# Regionalism and the Global Economy

## The Case of Central and Eastern Europe

Edited by
Jan Joost Teunissen

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**Regionalism and the Global Economy: The Case of Central and Eastern Europe**

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# Abbreviations

| | |
|---|---|
| AATPO | Association of African Trade Promotion Organizations |
| AAs | Association Agreements |
| ASEAN | Association of South-East Asian Nations |
| ASR | accelerated structural reform |
| BOP | balance of payments |
| CAP | Common Agricultural Policy |
| CECs | Central European countires |
| CEECs | Central and East European countries |
| CEEC-10 | Czech Republic, Hungary, Poland, Slovakia, Slovenia, Estonia, Latvia, Lithuania, Bulgaria, Romania |
| CEFTA | Central and East European Free Trade Agreement |
| CEFTA-4 | Poland, Czech Republic, Slovakia and Hungary |
| CEFTA-5 | Poland, Czech Republic, Slovakia, Hungary and Slovenia |
| CEPR | Centre for Economic Policy Research |
| CET | common external tariff |
| CSFR | Czech-Slovak Federal Republic |
| CIS | Commonwealth of Independent States |
| CMEA | Council for Mutual Economic Assistance (also named COMECON) |
| CPEs | centrally planned economies |
| CPI | consumer price index |
| CU | customs union |
| DC | developed countries |
| DEVs | developing countries |
| DEM | Deutsche mark |
| DMEs | developed market economies |
| EBRD | European Bank for Reconstruction and Development |
| EC | European Community |
| ECE | United Nations Economic Commission for Europe |
| ECU | European Currency Unit |
| EEA | European Economic Association |
| EFTA | European Free Trade Area |
| EMU | Economic and Monetary Union |
| ERM | Exchange Rate Mechanism (European) |
| EU | European Union |
| FDI | foreign direct investment |
| FSU | former Soviet Union |
| FTA | free trade agreement |
| G-24 | Group of Twenty-Four |
| GATT | General Agreement on Tariffs and Trade |
| GDP | gross domestic product |
| GDR | German Democratic Republic |
| GNP | gross national product |
| GSP | Generalised System of Preferences |
| IGC | Inter-Governmental Conference |
| IMF | International Monetary Fund |
| ITA | Interim Trade Agreement (between the EU and the CEEC) |
| MAI | Multilateral Agreement on Investment |

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# Preface

Regional economic integration is a much debated issue among analysts and policymakers and has gained particular interest with the European Union's envisaged deepening – the introduction of a single currency – and widening – the inclusion of East European countries – of its integration process. Interest in the prospects of regional integration has been spurred further by the surge of the "new regionalism" in Latin America and the Pacific-wide integration effort of APEC members including the United States, Japan, China, Taiwan, Malaysia, Australia and a dozen other countries bordering the Pacific Ocean.

The challenges that this new wave of regional integration arrangements poses to developing as well as industrial countries has led the Forum on Debt and Development (Fondad) to embark on a three-year research project which aims to explore how regional integration as well as multilateral cooperation can be promoted, in a mutually reinforcing manner. In this book, the research on Eastern European integration – and the discussion of it by a prominent group of researchers and policymakers at a conference in Prague – is put together. It is a follow-up to the previous volumes on Latin America and Africa (see the list of Fondad publication at the end of the book).

When the countries of Central and Eastern Europe embarked on their transition from communist regimes to democratic market economies at the end of the 1980s, new opportunities for regional integration were presented to both these countries and the European Union (EU). With the collapse of the communist regimes, the general mood in these countries has been to move away from the Eastern region towards the West, resulting in a sharp shift of trade and other economic relations from the East to the West.

The rapprochement between Eastern and Western Europe has led to the conclusion of the so-called Europe Agreements between the EU and ten Central and Eastern European countries – Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia. The implementation of these Agreements can be seen as an important step towards Eastern Europe's integration into the European Union.

The ultimate aim of the Europe Agreements is that these ten countries



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of Central and Eastern Europe will become members of the EU. However, this path of integration is not the only option available to them. At the same time, they can and do in fact seek cooperation among themselves, as the free trade agreements among the Baltics as well as among the Central European countries demonstrate. Finally, these countries also make serious efforts to integrate as smoothly as possible in the global Bretton Woods system. In this book, the integration of Central and Eastern Europe is therefore analysed at both the regional, sub-regional and global level.

A hot issue being discussed at the moment within the EU is whether the Union should be deepened and widened at the same time. Though most politicians still publicly declare that both objectives should be pursued, it seems unlikely that eastern enlargement will become reality soon. But this bleak perspective for rapid eastern enlargement does not make it less urgent for researchers and public and private policymakers in both East and West Europe to discuss the economic conditions for succesful integration. This book aims at making a contribution to that important debate.

The European Union's main reason for eastern enlargement is that it will bring more security in Europe. As one of the contributors to this book observes, "What is the European Union all about? Ultimately to achieve post-war reconciliation and ensure peace in Europe." In fact, Central and Eastern Europe's integration is the definitive test case of Europe's – all of Europe's – resolve to deal effectively with the important political, economic and social issues of the 20th century. It is in this spirit that those who contribute to this book have made an effort to assess the intricacies of Eastern European integration.

We are grateful for the solid and frank contributions by the participants in the Prague conference. Special thanks go to Zdeněk Drábek and Jan Klacek who have been of great help in preparing the conference; and Julie Bivin and Adriana Bulnes who assisted in the publishing of this book. Fondad gratefully acknowledges the co-sponsoring of the Prague conference by the Swedish International Development Cooperation Agency, the Institute of Economics of the Czech National Bank, and the European Union's Phare ACE Programme 1996. Fondad is also grateful for the generous support of the Dutch Ministry of Foreign Affairs.

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Director
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| | |
|---|---|
| MFN | most-favoured nation |
| NAFTA | North American Free Trade Agreement |
| NATO | North Atlantic Treaty Organisation |
| NTB | non-tariff barriers |
| OECD | Organisation for Economic Cooperation and Development |
| QRs | quota restrictions |
| RTAs | regional trading arrangements |
| SDR | special drawing right (in the IMF) |
| SMEs | small and medium-size enterprises |
| UN | United Nations |
| UNCTAD | United Nations Conference on Trade and Development |
| USSR | Union of Soviet Socialist Republics |
| WTO | World Trade Organization |

# I Regional and Sub-Regional Integration in Central and Eastern Europe: An Overview

*Zdeněk Drábek*[1]

## I Introduction

The political events of 1989 in Central and East European countries (CEECs) brought along a number of important changes in these countries' external economic relations. One of the legacies of communism for these countries was that they had been isolated from world markets and become extremely insular. Trade policies were highly protectionist and autarchic. Inward foreign investments were practically forbidden, and industrial cooperation agreements were at best limited to joint ventures with foreigners holding a non-majority interest in the enterprise. Outward foreign investments were few in number, and again limited only to securing "essential" services or material inputs. It goes without saying that the integration of labour markets was even more restrictive since the communist regime hardly permitted any internal labour mobility let alone foreign migration.

The abolition of communism dramatically turned the attitudes in these countries. External economic policies were completely overhauled. Suddenly, the most important challenge was no longer whether these countries should open up to external competition and whether they should seek world markets more actively, but the real question has become how these general goals should be achieved. Theoretically, the countries could pursue two separate routes: they could join the multilateral "club" of countries through participation in the Bretton Woods system or they could seek strong alliances in the regional context. The third alternative was to pursue

1 The views expressed in this paper are personal and should not necessarily be attributed to the World Trade Organization or its members. The paper has been prepared for the conference on "Regional Economic Integration and Global Economic Cooperation: The Case of Central and Eastern Europe", Prague, 13-14 January 1997. I have benefitted from rich comments of the conference participants, especially Mark Allen, Franz-Lothar Altmann, Stephany Griffith-Jones, András Inotai, Ricardo Lago, Friedemann Müller, Joan Pearce, Barbara Stallings, Jan Joost Teunissen, Albrecht Von der Heyden and Per Magnus Wijkman. Statistical assistance of Maika Oshikawa and typing of Lidia Carlos-Silvetti are also most gratefully acknowledged.



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both options at the same time. As we shall see, most of the countries under consideration indeed pursued both routes.

The issue of seeking full participation in the multilateral trading system, on the one hand, or partnership in regional trading and other economic arrangements, on the other, has been studied extensively. The desirability of multilateral versus regional trading arrangements has been recently addressed, for example, in WTO (1995), de Melo and Panagariya (1993) and others. According to some authors, regionalism constitutes a danger for the multilateral system, while others (see, e.g. Mistry, 1996) argue that it helps to strengthen it. *Pari passu*, this issue obviously looms very heavily over the region of Central and Eastern Europe. The purpose of this paper is, therefore, to review the recent literature which evaluates the new regional arrangements in Central and Eastern Europe and identifies the constraints for further integration of these countries.

Evaluating regionalism is neither simple nor straightforward. Regional arrangements arenormally assessed on the basis of the Vinerian "trade diversion" and "trade creation" criterion (see Viner, 1950). More recently, researchers have begun to focus more on the extent to which regionalism affects the country's welfare (e.g. Baldwin *et al.*, 1996). In practice, however, the evaluations run into many difficulties. For example, there may be conflicting factors which determine the efficiency consequences of regional integration arrangements (de Melo, Panagariya and Rodrik, 1992). Moreover, empirical studies have been subject to a number of technical and data problems.[2] For a brief comment, see, for example, WTO (1994). As a result, many analysts believe that assessments of regional arrangements are basically an empirical problem (Laird, 1995).

We shall approach the assessment of the regional initiatives in Central and Eastern Europe from two different perspectives. Our *first approach* will be to assess the regional agreements as options faced by these countries in the light of various alternatives. Following the general literature on regionalism (e.g. Bhagwati, 1995), this can be done by ascertaining whether the regional agreements meet any or all of the four following criteria: (i) the extent to which the multilateral and regional agreements are consistent with domestic policy objectives; (ii) whether the regional agreements create incentives to reduce, minimise or eliminate trade diversion; (iii) whether the agreements have been leading to a deeper integration than what could have been achieved through the "multilateral option"; and (iv) whether the agreements have allowed a faster rate of integration with outside countries than what would have been possible under the multilateral

2 For a brief comment, see, for example, WTO (1994).



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alternatives. In more concrete terms, we will raise questions such as: Do the regional initiatives in CEECs represent a protectionist trend or do they support the officially declared objective of liberalisation instead? Have the regional initiatives been concentrated only on trade arrangements or have they also been extended to other areas as well? Do the initiatives exceed the scope of measures and concessions negotiated in multilateral agreements? Have the measures negotiated in the regional arrangements been actually and fully implemented? If not, why? What is the time schedule for the completion of the negotiated trade measures and how does this compare with the multilateral agreement?

Our *second approach* will be to review the empirical literature which focuses on the quantitative assessment of regionalism in Central and Eastern Europe. The literature can be summarised under two separate headings. One route has been the attempt to estimate the nature and extent of trade diversion/creation. It includes studies based on "gravity models" and other methods to evaluate intra-regional trade, as well as studies which try to measure extra-regional trade effects. Another route has been to evaluate the impact of regional agreements on welfare in the EU and in the CEECs by looking at income, employment and the budget in the EU and income effects in the CEECs.

Due to limitations of space and time, we will concentrate on two agreements – the Europe Agreements and the Central and East European Free Trade Agreement (CEFTA). This means that we shall have to disregard a number of important bilateral agreements that have been concluded by the CEECs, such as the customs union between the Czech Republic and Slovakia, and various bilateral investment protection treaties. We shall focus on the "economics" of the regional arrangements although other issues may be equally important. For example, it would be interesting to address the broader question of the importance of global integration for transition of the CEECs but this would go beyond the scope of this study.[3] Non-economic factors, which also determine the success ofregional arrangements, will only be touched upon in this paper.[4] The paper will cover six CEECs – Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovakia. However, due to lack of information, Bulgaria and Romania will receive a relatively less rigorous treatment. Finally, the focus of the paper is trade, even though much more could and should be said about

3 The reader is referred to the World Bank's *World Development Report 1996* which addresses this question.

4 However, the reader may wish to consult Bofinger (1995) for more details and for a discussion of the broader political economy aspects of the EU enlargement. On the "eastern" view, see, for example, Richter (1996).

capital markets. This emphasis is arguably the weakest point of the study since the integration of capital markets has been quite successful, as will be shown in the text. But since it was the trade segment of the Europe Agreements and CEFTA that has been most controversial, our choice fell on trade rather than investment.

The paper is organised in the following way. Part Two describes the starting economic conditions for the CEECs to get more closely integrated into the world economy. The description is important because it helps us to understand the new opportunities created by the political changes. In addition, the description is necessary in order to evaluate various regional agreements in the rest of paper. Part Three reviews the main features of the Europe Agreements and CEFTA and discusses the main impediments to integration. Part Four reviews the empirical literature which focuses on quantitative assessments of these regional initiatives.

## II The Initial Conditions: the Collapse of CMEA and the New Opportunities for Integrating the CEECs into the World Economy

### *The Collapse of CMEA*

The collapse of communism in Central and Eastern Europe also resulted in the collapse of one of the "pillar" institutions of the former communist countries – the Council for Mutual Economic Assistance (CMEA, or COMECON). All six countries under consideration were a part of the CMEA, and all were, therefore, affected by its collapse. The collapse was sudden and abrupt. In CEECs, it resulted in the abolition of various domestic and foreign incentives, the conversion from rouble to dollar payments, the introduction of customs duties on imports from other CEECs, serious deterioration in terms of trade, adverse budgetary consequences, and the decline of domestic production (e.g. World Bank, 1991 and Oblath, 1995). The exact magnitude of the decline of trade is difficult to assess because of serious statistical problems and the differences in special trading arrangements in CMEA countries (Brada, 1995). In particular, the available statistical estimates vary greatly, with Hungary showing the lowest degree of inconsistency of data. I have reviewed six major sources which provide statistical data on trade of CEECs and these data are presented in Appendix Table 1. Unfortunately, we have no way of correcting these numbers nor are we in a position to identify the origins of these problems.

One consistent picture emerging from the literature is the sharp decline of total trade of all CEECs in the late 1980s (e.g. Csaba, 1992; Drábek,



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1992; Hrnčíř, 1992; Rosati, 1992; and Riditer, 1992). The fall started in 1989 and was relatively short-lived in Hungary and Poland. Trade continued to be depressed in the other countries until 1991 and in some countries even longer. Another common characteristic emerging from these studies is that trade recovery in Bulgaria, Hungary and Romania was very slow. It was not until mid-1990s that their total trade fully recovered. The recovery was much faster in the Czechand Slovak Republics and, especially, in Poland. Thus for the region as a whole, the recovery of trade was not in full swing until 1995. The collapse of sub-regional trade (i.e. trade between CEECs and other former CMEA countries) continued until 1992 in Poland and until 1994 in the Czech Republic and Slovakia.

The second conclusion that can be drawn from the data is that Bulgaria has been by far the most affected country in the region – with 50 to 70 per cent decline of trade between 1989 and 1994, depending on the source. The fall of trade in former Czechoslovakia was also steep – 20 to 30 per cent – while the other countries appear to have been affected considerably less. The reason for the decline of trade (and for the extreme situations in Bulgaria and Czechoslovakia) was the relative dependence of these countries on CMEA trade. As the same table shows, the decline of trade of each CEEC with the other CMEA countries – approximated in the table by a country grouping identified as "centrally planned economies" (CPE) – was extreme.[5] Since the share of CMEA in total trade of each CEEC was also high, the collapse of CMEA trade was mainly responsible for the decline in total trade of each country.

Notwithstanding these heavy economic losses, there was virtually nobody in CEECs who regretted the end of CMEA as a trade institution. There was also hardly anybody in these countries who wanted to revive sub-regional cooperation in any form. The CMEA was seen as an instrument of power politics of the former USSR, and in the minds of the people, it was synonymous with the inefficiencies of central planning. The collapse of communism and of CMEA coincided with other important changes which are described in the following section.

## *The Unilateral Liberalisation in the CEECs*

### *Changing Incentives for Domestic Agents and the Domestic Market Opening*

The political changes in Central and Eastern Europe brought along rad-

5 There were a few exceptions to this pattern, as always. For example, Polish exports to the centrally planned economies probably did not decline as steeply and as suddenly as in the other CEECs, as suggested by Riditer (1992).



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ical changes in trade policy and institutions. These changes had three important features: their scope was wide-ranging, the speed of the reform was fast and, last but not least, the changes were introduced unilaterally. The primary effect of these changes was a fundamental change of incentives for domestic economic agents and, as we shall see further below, a considerable market opening to foreign suppliers of goods and services in these countries.

Briefly speaking, the reforms included the following major steps.[6] (1) *De-monopolisation of foreign trade* has been actively pursued in every Central and East European country. (2) *Quotas* have been considerably reduced in all CEECs, and they have been virtually eliminated in the Czech Republic, Slovakia and Romania where they are only retained in exceptional and normally "sanctionable" circumstances. (3) *Tariffs* have been retained as the main instrument of trade policy. For a number of reasons, the average level of tariffs in the CEECs was set at a low level. (4) *Foreign exchange restrictions* have been greatly reduced, and the system of foreign exchange payments has been considerably liberalised. (5) *Exchange rate policy* has been completely overhauled leading to the elimination of highly overvalued exchange rates and of the system ofmultiple exchange rates. (6) *Internal and external subsidies* have been either considerably reduced or completely eliminated. (7) *The settlements mechanism* for payments on transactions with other formerly socialist countries has been changed, and the use of barter trade and the settlement system based on inconvertible currencies has been eliminated.

The scope of liberalisation was dramatic. Trade barriers were either completely eliminated or significantly reduced. Tariffs have been set – partly for historical reasons and partly by accident – at relatively low levels, as we shall see in the following section. As a result, the Czech Republic and Slovakia ended up with one of the lowest tariff levels in the world. Since unilateral liberalisation represents the first-best policy option among trade policy alternatives, one may question whether any regional arrangement should have been sought in such circumstances especially if one realises that international bargaining was not the driving force behind these countries' search for regional arrangements.[7] Since the liberalisations were unilateral, the ability of using international negotiations to obtain access to other markets has been weakened if not lost. The answer must, therefore,

6 The text of this section is based on Drábek and Smith (1995) where the reader is also referred for more details.

7 It is often argued that regional arrangements are a useful instrument for obtaining concessions from the country's trade partners in exchange for its own. This point was well elaborated, for example, by de Melo and Panagariya (1995).



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lie in areas other than the politics of international negotiations. One such area is the similarity of interests between the CEECs and the EU.

### *Aims and Objectives of the CEECs*

#### *Similarity of Interests with the European Union*

The primary reasons for regional economic arrangements in Central and Eastern Europe are political, strategic and environmental as well as economic. The range of common interests between CEECs and the EU was fairly wide and has greatly facilitated or even stimulated regional integration. First, the introduction of a democratic system based on a multiparty political system, the respect of human and minority rights and the principles of a market economy was a commonly agreed *political* objective in both parts of Europe. The second common interest was *security*. While the collapse of CMEA and its military arm – the Warsaw Pact – was generally welcomed, Russia's retreat from Central Europe was seen by many in Central Europe as temporary (e.g. Richter and Tóth, 1994). A closer security tie to the West has, therefore, been an important objective of the CEECs, while the EU considered this an important foreign policy instrument for maintaining stability in the region. The third common interest concerns *environmental* issues. The EU has a strong interest in closer cooperation with Eastern Europe in resolving a variety of environmental problems that have plagued the CEECs for decades and that are unlikely to be resolved by the Central and East Europeans themselves with the speed that the West would consider desirable.[8]

It is, of course, arguable whether all these interests are as commonly or as deeply shared in both parts of Europe. For example, the CEECs' interest in closer security cooperation with the EU is normally associated with the CEECs' desire to join NATO, which in Eastern Europe is often seen, wrongly, as the military arm of the EU. All sixCEECs have begun their discussions with NATO representatives, and they have already taken steps towards closer military cooperation. On the European Union side the responses have usually been more cautious. The security motivations tend to be somewhat different with only some overlap with the interest of the CEECs.

Perhaps the most controversial issue in the commonality of interests

8 Even though environmental questions have become very important in the whole EU, several member countries such as the Scandinavian countries or Austria have become particularly vocal and active to pursue their environmental interests with some if not all of the CEECs.



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concerns *economic gains*. Many economists have argued that the creation of a regional economic arrangement between the EU and the CEECs will bring considerable economic benefits to both partners. Such opinions have usually been expressed in the CEECs or by observers on behalf of these countries, while the opinions in the EU have been much more cautious. This difference of opinion will be discussed in more detail below, but a few comments may be in order here. The caution in the EU originates in the fear that cheap labour in the CEECs represents a serious threat for the EU countries because of cheap imports or the relocation of industries from the EU to the CEECs. A less disputable and more objective reason for believing that the distribution of economic gains is very likely to favour the CEECs is that their economic dependence on the EU is much higher than in the reverse case. For instance, a large proportion of CEECs' trade is with the EU, and not the other way around. Foreign investment flows move predominantly in one direction only – from the EU to the CEECs. Central and Eastern European countries also hope to receive relatively large budgetary transfers either as a part of regional support programmes, infrastructural projects or as support for agriculture. Finally, CEECs will also obtain technological benefits as they acquire access to modern Western technology.

In sum, most writers agree that the costs and benefits of regional economic integration between the EU and the CEECs are not restricted to the economic realm of, for example, trade liberalisation measures (see Baldwin, 1992; Winters, 1992; and Brada, 1992). Bofinger (1995) even argues that benefits are much less important than the establishment of a rules-based system built on the Treaty of Rome.

### *GATT/WTO Membership*

Five of the six countries covered in this paper were members of GATT at the time of the political changes. Their GATT membership also affected the countries' attitudes and policies towards regional arrangements. The countries included the Czech Republic and Slovakia as the successors to former Czechoslovakia, Hungary, Poland and Romania. The Czech Republic and Slovakia were the original Contracting Parties to GATT (1948) as the successors to former Czechoslovakia. Hungary became a Contracting Party in 1973, Poland in 1967 and Romania in 1971. Bulgaria applied for membership in 1986 and joined in 1996, and the Baltic countries joined in 1992. The latter obtained an observer status in GATT and, subsequently, in the WTO. Further details are provided in Table 1 below.

While being full members of GATT, the membership of the CEECs was more or less inactive during the time when these countries were cen-



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trally planned. Once these countries introduced market reforms, their membership could be fully activated but only after the countries "notified" and renegotiated the measures of the reforms in GATT including, in particular, their tariff schedules. Typically, the countries "inherited" a tariff schedule from the previous regime which had little economic rationale. For this reason alone, the countries thought it necessary to seek adjustments to their tariff schedules and negotiate them in GATT. The adjustments were accepted by the international community on the condition that the average tariff incidence remained more or less the same.

**Table 1 Foreign Trade Agreements and Trade Regimes of Countries in Transition: Eastern Europe and the Baltic States**

| Countries | Foreign Trade Arrangements | Trade Regimes |
|---|---|---|
| **Bulgaria** | • joined WTO in Dec. 1996.<br>• EU Europe Agreement in force since Feb. 1995, Interim Agreement covering trade components in force since Jan. 1994.<br>• EFTA Free Trade Agreement in force since July 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• Free Trade Agreements in force with Czech Republic and Slovak Republic since Jan. 1996. |
| **Czech Republic** | • GATT original contracting party as successor to CSFR (1948), WTO member.<br>• EU Europe Agreement signed with CSFR in Dec. 1991, renegotiated with Czech Republic Oct. 1993, entered into force Feb. 1995. Interim Agreement covering trade components in force since March 1992.<br>• EFTA Free Trade Agreement in force since July 1992 for CSFR, protocol on succession of CSFR agreement signed April 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since March 1993.<br>• Customs Union with Slovak Republic in force since Jan. 1993.<br>• Free Trade Agreements in force with Bulgaria (Jan. 96), Estonia (July 96), Latvia (July 96), Romania (Jan. 95) and Slovenia (Jan. 94). |
| **Estonia** | • WTO observer status (June 1992), working party on accession (March 1994).<br>• EC Trade and Cooperation Agreement in force since March 1993, EU Free Trade Agreement in force since Jan. 1995. Exploratory talks on Association Agreement.<br>• EFTA Declaration on Co-opera tion Dec. 1991; bilateral Free | • All other OECD countries have granted MFN and/or GSP.<br>• Baltic Free Trade Agreement in force since April 1994, Free Trade Agreement in Agricultural Products signed June 1996, (Baltic Customs Union intended by Jan. 1998).<br>• Free Trade Agreements in force with Czech Republic (July 96), Slovak Republic (July 96) and |



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Table 1 (continued)

| Countries | Foreign Trade Arrangements | Trade Regimes |
|---|---|---|
| | Trade Agreements in force with Finland (Dec. 92), Norway (June 92), Sweden (July 92) and Switzerland (Apr.93). EFTA Free Trade Agreement in force since June 1996 in replacement to the bilateral agreements with Norway and Switzerland. | Ukraine (March 96).<br>• MFN agreements on trade in force with Australia, Canada, China, Moldova, Poland, Romania, Turkey and Turkmenistan. |
| **Hungary** | • WTO member (1973); working party on re-negotiation of accession terms formed.<br>• EU Europe Agreement in force since Feb. 1994, Interim Agreements covering trade component in force since March 1992.<br>• EFTA Free Trade agreement in force since Oct. 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since March 1993.<br>• Free Trade Agreement with Slovenia in force since Jan. 1995 (tariffs phased out by 2001). |
| **Latvia** | • WTO observer status (Oct. 1992), working party on accession (1993).<br>• EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement in force since Jan. 1995. Exploratory talks on Association Agreement.<br>• EFTA Declaration on Cooperation Dec. 1991, bilateral Free Trade Agreements in force with Finland (July 93), Norway (June 92), Sweden (July 92) and Switzerland (Apr. 93). EFTA Free Trade Agreement in force since June 1996 in replacement to the bilateral agreements with Norway and Switzerland. | • All other OECD countries have granted MFN and/or GSP.<br>• Baltic Free Trade Agreement in force since April 1994, Free Trade Agreement in Agricultural Products signed June 1996, (Baltic Customs Union intended by Jan. 1998).<br>• Free Trade Agreements with Czech Republic and Slovak Republic in force since July 1996.<br>• MFN agreements on trade in force with Armenia, Australia, Azerbaijian, Hungary, India, Moldova, Poland, Russian Federation, Tadjikistan, Turkmenistan, Ukraine, United States and Uzbekistan. |
| **Lithuania** | • WTO observer status (Oct. 1992); working party on accession (1993).<br>• EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement in force since Jan. 1995. Exploratory talks on Association Agreement. | • All other OECD countries have granted MFN and/or GSP status.<br>• Baltic Free Trade Agreement in force since April 1994, Free Trade Agreement in Agricultural Products signed June 1996, (Baltic Customs Union intended by Jan. 1998). |



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Table 1 (continued)

| Countries | Foreign Trade Arrangements | Trade Regimes |
|---|---|---|
| | • EFTA Declaration on Co-operation Dec. 1991, bilateral Free Trade Agreement in force with Finland (July. 93), Norway (June 92), Sweden (July 92) Free Trade Agreement with EFTA signed Dec. 1995 in replacement to the bilateral agreements with Norway and Switzerland. | • Free Trade Agreement in force with Ukraine.<br>• MFN agreements on trade in force with Australia, Belarus, Bulgaria, Canada, China, Cyprus, Czech Republic, Cuba, Hungary, Iceland, India, Japan, Kazakhstan, Romania, Russian Federation, Slovak Republic, Slovenia, South Korea, Turkey and Uzbekistan. |
| **Poland** | • WTO member (1967), working party on re-negotiation of accession terms.<br>• EU Europe Agreement in force since Feb. 1994. Interim Agreements covering trade components in force since March 1992. | • EFTA Free Trade Agreement in force since Nov. 1993.<br>• All other OECD countries have granted MFN/GSP status.<br>• CEFTA in force since March 1993. |
| **Romania** | • WTO member (1971), working party on re-negotiation of accession terms.<br>• EU Europe Agreement in force since Jan. 1995. Interim Agreement covering trade components in force since May 1993.<br>• EFTA Free Trade Agreement in force since May 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• Free Trade Agreements in force with Czech Republic and Slovak Republic since Jan 1995. |
| **Slovak Republic** | • GATT original contracting party as successor to CSFR (1948).<br>• EU Europe Agreement with CSFR signed Dec. 1991, renegotiated for Slovak Republic October 1993, entered into force Feb. 1995. Interim Agreement covering trade components in force since March 1992.<br>• EFTA Free Trade Agreement in force since July 1992 for CSFR, protocol on succession of that treaty signed April 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since March 1993.<br>• Customs Union with Czech Republic since Jan. 1993.<br>• Free Trade Agreements in force with Bulgaria (Jan. 96), Estonia (July 96), Latvia (July 96), Romania (Jan. 95) and Slovenia (Jan. 94). |

*Source:* Based on EBRD, Transition Report (1994) and WTO Working Party Reports.



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*The Importance of Speed*

Another policy consideration of CEECs governments was the speed of reforms. All the policy changes that were taking place in the aftermath of the revolutions were very fast. They took everybody by surprise, as the internal events moved considerably faster than anybody – abroad or at home – was able to comprehend or predict. Even domestic policymakers were often only responding to actual events. Whether these countries would be able to establish stable and transparent economic relations with their foreign partners became, therefore, a legitimate question.

Under these circumstances it became obvious that regional economic arrangements could become more practical and effective than multilateral initiatives. What some of these countries needed was a signed legitimacy since some of them were "brand new" countries. What all of these countries needed was credibility of their economic policies since they had no track record of policymaking in a market environment. An international agreement –regional or multilateral– was clearly an important step towards the country's credibility. Since regional agreements tend to be easier to negotiate than multilateral agreements because of the smaller number of actors involved in negotiations, they could provide a faster resolution to the problem of legitimacy and credibility of the countries' policies. Membership of GATT was important but was regarded as less adequate for these purposes.[9]

*The Europe Agreements as an Instrument for Restructuring Foreign Trade*

The signing of the Europe Agreements (see next section) was expected to have a major impact on trade incentives in CEECs. The policy measures were expected to lead to an improvement of profitability of exports to the West and, in general, of production of tradables (see e.g. Rosati, 1990). They were also expected to lead to a significant change in relative prices due to the elimination of differences between domestic and foreign prices, to the abolition of special pricing arrangements in the CMEA and other peculiarities of the CMEA and of centrally planned foreign trade. In Poland, for example, the policy liberalisation initially led to the deterioration in the Polish-Soviet terms of trade which, in turn, reflected the fact that Polish export prices tended to be higher than Polish import prices prior to the introduction of market-based pricing rules. The former affect-

9 Many of these points are based on my personal experience as the Czechoslovak chief international negotiator. Unfortunately, these points have not yet been well documented in the literature to my knowledge.



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ed mainly foodstuffs, chemicals and other manufactures – hard goods – while the latter covered predominantly non-ferrous metals, iron and steel – soft goods. Prices of Polish industrial goods tended to be higher than world prices while the prices of Polish crude materials and food tended to be closer to world market prices. The reverse was true for Soviet exports to Poland (Rosati, 1990).

Even though it was well understood at the time that these policy changes would most likely lead to strong inflationary pressures and would call for major real adjustments indomestic economies,[10] Central and Eastern European governments strongly supported this policy reform. The higher import prices resulting from the domestic price realignment contributed to as much as 10 to 20 per cent of the initial inflation in Poland (Rosati, 1990). The driving force behind the change in trade incentives was the desire to re-establish what may be considered *natural* trade ties between the CEECs and Western Europe (Collins and Rodrik, 1991). The pursuit of this objective had a strong empirical support from economists. Using typically the "gravity" models, relevant studies indicated that the trade of the CEECs with the EU was artificially suppressed until 1990 while trade with other – then formerly socialist – countries was artificially encouraged.[11] The only disagreement that exists among experts is the magnitude of "under-trading" with the EU and the extent of "over-trading" with other Central and East European countries including the former Soviet Union. While the ratios between the potential and actual trade obtained from these models tend to be in the range of 2 to 3 for trade with the EU in the case of Baldwin (1994, p. 90), Collins and Rodrik's somewhat different methodology leads to ratios that are in the range of 3 to 5. Wang and Winters' results are broadly similar with those of Collins and Rodrik.[13] The results are summarised in the following Tables 2A and 2B. Moreover, the gravity models also show that the potential of trade expansion is not limited to a few EU countries. For example, Faini and Portes (1995) show that even the "Southern Wing" countries such as Greece and Spain have a potential for a significant increase of trade with the CEECs.

### *A Summary of Regional and Multilateral Initiatives*

The unilateral liberalisation noted above was the most important step in

10 These issues have also been discussed, for example, by Brada (1992), Havlik (1991), or World Bank (1991).

11 There is a long history of writing on this subject. For more recent examples, see Baldwin (1994), Wang and Winters (1991), and Hamilton and Winters (1994).

12 Baldwin (1994) also reviews other studies based on the "gravity" model which reach similar conclusions.



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**Table 2A CEECs-EU Trade: Actual and Potential Trade at the End of 1980s**
(billions of dollars)

| **Baldwin (1994)** | CEECs-EU12 Trade (1989) | | | CEECs-EFTA Trade (1989) | | |
|---|---|---|---|---|---|---|
| | Actual | Potential | Ratio | Actual | Potential | Ratio |
| Bulgaria | 0.5 | 2.9 | 5.8 | 0.1 | 0.5 | 7.3 |
| CSFR | 2.6 | 12.5 | 4.8 | 0.8 | 4.6 | 5.5 |
| Hungary | 2.6 | 4.5 | 1.7 | 0.9 | 1.5 | 1.7 |
| Poland | 4.0 | 8.5 | 2.1 | 1.0 | 1.9 | 2.0 |
| Romania | 2.5 | 3.0 | 1.2 | 0.2 | 0.6 | 3.2 |

| **Collins & Rodrik (1991)** | CEECs-EC Trade (1988) | | | CEECs-EFTA Trade (1988) | | |
|---|---|---|---|---|---|---|
| | Actual | Potential | Ratio | Actual | Potential | Ratio |
| Bulgaria | 1.3 | 6.7 | 5.2 | 0.2 | 1.1 | 5.5 |
| CSFR | 3.8 | 12.6 | 3.3 | 1.1 | 2.9 | 2.6 |
| Hungary | 2.4 | 5.9 | 2.5 | 0.9 | 2.6 | 2.9 |
| Poland | 4.3 | 20.1 | 4.7 | 1.4 | 4.1 | 2.9 |
| Romania | 2.2 | 9.0 | 4.1 | 0.2 | 1.4 | 7.0 |

| **Wang & Winters (1991)** | CEECs-EC Trade (1985) | | | CEECs-EFTA Trade (1985) | | |
|---|---|---|---|---|---|---|
| | Actual | Potential | Ratio | Actual | Potential | Ratio |
| Bulgaria | 0.4 | 2.5 | 6.3 | 0.06 | 0.6 | 10.0 |
| CSFR | 1.5 | 15.0 | 10.0 | 0.5 | 2.1 | 4.2 |
| Hungary | 1.3 | 6.5 | 5.0 | 0.7 | 0.9 | 1.3 |
| Poland | 2.5 | 12.5 | 5.0 | 0.6 | 2.6 | 4.3 |
| Romania | 2.5 | 5.2 | 2.1 | 0.3 | 1.2 | 4.0 |

*Source:* Based on Baldwin (1994), Collins and Rodrik (1991) and Wang and Winters (1991).

**Table 2B Intra-CEECs Trade**
(billions of dollars)

| | **Baldwin (1994)** 1989 | | | **Collins &Rodrik (1991)** 1988 | | | **Wang & Winters (1991)** 1985 | | |
|---|---|---|---|---|---|---|---|---|---|
| | Actual | Potential | Ratio | Actual | Potential | Ratio | Actual | Potential | Ratio |
| Bulgaria | | | | 2.7 | 0.9 | 0.3 | 9.8 | 2.6 | 0.3 |
| CSFR | 2.7 | 2.8 | 1.0 | 3.1 | 2.9 | 0.9 | 12.5 | 7.4 | 0.6 |
| Hungary | 1.8 | 1.4 | 0.8 | 1.0 | 2.4 | 2.2 | 4.4 | 4.1 | 0.9 |
| Poland | 2.2 | 1.8 | 0.8 | 1.6 | 3.7 | 2.3 | 5.9 | 9.1 | 1.5 |
| Romania | 1.8 | 0.8 | 0.4 | 1.0 | 2.1 | 2.0 | 4.0 | 4.3 | 1.1 |

*Source:* Based on Baldwin (1994), Collins and Rodrik (1991) and Wang and Winters (1991).



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the CEECs' move away from their traditional isolationism. The other step was their attempt to join or activate their membership in the multilateral economic institutions as well as to encourage various regional initiatives. Participation in both multilateral and regional initiatives was pursued simultaneously, but the regional arrangement with the European Union had a special attractiveness, as noted above. We have already reviewed the countries' relations with the GATT/WTO. It only remains to list their bilateral and other regional initiatives.[13] All of the bilateral and regional initiatives are summarised in Table 1 above.

The CEECs pursued a number of regional and sub-regional arrangements. Among these,the most important was arguably the agreement with the European Union. The six Central and East European countries signed Associate Agreements (later transformed into the "Europe Agreements") in the course of 1992-1993. The Baltic countries signed a relatively less comprehensive Trade and Cooperation Agreement with the EU in February and March 1993. In addition, all CEECs have signed an agreement with the remaining countries in EFTA while the Baltic countries have signed a relatively less comprehensive Declaration on Cooperation with EFTA. Furthermore, the Czech Republic, Hungary, Poland and Slovakia agreed to establish their own sub-regional trade initiative – the Central European Free Trade Arrangement (CEFTA) – in March 1993 and they have since invited Bulgaria, Romania and Slovenia to join. The Baltic countries established a free trade area following their agreement signed in April 1994. Moreover, there was a proliferation of bilateral free trade agreements, which are also summarised in Table1. As a special case, the list of bilateral initiatives also includes the establishment of a customs union between the Czech Republic and Slovakia following the separation of these countries from former Czechoslovakia. In addition to the elimination of all internal barriers and the establishment of a common external tariff, the main feature of this customs union was the establishment of a payment clearing system which was in place in parallel with the payments mechanism operating with other countries. The clearing system was eliminated at the end of September 1995.

Several CEECs have concluded bilateral free trade agreements. In particular, Czech Prime Minister V. Klaus has been actively seeking support for bilateral agreements not only in the region but also in other parts of the world. However, the number of bilateral agreements that the Czech Government has so far been able to sign is still relatively small (see Table 1

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13 The participation in the other Bretton Woods institutions – the World Bank and the International Monetary Fund – is not discussed in this overview paper. The reader may wish to refer to Schonfeld *et al.* (1995) for more details of this aspect.

above). In total, the Czech government signed six agreements before the end of 1995. These are the Europe Agreement, CEFTA, and the bilateral agreements with Slovenia, Latvia, Estonia and Romania. Slovakia, Hungary and Poland have also signed bilateral free trade agreements. All of these agreements concern countries with relatively small mutual trade. No bilateral trade of any of these countries exceeds 1 per cent of the respective country's total trade– with the sole exception of trade between the Czech Republic and Slovakia (see Appendix Table 3).

The above list of regional initiatives is not exhaustive. The countries in the region have pursued other regional initiatives. These include, for example, the "Central European Initiative", "The Danube Valley Cooperation", "South-East European Cooperation", "Border Cooperation of Poland and the Czech Republic" and attempts to develop military cooperation between Poland and the Czech Republic. These initiatives are typically either highly specific or they have not really got off the ground.

## III The New Regionalism in the CEECs

We have seen in the previous section that the initial conditions were highly favourable for the pursuit of regional initiatives. The CEECs and the EU had a broad range of similar objectives to provide the basis for the Europe Agreements. The discussion in this section is about the other three important criteria of successful regional arrangements mentioned in the introduction: (1) the establishment of incentives to stimulate trade creation; (2) the depth of the agreement; and (3) the speed of integration.

### *The Main Features of the Europe Agreements*

The dramatic liberalisation of economic policies in the CEECs has opened up newopportunities for other countries in this region, and for closer integration of the CEECs into the world economy. The most rapid response came from the European Union, which answered the calls of the CEECs for a closer integration by offering these countries the status of associate membership. The first three of these association agreements (later transformed into "Europe Agreements" covering all ten CEECs) were signed with the so-called Visegrad countries – Czechoslovakia, Hungary and Poland – in 1993, and they had several important features.

#### *The Speed of Establishing the Free Trade Area*

The trade component of the Europe Agreements provides for the estab-



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lishment of a free trade area between the EU and the CEECs over a period of ten years. The one major exception is agriculture, which remains subject to restrictive trade measures throughout the whole period. The Agreements also provide for the elimination of all quantitative restrictions on the date of entry of the Agreement into force except in the case of coal, steel, textiles and clothing. The Agreement provides, therefore, for completely free access of all industrial products, including textiles and steel, by the end of the ten-year transition period. The preferential treatment of industrial products has been phased in accordance with the following categories: (1) the "one-year delayed" free trade group; (2) the "four-year delayed" free trade group; (3) the "quota/five-year delayed" free trade group; (4) steel and coal schedules, leading to free trade by the end of the fifth and second year respectively and subject to some differences among the beneficiaries; (5) the Multi-Fibre Arrangement to be negotiated bilaterally and in the context of the Uruguay Round Agreement; and (6) the "immediately" free trade group.[14]

By deciding on a free trade area rather than other forms of integration, the CEECs did not intend to discriminate against third countries. This would probably have been the case if the Europe Agreements had led to the establishment of a customs union which, in turn, would have called for an agreement on a common external tariff. Since the existing external tariffs differed among the CEECs, the establishment of a customs union would have probably resulted in a higher level of external tariff for most of the member countries. The non-discriminatory nature of the Europe Agreements was further supported by two additional factors – the unilateral liberalisation pursued by these countries and the fact that of the six CEECs under review only Bulgaria was not a GATT/WTO member country. The GATT membership meant that the CEECs could not raise the level of protection above the commitments already made in GATT.[15]

*The Depth of the Agreement*

The aim and scope of the Europe Agreements extends beyond a simple free trade agreement. It covers not only merchandise trade but also trade in services, foreign investment, payments systems, various aspects of economic cooperation (such as customs procedures and administration, control of drug trafficking etc.). In addition, the Agreements provide for a virtually complete integration of capital markets. Particularly important are

14 This classification is based on Kaminski (1995), p. 20.

15 All of these countries have, however, restructured their tariffs, as noted above, while retaining the average tariff incidence more or less unchanged.



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the measures to liberalise inward foreign investment together with protection to be provided to foreign firms. Foreign firms are to be treated not only on the mostfavoured nation basis but they also receive "national treatment". Liberalisation of payments restrictions has become another important element of stimulating both foreign trade and inward foreign investment. Labour markets are affected significantly less,[16] but the Agreements provide for an extensive cultural and political cooperation.

*Linking of Europe Agreements to GATT/WTO*

Regional trading arrangements are often looked upon with concern in the WTO because of fears that they may violate ArticleXXIV of GATT and thus undermine the multilateral trading system. These concerns have also emerged during the negotiations and implementation of the Europe Agreements. Three major concerns were expressed. The first concern is about the *regional* mechanism for dispute settlement which is seen as a potential threat to the dispute settlement mechanism in the WTO. The second relates to competition policies and safeguard measures, and the third to the level of protection against third countries.

On the first count, the Europe Agreements clearly pose no danger for the WTO system since the Agreements do not provide any effective mechanism of dispute settlement.[17] On the second account, the situation is somewhat different but not entirely. The Agreements seems to provide for "own" definition of dumping and other safeguard measures that constitute a danger to local industries. In general, such provisions do not usually respect the national treatment obligation of the GATT, and this is also the case of the Europe Agreements. However, the problem can be solved by harmonising the markets through stronger competition enforcement and the parallel phasing out of anti-dumping measures.[18] Both of these steps are foreseen in the Europe Agreements because the CEECs will adopt EU competition policies. A number of steps still need to be taken but, as pointed out by independent observers, the Europe Agreements already contain the necessary provisions to accelerate the countries' integration into the EU.[19]

On the third account, the evidence is scarce. Nevertheless, given the rel-

16 See also discussion in the next section.

17 The Agreements enable consultations and specify procedure for lodging complaints. These procedures, however, do not offer any effective room for negotiating disputes. For more details see Drábek (1994).

18 For more details, see Marceau (1995), p. 38.

19 See, for example, Marceau (1995), p. 50.



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atively low level of tariff before the liberalisation, the commitment of those CEECs that were GATT members to maintain the existing level of tariff unchanged, and the fact that each CEEC has radically liberalised the domestic institutions of international trade, we can only surmise that the level of protection against third countries has not increased. As the evidence provided in the next section shows, the opposite is in fact more likely to be the case.

It is also fairly clear that the Agreements provide for at least two major policy changes in the CEECs which are essential for stimulating dynamic gains: the liberalisation of inward foreign investment and the liberalisation of the payment settlement mechanism. These are two crucial measures which create the condition for a welfare-improving regional integration between the EU and the CEECs. The other important policy measure is the liberalisation of mutual trade to which we shall now turn.

### *Market Access to the EU: "A Glass Half-Full or Half-Empty?"*

The first crucial and frequently discussed question is the extent to which the Europe Agreements represent a modest or a radical step towards closer integration with the EU. Another equally important question is whether the Agreements are an effective instrument for opening up markets. The usual response to the first question is that, because of their depth, the Europe Agreements represent an important instrument for closer integration of the CEECs and the EU. Nevertheless, the second question still remains unanswered in the minds of many people, that is whether the Europe Agreements have been "a glass that is half-full or half-empty", rather than a clear move towards a real market opening.

More specifically, there is considerable disagreement about the extent of concessions provided in the Europe Agreements by the EU. The traditional perception of the Agreements was that they significantly opened up opportunities for the CEECs (e.g. Castile, 1996; Bucker, *et al.*, 1994; and Drábek and Smith, 1995). Notwithstanding these concessions, however, many observers have been quite critical. The main point of criticism has been the relatively restrictive treatment of "sensitive" products – textiles, steel and coal and other agricultural products. Access to service sectors also remains relatively restricted.[20] Moreover, several observers have pointed out that the concessions granted in the Agreements did not substantially differentiate among the CEECs, especially in the light of concessions

20 See Winters (1992), Messerlin (1992), and European Commission (1994). Other critical studies are briefly reviewed in Drábek and Smith (1995).



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already offered to these countries under the generalised system of preferences (GSP) and similar treatments.

In order to evaluate the concessions negotiated under the Europe Agreements, it is necessary to compare various barriers to trade *before* and *after* the signing of the agreements. Their real importance is also dependent on the initial level of trade barriers, on the initial shares of mutual trade, the size of countries, and the level of diversification of their economies. Unfortunately, the literature has not so far covered all these elements which are necessary for a more thorough evaluation of the concessions. Nevertheless, several interesting conclusions can be drawn from the analysis of tariff concessions as reported in Table 3. The table shows that prior to the European Agreements, the CEECs faced barriers against their industrial exports to the EU that were neither prohibitive nor excessively high. The average EU industrial tariff on exports from Bulgaria and Czechoslovakia was about 7 per cent, even though these exports were probably more restricted by non-tariff barriers (NTB) than by tariffs. The other countries – Hungary, Poland and Romania – faced an even lower tariff in the EU as all three countries benefitted from the GSP rates. The level of protection was much higher on non-industrial goods, partly due to the agricultural policies of the EU and partly due to the fact that the GSP status did not apply to non-industrial products. In the case of industrial products, as the figures in the last column of Table 4 suggest, the share of CEECs exports subject to immediate free access was less than 40 per cent in Romania and less than 50 per cent in the other CEECs.

**Table 3 CEECs – Pre-Agreement Market Access to the EU: Industrial Products Versus Other Goods**

| | Index, 1991 1988 = 100 | | NTB coverage ratio (in %) | | Simple average tariff rate (in %) | |
|---|---|---|---|---|---|---|
| | industrial | other | industrial | other | industrial | other |
| Bulgaria | 162 | 165 | 22.5 | 48.3 | 6.9 | 11.6 |
| Czechoslovakia | 196 | 163 | 24.0 | 52.5 | 7.0 | 11.7 |
| Hungary | 188 | 156 | 24.2 | 57.7 | 0.1 | 9.4 |
| Poland | 202 | 165 | 23.6 | 48.6 | 0.1 | 10.5 |
| Romania | 68 | 85 | 28.4 | 59.8 | 0.0 | 8.6 |

*Source:* Kaminski (1995), p. 19.



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Table 4 CEECs – Composition of Industrial Exports to the EC by ITA Groups, 1988-92

| | "One-year-delayed" | "Four-year-delayed" | "Quota/five-year-delayed" | "Multi-Fibre Arrangement" | "Steel" | "Coal" (excluding Germany and Spain) | "Coal" (Germany and Spain) | "Free Trade Residnal" |
|---|---|---|---|---|---|---|---|---|
| **Bulgaria** | | | | | | | | |
| 1988 | 2.5 | 0.2 | 10.9 | 14.9 | 9.6 | 0.1 | 0.0 | 61.7 |
| 1989 | 2.1 | 0.4 | 12.6 | 15.7 | 14.2 | 0.0 | 0.0 | 55.0 |
| 1990 | 1.4 | 0.3 | 13.6 | 19.1 | 17.3 | 0.3 | 0.0 | 47.9 |
| 1991 | 1.4 | 0.1 | 16.3 | 20.9 | 11.4 | 0.1 | 0.0 | 49.6 |
| 1992 | 0.9 | 0.0 | 14.0 | 29.5 | 8.0 | 0.2 | 0.0 | 47.4 |
| **Czechoslovakia** | | | | | | | | |
| 1988 | 0.6 | 0.0 | 24.4 | 13.2 | 12.6 | 0.1 | 2.8 | 46.4 |
| 1989 | 0.7 | 0.0 | 25.3 | 12.3 | 13.6 | 0.1 | 2.7 | 45.3 |
| 1990 | 0.5 | 0.1 | 24.2 | 13.5 | 14.2 | 0.0 | 3.0 | 44.4 |
| 1991 | 1.1 | 0.1 | 26.5 | 13.6 | 10.5 | 0.0 | 3.0 | 45.2 |
| 1992 | 1.3 | 0.0 | 25.9 | 13.7 | 10.4 | 0.0 | 2.3 | 46.4 |
| **Hungary** | | | | | | | | |
| 1988 | 1.0 | 0.9 | 26.1 | 22.9 | 6.9 | 0.1 | 0.0 | 42.1 |
| 1989 | 1.5 | 1.0 | 25.7 | 21.5 | 6.5 | 0.2 | 0.0 | 43.6 |
| 1990 | 1.0 | 0.9 | 24.9 | 21.5 | 6.7 | 0.1 | 0.1 | 44.7 |
| 1991 | 0.7 | 0.5 | 24.3 | 21.4 | 4.2 | 0.1 | 0.0 | 48.9 |
| 1992 | 0.5 | 0.3 | 23.7 | 21.8 | 3.6 | 0.0 | 0.0 | 50.1 |
| **Poland** | | | | | | | | |
| 1988 | 0.2 | 0.3 | 22.4 | 13.8 | 4.2 | 9.5 | 3.5 | 46.2 |
| 1989 | 0.3 | 0.2 | 22.9 | 13.7 | 6.0 | 8.7 | 3.2 | 45.0 |
| 1990 | 0.5 | 0.4 | 23.7 | 15.2 | 5.4 | 6.0 | 3.9 | 44.9 |
| 1991 | 0.4 | 0.8 | 23.6 | 17.6 | 4.5 | 4.3 | 4.6 | 44.2 |
| 1992 | 0.7 | 0.7 | 24.4 | 19.0 | 4.3 | 3.7 | 3.5 | 43.6 |
| **Romania** | | | | | | | | |
| 1988 | 0.1 | 5.1 | 25.7 | 19.9 | 4.2 | 0.0 | 0.0 | 45.1 |
| 1989 | 0.2 | 5.2 | 23.1 | 19.3 | 4.0 | 0.0 | 0.0 | 48.2 |
| 1990 | 0.1 | 2.7 | 28.0 | 26.4 | 4.4 | 0.0 | 0.0 | 38.5 |
| 1991 | 0.0 | 1.6 | 31.4 | 28.2 | 3.6 | 0.0 | 0.0 | 35.3 |
| 1992 | 0.0 | 0.4 | 30.4 | 39.0 | 6.7 | 0.0 | 0.0 | 23.5 |

*Note:* ITA stands for "Interim Trade Agreement" between the EU and the CEECs prior to the coming into force of the Europe Agreements.
*Source:* Kaminski (1995), p. 36.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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Most other export concessions tended to be delayed if not "end-loaded". Perhaps even more importantly, exports of considerable interest to the CEECs – textiles and clothing (the "multi-fibre" commodities), steel, coal and agricultural products – were treated as "sensitive" products by the EU and thus were subject to specific liberalisation schedules, as noted above. Excluding agriculture, these products accounted for at least 25 per cent of industrial exports. In the case of Romania, the share was more than 45 per cent. More importantly, the "sensitive" products included not only commodities that have been historically subject to international regulations such as to the Multi-Fibre Arrangement, but also products for which import restrictions were much more unusual and therefore controversial. For example, the products on the list of Czech exports to the EU covered such commodities as passenger cars, cement, furniture, glassware, trucks, tractors and many other commodities of considerable interest to the Czech Republic (Mobius and Schumacher, 1994). However, a substantial improvement in EU market access should take place in the beginning of the sixth year of the Agreements when a large proportion of industrial goods will be liberalised (see Table 5). In sum, the Europe Agreements have improved market access, and the improvement has been relatively fast, but it was limited to a relatively small share of these countries' exports and excluded important and highly competitive products.

**Table 5 CEECs – Share of Duty-Free Goods in Industrial and Total Exports to the EU, 1992-98**

| | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 |
|---|---|---|---|---|---|---|---|
| **Share in industrial imports** | | | | | | | |
| Bulgaria | 54 | 54 | 57 | 58 | 59 | 60 | 61 |
| Czechoslovakia | 59 | 63 | 65 | 67 | 71 | 86 | 86 |
| Hungary | 62 | 64 | 66 | 67 | 68 | 78 | 78 |
| Poland | 56 | 63 | 65 | 66 | 72 | 81 | 81 |
| Romania | 39 | 39 | 42 | 44 | 46 | 48 | 61 |
| CEE-5 | 58 | 69 | 70 | 70 | 71 | 74 | 80 |
| **Share in total imports** | | | | | | | |
| Bulgaria | 43 | 43 | 45 | 45 | 46 | 47 | 56 |
| Czechoslovakia | 55 | 59 | 61 | 62 | 66 | 80 | 80 |
| Hungary | 48 | 50 | 51 | 52 | 53 | 60 | 60 |
| Poland | 47 | 53 | 55 | 56 | 61 | 69 | 69 |
| Romania | 36 | 36 | 39 | 41 | 43 | 45 | 57 |
| CEE-5 | 44 | 59 | 60 | 60 | 61 | 63 | 69 |

*Note:* In computing the duty-free shares, the commodity composition of flows in 1992 was applied to the anticipated customs status of each item in all subsequent years.
*Source:* Kaminski (1995), p. 37.



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The extent of concessions on *agricultural products* has been even more limited.[21] Overall, only modest concessions, mostly in the form of increased tariff quotas, were granted for cereals, sugar, beef and dairy products, somewhat better concessions were offered for pork, poultry, beef, game, fruit, vegetables and wine. In addition, the concessions granted by the EU to the CEECs did not cover all agricultural exports. In the case of Poland, they excluded, for example, ten agricultural products representing an export value of 150 million ECU, or 14 per cent of Polish agricultural exports to the EU in 1991. Moreover, non-tariff barriers such as health requirements, consumer protection standards and other specific import restrictions under the Common Agricultural Policy have remained in force. Mainly due to the use of a "reference period" and to other factors such as negotiating skills, the concessions appear to have differed among the CEECs. The concessions granted to former Czechoslovakia, for example, appear to be less favourable than those granted to Hungary and Poland. The coverage of trade concessions has been the widest in Bulgaria's Agreement and the narrowest in the Agreement with Poland and Czechoslovakia. In sum, the market openings provided by the Europe Agreements for the CEECs are estimated to be relatively small primarily during the first five years of the Agreement with some improvements in the sixth year and, mainly, thereafter.

### *Other Trade Policy Impediments in the European Union*

The Europe Agreements retain a number of elements that are often seen as serious shortcomings. We have already discussed one issue, the continued protection of "sensitive" products, but there are other trade barriers as well which have their origins in various safeguard measures. These are known as technical barriers or non-tariff barriers to trade. They have been quite high in the EU as can be seen from Table 6.

#### *Contingent Protection*

Measures of contingent protection are seen by many observers as potentially the most serious instrument for trade protection. In the Europe Agreements, the measures are treated under the heading of safeguards and anti-dumping, and they have generated considerable controversy. As with any provision for contingent protection, the controversy has revolved around two basic issues – whether the Europe Agreements' provision for

21 The following text is based on a detailed study by Tracy (1994).



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Table 6 **CEECs – Non-tariff Barriers Faced by CEECs Exports to OECD Markets, 1992**

| ISIC* | Sector | USA(a) | EU | Austria | Sweden | Japan |
|---|---|---|---|---|---|---|
| 100 | Agriculture | 33.1 | 79.8 | 83.6 | 71.6 | 159.3 |
| 311 | Food manufacturing | (b) | (b) | (b) | (b) | (b) |
| 321 | Textiles | 21.8 | 10.0 | – | – | – |
| 322 | Apparel | 28.3 | 18.0 | – | – | – |
| 323 | Leather | – | (b) | (b) | (b) | (b) |
| 351 | Basic chemicals | (b) | 16.0 | – | – | – |
| 352 | Other chemicals | (b) | 16.0 | – | – | – |
| 371 | Iron and steel | – | 22.0 | (b) | (b) | (b) |
| | Other sectors | (b) | (b) | (b) | (b) | (b) |
| | Whole economy(a) | – | 13.8 | – | – | – |

* ISIC: International Standard Industrial Classification.

*Notes:*
(a) NTB ad valorem equivalent rates: NTB ad valorem equivalent rates estimated by US ITC (CBO, 1991). These rates of protection concern all exporters to the US and thus cannot be directly compared to the estimates for the EC which concern only CEECs exports.
(b) Industries with few or non-binding NTBs for which combined MFN-GSP rates are considered as reflecting the level of protection.

*Source:* Aghion *et al.* (1992), Table 8.1, p. 178.

safeguards and anti-dumping is consistent with the GATT rules, and whether the existence of these provisions has any effect on trade. In one of the first studies, Winters concluded that while the safeguards and anti-dumping provisions in the Europe Agreements are probably GATT-consistent, their very existence is a threat to exporters.[22] He also points out that the adoption of competition laws by CEECs is clearly not sufficient to protect the CEECs' interests since EU maintains anti-dumping (Winters, 1992, p. 26). By implication, the recently adopted commitment at Essen Council to dismantle the contingent protection is, therefore, questionable.

22 See Winters (1992), pp. 20-21. The insistence and reliance on anti-dumping measures is somewhat surprising since the Agreements include provisions for competition policies, and since the competition policies of at least some of the CEECs probably fully conform to international standards. For example, Winters' view of the legal status of safeguards is consistent with later studies such as Marceau (1995) which find that, for example, the provision for competition policy in the Polish-EU Europe Agreement is consistent with the corresponding provision of the European Union. Hoekman and Mavroidis (1995) have also found that the domestic competition policy in the Czech Republic is on par with the corresponding policy in the EU even though the other CEECs have policies that deviate more or less from the blueprint of the European Union.



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The dangers to the CEE exporters from the provisions of contingent protection are serious, as most economists agree despite some attempts to mitigate the impact of the provisions (Castillo, 1996). In the course of 1990-1995, the European Union notified in GATT (WTO) 24 cases of anti-dumping against the CEECs. These measures mostly affected the Czech Republic and Slovakia which jointly faced twelve of such cases (three cases during the period of former Czechoslovakia, five cases against the Czech Republic and four cases against Slovakia after the split between 1993 and 1995), nine cases against Poland and three cases against Hungary. The actions affected mainly chemical and allied industries (9) and iron and steel (10). Other affected sectors were wood and paper (1), minerals (3), and other metals (1). Full information about the potential economic impact is not available nor are we aware of any other independent study to asses the implications. However, many of these cases affected imports which had an extremely small share in domestic consumption in the "injured" party's country. In five cases, the share of the relevant imports was less than 5 per cent, in two cases the share was 5 to 10 per cent and only in 3 cases was the share more than 10 per cent. The corresponding shares in the remaining 14 cases are not known.

