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INTERIM REPORT IR-98-020/April

The European Union and the Rest of the World: Complements or Substitutes for Central and Eastern Europe?

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Foreword

In 1996, the Economic Transition and Integration Project (ETI) at IIASA initiated a seminar series on the accession of the Central and East European countries (CEECs) to the European Union. The title of this series was "The Process of EU Accession: Preparation by Learning and Exchange."

This initiative was a logical one, since in recent years ETI has been active in research and policy advice on the international economic relations of transition economies. Moreover, ETI's latest research projects, such as the one on "Output Decline in Eastern Europe," and another on "Impediments to Exports in Small Transition Economies," have all had strong implications for the CEECs' integration into the European Union (EU).

The enlargement of the EU is a complex process whose importance for the countries concerned can hardly be overestimated. This probably justifies the large number of ongoing research projects in academia on EU accession. A distinctive feature of ETI's seminar series is that it is intended to promote an exchange of views and understanding among the transition countries aspiring to EU membership. IIASA, with its diverse composition of members from both parts of Europe (among other countries), including older and newer members of the EU, as well as the Central and East European (CEE) candidates for EU membership, seems to be the ideal research institution to enhance these goals.

The organization of the seminar series is supported by an advisory committee with the following members: Peter Pomezný, Advisor, Ministry of Finance (Czech Republic); András Inotai; Coordinator of the Strategic Task Force for European Integration (Hungary), Danuta Hübner, Head of the Cabinet of the President (Poland); Igor Kosír, Advisor, Ministry of Agriculture (Slovakia); and Andrej Kumar, Faculty of Economics, University of Ljubljana (Slovenia).

The first meeting in the seminar series was concerned with the "Strength and Advantages of Eastern Europe: EU's Net Gains from Accession," and was held in Laxenburg, Austria, in December 1996. That workshop was intended to help make the CEE applicant countries aware of their strengths and weaknesses in the context of EU membership and build up their self-confidence before negotiations start. The meeting had an interdisciplinary character; in addition to issues of purely economic importance, problems related to the environment, foreign policy, and national security were discussed. A summary of the workshop can be read on the World Wide Web in an Interim Report (http://www.iiasa.ac.at/Publications/Documents/IR-97-019.pdf).

A second meeting was held in Budapest on December 4-6, 1997, on the "The European Union and the Rest of the World: Complements or Substitutes for Central and Eastern Europe?" This paper summarizes that seminar.

The underlying idea of the seminar was as follows. In their transition to the market, most of the smaller CEE countries have oriented themselves toward Western Europe. This orientation has followed historical tradition and has a clear geographic and economic rationale. Links to the EU have also become stronger also as a consequence of the association process itself.

Turning to the EU inevitably means putting less focus on the rest of the world. One can see a clear tendency toward a decline in the formerly close relations of the applicant countries with certain groups of countries of the rest of the world (especially with non-dynamic developing countries, the ex-CMEA countries, and split-partner countries). With respect to other groups of nations, there is a moderate, far from spectacular, development in their economic relations. The focus on relations with the EU has been only slightly moderated recently by such initiatives as furthering the Central European Free Trade Agreement (CEFTA) process, development of the pan-European cumulation process, and the conclusion of numerous bilateral free trade agreements with non-EU member states.

Accession to the EU will give a further push to the orientation of the current applicant countries toward Europe. It is necessary to investigate the impact that accession will have for applicant countries' relations with the rest of the world, with respect to trade, flows of capital and labor, research and technology, environment, administration, and culture. Are there options for the applicant countries among which they can choose and which they can pursue during the negotiations over accession? Can they benefit from the potential of the more dynamic parts of the world economy beyond the borders of Europe? Will the common external tariff, common health and environmental standards, distribution of structural and cohesion funds, and agricultural transfers enhance only their relations to the EU members, or will there also be benefits for their interaction with the rest of the world?

The seminar in Budapest lived up to the expectations of the organizers and the participants with its substantive presentations, lively debates, and the ample opportunity it provided for participants from applicant countries and EU members states to build up new contacts with each other. Participation from CEECs other than the CEFTA countries was a specific feature of the meeting: presentations and interventions by experts from the Baltic states, Bulgaria, and Croatia were well accepted and helped other participants understand these countries' expectations with respect to the accession process.

In the initiation and support of this seminar, special role was played by *Mats Karlsson*, Secretary of State at the Swedish Ministry of Foreign Affairs and *András Inotai*, Coordinator of the Hungarian Strategic Task Force for European Integration (STFEI). The meeting was sponsored by these two bodies. IIASA would like to use also this opportunity to thank for their support.

The success of the seminar was greatly enhanced by two experienced conference organizers, Anikó Gyorgyovich (Institute of World Economy, Budapest) and Shari Jandl (IIASA), and by the hospitality of the Hungarian organizers, to all of whom we are indebted.

This report is structured as follows. The first section summarizes the most recent developments in the accession process in the individual candidate countries. The second is devoted to the tasks required by the adjustment to the EU's common external tariff and the process of common policy formation within the EU. The following section analyzes what will happen to the existing close bilateral relations after accession: both recent Austrian experiences and the expectations of candidate countries, such as Estonia and Bulgaria, are presented.

The prospects for capital flows originating from outside the EU are investigated in Section 4, from both the recipients' and external investors' points of view. The following section reports about on the already existing and broadening opportunities for technological cooperation across EU borders, based on the example of the EUREKA program. One of the most sensitive issues of the coming EU enlargement is agriculture. The Polish and Hungarian presentations on the subject discuss the challenges that these major agricultural producers face as they enter accession negotiations. Section 7 analyzes the core subject matter of the seminar in the broadest perspective: how does the coming accession fit into the overall process of regionalization and globalization in historical and economic perspective? The report ends with the summary statements made at close of the workshop.

The European Union and the Rest of the World: Complements or Substitutes for Central and Eastern Europe

János Gács and Michael Wyzan

Introduction[1]

The timing of this workshop is fortunate: half a year after the publication of the Agenda 2000 report and the Amsterdam Summit, and some days before the Luxembourg summit, it takes place at a qualitatively new stage of development for the candidate countries. It also promises new developments for EU member states in a number of critical areas which are important for the future development of the EU from both the global and European perspectives.

The Eastern enlargement is the first one that takes place in a global framework: enlargement is no longer a purely intra-European issue. Since CEECs can substantially contribute to the EU's competitiveness, it is Europe's competitiveness in the global context that is at stake. Unfortunately, to some extent the leaders of the EU member states, and, even more so, *public opinion* in many member countries, show little understanding of this fact. The previous enlargements involved diplomats, policy-makers, big business, and interest groups, but had little to do with public opinion. Few people in, say, Germany or the U.K. showed any interest in the enlargement of the Union with Spain or Portugal in the 1980s.

Today, however, there is an absolutely unjustified preoccupation with and even fear of the eastern enlargement of the EU in a wide strata of the Western European population. While there seems to be no opposition to the enlargement at the highest levels of politics, public opinion holds that enlargement will be harmful, costly, and should not take place. These opinions are based on fragile arguments at best. Most of the problems referred to in this context have nothing to do with the enlargement, but have been inherited from the past. They are consequences of the end of long-time division of Europe on the one hand, and of domestic rigidities and a failure to adjust in certain spheres (unemployment, lack of restructuring of the welfare system) in many member countries on the other.

[1] This part summarizes the introductory remarks of András Inotai.

The CEECs must solve a double problem: to shape accession in such a way that they can adjust to the requirements of the EU, but also to face global challenges. In most cases, these requirements can be met in one and the same way, but in others, the scope and sequencing of the required actions differ. All CEECs are interested in free trade globally and not in a "Fortress Europe"; the direction that developments will take in the future remains open. Another question is the extent to which our relations outside the EU can be positively used in our negotiations with Brussels. Will they be tolerated, welcomed, and consciously exploited for improving Europe's competitiveness in the future or will they pose a problem?

In some areas, Europe seems to lag behind the rest of the developed world, including new technologies, capital flows, information technology, and social and institutional flexibility, all of which are necessary for maintaining international competitiveness. We can only hope that as they adjust their economies to the EU's requirements, the CEECs will be doing so with respect to the better and more prospective characteristics of Europe, and not to those that make EU lag behind the most progressive non-EU countries.

The CEECs appreciate that intra-European and sub-regional cooperation is necessary in order to reduce their regional differences, which have deep historical roots. We must speak frankly about these gaps and devise long-term strategies within the framework of EU to remedy them. Moreover, the reduction of regional differences is also crucial for the continent's security, the most precious benefit of European integration.

1. Latest Developments in Accession Process: Updates from Applicant Countries

1.1 Czech Republic[2]

The account at last year's workshop[3] presented a picture of the Czech economy as a balanced one. However, at the end of 1997, it is unfortunately impossible to do so. External imbalance was already present in the Czech Republic in 1994, but by 1997 it deepened and was complemented with new imbalances: in 1996, the state budget was in deficit for the first time. This situation was aggravated in May 1997, when there was an attack on the Czech crown. The era of stability under a fixed exchange rate regime ended and the country switched to a managed float after an initial devaluation of 10 percent. In 1996, the current account deficit was 7.8 percent of gross domestic product (GDP) and the trade deficit 10 percent, a threat to the economy's future development.

On November 28, 1997, an open political crisis broke out; paradoxically just at that point in time economic indicators had just started to improve compared to 1996. In 1997, two economic packages were introduced to remedy imbalances, to cut state expenditures, speed up privatization, and control the trade deficit. The main topic of interest at present is the privatization of the four largest commercial banks.

[2] This section summarizes the presentation of Petr Pomezný.

[3] See Jarko Fidrmuc, "Strength and Advantages of Eastern Europe: EU's Net Gains from Accession," IIASA Interim Report no. IR-97-019, April 1997.

Earlier, political stability seemed to be an asset in the Czech Republic. As is commonly seen now, changes of government in Hungary and Poland seem to have borne more fruit there than stability brought the Czech Republic. Moreover, the necessary political change is not yet over in the Czech Republic: the coming new government will be a transitory one, and it will take at least six months to go through the procedure for achieving a real governmental change through the electoral process. The newly elected government will likely be a coalition of the social democrats and Christian democrats, while the two civic parties will undergo a deep crisis which may lead to the break-up of these parties or to their severe restructuring.

The European Commission's Opinion on the Czech Republic issued in July 1997 stated that the country might be apt to join the Union after meeting challenges mainly in the fields of micro-level restructuring, fostering the banking and financial system, making progress in such fields as environmental protection, infrastructure, agriculture and energy, and reforming the state administration.

For the coming negotiations, the problems related to the accession negotiations were divided to 15 sectors. The necessary position papers have already been prepared and discussed by the line ministries, as well as by the Ministry of Foreign Affairs, which is the coordinator of the accession negotiations. It was found that there were discrepancies between the Czech Republic's government structures and those required by the Commission. To eliminate these discrepancies, the new government must carry out a restructuring of the state administration. The creation of a relatively independent body, separate from the Ministry of Foreign Affairs, to coordinate the negotiations with the Commission, would be a desirable step.

1.2 Bulgaria[4]

Bulgaria applied for EU membership at the end of 1995. The Commission's Opinion published in July 1997 on Bulgaria suggested that negotiations should begin as soon as Bulgaria satisfies the criteria of the Copenhagen summit.

We can draw three major conclusions from the Opinion. (1) Bulgaria is on the way to satisfying the political criteria, namely, stable institutions, guarantees for the rule of law, and respect for the rights of minorities. (2) With respect to the economic criteria, progress so far has been limited. In the medium term, Bulgaria will not be able to comply with the competitive pressures and market forces within the EU. The main problem areas are the following: weak infrastructure, slow privatization, lack of structural reform, a high degree of state intervention, and a low level of the foreign direct investment (FDI) needed for modernizing the economy. (3) As for the ability to adopt the acquis,[5] the Commission expressed a negative opinion, indicating that Bulgaria will most likely not be able to do so in the medium term. Moreover, a deep administrative reform will be needed to ensure enforcement of the legislative changes.

Since the Opinions were published in July 1997, considerable progress has been made in stabilizing Bulgaria's fragile economy. Since the middle of 1997, Bulgaria has had a

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[4] This section summarizes the presentation of Rossen Rozenov.

[5] The "acquis" here and in what follows refers to the acquis communautaire, the body of laws and regulations necessary to assume the obligations of membership in the political, economic, and monetary unions.

currency board. As a result, the exchange rate for the lev has been fixed to the German mark and confidence has increased in the currency, followed by significant remonetization of the economy; lev-denominated deposits went up by 38 percent, and currency in circulation by 80 percent, between July and October 1997. The national bank's base interest rate fell from 20 percent to 6 percent per annum. Monthly inflation in October 1997 was only 0.5 percent. The balance of payments is strong, with surpluses on both the current and capital accounts. This has allowed that the Bulgarian National Bank to increase its foreign assets from DM 2.8 billion at the end of July to DM 4 billion to the end of October.

Despite these developments, there remains much to be done. The Association Committee met in Sofia at the end of October. It commended Bulgaria's initial success in stabilizing its macroeconomy, but encouraged a speeding up reforms, for example, with respect to reconciling Bulgarian legislation with that of the EU. In a review of the implementation of the association agreement, it was acknowledged that much of the agreement had been successfully implemented and that a further liberalization of trade with the EU can be expected in the future.

1.3 Hungary[6]

The Commission's Agenda 2000 project, with its assessment of the candidate countries was very useful, despite its shortcomings. The differentiation among the countries reflected a recognition of reality. Since this differentiation was made within a wider strategic framework, it outlined a general accession strategy for each country. The fact that the assessment was not based primarily on the macroeconomic features of the countries, but on their microeconomic and social performance was particularly valuable. This was the correct way to approach the issue of the adjustment capacity needed for accession. Another good idea was the linkage drawn between accession and overall developments within the EU, including reform of the Common Agricultural Policy (CAP), Structural Funds, and other EU institutions.

Currently in Hungary preparations are under way in advance of the negotiations scheduled to start at the end of March 1998. Ministries and inter-ministerial groups, as well as the coordinators of working groups the Strategic Task Force for European Integration (STFEI), have screened the required tasks with respect to the acquis. In the coming weeks, the general negotiation strategy for negotiations will be formulated and presented to parliament.

The negotiation guidelines suggested by the STFEI include the recommendation that the negotiators should set clear priorities, but apply a high level of flexibility, since it should be assumed that there will be major changes on both sides of the table over the next few years (i.e., the EU is a moving target). The negotiators' approach should be interdisciplinary and interdepartmental, encouraging cooperation between ministries and institutions.

The year 1997 in Hungary saw sustainable development for the first time, following several hard years of stop-and-go policies. This time the microeconomic fundamentals for economic growth of 4-5 percent per year are present. The almost 4 percent growth in

[6] This section summarizes the presentation of András Inotai.

1997 has been accompanied by a smaller current account deficit than in 1996, with more or less the same fiscal balance.

Although developments are encouraging, Hungary still badly needs a coherent strategy, not only to comply with the challenges of the accession, but also to set targets and a trajectory for the country's overall modernization. Such a strategy could either be imposed from abroad (via challenges from the EU) as an integration strategy, or, preferably, could be established as a general development strategy, of which integration strategy would be a component.

It is clear that such a general strategy should deal with agriculture, ecology, and regional development. Complaints about the CAP have been only a pretext for doing nothing; Hungary must come up with creative policies in the agricultural sphere. In 1996, parliament adopted a six-year environmental program. It is beneficial that this program overlaps two government cycles and therefore it will be obligatory for the new administration expected to be formed in June 1998 to honor it. With respect to regional development, there have already been institutional changes, including the creation of Euro-regions or NUTS (Nomenclature of Territorial Units for Statistics) two-level regions, and the establishment of a medium-term regional policy.

As in the Czech Republic, there is an internal conflict between Hungary's institutional set-up and the EU's requirements. Already in the first months of the next governmental cycle, a more appropriate institutional pattern of the administration must be created.

Recent years have proved that Hungary's financial absorption capacity is sufficient. There are bottlenecks, however, at the institutional level and with respect to the human factor. These two areas must be substantially upgraded.

The parties to be involved in implementing the integration strategy are not only politicians and experts but also professional and interest groups. Without actively involving them in the integration process, it will be difficult to defend Hungarian interests in Brussels.

Both inside and outside Hungary, public opinion must be informed and educated. The public must come to understand Hungary's real interests and the real benefits to EU members from accession in general, and from Hungary's joining the EU in particular.

Regional cooperation is highly rated by Hungarian institutions. The STFEI has organized several regional meetings on topical issues of enlargement and would like to continue this activity in the future. We hope there will be parties devoted to similar tasks in other countries which will be interested in taking part in this initiative.

1.4 Lithuania[7]

Lithuania's Europe Agreement, after it has been ratified by EU member countries, will soon come into force. For the management and implementation of polices related to integration, a governmental Commission on European Integration was set up under the leadership of the prime minister. In addition, an inter-ministerial delegation for negotiation on integration was established in early 1997.

[7] This section summarizes the presentation of Ramūnas Vilpišauskas.

The Commission's Opinion distributed in July 1997 stated that Lithuania would not be in a position to begin negotiations in 1998. Although it satisfied the set of criteria related to the political system, it would not be able to withstand the competitive forces within the EU. Notwithstanding the progress made in applying the acquis, there was still a lot to do and efforts were needed to reform the agricultural, energy, and environmental spheres.

The Lithuanian authorities were disappointed by the Opinion, claiming that the data that the Commission used were dated and that the situation has greatly improved in 1997. It is true that in 1996 GDP grew by 3.6 percent, while in 1997 it is forecast to grow by 5-7 percent. Consumer price inflation fell to 13 percent in 1996 and is expected to be lower in 1997; the share of trade with EU has stabilized at around 40 percent. In any case, it would have been impossible for the Commission to examine data more recent than those for 1996.

In contrast to Bulgaria, in Lithuania a further improvement in the monetary setup will be the abolishment of a currency board. The main argument here is that prospective membership in the economic and monetary union makes this necessary: currently, the litas is pegged to the U.S. dollar (at 4:1). With a view to eventual EU membership, it is planned that after the abolishment of the currency board, the litas will be pegged to either the euro or a basket of European currencies.

Slow harmonization of legal norms was one of the targets of the Commission's criticisms. The Ministry of Foreign Affairs prepared a Harmonization Program, which included an exhaustive list of the laws and other measures required for integration and the institutions that those measures implied, along with schedules and priorities. The latest data indicate that 39 percent of the legislative measures included on the list are already found in Lithuanian law. Other laws and measures in the pipeline for parliamentary approval will push this share up to 50 percent; by the end of 2000, the figure will reach 67 percent. However, one should be careful, in judging progress according to these statistics alone, since obviously these shares do not reflect the state of the laws' implementation, which lags behind their passage.

The main supervisory and coordinator authority for this process is the Ministry of European Affairs, which was created at the beginning of 1997, and the EU-Legal Bureau. Currently, the relationship between the Ministry of Foreign Affairs and the Ministry of European Affairs is unclear. There is evidence of a lack of coordination between them. Currently the new ministry is finalizing the national strategy for integration into the EU's internal market. This strategy has a lot of shortcomings, the main one being the lack of a coherent vision on the part of the Lithuanian authorities. It is largely a collection of documents from different ministries and institutions, with no effort having been expended to make them coherent. Unfortunately, there is as yet no vision of how to link the overall transition of the Lithuanian economy to the integration process.

As for informing the general public on EU integration, there have been some positive developments, for example, in the field of EU-related training. In 1997, the Institute of International Relations and Political Science started a new masters program in European Studies. Since the lack of educated civil servants has been a shortcoming in Lithuania, it is hoped that this program will increase the numbers of experts and qualified civil servants.

