The Pros and Cons of Central Europe's Joining the EU

Petr Hanel
Université de Sherbrooke, Québec, Canada

Abstract:

The paper starts with an account of trade reorientation of Central and Eastern European countries (CEEC) from East to West. Composition and evolution of trade flows between CEEC and the EU, and their respective comparative advantages are then discussed . An overview of the EU trade barriers and the impact of their liberalization under the Europe Agreements on bilateral trade flows, suggests that the EU's concessions were least important in sectors where CEEC enjoy a comparative advantage. This is particularly apparent in agriculture and food products. The protective effect of the EU's Common Agriculture Policy led to a three-fold increase in CEEC's imports of agriculture and food products from the EU while their exports to the EU increased only marginally.

Integration of factor markets is progressing rapidly through foreign direct and portfolio investment, mostly from EU countries, however, the region's share of global FDI still remains relatively low. In order to increase needed inflows of foreign investment, CEEC have to further develop their capital markets and improve the business climate in order to make investment there not significantly more risky than in the EU. Except for small border areas, labor mobility is, and will likely remain, quite restricted owing to the large wage differences between the EU and CEEC.

In exchange for membership in the European Union, CEEC will have to surrender a significant part of their autonomy in economic policy making . Some of the rules they will have to accept will not be in their best economic interest. This is unlikely to curb their resolve to enter the EU because the main reasons for integration are political.

Abstrakt:

Státy střední a východní Evropy (SSVE) reorientovaly rychle zahraniční obchod z Východu na Západ. Změny složení a vývoje zahraničního obchodu SSVE s Evropskou unií a jejich vzájemných komparativních výhod, jsou předmětem druhé části textu. Přehled obchodní politiky EU a dopadu Evropských dohod na vzájemný obchod ukazuje, že EU poskytla nejmenší úlevy z ochranářských opatření proti dovozu ze SSVE v odvětvích, v nichž mají tyto země komparativní výhodu. Nejlepším příkladem je obchod se zemědělskými a potravinářskými výrobky. Vývoz této kategorie ze SSEV do EU vzrostl od r. 1988 do r. 1993 pouze nepatrně, zatímco dovoz SSVE z EU vzrostl trojnásobně.

Integrace trhu výrobních faktorů postupuje rychle v oblasti přímých a portfoliových zahraničních investic z EU. Nicméně podíl SSEV na globálním toku přímých zahraničních investic zůstává relativně nízký. K tomu, aby se příliv potřebných zahraničních investic nadále zvyšoval, musí SSEV rozvinout kapitálový trh a zlepšit tržní prostředí (business climate) tak, aby investiční risiko nebylo podstatně vyšší než v zemích EU. Integrace trhu pracovních sil prakticky neexistuje a vzhledem k velkým mzdovým rozdílům mezi oběma oblastmi ještě dlouho existovat nebude.

Za členství v EU budou země střední a východní Evropy muset obětovat část své autonomie v provádění hospodářské politiky. Některá z pravidel, která budou muset přijmout nebudou odpovídat jejich ekonomickým zájmům. Vzhledem k tomu, že hlavní motivací ke vstupu do EU

jsou politické důvody, je nepravděpodobné, že případné ekonomické nevýhody by mohly odradit SSVE od rozhodnutí vstoupit do EU.

This paper was presented at CERGE-EI on March 25, 1996.

1. Introduction

Since the very beginning of their transformation process to a market economy, Central and Eastern Europe Countries (CEEC): Bulgaria, Czechoslovakia, Hungary and Poland have expressed their desire to become members of "Europe". Membership in the European Union (EU) is desired perhaps even more urgently for security and political reasons than for economic ones. The eastern part of the EU and western regions of the countries of Central Europe (CCE): the former Czechoslovakia (CSFR), Hungary and Poland) were traditionally linked by a dense network of economic transactions. Re-establishing these interrupted ties is even more important in view of the economic disintegration of COMECON and of the political and economic chaos in the former Soviet Union. Thus, in contrast to the economic integration process in North America, where Canadian politicians and the public discussed at length the presumed benefits and costs of freer trade with the United States, and Americans and Mexicans are still debating the NAFTA, there is little disagreement in CEEC regarding the desirability of membership in the EU.

Economists who have written on the subject, have usually taken the point of view of the EU, or have considered the prospects of a larger EU from a transatlantic perspective. The present paper is an attempt to survey the literature on the subject and to discuss some of the more obvious economic implications of the EU membership from the CEEC's point of view.

The paper starts with an account of the dramatic trade reorientation that took place in the first years of transition. It also reviews the first studies documenting the fact that the reversal of trade flows from East to West led to a deep change in the commodity structure of trade.

The next section attempts to review the evolution of commercial policies that the EC adopted *vis-a-vis* its Eastern neighbours and, less completely, also the situation in CEEC. It includes an overview of the major EC policy initiatives, the "Europe Agreements", and the attempts to evaluate their impact on CEEC. Even though there was a very substantial increase in trade between the two groups of countries, evidence suggests that it was only in part triggered by the EC's liberalization measures. The supply pressure of CEEC and the signalling effect of the integration prospect were probably even more important than the direct effect of liberalization. An analysis of the Europe agreements shows, that more than a

bilateral liberalization; they proved to be measures which insured the continuation of the EU's protection of so called "sensitive" sectors. This outcome is best illustrated in the lopsided evolution of trade flows in food and agriculture.

Liberalization of factor movements, especially capital investment, is expected to play an even more important role in CEEC's catching up process than the free trade in goods. The third section of the paper shows that based on this account, progress so far has not been very satisfactory. The inflow of investment, especially FDI, has been rather limited. The labour market integration with the East will not be part of the integration blue print for long time yet. Like the labour cost differential between the US and Mexico, very low labour costs in CEEC, relative to those in the EU, is the principal argument in favour of trade liberalization conceived as a substitute for increased legal and illegal immigration.

A comparison of arguments for integration, with related possible costs and disadvantages, both on the micro and macro level, concludes the paper.

2. Composition and recent evolution of trade flows between the countries of Central and Eastern Europe and the EU

One of the surprises of the economic transition is certainly the speed and the extent of trade flow reversals in the countries of Central Europe (CCE) from East to West. Even though a part of the spectacular redirection of trade that appears in trade statistics is due to valuation use of more realistic exchange rates than those based formerly on the overvalued transferable Ruble (Hanel, 1992; Brada, 1994), it is nevertheless undisputable that CCE succeeded in radically redirecting their trade from the collapsed CMEA market to the West, mostly the EU. The dramatic increase of trade with the EU is well documented in Table 2.1. It shows that the share of exports sold by the CCE in the EU almost doubled from 1989 to 1992 and the share of imports from the EU also increased dramatically. As geography would suggest, the trade of the two East European countries, Bulgaria and Romania, with the EU is not as intensive as that of the CCE with EU. Bulgaria's switch was, however, even more dramatic in relative terms, while Romanian exports started from a higher initial level but rose much less.

