Part II

Europe

From: Regional Integration and Multilateral Cooperation in the Global Economy
FONDAD, The Hague, 1998, www.fondad.org

Prospects and Priorities of Regional Integration in Europe with Special Regard to Eastern Enlargement

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I Introduction

Europe's 20th century history is characterised by a constant process of integration and disintegration. Though substantial differences in the level of economic development persisted, the continent was economically united before the end of the first world war. As a consequence of the peace treaties of 1919 and, later, as a result of the Great Depression, Europe became fragmented, autarchic and nationalist. Between the First and Second World War, the centre of growth and technological development shifted to the other side of the Atlantic, and the United States emerged as the clear economic leader of the world. Interestingly, while the European continent disintegrated, rapid growth and modernisation in Scandinavia – an economically backward and peripheral region before 1918 – created favourable conditions for increased European integration.

The outcome of the Second World War gave substantial support to both integration and disintegration. Europe became a split continent with strong integration tendencies, although patterned differently, in both the eastern and western parts of the continent. As a result of many factors including security aspects, domestic economic development and especially the implementation of the 'developmental pattern' of Western European integration, the peripheral Southern European countries and, even earlier Ireland, could be included in the Western European architecture.

Finally, the fall of the Berlin Wall had a fundamental impact on more recent integration processes in Europe. On the one hand, it ended the division of Europe and eliminated the ideological and political barriers to the integration of the whole continent. On the other hand, the fragmented character of Europe became more manifest and was substantially exacerbated by institutional disintegration as several states, created in different periods of European history, fell apart within a few years.

Europe now has a historical opportunity to foster the elements of integration and continue with the almost half-century long process of integration on a qualitatively new, continental level. Within one century, and fol-

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lowing Scandinavia and the Mediterranean, a third periphery, Central and Eastern Europe, is expected to become an integral part of 'modern Europe' in the next decade(s). In other words, the more developed part of Europe is once again being challenged by the next 'geographic sequencing' of expanding the boundaries of an integrated Europe towards the East. There is no doubt about the difficulties, uncertainties and likely traps of such an undertaking. First, the main actor of the process, the European Union, is simultaneously facing a number of other challenges. Second, the 'geographic sequencing' in itself raises questions, dilemmas, expectations and fears which must be properly addressed.

In this paper, I approach some basic issues, primarily concerning the eastern enlargement of the European Union, from an optimistic viewpoint. I am completely aware that there are other, less promising – and not unlikely – scenarios as well. It is the size of the paper and the hopefully not unjustified optimism of the author which explain why other possible scenarios have not been elaborated.

II Regional Integration in Europe

Unlike regionalism in some other continents, regionalism in Europe is characterised by several unique features. First, there is a clear gravitation centre of integration, the European Union (EU), and there are various sub-regional groups rotating around this centre; frequently from an external periphery position, but sometimes also from within the EU itself (regionalism within the EU). Second, Western European integration has reached a much higher level than any regional integration effort in other parts of the world. Partly, this is based on very strong micro-level integration of trade, services, finance and corporate governance. And partly, and not less importantly, the integration is highly institutionalised with Brussels being responsible for many issues that are an unquestionable part of national sovereignty in other parts of the world. Third, during the past decades the European Union has elaborated and implemented a two-tier integration pattern, consisting of market integration and developmental integration. This enabled less developed (member) countries to become increasingly integrated into the structure created by the more developed 'core' countries of Europe.

A second set of differences stems from a comparison of the present features to earlier characteristics of the European integration process. The European Union has never been so challenged by external developments as in the last years of this century. Some of the global challenges are institutionalised (WTO and other international organisations), some come from

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everyday business practice (competition), and some contain elements of uncertainty and even fear (migration, illegal and criminal activities). One has to emphasise that all of these challenges have a much wider scope than the consequences of Central and Eastern European developments, even though the post-1989 European situation may have contributed to higher 'sensitivity' in Western Europe for these challenges.

Beside the changing global role of the European Union, the integration process in Europe has also reached a qualitatively new level. To some extent, it became victim of its earlier successes. First, because more and more countries now consider the EU their modernisation anchor and would, therefore, like to become members of the Union as soon as possible. Second, because the internal logic of integration (and global competition) forces the member states to extend the scope of integration to new areas which were previously viewed as symbols of national identity (e.g. monetary policy).

The necessary deepening creates integrative and disintegrative trends at the same time. The deeper the integration is, the less countries are able to fully participate in the process. As a result, deeper integration produces fragmentation, albeit perhaps temporarily, *within* the previously integrated structure. Another threat of deeper integration is the non-sustainability of some integration mechanisms that have substantially contributed to the strengthening of cohesion among member countries in the past (common agricultural policy and structural funds but also institutional issues). In addition, most member countries are just now facing serious domestic problems (the future of welfare state, social and institutional flexibility, etc.) which may cause conflict between national priorities and commitment to integration. Finally, new and rather dynamic developments in Europe, including the pressure for early membership by the candidate Central and Eastern European countries, affect the European Union. To be sure, for decades, the European integration process has been developing in spite of crises, but the present situation is completely different. In quantitative terms, there are several overlapping crises which bring the given architecture into question. In qualitative terms, the current critical issues have to be settled in the global framework and, more importantly, without having an external enemy as a 'threatening anchor'.

It is no wonder that most of these problems have exploded the previously rather well-locked framework of Western European policymaking. All previous negotiations on enlargement were a matter of politicians and a few interest groups to be affected by accession of a given country. In the core countries of the EU, the accession of any country was considered as a security and political issue, settled in the traditional diplomatic way. The likely impacts, both positive and negative, did not filter down to the soci-

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ety. This time, however, we are witnessing an almost uncontrolled internalisation of all justified or unjustified concerns about eastern enlargement in practically all EU member countries. In fact, most of the fears result from increasing global competition, the accumulation of domestic problems that have been hidden by the status quo of a divided Europe, and the new challenges of European integration instead of from any 'Eastern threat'. Unfortunately, this distinction has not been properly communicated until now in the societies of EU member countries.

III The Challenge from Central and Eastern Europe

Since 1989, the process of integration has been accompanied by different processes of disintegration in the continent. While the EU became the unquestionable leader of European integration, its impact on selected countries of the continent varied (pyramid of preferences, including different levels of EU maturity and the EU's willingness to take new members). As a consequence, two parallel and contradictory processes evolved. On the one hand, the integration process became stronger by involving ten Central and Eastern European transforming countries into the institutional, political, trade and economic network of Brussels. On the other hand, the countries involved could make use of the new frameworks in different manners, as indicated by the share and structure of trade with the EU, subcontracting, intra-industry division of labour and cross-border programmes. Also, their transformation process in regional comparison shows substantial differences leading to the feeling of growing marginalisation in some countries despite the fact that they had signed the same Association Agreements as some more advanced countries. Moreover, not all countries of Central and Eastern Europe were grouped under this umbrella. As a result, though the previously institutionalised ideological, political, economic and income gap between Western and Eastern Europe was eliminated by the collapse of the Soviet empire, new gaps based on differences in income and development levels started emerging. Today, there are at least three (or four) serious income gaps within Europe – between Western, Central, Southeastern Europe and the successor states of the USSR. The income difference between Central and Western Europe is no larger than the income gap between Central and Southeastern Europe. In addition, a more differentiated situation is also unfolding within the present map of the EU. Eastern enlargement is likely to strengthen these differences. So the challenge of European integration is to cope with fundamentally different income and development levels.

In *Agenda 2000*, the Commission has tried to answer this question by

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providing an encompassing and flexible strategy for eastern enlargement and proposing the initiation of negotiations with the more advanced applicant countries early 1998. The differentiation of applicants made by the Commission was a bold political step, although it was by far no scientific discovery. It simply acknowledged realities in Europe and attempted to deal with them adequately. It must be emphasised that differences do not emerge because someone is talking about them. On the contrary, existing differences can only be kept under control as long as policymakers are completely aware of them and of the consequences stemming from such a varied situation.