The resolution of the problem was also interesting. In six cases, the actions have resulted in the imposition of duties, in two cases the protection was provided in the form of a tariff quota. In six cases, the relevant exporting firm had to take an appropriate measure. In two cases no injury was established, and the complaints were withdrawn. The remaining eight cases are still unresolved.

*Rules of Origin*

A major problem of free trade agreements (FTA) is usually the provision for rules of origin (e.g. Kruger, 1993). These rules protect member countries of the FTA against competition from third countries due to uneven rates of external tariff levied on imports from the third countries by individual member countries. The Europe Agreements are no exception in this respect since they provide strict conditions on rules of origin. The local content of products for exports within the boundaries of the EU and the CEECs has been set at 60 per cent. This "performance" requirement is quite clearly distortionary since it discourages the CEECs to seek cheaper, i.e. non-EU or non-CEECs sources of supply. The impact of this trade restriction may vary depending on the share of the non-EU country in total trade of the CEECs and/or the EU in question and on the commodity composition of trade, but the provisions concerning the rules of origin, or the "local content" as they are alternatively called, always lead to a pro-



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tection of domestic producers. It is, therefore, clear that these provisions not only distort trade but also adversely affect welfare in the countries concerned.[23]

*Asymmetry of Trade Concessions*

Another factor that has been quoted in the literature as a possible barrier to future trade is an asymmetry of concessions granted in the Agreements. Successful agreements should provide for a symmetry of concessions in order to make the agreements viable. Asymmetry of concessions or a perception of an involuntary asymmetry will jeopardise the willingness to fully endorse the agreement by the party that sees itself disadvantaged by it. The more asymmetrical the concessions, the less likely will it be to maintain normal trade relations and to enforce the provisions of the agreement. The reason is that asymmetrical trade concessions may provoke nationalistic sentiments, and these are often highly protectionist. The perception of asymmetry is also likely to increase the pressures of lobbies to increase the protection of their interests. In the Europe Agreements, the "balance" of interests was based on the principle of asymmetry in that the trade concessions granted by the EU were to be provided on more generous terms than the concessions offered in exchange by the CEECs.

In practice, the asymmetrical concessions by the EU did not work out as foreseen. The unilateral trade liberalisation adopted by the CEECs prior to the conclusion of the Agreements had resulted in the reduction of trade barriers to such an extent that at leastsome countries in the region could hardly benefit from the declared asymmetry (Aghion *et al.*, 1992). Given the timing, the speed and the scope of liberalisation, it is self-evident that the CEECs had used up their bargaining positions before the negotiations. Nevertheless, the European Commission has tried hard to preserve its face and to show that the concessions provided by the EU in the Agreements were indeed higher than those offered by the CEECs. For example, according to one of the recent European Commission reports on agriculture,[24] the CEECs liberalised their agricultural imports from the EU relatively less in comparison to the concessions offered to them by the EU. However, as Inotai points out, this asymmetry evolved contrary to the expectations of the CEECs. "The asymmetry in agriculture often meant

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23 The point has been strongly made by Inotai (1995, p. 128) who also tries to estimate the values of various subcontracting deals that are affected by the regulation.

24 The European Union has commissioned three studies on the agricultural sector in the CEECs to examine its adjustment needs and the adjustment implications for the agricultural sector in the EU. The study referred to here is Tracy (1994).



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that imports by the associated countries reached the 'sensitivity threshold' earlier than the Community expected, which triggered a halt to tariff reductions. Also, different levels of agricultural subsidisation created an inverse asymmetry in favour of the Community." (Inotai, 1994, p. 160) Inotai is also very critical of the aggressive subcontracting by the EU clothing industry in the CEECs made possible by preferential "rules of origin" as already noted above. Furthermore, he asserts that the EU erected a "highly sophisticated wall of non-tariff trade protection".

### *Supply Constraints in the CEECs and the Role of the Europe Agreements*

#### *Brief Account of Supply Constraints*

Trade between the CEECs and the EU has also been constrained by a number of impediments which have nothing to do with trade policy but originate on the supply side (Cekota, 1995). While most economists agree that supply constraints exist on both sides, it is clear that they are more serious in the CEECs.[25] At the same time, it is unclear how serious these constraints are since the empirical evidence is relatively limited. We have, for example, some indications of the presence of supply constraints from the inability of the CEECs to fully utilise their export quotas (e.g. Nagarajan, 1994). However, these and other similar indicators are imprecise and may be even misleading.[26] for the sake of clarity, let me therefore start with a brief account of supply constraints which are of relevance in analysing the role of the Europe Agreements.

Supply impediments include infrastructural and institutional constraints as well as constraints originating in various areas of macroeconomic and structural polices. The problems of *physical infrastructure* are numerous and wide-ranging, and they are relatively well-known. They include such prob-

25 In the EU, institutional reforms, for example, are quoted as a serious candidate for the most urgent changes. The problems are well known, and they concern the budgetary rules and the voting procedures. The budgetary rules will have to be modified in order to avoid an explosion in the EU structural and agricultural budget. The estimates of costs are discussed in more detail in Part IV below. For more discussions, see also Baldwin et al. (1996). Similarly, most observers agree that the voting procedures will also have to be changed in order to improve the effectiveness of the decision-making process within the EU.

26 For example, some of the quotas have been allocated to countries even if the countries had no or only a limited production capacity to fill them. In addition, some EU quotas were substantially increased, especially to allow for a rapid growth of outward processing trade. Low quota utilisation may also reflect inefficiencies in the administration of quotas. High transaction costs and lack of competition have been also used as arguments to explain low quota utilisation.

lems as poorly integrated transport systemsand energy networks, different and problematic environmental standards or inadequate border crossings, a poor system and quality of telecommunication services and many others.

With regard to *institutional constraints*, most observers usually identify two areas for reforms. The first area involves the need to adjust the legal provisions in each country in order to ensure consistency with corresponding legal provisions of the EU. The task ahead is truly daunting. It implies that the approximation of national laws in the CEECs to the laws of the EU must be based on the *acquis communautaire*[27] According to van Brabant, quoting a study of Reinicke, the CEECs will have to change about 10,000 laws and regulations in order to ensure legal consistency. In addition, the institutions for law enforcement will have to be established or strengthened.

Apart from legal and administrative constraints, there are other important institutional barriers to the integration of the CEECs into the EU. The most frequently quoted impediments include weak financial sectors, and poor functioning of labour markets (e.g. van Brabant, 1996, p. 16). The problems of the *financial sector* in these countries are both problems of weak banking and non-banking institutions and deficiencies in the regulatory framework (Griffith-Jones and Drábek, 1996). The poor functioning of *labour markets* is related to a number of factors. In particular, wage settlements in some countries have been subject to incomes policy. Labour mobility has been severely constrained by considerable housing shortages, housing subsidies and rent controls, uneven distribution of economic activities in different regions and government policies towards unemployment (Svejnar *et al.*, 1995).

Finally, the integration into the EU may be also affected by *macroeconomic instability* in the CEECs.[28] A stable macroeconomic situation is extremely important for regional integration. Unstable macroeconomic conditions create unstable trade policy and may even threaten the country's international trade commitments. In spite of the considerable progress made by CEECs, it is evident that none of these countries has been able to achieve full macroeconomic stability. Symptoms of instability

27 The legal and regulatory framework of the European Union.

28 The discussion of macroeconomic instability is relevant for one specific aspect of regional integration – monetary integration. While the discussion of this aspect may seem premature at this stage, it is not entirely out of place. The EU seems to be moving with a determination towards its own full monetary integration with a single currency. It is, therefore, only appropriate to ask what kind of a European Union the CEECs will be attempting to join when they actually sit down with the EU to negotiate their accession. In addition, there are some politicians in the CEECs region who argue that their countries are ready to join the "single currency" arrangement. In discussing these issues I am sure that the reader does not need to be reminded that impediments to monetary integration also exist on the EU side. These are well known as they are widely discussed at the present time.



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are present in every country of the region.[29] External balances in these countries are either weak, as reflected in large current account deficits, low international reserves, and slow growth of exports (Hungary, Poland, Slovakia and Bulgaria), and/or vulnerable due to potentially destabilising capital inflows (Czech Republic). Inflation has been running in every country at much higher rates than in the EU and unless significantly reduced within the transition period, it will either necessitate further tightening of macroeconomic policies, and thus risk an even greater unemployment, or it will increase the gap between the inflation rates of the CEECs and those of the EU countries and thus impair their ability to achieve full monetary integration. Income differentials are also rising extremely fast partly due to thesharp fall of output in the aftermath of the political changes and partly as a legacy of communism.[30] For Brada (1992), macroeconomic instability remains perhaps the most serious constraint on any regional effort in the region. These concerns are also echoed in CEPR (1992).

*The Role of the Europe Agreements*

Many observers believe that the Europe Agreements have played a positive role in easing the supply constraints on integration of the CEECs into the EU identified above. This has been done either directly or indirectly. The direct effect came from the relevant provisions of the Agreements. Other forms of assistance came as initiatives that have been separate from the actual Agreements or even came as an "after-thought". An example of these initiatives has been the support of the IMF-sponsored stabilisation programmes in the CEECs. These programmes were not a part of the actual Europe Agreements, but it was widely understood that there could be no associate membership or full membership of the CEECs unless the countries eliminated the inflationary pressures in their economies, for which they needed the IMF support and the support of Western governments. An example of "targeted" assistance was the assistance to the CEECs for specific projects such as those in infrastructure, even though no concrete steps were agreed in the original Agreements. The Agreements identify various areas for *infrastructural support.* These are (A) Transport, (B) Energy, (C) Border Crossing, (D) Road networks, (E) Nuclear safety, (F) Environment, (G) Social policy, (I) Science and technology.[31] Other infrastructural pro-

29 See, for example, Daianu (1994) on Romania; Maroudas and Rizopoulos (1995) on Bulgaria; and Drábek (1996b) on the remaining CEECs.

30 These issues are discussed in greater detail in Drábek (1996) and van Brabant (1996) who examine the relationship between macroeconomic stability and the stability of trade policy.

31 See the proposal made by the Corfu Council of June 1994 on Pre-accession strategy for CEECs (cf. van Brabant, 1996, p. 6).

grammes that have been identified and targeted for possible assistance from the EU to the CEECs are the establishment of export insurance and guarantee systems and credit facilities for exporters.[32]

***Financial Assistance.*** The articles of the Agreements provide for direct assistance of the EU to the CEECs in three broad areas. One type of support is technical assistance which is provided in the form of fully-funded technical expertise and as financial grants for technical assistance. As noted above, outside the Agreement but strongly in the spirit of the cooperation with these countries was the provision by the EU of major balance of payments support to accompany the IMF-sponsored stabilisation programmes. Between 1990 and 1994, the equivalent of approximately ECU74.7 billion in total assistance was committed by G-24 to the twelve Central and East European countries – Albania, Bulgaria, Czech Republic, Estonia, Hungary, the former Yugoslav Republic of Macedonia, Poland, Romania, Slovakia and Slovenia. The largest part of this assistance was balance of payments support, but it also included assistance to sectors such as transport, energy, environment, investment promotion and democratic institution building.[33] Within the G-24 process, the European Union and its member states accounted for 45 per cent of total assistance over this period, with the total contribution amounting to ECU33.8 billion. Further details of G-24 assistance are provided in the following Table 7. The massive financial support for balance of payments purposes is nowadays fully recognised in the literature and among policymakers as having played a crucial role in the initial transition phase of the CEECs (e.g. Drábek, 1995 and Schönfeld *et al.*, 1995).

The other important form of financial assistance was PHARE. Together with loans provided by the European Investment Bank, PHARE was one of the two sources of finance explicitly mentioned in the Europe Agreements. Its main objective was to finance technical assistance to the CEECs and help achieve the objectives of the Europe Agreement. In other words, the financial support provided in the form of technical assistance was specifically covered in the Agreements in contrast to the above-mentioned forms of financial assistance for macroeconomic stabilisation and for specific projects. In its first five years, the total commitments to these countries under the PHARE umbrella amounted to ECU4.248 billion

32 Ibid., p. 17.

33 The figure comes from Verrue (1995). Unfortunately, the author does not disaggregate the figures between the general balance of payments support and other forms of assistance. Partial indicators of BOP assistance can be found in Dixon et al. (1995).



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(Table 8). Despite many difficulties that have surrounded various stages of the "project cycle", there is no doubt that the funding of PHARE has been large, and that the PHARE programme itself has been the largest programme of technical assistance to these countries.[34]

**Table 7 G-24 Assistance by Recipient Country, 1990-94 (excluding assistance to the former Yugoslavia and multi-recipient programmes)**

| | Total Assistance (ECU million) | of which grants (ECU million) | Share of grants in total assistance (%) |
|---|---|---|---|
| Albania | 1,346.73 | 847.86 | 63 |
| Bulgaria | 3,440.77 | 655.15 | 19 |
| Czechoslovakia (1990-92) | 5,992.56 | 496.31 | 8 |
| Czech Republic (1993+) | 2,398.44 | 223.89 | 9 |
| Slovak Republic (1993+) | 1,030.55 | 146.56 | 14 |
| Estonia | 711.57 | 277.25 | 39 |
| Hungary | 11,709.34 | 904.54 | 8 |
| Latvia | 799.37 | 198.50 | 25 |
| Lithuania | 1,049.44 | 302.97 | 29 |
| Poland | 27,473.36[1] | 11,246.53 | 41 |
| Romania | 6,749.91 | 1,023.38 | 15 |
| Slovenia | 668.91 | 81.59 | 12 |

[1] of which ECU 8.3 billion in debt reduction.

*Source:* Verrue (1995), p. A2.

**Table 8 PHARE Commitments by Partner Country, 1990-94**
(millions of ECU)

| Country | Commitments | Country | Commitments |
|---|---|---|---|
| Albania | 244.00 | Lithuania | 84.00 |
| Bulgaria | 393.50 | Poland | 1,011.55 |
| Ex-Czechoslovakia (1990-92) | 233.00 | Romania | 541.72 |
| Czech Republic | 120.00 | Slovenia | 44.00 |
| Slovak Republic | 80.00 | ex-GDR | 35.00 |
| Estonia | 44.50 | ex-Yugoslavia | 141.12 |
| Hungary | 490.80 | Regional programmes | 475.14 |
| Latvia | 62.50 | Other programmes | 247.64 |
| | | Total | 4,248.47 |

*Source:* Verrue (1995), p.164.

34 Foreign assistance to the CEECs has been reviewed at length in a number of studies, such as IEWS (1995). The assistance has been seen with mixed views. Some people have been very critical such as Inotai (1994), but their criticism is in my view exaggerated. See, for example, Portes' response to Inotai (1994) who puts the criticism in a good perspective.



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***Non-Financial Assistance.*** The Europe Agreements also include non-financial assistance to help the CEECs in developing and standardising their statistical reporting systems, customs declarations, and for an exchange of customs officers. Assistance should be provided in other areas as well such as industrial cooperation, investment promotion and protection, cooperation in science and technology, education and training, energy, nuclear safety, transport, regional development and social cooperation. This form of assistance usually calls for technical assistance, and specific projects are already under way.

***Relaxation of Restrictions on Labour Mobility.*** The labour market arrangements provided for under the Agreements are very modest and, as far the CEECs are concerned, they represent a highly disappointing step towards integration of labour markets. The CEECs expected great concessions and assistance from the EU to enable them to take advantage of their cheap labour, but labour issues turned out to be politically highly sensitive. The Agreements make only marginal concessions to liberalise these important markets, and no fundamental change was foreseen for the whole duration of the transition period. As expected, the reason for this cautious approach was the fear of mass migration from the CEECs to the EU and of its impact on employment in the latter countries (Winters, 1992, and Layard *et al.*, 1992). The limited liberalisation measures that have been adopted refer to the movement of highly skilled labour, mostly executive-type, middle-management personnel and workers with specialised skills. In addition, several EU member countries have agreed to negotiate bilateral agreements with individual CEECs on the movement of labour, but, again, with a relatively small impact.

### *The Sub-Regional Arrangement: CEFTA*

The re-establishment of sub-regional cooperation in Central and Eastern Europe was a slow and painful process. Following the unhappy experience of the CEECs with the Council for Mutual Economic Assistance (CMEA),[35] the countries were only too happy to dismantle their agreement, and they were in no mood to replace it with another. For logical and economically rational reasons, however, they had to change their negative posture, and eventually agreed to establish the new sub-regional trading arrangement Central European Free Trade Agreement (CEFTA). As noted above, the agreement was signed on 21 December 1992 between the Czech

35 For a detailed account of the CMEA demise see, for example, Lavigne (1992).



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Republic, Slovakia, Hungary and Poland. Since then, CEFTA has been joined by Slovenia (1 January 1996). Bulgaria and Romania have also expressed their interest to join. Czech Premier Klaus has set as conditions for all prospective applicants that they have concluded their EU associated agreements, are members of the WTO and have concluded free trade agreements with each CEFTA member.[36]

The main objective of the original CEFTA was to create a free trade zone by the year 2001 at the latest. The original agreement was soon found to be highly unsatisfactory due to a limited coverage of concessions and slow speed of liberalisation. The document was, therefore, supplemented with additional agreements resulting in further reduction in the tariffs for industrial products and the expansion of customs concessions in the exchange of farm and food products. The Supplementary Protocol No. 2 shortened by one year the schedule of the gradual reduction or elimination of duties on industrial products – except the so-called "sensitive" products – while The Supplementary Agreement of the Central European Free Trade Agreement provided for an opening of CEFTA to other countries. The Agreement on the Admission of Slovenia and Supplementary Protocol No. 3 provided for the accession of Slovenia and for the expansion of concessions on farm and food products, starting from 1 January 1996, respectively. All these agreements were signed in the course of 1995.

A peculiarity of CEFTA is that the countries negotiated separate bilateral protocols concerning the speed and the coverage of concessions. While the Agreement calls for a complete elimination of trade barriers in industrial products by the year 2001, the countries negotiated separate protocols for the transition periods. The protocols were negotiated between former Czechoslovakia and Hungary, between Czechoslovakia and Poland and between Poland and Hungary. After the split of Czechoslovakia, the relevant Czechoslovak agreements became agreements with the Czech Republic and Slovakia.

*Rationale for CEFTA*

There were several powerful arguments why the CEECs should consider sub-regional integration, but there were also several strong arguments against such integration.[37] The establishment of CEFTA was based on several considerations. Since the CEECs are bound by a close geographical

36 As reported in Financial Times, 12 September 1995.

37 See Inotai and Sass (1994) and also Richter and Tóth (1994). Several of their arguments are reproduced here, others I have found more dubious and vague and they are not considered.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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proximity, some, albeit probably small amount of their trade can be viewed as "natural". In other words, there are "natural" incentives for these countries to trade with each other, and trade policies which obstruct the operations of these "natural" forces are distortionary. The importance of letting the "natural" (market) forces to operate freely has become even more acute after the conclusion of the Europe Agreements, because the Agreements have created conditions in which CEFTA countries discriminated against each other due to the rapid liberalisation of trade between the CEECs and the EU. Another argument in favour of the establishment of CEFTA is that these countries have similar cultural and historical experiences, thereby creating a basis for an economic and possibly also political and cultural unity. The experience obviously also includes their communist past and the transformation of their countries into market economies.[38] The provisions made in the Europe Agreements for rules of origin have also created incentives for the CEECs to work more closely together in order to intensify their sub-contracting work for the EU as discussed above. A strong case could also be made for a closer coordination of policies towards foreign direct investments to avoid heavy fiscal costs of investment incentives. Last but not least, to the extent that EU will treat the countries uniformly, common issues and positions are bound to emerge among the CEECs. Coordination of national approaches may be, therefore, beneficial in order to increase their negotiating power and to increase regional stability. Ironically, the establishment of CEFTA was particularly popular with many EU politicians since, in their view, it demonstrated to the outside world the civic and diplomatic maturity of the CEECs.

*Impediments to Closer Integration*

Despite the conclusion of CEFTA and the genuine attempts to establish close sub-regional cooperation, the cooperation among the CEECs remains difficult. The impediments to mutual cooperation and integration of the CEECs can be grouped under four separate headings: the shortcomings of the Agreement; the political, sociological and other non-economic factors; the differences in economic structures and conditions; and the implementation of the Agreement.

***Main Shortcomings of the Agreement.*** The scope of the Agreement is very limited – it only covers trade and not even those economic activities

38 See Inotai and Sass (1994). Needless to say, however, one could also argue the opposite: that the countries' negative experience of communism would push them to seek alliances elsewhere.



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that are additionally covered by the Europe Agreements. The trade component itself provides for liberalisation of trade but, again, is subject to exceptions including the so-called "sensitive" products and agriculture. The Agreement also includes other exceptions of industrial products that are subject to specific schedules. Within two years of its existence, the Agreement has been under severe strains. Facing balance of payments difficulties, Hungary, Poland andSlovakia imposed additional protective measures (import surcharges) on all imports and these remain in force even at the present time. Paraphrasing some observers from the region, (1) "sensitive" products are in CEFTA even more "sensitive" than in the Europe Agreements, (2) liberalisation of industrial products is slower and (3) very little has been achieved in the Agreement in the area of agriculture. Finally, (4) the coverage of "tradables" is also less comprehensive than in the Europe Agreements. Moreover, the Agreement only covers merchandise and not trade in services.[39]

***Non-Economic Impediments.*** Closer economic ties have been also constrained by various other impediments. Fear of competition, delay of company restructuring, ethnic tensions primarily involving Hungarian minorities in Slovakia and Romania, and the rise of nationalism have all contributed to an atmosphere of suspicion and a lack of trust. No serious attempt has been made to coordinate the countries' institutional reforms even in the most fundamental trade-related areas such as customs evaluation and procedures or the establishment of dispute settlement mechanisms. Moreover, countries' intentions and future strategy towards subregional integration remain unclear and often obscure. In countries such as Hungary and Slovakia, the authorities have been preoccupied with the loss of revenues from import duties as a result of trade liberalisation.

***Different Economic Structures and Conditions.*** Another impediment that has often been quoted in the literature is the relative differences in economic conditions in these countries. For example, Brada (1992) argues that different rates of inflation and differences in purchasing power will make the integration among these countries difficult. Similarly, significant differences in inflation could jeopardise integration as countries export their inflation and put strain on their macroeconomic polices. According to Brada and other analysts, close sub-regional integration is not even desirable because it would provide a ready market for poor quality products and would slow down restructuring (Brada, 1992; Sorsa, 1994). A similar posi-

39 For details see Inotai and Sass (1994) and Rudka and Miszei (1994).



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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tion is also taken by those who argue that the trade regimes of these countries are still fundamentally unstable (Drábek, 1996). As a result, CEFTA-like arrangements would help to "freeze" the highly distorted and inefficient production structures of the CEECs and thus lead to trade diversion.

***Implementation Problems.*** The implementation of CEFTA has run into several problems. In November 1992, Poland imposed import surcharge on all imports except alcoholic beverages, tobacco products, fuel and automobiles at the rate of 5 per cent, which was lowered to 3 per cent in January 1996. Hungary also introduced import surcharges on all products except primary energy carriers and machinery for investment at the rate of 8 per cent in March 1995. In the same year, the Hungarian government took the decision to prohibit imports of used automobiles for four years. In Slovakia, the government imposed import surcharge for a broad range of consumer products and foodstuffs at the rate of 10 per cent, which was later reduced to 7.5 per cent (July 1996). Czech exporters complained about additional non-tariff measures introduced in Slovakia with the effect of discriminating against their exports. Attempts to increase tariffs in Romania have also been reported by the EBRD.

The most serious situation turned out to be in Bulgaria. The first import surcharge was introduced in August 1993, and it affected all products except energy and basic raw materials. The rate was 3 per cent, which was reduced to 2 per cent in 1995 and eliminated in January 1996. However, at about the same time the government introduced tariff quotas on certain commodities (mainly agricultural and some pharmaceutical products). In June, the government re-introduced the import surcharge on all imports except energy products and basic raw materials at the rate of 5 per cent. In the same year it introduced an import tax on automobiles at the rate of 10 per cent.[40]

All these cases represent examples of a highly unstable macroeconomic situation in these countries. As a result, balance of payments have been under severe pressure and so were the countries' trade policies. Under the circumstances, the governments resorted to trade policy in addition to other measures to restrict imports to somewhat relieve the balance of payments pressures. The measures have, of course, also put additional strains on the relations among the CEFTA countries and, to some extent, also on their relations with the EU and other trade partners.

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40 The information comes from WTO and from publications of the US Trade Representative.



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## IV Quantitative Assessments

Quantitative assessments of the regional and sub-regional arrangements in Central and Eastern Europe have been subject to a variety of problems. In addition to the usual difficulties of measuring trade "creation" and "diversion" and of evaluating the dynamic effects of regional trading arrangements, which are common to all studies of regionalism, an assessment of the regional initiatives in Central and Eastern Europe is subject to specific problems. First, the assessment is still in some sense premature. The Europe Agreements have only been in force for a few years, and their effects may not yet be fully felt. This shortcoming is even more evident in the case of CEFTA, which is more recent. Second, it is difficult to distinguish between the effects of the regional Agreements and those the of various unilateral initiatives of the CEECs described above. Thus, the initial contribution of the Europe Agreements may have been small due to the unilateral liberalisation of the CEECs and due to the relatively favourable trade treatment of the region by the European Union prior to the Agreements coming into force. This would imply that market forces were more powerful than the Europe Agreements. This point has been strongly made by Inotai (1995) and Piazolo (1996). In addition, many of the important trade concessions have been "end-loaded" in the Europe Agreements as noted above, and their impact will, therefore, only be felt later. These specific problems should be kept in mind when reading the following sections. Finally, quantitative assessments can only be useful if the data are good. This, unfortunately, is not the case in the CEECs. The quality of the data is poor, particularly if one wishes to do cross-country comparisons. As we have seen above, the differences among different sources can be substantial. Therefore, the numbers discussed below must be treated with extreme caution and, in certain cases, conclusions must be avoided.

### *Geographical Trade Reorientation*

There is no doubt that one important effect of the Europe Agreements has been to encourage or at least support the geographical reorientation of foreign trade of the CEECs. The immediate impact of the collapse of the CMEA and the liberalisation of trade policy in the CEECs was a radical re-orientation of trade from the Eastern markets to the EU (e.g. Inotai, 1995; Maroudas and Rizopoulos, 1995; Piazolo, 1996; Drábek and Smith, 1995). The liberalisation of trade with the EU had obviously greatly facilitated this tradereorientation. In order to assess the extent of the trade reorientation, we shall again review several sources. These data differ a great deal, as we already observed above when we examined the decline of trade



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Table 9 **CEECs – Geographical Distribution of Trade (Total = 100)**

| | 1985 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|
| **I. Exports** | | | | | | | | |
| **Bulgaria** | | | | | | | | |
| EU | 18.9 | 19.5 | 34.5 | 40.4 | 42.3 | 43.3 | 45.5 | 51.4 |
| CEFTA | 23.0 | 17.4 | 12.5 | 7.5 | 2.6 | 2.2 | 2.2 | 1.8 |
| Rest of the World | 58.1 | 63.1 | 53.0 | 52.1 | 55.1 | 54.5 | 52.3 | 46.8 |
| Of which: FSU | – | – | – | – | – | 9.6 | 11.3 | 11.6 |
| **Czechoslovakia** | | | | | | | | |
| EU | 28.3 | 25.7 | 32.1 | 40.7 | 49.5 | – | – | – |
| CEFTA | 9.5 | 12.8 | 10.6 | 11.6 | 8.9 | – | – | – |
| Rest of the World | 62.2 | 61.5 | 57.3 | 47.7 | 41.6 | – | – | – |
| Of which: FSU | 33.4 | 31.3 | 25.9 | 19.4 | 10.6 | – | – | – |
| **Czech Republic** | | | | | | | | |
| EU | – | – | – | – | – | 49.6 | 50.9 | 59.5 |
| CEFTA | – | – | – | – | – | 23.7 | 23.6 | 24.1 |
| Rest of the World | – | – | – | – | – | 26.7 | 25.5 | 16.4 |
| Of which: FSU | – | – | – | – | – | 5.3 | 5.3 | 5.0 |
| **Slovakia** | | | | | | | | |
| EU | – | – | – | – | – | 33.8 | 39.9 | 44.1 |
| CEFTA | – | – | – | – | – | – | – | 46.1 |
| Rest of the World | – | – | – | – | – | – | – | 9.8 |
| Of which: FSU | – | – | – | – | – | 4.2 | 4.2 | 3.8 |
| **Hungary** | | | | | | | | |
| EU | 22.7 | 24.7 | 35.4 | 46.7 | 49.4 | 45.8 | 48.9 | 62.6 |
| CEFTA | 9.5 | 8.2 | 5.8 | 3.9 | 4.0 | 5.3 | 5.2 | 5.9 |
| Rest of the World | 67.8 | 67.1 | 58.8 | 49.4 | 46.6 | 48.9 | 45.9 | 31.5 |
| Of which: FSU | 33.5 | 25.0 | 20.2 | 12.0 | 13.1 | 14.0 | 15.0 | 10.0 |
| **Poland** | | | | | | | | |
| EU | 28.1 | 32.1 | 46.8 | 55.6 | 57.9 | 63.3 | 62.7 | 70.1 |
| CEFTA | 7.5 | 7.1 | 5.1 | 5.4 | 5.1 | 4.8 | 4.8 | 5.4 |
| Rest of the World | 64.4 | 60.8 | 48.1 | 39.0 | 37.0 | 31.9 | 32.5 | 24.5 |
| Of which: FSU | 24.6 | 20.8 | 15.3 | 11.0 | 7.1 | 6.2 | 7.4 | 11.4 |
| **Romania** | | | | | | | | |
| EU | 26.2 | 29.0 | 31.5 | 33.7 | 32.1 | 39.4 | 46.0 | 53.2 |
| CEFTA | 8.5 | 8.4 | 7.3 | 5.7 | 3.7 | 3.1 | 4.2 | 3.1 |
| Rest of the World | 65.3 | 62.6 | 61.2 | 60.6 | 64.2 | 57.5 | 49.8 | 43.7 |
| Of which: FSU | 21.4 | 21.4 | 25.2 | 23.0 | 13.9 | 9.1 | 6.6 | 5.8 |



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Table 9 (continued)

| | 1985 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|---|---|
| **II. Imports** | | | | | | | | |
| **Bulgaria** | | | | | | | | |
| EU | 39.5 | 35.0 | 46.7 | 48.4 | 32.5 | 36.6 | 41.3 | 46.0 |
| CEFTA | 16.4 | 13.2 | 9.7 | 5.0 | 3.3 | 2.3 | 2.8 | 2.9 |
| Rest of the World | 44.1 | 51.8 | 43.6 | 46.6 | 64.2 | 61.1 | 55.9 | 51.1 |
| Of which: FSU | – | – | – | – | – | 32.6 | 24.7 | 26.4 |
| **Czechoslovakia** | | | | | | | | |
| EU | 28.0 | 28.7 | 34.3 | 35.3 | 46.2 | – | – | – |
| CEFTA | 10.8 | 14.9 | 17.2 | 7.3 | 5.7 | – | – | – |
| Rest of the World | 61.2 | 56.4 | 48.5 | 57.4 | 48.1 | – | – | – |
| Of which: FSU | 36.2 | 33.0 | 23.0 | 34.1 | 26.9 | – | – | – |
| **Czech Republic** | | | | | | | | |
| EU | – | – | – | – | – | 47.4 | 54.3 | 65.5 |
| CEFTA | – | – | – | – | – | 19.6 | 17.1 | 16.0 |
| Rest of the World | – | – | – | – | – | 33.0 | 28.6 | 18.5 |
| Of which: FSU | – | – | – | – | – | 11.1 | 10.4 | 11.1 |
| **Slovakia** | | | | | | | | |
| EU | – | – | – | – | – | 28.8 | 35.1 | 41.4 |
| CEFTA | – | – | – | – | – | – | – | 42.3 |
| Rest of the World | – | – | – | – | – | – | – | 16.3 |
| Of which: FSU | – | – | – | – | – | 18.6 | 12.6 | 12.9 |
| **Hungary** | | | | | | | | |
| EU | 29.7 | 28.5 | 36.8 | 40.4 | 42.2 | 40.1 | 42.8 | 60.7 |
| CEFTA | 9.6 | 8.4 | 7.1 | 5.3 | 5.8 | 5.2 | 4.2 | 6.3 |
| Rest of the World | 60.7 | 63.1 | 56.1 | 54.3 | 52.0 | 54.7 | 53.0 | 33.0 |
| Of which: FSU | 30.0 | 22.1 | 19.1 | 14.3 | 16.8 | 20.9 | 23.1 | 14.4 |
| **Poland** | | | | | | | | |
| EU | 24.2 | 33.8 | 42.5 | 49.9 | 50.7 | 57.3 | 57.5 | 65.4 |
| CEFTA | 8.1 | 7.3 | 4.5 | 4.2 | 4.1 | 3.6 | 4.3 | 5.6 |
| Rest of the World | 67.7 | 58.9 | 53.0 | 45.9 | 45.2 | 39.1 | 38.2 | 29.0 |
| Of which: FSU | 29.8 | 18.1 | 19.8 | 14.1 | 10.0 | 8.3 | 8.3 | 9.6 |
| **Romania** | | | | | | | | |
| EU | 11.4 | 5.7 | 19.7 | 27.1 | 37.5 | 22.3 | 35.2 | 49.7 |
| CEFTA | 11.6 | 11.8 | 9.9 | 5.1 | 5.4 | 3.8 | 4.0 | 5.2 |
| Rest of the World | 77.0 | 82.5 | 70.4 | 67.8 | 57.1 | 73.9 | 60.8 | 45.1 |
| Of which: FSU | 22.4 | 31.5 | 23.6 | 17.0 | 14.5 | 21.8 | 17.9 | 18.3 |

*Note:* European Union consists of the current 15 member states throughout the period. FSU stands for former Soviet Union.
*Source:* Based on Direction of Trade Statistics (IMF) and national statistics.



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since the end of the 1980s. The data are summarised in Appendix Table 1 and Table 9 above.

We have already seen in Part Two that trade recovery has been slow in the CEECs, and this has been particularly the case of the sub-regional trade which only began to recover in 1994-1995. The overall trade recovery depended, therefore, a great deal on the revival of trade with the European Union. This trade component expanded dramatically in all CEECs though at a different speed. As a result, the trade shares of the EU also increased very strongly (see also Table 9 above and Crane and Sagers, 1995, Tables 1-5).

Nevertheless, there have also been negative effects of the Europe Agreements. We have identified the main impediments in Part Three above, and here we shall only report the findings of three empirical studies – two by the same authors – that analyse the impact of these impediments on trade flows in some of the "sensitive" sectors. The first study is Wang and Winters (1993), who argue that the import measures employed by the EU in the footwear industry have been extremely restrictive. Perhaps even more important is that they find both the CEECs and the EU would gain significantly even in the absence of any preferential arrangement. Exports of footwear to the EU would continue even if the EU trade measures in the footwear market were fully liberalised on the MFN principle. Both authors reached the same conclusions when they separately studied the impact of quantitative restrictions in the EU against the CEECs exports of steel and iron. Inotai (1994) argues that the attractiveness of the Europe Agreements "was exhausted" by the end of 1992, by which time the growth of the CEECs exports had virtually stopped. However, his argument has been overtaken by events as the export performance of the CEECs considerably improved in late 1994 and 1995.

### *The Impact on Extra-Regional Trade*

The interpretation of findings in the literature about the impact of regionalism on *intra*-regional trade may be relatively easier in comparison to the interpretation of empirical studies of the impact of regionalism on *extra*-regional trade. As Bhagwati (1995) has pointed out, the interpretation of figures on extra-regional trade is subject to serious analytical difficulties and can hardly be used in an unambiguous fashion for this purpose. Second, the data problems are particularly serious in the case of extra-regional trade flows. The following findings must, therefore, be treated as tentative.

Referring again to Table 9, we can see that the share of the "Rest of the World" declined in all CEECs. The speed and the extent of the fall differs from country to country, but the picture is generally consistent across the



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board and for exports and imports. Perhaps the only exceptions are Bulgaria (both exports and imports) and Romania (exports). By far the most important factor in this decline has been the dramatic fall of the former Soviet Union, which was the dominant trade partner of these countries. However, the bulk of this trade was economically inefficient, so the collapse of this kind of trade was highly desirable. Furthermore, the collapse of trade with the former Soviet Union was partially due to the collapse of export supply in the former Soviet Union, and cannot, therefore, be attributed to the effects of trade policy in the CEECs.

### *The Effects of CEFTA*

Quantitative assessments of the impact of CEFTA on the member countries' trade are rare. The experience is still too short to draw any meaningful conclusions. The data in Table 9 and Appendix Table 1 show that CEFTA trade dropped to a bare minimum after 1990, that the fall has continued until recently, and that the recovery is still modest. The small weight of CEFTA trade is consistent with the historical patterns prevailing in the inter-war period when trade between these countries was also very small, with exceptions such as the former Czechoslovakia (Drábek, 1985). Nevertheless, some expansion of mutual trade can be expected in the short and medium run. Recent estimates of Richter and Tóth (1996a,b) and those of Guzek *et al.* (1994) show a fairly significant trade recovery within the CEECs for Hungary and Poland, while sub-regional trade has also expanded recently in the Czech Republic and Slovakia. Even though historical evidence from the inter-war period may not be fully relevant in view of considerable distortions in world markets at the time, it is generally believed that geography and the existing factor endowments would suggest that the CEECs would normally trade with Western Europe rather than with each other.[41] Some doubt the political commitment of the CEFTA member countries to promote mutual trade and others emphasise macroeconomic instability as the major impediment to further integration (Margolis, 1994).

### *"Normalisation" of Commodity Trade*

Prior to the collapse of intra-CMEA trade, the *total* trade of the CEECs was dominated by the commodity composition of trade within the region.

41 The same point is made by Sorsa (1994) when she examines the prospects for a closer integration of the Baltic countries.

The composition was very different from the commodity composition of these countries' trade with developed countries, and, therefore, also from the composition of their trade with the EU (e.g. Drábek and Smith, 1995, p. 12 and Table 10). The reasons for the difference were several, but the usual explanation has traditionally been the lack of competitiveness of manufacturing products in the world markets (Drábek and Olechowski, 1989), the pricing policy in individual CEECs and in the CMEA (Marrese and Vanous, 1983) and the absence of currency convertibility (Lavigne, 1992). One of the effects of these factors was that the share of manufactures was much lower in CEECs' total exports than in CEECs' exports to the other CEECs and to the former Soviet Union. In contrast, the CEECs tended to export to the West "excessive" quantities of energy – and other natural resources – and labour intensive products.

**Table 10 Poland – Similarity Indices: Comparisons of Commodity Composition of Trade, 1989-1990**

| Poland | Similarity indices | |
|---|---|---|
| | CMEA-EU | CMEA-DC |
| **Exports** | | |
| 1989 | 43.6 | 46.3 |
| 1990 | 44.4 | 44.8 |
| **Imports** | | |
| 1989 | 52.7 | 56.3 |
| 1990 | 49.1 | 50.5 |

*Note:* CMEA stands for Council for Mutual Economic Assistance, EU for the European Union and DC for Developed Countries.
*Source:* Drábek and Smith (1995).

The opening of trade with the EU together with the collapse of the intra-CMEA trade have dramatically changed the countries' commodity trade structures. For example, the share of machinery, equipment and means of transport in total exports declined from 60 per cent in 1990 to 29 per cent in 1991 in Bulgaria, from 52 per cent to 28 per cent in Czechoslovakia, from 18 per cent to 12 per cent in Hungary, and from 29 per cent to 22 per cent in Poland. More aggregate and rigorous comparisons of commodity structures of trade using "similarity tests" give the same conclusions that the commodity structure of trade of the CEECs has substantially changed if one compares the pre- and post-1989/90 periods. The changes have led to the elimination of "trading excesses" and to trade



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"normalisation". These changes are consistent with predictions of many economists who have argued that the bulk of the manufacturing industry in these countries is highly inefficient and will have difficulties to compete in world markets (e.g. McKinnon, 1991). The empirical evidence of these trends has been collected in various country studies in all CEECs – for example, Dobrinsky (1994) for Bulgaria, Jackson and Biesbrouck (1994) for Romania, and the European Commission (1994) for other countries.

### *Trade Creation or Trade Diversion?*

The changes in the geographical composition of trade and in the commodity structure noted above have been brought about by five broad factors. Three of these factors were already noted above, and they included the impact of the elimination of special trading arrangements within the CMEA. In particular, the elimination of the highly arbitrary price policies and the clearing payments system has discouraged exports of high-value added manufacturing products and natural resource-based commodities into the former CMEA markets.[42] The other two factors, also noted above, were (a) poor competitiveness of the CEECs manufactured exports and (b) the absence of currency convertibility prior to 1990.

The change in commodity structure was induced by two additional factors. The first factor was the sharp decline in domestic output, which itself led to further changes in the commodity structure of trade due to different speed in the domestic inter-sectoral adjustment. The relative impact of these forces is now well understood in the literature (e.g. Holzman *et al.*, 1995). The second factor has been the continued presence of trade restrictions in the EU (and other countries) in "sensitive" markets. As pointed out by Inotai (1995), the so-called "sensitive" products did not play the role of an export engine in the CEECs as expected.

#### *Gravity Models*

The most important issue is the extent to which the new regional arrangements have been conducive to a more rational pattern of trade

42 The original policies were what was known as the policy of "subsidisation" of Eastern Europe by the former Soviet Union. This has been treated in a large number of articles and was the subject of a well-known public discussion. See, for example, Marrese and Vanous (1983).

43 In the literature in general, the trade diversion and trade creation have been typically measured with the help of "gravity" models. However, the use of these models has run into a number of difficulties which have been discussed at length, for example, by Baldwin (1994) and Bayoumi and Eichengreen (1995).



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reflected in a more efficient allocation of resources. Here the empirical evidence is provided from four sources. Following the traditional approach, a number of analysts applied the "gravity model" despite the somewhat controversial nature of this technique.[43] The results of the gravity model-based studies have been already reported earlier in this overview. It may suffice to remind the reader that all of the studies have shown a considerable degree of "undertrading" with the countries of the EU, a substantial potential for expansion between the CEECs and the EU and a somewhat smaller one in the case of sub-regional trade among the CEECs. The only matter of dispute today might only be the degree of the "undertrading".

*Comparative Advantages*

A second group of studies has looked at the extent to which the regional arrangements have stimulated growth of trade and specialisation according to the countries' comparative advantages. A serious effort has been made by a number of researchers to identify the pattern of comparative advantages in the CEECs and, by juxtaposing them against the pattern of concessions agreed in the Europe Agreements and in CEFTA, one may draw some conclusions about the nature of the concessions.

It appears, however, that there are no easy answers. According to Neven (1994), for example, the CEECs have a comparative advantage in industries that use capital and *unskilled labour* relatively intensively. In contrast, Hamilton and Winters (1994) argue that the CEECs have a high proportion of labour with secondary education – an important condition for tilting the structure of the labour force and the comparative advantage towards skilled labour. A different argument was presented in a review of the relevant literature by Halpern (1995). Discussing papers by Gács, Rosati and Landesmann, he concludes that the empirical evidence provided by these studies points to natural resources and unskilled labour as the factor determining the comparative advantage of all CEECs, including the resource-poor countries such as the Czech Republic.[44] Echoing the view of Hamilton and Winters, several writers suggested that the region is already more than challenging the industrial West in markets requiring *skilled labour*.[45] McKinnon (1991) is more pessimistic when he argues, "the cascading system of implicit tariffs in socialist economies raised the level of

44 The explanation for this apparent paradox is that the Czech Republic imported relatively cheaply natural resource-based products which were subsequently processed into higher-value added commodities.

45 Similar arguments have been put forward even for the least industrial countries of the region such as Bulgaria. See Novicki (1994).



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effective protection in finished goods to the point where most manufacturing exhibits negative (or very low) value added at world market prices." A detailed study by Hughes and Hare (1991) reached a similar conclusion when the authors identified a number of specific sectors in greater detail.[46] Even though this view is neither shared ad *extremis* by the rest of the profession nor fully backed up by empirical evidence (Havlik, 1995), the signs are clearly present that the CEECs will face major difficulties in finding markets for their manufacturing exports. This can be seen from the sharp decline in the share of machinery and equipment in total exports of these countries, especially in the Czech Republic, as noted above.[47]

The evidence obtained from studies of adjustment costs in the EU leads to rather different and more clear conclusions. The literature looks at the degree of similarity between both parts of Europe and demonstrates that there are sufficient differences between the EU and the CEECs (e.g. Faini and Portes, 1995).[48] This would suggest a high degree of mutual complementarity between both parts of Europe. For the bulk of the commodities, therefore, the conclusion will probably be that the Europe Agreements have been conducive to trade based on differences in factor endowments. This, in turn, would suggest that the total trade of the CEECs reflects the current comparative advantages of these countries better than in the past and leads, therefore, to a better resource allocation in the CEECs. This conclusion seems also to be shared by economists from the European Commission who found that the CEECs' exports "are clearly concentrated in highly protected sectors of the EU" (Bucher *et al.*, 1994, p. 89).

In sum, there is only indirect evidence in the studies of comparative advantages to suggest that the Europe Agreements have been unequivocally conducive to a "better" trade, one that leads to a more rational allocation of resources in that it is consistent with the existing factor endowments. The basic problem of most of the studies is their methodology and the fact that both technological conditions and capacity utilisation may dif-

46 The study has been heavily criticised in a number of studies such as Holmes *et al.* (1993). The shortcomings notwithstanding, the Hughes and Hare study does show at least that the cost structure differs widely in the countries under consideration.

47 According to a recent report by Bohata (1996), who draws on the data base of the Czech Ministry of Foreign Affairs, exports of machinery in 1994 were 30 per cent below the level of 1988 in US dollar terms. The comparison was made for the Czech Republic only. The share of this commodity group in total exports declined from 40.1 per cent in 1989 to 27.1 per cent in 1994. These findings are, however, contradicted by the performance of manufactured exports from Hungary, as pointed out by Inotai and as reported above. It seems, therefore, necessary to make a distinction between machinery and equipment on the one hand and manufactured products as a whole on the other.

48 See also the discussion of unemployment effects below.



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fer among countries and over time too significantly to allow precise measurements. Moreover, as Holmes *et al.* (1993) pointed out, the presence of X-inefficiencies makes a rigorous analysis extremely difficult since their bias cannot be ascertained *a priori.* Furthermore, the techniques of ascertaining "comparative advantages" – whether they were based on "domestic resource costs" or "revealed comparative advantages" or similar methods – have intrinsic deficiencies which become particularly apparent when applied to transition countries. These economies are rapidly changing as reflected in changes in production methods, technology and product mix – and the quality of data in these countries is often dubious. All this, in turn, makes it difficult to resolve even the basic controversies about the impact of the Europe Agreements, such as those concerning evaluations of "sensitive" sectors.

*Intra-Industry Trade*

The third group of studies includes studies of intra-industry trade. The Europe Agreements have opened up not only inter-industry trade, i.e. trade based on differences in factor endowments, but also intra-industry trade which is driven by other forces such as scale economies or differences in taste. Even though the evidence is scarce, there are reasons to believe that these opportunities are already well understood and exploited by firms in the EU and the CEECs. The evidence can be found in studies of *subcontracting* which has been taking place on a large scale, especially by German, Italian, Austrian and French companies (e.g. Graziani, 1994, p. 470). Further evidence comes from sector-specific studies such as Faini and Portes (1995), who find a great deal of intra-industry activities in trade between Greece and Spain, on the one hand, and the CEECs, on the other. Neven (1995) has found that the EU now has at least as much intra-industry trade with the CEECs as it has with Northern Europe. Their findings are consistent with those of Cado and de Melo (1996) who find little penetration from the CEECs, especially in the "sensitive" industries, but they also find a fairly high level of intra-industry trade,using the case of France. Moreover, Drábek and Smith (1995) show that the role of intra-industry trade between the EU and the CEECs has been increasing (Table11).[49] A similar conclusion has been reached by Graziani (1994) and in the country studies by the European Commission (1994). In sum, intra-industry trade is beginning to play a significant role in trade between the EU and the CEECs, and the role has substantially increased over time.

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49 Compare also with Drábek and Greenaway (1984).



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

**Table 11 CEECs – Intra-industry Trade with the EU, 1988-1993**

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 |
|---|---|---|---|---|---|---|
| Poland | 0.38 | 0.42 | 0.39 | 0.40 | 0.42 | 0.45 |
| Czechoslovakia | 0.46 | 0.46 | 0.47 | 0.50 | 0.53 | 0.59 |
| Hungary | 0.48 | 0.49 | 0.50 | 0.52 | 0.52 | 0.55 |
| Singapore | 0.38 | 0.38 | 0.40 | 0.41 | 0.39 | 0.36 |
| South Korea | 0.27 | 0.28 | 0.30 | 0.29 | 0.34 | 0.34 |
| Taiwan | 0.32 | 0.35 | 0.38 | 0.38 | 0.37 | 0.37 |

*Source:* Drábek and Smith (1995).

## *Trade Distortions?*

Even though positive, "trade-creating" effects can be clearly discerned from the pattern of trade between the EU and the CEECs, contrary evidence has also been shown in the literature. One area of "perverse" effects of the Europe Agreements on the EU-CEECs trade has been the impact of the Common Agricultural Policy (CAP) in the EU. The CAP, which has allowed the build-up of substantial agricultural surpluses in the EU, has encouraged the growth of agricultural exports from the EU to the CEECs. Most writers on this subject argue that these exports not only damage the agricultural sectors in the CEECs but also contribute to the existing distortions in the allocation of resources in the EU. In brief, these trade flows are examples of "trade diversion".[50] There is clearly no doubt that the trade liberalisation in the CEECs combined with the agricultural policy in the EU has permitted a rapid expansion of agricultural exports from the EU to the CEECs. In 1992, for example, EU agricultural exports accounted for 50 per cent of total Polish imports of agricultural and food products. The corresponding numbers were 44 per cent in Czechoslovakia, 34 per cent in Hungary, 42 per cent in Romania and 40 per cent in Bulgaria.

It is not clear, however, whether the expansion of agricultural imports was due to the agricultural subsidies in the EU or to domestic factors in the CEECs. Some writers, such as Inotai, have complained that subsidised exports of agricultural products from the EU have been primarily responsible for the emergence of a deficit in CEECs in their agricultural trade with the EU (Inotai, 1995, p. 127). But the point is disputed by Tangermann and Josling (1994) who argue that "export subsidisation has

50 This position is taken even in studies prepared for the European Commission by a number of external advisers such as Tangermann and Josling (1994) and Buckwell *et al.* (1994).



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

probably had less influence on rising CEECs agricultural and food imports than is sometimes assumed". They argue that the depression of the agricultural sector in these countries was caused by bad policies in these countries rather than cheap imports.

There are other examples of trade distortions. The evidence comes from studies of effects of import restrictions in other "sensitive" sectors such as footwear (e.g. Wang and Winters, 1992). However, these distortions would point to trade distortions arising from other arrangements such as the Multi-Fibre Agreement or from special bilateral arrangements concerning "sensitive" products such as footwear rather than to the distorting effects of the Europe Agreements *per se.* Unfortunately, the Europe Agreements did not undo these restrictive arrangements. It is not yet clear how serious these examples oftrade distortions are. My rough guess is that the magnitude of losses due to the distortions attributable to the Europe Agreement may be important at the margin but probably not on the aggregate level.

### *Effects of the EU Enlargement on Economic Welfare*

Even though there has been much talk about "who gains from the Europe Agreements and who does not", there is, once again, very little hard evidence. Typically, one should distinguish between two kinds of welfare effects of regionalism – allocative effects and the effect on capital accumulation and economic growth. The empirical literature – as limited as it is – typically focuses on the latter by estimating the budgetary costs of integration and the overall adjustment costs for the countries concerned following the signing of a regional agreement.

#### *Limited Economic Gains for the West*

The prevailing view among observers is that economic gains for the EU will be relatively small in the short run and limited in the medium run while the costs may be high. The basis for this assertion is the relatively small role of the CEECs in the economies of the EU. To make their argument, the sceptics usually point to the small share of the CEECs in total trade of the EU. In 1994, for example, the share of the CEECs in total imports of the EU was only 2.2 per cent and 2.6 per cent in the case of total exports (Schumacher and Weise, 1996). Moreover, the low levels of GDP per capita in the CEECs as well as the low combined level of GDP relative to that of the EU will also limit the dynamic effects in the short and medium run. All this would suggest that the current economic gains from integration must be relatively small, and that even the prospects for



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the gains to become really significant in the short or medium run are rather remote.[51] At the same time, the critics also point out that the costs of integrating the CEECs into the EU will be large partly because of heavy budgetary implications and partly due to the adverse impact of industrial relocation from the EU to the CEECs as a result of cheap labour in the latter. We shall now look at these arguments in some detail.

The prevailing view has recently received empirical support from Baldwin, Francois and Portes (1996) who quantify the net economic gains to the EU. Using a calibrated general equilibrium model of global trade, they estimate the long-run economic benefits of the CEECs enlargement under two scenarios – a conservative and a more optimistic one. They find that the income effects will add to growth of GDP in the EU by only 0.2 per cent per annum. Moreover, it makes no difference whether they make optimistic or pessimistic assumptions about the model structure – the impact on GDP growth is virtually insignificant. Somewhat more significant are their estimates of the impact on growth of exports of the EU. The enlargement will add more to the EU's growth rate of exports – about 1.5 per cent, which is not negligible but hardly dramatic.

***Employment Effects of the Europe Agreements.*** Cheap labour in the CEECscould make a large number of EU firms relocate into the CEECs, and this could lead to a loss of jobs in the EU. High wage costs and taxation combined with overblown payments for social benefits and rigid labour markets have been quoted as the most powerful force for Western companies to relocate into the CEECs (Schultz, 1996). While the relocation is making the companies more competitive in world markets, it has raised fears in the EU about the adverse impact of these changes. In this respect, the Europe Agreements might play an important role at the margin since the market penetration in a number of specific activities has been very large (Havlik, 1995, p.151). Moreover, the provisions in the Europe Agreements for some, albeit limited labour mobility has added to these fears. How important these effects are has been the subject of a number of studies.

These studies reach the fairly uniform conclusion that the competitive threats of the CEECs have been greatly exaggerated. A pioneering CEPR

51 In contrast, political gains could be very large indeed for the EU. These are not, however, considered in this review. The reader may wish to consult, for example, Bofinger (1995) for details. It must be said, however, that a minority of observers, for example, Inotai, suggest that economic gains of the EU have already been large, pointing at large trade surpluses with the CEECs as evidence of such gains. However, without going into detail, trade surpluses can hardly be considered the appropriate indicators in such a case.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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study of 1992 argued that the fears of the CEECs competition can be discounted provided that the market access in the EU improved for the CEECs, and credible promises of full membership for CEECs have been given to these countries. A number of subsequent studies have also found that the employment costs of the Europe Agreements for the EU member countries will be relatively small. The main reason is that the CEECs and the EU member countries tend to be dissimilar, as noted above. This dissimilarity has further increased in recent years even in those countries in which economic structures where probably more similar to those of the CEECs in the past (Faini and Portes, 1995). The most controversial and sensitive areas include industries such as steel, coal mining, textiles, footwear and clothing – the so-called "sensitive" industries. But even for these industries, the evidence suggests that the adjustment costs resulting from East European competition are likely to be relatively minor. Thus, Cadot and de Melo (1995) analysed the impact on French industries, Dimelis and Gatsios (1995) on Greek industries, and Gual and Martin (1995) and Martin (1995) on Spanish industries. Relatively minor adjustment costs can be expected in specific sectors such as steel (Winters, 1995) and textiles (Corrado, 1995).

The EU countries have protected their labour markets by means of restrictive labour migration policies. The logic of these restrictions was to limit the outward migration from the CEECs to the EU. The costs and benefits of these policies for the EU are difficult to ascertain since the issue has hardly been studied. Although the existing large wage differences have stimulated some outward migration from the CEECs to the EU countries, two studies indicate that the negative impact on Western employment is greatly exaggerated (Layard *et al.*, 1992 and Winters, 1992).

***Budgetary Costs of Integration.*** We have seen that the possibility of financial assistance has remained by and large outside the actual Europe Agreements. It became evident early during the negotiations that the EU's ability to help the CEECs to provide financial resources other than for technical assistance was very limited for *budgetary reasons* in the EU itself (Brada, 1992 and CEPR, 1992). As a result, the Agreements have not enabled the CEECs to access regional and structural funds of the EU even though the access to these funds has been regarded by many observers as crucial to the whole process of regional integration (Baldwin, 1992).

At present, there is a debate in academic and political circles about the importance of these budgetary constraints. These discussions are translated into discussions of costs of enlargement. The estimates of budgetary costs of full membership vary a great deal. The crux of the problem and the basis for the differences in the estimated costs of full membership lie main-


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ly in the assessment of the so-called cohesion costs, the countries' contributions and the costs of agricultural adjustment. The latter, in turn, reflects differentassumptions about the Common Agricultural Policy (CAP) and about the capacity in the CEECs to absorb foreign funds. Assuming no change in the CAP and no constraints on the capacity of the CEECs, the costs of enlargement would indeed be enormous. For example, Baldwin (1994) estimated the costs to be about 64 billion ECU. The CAP alone would result under "no-change" policy in 47 billion ECU. In contrast, Buckwell *et al.* (1994) have estimated that the costs would be considerably lower – 22 to 37 billion ECU, even though their estimates only cover the costs of enlargement under the present CAP. According to another estimate, the overall costs of enlargement would not exceed 20 to 25 billion ECU which most experts consider an acceptable burden for the existing member countries (Schumacher and Weise, 1996). A more recent estimate by Inotai puts the figure of enlargement costs even lower – at between 12 billion and 20 billion ECU.[52] Most writers and many politicians argue that the CAP will have to be significantly changed in order to reduce the level of protection for Western agriculture and decrease the large budgetary support.

Several writers have made useful summaries of the literature on the budgetary costs of the EU enlargement (e.g. Baldwin, 1996) and there is no need to repeat it in this paper. It may suffice to say that all the recent reviews of budgetary estimates and the estimates themselves confirm that the budgetary implications of the enlargement are likely to be significantly smaller than was previously believed. Baldwin (1996) himself has re-estimated the budgetary costs for the EU and found that "only" 17 billion ECU would be needed in year 2000 – a much lower figure than what he estimated a few years earlier. The differences lie primarily in the availability of better data, the assumptions about the agricultural productivity in the CEECs, about the future course of the CAP, about the absorptive capacity of the CEECs and the growth of the EU economies.

### *Significant Economic Gains for the CEECs*

In contrast to rather small economic gains for the EU, economic gains for the CEECs from the Europe Agreements and from full EU membership could be very large indeed. These gains would result from improved allocative efficiency as well as from faster economic growth. Even though the associate or full membership will imply adjustment costs in the

52 As reported in the Wall Street Journal Europe, 23 July 1996.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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CEECs, the overwhelming majority of observers believe that the economic benefits will significantly exceed the economic costs. Most of the arguments are presented by Brown *et al.* (1995), who also review some of the empirical studies.

***Effects on Growth.*** Notwithstanding the recent general findings of de Melo and Panagariya (1992) that membership in integration schemes has no effect on economic growth, there seems to be a general agreement among experts that the Europe Agreements have had a positive impact on economic growth in the CEECs.[53] The Agreements have clearly contributed to economic recovery in the CEECs after the collapse of the CMEA. Exports to the EU have been growing, and, for some of the CEECs, they have represented the only growing component of aggregate demand during the time of recession. In most of these countries, exports to the EU have been growing even faster than domestic output. In the future, with full membership of the EU, such exports will continue to make an important contribution to GDP growth in the CEECs. In a recent study, Baldwin, Francois and Portes (1996) have estimated the net benefits in terms of the contribution of trade to GDP growth that will result from the accession to the EU. In their conservative scenario, they estimate that the accession will add 15per cent to the GDP of the CEECs. In their more optimistic scenario, in which they allow for additional growth of capital investment as a result of the enlargement, they estimate that the corresponding contribution will be almost 19 per cent.

***The Contribution of CEFTA.*** While recovering relatively fast, mutual trade of CEFTA countries remains small. This reflects the absence of not only strong market forces but also government policies to discriminate in favour of CEFTA trade. Given the relatively small size of their mutual trade and of other economic relations, the current contribution of CEFTA to welfare of member countries is small, and in the medium run the net economic gains are likely to remain modest. The gains are much smaller than the economic gains from their trade with the EU, as Brown *et al.* (1995) have pointed out. Similar conclusions are reached by Guzek *et al.* (1994). Using an input-output model Guzek and his collaborators simulated the impact of CEFTA on price changes in Poland. In addition, they calculated the impact of CEFTA on government revenues. Their conclusion

53 The following discussion obviously covers only that part of the literature that has addressed the relevant problems of the CEECs. Nevertheless, similar conclusions have also been reached by analysts looking at the impact of regional arrangements in the CIS region. See Michalopoulos and Tarr (1996).

is that the total losses due to reduction in government revenues and to the reduction of incomes in affected industries are roughly equal to total gains. Once they allow for further dynamic effects of growth, they find that net gains would be positive but still relatively small.