Discussion of First Four Country Presentations

The discussion focused mostly on the sustainability of Hungary's growth, which, some discussants feared, may be relying excessively on investments by fully or partly foreign-owned companies to boost exports. The Hungarian presenter emphasized that these investments had been effected already in the post-transformation pattern and they have been organically and densely linked to domestic activities. For instance, General Motors has 2,200 subcontractors in Hungary; if each of them employed just five persons, we are talking about over 100,000 people. As opposed to previous years, when domestic demand lagged considerably behind exports (due to deep real wage cuts over 1995-96), in 1997 thee former has recovered somewhat, so future economic growth may not be primarily export-led.

Other questions were related to the chances for the Czech economy's recovery from its current crisis. The Czech presenter stressed that the new government must introduce several important measures, of which he mentioned two. It will have to give up the principle of a balanced state budget applied by previous governments, which principle was at odds with realities of life; an active element must be introduced in the budget. Second, it must introduce an import surcharge after discussing doing so thoroughly with the Commission.

1.5 Estonia[8]

Estonia is among the five CEECs with which the Commission recommended starting negotiations in 1998. To evaluate the questionnaires must have been difficult for the Commission, especially because of the dynamism of the transformation process; nevertheless it managed to do so in a professional manner. The Opinions form a complex document, a guide for the candidate countries to prioritize the areas that they need to reform.

The development of the institutions charged with handling accession in Estonia is a continuous process. At the beginning of 1997, a European Affairs Committee was formed in the Parliament; it is chaired by the Deputy Speaker and the Head of the Foreign Affairs Committee. Since then, this committee has developed excellent relations with the European Parliament and member-country parliaments. Since 1997, EU integration matters are directly under the control of the prime minister. The 1998 government plan for integration is currently in preparation; it is based on the Commission's Opinion. Each relevant minister has prepared a draft plan on implementing the acquis in the coming years. These plans will be incorporated into a national work program for the adoption of the acquis.

Estonian officials are looking forward to the Commission's announcement in early 1998 of an Accession Partnership with Estonia. This document will be based on the Opinion and its prioritized areas can be regarded as a checklist for integration, which should help in the construction of the government's work plan. It is envisaged that the Partnership, if there is adequate accompanying financial support, will become a useful tool in applicant countries' pre-accession strategies.

[8] This section summarizes the presentation of Katrin Kanarik.

Naturally, not only is the passage of the appropriate laws important, but those laws must be adequately enforced. Setting up the necessary institutional framework with the proper competence is costly. For 1998, the government plans to allocate for integration preparations an amount 3.5 times larger than that in 1997.

We expect that awareness of the EU in Estonia will grow in 1998. Recent public opinion polls show that support there for EU membership is growing: almost 30 percent of the urban population indicates that it has the necessary information to formulate an opinion on accession. But the majority still needs to obtain more information. In 1998, regional information centers will be established in Estonia's 15 counties, along with a centralized EU-Infocenter. These centers will carry out training programs and provide information services. It is hoped that if sufficient information is available, the public debate on EU accession will be based on objective information.

1.6 Latvia[9]

The following focuses only on the economic dimensions of accession.

The Commission's Opinion on Latvia indicated that, while there has been considerable economic progress in the country, in the medium term, it would have serious difficulty coping with the competitive pressure and market forces within the EU. Such an assessment would be valid to a certain extent for all associated countries. While the Commission's opinion is broadly correct, the concluding sections were not always consistent with background provided on the relevant countries; the former were also of lower quality.

It would be wrong, both technically and methodologically, to forecast a country's future potential for catching up based on its achieved level of economic development. It would be wrong methodologically because convergence should be the output or a byproduct of integration, rather than a precondition for it. It would be wrong technically because the unofficial economy is rather large in these countries, so it would not be correct to take the registered GDP per capita, convert it at purchasing power parity at 1993 prices, and compare it to the EU average, as was done for Latvia. (1993 prices in Latvia in fact reflected a big shock in that year.)

One can clearly see the dynamics of Latvia's economic development: GDP grew by 3 percent in 1996, and 5-7 percent growth is expected for 1997. This growth was investment-driven and came on the heels of a severe banking crisis in 1995. Privatization has made much progress, the private sector having reached 62-66 percent of GDP; the completion of large-scale privatization is expected by mid-1998. Unemployment continues to be low – at the end of 1997, 6.7 percent – relative to other transition countries.

In 1996, the flow of FDI surged in Latvia, outpacing that received by its Baltic neighbors, placing the country in third or fourth place among associated countries. In terms of stock of FDI Latvia is behind Estonia, but the tendency in growth is encouraging.

Latvia's direction of trade reflects a strong orientation toward the EU, with 51 percent of total exports and 53 percent of imports carried out with EU members. Latvia also

[9] This section summarizes the presentation of Inna Šteinbuka.

looks good according to the Maastricht convergence criteria. Inflation has been gradually declining, reaching the single-digit level in 1997. The peak level for the fiscal deficit was the 3 percent of GDP reached in 1993-94; in 1997, a small surplus was achieved, the first black ink since 1993. In the next two years, the government plans to run a broadly balanced budget. The gross debt is not excessive either, in 1997 amounting to 15.5 percent of GDP.

There is only one bad sign: the current account deficit is growing, reaching 10 percent of GDP in the first half of 1997. However, this is not so worrisome, if we take into account that the capital account shows an increasing inflow of FDI.

Official relations with the Commission give rise to optimism. Recently, we held three meetings with representatives of the Commission: a subcommittee on the approximation of laws, a working group on economic and financial issues, and a working group on financial services. All three concluded that Latvia is on the right track in terms of economic conditions and legal procedures.

1.7 Slovenia[10]

Some time ago, the political decision was made in Slovenia that the administration must do everything possible to steer the country into the first group of countries to start negotiations on EU membership. Accordingly, in recent years every facet of economic policy as well as social life has been focused on this end.

In recent years, Slovenia has achieved economic success. Inflation had been reduced to the single-digit level by 1996 and was maintained there in 1997. Of the Maastricht convergence criteria, two have already been fulfilled: those on public debt and the budget deficit. It is hoped that the exchange rate regime for the tolar, which is freely floating, will converge to European patterns, so that Slovenia will be able to join the EMU after 2000.

To achieve compatibility in legal regulations, for several years all new legislation has been examined from the standpoint of its compatibility with its counterparts in the EU. Quite often, however, parliament has amended laws in such a way as to spoil its consistency with EU legislation. Nevertheless, the overall development of the legal system is favorable.

Economic policy has been assisted by research on the preparations for and adjustment to membership. Since the publication of the *White Book*, much research has been done including the latest work, *Slovenia's Strategy for Accession to the EU.* This document summarizes the activities and time schedule that must be followed in the successful preparation for and conduct of the negotiations. The *Strategy* was recently accepted by the government and will be presented to representatives of Commission in Brussels. The Slovenian parliament will also discuss and adopt it soon.

In recent years, Slovenia has rapidly opened its market with the idea in mind that business must be prepared for complete integration into the internal market of the EU. The new tariff schedule introduced in 1996 has meant a substantial reduction in protection (especially for the manufacturing sector) from an average level of tariffs and

[10] This section summarizes the presentation of Andrej Kumar and his paper "Slovenia and Integration Into the Internal Market of the European Union".

other charges of 14.6 percent to 10.7 percent. This was a self-imposed liberalization which is expected to be further accelerated by the implementation of the association agreement. Under the Interim Trade Agreement, protection was eliminated in 1997 from 40 percent of imports from the EU (measured by import value). Since two-third of Slovenia's imports originate in the EU, this signifies a rapid opening up of the domestic market.

How is this opening reflected in the competitiveness of Slovenian products? Calculations of revealed comparative advantage (i.e., export/import ratios by sector) show that the international competitiveness of almost all Slovenian industries declined between 1992 and 1996. It is shocking that in sectors where Slovenia is thought to have a comparative advantage, such as the manufacture of furniture, lumber, and wood products, the drop in competitiveness measured in this manner was very pronounced. This shows that Slovenia has not been utilizing its comparative advantage.

A comparison of export competitiveness indicators (such as unit labor costs, real wages, labor productivity, and real exchange rates) for CEFTA member countries shows that in 1993-96 Slovenia's performance lagged behind the rest of CEFTA, especially in increasing labor productivity and controlling real wages. This finding defines the tasks for Slovenian economic policy in the future.

Calculations of another indicator of comparative advantage – whereby the ratio of Slovenian sectoral exports to world sectoral exports is divided by the ratio of total Slovenian exports to total world exports – also reveal worrisome tendencies. Over 1992-95 for one of Slovenia's most important export sectors (comprising 30 percent of the total), the production of machinery and transport equipment, the value of this indicator has continuously been below unity (mostly about 0.8). This means that Slovenia apparently does not have a comparative advantage in this sector on the world market. Clearly, the efforts at restructuring have not yet brought sufficient results.

In summary, the Slovenian economy has showed promising results, but during the accession process there are many areas in which efforts will have to be made to improve competitiveness. New investments, both indigenous and foreign, must be encouraged. The government should explore the feasibility of the Spanish example for Slovenia, namely, to invest into infrastructure before accession, so as to attract FDI.

1.8 Poland[11]

Poland has a new government as a result of the general elections held in September 1997, one comprised of Solidarity-related parties and the Freedom Union. This new government faces the prospect of leading Poland to EU membership. Since the senior official responsible for finance is the father of the Polish economic transition, Leszek Balcerowicz, there is a guarantee that reforms will continue and even accelerate.

The previous government did not make any serious mistakes in areas related to accession. Economic indicators show rapid growth in GDP (7 percent is forecast for 1997, as opposed to a planned 5 percent), and investments. Overheating and the emergence of imbalances is a source of concern. In order to avoid the problems that other CEECs have faced recently, such as an unsustainable current account deficit, the

[11] This section summarizes the presentation of Władysław Piskorz.

new government would like to slow economic growth. Accordingly, the new budget proposal includes increases in indirect taxes and a reduction in the rate of wage increases.

The year 1997 brought a catastrophic flood to Poland, with damage amounting to an estimated $4 billion. In the midst of this serious problem, it was nice to see solidarity among the CEECs: relief support arrived not only from our richer neighbors, but also from Hungary, Bulgaria, and others.

Poland was invited to be in the first group of countries to negotiate over EU accession. At the end of 1996, the government formed a special Committee for European Integration, which is coordinating preparatory activities, especially the preparation of a National Strategy for European Integration. This Strategy was adopted by the government, presented to parliament, and has already been well received by the European Commission. In the meantime, the implementation plan for this strategy was also adopted, including the list of measures needed to solve the tasks that were presented in the Commission's Opinion on Poland's preparations for EU membership.

The major directions that were set up in the Strategy will certainly be followed by the new government. Each ministry was charged with finalizing its basic documents concerning its negotiation position by the end of 1997. The biggest problem is adoption of the acquis. For each country, the Commission will prepare an Accession Partnership program, and the national program for the adoption of the acquis will be a part of this. The Polish administration is currently focusing on this program, with the understanding that a priority area which is not included in this program will certainly not receive financing from Phare funds. Thus, we are trying to identify what should really be the priority areas and subsequently to persuade the Commission of the importance of those areas.

1.9 Slovakia[12]

When the Slovak Republic was created in 1993, it was generally expected that independence would help to stabilize the political situation. It was also expected, however, that due to its inferior economic development, Slovakia's integration into the EU and the North Atlantic Treaty Organization (NATO) would be more difficult than it would have been within the framework of the former Czechoslovakia.

In recent years, Slovakia has achieved surprisingly favorable economic results. In 1996, the growth of GDP was 6.9 percent, one of the highest among transition countries, while inflation stabilized at 6 percent, virtually the lowest level among the CEECs. However, the deficits of the current account (10 percent of GDP in 1996) and of state budget caused problems for the economic policy in 1996-97.

Despite recording relatively favorable economic results, one could also see increasing political tensions in the country, mainly along the following three lines. First, the opposition is not sufficiently represented in parliamentary committees. Second, the situation of minorities is not ideal, especially with respect to the law on the use of minority languages. The position of the Roma population also requires more attention from the authorities. Third, the uses to which the police and secret service have been put

[12] This section summarizes the presentation of Jarko Fidrmuc. The presenter emphasized that he expressed independent views that in no way should be considered official.

by the government are grounds for concern. One of the critical remarks in the Commission's Opinion was that the role of secret police within the government structure was undefined and that there was a lack of opposition control over this institution.

In recent years, the political situation in Slovakia has been increasingly criticized by various institutions of the EU, the European Council, and the U.S. government. These concerns constitute a major barrier to the integration of the Slovak Republic into West European and Atlantic structures, including OECD membership. In the summer of 1997, the NATO's Madrid summit decided not to invite Slovakia into the military organization. The Commission's Opinion on Slovakia's application stated the following: "Slovakia does not fulfill in a sufficient manner the political conditions set out by the European Council in Copenhagen because of the instability of Slovakia's institutions, their lack of rootedness in political life and the shortcomings in the functioning of its democracy. This situation is so much more regrettable since Slovakia would satisfy the economic criteria in the medium term and is firmly committed to take on the acquis, particularly concerning the internal market even if further progress is still required to ensure the effective application of the acquis."

The exclusion of Slovakia from the first group of countries with which the Commission will start negotiations can be seen as a failure of Slovakia's accession strategy. However, it has also become clear that the EU has not yet defined its policy towards the countries that will not be in this first group. This unclear approach is especially disturbing in the case of Slovakia because the Slovak economy is already intensively integrated into the broad European market. While the share of Slovak exports to the EU15 is not particularly high (58 percent of total exports in 1995, not including exports to the Czech Republic), if we take exports to European countries, including the EU, EFTA, and all associated countries, Slovakia reaches the second highest export share in Europe (85 percent of total exports in 1995, including exports to the Czech Republic).

If we take current trade flows and assume that Poland, Hungary, and the Czech Republic join the EU, Slovakia would have the highest share of exports to the single European market among countries that are not part of that market. Since the structure of Slovak exports is very similar to those of the other CEECs, the exclusion of Slovakia from the first wave of Eastern enlargement is likely to result in a high degree of trade diversion and welfare losses that will make the integration of Slovakia into the EU more difficult later. Due to its geographical position, Slovakia would be locked into the enlarged EU (between Hungary, the Czech Republic and Poland), but intensive relations with member states would likely be impeded. This would also apply to cross-border tourism, due to the Schengen border that would be built up around Slovakia.

In sum, in the long run Slovakia has a sound base for integration into the EU and there are grounds for optimism. However, controversial political developments are expected to continue in the short term and, since the coming parliamentary elections are unlikely to improve the situation, this will also have negative implications in the medium term.

Discussion of Final Five Country Presentations

In the discussion the somewhat rosy picture presented on Estonia's position was complemented by a listing of the tasks that the country must meet before accession: strengthening the administrative structure and capacity, harmonizing legislation, improving the natural environment, and furthering the integration of the Russian-speaking population into Estonian society.

With respect to Bulgaria's position, it was argued that its current account surplus is not an achievement, even if recently other CEECs have built up huge deficits. In the position of transition economies, having moderate deficits financed by capital inflows is much more desirable, because the CEECs badly need capital from abroad to complement their meager domestic savings. Capital inflows (accompanied by current account deficits) is a reflection of expectations of a high return on capital. Moreover, if an economy is growing, it is a healthy sign to have a current account deficit, provided that the surplus in imports is not made of overwhelmingly of luxury goods but consists largely of investment goods, semi-finished goods, and raw materials.

In discussing the presentation on Latvia, it was mentioned that reference to the large share of GDP produced in the unregistered informal sector is perhaps not a good argument for Latvia's superior economic performance, since it could also indicate that the country is not efficient in applying the regulatory framework of the EU and in controlling criminal activity. In her answer, the presenter emphasized that not all unofficial activities are illegal and the reporting of previously unregistered activities is improving.

In the discussion it was accentuated that improving competitiveness should be an important element of the integration strategies of the candidate countries, and the reports on the preparations for EU accession did not devote sufficient attention to this issue.

In answer to this remark, it was reported that Latvia's maintenance of a strong currency had led to a real appreciation, which had had a negative impact on competitiveness. However, despite opposing estimates by the IMF and the World Bank, the government still sees the potential for competitiveness with current exchange rate. Substantial FDI inflows, favorable export performance, the increasing share of capital goods in imports, and the slow growth of real wages all indicate that competitiveness situation is not so worrisome as some imply, and it may improve in the future.

It was remarked that the loss of competitiveness by Slovenian manufacturing was exaggerated by the presenter on that country. The production of machinery is such a large and heterogeneous sector that Slovenia may have a comparative or competitive advantage in some sub-sectors thereof (probably those that are not human capital-intensive), and a comparative/competitive disadvantage in others. Thus, Slovenia's overall revealed comparative advantage may show a negative sign but that does not indicate a lack of competitiveness. In answer to this remark, the presenter pointed to the strong weight of pharmaceuticals in manufacturing exports and the problems related to patenting and licensing that this industry is likely to face in its export markets.

In the following phase of the discussion it was questioned whether the Maastricht criteria are fully relevant for assessing the preparations for accession. The candidate countries have probably not yet established a proper level of long-term interest rates, because the region's financial markets are very unpredictable. Budget deficits are not necessarily properly measured because several countries still need to put their fiscal systems in order. Exchange rates are not expected to be stable in the long run either, because their modification will be needed for improving competitiveness. Thus, EMU membership is not an immediate task for the candidate countries.

Several country presenters responded to this remark on the dubious importance of membership in EMU. In Poland, after some controversy, the established opinion is that EMU criteria are important for the country, but that Poland should not necessarily meet them on the first day of its EU membership. Estonia follows the policy of its neighbors, Finland and Sweden, with respect to convergence to Maastricht criteria: when the time comes, Estonia will have to be able to fulfill them. For Latvia, fulfilling these criteria is not an immediate task, but a long-term objective. Reducing interest rates, especially lending rates, will not be easy, because monetary policy has taken an anti-inflationary stance. For Slovenia, the EMU criteria are not immediate goals, are especially not worth following if they lead to increased unemployment. The Maastricht criteria will become interesting to the country only after 2002, the expected date of membership.

2. Common External Tariff and Common Commercial Policy

2.1 Expected Implications of EU Enlargement on Such Common Policies as Trade Policy[13]

This presentation is concerned with institutional reform within the EU and how it relates to the Eastern enlargement. It is based on three papers co-authored by the presenter.

The documents released by the Commission at the Amsterdam Summit suggested that the five candidate countries would fit into the current union. However, before enlargement, the EU itself needs to be reformed and discussion of such reforms should start before enlargement occurs. There are several reasons for initiating reforms within the EU: usually institutional reforms have been demanded in order to achieve more efficient institutions. However, there are always arguments for fairness behind institutional reforms. For example, currently in the Council of Ministers Germany has one vote for each 8 million citizens, while Finland has one vote for each 1.7 million citizens.

How would voting relations change with Eastern enlargement? As for efficiency, the main fear is based on the fact that the CEECs' population is one-third of that of the EU. This means that since voting rights in the Council are based on population figures, the CEECs will have a huge influence on EU policies. This can be illustrated by the following example. If we take the five CEECs that will start negotiations first, and assume that they join first, this CEEC5 will get 25 votes in the Council of Ministers, and the total number of votes will increase from 87 to 112. With current qualified majority rule, 25 votes may not be sufficient to create a blocking minority, but it is close to that. The rough probability that the CEEC5 will block any randomly chosen Commission proposal is 0.9, and this is a worrisome feature for the incumbents. Therefore, a plan for reform was issued which covers both the qualified majority voting rule (related to efficiency) and the allocation of votes (fairness).