While the EU market became the most important export destination for countries of Central and Eastern Europe (CEEC), the share of the EU's imports and exports are still

negligible (less than 2% in 1993). The variation of CEEC's share in the EC's imports and exports over the 1989-1993 period is presented in Table 2.2 below.

Comparative advantage and commodity composition of CEEC trade with the EU

In relation to the economically more advanced EU countries, the CEEC lack capital, above all human capital and technology. On the other hand, they are well endowed with skilled labor, and with some specific natural and energy resources. However, so far no reliable measures of CEEC's factor endowment are available. Empirical studies of the relationship between the factor content and the composition of trade of CEEC with countries of the EU are unanimous on some aspects of this relationship and divergent on others.

There is little disagreement among different studies (Landesmann,1994; Gacz,1994; Hanel and Cetkovsky, 1995; and Aiginger, et al.,1994 for Austria's trade with the CCE) that the share of capital intensive exports from the Central and Eastern European countries to the EU (12) decreased from the pre-reform situation in 1989. By the same token, the share of labor intensive exports increased.

There is, however, less agreement among various studies when it comes to more specific production factors such as R&D and skilled labor and energy. On the one hand, Gacz (1994) analyzing Hungary's trade and Landesmann (1994) looking at the five Central and Eastern European countries, present some evidence suggesting that there was an increase in the CSFR's, Hungary's and Poland's most R&D intensive industry's share of total exports to the EU.[1] Using the same measures of factor intensities, but focusing only on the Czech Republic's trade data, Hanel and Cetkovsky (1995) found that far from becoming more skilled labor or even R&D intensive, the new Czech exports to the EU originated mostly in energy intensive industries and in industries employing mainly unskilled labor. Owing to the fact that the factor intensity data, especially for the R&D and skill intensity, leave a lot to be desired and results depend to a great extent on the methodology used, further research is necessary to resolve the issue of factor content of CEEC's exports to the EU.

On the other hand, the picture regarding imports from the EU is clearer. The data available for Hungary, (Gacz, 1994), CSFR (Landesmann,1994 note for a seminar at

1 Unless specified otherwise, the EU refers to the 12 member countries as of 1994.

CERGE, March) and the Czech Republic (Hanel and Cetkovsky, 1995) show that imports from the EU, and Austria to the two aforementioned countries and Poland (Aiginger et al. 1994), are in agreement with the presumed relative factor endowments. Imports are increasingly capital and R&D intensive. At the same time, imports became also somewhat more labor intensive, reflecting probably more the effect of demand for western consumer goods than cost-related comparative advantages.

Thus the emerging pattern of inter-industry specialization between the CEEC and the EU confirms what West European businessmen already know. Labour in the CEEC is cheap and so is energy. Landesmann (1994) found that inter-industry specialization is more pronounced in the less developed countries of Eastern Europe, Bulgaria and Romania, while in the CCE there appears a shift towards closing the development gap by increased R&D intensive exports from CSFR and Hungary, and away from skilled intensive exports from Bulgaria. As mentioned above, our results do not support the closing of the R&D and/or skills gap.

Intra-industry trade

The data on intra-industry trade and its evolution suggests that two-way trade has been increasing in the CSFR and Hungary more significantly than in Poland. The extent of intra-industry trade still remains significantly lower than that observed for total EU trade. Surprisingly, the rather high aggregated Grubel-Lloyd index of intra-industry trade for Bulgaria in 1989 decreased by 1993 and for Romania it increased from a low initial level. However, even though the evidence suggests that CCE, especially Hungary and CSFR have turned to a more intra-industry pattern of specialization, the very large differences between the unit prices per kg between CCE's exports and other EU competitors suggest that a significant quality gap persists. This is supported by the finding that for the Czech Republic at least, the level of intra-industry trade is negatively correlated with R&D intensity. Thus the CR seems to be "specializing" in two-way trade exporting mainly simple products, while it imports products incorporating more sophisticated technology!

The evolution so far supports Landesmann's conjecture that the the Central European countries (former Czechoslovakia, Hungary and perhaps also Poland) are more advanced in the process of convergence to EU than their eastern neighbors.

TABLE 2.1

Percentage of each country's exports and imports which go to or come from the EU

	1989	1990	1991	1992	1993
Czech. Rep.					
exports	26.3	31.4	43.3	52.8	54.6
imports	26.5	31.9	39.8	47.7	51.4
Hungary					
exports	24.8	32.2	45.7	49.8	46.5
imports	29.0	31.0	41.1	42.7	40.1
Poland					
exports	32.1	45.1	55.6	59.1	63.2
imports	33.8	43.5	49.9	55.6	57.2
Slovakia					
exports	18.3	29.1	34.3	41.2	46.*
imports	20.4	25.3	23.1	34.4	37.3*
Bulgaria					
exports	5.5	5.0	15.7	29.4	28.1
imports	10.3	9.6	20.7	31.1	30.2
Romania					
exports	25.2	31.5	34.2	32.6	
imports	5.7	19.7	27.4	37.5	

Source : WIIW (Landesmann, 1994). Shares (in %) calculated from data in national currencies, data for Slovakia from World Bank, Slovakia Restructuring for Recovery, Volume II, July 11, 1994, and from the Stat. Urad SR, Zakl. prehled a slovenskom zahr. obchode za rok 1994.

Note : * 1994.

TABLE 2.2

European Community imports from and exports to CEEC

	Imports						Exports					
	1989	**%**	**1992**	**%**	**1993**	**%**	**1989**	**%**	**1992**	**%**	**1993**	**%**
Total EC	$ 1 158 980,00	100	$ 1 503 272,00	100	$ 1 288 212,00	100	$ 1 125 723,00	100	$ 1 439 528,00	100	$ 1 324 404,00	100
Poland	$ 4 288,00	0.37	$ 9 070,00	0.60	$ 8 964,00	0.70	$ 4 287,00	0.38	$ 10 389,00	0.72	$ 11 520,00	0.87
CSFR	$ 2 828,00	0.24	$ 7 082,00	0.47	$ 6 996,00	0.54	$ 2 582,00	0.23	$ 8 001,00	0.56	$ 8 472,00	0.64
Hungary	$ 2 828,00	0.25	$ 7 055,00	0.34	$ 4 608,00	0.36	$ 3 270,00	0.29	$ 5 178,00	0.36	$ 5 748,00	0.43
Romania	$ 2 758,00	0.24	$ 1 798,00	0.12	$ 1 956,00	0.15	$ 748,00	0.07	$ 2 302,00	0.16	$ 2 676,00	0.20
Bulgaria	$ 592,00	0.05	$ 1 144,00	0.08	$ 1 116,00	0.09	$ 1 608,00	0.14	$ 748,00	0.10	$ 1 560,00	0.12
Total CEEC	$ 13 344,00	1.15	$ 24 149,00	1.61	$ 23 640,00	1.84	$ 12 495,00	1.11	$ 1 608,00	1.90	$ 29 976,00	2.26
Index CEEC year/1989		100		140		159		100	$ 12 495,00	171		204

Source : Author's calculations from OECD International Trade Statistics.

