gateva 2010, p. 10). Pursuing a compliance in all policy areas necessarily

[6] Formulated gradually between 1993 and 1995. See *Summaries of EU legislation* (2015). Online: http://europa.eu/legislation_summaries/glossary/accession_criteria_copenhague_en.htm (accesed 21/06/2015)

transforms the country per se, yet its economic impact is reflected rather in the period following the adhesion.

The second stage comprises the early years of the actual membership. The political and institutional transformation, as well as the principles of an open market economy, had already been settled before the accession. The EC/EU lost the accession conditionality as the main tool for driving the transformation in the new Member State. Especially from an economic perspective, I will argue that the EC/EU influences the new entrant mostly through two main channels, i.e. the common market and the European policies. In my case study, I distinguish between the sectorial policies concerning the functioning of different areas of the private sector, and the Cohesion Policy, which is based on a re-allocation of public finances.

The impact of the European integration on the Member States is put in a general theoretical framework by Börzel (2005), who explains that it varies across the Member States and different policy areas. The depth of this impact (Europeanization) depends on the compatibility of national norms, policies, legislation, and economic processes with the consensual model of the Community (ibid, p. 50). It is usually classified in literature in five different levels (ibid, p. 58-59) – *inertia* (absence of change), *retrenchment* (negative change), *absorption* (incorporating EU policies and law without having to change much), *accommodation* (large changes, yet fundamental principles are preserved), and the *transformation* (a replacement of the existing principles, policies, and institutions by different ones, possibly including changes of constitution; a fundamental change of macroeconomic policies etc.). This classification offers a useful theoretical framework for assessing the contribution of the European integration to the overall transition of Portugal, which I will use in the summary of each section. Eventually, the aggregation of these results will allow me to draw a conclusion regarding the causality between the Europeanization and the comprehensive transformation of the country.

## 1.2 Methodology

The essential method of this thesis is a single-case study on the Portuguese transformation. This country was selected out of the three new southern Member States as an extreme case, for being the least developed one. Using Italy as a benchmark for comparing the different economic levels across the region, we may see that both Spain with 83 % and Greece with 78 % of GDP per capita compared to Italy were in a higher stage of the economic convergence to the EC than Portugal, only reaching 51 % in 1975.[7]

As Gerring (2007, p. 89) explains, an extreme case study must be supported by comparisons to a number of samples in order to achieve a desirable representativeness of the study. Comparing data from Portugal to other new Member States is therefore crucial (or even comparisons to old Member States to test whether or not the aspects examined were merely a part of a global phenomenon). The most suitable cases for a comparison with the Central and Eastern Europe countries are probably the Czech Republic and Hungary, nations of very similar size to Portugal (approximately 10 million inhabitants) and of an economic level largely comparable to that of Portugal around its EU accession (other CEEC were either too underdeveloped, or too small, often both). These countries nevertheless bear a difference useful for the analysis of the geographical factor in the European economic integration: while the Czech Republic is literally located in the backyard of the EU economic center, Hungary has a more peripheral position, similarly to Portugal.

The time period for the case study is 1981 to 1995. The first decade (1986 to 1995) of the EC membership comprises a period during which all relevant short, medium, and long-term integration-induced effects should become demonstrable (in some cases, development indicators go slightly beyond 1995). To test the causality of the EC membership and the impact of the accession process itself, five years preceding the actual accession (1981 to 1985) are in most cases considered as well. On the other hand, collecting data from the second half of the 1970s would not be particularly wise, given the very unstable political situation which likely influenced short-term economic indicators.

The interdisciplinary approach of this thesis applying economics in historical and international relations research, does not allow for an exclusive use of qualitative or quantitative

[7] UNCTAD Statistics (2015) and own calculations, GDP per capita in USD at constant prices and exchange rates (2005), 1975.

methods. An economic research based on a neoclassical theoretical framework would lack any relevance without statistical evidence, and at the same time, a purely statistical analysis of Portuguese accession to the EC would result in a mere description of the country's economic development ignoring the historical context.

The case study is segmented into three different chapters according to the major channels of influence of the European economic integration on a Member State. This structure proves to be very efficient, as employing each channel of influence involves a different kind of stakeholders (EC, government, domestic companies, foreign investors), changing the character of the particular transformative power. The first one reflects the effects of the comprehensive trade liberalization based on the Four Freedoms[8], where EC law and the private sector have the leading role. The second section examines the sectors which were subject of distinct legislation and policies. These include the agriculture and fisheries, shaped by the price guarantees and subsidies provided within the respective policies, and the banking sector, entirely liberalized only after the implementation of the Second Banking Directive in 1992. Development of these three sectors was mainly governed by EC law and the Portuguese authorities, yet impacted private businesses. The third chapter approaches Portugal as a beneficiary of the EC Cohesion Policy during the transformation, with only a limited involvement of the private sector.

## 1.3 Literature Overview

The following literature overview aims to reflect on the essential works that inspired my research design. Furthermore, it demonstrates the advancement of social sciences in research on the Portuguese transition and its relation to the EC accession, and incorporates this study into the current state of arts.

The almanac *Spain and Portugal in the European Union: The First Fifteen Years*, compiled by Sebastián Royo and Paul Manuel, contains a number of studies analyzing the Iberian enlargement from different disciplinary perspectives. Royo & Manuel (2003) develop several lessons from the EC accession based on a multi-disciplinary approach. Although some of them were inspiring for my research (relations to Spain, or the role of the Cohesion Funds), the wide scope of their analysis comprising both countries provides incentives for further, more concrete research, rather than binding conclusions. My study therefore elaborates on two of

[8] Free movement of goods, services, workers, and capital, as enshrined in the Treaties.

their lessons and provides comparisons to the Eastern enlargement, which allows for drawing inductive conclusions about the effects of the European integration on the economy of transforming countries. Firstly, I put the economic impact of the consolidation of Portugal’s bilateral relations with Spain into an economic perspective (section 2.1.4). Secondly, I elaborate on their conclusions concerning the slow convergence and the important role of the Cohesion Funds. The authors argue that the Cohesion Policy enhanced the economic development of the most disadvantaged regions. That is contradicted by Magone (2004) who highlighted the increase of the regional disparities throughout the 1980s and 1990s. In spite of the advancement in those regions, my research will prove that in Portugal, as well as in Central Europe, the richer areas converged faster with the old Member States (section 2.3).

Similarly, another essay in this anthology, by Sebastián Royo (2004), develops several possible links of the Portuguese case to the Eastern enlargement, which followed one year after the publishing. The author argues that for new entrants, the importance of the dynamic effects of the European integration prevails over the static ones. This statement shaped my focus on the qualitative, investment-led growth (see sections 2.1.1, 2.1.2, and 2.1.3). However, the author underestimated the significant difference in trade openness of the Central European countries (in general two or three times higher than in Portugal), which may result in an increased economic importance of trade creation and diversion. A brief examination of the static effects is therefore included in sections 2.1.3 and 2.1.4.

Lima (2000) deals with a research question similar to mine, aiming to draw conclusions of the Portuguese experience for the Eastern enlargement countries. She examines the Portuguese convergence process, the development of its trade openness, and the qualitative change of the exports. One of her most important conclusions, on which I elaborate in my research, is the difference in the relative benefits from the Cohesion Funds and the FDI inflows in Portugal (former higher, latter lower) and in Central Europe (vice versa). I reflect on this problem related to the principles of economic geography in sections 2.1.2, 2.1.4, and 2.3.1. By using the method of a revealed comparative advantage, she concludes (p. 1403-1405) that the traditional exports of apparel, textiles, and footwear lost on competitiveness after the EC accession. My research (section 2.1.3), which employs the Balassa index, suggests an opposite conclusion, and so does Corkill (1998). Although the share of these goods on the Portuguese exports dropped throughout the 1990s, it was not a result of the EC accession, but of the emergence of the competition from Asia and Latin America. On the contrary, the membership in the Single Market evidently softened the impact of the advancing globalization.

Baldwin & Wyplosz (2012) led me to analyze in chapter 2.1 the investment-led growth induced by the European integration. I particularly focus in section 2.1.1 on the domestic capital formation, in order to elaborate on the brief paragraph they dedicate in this matter to the Iberian enlargement. Their explanation of the growth effects of the European integration inspired me to focus in general on the investment-led, qualitative growth, comprised in the dynamic effects of the European economic integration. This is to a certain extent reflected in most sections of the case study – for example the modernization of the agriculture and fisheries sectors (2.2.1, 2.2.2), or the improvement of the infrastructure based on the EC Cohesion Policy (2.3).

Corkill (1999) dedicated his monograph exclusively to the Portuguese economic transformation during the accession process, and the first decade of the membership. His book contains an exhausting amount of information on the topic (used mostly in chapter 2.1), yet internalized as a part of Portuguese national history rather than conceptualized as a case study for the history of the European economic integration as such, for which a comparative approach addressing different cases is needed.

Hibou (2005) is addressing the integration of Portugal and Greece into the Communities in the compilation *The Member States of the European Union* from an inter-disciplinary perspective, covering the transformation of the domestic politics, changes on the European level, as well as some related economic issues. In my strong opinion, the wide scope of her study leads to rather shallow findings, based on weak empirical evidence. However, she infers a positive impact of the European integration on the bilateral relations of neighboring countries, which I approach in section 2.1.4 from an economic perspective. I elaborate on her conclusion by adding the examples from Central Europe, where consolidation of the historically burdened relations to Germany, and the Europe Agreements, led to a rapid increase of mutual trade volumes in the 1990s and the 2000s.

Pinto & Teixeira (2004) employ a purely historical approach to our topic, which has proved very important for my research by providing an excellent description of the Portuguese position in Europe during and after the accession process. They explain important nuances concerning Portugal's relations to EFTA, the United Kingdom, Spain, and the Community itself. Magone (2004) is in his monograph also focused on the politics of Portugal's

Europeanization. However, he adds a chapter on significance of the Cohesion Funds for the convergence of the country in the EC, which provides some good analysis, including criticisms included in the section 2.3.1. The social aspects and the economic philosophy of *Estado Novo*, as well as the nature of the Portuguese transition, are elaborated on by Wiarda et al. (2006). On the other hand, the authors were not entirely accurate in developing parallels to Central and Eastern Europe, as they do not consider the remarkable differences between the political or economic backgrounds of the individual post-communist countries.

There is a small number of publications approaching the Europeanization of Portugal from an economic perspective, especially those considering some implications for the Eastern enlargement. Particularly, there are none reflecting the situation in the new Member States from the perspective of more than 10 years after the Eastern enlargement, which created a sufficient historical distance and provided enough data to draw binding conclusions.

## 2. EUROPEANIZATION OF THE PORTUGUESE ECONOMY

Portugal was governed by a quasi-fascist authoritarian regime named *Estado Novo* (the New State), established by Antonio de Oliveira Salazar in the 1930s, when many other European countries also turned into dictatorships. For its neutrality during the Second World War, Portugal was allowed to participate in the Marshall Plan, the foundation of NATO, and also to join EFTA, which helped to preserve the traditional commercial ties to the United Kingdom. Neither the isolationist regime, nor the European Communities, ideologically based on liberal democracy, were interested in Portugal's participation in the mainstream European integration, as Pinto & Teixeira (2004) explain. Unlike Spain, which was entirely isolated from the international politics due to its direct collaboration with the *Third Reich*, Portugal had some experience from the international political arena and a powerful ally in London. Although both of these aspects facilitated the politics of the EC accession process, the economic dimension remained a big challenge.

The social and economic policies of *Estado Novo* were constrained by spending approximately half of the sovereign budget on the long colonial wars at the expense of public services common in Western Europe. As a result, a 15% illiteracy rate was reported at the end of its era (Bradley 1995). Other figures illustrating the alarming level of Portugal's under-development include 26 % share of labor force employed in the agricultural sector in 1980, a share more than three times higher than in France and almost double in comparison to communist Czechoslovakia. Personal remittances, the money transferred by Portuguese nationals working abroad to their families, reached 9 % of the GDP that year[9]. This is a value in no way comparable to any other European country, demonstrating the lack of opportunity to earn a living in the homeland. Although the country underwent a cumbersome but successful political democratization, and launched a promising economic growth, the socio-economic character of Portugal in the early 1980s resembled history text books.

The Salazarian regime was characterized by a minimal participation of the country in the international trade. Only after the arrival of the reformist successor of Salazar in the 1970s, Marcelo Caetano opened the Portuguese market. By 1980, after a short period of failed coupes and political instability, the share of exports on the Portuguese GDP exceeded 20 %[10].