To analyze fairness, let us start form the current distribution of votes. Germany has ten votes, each representing 8 million people, while Luxembourg has two votes, each representing 200,000 people. It is easy to compute the distribution of votes in the

[13] This section summarizes the presentation of Mika Widgrén.

Council that would lead to a fair distribution of “power.” One can distinguish between power and voting rates. Power here refers to the probability that a certain country is crucial for a given decision. Power is not the same thing as the voting rate. In weighted voting (for instance in a shareholding company), usually the member with the largest voting rate has the highest power, and vice versa. This fact can seen from Table 1.

Table 1: Voting Power and Population

Member State	Share of Population	Vote distribution which leads to the same power distribution as the distribution of population (votes)	Vote distribution which leads to the same power distribution as the distribution (percent)	Voting power when voting weight is determined by the population (percent)
Germany	0.215	79	19.8	24.5
UK	0.158	60	15.0	16.9
France	0.158	60	15.0	16.8
Italy	0.154	58	14.5	16.5
Spain	0.107	42	10.5	10.5
Netherlands	0.040	16	4.0	3.4
Portugal	0.029	12	3.0	2.2
Belgium	0.028	12	3.0	2.1
Greece	0.027	12	3.0	2.1
Denmark	0.014	6	1.5	1.1
Ireland	0.010	4	1.0	0.7
Luxembourg	0.001	1	0.3	0.1
Sweden	0.023	10	2.5	1.8
Austria	0.021	10	2.5	1.7
Finland	0.014	6	1.5	1.0

Source: Alan Kirkman and Mika Widgrén, “Voting in the European Union: European Economic Decision Making Policy: Progress or Paralysis?” *Economic Policy* 21 (1995), p. 435.

As the table shows, if we argue that Germany should have more power in the voting procedure, which should reflect its power as implied by its population, then it would have 79 votes in the Council, much more than it has today. In fact, in that case, Germany would command nearly one-fifth of all the votes. There is a straightforward question: would this kind of allocation be fair? If we take this hypothetical allocation to be fair, then the CEECs would lose influence relative to what they would have under the current rules. In the same way, such small countries like Finland and Sweden would lose votes.

The presenter argued that an allocation based on population size would not be fair. The current system is quite fair and the EU does not necessarily need a reform in this respect.

His reasoning was as follows: If we take the population figures as the base for vote distribution within the Council, we would implicitly define the EU as a state. This is obviously not the case. If we defined the EU as an association of states, at the other extreme, it would be fair to allocate one vote to each country. It is also certain that the EU is not an association of states. The EU is something intermediate between a single state and an association of states.

If we take the distribution of votes in the Council of Ministers as it is now, add the CEECs and then compute the distribution of power under the current rules, and run a regression using data for all 25 countries with explanatory variables p and s (where p stands for the population factor and s for the state factor), we get 79 percent explanatory power for the EU as a state, and 21 percent for EU as an association of states. This means that under the current rules we are closer to being a state than an association of states. Before making progress in deepening integration beyond the current level, there is no reason to give more weight to the variable representing the importance of the single state (p).This argument was also discussed in the course of the Amsterdam Summit.

It is enlightening that if we make the same calculations for the U.S. Congress with its two chambers taken together, we get 90 percent power for the single state factor and 10 percent for the association of states factor. This means the USA is a bit closer to a pure state than the EU is.

The conclusion of this exercise is that when the CEECs begin negotiations on their membership, it would be reasonable for them to argue along these lines. Otherwise, their interests would be damaged by the coming reform of voting, as would those of such small current member countries as Sweden and Finland.

Let us now look at relations between the Commission and the European Parliament, and how they may change after enlargement. The EU has three types of decision-making procedures: consultation, cooperation, and co-decision. Co-decision's goal is to give more power to parliament. If we take these three decision-making procedures and we take account of so-called "agenda-setting" (i.e., the fact that the Commission has a monopoly on making proposals), we have the power distributions found in Table 2.

We can see that the Commission's power index is 0.5 or higher, while those of the other bodies are very small. Accordingly, the Commission is certainly the main player within the EU and that is mainly due to its power in agenda-setting. The question is, how will this change after the enlargement? This is a very complicated topic and there is no space to do more than mention a few issues.

Just as there are gains from free exchange in international trade, there may be gains from integration; however, it must be kept in mind that within the EU the Commission can always manipulate decisions in order to achieve what it wants. There is possibility of making use of asymmetric information at both sides: also members states can hide something about their preferences. Then both sides – the Commission and member states – lose, but there is room (in the game-theoretic sense) for signaling, so it is profitable for member states to signal to the Commission their true preferences. In such a case, both will gain.

Table 2: Power Indices for EU Organs in Agenda-Setting

	Consultation		
	Commission	Council	Parliament
Total independence	0.501	0.049	0
Intra-body homogeneity	0.524	0.050	0
Inter-body homogeneity	0.539	0.098	0
	Cooperation		
	Commission	Council	Parliament
Total independence	0.500	0.003	0.000
Intra-organ homogeneity	0.501	0.014	0.001
Inter-organ homogeneity	0.530	0.059	0.028
	Co-decision		
	Commission	Council	Parliament
Total independence	0.500	0.003	0.000
Intra-organ homogeneity	0.507	0.014	0.009
Inter-organ homogeneity	0.528	0.055	0.028

Source: Annick Laruelle and Mika Widgrén (1997). "Voting Power in a Sequence of Cooperative Games: The Case of EU Procedures," (mimeo).

Under current rules, member states may amend a proposal if they do so unanimously, which means that the likelihood that substantial amendments will be made is fairly small. Under asymmetric information, this means that the Commission is the main player.

If we model member states as players in a multi-player game and analyze the implications of enlargement under a unanimity rule for amendments, we see that enlargement would actually increase the Commission's power, with the member states being the losers. Therefore, it is easy to see why certain member states are not so keen on expanding the Union and why the Commission is keen on it.

2.2 Common External Tariff and Domestic Adjustment in CEECs[14]

The presenter began by stating that he was increasingly taking part in meetings where András Inotai was the main speaker and where he, Drábek, felt it necessary to keep Inotai's optimism under control. Again this time, he tended to be a bit more pessimistic than Inotai had been in the latter's introductory talk. This did not mean that he is a

[14] This section summarizes the presentation of Zdeněk Drábek.

"Euroskeptic," but simply that he is an integrationist who takes a critical approach to the matters at hand.

The presentation covered trade in goods, and within that category, trade in manufactured goods. The presenter's skepticism with regard to the coming integration process is supported by the following three kinds of difficulties.

1. For countries that are currently members of the World Trade Organization (WTO) - five or six countries among the candidates - the main difficulty of adjustment to the EU trade system lies in the increasing instability of their commercial policy in the last few years. First Poland, then Czechoslovakia (later the Czech Republic and Slovakia), followed by Hungary, Romania, and Bulgaria, have all asked for derogations on their commitments to the WTO (mostly in the form of increased protection through import surcharges). In the case of one or two countries, this has happened twice. One can explain these requests partly by referring to the fact that the early speedy trade liberalization in these countries was probably not well thought through. It can also be explained partly by the fact that, after recovering from their transformational recessions, severe trade and current account deficits have emerged due to general macroeconomic imbalances and problems with macroeconomic policies.
2. In the case of countries that are not WTO members, it would be naive to imagine that a country could join the EU without first being a member of the WTO. Once these countries start their negotiations with the EU, it will become clear that WTO membership is a precondition for progress towards EU membership. It will then become a problem for these countries that will have to start and finish their negotiations with the WTO in a short time. Although China is in no way comparable to the candidate countries, one should recall that that country has been carrying out accession negotiations with GATT/WTO since 1986.
3. The rest of the talk covered in detail the adoption of the common external tariff by the candidate countries. The presentation touched upon the following questions: (a) what is the current degree of integration of candidate countries into the world economy in the sphere of merchandise trade; (b) what will it mean for these countries to adopt the common external tariff; (c) are there ways through which their process will be facilitated; and (d) what are the policy implications of the foregoing?

The degree of integration into the world economy depends on the current level of protection vis-à-vis external partners and each other. The latter relation is complicated by the existence of the many bilateral agreements that have come to constitute CEFTA. These bilateral agreements are not necessarily consistent with one other. What we see in CEECs is what Bhagwati calls a "spaghetti bowl" of trade agreements. The pattern is much more transparent with respect to the EU, due to the Europe Agreements, where the EU insisted on consistency. The irony is that for candidate countries doing business with the EU is easier than doing business with each other. A third area is the rest of the world, towards which each of these countries has its own system of tariffs.

But what is the level of these tariffs? The answer is that these tariffs vis-à-vis the rest of the world are much higher than the EU's external tariffs, with a few exceptions. (These exceptions are Estonia, the Czech Republic, and, surprisingly, Bulgaria.) One of the implications of this fact is that during the accession process the CEECs will have to adopt the lower tariffs of the EU.

Will this be an easy process? Table 3 helps to provide the answer to this question: it shows the difference between the EU's external most favored nation (MFN) tariff and the CEECs' MFN tariff. The rates are divided here between those tariffs that are 25 percent above or higher than the external tariffs of the EU and those that are below that level, and the unweighted shares of these tariff lines were calculated. In the Czech Republic, for instance, 28.8 percent of the tariff items fall in the first category. The next column indicates the share of those tariff items that were 75 percent or more above the EU's external tariffs. Again, for the Czech Republic this category showed 6.5 percent.

Anybody in business who learns that the tariff on a product which he produces and which is subject to fierce international competition must drop by 25 percent will tell you that he is not very happy: a 25 percent fall is a significant reduction. One can imagine the tension caused by a 75 percent decline. In fact, the table shows that the Czech Republic has a comparatively easy task, since the number of items in this category is not large. But for Hungary, 77.9 percent of tariff lines are in the 25 percent category and 50 percent of tariff lines carry tariffs at least 75 percent higher the EU's external tariffs. Poland and Slovakia are doing not much better. At the very least, this indicates that both the negotiations and the adjustment process are going to be tough ones.

Table 3. Differences in MFN Tariffs Between CEECs and EU

	Percentage of CEECs' Sectors with MFN Tariffs Higher Than	
	1.25 times the EU's MFN tariffs	1.75 times the EU's MFN tariffs
Founding members of CEFTA		
Czech Republic	28.8	6.5
Hungary	77.9	50.0
Poland	56.2	31.5
Slovakia	53.4	28.5
Baltic countries		
Estonia	0.0	0.0
Latvia	60.3	42.5
Lithuania	11.0	9.6
Other CEECs		
Bulgaria	0.0	0.0
Romania	60.3	32.9
Slovenia	95.6	95.9

Source: Zdeněk Drábek (1998). "Common External Tariff of the European Union and the Structural Adjustment in Central and Eastern Europe: Notes," WTO, Geneva, (mimeo).

The next question is whether negotiations would be facilitated if the CEECs pursued more liberal policies toward one other. A look at the maximum and minimum tariffs within CEFTA shows that tariffs are highly differentiated, and that this is the case for every product group. These variations are much higher than those indicated by the difference between the EU's maximum and minimum external tariffs. Consequently, the integration of tariff schedules with the EU's will hardly be facilitated by the existing system of trade agreements among the CEECs. In general, the CEECs' tariffs are extremely heterogeneous, which in most cases reflects the power of special interest groups. CEEC governments must deal with them systematically, not one-by-one, if not on an aggregate basis, by way of some sort of simplification of the whole system.

As for the policy implications of the foregoing, it is sensible to expect a long transition period for the new EU member countries to carry out the necessary tariff adjustments, since once the negotiations are concluded, each country would like to become a full member.

The exchange rate policies of CEECs have in recent years provided these countries with fluctuating protection levels. Most countries started with undervalued exchange rates, ensuring protection of domestic production without tampering with tariffs. Following real appreciations of the currencies, we have seen attempts to use tariffs to provide protection. While selective tariff protection can not be applied in the candidate countries in the future (if they take adjustment to the EU practices seriously), returning to the days of undervalued exchange rates is not a satisfactory alternative either. The countries must ensure that their exchange rates do not become excessively overvalued and that their exchange rate regimes remain sufficiently flexible, a recommendation that the Czech Republic failed to follow until recently.

Tariff adjustment will certainly induce structural adjustment of the real economy. This can happen only if restructuring takes place in a non-inflationary environment, with low interest rates and monetary and fiscal policies that ensure lower inflation than we are witnessing today. Moreover there should be an institutional mechanism in the financial system to provide the financing necessary for restructuring. Social safety nets which have been pushed to the side in recent years must be in place to ensure the taking care of people at a disadvantage.

Discussion of Previous Presentation

It was emphasized that the level of tariffs is as important as the difference in percent that these tariffs have to make up during their adjustment. If the new external tariff is 4 percent, then a 25 percent tariff reduction from a CEEC tariff means only 1 percentage point, which is not a problem at all. For manufactured goods these levels for most of the categories are probably no longer excessive, while for agricultural products tariffs are in the 100-300 percent range.

It was also emphasized that the dominant share of the candidate countries' trade is conducted with the EU, so only a small share of CEEC trade would be affected by adjustment to the common external tariff.

A warning was voiced that one should not focus only on MFN tariffs. The CEECs offer MFN status to many countries in the rest of the world, while the EU puts the same countries in the generalized system of preferences (GSP) category. Accordingly, the adjustment in tariffs will mean a reclassification from MFN to GSP, a step that may be more substantial than the adjustment of MFN tariffs.

The experts from the Baltic states emphasized that while their countries are not yet WTO members, they could become such as soon as1998. Lithuania has already signed free trade agreements with almost all CEFTA members and would like to join that association in the not too distant future.

The question was raised whether the CEFTA countries that do not get into the EU in the first round will maintain their preferential trade regimes with those that are in that round. The answer was that they would probably not do so. However, since non-preferential tariffs are not enormous, that is, they are not on African, Latin American, or even Asian levels, synchronization of these tariffs would not be difficult. The adjustment of tariffs vis-à-vis the rest of the world will be more difficult, since after the initial liberalization in 1991-92 all countries (with the exception of the former Czechoslovakia) increased their tariffs against the rest of the world, probably due to a fear of imports from China, Taiwan, or even Japan.

As for EU's possible assistance to the tariff adjustments in CEECs, it was stated that the EU is not in the position to raise its own protection levels in ways that would not conform to its WTO obligations. It is possible that the EU will slow down any further liberalization in the next round of WTO negotiations.

3. Future of Bilateral Relations and Regional Cooperation/Integration Across EU Lines

3.1 Effects of EU Membership on Austria's Trade with Non-EU Countries[15]

To assess the effects of Austria's EU membership in the light of theories of economic integration, we must recall that customs union theory predicts that integration can have two opposing effects: trade creation and trade diversion. In Austria's case, direct trade creation occurred when the trade barriers between Austria and the EU were removed. Already since 1972, when the free trade agreement between the European Free Trade Area (EFTA) and the EU was adopted, tariff and non-tariff barriers against industrial products have been eliminated. Border controls and formalities, arrangements regarding just-in-time warehouses, and certificates of origin restrained further trade creation, but all these regulations were themselves abolished in 1995 (the year of Austria's accession). It should also be mentioned that in addition to direct trade creation, indirect trade creation has occurred through increases in GDP, which spur increases in the demand for imports and encourage trade with third countries.

In the case of Austria's EU membership, trade diversion and suppression emerged because of the establishment of a new external customs border, especially vis-à-vis Switzerland and the CEECs. Unfortunately, no study seems to have investigated these effects of Austria's accession. Since the industrial structures of the CEECs and Austria were rather complementary, the effects must have been rather small.

[15] This section summarizes the presentation of Katharina Helmstedt.

The dynamic effects of integration are generally expected to be more important than the static ones. As in many countries, in the case of Austria they exerted their impact through the economies of scale and subsequent increases in production.

In recent Austrian history, steps toward increasing integration have been followed by increases in GDP relative to the average of the EU15. For 1960-72, when Austria was excluded from the EU integration process, trade diversion has been calculated to have reduced GDP growth by 0.12 percentage points per annum. This loss was three times higher than the trade creation effect of EFTA membership at that time. In the period 1973-91, however, the association agreement between EFTA and the EU brought the country about 0.24 percentage points of additional GDP growth per annum.

Additional moves toward integration by the EU which affected Austria were the creation of the Single Market after 1993 (which is estimated to have cost Austria 0.3 percent of potential GDP) and the start of the European Economic Area (EEA) in 1994. This was followed by Austria's accession to the EU, which is estimated to have added 0.46 percent of GDP per annum compared to the hypothetical case when Austria remained in the EEA.

Austria's trade is dominated by intra-industry trade, which at the four-digit level was about 80 percent of the total in 1996. This type of trade is concentrated on Germany (76 percent of trade with it is of the intra-industry type), while its share is smaller with the rest of the EU (73 percent). The level of intra-industry trade is smaller but still high with Visegrád countries (60 percent) and much lower with the other CEECs and the developing countries. Nevertheless, the share of intra-industry trade has increased over the past years for all of Austria's trading partners.

Austria's trade focuses heavily on neighboring countries, especially Germany. This can be explained by the gravity model of trade, which predicts that there will be more trade with closer countries and ones with larger economies and relatively more liberalized markets.

Since joining the EU, Austria's trade regime has been adapted to that of the EU and trade policy has been co-determined at the supranational level. The prevailing GSP as it is currently operated is much more differentiated than Austria's GSP was in the past. Austria's own GSP, as a rule, used to grant 50 percent reductions in MFN tariffs, whereas the EU grants, up to a given quota, larger reductions, potentially as high as 100 percent. Another difference appears with respect to the group of preferred countries. For instance, before accession, Austria granted preferential treatment to South Korea, Hong Kong, and Thailand, whereas this is not allowed by the EU's tariff regime. The effect of this change was that following Austria's accession its imports from these countries decreased.

Article 113 of the European Treaty lists those fields where EU members must act in accordance with each other's decisions. According to this stipulation, since 1995 Austria has not been allowed to conclude further bilateral agreements on merchandise trade. For trade in services, the relevant competencies are as yet undecided: The Commission would like to centralize them so as to achieve stronger negotiating power vis-à-vis the U.S. and Japan. Since the article does not cover investment, Austria continues to negotiate bilateral investment protection treaties on its own.

Since its accession, Austria has had to apply the preferential and other agreements concluded by the EU. These include non-reciprocal agreements offering market access (for the Lomé Convention countries and former Yugoslavia), preferential agreements with European partners (EEA with Liechtenstein, Norway, and Iceland; Europe Agreements with the CEECs; and the free trade agreement with Switzerland), and free trade agreements with Mediterranean countries (Tunisia, Morocco, and Israel). As a consequence, new suppliers have emerged in Austria's imports, such as North African countries and former Yugoslav republics.

Improving Austria's position with respect to cumulation was a major incentive for it to become a member. Before its accession, Austria and the CEECs were discriminated against by the EU: semi-manufactures from the CEECs processed in Austria and subsequently exported to the EU were not granted preferential tariff treatment by the EU. Similarly unfavorable treatment applied to Austria's outward procession arrangements with the CEECs. The damage originating from this treatment was vast: according to the calculation of the Austrian Institute of Economic Research (WIFO) the lack of cumulation in manufacturing resulted in a loss of 3.5 percent of exports and 1 percent of GDP. With accession, this problem disappeared: Austria no longer needs a certificate of origin for commercial operations with the EU.