3. The impact of trade barriers

How important are the existing trade barriers between Central and East European countries and the EC?[2] The EC's arsenal of import barriers facing CEEC's industrial products is very well presented and analyzed by Schumacher and Mobius (1994).[3] Trade in agricultural products is covered by the Common Agricultural Policy and it is discussed separately.

The EU protection measures facing CEEC can be grouped in three categories:

1. tariffs: Most Favoured Nation (MFN) rates and reductions within the Generalised System of Preferences (GSP);
2. quotas (QR) and Other Non-Tariff Barriers (ONTB);
3. government procurement and technical regulations.

Trade liberalization started with the Trade and Cooperation Agreements, followed by the EC granting the CEEC GSP in 1990 and 1991. In December 1991 the new Association Agreement, the so-called Europe Agreements, were signed with Poland, Hungary and the CSFR, and in Spring 1993 with Bulgaria and Romania. The final outcome will be a free trade area within 10 years.

Before the series of liberalizations started in 1990, the situation was as follows. The EC MNF tariff rates ranged from 0 up to 14% for many clothing articles, 20% for shoes and 22% for special trucks in 1990. Imports from Poland faced the lowest import weighted MFN duty rate of 6.2%, Romania, the highest rate of 7.7%; as these figures show, on average, the impact of tariff protection was rather similar.

The most competitive CEEC's exports (textiles), however, faced not only relatively high tariffs; they were prevented from free entry more efficiently by quantitative restrictions (QR) under the Multifibre Arrangement (MFA) and even more by other non-tariff barriers (ONTB). Schumacher and Mobius (1994) calculated the import coverage ratio (%) affected by QRs and ONTBs for each country. Imports from CEEC subject to QRs ranged from about 20% for Poland

---

2 Measures discussed here were taken by the European Community before the official birthday of the EU.1992. In agreement with the principal source of information for this section (Schumacher and Mobius, 1994) the reference in the text is to the EC rather than to the EU.

3 The description and analysis of the EC protection and liberalization presented resumes sections of the comprehensive study by Schumacher and Mobius, (1994). I am indebted to Jan Stankovsky for making the study available to me.

to over 32% for Bulgaria. The incidence of ONTBs- mostly anti-dumping procedures - ranged from about 9% for Romania to 20% for Bulgaria. For details and evolution over the 1988-1991 period, see the following table.

As for the protective effect of EC's public procurement and technical regulations, Schumacher and Mobius classified imports from CEEC as moderately or highly affected by PT barriers. Their assessment indicates that the share of PT affected imports was lowest from Poland and Romania (32%) and highest from Hungary (46%) in 1990.

Taking into account all three types of protection measures, several sectors in which some of the CEEC were particularly competitive were highly protected. Iron and steel, clothing and most textile products were highly protected against imports from all five CEEC. In addition, footwear and electrical motor imports from three and four CEEC were also in the highly protected category. Only a small category of imports from CEEC was not subject to any barriers at all, while more than half[4] to three quarters of imports were subject to average or high protection. The situation in 1990 is presented in Table 3.2 and compared with that of 1993, after the implementation of Europe Agreements.

Liberalization under the Europe Agreements

The liberalization of import duties and restrictions on Polish, Czechoslovak and Hungarian goods started in March, 1992. Imports from Bulgaria and Romania were liberalized in the course of 1993. The agreements instigate a gradual establishment of a free-trade area for industrial products over a ten-year period. The EC liberalization steps are concentrated in the first five years. An acceleration of market access measures offered by the EC to Poland, the Czech and Slovak Republics and Hungary at the Copenhagen summit in June 1993, concerned faster abolishing of custom duties; remaining quantitative restrictions were not removed. Without going into details, the more competitive the imports from CEEC in a given product category are, the more hesitant are the liberalization measures. The EC import duties were abolished for the majority of industrial products, however, with important exceptions! The exceptions are listed in country specific groups of primary products, "sensitive" products, textile goods (Protocol no.1) and steel and coal (Protocol no. 2).

---

4 Except for Romania, where 45% of exports to EC were subject to average or high import barriers.

TABLE 3.1

EC protection against industrial imports from CEECs, 1988-1991

Country/ 1988 1989 1990 1991	Industrial imports in ECU million	Share in total EC industrial imports (%)	MFN duty rate (%)	Import coverage ratio (%)		Duty relief (% of FN duty)
				QR	ONTB	
Bulgaria	320	0.1	6.5	23.1	11.3	0.0
	370	0.1	6.4	27.8	16.9	0.0
	406	0.1	6.7	32.9	19.6	0.0
	540	0.1	6.6	29.9	16.1	20.9
CSFR	1 977	0.6	6.2	21.8	17.5	0.0
	2 242	0.6	6.2	21.0	17.7	0.0
	2 397	0.6	6.4	22.9	18.5	0.0
	3 700	0.9	6.8	19.9	13.6	36.1
Hungary	1 472	0.5	7.1	26.8	14.2	0.0
	1 735	0.5	7.0	25.7	14.6	0.0
	2 133	0.5	7.1	25.5	14.4	32.9
	2 603	0.6	7.2	22.4	12.0	38.5
Poland	2 504	0.8	5.7	17.0	8.8	0.0
	2 811	0.8	5.9	18.0	9.7	0.0
	3 838	1.0	6.2	19.2	10.2	33.3
	4 847	1.2	6.3	20.3	8.6	35.9
Romania	2 115	0.6	7.3	22.0	8.5	n.a.
	2 424	0.6	7.2	21.2	7.3	29.2
	1 552	0.4	7.7	27.9	8.8	22.0
	1 370	0.3	7.8	30.2	9.5	22.6

Source : DIW calculations based on data from Eurostat and UNCTAD; Schumacher and Mobius (1994).

In fact, a larger definition of "sensitive" product categories includes all industrial goods subject to special protection listed above.[5] Rollo and Smith (1993) argue that the relatively poor export performance of CEEC in these industries to the EC market in the 1990-1991 period is due more to the EC's protectionism than to the lack of CEEC's competitiveness in these industries. Even though these sectors in the EC have higher import penetration from CEEC than other sectors, these imports rarely account for more than 1% of the domestic market of most EC countries. On the other hand, these industries are extraordinarily importance to the CEEC economies. There they accounted for 35 to 40% of VA in manufacturing and for 45 to 58% of CEEC's exports to the EC in 1989.

The EC's protection of these specific product groups relies on safeguards and anti-dumping procedures and is likely to increase over the next five years in response to increased imports from CEEC despite the decline of explicit protection.[6] The reliance on the contingent protection gives the EC all latitude in applying NTBs against any CEEC exporter who will succeed in increasing its share of the EC import market.

---

5 This large list of "sensitive" products includes: iron & steel, chemicals, food processing, textiles, clothing and footwear.

6 Imports of "sensitive" products are duty free within certain quotas, while the quantities imported in excess of the quota are subject to duties. The duty-free imports are annually increased and the duties on excess quantities reduced. Tariffs on textiles will be reduced in six steps and lifted after six years. Quantitative restrictions will continue to exist but will be dismantled within the next six years. Finally, the duties on coal will be abolished one year after signing of the Agreement, except in Germany and Spain, where they will persist for another three years. Duties on imports of steel will be reduced by 20% annually. The EC side of the free trade area for industrial products should be to a large extent completed by the beginning of 1997 (1998 for Bulgaria and Romania).