A differentiated approach should not lead to disappointment in countries not included in the proposed first round of negotiations with Brussels. If properly handled, factors of instability can be effectively controlled (except for instabilities deriving from other sources for which the EU must not be made responsible).[1] In this context, the overall enlargement strategy must be filled with substance. Instruments which have already been proposed by the Commission could be complemented by large infrastructure projects running through the first-round candidate countries into other candidate countries. Such projects would have an important economic impact as well as an equally important psychological one, i.e. suggesting that all candidate countries are ultimately expected to become member of the Union.

Coping with growing differences across Europe goes beyond the discussion about the forms of eastern enlargement. In fact, there is a potential conflict in the development pattern of the EU itself. Before, or shortly after, the fall of the Berlin Wall, the key elements of the longer-term development of the EU were defined on the basis of the old concept of 'keep Germany in and down'. For many policymakers, deepening became the 'second-worst' scenario (when compared to widening and its consequences). In the last few years, increasing global challenges have also fostered attempts at deepening. However justified this attempt may be, two dangers have not been considered. First, deepening may collide with national interests within the EU and the uncertain social flexibility of Western European societies.[2] Second, deepening may divide Europe, and the costs of division (and instability) may be substantially higher than the

1 A higher level of instability could indeed be expected from the *non*-differentiation which would transmit a very bad message to the more advanced Central European countries. If disillusioned, these countries may transfer instability problems to the very borders of the European Union, which would hardly be a welcome development for Brussels, Germany, Austria or Italy.

2 It is more than interesting that the social and economic consequences of EMU have not been analysed in detail, while most experts and policymakers seem to be fully committed to this project.

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costs of a slower pace of deepening. While the Commission thinks it has 'solved' this dilemma by their simultaneous support of deepening and widening, the real solution must come from European developments in the coming few years. Integration in Europe cannot be separated into different clusters. The genuine integration of Central (and Eastern) Europe into a stable European pattern needs both a security and an economic modernisation anchor. Evidently, modernisation cannot be successful without guaranteed security in the continent, at least in the crucial years of modernisation. In turn, stability cannot be sustained without successful modernisation and a quick catching-up process, the fruits of which will be perceived by large parts of Central and Eastern European societies.

Considering the essential income gap (measured in GDP per capita terms) in the continent, regional integration must be based on two patterns: market integration and developmental integration. The last element has been widely used in the integration process of Ireland, Greece, Portugal, Spain, and most recently, former GDR. All of the current candidate countries will require instruments of developmental integration since they are much less developed than the EU average. However, the same pattern should also be used by Central Europe with regard to Eastern Europe (with the entry of Romania into CEFTA, sub-regional income differences are likely to become more exacerbated than in CEFTA-5).

Although they are substantial at the moment, income gaps can more easily be narrowed than forecasts based on different growth rates point out. In fact, the experience of Ireland and the Mediterranean member countries indicates that the catching-up process can be explained by the appreciation of the national currency to 75-90% while the impact of growth differential is only 20-25%.

More concern is justified regarding the future of financial transfers. In the past, Germany has financed the expansion of EU transfers. But Germany seems unable to continue with this practice even though the current beneficiaries are not ready to sacrifice part of their benefits to the newcomers. The sometimes – not fully understandable – race to the EMU and the forceful – and probably unsustainable – fulfilment of the Maastricht budget deficit criteria may limit the readiness of the present member countries to a redistribution of resources in favour of the new entrants. In addition, the German behaviour, motivated by 'enlightened self-interest', can hardly be expected from any other country (least of all by France, although Germany very much supported the Mediterranean enlargement).

Taking into account that the EU is the indisputable core of the European integration process, each country looks at fostering its relations with the EU. Sub-regional cooperation and integration is generally not viewed as a second-best option, but as an imposed waiting room before membership in the EU. According to general experience (not only from Europe), more sub-regional cooperation is not a precondition but a consequence of successful integration into the developed European structures. Spain and Portugal started meaningful economic cooperation after (and not before, let alone instead of) membership in the EU. Similarly, trade among first-round Central European countries is expected to rise from about 8% in 1996 to about 12% in the first years *after* membership.

IV Global Environment and European Integration

The success of European integration crucially depends on its competitiveness in global markets. The sustainability or increase of Europe's global position has several preconditions including:

- guaranteed and predictable security (in order to concentrate resources on economic development instead of emergency measures to keep repeated crises under control);
- making use of the advantages offered by economies-of-scale production, based on the larger European market, with particular emphasis on products in high demand by Central and Eastern Europe (environment, investment machinery, selected consumer goods, etc.);
- development of new technologies by benefiting either from economies-of-scale production or from the technological knowledge available in Central and Eastern Europe;
- reduction of the economic and social costs of production by mainly using competitive production units in Central and Eastern Europe;
- higher flexibility of the labour market since capital is already moving freely around the world and is looking for the best investment locations in global comparison. Inflexible labour markets will necessarily increase capital outflows which, in the longer term, may result in general capital shortage, undercapitalisation and underdevelopment in the currently most developed part of Europe;
- finally, and probably most importantly, higher social and institutional flexibility is a major precondition for global competitiveness in the next century.

Eastern enlargement is not only important considering the aspects already mentioned in the previous paragraphs. In contrast to earlier enlargements, this will be the first one which is really taking place in a globalising economy. Therefore, eastern enlargement is not an intra-European affair. It is a major factor of Europe's future competitiveness. Costs and benefits of enlargement have to be assessed accordingly.

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V Europe's Present Position in International Comparison

Despite the undeniable gap in economic development level, income, social welfare, institutional setup and mentality, most European countries share some common features.

First, Europe has been struggling with low growth rates for a number of years now, and this situation is unlikely to change. In contrast, the transforming countries may achieve higher and sustainable growth rates in the coming years. While there is a lot of uncertainty about longer term growth, those Central and Eastern European countries which have reached the second stage of transformation (transformation with modernisation) are likely to have sustainable growth. Although these rates will not reach those in the Far East or some other rapidly modernising national economies, they can still be considered substantial – even more so if the EMU leads to rather sluggish (if any) growth in the present EU in the first years.

Second, Europe is the master in yesterday's technologies (of mass production). But it is increasingly lagging behind in tomorrow's technologies. The loss of market shares in high-technology sectors and the concentration of exports in medium and low-technology areas is a clear proof of this process.

Third, unemployment, reaching the two-digit level, seems to be a lasting component of European development and integration. Employment-neutral growth, increased technology-intensive production and the emergence of a knowledge-based society are not particularly favourable factors for changing this trend in the foreseeable future in any European country. Substantially lower levels of unemployment would require a much more flexible labour market and, at least as important, a booming economy in Central and Eastern Europe.

Fourth, income gaps are emerging between different countries as well as within similarly developed countries alike. Economic and social polarisation (and marginalisation) may become a serious threat to sustainable stability and economic welfare. More importantly, increasing gaps between reality (the financial capability of a person or a family) and patterns transmitted by the globalising media (what a person or a family *should* acquire and possess) can easily create political, social and psychological problems. This is by no means a uniquely European problem, but due to the size of income gap, the geographic proximity and the level of general education, the conflict may first emerge seriously in this part of the world.

Fifth, ageing population is substantially changing the ratio between producers and consumers of national income. The social security and pension systems are becoming increasingly challenged during a time where growth is low and fewer people are expected to produce the same (or higher) level

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of GDP. However, this situation will change in about eight to ten years when Europe will be struggling with a shortage of manpower. Availability of manpower (wherever it comes from) will be a basic condition for financing social security and pension systems all around the continent. As a consequence, a much more careful and forward-looking employment policy must now be developed.