Similarly, Bakos, quoted in Rudka and Miszei (1994), argues that former Czechoslovakia, Hungary and Poland have always been attracted to the West, and that their trade with other CEECs could never reach levels of real significance. Rudka and Miszei (1994) themselves take a similar view – which is strongly supported by empirical evidence of historical trade flows (Drábek 1985). In brief, the history makes these arguments quite convincing since none of the CEECs have ever traded intensively with one another, with perhaps the Czech Republic and Slovakia as the only exception.

*Effects of the Europe Agreements on Foreign Direct Investment and Capital Flows*

The Europe Agreements have had an impact not only on trade but also on other economic activities. Among the latter, the most important activity has arguably been foreign investment, representing an important step towards integrating the capital markets of the countries concerned. Here again, researchers face a general problem of distinguishing between the impact of the Europe Agreements and the unilateral liberalisations which the CEECs adopted in the early 1990s.[54] What matters, however, is that the Europe Agreements have provided the necessary set of measures to protect foreign direct investment in the CEECs, thus creating an "international" protection for foreign firms in the CEECs.[55] This has been well recognised in the literature, even by those observers who have been otherwise more critical of the Agreements (e.g. Winters, 1992, p. 23).

With these reservations in mind, there seems to be no doubt that the EuropeAgreements have actually played a highly positive role in encouraging foreign direct investment (FDI) in the CEECs. Starting from virtually zero, the total cumulative investment in the CEECs region is currently high, especially if compared to the late 1980s and to many developing countries. According to EBRD's *Transition Report*, the total cumulative

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54 By the time the Europe Agreements were negotiated, the CEECs had already liberalised foreign exchange transactions and had provided for a range of guarantees to foreign investors.

55 The protection was, in fact, provided not only for foreign direct investors but also for portfolio investors. The Europe Agreements do not make a distinction between these two types of investors.



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FDI amounted for the period 1989-1994 to (in millions of dollars) 6,913 in Hungary, 2,981 in the Czech Republic, 1,523 in Poland and 1,600 in Slovakia (EBRD, 1995, p. 87). In per capita terms, Hungary is already a country with one of the highest levels of FDI in the world. FDI in the Czech Republic and Poland accelerated in 1995 after additional measures taken to attract foreign capital.[56] By far the greatest share in total FDI has been held by firms from the EU, mainly Germany, Austria and France (see Drábek, 1996b). The combined contribution of the EU to the stock of foreign direct investment was about 60 per cent in 1994 in the case of Poland, and almost 67 per cent in the case of Hungary. In 1995, the corresponding shares in the case of Slovakia and the Czech Republic were 48 per cent and more than 70 per cent respectively.[57] Romania and, in particular, Bulgaria have so far received modest amounts of FDI because other factors have clearly discouraged foreign investors.

The size of markets is normally an important determinant of foreign investment. Many companies have, therefore, invested in the CEECs with the view of establishing a "hub" for the rest of the area. The successful implementation of CEFTA will create a market of 65 million consumers. *Pari passu*, many writers and, of course, individual investors still consider the markets of individual countries to be too small to warrant FDI in each of the markets individually. Thus the slow progress of integrating the economies of the CEECs has undoubtedly been a disincentive for foreign investors (Rudka and Miszei, 1994). Several analysts have even argued that the lack of closer integration of the CEECs has encouraged highly speculative and short-term foreign investors rather than investors with long-term horizons (Maroudas and Rizopoulos, 1995).[58]

## V Conclusions

The *first conclusion* that can be drawn from the literature is that trade, investment and other economic relations between the EU and the CEECs have been driven by market forces. The unilateral liberalisation of the CEECs has provided a strong impetus to trade re-orientation from the

56 These measures mainly included several privatisation deals in the Czech Republic and the conclusion of Paris and London Club Agreements with foreign creditors in the case of Poland.

57 The figures come from Drábek (1996b). The Czech figure includes only four EU countries – Germany, Austria, France and Belgium. The figure is greatly affected by the extraordinary high share of Germany – 48.4 per cent.

58 This sentiment was also strongly echoed at the seminar at which this paper was presented. The position was taken particularly strongly by Joan Pearce.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

"Eastern" markets to the markets of Central Europe and mainly to Western Europe and to other developed countries. Some of this re-orientation began to materialise before the conclusion of the Europe Agreements, which suggests that both trade and foreign investment have been positively stimulated by existing market conditions. The presence of these forces has been well documented in a number of empirical studies based on "gravity" models which show a large scope for trade expansion between the CEECs and the EU. In addition, the Agreements have provided a strong impetus towards the integration of capital markets. While the process has not yet been concluded, the growth of FDI and, most recently, of portfolio investment has already beenimpressive in some CEECs.

The *second conclusion* refers to the actual Europe Agreements. By general accounts and on three out of the four criteria mentioned in the introduction, the Europe Agreements have been so far very useful. Both parties to the Agreements have a broad range of common interests which is the basis for an effective completion of the integration process. The EU countries have a strong political interest to absorb the CEECs as members and an economic interest, that will perhaps only be realised in the long run. The CEECs have an immediate economic interest in addition to strong political expediency. The regional agreements became more practical and effective than multilateral initiatives even though the latter were approached by the CEECs simultaneously. The question of speed was crucial for these countries to provide legitimacy for new governments, policies and, indeed, even for new states. The Agreements have provided a legal "umbrella" for economic cooperation in that they "locked-in" the existing concessions by the EU to the CEECs and provided some new, additional concessions. The Agreements have been, therefore, useful in improving the market access for the CEECs and thus in stimulating mutual trade and foreign investment. In addition, the Agreements go beyond free trade agreements in that they have been an important instruments of deepening the integration of the CEECs into the EU. They have opened up room for foreign assistance – both financial and technical – and for the establishment of economic institutions in the CEECs. As a result, the Agreements have played a positive role in helping the CEECs shift their trade from the "Eastern" markets after the collapse of the CMEA, in helping to absorb the shock of the collapse of Eastern markets, and in helping to reduce the adjustment costs of transition. In contrast, the economic gains of the EU are relatively small. Their trade exposure to the CEECs is small at present, and is unlikely to dramatically increase in the medium run. At the same time, economic costs could become relatively high, especially if one considers the impact of investment relocated from the EU to the CEECs without an



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appropriate adjustment mechanisms in the EU, and if one assumes that the present budgetary policies of the EU remain unchanged.

The *third conclusion* concerns the future of the relationships between the EU and the CEECs, on the one hand, and among the CEECs, on the other. The former is crucial for the CEECs in view of their economic dependence on the EU, which is unlikely to be reduced in the future. Unfortunately, the future of the EU-CEECs relationship looks less promising today than before. The main reason is that the Agreements have not been entirely successful in eliminating all of the trade restrictions against the CEECs exports. Thus the Agreements do not pass with "flying colours" on our fourth criterion –to create incentives for the elimination of trade diversion. The presence of restrictions on the so-called "sensitive" products is a primary example of the problems at hand. This could prove to be particularly painful in the next few years when the CEECs will have to expand their exports beyond their existing market shares.

The *fourth conclusion* concerns the CEECs trade and economic relations with Russia and other CIS countries and with other CEECs. The question is often asked among experts, policymakers and the general public: How much integration or cooperation with Russia is possible or indeed rational? The answer that can be obtained from the literature is: not much. There are several reasons why this is the case. (1) External tariffs in Russia are much higher and non-uniform than in the CEECs. Unless Russia is prepared to reduce its tariffs, the CEECs cannot increase their exports to Russia. (2) Russia is even more unstable than the CEECs, hence closer links would destabilise the CEECs. (3) There are good reasons to believe that trade with Russia would lead to a great deal of trade diversion. Russia is a vast market. However, even with low tariffs it would not bedesirable to export to Russia on a preferential basis since the market is less competitive than that of the EU. (4) Unresolved problems of Russian debt to the Czech Republic and some other CEECs make it very difficult to bring these countries closer together. (5) Various payment restrictions exist in Russia, and it has not yet established a credible payment system (Drábek, 1992).

A similar question has been raised with regard to the prospects of mutual trade of the CEECs. Is CEFTA a good instrument to expand the mutual trade of the CEECs? Would such an expansion be desirable? The answer is no. Most writers believe that mutual trade of CEFTA countries would lead more to trade diversion than to trade creation. While this is probably an exaggerated view, the potential for future trade expansion is slim for economic reasons. Moreover, there is widespread agreement that CEFTA alone will not be sufficient to increase the level of cooperation of these countries significantly; other measures will be required in order to expand their mutual trade. However, CEFTA can play an extremely important



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role in helping the individual CEEC to strengthen their negotiation power.

The *fifth conclusion* is that neither the Europe Agreements nor CEFTA are instruments of protection against third countries. As free trade agreements, these regional and sub-regional arrangements do not coordinate the external tariff (and trade policy in general) towards third countries. Moreover, with the exception of Bulgaria, until recently the CEECs have been members of the WTO and could not, therefore, change their external tariffs unilaterally. The trade regimes have been liberalised in all of the CEECs unilaterally, and the agreements have provided an additional impetus for liberalisation; in the case of the Europe Agreements, they have provided a legal framework for other trade and investment-supporting measures. Indeed, both the Europe Agreements and CEFTA exceed the scope of liberalisation measures negotiated by these countries in international agreements so far. However, the implementation of the measures has been less than satisfactory. As we have shown above, several of the CEFTA countries have introduced a number of new protective measures indicating some policy slippage.

While the Europe Agreements and CEFTA represent a major change in the conduct of trade policy in the CEECs, both agreements also raise new questions. Unfortunately, there are still no definite answers to many of these questions. One such unresolved question concerns the *speed of integration* between the CEECs and the EU. At present, the question is not "whether" but when. For reasons discussed above, most writers agree, and the empirical literature presented in this review supports it, that the integration of the CEECs into the EU will be economically beneficial and rational. Most writers probably also agree that full integration (and membership) of the CEECs into the EU will take time and that the negotiations of accession will be much longer than was originally assumed. How long the process will last depends on the depth and nature of the problems perceived. The economic problems alone are substantial, and they could lead to long delays and difficult negotiations. As Baldwin has pointed out, "as a matter of self-defence, coalitions of farmers and poor regions are likely to veto the eastern enlargement until CEECs get much richer and the CAP is reformed" (Baldwin, 1994). But the issues are broader and include considerations of a political nature. For example, how long will it take the CEECs to adopt the EU environmental standards or to carry out full institutional reforms?

The other unresolved issue is the question of the *depth of integration*. So far, the integration with the EU has mainly taken the form of a free trade area with some additional measures in other areas. Nevertheless, the question is currently asked in the EU whether the EU should be deepened or



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widened or both at the same time. The answer to this question will obviously have serious implications for the CEECs which will have to make the necessary policy and institutional adjustments. The deeper the integration the bigger the adjustments that will be required. The question of which countries would or should be integrated first and which later also remains unresolved. If some countries are left behind, how should they be treated by the EU and the other CEECs? The more general unresolved question is that the full integration of any CEEC into the EU still remains a bit of a mystery. Nobody knows for certain what the EU will look like at the time of the accession. The CEECs themselves have not yet shown much interest in addressing this question and have stuck to their general statement that they want to become full members irrespective of the type of EU they will be facing.

# Appendix

## Appendix Table 1 CEECs Imports and Exports, 1988-1991

| | | Imports | | | | | Exports | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Percentage change (%) | | | | Indices (1988=100) | Percentage change (%) | | | | Indices (1988=100) |
| | | 1988 | 1989 | 1990 | 1991 | 1991 | 1988 | 1989 | 1990 | 1991 | 1991 |
| **Bulgaria** | | | | | | | | | | | |
| *Crane/PlanEcon* | *World* | *10.5* | *0.3* | *-14.5* | *-71.1* | *24.8* | *5.0* | *-9.9* | *-15.4* | *-50.1* | *38.1* |
| | CPEs | 5.0 | 2.5 | -10.0 | -77.5 | 20.8 | 6.3 | -7.9 | -21.7 | -52.8 | 34.0 |
| | DMEs | 4.2 | 0.6 | -25.6 | -55.4 | 33.3 | 2.9 | 17.2 | -10.8 | -31.9 | 71.3 |
| *Rosati/ECE* | *World* | *3.4* | *-9.9* | *-23.7* | *-51.5* | *33.3* | *9.1* | *-12.0* | *-21.3* | *-34.2* | *45.6* |
| | CPEs | -5.4 | -16.7 | -23.8 | -43.1 | 36.1 | 6.5 | -10.6 | -32.0 | -27.8 | 43.9 |
| | DMEs | 4.4 | 0.6 | -25.9 | -59.8 | 29.9 | 3.3 | 17.2 | -11.1 | -36.3 | 66.4 |
| | DEVs | 81.3 | -8.7 | -19.0 | 54.4 | 114.2 | -3.5 | -35.8 | 9.7 | -47.6 | 36.9 |
| *IMF* | *World* | *9.9* | *-10.6* | *-32.8* | *-19.7* | *48.2* | *8.1* | *-5.7* | *-25.4* | *1.2* | *71.2* |
| | CPEs | 9.3 | -15.4 | -67.5 | -34.2 | 18.1 | 9.4 | -10.9 | -55.6 | -30.0 | 27.7 |
| | DMEs | 1.9 | 1.1 | -21.5 | -15.5 | 67.0 | -6.6 | 9.1 | 25.2 | 14.6 | 156.5 |
| *World Bank* | *Total* | *0.2* | *-12.6* | *-28.3* | *-49.0* | *32.0* | *-0.1* | *-14.0* | *-27.5* | *-31.9* | *42.5* |
| | CPEs | -10.9 | -19.7 | -30.7 | – | 49.6[b] | 0.2 | -13.8 | -37.4 | – | 54.1[b] |
| | DMEs | 4.5 | 0.7 | -26.8 | – | 77.0[b] | 4.0 | 16.6 | -12.4 | – | 106.1[b] |
| | Others | 81.2 | -8.6 | -22.7 | – | 128.0[b] | -3.5 | -35.7 | 4.5 | – | 64.8[b] |
| **Czechoslovakia** | | | | | | | | | | | |
| *Crane/PlanEcon* | *World* | *3.7* | *8.2* | *9.0* | *-39.9* | *70.9* | *2.9* | *1.0* | *-6.0* | *-12.2* | *83.4* |
| | CPEs | 6.2 | 12.0 | 3.5 | -61.6 | 44.5 | -0.9 | -3.7 | -15.9 | -35.9 | 51.9 |
| | DMEs | 9.8 | -1.6 | 27.5 | -2.8 | 122.0 | 13.6 | 10.8 | 12.8 | 15.4 | 144.3 |
| *Rosati/ECE* | *World* | *5.8* | *-2.4* | *0.3* | *-7.2* | *90.9* | *9.2* | *-3.2* | *-10.5* | *5.6* | *91.5* |
| | CPEs | 1.5 | -6.9 | -17.1 | 0.3 | 77.4 | 5.9 | -11.7 | -27.4 | 6.8 | 68.5 |
| | DMEs | 9.8 | -1.6 | 24.6 | -13.7 | 105.8 | 13.6 | 10.9 | 13.4 | 6.9 | 134.5 |
| | DEVs | – | 17.0 | -12.0 | 4.4 | 107.5 | -2.5 | 0.1 | -10.9 | -6.0 | 83.8 |
| *Rodrik* | *World* | – | – | *-7.0* | *-23.6*[a] | *71.1*[c] | – | – | *-17.0* | *-13.3*[a] | *72.9*[c] |
| | CPEs | – | – | -7.3 | -70.6[a] | 27.3[c] | – | – | -18.9 | -76.4[a] | 19.1[c] |
| | DMEs | – | – | 20.5 | -24.9[a] | 90.5[c] | – | – | 7.9 | -1.2[a] | 106.6[c] |
| *IMF* | *World* | *-1.9* | *-2.9* | *-3.0* | *-25.3* | *70.5* | *0.4* | *-3.6* | *-17.4* | *-6.5* | *74.4* |
| | CPEs | -4.4 | -3.9 | -19.4 | -31.3 | 53.2 | 2.8 | -10.5 | -31.5 | -20.1 | 48.9 |
| | DMEs | 2.2 | -3.7 | 21.6 | -26.6 | 86.0 | 2.5 | 3.5 | 3.2 | 7.6 | 115.0 |
| *World Bank* | *Total* | *-0.1* | *-6.0* | *-5.7* | *-12.3* | 77.7 | *3.0* | *-6.5* | *-15.9* | *-5.0* | 74.7 |
| | CPEs | -4.4 | -10.3 | -23.6 | – | 65.5[b] | -0.3 | -14.8 | -33.1 | – | 56.8[b] |
| | DMEs | 9.8 | -1.6 | 28.1 | – | 138.5[b] | 13.6 | 10.9 | 13.4 | – | 142.8[b] |
| | Others | 0.0 | 17.0 | -12.0 | – | 103.0[b] | -2.5 | 0.2 | -10.9 | – | 87.0[b] |
| *EU* | *World* | – | – | – | *44.9* | – | – | – | – | *22.7* | – |
| | EU | – | 9.8 | 9.3 | 46.4 | 175.7 | – | 15.7 | 5.1 | 51.0 | 183.6 |
| **Hungary** | | | | | | | | | | | |
| *Crane/PlanEcon* | *World* | *8.9* | *1.7* | 2.7 | *-10.9* | *93.1* | *10.8* | *0.4* | *0.7* | *-7.3* | *93.7* |
| | CPEs | 12.1 | -1.4 | -3.0 | -62.6 | 35.8 | 5.5 | -4.6 | -14.3 | -52.2 | 39.1 |
| | DMEs | 1.4 | 10.5 | 5.0 | 64.7 | 191.1 | 20.3 | 8.9 | 22.4 | 33.6 | 178.1 |
| *Rosati/ECE* | *World* | *-4.9* | *-5.4* | -2.7 | *30.2* | *119.8* | *4.3* | *-3.3* | *-1.3* | *5.1* | *100.4* |
| | CPEs | 0.2 | -14.4 | -19.1 | 2.8 | 71.2 | 7.9 | -9.5 | -21.4 | -26.8 | 52.0 |
| | DMEs | 0.4 | 7.7 | 3.8 | 44.3 | 161.3 | 14.9 | 5.6 | 20.6 | 21.4 | 154.7 |
| | DEVs | 7.5 | -22.0 | 60.9 | 29.0 | 161.9 | 11.8 | -6.8 | -0.2 | 21.8 | 113.3 |
| *Rodrik* | *World* | – | – | *-0.1* | *34.3*[a] | *134.2*[a] | – | – | *0.8* | *0.4*[a] | *101.2*[c] |
| | CPEs | – | – | -9.8 | -51.0[a] | 44.2[a] | – | – | -17.3 | -74.4[a] | 21.2[c] |
| | DMEs | – | – | 14.6 | 38.4[a] | 158.6[c] | – | – | 19.3 | 11.3[a] | 132.8[c] |
| *IMF* | *World* | *-5.1* | *-4.9* | *-2.9* | *24.3* | *114.7* | *4.1* | *-2.7* | *-0.8* | *4.0* | *100.3* |
| | CPEs | -10.0 | -14.2 | -34.6 | -8.2 | 51.5 | -4.9 | -10.9 | -28.6 | -34.1 | 41.9 |
| | DMEs | -0.6 | 6.6 | 19.4 | 40.9 | 179.4 | 16.1 | 5.7 | 29.4 | 33.1 | 182.0 |



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**Appendix Table 1 (continued)**

| | | Imports | | | | | Exports | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Percentage change (%) | | | | Indices (1988=100) | Percentage change (%) | | | | Indices (1988=100) |
| | | 1988 | 1989 | 1990 | 1991 | 1991 | 1988 | 1989 | 1990 | 1991 | 1991 |
| *World Bank* | *Total* | *-2.7* | *-8.3* | *-7.6* | *26.3* | *107.0* | *6.7* | *-6.0* | *-6.7* | *1.7* | *89.2* |
| | CPEs | -5.7 | -17.5 | -25.4 | – | 58.0[b] | 1.6 | -12.7 | -27.6 | – | 64.2[b] |
| | DMEs | 0.4 | 7.7 | 3.8 | – | 112.2[b] | 14.9 | 5.6 | 20.6 | – | 146.4[b] |
| | Others | 7.5 | -22.1 | 61.0 | – | 134.9[b] | 11.7 | -6.8 | -0.2 | – | 103.9[b] |
| *EU* | *World* | – | – | – | *27.3* | – | – | – | – | *8.9* | – |
| | EU | – | 26.9 | -3.7 | 21.2 | 148.1 | – | 19.9 | 13.4 | 23.5 | 168.0 |
| **Poland** | | | | | | | | | | | |
| *Crane/PlanEcon* | *World* | *16.8* | *4.8* | *-11.5* | *1.9* | *94.5* | *11.2* | *0.5* | *17.1* | *-18.6* | *95.8* |
| | CPEs | 9.4 | 4.7 | -22.8 | -59.2 | 32.9 | 3.5 | -2.3 | -7.2 | -62.8 | 33.7 |
| | DMEs | 33.3 | 7.1 | 11.3 | 60.9 | 191.9 | 21.9 | 5.3 | 53.2 | 13.2 | 182.7 |
| *Rosati/ECE* | *World* | *12.8* | *-1.1* | *-2.5* | *24.3* | *119.8* | *13.3* | *0.6* | *24.7* | *-18.5* | *102.2* |
| | CPEs | -3.9 | -5.7 | 1.8 | -42.8 | 54.9 | 3.2 | -2.5 | 14.9 | -62.0 | 42.5 |
| | DMEs | 30.1 | 7.1 | -4.7 | 71.7 | 175.3 | 18.5 | 5.3 | 40.0 | 13.7 | 167.6 |
| | DEVs | 12.9 | -8.8 | -17.1 | 151.0 | 189.8 | 14.0 | -3.6 | 3.2 | -15.5 | 84.1 |
| *Rodrik* | *World* | – | – | *-2.5* | *64.7*[a] | *160.6*[c] | – | – | *11.8* | *-1.8*[a] | *109.8*[c] |
| | CPEs | – | – | -25.6 | -75.9[a] | 17.9[c] | – | – | -0.4 | -87.5[a] | 12.5[c] |
| | DMEs | – | – | 6.3 | 73.9[a] | 184.9[c] | – | – | 40.9 | 6.7[a] | 150.3[c] |
| *IMF* | *World* | *16.0* | *-17.9* | *-21.0* | *90.4* | *123.5* | *11.0* | *-0.1* | *0.7* | *9.5* | *110.1* |
| | CPEs | 20.7 | -41.9 | -35.0 | 34.6 | 50.9 | 27.2 | -23.6 | -30.2 | -19.9 | 42.7 |
| | DMEs | 40.4 | -1.7 | -4.1 | 105.1 | 193.4 | 27.4 | 6.9 | 36.2 | 23.9 | 180.3 |
| *World Bank* | *Total* | *4.1* | *-9.9* | *0.0* | *5.0* | *94.6* | *7.6* | *4.1* | *8.5* | *-25.4* | *84.3* |
| | CPEs | -8.6 | -14.1 | -4.1 | – | 75.3[b] | 0.3 | 1.4 | -6.1 | – | 95.5[b] |
| | DMEs | 30.2 | -2.5 | 2.5 | – | 130.2[b] | 19.6 | 9.4 | 32.5 | – | 173.2[b] |
| | Others | 12.9 | -16.9 | -10.8 | – | 83.7[b] | 15.1 | 0.1 | -2.4 | – | 112.5[b] |
| *EU* | *World* | – | – | – | *95.6* | – | – | – | – | *12.5* | – |
| | EU | – | 43.1 | 11.4 | 79.2 | 285.7 | – | 31.0 | 18.0 | 77.7 | 274.7 |
| **Romania** | | | | | | | | | | | |
| *Crane/PlanEcon* | *World* | – | – | – | *-41.8* | – | – | – | – | *-27.3* | – |
| | CPEs | – | – | – | -53.4 | – | – | – | – | -35.3 | – |
| | DMEs | -10.6 | -8.0 | 172.5 | -28.1 | – | 6.9 | -6.2 | -37.8 | -25.7 | – |
| *Rosati/ECE* | *World* | *-8.1* | *8.8* | *18.1* | *-17.6* | *105.9* | *8.6* | *-10.0* | *-43.4* | *-7.1* | *47.3* |
| | CPEs | 0.3 | -2.3 | -13.7 | -8.9 | 76.8 | 9.0 | -14.7 | -45.5 | 29.2 | 60.1 |
| | DMEs | -12.6 | 1.7 | 116.7 | -9.4 | 199.7 | 4.6 | -3.9 | -38.4 | -22.8 | 45.7 |
| | DEVs | -23.4 | 29.0 | 10.1 | -32.7 | 95.6 | 15.5 | -15.2 | -51.0 | -11.9 | 36.7 |
| *IMF* | *World* | *-6.3* | *-2.1* | *11.7* | *-45.0* | *60.1* | *10.7* | *-16.6* | *-43.4* | *-30.4* | *32.8* |
| | CPEs | 2.3 | 0.8 | -30.3 | -60.7 | 27.7 | 11.4 | -18.4 | -48.0 | -37.2 | 26.7 |
| | DMEs | -11.2 | -5.9 | 176.6 | -29.8 | 182.8 | 6.7 | -7.7 | -36.6 | -28.7 | 41.7 |
| *World Bank* | *Total* | *-12.6* | *5.5* | *11.5* | *-22.7* | *91.0* | *6.1* | *-11.5* | *-45.0* | *-13.7* | *42.0* |
| | CPEs | -5.6 | -5.8 | -20.4 | – | 70.8[b] | 2.6 | -17.8 | -49.8 | – | 42.4[b] |
| | DMEs | -12.6 | 1.7 | 116.7 | – | 192.7[b] | 4.6 | -3.8 | -38.4 | – | 61.9[b] |
| | Others | -23.4 | 29.0 | 10.2 | – | 108.9[b] | 15.5 | -15.2 | -51.0 | – | 48.0[b] |

*Notes:* [a] January-September.
[b] 1990.
[c] 1989=100.

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**Appendix Table 2 CEECs – Free Trade Agreement Notified in the WTO**

| | Signed | Notified | Working Party |
|---|---|---|---|
| EC + Bulgaria | 1993 | 23.12.94<br>L/7617 + Add.1<br>15.2.95<br>WT/REG1/1 | 20.2.95<br>G/C/M/1 |
| Latvia + EC | 1995 | WT/REG7/N/1<br>30.6.95 | 26.9.95<br>G/C/M/6 |
| Estonia + EC | 1995 | WT/REG8/N/1<br>30.6.95 | 26.9.95<br>G/C/M/6 |
| Lithuania + EC | 1995 | WT/REG9/N/1<br>30.6.95 | 26.9.95 |
| EC + Rep. Of Slovenia | | WT/REG10/N/1<br>1.8.95 | * |
| Rep. Of Hungary + Rep. Of Slovenia | 1994 | WT/REG19/N/1<br>15.8.95 | 26.9.95<br>G/C/M/6 |
| EFTA + Slovenia | | WT/REG20/N/1 | 1.12.95<br>G/C/M/7 |
| Czech Rep. + Bulgaria | | | |
| Slovak Rep. + Bulgaria | | | |
| EC – Czech + Slovak + Hungary + Poland | 1991 | 3.4.92 L/6992 | 30.4.92<br>C/M/256 |
| EFTA + Romania | 1992 | 3.6.93<br>L/7215 + Add.1 | 16.6.93<br>C/M/264 |
| EFTA + Bulgaria | 1993 | 7.7.93<br>L/7257 + Add.1 | 27.10.93<br>C/M/267 |
| EFTA + Poland | 1992 | 21.1.94<br>L/7372 + Corr.1 + Add.1 | 25.1.94<br>SR.49/1 |
| EFTA + Hungary | 1993 | 21.1.94<br>L/7360/Rev.1<br>+ Add.1 | 25.1.94<br>SR.49/1 |
| Czech + Hungary + Poland + Slovak | 1992 | 30.6.94<br>L/7498 + Add.1 | 20.7.94<br>C/M/274 |
| Czech + Slovenia | 1993 | 4.5.94<br>L/7447 + Add.1 | 21.6.94<br>C/M/273 |



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**Appendix Table 2 (continued)**

| | Signed | Notified | Working Party |
|---|---|---|---|
| Slovak + Slovenia | 1993 | 4.5.94<br>L/7448 + Add.1 | 21.6.94<br>C/M/273 |
| EC + Romania | 1993 | 23.12.94<br>L/7618 + Add.1<br>15.2.95<br>WT/REG2/1 | 20.2.95<br>G/C/M/1 |

* No Working Party established as the Agreement has been superseded by a "Europe Agreement".

**Appendix Table 3 Share of the Bilateral Free Trade Agreements in Total Exports**

| | FTA Partner country | 1994 | 1995 |
|---|---|---|---|
| Bulgaria | Czech Republic | 0.40 | 0.50 |
| | Slovakia | – | – |
| Czech Republic | Bulgaria | 0.36 | 0.34 |
| | Estonia | 0.08 | 0.10 |
| | Latvia | 0.05 | – |
| | Romania | 0.36 | 0.25 |
| | Slovenia | – | – |
| Estonia | Czech Republic | 0.23 | 0.27 |
| | Slovakia | 0.09 | 0.17 |
| | Slovenia | – | – |
| Hungary | Slovenia | 1.59 | 1.99 |
| Latvia | Czech Republic | 0.30 | 0.53 |
| | Slovakia | 0.10 | 0.19 |
| Romania | Czech Republic | 1.23 | 0.26 |
| | Slovakia | 0.13 | 0.20 |
| Slovakia | Bulgaria | – | – |
| | Estonia | – | 0.03 |
| | Latvia | 0.04 | 0.07 |
| | Romania | 0.59 | 0.42 |
| | Slovenia | – | – |
| Slovenia | Czech Rep. and Slovakia | 1.66 | 1.67 |
| | Estonia | – | – |
| | Hungary | 1.45 | 1.00 |

*Source:* Based on Direction of Trade (IMF).



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# Comment on "Regional and Sub-Regional Integration in Central and Eastern Europe: An Overview," by Zdeněk Drábek

*Ricardo Lago*

I found Zdeněk Drábek's paper very informative and authoritative on the matter of trade agreements in Central and Eastern Europe and trends toward European integration, and indeed, I will make it available to bankers in the EBRD. Many of the issues Zdeněk Drábek touches upon impinge on our project financing. Very often we have to muddle through financial projections of, for example, a brewery project, a textile project or a glass producing project, and we need to know what the rules of the game in terms of international trade for specific countries vis-à-vis the market are going to be. We are often surprised at what we find, and I would suggest that some of this micro evidence is included in the paper. For instance, Romania is a party to the WTO and in the process of renegotiating its tariffs. In a recent examination of a brewery project there, we discovered that the tariff on beer imports had risen from 240 per cent to 360 per cent. So there have been significant reversals and these need to be reflected in the paper. I cannot imagine countries other than Cuba and North Korea with tariffs as high as these tariffs on beer imports. We have also come across cases of trade restrictions such as in Poland with FIAT, where exceptions to trade liberalisation were made to entice the investor. With regard to the point on costs and gains to the European Union and the CEFTA countries, the key is not the measurement of gains and losses in terms of welfare triangles or the use of computable general equilibrium pointed out in the paper. In my view, the main benefit of these processes of integration of the Central and Eastern European countries with the European Union is to cement the policy reforms that have been undertaken in the region and to provide some sort of incentive, or carrot, to minimise the likelihood of deviations from this policy framework. In this respect, the EU integration incentive has worked very well, particularly in the Czech Republic, but also in Poland and other countries. Slovakia has deviated somewhat from the policy reform trend in the last two or three years. One question that arises is what is the likelihood of achieving the


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ultimate carrot, full membership in the European Union. I am sure that Joan Pearce will have some ideas on this. If I consider the range of estimates suggested in the paper regarding the costs to the budget of the Economic Commission in the event of accession of all ten of the countries that have applied for accession, the range goes from 64 billion ECU to 12 billion ECU.

This implies that the timing and form of that accession are uncertain. This also reflects the uncertainty in the shape of the European policies themselves with regard to e.g. the Cohesion Fund, the Structural Funds, the Common Agricultural Policy and other issues such as institutional decision-making. Indeed, there are many elements of uncertainty regarding what kind of European Union will evolve and how many East European countries will join. Another important issue which relates to the first one of cementing this process of reform is macroeconomic stability and general stability of the rules of the game. The achievements here have been phenomenal and they have exceeded the expectations of most of the practitioners and officials of the international financial institutions. In 1992, only Poland was growing; in 1996, 18 economies of the 26 borrowers of the EBRD are growing. In 1992, average inflation was close to 1000 per cent; in 1996 this figure has come down to around 30 per cent. The achievements are impressive. Against this background, I find that the flows of foreign direct investment – with the exception of Hungary, the Czech Republic, Estonia and perhaps Poland – are still very low. The population of our 26 borrowers is about 400 million, about the same size as Latin America's, but the level of foreign direct investment in our region, which includes the Russian federation, was less than half of that of Latin America in 1995, i.e. only 13 billion. Likewise, international bank financing of infrastructure in the region, both in terms of number of projects and amount of financing, amounts to only half that of Latin America. With the exception of the Czech Republic and Hungary, investors still overestimate the systemic risks and the likelihood of policy reversals. They feel more at ease with the traditional emerging markets rather than with the countries in transition. I don't think this is justified given the very strong macroeconomic performance of the region as a whole. In closing, much has been achieved, but daunting challenges remain. The whole issue of consolidation, particularly the formation of institutions, is the main challenge. Countries like the Czech Republic are at the forefront of this process. But the renovation of much of the capital stock and infrastructure is also a challenge. Most of the capital stock was inherited from the previous central planning regime. The reconversion of the stock of human capital is the main good news. One can feel very upbeat about the region in terms of human capital. We have knocked down half of the capital stock in the pro-



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duction function, but we have a reservoir of skills such as 100 per cent literacy which doesn't exist in the developing countries. To be blunt, it would take six months to make a banker out of a Russian mathematician; financial algebra would be a children's game for him. But it might take two or three generations to convert an Aymara Indian in the highlands of Peru or Chile or elsewhere into a banker.

First he must learn Spanish, move to the city, etc. This illustrates in a nutshell why we can be upbeat about the region. There is a vast reservoir of knowledge which can be converted, at minimum cost, to the demands of a market economy. There are those who claim that economic reform could have gone more quickly or been done differently. To this I would quote the comment of Jacob Frenkel, the Governor of the Central Bank of Israel. "In 1962, had Lee Harvey Oswald killed Khrushchev instead of Kennedy, what could we say about the course of history?" He concluded that the only thing that we could say – with a high probability of being right – is that Onassis would not have married Khrushchev's widow.



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# Comment on "Regional and Sub-Regional Integration in Central and Eastern Europe: An Overview," by Zdeněk Drábek

*Franz-Lothar Altmann*

The paper is divided into three sections. The first is a retrospective on Central and Eastern European integration. The second part focuses on the European Union, and the third part examines CEFTA. It is noteworthy that in the past (CMEA) as well as at present, the pressure for Central and Eastern European integration did not develop within the region itself, but was and is externally driven. Again, the region is orienting itself toward an integration scheme from outside, but instead of Moscow steering the course, it is now Brussels. This comparison may not be entirely appropriate, but it highlights the tendency toward Central and Eastern Europe's integration based on outside influence instead of forces from within. At the same time, it shows that a desire for integration exists.

The relationship between Central and Eastern Europe and the European Union is viewed rather critically in the main part of the paper, and the remaining obstacles receive substantial attention. After describing some positive effects, the author concludes that integration is profitable for Central and Eastern Europe, but not for the European Union. I would not be so pessimistic because the European Union is gaining quite a lot – if not in the short term, then in the medium or long term. The European Union is not only benefitting in the security and political arena, but should also benefit from harmonisation in environmental protection, for example. Even in pure trade and economics terms, the European Union would profit from intensified trade and intensified division of labour – a current trend that is likely to continue. This is particularly the case if we consider the future competitive position of the current EU vis-à-vis other economic blocs such as ASEAN or NAFTA. So in my view, economic gains for the European Union do exist, even though I agree with Ricardo Lago that economic figures are not the only measure of gain. In absolute terms, the increase of GDP is not much, but in relative terms it is a substantial gain given the little weight that trade with Central and East European countries currently has in total foreign trade of the European Union.



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The paper is very cautious in assessing the potential of sub-regional integration. It suggests that CEFTA could lead to more trade diversion, but this is not a strong argument. It is more likely that Central and Eastern European politicians are focusing on other areas and are sceptical of sub-regional integration.

It would be interesting to examine other integration attempts as well, such as the Central European Initiative which was one of the first. At a recent conference in Munich on economic cooperation in Southeastern Europe, high-ranking officials outlined their programmes. It was interesting to hear how these programmes are full of intentions but empty of reality or achievement. This is primarily due to political barriers. There are some positive developments, but not at the level of trade. My question therefore is: should integration only be seen as trade integration, or can we look at other areas such as the environment, infrastructure or the promotion of SMEs (small and medium-size enterprises)? In Northern Bohemia, the trilateral Polish, German and Bohemian integration attempt is working quite well and has the support of the European Union. One possibility in Central and Eastern Europe would be to extend sub-regional integration ideas from the state level down to other levels. For this to happen, regional administrative levels would first have to be established in Central and Eastern European countries to enable them to cooperate at a lower level across the borders.

Let me conclude with the finding that, for obvious reasons, sub-regional cooperation is still a very low-key issue in Central and Eastern European countries. Seen from outside, however, it seems that such cooperation could be intensified – also in collaboration with European Union countries – and this could be a helpful instrument for further European Union integration.



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# Floor Discussion of the Drábek Paper

## Gains and Losses

Miroslav Hrnčíř began by requesting Zdeněk Drábek to clarify the underlying assumptions of the models that try to assess gains and losses of EU enlargement.

"What type of gains are included in the model? Certainly, the expected gains for the EU countries are marginal and the expected gains for the applicant countries are much greater. But I think a time horizon should be added to the evaluation of the gains and losses for both groups of parties. I therefore would like you to identify more precisely what is included in these models."

Zdeněk Drábek responded that he viewed a lot of econometric calculations with a great degree of caution. "In this case, I used the Francois, Portes and Baldwin numbers because they happen to be the most comprehensive and they give the argument a somewhat quantifiable dimension. Still, the share of trade of the Central and Eastern European countries with the European Union is small, between 2.2 and 2.6 per cent, and it is obvious that the EU cannot gain very much. There will be differences among countries. Austria will probably benefit more than Spain or Portugal, and Germany will be affected differently than Great Britain. We don't need a general equilibrium model to reach this conclusion. These general equilibrium models clarify the trade restrictions and then input these into the model to arrive at a number, so one answer is that they attempt to determine what might happen if a tariff equivalent is changed. The model itself is dynamic and the intention is to capture not only the static gains, but the dynamic gains as well; this is the advantage of general equilibrium models. Hopefully, when the IGC is concluded, we will begin negotiating the accession, and instead of focusing on economic gains as a main argument, I would suggest dealing with other issues which are more important and more tangible as gains such as security, politics, environment, immigration and so on.

Since I am already talking about numbers, I would also like to respond to Roberto Lago's reference to the issue of the cost of enlargement. Our knowledge about estimated costs of agriculture supports, in particular, has improved greatly. The numbers that were produced for 1994 were apparently based on unrealistic assumptions. Today, most people would argue



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that the cost of enlargement will be between 12 and 20 billion ECU. Baldwin suggests 17 to 18 billion ECU. Anything above 20 billion ECU is highly unrealistic. The other important element in these estimates is that they are based on assumptions about what the European Union will do as well. It is now assumed that the EU will reform its current policy. The problems that Baldwin encountered in his estimates were the assumption about pricing policies in the European Union and our knowledge about yields and general productivity in agriculture in Central and Eastern Europe."

With regard to expected gains of EU enlargement, Frans van Loon stressed the importance of investments in the CEECs. "The lowering of the perception of risk that will follow accession would be one of the major economic effects, and the lowering of the barriers will result in a vast increase in foreign direct investment. We have seen it elsewhere in the world. The main change in composition of capital flows, whether in Latin America or Asia or the rest of the world, is in the foreign direct investment portion, and this is what drives big business in the banking and financial world. Looking at the way large investments are being made in the world now, I would suggest that two major basesexist. One is the drive into emerging markets, and the other is concentrations and the re-engineering of all those massive structures. If you put these two things together in the context of Central and Eastern European countries joining the European Union, it is possible that rather massive investments will take place within the new European Union, and this should be one of the main determinants in calculating the gains to the current member countries."

Stephany Griffith-Jones commented on the link between increased FDI flows and EU membership. "I think there is excessive optimism about how much FDI will be generated upon joining an important trade region like the EU. The extent to which increased FDI flows depend on individual country performance is underestimated. For example, when Spain and Portugal joined the EU, FDI indeed increased, but in the case of Greece increase was very small because the economy was not so well managed. For investment flows to increase, macro and micro policies must be in very good shape. We can also draw on the Mexican experience in joining NAFTA. When Mexico joined NAFTA, there was an incredible optimism among Mexican policymakers that some of the mistakes they were making in macro policy somehow didn't matter because they were going to be part of NAFTA. The peso crisis illustrated that the situation was quite the opposite. So good economic policies are needed to attract foreign investment.

On a related point, many seem to believe that certain things in macro policy must be done because they are preparing for the EU. For example,



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it is believed that inflation must be lowered quickly even if it results in costs in terms of exchange rate values. While lowering inflation is an important policy objective, I am not sure that it should be driven by these kinds of considerations. The policy objectives should evolve in terms of the internal coherence of the macro-policy stance instead of by objectives of preparing for accession to the EU – which remains uncertain in terms of dates."

Joan Pearce was concerned with the comparison of the EU to free trade areas. "The European Union represents a much higher degree of integration. If it were only a free trade area, this discussion and the pre-accession strategy would be something totally different. It is important to remember that there is a limit to how far you can draw comparisons. Second, the European Union and the European Commission are well aware of the importance of the applicant countries catching up with the rest of the European Union – accession will be a failure if they do not. Therefore, we must be sure that any arrangements made in terms of macroeconomic policy do not impede this catching-up process."

Inna Šteinbuka elaborated on Drábek's remark about assessing yields and productivity in agriculture in Central and Eastern Europe. "If the estimates of gains and losses are critically sensitive to assumptions about the rate of capital accumulation, have you estimated the share of investment goods in the imports to CEFTA countries? In the Baltic countries, the share of investment goods is quite small and the dynamic is not encouraging. Considering that the share of investment goods reflects investment inflow to some extent, what is the situation right now in CEFTA countries, and what do you expect to happen in the near, medium and long run?"

Zdeněk Drábek answered that the situation in Central and Eastern Europe was exactly the opposite of the Baltics, according to official figures. "The share of investment in imports in the Czech Republic has grown dramatically. Rather complacent policymakers cite this as a reason for not worrying about the rising current account deficit. They believe that the rise in the deficit is due to growing imports, and imports are growing because ofthe heavy investment-goods component of imports, which is something temporary and necessary for countries at this stage. This is the official position. But some doubt the figures on shares of investment which are provided by official authorities, so it remains controversial."

Albrecht Von der Heyden suggested that while the Central and Eastern European countries might gain considerably more with accession than the EU countries, this should not be the only or even the main factor. "We may be impressed by the development of trade and investment during the first period of the Europe Agreements, but it is also important to look at



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other challenges for both the European Union member states and the countries of Central and Eastern Europe. For example, Central and Eastern European structures need to be reformed in order to be competitive. On the other hand, there are also challenges facing the European Union, for example with regard to the problem of unemployment. If you look at these aspects in the short term, increased competition from Eastern Europe might be disadvantageous for West Europe, especially in the border regions. But I think that we should try to convince our people that the new challenges which pressure us to be more competitive will be to our benefit in the long run in terms of increasing our worldwide competitiveness. For the present EU members, it is a good opportunity to become more competitive in relation to the dynamically growing economies of Southeast Asia and other parts of the world. So I see a lot of advantages apart from the direct costs of financing."

András Inotai had some additional comments with regard to the issue of gains and losses. "First, there is an asymmetrical gain to Central and Eastern Europe in comparison with the European Union. But we should not start talking about who will gain more when accession occurs because substantial gains on both sides have been realised since 1989-1990 and these must be included in the analysis. Second, if you compare the different inter-regional and intra-regional trade flows, there are two dynamic flows that can be compared with the highest ranking Asian or trans-Pacific flows. One is between the European Union and the CEECs, and the second is in the intra-CEFTA trade. My third point is that during periods of high growth in Western Europe, the impact of trade with CEECs is relatively unimportant, but the situation is different if there is a recession. We have calculated that the 1993 recession would have been 0.2 per cent deeper in Germany if they had not had trade with Eastern Europe. Of course all these gains are differently distributed among different countries.

Furthermore, we have to be very careful when we consider the Central and Eastern European countries as a group because they are not a group. There are at least three major differences which may remain for the next few years. One is the level of development. The development gap as measured in per capita income between the Czech Republic, Slovenia or Hungary and some of the other countries in transition is at least as great as the gap between these countries and Austria. Second, there is a substantial differentiation process going on regarding dynamics. And third, there are major differences between CEFTA countries when we compare not only macroeconomic but also microeconomic developments – and microeconomics is a key issue of successful adjustment to the European Union. I will not deny the importance of macroeconomic figures, but macroeconomic figures may hide a number of microeconomic problems which soon-



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er or later have to come to the fore. In view of all this, my question is: To what extent can regional trade agreements really contribute to decreasing the growing differentiation among the Central and Eastern European countries? Are they able to do this or will theopposite happen?"

Per Magnus Wijkman stressed that Eastern enlargement is essentially a political issue and not an economic one. "Nevertheless, economic calculus does point to some important policy implications, and these have been well illustrated in the paper and by the discussion. The first implication is the unequal negotiating power between the applicant countries and the European Union. We should not be surprised at the imbalance in the benefits because these are primarily small countries. One obvious implication of this is not to put all of your eggs in one basket. CEFTA is not an alternative to EU membership, it is a complement to membership. If one is serious about EU membership, then free trade among the Central and Eastern European countries is something that should occur as well. The necessary institutional arrangements should not be viewed as a net burden since they can be an indication of credibility. I would quickly add, however, that this should be viewed as part of the negotiation process and there should be a quid pro quo in response to this unequal balance. The key is to acquire allies within the European Union – not necessarily countries, but other actors such as interest groups. Foreign direct investment in the East European servicing of the Western markets could be a very powerful instrument in breaking up the unbeatable coalition, as Baldwin has discussed, of taxpayers and consumers who are opposed to this kind of market opening, especially in the sensitive sectors. Foreign direct investment requires a rapid progress of transition and stable rules. A key priority is getting foreign direct investment. This would create an interest group which might favour rapid accession and thus increase Eastern Europe's position in negotiations.

Finally, this economic calculus which suggests small benefits from trade liberalisation and large budgetary costs for the EU is disconcerting because it could mean that there will be no eastern enlargement. The policy implication is that one has to reform the European Union from within. The EU has to do something for eastern enlargement to occur and that is reform, essentially of the agricultural policy but also of the structural funds. There are adjustments to be made on both sides and one should not take the European Union system as a given on the policy conclusions."

Joan Pearce warned against placing too much emphasis on economic costs and benefits. "Using 1995 data, the GDP of all 10 applicant countries amounted to 4 per cent of that of the European Union. All 10 of these countries together are roughly equivalent to the Netherlands, and there is a limit to how much you can expect of countries with a combined GDP of



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that size. We hope and expect that they will be growing significantly faster than the economists have foreseen so that this percentage will be somewhat higher by the time the accession takes place. But even if you think of a large growth differential, it is still not going to be substantial. This being said, I would plead against attaching too much importance to this question of costs and benefits. It is very exciting for econometricians, but what is its purpose in the political context of enlargement? If it is to persuade the constituencies in the European Union that they should favour enlargement, then frankly, I don't think it helps very much.

If we look back on the enlargement to include Spain and Portugal, I don't recall anybody trying to convince the then European Community of the economic benefits of enlarging to include Spain and Portugal. To the extent that costs and benefits were discussed, they were discussed in terms of sectoral interests such as fishing interests and citrus growers. My guess is that once we really get down to the nitty gritty of negotiating accession, this is the kind of debate that will matter politically, and not whether there willbe an overall contribution of 1 or 2 per cent of GDP to the European economy in aggregate. Per is absolutely right that we should focus on those types of interest that could be favourable toward enlargement."

She then added two comments on the issue of foreign direct investment. "One of the reasons that foreign direct investment has been disappointing in most countries of Central and Eastern Europe is precisely because of this hub-and-spoke arrangement of trade agreements. If you are an investor who wants to serve both the market of the European Union and of Eastern Europe, then you are better off locating in the European Union because by locating in one of the East European countries, you would gain privileged access to that country's market and the markets of the EU, but you would not gain privileged access to the countries of Central and Eastern Europe. To some extent, CEFTA offsets this problem, but the fact remains that all of the incentives for foreign investors in terms of market access are to locate in the European Union rather than in Central and Eastern Europe. The second thing I would say about foreign direct investment is: by all means make strenuous efforts to attract it, but not by some of the means that have been used in CEE countries in the past such as offering protective markets, because that simply will not work. Foreign investors know that once a Central or Eastern European country becomes a member of the EU, that protection will disappear."

Contingent protection was the topic of a further comment by Joan Pearce. "I would like to recall that the conclusions of the Essen Council in December 1994 did make an undertaking to begin dismantling some of the EU protection in line with the application of EU competition policy in the Central and Eastern European countries. The signs are that there has not


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been a great deal of progress in that direction, but while the institutions of competition policy have been established in those countries, the application of competition policy is not yet very effective. Bernard Hoekman at the World Bank is involved in some work at present which is looking in great detail at enterprise levels of the performance of competition policy in these countries. Interestingly, this tends to show that in most cases, these countries have used a liberal trade policy as a substitute for a firm competition policy."

## Open Regionalism and CEFTA

Barbara Stallings placed some of the comments in a broader perspective. "First, both in Asia and in Latin America, it is believed that sub-regional integration is very much a complement to a broader kind of integration. The phrase that is used both in Asia and Latin America is "open regionalism", which views regional integration as a step toward working within a broader international context. If you look at the dynamics of different parts of the world in the last decade, some of the most dynamic areas have emerged in the developing countries of Asia and Latin America, especially the southern trade region in Latin America, the Mercosur group. One of the ways that sub-regional and regional integration schemes have been seen as complementary has to do with the necessity of looking at microeconomic foundations. How was the competitiveness of these countries increased and how were they made more capable of exporting a higher value-added type of good? In the Latin American and Asian cases, this has been done through a staged approach. The first stage was to export to your neighbours who are somewhat less competitive, but this was only a step toward being able to export to a much larger market. For example, Chile viewed membership in Mercosur as absolutely vital in order to increase its ability to export industrial goods to the Mercosur countries, as well as to the United States and even to Asia and Europe.

I support this idea of including investment as part of the calculation and not just to rely on trade. When the calculations were made on the value of a hemispheric integration in the Western Hemisphere, the idea was that trade gains would be quite small, but that the big gains would come from investment – the inflows to Latin America as well as the benefits that US firms would realise from investing in Latin America. I assume that there would be some similarities in the European case."

Barbara Stallings concluded by presenting a particularly interesting viewpoint on sub-regional cooperation. "You should look at the growth triangles in the Asian case. One needn't talk about either European-wide integration or Central and Eastern European integration, but look at the



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smaller cooperation possibilities around some kinds of natural resources. In the Asian case, these have been the most dynamic. There may be some parts of Central and Eastern Europe working together with parts of Western Europe that might have special advantages."

Mark Allen added some specific comments about the creation and role of CEFTA. "The political reasons for the lack of support of integration arrangements among former Soviet countries are obvious. No one wanted to recreate another Comecon, but also since the major political objective was to get into Western systems, these countries feared that if they established their own institutions, the West would say, 'Well, you've got your own CEFTA arrangements and defence arrangements so you can just organise things there.' There was a conscious attempt to avoid setting up arrangements which might have been quite sensible from the economic point of view, and all effort was directed toward European Union accession.

I was struck by the sentence at the end of Zdeněk Drábek's paper which suggested that most findings indicated that CEFTA had a net trade diversionary effect. This is a rather surprising finding if it is true. Capitalist integration should take place on the elimination of obstacles to trade between countries. This is the open regionalism that Barbara Stallings was talking about. Clearly, it is a rather anomalous situation in this part of the world to have opened up toward the European Union while being faced with increased barriers among the individual countries in the area. There seems to be a strong case for extending tariff liberalisation in the region, particularly in the direction of the Ukraine, which could be one of the dynamic economies.

What sort of institutional arrangements would promote the reduction of barriers in this part of the world? On the one hand, you could agree on a bilateral basis to eliminate tariffs on mutual trade. But the tariffs are already relatively low in this part of the world, and the obstacles to trade are often in the non-tariff barrier area – not so much in quotas but in standards and customs procedures. If we look at the EU, the major impetus in the past 10 years has been the single market policy which is designed to go well beyond tariff or quota elimination between countries, and deal with all of the other smaller aspects that make trade between countries difficult. These problems loom fairly large in relationships between individual Central and East European countries. It might be worthwhile to establish an institution as a reference point on what actions are necessary for the settlement of disputes. Perhaps this can be done in conjunction with the EU arrangement for handling microeconomic trade disputes.

I think that the negative evaluation of CEFTA is overdone, and with the lack of political support for CEFTA, it is not surprising that more haven't



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taken advantage of CEFTA as a broader market area to capture. There are signs that investors are beginning to do this, andI suspect that non-European investors in particular are taking advantage of the CEFTA arrangements for their investment.

Finally, this is going to be a very dynamic region of the world. While politically, we can suggest that this dynamism can only be achieved inside the context of the EU, economically, it might be a different case. In Spain and Portugal, trade liberalisation, structural economic change and foreign investment were tremendously important. The Central and Eastern European countries have already undergone unilateral trade liberalisation and structural change. There are currently much more open international capital markets, and huge amounts of money are sloshing around looking for a home. Though membership in the EU might provide additional confidence that these changes are permanent, there are also options outside the Union. If macroeconomic policymaking is made more difficult by being members of the Union, it may not be a total disaster if they did not join – they may still become a very dynamic region of the world such as Southeast Asia has become."

## Reply by Zdeněk Drábek

"It is interesting that there has been a lot of discussion about CEFTA. My paper does not cover CEFTA as much I would have liked, but please remember that my paper reviews the literature, and to that extent it reflects very much the interest of researchers. In fact, it is astonishing how little analytical work on CEFTA and the integration of CEE countries I have found – and some of what I have found is already outdated. There is now a better understanding on the part of many politicians that there must be some form of cooperation among these countries. There are already attempts to take steps in this direction. Poland and the Czech Republic have agreed to cooperate in the acquisition of military technology. And there are tangible steps toward the resolution of border issues between the Czech Republic and Poland. Many of these initiatives are still marginal and frequently they have not been implemented. A number of Central and Eastern Europeans and West Europeans have been trying to get the CEE governments to talk about, for example, economic issues. When I was still working for the Czech government and Premier Klaus discovered this, he wrote to me and said, 'It is all fine as long you are doing it as a private initiative; but don't count on my support'. The reality is that it remains difficult to get some of these politicians to realise that there must be more cooperation. Politicians often want to do things on their own terms.

No one knows for certain whether trade within the sub-region is trade



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diverting. What often forms the basis of arguments for those writing about this topic is that there has been an impetus in these countries toward a positive discrimination in favour of sub-regional arrangements within CEFTA. This would mean discrimination against third countries and maybe even the EU. This is what they have in mind when they argue about trade diversion. But today we are, hopefully, witnessing a general lowering of trade barriers simultaneously with the evolution of a regional arrangement. In this sense, I would expect a great deal of trade creation even within the sub-region. Having said this, however, I think that there are strong arguments for maintaining the positive orientation toward the EU. These countries must remain in a competitive environment with industry exposed to competition as quickly as possible.

All of the comments on foreign direct investment are very good points. While I entirely agree that one of the major benefits of enlargement or closer integration should be theadditional incentive for FDI, I also agree with Stephany Griffith-Jones that enlargement is not a sufficient condition – other things must also be in place. In fact, the studies that have tried to envision the impact of enlargement make precisely this point. Baldwin, Francois and Portes estimate that gains arising from tariff concessions could lead to a contribution to the CEE of roughly 1 per cent annually to GDP. But they also say that if you assume the real benefit of enlargement to be capital accumulation, then the benefits will shoot up to 19 per cent of GDP.

With regard to gains to the European Union, we cannot alter the discussion of economists or politicians and thereby lessen their interest in the costs of enlargement and the minimal gains to the EU. While economic gains may not be large in the short run, once the institution works, the gains will be larger. Per Magnus Wijkman reminded me of a second, equally important argument. I have essentially assumed no fundamental change in the European Union. In fact, the existing EU system is already too costly for the members and the decision-making processes are too cumbersome. This will have to be changed, so the process of enlargement will probably be a process of double adjustment. Negotiations will have to take this into account."



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# The Global and Regional Outlook in Central Europe

*Miroslav Hrnčíř*[1]

## I Introduction

The process of regional integration in Central Europe[2] reveals two dimensions. On the one hand, integration efforts of Central European countries are just one example of integration processes in the contemporary world economy. As such, they are subject to the standard arguments of costs and benefits of regional versus global arrangements, and they can be discussed in terms of standard theories, starting with Viner's concepts of trade creation and trade diversion. On the other hand, there is a dimension specific to the region's conditions and developments which is characterised by an ongoing process of deep political, social and economic transformation in Central Europe. This underscores the suggestion that in the case of the former communist countries of Central and Eastern Europe, prospective EU membership is not just "another accession".

To reflect this dual dimension of regional and global issues in Central European integration efforts, the paper is structured as follows. In Sections Two and Three, the role of CEFTA is identified together with the macroeconomic situation of its member countries. Section Four presents the EU perspective and policies with regard to eastern enlargement of the EU.

## II The Central European Countries' Perspective

### *Hierarchy of the Central European Countries' Aims*

The emerging market economies of Central and Eastern Europe have

1 The views expressed in the paper are personal and should not be attributed to the Czech National Bank.

2 This paper is primarily concerned with CEFTA member countries, Czech Republic, Hungary, Poland, Slovakia and Slovenia, i.e. the CEFTA-5. Their developments are occasionally compared with the other countries which have signed the Europe Agreements, i.e. Estonia, Latvia and Lithuania, Bulgaria and Romania. For the ten countries together, we use the abbreviation CEEC-10.



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clearly demonstrated their interests in membership in global, regional and sub-regional institutions. At the time of writing:

- seven countries have been members of the WTO, with Bulgaria joining most recently in December 1996;
- nine countries have accepted the obligations of current account convertibility in accordance with Article VIII of the Articles of Agreement of the IMF;
- seventeen countries are members of the Council of Europe, nine are members of the Bank of International Settlements and three countries have already become members of the OECD.

At the same time, their trade and capital flows have become more intense compared to the start of transition. An increasing number of economies in transition have been able to raise funds on international financial markets and to obtain reasonable credit ratings from major rating agencies. These developments toward greater integration in the global economy and their institutional structures notwithstanding, the major objective for most Central European countries continues to be accession to the European Union. EU membership is seen as the most effective way to achieve economic development and guarantee social and political stability and security.

The Central European countries (CECs) have articulated a range of aims which could be achieved through accession to the EU, and these have an implied hierarchy. In our view, the ultimate goal of the CECs is not EU membership *per se*, even though these countries appear to be preoccupied with an early membership. Rather, the ultimate goal is to bridge the income gap, reach the developed market economies' level of institutional and social standards, and overcome the unfavourable heritage of previous – in particular post-war – developments and the resulting division of Europe. Authorities in the transition economies as well as domestic and external experts strongly believe that integration into the EU can lead to the attainment of these ultimate goals. It is also believed that, compared to other strategies, EU accession provides the best opportunity for achieving these goals in a smooth, rapid and inexpensive manner.