When reporting on Austria's direction of trade following accession, one must be cautious in interpreting the data (especially those for 1995), due to a change in the statistical recording system for foreign trade that occurred simultaneously with membership. After accession, trade with the EU picked up, growing much faster than Austria's total trade (for exports, 15.0 percent and 13.2 percent, respectively; for imports, 12.1 percent and 6.2 percent, respectively). However, the economic downturn of 1996 halted this process. In 1996, the EU's share of Austria's exports was 64 percent, and its share of Austria's imports was 71 percent. The largest trade partners are Germany (accounting for about 40 percent of exports and imports), Italy (8-9 percent), and Switzerland (4-6 percent).

Since the removal of the iron curtain, there has been an exceptionally large shift in Austria's trade structure toward trade with CEECs. The larger the distance from a country to Austria the less intense is bilateral trade. Neighboring countries make up about two-thirds of total trade with the region. Austria is the leading country in the EU as far the percentage of trade conducted with the Central and Eastern European region is concerned.

Austria's trade surplus with the region increased from 7.4 billion schillings in 1989 to 23 billion schillings in 1996. This growth was achieved especially in trade with Hungary, Slovenia, Poland, and the Czech Republic.

Many CEECs are currently making efforts to reduce their large current account deficits, a tendency that may negatively affect Austria's exports in the near future. For instance, Hungary's stabilization measures of 1995 reduced Austria's export growth with that country from 20 percent in 1994 to 5.3 percent in 1995. Similar developments can be expected vis-à-vis Slovakia, the Czech Republic, and Poland.

In conclusion, one should warn that it is not easy to qualify the effects of EU membership on Austria's economy, partly due to unreliable trade statistics. The trade effects of such membership were recorded mostly on the import side and were caused largely by the changeover to a new GSP system. The two main events of the 1990s for Austria's trade were accession and the opening up of the Central and East European region. However, neither occurrence was sufficient to cause the export/GDP ratio to rise above its long-standing value of 40 percent.

Nonetheless, after the fall of communism, trade – especially exports to the Czech Republic, Slovakia, Hungary, and Poland – increased substantially and this tendency has not been modified by Austria's accession to the EU. Links to EFTA countries, especially Switzerland, have become less intense. As for overseas countries, exports have remained on previous levels, while imports have decreased, especially from Japan.

Discussion of Previous Paper

In response to a question, the presenter explained that the drop in Austria's imports from Japan has occurred because earlier Austria had had a special system for encouraging certain imports from Japan, which it was forced to phase out after 1995. According to that system, Japanese cars entered Austria duty-free if the Japanese producers imported a certain amount of semi-finished products from Austria which were used for the production of those cars.

As for the drop in imports from the Asian Tigers, the explanation lies in the changes in the GSP: Austria had granted them a 50 percent reduction on MFN tariffs before membership, and this too had to be eliminated after accession.

As a comparison, Sweden's experience was recalled. Since accession Swedish trade with the other members of the EU has changed remarkably little. Major shifts were experienced, however, in trade with Asian countries: Swedish exports has grown and imports decreased with these partners. The surge in exports occurred largely in those types of products where distance is less relevant, namely telecommunications products and to a lesser extent in pharmaceuticals.

3.2 Future of Regional Integration Across EU Lines: Estonian Perspective[16]

Three cooperation frameworks have been established in the Baltic-Nordic region: (i) the Baltic Council of Ministers (BCM); (ii) so-called 5+3 Cooperation between Nordic and Baltic countries, and (iii) the Council of the Baltic Sea States (CBSS).

(i) The main objective of the BCM is to assure the security and economic prosperity of all the people of the region. The Baltic countries have set their goals within the context of European and North Atlantic economic and security. Baltic cooperation is considered part of a wider security strategy, and should be consistent with the goal of integration into the EU. Since the harmonization of Estonian, Latvian, and Lithuanian legislation with their EU counterparts is an EU membership criteria, such harmonization will also lead to a harmonization of the economic relations among the Baltic states. Accordingly, Baltic cooperation is very important during the phase of preparation for membership.

This organization's priority areas include the following: economic and security issues, sea transportation, energy, and crime prevention. Complementary to the already existing free trade area among the three economies, a common Baltic transit procedure is planned. In addition, the three countries are finalizing the establishment of joint border crossing checkpoints in order to enhance cross border flows of people and goods. They

[16] This section summarizes the presentation of Katrin Kanarik.

are also negotiating over opening their markets to trade in services (including financial services and telecommunications), although the implementation of such a step would require enhancement of the efficiency and competitiveness of the providers of these services.

The three nations are determined to introduce the four freedoms into the Baltic area according to the pattern of EU.

The Estonian governments considers the Baltic cooperation to be of strategic importance. This view was already expressed immediately after regaining independence, rather than by such external forces as the Madrid or Amsterdam meetings of the European Council. Since independence, a series of structures have been created to institutionalize cooperation among the parliaments, heads of states, and governmental structures in the region. In the course of this, the Baltic states have taken inspiration from their Nordic neighbors. There are more than 20 committees composed of senior officials within the framework of the BCM. It is expected that in the future these mechanisms for intergovernmental cooperation will acquire a more concrete and practical content.

In Estonia the following are the priority areas of the cooperation:

1. consolidation and further elaboration of the Baltic Free Trade Area. On November 20, 1997, agreements were signed which abolished non-tariff barriers;
2. improvement of transit, including the improvement of infrastructure and the introduction of unified procedures for international cargo transit;
3. improvement of cooperation in strengthening the external border of Baltic states (this is also a precondition for EU membership);
4. cooperation in defense and security (this has already been one of the more successful areas of cooperation); and
5. crime prevention, environmental, and judicial affairs.

(ii) Nordic cooperation is based on shared history, geographical location, and linguistic relationships, as well as on similar social structures. Based on the principles of the Helsinki treaty of 1962, there are various institutions, including the Nordic Council (a parliamentary forum founded in 1952), and the Nordic Council of Ministers (established in 1971). Nordic cooperation has three pillars: cooperation within the Nordic region; with EU and EEA; and with adjacent regions (such as the Karelia, Leningrad, Murmansk, and Kaliningrad oblasts of Russia).

For adjacent areas, programs and projects have been devised in various policy areas with the support of the Nordic countries. The main themes of the concrete programs are as follows: culture, education, research, environmental protection, social and health affairs, transport, telecommunication, harmonization of legislation, border guarding, customs, migration, and crime prevention.

From the Estonian viewpoint, the working out of an adjacent areas program for the Nordic and Baltic countries would promote regional 5+3 cooperation. It is envisaged that cooperation among equal members would grow out of such a program. It is important to develop cooperation in EU-related areas and to diversify the focus of cooperation beyond the capital cities to include rural areas.

(iii) The members of the CBSS include the countries participating in Nordic 5+3 Cooperation, along with Russia, Poland, Germany, and the European Commission. The CBSS was established in Copenhagen in 1992. Several areas for common action were identified, all of them related to the stability and well-being of the region as a whole. These areas include the following: assistance to democratic institutions; economic and technical cooperation; humanitarian matters and health; environmental protection and energy; cooperation in culture, tourism, and information services; and transport and communication.

Three working groups have been established in the first two of these areas, as well as in nuclear and radiation safety. In the last of these instances, information is collected on nuclear and waste-storage facilities in the Baltic region, with special emphasis placed on sites that require immediate action in order to reduce the risk to the general public and environment.

From the Estonian point of view, the CBSS should concentrate primarily on economic cooperation, including the development of infrastructure, investment, production, and trade. Cooperation in the field of research into and the development of high and middle level technology would improve the Baltic states' competitiveness vis-à-vis the developed world.

In addition to the three aforementioned cooperative institutions, Finland has initiated a new one, known as the "Northern Dimension of the EU." This initiative aims at strengthening the role of the EU in the EU's northern region within the framework of the EU's external policy. It would cover the Baltic and Barents Sea regions, and would treat them similarly to other Euro-Atlantic regions. It is envisaged that this initiative would explore the advantages that the northern region can offer Europe. Estonia has welcomed this proposal and is interested in its development especially as regards transport and energy networks.

From Estonia's point of view, the continuation of regional cooperation and integration is of utmost importance. It is not an alternative but a support to linking processes in the Baltic region to wider European integration.

Discussion of Previous Paper

A question was raised concerning the fate of the proposal for a Baltic customs union that floated around for a number of years in the Baltic capitals. The presenter explained that the customs union was still popular among politicians, but experts were reserved about it, due to its perceived inefficiency and the message that it would send to the EU on regional developments which are distinct from integration with the EU. A couple of years ago, the three Baltic prime ministers signed an agreement on the intention to elaborate a Baltic customs union, which would have begun in January 1998. Currently, this initiative is completely unrealistic: the administrations speak about establishing a common transit procedure, rather than a customs union.

A question was raised as to whether the Baltic region may be replicating developments in the Nordic region, whereby some countries joined the EU, while others remained outside of it. In the Nordic region, this happened due to the countries' own decision, while in the Baltic case, if this occurs, it will be against the will of the nations involved. The presenter acknowledged that the Baltic countries can learn from their Nordic partners how to cooperate while having one's own priorities and belonging to different regional groupings. The Baltic countries have similar histories and goals – accession to the EU, NATO, and the OECD – and will probably follow the same road, although perhaps at different times.

The European Commission's distinction between first round and second round countries has engendered bitterness in the Baltic region, but more so among politicians than among civil servants and scholars. The distinction between Estonia, on the one hand, and Latvia and Lithuania, on the other, will probably not alienate the latter two excessively, as it may do in the cases of Slovakia and Romania. As for the Baltics, there is the common view that at least one of them should join in the first round and that eventually all should join.

In a comment, it was mentioned that the trade structures and the comparative advantages of the Baltic states (as evidenced by Balassa indices) are quite narrow and that there was not much change in this respect between 1992 and 1996. This may be worrisome for the Baltic states when they join the EU, since their exports are limited to certain sectors, some of which have no real comparative advantage compared with other EU members. Lithuania, for instance, exports – or rather re-exports from Russia – mainly minerals to the EU, along with textiles in the framework of outward-processing based in Italy, and wood and wood products produced from indigenous materials. This structure has hardly changed in the past five years. It is not clear whether this export structure will continue to reflect the country's comparative advantages after real wages there catch up.

It was also mentioned that Latvia's position with respect to exports to the EU is similar (exporting wood products, textiles, and chemicals), but that there is hope that FDI will sustain the already emerging tendency for growth in the share of higher value-added products. The structure of Estonian exports is similar (timber, textile, and equipment), and the government there hopes that cooperation will be intensified in high and middle level technology, such as in the production of mobile phones.

3.3 Trade and Development If Some CEFTA Countries Become EU Members Before Bulgaria's It Does[17]

In recent years, Bulgaria's trade with CEFTA has been much smaller than its trade with the EU. In January-September 1997, 43 percent of Bulgaria's exports went to the EU and only 3 percent to CEFTA, while the respective shares for imports were 37 percent and 6 percent. Since 1992, Bulgaria's trade with CEFTA has been in deficit.

As of December 1997, Bulgaria has yet to join CEFTA, but it has signed free trade agreements with three of its members (the Czech Republic, Slovakia, and Slovenia) and it is about to do so with the other three (Poland, Hungary, and Romania). Until recently, outstanding debt to Poland and Hungary, inherited from the period of central planning, stalled the signature of free-trade agreements with CEFTA countries, but according to the latest information, these debts have been cleared or will be cleared shortly. Bulgaria is expected to become a CEFTA member in 1998, after which it will probably enjoy several years of free trade within this framework, before several CEFTA members join the EU.

[17] This section summarizes the presentation of Rossen Rozenov.

As for trade with the EU, the best year was 1995 – the year in which overall trade performance of Bulgaria was the strongest – when both exports and imports with EU partners surpassed $2 billion. In 1996, due to macroeconomic instability, trade with the EU declined; according to Bulgarian statistics, it enjoyed a surplus with the EU. The first nine months of 1997 have brought increasing trade volumes and another surplus with the EU.

With respect to the commodity composition of Bulgaria's exports to CEFTA (based on the sections of the Harmonized System of Commodity Description and Coding) the leading export items are chemical products (mainly fertilizers), base metals, while the major import items are vegetable products, textiles, chemical products and machinery.

To understand what can be expected to happen to Bulgaria's trade with CEFTA countries after several CEFTA members join the EU, one has to apply the theory of discriminatory trade policies. We must assess the extent of the trade diversion that will occur on EU markets at the expense of trade with Bulgaria. Another question is, how much displacement of Bulgarian trade will occur on the markets of the new member countries? However, this is of negligible concern, due to the low level of trade with those countries (3 percent of Bulgarian exports) and to the fact CEFTA trade with the EU (for those CEFTA countries without free trade agreements with Bulgaria) is already more liberal than that with Bulgaria.

In order to assess the extent of possible trade diversion, we need information on the elasticities of the supply curves of the countries concerned (CEFTA and Bulgaria) and the elasticity of import demand in the EU for imports from Bulgaria and the CEFTA countries. Data limitations prevented the presenter from carrying out such an exercise. We may expect, however, that there will be some trade diversion, its extent depending on the structure of Bulgaria's and CEFTA's exports to the EU. The larger the overlap between these structures, the more trade diversion is to be expected.

How can Bulgaria handle this issue, if trade diversion will be excessive? First, Bulgaria can negotiate concessions from the EU. This happened already in connection with the latest EU enlargement, when Bulgaria managed to achieve larger preferential tariff quotas, although until now it has not been able to fulfill those quotas. The main causes of the under-utilization of quotas have been the poor state of the agricultural sector (including problems with land restitution and the unfavorable pricing of the agricultural products), a lack of information on the quotas, and the complicated procedures for distributing the quotas within the country.

Another means to fight trade diversion is raising the competitiveness of Bulgarian products. Bulgaria probably has the worst labor productivity record in Europe, due to the delays in its structural reforms. It is a miracle that Bulgaria is still able to export anything at all. Most state-owned enterprises are known to be selling at a loss: statistics show that aggregate after-tax profitability was negative for most sectors over 1992-96. These losses were reflected in the accumulation of bad loans in the banking system; they were eventually covered indirectly by the state budget. The previous (socialist) government passed a law guaranteeing 100 percent of the value of the bank deposits of individuals and 50 percent of those of enterprises. This meant that, when a series of bank failures hit Bulgaria in 1996, the government itself eventually took on all the debt.

As we see, without sound structural reform, Bulgaria's prospects for attaining international competitiveness will not improve. It has a trade surplus, but that is not necessarily good news. It is more the result of a sharp decline in imports than of rising exports. Imports fell by almost 8 percent in 1997, after hyperinflation and exchange rate depreciation hit the country.

One can expect that in 1998 and thereafter the country will face serious problems with its current account, not only due to real appreciation, but also to the effects of the further liberalization of trade with the EU. Trade liberalization in general and in the long run is beneficial but its short- or medium-term consequences must also be taken into account. When, for example, Greece joined the EU in 1981, its current account deficit increased considerably. Likewise, once Bulgaria achieves free trade with the EU, its current account will surely be in deficit for quite some time.

Discussion of Previous Paper

To a question asking whether one reason for excessive enterprise losses was not due to their underreporting of exports, Rozenov answered that state enterprises, as a rule, do not care whether they pay taxes or not. In any case, trade data comes from balance sheets submitted to the statistical office and not from those filed with the tax authorities.

A question was raised concerning what privatization would mean for export competitiveness, when there are so many negative value-added activities. The presenter explained that privatization for companies like the big metallurgical complex at Kremikovtsi would inevitably lead to the closing down of numerous parts of the company engaged in unprofitable activities. The structure of trade, however, can not be changed radically and immediately, since Bulgaria's productive capacity is largely in metallurgy and chemistry, so time is needed to change the structure of industry.

4. FDI: Impact of Enlargement on Investment from Non-EU Countries

4.1 Prospects for FDI in Countries Joining NATO and EU[18]

The question in the title is very straightforward, but it is not easy to answer it in an equally straightforward way. This especially holds for the influence of NATO membership, which largely escapes analysis based on economic theory.

NATO and EU reflect, by their nature, aims, purposes, mechanisms of functioning very different types of alliances. In this context, the following two questions arise:

1. how important is political instability and risk in a host country to a foreign investor's decision to invest; in our case, this applies to non-EU investors, what basically means those from the U.S. and Japan and
2. what is the impact of the economic and political integration process on a foreign investor's decision (again, in our case, for investors from outside the integration area) to invest in a member country of an integration scheme? Here, reducing political instability and risk is only one of the elements, and definitely not the most important one, provided by integration.

[18] This section summarizes the presentation of Matija Rojec based on his paper "Foreign Direct Investment – How Much Does NATO and EU Membership Enhance Investments by Non-EU Investors?"

Data indicate that FDI inflows to the CEECs are increasing rapidly in absolute terms, as well as with respect to their shares in worldwide FDI inflows. Starting from a level of virtually zero, annual inflows to the CEECs reached $12 billion in 1995, 3.8 percent of world FDI that year. Among investing countries, Germany is the leader, followed by the U.S., Austria, the Netherlands and France (this applies to the CEEC 7, i.e., the CEFTA countries plus Bulgaria). The U.S. and Switzerland are the only significant non-EU investors in the CEECs. Japanese investors are present, but their overall engagement in the region is still low.

NATO membership can contribute to the attractiveness of a member country as a host for FDI by reducing the country's (perceived) political instability and risk in the eyes of foreign investors. Therefore, the real issue with respect to NATO membership and FDI inflows is the importance of a host country's political instability and riskiness for the investment decision of investor from outside the EU.

Theory suggests that uncertainty in the form of political volatility adversely affects the economic viability of a firm's present or future value-adding activity, likely leading to a low level of FDI. Various country-risk analysts (such as those of *Euromoney*, *The Institutional Investor*, Frost and Sullivan, and so on) attach considerable importance to the political risk. For instance, *Euromoney* assigns a weight to political risk within total risk of 25 percent, the same as its weight on economic performance.

However, the results of research on the impact of political instability and risk on FDI inflows are ambiguous. In 1993, John Dunning, a prominent expert on FDI, carried out a comprehensive overview of empirical studies on the influence of political instability and risk on FDI. He found that early field studies all suggested that political risk ranked very high among the variables taken into consideration by multinational enterprises (MNEs) in determining the location of their overseas operations. However, later statistical studies which have embraced political environment indicators have yielded more ambiguous results. (As a rule, these analysis studied the influence of political volatility on U.S. investors, which increases the relevance of their findings for our topic.)

In sum, empirical analysis suggests the following:

1. political instability and risk are important for foreign investors when they consider their locational decisions, but their importance varies in time and across countries, with the developing countries being under tighter scrutiny;
2. foreign investors are especially adverse to drastic types of unfavorable international or domestic events, which are especially likely to occur in less developed countries; and
3. on the other hand, for a good investment opportunity, foreign investors seem prepared to take on a fair amount of political instability and risk.

The only empirical example of NATO's influence on FDI inflows occurred when Spain joined NATO in 1982; all the other member countries joined NATO before the mid-1950s, when the role of FDI in international economic relations was still rather weak. Data show that FDI inflows into Spain did not really increase after 1982, either in absolute terms or as a share of FDI inflows to OECD countries. Neither did the share of Spain in the U.S.'s FDI outflows or stock increase after 1982, although in the case of Japan there was a slight increase. All this hardly provides a basis for the conclusion that

NATO membership plays a positive role in enhancing inward FDI in general, or that from non–EU countries in particular.

It is too early to analyze the affects of the Czech Republic's, Hungary's, and Poland's joining NATO on inward FDI flows to these countries. A possible illustration is *Euromoney*'s assessment of political risk. In all three countries, political risk in the period March-September 1997, during which they were invited to join NATO, actually deteriorated. However, according to that magazine, political risk in comparable countries not invited to join NATO (Estonia, Slovakia, and Slovenia) worsened to an even greater extent.