In addition to these disadvantages, Europe has the following advantages.

First, enormous economic power is accumulated in a geographically concentrated space.

Second, new growth regions are emerging, including in the central and eastern parts of the continent. Even if this growth will not be able to substantially change the outlook for Western Europe, it can essentially and positively influence business expectations. In the last few years, this market has already proved to be the most dynamic export market for the EU. Between 1992 and 1996, the share of the six CEFTA countries in EU's extra-regional exports grew from 5.8% to 9.2%, by far the highest increase in international comparison. In addition, in the same period, the EU has registered a trade surplus of ECU40.9 billion with the ten associated countries, i.e. almost 80% more than the total surplus from the EU's extra-regional trade. In other words, the associated countries fully financed the EU's trade deficit with other parts of the world. Although the EU may have used some of the benefits emerging from trade liberalisation without providing full membership for the Central and Eastern European countries, large benefits deriving from dynamic effects of intra-regional trade can still be expected for the years of membership.[3]

Third, the enormous cost difference in educated manpower is a unique potential of global competitiveness. Previously, international intra-industry trade and subcontracting were based on the huge wage differences in the unskilled and low-skilled labour market segments, and both the United States and Japan based their industrial relocation policies on this factor. Western Europe, never eager to go this way (due to enlargements by high-cost new members, additional temporary markets, non-availability of convenient labour in preferential trade areas), now has a historical chance to make use of the highly educated and flexible labour of Central and Eastern Europe. As the development of FDI in Hungary shows, this new pattern is already evolving on the micro-level as a result of rapid learning by multinational companies. In the longer term, it could substantially modify the well-known theoretical pattern of international division of labour among countries with different levels of economic development.

3 In turn, non-membership and growing trade balance problems may even jeopardise the already achieved level, and this could have a serious negative impact on the EU's overall growth, trade and, indirectly, also on European security.

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Fourth, investment in environment is likely to create a qualitatively higher demand, leading to economies-of-scale production of many technologies and commodities. This may offer Europe a competitive edge in the global marketplace.

Fifth, a potential contribution to Europe's global advantage of Central and Eastern Europe may be identified in its higher institutional and social flexibility as proved in the first years of transformation (provided that this feature will be sustainable in the next period as well).

Sixth, while higher social standards may provide additional advantages such as social peace, more even income distribution and a wider tax base, it is not entirely clear to what extent they can be financed, and how the basic framework of the 'social market economy' can survive in an increasingly competitive international environment. In addition, higher social standards in Central and Eastern Europe may increase the cohesion of the continent and facilitate the accession process. On the other hand, however, such a development may also be counterproductive, if too high and too rapidly introduced social adjustment to EU standards results in loss of competitiveness, declining growth rates and growing unemployment.

VI Regionalism in Europe, For What?

One option of European regionalism is the establishment of a fortress Europe. It can consist of the present EU members and exclude all other European countries, or even include some of the candidate countries and let them participate in an extended fortress. Both options tend to threaten Europe's global position.

Only an open European regionalism can be supported, and the candidate countries are very much interested in such a development. At present, Europe is open to different degrees in selected areas. Trade and services are relatively open and are likely to open even more as a result of the WTO negotiations. Capital markets are widely open and no national or EU-level initiative could substantially change this feature. On the other hand, labour markets are highly protected, and high unemployment only tends to increase the level of protection. This could, however, prove extremely counterproductive since capital would leave labour market-protecting countries more rapidly in search for competitive locations and production all around the globe. Finally, a change in mentality is needed, mainly in Western Europe. Almost one decade after the fall of the Berlin Wall, status quo mentality still seems to prevail. There is widespread fear of other ideologies and different social attitudes and patterns. These fears encompass not only Islam fundamentalism and Eastern orthodoxy, but they also include

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increased flexibility and lower social standards represented by countries which were historically shaped by Western (European) civilisation.

More open regionalism in Europe, including institutionalised regionalism in the framework of an enlarged Union, will not necessarily have negative effects on those countries and groups of countries with which the EU has had lasting and contractually established relations. First, if there is a crowding out of some (mainly African) countries, it will not be the result of EU enlargement since the trade pattern is completely different and, in most cases, Africa, the Middle East and Central and Eastern Europe do not compete for potential investors. On the contrary, since the new members have to accept the EU's system of international trade relations, all EU partners will have a larger market for their products and also a larger volume of financial and technological support.

Until now, benefits and threats (costs, risks) of open regionalism in Europe have not been carefully studied. A higher level of openness brings substantial economic benefits (for efficient competitors) but it can also be accompanied by new security threats. Will the latter be smaller or larger than the net economic benefits? Or, will economic benefits of openness be larger than the loss registered by non-competitive sectors and firms? Can the latter be compensated in order to sustain internal stability? How can openness be enhanced and sustained if some fundamental structural changes become unavoidable (e.g. change of social welfare system, mentality and status quo attitude). Earlier, such exercises were carried out in a relatively closed economy and society, and opening up was the consequence of successful domestic restructuring. This sequencing, however, is hardly possible today since any delay in opening up can easily lead to marginalisation (of course in itself, opening up is no remedy against marginalisation either).

It is the dilemma of the candidate countries that they are policytakers in Europe. Viable alternatives to EU membership can hardly be envisioned, even if some experts have already raised the issue of a more diversified external economic orientation. Higher growth in Asia and North America, technological advantage of non-European countries and huge potential financial resources outside the 'old continent' have been suggested as reasons, but geographic, economic, social and cultural realities would allow such an 'adventure' only within a rather narrow scope – if at all. Certainly, small, vulnerable and world economy-dependent countries have to do everything to shape diversified economic relations but not by ignoring or rejecting obvious realities. The integration of the Central and Eastern European countries into the EU can be viewed as a stepping stone to more global involvement, both in security, political and economic terms, but here, again, the 'geographic sequencing has to be observed.

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VII The Future of Regional Cooperation in Europe

There are two basic geographic shifts already taking place in Europe, and both are likely to become even stronger in the next few years as a result of the eastern enlargement of NATO and the EU. The first shift means the inclusion of a second sea into the 'empire of mare nostrum' of Europe. Besides the Mediterranean, the Baltics are becoming a 'European territory'. This shift can be characterised as a South-North shift, which already started with the last enlargement of the EU to the North. The second shift is from the Atlantic coast towards the geographic core areas of the continent – a West-East shift. Both of these shifts will fundamentally shape the future pattern of regional cooperation.

Another important factor of regional cooperation is the emergence of new growth centres all over the continent. They are likely to develop in the following areas:

- transborder cooperation between and among highly developed EU member countries;
- cooperation between regions with different levels of development, also supported by EU funds;
- catching up countries of Central (and Eastern) Europe with relevant growth potential;
- special geographic position of some candidate countries. One has to remember that the first wave of eastern enlargement will integrate countries into the EU that do not represent the geographic periphery of Europe (all the four earlier enlargements included peripheral countries). In geographic terms, they are located between Western and Eastern (Southern) Europe, and can be considered gateways to other emerging markets. As a result, the multiplier impacts of the geographic factor of eastern enlargement are not comparable with those of earlier accessions.

In the longer term, economic relations in general, and intra-industry trade based on competitive costs in Central and Eastern Europe in particular, may have a sensible influence on the global competitive position of the present member countries. Those countries (and firms) that are already widely using the production cost differential in their investment and production policies and created a subcontracting network in the candidate countries, are likely to enjoy comparative advantage vis-à-vis those countries (and firms) that have not yet been involved in such activities. As a result, different levels of engagement in Central and Eastern Europe may influence the competitive position of the individual EU member countries differently. Provided that the affected EU countries are members of the EMU, relative changes in their competitive position will necessarily lead to the use of policy instruments to correct this distortion. As a consequence,

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shifts within the European balance of economic power cannot be ruled out.