TABLE 3.2

Distribution of the incidence of all EC Import Barriers before and after the Europe Agreements

	None		Weak		Average		High		Total	
	1990	**1993**	**1990**	**1993**	**1990**	**1993**	**1990**	**1993**	**1990**	**1993**
Bulgaria	1.6	44	23	23	43	8.9	32	24	100	100
CSFR	3.5	39	27	37	38	12	32	11	100	100
Hungary	0.1	53	31	25	45	2.3	24	20	100	100
Poland	0.5	36	46	35	33	11	21	18	100	100
Romania	0	17	55	40	17	6.3	28	37	100	100

Source : Schumacher and Mobius, 1994.

A measure of particular practical importance to CEEC was the further opening of a duty exemption for outward processing in CEEC. Imports under the provision of the outward processing trade-duty exemption (OPT) accounted for more than half of the total imports of products of the knitting and clothing industry and also at least 20% of woven fabrics. Their importance varied among CEEC as can be seen in Table 3.3.

TABLE 3.3

Imports under the OPT duty exemption, 1992

Country of processing	Share in textile imports %	Share in industrial imports %
CSFR	37	5
Hungary	68	15
Poland	74	14
Bulgaria	42	12
Romania	64	24

Source: Schumacher and Mobius (1994).

The tariff reductions in % points for imports from each CEEC depend mainly on the relative importance of textiles to total imports since textiles paid the highest import duties. The annual duty reductions due to the GSP and Europe Agreements amounted to about 2 to 3% points for CSFR, Hungary and Poland from 1990 to 1991, and to 1992. The actual annual increase of imports from these countries during these years was much higher (22 to 54% points in 1991 and 17 to 38% points in 1992 for Hungary and CSFR respectively); imports from Poland increased slightly more than those from Hungary. Assuming a unitary price elasticity of import demand, tariff reductions could not account for more than a very small fraction of actual import increase.

Import quotas, especially for imports from the three CCE,were gradually increased for textile categories which did use less that 50% of quotas in the last three year. The assessment of quantitative restrictions for the whole EC (Schumacher and Mobius, 1994) is, however, not a very meaningful indicator of increased access to the EC market. Due to geography and established distribution networks, CEEC fill the quotas in some countries, Germany first of all, while large portions of quota in more remote, less familiar markets such as Ireland, Portugal, Spain or Greece remain under-utilized. Although there has been a reduction in the proportion of textile imports subject to QRs, the most important textile products still belong to the "highly protected" category.

There were also a series of anti-dumping cases, especially against Czech, Slovak, Polish and Romanian steel products. Imports exceeding quotas paid duties of 25 to 30%. Other products facing ONTBs were chemicals and cement.

Trade policies in the CEEC

Under the state monopoly of foreign trade, tariffs had no real economic function and most socialist countries adopted low tariffs in accordance with GATT requirements. These low tariffs remained in force during the transition period. Tariffs in Czechoslovakia were relatively low (4.6% on average) and rather uniform. In order to assist industries in transition a 20% import surcharge was introduced in 1991 on many consumer goods. Owing to a weaker than expected demand for imports, the surcharge was reduced from 20 to 15% in June 1991 and gradually reduced and eliminated at the end of 1992. After separation, Slovakia again introduced an import surcharge on consumer goods in July 1993.

The average level of customs duties in Hungary until the end of 1990 was 11.2%. A tariff reform was introduced on January 1st, 1991, and rates were reduced for 600 product categories. The low custom duties have been maintained and Hungary reacted to deterioration of its trade balance by an import surcharge of 8% . The average tariff rate in Poland was 11.8%, the average for consumer goods was 15.8%. After a significant deterioration of its trade balance in the first half of 1991, Poland increased its custom duties; the average tariff rose to 18.2% in 1992. This meant a shift from unilateral trade liberalization to bilateral negotiations for future mutual tariff and NTB reductions.

Individual countries increased selectively import duties on specific products in negotiation with prospective foreign investors (For example, Poland in the deal with Fiat and Czechoslovakia with Volkswagen, both increased protection of the car industry).

Under the European Association Agreements (EAA) all CEEC will eliminate their tariffs on industrial goods so as to introduce free trade for industrial goods within ten years.

Effects of the European Association Agreements on the CEEC's foreign trade

The process of liberalization by the EC vis a vis imports from CEEC is viewed by some authors (Winters (1992), Rollo and Smith (1993)), as being designed more to minimize the adjustment in the EC than to help the CEEC. Authors that look into the incidence of EC protection on CEEC exports to the EC agree that the most competitive export sectors are hardest hit. Landesmann (1994a) and Gacz (1994) show that exports to EC and indicators of comparative advantage of the CSFR and Hungary vis a vis the EC are positively correlated with

the aggregate index of protection in 1991-1992. Landesmann also reports that the CSFR exports were moving away from the most protected product categories from 1989 to 1992.

It is yet too early to observe and assess quantitatively the effects of the EAA on the evolution of the volume and, more important, on the structure of CEEC's exports to the EC. Rollo and Smith (1993) projected a 400% increase in CEEC's "sensitive exports" to the EC, and modelled their probable welfare impact in a partial equilibrium framework with perfect and imperfect competition. Overall, the net welfare effects on the EC of tariff reduction in "sensitive" industrial products (the analysis of the effect of liberalization of agriculture is presented in the next section) are positive but very small. The increased consumer surplus is almost completely compensated by the loss of producer surplus. In the case of non-tariff barriers it is ass15umed that the CEEC producers capture the rents, so that liberalization of NTBs benefits them little! Even though the model represents an unrealistically pessimistic scenario for the EC, assuming that the community's exports to CEEC will not change, nor does it take into account gains related to capital investment, the net effect of the opening of the EC is very small and does not help to explain why the "sensitive" sectors are treated as such. One should add that the analysis has not taken into account the realistic possibility that the trade between the EC and (at least) the four western CCE will increasingly evolve in the two-way (intra-industry) direction. This should make the adjustment even easier!

Looking at the EC's policy response from a different, probably more realistic angle, Brada (1994) finds the protectionist attitude of the EC quite natural in light of the Association Agreements. Since the CEEC want to become, as soon as possible, members of the EU, the objective of the Agreements "... must be viewed within the political economy of protection and subsizing that exists within the EC against outsiders. This pattern of protection and subsidizing within the EC has led to its own particular pattern of production and special interest lobbying to which the economies of the potential new members must be bent just as surely as their laws must be harmonized with those of the Community." Now Brada includes in this group only the CCE (Czech and Slovak Republics, Poland, Hungary) and concedes that for the other countries some preferential access may be justified.[7]

---

7 Brada also suggests that it is not in the interest of the CEEC to receive preferential access for food, steel and textiles, which are hypertrophied and inefficient in CSFR, Hungary and Poland. Thus it is in the CEEC's interest to downsize these sectors and not keep them oversized by preferential access to the EC market. While there is no doubt that the size of some of these industries is too large, all not are necessarily inefficient.