All in all, the existing – rather fragmentary and poor – data do not support the idea that NATO membership will be a significant enhancing factor for inward FDI to prospective NATO members. However, taking into account that it is mostly drastic types of political instability and not "reasonable" such instability which diverts foreign investment, one should not expect that the ability of these fairly stable countries to attract such investment will be significantly improved by joining NATO.

The question of the role of EU membership in enhancing FDI, in particular for investors from non–EU countries, is largely the same as the issue of the impact of regional economic integration on FDI in general, and on FDI inflows from outside the region in particular. According to Dunning, one should distinguish between the primary (or initial) effects and the secondary (or consequential) effects of economic integration processes on FDI.

The primary effects occur because integration: (i) makes, *ceteris paribus,* intra-regional trade more attractive than extra-regional trade, which stimulates MNEs from outside to replace their exports to the integrated area with FDI; and (ii) creates a new configuration of locational advantages, which forces MNEs to adjust their pre-existing investments in the region to reflect enlarged free intra-regional trade. In the first case, FDI inflows in the region will increase, while in the second, for the region as a whole FDI gains by some countries will be offset by FDI losses by others.

However, the secondary effects of integration are likely to be of greater importance in the long run. These effects arise from both the restructuring of activities between countries, sectors, and firms within the enlarged integrated area, and from new opportunities for firms to increase their technical and scale efficiencies by reducing production and transaction costs. These secondary effects will lead to increased FDI in regionally based affiliates and to increased sourcing by MNEs in the region.

The EU represents probably the most widely studied case of the effects of integration on FDI and the data on it strongly support the theoretical premises provided above. Integration processes within the EU have represented an important incentive for intra- and extra-EU FDI flows, and have also resulted in certain specific structural characteristics of FDI in the region. There was a radical increase in FDI flows between 1985 and the end of 1992, a period marked by the adjustments of MNEs to the needs of the coming internal market. The announcement of the internal market in 1985 compelled both investors from outside and especially those from within the EU, to radically intensify their investment activity in the region. It was in the first place MNEs from the EU which tried to take advantage of the forthcoming deepening of integration. The major vehicle in this regard was merger and acquisition activity.

In addition to intra-EU FDI, major non-EU investors, namely, those from the U.S. and Japan, also significantly increased the shares of their total FDI directed to the EU. Thus, in 1982–91 the share of the EU-12 in the total U.S. outward FDI stock increased from 35.8 percent to 41.9 percent, while the respective figure for Japan rose even more, from 6.7 to 17.6 percent. The increased activity of U.S. and Japanese investors in the EU was far from equally distributed among the EU countries, with by far the largest recipient being the U.K.

The major impetus given to FDI by the internal market scheme points to the relevance of different stages of integration for FDI flows: the deeper the integration, the more important are the effects on FDI flows, and even more so on the character and structural characteristics of MNE's activities. The following effects of the EU's internal market on FDI, as put forward by John Cantwell, seem especially relevant:

1. While, in the early stages of EU integration MNEs competed with each other so as to serve one another's domestic markets either through FDI or trade, in the internal market era, regional corporate networks and alliances of MNEs of varying national origin have been built to serve the whole EU market.
2. For most MNEs, integration has become increasingly intra-EU, at the expense of inter-regional integration. Corporate networks have normally been constituted at the regional level, integrating affiliates located within the EU. Consequently, MNE trade and specialization is developing fastest within the EU. Since similar processes are under way in the U.S. and Japan, the international integration of affiliate networks has essentially involved a process of regionalization and development of regional strategies.

Of special interest here is the behavior of FDI inflows to countries once they joined the EU. The accession of Greece to the EU in 1982 did not result in an immediate increase in FDI inflows to the country. FDI inflows to Greece began to increase in 1987, coinciding with the general trend of strong increases in FDI inflows within the EU as the internal market approached.

On the other hand, for Portugal and Spain, joining the EU in 1986 represented a turning point in these two countries' inward FDI. Inflows to Portugal and Spain increased after 1986 not only in absolute terms but also as shares of worldwide flows and as shares of FDI inflows within the EU (see Table 4). The U.S. and Japan also began to see these countries as more attractive locations for FDI. In 1986–91, the share of Spain in the total U.S. outward FDI stock increased from 1.0 to 1.7 percent, and that of Portugal from 0.11 to 0.20 percent.

The lessons of past experience with respect to the impact of EU integration on FDI inflows from non-EU countries are as follows:

1. the accession of the CEECs to the EU will increase FDI inflows to the new member countries. This increase will come in the first place from other member countries, but also from non-member countries. EU membership will probably increase both the absolute and relative attractiveness of the CEECs as investment sites for EU and non–EU investors;

Table 4: Shares of EU-12, Spain, Portugal, and Greece in Total FDI Inward Flows to OECD Countries, 1981–91 (in percent, where OECD = 100%)

	EC-12	Spain	Portugal	Greece
1981	37.5	4.18	0.43	1.27
1982	44.1	5.92	0.48	1.43
1983	46.1	5.34	0.49	1.42
1984	20.5	4.96	0.55	1.36
1985	38.2	5.26	0.74	1.21
1986	29.7	5.31	0.37	0.73
1987	33.7	4.19	0.43	0.63
1988	43.2	5.49	0.72	0.71
1989	46.9	5.28	1.09	0.47
1990	54.6	8.70	1.66	0.64
1991	66.6	10.27	2.42	1.12

Source: OECD, *International Direct Investment Statistics Yearbook 1993*.

2. the major effect of the CEECs' membership in the EU will be a change in the attractiveness of intra-regional versus extra-regional trade. This will encourage MNEs from outside the EU to replace exports with FDI and production by the local affiliates benefiting from such investment. In this regard, one should not forget that the ten CEECs already have Europe Agreements, which imply a significant degree of integration with the EU. The major question here for MNEs is, in what ways does full EU membership offer more than the Europe Agreements with respect to FDI? The answer is that the internal market has had a strong enhancing effect on intra- and extra-FDI inflows in the EU, and only full membership can make the CEECs participants in the internal market;
3. the effect of accession on FDI inflows will not be the same for all new member countries. Non–EU investors, in particular the U.S. and Japan, show a preference for such larger countries as Poland;.
4. The CEECs' EU membership will attract non–EU FDI intended to supply the EU market from the new member countries. However, it may also happen that some U.S. and Japanese MNEs will increasingly use their existing springboards elsewhere in the EU, in particular in the U.K., to service the new members' markets. This phenomenon may offset to a certain extent the positive influence of EU membership on FDI inflows to the CEECs from non–EU countries;
5. The CEECs' EU membership may bring about some reorganization of MNEs in the EU, and of the FDI made by those MNEs, in view of the relative competitive advantages of individual countries. One can expect the shifting of foreign affiliates from stand-alone, domestic-market orientations toward regionally integrated production systems.

In summary, if one raises the underlying question of the workshop concerning FDI, namely, whether FDI based within and outside the EU will be complements or substitutes, the answer is self-evident: whether the CEECs are members of the EU or not, non-EU originating FDI will never be more than a complement to FDI originating from the EU.

Discussion of Previous Paper

It was suggested that the contrasting experiences of Spain, Portugal, and Ireland on the one hand, and Greece on the other show that EU membership is far from sufficient to attract additional FDI. One may even assume that domestic policy is more important in this respect than EU membership, a sensible lesson for the candidate countries. However, if the domestic policy regime is adequate, membership will certainly give a push to FDI.

The question was raised as to the extent to which the accession negotiations will affect future FDI. In his answer, the presenter emphasized that since the FDI phenomenon is rather recent, and the integration process is in flux, it is very difficult to attribute the growth of FDI to individual factors. The announcement of the internal market in 1985 led companies to anticipate the change, and the major increase in FDI happened two years before the start of the internal market. The Europe Agreements did not provide a major kick to FDI and neither will be the start of the negotiations. Only when accession is approaching with certainty will investors respond to it. In fact, the accession negotiations themselves will not be decisive; what is important is whether or not the legal system has adjusted to that of the EU, whatever the latter's imperfections. If there is substance behind the formal changes, it would provide an impetus to FDI.

Portugal has been in NATO since the 1950s. In fact, for Spain and Portugal, what happened in the course of the transition from dictatorship to democracy was more important than NATO membership.

4.2 Past Experience and Expectations on EU Enlargement from Viewpoint of Japanese Investors[19]

The following is based partly on the experience of Nomura, a Japanese bank with a large presence in Central and Eastern Europe that provides intermediation for portfolio investors.

Japanese FDI has only a short history. In 1951-95, Japan spent almost $550 billion on FDI around the world, 80 percent of this in the last 20 years. Thus, Japanese business is a newcomer in this field. Of the total, about 44 percent was invested in North America, 12 percent in Central and South America, and only 20 percent in Europe. While this share has oscillated from year to year, the average has remained at about 20 percent.

In the second half of the 1980s, Europe became an investment target for Japanese companies, mainly because of the EU's expansion and the increasing importance of its internal market. After this boom in Japanese investment in the region, Japanese FDI flowed back to Asia, and as a consequence, Europe's share is currently stagnating. With this in mind, it is easy to understand why Japanese investment has been so low in Central and Eastern Europe: investment in all of Europe has been very negligible.

[19] This section summarizes the presentation of Tsuneo Morita.

Nevertheless, the share of Hungary in Japanese FDI has reached 0.1 percent of the worldwide total. For the other CEECs data on this order of magnitude cannot yet be found. Within Japan’s European investment, Hungary’s share reached 0.36 percent in 1993, which is remarkable since it is higher than the shares of Austria, Portugal, Greece, and Sweden. In fact, Hungarians should not complain about the weak interest of Japanese investors.

Japanese investment strategy in Europe focuses first of all on location. As mentioned by the previous speaker, the U.K. has been the major springboard for the Japanese investors to the EU market. As a result, the U.K. has consistently received about 40 percent of Japanese investment in Europe.

The main reasons for the U.K.’s prominence are as follows:

1. the government of the U.K., especially under Mrs. Thatcher, has strongly supported Japanese investment. In addition, investors have encountered no prejudice against existing FDI in the U.K.;
2. Japanese companies have not faced strong domestic competition on the U.K. market, but rather found local enterprises to be complementary. This has led to a friendly coexistence between Japanese and British business;
3. The U.K.’s domestic market is rather large and has easy access to other EU markets;
4. Japanese businessmen have found a similar “island” mentality in Britain to their own. When we move to an unknown place, similarity in thinking and mentality is important; and
5. Although the Japanese are not skillful with foreign languages, the English language is the most familiar for them.

In the second half of 1980s, there was a big expansion in Japanese investment in Europe; at the time, Japan chose the Netherlands as its next springboard to the region. Currently, the Netherlands receives 22 percent of Japanese investment in Europe. Since this process began only in 1987, there was a very fast buildup of investment there over ten years.

It is not easy to find the clear reason for the choice of the Netherlands in the 1980s. Nevertheless, in the Netherlands, Japanese business has received strong government support, and has not sensed any prejudice against it. Access to a good seaport was also essential for shipping the necessary material and equipment from Japan. Relatively good infrastructure and access to European markets were further explanatory factors, but there must be other, unknown factors that explain the choice of the Netherlands by Japanese businesses.

Japan is currently looking for its next springboard – that is, its next production and business base – on the eastern side of Europe. Many companies are still considering which countries are the most suitable in that regard. The process will accelerate as EU membership becomes a reality for the CEECs. Within the next five years, some big move will certainly be taken by the Japanese side.

In the summer of 1997, the Nomura Research Institute conducted a survey on the expectations of Japanese companies about the Eastern European region. The survey covered 1,249 listed companies, mostly Nomura clients. The number of respondents was 310. The sectoral composition of the respondents was dominated by vehicle and automobile companies (22 percent of the respondents) and electronics (16 percent). The size structure was dominated by companies with 1,000-5,000 employees (41 percent), which is considered medium-sized in Japanese terminology.

More than half of the companies surveyed already had a presence in Europe, with most of them concentrating on the U.K., Germany, and France. They are most active in such sectors such as vehicle and automobile production, electronics, and financial services. Medium-sized companies play a key role in European investments, carrying out 51 percent of these investments. Among the enterprises' main functions, sales promotion is dominant, followed by manufacturing, and then information distribution and processing. As for ownership, there is a preference for full Japanese ownership: 71 percent of the joint ventures in Europe in the sample were fully Japanese owned.

What is the main factor behind the location decisions that these companies have made within Europe? The leader among the explanatory factors is market size (42 percent), followed by political stability (12 percent) and an established capital market (9 percent). Among investors' major sources of concern, the leader is fear of unstable exchange rates.

The survey also included questions on companies' presence in and attitudes toward CEECs. It turns out that, while only one company out of ten was already operating in the region, most of them had already had business experience there. As for their major target country, the largest numbers named Poland (25 percent), the Czech Republic (23 percent), and Hungary (21 percent). As for the major functions of the existing joint ventures in the region, the companies named sales promotion (49 percent), manufacturing (26 percent), and sales service (15 percent).

Among the problems in the region feared by the companies, they named volatile exchange rates (33 percent) as most important. The sectoral distribution of the planned investments reflected the dominance of vehicle and automobile production (31 percent), followed by electronics (24 percent) and machinery (17 percent). The most popular countries of the region for the potential investors were Poland (33 percent), Hungary (26 percent), and the Czech Republic (18 percent). The investors plan to expand their operation mostly in manufacturing (50 percent), sales expansion (36 percent), and sales service (5 percent).

In answer to the question as to why their companies had not invested so far in the region, the most frequent answers given were insufficient market size (30 percent), inadequate geographical position (16 percent), and political volatility (13 percent).

Poland may be the next platform for Japanese companies, although there are images of the CEE nations among Japanese businessmen which seem to contradict this expectation. Especially among financial institutions, and to a lesser extent among production companies, Polish workers and business are considered a bit undisciplined and untrustworthy. Unpaid debts inherited from the communist era may have helped to create this image.

Czech employees are considered clever and hard working in the manner of Germans, but a bit stoic and inflexible. Slovakia has not got a concrete image, but a recent analysis showed that there is excessive political interference in business. As for Hungarians, the Japanese always say that they are somewhat rough, but that they are hospitable and flexible. The Japanese see in them a certain similarity to themselves.

This may be a partial explanation for why most Japanese investment in the region has gone to Hungary.

Discussion of Previous Paper

Some workshop participants, citing the existing pattern of Japanese FDI, expressed skepticism concerning CEECs' chances for attracting such investment. Japan has always looked to the more advanced regions in Europe (e.g., the U.K. and the Netherlands) and not to such peripheral countries as Spain, Portugal, or Ireland. In his answer, the presenter emphasized that the geographical position of investment sites is very important for Japanese investors. Since each CEEC, other than Poland is very small, Japanese companies will use them only as export bases, showing little interest in their domestic markets. It may be that in the future Japanese companies will invest in Poland plus one additional country in the region.

For Japanese investors, geographical distance to the future investment target country is a major factor because, due to the scarcity of information, it is more difficult to assess the opportunities in a more distant country from Japan. It is also harder to withdraw investments from more distant lands in case of trouble. This is why, for instance, German companies' presence in Asia is low. The major difference between portfolio investment and FDI is that the former depends on opportunities and risks, while FDI relies on the presence of markets.

A question was raised on Japanese plans with respect to such small countries as Latvia and the other Baltic states. In reply, the presenter argued that if a market is small, the next criterion for investors is ease of access to major neighboring markets. If such markets are insufficiently mature, there is no hope for a small country to receive Japanese FDI. In Toyota's recent selection of a European site for producing compacts cars, the company eventually decided that Central and Eastern Europe as a region was not sufficiently mature for the investment. Toyota may choose a site in this region in the next stage of its expansion.

4.3 Integrated European Capital Market and Impact of Euro: Portuguese Experience with Capital Flows After Accession[20]

Capital flows are traditionally divided into FDI and portfolio investment, with FDI further broken down into that going into manufacturing, tourism, and banking and financial services, and portfolio investment into that flowing into bonds and equities. There is also short-term foreign investment of a speculative nature. However, these distinctions have increasingly become blurred. With the modernization of the financial system, FDI into banking and financial services is difficult to separate from portfolio investment.

It remains important to focus on FDI in manufacturing, because it plays an important role in changing comparative advantage and raising productivity. However, FDI in Portugal is not just in manufacturing, but increasingly in tourism and banking and financial services. This is related to the EMU and Portugal's opportunity to participate in it from its inception.

[20] This section summarizes the presentation on the impact of EU accession on the Portuguese economy of Nuno Cassola.

An important issue for countries acceding to the EU is real convergence, which necessitates structural change. The convergence process is equilibrium-revealing and results in a gradual upward movement of the price level. This movement is easy to confuse with a loss of international competitiveness and an unsustainable movement in relative prices. However, in Portugal, where a real appreciation of the equilibrium exchange rate has been necessary for nominal adjustment, there is a link between real convergence and nominal adjustment.

Nominal adjustment means fulfillment of the Maastricht criteria, which for Portugal entails a reduction in inflation, convergence of nominal bond yields to their reference values, a stable nominal exchange rate, and a sharp fiscal adjustment. Modernization of the financial system is helpful by fostering fiscal adjustment, privatization, nominal adjustment, and changes in monetary policy. When there is nominal adjustment and structural change, monetary policy must change as well.

Portugal has been a member of EFTA since 1959, signed a trade treaty with the EU (at the time, the European Economic Community) in 1972, and acceded to the EU in 1986. The last of these actions has had the biggest impact on Portuguese financial inflows and outflows.

Portugal has mainly been a recipient of FDI, with outflows amounting to only about 20 percent of inflows. Flows have been volatile, but have stabilized since accession. In 1995 and 1996, there was a remarkable change, as Portugal became a net foreign direct investor, rather than a net recipient. The story for portfolio flows is similar, as most of the action on this front has taken place since accession, in particular after 1992. In January 1993, Portugal fully liberalized its capital account, and the bulk of portfolio flows have occurred since then.

We can clearly see the effects of the political crisis of 1975 and 1976 in a decline in FDI relative to GDP. With democratic normalization – that is, the election of a new government, approval of an IMF adjustment program, and the commitment of the president to join the EEC (in 1977) – FDI picked up relative to GDP.

Why has Portugal been so attractive to foreign investors? Relatively low costs have given the country considerable growth potential, and that has been the main factor behind the surge in capital inflows.

In the 1960s, the main trading partners were the U.S., Portugal’s African colonies, and the U.K. In 1980, Portugal’s main trading partners were the U.K. and Germany, both quite distant from the country; Portugal was blocked off from the European market by Spain. At that time, there were only narrow, winding roads from Portugal to the French border. Most trade went by sea, making Portugal something of an island economy.

In 1980, Spain accounted for only 3.6 percent of Portuguese exports, 5.5 percent of its imports, and 1 percent of total FDI inflows, while West Germany was responsible for 11.7 percent of exports, 13.5 percent of imports, and 9.8 percent of FDI. There is a historical reason for the importance of economic relations with the U.K.: the two countries have been allies since the 12th century, the oldest alliance in Europe. In 1980, 14.8 percent of exports went to the U.K., 8.6 percent of imports came from there, and that country accounted for 14 percent of FDI. After their independence in the mid-1970s, the former African colonies vanished as trading partners, as those countries were ravaged by civil wars; trade with them is now slowly recovering. The importance of economic relations with the U.S. has been declining.