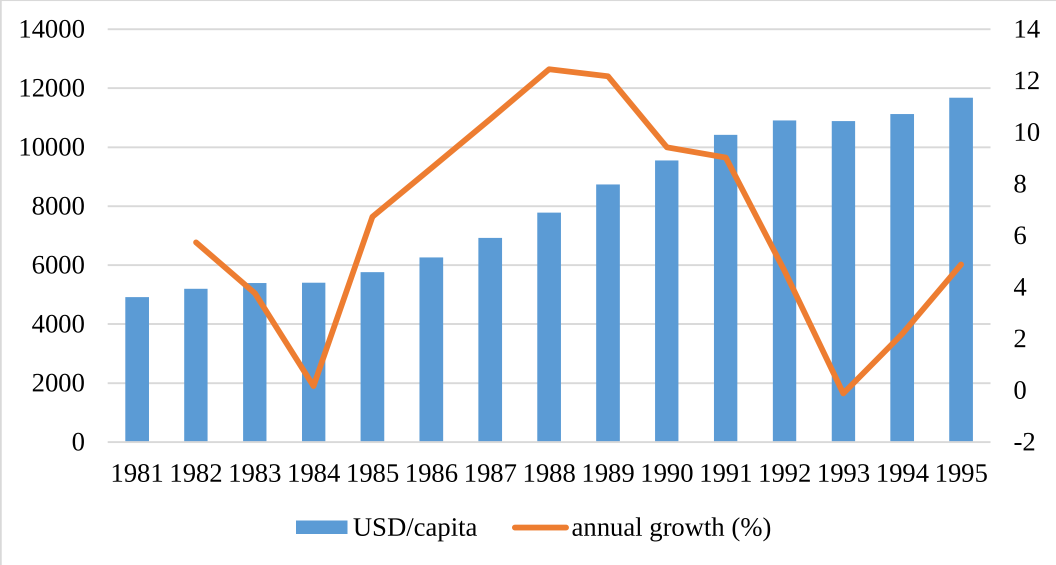
[9] UNCTAD Statistics (2015)
[10] ibid

Contrary to the founding members of the Communities, the nation still lagged behind with respect to the European identity. Royo & Manuel (2003) argue that ignoring the existence of Europe was a legacy of the pro-colonialist regime. However, a gradual change of the public perception of belonging to Europe took place after the revolution, when European integration was not only considered essential for consolidation of the new Portuguese democracy, but also an irreplaceable alternative for the lost African markets. The center-left cabinet of Mario Soares applied for EC membership in 1977.

In the most general economic terms, all studied sources agree on an outstanding progress of the Portuguese economy during its transformative period, marked by the integration into the European Communities. After the turbulent revolutionary years, the country embarked on a period of 8 consecutive years of unprecedented growth, which accelerated into double-digit rates in the first years of the EC membership. Such values are only typical for economies undergoing a successful transformation.[11] As the figures in Graph 1 demonstrate, Portugal managed to double its GDP during the first decade. Moreover, Campos, Coricelli & Moretti (2014, p. 36)[12] calculated in their recent study that the difference between the actual GDP level and an estimated level without an EC accession, accounted to 16,5 % for the first decade of the membership – a difference only outranked by the three Baltic states after the Eastern enlargement. Its outcome confirms the causality between the EC accession and the economic growth.

[11] E.g. industrializing emerging markets (BRICS), among other EU Member States only Slovakia and the Baltic countries reached values over 10 %, and for two consecutive years in maximum (UNCTAD Statistics, 2015)
[12] The figures must be considered as mere estimations due to the use of rather unorthodox econometric method of synthetic counterfactuals. For more about the discussion concerning the methodology used, see the Economist (2015). Online: http://www.economist.com/comment/2356423 (accessed 22/05/2015)

**Graph 1: Economic growth in Portugal 1981-1995 (absolute increase on the left axis, and a year-on-year growth rate on the right one)** [13]**.**




## 2. 1. PORTUGAL IN THE FREE EUROPEAN MARKET

This chapter approaches the transformation of the Portuguese economy during the accession to the EC from a perspective of free trade and an increased economic interaction with other European market economies. The theoretical basis in the following sections uses the *Heckscher-Ohlin theorem*, and Robert Solow's model of the investment-led growth.

### 2.1.1. INVESTMENT-LED GROWTH

This section aims to examine the relation between the EC accession and an investment-led output growth in Portugal in the observed period. To provide this chapter with a theoretical basis, I will first summarize the investment-led growth model by Robert Solow, and introduce Richard Baldwin's linking of the model to the effects of European integration. I will then empirically examine the extent to which this model of growth is applicable in the case of Portugal and briefly compare the findings with other countries.

The specific model of an investment-led growth described by Baldwin & Wyplosz (2012, p. 187-200) starts with a positive impulse of the European integration on the investment environment. The increased motivation for investments rests on the free movement of goods,

[13] OECD (2015), Net national income (indicator). doi: 10.1787/af9be38a-en (Accessed on 21 May 2015) + own calculations

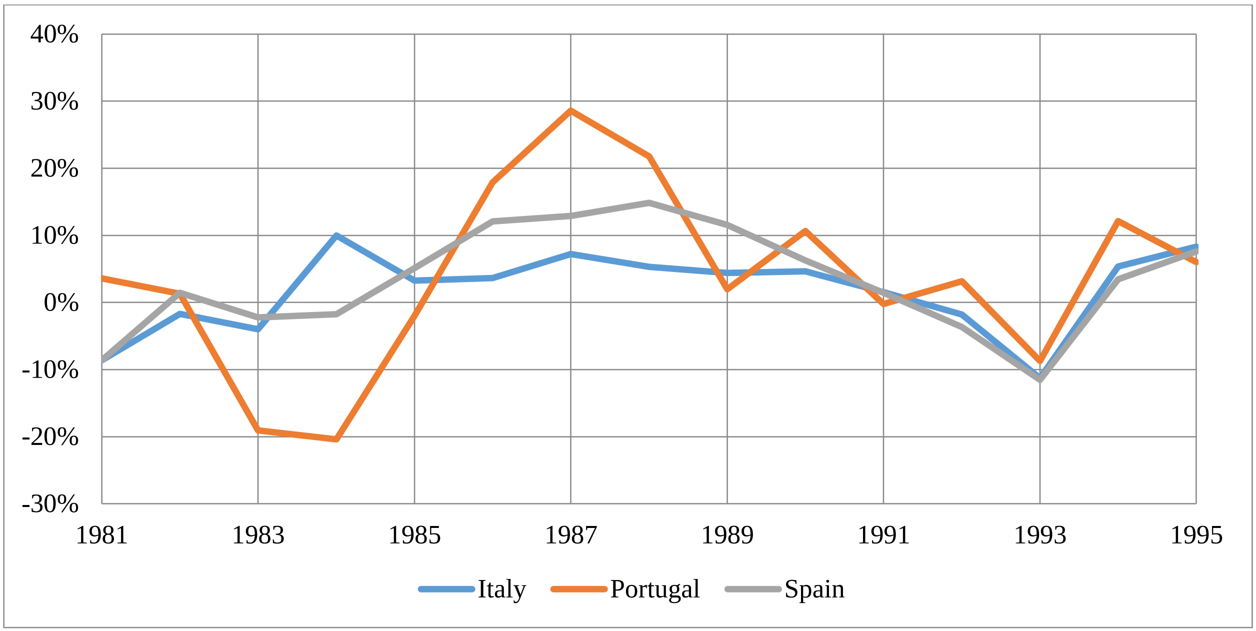
services, capital, and workers, which results in a more efficient allocation of economic resources. The investments into new technologies and human capital bring about a technological progress. This was determined by Robert Solow as a prerequisite for the capital accumulation itself, which provides resources not only for further investments but also for higher consumption and tax revenues. Before this re-formulation of the investment-led growth model, it was believed that an accumulated capital creates investments. Solow empirically proved that the opposite relation is more important, i.e. investments leading to higher capital stocks, triggering a positive multiplication effect in the whole economy.

In case of the European economic integration, as Baldwin & Wyplosz (2012, p. 187-200) further elaborate, the efficiency of the Single Market leads to a higher output per worker, which creates more capital available for investments. These are assumed to be used by the companies for modernization of their production facilities, gradually increasing the long-term capital/labor ratio[14]. Higher capital to labor ratio accelerates the growth of output per worker. However, the initial impulse (i.e. the transition into a fully open economy) for this mechanism is eventually exhausted, therefore we consider this as a medium-term (micro-economic) growth effect. Nevertheless, there are also long-term effects related to this mechanism, based on the (macro-economic) multiplication effect described in the paragraph above. Note that this model does not include the positive effect of the EU accession on stock market prices, long-term investment to GDP ratio, and inflow of foreign direct investments. The following analysis will also include the latter two, in order to create a comprehensive overview of the integration-induced growth.

In contrast to Baldwin & Wyplosz (2012, p. 187-200), who use investment to GDP ratio to compare the gross capital formation growth in the convergence countries, I chose the year-on-year growth of the total gross capital in constant prices as a more suitable way to examine the increase of capitalization in the Portuguese economy, avoiding statistical distortion rooted in the different GDP growth rates in the observed countries. The development of the gross capital formation is compared to Spain, joining the EC in the same year, and to Italy, the only old Member State in the region.

[14] The higher the ratio, the more developed economy. This process is called induced capital formation.

**Graph 2: Growth of Gross Capital Formation (values in constant USD 2000, year-on-year change in %, 1982 - 1995)[15]**



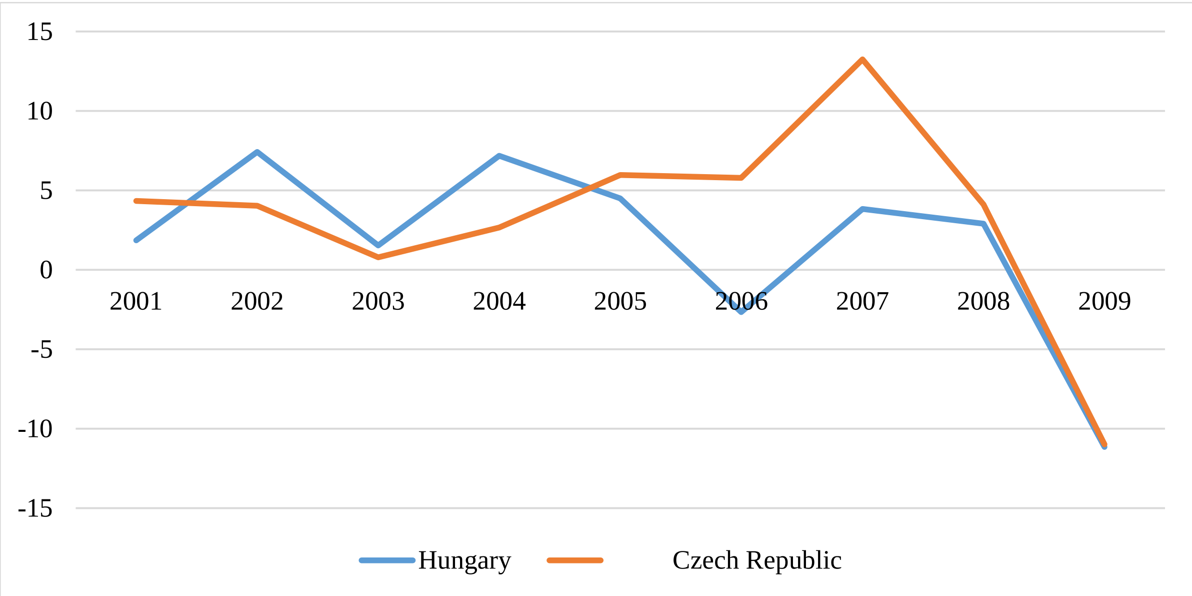

Graph 2 confirms the existence of a medium-term growth effect of the European integration. Upon EC accession, the accumulation of capital grew by very high rates for four consecutive years, after which it followed values typical for the whole region. Stimulated by the psychological effect of the EU accession, the Portuguese companies invested into their assets, in order to increase and modernize their production capacities, exactly as the model assumes.

A similar, yet less dynamic, scenario took place in Spain. Although the countries embarked on the values equal to the general business cycle in Europe after the effects of the initial investment stimulus diminished, Portugal kept gaining the capital stocks the fastest. This may be explained a premise expecting that poorer countries should under normal circumstances grow faster than richer ones during a convergence process, as they have, simply put, more obsolete assets to modernize. Italy, as an old Member State not benefiting from an ongoing accession process reported more stable, and lower, rates. The dynamic increase of the domestic capital accumulation was most likely a result of the integration-induced investment activities.