He also dismisses the suggestion by Baldwin (1992) that the CEEC should first join the EFTA. Why should they waste time and energy to join the EFTA when its members are abandoning it? As regards the suggestion of reviving the intra-regional trade with the former CMEA partners, it should be expanded only as much as it may be justified on economic grounds.

Agriculture and food products

The share of agriculture in CEEC's output and employment is more than twice as high as in the EC. In a free trade environment the reformed CEEC agriculture output would be likely to rise and put additional pressure on world prices and even help to speed up elimination of CAP. However, as Hamilton and Winters (1992) have noticed for agriculture both in CEEC and the EC, the change of trade regimes is more important than productivity catchup or income growth. The agriculture and related food product industries continue to be the most protected sector of the EC.

After liberalization dismantled their distorted and inefficient state and cooperative farm system and their export markets in the former CMEA vanished, farmers and food producers in CEEC discovered that they were losing their internal market to subsidized imports from the EC. At the same time exports of agriculture goods to the EC continue to be subject to an elaborate system of QRs only modestly helped by the EAA.

The protective effect of the EC CAP on trade is reflected in the fact that while CEEC's exports of agriculture and food products were in 1993 only marginally higher than in 1988, CEEC's imports from the EC increased three times (Table 3.4).

As the results of GATT show, free trade in agriculture and food products is not going to happen quickly. In contrast to the ten year target of free trade in industrial products, free trade in agriculture and food products between the CE and CEEC is not in view, nor are the EC's intentions vis a vis CEEC.

So far, the transformation of agriculture in CEEC has not resulted in a surge of production but in a crisis. According to an expert report to the EU by Nallet and Van Stalke[8], problems of privatization, disrupted input supplies, and decreasing mechanisation caused by the credit crunch, are compounded by the loss of CMEA market and the increase of subsidized imports

8 Reported by Hadova (1994) (Vztahy mezi Evropskou unii a zememi stredni a vychodni Evropy v oblasti zemedelstvi a potravinarske vyroby, zprava expertu, HN, J.Hadova, 11 srpna, 1994, p. 6).

from the EC and led to a situation, where in some CEEC the agriculture costs exceed prices leading to the curtailment of production. The report recommended a series of interventionist measures aimed at preventing the deepening of the crisis by a system of support prices integrating CEEC exports with those of the EU without disturbing the protection of the EU market!

CEEC have meanwhile introduced subsidized credit for farmers, and increased agricultural tariffs; Hungary has even introduced import licenses, and the other countries (CR, SR and Poland) have instituted import levies keeping domestic prices stable when import prices change. Far from being another nail in the CAP's coffin, as Hamilton and Winters (1992) anticipated, the trade arrangement between the EC and CEEC has helped the former partner to substantially increase its exports to the latter. On the other hand, it induced CEEC to embark on the introduction of mini-CAPs, including export subsidies for selected products.[9] It can be expected that CEEC will emulate the behaviour of their future partners and in conformity with the "restaurant bill" theory [10] each country will seek price increases for goods for which their share of EC production exceeds their share of GNP. Thus, the Central Europeans, encouraged by the EC, are following the distorted path of the CAP.

---

9 According to a second-hand account of the report, the recommendation is to create a system that looks like a combination of tariff financed subsidies for the EC agriculture exports to the CEEC. The objective of the proposed system is to introduce a price stabilisation system that would keep prices in CEEC above the "hard core" production costs. The difference could be financed (or co-financed) from a special EC support fund. Since the production costs of CEEC are lower than the world prices, the authors recommend that the EC export subsidies for agriculture exports to CEEC be correspondingly lower than subsidies to exports to the rest of the world. The revenue from the tariffs and the "savings" from export subsidies to CEEC relative to subsidies to exports to the rest of the world would constitute a fund for the support of CEEC agriculture.

10 According to Winters (1994) the "restaurant bill" theory, afflicts the annual price fixing by the Agricultural Council. The cost of high prices are borne by consumers and by the EC budget. The benefits are more or less proportional to production. Because the marginal ECU of the EC budget is levied proportionately to GDP, each national government has incentive to seek a price rise in any commodity for which its share of EC production exceeds its share of GDP. The fact that CEEC are not yet EC members and do not contribute to the budget, makes price increases only more attractive as a measure in anticipation of full membership.

TABLE 3.4

Index of trade with agriculture and food products between the EC and CEEC, 1988-1993

Year	CEEC exports to EU	EU Exports to CEEC
1988	100	100
1989	127	175
1990	134	175
1991	152	257
1992	140	286
1993*	109	316

Source: Hospodarske noviny, August 11, 1994 account summary of Nallet and van Stalke's report to the EU.

Note: 1993* January-November

4. Liberalization of factor markets and their impact on capital and labour mobility

Membership in the EU would imply integration of factor markets, i.e. perfect mobility and national treatment of foreign investment and mobility of labour and services.[11] There is no doubt that relative to the EU countries, CEEC are in need of capital and have an abundance of labour. Although they all badly need capital, they need even more the combination of capital, technology and management skills that are brought by direct investment. Their success in attracting foreign direct investment has varied from country to country and is changing over time, but in general, the number of projects has so far been more impressive than the actual flow of FDI.

After increasing rapidly in 1990 and 1991, the FDI flow to Central and Eastern Europe appears to have amounted to $2.6 billion in 1993, slightly less than in 1992.[12] The inflow to the whole region ($4.6 billion including former USSR and other East European countries) represents less than one half of one percent of total world FDI in the same period, less than one percent of Western Europe's share and less than one fifth of FDI in Africa (UNCDAT, 1994). In per capita terms, the FDI is also much less than one would expect. The annual average 1992-1993 net inflow per person ranges from $130 in Hungary to $5 in Bulgaria (The Economist, June 18, 1994). Compared with the risk rating the CEEC show, the low FDI inflow can not be blamed on the evaluation of high risk; Czech Republics risk rating is better than Chile's or Thailand's, and Hungary's is about the same as Mexico's and much better than that of Argentina, Brazil or Turkey, countries that have experienced strong FDI inflows. Rather it suggests that it takes some time before foreign firms start to orient themselves to a new environement, where the investment climate is still rather unfamiliar for foreign investors (see Table 4.1 for details).

After reviewing the situation in CEEC, K-D Schmidt (1994) concluded that this situation is consistent with what one would expect from the theory of FDI and conventional wisdom. The situation in CEEC is still not very favorable to foreign investment, for a series of reasons including:

---

11 Since the mobility of services also usually involves foreign investment and movement of persons, it is mentioned in this section of the paper rather than in the section on trade of goods.

12 The data on DFI flows for the whole region are far from reliable, and mixing them several sources as I have done by necessity, gives an approximative order of magnitude only.

- Legislation with respect to FDI is still imperfect
- Limitations on acquisition of real estate by foreign investors
- Red tape, sectoral restrictions and government involvement and control complicate has complicated and discouraged investment and business
- Complicated tax laws
- Privatization in practice is still very opaque and subject to heavy government intervention
- Value of domestic assets and capabilities is often evaluated unrealistically high.