By 1996, the picture had totally changed. Spain is now Portugal's main trading partner, accounting for 14 percent of exports, 22 percent of imports, and 87 percent of net FDI. This represents regional integration, as Portugal is now part of a larger Iberian economic space. The U.K. was responsible for 10.8 percent of exports, 6.7 percent of imports, and 30 percent of FDI. France accounted for 14 percent of exports and 11 percent of imports. Germany was responsible for 21 percent of exports, 11 percent of imports, and -12 percent of FDI (i.e., it is disinvesting).

Infrastructure investment in Portugal and Spain have changed dramatically the costs of transport for these countries to the heart of Europe. EU funds have been used to build roads, railways, and communications.

Looking at the current account of the balance of payments, we see that there has been a structural trade deficit, as Portugal has been importing machinery that it does not produce. Investment opportunities in the country exceed its savings capacity, so we see a typical case of intertemporal smoothing of consumption and investment. In the past, the trade deficit was financed by private transfers from Portuguese resident abroad, services (mainly tourism), and a small amount of public transfers; the result was a reasonably balanced current account. More recently, EU funds have grown in importance, now amounting to 5 percent of GDP.

Since capital inflows have generally overwhelmed the current account deficit, the authorities have been posed with a tremendous structural adjustment problem arising from large-scale liquidity creation. Their goal has been to have macroeconomic stability, meaning a stable exchange rate and low inflation.

FDI plays a major role in changing a country's comparative advantages, especially when it affects the cost of transport. Portugal has had comparative advantages in labor-intensive industries, such as clothing, footwear, and textiles; scale-intensive industries, such as pottery, china, and paper products; and resource-intensive industries, such as wood and paper products. But this situation is changing rapidly. The new directions of the economy involve scale-intensive industries, such as transport equipment, chemicals, and rubber products; differentiated goods, such as industrial machinery (for wood- and metalworking), nonferrous metals, and leather.

The share of Portuguese exports accounted for by clothing and footwear is falling and that of machinery and transport equipment is rising. FDI has been especially important in the automotive sector. First, there was investment in this sector by Renault, followed more recently by an investment by Volkswagen and Ford to produce a car for the European market. Studies show that FDI was instrumental in raising productivity in sectors receiving such investment. That investment created some positive externalities, as Portuguese firms in sectors where FDI was dominant had to adapt to raise their own productivity.

Since 1990, FDI has been falling in Portugal (and to a lesser extent in Spain), while it has been rising in CEECs. Germany, especially, has shifted its investment toward the Central and East European region.

Portugal suffered from an adjustment problem when it entered the EEC: it had 10 percent inflation, well above Spain's and Germany's. Moreover, before accession, Portugal's financial system was characterized by nationalized banks – which were sheltered from foreign competition – and a poorly developed capital market (see Table 5). After accession, the country liberalized and deregulated its financial system, and privatized these banks, and the capital market revived. These changes in turn forced revisions in monetary and exchange rate policy. The authorities abandoned the use of direct methods of monetary control, such as credit ceilings, administratively fixed interest rates, and capital controls. They currently employ indirect, market-based methods.

Exchange rate policy was also changed: a passive crawling peg that simply offset previous inflation vis-à-vis Portugal's main trading partners was eliminated. During 1990-92, Portugal employed a "shadowing" exchange rate mechanism (similar to that used by the U.K. at the time), and in April 1992 it joined the Exchange Rate Mechanism.

Table 5: Economic Policy in Portugal Before and After EU Accession

	Before Accession to the European Union	**After Accession to the European Union**
Monetary Policy	Direct methods of monetary control: • credit ceilings; • administratively fixed interest rates; • capital controls on external transactions.	Indirect methods of monetary control (1991): • market based mechanisms; • intervention interest rates; • elimination of capital controls on external transactions.
Exchange Rate Policy	"crawling peg" regime: pre-announced monthly depreciation rate of the escudo vis-à-vis a basket of 13 currencies; • designed to offset the Portuguese inflation differential vis-à-vis its major trading partners; • discrete devaluation.	"crawling peg" regime (1986-90): • reduction of the escudo's monthly depreciation rate. Limited float (1990-92): a composite index of leading ERM currencies was adopted as a reference medium-term objective; ERM membership since April 1992.
Financial System	• Financial institutions sheltered from foreign competition; • nationalized banking system; • poorly developed capital market.	• Liberalization and deregulation in the context of the Single Market; • privatization of nationalized banks; • revival of the capital market.
Fiscal Policy	Large fiscal imbalances due to: • vigorous expenditure growth only partially offset by rising revenues; • inefficient tax system.	Overall reform of public finances: • adoption of medium term programs of fiscal consolidation based on expenditure restraint; • tax system reform (direct and indirect taxation); • privatization.

The costs of Portugal's efforts to converge to the Maastricht criteria have been moderate. GDP growth has been above the average of the EU-15, except during 1993 and 1994. Despite some increases in the unemployment rate, it remains substantially below the average for those countries. The difference between Portuguese and German bond yields has declined since January 1996 and is now only 20 basis points, roughly equal to the remaining sovereign risk.

Discussion of Previous Paper

The discussion following the presentation emphasized how encouraging the Portuguese experience was for acceding transition countries and the importance of investment in transport infrastructure for changing Portugal's comparative advantages and trade patterns. Another point that arose was that before making the adjustments toward meeting the Maastricht criteria, capital flowed in because the authorities ran a tight monetary policy to curb inflation and kept the exchange rate stable, so there was little risk in investing in Portugal. After adjustment, interest rates fell and it became less profitable to speculate. Sterilization was used to mop up excess liquidity, as central bank paper was sold to private banks; that paper could be used as collateral in repo transactions. The authorities also used reserve requirements, liberalized capital outflows, and used some of the inflows to retire public debt and pay off inherited foreign debt.

Portugal has now become a net exporter of capital, as firms realize the need to establish networks to benefit from the single market. The government has encouraged this process by offering incentives to invest abroad. Portuguese firms are also investing now in Brazil and Morocco.

5. Technological Cooperation: EU Programs Limited to Europe or Broader Schemes? Opening Up of EUREKA to Globalization and to Requests of European Industry[21]

This discussion focuses on three topics: what EUREKA is; how it developed from a West European organization into a European one; and how it is facing and preparing itself for globalization.

EUREKA is a child of the Cold War, a try to position Europe between the U.S. and Japan in the technological field. Its founding in 1985 was an answer to the U.S. Strategic Defense Initiative (SDI, popularly known as "Star Wars"). French President François Mitterand held that Europe should not participate in SDI, but should foster cooperation within Europe in developing and promoting civilian technology.

EUREKA was created as a network for European cooperation, not affiliated with the European Commission (EC), because the French, Germans, and many others thought that the EC was excessively bureaucratic, large, and rigid. EUREKA's most important characteristics are that it is not an organization, but a network; that it provides a framework for cooperation between research and industry; and that it is an instrument for exploiting R&D results and innovation. The objective in creating EUREKA was to

[21] This section summarizes the presentation on the EUREKA program and its relations with Central and Eastern Europe of Benno Schmidt-Küntzel.

increase European competitiveness vis-à-vis the U.S. and Japan – the main competitors at the time – and to promote cooperation in the field of high technology. In practice, the key aspect of EUREKA's activities is fostering innovation within Europe.

Although EUREKA is not part of the EC system, the EC is one of EUREKA's 26 members. In principle, the EC concentrates on pre-competitive, top-down, less applied research requiring large central funding, with the results becoming the property of the EC and the partners cooperating on the project. EUREKA concentrates on market-oriented, bottom-up research, requiring less funding (which comes from individual nations), with the results becoming the property of the partners alone.

That EUREKA's approach is bottom-up means that it has no clear program and no priorities; it issues no calls for proposals, but waits for its clients to take the initiative. Those clients are research institutes (including universities) and industrial corporations, who may come up with a proposal at any time, on any subject, using any technology, as long as it is innovative and such that international cooperation would be more efficient than national cooperation.

EUREKA receives no European funding, but only decentralized, national, and relatively small funding. If, for example, a Hungarian participant wants to cooperate in a Eureka project, he must seek funds from the Hungarian State Committee for Science and Technology. This fact scares away many firms. However, according to a Danish study, while many partners came to EUREKA largely to obtain funding, at the end of their projects they realized that the framework that it provided for cooperation and the EUREKA quality label were more important than that funding.

Total investment sponsored by Eureka is 16-17 billion ecu, compared to 13 billion ecu in the EC's European Framework Program (EFP). But these figures are not comparable. EFP funding is for 4-5 years, which is the lifetime of the program, and includes only public money. EUREKA funding is for 10-11 years and comes from both the private and public sectors.

The participants in EUREKA projects come 70 percent from industry (60 percent of those from small and medium-sized enterprises) and 30 percent from research institutes and universities. But the situation is the opposite in CEECs, where academic institutions make the most proposals. While in the whole of EUREKA 29 percent of all participating organizations are from industry, from CEECs the percentage is only 14; but while 15 percent of all participants are research institutes and 12 percent are universities, for CEECs the percentages are 34.5 percent and 15.5 percent, respectively.

The difference between Western Europe and Central and Eastern Europe in this regard partly results from the fact that research institutes in the latter are being downsized, privatized, and forced to earn their own money. At the same time, industry in CEECs is struggling for day-to-day survival and less interested in long-term cooperation and innovation. This will change in the future.

Out of a total of 668 projects, Germany (with 219), France (203), the Netherlands (163), and the U.K. (149) are the largest players in EUREKA. However, the picture is somewhat different with respect to the amounts of money invested. The countries that really take the initiative in projects include such smaller ones as Austria and Switzerland.

Although EUREKA does not emphasize particular technological sectors, for statistical purposes it compiles a sectoral breakdown by numbers of projects. The environment is the subject with the largest number thereof (with 138), followed by biotechnology (127), information (119), robotics (96), materials (76), and transportation (47). In terms of funding, information is by the largest sector.

EUREKA has by now outgrown the EU. The process of expanding beyond the EU began in 1992, when Hungary joined, followed by Russia in 1993, Slovenia in 1994, the Czech Republic and Poland in 1995, and Romania in 1997. The EC has been a rather unimportant member, although EUREKA believes that there are certain large projects for European industry that require cooperation between it and the EC.

In addition to membership, EUREKA has established a network of national information points (NIP) in post-communist countries which coordinate and promote cooperation within the EUREKA network; the countries are Albania, Bulgaria, Estonia, Latvia, Lithuania, Slovakia, and Ukraine, with the Baltic states being the most active. There are a few countries with which there has been no involvement, including Belarus, Moldova, and Yugoslavia. Croatia has just stated that it wants to open a EUREKA office, with a visit expected by that country's deputy minister of science and technology.

Under the British chair, a group of high representatives of European industry recommended in the 1996 Davignon Report that, rather than exhibiting a "Fortress Europe" mentality, that industry should go global, seeking partners on a global scale, and that EUREKA should follow this initiative. Such globalization has now been integrated into EUREKA's medium-term plan (covering 1996-2000), although it has developed no clear policy yet in this direction.

Concretely, there is a special agreement with Israel, some partnership and brokerage events with the U.S., and under the Portuguese chairmanship there were partnership and brokerage events with Macao. China seems very interested in opening a EUREKA office, but distance from Europe and a lack of resources are problems. At the moment, only 26 of 668 projects involve countries that are not members of EUREKA.

In summary, EUREKA fits well with national policies on innovation and cooperation between research establishments and industry. It is a flexible instrument, but it is underperforming, in that its service to its members could be must better, especially as regards integration with CEECs. EUREKA provides a protective environment for cooperation according to free market rules; it ensures that a university or small enterprise is not exploited by big industry.

Discussion of Previous Paper

In the discussion, it was emphasized that relations between the EC and EUREKA have been distant, the EC viewing it as underfunded, and excessively flexible and decentralized. The two organizations have cultures and rules that are too different from each other to cooperate well. There are some strategic projects for the survival of European industry where the two bodies could collaborate, the EC on basic research and EUREKA on work closer to the market, but it appears that the EC is not interested in this.

A number of concrete projects involving participants from CEECs were listed. These include plastic springs for cars, trucks, and buses (U.K., Czech Republic, Lithuania); tiny electrical engines with permanent magnets (Czech Republic); and a project to recommend solutions to the problems of Silesian coal and steel regions (Austria, Poland, Czech Republic).

It was also noted that there are no statistics allowing one to determine the efficiency of projects involving CEECs relative to other projects. Generally, West European countries have taken the lead, but this is changing. Finally, it was observed that while EUREKA's activities must be in the interest of its European clients, if those clients want to find technology or other forms of cooperation outside of Europe, that is no problem for EUREKA.

6. Agriculture

6.1 Opportunities and Challenges of EU Accession: Perspective of Polish Farming Sector[22]

Poland continues to have a substantial agricultural sector, accounting for 25 percent of the labor force and 6 percent of GDP. Some EU member states, such as Greece, have a similar share of the labor force in agriculture, but twice the share of that sector in GDP, demonstrating the low level of productivity in Polish agriculture.

This situation results from the fragmented nature of farms, with a farm of three hectares often divided into 20-30 pieces of land in different locations. There is also excessive labor remaining in agriculture, with huge hidden unemployment (in rural areas, 50 percent of people under 30 years of age are jobless), insufficient work for all people living on farms, and low incomes which have declined relative to those in other sectors. The agricultural population's educational level is low on average. Almost half of the farm population receives its income mainly from retirement pensions or work outside the farm. Very few farms are specialized, with most farms having a mixed production structure.

Some 75 percent of farmers do not see any prospects for their farms in the future. Many farmers say that their situations were better in the old days, which is surprising, since agriculture was the only sector where private property was maintained and market economy kept alive. It is difficult for small farmers to learn and adapt to the requirements of the capitalist economy. They expected more state intervention on the market, state control of prices, and guaranteed profitability and markets. The farming population has little knowledge of the impact of EU accession on its situation.

The interests of Poland and the EU with respect to Polish accession are not identical; the EU may obtain different benefits and bear different costs from Poland. The EU will decide the conditions governing Poland's joining the club and Poland must accept those rules. If the gap between the EU's choices and Poland's preferences is too big, there could be a problem with the passage of the national referendum on the accession treaty.

Poland's officials are told that in joining the EU it must accept the Acquis Communautaire, but Poland asks whether there is but one acquis or different ones for different countries. Especially in agriculture, there is reason to believe that there will be one acquis for current member states and another one for candidate members. One gets this impression especially from Agenda 2000, which says that applicant countries will not have access to compensatory payments because they will not face price declines.

[22] This section summarizes the presentation of the paper "Implications for Polish EU Accession for the Farm Sector: Polish Perspective" by Władysław Piskorz.

The current acquis was adapted to the needs of the current members, which are generally better off than Poland (which has one-third of the EU average GDP per capita) and have much smaller agricultural sectors. Poland has the potential to be a net agricultural exporter, even if at present it is a net importer of such products. Policies suitable for agricultural importers in the 1950s and 1960s may not be appropriate for actual or potential exporters such as Poland.

In the European Commission's Opinion and proposal for Accession Partnership, one requirement placed on Poland was to work out on short notice a coherent, well-defined strategy for rural development. But the EU itself does not yet have such a strategy; it has neither presented any good proposals nor had any good experience in this connection.

Understandably and legitimately, Poland expects that accession will help it increase agricultural support and protection. Economists criticize this sort of assistance as unsound and there is reasons to agree with the critics of the EU's Common Agricultural Policy (CAP). But in a country such as Poland, with its huge agricultural sector, such support has considerable political significance. Transfers would make it easier to convince the rural population that accession is beneficial.

With the publication of Agenda 2000, it is now clear that the "transfer window" will be closed to Poland. As compensation, Poland is offered access to the Regional and Rural Development Funds, but there are strings attached to the availability of such funds. First, those funds may not exceed 4 percent of GDP. The Agricultural Policy Analysis Unit (APAU), under the PHARE program have calculated that if compensatory payments were applied under the same conditions as to current member states, they would exceed that level. Second, the funds are subject to co-funding requirements.

Poland holds that the treatment of the application of compensation payments in Agenda 2000 is logically inconsistent with the concept and spirit of the single European market. How can such a market exist when some farmers are paid compensation payments and others are not? Payments are compensation for the removal of the previous level of support, but the problem is that farmers in candidate countries were never fortunate enough to receive that support.

Two years ago, the APAU conducted a series of analyses using assumptions tailored to meet the conditions prevailing in 1991-93, in an attempt to determine the impact of EU accession on the Polish farming sector. It repeated this analysis two years later using assumptions for 1994-96. In the meantime, the farm-gate price gap between Poland and the EU had narrowed. In the earlier analysis, it was incorrectly assumed that that price gap would narrow only if Poland acceded to the EU. But it is now clear that such a price realignment will occur regardless of whether Poland accedes. One reason for the declining price gap is the real appreciation of the Polish currency. A second is the increasing protection of agricultural products in Polish trade.

Accordingly, accession to the EU should not result in a significant increase in the production of major agricultural products nor a major increase in prices. The cost to the EU budget of extending CAP measures would be about 4.3 billion ecu, a figure that would be reduced by 70-80 percent if compensatory payments are not provided to Poland.

6.2 Is CEFTA a Substitute for or a Supplement to EU Accession? Case of Agricultural Trade[23]

This paper examines whether CEFTA will be a substitute for or a supplement to EU accession in the field of agriculture.

CEFTA was signed in December 1992 among the three Visegrád countries at the time. The main motivation was to prevent a further contraction of foreign trade among those countries and to promote an increase in mutual trade, on the basis of certain complementarities in their economic structures and the similarity of their levels of economic development. As a consequence of these countries' signing association agreements with the EU, some trade diversion had occurred and their mutual trade had contracted. The most important aspect of CEFTA is the liberalization of foreign trade, first and foremost by reducing and eliminating tariffs and non-tariff barriers, especially on industrial goods.

After five years, some 90 percent of industrial goods are traded freely and all such goods are covered by concessions. About 80 percent of agricultural products traded within CEFTA are covered by some kind of concession. As a result of this liberalization, the share of CEFTA countries in each other's trade has increased, albeit from a low base; it does not yet exceed 10 percent and has not reached pre-transition levels (see Table 6).

There will be some expansion of within-CEFTA agricultural trade because of further trade liberalization, because of the establishment (in 1997) of the pan-European cumulation zone, and because of the enlargement of CEFTA by the addition of Slovenia, Romania, and in the future Bulgaria.

CEFTA's agricultural provisions are quite complex. At present, agricultural products are classified into three groups. The first, the "duty-free list," contains goods on which tariffs are eliminated. The second group lists products with CEFTA-wide, unified tariff rates which are below the rates implied by most-favored-nation status, although certain quantitative restrictions remain. The third contains products for which bilateral concessions were given.

There is a consensus that future agricultural trade liberalization within CEFTA would be desirable. But most CEFTA members have moved in the opposite direction, examples being the Czech and Slovak import deposits and certain recent Polish moves against Hungarian meat shipments.

There have been some achievements in agricultural trade as a result of the formation of CEFTA. For Hungary, CEFTA is growing in importance as an agricultural market, with 12.9 percent of its agricultural exports now going in that direction (compared to an EU share of 44 percent), versus 4-5 percent in the past (see Table 7). Hungary is a net agricultural exporter with respect to both CEFTA and the EU. Hungarian export growth to CEFTA has been so rapid because it has followed an export-oriented agricultural development strategy, with its main interest in this regard being to find reliable and expanding markets for its agricultural products. It also wants to regain traditional markets in CEECs.

[23] This section summarizes the presentation of the paper "Agricultural Trade within CEFTA: A Substitute or Supplement to EU Accession?" by Judit Kiss.