VIII Concluding Remarks: Challenges Ahead

It is certainly true that Europe influences global trends, but the future of regionalism in Europe is also increasingly shaped by external factors. In this context, the role of non-European capital (mainly from the US, Japan and other Far Eastern economies) can be decisively important. We do not currently know to what extent non-European actors would like to intervene into the process of (open) regionalism in Europe. Their interventions – and Europe's response to them – will depend on the specific area under discussion. This is well illustrated by the US which tends to intervene when security and trade are concerned, but is less inclined to intervene with regard to capital flows. US intervention may even produce conflict when issues of culture or mentality are involved. Although Europe's place in the sun in the 21st century must be mainly defined by Europe itself, non-European strategies and interests will have to be considered. Non-European strategies may not only contribute to Europe's future role in the world economy but also to the intra-European pattern of balance of power and of cooperation, and Central and Eastern Europe will become an integral part of this development.

The impact of intra-European developments during the next decade will be equally important. In all countries, the 'war generation', who personally experienced the cruelty and irrationality of war and its painful consequences, is stepping down in the next couple of years. They will be replaced by a new generation which, in Western Europe, acquired its basic 'life philosophy' in the post-war decades which were fundamentally shaped by the integration process. As the main beneficiaries of a Western European integration process which produced peace, stability and welfare, will this generation be the carrier of an even stronger and deeper integration of the continent, or will their priorities be changing due to new challenges and concepts?

One of the biggest conflicts may emerge between economic necessities and the established political system. Such a conflict can become manifest in three areas.

First, the current political system, as the 'superstructure', should meet the requirements of a mature, developed market economy based on industrial (mass) production. The world, and also Europe are rapidly moving towards a knowledge-based economy and an information-led society. Is the inherited political system appropriate to cope with the new challenges or will it increasingly become a barrier to economic and social restructuring?

Second, the whole of Europe (and not only the transforming countries) is already facing the challenge of modernisation. In the last fifty years, the security map of Europe and the predictability of economic (and social) development within the framework of a developed welfare state did not put overall and sweeping modernisation on the agenda. Now, however, the pressure of economic, social and mental modernisation can hardly be delayed any further. Unlike 'normal' times, the time frame of modernisation does not necessarily overlap with the four-year cycle of the inherited political structure. Is the present political system flexible and stable enough to adjust to the challenge of modernisation and, at the same time, define and defend the key elements of successful modernisation over one, or maybe more than one, four-year election period?

Third, future mainstream politics may be increasingly defined by older people who are less interested in modernisation plans overarching two generations, but in maintaining their status quo. With a continuously increasing share of older people among the citizens entitled to vote, this danger becomes greater. In this context, the whole electoral system of the European democracy may be defied.

Obviously, the construction of a new Europe, with widening European integration as its core element, needs a clear strategy, a transparent time frame including gradualism and 'geographic sequencing', patience, bold measures, innovative politics, forward-looking politicians – and also some luck offered by history. It should not be forgotten that there will be a lot of sensitive issues damaging the short-term interests of various countries, sectors, regions and lobbies. The balancing out of such conflicts with different instruments will become a major strategic issue. In this context, the original idea of solidarity and social cohesion of European integration has to be extended to the whole continent. Few things would be more destructive than the application of a double standard between 'ins' and 'outs'. Unfortunately, there have been some evident efforts in this direction in the last years (partial membership, exclusion of new member countries from financial transfers, second-class membership, etc.). Everybody is aware (or will be aware soon) of the fact that the Europe of the future has to be different from the Europe of the past. Vested interests of the present member countries cannot be fully defended since expected benefits of would-be members based on the past system of integration have to be revised as well. However painful, equal footing can be sold in Europe. Any other approach, even temporarily, would undermine not only trust and confidence in Europe but, as a direct consequence, also stability and global competitiveness.

Transition and Integration in Central and Eastern Europe

Hans Peter Lankes

I Introduction

At about $3,200 per capita in 1997, incomes in the accession countries of Eastern Europe are far below the EU average. Nevertheless, incomes are rising fast. In 1991, per capita GDP was at $1,900.[1] But it is important to note that the conditions for EU accession have not been formulated in terms of per capita GDP. If we look at the accession criteria defined at the Copenhagen Summit in 1995, the economic aspects of those criteria look very much like a test of success in the transition process, i.e. they define what we mean by the development of a competitive market economy.[2] Thus, we conclude that furthering the transition process would also further a country's chances of accession to the EU. What does this mean?

In our view, the countries of Central Europe and most of the countries of the former USSR are already market economies in that most economic decisions are made on the basis of prices that are determined by demand and supply, and often by competition from (and entry by) foreign providers. Thus, markets are generally liberalised, but what is lacking – and this is true throughout the region to varying degrees – are some of the ingredients that make markets function well. These include, among others, public and private institutions and behaviours. Before I turn to these topics, let me present some evidence about the existence and effects of markets in the region.

1 Between 1991 and 1997, real GDP was virtually constant, so the effect of real appreciation has been significant.

2 While the conditions for successful transition and for meeting the requirements of membership of the EU are similar, the latter also embody a large number of very detailed and demanding obligations which go beyond my topic here. Some of these require the strengthening and adjustment of public institutions, as for instance in the regulation of product standards or of competition. Others will have strong implications particularly for investment in infrastructure, enterprises and financial institutions.

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II Progress towards Market Economy

One way of assessing the effectiveness of markets is by measuring the extent and direction of structural change. The centrally planned economies differed significantly from western market economies in the relative size of their industrial sectors, and in relatively underdeveloped service sectors. Employment shares are one important measure of structure. In an EBRD study we have estimated a benchmark share of employment, based on 41 industrial and developing market economies, for different economic sectors. After adjusting for income, in 1989-1990 the share of employment was 36% in the industrial sector in Eastern Europe and former Soviet Union compared with the benchmark value of 23%. By 1995, the actual share of employment in the industrial sector had fallen to 28%. Since incomes fell in real terms during that period, the benchmark fell and the gap has not diminished, but there has clearly been a sharp movement towards what we would consider a market-determined size for this sector. There is movement in the opposite direction for market-oriented services (excluding education, health and similar government provided services) where the employment share increased from 21% to 24% and has actually overshot the benchmark which has fallen as a result of the contraction in income. The point of these comparisons is that they demonstrate that markets have had a very powerful effect on economic structure. This is one good reason why we should view these countries as being market economies. But can we say a bit more about the quality with which these markets function?

At EBRD, we produce an annual measure of how countries progress along several different dimensions of transition including: privatisation; the restructuring and governance of companies; liberalisation of prices, trade and foreign exchange markets; banking sector reform; securities markets and other non-bank financial services; and competition policy. We define what constitutes a market economy in terms of the mechanism that guides economic decisionmaking, and we assess how countries perform based on progress on the different dimensions.

We rate performance on a scale of 1 through 4 where one is the level where all of the countries more or less began – though Hungary and Poland may already have been more advanced – and four represents a market economy. According to this measure progress has been strongest in Central Europe and the Baltics. Despite some variation, the candidate countries have performed rather well in our view in terms of the averages across all of the dimensions as we defined them.