I would add to this list an attitude problem; foreign investment is still very much considered as a sell-out of the country's "family silver". Several well publicized initial failures (eg. the Air France - Czechoslovak airlines partnership) reinforce this deeply seated mistrust. A problem is also the business ethic in CEEC, or rather the lack of it.

One of the tenets of the FDI theory has always been that the parent company insists on majority control so as to be able to fully realize advantages of ownership, and to manage the subsidiary more efficiently. Most FDI investment projects in the CR and SR, areas with which I am more familiar, do not involve majority control. The privatization of large and/or "strategic" enterprises typically reserved only a minority share for foreign investors. The ensuing difficulties for the new, mixed management team is one of the reasons for the poor performance of some of these projects. The situation is typically one of assymetric information and it increases uncertainty for the foreign investor. This may help to explain why investors have so far been reluctant to commit more resources to CEEC.

In order to attract FDI, CEEC rely more on ad hoc concession in trade policies than on fiscal concessions. They were ready, at least in the first years after the start of reforms, to comply with their foreign suitors' demands and accorded them increased tariff protection in the local market Thus Fiat negotiated special tariff protection for its cars produced in Poland and a similar deal was negotiated also by Volkswagen with the Czechoslovak government. Similar deal between Ford

and the Hungarian Government, led to fierce oposition from the EU car builders and the conscession was eventually removed. (EBRD, Transition report, ch.9,1995).

Most of the foreign direct investment came to CEEC from the EU countries. The statistics are more difficult to come by and cover only the 1991-1992 period. The sectoral distribution of FDI is not very different from the typpical pattern found in other countries at a comparable level of development. More than half is in manufacturing, about a quarter in services (construction, banking and insurance) and about one fifth in the rest of the economy. More important than FDI are portfolio investments, attracted to the more developed CEEC by a large choice of shares and bonds issued by recently privatized companies on the local stock exchanges.

Foreign borrowing is also an important source of foreign capital in the central European countries, where restrictive monetary policies and tight credit keep interest rates much higher than on the international market. Owing to their good credit rating, several large CEEC banks borrowed extensively abroad and so did large corporations and cities. The Central European countries are thus being increasingly integrated in the international capital market and most capital comes from the EU countries.

TABLE 4.1

Foreign Direct Investment in CEEC
by Host Country, 1989-1995 (in million $)

	1989	1994	1995	1990-95
Bulgaria		105	150	412
Czech rep.	256*	878	2 500	5 666
Slovakia	*	187	200	775
Hungary	550	1 146	4 400	11 200
Poland	100	1 875	2 500	7 148
Romania		340	400	933
Total	906	4 531	10 150	26 134

Sources: K.D. Schmidt (1994) data for 1989
Financial Times 25.3.1996, data for 1990-95

Note: * The figure is for former Czechoslovakia

Labour market and migration

The comparison of wage costs between Western Europe and its Eastern neighbours suggests that the principal attraction for FDI and for OPT are the low wages[13] of a fairly skilled and educated labour force. Cheap energy and natural resources are additional attractions. Even taking into account lower productivity in CEEC, it does not completely offset the enormous differences in nominal wages. For instance, the minimum wage in the Czech Republic is 1/16 of the minimum wage in Germany, the ratio of GNP/person is about 8 times higher in Germany than

13 Aiginger (1993) reports that in a survey of Austrian businessmen 88% selected low wages as the main advantage of producing in the CEEC. Presence on the consumer market was second (37%), low energy costs third (23%) and low environment standards fourth (21%).

in the Czech Republic, suggesting that the unit wage cost in CR is about half the German rate.[14] A productivity and labour cost comparison for Austria is presented below in Table 4.2.

TABLE 4.2

Labour cost and Productivity Comparison in Industry- 1990

	GDP/empl.	**Wage bill/empl**
CSFR	18.4	8.8
Hungary	16.2	11.4
Poland	9.5	5.1
Austria	100	100

Source: Peneder, M. "Kosten und Produktionsstruktur der Industrie in den Landern Ost-Mitteleuroppas in K.Aginger (ed) Chancen und Gefährdungs potentiale der Offnung: Konsequenzen fur die Osterreichische Wirtschaft", Wien,WIFO, Feb., 1993.

The free movement of factors between the EU and CEEC does not yet exist, even though the inflow of capital to CEEC is relatively free. A faster inflow of capital would help to increase labour income in the CEEC and thus contribute, along with the trade in goods, to convergence of income in the two regions. Even though language barriers and high unemployment in the EU reduce the potential for labour immigration, the flows, if not checked, would still rapidly become politically and economically unacceptable. In order to stem an uncontrolled inflow of migrants looking for higher wages in the West, the EU has restricted labour immigration from the Central and Eastern Europe. Similar barriers have also been erected in the CEEC, in order to control immigration flow from the East.[15] At present the labor migration is restricted to crossborder movement of a tightly controlled limited number of temporary workers from the Czech republic and Poland to Germany.

15 There is a growing population of legal and illegal temporary workers from Slovakia, Ukraine, Poland and Russia employed in the Czech Republic.

Even though wages and salaries in CEEC are very low by EU standards, employees enjoy a fair standard of social benefits. These are, however, less generous than the "social charter" of the EU. It would not be in the interest of the CEECs to adopt the EU social charter before closing the economic gap separating them from their western neighbors. Adopting the prohibitively expensive social charter would accelerate the loss of their initial advantage in low labour costs.

Since important income differences are likely to persist between CEEC and their western partners, immigration pressure persists, especially to Germany. In this context it can be expected, that the EU will not offer to CEEC full membership including "European citizenship" with free labour mobility, before a substantial narrowing of the real wage gap and living conditions in general.

Given the large labour cost differentials and the uncertainty surrounding FDI, it is easy to understand the rapid development of outward processing in the textile and clothing sector (See Table 3.3). This fast growing activity is a temporary[16] substitute for migration of labour and for FDI. As the experiences of other countries has shown (Hanel, Bilodeau, Abid, 1994) its effect is positive in terms of income creation but likely less effective than FDI in terms of positive externalities on management, technology and local sourcing.

5. Advantages and disadvantages of integration with the EU for the CEEC

The overview of the progress toward integration of CEEC with the EU suggests that the process is well advanced in international trade and investment. The likely advantages and disadvantages for the CEEC of integration with the EU, can be assessed on three points:

First, integration offers countries an opportunity to benefit from their differences, reallocating resources to more efficient use. Second, integration offers further opportunities for gains from increased competition and rationalization to realize economies of scale and scope. Third, integration also poses problems of adjustment and income distribution (Krugman, 1989).