The pursuit of EU membership does not diminish the dominant role of the domestic environment and domestic growth factors in the countries' development. In the discussion on the most effective development paths, the East Asian case has often been highlighted (compare Sachs and Warner, 1996). Most of these countries, including Japan and more recently the "tigers", achieved high growth rates while maintaining tightly regulated trade and foreign exchange regimes. While the specific conditions which proved conducive to East Asian development are not present in Central Europe, arguments exist for the potential positive impact of



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Central European regional integration. In particular, in the pre-accession period the determination to become a member of the EU acts as an incentive for the endeavours of the potential candidate, and these endeavours are supported by the EU institutions. Moreover, after accession, the newcomers into the EU should enjoy the incentives and advantages of membership in an European-wide integrated area. If the conditions and timing of entry are properly established, the benefits of accession could definitely be expected to outweigh the implied costs of necessary adjustment. In this respect, the success which followed the EU entry of countries like Ireland, Portugal and Spain serve as an example.

On the whole, accession to the EU would be regarded as validating the attainment of the major goal of Central and East European economies: to go through transition and join the club of developed market economies of Europe.

It is this context in which the issues of Central European cooperation schemes and projects should be assessed. In our view the interest is, and should be, focused only on those arrangements, groupings and institutions which can be expected to facilitate easier and earlier EU membership and, as a result, provide better chances for achieving the ultimate goal of catching up. Thus the types and forms of sub-regional cooperation should not be viewed as an alternative to the EU enlargement process, but as a complement.

### *CEFTA: Its Role and Potential Impact*

The original CEFTA members are former Czechoslovakia, Hungary and Poland (CEFTA-3), the so-called Visegrad countries. After the separation of Czechoslovakia, it was transformed into CEFTA-4, and Slovenia became the fifth member state in January 1996 (CEFTA-5).[3]

Powerful incentives existed for the formation of CEFTA:

- CEFTA members are neighbouring countries with traditional economic and cultural linkages, transport cost advantages and shared interests in infrastructure projects, environmental protection and region-wide investments;
- without a CEFTA-type institution, intra-regional trade would become increasingly less favourable compared to the advancing liberalisation of bilateral trade of individual associated countries with the EU;
- there are common interests of associated countries with respect to the

3 A number of specialised studies has been devoted to the assessment of CEFTA's institutional framework and to its developments. For a survey see Zdeněk Drábek's contribution to this volume.



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EU, in particular the strengthening of the bargaining position for the negotiations on the terms of the EU eastern enlargement;
- the CECs' capability and readiness to work towards the integration of individual countries into the European institutions and close cooperation within the region has been demonstrated.

Since its formation, CEFTA has been relatively confined, in principle, to the trade sphere. The time horizon of the liberalisation process of intra-CEFTA trade was initially set at the year 2001, with differentiated procedures and coverage of individual product groups. Moreover, a number of clauses enabled retrogressive measures of individual member countries. These institutional features constrained the potential effects of CEFTA. Apart from institutional weaknesses, CEFTA's impact has been constrained by:

(i) *the small internal market:* The Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEFTA-5) comprise a market of only 67 million citizens, i.e. roughly one-sixth of the EU. Though its capacity and potential has been increasing, the gains from the small sub-regional free trade area have been relatively limited (see Table 1).

(ii) *the modest share of Intra-CEFTA trade:* As a share of total trade, intra-CEFTA trade has been rather low (see Annex Tables 1-5). The Czech and Slovak Republics were the only exceptions as a result of the close trade ties dating back to the former common state and, to some extent, also the customs union maintained since the separation of the federal republic, i.e. former domestic trade was reclassified as international. While the role of intra-CEFTA trade for Hungary, Poland and Slovenia amounted to only 4-8 per cent of their total trade, the figures for Slovakia exceeded 40 per cent in exports and 30 per cent in imports. In the case of the Czech Republic these were 20 per cent and 15 per cent respectively.

**Table 1 CEFTA Size of Member Economies in 1996 and Share of Intra-CEFTA Trade**

| | **Nominal GDP** (billions of dollars) | **Population** (millions) | **CEFTA trade as % of total** | |
|---|---|---|---|---|
| | | | **Exports** | **Imports** |
| Czech Republic | 52.1 | 10.3 | 22.9 | 14.6 |
| Hungary | 43.4 | 10.2 | 8.8 | 7.8 |
| Poland | 134.3 | 38.6 | 5.8* | 5.8* |
| Slovakia | 19.0 | 5.4 | 41.4 | 29.8 |
| Slovenia | 18.5 | 2.0 | 4.8 | 7.4 |
| Total CEFTA | 248.8 | 66.5 | 16.4 | 11.7 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin.



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The share of intra-CEFTA trade has gradually been increasing in all member countries – except for the trade between Czech and Slovak Republics which continue to decrease in relative terms. The overall picture is thus one of a small, but significant increase in the role of sub-regional trade. For example, the share of Hungary's exports to CEFTA members rose from 5.2 per cent in 1993 to 8.8 per cent in 1996 while the share of Poland's exports to CEFTA members rose from 3.6 per cent to 5.8 per cent over the same three-year period. Compared to other regional blocks, however, the share of intra-CEFTA trade is marginal, and this suggests a relatively minor impact of CEFTA on development and growth potential of its member countries.

### *Development Alternatives for CEFTA*

In the future, CEFTA could develop along three alternative lines. The first alternative concerns whether CEFTA should limit cooperation to a free trade area or expand into other spheres. This alternative relates to the decision on whether to build a more institutionalised arrangement or maintain a relatively loose and interim group. The lessons from the pre-transition situation provide strong arguments against the highly institutionalised integration of Central European countries. The experience from COMECON institutions proved counterproductive since, in reality, those institutions effectively separated member countries and their enterprises from world market criteria and behaviour patterns; there was no necessity to adjust and, consequently, no timely reaction was initiated, for example, to oil price shocks.

This explains the spontaneous and unanimous decision to dismantle COMECON in 1990, and the remaining distrust for the revival of any similar regional groupings in Central Europe in the initial stage of transition. The inertia of previous trade patterns implies low technical standards and the production and trade of inferior quality goods. Therefore, any such groupings are viewed as counterproductive to the interests of restructuring and re-entry to world markets. Moreover, any sub-regional initiative in Central Europe would have had the connotation of the "poor men's club" viewed with scepticism – especially when proposed by Western observers.

This line of reasoning also applies to the repeated proposal to introduce a parallel to the European Payments Union (van Brabant *et al.*, 1992). The experience of payments union in Western Europe was certainly positive; in the 1950s it contributed to the restoration of trade and to economic recovery. Moreover, it became a vehicle for the restoration of currency convertibility. However, conditions in Central Europe in the early 1990s were



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entirely different. Unlike post-war Western Europe where current account convertibility was restored only at the end of the 1950s, the economies in transition mostly opted for a move to currency convertibility at the very start of their transition. This was a noteworthy achievement which distinguishes Central European transition from post-war Western Europe, as well as other parts of the world economy, where the restoration of convertibility took much longer (Cooper, 1997).

The influence of the pre-transition experience has diminished in the course of time. The institutional framework in the CECs has undergone radical change and acquired the potential for sub-regional cooperation. In this context, various ideas have recently been suggested, for example, for policy coordination and joint institution-building (van Hagen, 1996).

Views on the desirability of closer sub-regional cooperation have diverged not only over the course of time but also across individual CEFTA member countries. While the Czech authorities have tended to confine CEFTA to the trade sphere, other CEFTA members have expressed their readiness to supplement free trade with other areas. In their view, a path parallel to the gradual deepening of EU integration since the early 1950s could be followed.

The second alternative for CEFTA development concerns whether it should be enlarged or should maintain its relative homogeneity and further deepen its cooperation. In September 1995, the representatives of CEFTA member countries met in Brno, the Czech Republic, and passed the resolution which provided for the enlargement of CEFTA and stipulated the conditions for the accession of other European states (Article 39a of the Agreement on CEFTA).

The recently enhanced role of CEFTA in the European integration perspective has resulted in increasing interest in CEFTA membership. Apart from the Baltic states – particularly Estonia – Romania and Bulgaria are prospective candidates. In a September 1996 meeting in Bratislava-Jasná in the Slovak Republic, representatives of CEFTA-member governments consented to begin negotiations with Romania. Romania has been a party to GATT since 1971 and a founding member of WTO. Romania has also concluded an Association Agreement with the EU thus meeting the preconditions for CEFTA membership. Romania will become the sixth member of CEFTA in July 1997. This newest member of the club will add another 22.7 million citizens (consumers) and $33.5 billion to aggregate GDP.

The third alternative for CEFTA development concerns trade liberalisation. To a great extent, the quantitative and tariff barriers in mutual trade will be removed in line with the gradual elimination of these barriers on EU and EFTA imports. This scenario implies the creation of parallel con-



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ditions in intra-regional trade to those in trade with Western Europe. While such an approach is more or less embedded in the present CEFTA Agreement, its implementation might not keep pace with EU trade liberalisation given the various provisions and exclusions involved.

*The Impact of CEFTA*

The gains from CEFTA formation can only be identified in a tentative way, and given the aforementioned constraints, they should not be unrealistically exaggerated. CEFTA was created to encourage the development of trade within the Central European sub-region by removing trade barriers between member countries. The share of intra-CEFTA trade on total trade of its members, though steadily increasing, remained relatively limited in the examined period (see Table 1 and Annex Tables 1-5). This does not imply, however, that it was unimportant.

The assessment of the gains from CEFTA trade must be discussed in the relevant historical context. Mutual trade of participating countries was artificially inflated under the COMECON regime via strictly planned targets, and this was at the expense of trade with other parts of the world economy. The dismantling of COMECON institutions presented the opportunity and – at the same time, the necessity – to re-orientate the majority of trade of former COMECON countries. On the whole, this re-orientation has been a remarkable success though differentiated across individual countries. In 1995, almost two-thirds of Central and East European exports went to Western market economies compared with 43 per cent in 1989. The most important and dramatic element of this shift has been trade with the EU. Compared to only about one-third of Central and East European exports in 1989, the EU accounted for more than 60 per cent in 1995.

It may be argued that some enhancement of mutual trade among the emerging market economies of Central and Eastern Europe should occur, and judging recent trends in intra-CEFTA trade, this has already been taking place. The available evidence suggests that the mutual trade potential of economies in transition was not utilised in the early 1990s. The main reasons were transition and necessary institutional changes. Once these changes were consolidated, the prospects for utilising regional trade potential became more favourable. In this respect, CEFTA's role seems to be of increasing importance.

The increasing share of intra-CEFTA trade, the trend toward CEFTA enlargement and the deepening of CEFTA markets has alleviated the constraints experienced in the past, particularly the market size constraint. It is likely that CEFTA economies will form an increasingly important export



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market in the medium term – not only for each other but for EU members and others as well. The expansion of intra-regional free trade should also help strengthen the CEFTA economies' medium-term growth prospects since both economic theory and empirical evidence suggest that openness to international trade is beneficial for growth. The factors behind the recent CEFTA revitalisation are, therefore, likely to play an important role in the development potential of the countries in the region over the next decade.

## III Macroeconomic and Institutional Developments in CEFTA Countries

In transition economies, macroeconomic, systemic and institutional conditions have been stage-specific. They have undergone profound change within a relatively short time span. The distinguishing features of each stage resulted from macroeconomic and institutional changes and the interaction of the two.

### *The First Transition Stage: the Challenge of Liberalisation and Macroeconomic Stabilisation*

During the early 1990s, disinflation and macroeconomic stabilisation had priority in all CEFTA member countries. During price, foreign trade and foreign exchange liberalisation, the governments were faced with previously "hidden" inflationary potential inherited from the past as well as inflationary pressures generated in the course of transition itself. The aim was to avoid surging price levels and vicious circles of wage and devaluation spirals from developing when price ratios went through profound adjustment. Accordingly, the restrictive stance of macroeconomic policies was necessary.

#### *The Case for Exchange Rate Based Stabilisation in the Early 1990s*

Following the stabilisation programmes applied elsewhere in the world in the 1970s and 1980s, particularly those sponsored by the IMF, some transition countries opted for a nominal anchor strategy for stabilisation. The role of the key nominal anchor, and therefore the key in stabilising price levels and the inflationary expectations of economic agents, was attributed to the stable nominal exchange rate pegged to the basket.

The exchange rate anchor is a transparent commitment – comprehensible and controllable by the public. Exchange rate based stabilisation was


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therefore expected to provide important advantages compared to other alternatives such as money based stabilisation. As the demand for money was almost unpredictable due to discontinuities and shocks inherent in the initial stage of transition, the assessment of the proper volume of monetary aggregates was subject to a high margin of error. Accordingly, these could not have been expected to be a reliable anchor option.

Nevertheless, as the experience of a number of emerging market economies has suggested, stabilisation could be accomplished with different nominal anchors. In fact, Begg has argued that controlling any relevant nominal variable may be effective as long as the changes in monetary values are multiples of those in real ones (Begg, 1996). This was the case in the initial stage of transition when changes in monetary and real magnitudes widely diverged. Once stabilisation was successfully accomplished, i.e. once changes in real variables were no longer so small in comparison to monetary ones, the proposition became irrelevant.

With the benefit of hindsight, it can be claimed that stabilisation policies in CEFTA member countries during the initial period of reforms were successful. Inflationary pressures eased after the initial price level surge, though with differentiated time spans and intensities across individual countries (see Table 2).

**Table 2 Consumer Price Inflation in CEFTA Countries**
(percentage change relative to preceding year)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 |
|---|---|---|---|---|---|---|---|
| Czech Republic | 9.9 | 56.7 | 11.1 | 20.8 | 10.0 | 9.1 | 8.8 |
| Hungary | 28.9 | 35.0 | 23.0 | 22.5 | 18.8 | 28.2 | 23.6 |
| Poland | 585.8 | 70.3 | 43.0 | 35.3 | 32.2 | 27.8 | 19.9 |
| Slovak Republic | 10.6 | 61.2 | 10.0 | 23.2 | 13.4 | 9.9 | 5.8 |
| Slovenia* | 549.7 | 117.7 | 201.3 | 32.3 | 19.8 | 12.6 | 9.7 |

* Retail prices.
*Source:* National statistics.

The other side of the coin was a deep and protracted contraction of economic activity in the first transition years. Table 3 presents the growth performance of CEFTA member countries which fared relatively better among economies in transition during 1990-96. The data reveal two entirely different phases. The first phase is characterised by a steep decline in economic activity while the second exhibits a revival of positive growth rates. Compared to expectations and predictions, the contraction of economic activity in the initial stage was deeper and more protracted. This



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was the case in all CEFTA countries regardless of the adopted transformation strategy and policies and in spite of differences in macroeconomic and institutional conditions at the outset.

**Table 3 GDP Growth Rates in CEFTA Countries**
(percentage change relative to preceding year)

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|---|---|---|
| Czech Republic | -1.1 | -14.2 | -6.4 | -0.9 | 2.6 | 4.8 | 4.4 |
| Hungary | -3.5 | -11.9 | -3.0 | -0.8 | 2.9 | 1.5 | 0.5 |
| Poland | -11.6 | - 7.0 | 2.6 | 3.8 | 5.2 | 7.0 | 6.0 |
| Slovak Republic | -2.5 | -14.5 | -6.5 | -3.7 | 4.9 | 7.4 | 6.9 |
| Slovenia | -4.7 | -8.1 | -5.4 | 1.3 | 5.3 | 4.0 | 2.5 |

* Preliminary figures.
*Source:* National statistics.

Recession was no less severe in the Czech and Slovak Republics despite the relatively favourable macroeconomic situation of former Czechoslovakia at the start of transition (see Table 3). And while Hungary did not embark on the stringent stabilisation programme of the Polish and Czechoslovakian type, it still experienced a parallel downturn in economic activity. The evidence tends to support the consensus on the specific, structural character of recession in transition economies in the early 1990s or, as phrased by Kornai, a "transformational" recession. Its structural nature was reflected in price level developments. In a cyclical type of behaviour, recession would be expected to result in price level stabilisation or in diminished inflation rates. Contrary to this, the decline in economic activity in transition economies was accompanied by a price level rise after the implemented liberalisation. On the other hand, the follow-up period of economic recovery and growth acceleration was accompanied by declining inflation levels, and not the other way around (compare Table 2).

### *The Follow-up Stage: From Transformational Recession to Sustainable Growth*

In macroeconomic terms, after the period of structural recession of 1990-1993, the performance of CEFTA member countries made remarkable progress to economic recovery and accelerated growth rates. To identify and assess this performance, we compare CEFTA member countries (CEFTA-5) with other associated countries, i.e. with those which concluded Europe Agreements with the EU (CEEC-10).


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*Growth Performance*

In 1995, the aggregate economic growth of CEEC-10 increased to 5.2 per cent, and most associated countries recorded higher growth than in the previous year. Particularly high growth rates – around 7 per cent – were recorded in Slovakia, Poland and Romania while Hungary, Latvia and Slovenia experienced a certain slowdown. In Slovenia, the appreciation of the domestic currency (the tolar) discouraged exports with an accompanying adverse impact on growth. In Hungary, restrictive policies of the stabilisation programme launched in 1995 were targeted to tackle the country's expanding current account and budget deficits. The resulting slowdown brought an improvement in the existing imbalances and this, in turn, formed the foundation for faster growth in coming years.

In addition to current account and trade balance constraints, the fragility of financial systems proved to be the other primary constraining factor in transition economies. The outbreak of banking crises in Latvia and Lithuania adversely affected their growth potential.

Compared to 1995, average GDP growth in CEEC-10 was expected to slow down to just below 5 per cent in 1996 and 1997. The primary cause for this slowdown in most CEEC-10 is the lower contribution of net exports to growth. Though economic recovery was initially sparked and supported by increasing exports, the current revival of growth in most of the associated countries is driven primarily by domestic demand. Given the continued relative slowdown in Western Europe, which has become the major export market for associated countries, domestic demand has evidently remained the primary contributor to growth in 1996. The same tendency is expected in 1997 as well.

The European Commission Services' forecasts of the growth rates for CEEC-10 are as follows:

A slowdown, albeit a marginal one, was envisaged for the group of associated countries in 1996 and 1997 compared to 1995 (see Table 4). The CEFTA countries were expected to remain in the lead, maintaining relatively robust rates of growth exceeding 5 per cent. At the same time, a tendency toward more balanced development dynamics within CEFTA seems to be emerging. Accelerated growth is envisaged in the case of Hungary, while the fast growers, Poland and Slovakia, were expected to slow down from their record 7 per cent growth rate in 1995.

*Inflation Record*

Inflation rates in CEFTA countries have also been reduced considerably, although substantial differences among individual countries remain


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**Table 4 Gross Domestic Product of CEEC-10 in 1994-1997***
(real percentage change)

| | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| Bulgaria | 1.4 | 2.7 | 2.1 | 1.7 |
| Czech Republic | 2.6 | 4.8 | 5.5 | 5.9 |
| Estonia | 3.2 | 4.5 | 4.0 | 3.8 |
| Hungary | 2.9 | 1.7 | 2.1 | 3.5 |
| Latvia | 1.9 | -1.6 | 1.2 | 2.2 |
| Lithuania | 1.0 | 2.5 | 1.0 | 2.5 |
| Poland | 5.2 | 7.0 | 6.0 | 5.5 |
| Romania | 3.9 | 6.9 | 4.5 | 5.2 |
| Slovakia | 4.9 | 7.4 | 5.5 | 4.6 |
| Slovenia | 5.3 | 4.2 | 4.4 | 4.6 |
| CEEC-10 | 4.0 | 5.2 | 4.7 | 4.9 |

* 1994-95 actual, 1996-97 predicted.
*Source:* European Economy, Supplement C, No. 1, May 1996.

(compare Table 2). The Czech Republic, Slovakia and Slovenia were the first transition economies to achieve single-digit inflation rates. Hungary, on the other hand, was the only country where inflation accelerated in 1995 as a consequence of a considerable depreciation of the domestic currency (forint) and of indirect tax increases.

Predictions are that most CEEC-10 countries would be able to reduce average yearly inflation to below 20 per cent in 1997 (see Table 5). This means that relatively high growth rates of economic activity in the region

**Table 5 Inflation in CEEC-10 in 1994-1997**
(real percentage change)

| | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|
| Bulgaria | 81.7 | 62.0 | 33.0 | 30.0 |
| Czech Republic | 10.7 | 9.1 | 8.5 | 7.4 |
| Estonia* | 33.6 | 28.9 | 20.0 | 18.0 |
| Hungary | 19.6 | 26.4 | 23.0 | 18.0 |
| Latvia* | 28.1 | 26.0 | 18.5 | 14.0 |
| Lithuania* | 44.6 | 37.0 | 28.0 | 19.0 |
| Poland | 32.2 | 28.0 | 21.0 | 17.0 |
| Romania | 129.7 | 33.1 | 24.0 | 20.0 |
| Slovakia | 13.6 | 9.7 | 6.5 | 6.0 |
| Slovenia | 18.5 | 12.6 | 8.7 | 7.0 |
| CEEC-10* | 38.9 | 23.7 | 17.7 | 14.3 |

* GDP deflator.
*Source:* European Economy, Supplement C, No. 1, May 1996.


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notwithstanding, inflation was expected to be further suppressed. However, the rate of its envisaged reduction was modest compared to previous advances. This proved to be a more widespread phenomenon of the current stage, i.e. maintaining the rate of disinflation became more demanding and less feasible. The existing levels of inflation, however differentiated across individual countries, seemed to be built into the expectations of economic agents. In relative terms, CEFTA countries continued to fare better; Slovakia, Slovenia and the Czech Republic not only expected to maintain their one-digit inflation rate, but to improve it. Nevertheless, even in the case of the Czech Republic, progress was not entirely satisfactory and a substantial distance to the EU standard remained.

*Trade Performance and Balance of Payments Constraints*

Though differentiated across individual countries and time periods, a tendency toward trade and current account deficits has been a general feature of CEFTA members. In the case of Hungary, the surging current account deficit together with a budget deficit peaked in 1993 and 1994 when it reached around 9 per cent of GDP for two consecutive years (see Table 6). A stabilisation programme with tough austerity measures had to be introduced in 1995 to cope with the twin deficits. Though a crisis was avoided, the price for balancing external and public sector's accounts was quite high in terms of depressed growth rates, significant cuts in real wages, currency depreciation and increased inflation (Kornai, 1997).

A similar situation developed in the Czech Republic in 1995 and in the Slovak Republic in 1996. In the Czech Republic, trade deficits were covered through service balance surpluses up to 1994, but since 1995 current accounts have turned increasingly red. In 1995, the current account deficit amounted to about 3 per cent of GDP while in 1996 it soared to 8.6 per cent. If policy corrections are not made, the trade gap is likely to widen further in 1997 making current account developments and the entire macroeconomic situation extraordinarily vulnerable.

The weak point in Czech developments was the lagging domestic supply side response linked to the slow pace of restructuring and improvements in corporate governance together with deficient legal norms. In these conditions, dynamic domestic demand fed by soaring private consumption and domestic investment was transmitted into an increasing current account deficit (see Table 6).

As can be inferred from data in Table 7, this trend was a common phenomenon in transition economies. Trade balance developments primarily reflected trends in domestic demand. In 1994, low domestic demand combined with enhanced export performance secured a significant improve-



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**Table 6 Foreign Trade (Goods and Services) and Current Account Balance of CEFTA Countries**

| | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| **A. (percentage of GDP in market prices)** | | | | | | |
| **Exports** | | | | | | |
| Czech Republic | 52.4 | 57.5 | 56.6 | 56.7 | 52.5 | 49.5 |
| Slovakia | 26.5 | 46.3 | 70.3 | 61.6 | 65.2 | 62.7 |
| Poland | 25.0 | 23.5 | 23.7 | 22.9 | 24.0 | 24.9 |
| Hungary | 31.1 | 32.8 | 31.4 | 26.4 | 28.9 | 34.9 |
| Slovenia | 90.8 | 83.5 | 63.1 | 58.5 | 59.0 | 58.7 |
| **Imports** | | | | | | |
| Czech Republic | 51.1 | 50.7 | 56.2 | 54.5 | 52.9 | 54.5 |
| Slovakia | 35.5 | 49.3 | 74.3 | 67.1 | 59.7 | 59.4 |
| Poland | 17.8 | 25.4 | 22.2 | 22.0 | 23.0 | 24.8 |
| Hungary | 28.5 | 33.7 | 31.7 | 34.6 | 35.4 | 37.0 |
| Slovenia | 78.5 | 74.3 | 56.2 | 57.9 | 56.7 | 60.2 |
| **Trade Balance** | | | | | | |
| Czech Republic | 1.3 | 6.8 | 0.4 | 2.2 | -0.4 | -5.0 |
| Slovakia | -9.0 | -3.0 | -3.9 | -5.5 | 5.5 | 3.3 |
| Poland | 7.1 | -1.9 | 1.5 | 1.0 | 1.0 | 0.2 |
| Hungary | 2.6 | -1.0 | -0.3 | -8.2 | -6.5 | -2.2 |
| Slovenia | 12.2 | 9.3 | 7.0 | 0.6 | 2.2 | -1.5 |
| **B. (annual percentage changes)** | | | | | | |
| **Exports** | | | | | | |
| Czech Republic | -7.0 | -9.8 | 6.8 | 7.5 | 0.2 | 8.0 |
| Slovakia | – | 33.4 | 47.4 | -0.2 | 14.1 | 3.2 |
| Poland | – | 12.7 | 10.8 | 3.2 | 13.1 | 18.4 |
| Hungary | -5.3 | -3.1 | 2.1 | -10.1 | 13.7 | 13.4 |
| Slovenia | – | – | – | -0.9 | 10.8 | 6.0 |
| **Imports** | | | | | | |
| Czech Republic | 3.2 | -21.7 | 22.0 | 10.4 | 7.8 | 19.2 |
| Slovakia | – | -14.7 | 47.1 | -0.8 | -3.5 | 6.7 |
| Poland | – | 56.2 | 1.7 | 13.2 | 11.3 | 22.8 |
| Hungary | -4.3 | 5.4 | 0.2 | 20.2 | 8.8 | -0.7 |
| Slovenia | – | – | – | 17.3 | 10.5 | 13.0 |
| **Current Account Balance** | | | | | | |
| Czech Republic | -1.8 | 7.0 | -0.3 | 0.4 | -0.1 | -2.9 |
| Slovakia | -5.0 | -6.8 | 0.2 | -4.4 | 4.8 | 1.0 |
| Poland | 13.9 | -0.9 | -0.3 | -2.7 | -1.0 | -0.1 |
| Hungary | 1.1 | 1.2 | -0.6 | -8.9 | -9.4 | -3.2 |
| Slovenia | – | – | – | 0.0 | 3.7 | 0.7 |

*Source:* V. Nachtigal, "Czech Economy in the First Half of 1990s", Institute of Economics, Czech National Bank, 1996.



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ment in trade balances in most CEEC-10 countries. However, the trend reversed again in 1995. The recovery of domestic demand revitalised imports and worsened trade balances in CEEC-10 countries. As the data in Table 7 indicate, a further deterioration was envisaged for 1996 and 1997.

**Table 7 Trade Balance of CEEC-10 in 1993-1997**
(in percentage of GDP)

| | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|---|---|---|---|---|
| Bulgaria | -8.2 | -0.2 | 3.3 | 3.6 | 4.4 |
| Czech Republic | -1.0 | -2.5 | -8.7 | -10.4 | -11.0 |
| Estonia | -5.4 | -15.5 | -20.4 | -17.8 | -13.0 |
| Hungary | -8.4 | -8.8 | -5.8 | -4.5 | -3.9 |
| Latvia | -7.3 | -11.1 | -11.9 | -11.1 | -10.3 |
| Lithuania | -10.9 | -7.9 | -5.5 | -5.5 | -6.3 |
| Poland | -2.7 | -0.9 | -1.6 | -2.0 | -2.7 |
| Romania | -6.2 | -3.2 | -6.2 | -4.2 | -3.6 |
| Slovakia | -7.4 | 0.6 | 0.3 | -1.3 | -2.6 |
| Slovenia | -1.1 | -1.3 | -4.5 | -4.6 | -5.5 |
| CEEC-10 | -4.3 | -3.0 | -4.1 | -4.2 | -4.6 |

*Source:* European Economy, Supplement C, No. 1, May 1996.

The export performance of associated countries has become a key development challenge. If not corrected, trade and current account deficits will be a major point of vulnerability of their economies, effectively constraining their growth potential and their process of catching up to the EU standard.

### *Institutional Developments*

In addition to macroeconomic changes, the transition economies have also undergone profound institutional change in a relatively short time span. To identify and assess these changes, we have used the concept of financial openness as an organising criterion. Accordingly, we distinguish rudimentary and advanced stages of financial openness, though no clear-cut dividing line can be drawn, and in reality, some features of each stage overlap.



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*1. The Stage of Rudimentary Financial Openness*

In this stage, which occurs in the first transition years:

- only an "internal" form of currency convertibility was introduced in CEFTA countries. It was initially confined to the free access to foreign exchange for import purposes and was gradually extended to other types of agents and current account items. Nevertheless, according to international standards, domestic currencies remained non-convertible;
- external liberalisation, however radical compared to previous rigid regulations, was limited to current account items. Capital flows continued to be strictly regulated;
- domestic financial markets and financial intermediation were only in their infancy stage. Their underdevelopment and persistent rigidities were reflected in the limited range of marketed products, low responsiveness of economic agents to monetary and credit policies and in scarce correlation between money market and clients interest rates.

A review of these features in light of more current conditions, reveals the depth and speed of institutional and systemic changes which were taking place.

*2. The Stage of Advanced Financial Openness*

In this stage:

- the move from internal to external currency convertibility on current accounts was implemented in compliance with Article VIII of the Articles of Agreements of the IMF. As a result, the CEFTA countries' currencies entered the "club" of convertible currencies;
- liberalisation was extended to some major forms of capital flows, i.e. beyond the provisions of Article VIII of the IMF. This substantial advance on the liberalisation front paved the way for the Czech Republic, Hungary and Poland to become members of the OECD.

### *The Exchange Rate Regime*

A wide range of exchange rate arrangements – from currency board systems to floating options, more or less managed – were adopted by the emerging market economies of Central and Eastern Europe. This regime differentiation evolved even though the initial characteristics of these countries were highly similar.

Poland and former Czechoslovakia represent those emerging market economies of Central and Eastern Europe which opted for a fixed exchange regime at the start of transition. This choice was particularly



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appropriate given the key role of a fixed exchange rate in the IMF-type stabilisation programmes adopted by these countries.

In the case of former Czechoslovakia, the policy of nominal exchange rate stability was initiated in 1990. It was aimed at anchoring the stabilisation process after sweeping price and foreign exchange liberalisation in the beginning of January 1991. However, no binding commitment was publicly made to keep the introduced fixed exchange rate regime and the given exchange rate level unchanged, neither indefinitely nor for any pre-announced period. Nevertheless, the regime pegging the domestic currency to the basket was maintained in the Czech Republic until the end of February 1996, i.e. for 62 consecutive months despite the separation of former Czechoslovakia and its common currency, the Czechoslovak koruna. Such long-run exchange rate stability has indeed been exceptional in a transition economy – especially when compared to some OECD member countries. At the end of February 1996, keeping central parity untouched, the exchange rate fluctuation band of the Czech koruna was widened to ±7.5 per cent.

Unlike former Czechoslovakia, most emerging market economies of Central and Eastern Europe, including Slovenia, Bulgaria, Russia and almost all other CIS countries, adopted a managed float, i.e. a flexible type of exchange rate regime from the beginning of transition. Slovenia and Bulgaria opted for managed floating primarily because of the lack of foreign exchange reserves. In their "starting" conditions, the fixed exchange rate regime appeared unsustainable.

Sooner or later, others found it necessary to depart from the initial fixed exchange rate. These were, among others, Poland and Hungary. Poland started its transition in 1990 with a fixed rate pre-committed to a specified period. That regime was replaced by an adjustable peg system in May 1991 and by a crawling peg in October 1991. Later, the band was widened to 7 per cent (May 1995). Thus Poland joined some other emerging market economies, including Israel, Colombia, Chile and Mexico, in introducing a crawling band system.

The Hungarian authorities traditionally pursued a policy of small, irregular, discrete re-alignments (devaluations) with respect to the basket. The objectives of the policies, however, changed in the course of time. Over several periods, the devaluations just corrected for the inflation differential, i.e. a real exchange rate was held stable in principle; in others, some real exchange rate appreciation was allowed to occur. Within the framework of the initiated stabilisation programme, starting from March 1995, the previous policies of occasional minor adjustments were replaced by a pre-announced crawling.

Instead of this more flexible arrangement, a currency board system was



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introduced by Estonia (1992) and Lithuania (1994). This regime imposed a fixed exchange ratio on the "pilot" currencies (German marks and US dollars respectively) and implied sacrificing the central bank's authority to devise and calibrate monetary policies. These newly independent Baltic countries, which are very small, open economies, lacked the institutions and experience in monetary management. Inflation was reaching hundreds of per cent in Estonia and more than a thousand per cent in Lithuania in the early 1990s. The currency board was thus viewed as a good way to radically reduce inflation.

After a period of a floating rate, Russia introduced a "trading corridor" for the rouble in mid-1995. This was replaced by a version of a formal crawling band in July 1996. With a margin of about ± 6 per cent, the rouble exchange rate was targeted to depreciate at 1 to 1.2 per cent per month with respect to the US dollar.

These examples suggest that country-specific priorities and constraints proved to be key factors in exchange rate regime choice at the start of transition and in follow-up changes as well. As could be expected, most transition economies adopted exchange rate arrangements somewhere between irrevocably fixed and freely floating rates. To satisfy competing requirements of stability and competitiveness, exchange rate policies were typically compromise solutions, such as an adjustable peg, a crawling peg and various forms of managed floating. Polar regimes seemed inappropriate for transition economies except, possibly, for the short run. In this respect, the evident viability of the currency board experiments of Estonia and Lithuania provided an interesting counter experience.

### *The Openness of CEFTA Countries*

Except for Poland which can be classified as a medium-size economy, CEFTA countries are small economies. Accordingly, the share of trade and service flows on their GDPs has been rather high. In the transition years 1990-1995, the highest share of both exports and imports on GDP was reached by Slovenia and Slovakia, the two smallest CEFTA countries (see Table 6).[4] In 1995 their export and import flows of goods and services amounted to about 60 per cent of their GDP. The Czech Republic's ratio was only slightly less, but with a widening gap between export and import ratios. The degree of openness of the three mentioned CEFTA countries exceeding 50 per cent was rather high, surpassing that of countries like

4 The figures for Slovakia and Slovenia in 1990-1992, as shown in Table 7, are evidently biased due to the fact that both countries were then part of a wider federation. The available data calculated ex post are therefore less reliable.



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Austria, Sweden, Portugal and Greece in which the ratios fluctuated between 25 and 40 per cent (compare Nachtigal, 1996). On the other hand, the trade/GDP ratios of Hungary and Poland matched in broad terms those of comparable West European countries.

We can infer from the trade/GDP ratios that CEFTA member countries became very open economies.[5] This characteristic suggests that the dynamics of their economic activities must have been highly sensitive to their export performance and competitiveness.

## *Competitiveness and its Determinants*

Though the various concepts of country competitiveness and their assessment are subject to discussion and critique (compare Krugman, 1994), the very issue of price and non-price competitiveness and their causal factors are of crucial importance for the prospects of any open economy, including CEFTA countries.

In Table 8, the position of three Central European countries, Czech Republic, Hungary and Poland is assessed compared to four EU countries with relatively inferior competitive records among EU members.[6]

**Table 8 Comparative Competitiveness Record**

| Countries | Factors of competitiveness, positions in 1996 | | | | | | | | Country position | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Domestic economy | Internationalisation | Government | Finance | Infrastructure | Management | Science & technology | People | 1995 | 1996 |
| Czech Republic | 34 | 34 | 34 | 33 | 35 | 39 | 43 | 28 | 38 | 34 |
| Hungary | 43 | 30 | 40 | 43 | 24 | 38 | 36 | 33 | 40 | 39 |
| Poland | 40 | 42 | 43 | 44 | 45 | 37 | 37 | 30 | 44 | 43 |
| Spain | 33 | 25 | 35 | 25 | 23 | 33 | 30 | 26 | 27 | 28 |
| Italy | 28 | 21 | 45 | 27 | 29 | 26 | 24 | 25 | 28 | 29 |
| Portugal | 42 | 32 | 32 | 29 | 39 | 41 | 35 | 32 | 31 | 36 |
| Greece | 39 | 35 | 42 | 39 | 41 | 43 | 39 | 29 | 39 | 40 |

*Source:* The World Competitiveness Yearbook, IMD, 1996.

5 This conclusion must be qualified for a lower level of GDP compared to the West European average. It explains why per capita export performance in CEFTA countries continued to be only a fraction of the volume reached in comparable EU countries.

6 Data are taken from the World Competitiveness Report which provides a multi-dimensional assessment of competitiveness based on the evaluation of 8 groups of factors (as applied in Table 8) covering 378 criteria. Two-thirds are "hard" statistical data, and one-third is "soft" data of a qualitative nature based on surveys. In the covered sample of 45 countries in 1995 and 46 countries in 1996, three CEFTA countries were included.



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While the Czech Republic, Hungary and Poland are not among the global forerunners, their positions can be compared to Spain, Italy, Portugal and Greece. There were, however, some remarkable differences across individual CEFTA countries. The Czech Republic's least favourable assessment is in science and technology (43), while in Hungary finance (43) is unfavourable and science and technology is considered relatively more advanced (36). In the Polish case the most unfavourable assessments were given to government (43), finance (44) and infrastructure (45). On the other hand, the human factor "people" of the CEFTA countries is, as could be expected, evaluated more favourably – in principle, at the same level as in the compared group of EU members.

### *Capital Flows and CEFTA Countries*

Prior to the start of transition in CEFTA countries in 1990, capital flows were strictly controlled and their macroeconomic importance was rather limited. Transition brought a reversal: both the volume and forms of capital flows expanded and diversified within a few years. Since the early 1990s, capital inflows into CEFTA countries became a major factor of economic development but, at the same time, a major policy issue as well.

The progressing transformation and external opening of former centrally planned economies offered new investment possibilities. On the one hand, incentives to invest were related to successful stabilisation, the restoration of currency convertibility, and the advancing privatisation and liberalisation of external flows and the domestic economy. On the other, capital inflows were also stimulated by a rather constrained domestic supply of financing, particularly of long-term credits, and by a much wider interest rate differential compared to developed market economies. Thus capital inflows resulted both from the success of stabilisation as well as from the implied imbalances and constraints inherent to the transition.

Despite the evolving wave of capital inflows into CEFTA member countries in the mid-1990s, from the real economy point of view, the volume of capital inflows appeared lower than desired and lower compared to the volumes flowing to emerging market economies in other parts of the world economy.

## IV The European Union Perspective

Two projects will keep the EU on the move in the years to come: the formation of the European monetary union with the introduction of a single currency, and the EU eastern enlargement.



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With regard to the latter, observers in transition economies as well as outside point to some ambiguity in the EU approach. While policy steps have been taken toward early accession and there are signals from the EU of their wholehearted support of the transition process, until recently there was a lack of any binding commitments from the EU to the accession of former centrally planned economies of Central and Eastern Europe. Critics have repeatedly pointed to the reluctance of the EU authorities to stipulate concrete conditions and a working timetable for the accession. As a result, any discussion of eastern enlargement must include factors behind the EU stance.

### *EU Policies Regarding Central and Eastern Europe*

EU policies on association and prospective membership of the emerging market economies of Central and Eastern Europe have been subject to thorough assessments (see de Largentaye, 1993; Nuti, 1996; Drábek, 1997). The Europe Agreements acknowledged the associates' desire to eventually join the EU. However, they provided no explicit assistance to the associated countries to support their development toward market economies and political democracies. It was only in June 1993 in Copenhagen that the European Council decided "that the associated countries in Central and Eastern Europe that so desire shall become members of the Union", and general conditions for their membership were explicitly formulated. Accordingly, associated countries were to be regarded as potential members providing they had established:

- a political democracy and stable institutions;
- a legal regime securing human rights and the rights of minorities;
- a functioning market economy;
- the capacity to sustain competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership, including political and economic goals of the Union.

In principle, the conditions stipulated for membership required the acceptance and implementation of the EU's *acquis communautaire.*

In June of 1993, there was also explicit reference to the pre-conditions on the side of the Union, for the first time. The key issues were related to the capacity and the readiness of the Union to absorb new members.

The European Council summit in Essen in December 1994 offered the Central and East European countries a "structured dialogue". At the same time it confirmed that "the Union's capacity to absorb new members, while maintaining the momentum of European integration and respecting its internal cohesion and fundamental principles, is also an important con-

sideration". Later on the European Commission, focusing on legal dimensions of the preparations for membership in the single market presented the associated countries with a set of tasks in the "White Paper on the Eastern Enlargement".

The European Council summit in Cannes of June 1995 invited the associated states to participate in the discussion for the first time. And the European Council summit in Madrid in December 1995 discussed the cost of enlargement in terms of the Common Agricultural Policy (CAP) and reaffirmed its commitment to enlargement as "both a political necessity and a historic opportunity for Europe".

### *The EU Stance Towards Eastern Enlargement*

With regard to political and security aspects, early enlargement has been supported by all the EU member countries. Like the eastern countries themselves, the EU also has a major interest in the security and political stability of Central and Eastern Europe. Indeed, this has perhaps been the principal consideration. Moreover, the EU member countries have felt a commitment to provide assistance to that part of the continent which suffered most from the post-war division of Europe.

Unlike political and security dimensions, the economic issues of the eastern enlargement are less straightforward, if not controversial. It is this dimension in particular which has been the source of apparent ambiguity in the EU position and policies. In avoiding (premature) clear-cut commitment for eastern enlargement, the EU policy has developed in a step-wise manner with obvious reluctance to binding decisions and commitments.

This approach has been supported by certain rational arguments. First, it was quite obvious that not only benefits but also costs would be involved, for newcomers and for incumbents as well. While both groups of countries were interested in reaping the benefits of an extended free trade area and capital mobility and of new trade and investment opportunities, the expected economic gains from eastern enlargement did not loom particularly large for the existing EU members.[7] Moreover, these gains were most likely only in the medium and long term, while the costs of adjustment and budgetary expenditures related to the EU funding were a matter of immediate concern.

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7 It was argued that economic gains from eastern enlargement are likely to be rather small due to the limited size of their markets while trade and investment flows have been increasing anyway. The counter arguments pointed to the dynamic perspective compared to the static gains, to the increasing depth of eastern markets in the course of time and to the resulting enhancement of the productive potential and of competitiveness of the whole region.



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Nevertheless, the conditions related to the eastern enlargement are specific and, accordingly, the experience from the past accessions is hardly relevant. In the case of the emerging market economies of Central and Eastern Europe, the EU is dealing with a group of countries in which the institutional frameworks have developed in an entirely different manner from the *acquis communautaire* for decades.

**Table 9 GDP per Capita in 1993: CEFTA and EU Countries**

| **A) multilateral comparison*, PPP base** | | | | |
|---|---|---|---|---|
| Austria = 100 | | | | |
| EU-15 | | | 89.6 | |
| | of which: | Spain | | 68.5 |
| | | Portugal | | 61.4 |
| | | Greece | | 55.7 |
| CEFTA-5 | | | 29.7 | |
| | | Slovenia | | 48.2 |
| | | Czech Republic | | 44.1 |
| | | Hungary | | 31.2 |
| | | Slovak Republic | | 30.2 |
| | | Poland | | 24.4 |
| **B) bilateral comparison**, current exchange rates** | | | | |
| Austria = 100 | | | | |
| | | Slovenia | | 27.9 |
| | | Czech Republic | | 13.3 |
| | | Hungary | | 16.4 |
| | | Slovak Republic | | 9.1 |
| | | Poland | | 9.8 |

* Based on European Comparison Programme (ECP).
** Bilateral comparisons with Austria.
*Source:* Bulletin, Czech Statistical Office, 12/1995.

As follows from Table 9, the income level gap between the EU average and the (relatively advanced) group of CEFTA-5 countries was much wider than for any of the previous newcomers. This is the case in spite of reservations about the potentially biased calculations due to the sweeping price ratio adjustments under way. In PPP terms, which are more favourable compared to current exchange rates, the per capita income level for CEFTA-5 in 1993 was 29.7 per cent of the Austrian level, while the EU (15) average was 89.6 per cent of that level. On the other hand, the position of the most advanced CEFTA countries, Slovenia and the Czech Republic, with 48.2 per cent and 44.1 per cent respectively, was not greatly inferior to those of Portugal (61.4 per cent) and Greece (55.7 per cent).



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A number of factors, specific to economies in transition, have made the feasibility of eastern enlargement a rather complicated issue for the EU authorities. The very assessment of its likely costs and benefits is only very tentative and hypothetical given the entirely different institutional framework of Central and East European countries. Sweeping changes are under way but they currently lack a track record comparable to member countries. This uncertainty in assessing costs and benefits is linked to the uncertainty in appraising whether and when the countries in transition would be advanced enough to comply to the rules and regulations governing the Single European Market and its competition standards.

The importance of this type of uncertainty for understanding the potential course of eastern enlargement has been highlighted by van Hagen (van Hagen, 1996) who argued that there could hardly be any track record for CECs concerning their commitment to EU membership, their capability to comply with the requirements of the Single Market or the irreversibility of their market-oriented policies. As a result, the argument of the optional value of waiting has been suggested. This implies that the postponement of the Central and East European accession is warranted, when adjustment reaches a more mature stage.

The costs and benefits of eastern enlargement would not be equally distributed, in fact, the opposite is true. Distributional asymmetries are likely to be common among existing members, between existing members and new members, and across different sectors and over time. Germany, as a neighbour of the potential candidates, would certainly be more affected and reap more benefits both in security and economic terms than the Mediterranean countries for example.

An asymmetry would also exist in EU budgetary costs. Entry into the EU of ten potential candidates (with a Europe Agreement) would imply a substantial expansion of the Union's budget. Though we do not attempt any quantitative assessments (see e.g. Bárta and Richter, 1996), both the current beneficiaries of the regional policies (via structural and cohesion funds) and the Common Agricultural Policy as well as the net contributors would be affected. The distributional issue is likely to be highly sensitive. Given the pressure throughout the Union to reduce budgetary deficits to meet the Maastricht criteria and the difficulties experienced in cutting welfare expenditures, any additional significant burden on net contributors is hardly viable – especially in the current race for qualifying for the single currency. The drive toward fiscal consolidation to meet the EMU criteria and the requirements of the stability pact applies to the beneficiaries as well, namely to Ireland, Spain and Portugal. The potential cuts in their fund inflows, or even the shift in their position from net recipients to net contributors, would carry the risk of their – at least implicit – veto to accession.



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This points to the importance of the adjustment process both on the side of the associated countries as well as within the EU. Though the costs and benefits will remain a multi-dimensional issue distributed asymmetrically with different weights for incumbents and potential newcomers, their interests could be made more compatible.

### *EU Features Which Are Unfavourable to Eastern Enlargement*

Some specific features of the EU could interfere with the goals of eastern enlargement. These include its current institutional arrangement, the type of governance and specific policies such as CAP and regional policies.

Compared to Europe's main competitors, especially the United States and NAFTA and the East Asian countries including Japan, the "tigers" and China, the EU development potential and competitive position are constrained by a overly generous West European welfare model, relatively slower technological advance and labour market rigidities resulting in a structurally (not only cyclically) high level of unemployment.

The consequences of those features for associated countries have been indirect, but not negligible. The fear of cheap labour competition from the emerging market economies of Central and Eastern Europe evidently contributed to the introduction of restrictive arrangements in sensitive product groups and in agricultural products which were the main items CECs could supply, particularly at the start of transition (Rollo and Smith, 1992; Hrnčíř, 1994). Though the asymmetry in the timetable of trade liberalisation in favour of associated countries was adopted, contingent protection provisions in case and/or threat of serious injury to a domestic industry together with anti-dumping protection in fact counterbalanced the potential advantages of asymmetrical phasing-out of tariffs for associated countries. Moreover, contingent provisions remain in place even after trade liberalisation is completed.

Unlike the timetable for the liberalisation of capital movements, the Union and the Europe Agreements did not provide access to workers from the associated countries beyond what was guaranteed bilaterally by its member states. The tensions and rigidities in EU labour markets were evident causal factors despite the public declaration of the commitment to the four freedoms of movement (goods, services, labour and capital).

Though the welfare heritage of economies in transition proved to be a considerable burden itself (i.e. the recent experience of Hungary and the resulting austerity programme of 1995; see Kornai, 1997), the imitation of the West European welfare model would hold possibly disastrous consequences for associated countries. The maintenance of such a generous model has proved to be increasingly demanding for the EU members



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themselves in spite of their relative wealth.

Another group of obstacles to enlargement is related to the EU internal arrangements, particularly the type of decision-making processes and the governance in the Union. The EU's rules were originally drawn up for six rather than fifteen members, and adherence to the rules with ten additional members would result in a cumbersome and barely feasible decision-making process. It seems to be widely accepted that in any case, and even more with the perspective of eastern enlargement, new rules need to be agreed upon. These include the introduction of qualified majority voting in some areas of decision-making, the enhancement of institutional efficiency and the formulation and implementation of common policy positions with regard to budgetary matters.

Given the existing income gap between the associated countries and the EU, the costs of EU policies, namely of the CAP and regional policies, is too high to be borne by the member countries. This conclusion becomes even more clear given current endeavours of the EU member countries to meet the Maastricht fiscal criteria for EMU.

Eastern enlargement appears to be too burdensome without remedying present EU internal issues of governance and decision-making and without reforms in implementing and funding CAP and regional policies. These issues are among the most important for the Inter-Governmental Conference (IGC) which opened in Turin in March 1996 and is scheduled to complete its work in June 1997. The position of the European Commission before the start of IGC was quite clear, "there can be no question of trying to accommodate further enlargements with the present arrangements" (European Commission, 1995).

In our view, these challenges should be identified and interpreted in a broader perspective of EU integration. The EU has gone through a number of stages since its establishment in the 1950s. It has widened and deepened, and current ambitions are evolution into a monetary union and a single currency scheduled for the beginning of 1999. In addition to economic and monetary spheres, there are also suggestions for further cooperation in policy formation in areas such as foreign policy, security and defence, the legal system and judiciary, and social policy. However, substantial disagreement with regard to the entire process of the integration deepening exists, reflecting the two competing concepts of European development: a federal Europe versus a Europe of sovereign states.

The IGC is charged with the task of agreeing on how to proceed with deepening the integration among the existing EU members. At the same time, the agreed institutional changes and reforms should allow for the eastern enlargement. At the special meeting of the European Commission in Dublin in October 1996, the Irish Prime Minister, then President of the



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Council, declared "we will be ensuring that the changes we make in the IGC are adequate to provide a basis for an enlarged European Union".

Indeed, the EU deepening versus enlargement has been a persistent problem since the very beginning. The EU's reluctance to make any binding commitments with regard to the accession of the associated countries, its time horizon and concrete conditions must be seen primarily in terms of the controversial requirements of integration deepening versus enlargement. Given the large number and diverse range of potential CEEC members and their lower level of development, EU authorities and member countries are concerned that early accession would inhibit the process of deepening economic and political integration. As stated by European Commission President Santer, "without institutional reforms there can be no enlargement or if there were the Union would be paralysed." (Presidency Press Conference in Dublin, October 5, 1996).

### *Accession of the Associated Countries to the EU*

Despite considerable advances since the start of transition, the associated countries of Central Europe are currently facing the reality of substantial differences with regard to their EU counterparts.

The existing gap is a multi-dimensional issue which may be structured into:

(1) *the income gap* identified especially as a difference in GDP per capita;

(2) *the institution gap* reflected in existing imperfections in the legal environment, lower efficiency in law enforcement, lagging standards of financial and labour markets' institutions and functions, and in safety, health and environmental protection;

(3) *the macroeconomic gap* which can be illustrated in comparison to the Maastricht convergence criteria. Though this gap differs widely across individual associated countries, and some appear to meet the fiscal criteria (budget deficit and debt) better than a number of current EU members, all of them remain far from inflation targets and long-term interest rate targets;

(4) *the performance gap* reflected in much lower levels of labour and integral productivity and the deficient quality and technical standards of goods and services compared to West European levels;

(5) *the credibility gap* which results from the fact that potential newcomers undergo a sweeping transformation in political, social and economic fields. As a result they necessarily lack a longer track record of sustained commitment to political democracy and market institutions comparable to most EU members.

While the extent of these gaps inevitably determines the prospects and



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time horizon of the possible accession, we share the view that the capacity of each country to adjust, pursue and carry out such policies which effectively react to the existing constraints and narrow the implied gaps is even more important (compare Pearce, 1995). The diverging experiences of countries such as Ireland and Portugal on the one hand and Greece on the other are quite instructive in this respect.

Entry negotiations should not only be concerned with the time horizon of accession but also with the strategy of making as easy and inexpensive as possible. It would be unrealistic to expect any significant compromise from the EU with regard to compliance to the *acquis communautaire*. At the same time, the EU authorities and most of the existing member countries are evidently unwilling to contemplate eastern enlargement without internal EU reforms. The prospects of potential newcomers are therefore critically dependent on the progress of the present IGC.

It is obvious that the main burden of adjustment and narrowing the gap with EU standards falls on the associated countries. These costs will have to be borne individually by each candidate. A too rapid introduction and enforcement of EU regulations may be rather costly since it might erode certain advantages that the associated countries have on the markets due to their less stringent regulations. These regulations should be enforced, but at a pace commensurate with each country's capacity to adjust. This should warn against the temptation of a hasty and premature accession. Further economic restructuring and progress in factor markets, institutions and efficiency are evidently necessary before the economies in transition become less vulnerable and able to withstand the EU competition. This suggests the importance of a balanced trade-off between speed and costs of the adjustment.

A well targeted pre-accession strategy shared by both candidates and incumbents would enhance the credibility of the future accession and, consequently, enable the economies in transition to reap some benefits of wider markets and investment opportunities before the entry itself is accomplished. In this respect, reliable access to EU markets is of utmost importance. At the present stage, when the shift to the dominance of private property and market oriented pricing has been accomplished in most of associated countries, the contingent protection clauses and rigorous anti-dumping procedures have become a factor of unnecessary uncertainty. This would be a good area for the EU to demonstrate, without significant cost and damage, a more broad-minded approach in meeting the needs of the associated countries.


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# Annex Tables

**Annex Table 1 Czech Republic – Territorial Composition of Foreign Trade**
(percentages)

| | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|
| **Imports from main partners** | | | | |
| Germany | 25.4 | 25.5 | 25.8 | 30.3 |
| Slovakia | 17.4 | 14.2 | 13.1 | 9.8 |
| Russia | 9.8 | 8.4 | 8.9 | 7.3 |
| Austria | 7.8 | 8.1 | 6.9 | 5.9 |
| Italy | 4.7 | 5.1 | 5.8 | 5.9 |
| others | 34.9 | 38.7 | 39.5 | 40.8 |
| **Imports from CEFTA countries** | | | | |
| Hungary | | 6.3 | 5.6 | 10.7 |
| Poland | | 15.6 | 17.6 | 19.3 |
| Slovenia | | – | – | 3.7 |
| Slovakia | | 78.1 | 76.8 | 66.3 |
| Share of CEFTA on total imports | | 19.0 | 16.0 | 14.7 |
| **Exports to main partners** | | | | |
| Germany | 26.0 | 29.4 | 31.8 | 36.6 |
| Slovakia | 21.5 | 16.4 | 16.2 | 13.9 |
| Austria | 6.0 | 7.1 | 6.5 | 5.9 |
| Italy | 5.0 | 4.4 | 4.0 | 3.3 |
| Poland | – | – | 5.4 | 5.4 |
| Russia | 4.5 | 3.9 | – | – |
| others | 37.0 | 38.8 | 36.1 | 33.9 |
| **Exports to CEFTA countries** | | | | |
| Hungary | | 6.3 | 5.6 | 7.0 |
| Poland | | 15.6 | 17.6 | 23.9 |
| Slovenia | | – | – | 4.9 |
| Slovakia | | 78.1 | 76.8 | 63.3 |
| Share of CEFTA on total exports | | 23.0 | 21.0 | 22.6 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin 1996.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

**Annex Table 2 Hungary – Territorial Composition of Foreign Trade**
(percentages)

| | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|
| **Imports from main partners** | | | | |
| Germany | 21.6 | 23.4 | 23.4 | 23.4 |
| USSR | 22.2 | – | – | – |
| Russia | – | 12.0 | 11.8 | 12.4 |
| Austria | 11.6 | 12.0 | 10.7 | 9.6 |
| Italy | 6.0 | 7.0 | 7.9 | 8.1 |
| United States | 3.9 | – | – | – |
| United Kingdom | – | 4.0 | – | – |
| France | – | – | 3.9 | 4.2 |
| others | 34.7 | 41.6 | 42.3 | 42.3 |
| **Imports from CEFTA countries** | | | | |
| Czech Republic | | 38.8 | 37.1 | 39.3 |
| Poland | | 21.6 | 25.3 | 23.8 |
| Slovenia | | – | – | 7.2 |
| Slovakia | | 39.7 | 37.5 | 29.7 |
| Share of CEFTA on total imports | | 6.2 | 6.4 | 7.7 |
| **Exports to main partners** | | | | |
| Germany | 26.6 | 28.2 | 28.6 | 29.4 |
| USSR | 15.3 | – | – | – |
| Austria | 10.1 | 10.9 | 10.1 | 10.5 |
| Italy | 8.0 | 8.5 | 8.5 | 8.2 |
| Russia | – | 7.5 | 6.4 | 5.8 |
| United States | 4.2 | – | – | – |
| United Kingdom | – | 4.3 | – | – |
| France | – | – | 4.0 | 3.8 |
| others | 35.8 | 40.6 | 42.4 | 42.3 |
| **Exports to CEFTA countries** | | | | |
| Czech Republic | | 35.1 | 27.4 | 24.3 |
| Poland | | 39.4 | 44.5 | 33.4 |
| Slovenia | | – | – | 21.3 |
| Slovakia | | 25.5 | 28.1 | 21.0 |
| Share of CEFTA on total exports | | 5.3 | 5.9 | 7.7 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin 1996.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

**Annex Table 3 Poland – Territorial Composition of Foreign Trade**
(percentages)

| | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|
| **Imports from main partners** | | | | |
| Germany | 28.0 | 27.4 | 26.6 | 24.5 |
| Italy | 7.8 | 8.4 | 5.8 | 5.9 |
| Slovakia | – | – | 13.1 | 9.8 |
| Russia | 6.8 | 6.8 | 8.9 | 7.3 |
| United Kingdom | 5.8 | 5.3 | – | – |
| Austria | – | – | 6.9 | 5.9 |
| United States | 5.1 | – | – | – |
| Netherlands | – | 4.6 | – | – |
| others | 46.5 | 47.5 | 39.5 | 40.8 |
| **Imports from CEFTA countries** | | | | |
| Czech Republic | | 54.6 | 56.6 | 54.9 |
| Hungary | | 24.0 | 21.7 | 18.2 |
| Slovenia | | – | – | 7.1 |
| Slovakia | | 21.4 | 21.7 | 19.8 |
| Share of CEFTA on total imports | | 4.3 | 5.1 | 5.7 |
| **Exportsto main partners** | | | | |
| Germany | 36.3 | 35.7 | 38.3 | 34.8 |
| Netherlands | 5.9 | 5.9 | 5.6 | 5.0 |
| Italy | 5.2 | 4.9 | 4.9 | 6.1 |
| Russia | 4.6 | 5.4 | 5.6 | 6.9 |
| United Kingdom | 4.3 | 4.6 | 4.0 | – |
| France | – | – | – | 4.4 |
| others | 43.7 | 43.5 | 41.6 | 42.8 |
| **Exports to CEFTA countries** | | | | |
| Czech Republic | | 55.4 | 56.1 | 56.6 |
| Hungary | | 22.3 | 21.3 | 21.2 |
| Slovenia | | – | – | 3.1 |
| Slovakia | | 22.3 | 22.8 | 19.1 |
| Share of CEFTA on total exports | | 4.8 | 5.2 | 6.0 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin 1996.

