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

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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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