Integration through international trade

The large differences in factor endowment and hence in factor prices and the, so far, much less than optimal level of bilateral trade offers the smaller partner, the CEEC important gains from trade based on inter-industry specialization. The accelerated liberalisation of import duties by the EU has certainly helped CEEC to increase their exports, especially in "non-sensitive" categories of goods. Increased imports from the EU helped to curb abuse of monopoly power of domestic producers and contributed to introduce a more rational system of relative prices for industrial products. Imports improved consumer welfare not only by increasing the consumer

16 If a real income convergence between the EU and CEEC takes place, the outward processing there will cease to be profitable. In this respect it would be interesting to see the effect of outward processing in CEEC on the export processing activities in Tunis and other similar areas.

surplus, but also by introducing on the market more variety and better quality. Imports of intermediate industrial goods and of machinery and equipment contributed to the modernization of industrial production and services. This process, especially the trade in industrial inputs and machinery, is likely to intensify with the restructuring and growth of industrial production in CEEC.

After an initial phase when the undervalued exchange rates helped to export at any price to save firms from going bankrupt, a period of inter-industry specialization and adjustment is beginning. This period will coincide with the intensification of integration. In order to be really beneficial to CEES, the integration should allow them to allocate resources to their most efficient use, based on undistorted prices and as freely competitive as possible. The arsenal of contingent protection of non-tariff barriers that CEEC exports are facing in the so called "sensitive sectors" are a serious obstacle to this process. On the one hand, they can be triggered at will and therefore will act as a deterrent against investment in fields in which CEEC may really have a comparative advantage. On the other hand, if there is to be a gradual process of cartelisation of the CEEC-EU trade - as is apparently already happening in the iron and steel industry (Messerlin, 1992)- the welfare effects of increased trade in these products are less clear. The direct effect on the exporting industry will depend on the distribution of rents (the persistence of much lower unit export values for even very standardized CEEC products in the EU market suggests that it is not necessarily the exporters who are collecting those rents). On the other hand, if exporters can appropriate the rents, the indirect effects of higher export prices of basic industrial inputs such as iron, steel, chemicals and textiles are detrimental to downstream activities for which CEEC may have comparative advantage related not only to the low cost of labour but also to its technical skills. Thus the advantages of further integration in "sensitive" industries are less certain and more difficult to assess. As the example of agriculture shows, trade "liberalisation" with a partner conducting inefficient policies lead to a diffusion of inefficiency rather than to gains from freer trade. It can also lead to a diffusion of fraud, mismanagement and corruption (The Economist, July 30,1994) that would find very fertile soil in CEEC.

Intra-industry trade

Aside from and in addition to gains from trade related to comparative advantage, integration with the EU should increase the intra-industry trade based on economies of scale and scope and on product differentiation. With regards to economies of scale, one should keep in mind that in contrast to western industrialized countries, industrial firms in CEEC were often inefficiently large rather than inefficiently small! In this context, a successful integration with the EU may replace only part of the large market lost in the former CMEA, with a corresponding scale effect. However, these industrial mammoths were heavily and inefficiently vertically integrated, striving for maximum self-sufficiency. Many of these big industrial concerns have not yet been effectively restructured. In order for these firms to survive they have to rationalize

their production and become part of the European integrated industrial structure, i.e. members of the network linking suppliers and users of industrial inputs, often clustered around large enterprises. Integration to a single European market, subject to common technical standards, common competition policies, free from administrative and border barriers, offers a potential for the much-needed modernization for those firms able to take advantage of it. The geographical and cultural proximity may be an important asset. In this respect, as their intra-industry trade with the EU shows, Hungary, the Czech Republic and Poland probably have an initial advantage over their less industrialized and more remote eastern neighbors. The outward processing trade between Germany and the three countries is already very active. However, to exploit the potential of intra-industry trade to its full advantage, there is a need to more effectively attract FDI. Further development of intra-industry trade with the EU should not only help the restructuring and revitalization of some of the more high-tech industries left in doldrums after the demise of the CMEA market; it has the additional advantage of having lower adjustment costs.

The possible adverse effect of integration under condition of imperfect competition is that some enterprises, industries, regions, and even countries may emerge as net losers (Venables, 1994, WA; Krugman, 1989). An uneven division of gains in imperfectly competitive industries is a real possibility. It should come as no surprise that privatization of large enterprises in CEEC, especially with foreign partners, in fields dominated in the West by strong oligopolies or monopolies, proceeds with great difficulty and is often subject to intense government intervention. What is often at stake is the fear, justified or not, of losing long-established strategic advantages.

Integration of the capital market

This brings the discussion to the integration of capital markets. Long-run transfer of resources by capital investment is a substitute for international trade. There are significant differences between the five CEEC with respect to their capacity to attract badly needed capital, the most important probably being economic and political stability and accumulated foreign debt, and the capacity of the country to service that debt. Their capital markets are still small, under-developed, and better known for spectacular financial scandals than for efficiency. Again, the situation is very different from one country to another. In preparation for integration, all five countries have pursued with different success and commitment, the objective of streamlining the legal and institutional framework so as to fit the EU. If they succeed in reducing uncertainty, so as to make investment in CEEC not significanly more risky than investment in the rest of EU, badly needed capital will come in response to real economic opportunities.

One of the fields where closer integration should be especially beneficial is further opening of the local financial market to foreign banks. Although foreign banks already operate in CEEC,

their activities are often restricted to servicing foreign investment only. I am not aware of the situation in other CEEC, but in the Czech Republic they are not yet allowed on the financial retail market, which could benefit from competition and increased efficiency.

Gradual integration with the financial markets of the EU will increasignly lead to two-way flows of capital that should improve financial markets in terms of their capacity for improved:

-risk diversification,

-intermediation,

-information flows,

-competition.

That such situations might well arise in CEEC where the banking system and the financial markets are in their infancy is a real possibility.

Integration of labour markets

Before it is possible to think of integration of the labour market between CEEC and the EU it is necessary to ensure a better integration of national labour markets. The long tradition of occupational immobility coupled with a permanent housing crisis resulted in a very imperfect, geographically segmented labour market. The economic transition appears to have increased occupational mobility but not yet the housing crisis.

Social protocol

The conditions of social protocol are one of the more ambiguous aspects of integration to be considered by the CEEC. By stipulating working conditions, social security, etc. it is, on the one hand, a useful instrument for the unions and employees in their negotiations with employers and governments. On the other hand, the social protocol is unlikely to take into account the economic and social constraints particular to CEEC which are much poorer and are facing different priorities than the established members of the EU. In their eagerness to enter the EU, the prospective members may accept costly constraints that could undermine their competitiveness, slow down the growth, and increase unemployment.

International migration

As long as the unemployment and growth prospects do not improve, it is unrealistic to expect that the EU would open the door to free immigration from its new eastern members. There are, however, arrangements in the border areas that offer limited access to temporary workers to Germany. The rapid expansion of outward processing described above is probably a better and more efficient substitute for migration for purely economic reasons.

It can, however, be expected that increased economic and industrial integration will increase the scope for a two-way migration. The phenomenon can be observed for example in Prague, where there is a thriving expatriate community composed of students, personnel of foreign firms and businessmen, not to mention drug dealers and the like. Aside from giving the old city a more cosmopolitan flair, their presence brings a non-negligible flow of revenue, it helps to improve services, and has led to the establishment of a parallel housing market. At the other end of the occupational distribution, there are many temporary foreign construction workers happy to work at the Czech minimum wage level, which is really minimal even compared to Central European standards. The economic impact of this cross-border movement is a faster diffusion of western ways and values. Its adverse effects are also plainly observable: increased crime, an outburst of xenophobia, and the accelerated loss of cultural identity.