But the country averages do not tell the full story. We can divide the different reform dimensions into those where the government must stop doing

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something – e.g. stop controlling prices, stop owning and controlling companies – and dimensions where the government or private sector must take action to design frameworks in which markets function well, e.g. promote business standards, ensure the soundness of financial institutions and capital markets, enforce creditor rights and product standards, maintain competition. The performance of the countries has varied widely across these two types of reform, individually and averaged as a whole. Performance has been far weaker on those dimensions where the government has to take concrete action. These deeper institutional and behavioural issues are important dimensions of transition, going beyond the passage of the required reforms by legislatures. However, change of this nature is also very complex. Since it involves fundamentally a learning process, it does not depend on simple fiat but draws on the gradual build-up of experience and therefore requires time. It is precisely here that the most important advances are required before these countries would be ready for accession to the EU. We can discuss these under the headings of government and enterprise capacity.

III Government Capacity

Government behaviour affects enterprise performance and growth in two fundamental ways. The first concerns uncertainty about government policy (such as taxation and tariffs) and unpredictability of actions by the government and judiciary, both of which can lead to the postponement of investment and to short-term horizons for business decisions. The second stems from the state (the government, bureaucracy and judiciary) operating in a highly discretionary manner and thereby generating inefficiencies through the seeking and granting of special privileges and by stifling entrepreneurship altogether. In both cases, growth is inhibited because investment in existing enterprises is reduced, entry and growth of new firms is hampered and foreign investment is deterred.

Throughout the region, we witness a series of weaknesses of the state. It is more extreme in some cases such as the former Soviet Union where the central government was virtually destroyed when the communist party was destroyed, and the normal state institutions have had great difficulty reforming and recreating themselves. In the following I discuss just three examples of weak state governance, taxation, corruption and subsidisation, but it should be clear that problems exist in many areas in which state institutions (should) play an important role for market activity.

The most prominent example of government activity where good governance is crucial for the functioning of a market economy is taxation. Taxation is one of the biggest problems facing foreign investors in a number of countries in the region, particularly in the CIS but also to some extent in the accession countries. The problems lie not in the existence of taxation but in its design and functioning. In practice, it often involves definitions of tax bases and rates which, if applied literally, could drive the honest tax-payer out of existence (for example, definitions of profits which make no allowance for a number of substantial and genuine costs[3]). The result is widespread discretion by both ministers and revenue officers and a plethora of special deals and exemptions.

Corruption is another crucial problem that exposes the states' weaknesses. According to a variety of surveys, corruption levels in the CIS are perceived as being the highest in the world. Those in Eastern Europe and the Baltics are not as extreme but still rank relatively high compared to, say, Southern Europe. Corruption has a particularly strong deterrent effect on market entry by new operators. There is much that sound institutional and policy design can achieve in promoting responsible behaviour and limiting corrupt practices. Government structures should, as far as possible, limit the number of licences and permissions required and the discretion of civil servants over the ordinary economic activity of entrepreneurs and consumers. It is when permissions or discretionary decisions start to permeate throughout the economy and society that bureaucratic interference develops and the potential for corruption grows. There is a great deal also that private firms and financial institutions can do to limit corrupt practices.

An additional state weakness lies in the governance of state enterprises and banks, for instance in government provided soft-budget constraints. Beginning in 1990, direct budget subsidies were cut to levels quite low and comparable to Western Europe. But at the same time, a process of off-budget subsidies evolved through the banking system and tax arrears which compensated enterprises for the loss of financial backing by the government to some extent. Non-performing loans on which no action was taken and tax arrears have both stopped increasing around 1994 so we deduct that this element of softness has receded in the Central European applicant countries and the Baltics. Nevertheless, energy and fuel prices continue to be far lower than in the EU countries – providing implicit protection – and there remains a large variety of technical barriers to trade which will have to disappear as the pre-accession process advances.

IV Enterprise Capacity

In our discussion of governance so far we have emphasised the behaviour

3 These definitions can be particularly pernicious in an inflationary environment.

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and practices of government itself. But effective governance requires the cooperation and participation of the governed. In particular, in economic affairs it requires sound business practices in enterprises. Sound practices may be expressed in terms of those practices which implement long-term profit maximisation for the benefit of shareholders (including minority shareholders) while maintaining and developing good and honest relationships with those with whom the enterprise interacts. They also imply the ability to restructure to adjust to market circumstances. Such principles are not yet widely and immediately understood in transition economies. Indeed, it has taken many decades (running into centuries) for them to be established in more advanced market economies. However, it is crucial that these practices become established quickly in transition economies.

The governance of most medium-sized and large enterprises in Eastern Europe requires dramatic change. Privatisation represents a first step, but the form of privatisation (involving a number of compromises) has not, in most cases, provided effective governance. There are a number of methods of privatisation. Hungary and Estonia have used sales to outsiders as their primary method of privatisation; five other countries have used equal access voucher privatisation; three have used voucher privatisation with insider concessions; and nine used management-employee buyouts as their main method of privatisation. Theory and practice will tell you that the latter methods are most likely to compromise corporate governance in a period where enterprises need access to external resources to implement large scale, deep restructuring. Employee-owned funds will have more difficulty coping with such structural pressure than those acquired by strategic investors from outside.

Following privatisation, therefore, change is often required in the ownership structures and in the methods of corporate governance. Instrumental to this change will be development of the financial sector to provide an effective source of outside finance for investment and a market in which changes in ownership and control can take place. In several transition economies, however, including some of the accession candidates, lack of transparency and deficiencies in the codification of shareholder rights have allowed the financial sector to act as a brake on the establishment of sound governance.

V Conclusion

Following the rapid liberalisation and privatisation of the earlier years of transition and the impressive progress in macroeconomic stabilisation, growth is returning in the region as the transition is entering a new phase.

Most countries of the region are already market economies in some shape or form. The central challenge of the current phase of transition is building the governance and institutions which will underpin a well-functioning market economy. This is also the key challenge in promoting sustained growth and in preparing countries for EU accession. It will be governance and institutions that deliver effective and competitive markets which in turn deliver restructuring and sustained growth.

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The Challenges of EU Accession in the Baltics

Piritta Sorsa[1]

I Introduction

The challenges of EU accession in the Baltics are closely related to the challenges of transition. While all three Baltic countries have made substantial progress in macroeconomic stabilisation since the beginning of transition, a number of structural challenges remain. The key criteria mentioned by the EU in *Agenda 2000* are a functioning market economy and an ability to cope with competitive pressures and market forces. This means that the applicants are not only expected to adopt EU policies, but they must also be able to enforce them so that companies on both sides can compete fairly. In practice, this means that there must be more progress in structural adjustment toward a market economy.

II The Maintenance of Successful Stabilisation

All three countries have made considerable progress in stabilising their economies. Inflation is down to nearly single digits. Growth resumed a number of years ago, reaching nearly 10% in Estonia during some quarters of 1997. Fiscal deficits have been small ranging around 0-2 percentage points of GDP, and exchange rates have been stabilised within currency boards (Estonia and Lithuania) and a fixed peg (Latvia to SDR). Foreign trade and most prices have been liberalised. In trade policy, Estonia is the most liberal with a practically restriction-free trade regime. All three countries have redirected trade from the East to the West. Again, Estonia has been the most successful with about three quarters of its exports now going to countries outside the former Soviet Union. Foreign direct investment (FDI) has increased in all three but the increase has been greatest in Estonia. Estonia's cumulated FDI per capita was $538 in 1996 compared to $256 for Latvia and $102 for Lithuania.

1 The views presented are solely those of the author and do not necessarily reflect those of the International Monetary Fund or its Board of Directors.