15 UNCTAD Statistics (2015) and own calculations.

The data from the Eastern enlargement for our comparative causality test are provided in Graph 3 below. Markets in both countries reacted positively on the EU accession in 2004 in terms of an increased private investment activity, especially in case of the Czech Republic, which eventually reached values comparable to the dynamic development of Portugal in the late 1980s. The statistics from Hungary are likely negatively influenced by the economic stagnation beginning in the country in 2006[16]. Eventually, both markets slumped into the Great Recession in 2009, discouraging firms and banks from most investments, which substantially distorts the statistical comparison.

**Graph 3: Year-on-year growth (in %) of the Gross Domestic Capital Formation in the Czech Republic and Hungary throughout the EU accession.[17]**



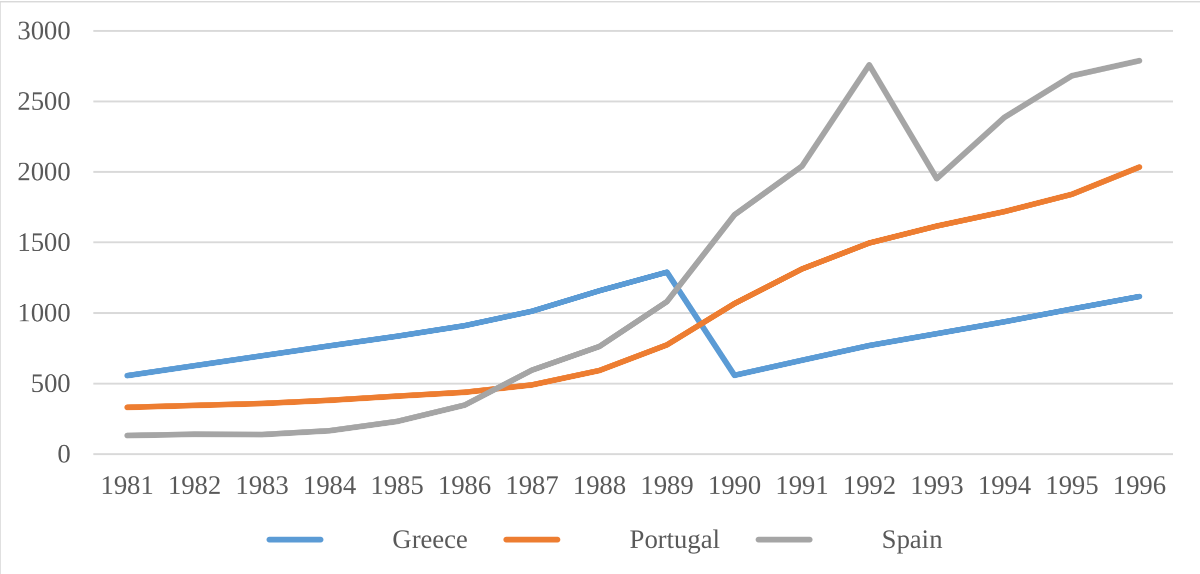

## 2.1.2. FOREIGN DIRECT INVESTMENTS

The positive impact of EU accession on the investment environment is expected to add on the attractiveness of a market for foreign investors. Moreover, the inherent freedom of establishment, a core principle of the European integration, facilitates investment flows across the Communities. Narula & Bellak (2009, p. 11-13) provide two important arguments for this assumption. Firstly, as a new Member State enters the common market, its actual market size can be with the Four Freedoms de facto seen as large as the EU market itself. Secondly, it is

[16] OECD (2015), Net national income (indicator). doi: 10.1787/af9be38a-en (accessed on 21 May 2015).
[17] UNCTAD Statistics (2015) and own calculations based on these data.

believed that the adhesion to the EU is a sufficient guarantee of a functioning economy and institutions, which promotes the image of the country to the global investors. Nevertheless, as the authors further suggest, the effect of EC accession on attraction of FDI was only this strong in the South European enlargements. It decreased on importance after the 1990s not only because the Central and Eastern European markets had started attracting foreign investments years before their actual accession, but also due to the emergence of perspective markets outside of Europe.

**Graph 4: Foreign Direct Investment in South Europe upon the EC accession. Inward FDI stocks per capita, current USD, 1981 – 1996.[18]**




As Graph 4 illustrates, the FDI stocks were growing steadily after the adhesion to the EC in all three countries. The growth in Portugal was not very dynamic, yet very stable, unlike in cases of Greece and Spain, both experiencing an outflow shock in the early 1990s. The graph demonstrates the stocks of FDI per capita, in order to eliminate potential discrepancies caused by the size of Spain, which as a large market absorbed more investments. Even then, the stocks per capita remained considerably higher in Spain for two reasons. Firstly, arguably because of the proximity to the core of the European economy. Secondly, the actual size of Spain enabled the incoming businesses to operate on a larger market and enjoy the economies of scale for costs of entry comparable to an investment in a smaller country. Despite the considerable

[18] UNCTAD Statistics (2015)

increase of foreign capital stocks, Portugal remained together with remote Greece on the periphery of the European economy.

The Czech Republic and Hungary, both undergoing their transformation into free market economies in the 1990s, and having entered the Union first in 2004, reported comparable levels of FDI stocks per capita already before 2000. The Czech Republic even overtook Portugal in 2008[19]. The comparison to the two post-communist countries underlines the importance of the geographical factor, in particular the proximity to Germany. The geographical position also determined the composition of FDI inflows by source countries – the major investor in the country was initially the United Kingdom (OECD, 1992), Portugal's traditional trading partner on the Atlantic coast.

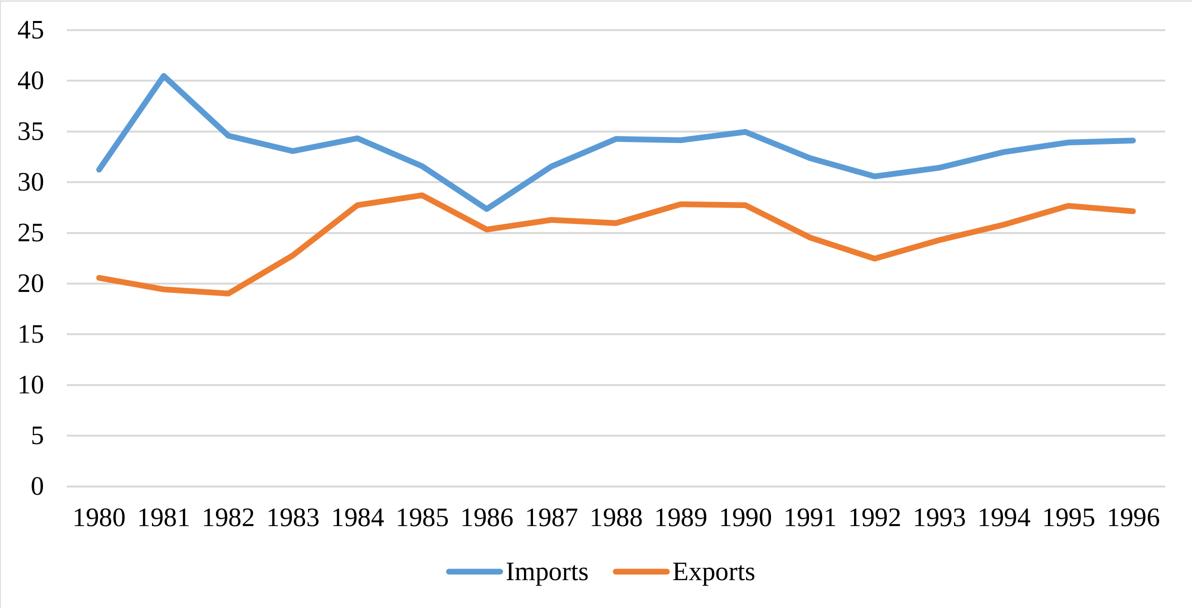
Slightly surprising are the target sectors for foreign investments. Although the foreign direct investments into Portuguese industry quadrupled throughout the first five years in the EC, by the 1990, 67 % of all stocks were allocated in the service sector – mostly in financial institutions and the real estate services. These investments enjoyed high profits for lower financial inputs than in the manufacturing sectors, where a large investment took place first in 1995, when the Ford-Volkswagen group established a joint venture car factory in the Setúbal region, for Portugal an industrial complex of an unprecedented size (Corkill 1999, p. 158-162).

### 2.1.3. EFFECTS OF FREE TRADE ON THE DOMESTIC INDUSTRY

A general analysis of the foreign trade statistics does not lead further than to a universally accepted statement that Portugal is a less competitive EU country with serious current account deficits. The recovery of the economy after a turbulent period of political instability led to a consolidation of the current account balance in the mid-1980s, as illustrated in the Graph 5. Subsequently, the negative difference between exports and imports stabilized on ca. 7 % of the GDP in the following decade, creating the foundations for long-lasting and serious current account deficits.

[19] UNCTAD Statistics (2015)

**Graph 5: Trade Openness of the Portuguese Economy - goods and services, as % of GDP[20].**




For the purposes of this thesis, it is more relevant to demonstrate the qualitative, sectorial changes implied by this process. These are suitably depicted by the Balassa index in the Table 1. This index is a simple quantification of the competitive advantage in a given sector, calculated from the shares of examined commodity on the total exports domestically and globally. Values above 1 suggest that a country is more competitive in trade with a certain commodity, because its businesses export respective goods relatively more than the rest of the world (or any other reference area). And vice versa, values under 1 mean that the domestic producers in certain sectors are outperformed by foreign competition (Amador et al. 2007, p. 147).

**Figure 1: The Balassa index**

$$Balassa\ index = \frac{\frac{Export\ of\ comodity\ A\ in\ country\ X}{Total\ exports\ of\ country\ X}}{\frac{Export\ of\ comodity\ A\ in\ the\ World}{Total\ exports\ in\ the\ World}}$$

Focus should be put to the traditional flagship sector – textiles and footwear industry, which were representing one third of the total industrial output and employment in the observed period. Small-scale producers of footwear, textiles, and quality apparel, located mostly in north Portuguese cities such as Porto and Braga, were part of the international image of the country

[20] UNCTAD Statistics (2015)

for centuries. As Corkill (1999, p. 158-162) explains, exposition to the open European market therefore represented many opportunities as well as threats. Monitoring the adaptation to the common market in 1992, the OECD listed low investment, weak marketing activity, and most importantly the emerging competition from Eastern Europe and Asia as the main threats the sector was facing. At the same time, several producers accenting high quality succeeded in building respected brands (OECD 1992). The last line of Table 1 shows that the competitiveness of Portuguese apparel and shoe producers remained very high throughout the 1980s and 1990s and only dropped slightly in course of time due to the increased competition of the emerging markets. However, considering the vast inflow of cheaper products from Asia and Eastern Europe, where a mass production boomed in the 1990s, a Balassa index value of 3.7 in the late 1990s is still a very satisfactory outcome of the trade liberalization. Although the importance of apparel and footwear industry lowered, important changes in the sector took place, as Corkill refers (1999, p. 158-162). The obsolete small scale firms, often employing three generations of one family, including children under 15 years, were gradually replaced by medium-sized companies with a more qualified labor force and higher investments in production facilities. The most efficient producers remained highly competitive despite the negative perspectives related to the advancing globalization; to a large extent as a result of the participation in the Single Market. The quality apparel and shoes found new target markets mainly in Germany, Britain, and France. The Portuguese openness to Europe therefore confirms the theoretical presumption based on the *Heckscher-Ohlin theorem.* The labor-intensive production sectors, in which Portugal held a competitive advantage, indeed profited from the trade liberalization. To conclude the impact of the EC accession on this key sector of the Portuguese economy, we can state that the efficiency of the apparel and footwear industry was substantially promoted.