Macroeconomic implications of integration

If the conditions of the Maastrich treaty remain intact, members of the European Monetary Union have to satisfy five macroeconomic criteria. Their inflation must remain within 1.5% and interest within 2% of the three best performing states; a budget deficit of less than 3% and a national debt of less than 60% of GDP, and no devaluation within the exchange mechanism for the past two years.

These conditions show that there remains a very limited scope for independent economic policy making at the national level. The advantage of such a system is that it imposes strict macroeconomic discipline on the members of the union. The disadvantage stems from the need for coordinated policies. At worst, the problem of coordination could negate the microeconomic benefits of integration (Krugman, 1989).

The inefficiency of monetary policy under the fixed exchange rate and integrated capital market

With the fixed exchange rate and efficient capital market integration, the member countries cannot use independent monetary policy. That the problem arises even with very imperfect capital market integration can be seen in the Czech Republic. The Czech National Bank has difficulty in reconciling two goals simultaneously: (1) control inflation and (2) keep the exchange rate from appreciating. The effort to sterilize the inflow of foreign capital is costly and cannot be conducted indefinitely. On the other hand, the monetary discipline required to maintain the exchange rate increases the confidence and credibility of economic policies. The Czech and even Slovak situation in comparison with other CEEC illustrates the point.

Macroeconomic repercussions transmitted by international trade

An increase or a slowdown of growth in one country changes its demand for imports and affects, through the multiplier effect the growth of its trade partners. Increasing integration intensifies this linkage.

The increased need to coordinate fiscal policies under the fixed exchange rate and integrated capital market

Krugman (1989) illustrates that under capital mobility and the fixed exchange rate maintained via coordinated monetary policy, countries can pursue independent fiscal policies. These independent fiscal policies may yield suboptimal results because each country ignores the effect of its policies on the other's exports. A simultaneous unco-ordinated fiscal restriction is likely to lead to an excessive restriction. In order to avoid this more coordination of economic policy is needed.

Regional equalization fund

The EU requires that its members contribute to the budget, and offers them aid and various programs, including access to a regional fund that supports the less affluent regions. The estimates of the cost of integrating CEEC into the EU vary according to assumptions used. Given the low level of GDP per capita in the CEEC, it could take, according to one of the estimates, between 21 and 39 years before they would reach 75% of the average GDP of the EU to outgrow the subsidy, according to today's criteria; and the cost of integrating the four countries and Slovenia would cost more than 50 billion DM annually (Der Spiegel, 50/1994,p.29).

It is unlikely that the EU will maintain the same rules; they appear incompatible with the declared intention of including CEEC in the not too distant future. The unpleasant perspective for the new eastern members of the EU could be that they will have to surrender a large part of their autonomy in macroeconomic policy making without having the benefit of access to regional aid.

Conclusion

In order to make the EU work successfully, the member states have to surrender a significant part of their autonomy in economic policy making. Since the CEEC will be entering a club of "rich" countries, some of the rules they will have to accept are likely not to be in their best interest. This, however, will not stop CEEC resolve to enter the EU as soon as possible, because the main reasons for integration are political. Economic arguments are unlikely to stop the progress toward integration. It is in the interest of the prospective new members of the EU to understand the economic implications of association and to adjust their policies and negotiation strategy accordingly.

References

Aiginger, K. 1993. *Determinants of the Net Trade Flows Between West and East Before and After Transition.* Paper presented at the EARIE Conference in Tel Aviv. Vienna, Austria.

Aiginger, K. Peneder, M. Stankovsky, J.1994."The Explanatory Power of Market-Based Trade Theories for the Trade between Market Economies and Reform Countries." *Empirica* 1: 1-24.

Anonymous. 1994." Incredible Edibles." *The Economist* July 30.

Anonymous. 1994." Emerging-Market Indicators." *The Economist* February 19.

Anonymous. 1994. "The European Community." *The Economist* July 11.

Anonymous. 1994. "Falsche Hoffnungen." *Der Spiegel* 1950:28-29.

Brada, J. 1994. "Regional Integration versus Integration into World Economy: The Choices for Central and Eastern Europe." *World Economy* 17:603-618.

Gacs, J. 1994. *The Economic Interpenetration Between the EC and Eastern Europe: Hungary. Laxenburg,* Austria, International Institute for System Analysis (IIASA).

Hamilton,C.B. and Winters A. L. 1992. "Opening Up International Trade with Eastern Europe. *Economic Policy* 7.

Hanel, P. 1992. " Trade Liberalization in Czechoslovakia, Hungary and Poland Trough 1991: A Survey" *Comparative Economic Studies*, Fall-Winter, 34, 3-4 .

Hanel, P. Bilodeau, M. and Abid, M. 1994. *La contribution du régime des entreprises entièrement exportatrices à l'économie tunisienne, 1972-1991.* mimeo, Sherbrooke, (Que.) Canada Dept. d'economique, Universite de Sherbrooke.

Hanel P. and Cetkovsky, P. 1995. *Factor Intensity and Composition of Foreign Trade, Czech Republic.* mimeo, Sherbrooke, (Que.) Canada Dept.d'economique, Universite de Sherbrooke.

Hughes, G. and Hare, P. 1994 "The International Competitiveness of Industries in Bulgaria, Czechoslovakia, Hungary, and Poland." *Oxford Economic Papers* 46:200-221.

Krugman, P. 1989 "Economic Integration in Europe: Some Conceptual Issues" in Jacquemin A. and A. Sapir, eds.1989. *The European Internal Market.* New York, Oxford University Press.

King, N. Jr. 1994. "Competition Clashes with (Industrial) Welfare as East Meets West." *Industry Week* (June 6).

Landesmann, M. A. 1995. "The Pattern of East-West European Integration: Catching Up or Falling Behind." *European Economy.*

Peneder, M.1993. "Kosten und Produktionsstruktur der Industrie in den Landern Ost-Mitteleuroppas." in K.Aginger (ed.) *Chancen und Gefährdungspotentiale der Öffnung: Konsequenzen für die Österreichische Wirtschaft*, Wien, WIFO.

Rollo, J. and Smith, A. 1993. "The Political Economy of Eastern European Trade with the European Community: Why So Sensitive." *Economic Policy* 8:140-183.

Schmidt, K. D.1994. *Foreign Investment in Central and East European Coutries: State of Art and Prospect.* Paper presented at the conference: Transforming Economies and European Integration. Sofia, Bulgaria, May 27.

Schumacher, D. and Mobius, U. 1994. *Analysis of Community Trade Barriers Facing Central and East European Countries and Impact of Europe Agreements.* Berlin, Deutsches

Institüt fur Wirtchaftsforschung,(DIW)). Final report for the EC group on the economic interpenetration between the EC and Eastern Europe.