Table 6: Share of CEFTA-Countries[a] in Individual CEFTA Countries' Exports and Imports (%)

	Czech Republic[b]		Slovakia[c]		Hungary		Poland		Slovenia	
	Ex	Im	Ex	Im	Ex	Im	Ex	Im	Ex	Im
1993	5.8 (27.3)	4.3 (21.8)	8.1 (50.5)	3.6 (39.5)	6.7	5.7	5.9	4.1	4.2	5.1
1994	7.8 (24.2)	4.4 (18.6)	9.0 (46.4)	4.5 (34.1)	7.0	6.7	6.1	4.6	4.4	6.1
1995	7.3 (21.2)	4.1 (15.9)	10.1 (45.3)	5.5 (33.2)	7.9	7.0	7.1	6.0	4.9	6.7
1996	8.3 (22.6)	4.5 (14.1)	10.4 (41.4)	5.0 (29.5)	8.8	7.7	6.1	5.8	5.5	6.5

[a]Czech Republic, Hungary, Poland, Slovakia, and Slovenia.
[b]Data in brackets include the country's exports to Slovakia.
[c]Data in brackets include the country's exports to the Czech Republic.

Source: Based on data in Sándor Richter, "European Integration: The CEFTA and Europe Agreements," Vienna Institute for Comparative Economic Studies, 1997.
Note: Ex: Exports; Im: Imports.

Another important factor is the activity of foreign capital and foreign direct investment. Most multinational corporations active on the Hungarian market have concentrated on that market, but since it is limited, they want to expand beyond Hungary's borders. They are trying to expand their exports to neighboring markets, including those of the CEFTA countries, and are thus interested in further agricultural trade liberalization within CEFTA. A further aspect of the situation is the export of Hungarian capital to CEFTA countries, which has also played a role in the expansion of the country's agricultural exports to these countries; subcontracting has occurred in the food industry, which is trade creating. Hungary's agricultural imports from the region are very limited.

In conclusion, it can be said that at the beginning of the 1990s there was a need to revitalize economic cooperation within CEFTA and that CEFTA has turned out to be a vital organization. But it is only a supplement to EU accession, not a substitute for it. Still, it could play an important role in promoting accession of its members to the EU, largely through coordination of accession strategies. At present, CEFTA countries are competing, rather than cooperating in those strategies; they are competing for EU markets, for each other's markets, for other eastern markets, to attract foreign capital, and for EU accession.

Such competitive attitudes may decrease the countries' bargaining strengths; what is needed is coordination of strategies on such issues as migration, accession, and agriculture. In the last of these areas, harmonization is required on such issues as compensation payments, production controls, quotas, transition periods, and accession to the agricultural funds.

Table 7: The Share of CEFTA in Hungarian and Polish Agricultural Trade (%)

	Hungary		Poland	
	Exports	**Imports**	**Exports**	**Imports**
1991	4.9	4.7	1.5	5.5
1992	7.2	4.0	1.0	5.4
1993	8.4	4.7	2.8	3.5
1994	9.3	4.1	2.4	3.6
1995	10.6	3.7	2.8	7.9
1996	12.9	3.4	n.a.	n.a.

Source: For Hungary, János Kartali, "A CEFTA országok és Magyarország agrár-külkereskedelme," Agrárgazdasági Kutató és Informatikai Intézet, Budapest, 1996; and own calculations. For Poland, calculations were made by Balázs Szilágyi on the basis of Polish national statistics.

Discussion of Previous Two Papers

The discussion began with an expression of surprise that the presenters were so uncritical of the CAP, which can be described as a disaster, that is contrary to everything that EU member countries and CEECs have been told about the market, the private sector, and the role of government. The main instrument of the CAP is price supports, which have raised EU prices to two to three times world levels, leading to overproduction, which in turn has led to subsidized exports to the world market (further reducing world prices and hurting Third World producers). Higher product prices also raise land prices, which results in more intensive farming and enhanced environmental degradation.

If the CAP is implemented unchanged in CEECs, there will be enormous costs to those countries' citizens, who are poorer than those in the EU. It was argued that acceding countries should not take the existence of an unchanged CAP as given, but should push for reforming it. Further discussion of this emphasized that CEECs did not believe that they were in strong enough bargaining positions to argue against the CAP, that they do not know in what direction it will be reformed before they accede, and that the CAP's failings were common knowledge in these countries.

In the discussion, it was noted that it is too soon to tell what the effects of the categorization of agricultural exports within CEFTA into three groups had done to trade in them, since that scheme has only come into existence at the end of 1996. In Hungary, exports are divided approximately evenly into the three categories. It was also noted that with both CEFTA agricultural trade liberalization and the EU association agreements, foreign trade measures are less important than whether countries are in a position to make use of the concessions offered them.

In the case of CEFTA, another important factor is FDI, with 67 percent of the assets in the Hungarian food industry in the hands of foreign investors, which means that such investors are in powerful decision-making positions. Certain CEFTA countries, especially as their domestic economic situations have deteriorated, have taken measures that counterbalance the liberalizing effects of trade policy moves.

Other points made in the discussion included the following: that the most important pressure for CAP reform will not come from the acceding countries, but from the next round of World Trade Organization negotiations, U.S. pressure on the EU, and the fact that latest U.S. farm bill provides for expansion of production and exports; that the uncertainties over future EU agricultural policy complicate policy-making in that sphere in the acceding countries, especially in Poland, with its large agricultural constituency; and that CAP reform is being forced on the EU by budget constraints, environmental and rural development issues, and loss of world markets.

Further points included the following: that EU products seem to crowd out Hungarian products on CEFTA markets, while Hungarian products compete with EU products on EU markets, but those Hungarian goods are often produced by multination companies based in the EU; that Hungarian milk quotas, while seemingly introduced to acquaint local farmers with the EU's quota regimes, are different from those regimes in that in Hungary they exceed production levels.

Finally, the discussion turned to the fate of CEFTA once, as is likely, certain of its members accede to the EU before the others. The points made included the following: that if that happens, CEFTA will have had too short a life to have been relevant; and that trade between current CEFTA countries that accede will increase much more after they accede, It was noted that CEFTA differs from the European Free Trade Agreement in that the countries remaining in the latter are wealthier than those that acceded to the EU, while for CEFTA, it would be the other way around, so having some of its members leave would likely destroy CEFTA.

7. Will There be a Tripolar World? New Regionalism and Eastern Enlargement

7.1 Trends and Future Prospects for Trade and FDI Within Europe and Between Europe, America, and Asia[24]

One of the main questions at this workshop is whether Central and Eastern Europe should consider the EU and the other major players in the world economy (i.e., America and Asia) complements or substitutes. One sometimes has the impression that politicians see them as substitutes. Clearly, CEECs displays a strong bias toward the EU, especially in trade, which would be natural if regionalization were the only game in town. But that is only part of the story: regionalization is occurring in the context of globalization, which has important implications. More concretely, Central and Eastern Europe may face considerable costs if it considers regionalization as an alternative to taking part in the global division of labor.

It is indisputable that there has been an increasing division of labor on a global scale for the last 20 to 25 years: trade has grown faster than production worldwide. Is this due to

[24]This section summarizes the presentation of the paper "Will There be a Tripolar World? New Regionalism and the Eastern Enlargement" by Peter Nunnenkamp.

regionalization or globalization? This question is of more than academic interest, since if the international division of labor is proceeding at beyond the regional level, decision-makers should consider all regions of the world when making their policy choices.

Moreover, if regionalization were the only thing happening, lower-income countries such as CEECs would have no chance to catch up economically with the more advanced nations if they were not part of a regional bloc (such as the EU in the case of CEECs). On the other hand, if we observe both regionalization and globalization, poorer countries may be able to catch up even without belonging to any bloc. Furthermore, if the latter is the case, CEECs will most probably have to play two games simultaneously, both joining the EU and becoming involved in the global division of labor.

Do the stylized facts show that we are proceeding in the direction of a tripolar world or is the division of labor becoming closer, not only at the regional level but also between the three regional poles? Those poles are “Europe” (the EU, EFTA, and Central and Eastern Europe), “America” (the U.S., Canada, and Latin America), and “Asia” (Japan, Australia, New Zealand, and developing East and South Asia).

The first stylized fact is that the share of intraregional trade in world exports increased between 1980 and 1996. That might suggest that regionalization has been dominant over globalization. However, the share of intra-European trade in world trade has held steady at about 30 percent. Ironically, the increasing trend in the overall share of intraregional trade is entirely due to Asia, the only one of three poles without the institutionalized regionalism exemplified by the EU or the North American Free Trade Agreement (NAFTA).

The second stylized fact is that, not surprisingly, the share of intraregional trade within a region’s total trade is highest in Europe; that share increased only marginally between 1980 and 1996. Consistent with the first stylized fact, the increase in this indicator is greatest in Asia.

The third stylized fact is that the increasing trade intensity within Europe has not come at the expense of America or Asia (see Table 8). Trade intensity is a measure of whether trade with a given partner is more of less significant than the economic size of that partner would suggest. A trade intensity in excess of unity indicates a bias toward a given partner.

The evidence shows that, not surprisingly, in both 1980 and 1996, intraregional trade intensity was above unity. Did the increase in intra-European trade intensity come at the expense of trade with America and Asia? The answer is negative, since trade intensity with America remained roughly constant, while that with Asia, traditionally fairly low, increased somewhat. The only case where increasing intraregional trade intensity occurred simultaneously with declining trade intensity with other regions was America.

Between 1980 and 1996, trade expanded within all three regions, but European exports to the other two regions expanded by even more. The growth in European trade with Asia occurred from a low base, but even so, it is clear that both regionalization and globalization are taking place.

The fourth stylized fact is that data on FDI flows reflect both regionalization and globalization. European FDI is heavily concentrated within Europe, but European investors have been increasing their activity in Asia, again from a low base. FDI from Asia is heavily concentrated in America, but Asian FDI within Asia has grown rapidly.

Table 8: Trade Intensity[a] Within and Between America, Asia, and Europe[b]

Exports from		Exports to		
		America	Asia	Europe
America	1980	2.18	1.06	0.56
	1996[c]	2.31	0.86	0.45
Asia	1980	1.24	2.50	0.37
	1996[c]	1.07	2.03	0.40
Europe	1980	0.43	0.30	1.41
	1996	0.42	0.37	1.69

[a]Calculated as: $I_{ij} = (X_{ij} / X_i) : (X_{wj} / X_w)$, with: X_{ij} = exports of region i to region j; X_i = total exports of region i; X_{wj} = world exports to region j; X_w = world exports to all destinations.
[b]America: Canada, U.S., and Latin America; Asia: Australia, Japan, New Zealand, and developing countries in "other Asia" (excluding Middle East); Europe: all European industrial countries and Central and Eastern Europe (excluding former USSR).
[c]Exports in 1995, instead of 1996, for Australia and New Zealand, Japan, and United States.

Source: UN Monthly Bulletin of Statistics.

Table 9: Trade Intensity of Central and Eastern Europe[a] with Selected Trading Partners

	Industrial countries in Europe	Central and Eastern Europe[a]	Canada and United States	Latin America	Japan	DCs in Asia[b]
A: CEEC exports to selected trading partners[c]						
1980	0.50	6.04	0.12	0.30	0.06	0.40
1992	1.10	6.57	0.14	0.28	0.14	0.43
1996	1.53	7.19	0.15	0.23	0.07	0.22
B: Exports of selected trading partners to CEECs[d]						
1980	0.51	6.04	0.24	0.40	0.15	0.33
1992	1.34	6.57	0.22	0.26	0.14	0.30
1996[e]	1.51	7.19	0.15	0.16	0.08	0.31

[a]Excluding former USSR.
[b]Excluding Middle East.
[c]Share of CEECs' exports to the particular trading partner in total exports of CEECs, relative to the share of the trading partner's overall imports in world trade.
[d]Share of the particular trading partner's exports to CEECs in the trading partner's total exports, relative to the share of CEECs' overall imports in world trade.
[e]1995 for exports of Japan and United States.

Source: UN Monthly Bulletin of Statistics.

One implication for Central and Eastern Europe of these stylized facts is that if CEEC decision-makers concentrate excessively on Europe, they may miss opportunities to export to countries outside Europe and to attract FDI from there. Some facts are reassuring: the U.S. is the second largest foreign investor in Central and Eastern Europe and even Japan, whose total investment in the region ranks relatively low, is ahead of such countries as the U.K. and France.

However, with respect to trade, there is a strong bias in favor of European partners. Central and Eastern Europe's trade intensity with the industrial countries of Europe increased tremendously between 1980 and 1996 (see Table 9). This is to be expected on the basis of gravity models. Nonetheless, there may be grounds for concern in the extremely low and declining trade intensities with Asia and Latin America.

This suggests that some policy-makers in CEECs are excessively interested in regionalization, which will hurt the region's chances of catching up by attracting FDI. For example, if trade with Japan continues to decline, it will reduce CEECs' attractiveness to Japanese investors. Current thinking in economics tends to see FDI and trade as complements rather than substitutes.

7.2 Are Trading Blocs Emerging in World Economy: Empirical Evidence and Economic Policy Evaluation[25]

The question of whether three trading and (possibly) investment blocs are emerging is important for Central and Eastern Europe (CEE), because if so, CEE's options will differ from what they would be in a situation where this were not the case.

We can define three related concepts, the first being bloc formation, which means a relative *concentration* of trade or investment among groups of countries which have signed a formal agreement on integration. The second concept is *regionalization*, which refers to the same thing as bloc formation, except that the agreement is informal. The difference between these two notions is important, because in the case of the former, policies play a role, while the latter may be due to spontaneous factors. The third concept is *polarization*, which means that the trade of a region is totally focused on another one, an example being African trade with Western Europe.

We can examine a "network of world trade," which is a sort of input-output matrix showing trade within and among eight regions of the world in 1960 and 1995 (see Table 10). The regions are Western Europe, Japan, North America, CEE, Africa, Asia (including Australia, South Asia, East Asia other than Japan, and the Pacific islands), Latin America, and the rest of the world (mainly the oil-exporting countries). Total world trade over this period rose from $128 billion to $4.89 trillion. The share of

Western Europe in both exports and imports increased because of the free trade arrangement in that region. Japan's exports as a share of world trade rose, America's declined, and Africa's collapsed, as did CEE's.

[25]This section summarizes the presentation of the paper of the same name by Jacob Kol.

Table 10: Network of World Trade, 1960 and 1995 (percentage distribution)

1960 **Region of Origin**	**Region of Destination**								
	WE	**JPN**	**NA**	**CEE**	**AFR**	**ASIA**	**LA**	**ROW**	**World**
Western Europe	23	•	4	2	3	3	3	2	40
Japan	•	•	1	•	•	1	•	•	3
North America	7	1	5	•	•	2	3	1	20
CEE	2	•	•	6	•	1	•	•	10
Africa	3	•	•	•	•	•	•	•	4
Asia/Oceania	3	1	1	1	•	3	•	•	10
Latin America	3	•	3	•	•	•	1	•	8
Rest of World	2	•	•	•	•	•	•	•	4
World	42	3	16	10	5	11	8	4	100
1960 Total World Exports: $128 billion									
1995									
Western Europe	31	1	3	2	1	3	1	2	45
Japan	2	•	3	•	•	4	•	•	9
North America	3	1	6	•	•	3	2	•	16
CEE	2	•	•	1	•	•	•	•	3
Africa	2	•	•	•	•	•	•	•	2
Asia/Oceania	3	3	4	•	•	7	•	1	18
Latin America	1	•	2	•	•	•	1	•	4
Rest of World	1	1	•	•	•	1	•	•	3
World	43	6	18	3	2	19	5	4	100
1995 Total World Exports: $4,890 billion									

Source: For 1960, own calculations from UN trade database. For 1995, own calculations from WTO *Annual Report*, 1996.

Note: • indicates trade flow is less than 0.5 percent of world exports.

In the matrix for 1995, Western Europe is the only region with a full row and a full column, where cells in the matrix are left blank if the percentage of world trade in that cell is less than 0.5 percent. This is true neither of America nor Japan. This would make it appear that Europe is the natural champion of the cause of the WTO (more on this below). Africa exports to Western Europe only and imports only from that region, and the same thing is largely true for CEE. Another fact about the latter is that trade within CEE has fallen from 6 percent of world trade in 1960 to 1 percent in 1995. Africa's and CEE's focus on Western Europe is not a positive phenomenon, but we must remember that CEE has started on its new regime only very recently.

If we look for evidence of polarization, we see that African countries in both 1960 and 1995 did not trade much within their own region, but largely with Western Europe. This is why Africa is not interested in the WTO negotiations, but wants preferential access to the EU market. But African trade represents only 3 percent of the EU's total. Similarly, CEE in 1995 was totally focused on Western Europe, after focusing on intraregional trade in 1960, while it remains a minor market for the EU. For Latin America, we see the same trade polarization, in this instance with respect to North America.

However, matters are different in Asia. In the 1960s, many Asian countries still had colonial ties with Western Europe, so trade focused on that region. Asian intraregional trade increased between 1960 and 1995, but Asian trade is now spread evenly across Western Europe, Japan, and North America. This is not surprising, since these countries are industrializing, so that is normal for them to trade with each other; when they specialized in primary commodities, they tended to trade with the North. The even distribution of Asian trade may explain why these countries supported a multilateral trade environment in the Uruguay round negotiations.

Does the intensification of internal trade within the EU reflect hostility toward the outside world? There is intensification of trade within regions, which we would expect given existing integration schemes. Indeed, intra-EU trade as a percentage of extra-EU trade rose from 55 percent in 1960 to 176 percent in 1996. The story is more or less the same for primary products and manufactured goods. Due to the CAP, the increase is even larger (from 41 percent to 234 percent) for food products; there has also been a larger than average increase for road vehicles. The smallest increase is for textiles and clothing.

From a policy standpoint, NAFTA and Asia Pacific Economic Cooperation (APEC) are based on deregulation and liberalization, both internally and worldwide. In contrast, EU trade policy is highly discriminatory, contradicting the WTO principle of non-discrimination. The EU discriminates by signing separate agreements with individual countries and regions (e.g., Malta, Turkey, Israel, North Africa, the Middle East, the Europe Agreements, the Lomé Convention, the GSP). It also discriminates sectors for given trading partners in its antidumping procedures.

However, this is only part of the story. The 1992 program provides for a massive amount of internal deregulation and liberalization. The European Commission subsequently took the initiative to extend these moves beyond the EU in such areas as banking, insurance, and telecommunications, allowing countries from outside the grouping to compete on its markets.

To conclude, we can say that trading blocs are emerging in Africa and CEE and within the EU to the extent that intra-EU trade has intensified. But this is not the case with respect to policy-making in the EU, NAFTA, or APEC. Furthermore, multination companies are keeping the world market as open as possible.

Discussion of Previous Two Papers

In the discussion, one participant noted that, while he agreed with the papers' policy conclusions on not ignoring economic relations with non-European countries, Central and Eastern Europe's high trade intensities with Western Europe and within its own region were explicable based on the standard gravity model. Trade intensity takes into account only the size and level of economic development from among that model's explanatory variables. The flowering of trade between CEE and the EU has been fostered by the agreements signed between them, especially the Europe Agreements. Accordingly, there is no evidence of CEEC leaders having made any policy mistakes. The rejoinder was that the EU has paid a price in terms of lost opportunities for trade and investment, especially in Asia, for its preoccupation with the single market, and that CEECs should not make the same mistake.

Looking at the data on trade shares from a different angle, it emerges that the only bilateral relationship in which Western Europe raised its share between 1960 and 1995 was intraregional trade. This may imply increased regionalization. If so, it could be explained by market factors (i.e., more specialization within Europe), which would be positive, or by institutional ones, which may be unfortunate (if it is the result, e.g., of the CAP). It might also reflect a decline in competitiveness on a global scale, working either through being crowded out of other markets or being forced to build up the local market because of an inability to compete globally.