**Table 1: Balassa Index values for selected sectors of the Portuguese economy.** (Amador, João et al. 2007, p. 158)

| | 1980-84 | 1985-89 | 1990-94 | 1995-99 |
|---|---|---|---|---|
| **High-technology products** | **0.6** | **0.4** | **0.3** | **0.3** |
| **Medium-high-technology products** | **0.4** | **0.5** | **0.6** | **0.8** |
| Other electrical machinery and apparatus | 0.5 | 0.8 | 1.3 | 1.5 |
| Motor vehicles, trailers and semi-trailers | 0.3 | 0.5 | 0.6 | 1.2 |
| Chemicals excluding pharmaceuticals | 0.7 | 0.6 | 0.5 | 0.4 |
| Railroad equipment and other transport equip. | 0.4 | 0.3 | 0.4 | 0.8 |
| **Medium-low-technology products** | **0.6** | **0.6** | **0.7** | **0.8** |
| Rubber and plastics products | 0.3 | 0.5 | 0.6 | 0.8 |
| Other non-metallic mineral products | 1.7 | 2.2 | 2.7 | 2.6 |
| Fabricated metal products, excluding machinery | 0.9 | 0.8 | 0.9 | 1.0 |
| **Low-technology products** | **2.5** | **2.5** | **2.4** | **2.1** |
| Other manufacturing and recycling | 0.9 | 0.6 | 0.7 | 0.7 |
| Wood, pulp, paper and printed products | 3.1 | 2.8 | 2.2 | 2.1 |
| Food products, beverages and tobacco | 1.2 | 1.0 | 0.9 | 0.9 |
| Textiles, textile products, leather and footwear | 4.0 | 4.4 | 4.3 | 3.7 |

Besides the light industry in north Portugal, more progressive sectors producing machines and electronics emerged in the heart of the country, around Lisbon and Setúbal, (Solsten 1993). Lima (2000, p. 1403-1404) admits that the lack of know-how as well as of the financial and technological capital demanded an inflow of foreign investments for the development of the capital-intensive sectors. Table 1 with the values of Balassa indexes for selected commodity categories demonstrates that the medium-high technology sectors profited from the FDI inflows more than others. Motor vehicles and electrical machinery became common export articles of the Portuguese industry within the first ten years of the membership in the Communities. In particular, the above mentioned Ford-Volkswagen car factory in Setúbal opened in 1995, contributed to the increase of Balassa index for motor vehicles exports from 0.6 to 1.2 in the late 1990s.

From the perspective of the global trade, the structural transformation of the country rested on the improvement of the business climate, political stabilization, and a comprehensive liberalization of trade based on the integration into the EC. Such changes approximated the structure of the Portuguese economy to the model of a highly developed economy. Applying the *Hecksher-Ohlin theorem* on the emerging capital-intensive industries, which should under free trade dwindle, is not entirely possible, as the significant inflow of foreign investments disrupts the prerequisites for its validity.

The development in Central Europe was not dissimilar in the 2000s, as the Table 2 suggests. Especially the Czech Republic profited from the quickly inflowing FDI in terms of an increasing export capacity of the high-skill (i.e. capital intensive) products. The exports of low-skill products have been decreasing, as this traditionally industrial country gradually transformed from an inefficient and low-skill mining and arms industry into machinery and electronics production with higher requirements on capital inputs. Hungary seemed to have gained some competitiveness as well, yet to a lesser extent. Most changes took place within the three general product categories. For instance, while the Hungarian chemical industry did not expand abroad significantly, machinery exports tripled between 2000 and 2013.[21] Similarly to Portugal, the labor-intensive sectors in Central Europe profited from the Heckscher-Ohlin mechanism, while the more capital-intensive industries could soar as a result of vast foreign investment.

**Table 2: Average Balassa indexes for categories of exported goods in the Czech Republic and Hungary[22].**

| Country | Product category | 2000-2004 | 2005-2009 | 2010-2013 |
|---|---|---|---|---|
| CZ | Low-skill | 1.5 | 1.2 | 1.1 |
| | Medium-skill | 1.2 | 1.2 | 1.2 |
| | High-skill | 0.8 | 1.1 | 1.2 |
| HUN | Low-skill | 0.6 | 0.5 | 0.5 |
| | Medium-skill | 1.5 | 1.5 | 1.7 |
| | High-skill | 1.2 | 1.3 | 1.2 |

[21] UNCTAD Statistics (2015)
[22] Own calculations based on the UNCTAD Statistics. Please note that the source is different than in the case of Table 1 concerning Portugal in the 1980s and 1990s due to the availability of data. Table 2 therefore merely has an indicative role.

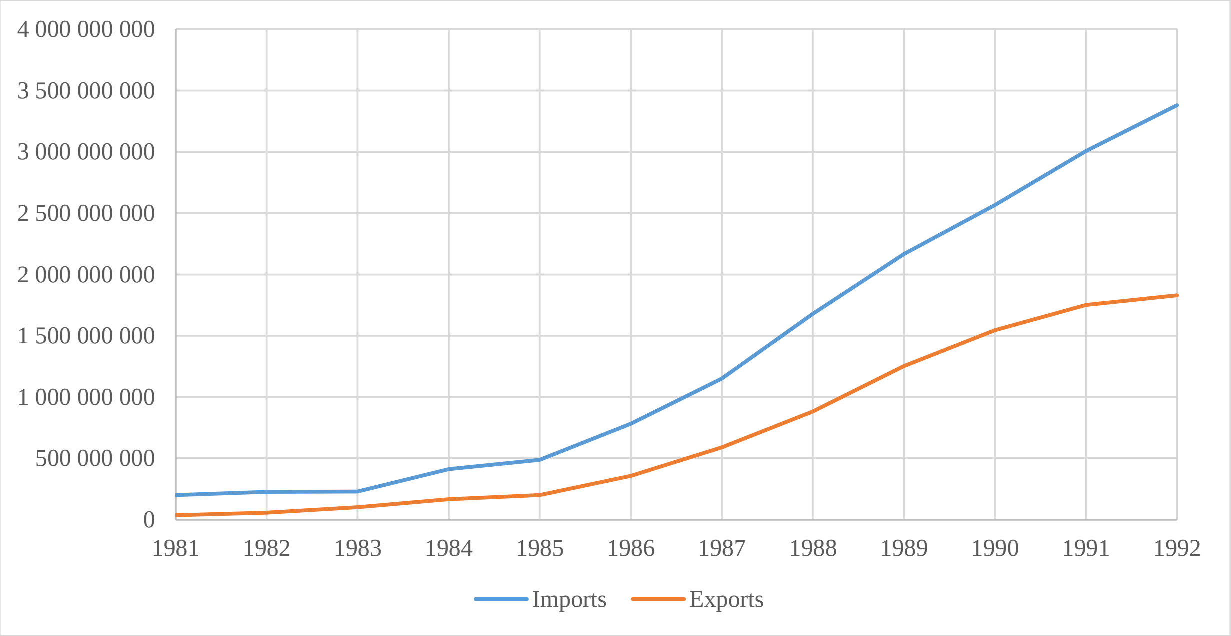
### 2.1.4. SPAIN: A REDISCOVERED BROTHERHOOD

The adhesion to the European Communities in 1986 did not represent a turning point for the trade openness of Portugal, because of an instant removal of the last trade barriers to Western Europe. The country had already enjoyed zero tariffs for its merchandise exports to the EC market. The major reason for a change in the trade statistics was based closer to the Portuguese producers and consumers than expected – in Spain (Coppolaro & Lains 2013, p. 73-76).

Despite the ideological affinity of the former Iberian dictators, both Franco and Salazar had been pursuing a self-sufficient production, rather than flourishing trade relations between the two nations. The revolutions in the mid-1970s did not initially change much. Instead of a strategic cooperation, both countries merely competed for the status of a "better pupil" of the enlargement process. While the Spanish politicians lacked respect for the poorer and politically less stable neighbor, Portugal sought an earlier accession as a matter of pride for a NATO and EFTA member state. Unlike Spain, which inspired serious political concerns in the Communities for its immense agricultural and fisheries sector, Portugal had a valuable ally in London. Britain, with its traditionally tense relations to Spain, dating back to the failed invasion in the 16$^{th}$ century, used to be a major market for Portuguese wine, cork, and fruits for centuries. In light of the old alliance, Margaret Thatcher openly supported the option of an earlier adhesion of Lisbon to the Communities, yet the arrival of Francois Mitterrand in office in the early 1980s restored the balance in favor of Spain (Royo & Manuel 2003, p. 9-10).

Concerned about the tensions between Lisbon and Madrid in the late 1970s, the European Communities forced both countries to fix their bilateral relations and conclude a free trade agreement (Pinto & Teixeira 2004, p. 122). Multiple authors agree that it was the European integration that finally brought the two nations sharing the Iberian Peninsula together, immediately resulting in a boost of the mutual trade (Royo 2002; MacDonald 1993).

**Graph 6: Merchandise Trade of Portugal with Spain (EUR, const. 2000)** [23]




As Graph 6 demonstrates, with the institutionalization of mutual economic relations, the tariffs between the two countries were cut on a level acceptable for expansion of commerce. The trade flows were soaring in both directions, doubling the size every two years between 1983 and 1989. However, richer and more industrialized Spain turned out to be a more dynamic exporter. Although the intensified trade arguably brought about an increase in welfare and inflow of technologies and know-how, the old sentiments of Spanish hegemony reoccurred in the Portuguese society in the 1990s, especially later after the acquisition of several Portuguese financial institutions by stronger Spanish banks. Spain quickly became the second most important trading partner after Germany and an irreplaceable market not only for the traditional Portuguese products but, more importantly, for the growing machine and electronic sector (MacDonald 1993), providing an additional stimulus for the development of the capital-intensive industry.

The high tariffs and trade barriers imposed on the Spanish imports before 1983 transformed the two neighbors, in economic terms, into two far distant countries. With an instant disappearance of these barriers, the trade increased to a level appropriate for two neighboring countries, i.e. to the position of major trading partners (Lima 2000, p. 1403). This

[23] INE – Instituto Nacional de Estatística, IP. / Statistics Portugal (2015)

development corresponds to the gravity model of trade, which quantifies the impact of distance and market size on bilateral trade relations (Krugman & Obstfeld 2009, p. 15).

**Figure 2: The Gravity Model of Trade**[24]

$$T_{12} = A \times \frac{GDP_1 \times GDP_2}{D_{12}}$$

This consolidation of the bilateral relations which provided a significant impulse for the Iberian businesses is a direct outcome of the EC enlargement policy and must as such be counted as one of the major accomplishments of the Transformative Power Europe in this thesis.

However unrelated the development of the Portuguese-Spanish relations and its implications may seem at first sight, there are some parallels of transforming bilateral relations with a dominant neighbor during the process of integration into the Communities in Central Europe, which had a similar impact on the domestic economy. The consolidation of the historically burdened relationship to Germany was the crucial foreign political goal in Czechoslovakia. The communist government never allowed for a reconciliation with Western Germany after the Second World War; the violent expulsion of three million Germans from the Czechoslovak territory in 1945 was exclusively perceived as an act of historical justice. Post-communist Hungary had to reinvent the relations to Austria and Germany as well.

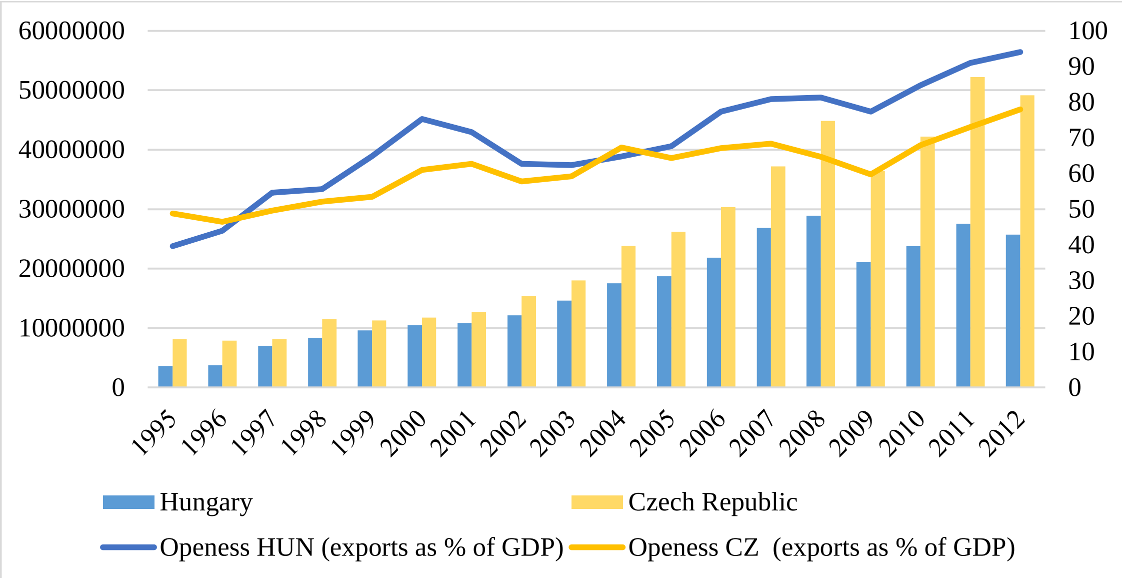
Although the Czechoslovak economy was also relatively open before 1989, 78 % of its exports were targeted to the COMECOM[25] countries, in particular to the Soviet Union (Gawdiak 1989, p. 164). The political realities of the communist era disrupted the traditionally strong economic ties to Germany. In accordance with the gravity model of trade, the large and industrialized market of Germany, sharing hundreds of kilometers of frontiers with Czechoslovakia, should be Prague's main trading partner.  Appropriate changes in trade patterns were launched by the fall of the Iron Curtain. The free trade area, based on the Europe Agreement from 1991, between the EU on one hand, and Poland, Hungary, and Czechoslovakia

[24] $T_{12}$: Trade volume of the two countries, A: a constant, D: the distance between the countries. $T_{12}$ increases with higher GDP of the both trading partners and decreases with growing distance from each other.
[25] Council for Mutual Economic Assistance: a Soviet-led economic organization comprising East European countries, Mongolia, and Vietnam.

on the other, was gradually developed throughout the 1990s[26], enabling these countries to benefit from their proximity to the Europe's largest market (Sedelmeier 2005, p. 410-411).