**Annex Table 4 Slovak Republic – Territorial Composition of Foreign Trade**
(percentages)

| | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|
| **Imports from main partners** | | | | |
| Imports from main partners | | | | |
| Czech Republic | 35.9 | 29.6 | 27.5 | 25.6 |
| Russia | 19.5 | 18.0 | 17.0 | 18.0 |
| Germany | 11.4 | 13.4 | 14.4 | 14.5 |
| Austria | 6.2 | 5.8 | 5.1 | 4.6 |
| Italy | 3.0 | 4.4 | 4.7 | 5.7 |
| others | 24.0 | 28.8 | 31.3 | 46.1 |
| **Imports from CEFTA countries** | | | | |
| Czech Republic | 91.4 | 87.1 | 83.2 | 83.2 |
| Hungary | 3.4 | 4.9 | 6.7 | 6.2 |
| Poland | 5.0 | 7.0 | 8.4 | 7.9 |
| Slovenia | – | – | – | 1.7 |
| Share of CEFTA on total imports | 39.3 | 34.0 | 33.1 | 30.7 |
| **Exports to main partners** | | | | |
| Czech Republic | 42.4 | 37.4 | 35.2 | 31.5 |
| Germany | 15.2 | 17.1 | 18.8 | 20.8 |
| Austria | 5.0 | 5.3 | 5.0 | 6.1 |
| Italy | – | 4.3 | 4.8 | 4.9 |
| Russia | 4.7 | 4.1 | 3.8 | – |
| Hungary | 4.5 | – | – | – |
| Poland | – | – | – | 4.7 |
| others | 37.0 | 38.8 | 32.4 | 32.0 |
| **Exports to CEFTA countries** | | | | |
| Czech Republic | 85.0 | 81.8 | 79.6 | 75.5 |
| Hungary | 9.1 | 12.0 | 10.3 | 10.6 |
| Poland | 5.9 | 6.2 | 10.0 | 11.3 |
| Slovenia | – | – | – | 2.4 |
| Share of CEFTA on total exports | 49.9 | 45.7 | 44.3 | 41.7 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin 1996.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe
FONDAD, The Hague, 1997, www.fondad.org*

**Annex Table 5 Slovenia – Territorial Composition of Foreign Trade**
(percentages)

| | 1993 | 1994 | 1995 | 1996* |
|---|---|---|---|---|
| **Imports from main partners** | | | | |
| Germany | 25.0 | 23.7 | 23.2 | 22.1 |
| Italy | 16.2 | 17.2 | 17.0 | 16.7 |
| Croatia | 9.1 | 6.8 | 6.1 | 6.2 |
| Austria | 8.5 | 10.3 | 9.7 | 9.1 |
| France | 8.0 | 8.4 | 8.4 | 9.7 |
| others | 33.2 | 33.6 | 35.6 | 36.2 |
| **Imports from CEFTA countries** | | | | |
| Czech Republic | 36.7 | 39.4 | 39.0 | 39.6 |
| Hungary | 49.8 | 42.7 | 42.1 | 37.3 |
| Poland | 4.2 | 5.0 | 5.9 | 7.9 |
| Slovakia | 9.3 | 12.9 | 13.0 | 15.2 |
| Share of CEFTA on total imports | 5.1 | 6.2 | 6.7 | 6.4 |
| **Exports to main partners** | | | | |
| Germany | 29.5 | 30.3 | 30.2 | 29.1 |
| Italy | 12.4 | 13.5 | 14.6 | 13.1 |
| Croatia | 12.1 | 10.8 | 10.5 | 10.9 |
| France | 8.7 | 8.6 | 8.2 | 7.7 |
| Austria | 5.0 | 5.5 | 6.4 | 6.6 |
| others | 32.3 | 31.3 | 30.1 | 32.6 |
| **Exports to CEFTA countries** | | | | |
| Czech Republic | 21.4 | 26.8 | 32.7 | 32.5 |
| Hungary | 33.6 | 32.1 | 28.5 | 23.2 |
| Poland | 33.5 | 31.3 | 26.0 | 31.5 |
| Slovakia | 11.5 | 9.8 | 12.8 | 12.8 |
| Share of CEFTA on total exports | 4.3 | 4.5 | 4.8 | 5.5 |

* I-III quarters.
*Source:* CESTAT, Statistical Bulletin 1996.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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# Comment on "The Global and Regional Outlook in Central Europe," by Miroslav Hrnčíř

*Mark Allen*

Miroslav Hrnčíř's paper provides a good overview of some of the issues facing the CEECs in the process of deepening European integration. The main focus is on relations with the European Union, particularly the accession negotiations, with the CEFTA playing a useful supporting role. This seems quite correct, and in fact, there was relatively little in the paper with which I disagreed. I should like to develop some of the arguments of the paper a bit further, using the more speculative license given to a commentator, and flag a few points where I am at variance with Miroslav Hrnčíř.

Miroslav Hrnčíř's comments about the hierarchy of Central and East European Countries' goals were particularly interesting. He remarks that for these countries, the goal is not European Union membership *per se*, but catching up with all the things that they have missed since 1939. In a way, membership of the European Union is seen in the Central and Eastern European countries as just another part of the process of rejoining developed country structures. In a recent paper on "How Far is Eastern Europe from Brussels?", Fischer, Sahay and Végh estimate that the two-generation communist experiment cost the Central and Eastern European countries about a generation's worth of growth. It is natural for these countries to view European Union membership as part and parcel of the things that they have been missing for so long and as part of the process of cementing themselves into Western institutions.

But we may be in for considerable disappointment on both sides, as Miroslav Hrnčíř hints. It is not clear that the public or the politicians of the applicant countries have fully grasped the degree of accommodation that they will be required to make as members of the European Union. Parliaments that have only just recovered real power will find that their scope for independent action is considerably circumscribed by the weight of the *acquis communautaire*, and that the degree of harmonisation and consultation extends deeply into many aspects of political and administrative life. Of course, it can be argued that the surrender of sovereignty is only apparent, and that full membership allows the realisation of possibilities that non-membership would not. But this is quite a sophisticated



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argument, and one that requires a lot of hard political experience to accept.

If on the other hand, membership is sold on the grounds that regional and Common Agricultural Policy transfers will be positive, there may also be disappointment. As Miroslav Hrnčíř and András Inotai note, current regional policies and CAP will need to be considerably modified before the new applicants come in, since the present members are unlikely to be willing to finance the transfers involved in maintaining current arrangements. If membership is sold to the population as a way of accessing European Union funds, there could be a considerable backlash if it appears that the rules are being modified just as the negotiations are getting underway. Thus, it would seem essential to do some further thinking on the motivations for membership within the applicant countries, to ensure that there is a constituency for taking part in the construction of Europe, or for reaping the advantages of pooled sovereignty.

Miroslav Hrnčíř draws attention to the cost of enlargement for the existing members of European Union, but he does not pay as much attention to the difficulties ofmicroeconomic adjustment as they deserve. It will be difficult to convince existing members that single market rules are being applied fairly in the applicant countries. These rules cover a range of matters from consumer protection, financial supervision, phytosanitary controls, border controls and tax enforcement to competition policy. In existing member countries, lobby groups, fearful of increased competition from the East, are likely to emerge using the excuse that standards are not being properly enforced. While ultimately, as in the cases of Greece, Spain and Portugal, the political imperative of admitting the countries may rapidly prevail, it will not be without domestic political fights in some of the existing members. None of this should be interpreted that I am at all hostile to the accession of Central and Eastern European countries to the EU, but I don't think we serve the cause by pretending that it is going to be easy.

The other topic I would like to address is how macroeconomic policy will be affected by the regional processes we see underway. A number of the Central and Eastern European Countries can already be characterised as dynamic emerging market economies, and the others should be able to join this group too, if they stick to the right sort of stabilisation and structural reform policies. What are the features that characterise these economies? The first is their enormous growth potential. They have a well-qualified and motivated labour force which can be hired at a fraction of the cost of that in Western Europe. They have good access to nearby West European markets for their output, and constitute obvious investment locations for Western firms seeking to tap both the regional and the European Union market. They can also hope to benefit from a revival in



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their traditional markets to the East. These economies are thus likely to grow very fast, and undergo very considerable structural change.

The main structural changes that should accompany this process are rising productivity, increasing real wages and massive inward investment flows. While these developments are welcome, they also pose a number of challenges to macroeconomic management. As real wages rise, there should be a continual process of reallocating labour between sectors. Certain sectors which are profitable at current exchange and wage rates are likely to become unprofitable over time, requiring the closure of existing firms. If the economy is managed well, new employment opportunities should be created at the same time, meaning that the released labour can be absorbed – but this rapid structural change can create a number of problems. First, there is the level of unemployment, which is likely to have a higher frictional component than in other countries. Second, the expected high rate of failure among companies can create severe problems for domestic banking systems if they do not have strong enough financial basis. Third, it maybe difficult to accommodate the structural change in the economy without a certain amount of inflation.

Another aspect of the outlook for these countries comes from the large inflows of external capital that are already occurring. From the experience of a number of countries, we have already seen how large-scale capital inflows, while bringing major benefits, can complicate the process of macroeconomic management. Capital inflows make it difficult to judge the stance of balance of payments policies. They put pressure on the exchange rate for an appreciation as the improved capital account leads to a worsened current account balance. It can be very hard to tell if the worsening of the current account is appropriate (for example because of increased imports of investment goods) or if it reflects an excessive worsening of the country's competitiveness. As the experience of other countries has shown, international capital flows can be extremely sensitive to domestic macroeconomic conditions and to confidence effects, thus requiring governments to bevery careful in their macroeconomic policymaking for fear of the reversal of flows. They put the domestic financial system in the line of fire, making it a matter of the highest priority that governments ensure that their domestic banking systems are sound.

A third characteristic is the tightness of the fiscal position of these countries. The collapse of the traditional tax system, the reduced reliance on trade taxes, and the difficulty of spreading the tax net widely have meant that it has required great effort to keep fiscal revenues strong. At the same time, the need to finance relatively generous social security systems, and the various costs of enterprise restructuring – such as recapitalisation of banking systems, unemployment compensation, etc – have left these coun-



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tries with high levels of expenditures. In an effort to keep budget deficits under control, the level of taxation and related contributions for those actually paying have become very high. The correct policy response to the high inflows of capital include a tightening of the fiscal stance to encourage a reduction in interests rates, to ensure that the capital can be productively invested, and to reduce the likelihood of a reversal of flows.

These various aspects of policy – fiscal policy, real exchange rate appreciation, structural change and capital inflows – will all acquire a new dimension with the accession to the European Union. The countries will be entering the Union at the time that Phase III of the European Monetary Union is underway with the Exchange Rate Mechanism 2 in place. This will impose certain demands and constraints on macroeconomic management in the acceding countries. They will be required to make their central banks independent and subscribe to price stability as the overriding goal of monetary policy; they will be obliged to seek a balanced budget as a central feature of fiscal policy; they will be obliged to draw up convergence plans. It is unclear at this point whether the acceding countries will be obliged to enter ERM2 as part of the *acquis communautaire*, or whether they will be permitted to derogate from it. The Council resolution does talk of membership remaining voluntary, though countries are expected to join as soon as they can. But this may apply only to existing European Union members.

The fiscal objectives in the EMU area seem to be appropriate for the acceding countries. I have already mentioned the pressing need of these countries to keep the fiscal situation under control. Price stability may be more difficult to achieve, given the structural shifts occurring in these countries. Even more problematic may be undertaking exchange rate obligations. First, the secular trend should be for a real exchange rate appreciation, and this is better done through a gradually appreciating rate rather than through higher inflation. If the rate is expected to appreciate, other European Union members guided by concerns of their own competitiveness may press for the appreciation to take place sooner rather than later. However, this runs up against the problem of judging the stance of policy, given the rapid structural shifts and the skittishness of the capital inflows. There is a real danger of countries' getting stuck temporarily with too appreciated exchange rates and running into balance of payments crises. While there is an obligation (presumably on both sides) under ERM2 to defend the limits of the band with unlimited intervention, in practice, we can expect to see parities abandoned. In sum, I see these countries as having a need to retain flexibility on exchange rate policy until structural convergence has gone much further. I am encouraged by Joan Pearce's remarks that the EC would give highest priority to the need of these coun-



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tries to achieve convergence in terms of real growth, and whatever system was finally decided, the existing members would not encourage the Central and Eastern Countries to follow an exchange rate policy that would undermine these goals.



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# Comment on "The Global and Regional Outlook in Central Europe," by Miroslav Hrnčíř

*Roberto Rocha*

I agree that the ultimate goal is not membership of the European Union *per se*, but catching up with the European Union's per capita income and standard of living. I also agree that the effort to comply with the formal accession requirements could, in general, help achieve this ultimate objective. I will further concentrate my comments on two points.

In general, the paper fails to identify or elaborate the main components of a pre-accession strategy for trade – or for other areas such as macroeconomic or structural policy. In trade, for example, we can envisage two scenarios for Central Europe. In the first scenario, liberalisation simply follows the Europe Agreements, and the Central European Free Trade Agreement (CEFTA) is rather insignificant. In the second scenario, rapid CEFTA liberalisation would play a significant role. This question of optimal trade policy during the pre-accession period has not been answered. Indeed, given the small volumes of trade within CEFTA countries, one may question the practical or empirical relevance of this trade issue. Nevertheless, it remains important. For instance, should the Central and Eastern European countries immediately adopt a common external tariff? The World Bank has been advising Poland to do so since its tariffs are slightly above the common external tariff of the European Union. And they have advised Slovakia not to do so because Slovakia's tariffs are slightly below the EU's common external tariff. Thus, the answer to the question obviously depends on initial conditions.

An interesting question in the macroeconomic area is: What set of macroeconomic policies should these countries follow during the pre-accession period? Before answering this question, we must note two things. First, we cannot say how long this period will be, some say 2002 and some say 2005, so let us simply say the first half of the next decade. And second, while output has been recovering and the inflation rate has been declining, this has occurred at a very uneven pace in the various countries, and some have even developed problematic current account deficits – in the order of 10 per cent of GDP in some cases. So, what is the optimal macroeconomic policy during the pre-accession period? First, we must determine what pol-



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icies can bring inflation rates closer to West European levels and whether these policies would result in unreasonable recession. Second, we need to ascertain the set of macroeconomic policies which is consistent with a high-growth strategy. Ms. Pearce has suggested that these countries would be viewed much more favourably and their accession to the EU would be facilitated if they became high-growth performers by the year 2002 or 2005. So any set of macroeconomic policies which would achieve both objectives of lowering inflation and placing these countries on a high-growth path would be desirable.

With regard to an optimal macroeconomic policy during the pre-accession period, the paper would benefit from identifying and elaborating the success stories. What set of policies was used for the three success stories in this region, the Czech Republic, Slovakia and Slovenia? I think there are common elements in these three cases. In all three cases, the exchange rate was used intensively as an anchor. Also in these three cases, fiscalpolicy was much more restrictive than the policy of neighbouring countries in the region. In addition, wage policy was used in some cases as an additional anchor – not an active wage policy, but wages were not allowed to spiral out of control. So an identification of the common ingredients in the three success stories would be highly beneficial.

What set of macroeconomic policies is consistent with a high-growth strategy? We know from recent growth literature that we should be optimistic about the long-run prospects of this region. The region already exhibits many of the conditions identified as necessary for high growth. They have a highly-educated labour force and proximity to markets, they are open to trade and they have relatively low inflation. While this provides reason for optimism, two basic indicators are still lacking. First, investment ratios are low. The Czech Republic and Slovakia have been able to maintain rather high investment of GDP ratios, about 30 per cent. In 1996, Slovakia's ratio even increased to an astonishing 34 per cent, which is similar to Southeast Asian figures. The Czech Republic and Slovakia are the only two countries in the region that did not experience a complete collapse of investment in the late 1980s and early 1990s. Most countries' investment ratios collapsed to below 20 per cent during the dismantling of central planning, and so far they have not been able to raise them again. The second problem facing these countries is the inherited tax system with extremely high marginal tax rates.

To summarise, we believe that growth prospects of these countries are good, and that achieving the formal pre-accession requirements would coincide with a high-growth strategy which increases economic efficiency. An effort to comply with the formal pre-accession requirements would, in general, help these countries achieve the objective of catching up with



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Western Europe. According to our regressions and based on current policy, we anticipate convergence with Western European averages by 2030-2050. Finally, in addition to macroeconomic policy, we need to examine other areas, such as social policy and labour policy, in more detail. The pre-accession requirements are vague in these areas. While this offers substantial freedom for these countries to adopt the systems they want, it can also be hazardous. Countries in this region should avoid committing the same mistakes that have led to the excessive taxation and labour market rigidity that are plaguing Western European countries today.



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# Floor Discussion of the Hrnčíř Paper

## The Reliability of Official Figures and Catching Up with the EU

A spirited discussion of the reliability of official figures followed from a comment by Zdeněk Drábek on the investment rates in the Czech Republic and Slovakia. "I think that we should be a little bit sceptical about the numbers, because if Slovakia's investment rate is 34 per cent and their GDP growth rate is 45 per cent, then some of us or our international finance institutions should wake up and realise that there is something wrong."

Ricardo Lago agreed and cited the current US example. "In December, there was an article in the *Financial Times* reviewing US economic statistics. These statistics indicate that over the last two decades, the US consumer price index averaged 3 per cent per year. But by updating the index each year by increasing the basket of consumer goods to reflect consumer preferences, it was, in fact, only 1.9 per cent. This overestimation of the CPI led to an overestimation of inflation in the United States cumulative over two decades of 25 per cent and – accordingly – a cumulative underestimation of GDP growth and productivity growth of 25 per cent. In Latin America, we refer to national accounts as national tales because what you read is rarely what you get. Given that most of the countries in transition do not have consistent methodologies and a reliable tax system, I think figures on savings rates and investment must be viewed cautiously. While the EBRD's experience in giving credit to Slovakia for their macroeconomic performance is better than we originally expected, at the micro level the investment partnership has not been the best. I would be surprised if Slovakia is at the forefront in 2013 or 2105 unless some of the micropolicies and micro interventions are changed."

"I agree with this attitude of suspicion toward numbers, having worked in the region and being Latin American by origin," added Robert Rocha. He continued with an explanation of the underestimation of the US consumer price index, "It occurred primarily because of the shift from industry toward services. Productivity growth in the service sector is measured by hours worked instead of types of service per hour worked, so the growth slow down in the United States in recent years has been overestimated, and there has been more GDP growth than the figures show. We have more reason to be sceptical of statistics in transition economies. Having lived in Budapest for the last three years, I think, for instance, that the Hungarian national accounts are not reliable.



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Also, why were the Czech Republic and Slovakia able to avoid this investment collapse that Slovenia, Croatia, Hungary and Poland experienced? I do not have a good answer, but I have been told that it had to do with the 1991 stabilisation programme. There was much less concern in the Czech Republic and Slovakia about protecting consumption standards during that period and as a result, real wages fell more quickly and enterprise losses were much smaller. When you look at enterprise data in 1992 in all countries except Poland – which had a stabilisation programme in 1990 – then 1992 was the worst year in the region. Enterprise losses in Slovenia and Croatia were around 14 per cent of GDP while the Czech and Slovak rates were 3 to 5 per cent. Perhaps enterprise growth loses to GDP. The situation has since improved tremendously in Slovenia and Hungary, and Slovakia and the Czech Republic have improved moderately because they started from a better position. My question is: Was the 1991 stabilisation programme in the Czech Republic and Slovakia – which was considered too drastic by many – the cause of the later benefits? Perhaps that adjustment actually protected investment ratios in these countries, and now these two countries are reaping the benefits. This is more a question than a statement, and I would be interested in hearing more on this."

Jan Klacek confirmed that investment data in the Czech Republic are unreliable, especially 1991-1992 data. "The economy was in steep decline even if we account for the underestimation of shadow economy activity. Investment decline was in line with decline of consumption, so in this respect, I see little difference with the other countries. The growth period occurred after the split of Czechoslovakia began in 1994. In 1994, there was a dramatic increase in public investment after a lengthy debate on whether the decline in economic activity should be allowed to continue or whether some major activity in the economic sphere should not be encouraged in order to reverse the trend. The high investment rate was initiated by massive public investment, primarily infrastructural investment, and private investment followed later. So far, growth in the Czech Republic has been more investment-led than export-led. It is true that a combination of investment and export would be almost ideal. The question now is whether it can be sustained given the national savings rate, which is much lower than the national investment rate, and also given the erosion of confidence among foreign investors."

András Inotai expressed embarrassment about the data. "I am embarrassed about the figures themselves and even more embarrassed about their reliability. We should strive to develop the proper understanding of figures, and if we only focus on macroeconomic figures without any criticism, then we will be surprised in the coming year."

Inotai continued with two comments on the interpretation of data.



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"First, we should be careful in describing CEFTA as open since part of CEFTA's openness is the result of the separation of countries. Also, there is a tremendous discrepancy in the level of per capita exports and imports between EU and CEE countries due to our lower level of development. The real question is: How do we increase our GDP growth to Western rates?

Second, CEFTA trade is higher than what is officially registered because a large part of intra-CEFTA trade is carried out by Western intermediaries. In the case of Hungary and Poland, about 30 per cent of intra-CEFTA trade is conducted by Germany, Switzerland and Austria, which are listed in the figures as German-Hungarian, etc. and not as Hungarian-Polish. The same holds true for other bilateral relations. Another point about CEFTA is that the discrepancy between the pattern of trade within CEFTA and with the EU is interesting. Logically and theoretically, we should have a much more technologically developed trade or a higher value-added trade in our intra-regional contacts, but in fact the opposite is true. More than 80 per cent of machinery exports are going to the European Union while intra-CEFTA trade is primarily in raw materials, agricultural products and semi-finished products. This is changing and will continue to change with higher import demand and higher growth rates.

I am sceptical about the World Competitiveness Report. It would be much more revealing to examine the *change* in CEFTA's import shares in the EU, and thereby determine the pattern. This tells us substantially more than the figures alone. Also, the growth rate of CEFTA countries as a share of EU extra-regional imports was by far the highest in the last six years. We have outpaced everyone, even the very successful Asian countries, including China, which have gained tremendous relative market shares in the EU market. The CEFTA-4 and the CEFTA-5 were even more successful, not in the global market, but in the EU market."

Ricardo Lago also commented on the interpretation of the available data. "Exports and imports related to GDP are meaningless unless they are adjusted for the size of the country. Other factors being equal, the larger the size of the domestic market, the lower the ratio of exports and imports to GDP. The higher the driving force and the scope of the domestic market, the larger the size of the non-tradable sector. This has implications for the real exchange rate. A small appreciation of say 10 per cent in Slovenia vis-à-vis a 10 per cent appreciation in Poland would be a disaster in Slovenia but not in Poland. The real exchange rate index has to be adjusted for the size of the domestic market.

Further on real exchange rates, when I was studying economics in Spain in the late 1960s, the third or the fourth development plan of General Franco was to achieve $1500 or $2000 per capita. Today it is $12,000 or



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$13,000 per capita, but of course the real growth in Spain has not been six-fold. The real exchange rate in most of the countries in transition should be understood as a discount factor on the stock of capital and the lack of mobility of the labour force. So we would normally expect a path of real appreciation, and as transition progresses, systemic risks decline and this discount factor should decline along with it.

More specifically, if we take the four Visegrad countries plus Romania and Bulgaria, we have a total of 100 million people. For comparative purposes, Spain has 42 million inhabitants and a GDP of 0.6 trillion while the GDP of the 100 million inhabitants of the Visegrad-4 is not any higher that 0.5 trillion. But I don't believe that the standard of living in Spain is three times what it is, on average, in the region. The indicators which suggest that the CEECs make up 4 per cent of European Union GDP are understating the size of CEE economies. Here we have the statistical aberration of using the wrong exchange rate for the comparison. I would be more optimistic in terms of convergence because there is likely to be a combination of one-third real growth – outpacing the growth in the EU – and two-thirds real appreciation of the exchange rate. This was the case in Argentina in 1989-1990 and Spain from the early 1970s until now.

On current account deficits, the CEECs are now having a tough time, but I think they have a promising future. Consumption is not only going to depend on current income but also on the prospect of future income. This means that domestic savings are going to be small. On the other hand, because the capital stock has to be renewed, it is profitable to have relatively high investment. The financing for this investment will come from abroad. However, the issue is that these foreign investments should be sustainable; authorities should guard against becoming too vulnerable."

András Inotai concluded this part of the discussion with a comment on the exchange rate and currency appreciation for the speed of the catching-up process. "The calculations on how much time the CEE countries need to catch up with the EU – 10 to 15 years – have not taken currency appreciation into account. If a currency appreciation can occur without endangering competitiveness, then the appreciation might become important as an element of catching up in ECU, German mark or Euro terms. What kind of appreciation would this be? If there is a difference in the inflation rate between the main trading partners, then you should depreciate at the same rate in order to maintain the real exchange rate. However, if there is a difference in productivity rates, which is in fact the case, then you may depreciate at a lower rate because part of the depreciation will be practically compensated by productive gains."



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## EU Criteria of Price and Exchange Rate Stability

Joan Pearce dwelled on the relationship of the EU to the Central and European countries. "The EU is not just a regional organisation of market economies – it is a very specific model of market economy. If the Czech Republic or any other applicant country is not committed to that model, then they are going to cause themselves and the other members of the EU a great deal of grief which could be avoided. Perhaps I could, in turn, provoke Miroslav Hrnčíř by asking: Why not join EFTA which is a perfectly respectable European organisation of market economies? This would require much less by way of adjustment of domestic policies.

My second comment concerns some of the implications for the acceding countries being in economic and monetary union. They will come in as so-called pre-ins, and they will not immediately be expected to be part of the single currency. Incidentally, this means that the Maastricht criterion which relates to a single currency will be not be a criterion for their membership. But even as pre-ins, a number of requirements will be imposed. If anyone is interested, these are discussed in some detail in a paper that two colleagues of mine presented at the European Economic Association annual meeting in Istanbul. The acceding countries will have to accept membership of the EMU as part of taking on the *acquis communautaire*. They can, however, request and negotiate derogations. We have given some thought to the type of derogations that one might want to contemplate given that these countries will still be in transition, in all probability, when they join the EU. These relate in particular to the question of catching up. It is clear that if these countries are catching up and have growth rates of productivity that are faster than those of other members of the EU, their currencies will be undergoing real appreciation as against the rest of the EU. This means that they will not be able to meet both criteria of price stability and exchange rate stability, and there will have to be some trade-off. At present, there is no very strong view in the Commission as to which way this should go. There are some who argue that we should aim for the price stability criterion. Others argue that it might be wise to relax the price stability criterion in order to permit the continuing shift in relative prices to occur relatively smoothly and focus instead on exchange rate stability. These are certainly issues that will have to be discussed.

Other areas of discussion are the appropriate degree of fiscal tightness for these countries, given that they will still be in the process of restructuring and given that we might reasonably expect a higher return on public investment there. A further area would be the liberalisation of capital movements where we might not want to fully impose the requirements of the EMU. The distinction is between having precise quantitative criteria



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and pursuing policies that go in the direction of price stability, exchange rate stability and so on. It is the latter that will apply in the case of the acceding countries. Certainly they will not be expected to have met any precise quantitative criteria before they are allowed to join the EU and the EMU."

Albrecht von der Heyden inquired about the degree of intra-CEFTA trade. "CEFTA's past performance has been regarded as poor. While there have been some more encouraging tendencies, what are the consequences of this and what will the future development be? Is the deepening and widening of CEFTA desirable, and are there ideas about the direction in which this development should go? What kind of instruments could be developed in order to speed up intra-CEFTA trade? I agree with Mr. Altmann that cross-border and regional cooperation are important. In the end, these also contribute to stability. Poland and Germany have very intensive border cooperation, and would it not bepossible to develop CEFTA in this direction?"

Zdeněk Drábek responded by suggesting that there was no shortage of ideas regarding Central and Eastern European cooperation. "While there have been many proposals for mutual cooperation, there has been no political will to implement these proposals. This is what is needed to make a difference."

He then turned the discussion to the issue of micro versus macroeconomic policy. "Our vice-governor has said that we are currently in a situation where macroeconomic policies are no longer an issue; the issue is microeconomic policy. I find this a surprising position. According to Miroslav's table on inflation figures, growth rates and current account deficits, how can anyone say that macroeconomic policy is no longer an issue?"

Stephany Griffith-Jones concluded the discussion with a comment on exchange rate policy. "There is some conflict between the long-term objective of using the exchange rate as a mechanism for restructuring and micro-management, and the equally important objective of not letting the exchange rate get too far out of line in the short term to minimise the risk of a foreign exchange crisis which is disruptive to growth. Growth is an important policy objective particularly in these countries because one has to deliver to the population clear proof of the benefits of the economic strategy. There are no clear lessons of international experience for exchange rate policy, so it is important to be pragmatic. A fixed exchange rate may be valuable at certain points in time, for example at the beginning of stabilisation efforts, and this is true for for a number of countries internationally, but it is also true in the Czech Republic. One of the tricks may be to replace a rigid policy with a more flexible one as the situation changes."



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### Response by Miroslav Hrnčíř

"I agree that the paper lacks an elaboration of a pre-accession strategy, and it would be reasonable to describe it. There is a basis for this exercise. There was an interesting discussion on the data. In the Central Bank, we are often proud of how reasonable our monetary policy is, then with a time lag and a revision of GDP figures, it seems that the situation was not as good as we thought. We are confronted with these data problems, but I think at least some data are available and the issue is their correct interpretation.

With regard to the exchange rate issues, perhaps we should understand the exchange rate issue in the transition economies more in connection with general macroeconomic policies and the different stages of development in transition economies. The role of the exchange rate at the initial stage of transition and the potential role of the exchange rate in later stages are quite different things. The economies have now become much more open; initially, there were just official capital flows and nothing else. Now we have a reasonable amount of private capital flows as well so the possibilities of coping with different exchange rate regimes in different stages should be distinguished. I wouldn't discuss the exchange rate regime per se, but in combination with the macroeconomic framework. The extent to which the acceding countries should be committed to the fixed rate or to price stability depends on the different preferences in different stages of development.

The issue of the Czech current account deficit is crucial at this particular stage of our development. At the same time, these macro-developments are the reflection of what is going on in the micro-sphere, i.e. the institutional sphere – the issue of restructuring the financial position of companies, developments in the capital market and developments in the banking sphere. These are the issues which have a direct impact on the macroeconomic figures, with some time lags.

I certainly think that there are various options of how to cope with this ultimate goal of becoming a standard European market. Joan Pearce has suggested that we join EFTA, and I think this would be a good interim solution. The looser environment of EFTA would allow our countries to go through some adjustment and gather some ideas on how to adjust to the demanding positions of the EU. I would not view it as an alternative, but as a complementary step."



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# The Global and Regional Outlook in the Baltics

*Piritta Sorsa*[1]

## I Introduction

Restoration of growth in the Baltics and their re-integration into the world economy will first and foremost depend on success in transition and the introduction of market-based economies. Open trade and other integration agreements can facilitate the process by opening up trade and investment opportunities, and locking in reforms with external anchors. But regional trading arrangements (RTAs) are also second best to unilateral trade liberalisation, and can lead to trade diversion if barriers to third countries remain high.

Since re-independence in 1992, RTAs have been important in facilitating the Baltics' integration into the world economy and their export development. As the Baltics were not yet members of the World Trade Organisation (WTO), which sets multilateral rules for trade and market access, RTAs were also important in creating initial rules for their trade relations and helped open external markets. Their integration with Europe has gradually deepened and the Baltics applied for EU membership in 1995. The large and high-income Europe was an attractive market for them, and being part of Europe was an important political goal after years under Soviet rule. Initial steps have also been taken to deepen integration among the Baltics. Trade and economic relations with other countries of the former Soviet Union (FSU) first disintegrated but are gradually being rebuilt under market principles. Apart from some trade agreements, so far no deeper integration has taken place.

This paper discusses the role of RTAs in present and future trade and foreign direct investment (FDI) performance in the Baltics. As small and open economies a major determinant of growth and transition will be trade performance. Foreign direct investment can speed transition by transferring technology and increasing savings for investment. After reviewing past

1 The views expressed are solely those of the author and do not necessarily reflect those of the IMF or its Board of Directors. The author wishes to thank the discussants, Mr. P. Wijkman, Mr. Karlsson, and Ms. Šteinbuka, and Mr. P. Pallum for helpful comments.



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trade and FDI performance of the Baltics, the paper discusses the role of transition policies and RTAs in fostering trade and FDI, and thereby growth and transition, in the region. The analysis is made difficult due to poor data especially on trade, but data for other economic indicators also tend to vary frequently in different sources.

Available data indicate that regional integration would in general have led to trade creation – especially with Western Europe. The RTAs with the European Union (EU) and the European Free Trade Association (EFTA) countries since 1992 are likely to have contributed to rapid reorientation of Baltic exports and increased intra-industry trade in textiles and machinery, and helped transition by requiring rapid approximation of laws to Western standards. The Agreements, however, have not yet attracted export-related FDI. FDI in general is still low in per capita terms and most of it has gone to non-tradable services. Restricted market access in agriculture, fisheries, textiles, and services in the EU, restrictive rules of origin, safeguards, and the hub-and-spoke nature of the RTAs can explain some of the disappointing FDI performance, although the need for more progress with transition and the overall policy framework are likely to be more important in this. The most liberal Baltic country – Estonia – has performed best in both trade and FDI. In Latvia and Lithuania the RTAs are likely to have promoted liberalisation of trade policiesby requiring market opening and approximation of laws to EU standards. The Baltic Free Trade Agreement (FTA) has not yet resulted in expected increases in mutual trade or FDI. Baltic trade with the FSU countries faces many non-tariff barriers and, after an initial decline, continues especially in energy, but food exports from the Baltics have also increased in recent years.

In the highly trade-dependent Baltics, future growth potential will continue to depend greatly on trade developments. First, the most important in this will remain progress with transition – maintenance of macroeconomic stability, and structural policies that promote allocative efficiency and improve incentives and legal frameworks for private sector development to attract FDI, and higher savings for investment. RTAs can play a role in promoting further liberalisation and locking in policy reforms. Second, preparation for EU membership is likely to dominate trade relations and will gradually harmonise policies within the Baltics. The preparation process would be helped by clearer timetables for EU accession and required policy reforms, better access to the EU market in sensitive products and coverage of services in the RTA with the EU – the so-called Europe Agreements. Third, intra-Baltic integration and that with other Central and Eastern European countries with Europe Agreements should be deepened within FTAs to reduce the trade and investment barriers from the EU's hub-and-spoke system of RTAs. Fourth, deeper integration with



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the FSU is not likely to offer many economic benefits, but these markets in the medium term offer large trade potential in both goods and services. Fifth, to develop FSU and other trade relations the Baltics should pursue their membership of the WTO and consider joining other broader agreements, such as the Organisation of Economic Cooperation and Development (OECD) or the planned Multilateral Agreement on Investment (MAI), that can foster further liberalisation, rule-based trade relations and increase the credibility of policy reforms.

## II Trade and Foreign Investment Patterns during Transition in the Baltics

The Baltics depend on trade for a large part of their GDP, which makes trade an important engine of growth and transition to a market economy. Although trade data in general are poor and vary greatly in different sources, existing statistics (IMF) show that exports of goods and services in 1995 were three-fourths of GDP in Estonia and about one-half in Latvia (47 per cent) and Lithuania (55 per cent). The shares are higher than in many other transition countries (e.g. Hungary 29 per cent) or in small industrial countries (e.g. about 33 per cent in Finland or Sweden). Closeness to main European markets, location between Eastern and Western Europe, low wages and high skills have been the main sources of Baltic comparative advantage since re-independence (for more details see Sorsa, 1994).

After the initial collapse[2] of trade in the early 1990s, **recovery of exports** of both goods and services has been good. Both in terms of overall increase and per capita, Estonia has been the most successful in developing exports. Between 1992-1995 total exports of goods increased four-fold in Estonia, and nearly two-fold in Latvia (in nominal dollar terms). In Lithuania growth of exports between 1993 and 1995 was about 30 percent (Table 1). Exports of services have increased even more.[3] Estonia has also been the most successful in attracting **foreign direct investment** – its

2 Comparisons of levels of trade before and after transition are difficult and unreliable because of the difficult valuation problems related to trade under central planning under overvalued exchange rates. According to one estimate of pre-independence trade (Kaminski, Wang and Winters, 1996) the 1995 level of goods' exports in Estonia was 71, in Latvia 33, and in Lithuania 49 per cent of their 1991 level.

3 Baltic trade statistics are subject to many discrepancies, calling for some caution in their interpretation even after independence. Differences among various sources are large, e.g. in 1994 IMF reported exports of $1,327 million compared to 1,103 million by the World Bank (Michalopoulos and Tarr, 1996) for Estonia. All Baltics have large shares of transit trade, which may be reported differently in different sources. High inflation makes valuation difficult on an annual basis.


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cumulative per capita FDI was nearly three times that in Latvia and nearly seven times that in Lithuania. But compared to a number of other transition countries or fast growing developing countries, Estonia's FDI at $451 per capita in 1995 is still modest – by 1995 Hungary had attracted a cumulative $1,113 per capita, and the Czech Republic $512.

**Table 1 Export and FDI in the Baltics during Transition, 1995**

| | Growth of exports of goods and services) 1995/92* (per cent in dollars) | Exports/ capita (dollars) | Export share to FSU (per cent) | Services exports in total exports (per cent) | FDI cumul. 92-95 (millions of dollars) | FDI per capita (dollars) |
|---|---|---|---|---|---|---|
| Estonia | 300 (330) | 1956 | 37 | 28 | 673 | 451 |
| Latvia | 70 (150) | 822 | 38 | 39 | 414 | 164 |
| Lithuania | 30 (150) | 858 | 52 | 14 | 228 | 61 |

* for Lithuania 1995/93 for lack of comparable 1992 data.
*Source:* ECE, DOT, IFS.

## *Trade in Goods*

During the first five years of transition the **structure** of Baltic exports has been changing rapidly and reflects some of the above-mentioned comparative advantages and the restoration of more realistic relative prices[4]. Resource- and skill-intensive products now dominate exports, while imports are mainly raw materials (energy) and machinery. Both inter-industry (trade between countries with different factor endowments) and intra-industry (trade between countries with similar factor endowments) trade have increased. Some exports are "new", such as natural resources (metals, oil and wood), in the sense that they did not exist during central planning in the Baltics under distorted relative prices. Within the Soviet command system the Baltics exported machinery, light goods (food and textiles) and chemicals from imported inputs and energy (Sorsa, 1994). Wood exports now account, for example, for a quarter of Latvia's exports. Since transition Estonia has rapidly moved from being a natural resource

4 Product level data are particularly poor, which makes any detailed analysis difficult. Therefore the following assessment is by nature relatively general and based on varying sources subject to large measurement errors.



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exporter to one that exploits more its low-cost, high-skill labour force in processing activities (see below). With the increase in real wages and productivity, its structure of trade is likely to move gradually closer to that of industrial countries. Similar developments are taking place in Latvia and Lithuania, although at aslower pace. Exports from some of the "old" industries (food, textiles, machinery) have recovered, suggesting that successful restructuring may have taken place during transition and that they are exploiting past market links and know-how. A number of homogeneous, resource-intensive products such as chemicals and mineral products (oil) have remained important in Lithuania's exports (24 per cent of total exports).

**Table 2 Increase in Baltic Exports of Goods by Direction between 1995 and 1993**
(percentage)

| | Total | EU | EFTA | Baltics | Russia | Ukraine |
|---|---|---|---|---|---|---|
| Estonia | 140 | 202 | 160 | 96 | 4 | 80 |
| Latvia | 23 | 70 | 290 | 82 | 4 | 20 |
| Lithuania | 122 | 53 | 340 | 42 | 620 | 100* |

* figure corresponding to 1995/1994.
*Source:* DOTS. In Lithuania there is a large discrepancy between DOTS and IFS data for 1993 explaining the difference in total growth between 1995 and 1993 compared to Table 1.

Since the start of transition in 1991/1992 the **direction** of the Baltics trade has changed dramatically. Europe has become their main trading partner, as the collapse of intra-FSU trade was replaced by exports to new markets (Table 2). In 1995, over 60 per cent of Estonia's, 44 per cent of Latvia's and 47 per cent of Lithuania's exports went to the EU, compared to nearly none at the start of transition. Trade with EFTA countries has been a small, although growing, share of the total (around 2 per cent). Despite the FTA, intra-Baltic trade has remained around 10 per cent of total exports. Trade with Russia and other FSU countries after the initial collapse has remained a declining share of total exports in Estonia and Latvia, but increased substantially with Lithuania. The share of Ukraine after the initial collapse has increased, but less than total trade.

The pattern of trade by direction – the EU and FSU – is quite different (Table 3), which is to be expected due to the large differences in factor endowments in these markets. Initially upon independence trade with the EU was typically of an inter-industry nature. The Baltics exchanged raw materials – their own such as wood, or re-exported such as petroleum and


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metals – against machinery and other consumer goods.[5] In 1995 resource-based goods continued to dominate Latvia's exports to the EU (wood), while Lithuania was exporting food and raw materials to the EU. Some intra-industry trade such as the processing of textiles from EU raw materials has emerged in all three. In Estonia the shift to intra-industry trade was most pronounced (about 20 per cent of total exports) – in addition to textiles, various machinery products are now processed in Estonia, that exploits its inexpensive but highly skilled labour.

**Table 3 Structure of Baltic Exports (and Imports) by Direction in 1995**
(percentage of total)

| | Estonia | | Latvia | | Lithuania | |
|---|---|---|---|---|---|---|
| **Products** | EU | CIS* | EU | CIS* | EU | CIS* |
| Manufactures | 57 (73) | 40 (38) | 48 (80) | 64 (40) | 62 (82) | 48 (27) |
| Textiles | 18 (11) | 4 (8) | 16 (12) | 13 (1) | 19 (11) | 7 (1) |
| Machinery | 21 (37) | 25 (14) | 6 (35) | 32 (14) | 7 (40) | 21 (7) |
| Food | 9 (14) | 35 (7) | 3 (10) | 30 (3) | 16 (14) | 32 (2) |
| Oil | 5 (5) | 13 (41) | 1 (8) | 3 (53) | 6 (1) | 18 (65) |
| Other raw materials | 27 (8) | 22 (14) | 48 (2) | 3 (4) | 16 (3) | 2 (6) |

* Commonwealth of Independent States (CIS) includes Russia and Ukraine.
*Source:* COMTRADE, Estonian Statistical Yearbook (1995).

The Baltics seem to be reinforcing their past "comparative advantage" as processed food exporters to other CIS countries (fish, drinks, sweets). Other CIS exports are machinery, especially from Latvia and Lithuania, which is also likely to reflect the pre-independence trade patterns. In Estonia, part of machinery exports is various repair services for ships, trucks or trailers. Oil is still an important item from Lithuania. Some recent estimates with gravity models predict that the relative share of the FSU in total trade will increase from present levels (Cornett and Iversen, 1996).

Intra-Baltic trade is dominated by chemicals and energy, but exports of textiles and food have increased slightly in recent years. Lithuania's main export to the other Baltics is refined petroleum (35-50 per cent). Latvia exported food, textiles and other manufactures to the other Baltics, but

5 One study estimated the share of re-exports of FSU raw materials (or so-called arbitrage goods) in 1992 in total exports as 45 per cent in Estonia and about 70 per cent in the other two. In 1994 their share had already declined to 22 in Estonia and 47 in Lithuania, but remained high in Latvia at 58 per cent (Hoekman and Djankov, 1996).



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trade flows have been erratic. Food trade is likely to increase with the free intra-Baltic trade in agricultural products established in 1997.

### *Services and Investment*

Trade in **services** has become an important element of total trade in the Baltics. Services were already important under central planning as the Baltics were among the main ports of the FSU to the West. Today the largest service exporter is Latvia. Nearly 40 per cent of total export earnings are services, compared to 28 per cent in Estonia, and only 14 per cent in Lithuania (Table 1), but services exports have grown substantially in all three countries. In Latvia main service exports were linked to transport, either by sea or land. Travel, tourism, business services and construction are also important. These activities are likely to offer high future growth potential as incentives for private sector evolve. As establishment is an important element for trade in services, the incentive framework for investment is important for further trade in this sector.

The RTAs have not generated **foreign direct investment** in export industries geared to Western markets. Most FDI has been in often non-tradable services and in industries that export to the Baltic or FSU markets (chemicals, food). In Estonia, a large share of FDI (about 30-40 per cent of inflows in 1994-95) was related to privatisation programmes (ECE, 1995). The largest investors were Finland (20 per cent), followed bySweden (19 per cent), and Russia (15 per cent) according to stock on January 1, 1996 (ECE, 1996). About half was in manufacturing (mostly chemicals and food industries), while trade and transport were the largest recipients in services. In Latvia, FDI started to increase in 1994. In Latvia as well a large part of FDI was related to the privatisation of state utilities – one large sale of telecom in 1994 accounts for most of it. Most investments (nearly 70 per cent) have been in services (mostly finance). One-tenth of the total was in food industries. The largest investors in 1996 were Denmark (26 per cent), Russia (19 per cent) , and the United States (12 per cent). Lithuania has received the least investment among the Baltics. The largest investors have been Sweden, Germany, the United States, and Russia. No sectoral breakdown is available.

## III The Role of Transition Policies in the Baltic Trade and FDI Performance

While open integration agreements can create a framework for trade and investment growth, the speed of integration and the actual benefits

from it depend crucially on progress with transition – with the introducing of market-oriented policies and with the restructuring of their economies. Progress in this has been good, but slightly different among the three Baltics. While all three have been successful in stabilising their economies, Estonia seems to be clearly ahead in structural reforms. Its trade policy framework is the most liberal among the Baltics, and it is also more advanced in privatisation and creating incentives for investment and private sector growth. This may partly explain its better export performance and success in attracting FDI.

### *Stabilisation Policies*

Transition in the Baltics has proceeded rapidly since 1992, and all three have now successfully stabilised their economies.[6] Inflation in early 1996 was around 20-35 per cent and interest rates have declined to 16-35 per cent annually in 1995. Output growth resumed in 1994/1995 (Table 4) and was 3 per cent in Estonia and Lithuania and zero in Latvia in 1995. The return of output growth and the decline in interest rates have been slower in Latvia than in the other two, while its inflation has been the lowest. Fixed exchange rates (currency boards in Estonia and Lithuania) tend to lower interest rates when the currency is anchored to an international currency and thereby to international interest rates. Recently, external imbalances have increased in all three as imports of (especially of capital goods) have increased. However, since the deficits reflect largely private sector activities and not excessive public consumption and have been financed by FDI and other longer term capital, they have not been of much concern.

The results were achieved with slightly different policy mixes. Stabilisation in Estonia (in 1992) and later in Lithuania (1994) relied on a nominal exchange rate anchor within a currency board arrangement. In Latvia, stabilisation was initially achieved by tight monetary policy with money as the nominal anchor (tight limits on the growth of credit, and later the monetary base), but since 1994 the currency has been pegged to the Special Drawing Right (SDR) (informally). A key to success in all three was the maintenance of tight fiscal policies that helped maintain the credibility of the anchors. Recent analysis suggests that what mattered for disinflation in the Baltics was not the exchange rate policy framework (fixed or flexible exchange rates) but the policy content. Some analysts,however, attribute the larger decline in interest rates in Estonia (and also recently in Lithuania) to

6 For in-depth discussions of stabilisation in the Baltics, see Saavalainen (1995) and Citrin and Lahiri (1995).



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the larger credibility of the currency board (Saavalainen, 1995).

In the medium term, the challenge in all three Baltics is to maintain the prudence in their macroeconomic policies in the face of increasing fiscal pressures and moves away from the currency board, especially in Lithuania. This will call special attention to revenue performance. Higher foreign and especially domestic savings will also be important to finance investments to sustain the growth performance and help the Baltics catch up with Europe.

**Table 4 Transition Indicators in the Baltics**

| | 1993 | 1994 | 1995 |
|---|---|---|---|
| **Inflation** (%) | | | |
| Estonia | 36 | 42 | 29 |
| Latvia | 35 | 26 | 23 |
| Lithuania | 188 | 45 | 35 |
| **GDP** (%) | | | |
| Estonia | -2.1 | -0.1 | 3.2 |
| Latvia | -16 | 2 | 0 |
| Lithuania | -24 | 1 | 3.1 |
| **Current Account** (% of GDP) | | | |
| Estonia | -1.4 | -7.5 | -5.3 |
| Latvia | 7.0 | -2.4 | -3.5 |
| Lithuania | -4.6 | -3.1 | -2.3 |
| **Budget (Financial) Deficit** (% of GDP) | | | |
| Estonia | 1.4 | 2.9 | -0.9 |
| Latvia | 1.0 | -1.7 | -2.7 |
| Lithuania | 2.4 | -1.5 | -1.8 |
| **Investment** (% of GDP) | | | |
| Estonia | 25 | 29 | 26 |
| Latvia | 13 | 19 | 19 |
| Lithuania | 18 | 19 | 18 |
| **Lending Rates** (%) | | | |
| Estonia | 27 | 23 | 16 |
| Latvia | 86 | 56 | 35 |
| Lithuania | 91 | 62 | 27 |

*Source:* IMF, International Financial Statistics.

## *Structural Policies*

Stabilisation was accompanied by rapid liberalisation of most prices and liberal trade policies, although some controlled non-traded goods prices are still adjusting and explain part of the high inflation levels. In trade poli-



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cies, Estonia differs from its neighbours by maintaining the most liberal trade regime at zero tariffs with no quantitative restrictions (Annex Table 1). Protection of agriculture has been higher in Lithuania (average tariffs of 38 per cent) and especially in Latvia (average production weighed tariffs over 50 per cent), which may have slowed restructuring in their agricultural and food sectors. This may also explain some of the better export performance of Estonia and Lithuania (exports of foodstuffs doubled in Estonia between 1993 and 1995 and nearly tripled in Lithuania between 1992 and 1994), while Latvia's exports of food grew only moderately and remained at a low overall level. The free trade environment in Estonia is likely to have facilitated processing for export from imports at world prices. The Baltic Free Trade Agreement and to a lesser extent the Europe Agreements are likely to increase competitive pressures in agriculture in the near future.

Tariffs are also higher on industrial goods in Latvia and Lithuania. Lithuania protects a selected number of mostly domestically produced products. In Latvia effective rates of protection can be high in many industries due to dispersion of rates between inputs and final products (between zero and 15-20 per cent). The impact of protection in industry is, however, lowered by the free trade agreements among the Baltics and with EU and EFTA (see below).

Barriers in services trade, which conceptually includes establishment trade (market presence), and which are related to regulatory frameworks, barriers to foreign investment and entry and exit of firms, seem also to be the lowest in Estonia. Both Estonia and Latvia have relatively liberal laws for foreign and national investors with no restrictions to share ownership. Land ownership in Latvia is subject to some restrictions. Latvia in the Europe Agreements made some reservations on the establishment of foreign companies in some service industries in which Latvia may have a comparative advantage (ports). This may reduce efficiency gains in a sector with large future growth potential. In Lithuania, foreign investment proposals require government approval, although there are no limits to foreign ownership of shares or companies as such. Foreigners cannot own land, which can only be leased, although changes to this are planned. The conclusion of the Europe Agreement may help in liberalising laws related to establishment in Lithuania.

In a recent EBRD classification of laws fostering foreign investment in 1996, Estonia scored 4 (the maximum) in both extensiveness and effectiveness of legal rules. Latvia came second with 4 and 3 respectively, while Lithuania only received a 2 on both counts (EBRD, 1996). The weaker FDI framework in Lithuania may help explain the lower levels of FDI there.

Privatisation is the most advanced in Estonia as well. In 1995 an esti-



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mated 65 per cent of GDP was private, while in Latvia it was about 58 per cent and in Lithuania 55 per cent (EBRD, 1996). In Latvia especially, large-scale privatisation has been slow. The opening of the privatisation process for foreign investors in Estonia is likely to have helped attract foreign investment. In Latvia foreign ownership in privatised companies was only allowed at a later stage in the process (in 1996).

Restructuring of the privatised or other companies seems also the most advanced in Estonia. For many enterprises restructuring is essential if they are to be competitive in world markets. This in Estonia is likely to have been helped by open trade policies, and a functioning bankruptcy law since 1992. In Latvia restructuring has been left to owners of enterprises, which previously were dominated by former management and workers. A new bankruptcy law will enter into force in 1996 and can speed up restructuring. In Lithuania most privatisation has been left up to former managers, who have been at times unwilling to restructure the companies. A bankruptcy law has been functioning recently. Labour laws in the Baltics are relatively liberal and are not a major obstacle to restructuring.

Rapid stabilisation, price and trade reforms and the initial undervaluation of the exchange rates are likely to have helped create incentives for successful reorientation of trade to Western markets. The more liberal trade policies and more rapid progress withmarket orientation in Estonia are likely to have contributed to its better trade and FDI performance. Completion of the privatisation process, and the legal framework for private sector development and containing pressures for more protection are likely to be the main near term challenges in the Baltics in the structural policy area for continued trade and FDI performance.

A recent study by Sachs and Warner (1996) on the performance of fast-growing developing countries also noted that raising the savings rate and attracting more foreign investment are areas in which transition countries like the Baltics could do more to achieve higher growth rates. The study concluded that key elements in successful growth strategies were (i) allocative efficiency (reliance on market forces and low level of government intervention), (ii) high savings and investment rates, and (iii) openness to FDI to promote transfer of technology. On the first, the Baltics are already doing well, although protection of agriculture (especially in Latvia, but also in Lithuania) and the slow pace of privatisation and restructuring in some privatised enterprises can be of concern (especially in Lithuania). As noted above, more efforts are needed to improve private sector legal frameworks in all three but especially in Lithuania. Investments in infrastructure are needed in all three.

All three need to increase their investment and savings ratios. At present investment ratios are highest in Estonia at about 26 per cent of GDP,



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which is low compared to the levels of over 30 per cent in many fast-growing Asian countries. In Latvia and Lithuania they are still below 20 per cent. About one-fifth of investments in Estonia are financed by foreign investment, and much less in the other two. The domestic savings rates in Latvia and Lithuania of 15 per cent of GDP and of about 21 per cent in Estonia are low.

### *Competitiveness and other Future Issues*

The increasing trade imbalances in the Baltics (Table 4) have at times raised concerns about competitiveness. The fixity of the exchange rates and the higher inflation than in their main trading partners have caused some observers to make statements on the potential overvaluation of the real exchange rates in the Baltics. In Lithuania, discontinuing the currency board was a topic in the recent elections.

Some recent studies on sources of inflation in the Baltics (Saavalainen, 1995, Richards and Tersman, 1995) have concluded that changes in prices mostly reflect differential productivity growth between traded and non-traded goods and price arbitrage. Prices continue to increase as administered prices adjust, and wages have increased in response to productivity increases in the traded goods sectors. The substantial initial undervaluation of the exchange rate left much room for real appreciation without undermining export performance (Saavalainen, 1995). The above studies have concluded that, provided the current prudent macroeconomic policies are continued, the inflation performance is of no concern and is only an indication of the transition process.

In Lithuania, a shift away from the currency board may be considered for political reasons to gain more flexibility in monetary policy. In any case it can be noted that while the currency board arrangement is likely to have been an important element of stabilisation, similar results were achieved initially by Latvia with a different arrangement. This suggests that the key element in maintaining a credible exchange rate policy is prudence in monetary and fiscal policies.

While any equilibrium real exchange rates are hard to estimate, some indication of the sustainability of present levels of exchange rates can be assessed by looking at a number of competitiveness indicators. Although real wages have increased in all three (Table 5), exports continue to grow and reserves are comfortable. Also, price differences withWestern Europe are still important – one study estimated Latvia's price level as 60 per cent of that in Western countries in 1995 (Richards and Tersman, 1995). Despite the wage increases, e.g. doubling in dollar terms in Estonia between 1994 and 1996, the overall level of salaries in the Baltics remains

low compared to Western Europe, suggesting that there is still a lot of room before wage increases seriously affect competitiveness. Estonia is rapidly approaching wage levels in Central European countries (about $340 per month in the Czech Republic, Hungary and Poland). This process is part of transition and catching up with Europe. Real exchange rate appreciation is likely to continue in the future as the Baltics increase productivity. The continued decline in interest rates also suggests that markets are not considering the pegs unrealistic.

**Table 5 Some Competitiveness Indicators in the Baltics**

| | Increase in goods exports in 1995(%) | Reserves in 1995, months of imports | Increase in average dollar wage 95/94 (%) | Increase in average dollar wage 96/95 (%) | Average dollar wage per month 1996 | Interest rate (lending) latest 1996 (%) |
|---|---|---|---|---|---|---|
| Estonia | 40 | 3 | 57 | 27 | 261 | 14.1 (Sept) |
| Latvia | 34 | 3 | 34 | 2 | 190 | 24 (Aug) |
| Lithuania | 33 | 4 | 42 | 28 | 165 | 23 (Aug) |

*Source:* IMF.

## IV The Role of Regional Integration Arrangements in the Baltic Trade and Investment Performance

In the absence of WTO membership, regional arrangements were a major determinant of the Baltics' foreign trade relations. As much of the focus of the paper is on the impact of regional integration arrangements on the Baltic trade and FDI performance at present and in the future, this part will first examine some basic issues with regional integration and determinants of or guidelines for open regionalism. Subsequently, the Baltics' RTAs are analysed in light of their economic potential for trade-creating integration and these "guidelines".

### *Basic Issues with Regional Integration and Determinants of Open RTAs*

In recent years, the topic has been discussed extensively in numerous forums and publications (see for example, WTO, 1995, de Melo and Panagariya, 1992, de la Torre and Kelly, 1992). Globalisation and the larger role of services in GDP increasingly underline the importance of analys-



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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ing RTAs in broad terms beyond static trade creation in goods to include investment and other potential dynamic benefits of integration.[7] Regionalintegration can have different degrees, ranging from simple free trade agreements to economic and political union. It is generally acknowledged that while unilateral liberalisation is the first-best policy, open regional arrangements can promote liberalisation of trade and FDI flows. But regional integration is not a panacea and its economic benefits depend on the open nature of the regional agreements, and on the policies applied by the partners. RTAs behind high tariff walls can slow down structural change and maintain inefficient activities, with dire consequences for growth.

The expected static and dynamic benefits from regional integration can be: increased allocative efficiency from more trade and competition, economies of scale and scope, foreign investment, transfer of technology and know-how. RTAs can also go beyond multilateral liberalisation in many areas. Locking in policies within an RTA can help improve policy credibility in reforming countries and prevent policy reversals. The literature[8] has developed various economic indicators for "benign" or welfare-increasing regionalism. In general, static and dynamic benefits are likely to be larger with deeper integration, removal of non-border barriers to both trade and investment and coverage of many sectors and policies (Mistry, 1996). Economic gains from integration – static and dynamic – tend to be enhanced when (i) existing mutual trade is high (less potential for trade diversion), (ii) when the partners are complementary in economic structure and when the partner's market is large (more potential for trade creation), and (iii) when the partners' tariffs are low (less potential for trade diversion). Maintenance of low trade, investment or other barriers to outsiders is a fundamental condition for open regionalism. Therefore, open regionalism is best enhanced by RTAs that (i) cover most trade and do not increase protection to third countries,[9] (ii) include deep integration (non-tariff barriers, investment barriers), (iii) include liberal rules of origin with

7 Earlier analysis of RTAs concentrated on assessing static trade effects in terms of trade diversion and trade creation. This was later refined to include models incorporating more dynamic aspects of integration such as imperfect competition leading to gains from scale economies, and increased product variety. The latest analysis is concentrated in analysing other, mostly non-border, barriers to integration which affectestablishment and entry and exit of firms (or other investment barriers). This has led to the merging of the literature on investment and trade (see Owen, 1996; UNCTAD, 1996), which better reflects the increased globalisation of the world economy.

8 See for example Michaely (1996), Shiells (1994).

9 This criterion is generally required from WTO-consistent RTAs. However, these are not enough for open regionalism as these two conditions can be fulfilled, for example, by RTAs that maintain high tariffs to third countries.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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possibility for cumulation[10] among different RTAs, iv) eliminate contingency protection (anti-dumping, voluntary export restraints etc.), (v) are open to third countries, and (vi) foster low MFN duties.

### *Integration with the West: The Challenge of Handling Transition to Eventual EU Membership*

One cornerstone of transition in the Baltics has been a gradually deepening economic integration with Western Europe. The first free trade agreements on industrial goods concluded in 1992/93 with the Nordic countries and Switzerland were replaced in 1995/1996 by a FTA with the European Union and EFTA-wide FTAs (Table 6). Integration with the EU will deepen further once the Europe Agreements[11] signed in 1995 are ratified, which is still pending in some EU members. In 1995 all three Baltics officially applied for EU membership, which will set the framework for many of their structural policies in the coming years.

Baltic relations with Europe will be dominated by eventual membership of the EU.[12] The latter has, however, refused to give the Baltics any specific timetables or conditions for membership. The EU enlargement will be discussed in more detail at the EU's Inter-Governmental Conference in 1997, whereupon the Commission is expected to submit its opinion on the applicants to the Council, which will then decide on the start of the accession negotiations. The most frequently cited conditions for accession are: progress with market reforms, especially with privatisation, introducing administrative reforms necessary to enforce private contracts, and credible macroeconomic policies (CEPR, 1992). These may also include progress with issues such as minority rights and introduction of democratic institutions.

Even in the best of circumstances, full membership is not likely during the next five to ten years. The EU has recently made clear that among the presently ten Eastern European applicants perhaps three to four may be among the first group of candidates with whom negotiations will be held.