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The Baltics are facing at least three main issues which influences their ability to maintain their positive performance. First, all three are struggling with relatively large current account deficits, the largest one being in Estonia of over 10% of GDP. Closely related to this is concern about competitiveness in an environment of fixed parities, large capital inflows and several years of high inflation. A number of indicators on the sustainability of current account deficits suggests that while the deficits are high, they may be manageable since they reflect mostly private sector imports related to transition. Furthermore, exports in all three have been growing, and real interest rates have continued to decline indicating confidence in the parities and maintenance of competitiveness of exports. Many of the imports are capital goods related to investments, which should generate income to pay for the deficits. Also, much of the price adjustment seems to reflect price arbitrage and increased productivity growth in the tradable goods sector. However, the recent growth of credit and increases in shorter-term foreign borrowing by banks calls for vigilance, especially in Estonia. The tightening of monetary conditions (increases in banks' reserve requirements) in 1997 is likely to slow demand for credit to prevent overheating. This also underlines the importance of proper credit risk assessments in the banking sector so that the capital inflows are invested wisely.

Another challenge lies in the fiscal area with the role of the state. All three Baltic countries face the challenge of designing an appropriate role for the state in a modern market economy. Although government involvement in the economy has been successfully reduced in many areas of economic activity, developing the activities of the state in areas where it should play a role remains a challenge. These areas include many regulatory functions such as competition policy and environmental regulations, and it is important for the Baltics to bring their policies and regulations up to EU standards. Also, the relatively high share of government expenditures in GDP calls for rationalisation of public sector activities.

The third challenge is the creation of incentives for higher savings rates. This is closely related to pension reform and a reduction of public expenditures. Savings rates have also been relatively low in the Baltics – between 13-16% of GDP – compared to other emerging market economies which often have rates between 20-30%. All three countries need to make more of an effort to mobilise savings to finance future investment needs for higher growth.

III Structural Reform

The remaining challenges are primarily in structural reform, and this

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seems to be the area in which the European Commission differentiated between Estonia and the other two Baltic countries. Key areas for further reform are privatisation and private sector incentives, restructuring of enterprises, financial sector reform and environmental regulation. One indicator used by the Commission concerning progress in structural reform and the ability to withstand competitive pressures was the degree of diversification of the export base in the applicant economies.

The EU expressed some concern that the weak export bases in Latvia and Lithuania indicated a slow restructuring of industry and a slow implementation of market reforms. Most of the Baltic countries' exports are still resource-intensive goods with low value-added. In Estonia, statistics indicate some intra-industry trade in textiles and some machinery products. A lack of diversification in Latvia and Lithuania may reflect higher protection levels in some activities (especially agriculture), but it may also reflect high protection of value-added in goods produced by local industries. This would tend to keep resources in protected activities at the cost of developing export industries. Progress in privatisation and private sector incentives is also an important factor for developing a dynamic export base.

Privatisation needs to proceed further, especially in Latvia and Lithuania; Estonia is most advanced in this respect having completed privatisation in all but a few utilities and infrastructure facilities in its economy. In Latvia and Lithuania, privatisation of both large- and small-scale enterprises needs more progress. Restructuring of (the privatised) enterprises is another area where more progress needs to be made in Latvia and Lithuania. In this area, Lithuania seems to be lagging furthest behind, but this may reflect the nature of privatisation undertaken there. Compared to direct sales to new owners, new managers in management buy-outs tend to be less willing to restructure privatised enterprises. And since management buy-outs have been the most common form of privatisation in Lithuania, this may explain their slower progress in restructuring.

Private sector incentives is another area in which all three, but especially Latvia and Lithuania, need to make additional progress. This includes policies such as regulations on entry and exit barriers to enterprises (especially bankruptcy procedures, right to establishment), enforcement of property rights (land ownership, the legal system) and infrastructure development. In Estonia, private land ownership and bankruptcy procedures have been in force the longest.

Financial sector development is another area of importance to transition calling for further reform. An efficient financial sector is essential to allocating foreign or domestic savings to most efficient uses. This is especially important to channelling large capital inflows into productive uses to prevent an unsustainable debt build-up or reversal of capital flows. In Latvia and Lithuania efficient banking may be somewhat impeded by the existence of a non-performing loans in the banks' portfolios. Also credit and risk assessment tools need to be developed further.

IV Challenges for the EU

The EU can assist the transition of the Baltic countries by keeping its markets open. Despite apparently liberal trade agreements, a number of sensitive goods from the Baltic countries remain subject to trade restrictions by the EU. These include agricultural and fish products and textiles which together account for about a third of Baltic exports. Furthermore, trade in services is outside the scope of the agreements, and the Baltics may have some comparative advantages in this sector. Since all three Baltic countries are highly trade dependent (exports account for 30-60% of GDP), conditions of market access for their exports are vital for in transition and growth performance.

Another area in which the Baltics would welcome action from the EU is reform of its agricultural policies. Currently, the Baltic countries are less protectionist in agriculture than the EU. Joining the Union would mean an increase in protection in the agricultural sector with negative efficiency implications for resource allocation. High protection in the EU might create an expectation in the Baltic countries of higher future protection, and this could reduce incentives in the Baltics to develop efficient agriculture.

An additional area where the EU could provide help is technical assistance in drafting the necessary laws required by accession.

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Floor Discussion of "The New Europe"

Competition and Trade

Arvind Panagariya began the discussion by commenting that while under the association agreements the Central and Eastern European countries (CEECs) have already opened their markets to the EU, the reverse is not the case in products such as steel, textiles and agriculture. He wondered whether the EU feared competition from the CEECs.

Henk Post, head of cabinet at the European Commission, responded that the Europe Agreements are, on the contrary, asymmetrical and in the CEECs' advantage since EU borders will open to the CEECs much earlier than the other way around. "There is no evidence nor any reason for the EU to fear competition from the CEECs on agriculture or in any other field, nor is our policy based on any such fear. However, if you study the structure of agriculture in some of the candidate countries, you can see that an enormous amount of work needs to be done in order to enable them to compete in the internal market. In most of these countries, there is insufficient regulatory structure for veterinary control, BSE prevention, and numerous other consumer protection measures. Several billions of ECU have been reserved by the EU to finance the restructuring of agriculture in the CEECs to enable them to adjust to the EU agricultural policy more easily and to overcome the enormous problems in terms of stocks, food safety and pricing which they would have if they do not restructure."

According to András Inotai, the EU is afraid of competition in areas other than the so-called sensitive areas of textiles and agriculture. "The real fear of competitiveness on the part of the EU is in the highly-skilled industries in which we are competitive. This is the challenge which has not been reckoned with in the mentality of Western Europe. Competitiveness in the next century will be based on the competitiveness of societies and institutions. In this sense, Central and Eastern European countries are in a good position as a result of the transformation process."

Inotai also responded to a question from Andrew Cornford on the competitiveness criteria in relation to exchange rates, "Once a candidate country becomes a member of the EU, it will become a member of the EMS-2 and not the EMU. As a result, it will have very limited autonomy in terms of its exchange rate policy. The national currency will be linked to the Euro and there will be a certain margin of fluctuation. The question is how

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large the margin will be. I think there will be an appreciation of the currency of the new member country, but this will be offset by occasional double-digit annual growth of productivity."

Piritta Sorsa disagreed with Henk Post's statement about asymmetry and referred to the impact of EU quotas on investment in the Baltics. "In the case of Estonia, there is no asymmetry. Estonia gave free access both in manufacturing and in agriculture, and the EU is restricting agriculture quite a lot. Another point is whether the fact that quotas are not fulfilled is a sign of openness or restrictiveness. When one has quotas or even surveillance of a product, it does affect investments because it is an uncertainty for investors in market access. Statistics show that in the Baltics, most FDI has gone to services or to industries that do not export to Europe, so there is very little investment that would be geared to the European market."

Arvind Panagariya turned the discussion to trade. "The point was made that at the moment, many of the countries in Central and Eastern Europe are not interested in joining the EU, nor are they ready for it. From an economist's perspective, that is rather odd since the gains from trade are available to all countries regardless of whether they are rich or poor. This philosophy has also been behind the advocacy of trade liberalisation from the IMF and the World Bank."