Graph 7 demonstrates the development of the bilateral economic relations to Germany, which along with the economic growth in both countries (particularly in the Czech Republic in the 2000s), led to the current situation of Germany being the top trading partner absorbing one third of the Czech exports. A similar situation applies for Hungary, however the export volume is only half of the Czech exports volume (due to a greater distance and a smaller economy)[27].

**Graph 7: Trade Openness (% of GDP) and Exports to Germany (thousands USD, const. 2000)** [28]




The cases of Portugal, the Czech Republic, and Hungary, not only confirm the general validity of the gravity model of trade, but more importantly its applicability for the European integration, which evidently enhances a transformation of geographical neighbors into key economic partners. This "side-product" of the integration is especially important for newly democratized countries which need to rebuild their international position and foster relations with their neighbors and regional powers.

[26] In 1993 new agreement with the Czech Republic and Slovakia were signed in response to the separation of the federation.
[27] UNCTAD Statistics (2015)
[28] ibid

The comprehensive trade liberalization based on the Four Freedoms may have much deeper implications for the economy of a new Member State than a mere increase of exports and import volumes (i.e. the static effects). As demonstrated in the case of Portugal, the integration into the EC stimulated the domestic investments, which enhanced the modernization of the manufacturing sectors. A transformation of the country into an advanced industrial market with an important service sector would be unthinkable without the FDIs, which brought about new technologies and know-how. Furthermore, the European economic integration restored natural market mechanisms disrupted by a negative political situation, such as the geographical determinants of the intensity of trade, illustrated on the example of relation between Portugal and Spain, and the Czech Republic and Germany. The depth of Europe's impact on the new position of the country in the global economy should be classified as a *transformation*,[29] given the increased presence of foreign capital, and the fundamental change in territorial and commodity structure of the Portuguese exports.

## 2.2. PORTUGAL IN THE REGULATED EUROPEAN MARKET

This chapter aims to analyze the effects of Portugal's EC accession on the sectors that are governed by distinct European (or national) policies and rules rather than by the Four Freedoms and free market mechanisms. Three crucial areas belonging to such category are examined: fisheries, agriculture, and the banking sector.

The underdeveloped, insufficiently industrialized economy had been a symptom of a generally poor governance in Portugal for centuries. It is therefore no wonder that the agriculture and fisheries sectors played an incomparably more important role in terms of the economic output and the employment during the accession. Agriculture was still employing 21 % of the labor force in Portugal in 1986, compared to 15 % in Spain and 10 % in Italy.[30]

The agreement between Lisbon and the EC on pre-accession aid from 1980 allocated 125 million ECU of grant aid and 150 million ECU for, *inter alia*, investments leading to modernization of agriculture and fisheries, in response to the foreseen inefficient the primary sector could face on the common market. Investments in these sectors were eligible for a 3 %

[29] Based on the theoretical framework adopted in the section 1.1.2.
[30] UNCTAD Statistics (2015)

interest rate subsidy[31]. Higher amounts were later distributed within the actual European policies after Portugal joined the Communities.

### 2.2.1. FISHERIES

The fisheries sector soon proved to be one of the most difficult items in the pre-accession negotiations. In fact, an additional document was signed only one month after the final accession agreement in spring 1985 (Veber 2009, p. 317). Both sides agreed on a long process of the tariff removal on seafood, with Portugal enjoying only slightly more favorable terms than the rest of the Community[32]. In contrast, the free access to other Member States waters was designed much in favor of the pre-1986 EC countries. Afraid of the disproportionally vast fishing fleets of the Iberian countries, the old Member States restricted in the agreement the access of the Spanish and Portuguese ships into the most of EC waters until 2002, in order to protect the fish stocks for the domestic fishermen. In contrast, the free access to the (already overexploited) waters around the Iberian Peninsula was not limited for the rest of the Community (Churchil & Owen 2010, p. 11-13). A reduction of the large Portuguese fleet capacity was crucial for the country's smooth integration into the common market, at least in perspective of the EC fisheries powers such as France or the United Kingdom.

An analysis of the impact of the Common Fisheries Policy (CFP) on the Portuguese fleets provides ambiguous results. The goal of the Fisheries Policy was limiting the fleet capacity (including the number of people employed in the sector) while promoting the efficiency. Nevertheless, the data in the Table 3, illustrated further in Graph 8, suggest that the first decade under the CFP merely led to a reduction of employment in the sector without any major promotion of its efficiency.

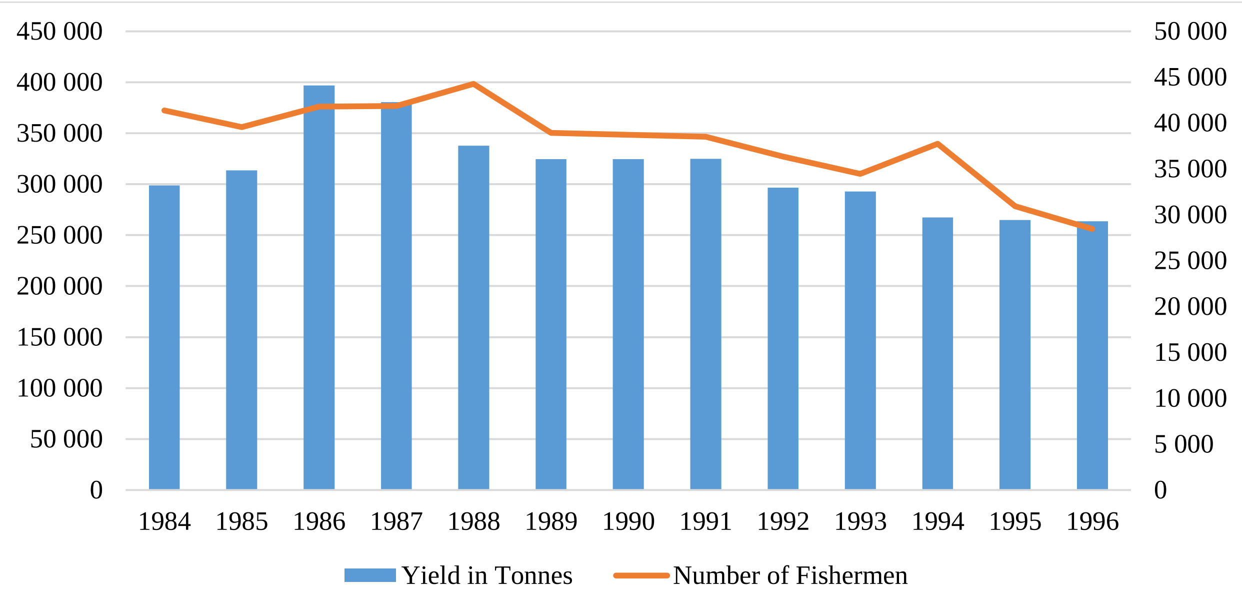
[31] *Agreement in the form of an exchange of letters between the European Economic Community and the Portuguese Republic concerning the implementation of preaccession aid for Portugal.* Official Journal of the European Communities. 1980. Online: http://eur-lex.europa.eu/resource.html?uri=cellar:3fd9165f-a85f-4868-8839-9c7d45840d16.0003.02/DOC_2&format=PDF. Letter nr. 349/3

[32] *Documents concerning the accession of the Kingdom of Spain and the Portuguese Republic to the European Communities.* Official Journal of the European Communities, 1985. Online: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=OJ:L:1985:302:FULL&from=CS Art. 360

**Table 3: Development of the Portuguese Fisheries Sector upon the EC accession.**

| Year | Output in Tons[33] | Number of Fishermen[34] | Tons/Fisherman[35] |
|---|---|---|---|
| 1984 | 298 734 | 41 352 | 7.2 |
| 1985 | 313 609 | 39 547 | 7.9 |
| 1986 | 396 898 | 41 775 | 9.5 |
| 1987 | 380 342 | 41 844 | 9.1 |
| 1988 | 337 874 | 44 255 | 7.6 |
| 1989 | 324 605 | 38 924 | 8.3 |
| 1990 | 324 677 | 38 700 | 8.4 |
| 1991 | 324 795 | 38 507 | 8.4 |
| 1992 | 296 479 | 36 337 | 8.2 |
| 1993 | 292 778 | 34 454 | 8.5 |
| 1994 | 267 440 | 37 721 | 7.1 |
| 1995 | 264 996 | 30 937 | 8.6 |
| 1996 | 263 731 | 28 458 | 9.3 |

**Graph 8: Fisheries sector in Portugal 1984-1996[36]**




[33] FAO (1999), p. 91
[34] FAO (2015)
[35] Own calculation – the overall yearly yield divided by a respective number of active fishermen
[36] Same sources and figures as in Table 3.

This is most likely rooted in Portugal's use of the EC subsidies and structural funds in the sector, which differed not only from the other convergence countries, but also from the old Member States. Throughout 1995, Portugal had received the third highest amount of funds within the CFP. More money was only allocated to Italy and Spain, which had to redistribute it to larger fisheries communities. The lacking increase in efficiency of the Portuguese fleet can be explained by the small proportion of money invested into the fleet modernization. The CFP Funds were supposed to assist the converging countries (Portugal, Ireland, Greece, and Spain) to modernize their traditionally large fisheries sectors. However, if we examine the use of these funds in Portugal, we can argue that Portugal failed to invest the available finances appropriately. While Portugal (and Greece) only invested 2,6 % of the available finances into modernizing their fleets, Spain dedicated for this purpose 8,6 % and Ireland 17,4 % of the CFP money. Contrary to the stagnating efficiency of the fisheries sector in Portugal, the yield per fishermen increased by 72 % in Ireland (1984 through 1995), and by 23 % in Spain (1988[37] through 1995)[38]. In other words, instead of concentrating the EC-funded investments into creating a smaller but more efficient fleet, as was the goal in the rest of the Community, Lisbon rather invested into additional ship building and inadequately supported modernization of the existing assets.

**Table 4: Use of Common Fisheries Policy funds in Portugal** (Jensen 1999, p. 56).

| Expenses (selected items) | Portugal | EEC12 weigh. average |
|---|---|---|
| Fleet Temporary Withdrawal | 1.4% | 3.5% |
| Fleet Permanent Withdrawal | 23.3% | 26.0% |
| Fleet Construction | 16.4% | 12.2% |
| Fleet Modernization | 2.6% | 7.5% |
| Total Transfers (ECU) | 250.08 mil. | 1907.42 mil. |

Under the withdrawal subsidies and the increasing pressure of competitors from the more efficient EC fleets, the traditionally large fisheries sector in Portugal shrunk by approximately one third both in terms of the total yield and in overall employment (Graph 8). This decline in absolute terms was not accompanied by a promotion of the efficiency as in Spain and Ireland.

[37] Earlier data for the number of fishermen not available.
[38] Data from Jensen (1999), FAO (1999), FAO (2015), same as in Table 3, and incl. own calculations.

Although Portugal had more finances available than most other Member States, it did not sufficiently invest into the modernization of its old fleet. The country failed to catch up in terms of efficiency and the technological readiness of the fisheries sector with the rest of the Community.