10 Rules of origin mean that in order to benefit from free trade among partners the product has to originate in the partner countries. This is often defined either in terms of percentage of value added or transformation of the product so that its tariff classification changes. Cumulation means that qualifying inputs can originate in the other FTAs included.

11 These subsume the FTAs and include provisions for investment, technology, approximation of laws etc.

12 The FTA with EFTA will not be discussed here. It is very similar in nature to the EU FTA – the main difference being that agricultural protection is even higher in the EFTA countries, suggesting more distortions in this trade within an FTA.



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## Table 6 RTAs in the Baltics

### Estonia

| Agreement | Main Provisions | Rules of Origin | Safeguards |
|---|---|---|---|
| EU FTA (signed in 1994, in force since January 1995); overtook bilateral FTA with Finland and Sweden since 1992; Europe Agreement (signed June 1995), ratification pending. | Free trade in most industrial goods; EU surveillance on textiles; tariff-quotas and zero-duty quotas on agricultural products; tariff quotas on fisheries, elimination of export duties and quotas. | Baltic cumulation of origin. | Special agricultural safeguards; Estonia can use infant industry and restructuring safeguards until end-1997; general safe-guards (import or export restrictions); antidumping; never used by either side. |
| EFTA FTA (signed in 1995; in force since July 1996); replaced bilateral FTAs from 1993. | Free trade in industrial goods, except in sensitive items (EFTA QRs); bilateral agreements in agriculture and fisheries. | Baltic-EFTA cumulation. | General safeguards (export, import); Estonia can use restructuring safeguards until mid-1999; anti-dumping; never used by either party. |
| Baltic FTA (signed in 1993, in force since 1994); agriculture signed in 1996, in force since January 1997); CU in 1998? | Free trade in industrial products; Latvia and Lithuania maintain some export restrictions; free trade in agricultural products. | Baltic origin cumulation. | General safeguards (EFTA model), dumping; never used by either side. |
| CEFTA – FTA with Czech and Slovak Republics (provisional application since July 1996); FTA with Slovenia since January 1997). | Free trade in industrial goods; Czech and Slovak Republics and Slovenia maintain QRs on selected items (until end-2000) and some export restrictions (automatic licensing until end-1996), in agriculture free trade in some goods, MFN duties on remainder. | EU-EFTA-Baltic-Bulgaria-Romania. | As above. |
| Ukraine FTA (signed in May 1995, in force since March 1996). | Free trade in all goods. | Cumulation with EU, other Baltics foreseen when all parties have FTAs. | As above. |

LATIA (continued)

| Agreement | Main Provisions | Rules of Origin | Safeguards |
|---|---|---|---|
| EU FTA in force (signed in 1994, in force since January 1995); over-took bilateral FTAs with Finland and Sweden in force since 1992; Europe Agreement signed (June 1995), ratification pending; appled for EU membership in 1995. | Free trade in industrial goods, in Latvia 6 year transition period; Latvia to eliminate export duties in 4 years; EU zero-duty quotas in textiles, EU tariff quotas and zero-duty quotas on agricultural products, tariff quotas on fisheries. | Baltic cumulation of origin. | Special agricultural safeguards; Latvia can use infant industry and restructuring safeguards until end-1997; general safe-guards (import or export restrictions); antidumping; never used by either side. |
| EFTA FTA (signed in 1995, in force since July 1996); replaced bilateral FTAs from 1993. | Free trade in most industrial goods, EFTA maintains QRs on sensitive products; Latvia to eliminate export duties by end-1998, bilateral agreement in agriculture. | EFTA-Baltic cumulation. | General safeguards (export, import); Latvia can use restructuring safeguards until mid-1999; antidumping; never used by either party. |
| Baltic FTA (signed in 1993, in force since 1994), Agriculture (provisional application since July 1996); CU by 1998? | Free trade in industrial goods, Latvia main-tains some export restrictions, free trade in agricultural goods. | Baltic cumulation. | General safeguards (EFTA model), dumping; never used by either side. |
| CEFTA – FTA with Czech and Slovak Republics and Slovenia. | Free trade in industrial goods with QRS on selectd items, in agriculture free trade in some products, MFN duties on remainder. | EU-EFTA-Baltic-Bulgaria-Romania cumulation foreseen. | As above. |
| Russia MFN Agreement. | Application of MFN duties, not applied (?) | | |

**LITHUANIA (continued)**

| Agreement | Main Provisions | Rules of Origin | Safeguards |
|---|---|---|---|
| EU FTA (signed in 1994, in force since January 1995), overtook bilateral FTA with Finland (since 1993) and Sweden (since 1992); Europe Agreement signed (June 1995), ratification pending; applied for EU membership, 1995. | Duty free entry to EU in most industrial goods, Lithuania to eliminate import duties and export restrictions by 2001; in EU agriculture tariff quotas zero-duty quotas in certain products; EU zero-duty quotas in textiles, agricultural products. | Baltic cumulation of origin. | One antidumping investigation on Lithuania by EU; special agricultural safeguards; Lithuania can use infant industry and restructuring safeguards until end-1997; general safeguards (import or export restrictions); anti-dumping; safeguards never used by either side. |
| EFTA FTA (signed in 1995, in force since January 1997). | Free trade in most industrial goods except in sensitive item QRs in EFTA; in Lithuania a transition period until end-2000, bilateral agreement in agriculture and fisheries. | EFTA-Baltic cumulation. | General safeguards (export, import); Lithuania can use restructuring safeguards within 3 years of entry into force; antidumping; never used by either party. |
| Baltic FTA (1994); in Agriculture in force since January 1997; CU in 1998? | Free trade in industrial goods; Lithuania maintains export restrictions on (5) goods, free trade in agriculture. | Cumulation of Baltic origin. | General safeguards (EFTA model), dumping; never used by either side. |
| CEFTA – FTAs with Czech and Slovak Republics (provisional application since January 1997), Poland (in force since January 1997), Slovenia (in force since January 1997). | Free trade in industrial goods: one year transition period, in agriculture free trade in some goods. | EU-EFTA-Baltic-Bulgaria-Romania foreseen. | Same as above. |
| Russia MFN Agreement (ratification 1995). | Application of MFN duties. | | |



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The process will also be influenced by the EU's internal reform in decision-making in a substantially enlarged Union and on how it decides to deal with the possible costs of extending agricultural support and structural funds to new members. As there are differences in economic performance and introduction of market-based policies among the Baltic states, the eventual timetable for membership may also differ between them.

*The Economic Potential*

The potential benefits of closer integration with the European Union (or EFTA) can be important for relatively obvious reasons. Integration with the European Union meets many of the criteria set in the literature for trade- and growth-creating regional integration – size of market (GDP), diversity or likely complementarity in production (GDP per capita, share of agriculture in GDP), share of existing trade between partners and level of existing protection. The EU's large economic size, high incomes, high import elasticities, diversity and large share of present trade with the Baltics favour trade creation over trade diversion, and dynamic benefits from integration (Table 7). Deeper integration with a high-income large market can lead to investment creation and transfer of technology enhancing the dynamic benefits of closer integration. The level of protection in general is low in the EU (low average tariffs and few non-tariff barriers (NTBs)) except in some sensitive sectors – agriculture, textiles and clothing and perhaps steel industries. In these areas levels of existing protection can lead to trade diversion and misallocation of resources.

*The Agreements*

The present RTAs with Europe (Table 6) fulfill some, but not all, of the criteria set in the literature for trade- and growth-creating RTAs.[13] While providing for improved market access for Baltic exports in goods and for a gradually deepening integration, the FTAs with the Western European countries have a number of drawbacks in coverage, rules of origin, and maintenance of contingency protection, which maintain trade and investment barriers in trade between partners. For example, about

13 These are: WTO compatibility (coverage of most trade, no increase in external barriers); low MFN tariffs; liberal accession clauses; liberal rules of origin; deep integration (reduction in non-tariff and investment barriers and regulatory barriers); and limits on contingent protection (Shiells, 1995).



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## Table 7 Trade Creation Indicators in Baltic Regional Partners

| | Size | Diversity | | | | |
|---|---|---|---|---|---|---|
| | GDP (billions of 1994 dollars) | GDP/CAP (billions of 1994 dollars) | Agriculture in GDP (%) | Share of partner-trade (% of 1995 exports) | Tariffs* (% average unweighted) | Other Trade Restrictions |
| **Estonia** | **43** | **2820** | **10** | | **0** | – |
| EU | 7590 | 20530 | 2 | 61 | A = 25<br>I = 6 | Various NTBs in sensitive products |
| EFTA | 385 | 33218 | 1 | 2 | A = 74-82<br>I = 3-6 | Various NTBs in sensitive products |
| other Baltics | 11 | 1730 | 15-21 | 10 | Li = 3<br>La = 10 | Export restrictions in Latvia and Lithuania, specific duties |
| Ukraine | 81 | 1570 | 39 | 3 | 12 | Payments and regul. barriers |
| Russia | 392 | 2650 | 7 | 13 | 13 (weighted) | Payments and regul. barriers |
| CEFTA | 98 | 3590 | 6 | 1 | 8 - 14 | Various NTBs in sens. products |
| **Lithuania** | **5.0** | **1350** | **21** | | **10** | Export bans (skins, feathers), export tax on skins, wool, red clover seed, timber, glands). Import quotas on agriculture. |
| EU | 7590 | 20530 | 2 | 47 | A = 25<br>I = 3.6 | Various NTBs on sensitive products |
| EFTA | 385 | 33218 | 1 | 1 | A = 74-62<br>I = 3-6 | Various NTBs on sensitive products |
| Ohter Baltics | 10 | 1587 | 15-21 | 7 | E = 0<br>La = 10<br>(A = 53) | Latvian export restrictions, import restrictions |
| Ukraine | 81 | 1570 | 39 | 10 | 12 | Payments and regul. barriers |
| Russia | 392 | 2650 | 7 | 14 | 13 (weighted) | Payments and regul. barriers |
| CEFTA | 98 | 3590 | 6 | 4 | 8 -14 | Various NTBs in sens. products |



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Table 7 (continued)

| | Size | Diversity | | | | |
|---|---|---|---|---|---|---|
| | GDP (billions of 1994 dollars) | GDP/CAP (billions of 1994 dollars) | Agriculture in GDP (%) | Share of partner-trade (% of 1995 exports) | Tariffs* (% average unweighted) | Other Trade Restrictions |
| **Latvia** | **5.9** | **2290** | **15** | | **10** | Export taxes on wood, metal, limestone<br>Import QRs on agriculture and alcohol |
| EU | 7590 | 20530 | 2 | 44 | A = 25<br>I = 6 | <br>NTBs on sensitive items |
| EFTA | 385 | 33218 | 1 | 2 | A = 74-82<br>I = 3-6 | <br>NTBs on sensitive items |
| Other Baltics | 9 | 1730 | 10-21 | 9 | E = 0<br>Li = 3 | <br>Lithuanian export restrictions |
| Russia | 392 | 2650 | 7 | 14 | 13 (weighted) | Payments and regul. barriers |
| Ukraine | 81 | 1570 | 39 | 10 | 12 | Payments and regul. barriers |
| CEFTA | 98 | 3590 | 6 | 4 | 8-14 | Various NTBs in sens. products |

* In tariffs A=agriculture, I=industry, E=Estonia, La=Latvia, Li=Lithuania.
*Source:* IMF Direction of Trade Statistics, World Bank Atlas, Leidy-Ibrahim (1996), various TPRs.

one-third of present Baltic exports of goods are subject to limited or conditional liberalisation in the EU (agriculture, fisheries and textiles), and services are not covered in the present FTA. This also implies that the Agreements are imbalanced, as the Baltics will liberalise market access in nearly all goods after relatively short transition periods and rapidly adopt many of the EU's laws.

Coverage

An imbalance in the Agreements on goods trade arises from partial coverage of a number of sectors by the EU – **agriculture, fisheries and services.** In agriculture and fisheries, the EU gave mostly quota-restrained concessions on a limited number of products, while the Baltics (subject to tariff quotas on some products in Latvia and Lithuania) made concessions on all products (Annex Table 2). EU concessions to the three Baltics are relatively similar. In agriculture, these are (i) "natural" products (honey, berries, plants, apple juice) with special reduced duties; (ii) dairy and meat products and some vegetables with reduced levies within increasing quotas; (iii) bovine, sheep and live animal meat quotas at reduced levies; (iv) processed agricultural products (sweets, drinks) with increasing tariff quotas; and (v) a few fisheries products with tariff quotas. All other agricultural imports are subject to full most-favoured nation (MFN) tariffs. The limited market access is reflected in low shares of trade in food products with the EU, which otherwise is a major export from the Baltics to other markets.

The FTAs are most liberal in **industrial goods** with duty-free access to Baltic exports for most goods in the EU. The exception in the EU is textiles, in which conditions also differ between the Baltics. While most textile and clothing imports from the Baltics are under surveillance, imports of most products from Latvia and Lithuania are free of duties but subject to annual quotas (to be renegotiated in 1997). Estonian textile exports to the EU have no restrictions apart from surveillance. While this is likely to lead to trade creation in the Baltics, the potential is reduced by the maintenance of restraints without clear timetables for the elimination of restrictions. Some trade diversion is possible in Latvia and Lithuania, where duties on many final products are around 15-20 per cent. Trade diversion in Estonia may only arise from origin rules.

By limiting access and reducing security of access to EU markets the restrictions may act to deter export-related FDI in the textiles sector. The FDI statistics discussed above give some support to this view. The main impact of the FTAs seems to have been an increase in intra-industry trade (processing of EU inputs for further export), which is likely to have led to

important transfer of technology and know-how. As market access in other industries in the EU is free of restrictions, the restricted access in textiles coupled with rapidly increasing wages in the Baltics may speed up the shift of comparative advantage tomore skill-intensive activities. Some indication of this is already the substantially increased intra-industry trade in machinery in Estonia in 1995.

Coverage of sectors on the Baltic side is most liberal in Estonia, which offers duty-free treatment immediately to all EU exports. Latvia and Lithuania have four- and six-year transition periods respectively whereby some sectors (see Annex Table 2) will only be opened gradually to competition. This is likely to slow down transition and structural change in the protected industries in Latvia and Lithuania.

In **services**, coverage in the planned Europe Agreements is very limited at present in both partners (Annex Table 2). The limited coverage of services in the Agreements is likely to limit the trade potential of the Baltics in an area in which they are likely to be competitive in the future. Cross-border trade is only subject to a standstill commitment on new restrictions, and progressive liberalisation of cross-border supply of services will be discussed eight years after the entry into force of the Europe Agreements. Some liberalisation will take place in international maritime transport, where the agreement forbids e.g. cargo-sharing (except within the UN Liner Conference), and requires national treatment in access to ports, use of infrastructure and port facilities. A transit agreement is to be negotiated by 1999.

Establishment trade (commercial presence) in services or in other sectors is slightly more liberal (see below), although the main transport sectors are at present excluded from coverage. In addition, Lithuania has temporarily excluded many important services such as telecommunications and postal services, and Latvia some port services, in which liberalisation to foreign investors could promote rapid transfer of technology, bring large efficiency gains and the development of comparative advantages in these sectors.

### Increase in Protection

At present the free trade agreements will not imply any direct increase in protection to outsiders. The question will need to be posed again when the Baltics adopt the EU's common external tariff upon EU membership. For Estonia at present levels of protection in both partners, this will necessarily mean an increase in protection. In Latvia and Lithuania, increase in protection will depend on sectors. As in many agricultural products, the overall level of protection in the Baltics is lower than that in the EU, closer


*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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integration in the longer run may lead to increased protection in the Baltics. This depends on how the EU reforms its agricultural and other policies. In the meantime, the potential for adopting the EU's common external tariff should not be used as an excuse to maintain protection in the Baltics.

By maintaining or increasing openness during the transition period to EU membership, the Baltics will help to create efficient industries that contribute to growth and trade development to other markets as well. This is reinforced by the fact that the accession process is likely to take at least ten years and in the meantime EU levels of protection may also decline. Preferential access to the EU behind high protectionist barriers may slow down transition in protected sectors.

## Deep Integration

The Europe Agreements cover deepening of integration. They have important provisions on establishment that can promote competition, foreign investment and trade (Annex Table 2). The Agreements provide for national treatment in establishment and operation for companies from signatories except in air transport, inland waterways and maritime cabotage transport services. Negotiations to liberalise these sectors are foreseen. Theestablishment of Baltic nationals (the right to take up economic activities as self-employed persons) and their operation in the EU is to take place as of end 1999 and immediately for EU nationals in the Baltics. This means that EU and domestic investors are to be treated equally as far as establishment is concerned. In principle it should cover access to privatisation programmes, which Estonia and Latvia are already implementing. However, a safeguard clause allows the Baltics to exclude establishment of foreign enterprises under certain criteria until 1999, which may include privatisation programmes. As mentioned above, Latvia and Lithuania maintain temporary and permanent exceptions in some sectors (see Annex Table 2). The Agreements also provide for some investment protection clauses. Capital mobility is required for the investment and its repatriation, to which balance-of-payments safeguards do not apply. They also commit the Baltics to adopt EU rules of capital movement in the near future. The agreement is weak on labour mobility. Negotiations on further labour mobility, and mutual recognition of qualifications, are to be undertaken later.

In the Baltics many of the above benefits are already extended to all foreign investors outside the EU. The importance of the Europe Agreements for EU investors is to provide an external framework in which the rules are



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bound, which can increase security for investors. There is no reason why the Baltics should not extend investment guarantees to all investors, which is important in avoiding discrimination and ensuring efficiency in investment. This can be done to some extent by joining the planned Multilateral Agreement on Investment (MAI) under negotiation at the OECD. At present, the Baltics have bilateral investment agreements with many countries. Estonia does not discriminate between any foreign investors, while Latvia seems to restrict land ownership to countries with bilateral agreements.

Approximation of laws in the Baltics to EU standards (see Annex Table 2) in some areas has relatively tight timetables, and is likely to promote transition. For example, by the end of 1998, Estonia will adapt its laws to those of the EU in road, rail, inland waterway and air transport. Latvia and Lithuania will do so during their general four and six-year transition periods. Intellectual property protection is to be brought up to EU standards by 1999. Approximation of laws in banking, company law, financial services, competition, standards and technical rules, and the environment will be undertaken gradually. These provisions provide an important framework for modernising laws and a standstill on certain regulations, which is likely to facilitate the transition to a market economy and to EU membership.

### Rules of Origin and Contingent Protection

The rules of origin in the Europe Agreements are relatively restrictive (Winters, 1992). In many sectors, 60 per cent of value added is required to benefit from the market access concessions. Cumulation of origin is allowed between the Baltics and is planned soon with all parties to Europe-wide FTAs. Strict rules of origin may act to deter investments in small markets, and discourage processing of non-EU materials, and may explain the lack of trade-related investments in the Baltics. The planned Pan-European cumulation could also change the situation in 1997 by allowing cumulation in all countries with FTAs with the EU.

The Agreements also maintain contingent protection. WTO anti-dumping and countervailing duty laws apply until the Baltics establish competition laws. At present the EU has used these provisions only once against one product from Lithuania. In addition, special safeguards are allowed in agriculture, textiles and other products that can reduce the security of the market access concessions. These have not been used, however. All this may reduce the investment and trade-creation potential of the Agreements.



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Other Drawbacks

The bilateral hub-and-spoke nature[14] of the Agreements tends to concentrate trade flows between the spoke (a Baltic) and the hub (the EU). This pattern has a tendency to marginalise the spoke economies (Baldwin, 1992), because it tends to encourage outsourcing by the hub from the spoke of certain processes and discourage investment there. Investment then tends to be concentrated in the hub country, as exports to and imports from other markets of the spoke are subject to barriers. This may partly explain the present pattern of EU intra-industry trade with the Baltics and the lack of trade-related investments. The Baltic Free Trade Agreement (see below) has reduced some of the potential marginalisation of trade in goods, but it remains in services. The marginalisation problem can be further reduced by the conclusion of free trade agreements with other Eastern European countries with Europe Agreements (CEFTA).

*The Impact of the Agreements*

Despite the drawbacks, the overall impact of the EU FTAs is likely to have been positive on net trade creation in the Baltics. First, the Agreements are likely to have facilitated trade re-orientation in the Baltics and contributed to export expansion. In many sensitive products – especially textiles – access to the EU without preferences would be difficult. The relatively modest levels of protection in most products in the Baltics reduce potential for trade diversion. Second, a large share of trade in manufactures is outward processing trade, especially in Estonia, but also in Latvia and Lithuania. This is likely to provide an important channel for the transfer of technology and modern management practices in the Baltics. Third, the Agreements have not led to increased foreign investments linked to better market access to the EU market. The determinants of FDI are manifold,[15] but the restrictive market access in the EU in many products, restrictive provisions in the rules of origin, and the hub-and-spoke nature of the Agreements may have contributed to this. The largest FDI inflows have been in Estonia, but they have been mostly to industries or services that do not cater to the EU market. Fourth, the conclusion of

14 Hub-and-spoke means that trade is liberalised between a large country and many small countries bilaterally. Trade between the hub and a spoke is free but subject to restrictions between the spokes.

15 Traditional motivations for FDI have been the existence of import barriers, competition in oligopolistic industries, lowering of transport or production costs, and proximity to consumers. The growing importance of services, which require presence close to consumers, can be an important determinant of investment flows.

the Europe Agreements and anticipation of EU membership are likely to have promoted progress in approximation of laws to EU standards, promoted liberalisation in the Baltics and locked in some of the reforms in the transition countries. However, the lack of specific timetables in many areas may slow down reform.

The Agreements raise a number of issues for future integration and trade relations. First, the Baltics should press for a concrete timetable for membership from the EU. This could bring further credibility to policy reforms and help attract FDI. Second, market access in the EU could be improved in sensitive products. Estonia, for example, has agreed to very ambitious goals in adjusting to various EU legal frameworks, and offered fully open access to its markets for EU goods, but was met by the EU with restrictions in several products of export interest to Estonia. While openness on its own is likely to speed up transition in Estonia and its ambitions of EU membership, there is some imbalance in the agreement. Even Latvia and Lithuania maintain less restrictions in intra-trade than the EU. Third, the EU should speed up negotiations in opening cross-border services and the removal of remaining restrictions in establishment trade. Fourth, the overall trade and investment performance of the Baltics would benefit from speedy accession to the WTO and to potential other forums such as the OECD or the planned MAI. The benefits of WTO accession are avoidance of discrimination in trade between member countries, access to a neutral system to solve disputes, and more predictable trade rules. Membership of the planned MAI can help attract FDI by increasing security of investment laws. In services, for example, liberalisation in the Baltics might be faster within the WTO framework than in the EU one.

*Intra-Baltic Integration: The Necessity of Closing the Spokes*

Intra-Baltic integration has been pursued in its own right and as a complement to European integration. A Baltic Free Trade Agreement in industrial goods was concluded in April 1994, which was extended to agricultural goods in 1997. A declaration of principle exists on a Baltic Customs Union by the year 1998. Several FTAs have been concluded or are in preparation with the CEFTA[16] countries (Table 6).

*Economic Potential*

Most of the economic arguments favouring regional integration are not

16 CEFTA membership requires the conclusion of FTAs with all CEFTA members (Czech Republic, Hungary, Poland, Slovak Republic, and Slovenia) and WTO membership.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

met by integration among the Baltic countries. The potential for static and dynamic trade gains is reduced by their small economic size and moderate incomes (Table 7). In terms of diversity there is some differentiation between Estonia and Lithuania, agriculture being more important in the latter. Production structures are similar in the Baltics – all are textile, food and wood exporters, which can reduce potential for complementarities in trade. Trade among the Baltics is still subject to a number of non-tariff barriers (border formalities, poor transport networks, payment arrangements, some licensing requirements) which reduce trade creation potential and which may not be solved by FTAs. The differences in trade policies would favour trade creation for Latvia and Lithuania with the more liberal Estonia. For Estonia deeper integration with more protectionist partners could be trade-diverting. If integration takes place within FTAs, the risk for trade diversion is reduced by Estonia's open trade regime. The main argument favouring intra-Baltic integration is the hub-and-spoke nature of the Europe Agreements. Removing barriers between each other will reduce the distortions created by the Agreements in favour of EU enterprises vis-à-vis Baltic enterprises, reducing a potential disincentive to FDI.

*The Baltic Free Trade Agreement*

The Baltic Free Trade Agreement (BFTA) meets some of the criteria set for trade- and growth-creating RTAs. In terms of coverage in goods trade it is broader than the EU FTA, as all industrial and agricultural products are included without restrictions (except some temporary export restrictions from Latvia and Lithuania – see Annex Table 2). Services trade is not covered. This may work against investment and trade creation in the region. But barriers to services trade are being reduced outside the BFTA by improving regulatory frameworks for the private sector for all partners. Protection is not increased, as all three maintain existing tariff regimes. However, some protection is provided by rules of origin and safeguards (Table 6). These may reduce potential for trade and investment creation, although the safeguards or dumping clauses have not been used by the Baltics.

The weakest element in the BFTA is the lack of provisions for **deeper integration.** The agreement does not cover establishment, labour, or other forms of liberalisation of non-tariff barriers. Some of these will be addressed in the transition process or in the EU agreements. Many laws in the Baltics will be harmonised automatically in the process of EU integration. Progress with transition will gradually remove many other non-tariff barriers such as payments problems, border formalities, transport infrastructure, etc. However, the lack of deeper intra-Baltic integration may



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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prevent investment and trade creation, especially in services, but also in other sectors of the economy. The hub-and-spoke distortions from the Europe Agreements will remain in services and some aspects of investment policies, unless they are addressed in multilateral agreements or unilaterally.

Experience so far in intra-Baltic trade flows confirms the lack of substantial trade creation among the Baltics. Existing statistics show that the share of intra-Baltic trade in all three has remained around 10 per cent, which suggests that it has increased in line with overall trade growth but not more. There is no clear pattern in the trade between the countries, which still partly reflects patterns inherited from central planning (large share of energy, special machinery). This is likely to reflect the lack of complementarities and the small size of the Baltic markets compared to other export opportunities for the Baltics or non-tariff barriers in intra-trade. There is, however, some indication of recent increases in trade in food and textiles products. This may be further reinforced by the extension of the BFTA to agricultural products. The existing structure of production would suggest that the more protected agricultural sectors in Latvia and Lithuania would be subject to much competition from Estonian producers that may promote competition and efficiency. Investment statistics indicate some participation of Baltic investors in each other's markets. In 1996 Estonian companies started to invest more in Latvia and to some extent in Lithuania, e.g. in 1996 there were over 400 Estonian companies established in Latvia.

The above raises a number of issues for the future. First, the Agreements could be deepened beyond market access in goods. The extension of the BFTA to agriculture was an important step. Extension of the agreement to services and establishment would remove potential discrimination between Baltics and EU companies. Some of these issues will, however, be addressed in the WTO accession process.

Second, deepening of integration towards a customs union (planned for 1998) should be resisted. There is a strong likelihood that this would result in higher protection. This naturally would depend on the level of the common external tariff (CET) chosen. Any duties for Estonia would mean higher protection. Despite having relatively moderate levels of overall protection, in many products Latvia and Lithuania have duties of 20-40 per cent compared to zero in Estonia. The cost of higher protection would have to be weighed against the likelihood of only moderate gains from trade creation in a small market. In any case, many of these benefits can already be achieved within the existing FTAs. Although the longer-term framework for trade policies will eventually be the EU's common external tariff, Estonia is better off maintaining its present open regime during


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transition as it will foster restructuring and transition to an efficient economy.

A customs union could also have high administrative costs. Any negotiation on a common external tariff, on rules for the distribution of tariff revenue or on how to distribute gains and losses from integration would require much costly time of the administration, which might be better used in other activities (e.g. reducing the isolation of the spokes). Many of the benefits of deeper integration can be achieved without a customs union. Extending the BFTA to services and establishment, or the reduction of NTBs, do not require a customs union.

### *Integration with the East: Gradual Re-establishment of Trade Relations*

Relations with the CIS countries have been characterised by the disintegration and gradual re-establishment of trade relations. The collapse in FSU demand and payments systems, changes in relative prices, and the establishment of border barriers have redefined Baltic trade relations with their Eastern neighbours. Political concerns slowed down the ratification of basic MFN-based trade agreements with Russia, which Latvia and Lithuania have now finalised but Estonia has not. As a result Estonia is facing double the MFN duties in its exports there. Estonia's access to Ukrainian markets was improved recently by concluding a free trade agreement with Ukraine (March 1996) that covers free trade in all goods. Russia and Ukraine are potentially important markets for the Baltics for their exports and especially for transit or other service activities. However, in both markets tariffs are unlikely to be the most important barriers to trade compared to payments problems, poor trade infrastructure and slow border clearance. Most of these issues cannot be solved with RTAs.

#### *Economic Potential*

Compared to the Baltics, the size of potential Russian and Ukrainian markets is large. At present incomes are modest, reducing the economic potential from deeper integration. In terms of diversity Ukraine, with a large agricultural sector (39 per cent of GDP), is likely to be more complementary to the Baltics than Russia (agriculture only 7 per cent of GDP). But the Baltics offer other complementarities with Russia. Geography is one, as Russia's access to sea ports to Europe is limited and the Baltics offer large potential in this. Diversity therefore can offer some trade- and investment-creation potential. Trade between the parties, despite declines during the past five years, is still a large share of the total. However, potential for trade diversion with deeper integration, especially in the remaining,



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protected “old industries”, can be large, and could slow down adjustment and restructuring. The overall level of tariffs and trade restrictions in Russia and Ukraine is higher than in the Baltics (Table 6), suggesting that an FTA could lead to trade diversion, especially in Latvia and Lithuania.

*The Agreements*

At present the only free trade agreement with the CIS countries is between Estonia and Ukraine. This is very liberal in nature as all trade is covered (including agriculture) and there are no transition periods. The FTA implies no increase in protection. Many non-tariff barriers exist in Ukraine, which limits trade creation. These are more related to transition to a market economy than to trade policies. Deeper integration at this stage with Ukraine may not bring many benefits until transition proceeds further in Ukraine. However, exports to Ukraine seem to have increased since the FTA.

Trade relations with Russia have been governed only with regular MFN agreements in Latvia and Lithuania. Estonia has no agreement with Russia, which has led to higher duties on its exports than the MFN duties. Nevertheless, Estonia has been able to export some products to Russia. Any further trade integration is likely to lead to few benefits until Russia progresses with transition. Most trade barriers are still related to non-tariff ones. An MFN agreement between Estonia and Russia should be concluded. The main potential in trade with FSU at present is offered by transit trade via the Baltics, which can take place without trade preferences. Its development is more dependent on the development of infrastructure, investment in more efficient services, etc. Openness to investors from all sources could promote efficiency. WTO membership should reduce discrimination.

## V Conclusions

Despite similar RTAs, the difference in trade and FDI performance among the Baltics highlights the importance of other factors in export and investment performance. The most prominent among these is progress with transition. Estonia stands out among the Baltics in trade, FDI and transition performance, although all three have performed well. Estonia has the most liberal trade regime, is the most advanced in developing private sector incentives, and has the highest savings rates. Regional integration agreements with Europe have been important in contributing to Baltic trade performance and are likely to remain so in the future. Trade creation


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is likely to dominate trade diversion. However, their contribution to FDI has so far been minor. In the absence of WTO membership these RTAs created a basic framework for foreign trade and economic relations for the Baltics. Their application for EU membership will form the basic framework for their future trade policies.

The RTAs with Europe are likely to have contributed to increased intra-industry trade with the Baltics and rapid approximation of laws to Western standards. Restricted market access in agriculture, fisheries, textiles, and services in the EU, restrictive rules of origin, safeguards, and the hub-and-spoke nature of the Agreements can explain some of the poor FDI performance, although the stage in transition and progress in introducing market-oriented policies are likely to be more important in this. The FTAs with the EU are likely to have promoted liberalisation of trade policies in Latvia and Lithuania. The Baltic FTA has not resulted in expected increases in trade (or investment). Trade with the FSU countries faces many non-tariff barriers and after initial decline increases, especially in energy, but food exports have also increased in recent years.

In the highly trade-dependent Baltics future growth potential will continue to depend to a large extent on trade developments. Most important will remain progress with transition – maintenance of macroeconomic stability, structural policies that promote allocative efficiency and improve incentives and legal frameworks to private sector development to attract FDI, and higher savings for investment. RTAs can continue to play a role in promoting liberalisation and locking in policy reforms. Preparation for EU membership will dominate trade relations and will gradually harmonise policies within the Baltics. The preparation process would be helped by clearer timetables for accession and policy reforms, better access in sensitive products, and coverage of services. Baltic integration and that with other Central and Eastern European countries with Europe Agreements should be deepened within FTAs to reduce the trade and investment barriers from the EU's hub-and-spoke system of RTAs. A Baltic customs union is not recommended as it would bring few benefits and have high administrative costs. Deeper integration with the FSU is not likely to offer many benefits, but in the medium term these markets offer a large trade potential in both goods and services. Although RTAs can help market access in the near term, the Baltics should consider other agreements such as the OECD's agreement on investment or the planned Multilateral Agreement on Investment that can foster further liberalisation and FDI and increase the credibility of policy reforms.



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# Annex Tables

**Annex Table 1 Synopsis of the Trade Regimes of the Baltics – 1996**

Estonia

| | Quantitative restrictions | | Tariffs/Taxes | |
|---|---|---|---|---|
| | *Imports* | *Exports* | *Imports* | *Exports* |
| **Current regime** | Import restrictions are limited to those required for health and security reasons. | There are no quantitative restrictions on exports. | Zero. | Export tax of 100% applies to items of cultural value. |
| **Other obser-vations** | | | Antidumping legislation has been submitted for parliamentary approval. | |

Latvia

| | Quantitative restrictions | | Tariffs/Taxes | |
|---|---|---|---|---|
| | *Imports* | *Exports* | *Imports* | *Exports* |
| **Current regime** | Imports of sugar, grains and alcohol are subject to quotas; licensing requirements apply to imports of tobacco and sugar. | | Basic rate on final goods is 20% (the MFN rate is 15%), and on inputs 1%; average production weighted tariff on agriculture is 53% (average MFN rate is 46%), and some specific rates apply. Average tariff for non-agricultural goods is 3.7%. | Export taxes apply to waste/scrap materials, round logs and art works/antiques. |
| **Other obser-vations** | | | Reference prices for some imports. | The export taxes on waste/scrap metals and round logs scheduled to be eliminated by end-1998. |



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Annex Table 1 (continued)

**Lithuania**

| | Quantitative restrictions | | Tariffs/Taxes | |
|---|---|---|---|---|
| | *Imports* | *Exports* | *Imports* | *Exports* |
| **Current regime** | Tariff quotas apply to import of some agriagricultural goods, alcohol, raw sugar, live pure-bred, poultry, cereals, glass bottles. | A temporary exportbans remain on 5 product categories (red clover seed, feathers and down used for stuffing, raw skins and hides, certain type of timber, and certain glands and organs). | For non agricultural products, there are 7 rates ranging from 0% to 30% most goods carry a duty between 5 and 15%, though many enter duty free, and higher rates on some foods, alcohol, and tobacco. The average tariff on non-agricultural goods is 3%. For agricultural products, tariffs range from 14% to 45% with an average of 27.5%. | A temporary export tax of 50% is levied on raw skins and hides, and certain and, certain types of wood. |
| **Other obser-vations** | | | Reference prices on some imports. | |

*Source:* Leidy-Ibrahim (1996).



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**Annex Table 2 Summary of Baltic-EU Europe Agreements**

**Estonia**

| Market Access | EU | Estonia |
|---|---|---|
| Agriculture | • Reduced duties on 15 products (honey, plants, berries, cucumbers, apple juice); some berries subject to minimumprices (Annex III).<br>• Tariff quotas for meat (live animals, bovine meat, sheep meat); levy within quota 25 or 40 percent of regular levies (Annex IV).<br>• Tariff quotas for 10 products; levy 40 percent of regular, increasing quantities until 1997 (pork, chicken, milk powder, cheese, potatoes, apples, sausages) (Annex V).<br>• Tariff reductions for 41 processed agricultural products, 13 of which are subject to increasing quotas until 2000(sweets, beer, vodka, chewing gum, drinks) (Protocol 2 - Annex I, II).<br>• Regular tariffs on other products. | • Zero duties. |
| Fisheries | • Tariff quotas on 6 products (duties 0-10 percent) (Annex VI).<br>• Regular tariffs on other products. | • Zero duties. |
| Industrial goods | • Zero duties (textilessubject to surveillance) (Protocol 1). | • Zero duties. |
| Services | • Negotiations on liberalisation of cross-border services to start 8 years after ratification. International maritime transport services open access. | • Same as EU. |
| Investment | • National treatment in establishment of companies (except in some real estate), in 1999 for Estonian nationals, except in air transport, cabotage and inland waters. | • National treatment in all establishment except in the same 3 transport sectors as EU. Free capital and current account transfers. |
| Labour | • Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed. | • Same as EU. |
| Approximation of laws | | • In road, rail, inland waterways by end 1998. TRIPS by end 1999, commercial law gradually. |



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**Annex Table 2 (continued)**

**Latvia** (4 year transition period)

| Market Access | EU | Latvia |
|---|---|---|
| Agriculture | • Reduced duties on 13 products (honey, plants, roses, mushrooms, cucumbers, berries, apple juice); some berries subject to minimum prices (Annex VII). | • Some tariff reductions for 146 products, 26 of which subject to quotas (meat, cut flowers, vegerables, wheat, margarine, sausages, wine) (Annex X). |
| | • Tariff quotas for meat products (live bovine animals, meat, sheep meat); levy within quota 25 or 40 percent of regular (Annex VIII). | • Tariff reductions by 2000 on 127 processed agr. products (Protocol 1 - Annex III). |
| | • Tariff reductions for 14 products; levy 40 percent of regular, increasing quantities until 1997 (meat, milk powder, butter, cheese, tomatoes, vegetables, sausages) (Annex IX). | • Tariff quotas on 6 processed agricultural products increasing over 6 years (yogurt, bread, soups, gin) (Protocol 1 - Annex IV). |
| | • Tariff reductions on 10 processed agr. products; 10 of which subject to quotas increasing until 2000 (sweets, beer, vodka) (Protocol 1 - Annex II). | |
| | • Regular duties on other products. | • Zero duties on other products. |
| Fisheries | • Tariff quotas for 5 products (Annex XII).<br>• Regular tariffs on other products. | • 6 products with tariff quotas (Annex XIII).<br>• zero duties on other products. |
| Industrial goods | • Duty free quotas (Annex V) in textiles; surveillance of textiles (Protocol 1).<br>• Zero duties on other products. | • 23 products (cement, luggage, skins, footwear, textiles, ceramics) duties to zero by 1997 (Annex II); 28 products (some footwear, machinery, electronics, furniture) duties to zero by 1997 (Annex III).<br>• Export duties on 16 products to be eliminated by end 1998 (gypsum, hides, wood, metal scrap) (Annex IV).<br>• Zero duties on other products. |
| Services | • Negotiations on liberalisation of cross-border services to start 8 years from ratification; maritime services free access. | • As EU. |
| Investment | • National treatment in establishment except in air transport, cabotage and inland waters; real estate, and Latvian nationals in EU. | • National treatment in esrablishment except in weapons manufacture, gambling, real estate, port infra structure ownership (until end 1988), and the 3 transport sectors. Free capital and current account transfers. |
| Labour | • Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed. | |
| Approximation of laws | | • In road, rail, inland waterways by end 1998. TRIPS by end 1999, commercial law gradually. |



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**Annex Table 2 (continued)**

**Lithuania** (six-year transition period)

| Market Access | EU | Lithuania |
|---|---|---|
| Agriculture | • Reduced duties for 11 products (horses, duck livers, honey, vegetables, mushrooms, berries, apple juice) Annex IX; minimum prices on berries.<br><br>• Tariff quotas for meat products (live bovine, animals, bovine and sheep meat); levy 25 and 40 percent of regular (Annex X).<br><br>• Tariff quotas for 10 products at increasing quantities until 1997; levy 40 percent of regular (pork, chicken, milk powder, butter, cheese, tomatoes, garlic) (Annex XI). | • Reduced duties until 2000 on 95 products (Annex XII) 15 of which subject to quotas increasing until 2000 (Annex XIII). |
| | • Tariff reductions for 12 processed agr. products (sweets, vodka); 4 of which subject to increasing quotas until 2000 (Protocol 2 - Annex I, II). | • Reduced duties (by 2000) for 21 processed agricultural products (Protocol 2 - Annex III). |
| | • Regular duties on other products. | • Zero duties on other products (Annex XII). |
| Fisheries | • Tariff quotas for 10 products (Annex XIV).<br><br>• Regular duties on other products. | • Tariff reductions over 6 years for 6 products (Annex XV).<br><br>• No restrictions on other products. |
| Industrial goods | • Duty free quotas in textiles (Annex VI). Surveillance of most textiles (Protocol 1).<br><br>• Zero duties on other products. | • Footwear duty elimination in 1997 (Annex II).<br><br>• Duties on 122 products to be eliminated by 2001 (metal products, plastics, wood products, footwear, appliances, electronics, furniture) (Annex III).<br><br>• Duties on used cars to zero by 2001 (Annex IV).<br><br>• Elimination of export duties by 2001 (hides, wood, metal scrap) (Annex V).<br><br>• Zero duties on other products. |



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**Annex Table 2 (continued)**

**Lithuania**

| Market Access | EU | Lithuania |
|---|---|---|
| Services | • Negotiations on liberalisation of cross border services to start 8 years after ratification. International maritime transport services open access. | • As EU. |
| Investment | • National treatment in establishment of companies (except in some real estate), in 1999 for Lithuanian nationals, except in air transport, cabotage and inland waters. | • National treatment in establisment except acquisition of land, mineral deposits and natural resources; gambling, and temporarily in manuf. of alcohol, exploitation of natural resources, post and telecom, services until 2001; and in 3 transport sectors. Free capital and current account transfers. |
| Labour | • Limited to temp. movement of professional service providers; mutual recognition of qualif. to be examined; end 1999 labour movement reviewed.<br>• As EU. | |
| Approximation of laws | | • In road, rail, inland waterways by end 2000.<br>TRIPS by end 1999, commercial law gradually. |

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# Comment on "The Global and Regional Outlook in the Baltics," by Piritta Sorsa

*Mats Karlsson*

Jan Klacek joked yesterday that Prague was the centre of Europe by all definitions. I don't think I have been in any country that doesn't view itself as the centre. But even if you take Brussels as the centre of Europe, you will find that Tallin is equidistant from Brussels with Lisbon, Dublin and Vienna. And Athens is equidistant from Brussels with Reykjavik, but of course the idea is to create a union which is not dependent upon geography, but upon the idea of shared values. These are not necessarily European values, but clearly they are the values which are embodied in the first Copenhagen criterion for enlargement. There are also the visions, the dynamism and the willingness to take on a membership ethic, and that is the fourth Copenhagen criterion which defines what this whole operation is about. I begin with this because I find that the Baltic states are not included in many conferences and reflections on the enlargement, and that annoys me. In fact, it is at odds with what the European Union tradition really is. I also believe that is why this is a special enlargement, in spite all of the difficulties. In the coming few years, intensive work will be undertaken to ensure that this enlargement takes place and takes place soon. There is a chance that the first enlargement will be a broad one, which the NATO enlargement certainly will not be.

Having been the beneficiary of this European Union attitude toward enlargement, and looking at the Baltic States' enlargement from a Swedish point of view, we want to extend these benefits to others. For us, it has to do primarily with security reasons, and permanently changing the situation.

There are also dynamic economic reasons. The figure of 0.2 per cent for the European Union carries political significance for current members who might want to stall the enlargement. But if you look at it from the Baltic sphere, it is clear that in a generation or so, immense gains can be realised by integrating over the Baltic Sea. This will create a boost in Nordic structural change which is extremely important. Gravity models work over a stretch of water as narrow as the Baltic Sea as well as over a Central European river – and you can cross the Baltic Sea more easily than some Central and Eastern European mountains.



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We must also keep the time dimension in mind since we are talking about a rather long stretch of time. This transition started in 1989. It is now 1997, and we are talking about accession between 2000 and 2005. If we add to that a transition period of perhaps 5 to 10 years, we have a 13-year minimum from the beginning of the process to actual membership, and about 16 to 26 years if you include the transition period – that is a long time. Why any differences that may exist between the Baltic states and the Central and East European countries should not be overcome during this period I find hard to understand. The Baltic states may be perceived as small and distant or they may be associated with conflicts with Russia, but a closer look reveals that real change is taking place. The perspective that the Baltic states are frequently placed in is the result of a sort of laziness that is part of the European intellect. There is a lack of imagination, and we know how that attitude has affected some issues in other parts of Europe's disastrous history.

The Baltic states have a proven record. There is democratic change on the political front. There is an immature political party system, but uncertainty in the party systems of other current member countries exists as well. The issue of human rights is often made out to be a very big one. We can always discuss more practical compromises, but the human rights situation in the Baltics meets all international standards. Soon, outstanding border issues with Russia will be settled, so we are clearly over the threshold politically. Economically, they are also within the mainstream. They are through the first generation of reform, and they started from a worse position. Estonia is rightly singled out as having come further, but over a period of time the differences will not be that dramatic. Given their initial difficulties, there is a lot of imaginative dynamism there. They have no easy windfall gains like tourism in Prague, which significantly boosts Czech figures. This must be kept in mind when judging the Baltics.

There are some issues which need to be dealt with. Administrative capacity in the Baltic states has a long way to go. For example, a rule of law must be established. Organised crime is making life difficult there and restricting foreign direct investment. Long-term success in these countries will be easier if Russia changes, but even without changes in Russia, things are going quite well – just look at the trade statistics we just heard.

If we turn to some Baltic spheres of integration, there is an emerging political coordination on a number of political issues, but these countries are vastly different. Even during the interwar period, they were not working very closely with one another. But they are doing themselves a disservice by not working more closely politically and economically given their small markets. Such cooperation would instill confidence and attract greater foreign direct investment.



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There was criticism of a customs union and I can understand that – Estonia would have to raise tariffs and so on. While no tariffs or a sort of unilateral liberalisation is a first best choice in all theory, are we really sure that this is the case in all transition situations? Mr. Drábek mentioned the glass industry and how it is included in the sensitive goods from the European Union. What would happen to the glass industry of the Czech Republic if there were to be unilateral liberalisation? These issues require more thought.

Turning to relations between the Baltic and Nordic countries, the 5 plus 3 notion may not be a concept in Central Europe, but it is clearly an issue in Nordic politics. There is a network between local communities on the regional level as being of singular importance in changing the way things are done, for modernisation in administration. We can speak of expanding that sphere to the full Baltic Sea states region and include Poland, Germany and Russia, and it becomes an important grouping with great potential. In May 1996 at the Visby Summit, leaders of the countries around the Baltic Sea established the basic guidelines for this evolving region within Europe. Furthermore, the ministers for foreign affairs in the Council of Baltic Sea States adopted three action programmes on people-to-people contacts, on economic and infrastructural cooperation, and environmental issues in July 1996. These are important for attracting FDI and for overcoming the obstacles to integration.

With regard to CEFTA, no doubt there is a lot to be gained by this integration. We have a beauty contest syndrome with regard to accession to the European Union. Mr. Drábek spelled out the post-Soviet unwillingness to create anything second or third best to full integration that is reminiscent of old Cold War map groupings, but the European Union is about membership solidarity and ethic. I am not saying that what is going on in Brussels is always ethical and transparent, but the willingness to take on membership responsibilityis one clear requirement. This means that to be welcome, you must show that you are a partner who can take on multilateralist responsibility. As accession draws near, the present members are going to look to see what kind of creature you are. If you have a proven track record of behaving and cooperating with your neighbours, your competitors and even those you are not fond of, then you are going to have a greater chance of achieving your interests. CEFTA is important as a pre-accession issue. Another important issue is that some are not going to get in in the first round. We need something that goes beyond the hub-and-spokes attitude. Sweden's accession was made easier as a result of the European Economic Area. This idea needs to be developed for those who might not get in in the first round. It is, in fact, also interesting for those who do get in in the first round because they are going to be neighbours



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with somebody who did not. This might be the case with the Czech Republic and Slovakia, for example.

Some final points on European Union membership. We need to seriously and substantially begin membership negotiations. This is clearly a Swedish security issue, but I believe there are also clear economic arguments as well as overall political arguments in Europe for the initiation of such negotiations. The main reason is that no matter what we do with regard to integration, whether in the European Union or in NATO, we must not create situations where countries risk being unable to influence their future. If you block someone from participation in the core, you create very unwelcome problems. This frustration can be the ground for populists to play havoc with Europe as they have done so frequently in our history. And we know from Sweden and Austria, there is a lot of scope for populist, anti-European feeling that can work against enlargement. We believe we are building a new Europe, but we must be very careful of what kind of frustrations we build into the enlargement process.

Winning the public is very much an issue of looking after your own interests. That is why the transition needs must be defined clearly and early. Yet, I see very few clearly spelled-out demands of the applicant countries on the Union for what kind of transition arrangement or considerations would be interesting for them. If you think you have none, then you need to look again because many issues evolve during the process which you don't foresee and I speak from Sweden's experience. We need to look at whether the political framework for the enlargement process is really in place. Ultimately, it is in everyone's interest to make the Union work. This is important because there is a clear dialectic between the integrational aspects and the transformation aspects. We are in the second transformation generation, involving institution-building. You must also discuss the social issues: what kind of Europe are we going to build? The European Union has built a strong common ground around the social market economy, and this common ground is part of the force for enlarging the European Union.



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# Comment on "The Global and Regional Outlook in the Baltics," by Piritta Sorsa

*Inna Šteinbuka*

Latvia is the geographical centre of the Baltics, but the question of regional and sub-regional integration is not only a question of geography. The regional integration of the Baltics should be considered in a very broad context. I would like to comment briefly on Latvia, focusing on some macroeconomic and legal aspects of its integration into the European Union.

Important preconditions are the prospects for macroeconomic and legal convergence. When I compare what I know about Latvian macroeconomic performance, as an insider, with what has been drafted in various papers at this conference, the discrepancies are quite substantial. This is not meant as a criticism because even in Latvia the available statistical information is contradictory, which does not facilitate gaining a coherent view of the situation. Therefore, I would like to fill in to some extent the information gap about Latvian prospects in ensuring sustainable growth.

The income gap with the European Union is a crucial problem for Latvia. Latvia has a low GDP per capita coupled with low growth. After a downward trend in 1995 (-1.6 per cent in real terms) in 1996 GDP growth is expected to be around 2.5 per cent. The Ministry of Finance has worked out a prognosis of Latvia's economic and financial development up to the year 2002. Possible development is projected within two scenarios: base scenario and accelerated structural reform (ASR) scenario. The ASR scenario assumes that the government is able to promote the necessary private sector development and industrial restructuring. What are the factors driving growth? Higher level of investment and particularly FDI allow an increased growth of export and output. GDP growth accelerates from 3.8 per cent in 1997 to 5.6 per cent in 2002.

The main challenges for policy are to promote growth through investment. FDI in Latvia has increased since 1992, but remains relatively low (in 1996 the cumulative per capita FDI inflows amounted to $239). The main impediments to FDI inflows are of a structural nature. Privatisation must be accelerated, restructuring should continue and some restrictions should be eliminated, especially in bureaucratic procedures. The increase in FDI will be facilitated by:



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- The establishment of the Baltic free trade zone (after 1 January 1997) and Latvia's joining of WTO (planned for 1997);
- The BBB (investment grade) credit rating assigned to Latvia by *Standard Poors* will encourage FDI both directly and indirectly.

Low interest rates and a more soundly-based banking system may encourage domestic investment. The limited availability of capital is perhaps the most binding constraint on the economic growth. With regard to lending processes, bank lending rates are falling dramatically. In 1994, lending rates were 70 per cent, in 1995 they fell to 40 per cent and in 1996 lending rates were around 25 per cent. Still, structurally related microeconomic problems, such as difficulty with arranging collateral for loans, have caused the contraction in lending and this is in spite of commercial banks' extra reserves.

To my mind the convergence criteria will not play a major role in the accession process. I think the Union will not look so much at quantitative indicators, but primarily at qualitative improvements, i.e. the capacity of the country to correct macroeconomic distortions with policies and instruments that are compatible with the market mechanism in general and EU rules in particular.

If one takes a look at the actual state of Latvia's compliance with the Maastricht criteria, bearing all these qualifications in mind, a rather positive picture emerges (low fiscal deficit, reasonable state debt, low inflation, etc.)

However, more interesting than the actual state are the prospects for macroeconomic convergence. Most recent economic forecasts within the ASR scenario contain a positive prognosis with fairly high growth, slowly falling inflation and further fiscal improvement.

Any problems Latvia has experienced with fiscal deficit can be related to 1995 when Latvia faced an internal banking crisis. At that time, the general government fiscal deficit reached its peak (3.5 per cent of GDP) which is, in fact, not critical. In 1996 the fiscal deficit is even below IMF targets and the Latvian government has already adopted a zero-balanced government basic budget for 1997 in terms of fiscal deficit. Both base and ASR scenarios show that the fiscal deficit will be maintained up to 2002 within the limits that are set in the Maastricht treaty, thus reducing the likelihood of any increase in the external debt.

Foreign debt in Latvia in 1996 amounted to 16 per cent of GDP (internal debt 7 per cent and external debt 9 per cent). Compared with a number of EU member states, these figures are encouraging. As a result of fiscal discipline, the debt will decline as a proportion of GDP.

It is clear that a series of problems will have to be tackled on the road to further convergence with respect to inflation. It should be stressed that



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inflation has been substantially reduced and come close to single-digit levels in Latvia. The 1996 inflation rate was 13.1 per cent (December to December) or 17.6 per cent (year to year), which is low by transitional economy standards. A significant further lowering of inflation will, however, be a difficult task, taking into account in particular the persistence of several elements of cost-push inflation (e.g. the full adjustment of energy prices to cover costs and allow for adequate profit margins or with respect to nominal wage pressures).

I agree with Piritta Sorsa that the reason for inflation was and will be the adjustment to international price levels. By IMF estimate, the Latvian price level in 1996 may be around 60 per cent of the US price level. The space for the adjustment of prices is in the non-tradable sector, particularly in transport services, housing and energy.

It is instructive to note that in spite of price rises and the dramatic appreciation of CPI-based nominal exchange rates, the margins for competitiveness still remain, and there are two clear indicators of this: low wages (around $200) and accumulation of foreign reserves. Considering the very strict budget and conservative growth, the wages continue to be low by Western standards.

Let me stress the importance of Legal Convergence. Economic and monetary union embodies a set of institutional and legal provisions, particularly in the fields of central bank independence and the prohibition on budgetary financing by central banks. A related issue is full convertibility, which not only constitutes a main element of Stage One of economic and monetary union, but is also a precondition for joining the EU internal market.

The prohibition on budgetary financing by the central bank (Article 104 EC Treaty) has been met. Lending to the Government is strictly limited in terms of amount and maturity. The Bank of Latvia is not involved in budgetary financing any more. Fiscal deficits weremainly covered by T-bills. In the area of convertibility, current and capital account transactions have already been fully liberalised. Latvian currency is convertible according to Article VIII of the IMF's Articles of Agreement.

Integration into the EU as the central goal of Latvia's foreign policy helped us to mobilise all our efforts to achieve the necessary institutional and legal changes, that, in turn, contributed to the overall stabilisation of the economic and political situation of the country. The new Customs Law expected to come into force by the middle of this year will better serve both state and private business needs. Also, a capital market is developing quickly. To a large extent this is a merit of a well-organised securities market, which is considered as one of the best in the transition economies from a legal and institutional point of view. In addition, banking and insu-



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rance sector regulations were considerably strengthened and meet so-called "Stage I" requirements.

Finally, let me stress that the European Commission has suggested to work out a project on the medium-term economic strategy in cooperation with local experts. The importance of this project cannot be underestimated. Currently, the IMF approach is dominant among Latvian politicians. The elaboration of an alternative medium-term economic strategy with the assistance of DGII will play an important role for Latvia on its way to joining the European Union.



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# Comment on "The Global and Regional Outlook in the Baltics," by Piritta Sorsa

*Per Magnus Wijkman*

Piritta Sorsa's paper marshals the facts nicely, provides incisive insights and presents diplomatically formulated understatements concerning policy recommendations. My comments will focus on a question common to all the countries treated at this conference: what is the right policy balance between regional economic integration, global economic cooperation and domestic reforms? While EU membership is the declared policy priority for most countries in former "Eastern Europe", it is unlikely to occur in the near future. The best way to speed up accession may be to hasten domestic reforms, to participate in key international economic institutions and to deepen integration in Europe. This is especially true for the Baltic countries.

The prospects that the Baltic states will achieve EU membership in the near future are less bright than for other states. They are small countries on the periphery of the European Union. The are close to the ex-USSR, they lacked national institutions when they regained independence. Hence, institution-building is crucial for their transition to a market economy and this takes time. Consequently, the Baltic states face special and formidable challenges in their pursuit of EU membership. They may not be the last in the queue, but they can hardly be said to have a head start in the race. A number of states have indicated that they expect to become EU members immediately after the turn of the century. In my view some time around 2010 is a more likely date for most countries. With EU membership uncertain and distant, it would be most unwise to focus policy efforts exclusively on that goal. All eggs should not be put in one policy basket. The appropriate balance for the Baltic States must include a heavy emphasis on domestic reform and participation in Western economic organisations other than the EU.

## Regional Integration

Sub-regional integration is often advanced as a stepping stone to EU membership. True enough! But this begs the key question: what is the appropriate sub-region? The European Commission made a Baltic Free



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Trade Agreement a pre-condition for the Europe Agreements in much the same way as CEFTA was made a precondition for trade agreements with the Visegrad four. These trade agreements are good in principle but one deludes oneself if one believes that they will contribute much to solving the economic and political problems of the Baltic countries. Piritta Sorsa's paper well illustrates the limited benefits that such sub-regional integration provides for the Baltic countries by highlighting the relatively small size of intra-Baltic trade. Creating a Baltic sub-region and linking it to CEFTA can hardly be a primary policy option for the three Baltic states. It would be little more than a satellite appended to a satellite dependent on Brussels.

The relevant sub-region for them is Northern Europe. No doubt they find it more interesting to deepen East-West integration in Northern Europe than to strengthen North-South integration on the eastern fringe of Europe. The trade routes of the Hanseatic League once connected the Baltic Sea with the North Atlantic Sea and probably still provide a useful basis for sub-regional integration. Each Baltic State may well havegreater communality of interest with the Nordic countries and Germany than with each other and with the CEFTA countries. Upon regaining independence the Baltic states expressed interest in becoming members of the Nordic Council, reflecting their perceived communality of interest. At the time the Nordic states were preoccupied with securing EU membership. Maybe they would be more receptive to such overtures today than they were then. If so, they could provide an important contribution to sub-regional cooperation.

The same reasoning applies to the other countries in Central and Eastern Europe. They also assign top priority to East-West integration rather than to deepening or widening integration through CEFTA. The sub-regions that interest them include at least Germany, Austria, France or Italy in Western Europe. Hence their understandable reluctance to define sub-regions as encompassing only countries in the east of Europe.

Sub-regional integration is a useful exercise in the proper context. Clearly, the eastern countries can benefit from extending the free trade now established with the EU to each other as well. In economic terms, it does not make sense for them to discriminate against each other in favour of the countries of the EU. But in political terms, it makes sense for them to want this pan-European free trade to take place within a Pan-European institution. They are reluctant to set up a sub-regional trading institution in the east which is then linked with a sub-regional trading institution in the west of Europe. they view Europe as the relevant region of which they are a part and wish to see institutions which encompass the region as a whole.

A European customs union encompassing the EU and the applicant



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countries would accomplish this. It would eliminate the hub-and-spoke patterns which favour investment in the hub rather than in the spokes. It would provide a common set of rules of origin and full cumulation of origin throughout most of Europe. It would make it easier to deal with contingent protection and restrictions on sensitive products. While acknowledging the benefits of the Europe Agreements, Piritta Sorsa illustrates nicely what she calls "a certain imbalance" in the agreements. For instance, the EU's quotas on textile exports from Latvia and Lithuania curtail the development of a sector where there is a large potential for trade and foreign direct investment. The same applies to the surveillance on textile imports from Estonia. These types of restrictions are easier to maintain in a hub-and-spoke system where the hub negotiates bilaterally with each spoke. The bargaining power of the "spokes" is strengthened in a Pan-European institution by the possibility of forming coalitions with each other and with individual members of the hub.