Henk Post responded, "I would like to stress that the EU is not a free trade area. The EU is a Union which has an *acquis* and an internal market and this goes much further than just a free trade area. We need to avoid a situation where enlargement results in a pseudo free trade area which would weaken what we have achieved over the years."

András Inotai followed up on the issue of trade and asymmetry. "Except for agriculture, there are really no trade barriers for CEEC exports to the EU. Whether and to what extent this temporary asymmetry has provided advantages is another question. The gap was not a trade gap but a development gap, a historical legacy which can hardly be compensated by 5 years of temporary asymmetry. It helps, but it will not contribute substantively to changing the development pattern."

He continued with a spirited account of the recent dynamism of East-West European trade relations. "There was no other bilateral trade relationship in Europe which developed more dynamically in the last 5 years than trade relations within the CEECs on the one hand and between the CEEC and the EU on the other. Hungary is currently ranked higher than 5 EU member countries in exporting finished manufactured goods to Germany. Almost 50 percent of Hungarian exports consists of machinery, computers and transport equipment, while 5 years ago this share was only 13 percent. This is a tremendous change. All of this is certainly supported by foreign direct investment and restructuring. In addition, MNCs have

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started sub-contracting in research and development activities because we have some comparative advantages in this area. Our comparative advantage is not only in the area of unskilled labour. In contrast to the 1970s and early 1980s when the international division of labour between the US and Latin America and between Japan and Southeast Asia was based on a pattern of unskilled labour, the division of labour in Europe is based on educated, skilled labour. This is the real challenge for Western Europe."

EU Institutional Reform and Policies

Stephany Griffith-Jones asked Henk Post to elaborate on the EU's plans to begin negotiations for a Free Trade Area with Mercosur and Chile and also possibly with Mexico. Post responded that while some member states viewed these upcoming negotiations as far too liberal, he believed it would have a positive impact on the EU's position in global terms.

Percy Mistry suggested that the European Commission was overloading its administrative circuits "by going for extremely complex programmes of deepening followed by widening, and raising too many issues simultaneously. The budgetary machinery of the member governments may not be able to handle this either. How does the Commission see this problem of circuit overload and if the circuits trip, what is going to be the trade-off priority? Will it be the EMU, which will probably be complete in 3 or 4 phases instead of 2? Will it be the reform of the Common Agricultural Policy (CAP) and the structural funds? Or will it be something else?"

Henk Post did not believe that the EU's circuits could easily be overloaded. "We have, on the one hand on purpose, put all of the political decisions in one basket because we know from experience that this is the only way to get difficult decisions through at the highest political level in the EU. If we would go piecemeal and give one element out of the package to the Council every so many months or years, it would result in a very long-term and painful process that would probably end up in a blockage.

But there is another more practical reason and that is that all of the elements that we put in our package need to be dealt with at the same time. The current structural funding regulations expire by the end of 1999, so they have to be reformed and renewed. In agriculture, beef and cereals stocks will increase from the year 2000 to 2001. In order to have the necessary reform to avoid this, evidence shows that we have to start about 18 months in advance. So we have to put forward proposals for reform in these sectors. There is no way around it, it has to be put all together and it will result in an complicated package which has to be agreed upon. On top of that, there will be institutional reform within the EU itself. We will certainly have a new intergovernmental conference to deal with institutional

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reform within the EU in a couple of years' time, as the Commission has proposed, before the first enlargement takes place. The closer we get to the first new member coming in, the bigger the incentives are for the present members to agree to institutional reform."

Salvatore Zecchini inquired as to what kind of parallelism was envisaged between the conditions required for the new candidate countries and the reform of the EU's internal institutions and policies.

Henk Post responded that in the circles of the Finance Ministers and the heads of state, the main focus was on the internal reform and on the financial framework for the coming years. "The negotiations with the CEEC will begin with a screening phase and this will be followed by a phase of working through the entire *acquis* of the internal market and the *acquis* of other related internal policies. The main spending policies, agriculture and structural funds will be dealt with at a later stage. It is only logical that member states, in presenting their common positions, will concentrate on the *acquis* phase for the negotiations with the CEECs and leave enough time for discussing and negotiating the other policies later on. Another reason I think that it will happen like this is that there is no other way to do it. We have to define the financial framework for the coming 7 years, the expenditure of the CAP and the expenditure on structural funding within the Union."

Enlargement and Adjustment

The implications of enlargement for Third World development was the subject of a comment by Bertil Oden. "Specifically I am interested in the Union's attitude toward the Third World in terms of aid, and the attitudes and values of the negotiations now on the agenda in the post-Lomé negotiations. We have one example in the ongoing EU-South Africa trade agreement where it is reported that some member countries in the EU have requested exemptions on products which are not produced by South Africa but which are produced by Eastern Europe."

Percy Mistry was also interested in this issue and gave an example. "When it comes to widening, we had this disingenuous argument in 1990 where all of the donor countries, but particularly the EU countries, assured the developing world that any aid flows to the CEECs would be additional. There is ample evidence now that there was no additionality. In fact, there was a direct diversion of aid from traditional recipients to non-traditional recipients. Now if this 75 billion ECU that has been suggested by the Economic Commission is a serious proposition, what will the potential impact be, especially on the countries south of the Mediterranean and on the eastern rim of the Mediterranean which could be in a competing situa-

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tion or a conflict of interest situation for resources?"

Mistry also wondered whether the EU membership carrot was not being dangled prematurely, "And if so, what is the political motivation behind it? There can be dangers in dangling incentives so far in advance that they almost seem permanently out of reach. How do both sides see it and what are you going to get out of this?"

Henk Post agreed with this last point. "It is indeed one of the dangers in this entire process that expectations are raised in public in an age of media-driven politics while, in reality, quite different matters on a different level of ambition are being discussed. There are two sides to this issue. One is that I hope that the Luxembourg Council which will convene in December of this year will agree to the proposals that the Commission has made and will set them in stone. This will remove some of the unrealistic expectations that have been raised in the past. At the same time, however, it is very important for the political leaders of the candidate countries not to raise expectations there either. Enlargement is a process of motivating the populations of the candidate countries for the very painful economic reform they will have to go through in order to become a member of the EU. It is not a very popular political platform to take, but it is a necessary one to take in order to make the process succeed."

Janos Gács pointed to the fact that the costs for the EU of opening up to Central and Eastern Europe and acquiring new members from this region tend to be exaggerated. "In fact, in the last year I see an ever growing gap between the understanding of enlargement by politicians and by scholars. Let me just give two examples. The first is from Austria where I work and have been fortunate to be able to follow their approach. From the beginning, Austria has been very supportive of opening up and transition. They have given a lot of support in terms of technical assistance – some have even talked of a re-emergence of the Austro-Hungarian monarchy. However, in the past year, there are signs of a change in the public attitude, and a number of politicians and public speakers have spoken out against enlargement. They speak of the threat of enlargement on their industries, on employment and they would like to postpone enlargement for as long as possible. My second example is that in 1997, a committee of the European Parliament argued that Poland's large agricultural sector might pose a problem for the EU, and then the Parliament leaked out the results of some calculations of enlargement which were way off line from the calculations of scholars. What the major scholarly works about enlargement boil down to is that enlargement requires profound adjustment in CEECs and will lead to negligible costs to the EU."

András Inotai elaborated on the issues of adjustment and misleading perceptions. "Everyone knows how painful and difficult the process of adjustment to EU standards is. But the last 6 years and the tremendous adjustment that has already taken place is a good indication that most of these adjustment criteria can be met if the reform dynamic can be maintained. We should be careful about making unjustified generalisations. The 10 CEECs cannot be put into the same basket, there are substantial differences between them. None of the EU policies or strategies suggest that these 10 countries will be taken as members at the same time, and all of those calculations and generalisations which view those 10 countries as a homogenous group are fatally misleading. It is not true that the countries are not competitive. They have different levels of competition and different institutional capabilities, and we know where the deficiencies are. In some areas, some of the transforming countries are ahead of Western Europe. I would not like for these countries to be measured by a double standard. It has a very negative psychological impact, it backfires in politics and it will certainly not increase either confidence or stability in Europe.