Seeking any parallels with the Eastern enlargement is rather difficult, given the marginality of the fisheries sector in most of the respective countries, many of them being landlocked. The only three new Member States with relatively significant fleets are Poland, Latvia, and Lithuania. In the two letter cases, the fleet capacity as well as the total catches volumes were declining rapidly after the EU accession. In case of Poland, a reduced capacity was accompanied by a slightly increased production, possibly because the efficiency was improved.[39]

### 2.2.2. AGRICULTURE

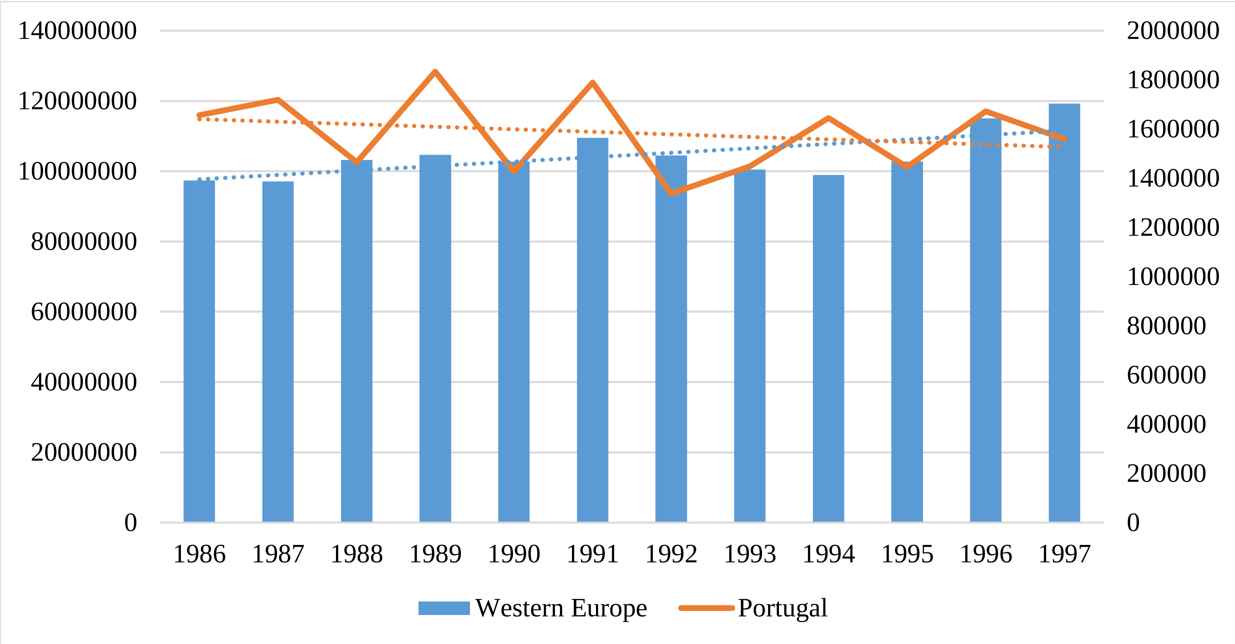
The agricultural sector during the era of *Estado Novo* was unusually large and inefficient. The technological under-development combined with the unfavorable natural conditions of a very dry climate and a hilly landscape inspired a lot of concerns about the future of the Portuguese farmers under the Common Agriculture Policy. Moreover, the policy designed in the 1960s was tailored more to the French or Dutch farmers specialized in mass grain and animal production, rather than to the small-scale producers of fruits, olives and wine, typical for Southern Europe. It became soon evident that mainly the cereal and dairy production would face fierce competition of cheaper imports from Western Europe (Solsten 1993). In this section, I shall examine the impact of CAP on the specialization in agriculture in the classical perspective of trade liberalization, and on the employment in the sector.

We may assume that the trade liberalization, along with the generous subsidies under CAP, promotes the specialization in the production scheme of the Portuguese farms. These should, in light of the classical trade theory, focus on growing products prospering in the natural conditions of the Iberian Peninsula. In the following model, the production of cereals and fruits is examined, in order to demonstrate an example of two different commodities. West European countries likely hold an absolute advantage in the cereals production, whereas Portugal in

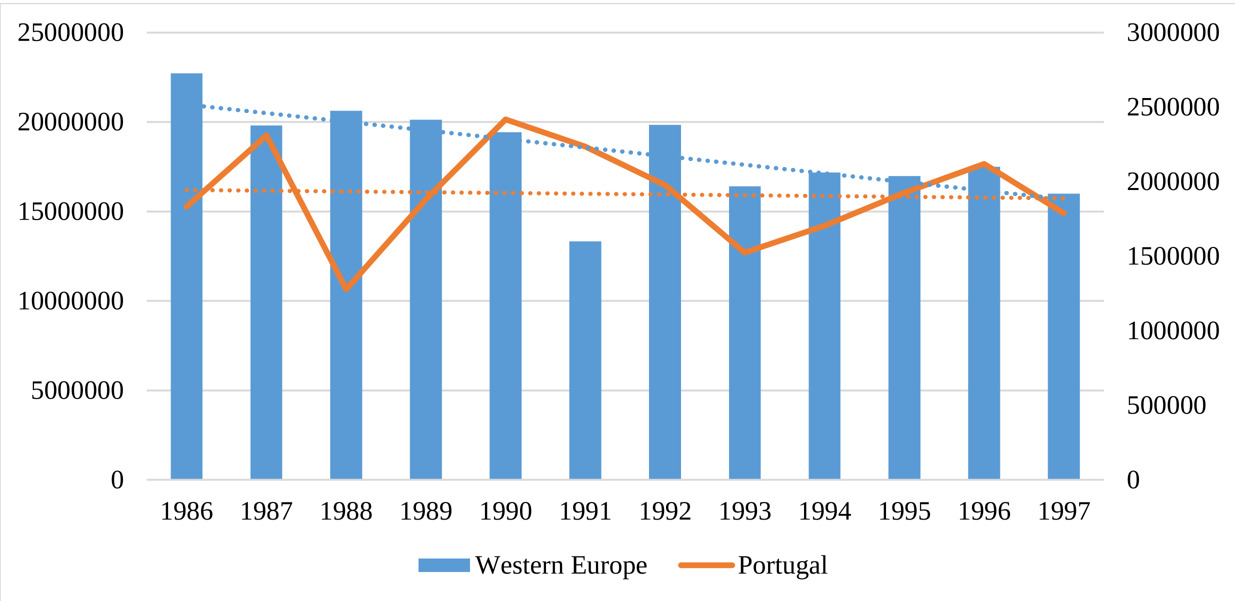
[39] Eurostat (2015)

growing fruits. The trends in the production of both commodities are illustrated in graphs 9 and 10, which reflect the decade after the EC accession.

**Graph 9: Total Production of Cereals in Portugal and Western Europe (in tons)[40]**




**Graph 10: Total Production of Fruit in Portugal and Western Europe[41]**



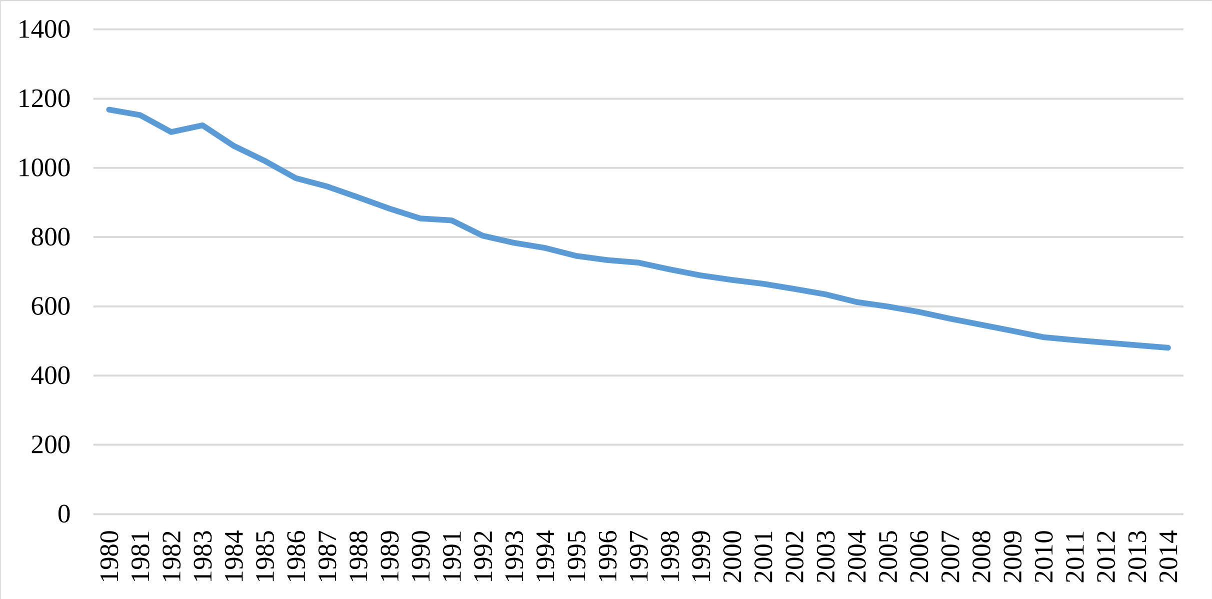

[40] FAO Statistics (2015). The left vertical axis marks values for the EU12, the right one for Portugal. The dotted lines in the respective colors illustrate the long-term linear trends.
[41] Ibid, same description applies.

The production scheme of both Portugal and Western Europe slightly changed in the observed period. The dotted lines representing the long-terms trends in agriculture output in Graphs 9 and 10 confirm an increasing specialization in both reference areas. While the production of cereals continued to grow in Western Europe by an average growth of 1,9 % p.a., the respective output in Portugal kept declining by 0,5 % p.a. Although the production of all fruits was decreasing in both territories observed, in Portugal it was so to a lesser extent than in Western Europe (average yearly decline of 0,2 % for Portugal compared to 3,2 % in Western Europe)[42]. The results of this model suggest that entering the EC market under CAP promoted the specialization in the Portuguese agriculture, which in the logic of foreign trade theories also means an increase in efficiency. Similar conclusions are offered by Solsten (1993) or Freire & Parkhurst (2002). The classical theory of an *absolute advantage* proved applicable for liberalization in trade with agricultural goods.

As far as the employment is concerned, I assumed that a massive leaving of the sector took place after 1986, reflecting a decline of the inefficient farming sectors and the introduction of financial incentives for an earlier retirement of farmers. Nevertheless, the downturn of overall employment in agriculture remained linear ever since the early 1980s. In fact, Graph 11 suggests that CAP per se had no immediate impact. More likely, the Portuguese agriculture was undergoing a continuous modernization, during which the retiring generation was not entirely replaced by a new one, as young Portuguese men and women rather sought employment in the emerging sectors of industry and services.

[42] Methodology: geometric mean of the year-on-year changes in the total output according to the yearly statistics of FAO (2015).

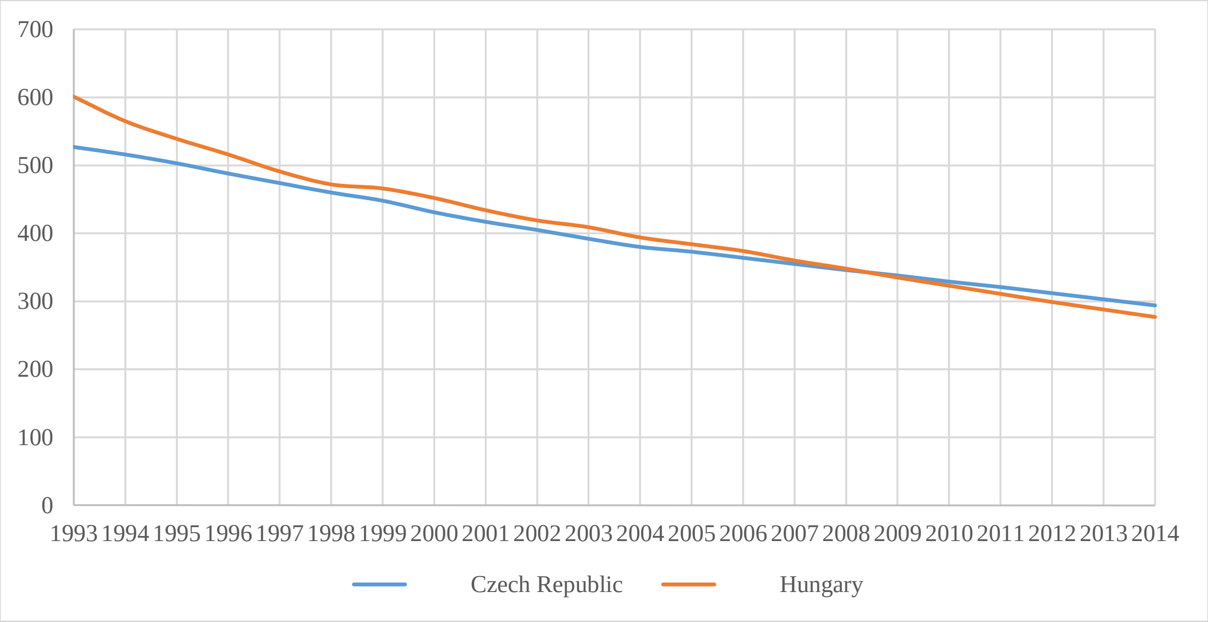
**Graph 11: Total employment in Portuguese agriculture (in thousands).[43]**




The functioning of CAP had been initially set rather unfavorably for Portugal. For a European country in the 1980s, the employment in the farming sector was evidently excessive. A continuous decline of its share may therefore be interpreted as a side effect of the complex economic modernization. As the *Estado Novo* pursued food self-sufficiency, the Portuguese farmers grew crops less suitable for the natural and climatic conditions of the Iberian Peninsula. Liberalization of trade in agriculture may have increased the total imports of foodstuffs, but at the same time enhanced the specialization and efficiency, as the model with cereals and fruits production confirms.