## Domestic Reform

Vigorous domestic reform is a pre-condition for EU membership. Key domestic policies in the Baltic countries are liberalisation of markets, privatisation and adoption of the *acquis communautaire* especially in the areas of competition policy, company law and services. In addition, the Baltic countries need to build institutions and train personnel in the fields of tax collection, statistical systems and customs administration. Successful domestic policies in these fields are essential for attracting investment, especially foreign investment, and promoting growth. Growth can dramatically improve the prospects of accession simply by closing the income gap. If the applicant countries grow at 6 per cent per annum over the next ten years while the EU countries continue their long-term trend of 1.5-2.0 per cent growth, many of the budgetary concerns vexing the tired economies of Western Europe can be eased.

Piritta Sorsa rightly stressed that the Baltic countries have a strong comparative advantage in services, in particular tourism and transport. The service sector's growth potential lies in exports to Western Europe and in *entrepôt* trade between Western Europe and Russia, given the appropriate transport infrastructure. Realising this growth potential depends on obtaining Western marketing skills, technology and capital. Foreign direct investment can play a critical role to this end. It will come on a sufficient scale only if the appropriate domestic policies are in place. This requires a legal framework that can protect private property rights and ensure law and order. Furthermore, the Baltic countries need to adopt the *acquis communautaire* in transport, telecommunications and financial services.



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## Participation in Western Economic Organisations

The high probability that there will be a long waiting period for a significant number of countries underlines the need to anchor the applicant countries securely in Western institutions such as WTO and the OECD during the pre-accession period. Nevertheless, several countries in Eastern Europe have experienced difficulties in becoming members of WTO, and progress in attaining membership in OECD has been slow.

Our mental map tends to remain one where Europe is divided into an eastern and western part without pan-European institutions. The countries of the former CMEA and Warsaw pact remain in an institutional vacuum waiting to be admitted into Western institutions, whether EU or NATO. This may not worry those geopoliticians who feel that the balance of power has shifted sufficiently so that developments in Russia do not constitute a threat to states bordering on Russia. But one does not need to believe that what we today assume is irreversible can indeed be reversed to have cause for concern. It is sufficient to note that the political stability of these countries depends on economic progress and that this in turn depends on rapid economic and political integration with the West. Therefore it is imperative that pan-European institutional arrangements be set up to anchor these countries securely among the Western democracies in the long interim period that for many of them may well proceed membership of the European Union.

This may be difficult to imagine, but if the EU can have a customs union with Turkey, why can it not have a customs union with the other applicant countries to the EU? A customs union was considered as a part of the EEA Agreement but was rejected by those countries which wished to maintain their own commercial policy towards third countries. This is not the case with the applicant countries who are prepared to accept the EU commercial policy. Given their readiness, the question is rather: why do they not unilaterally adopt the EU tariffs sooner – rather than later? A customs union encompassing the EU and all applicant countries would be an important step in integrating the European region. It would be especially important to take this step if EU membership appears to take time for many of the applicant countries.

## Conclusion

Let me conclude in the spirit of the hierarchy of values that Miroslav Hrnčíř has referred to. What is the European Union all about? It is ultimately to achieve post-war reconciliation and ensure peace in Europe. The common market is more than a free trade area. The internal market is



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more than a programme of supply-side economics. The pooling of national sovereignty is to achieve more than just economic prosperity. The fundamental aim of the common endeavour that is the European Union is to ensure that national rivalries in Europe will never again set off a world war. Two world wars in this century have left a bitter heritage. The European Union has been extremely successful in overcoming this heritage. It has produced post-war reconciliation between Germany and its western neighbours. However, the process of reconciliation has only recently been started between Germany and its eastern neighbours in the new Europe that has emerged after the fall of the Berlin Wall. Completing this unfinished business is a major task for the European Union. Czechoslovakia and Poland were, after all, the prime victims of the German aggression that initiated the Second World War. The war would have started sooner if France and the United Kingdom had honoured security commitments to Czechoslovakia as they later did in the case of Poland. The logic of post-war reconciliation and peace through economic and political integration that has proved so successful in Western Europe also holds for Eastern Europe. The first step in this process is EU membership for Poland, the Czech Republic and Slovakia. The *economic* difficulties of eastern enlargement are well known – but beside the point. Post-war reconciliation with the first victims of the Second World War is a *political* imperative. The accession of these first victims of the Second World War cannot be allowed to be determined by a purely economic calculus. If this happens, the European Union will have lost its soul and raison d'être.



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# Floor Discussion of the Sorsa Paper

## The Identity of the Baltic States and Sub-Regional Cooperation

The discussion began with various ideas on how the Baltic states should be viewed. Franz-Lothar Altmann asked about Estonia and its relations with CEFTA and Russia. "Why is Estonia not interested in CEFTA while Latvia and Lithuania are? Also, Russia has concluded MFN negotiations with Latvia and Lithuania; why haven't MFN negotiations between Russia and Estonia been concluded? Is Estonia trying to find its own way or is there a lack of concerted behaviour between these three countries with regard to sub-regional behaviour? My second question concerns the Baltic Sea Council. It is a rather young programme, but I would be interested in knowing what programmes it has developed so far and whether they appear promising?"

Friedemann Müller questioned the pessimism regarding Baltic integration. "The Baltics together have fewer inhabitants than the Czech Republic or Hungary; why shouldn't it be possible to put a little bit of healthy pressure on them to compromise among themselves so that they can present themselves in a more common way toward Europe? When the three Baltic foreign ministers come together, they receive much more attention than one alone does. What is the rationale behind not asking them to be more integrated?"

Mats Karlsson disagreed and supported the distinct identity of the Baltic states. "It is true that the Baltic states are doing themselves a disservice by not cooperating on various political and economic issues. But when I hear this formulation of the question, I jump to the other side. Smallness is part of what they are, and there are many small countries in the world; we have to make room for them and recognise their differences. We cannot expect these countries to creep out of Soviet domination and then be grouped into some kind of in-between entity. They must live out their identity, and that is just part of the process. It is not surprising that countries adopt different attitudes toward regional and sub-regional cooperation."

Franz-Lothar Altmann suggested the usefulness of sub-regional cooperation arrangements such as the Baltic Sea Council. "It is unique in that some countries such as Germany or Sweden are EU members while others are not. It would be interesting for these non-member countries to have links via the member countries. I would argue in favour of these sub-regional cooperation arrangements as interlinking instruments. Other



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instances of these overlapping circles exist, and from membership in smaller cooperation schemes, you can gain access to larger arrangements."

Inna Šteinbuka observed that the Baltic Free Trade Agreement had aroused much discussion in the Baltic countires. "In fact, in Latvia there was a lot of discussion about the possible outcome of the agreement. Latvia is somewhat more expensive, so there was naturally concern that a free trade agreement, particularly in agriculture, would result in disadvantages for the domestic Latvian producer. While the first official figures seemed to indicate that trade flows had not changed much, unofficial flows told a difference story. In 1994, we conducted research on informal import flows to Latvia in different commodities and we realised that one example, the informal import of eggs to Latvia, was 100 times greater than officially indicated in customs statistics. So these free trade agreements in the Baltic states contribute to changes in our GDP and in our exports because every country tries to find space for improvement and growth."

**Currency Boards versus a Fixed Exchange Rate**

Roberto Rocha recalled that when they became independent in 1992, many people suggested that the Baltics needed a currency board. "The same advisors suggested that Bulgaria, Romania and Slovenia needed currency boards because they were unskilled and the central banks were technically unprepared to cope with monetary policy. But none of the three success stories has a currency board. Slovenia experienced capital inflows and managed to bring down inflation to one-digit levels. At the same time, Estonia introduced a currency board and has not been able to substantially reduce inflation. Many of those who advocated a currency board are now embarrassed by the fact that the countries who introduced them have a poorer record in reducing inflation than those who did not. What is the story behind inflation? We have been expecting it to drop to international levels in the Baltics for a long time now, but it has not."

Inna Šteinbuka explained the case of Latvia. "We have no currency board but a fixed exchange rate. Even when our money supply was going down as a result of the banking crisis and low demand, we still had some price increase because of fiscal adjustment and liberalisation of services. So the story behind inflation is different and unrelated to monetary issues."

Ricardo Lago dwelled on the issue of banking crises, arguing that they are a necessary evil "because you have non-performing loans inherited from the old enterprises which are non-viable. Also, you are moving in that environment where all relative prices are re-accommodating, the rules of market entry and exit are changing and the rules of competition with the rest of the world are changing. It is a problems of stocks and flows and sig-



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nalling who is ultimately the viable borrower. This puts the commercial banking system in these countries in a course of recurring crisis – this is inherent in transition."

He then compared the benefits of a currency board to a fixed exchange rate policy. "The benefit of having a currency board in countries like Estonia and Lithuania is that the government is obviously putting its reputation on the line. It is making a commitment to a very restrictive policy of deposit insurance. If banks go bankrupt, the treasury will have to pay the depositors. Also, it is tying its hands in terms of using the lender of last resort function. The banking crisis in Estonia was managed in a very orthodox way – depositors lost money but macroeconomic stability was preserved. Obviously, if you have a massive banking crisis, the worst thing that could happen is that you have to violate the rules of the currency board. Whenever you make a commitment to a fixed exchange rate or pre-announcement, then you tie your hands in the form of a currency board. If the worse situation develops and you have to reverse the convertibility and abolish the currency board, you are going to lose credibility. It is a gamble which has worked fine in Argentina and Hong Kong, and I think it works fine in Estonia. The Lithuanian case remains to be seen."

Stephany Griffith-Jones was not convinced that banking crises were necessary in transition countries. "Recent IMF studies show that the number of banking crises in the past few years has been absolutely astronomical in all countries that have undertaken rapid financial liberalisation. This is a serious problem, but I would not accept that it is inevitable because the same kinds of avoidable mistakes have been repeated. For example, liberalisation has been too fast or there has been insufficient emphasis on regulation and supervision, and these put unacceptable pressures on the banking system. There are cases where a crisis doesn't have to happen, and avoiding crises is important because they arecostly fiscally and in terms of lost output, regaining confidence and so on. Ricardo Lago's view of the success of the Argentinean currency board is controversial. I don't think that 18% unemployment is an acceptable result, and this is what Argentina has at the moment. Other benefits exist as well, but it is at the cost of possibly lower long-term growth because of problems of competitiveness."

Ricardo Lago rephrased his view of the inevitability of a banking crisis, "The likelihood of a banking crisis is very high whenever the real sector of the economy is changing drastically because the signals in the system are changing." He then added some comments on the case of Latvia. "The issue with regard to currency boards is one of credibility. In the case of Latvia, there was no banking supervision. Discussing monetary regimes and exchange rate regimes when you don't know what – if anything – is on the other side of the balance sheet is financial fiction. You must tell the



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depositors that they will lose money if things go wrong. When one bank goes under, you need to be tough. You must ensure, by law, that the central bank has no possibility of bailing out anybody. If the government wants to pay, they should increase taxes. This is what they did in Latvia and why exchange rate stability was preserved. Depositors lost money, it is tough, but so is transition."

Roberto Rocha related the Slovenian experience with regard to the currency board issue. "This discussion on currency boards was very intense in Slovenia right after independence. They argued that they didn't need a currency board, and they could achieve the same result by using the exchange rate as an anchor and developing independent central bank law. Central bank law in Slovenia reveals a very independent central bank. Everything that has been said about Estonia could be replicated in Slovenia, however, they managed to have greater success in reducing inflation and retaining some degree of flexibility in monetary policy, which proved very useful during the 1993 banking crisis. This needs to be on record because those who doomed Slovenia back in 1992, saying that it would not be able to reduce inflation, were just proved wrong."

Mats Karlsson wrapped up the discussion with an overview of cooperation and integration and reiterated his plea for recognising the distinct identities of Central and Eastern European countries. "There are two big clubs in Europe in the Northern Atlantic region, the EU and NATO. Regardless of the reasoning behind NATO enlargement or changing security cooperation, I certainly hope that when it comes to the EU, we will have transparent criteria and a transparent process. I wouldn't like to see the creation of clubs of friends or spheres of influence. We are actually creating a changing Europe, and we have started on a transparent basis with the Copenhagen Criteria. Each country should be accorded equal and individual treatment, and they should face the demands of the *acquis communautaire*. There should be a complementary accession strategy in support of all these countries that will eventually determine who gets in in the first round. If it is perfectly reasonable to assume that the Czech Republic could get in without Slovakia getting in, despite their intrinsic, historical relation, why is it not reasonable for Estonia to get in without Latvia when there isn't a strong link between the two?"

He then responded to Franz-Lothar Altmann's inquiry at the beginning of the discussion on the Council of Baltic Sea States. "First, we need to note that this kind of regional or sub-regional cooperation has a lot of potential because we are not talking about specific trade regimes but about the political muscle in creating a movement in other organisations. Perhaps this simply concerns the political energy in the region in building an identity because we are close to each other, but we are not that close,



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and there is a lot of learning to be done and a lot of wounds to be healed."

### Response by Piritta Sorsa

"First, in response to Franz-Lothar Altmann's question regarding Estonia, I would not say that Estonia is not interested in CEFTA, but it is a matter of priorities. The three Baltic states are extremely small countries, and they have very few individuals who are able to negotiate these treaties. I have spoken with some Estonians who say that their time was initially spent on the EFTA-EU agreements and that CEFTA got less priority because of the smaller markets of the member countries. They have concluded trade agreements with the Czech Republic and Slovakia, and they are negotiating with Poland and Hungary. For CEFTA membership, you need to have a free trade agreement with all of these countries, plus you need to be a WTO member. These WTO negotiations are time-consuming. For Lithuania it is obviously much more important to have an agreement with Poland, for example, as a neighbouring country. On the Russia MFN question, Estonia would like an agreement, but the Russians have been very vague, and it is a highly politicised issue.

There is very little potential for increased trade in the Baltics, since these are similar countries with moderate incomes. Of course, these agreements are not a bad thing to do, but they are not going to solve their problems. There has been a free trade agreement in industrial goods in the Baltics since 1994, and now they have one in agricultural goods, but in reality there has not been much trade. Economically, it would be a step backwards for Estonia to join any kind of a customs union. In this sense, their interest might be beyond Europe because by maintaining zero duties, they create an efficient base in industry, services or agriculture and they can export elsewhere as well.

Estonia's inflation is very much the same as in Latvia. If you look at the increases in traded goods prices, it is much less than in non-traded goods prices; the latter are still adjusting, and that is the major source of high inflation. As a result, they are not that worried about it.

On the currency board question, Lithuania is a good case to explain where a currency board was the right choice. They did not initially decide on a currency board, but the Central Bank was not independent, and they were unable to restrict monetary policies on their own because of constant political interference. They established a currency board to rid themselves of this political interference of requesting credits from the central bank to finance either state enterprise deficits or some other government expenditures. In Estonia, the Central Bank has been quite independent, and whether they could have conducted tight monetary policy without the cur-



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rency board is a good question. In Latvia, the inflation rate initially came down with the flexible exchange rate because they had an independent central bank which maintained monetary tightness and their fiscal balance was ok.

I would like to make two points in conclusion. I agree that if Estonia enters and the others don't, it doesn't really matter that much – Sweden is a member and Norway is not. Europe has lived with these kinds of arrangements before. With regard to the low figures for FDI, there is still a perceived transition risk in general, but there are factors which are specific to the Baltics as well. In Lithuania, for example, you cannot own land and there are other regulations which prevent foreign investors from investing. There are also certain aspects of the trading arrangements with the EU that may have restricted access and prevented companies from investing there for export-oriented activities – the hub-and-spoke nature and some policy uncertainty. So there is a host of factors which affect investment performance."



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# Prospects for Joining the European Union

*András Inotai*[1]

## I Introduction

For a long time, accession to the European Union (and its predecessors) by Central and Eastern European countries (CEECs) did not represent a realistic element of any major strategic approach in Europe. Even the Association Agreements[2] (AAs), signed just five years ago with the first three Central European transforming countries, avoided establishing any clear linkage between the AAs and potential future membership. Although the preface to the AAs contained a unilateral statement by Czechoslovakia, Hungary and Poland that these countries considered the AAs as an important stepping stone towards the historical goal of achieving full membership in the EU, this approach was not shared and supported by Brussels.

Five years later, however, the main question is no longer *whether* the CEECs (or at least some of them) will become members of the EU but *when* and . The real issues seem to be "technical". Nevertheless, they are of the utmost strategic importance for the future of Europe and for all present and would-be member countries of European integration.

Four fundamental technical questions can be raised:

(a) when will the enlargement (or enlargements) take place;
(b) how and under what conditions will the accession process proceed;
(c) why is enlargement vital not only for the newcomers but also for the present member countries of the EU and for the EU itself;
(d) what kind of a European Union will accept the candidate countries as new full members?

The answer to these questions will be conditioned by developments occuring in four different spheres. First, developments in the global sphere have influenced and will continue to influence the enlargement process. Second, and probably more importantly in the short term, developments in the intra-European sphere – mainly Russia and some other successor states

1 The views expressed in the paper are personal and should not be interpreted as those of the Institute for World Economics or the Hungarian Task Force on Integration Strategy.

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2 The Association Agreements were replaced by the so-called Europe Agreements at the meeting of the European Council in Copenhagen (1993). At the same time, the EU then endorsed the idea that the ten CEECs would join the EU if certain conditions were met.



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of the Soviet Union – are expected to affect the modalities of enlargement. Third, processes in the intra-EU sphere seem to play a crucial role. While the EU is unlikely to block enlargement or even radically postpone its date, it can fundamentally influence conditions, costs and benefits of the enlargement and the whole integration framework in which new members are allowed to join the EU. Fourth, developments in the transforming candidate countries themselves may substantially affect the modalities of accession.[3] In fact, the last two spheres have dominated both thinking and policymaking in the first half of the nineties. However, it is not yet clear how the relative weight of these four spheres might change. The growing importance of global and Pan-European issues may substantially affect the framework in which eastern enlargement will take place.

A realistic and comprehensive analysis is even more complicated because the four "technical" questions raised are interrelated and interacting. The timing of enlargement exerts an impact on the conditions of accession and vice versa. Costs and benefits are, to a substantial extent, dependent on sequencing, conditions, and the internal situation of the EU.

In addition, the issue of whether enlargement should or should not take place has been decided mainly on the basis of security and political, i.e. non-economic considerations.[4] It is obvious that the remaining "technical" (but, in reality, very strategic) decisions on timing and conditions of enlargement will largely be based on similar considerations, even if the "policy mix" of enlargement may be changing according to global, European and intra-EU requirements.

In a nutshell, a comprehensive and all-embracing survey should address all moving objects, all moving targets and all moving external frameworks. Depending on different constellations, dozens of scenarios should be described and analysed. This, however, would go much beyond the modest task of this paper and would greatly exceed the knowledge and capacity of the author. Therefore, while concentrating on the future development of the enlargement process, some assumptions have to be set. We assume that conditions in both the global and the European spheres will not inhibit the

3 Until now, little attention has been devoted to the short and medium-term prospects of the individual CEECs. In fact, in the first half of the nineties, we witnessed a surprisingly smooth pattern of transformation, both in political and economic terms, despite the heavy economic and social costs already involved. However, most countries will only now be entering the more difficult period of transformation, in which they have to find answers to basic questions swept under the carpet in the first years. One can only hope that also these tasks will be solved as efficiently and smoothly as previous challenges had been faced.

4 Evidently, dynamic economic interaction between the EU and the CEECs represented by high growth rates of bilateral trade flows, growing intra-industry trade and booming foreign direct investments in some CEECs have successfully contributed to shaping the (micro)economic framework of the positive decision on enlargement.



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enlargement process in the next, crucial period of about 5 to 10 years.[5] We also assume that the next stage of the transformation process will not produce major socio-political and economic instabilities, at least not in the more promising candidate countries. Finally, we assume that the internal reforms of the EU will proceed according to Brussels' (and most member countries') plans, certainly not without difficulties and delays, but hopefully without paralysing or even breaking up the integration process.[6] Thus, it is assumed that the EU will be able to maintain its main priorities, including enlargement, despite the fact that it will have to give more attention to some obvious, pressing issues such as unemployment, internal security and internal cohesion.

There is another serious limitation to our approach which stems from the fundamentally policy-taker status of the CEECs and the largely policy-maker status of the EU.[7] Any accession strategy developed by the CEECs has to consider the fact that most decisions on enlargement (timing, conditions, forms, modalities, etc.) will not be taken by the candidate countries but by Brussels and the present member countries that are in a much stronger position than the CEECs. Therefore, a more comprehensive survey should include the various EU options before analysing realistic accession strategies.

This paper, however, focuses on the CEECs' preparation for membership, with special regard to the Central European countries (CEFTA-4 or CEFTA-5). It is structured in the following way. Part Two describes the basic framework conditions of preparing for membership. Part Three provides a short presentation of the current level of preparation. Part Four deals with some domestic tasks whose solution may be vital for efficient and successful preparation in the coming years. Selected priority topics of negotiation on accession will be addressed in Part Five. Part Six collects arguments for *why* to enlarge and deals mainly with benefits from enlargement for the EU. Part Seven surveys the modalities of *how* to enlarge. The paper ends with some concluding remarks.

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5 Considering that the eastern enlargement of the EU will be gradual.

6 Included in this "package" are the gradual reform of the common agricultural policy, some basic achievements in the institutional field (although more might be necessary at a later stage), the implementation of EMU with strong political support but, unfortunately, not without strong economic repercussions a few years later, agreement on the future of structural funds and the reduction of the "democracy deficit" in the member countries' societies.

7 It does not invalidate serious attempts of the CEECs to pursue a more active policy of shaping the future of European integration. Certainly, the policy-taker status must not be considered as a one-way (passive) adjustment. However, the basic sense of Realpolitik has to be maintained (also in order to use important "niches of active influence").


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## II Framework Conditions of Preparing for Membership

### *Three Levels of Preparation*

At present, preparation for membership can be observed on three different levels.

(a) The first level involves the requirements stipulated by the AAs. In the last months, some developments in the EU-CEECs relations and intra-EU issues seemed to put this highly important issue into the background. However, it has to be clear to each applicant country that future membership crucially depends on the fulfilment of the AA. It is the AA which contains the framework of trade liberalisation and the creation of a free trade for non-agricultural products by 2001, no matter whether the associated country will or will not join the EU immediately after this date. In addition, the AA enshrines a large part of the adjustment tasks, generally known as the *acquis communautaire*. It is evident that without meeting the requirements involved in the AAs, no membership can materialise. As far as trade provisions are concerned, the AAs have reached their mid-point. In the next years, the temporary trade asymmetry granted by the EU has to be reversed, so that the associated countries will have to dismantle their existing tariff- and non-tariff-barriers.[8] It has to be stressed that other areas covered by the AA have, in the best case, a three-year track record only. As a result, a large number of non-trade-related liberalisation measures will be due in the next five-year period (including the creation of the necessary legal framework). The tasks have to be performed in a qualitatively new (to some extent improved, to some extent critical) period of transformation *and* modernisation, accompanied by serious trade, and potential financial and other imbalances (see later).

If they fully respect the AAs, the associated countries will become members of a large European free trade zone. Some of them are likely to be seriously hit by a new trade asymmetry, now in favour of the EU. Since trade in agriculture will not be fully liberalised, those associated countries with a high share of agricultural exports to the EU and a low share of agricultural imports from the EU may suffer the negative impacts of asymmetrical trade liberalisation. Among other arguments, this factor points to the need for a smooth and quick transition from the AAs to full membership.

8 By the end of 1996, the EU has abolished all restrictions except for trade in agricultural commodities, which will not be totally liberalised until 2001.



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(b) The formidable tasks ahead have been temporarily eclipsed by the answering of the EU questionnaires in 1996. All candidate countries have filled out this document and initiated a follow-up period with new questions, answers and clarifications. This period is expected to last until shortly before the Amsterdam summit of June 1997 and will end with a report *(avis)* to be presented by Brussels in order to determine the countries which will begin accession negotiations in the foreseeable future.

Although the EU sent out the same questions (in the same structure), and, for obvious political reasons, wanted to avoid any kind of premature differentiation, the incoming answers can provide motives for preselection. On the one hand, the understanding of some questions and the importance attached to them is a good indicator of the level of EU maturity of a given country. On the other hand, the "internal cohesion and logic" of the answers sheds light on the general political, economic, legal, social, etc. situation of the candidate. Third, by comparing and contrasting the answers with information received from other sources (including EU firms located in the applicant countries) and with the political and socio-economic reality, additional useful inputs can be gained. It is, of course, a different question whether the EU wants to use the varying quality of answers as a tool of preselection, and if so, at what time.

Beyond providing important information to the EU, the answering of the questionnaire has contributed to the domestic process of preparation as well. It has truly reflected the professional ability of civil servants in each country. Moreover, it has forced different ministries, with often very different particular interests, to cooperate with each other, for many questions could not have been correctly answered without the input of various government divisions. Also, new priority areas of preparation became clear, including the improvement of public administration and better statistical services. In some countries, it was the questionnaire that made governments aware of the key importance of strategic thinking and acting during the preparatory period.

In sum, the filled-out questionnaire can be regarded as the most comprehensive (although not all-embracing) document prepared in the applicant countries after the radical political and economic transformation started.[9] It is unlikely that such an effort would have been under-

9 In the case of Hungary, the last comprehensive survey, limited mainly to economic issues, was prepared before the introduction of the new economic mechanism in 1968. Poland may have undertaken a similar exercise in 1989-1990. Most other countries, however, did not prepare any comparable report for decades.



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taken as a result of purely domestic initiative. In this case, "mild external pressure" proved a welcomed catalytic agent.

(c) Lessons drawn from the questionnaire have strengthened the importance of full-fledged pre-accession strategies even in those countries which started to elaborate such an approach in recent years. The pre-accession strategy covers three periods:
  - preparation for starting negotiations (elaboration of the negotiation strategy);
  - period of negotiations until membership;
  - first years of full membership with continuous and further adjustment, due to derogations and new challenges deriving from membership.[10]

### *Time Schedule Membership Preparation*

This paper is based on the assumption that country reports *(avis)* will be ready by mid-1997, and virtual negotiations can start early in 1998 with all or some of those countries receiving positive *avis.*[11]

According to the Madrid summit and reinforced by the Dublin summit, negotiations on enlargement are set to start six months after "successfully finalising" the Inter-Governmental Conference (IGC). We can only speculate what "successful" and what "finalising" in this context mean. Most probably, the IGC will produce some success (although less than many would have expected and much less than necessary for a fundamental reform of the decision-making process even in the present Union). Also, it is likely that the IGC will be finalised before end-summer of 1997, although it will certainly not be the last highest-level conference on institutional reforms. Anyhow, negotiations on accession, pushed both by Pan-European developments, intra-EU efforts and pressures coming from the candidate countries, are expected to start in early 1998.

10 Potential Central and Eastern European member countries should avoid the problems Austria, and to some extent also Sweden have been facing after membership. Integration strategy has to be maintained at least in the first years of full legal membership, because several adjustment problems will become clear immediately after becoming a full member.

11 Some experts expect that, because of political consideration, all applicant countries will get a positive *avis* from the Commission. A negative *avis* would probably mean the postponement of negotiations indefinitely, although there is a contrary case known in the practice of integration (Greece started and successfully finished negotiations with a negative *avis).* It must be emphasised, however, that the final decision will be taken by the Council of Ministers, which has the right to change the opinion of the Commission. As a result, at least in principle, it is possible that negotiations will start with a country on which the Commission presented a negative opinion and vice versa.

12 It may even become more complicated as a result of institutional and other reforms to be introduced before or during the accession negotiations.



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It is more difficult to predict the duration of the negotiations. Obviously, it will depend on the level of preparation of both parties. The CEECs are interested in quick negotiations and are therefore well-advised to have a clearcut negotiation strategy based on a few carefully selected priorities. At the moment, the preparedness of the EU is less evident. It will depend on the state of various internal reforms, on global and European developments and also on the approach to be chosen for starting negotiations (startliner vs. group approach). Comparisons with the length of earlier negotiation periods are hardly useful, because the agenda to be negotiated on is different from previous agendas. Moreover, the EU now is a much more complicated institution than in earlier negotiation periods.[12] In addition, the more advanced CEECs have already liberalised their economies more than the Mediterranean member countries did before becoming members,[13] and will continue to do their homework before starting negotiations.

As a result, negotiations, if well-prepared on both sides, may last about two years. Another unknown factor is the duration of the ratification process in the 15 member countries and the European Parliament, as well as the referendum in the potential member countries. According to a current realistic scenario, full membership for the first CEECs can be envisaged for 2002.

## III Present Level of EU Maturity

In the last years, all CEECs have undertaken serious efforts to comply with the so-called Copenhagen criteria and to gradually adopt the *acquis communautaire* as laid down in the White Paper of Cannes. For various reasons, however, their performance is rather different and the gap among well-performing and less well-performing countries may even widen in the next few years. While a selection based on political criteria seems to be relatively easy, economic maturity is much more difficult to be rightly assessed. First, the candidate countries, including the more advanced ones, are in different stages of economic transformation. Therefore, even their macroeconomic indicators are hardly comparable.[14] Evidently, countries which have already undergone microeconomic restructuring with deep

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13 Not only their trade liberalisation is much more advanced. The level of demonopolisation and privatisation cannot be compared with that of Greece, Portugal or Spain at the date of the latters' accession to the EU.

14 This holds particulary for (statistically registered) growth, unemployment, inflation, budgetary position, trade and current account balance.



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structural reforms in the implementation phase reveal different features than countries which have not yet undertaken such (unavoidable) steps. Second, as the first stage of transformation characterised by macroeconomic stabilisation enters its second stage called transformation with modernisation, microeconomic agents become more and more important. If the macroeconomic stabilisation did not give sufficient attention to firm-level restructuring (which was the case in most countries)[15], the problem of "repressed microeconomic modernisation" with serious consequences for employment, budget and external balance has to be faced. Third, as adjustment to the EU digs deeper and deeper into the productive, institutional and social structure of the CEECs, the largely different micro-level adjustment capacity of the individual countries becomes increasingly manifest. A telling case in point is the difference between legal harmonisation on the level of law-making and the enforcement of new standard laws (both in legal, social and financial terms).

In sum: parallel with economic modernisation and adjustment to the EU rules, we expect a widening performance gap among the candidate countries. Also, as a result of individual efforts, the gap between the EU average and the most promising candidate countries may be temporarily widening (e.g. in per capita real income, if and when the produced GDP is used for financing future-oriented and competitive investments instead of current consumption). In order to avoid further fragmentation, both between the EU and the candidate countries and among the candidate countries themselves, the EU should become aware of its role as "modernisation anchor" for the whole transforming region.[16]

The seriousness of preparing for membership has been underlined in most countries by the creation of a new and more efficient institutional framework for decision-making on integration-related issues. At least the Central European countries have realised that they need a transparent national integration strategy which goes beyond legal harmonisation, trade policy or even economic policy. Evidently, all of these elements are an integral part of such astrategy, but they have to be subordinated to the strategic goals to be achieved through membership.

Several countries have created a comprehensive institutional structure of preparing for integration. At the top, an integration cabinet chaired by the Prime Minister is preparing and/or taking strategic decisions. A Secretariat of European Integration deals with high-level technical issues and coordi-

15 Here the different time requirement of (shorter-term) macroeconomic stabilisation and (longer-term) microeconomic restructuring has to be taken into account.

16 In this context, the AAs are a helpful but insufficient instrument. New, large-scale EU projects, preceding membership and facilitating adjustment, are not in sight.



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nates the work of government institutions involved in integration tasks. Inter-ministerial committees and the Parliaments are part of the new institutional set-up too.[17]

The progress of integration can best be followed in the field of factor integration. Excluding labour, bilateral flows of commodities, services, technologies and capital witness the rapidly evolving new pattern of division of labour between the EU and (most of) the candidate countries. In

**Table 1 Share of Selected Countries and Regions in Total Extra-Imports of the European Union**
(percentage of total extra-imports)

| Exporting countries | 1989 | 1992 | 1994 | 1995 |
|---|---|---|---|---|
| Poland | 0.86 | 1.45 | 1.96 | 2.25 |
| Czech Republic | 0.57[a] | 1.13[a] | 1.42 | 1.65 |
| Slovakia | [a] | [a] | 0.43 | 0.57 |
| Hungary | 0.58 | 0.82 | 1.17 | 1.39 |
| CEFTA - 4 | 2.01 | 3.40 | 4.98 | 5.86 |
| Slovenia | — | — | 0.73 | 0.78 |
| CEFTA - 5 | — | — | 5.71 | 6.64 |
| Turkey | 1.23 | 1.35 | 1.52 | 1.70 |
| Canada | 2.18 | 1.84 | 1.90 | 2.15 |
| Brazil | 2.33 | 1.87 | 2.11 | 1.98 |
| Mexico | 0.61 | 0.60 | 0.52 | 0.59 |
| India | 0.93 | 1.00 | 1.40 | 1.43 |
| Thailand | 0.75 | 1.16 | 1.28 | 1.22 |
| Malaysia | 0.78 | 1.01 | 1.54 | 1.68 |
| Singapore | 0.90 | 1.16 | 1.58 | 1.61 |
| Rep. of Korea | 1.55 | 1.52 | 1.79 | 2.01 |
| Hong Kong | 1.43 | 1.21 | 1.37 | 1.31 |
| Taiwan | 2.06 | 2.20 | 2.11 | 2.16 |
| PR of China | 2.04 | 3.44 | 4.75 | 4.84 |
| ACP countries | 4.31 | 3.68 | 3.69 | 3.64 |
| Latin America | 5.80 | 5.02 | 5.53 | 5.58 |
| Africa | — | — | 9.17 | 8.83 |
| North Africa | 4.29 | 4.53 | 4.51 | 4.15 |
| 4 small tigers [b] | 5.94 | 6.09 | 6.85 | 7.09 |
| 6 modernizing Asian countries [c] | 7.47 | 8.26 | 9.67 | 9.99 |

[a] former Czechoslovakia
[b] Hong Kong, Korea, Singapore, Taiwan
[c] as above plus Malaysia and Thailand

*Source*: Own calculations based on Eurostat 6B, External Trade. Monthly Statistics, various issues.

17 In the case of Hungary, the structure is complemented by an independent Strategic Task Force on European Integration addressing strategic questions of integration and advising the Government.



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**Table 2 Changes in the Relative Competitive Position of CEFTA in Extra-EU Imports**
(share of CEFTA always 100)

| Countries and regions | 1989 | 1992 | 1994 | 1995 | 1994 | 1995 |
|---|---|---|---|---|---|---|
| | | CEFTA - 4 | | | CEFTA - 5 | |
| **CEFTA** | **100** | **100** | **100** | **100** | **100** | **100** |
| Norway | 171 | 104 | 92 | 80 | 80 | 70 |
| Switzerland | 356 | 210 | 162 | 138 | 141 | 121 |
| Turkey | 61 | 40 | 31 | 29 | 27 | 26 |
| Canada | 109 | 54 | 38 | 37 | 33 | 32 |
| Brazil | 116 | 55 | 42 | 35 | 37 | 30 |
| Mexico | 31 | 18 | 11 | 10 | 9 | 9 |
| India | 46 | 29 | 28 | 26 | 24 | 22 |
| Thailand | 37 | 34 | 26 | 21 | 22 | 18 |
| Malaysia | 39 | 30 | 31 | 28 | 27 | 25 |
| Singapore | 45 | 34 | 32 | 27 | 28 | 24 |
| Rep. of Korea | 77 | 45 | 36 | 33 | 31 | 30 |
| Taiwan | 103 | 65 | 42 | 37 | 37 | 33 |
| Hong Kong | 71 | 36 | 28 | 23 | 24 | 20 |
| PR of China | 102 | 101 | 95 | 82 | 83 | 73 |
| ACP | 215 | 108 | 74 | 64 | 65 | 55 |
| Latin America | 291 | 148 | 111 | 98 | 97 | 84 |
| North Africa[a] | 214 | 133 | 91 | 73 | 79 | 63 |
| 4 small tigers[b] | 296 | 180 | 138 | 120 | 120 | 107 |
| 6 modernizing Asian countries[c] | 372 | 244 | 195 | 169 | 169 | 150 |

[a] Algeria, Morocco, Tunisia, Libya, Egypt
[b] Hong Kong, Rep. of Korea, Singapore, Taiwan
[c] Hong Kong, Rep. of Korea, Singapore, Taiwan, Malaysia, Thailand

*Source*: Own calculations based on Eurostat 6B, External Trade. various issues.

addition, and underlining the already mentioned differentiation process, different patterns of division of labour are already emerging even among the Central European candidate countries.

As a result of dramatic shifts in the last six years, the share of the EU in total exports and imports of the CEFTA countries already accounts for 60 to over 70 per cent, which is a clear sign of EU maturity. More important is the fact that geographic reorientation has been accompanied by the gaining of market shares of CEECs in extra-regional imports of the EU. The share of CEFTA-4 in total EU extra-regional imports amounted to 2 per cent in 1989 and reached almost 6 per cent in 1995 (Table 1). CEFTA's competitive position improved dramatically vis-à-vis all major non-EU exporters to the EU. For example, in 1989 Norway alone exported almost twice as much to the EU as the CEFTA-4, but in 1995 Norway's exports

were only 80 per cent of those of CEFTA-4. Brazil, Canada and Taiwan each exported in 1989 more to the EU than CEFTA-4, while in 1995 these three countries together exported only one-third of CEFTA-4 exports to the EU. Perhaps the most telling example is the comparison between the four small Asian tigers and CEFTA. In 1989, the former's exports were almost three times higher than those of CEFTA-4. But in 1995, they exported just 20 per cent more to the EU than CEFTA-4 and only 7 per cent more than CEFTA-5 (Table 2).

It is of strategic importance that trade reorientation and growing competitiveness were accompanied by unprecedented structural changes in the export pattern of the CEECs. Although trade liberalisation carried out by the EU has contributed to the rapid increase of exports, it has remained a minor factor concerning the evolving commodity pattern of exports. It is remarkable when predicting the pattern of division of labour based on comparative advantages that the most dynamic impacts on exports emerged in non-sensitive areas, such as machinery, car parts, electronics and other non-sensitive consumer goods. In Hungary's total exports to the EU, machinery and transport equipment (SITC 7) accounted for 36 per cent in 1995 (as compared with 13 per cent in 1989). In the exports of other CEFTA countries, other manufactured goods (SITC 6+8) play a decisive role. In 1995, the structure of EU imports from the CEFTA-5 and from the whole group of non-EU countries indicate a clear CEFTA specialisation in manufactured goods (49 vs. 30 per cent) and a rapidly decreasing specialisation in machinery (27 vs. 32 per cent) (Table 3). Structural upgrading on the important German market is even more telling. A comparison between CEFTA-4 and thethree Mediterranean EU member countries shows that CEFTA-4's exports to Germany reached just 50 per cent of imports from Spain, Portugal and Greece in 1989. In 1995, however, CEFTA-4 already exported almost 20 per cent more to Germany than the three EU member countries together. Regarding machinery exports, the CEFTA:Mediterranean relation changed from 40:100 in 1989 to 170:100 in 1995.

Although the engine of export growth in each CEFTA country was manufactured goods, there is a growing differentiation in the export patterns of the individual countries. This becomes particularly evident if the structure of incremental exports is calculated. Between 1992 and 1995, all CEFTA countries substantially increased their exports to the EU. 60 per cent of the increase of Polish exports and 47 per cent of exports from the Czech and Slovak Republics were due to increases in exports of manufactured goods (SITC 6+8). In turn, in Hungary's exports to the EU, machinery (SITC 7) played a dominant role with 54 per cent of total export increase (Table 4).


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**Table 3 Commodity Structure of Imports by the European Union from the CEFTA Countries**
(total exports of each CEFTA country to the EU = 100)

| | | 0+1 | 2+4 | 3 | 5 | 7 | 6+8 |
|---|---|---|---|---|---|---|---|
| **EU extra-imports** | **1994** | **8.4** | **6.8** | **13.3** | **7.3** | **31.7** | **29.7** |
| | **1995** | **7.9** | **7.4** | **11.9** | **7.9** | **31.8** | **30.3** |
| Poland | 1994 | 9.0 | 5.8 | 10.3 | 4.7 | 16.2 | 52.8 |
| | 1995 | 7.2 | 5.1 | 8.2 | 5.6 | 18.6 | 53.9 |
| Czech Republic | 1994 | 3.6 | 9.1 | 4.4 | 7.7 | 24.0 | 49.2 |
| | 1995 | 2.9 | 8.0 | 3.9 | 7.4 | 28.2 | 47.8 |
| Slovakia | 1994 | 2.3 | 5.5 | 2.9 | 8.7 | 17.2 | 60.2 |
| | 1995 | 1.7 | 5.0 | 1.9 | 9.2 | 25.4 | 55.5 |
| Hungary | 1994 | 13.1 | 6.5 | 3.3 | 7.7 | 28.7 | 39.6 |
| | 1995 | 10.5 | 5.6 | 2.7 | 7.8 | 36.0 | 36.2 |
| Slovenia | 1994 | 2.0 | 2.6 | 0.0 | 4.1 | 33.3 | 57.2 |
| | 1995 | 1.4 | 2.9 | 0.1 | 4.3 | 34.6 | 56.0 |
| **CEFTA - 5** | **1994** | **7.1** | **6.3** | **5.5** | **6.3** | **23.1** | **50.3** |
| | **1995** | **5.7** | **5.7** | **4.5** | **6.7** | **27.1** | **49.0** |
| Romania | 1994 | 3.9 | 3.0 | 2.9 | 5.0 | 8.6 | 75.3 |
| | 1995 | 3.1 | 2.3 | 1.7 | 5.6 | 9.5 | 76.6 |
| Bulgaria | 1994 | 13.7 | 8.9 | 1.6 | 10.4 | 12.1 | 52.6 |
| | 1995 | 10.0 | 8.7 | 1.0 | 13.0 | 7.8 | 58.6 |

*Source*: Own calculations based on Eurostat 6B, External Trade. Monthly Statistics, Nos. 8-9-10. 1996.

**Table 4 Commodity Pattern of Incremental Imports by the European Union between 1992 and 1995**
(incremental imports of selected regions and countries = 100)

| Imports from | total | 0+1 | 2+4 | 3 | 5 | 7 | 6+8 |
|---|---|---|---|---|---|---|---|
| Extra-EU total | 100.0 | 8.3 | 11.1 | -0.5 | 16.1 | 47.7 | 32.8 |
| Former USSR * | 100.0 | 2.2 | 15.8 | 11.0 | 14.3 | 0.6 | 59.1 |
| Poland | 100.0 | 0.5 | 0.3 | 9.7 | 3.9 | 26.8 | 60.0 |
| Czech+Slov. R. ** | 100.0 | 1.1 | 7.1 | 3.6 | 7.2 | 33.0 | 46.9 |
| Hungary | 100.0 | 2.0 | 4.4 | 3.9 | 5.5 | 54.3 | 29.1 |
| CEECs *** | 100.0 | 2.1 | 8.0 | 5.4 | 8.2 | 23.0 | 53.3 |
| Visegrád Group **** | 100.0 | 1.1 | 3.9 | 5.7 | 5.7 | 35.9 | 47.1 |

* For 1995, Russia and Ukraine only
** For 1992 former Czechoslovakia
*** For 1992 CEECs and former Soviet Union, for 1995 CEECs and Russia and Ukraine
**** Czech Republic, Hungary, Poland, Slovak Republic

*Notes:* EU-12 for 1992 and EU-15 for 1995.
Sums larger than 100 reflect shrinking SITC 9 shares between 1992 and 1995. Negative figures indicate decreasing import values between 1992 and 1995.

*Source:* Own calculations based on Eurostat, External Trade, Monthly Statistics, no. 7. 1994 and nos. 8-9-10. 1996.

The rapidly growing competitiveness of the CEECs in general and that of the CEFTA countries in particular is demonstrated in Table 5. Between 1992 and 1995, CEFTA-4 accounted for 27 per cent of the total incremental extra-regional imports of the EU (or more than ECU15 billion from the total increment of ECU57 billion) while it had a share of 39 per cent (ECU 7.1 billion) in the EU's manufactured goods imports (SITC 6+8) and slightly more than 20 per cent (ECU 5.5 billion) in its imports of machinery (SITC 7).[18]

It is not the aim of this paper to analyse the underlying motives of structural upgrading and differentiating export patterns. It suffices to mention that they are the result of different macro and microeconomic policies, different privatisation practices, different sizes and patterns of foreign direct investments as well as different economic, institutional and socio-cultural structures.

**Table 5 Share of CEECs in the Incremental Imports of the European Union Between 1992 and 1995, by Main Commodity Groups**
(total extraregional imports of EU in each commodity group = 100)

| Imports from | total | 0+1 | 2+4 | 3 | 5 | 7 | 6+8 |
|---|---|---|---|---|---|---|---|
| extra-EU total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Former USSR * | 11.9 | 3.2 | 17.0 | ** | 10.6 | 0.1 | 21.4 |
| Poland | 9.1 | 0.5 | -0.2 | ** | 2.2 | 5.1 | 16.6 |
| Czech+Slovak R. *** | 11.5 | 1.5 | 7.4 | ** | 5.1 | 8.0 | 16.5 |
| Hungary | 6.3 | 1.5 | 2.5 | ** | 2.2 | 7.2 | 5.6 |
| CEECs **** | 59.7 | 14.9 | 43.4 | ** | 30.4 | 28.9 | 969 |
| Visegrád Group ***** | 26.9 | 3.5 | 9.7 | ** | 9.5 | 20.3 | 38.7 |

* For 1995, Russia and Ukraine only
** cannot be interpreted for declining total EU extra-imports were accompanied by growing imports from CEECs
*** For 1992 former Czechoslovakia
**** For 1992 CEECs and former Soviet Union, for 1995 CEECs and Russia and Ukraine
***** Czech Republic, Hungary, Poland, Slovak Republic

*Notes:* EU-12 for 1992 and EU-15 for 1995. Negative figures indicate decreasing import shares between 1992 and 1995.

*Source:* Own calculations based on Eurostat, External Trade, Monthly Statistics, no. 7. 1994 and nos. 8-9-10. 1996.

18 In fact, almost 60 per cent of the total increase in the EU's incremental extra-regional imports and nearly 100 per cent of the SITC 6+8 group between 1991 and 1995 originated from the CEECs (including Russia and the Ukraine).



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

At any rate, by measuring the share of the EU in the total trade of the CEFTA countries, the pattern of exports and the level of intra-industry trade, as well as the inflow and pattern of FDI, all Central European countries seem to qualify for EU membership. Their performance and the integration level already achieved are much higher than those of some member countries not only before their accession but even today (Greece, Finland, partly Portugal and Ireland).

## IV Priority Areas of Further Adjustment

Despite the surprisingly successful adjustments, as indicated by selected trade figures, even the most advanced associated countries will have to make further efforts to qualify for membership by 2002.

First, they will have to carry out the legal adjustment and adopt the substantially expanded (and perhaps to be expanded) *acquis communautaire*. As already mentioned, it does not mean exclusivley making laws according to EU standards. More importantly, it requires the enforcement of EU-standard laws and the careful selection and negotiation of possible derogations.

Second, by 1997 all countries will be entering the period of "reversed asymmetry". They will have to create a free trade for industrial products within five years. The conditions arenot promising, taking into account the already high deficit in most countries' bilateral trade with the EU. Between 1992 and 1995, the CEFTA-5 accumulated a four-year trade deficit of ECU22.7 billion,[19] and 1996 has produced another record deficit for Poland, the Czech Republic and Slovakia. As a result, trade liberalisation has to be implemented under circumstances of persistently high and even increasing trade deficits.[20] In addition, all CEFTA countries have now entered a qualitatively new stage of transformation, in which rapid economic modernisation is a precondition of sustainable transformation and of successful integration into the EU. As in countries poor in raw materials and at a medium level of development, modernisation generally starts with high imports, the trade balance is likely to be worsened even more in the next years which are crucial for preparing for membership. Also the import requirement of "repressed microeconomic adjustment" has to be added. Obligations deriving from WTO rules and the elimination of still appli-

19 In four years, total Polish trade deficit with the EU amounted to ECU8.8 billion, for the Czech and Slovak Republics ECU6.9 billion, for Hungary ECU5.1 billion and for Slovenia ECU1.9 billion.

20 There are rather limited opportunities to finance EU-related trade deficit from other bilateral trade relations. Just the opposite is the case, as all CEFTA countries carry a permanently high trade deficit with Russia, due to the latter's energy deliveries.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

cable import surcharges have to be considered. Moreover, EU member countries, suffering under the strict Maastricht criteria and with low GDP growth, are likely to find outlets for an increasing share of their production in CEFTA countries and will thus contribute to the deterioration of CEFTA's trade balance. Even in the most optimistic case, considering the temporary character of this "gap" between exports and imports alone,[21] the financing of the trade deficit may become and remain a key problem for about the next five years.

As the reintroduction of import restrictions (in whatever form) would be highly counterproductive for negotiations on accession and would certainly be used by some EU member countries (or interest groups) as a good argument against enlargement, mainly "non-trade policy" elements of financing the deficit have to be found. Foreign direct investments, EU-style support to enhance exports, invisible incomes, new credits (leading to higher but hopefully not dangerous levels of indebtedness), and/or the partial use of available foreign reserves may help overcome this situation. The real question is, however, whether these elements, in whatever combination, will be sufficiently high to compensate for the deficit. And what happens if this is not the case, or if the financing of deficit leads to high-level indebtedness? The situation becomes even more complicated if the possibilities and consequences of devaluation, as the most obvious instrument to improve the competitive position of exports, are considered. What happens if a major devaluation cannot be avoided (which, sooner or later, is most likely)? As a large part of foreign exchange reserves are portfolio investments seeking advantage in the higher interest rates offered at fixed exchange rates, the giving up of the fixed exchange rate policy would immediately lead to a dramatic outflow of capital desperately needed to finance import surplus.[22] How could external balance, anti-inflationary policies and budgetary equilibrium, just to mention some of the key issues, be maintained under such conditions? And all this in a crucial stage of preparing for joining the EU.

Third, applicant countries are advised to achieve higher or sustain already high growth rates. Growth, however, can threaten macroeconomic stability, as already happened in some countries and, according to the scenario described above may happen in some others. One of the most difficult tasks is to coordinate stability-sustaining and growth-enhancing poli-

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21 This expectation is based on the assumption that today's imports serve tomorrow's export capacities.

22 In contrast with Hungary, a large share of foreign capital in Poland and in the Czech Republic is portfolio and not direct capital investment. Beyond the different exchange rate policies, the different patterns of privatisation also supported this kind of capital investment.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

cies. In the years of preparation for membership, in general terms, one could argue for a minimum level of stability accompanied by high growth rates. This, however, can only be achieved if a country has either substantial stability reserves, or a new, competitive structure as a result of the implementation of microeconomic transformation.

There are many arguments in favour of sustainable growth in the CEECs. Higher growth makes restructuring in general, and reforming of the social welfare system in particular easier.[23] Growth in itself is considered as a pillar of economic and socio-political stability. (Not only is stability expected to lay the foundation of sustainable growth, but growth is also creating stability.) One powerful argument in favour of higher growth is to make hesitating EU member countries interested in the accession of high-growth countries to the EU. This is particularly important for EU member countries which fear the competition of the newcomers for EU markets and funds, and also fear the competition of other EU member countries in the newcomer's markets. As a result of EMU and strong budgetary discipline, the existence or emergence of new high-growth markets is expected to attract special attention from the business community. Finally, at least in the medium term, high growth is likely to reduce EU funding of CEECs and to ease pressure on the redistribution of transfers.[24]

Fourth, sustainable growth has to be based on exports and investments. As CEECs have to further strengthen their international competitiveness and have to recreate production capacities lost during the initial years of the transformation, there is no other way than to substantially increase domestic and foreign savings and attach priority attention to investments. Current accumulation rates of about 20 per cent of the GDP are absolutely inadequate to successfully prepare for full membership within a few years. Since even the most advanced candidate countries are historically poor in physical capital and only have a limited saving capacity, successful pre-accession strategies would need EU transfers earlier than full membership materialises, and particularly in the crucial years of preparing for accession (see below).

Fifth, investment-led growth in itself requires the fundamental redistribution of national income from consumption (both private and public) towards investment. Such reallocation of resources also calls for reforming the inherited structure of social welfare. As a result, radical and transparent

23 It is always easier if the redistribution of the GDP only raises the question of redistributing the increment and not that of redistributing already gained (hardly fought) assets.

24 On the contrary, slow growth may increase fears of larger transfers towards slow-growing countries and, as a result, enhance concerns of some member countries about enlargement.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

budgetary reforms cannot be avoided. They have hardly started in some countries, while governments in other countries fear the political, economic and social protest of their citizens. One of the most difficult tasks ahead is the implementation of budgetary reforms which are needed to increase competitiveness and adjust to EU standards, and the maintenance of political and social stability which is also needed for future membership.

It should be added that budgetary reforms are also necessary to establish the institutional structure for efficient absorption of future EU transfers and to create the necessary domestic cofinancing resources well before full membership becomes reality.

## V Some Expected Key Issues of Negotiating on Accession

The view is generally shared that negotiations on accession will centre on "hard core" issues. As in earlier negotiations, also the next round of enlargement will also produce derogations on both sides. However, at present it is impossible to identify the scope and areas of derogations, because they will depend on the negotiation strategy of both parties (quick negotiations with less problematic areas or longer negotiations with more issues to be raised). In addition, the future of CAP, the scope of institutional reforms and, first of all, the new pattern of structural funds and transfers are likely to affect derogations substantially. Agreements on many issues will be intersectorial, so that more flexibility of the candidate countries in one area may be compensated for by greater flexibility of the EU in other areas and vice versa.

Despite all these uncertainties, four fundamental issues have been singled out in this paper: agriculture, financial transfers, manpower and sovereignty.[25]

### *Agriculture*

For most CEECs agriculture is a much more important sector of economic activity, exports, employment and social cohesion than for the EU. Nevertheless, there are tremendous differences among the candidate countries, which makes any general assessment meaningless, or even more, dangerously distorted.

Fears of the EU that cheap Central and Eastern European agricultural exports may flood EU markets proved completely unfounded.

25 Evidently there are additional key issues, such as environment, transportation or the institutional capacity of the applicant countries.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

Transformation problems, uncertainty about land ownership, dramatic decline of agricultural production in most countries and agricultural protectionism prevailing also in the framework of the AAs have led to declining or stagnating agricultural exports to the EU. While the EU's extra-regional agricultural imports grew by 12.2 per cent between 1992 and 1995, those from CEFTA-4 increased by only 9.1 per cent. Agriculture remained the only one-digit commodity sector in which the CEFTA-4 could not increase its market share. While in Hungary's total exports the share of the EU amounts to 64 per cent, in the country's agricultural exports the EU share fluctuates between 40 and 45 per cent, a clear sign of despecialisation.

More importantly, in the first five years of the AAs, it was the EU that could benefit much more from agricultural trade. Except for Hungary, all CEECs currently have a deficit in their agricultural trade with the EU. In contrast with the CEECs' exports to the EU, agricultural exports proved one of the most dynamic factors of EU exports to the transforming region. Among many other factors, subsidising of exports contributed to this development.[26] For more than one CEEC, export revenues from agriculture are an important source of financing "modernisation imports", "reversed specialisation" may deepen balance of trade problems and substantially narrow the financing of vital imports (machinery, technology, intermediate goods, etc.).

Calculations of the costs of agricultural adjustment have been largely overestimated and did not take into account the different positions of the individual CEECs. First, realistic calculations are extremely difficult to make because we do not know how the reformed CAP will work at the time of accession. Second, the future level and pattern of agricultural production in the candidate CEECs is hard to assess. Third, new commitments to be made in the ongoing world trade negotiations may modify the starting situation. Finally, in the case of a gradual enlargement, which is taken for granted in our scenario, the agricultural costs of accession will only cover the first-wave countries.

Attention should be directed to the fact that the virtual costs of agricultural adjustment can hardly be derived from the two indicators widely used in the EU (share of agricultural output in GDP and share of agricultural manpower in total manpower). First, except for Poland, all CEFTA countries have comparable figures with more than one EU member country and according to these criteria would fit immediately into the EU pattern. Second, and more importantly, the real costs of adjustment substantially

26 At the same time, subsidised EU exports deprived exporting CEECs of some of their important regional markets.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

depend on the "modernising capacity" of agriculture in the candidate countries. Countries with a modernised agriculture, where ownership structures, vertical integration, institutional background, high-level experts and market-oriented mentality are available, are expected to show a high degree of flexibility and high and efficient absorption capacity of temporary transfers. In turn, adjustment in those countries without such inputs is likely to cost several times more.

It is evident that the eastern enlargement of the EU requires substantial reforms in agriculture on both sides. Because the EU is the policymaker, efficient adjustment in the CEECs has to be based on reliable information about the direction, speed and scope of the reform of the CAP.[27] Even more, further CAP reforms should already take into consideration the agricultural features of the candidate countries. In order to save resources and avoid structural blind alleys, CEECs should be included in the CAP reform well before membership materialises. Also transfers supporting a more efficient agricultural division of labour and reducing future costs – which may emerge after membership in case of a non-adjusted agriculture – have to be envisaged during the pre-accession period.[28]

### *Financial Transfers*

It is no secret that the CEECs look to the EU as the economic modernisation anchor of the region. Beside free market access and long-term reliability, this anchor role is expected to become manifest in the financing of the modernisation process as well. There is general agreement that all Central and Eastern European candidates will become net beneficiaries of EU transfers, whatever the new structure will look like. At this point, however, the consensus ends and widely different views gain ground. The huge discrepancies reflected by various calculations clearly show the uncertainties and provide a good opportunity for highly politicised assessments. Although no exact calculation can be made at present, some framework conditions can be considered in order to put this issue in the proper perspective.

First, it has to be accepted that the present form of EU transfers will not be maintained. Therefore, any calculation based on the static prolongation

27 This scenario is based on largely stable world agricultural markets. It can, however, not be ruled out that solvent agricultural demand for some basic foodstuffs may substantially increase in the next decade (mainly as a result of higher consumption in the Far East and China). In this case, the present system of cutting back production and withdrawing arable land from production should be fundamentally revised, with tangible impacts on the future of CAP but also on the cost-benefit analysis of enlargement as well.

28 In this context, see Fischler's proposal for a "pre-accession fund" for agriculture.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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of the present system and its application to the new members cannot be regarded as a realistic assessment. Second, the transforming CEECs will be progressing until membership, and are likely to enter the EUwith different characteristics than those at present.[29] Third, GDP per capita calculations must not be based on the extrapolation of different growth rates. The lesson of most rapidly modernising economies indicates that the catching-up process consists of two basic elements: higher growth rates and currency appreciation. The latter is expected to narrow the present gap in the future at least as much as growth differentials. Fourth, as already mentioned in the agricultural section, it is incorrect and dangerous to throw all CEECs into the same basket. On the one hand, they require largely different sums of transfer (let alone the structure of such transfers). On the other hand, gradual enlargement will distribute the transfer burden for a longer period, so that only part of the potential transfers will appear during the first enlargement. Fifth, any analysis of costs and benefits has to take into account not only potential future transfers but also gains (and losses) already generated. A balanced assessment should not neglect the benefits already earned by the EU in the form of substantial trade surplus, market gains, in many cases market-dominating participation in privatisation, activities of EU-located FDI in the CEECs, etc. Sixth, the assessment of costs and benefits has to consider that this balance is a dynamic one, and short-term costs may be converted into long-term benefits and vice versa. In addition, costs and benefits are likely to differ along sectors, regions and labour markets. Moreover, as the enlargement process cannot be reduced to economic issues, the qualitative (not quantifiable) elements (higher level of influence, security, etc.) have to be taken into account as well. Seventh, the financing of enlargement may be divided into two main sections. Only the direct financing will be translated into transfers to the new members. In turn, the indirect financing that may be required by some present member countries in order to get compensation for the "negative effects" of enlargement (new competitors, shifting of FDI and transfers) increases the total costs of enlargement without benefitting the newcomers.[30]

One of the crucial issues of financial transfers is timing. At present, the CEECs are confronted with three historical tasks within an unprecedentedly short period. They have to finance transformation, delayed modernisation and adjustment to the EU. Although some of the tasks in these three areas overlap the costs are amazingly high. In historically undercapi-

29 Nevertheless, all of them will remain substantially below the EU average of GDP per capita.

30 In the past, in many cases, the Mediterranean countries have efficiently used the instrument of "blackmailing". If this practice cannot be stopped, the eastern enlargement may cost much more than the sum to which the virtual transfer to the new members amounts.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
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talised, medium-developed economies, which in addition are poor in raw materials, the imminent costs can hardly be financed by domestic savings and currently available channels of external borrowing alone. A further discrepancy develops between costs of preparing for membership which have to be paid today and potential (expected) benefits deriving from membership which will become available only in the future. Therefore, the most important issue is *not* to what extent the CEECs will benefit from EU funds once they become full members, but how they could share the costs of adjustment today and in the next years of preparing for membership. Unfortunately, very little attention has been paid until now to the costs of legal enforcement. Policymakers focused on "cloning" EU directives and rules and let the new, EU-style national laws pass through Parliament. However, the costs do not emerge in the area of law-making and translation, but during implementation (e.g. environmental standards, setting up of new institutions, etc.).