With regard to unemployment, it is a global issue. Even if there were no exports by the CEECs to the EU, the global challenges would require adjustment in the labour market in Western Europe. Up to now, East-West trade has created more jobs in Western Europe than in Central and Eastern Europe. The huge trade surplus is proof of this. As for migration, I do not see this as an important issue since, in many sectors, the labour demand in Western Europe is different from the labour supply in Central and Eastern Europe. Moreover, a recent survey in Hungary indicated that 1 percent (50,000 people) of the economically active population would be interested in migrating and another 2 to 3 percent would like to work in the EU for a couple of years. So the ramifications of this issue have been exaggerated."

Janos Gács emphasised that the cooperation between Eastern Europe and Western Europe in the last 7 years has provided a useful practice field for globalisation for both sides. "In fact, from the establishment of bilateral cooperation agreements between the various countries to the association agreements, these countries are learning how to open up their markets to the rest of the world as well. First, they opened up to Western Europe and then they established controlled relations with the rest of the world. Next, they attained WTO and OECD membership which also had some implications for their relationship with the rest of the world and for understanding globalisation. This adjustment also had a component in Western Europe. Western Europe has had to adjust to the challenge of coping with a surge of trade from the CEECs. When the CEECs become members, another phase of negotiations will follow, and this phase will again create a new practice field."

Hans Peter Lankes took up the issue of investment costs of acceding to the EU. "If one looks at the structure of investment needed to meet EU directives, one finds that the vast majority are investments in the environmental sector. In addition, investments should be made in the transport infrastructure even though this is not required for accession.

On the environmental side, out of the 60 to 80 billion ECU that is currently being suggested to meet European directives, about 40 to 50 are related to municipal environmental infrastructure, such as sewage and waste infrastructure. While I would not expect this to be made a condition of entry, I would expect it to be made an issue of a longer transition period. For the rest, there is a great deal of investment required in sectors such as heavy chemicals or power generation to change processes in order to meet both environmental as well as health and safety standards. If you look at what is happening in the region, a lot of this investment will happen anyway, accession or no accession, simply because of the process of modernisation of these industries. In many countries, investment in manufacturing and power generation as well as in other sectors, has been put off for years, but it is now picking up. Many of these facilities are reaching the end of their useful life and one would expect increases in investment as a result of a normal process of modernisation – and not simply to meet EU directives.

At EBRD, we have done some estimates of incremental investment needs taking sequencing needs into account, and we have come to the conclusion that between 1997 and 2002, it would amount to something like 5 to 5.5 percent of GDP, and between 2002 and 2012, taking into account increases in GDP in that period, it would fall to 4 percent or less. After 2012, it would be somewhere in the range of 2 to 3 percent of GDP. I think this is a point worth making because it is often brought up as a major obstacle to accession to the EU. We don't see it that way."

Stephany Griffith-Jones brought up the ratification process. "Henk Post categorically stated that enlargement is going ahead and the Commission, as well as the executive branches of all of the West European governments, has taken a clear stance. But what about the parliaments who still have to ratify this? We have just seen that while President Clinton was obviously committed to fast-track for NAFTA, the US Congress was not. So there may be serious problems in ratification. And also, even if it does pass through all of the parliaments, the conditions under which it may ultimately be offered may not be particularly favourable."

Henk Post suggested that substantial differences exist between President Clinton and the European Council. "The Council's position has been fully accepted, not only in 1993, but in all subsequent years and in all national parliaments. Enlargement as a policy is an accepted policy. It has not been ratified by all parliaments, but is has been accepted by all parliaments. The problem is not so much to have parliaments agree on enlargement, but to have them agree on the results of negotiations, the modalities of enlargement and the costs for themselves."

Institutional Capacity of Eastern Europe

Various participants raised questions about the institutional capacity of the CEECs. Frans van Loon, for instance, referred to widespread concern about the uncontrollability of portfolio flows and the fragility of banking systems in emerging markets. He wondered what type of policy the EU would develop. "I can imagine that the risks are rather substantial given the fact that the banking systems in a number of CEECs are still fragile and therefore pose major threats to stability." Zdeněk Drábek brought up the issue of state aid. "I agree with Mr. Post that the CEECs do not yet have the institutional capacity to implement market-type reforms, but how will the EU deal with this problem considering the examples of Crédit Lyonnais and Air France, private companies which have repeatedly asked for and have been granted various state subsidies?"

Henk Post responded by saying, "Cases like Crédit Lyonnais and Air France are exceptional cases as compared to the thousands of cases that we deal with each year that result, in almost every case, in very painful restructuring of the companies concerned. But also in both Crédit Lyonnais and Air France, dramatic restructuring is taking place upon the demand of the Commission. So I think that the EU is certainly capable of dealing with these problems. Furthermore, this view is shared by the governments of the candidate countries. Officials – and politicians – of the CEECs all share the perception that enormous restructuring must occur in their industries and enterprises, and they are relying on the Commission's assistance since this will make it easier to sell it to their own citizens.

There is no way that financing alone can take care of the needs that exist. We must help the candidate countries to enable private financing for public infrastructure works. The banking sector needs to be drastically reformed, and this will require shared management, shared experiences, benchmarking and a change in mentality. The same applies to the institution building that has to take place. As far as the risk of financial instability is concerned, this will take considerable effort, and we will find the candidate countries on our side, because it is also in their best interest to maintain a stable financial environment. This can be done in the manner I have just described by setting up programmes in which private organisations like banks and other institutions can participate to their own advantage and to the advantage of the candidate country."

Finally, Barry Herman questioned some data used in comparing CEEC output, labour and economies. "I want to take issue with some of the num-

From: Regional Integration and Multilateral Cooperation in the Global Economy
FONDAD, The Hague, 1998, www.fondad.org

bers. First András, in comparing the value of output in CEEC in the early and mid-1990s, you suggested that despite the fall in measured output, CEEC is not as small as it had seemed and that total output was more formidable. Then Hans Peter Lankes said that in the mid-1990s, markets were actually functioning, and this is an interesting statement because it means that in the early 1990s, markets were *not* actually functioning and prices did not have the same meaning. The result of these two comments is that we have GNP per capita figures for the early 1990s which have been calculated by adding up a bunch of prices which had no meaning and we converted them to dollars with an exchange rate that also had no meaning. In fact, we faced this issue at the UN in the early 1990s when we were trying to figure out how big their economies were and how to weight them in calculating aggregate growth rates. We found that the actual prices were not very indicative. So I don't think that the case is really made by saying they are less different than we thought they were by citing these earlier numbers.

Next, Hans Peter Lankes showed us a graph depicting labour, and the most striking thing is that in the early 1990s, the employment share in manufacturing or industry was very high compared to the benchmark. In the mid-1990s it looked more normal, partly because a lot of workers in the industrial sector became unemployed. But labour wasn't used in the same way in these economies as in the benchmark economies. And so again, I don't think the comparison is very meaningful. There has been some convergence in the sense that Eastern Europe now has Western European unemployment rates, but I don't think there is convergence in terms of the production structure of the economy.

I would say that to make the case, one should look at other things such as GDP calculated in purchasing power parity terms. Here Hungary is and has been the benchmark. It has been linked to Austria in the PPP exercises. The trends based on PPP and social indicators might give us some indication of actual possibilities of expenditure. It is a totally different kind of indicator, but when the economic numbers are not useful, sometimes the social indicators can be."

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