[43] UNCTAD Statistics (2015)

**Graph 12: Labor Force in Agriculture in the Transforming CEEC (in thousands).[44]**




A brief examination of two similar countries of the Eastern enlargement suggests the same trend, ruling out a direct impact of CAP on the employment in the agriculture sector of new Member States. Initially, in 1993, the share of agriculture in employment accounted for 10.5 % in the Czech Republic and 13.7 % in Hungary. Although ten years after the EU accession only 5.6 % of the Czech employees and 6.7 % of Hungarians worked in the farming sector[45], the long-term trend illustrated by Graph 12 leads to the same conclusion as in the case of Portugal.

### 2.2.3. BANKING

The banking sector is included in this chapter because its importance for the functioning of a market economy leads governments to formulate complex policies and numerous legislative acts that make doing business in this sector very different from most other branches. The Europeanization of the Portuguese banking sector was a particularly delicate matter, given the turbulent post-revolutionary development in the country. Following the rise of radical left, all but three foreign banks were nationalized in 1975. After the political consolidation which secured better conditions for the financial sector, ten private banks were admitted in 1983 – six of which foreign (Honohan 1999, p. 25-37).

[44] ibid
[45] Calculations of the shares on employment based on the UNCTAD Statistics (2015)

The EC adhesion required Portugal to respect the freedom of trade with services and of establishment, for any corporation active on the common market. However, the reluctance of national governments and the complexity of this branch required the creation of supportive secondary legislation ensuring a successful integration of the financial markets. The First Banking Directive, regulating the sector until 1992, preserved a lot of the power of the national governments. The Member States were still empowered to issue an authorization for the banks incoming from other EC countries. Moreover, the established branches of EC banks were subject to state control and were exposed to numerous distinct rules and restrictions in the host country. The Second Banking Directive, implemented in 1992, introduced the so-called *single passport* for any European financial institution, and brought about the principle of a mutual recognition and home country control, necessary for the advancement of the Single Market (Gruson & Nikowitz 1988, p. 209-210).

In 1989, the constitutional provision that enacted an irreversibility of the 1975 bank nationalizations was finally abolished. Until 1995, all but the biggest savings bank *Caixa Geral de Depósitos* were gradually transferred into a private ownership, which eventually led to a higher efficiency of the whole sector. Contrary to the other EC countries, where the retail bank network was rather dwindling, the liberalization in Portugal allowed for the existence of 44 different banks with ca. 3400 branches across the country in 1994 (Canhoto & Dermine 2003, p. 2089).

Nevertheless, throughout the 1980s and 1990s, the foreign-owned banks did not cover more than one tenth of the market. The Spanish *Banco de Santander*, leader of the Iberian financial market, did not take up more than a 1.5 % share in the observed period. The reason for the relatively small representation of foreign banks was caused by a reluctance of the Portuguese government to allow for the privatization of the traditional national banks to foreign owners. According to Honohan (1999, p. 25-37) they only did so to the minimum level required by the Communities, yet constantly attempting to obstruct this situation by all possible means, which was not particularly difficult under the First Banking Directive. A relatively small share of the foreign ownership in the Portuguese banking sector, despite a vast inflow of capital (rarely securing ownership rights), is considered to be rather unique for a small European country. However, it is important to point out that unlike Spain and Greece, Portugal did not suffer any turbulence in the sector in the early 1990s (Canhoto & Dermine 2003; Honohan 1999).

It is difficult to draw strong parallels to the Eastern enlargement since in case of the post-communist countries, a private banking sector had to be (re-)established in its entirety. In the Czech Republic, dozens of commercial banks emerged in the early 1990s but withdrew from the market within a couple of years as they were not able to function in the changing economic environment. The share of the foreign capital in the banking sector soared, as only a very small number of the Czech private entities remained on the market. By 2000, one fourth of institutions were publicly owned, one fourth in hands of private Czech capital, and one half by private foreign owners, mostly from the EU15 countries (Hájková, Hanousek & Němeček 2002, p. 56-58). The situation in Hungary, where the share of foreign capital (dominated by the EU15 Member States) reached 70 % in 2000 was very similar.

The inflow of foreign capital, most significantly from prestigious western financial groups, had an essential and positive impact on the business environment in the post-communist countries and helped them to attract more foreign direct investments. The lack of expertise, a legal framework, and of the actual capital made acquisition by foreign owners inevitable and the whole situation therefore completely different from the Portuguese case (Szapáry 2001, p. 16-17). Unlike in Portugal, the CEEC cases underline the importance of an increasing openness towards Europe for transformations of this crucial economic sector. Nevertheless, these particular changes were induced by the West European banks rather than by the EU per se.

The three observed sectors governed by specific European and national policies are very different from each other, and so was their development during the economic transformation of Portugal into a modern European country. The excessive agriculture and fisheries sectors kept declining in terms of employment towards the marginal numbers common in Western Europe. Contrary to agriculture, the Portuguese fisheries sector failed to use the opportunity to largely modernize. In light of the advancing modernization, the banking sector significantly expanded. Unlike in the post-communist countries, most of the banks were not overtaken by foreign owners. Therefore I argue that the Portuguese economy in the most regulated sectors merely *accommodated* to the European standards, instead of undergoing a deep *transformation*.

## 2.3 PORTUGAL AS A RECIPIENT OF EU FUNDS

The South European enlargement represented a challenge for the Communities budget. Until the 1970s, the Member States had been rather homogeneous in terms of the level of their economic development, with the exception of the Italian *Mezzogiorno*. The adhesion of formerly poor Ireland was still manageable within the existing policies. However the upcoming accession of Greece, Portugal, and Spain, with considerably underdeveloped economies, and an agricultural production scheme unable to fully profit from CAP funding, required a substantial change in the structure (and volume) of EC budget expenditures. The increased political power of the four convergence countries in the Council secured the creation of the Cohesion Fund, designed to finance regional development projects exclusively in the four Member States. This was a political price for their support to the Single Market and the monetary integration, both believed to bring more profits to the northern, industrial Member States. Between 1985 and 1995, the spending on regional development doubled, while the expenditures within CAP decreased by one third (Baldwin & Wyplosz 2012, p. 289-290). This section shall examine how this vast inflow of finances from Brussels influenced the economic growth in Portugal, and contributed to the development of the peripheral regions in particular.

When analyzing the impact of EC regional policy on Portugal in a comparative perspective, it is important to highlight that the country benefited from an unusually high financial support due to the fact that it shared the Cohesion Fund money with only three other Member States. Especially in case of the most remote countries – i.e. Portugal and Greece, these funds compensated for a smaller attractiveness for foreign direct investment, rooted in the distance from the geographical center of the European economy. This fact implies a decisive importance of the EU funds for Portugal, especially in comparison to the CEEC, where the structural aid had to be distributed among a higher number of countries. At the same time, the eastern Member States were by far more successful in attracting the FDI, for being closer to the source countries (Lima 2002, p. 1406). Neal (2007, p. 361) highlights the contribution of the EU funds by listing the most important infrastructural projects aimed to improve the unsatisfactory situation in the road and railway network, as well as in the communication sector. The total length of the Portuguese highways quadrupled in the 1990s and amounted to ca. 1000 kilometers in 2004. A new high-speed railway between Lisbon and Madrid was constructed, reflecting the transforming relations of the two countries as elaborated in section 2.1.4. The capacity of the international airport in Lisbon was enlarged, in order to meet the demand of the growing number of incoming tourists and attract more international investors into the country.

According to a study by the European Commission (1993), Portugal succeeded to acquire and utilize the available funds from the Community programs in a very efficient way. Its estimations suggest that out of an average annual GNI growth of 2.6 % between 1989 and 1993, 0.7 % were accounted to the effects of the Cohesion Funds' investments - i.e. more than one fourth share on the total economic growth, a notably higher outcome than in the other convergence countries (effects in the same period: Spain 0.2 %, Ireland 0.3 %, Greece 0.5 %).

Next, we should examine the relation between the Cohesion Funds and the level of domestic investments (see 2.1.1). Besides the Cohesion Fund investments incorporating public finance, we shall consider the impact of the Common Support Frameworks, which include participation of the private domestic capital on the final investments (Royo 2005, p. 14). These investments stimulated 27.7 % of the total Gross Fixed Capital Formation in 1993, representing once again the highest influence of this EU policy across all convergence countries (Commission 1993, p. 85). Applying the extensive definition of the Gross Fixed Capital Formation by the World Bank (2015), we can state that the investments with an EC participation co-financed one fourth of, inter alia, plant and machinery purchases by the Portuguese industry, land improvements in the agricultural sector, or the construction of offices and commercial spaces in the soaring service sector, and therefore contributed to the modernization of the whole economy.

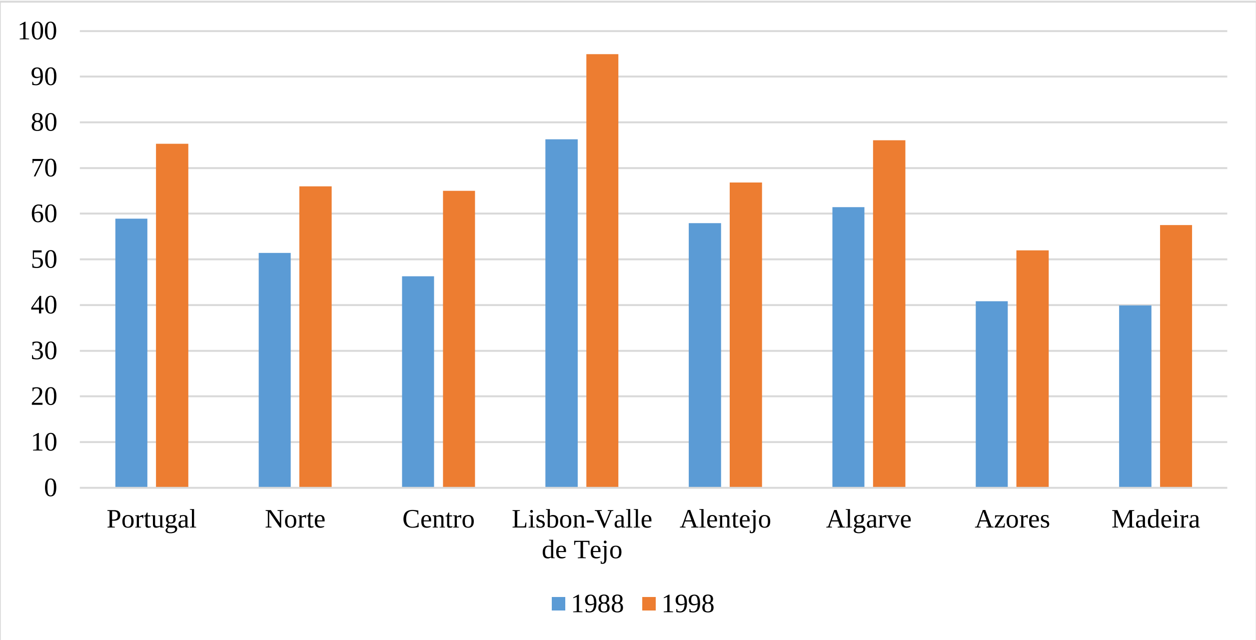
### 2.3.1 CRITICISMS OF THE EFFECTS OF EC COHESION POLICY

Royo & Manuel (2003, p. 20-21) concluded 15 years after the Iberian enlargement that one and half decade had not yet been enough for a complete economic convergence. Although considerable approximation in terms of the GDP per capita had been reached in the 1980s and 1990s, Portugal only managed to outrank stagnating Greece, and remained a relatively poor member of the EU15.