At present, the main unilateral transfer for the CEECs is the PHARE programme. It is a highly useful instrument to finance some of the outstanding issues, but definitely short of theresources needed to finance the triple historical task. According to figures from 1994, the potential per capita transfer via PHARE was DEM16 for Hungary. In turn, per capita figures for EU countries benefitting from EU funds were DEM1303 for Ireland, DEM843 for Greece, DEM510 for Portugal, and even Denmark and Belgium received 9 and 14 times more net transfer, respectively, than Hungary (Table 6).

Another hot topic is the absorption capacity of the CEECs. Some calculations, based on "inputs" criticised earlier in this section, argue that, for some countries, the hypothetical transfers would be so high in terms of GDP that the beneficiaries would be unable to absorb them. In theory, this may become a problem. However, at present the situation the CEECs are

**Table 6 Net Contributers and Net Beneficiaries of EU Financial Transfers in 1994**

| Countries | DM per capita | Countries | DM per capita |
|---|---|---|---|
| Luxembourg | 4,217 | Denmark | 143 |
| Ireland | 1,303 | Italy | -16 |
| Greece | 510 | France | -29 |
| Portugal | 843 | Great Britain | -74 |
| Belgium | 222 | Netherlands | -170 |
| Spain | 195 | Germany | -63 |
| | | Hungary* | 16 |

* memorandum item
*Source:* Weltalmanach 1996, Bayerische Landesbank.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

confronted with is not abundance of funds but just the opposite, the dangerous lack of resources for long-term financing. But even the volume of "absorption capacity" requires an extremely careful and country-by-country assessment. The EU's reluctance can be understood if we consider the impact of jumbo transfers from Western to Eastern Germany or if we analyse the by far not always efficient use of EU transfers to more than one member country. However, the CEECs must not be evaluated on this basis.

First, all applicant countries are fully aware that they cannot expect German (or even EU average) income levels within a few years. Second, some countries have already shown a high level of absorption capacity. The best case in point is Hungary, which has efficiently absorbed $16 billion as foreign direct investment. More importantly, each year about $1 to 1.3 billion flow to this country without major privatisation deals and headline-making green-field investments. The per capita FDI level of about $1,500 is among the highest figures in the world. Third, the absorption capacity of an economy is positively related to the general level of education, an area in which the CEECs have been and still are clearly above the level of the Mediterranean countries. Fourth, the geographic location of the CEECs in general, and that of the CEFTA-5 in particular, generates multiplier impacts that can only partially be produced by "peripheral countries" in geographic terms. Therefore, investments in infrastructure promise better absorption and higher profits. Fifth, the efficiency of absorbing resources also depends on the social and institutional flexibility of the beneficiary. The transformation, if well managed, may create a better socio-political environment for absorption than a less flexible country with status quo mentality.

Finally, a realistic assessment of the costs of enlargement also has to address the issue of the costs of non-enlargement.

### *Manpower*

One of the most delicate questions of enlargement is the integration of the labour market of the applicant countries into the EU market. First, persistent two-digit unemployment in most EU member countries represents a major barrier to quick and smooth integration. Second, substantial income and wage differences nourish Western European fears of large-scale labour flows from the candidate countries to the EU in general, and to the two neighbouring countries, Germany and Austria, in particular. In consequence, integration in this field will be rather slow, gradual and subject to substantial derogations on the EU side.

At present, labour market policies are managed by the EU member countries. Although the AAs have left open this issue for bilateral contracts, there are only two EU countries which signed such agreements with



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the CEECs (Germany and Austria). However, as the labour market conditions started to worsen, these limited possibilities experienced further tightening in the last few years.

Beyond regulation in the accession treaties, prospects for labour flows reveal two strategic issues.

First, even today, there are few, if any, restrictions on the flow of highly skilled labour from Central and Eastern Europe to the EU (and to North America). It is important that highly skilled labour remain in Central and Eastern Europe where it is desperately needed in order to successfully implement modernisation strategies.

Second, restrictions on labour flows from the East to the West are likely to increase the volume of capital flows from the West to the East. The tighter the labour market is controlled, the more capital is expected to flow out of the EU countries to the neighbouring CEECs offering competitive production opportunities. A rapidly increasing share of FDI entering mainly the CEFTA countries is already based on cost advantages. Even more importantly, more and more EU jobs can only be kept if parts of the production process are relocated to the CEECs. In this context, the CEECs become gradually integrated into the European and global network of large (multinational) companies and contribute to higher global competitiveness of the companies involved in this process. This development has a number of advantages for both sides and strengthens the integration process. At the same time, in the medium term, it may also create new tensions within the EU, because not all EU countries will participate equally in the relocation process. Those countries heavily involved in the process will become more competitive than those less or not involved. As a result, the relative competitiveness among present EU member countries may substantially change over time.

During the pre-accession period and also in the first years of full membership the overwhelming pattern will be the flow of Western European (and non-EU) capital to the labour available in the CEECs, and not the old pattern of bringing labour where capital used to be available. For the next years, this is a more favourable pattern of division of labour for the CEECs. In the longer term, however, the EU will hardly be able to avoid strategic answers to two issues. First, the flexibilisation of labour markets, including that of wages, has to be tackled. Second, "decapitalisation" may raise new problems, as investment activities (and future jobs) will increasingly be exported to better locations.[31]

31 This is already the case in Germany, where the upswing of business cycles is accompanied by rather slow growth of investment activities. This is, however, primarily due not to generally sluggish investments, but to the fragmentation of investment activities of leading firms between slow (if any) domestic investment and booming investments abroad.



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*Sovereignty*

Membership of the EU requires the abandoning of national sovereignty in selected areas. Depending on the outcome of the IGC and further integration processes, this part of the *acquis communautaire* may expand further before full membership of some of the CEECs. It is widely understood in the applicant countries that in areas of common policy the pooling of sovereignty is not negotiable. Nevertheless, there are "soft areas" in which a mixture of common and national policy factors coexist.

Although all CEECs regained their national independence only a few years ago, their "sensitivity threshold" regarding national sovereignty is rather different. This is partly due to the different historical experience and heritage deeply rooted in the public perception of sovereignty. In addition, even during the period of Soviet domination they enjoyed different levels of "small freedoms", including civil rights, economic opening, tourism and social contacts with Western citizens. Moreover, in more than one case, political independence resulted in the (re)birth of nation states. Czech independence dates back to 1618, Slovakia has a record of a few years of national independence, while Slovenia has never been an independent state before. The same pattern holds for most of the successor states of the USSR and for ex-Yugoslavia. Thus in many countries nation-building (and state-building) has to be carried out simultaneously with integration into the global economy and adjustment to the EU. This process will not be finished before negotiations on accession start. Therefore, for some countries (including Poland and the Czech Republic, although for partly different reasons) the issue of national sovereignty may belong to the "hardest core" of domestic policies on negotiations and future membership. In each candidate country, a carefully designed and well balanced communication strategy will be required to convince the society about the costs and benefits of giving up part of the sovereignty. At the moment, this issue seems to be less delicate in Hungary, where historical experience has several times shown the limits of a small country to enforce national interests in the international framework. It is just EU membership which is expected to create interest alliances and thus increase bargaining power in the international arena.[32]

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32 In the Hungarian case, relations to ethnic Hungarian minorities in the neighbouring countries are a central topic. Once Hungary becomes a member of the EU, some (or all) neighbouring countries with large Hungarian minorities may follow in later waves of eastern enlargement.

## VI Why Enlarge?

Until very recently, professional and political discussion about the eastern enlargement of the EU was clearly dominated by a one-sided approach. The obvious (or not so obvious) benefits of the candidate countries and the similarly obvious costs of the EU were stressed. On the rather few occasions when the interests of the EU were addressed, arguments remained in the narrow field of security and "moral obligations". Economic interests were not identified or they were even denied.

In this short section, some thoughts on the virtual or potential benefits of the EU will be developed.

To start with, part of the benefits have already been enjoyed by the EU. The opening up of the CEECs' domestic markets generated (and will keep on generating) rapidly growing export flows. Particularly the CEFTA countries became the most dynamically expanding market for EU exports and helped dampen the negative impacts of economic slow-down both in 1993 and in 1996. In 1995, 7.7 per cent of total EU extra-regional exports were allocated in the CEFTA-5 region (against less than 3 per cent five years earlier). The CEECs in general, and CEFTA-5 in particular, became one of the most important trade surplus-generating regions for the EU. Between 1993 and 1995, the EU's cumulated trade surplus with the ten associated countries amounted to ECU22.9 billion, or 82 per cent (20.4 billion or 73 per cent represented by CEFTA-5) of the total surplus of the EU in its extra-regional trade. Comparing it with about 8 to 9 per cent of total CEECs share in EU extra trade, the difference (i.e. the gain for the EU) is striking.[33]

The candidate countries will remain one of the most dynamic external markets for the EU.Their trade liberalisation will have to be completed in the next years. Higher growth will produce higher consumption (both public and private). Modernisation requirements will mainly be met through imports from EU countries. Evidently, potential financial transfers would also mainly flow back to the EU and finance imports originating from present member countries.

Substantial benefits derive from rapid productivity growth mainly in the CEFTA countries and economies-of-scale gains. In addition, the involvement of the CEECs in the network of international sub-contracting is improving the cost structure and the global competitiveness of EU-located companies investing and producing in the region. With low-cost countries

33 In 1995, CEFTA-5 accounted for 6.7 per cent of the EU's total extra-regional imports, but generated 32.5 per cent of the EU's trade surplus.



*From: Regionalism and the Global Economy: The Case of Central and Eastern Europe*
*FONDAD, The Hague, 1997, www.fondad.org*

in its geographic neighbourhood, the EU may become more competitive vis-à-vis North America and the Far East, who have already made extensive use of such a potential in their neighbourhood.[34] One of the EU's potential advantages in integrating the CEECs is rooted in the use of skilled labour.[35] Direct investments mainly coming from the EU countries reinforce both the presence of EU exporters on the market of the CEECs and strengthen subcontracting networks.

Common rules on European environment are expected to substantially improve the quality of life in the EU countries too. In addition, huge projects to clean and protect the environment in the applicant countries not only offer large markets, but, based on economies-of-scale advantages and on solving special environmental problems, may generate new technologies and create or strengthen Europe's global competitiveness in this highly important future-oriented sector.

One of the key long-term advantages is in the field of infrastructure. Large-scale, regionally designed projects have direct and indirect impacts on trade. Here, the implementation of the projects is likely to produce smaller gains in comparison with the forthcoming benefits covering higher income, more dynamic growth, new sub-regional development centres and increased trade relations both in West-East and in North-South directions. Better infrastructure will reduce delivery times, cut transportation costs and improve global competitiveness for all participants.

Until now, little attention has been paid to the impact of enlargement on the institutional development of the EU. In an adequately reformed framework, newcomers may speed up the decision-making process and, more importantly, create a better balance of power within the enlarged EU.[36] Regarding the first issue, the enlarged Union will obtain new impetus, resulting both from new challenges posed by the enlargement, and due

34 In the last ten years, the decline of Western European competitiveness on the global scale was partly due to the low level of reliance on competitive labour. The internalisation of external trade has increased the division of labour among high- and highest-cost countries, while opportunities of outsourcing have not been duly observed. Areas connected to the EU by preferential agreements, such as the ACP or the Mediterranean basin, did not offer the same factor endowment and comparative advantages as some Latin American and most South East Asian countries to the EU's main competitors. In this context, the CEECs seem to be the right partners.

35 It is, however, an open question to what extent shortsighted political interests will be able to use this advantage. Conflicts between the interest of international capital and national labour policies cannot be excluded.

36 In this context, interesting and changing alliances can be forecast. Except for Poland (and partly Romania), all candidate countries belong to the category of small (or smallest) countries. The enlargement will necessarily increase the relative bargaining power of smaller nations.



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to fresh, unconventional and innovative approaches by the newcomers in order to find appropriate answers to global and European problems. Concerning the second topic, the applicant countries are expected to shape already, although in an indirect way, the future institutionalset-up of the EU, to be worked out by the IGC. A better balance of power between small and large countries has to take into account the accession of mainly small (and one or two medium-sized) countries. In addition, new interest groups and temporary (or lasting) alliances, with substantial impact on the future of the integration process, are likely to develop. In political terms, the weight of Europe can be increased on the threshold of the "Asian century".

Last but not least, security aspects have to be emphasised. Although they cannot be quantified, it can be predicted that they will play a crucial role in negotiations on accession. Higher security for the citizens in Western (and Central and Eastern) Europe has already become a priority issue in the EU and led to the upgrading of the third pillar in intra-EU cooperation. In this context, candidate countries becoming the new eastern border of the Union have to assume the responsibility of providing the necessary security for the citizens of the Union. In addition, the newly defined concept of security includes social (migrational) and environmental aspects.

When arguing in favour of enlargement, one has to stress the "negative argument", i.e. what would happen if enlargement were not carried out. On the one hand, non-enlargement would eliminate most of the benefits derived from larger markets, higher growth, modernisation, economies-of-scale and global competitiveness. On the other hand, it would create additional problems and potential sources of conflict which would have to be permanently controlled by the EU – a rather costly undertaking without any prospect of economic benefits and with a loss of competition as a result of diverting part of the available resources from welfare generation to damage limitation.

One of the urgent common tasks of EU and CEECs experts should be a detailed and, as far as possible, quantitative analysis of the benefits of enlargement (for both sides) and the costs which may be attached to non-enlargement. Obviously, benefits and costs are always time-dependent. Therefore, the survey should include various calculations for different timings of enlargement as well.

## VII How to Enlarge?

After the political decision on eastern enlargement had been taken, the modalities of enlargement entered the focal point of discussions about the



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future of the European architecture. In our view, several questions have to be raised and at least partially answered.

### *What Kind of Enlargement?*

The planned eastern enlargement of the EU needs a careful survey of similarities and differences in comparison with earlier enlargements, particularly with those countries joining the EU with less-than-average performance.

Similar to both Mediterranean enlargements, the present candidate countries look to the EU as their external anchor of security and modernisation.[37] As in those cases, these two anchors cannot be separated from each other today either. Long-term security, provided both by the EU and by NATO, is a precondition for predictable economic modernisation. In turn, without substantial economic modernisation no sustainable security can be granted. Brussels (and some member countries particularly stressing the security aspect) has to realise that the highest-ranking goal of security can only be guaranteed if the highest-ranking goal of economic modernisation of the CEECs is given sufficient attention and resources.

Also similar to previous enlargements, the decision on enlargement is largely motivated by political considerations. New aspects and trends of internal security provide additional reasons for this approach. Obviously, it does not mean that economic considerations could be set aside, but they have to be integrated into the global framework of the strategic decision-making process. The more applicant countries are economically prepared for membership, the higher the benefits and the lower the costs and frictions of a politically-driven enlargement will be.

Another similarity is the less-than-average level of economic development of the candidate countries. Their incorporation into the integration framework and their quick development both in the pre-accession and the post-accession periods require a mixed approach. As in previous periods, the EU has to combine market integration methods with instruments of developmental integration. No matter in how many waves and in which country composition enlargement will take place, all new entrants will need a developmental approach. The EU's strategic planning and the distribution of resources have to cope with this reality. At the same time, there are several new features connected with eastern enlargement.

First, the newcomers have to adopt a much broader and qualitatively upgraded set of EU rules and standards than earlier entrants. In part, there

37 In the case of Ireland, only the modernisation anchor played a key role.



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is a broader gap between the new requirements of the EU and the present level and problems of development of the candidates. In part, however, this gap can substantially be narrowed by better preparation in various areas, including the fulfillment of the AAs, deregulation, openness, privatisation, and also by a higher level of social and institutional flexibility.

Second, and more importantly, eastern enlargement is likely to take place in a global environment in which the consolidation of Europe's position is a priority task. During earlier enlargements, this issue did not emerge as a major challenge.

Third, eastern enlargement is adding to the EU countries with dynamic growth, world-record productivity increase, substantial future growth potential as well as abundance of skilled and innovative labour. A "banana" of European-type "small tigers", spreading from Slovenia over Central Europe to the Baltics, represents a unique challenge to the EU. It is up to a coherent strategy that rightly or wrongly perceived risks and threats could be dampened and the historical opportunities be grasped.[38]

Fourth, for the first time in the long history of enlargements, the first wave of eastern enlargement will not extend the EU's external borders to the geographic periphery of Europe. All previous enlargements reached different corners of Europe's geographic periphery.[39] As a result, all infrastructural projects reached an end-point determined by the physical realities of the continent. The first round of eastern enlargement will integrate continental countries with substantial transit potential. In consequence, efficiency and multiplier impacts of investments in infrastructure are expected to be higher than in previous cases. If earlier entrants rightly stressed their special role in connecting the EU to other, partly far-away continents,[40] the Central European candidates all have the right to present themselves as bridges to the East, the South and the North. They all have to (and in reality did already) realise that their transit position, a major strategic advantage, can only be used adequately if they remain open to their neighbours.

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38 The scope and timing of these potential gains also depends on whether and how successfully the more developed applicant countries can cope with unique challenges of the second stage of transformation.

39 The first enlargement included the Northwestern part of the continent, the second the Southeastern region, the third the Southwestern one. Finally, the latest enlargement incorporated the Northern part of the continent.

40 Ireland used its North American connection very efficiently, Greece, with much less efficiency, its Eastern Mediterranean role, Spain and Portugal, with high political and low economic commitment, Latin America (and Africa). During the last negotiations, Austria (and Finland) claimed to become bridges to the East – with, to put it mildly, ambiguous Austrian attitudes until now.



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### *What Kind of a European Union to Join?*

As policy-taker countries, at present, the candidates have extremely limited power to influence the future shape of the EU.[41] Nevertheless, some of their priorities can be identified.

First, everybody is interested in an open European Union which will not create a fortress Europe but will remain open to the world. Second, the newcomers would like to contribute to build a Europe that is competitive on global markets. Third, all want a European integration characterised by a sustainable internal balance of power. Finally, as the new external borders of the enlarged Union, they want a clear strategy of eastern enlargement and the extension of the integration further to the East, the North and the South, according to a correctly constructed timetable.

### *How to Define Priorities for Negotiation?*

As all candidate countries are small economies with low bargaining power,[42] they have to develop a very clear negotiation strategy based on detailed cost-benefit analysis. In addition, alternative scenarios have to be designed and high-level flexibility has to be demonstrated during the official negotiations.

One of the most challenging tasks is to select priorities and construct a comprehensive package of priorities. The first phase of this undertaking will be relatively easy, provided that all sectors affected by (and not only interested in) membership of the EU will be addressed and involved in this activity, and also provided that everybody will be in a position to formulate its priorities adequately. The next stage will be much more delicate and will need a clear communication strategy. Obviously, by no means all particular priorities can become part of the list of national priorities. On the one hand, some of the priorities will be in conflict with other part of them. On the other hand, some individual priorities can be integrated into major sets of priorities. Finally, some priorities, although their importance would be acknowledged, may be left out of the negotiation package, either because there is little chance of defending them or because they may weaken other priorities. After selecting the national priorities, the governments of the CEECs have to communicate with all sectors involved why some priorities have not been accepted, and what kind of alternative solutions

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41 They may have more power once they are inside the Union.

42 The aggregate GDP of CEFTA-5 amounts to about ECU200 billion at official exchange rates and to about ECU300 billion at PPP rate. This represents 3.1 and 4.6 per cent, respectively, of the EU's total GDP.



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are feasible or can be created. A third stage emerges during negotiations, when, as a matter of fact, not all national priorities can be built into the accession treaty. Here, another and very important feedback will be necessary in order to prevent meaningful opposition to EU membership.

The definition of priorities in general, and their scope in particular, depends on the governments' decision regarding the expected duration of negotiations. If the candidate countries are interested in quick negotiations and early membership, they should be advised to limit themselves to a small number of high-priority issues. The more priorities that are presented on the national agenda, the longer negotiations may last. Negotiators must be aware of the fact that the double maximum of quick negotiations and a wide range of priorities to be accepted cannot be reached. Instead, an optimum has to be striven for, consisting of a mix of quick negotiations and the protection of an adequate level of key priorities. This "mix" may easily shift towards the acceleration of negotiations if the domestic and external environment requires it. Also, an opposite trend is possible, if, for instance, the EU were not interested in or prepared for rapid negotiations, or quick adjustment would put too large a burden on the applicant country.

At present, it is extremely difficult to assess the right negotiating position. However, there are some arguments in favour of rapid negotiations and early membership, even if some of the priorities may not be defended. First, part of the necessary adjustment can only be carried out from within the EU. (This is a powerful reason why post-accession strategies are also needed.) Second, in well-defined cases, derogations can be achieved. Third, some priorities abandoned during the negotiations may be successfully represented once the candidate becomes full member. Fourth, early membership may entitle newcomers to have access to EU funds which may compensate for losses deriving from giving up some priorities. Finally, and most importantly, the early timing of accession should eliminate political and economic uncertainties, and change the applicant country's position from "external periphery" to "internal periphery". Depending on the general political climate in Europe at the time of accession, this argument may even gain in strength.

### *The Sequencing of Enlargement*

This issue occupies a central role in the present discussion on enlargement. In principle, there are two basic scenarios: selecting a small group of applicant countries and starting negotiations with all candidates who have a positive *avis*. Both approaches have several pros and cons.

The small-group approach, embracing four or five Central European countries, seems to be justified because the candidate countries are and will



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be differently prepared for membership once negotiations open. Three of them (Czech Republic, Hungary and Poland) are OECD member countries, a very clear distinction provided by a highly appreciated international institution. The same three countries are expected to become the first NATO members well before they will be allowed to join the EU. The lion's share of trade and foreign investments are concentrated in the Central European countries, indicating that the international business has already anticipated their accession to the EU. Also they are much more integrated into intra-industry trade and have more developed production and export patterns. Their per capita GDP is much higher than that of other applicants.[43] In addition, they have formed CEFTA, a regional free trade area, and started high-level political consultations on regional priorities, including preparation for membership of the EU. On the EU side, the group approach seems to be the only viable option for technical reasons, since it is physically impossible to conduct negotiations with all applicants at the same time.

In turn, this approach also has some manifest handicaps. It may create an *institutionalised* political, security and economic gap within Europe, and generate further differentiation with incalculable consequences. More importantly, it would transmit a doubly dangerous message to those left out of the enlargement. On the one hand, it could give (unintended) support to populists and nationalists within the "dis-preferred" countries and increase anti-European emotions. On the other hand, it could signal to potential dominant powers, both in the region and outside it, that the "dis-preferred" countries are free to be "conquered".

The "startliner approach" tries to avoid the above danger by preventing any *openly declared* differentiation among the applicants. Also it may fit into the special interest pattern of the present member countries, as almost each of them has a special candidate to be preferred (which, in some cases, may not belong to the first round of enlargement). On the applicants' side, it may provide higher flexibility, for the Central and Eastern European countries could move from one group to another during the negotiation process. This may be particularly important for in-between countries, that, as a result of domestic political transformation, could "upgrade" their present position within a relatively short time (e.g. Slovakia).

However, this approach may have even more problems. While not being able to stop already progressing differentiation based on and fuelled by economic and socio-political realities, it transmits a bad message to the

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43 It has been generally overlooked that the "wealth gap" between the EU and Central Europe is not wider than the "wealth gap" between Central Europe and some Eastern and Southeastern European countries, let alone the successor states of the USSR.



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more advanced countries. The latter may fear that the time of their accession will be (indefinitely) postponed, as they have to wait for the less prepared countries.[44] Also, this approach could be used by some member countries to delay enlargement and sustain their privileged status quo position. Moreover, flexibility can easily be used (or even misused) by the EU to play applicant countries off against each other and undermine their anyhow not very strong negotiation position. The most important handicaps of this approach are, however, in the strategic context. First, it would be unable to provide a convenient answer to the challenges Europe is facing at the turn of the century, in security, social, economic and also psychological terms. Second, it could have serious repercussions on the internal cohesion of the Union. Third, it would definitely establish a barrier to more intensive (sub)regional cooperation.

Considering both options, a mixed policy seems to be most realistic. It should be based on two pillars. First, negotiations should be opened with each candidate, and be seriously continued with a few of them, representing the first round of enlargement. Second, and no less importantly, an overall strategy of enlargement should be designed and communicated before starting negotiations. It should include a clear timetable of various waves of enlargement, strengthen cooperation between new members and their non-member neighbours through different instruments (cross-border cooperation, trans-European infrastructure projects) and upgrade financial support to countries joining the EU later.[45] The establishment of a clear and lasting framework is not only the task of the present members of the EU. Also the prospective in the first wave of enlargement have to be deeply interested in and involved in the implementation of such a longer-term strategy. Already at this early time, responsibility has to be shared between the present and future members of the EU.

### *How to Communicate Enlargement Strategies?*

Both the EU and the applicant countries need a clear communication strategy to prepare the societies for enlargement, explaining benefits and losses and creating a new European identity. Most of these tasks will have to be performed in the next years.

44 This was a well-known phenomenon during the CMEA era. Fears rooted in this period are still vividly remembered in Central Europe.

45 Here, reference has to be made to the decisions on the preparatory work for the Madrid summit in December 1995. Besides opinions on each of the applicant countries, the Council will consider a document that is expectedto establish the general framework of the strategy on eastern enlargement. The multi-speed process of enlargement has to be embedded into this framework.



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It is, however, extremely urgent to shape a credible communication strategy for the EU. While politicians regularly state that the enlargement process cannot be reversed, concern and fear about enlargement is growing in the societies of many EU member countries.[46] In order to get the necessary social support for enlargement, the negative arguments based on damage limitation have to be quickly replaced by positive arguments emphasising the political, security and economic benefits the EU has already gained and is expected to gain from eastern enlargement.

### *The Role of Regional Cooperation in the Enlargement Process*

Regional cooperation, mainly in the framework of CEFTA, has three important tasks to be fulfilled.

First, a more comprehensive and better coordinated pre-accession strategy is required. Although the potential of sub-regional cooperation will get the most important impetus from joining the Union,[47] above average growth of regional trade can be registered already in the preparatory stage. Emerging different patterns of specialisation started to create favourable environment for intra-industry trade. Also FDI can be considered as an important impetus to regional cooperation. Official consultations on regional and EU-related issues have become common practice.

Second, special attention should be devoted to those neighbouring countries which are unlikely to become members in the first wave of enlargement. For obvious security and economic reasons, contacts have to be developed before accession, and the CEFTA's openness to the other candidates has to be further enhanced. This is an indispensable precondition of making use of the advantageous geographic transit position of Central Europe. Already in the present stage, this transit role should be strengthened by the presentation of joint projects starting from small-scale cross-border cooperation deals to be financed by the Multiphare Programme to largest-scale trans-European networks. Also, openness and rapidly developing contacts may accelerate the process of further eastern

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46 It has to be noted that fears can be grouped into two major categories: security and economics. The latter includes both growing external competition (commodities and labour) and the diversion of resources (FDI and transfer flows). While the less developed countries of the EU emphasise their economic concerns, geographical neighbours fear impacts on their internal security. Austria is the only country experiencing both impacts, which, in part, may explain the rather hostile attitude of this country, bordering on no less than four candidate countries, to (early) enlargement.

47 As a case for comparison see the booming of relations between Spain and Portugal after membership. It has to be added that the present level of CEFTA cooperation is both quantitatively and qualitatively much higher than that between the two Iberian countries before membership.



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enlargement, keep the time of the first enlargement as short as possible and reinforce the temporary character of some of the new external EU borders dividing Central Europe from its eastern, northern and southern neighbours. In addition, good neighbour relations, including the adequate treatment of minority issues, are a major contribution to regional security, a key qualifying element of (potential) EU membership.

Third, new areas of cooperation should be carefully envisaged vis-à-vis the EU. Evidently, one key issue is the more coordinated preparation for membership. Although each country will negotiate on its own terms, merits and handicaps, even in the case of the most careful preparation, each of them will have a weak negotiating position. In the optimal case, first-wave candidates should support each other to achieve better results at the negotiating table. However, if this turns out to be wishful thinking, at least, as a minimum requirement, the undermining of each other's position has to be avoided.[48] A second area of possible cooperation could be the designing of regional infrastructural projects as a useful contribution of the EU to the success of pre-accession strategies. Another issue to be dealt with could be the common thinking about the creation of a special fund for the countries belonging to the first wave of eastern enlargement. Previous enlargements regularly created a new fund tailored to the specific needs of the newcomer(s). Moreover, such a fund might dampen the fierce fighting about the redistribution of EU funds and offer an opportunity to the net contributing countries to redirect (relabel) their support to be paid into the central budget of the EU. Equally important and even more timely would be the development of a joint communication strategy towards the Western European societies. Taking the group approach for granted, the first wave of eastern enlargement will affect more than one country, and most probably, a more or less homogeneous region. Thus the group approach will be based on regional considerations. Central Europe, by anticipating this approach, should already start a communication strategy emphasising the regional importance and aspects of enlargement.

## VIII Concluding Remarks

Membership of the European Union by Central (and probably later Eastern) European countries is one of the most important strategic tasks of

48 In this respect, the story of the negotiations of Spain and Portugal, on the one hand, and those of Finland, Sweden (and partly Austria), on the other hand, with the EU are extremely enlightening. The first provides lessons on how not to negotiate, while the second delivers useful inputs on how to achieve in joint action something that would be unlikely to be achieved in separate deals.



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Europe at the turn of the century. It coincides with other strategic decisions to be made on the future architecture of the Union. In all cases, two overriding priorities have to be considered:

(a) the security of the continent, which cannot be sustained without rapid and predictable modernisation of Central and Eastern Europe, and
(b) the strengthening of Europe's place in international politics and the global economic system.

Following the positive political decision on enlargement, the no less important (strategic) answers on when and how enlargement has to be implemented have to be formulated on the basis of these two priorities.

As security and competitiveness are not static but highly dynamic, the timing of enlargement (including its pre- and post-accession periods) seems to be crucial.

More than seven years ago, an ex-secretary general of an ex-great power told to another ex-secretary general of another ex-country that history would punish those who are delayed or delaying things to happen. At present, this remark is no less timely. However, it is no longer related to Central and Eastern Europe, but to the more developed and (still) luckier part of the continent.


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# Comment on "Prospects for Joining the European Union," by András Inotai

*Joan Pearce*

I would like to begin by saying that my remarks reflect entirely personal views and should in no way be attributed to the European Commission. I very much enjoyed András Inotai's paper. I thought it was vigorous, straightforward and clear. It covered a vast amount of ground and did so in a very systematic way. I cannot possibly comment on the whole paper, so I am going to confine my comments to a few topics. I will talk almost exclusively about economic aspects. This is in no way to dissent from the view expressed by András Inotai that the security aspects of enlargement are extremely important.

I would also very much agree with another point made by András Inotai that the economics of enlargement are not technical issues, they are highly political. And if I have a general criticism of the paper, it is that it doesn't take enough account of the political nature of the economic issues and indeed some of the sheer administrative aspects of the economic issues.

I will talk briefly about three things touched on in the paper: the Europe Agreements, the opinions and differentiation among candidate countries. I will then talk in a little more detail about the negotiations themselves.

First of all, the Europe Agreements. András Inotai very rightly calls attention to the agreements as comprehensive documents. They go far beyond mere trade agreements. They have a lot of other things in them. Incidentally just to clarify one point: the trade provisions of the Europe Agreements came into force two years before the non-trade provisions. So, whereas we are now approaching the mid-point of the 10-year life of the agreements as far as the trade provisions are concerned, as far as the non-trade provisions are concerned, that will not come for another two years.

The non-trade commitments in the Europe Agreements are far from trivial. For example, in the area of competition policy the Europe Agreement countries are required to adopt rules which are consistent with those of Community competition policy for anti-trust and state aids within three years of entry into force of the Europe Agreements, which for Poland and Hungary will be the end of 1997. This entails not only adapting their legislation to that of the EU but also agreeing on implementing rules. In the context of this commitment the Commission is asking the


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associated countries to set up their own administrations to vet state aids. This is something that no member state and no member of the European Economic Area is required to do because all of those countries have a supra-national authority – the Commission in the case of the member states, the EFTA surveillance authority in the case of the European Economic Area. It is quite a tall order, and one to which the Europe Agreement countries will have to devote considerable administrative resources.

Let me move on to the opinions. According to the conclusions of the Madrid Summit of December 1995, as soon as possible after the conclusion of the IGC, the Council will consider four documents. The first document comprises the opinions; the second is a horizontal paper which will look at accession in a horizontal way with the aim of ensuringthat all applicant countries are given equal, comparable treatment. The third paper, the so-called impact paper, is designed to assess the impact of enlargement on the policies of the Union and the fourth paper is a paper which will examine the financial framework of the Union after December 1999. This is because the present budget arrangements are only in place until December 1999 and new arrangements will have to be agreed for the period after that.

The Council is supposed to consider these four documents and then take decisions for launching accession negotiations. According to the Madrid Summit, the Council hopes that the preliminary stage of accession negotiations with the CEE countries will coincide with the start of negotiations with Cyprus and Malta – and now only Cyprus because Malta has decided that it does not wish to negotiate accession. Cyprus has been promised that its negotiations will be started six months after the conclusion of the IGC, so that is the soonest that negotiations can start with the CEE countries.

The IGC is due to conclude with the Amsterdam Council in June 1997, and the opinions could be delivered very soon after, in July. András Inotai seems to imply that they will probably all be positive, but this is unlikely, as the conclusions of the Commission's seminar on enlargement at the end of November 1996 indicated. Certainly the Commission services take very seriously the responsibility of issuing objective opinions on the readiness of countries for membership. That being said, whatever opinions the Commission comes up with, they are precisely that, opinions. And it is open to the Council to overrule them, in either direction. The Council could decide not to negotiate with a country on which the Commission has delivered a positive opinion, or it could decide to negotiate with a country on which the Commission has delivered a negative opinion. That is entirely up to the Council.



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I agree broadly with what András Inotai has said about how negotiations might most efficiently be launched. One possibility would be to begin negotiations with only a small group of countries. The reasons for this from the Union's point of view are that it is not physically possible to negotiate with ten countries simultaneously, and it is certainly not possible for the Union to absorb ten countries simultaneously. When one thinks that in its entire history, the Union has grown from six countries to 15, or 15 if you count East Germany, it has taken in at most 11 new countries since it was formed. The idea that it could now take in ten in one go is clearly not realistic and no enlargement has involved more than three countries in the past. President Santer is indeed on record as saying that he thinks the first wave of enlargement should probably comprise three or four countries, and the Commission seminar indicated that enlargement was likely to take place in stages.

An alternative would be to begin negotiations with all ten countries at the same time on the understanding that this would be a multi-speed process in which negotiations would advance much faster with some countries than with others, and András Inotai points out that there are a number of good reasons for doing this. It provides some assurance for those who have so far made less progress than others, and it perhaps helps to overcome the fact that among the member states some have preferences for some countries and others have preferences for other countries. One further advantage to this kind of approach is that it allows more flexibility. It provides the possibility that countries could begin slowly but later accelerate if the conditions were appropriate. This might be particularly important for a country where policy changes made the prospects of its accession to the European Union look somewhat different from how they look today.

There is also the crucial issue, to which András Inotai draws attention, of what to do about the countries that are not in the first wave. It will be important not to allow what may be a rather disparate group of countries to become disaffected or dissociated in any way from the rest of Europe. We have to think about what sort of regional linkages we want to encourage and intensify.

Let me go on now to negotiations. I will talk about two aspects from this section in András Inotai's paper, one is the speed of negotiations and the other is the issues involved in the negotiations. The paper places substantial weight on the speed of negotiations and suggests that negotiations could be completed in two years. This is somewhat longer than the time that was taken for the last enlargement negotiations to include Austria, Finland and Sweden, but it is very much less than the period necessary to negotiate the enlargement to include Spain and Portugal. It is important to ask why there was such a difference in the length of negotiations. One very


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clear reason is that the three countries involved in the last enlargement were already part of the European Economic Area which meant that large parts of the *acquis communautaire* had already been taken on by these countries as members of the EEA. Second, there was the familiarity that Mr. Karlsson referred to: each side already knew how the other operated. There were far fewer question marks.

One can also see how ambitious this timetable is from another perspective. If this first wave of enlargement were to take place in 2002, and with derogations of up to ten years, that would mean full membership, having completed transition periods, by 2012. That would be 20 years after the first trade agreements came into effect, which would be faster than any other member state of the European Union. No country has ever gone from a free trade area with the European Community to full membership including the completion of all transition periods as part of the single market in 20 years. In addition, these are transition economies that are aiming to come into this highly developed integration arrangement.

Furthermore, meeting that very ambitious target is not necessarily advisable. While in other sections of the paper András Inotai sets out both sides of the argument, when it comes to rapid accession he discusses only the advantages. At one point, he talks about the costs of non-enlargement against enlargement, but enlargement can be achieved in more ways than one and some may be more satisfactory than others. The new member states are going to be required to take on the entire *acquis communautaire*, though they will be allowed transition periods and limited derogations in doing this. It would be a mistake for either the EU or the applicant countries to give priority to rapid accession over ensuring that the commitments that the applicant countries make are commitments both that they are able to meet and that will not weaken the *acquis communautaire* in ways that might hamper the progress of the European Union.

Now I will turn to some of the issues for negotiation. One of the issues that András Inotai mentioned is sovereignty. He suggests that this may belong to the hardest core of negotiations. But the pooling of sovereignty is not negotiable: it is an integral element of the European Union. So, for instance, in the area of common policies such as the common commercial policy, any country that is going to accede to the Union has to accept that it will not be free to determine independently its external trade policy. In preparing trade negotiations, for example, each member state has an opportunity in the Council (specifically in the Article 113 Committee) to influence the negotiating mandate. It may or may not succeed, and it may have to make concessions to other member states in order to get what it wants. In any event, at the negotiating table in WTO or with bilateral trade partners, it is the Commission that negotiates on behalf of the



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Community. Those arrangements are in place and are not negotiable. So it is important that applicant countries understand what pooling of sovereignty means.

One area where problems will have to be tackled is the environment. The World Bank has been analysing some of these problems and has come to the opinion that virtually all of the applicant countries are quite unrealistic about the amount of time it is going to take to bring the application of environmental standards into line with those of the Union. A further point that the Bank has made is that the cost of implementing these environmental standards will be much higher if it is done in a relatively short time span than if it is done over a relatively long time span. This is because in order to change very quickly, it is necessary to adapt existing plants, whereas if change takes place over a longer period, new plants can be built. It is actually more expensive to adapt existing plants than to build new ones that meet the standards. There are going to be questions here about the transition periods, permissible derogations, the trade-off between the length of time and the money it will cost and whether some financial assistance should be provided and if so, how much and on what criteria and so on.

Another issue which concerns the Commission is the institutional capacity of the applicant countries. This has already been alluded to in earlier sessions. The Union is a rather hybrid animal. It has elements of an intergovernmental organisation and elements of a federal state. To the extent that it is a federal institution, it is more on German lines than American lines, by which I mean that to a large extent, the laws and regulations are implemented and enforced by member states. We often hear references to Brussels which imply that there is some large bureaucracy sitting in Brussels, but this is not the case. The officials of the European Commission number 14,000, which is fewer people than are employed in the Scottish office in the United Kingdom. What is more, one-third of them are interpreters and translators.

The Commission, furthermore, has very few sanctions at its disposal to ensure that member states enforce the rules and regulations of the EU, even in key areas such as the internal market. Hence it is necessary for current member states to have a substantial amount of confidence in the ability and willingness of new member states to implement and enforce the laws and regulations of the Union. Moreover, membership is irreversible. A country cannot be thrown out of the EU. A country can decide to remove itself from the EU, but as long as it wants to stay, the other members have to accept that it is there for the indefinite future. All of these factors mean that establishing the credibility and reputation of institutions is critical, and although this may not be a direct subject of negotiation, the


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concern about the institutional capacity of these countries will impinge on the way that many aspects of the negotiations are treated.

András Inotai points out that preparation for membership will impose costs on the applicant countries, and the Commission is keenly aware of the need for a major effort to help the applicant countries prepare for accession. It has recently drawn up new guidelines for the Phare programme which will in future concentrate on two main objectives: first, to help theapplicant countries develop public services that are able to implement Community rules with the same guarantee of effectiveness as in the member states; and second, to help them to bring their industry and major infrastructure up to Community standards by making the necessary investment. These new guidelines signify the determination of the Commission to work with the applicant countries to ensure that accession is well prepared.



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# Comment on "Prospects for Joining the European Union," by András Inotai

*Friedemann Müller*

A famous German comic from the first half of this century once said "Everything has already been said, however, not by everybody". This gives me the right to be repetitive but brief.

For 22 years, I have had the pleasure of being an enthusiastic reader of András Inotai's papers. There was not a single time that I did not learn from each new paper that I read. This holds true for this paper. I would like to focus on only one point – and 5 sub-points.

The major point is that this paper is a little too conservative. It focuses a little too much on the problems of the past seven years instead of looking toward the problems of the coming seven years. András Inotai would probably disagree, so I would like to elaborate by taking up these 5 sub-points. I have one minor comment first. The paper suggests that there are four spheres of influence: a global, a Pan-European, an intra-European and an intra-candidate, and the paper focuses primarily on the last two. I would like to argue that the global and Pan-European spheres might have even more influence in the next seven years than the presentation suggested.

My first sub-point concerns the IGC. András Inotai says that the negotiations will start after "successfully finalising the IGC". It sounds a little ironic; it is almost like saying "after successfully solving all of their problems". My question is: Does the current European Union not have the right to have deep problems in its own integration process? The IGC is a further step of integration, and there have been several in the past 30, almost 40 years of European integration – some successful, some not very successful. It is quite unclear whether the IGC will be a success, but this is a very normal process. In comparison with what has already been said on the sub-regional processes in CEFTA and the Baltic countries, András Inotai claims that CEFTA success will be limited. Why not make the effort to make CEFTA a success – it will be painful, just like the IGC is painful, but why should the CEFTA countries be less able to be a cohesive region than the current European Union? Why should there be a more common integration notion between Ireland, Portugal and Austria than between the current CEFTA countries? Events in European Union integration do not remove your responsibility to do what you can do with integration efforts



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in your own regions.

My second point is on globalisation, and I am not talking about the European Union as an entity but about the individual member countries. At least for Germany, there is no concept of how to meet this challenge. We have double-digit unemployment rates, we have a capital outflow ten times greater than capital inflow, and this is connected to the availability of employment. Why shouldn't these problems be as important as the problems of adjustment to European Union standards? Globalisation causes a problem far beyond the question of employment. It is a question of a competitive struggle which means that all sorts of public demand must be reduced and individual demand becomes important. It becomes important because the capital market is free and nobody has a chance to restrict it. We might want to keep public demand in some spheres like education or environment or some kind of preventive measures against security threats. In this situation, how can webe totally free to support any enlargement?

My third point refers to your very nice expression "the banana of European-type small tigers", which is what you call these countries from Slovenia to Estonia. I have been directing a research project on the environment and energy in Central and Eastern Europe. Scholars are participating from Russia, Ukraine, Poland and the Czech Republic. As you know, these are very different countries, especially in their recent development. But they are similar in one respect. In all of these countries, it is impossible to cut energy subsidies because this would have a major effect on the social situation by pushing many households below the poverty line. Although the government is not in charge of subsidising energy, it is in charge of social policy. And unfortunately, governments opted for the most inefficient way of implementing social policy, which is subsidising a product so that people can buy it cheap and waste it. In all of these countries, the energy consumption per GNP unit is at least three times higher than in Western Europe, and in some cases even six times higher. Mr. Karlsson brought in this notion of the second generation of transformation, and I think you have to get serious about transition – do not mix up subsidy policy with social policy. It is extremely inefficient and as long as you do it, you will not get a small tiger type economy.

My fourth point is the sensitivity threshold regarding national sovereignty. The paper recommends "a carefully designed and well-balanced communication strategy". This makes it sound like it is the responsibility of the current European Union to be sensitive with this question. I am from a country that for decades felt itself to be an outlaw with no international responsibility. We were pushed to take more international responsibility, and I would like to relate this experience to the Central and Eastern European countries. You must take more responsibility, even dur-



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ing a time of hardship, and one part of this responsibility is to deal with these sensitivities of sovereignty. You must be clear and transparent to the population. It is not just a question of being diplomatic on the European Union side.

My final point is your pledge for a small-group approach of first-wave countries and your preference for Poland, the Czech Republic and Hungary as first candidates. As I just learned, this is close to official EU policy. But who is responsible for what happens to the remaining candidates? This is a delicate question and should not be left to the European Union alone. It should be part of the new responsibility of those countries in the first wave. Especially important in this regard are all of those questions about the second or third wave which might be delayed until 2010. Is this realistic and what happens in the meantime?

I will conclude with an appeal to the evolving responsibility on the side of the candidates because, otherwise, we will witness very difficult problems considering the fact that the European Union itself and its member countries are not as stable as some people seem to think.



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# Floor Discussion of the Inotai Paper

## Conditions for Accession and the Adjustment Process

The comparison of Eastern enlargement with the previous Southern enlargement of Spain, Portugal and Greece provided the basis for a number of comments. Franz-Lothar Altmann began this part of the discussion by focusing on the financial flows. "If you compare the utilisation of these financial flows and the absorption of these flows to Portugal and Spain on the one side and Greece on the other, there is a substantial difference. It was clear that Greek import surpluses at the beginning of membership were in consumption, whereas for Portugal and Spain, the import surpluses clearly resulted in a high inflow of investment goods. The financial means, not only what was imported but what was transferred from other EU members into the new member states, was also very different in Greece. The major criticism was – and still is – that there was an enlargement of the state sector and that much of these financial means ended up there instead of in investment or in modernisation which could improve overall production capacity. The lesson is that one should also look at what happens with the expected inflow of means after accession in order to speed up the adaptation process."

Joan Pearce added two comments on this comparison. "András Inotai refers to the position of the applicant countries now and of Spain and Portugal when they were applying, but that is not the relevant comparison. The relevant comparison is Spain and Portugal in relation to the community as it was at the time of their application and the applicant countries in relation to the EU today. It is true that there is a greater degree of privatisation and demonopolisation in the applicant countries, but the Union has also progressed tremendously in this respect. The context in which Spain and Portugal were joining was quite different.

My second point concerns another lesson from the Spanish and Portuguese enlargement. The negotiation of accession for Spain took almost nine years. One of the reasons why negotiations took so long was that a lot of people thought that Greece had been brought into the community too quickly, and that this had caused a lot of problems. People were very wary about bringing in two more countries that might have similar problems. This is a lesson that we all need to keep in mind, particularly if the first-wave countries are concerned for the second-wave countries. This is one more reason why the first-wave enlargement has to be a success. If it



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happens, but then generates all kinds of problems in the Union, there is going to be great reluctance to contemplate a second wave in a relatively short time span after the first wave."

Zdeněk Drábek commented on the maturity of countries in Central and Eastern Europe. "Quite frankly, I think that András Inotai is overly optimistic in judging the adjustment ability of the countries themselves or the successes in adjustment so far. I was struck by his comments about substantially increased export competitiveness of the region. This may be the case in Hungary, but I doubt that this is the case in the Czech Republic where there is a very serious problem with the competitiveness of the tradable sector.

With regard to the adjustment process and the role of macroeconomic policy, you say that there has been a very successful adjustment, but in my view, adjustment has not been good enough in terms of an integration strategy toward the EU. How important is the maturity question? How mature do we have to be to become members of the EU? If thesecurity question is the driving force of negotiations – and this would not surprise me – then the EU might even take a less mature member in order to increase stability in the region."

Joan Pearce linked the issue of security with the question of financial transfers. "Security is the driving force in that the EU's raison d'etre for enlargement is seen mainly in security terms. On the whole, it is seen as a process that will bring security benefits at certain financial and economic costs. I agree, András, that is not an accurate assessment of the costs and benefits, but nevertheless, it is the perception. When considering what is meant by security, some would be sufficiently blunt and say, 'enlargement is about Poland'. While this is an overly simplified expression, there is some truth in it. So when you say that there will be significant differences in financial transfers for the various applicant countries, this is certainly true if we look at the present arrangements for agriculture and structural funds. The big ticket item is going to be Poland, but Poland is also the country in which there is the most interest from a security perspective, so there you would expect to find a balance between the perceived costs and benefits. There are other countries where the security benefits are much less and the financial costs rather high – if not quite as high as Poland – and therefore the security argument would not be sufficient to outweigh the financial argument."

Mark Allen expressed concern about the assessment of the benefits in the transition process. "There is this notion that because the EU was running a large trade surplus that the benefits have been asymmetrically distributed so far in the process. This is an incorrect analysis of the situation. The distribution of benefits cannot be judged separately from the move-



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ment of trade balances or current account balances. Current account balances are going to depend on the savings investment balances in the individual countries, not on matters of trade policy. All that trade policy can do is change the distribution of items inside the balance of trade. What is more important is to determine whether exports have been behaving dynamically on the two sides as a sign of where the benefits are really occurring. What I find particularly disturbing about the argument that trade surplus on the EU side is a sign of the wrong distribution of benefits is that, at the same time, one is asking for substantially larger financial transfers from the community and, of course, the financial transfers are precisely the counterpart of the current account deficit. Thus, the bigger the financial transfers, the larger the current account deficit of these countries is going to be and, on this analysis, the more the transfers, the worse the distribution of benefits – which is clearly not the case. So an analysis of who has gained most from the trade liberalisation process so far has to be done on a different basis."

## Negotiations

Franz-Lothar Altmann turned the discussion to the negotiations and the question of sequencing. "We should try to avoid making groups of countries because, groups entail the danger of erecting new borders between these countries. Groups are going to emerge in the process of accession anyway, but it is important from the start to avoid calling three or four countries a group. This could have a negative impact on all of the endeavours of these countries in the course of preparation and adaptation for new membership. Rather, we should use the baseline approach in which we begin negotiations with all of these countries at the same time, but with varying intensity and speed. Then, when one, two or three countries are ready and both sides agree, treaties can be signed. This country-by-[15] country approach would not entail the danger that there would be a long waiting period for successive groups while the EU is dealing with the problems of the first group. We must search for additional means and economic and political cooperation with these countries, but at the same time, we should not forget the other countries which are not one of the ten or eleven accession countries. Ultimately, countries like Croatia, Serbia, Montenegro, Albania, Macedonia or the Ukraine will probably also apply for associated status, so we have to think more in advance of these countries and prepare for the additional incorporation of these countries into the wider Europe."

Joan Pearce responded to Franz-Lothar Altmann's view on a case-by-case approach. "I am certainly in favour of beginning negotiations with all



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the applicant countries and then maintaining as flexible an approach as possible which would permit some to accelerate. It would be case by case in the sense that negotiations would be bilateral. But, just as it is inconceivable that the Union would take in ten member states simultaneously, it is equally inconceivable that it would take them in one at a time. On pure institutional and administrative grounds, it takes about two years to absorb a new member state, and the idea that Europe would spend ten to twenty years taking in ten countries at the rate of one or two every two years would be incredibly disruptive to the Union. It is simply not in the cards. There will come a point when, whatever the shifting in the relative speeds during the process of negotiation, certain groups of countries are ready for accession and they will come in as the first wave and then groups of countries will form the second or third waves."

Zdeněk Drábek emphasised the importance of distinguishing among the countries and suggested some specific negotiating issues. "For example, financial transfers will surely be less of an issue for the Czech Republic for some other countries. On the other hand, there will be some very sensitive topics to negotiate, and here are three suggestions which will become important on your list. One, certainly for the Czech Republic, is the issue of property ownership on border areas with the Austrians. Another one will be transport, particularly road transport. And a third one will be macroeconomic policy, my favourite topic. I can foresee a situation that the EU will be, by then presumably, an EMU and the extent to which these countries will be able to join will depend on their macroeconomic situation."

Barbara Stallings made a comparison with the position of Mexico in the NAFTA negotiations. "If one takes Mexico and NAFTA as an example, Mexico has as much trade with the US as the CEFTA countries have with the EU, but in Latin America, this is seen as a problem. As a matter of fact, when Mexico was in the process of negotiating the NAFTA agreement, important people in the Mexican government publicly said their reasons for joining NAFTA was to make Mexico more attractive as an investment and trade partner for Asia and Europe. But this notion doesn't seem to be part of the game plan of the CEE countries. What is your opinion on the notion that they would make themselves even more attractive to Europe if they were a bit more diversified? Their lack of bargaining power has been mentioned. Would it help their bargaining power if they had a more diversified economic base?"

Albrecht von der Heyden elaborated his view of the role of CEFTA both before and after accession. "It has a specific role in the preparatory process but also a key role after accession for those who are not in the first accession track. I have the impression that CEFTA has been reduced to a



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tool for the bargaining position of the countries concerned. We should think about alternatives and procedures to guarantee that the accession process is not limited to those who have the best chances in terms of maturity, but make sure thatthe accession process for all ten countries is continued. No one has a sufficient solution for this, including those who have made specific proposals, such as the French and German foreign ministers who suggested a European conference. It is an expression of apprehension that if we don't find the special tools for guaranteeing that we see it as a process of accession as a whole, then we won't achieve our goals. I would like to take up the ideas mentioned with regard to the customs union and the EEA, and I would like to limit our task to finding some kind of procedure."

## Response by András Inotai

"The first issue I would like to comment on is the security issue. As it concerns enlargement to the East, the first-wave countries should definitely be interested in a strategic framework for further enlargement. Nobody who is thinking in strategic terms will want to become a member of the EU and then close it down. This would just transfer the security risks from the western border of these applicant countries to their eastern borders. Four kinds of countries may emerge. One is the country which is already an EU country, such as Germany and Austria. The second is the country which borders and is likely to join the EU. The third group includes those countries who are expected to become members later on. And the fourth group is made up of those countries who are not expected to become members, at least as the situation stands today – I would never use the word never. In our security perception, and this should be shared by the EU, we need a very different and very careful approach to these groups. I have discussed this issue in Hungary with some individuals who only look at the uncertainties, dangers, dilemmas and challenges arising from the accession of Hungary and the simultaneous non-accession of some countries with a large Hungarian minority. It is a first-rank security issue for the whole of Europe. It is a very important issue for using the potential Hungarian, Polish, Czech and other advantages in becoming a transit country and not a fortress country. And it is very important for our bilateral economic relations. Please do not forget that some of the most dynamic relations in our trade, and not only Hungarian trade, are with the neighbouring countries and they will remain so. Nobody is interested in finishing with the first enlargement. We are very interested in securing the framework for further enlargement, also for security reasons.

My second remark concerns speed. Joan Pearce has suggested some



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ideas about why speed should not be considered so important. Of course speed is not the only component and a lot depends on other factors. However, it is difficult to compare the speed of negotiations of the CEE countries with that of Portugal and Spain for different reasons. The transformation process itself is much faster than has been envisaged and than any other adjustment process. It does not mean that transformation may not produce some setbacks, and that many questions remain regarding the next stage of transformation, in all of our countries. This might have repercussions on our preparation for membership, and it would be very interesting to analyse what the ideal sequencing of transformation on the one hand, and the ideal sequencing of adjusting to the EU would be, on the other. I am not sure that the sequencing is the same in all cases. What kind of compromises need to be made? What is the right policy mix? These are some of the biggest challenges we are facing. Europe is a very different place from when Spain and Portugal were negotiating. At that time, there was a divided but predictable Europe without too much unforeseen, unpredictable dynamism. It was reliable and there was time. Today, the time constraintmay substantially influence the speed, and this is particularly the case if we consider intra-European dynamism which is also shifting. Berlin will be the future capital of Germany, and I don't think that it can remain just 60 kilometres from the eastern border of the EU. There are tremendous dynamic forces, and in order to maintain the internal balance and stability of the Union, enlargement is imperative probably earlier than many people think today.

I do fear the view that all those first-wave countries are responsible for the future of Europe and for the future of handling security and other issues in their neighbourhood. They must have a very specific role, not just as a member of the Union, but much more. I do agree with Lothar that groups should not be created artificially, but some groups have already been created. There are three OECD countries in the region; what is that if not a clear distinction? Is it possible that a non-OECD country could become a member of the EU? It has not been the case up to now. Will there be a change in EU policy or will these countries first become members of the OECD? There will probably also be some NATO members before enlargement. I think there is a linkage between NATO membership on the one hand and EU membership on the other. While I understand the fear regarding the creation of groups, there are also fears in the applicant countries in the other direction. The more developed applicant countries may fear that the non-creation of groups is practically equivalent to the postponement of enlargement, and this also contributes to paralysing sub-regional cooperation. They would be much more able and willing to enter a sub-regional cooperation arrangement if they knew that this was



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the group that would join. They would consult each other in a much more intensive way.

As for the diversification mentioned by Barbara Stallings, you are absolutely right that our trade and other relations should be more diversified, and this is already the case regarding FDI. A number of US, Japanese and Korean companies have come to Central Europe to invest in the CEFTA countries – with one eye on the EU market. One problem for these countries, mainly the Far Eastern ones, is the 60 per cent share of domestic EU and CEFTA inputs. Especially in their first years, they would like to have their own inputs and parts to be imported and shipped to these countries. But if you look at Suzuki in Hungary, for instance, it managed to produce 70 per cent of its inputs in Hungary, EU and CEFTA countries. We are very much interested in capital from the global market, and since most of the available capital today is from non-European countries, we think that the speeding-up of the enlargement process will certainly contribute to convincing non-European investors to invest more heavily in this part of the world.

Finally, I would not like to be misunderstood with regard to the trade surplus of the EU. It was not meant as an indicator of the distribution of benefits toward the EU. It is just one factor, and no one has denied the favourable impact of the association agreement on the associated countries. The temporary trade asymmetry in our favour is unlikely to compensate for the historical development asymmetry between the two parts of Europe. In the case of Spain, Portugal and Greece, the trade deficits with the EU have been largely offset by EU transfers. In the case of Portugal, between 1986 and 1992, they have accumulated a trade deficit with the EU in the amount of about 30 billion dollars. Half of this can be accounted for by transportation and so on. The other half was unilateral transfers from Brussels to Lisbon."



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# Appendix

**List of Participants in the Conference on Regional Economic Integration and Global Economic Cooperation: The Case of Central and Eastern Europe, held at the Institute of Economics of the Czech National Bank on 13-14 January 1997**

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|---|---|
| Mr. Mark Allen | Senior Resident Representative, International Monetary Fund |
| Mr. Franz-Lothar Altmann | Director, Südost-Institut |
| Mr. Zdeněk Drábek | Senior Adviser, Economic Research and Analysis, World Trade Organisation |
| Ms. Stephany Griffith-Jones | Senior Fellow, Institute of Development Studies, University of Sussex |
| Mr. Albrecht von der Heyden | Head of Desk, Economic Relations with Central and Eastern Europe, German Ministry of Foreign Affairs |
| Mr. Miroslav Hrnčíř | Member of the Bank Board, Chief Executive Director, Czech National Bank |
| Mr. Henrik Huitfeldt | Senior Economist, Department for Central and Eastern Europe, Swedish International Development Cooperation Agency |
| Mr. András Inotai | General Director, Institute for World Economics of the Hungarian Academy of Sciences; Head of the Hungarian Task Force on Integration Strategy |
| Mr. Mats Karlsson | Under-Secretary of State, Swedish Ministry for Foreign Affairs |
| Mr. Jan Klacek | Director, Institute of Economics of the Czech National Bank |



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| Mr. Martin Kupka | Economist, PATRIA Finance a.s. |
| Mr. Ricardo Lago | Deputy Chief Economist, European Bank for Reconstruction and Development |
| Mr. Frans van Loon | Director Emerging Markets Group, ING Bank International |
| Mr. Friedemann Müller | Senior Research Associate, Research Institute for International Politics and Security |
| Ms. Niina Pautola | Economist, Unit for Eastern European Economies, Bank of Finland |
| Ms. Joan Pearce | Counsellor, DG II, Economic and Financial Affairs, European Commission |
| Mr. Roberto Rocha | Senior Economist, World Bank, Budapest Resident Mission |
| Ms. Piritta Sorsa | Senior Economist, International Monetary Fund, Geneva Office |
| Ms. Barbara Stallings | Director, Economic Development Division, UN Economic Commission for Latin America and the Caribbean |
| Ms. Inna Šteinbuka | Director, Economic Analysis and Forecasting Department, Latvian Ministry of Finance |
| Ms. Eva Sundquist | Special Advisor, Division for Central and Eastern Europe, Swedish Ministry for Foreign Affairs |
| Mr. Jan Joost Teunissen | Director, Forum on Debt and Development |
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