However, their research confirms that the EC cohesion policy was indispensable for the economic development of Portugal, generally perceived as very successful (ibid, p. 24-25). During the crucial years of the economic transformation, the direct EU finances arguably played an irreplaceable role. This fact none the less represented a potential threat for the future investments in the country, because as Mota (2000, p. 149) argues "*the excessive use of non-reimbursable subsidies for the private sector, to the detriment of other financial engineering schemes, creating excessive dependence on the part of investors on this type of support and removing the incentive from some innovative measures,*" left the Portuguese businesses unprepared for the diversion of most funds towards the new Member States after 2004 (Magone 2004, p. 223).

Another part of criticism related to the regional policy is connected to the fact that the investments enhanced the convergence of Portugal as a whole in the Communities, but the disparities within the country increased (Magone, 2004, p. 227-230)[46]. Graph 13 proves that despite the total catch-up of more than 16 percentage points with the Community average, the remote islands of Madeira and Azores reached the benchmark level of the economic development only by one half, while the *Lisbon-Valle de Tejo* area almost came to the EU15 average in 1998.

**Graph 13: Convergence of Portugal and its regions with the EC. (Relative GDP per capita, EU15=100, period 1988-1998), (Commission 2001, p. 70-71)[47].**



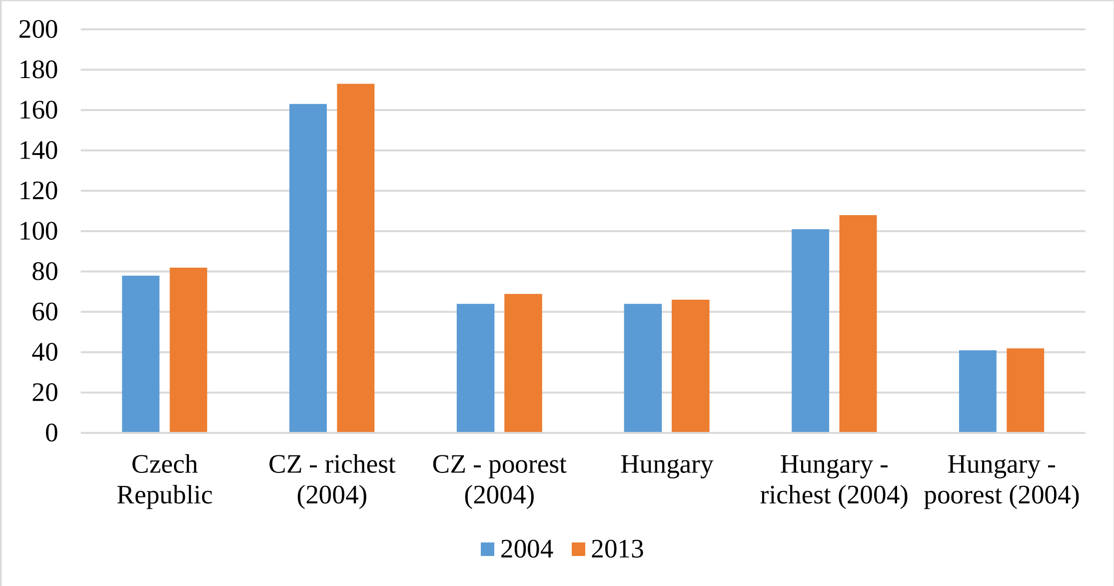

[46] Variation of the GDP per capita across the regions increased by 8 %. Own calculation based on the data in Graph 13.

[47] Used also in Magone (2004, p. 228)

More than a country-specific problem, the divergence inside the individual EU Member States was empirically proved to be a major shortcoming of the Cohesion Policy rooted in certain principles of the economic geography. As the richer regions attract more residents, a steadily increasing population is an incentive for more investment. Growing consumption and investment implies faster growth of GDP (Baldwin & Wyplosz 2012, p. 274, 279). However significant the EU investments were for the economic convergence, those for peripheral regions unfavorable market mechanisms prevailed.

Graph 14 underlines the ambiguity of the Cohesion Policy impact. The convergence to the rest of the EU was much slower in Central Europe than in case of Portugal. As previously mentioned, the two reasons were a lower amount of finance allocated to each Member State of the Eastern enlargement, and the fact that the growth effects of their transformation partially exhausted before their adhesion to the European Union. This reflection of the first ten years of the Central European convergence confirms the pattern of a multi-speed regional development. The geographical factor proved to be a stumbling block for the regional convergence in Central Europe. In case of the Czech Republic and Hungary, the richest regions were the metropolitan areas of their capitals. Both Prague and Budapest are the economic centers of the respective countries. Furthermore, the capitals are geographically located closer to the economic core of the Union (i.e. in the northwest of their territory) than the rest of the country. On the other hand, the NUTS-2 regions *Moravskoslezzko* (Czech Republic) and *Észak-Alföld* (Hungary) ranked the lowest. Similarly to Azores and Madeira in Portugal, *Moravskolezsko* and *Észak-Alföld* are the outermost regions both inside their country. Moreover, they are also the most remote regions in terms of their distance to Western Europe, as they only share a border to the even poorer regions of south Poland in case of *Moravskolezsko*, and to Ukraine and Romania in case of *Észak-Alföld*. In all of the three countries, the economic growth in the richest region outperformed the poorer ones.

**Graph 14: Convergence in Central Europe (EU28 = 100 %, GDP per capita PPS)**[48]




This section draws an inductive conclusion exceeding the boundaries of Portugal. The European economic integration apparently favors the central regions of each Member State more than its periphery. The metropolitan areas of all three observed countries outperformed the margins of each country. Furthermore, the most disadvantaged areas are in all three cases geographically oriented in the opposite direction to the "Blue Banana", i.e. to the south and west in Portugal, and to the east in case of the Czech Republic and Hungary. With the advancing economic integration of Europe, these regions seem to be facing a double handicap of peripherality, being marginalized both inside the country, as well as within the Single Market.

I argue that the impact of Europe should be classified as *transformative* for two reasons. Firstly, the implementation of the Cohesion Policy required a creation of new institutions and legislation governing the regional development and managing its administration on multiple levels. Secondly, the outcomes of this policy significantly contributed to the economic growth and modernized the infrastructure in Portugal.

[48] Eurostat (2015)

# 3. CONCLUSION

The integration of Portugal into the European Communities significantly enhanced the modernization of the formerly underdeveloped country and decisively contributed to its successful transition into an open market economy. Despite the generally negative perception of the Portuguese economy, partly based on the traditional image of the poor country, and recently worsened by the Great Recession, which degraded the country into the *P* of the infamous abbreviation *PIGS*, its economy recorded in the last two decades of the 20$^{th}$ century the most dynamic growth in its modern history. The EC Cohesion Policy, foreign investors, and the domestic producers, generated investments entirely changing the face of the country, which significantly approximated the income levels to those common in the rest of the EU by the late 1990s. Moreover, most of the economic patterns are applicable also for the developments in the countries of the Eastern enlargement, which allows for drawing some general conclusions concerning the impact of the European integration on new, transforming Member States.

On the basis of the Portuguese experience and supported by the data illustrating the recent changes in the Eastern Member States, I draw the following eight lessons concluding this study:

I. New EU Member States generally experience a dynamic, investment-led economic growth upon their accession. This can to a certain extent be explained by the integration-induced stimulus for the domestic investments. The domestic capital formation was faster in the Iberian enlargement than in the CEEC. The Members States in Central Europe benefited in contrast more from the foreign investments.

II. Although the allocation of foreign direct investment is indispensable for a transforming economy, and all the new EC/EU entrants largely benefited from their inflows, the geographical factor distinctly favors the Member States that are closer to the economic center of the Community. Considering the figures from both enlargement rounds, the proximity to the West European countries, Germany in particular, seems to be even more important factor than the EU accession per se. While FDI started flowing to Portugal on a large scale only after the accession, the Central European countries attracted the global investors years before their entry in the Union.

III. Contrary to a popular perception, accession to the common market may represent an essential opportunity for some traditional, labor-intensive industries. The old

Member States with rather capital-intensive industry may turn into stable target markets for high quality goods, in spite of the growing international competition in manufacturing industry. The development in the Portuguese footwear and apparel sector is supported by figures from Central Europe, where low-skill industries did not necessarily dwindle either. This pattern corresponds to the *Heckscher-Ohlin theorem* applied in the theoretical framework of this study. At the same time, all of the observed countries experienced a dynamic growth in the modern, capital-intensive sector, most importantly because of the FDI inflows. Due to the inflow of external capital, the above mentioned model cannot be applied for these sectors.

IV. This thesis concludes that the European integration largely contributes to good neighborhood relations between the Member States. This can be based on an explicit conditionality as in the Iberian Peninsula, or through the free trade mechanism as in Central Europe. An EU accession significantly helps to restore intensive trade relations interrupted by an unfavorable course of history. The *gravity model of trade* proved to be a pattern of the European economic integration. In further research in this area, an extensive comparative study analyzing such cases, including Slovenia and Italy, Estonia and Finland, Poland and Germany, Bulgaria and Greece, or Spain and France, could further develop this motion.

V. In sectors were the market is more regulated than free, as in agriculture, fisheries, and the banking sector, no patterns explaining general economic mechanisms may be developed, as the specifics of each country and the EU policies make all cases too different. In fisheries, Spain managed to increase their efficiency considerably by using the tool available after the EC accession, while the sector rather declined in Portugal, probably because of its poor central management. In contrast, the impact of the Common Agriculture Policy on the efficiency in Portugal was positive, considering the size and underdevelopment of the sector in past. However, the empirical examinations of the employment in agriculture suggest that the constant decline is a long and natural process, not necessarily influenced by the powerful European policies in neither Portugal nor Central Europe.

VI. Both Portugal and the CEEC experienced a convergence to the European income levels on a national level (though in case of Portugal a faster one, due to the statistical factor and the reception of higher EC investments). Yet the Eastern enlargement confirmed the trend observed in Portugal, where an internal convergence did not take place. Richer regions, located closer to the European economic center, keep growing faster than the underdeveloped areas, which in Central Europe typically face east and in Southern Europe south. This trend was not averted by the investments from the Cohesion Funds and is most likely based on the decision-making of private investors, who rationally prefer to be active on a territory that promises higher return on their investments. The most marginalized regions in the EU are double-handicapped by their peripheral position; as they cannot fully profit neither from the economic growth of the country nor from the European economic integration. This double handicap of peripheral regions needs to be elaborated in further research on the European economic integration.

VII. EU accession provides powerful tools to enhance a transformation into a modern and competitive economy, but its outcome largely depends on the will and capacities of the national administration. The depth of the impact of Europeanization was strongest in the economic sectors fully enjoying the Four Freedoms, which were entirely *transformed* by the unregulated exposure to the European market. This was not the case in the protected banking sector, where a mere *accommodation* to the *acquis* took place, or in fisheries, which effectively did not undergo any fundamental changes. Exactly as Börzel (2005) described, the impact of Europeanization remained variable across the different policy areas.

VIII. Thanks to the transformation in the 1980s and 1990s, Portugal has a solid basis of a real economy diversified in multiple sectors, which significantly promotes its chances to recover from the ongoing debt crisis. A stable banking sector, tourism, the traditional light industry, as well as the new capital-intensive machine and electronics production, stand behind the improving current account balance and the total output reaching almost the pre-crisis levels as of mid-2015[49]. With the Portuguese competitiveness being slowly restored, the government now has a historical chance to reduce the public debt of the country; the Achilles' heel of the local economy during the recent crisis.

[49] Eurostat (2015)

The scope of this thesis only comprised selected aspects of the Portuguese transformation and Europeanization. Further research in this area should therefore include the changes in economic governance, such as the introduction of the value added tax, transformation of the social models, impact of the free movement of workers, etc.

The Portuguese case proved that an economic transformation and the process of Europeanization can largely interact and create a synergy stimulating the economic development of a European country. The similar developments of this process were identified in Central Europe after two decades later. The evidence from both periods allow me to conclude that these mechanisms could also prove valid in any upcoming enlargement process.

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