One discussant argued that new members of the EU will be very restrained in voicing their opinions in the European Commission on the choice between regionalism and globalism. In reply, it was noted that new members will have an impact on the Commission's decision-making; the presentation by Widgrén showed that the Commission's power is increasing, which will have implications for this issue. In any case, previous fears about Fortress Europe proved to be unjustified.

The discussion turned to the question of whether with enlargement, the EU will not inevitably become more self-absorbed. It was noted that it was natural for the massive single market program to be the main focus of attention in 1992. However, the Commission realized very quickly that if the EU was to maintain its relative position in the world in terms of income per capita, it must have extensive trade and investment relations beyond its own borders.

The main impetus for this view came not from politicians, but from the roundtable of industrialists from such companies as Philips, Shell, Unilever, and Siemens. In fact, there were two strains of thought in the grouping. Philips held that the single market meant that European producers should be able to first sell their products on a sheltered market and then go outside the EU once those products were established. The other view, which was embraced by Unilever and Shell and which won the day, held that Europe should not be a protected market. There has also been a change in the EU's attitude toward foreign trade over the years, as a mercantilistic view espoused by the French has been eclipsed by views more favorable to free, nondiscriminatory trade relations favored, for example, by the U.K. and Sweden. But there are still battles to be fought over such products as cars and bananas and over the CAP.

Multinational companies have played a big role in shaping the internal market; such corporations are more favorably disposed toward having an open world market than politicians, who tend to be more nationalistic. Individual nations often come up with policies that tend to fragment the world market, examples being non-tariff barriers and trade-related investment measures. The multinational companies avoid import barriers by “tariff jumping” or in other ways, and if a country requires too much of them in terms of local sourcing, they locate in a neighboring land. They also need a certain guidance, and the OECD is dealing with that issue through the drafting of new agreements governing their conduct.

One discussant noted that a major reason why East Asian trade was more diversified than that of Latin America or Africa is that East Asia has grown more rapidly; trade diversification can be viewed as something of a normal good, especially in view of the high transactions costs of diversifying one’s trade relations. The view that CEECs should not ignore the rest of world has disturbing policy implications if it means that those countries should devote scarce resources to sending trade delegations to distant markets. The extent of the diversification a country’s trade relations may be a function of fundamental economic variables and not very sensitive to policy measures.

In response, it was observed that East Asia’s trade success was related to policy matters, including those promoting macroeconomic stability, high domestic savings and investment, and human capital formation. Those factors that led to success at the regional level in East Asia triggered success at the global level. Moreover, belonging to a trade bloc is less important than having sound economic policies, as we observe from the greater success of some EU members, such as the U.K. or the Netherlands, in attracting Japanese FDI than others.

The discussion then focused on the relevance of certain trends in world trade, such as the growing roles of trade in services and intra-firm trade, for CEECs. Although these tendencies have probably not yet made themselves felt strongly in the region, they demonstrate several important points. The prevalence of intra-firm trade – by one estimate such trade makes up about half of world trade – shows that trade and FDI are no longer substitutes. The unhappy experience of Latin America, which tried to attract FDI by erecting trade barriers, relative to East Asia, where they have long appreciated the complementarity between trade and FDI, demonstrates this point.

Moreover, FDI and intra-firm trade are related in complicated ways. For example, in CEE we do not know to what extent U.S. investors are importing from their subsidiaries in Western Europe. This depends on whether the West European subsidiaries are investing or the capital is coming directly from the U.S. In any case, the sequencing that used to hold in earlier times – that trade came first, then once the local market had become difficult to maintain or was too small or because of high tariffs, comes FDI – no longer applies. Investors come to small CEE countries for sourcing purposes, and sourcing means that FDI comes first and is followed by trade. In any case, it seems that market forces are more important than political ones in determining trade patterns, although we should not underestimate the latter, as demonstrated by the EU’s special treatment of the so-called sensitive sectors.

Trade in services has grown rapidly throughout the OECD. With rising per capita incomes, services have become a larger part of the economy. Furthermore, with technological improvements in transportation and communications and the spread of international finance, trade in services tends to grow faster than their production.

It was remarked that Western Europe’s large share of world trade is mostly a scale phenomenon, that is, it is because its GDP is so much larger than other regions’. The response was that the U.S. is not very different in scale, and yet has relatively insignificant trade volumes with many regions of the world, which cannot be said of Western Europe.

One serious issue is what will become of trade between countries joining the EU and the former Soviet republics, especially Russia and Ukraine. Estonia's signing of a free trade agreement with Ukraine, which governed a tiny amount of trade, caused great concern in Brussels, even before Estonia had begun accession negotiations.

The extent of regionalization and globalization varies greatly across the main commodity groups. Within the EU, for agricultural commodities, there is a higher than average degree of regional concentration of trade (due to the CAP), while for CEE and Latin America, but not East Asia, machinery has this characteristic. At present, intra-CEFTA trade is concentrated on raw materials, chemicals, and intermediate products, and most machinery production is sold to Western Europe, which may be seen as a favorable pattern.

7.3 Globalization and Regionalization in Central and Eastern Europe[26]

This paper presents a larger, more politically oriented picture of globalization and regionalization, two processes that will in the future create the context for EU enlargement. The EU is not synonymous with Europe, but the enlargement process is reducing the gap between the two. That process is now moving in an eastward direction, after the southwestern, western, and northern enlargements that occurred previously. Indeed, the issue of enlargement is now also the issue of Europe's eastern border.

We analyze here not so much the formal accession process, but the underlying reasons for the "urge to merge" that is prevalent now all over the world. Indeed, there are few countries that are not involved in some type of integration scheme, with even Burma on its way into the Association of Southeast Asian Nations (ASEAN), although North Korea remains an exception in this regard. There are also various schemes in Europe that cut across EU lines, such as the Council of Baltic Sea States CEFTA (after some of its members accede to the EU).

We are witnessing a new regionalism, which can only be understood in the context of the ongoing globalization process, and which is in fact a reaction to globalization. In an earlier presentation, it was stated the EUREKA favored globalization, so that European firms could compete with firms from all other the world, particularly Japan and the U.S. Technological globalization may be a good thing, and in any case it is inevitable, since technological secrets cannot be maintained for long.

But economic and financial globalization, especially the latter, have been under considerable debate, largely as a result of the East Asian crisis. Relatedly, there are those who believe that economic restructuring without regard for its social consequences may be counterproductive, even in terms of economic criteria in the long run. The current vulnerability of the Polish and Estonian peasantry is a case in point.

[26]This section summarizes the presentation of the paper "Globalization, Regionalism, and the Europeanization of Europe" by Björn Hettne.

We will probably see a good deal of social and ethnic unrest in East and Southeast Asia following the (necessary) restructuring of their economic and financial systems.

Based on the work of the Hungarian economic historian Karl Polányi, in his *The Great Transformation*, we can argue that the logic of the market, its tendency to disembed the economy from society, causes social and political turbulence. A period of market expansion, what Polányi called the "first movement," is followed by one of political retrenchment, which he termed the "second movement." Together, these two movements form the Great Transformation, which covers much of twentieth century history – the free trade era, the Great Depression, and the many types of political interventions that followed, including communism, fascism, and social democracy.

After World War II, we have seen a new phase of market expansion, under the Bretton Woods system, which might be called the "compromise of embedded liberalism," meaning internationally free trade and domestic regulation based on Keynesian theory. Globalization started with the breakdown of this compromise in the early 1970s. Today, the distinction between the domestic and international economies no longer makes sense. Nonetheless, there will be different types of political reactions to this trend, and some of them will be ugly and destructive.

Other types of political reactions will perhaps lay the groundwork for a second great transformation, a new disembedding of the global market into some kind of political framework. One aim of that transformation would be to reduce the gap between the financial economy (what Susan Strange calls "casino capitalism") and the real economy. Another would be to provide shelter for the Polish peasant and other vulnerable groups, which represent a very large percentage of the population in many countries (e.g., China's 100 million-strong "floating population," whose ranks will probably increase because of the current Asian crisis).

An important component of current trends is the new regionalism, which is occurring in a multipolar world, that fact being the main difference between it and the old regionalism. The latter was deformed by the Cold War, which had a strong impact on regional cooperation in most regions, as we saw the U.S./Soviet division in Europe, East Asia, and Africa, among other regions. World regions are now developing spontaneously and from below. There are more actors involved than nation states, and the regions are multipurpose. It is no longer simply a matter of trade and economic cooperation, but also cooperation on ecological issues, peacekeeping, conflict intervention, and so on. In the long run, these new regions may even develop into "region-states," which may be more similar to modernized empires than nation states. So far, Europe, with its Maastricht project, is the only example of this tendency.

We can thus speak of a "post-Westphalian" political rationality, which may become more prevalent in the next century. The 350th anniversary of the Peace of Westphalia will be celebrated in 1998 and we can say the Westphalian era has ended. We can divide the post-Westphalian world into 17 unequal regional groupings, which can be designated as *core*, *intermediate*, or *peripheral*. Some of these groupings are formally institutionalized, while others are only embryonic. Regionalism can be seen as merely something that occurs in a given geographical area because, for example, of close networking. Such is the case in East Asia, where there is no formal regional grouping, but Japanese capital and Chinese entrepreneurship provide the basis for ever deeper integration.

The *core regions*, which are rich and powerful, influence the rest of the world. The intermediate ones approach the core in terms of economic policy, political regime, and political stability, while the peripheral ones are characterized by underdevelopment and civil war. The core regions are North America (as symbolized by NAFTA), Europe (basically the EU), and East Asia.

The *intermediate regions* are CEE (waiting for EU membership); MERCOSUR (which stands for Mercado Común del Sur, and may become part of a continental free trade area, although cultural problems may lead to polarization between it and NAFTA); the ASEAN states (which is growing into one region with East Asia); the European Pacific (Australia and New Zealand) and the South Pacific, both of which are being drawn by Japanese capital into the larger East Asian economic space; and coastal China, which has applied similar economic policies to East Asia and has perhaps the most impressive growth rate in Asia. Regions on the border between intermediate and peripheral include southern Africa, because of the role of South Africa and the peace in the former Portuguese colonies after ten or twenty years of civil war; and North Africa, which would be close to becoming part of a Mediterranean economic space if not for the Algerian problem.

Among the *peripheral regions*, we may number the Commonwealth of Independent States, which has great potential to move upward as soon as its internal problems are solved, which should happen within five to ten years; the Balkans, a hopeless case, with a lack of development and an absence of cooperation; the Middle East, because of the absence of progress in the peace process; the nations of the South Asian Association for Regional Cooperation, which is peripheral because of the lack of cooperation between India and Pakistan, which keeps the entire region in a low position; Indochina plus Burma, a region on its way into ASEAN, with only Cambodia on the waiting list, although Vietnam, Laos, and Burma are not comparable to the other ASEAN members; inland China, which has missed out modernization and lags for behind the rest of the country; and the rest of Africa, particularly Central and East Africa and possibly West Africa.

There is a new political map of the world, with geographical Europe appearing on all three structural levels (core, intermediate, and periphery). Politically, Europe is defined by the economic, political, and minority-rights criteria implied in the process of EU enlargement. Europe has no explicit cultural definition. But there is also a “real Europe” that is growing spontaneously out of the new networks arising after the Cold War. From this standpoint, it makes more sense to integrate sub-regions – such as the Nordic region, the Baltic region, CEE, the Balkans – rather than individual countries, into the EU.

In any case, the new larger European landscape will consist of smaller sub-regions. It does not make sense to leave out a country that forms an integral part of a particular sub-region (as the EU has done in the case of Slovakia) or to choose one country within a sub-region (as it has done in the case of Estonia). Norway has voluntarily stayed out of the EU, but that only means that it is part of the EU economically but cannot influence its decisions. There seems to be no long-term strategy of enlargement; unfortunately, we are in a phase of short-sighted national politics.

The answer to this regression to Westphalianism in a post-Westphalian age is to build the regions from below, through networks and civil societies which transcend nation-state borders. In the long run, this should also happen in the Balkans, where there is an extraordinarily low level of regionalism, although there is a European movement even in Serbia, which should be supported in its fight against fascism.

Discussion of Previous Paper

In the discussion that followed the paper, it was pointed out that there is a fear in the EU and in CEE that regionalization will lead to fragmentation, not only in a geographical context, but also in a cultural, functional one. Economic developments are moving much faster than political and institutional ones: the CEECs are already highly integrated at the micro level into EU economic structures, if one looks at trade shares, FDI, or tourism flows, but such tendencies are much less clear in institutionalized politics. Generally speaking, regionalism can be interpreted either positively (i.e., bringing smaller units together) or negatively (i.e., breaking up larger blocs), both of which are occurring in Europe.

In response, it was noted that regionalization implies both integration and disintegration, since as one builds new structures one destroys the previous formations. Mercantilists built the modern nation-state, thereby destroying many local feudal structures. In Europe, one can distinguish between macro-regionalization and micro-regionalization, with the former referring to the overall process of enlargement. At the same time, there are possibilities for new interactions between various sub-national regions, a development that will occur at the expense of the nation-state. Micro-regionalism is a practical and nonviolent process of transformation, which can be contrasted with "morbid Westphalianism," an ethno-national trend evident in the Balkans.

Another discussant noted that the Westphalian approach is Euro-centered; in other parts of the world, there are quite different trends. In any case, the Peace of Westphalia marked the establishment of colonial regimes, introducing a long period during which great empires ruled the world. Today, in many parts of the world the end of the Westphalian order has seen the establishment of many small states. By one count, there are about 5,000 ethnic groups in the world that could claim national independence on the basis of the UN charter. Relatedly, the disintegration of the Soviet Union, the last great empire, has perhaps created the danger of the emergence of new regional powers, around which a number of client states cluster. If such happens, it would mark a return to the traditional power structure of the world.

In response, it was acknowledged that the Westphalian notion is Euro-centric, but added that with decolonization the entire world was organized into nation-states, which needed to defend themselves and create alliances, notions that had arisen in Europe. Many of the nation-states created from the old colonial areas were artificial, leading to a second liberation in many countries in South Asia and Africa, where the elites who had inherited the colonial states are being challenged. But this process will not result in more than a handful of new states, because the level of integration on the global level has reached such a point that a further creation of myriad new states would defeat its own purposes. On the emergence of new regional powers, we can only hope that these will be benevolent hegemons, as seems to be the case with South Africa. India could play that role in South Asia, as could Argentina and Brazil in South America, but there are also such cases as Iraq.

A discussant remarked that in the current debate on globalization, the power centers – the EU, the U.S., and Japan – are displaying the most concern that economic integration will reduce their economic welfare. Several decades ago, there was concern about exploitation of the periphery by the core, so the anxiety about such integration occurred in the periphery. Today, the rich part of the world fears that its wage levels or wage structure will be changed by trading freely with weaker partners.

Another discussant noted that when the nation-state was integrating internally, it had a tendency to be less cooperative with the outside world and to be more aggressive. More recently, when the EU was strengthening itself internally, it became more cooperative, at least in the medium term, with the rest of the world. In response, it was noted that countries in the intermediate position tend to favor an open regionalism. However, for ones on the periphery, there remains a need for cooperative schemes of infrastructural development and industrial policy, of the same kind that was born in the nation-state in the 19th century. In the latter, there is a need for a temporary exclusion from the rest of the world to build up an institutional base; otherwise, these countries will become clients to various regional powers.

Another question concerned the identity of the actors in the new regionalism, whether they will be the state, multinational companies, the business sector, or international organizations. In reply, it was observed that the most that could be said at the moment is that there will be more actors than in the old days. Today, there is a different kind of networking, with business groups and various movements organized in regional contexts. The state tends to be conservative and slow-moving compared to these other actors.

A discussant observed that in the process of accession to the EU, the state will be in the strongest bargaining position relative to the European Commission. However, much of CEFTA trade is being driven by the multinational companies, a tendency that will likely be even more pronounced after CEECs join the EU. It was reiterated that what makes the new regionalism new is that it is occurring in a multipolar world (after the Cold War); that it is a multipurpose, multidimensional process, covering ecology, security, and so on. For instance, MERCOSUR is a distinctive regional organization because it is a political project which emphasizes security and maintaining regional credibility by facilitating political stability. A discussant noted, however, that purely in economic terms, it was unclear that MERCOSUR really exemplified an open regionalism. Another participant noted that, even in economic terms, current tendencies toward greater regional integration display qualitatively new features.

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In closing the conference, András Inotai noted that the next enlargement of the EU will be the first to take place in a changed global environment. All earlier enlargements were largely intra-European affairs. This means that the EU has to take into account global challenges that it did not have to deal with previously. For the applicant countries, it means that they face a threefold challenge: those arising from the global context; those arising from accession; and those arising from various aspects of regional cooperation.

The future of Europe and the success of accession will substantially depend on whether these three requirements can be put into a viable framework. If this project fails, the consequences will be a loss of global competitiveness, missing out on accession, or an undermining of regional cooperation, which would have major macroeconomic implications for everyone concerned. Global challenges are occurring on two levels, the institutional level and the business level. A shift between these two challenges is taking place, a fact that applicant countries must take into account in their accession strategies, which is no easy task.

APPENDIX I: Workshop Program

Program for the Workshop on

European Union vs. the Rest of the World: Complements or Substitutes for Central and Eastern Europe?

4–6 December 1997

Hotel Mercure Buda, 1013 Budapest

Organized jointly by IIASA, the Swedish Ministry of Foreign Affairs and the Hungarian Strategic Task Force for European Integration

Thursday, 4 December

14:00 Opening of the Workshop

14:15 Introduction: **János Gács** and **András Inotai**

14:20 Latest Developments in the Process of Accession — Updates from the Applicant Countries — *Chair*: **János Gács**

Czech Republic:	**Petr Pomezný**
Bulgaria:	**Rossen Rozenov**
Hungary:	**András Inotai**
Lithuania:	**Ramūnas Vilpišauskas**

14:50 Questions and Discussion

15:20 *Coffee Break*

15:40 **SESSION I:** Common External Tariff, Common Commercial Policy and Centralized Trade Negotiations

Mika Widgrén: The Expected Implications of EU Enlargement on Common Policies Such as Trade Policy

16:00 Discussion

16:15 **Zdeněk Drábek:** Common External Tariff and Domestic Adjustment in the CEECs

16:35 Discussion

16:50 **SESSION II**: The Future of Bilateral Relations and Regional Cooperation/Integration Crossing EU Lines

Katharina Helmstedt: Effects of EU Membership on Austria's Trade with Non-EU Countries, Such as Japan, South-East Asian and Middle East countries

17:30 Discussion

18:00 End of Discussion

18:30 *Reception in the Ministry of Industry, Trade and Tourism*

Friday, 5 December

09:00	Latest Developments in the Process of Accession — Updates from the Applicant Countries — *Chair*: **Jacob Kol**	
	Estonia: **Katrin Kanarik**	
	Latvia: **Inna Šteinbuka**	
	Slovenia: **Andrej Kumar**	
	Poland: **Władysław Piskorz**	
	Slovakia: **Jarko Fidrmuc**	
09:30	Questions and Discussion	
10:00	**SESSION II:**	The Future of Bilateral Relations and Regional Cooperation/Integration Crossing EU Lines (continuation)
	Katrin Kanarik:	The Future of Regional Integration Crossing EU Lines — An Estonian Perspective
	Rossen Rozenov:	Bulgaria's Trade and Development in Case Some East European (CEFTA Member) Countries Become EU Members Earlier than Bulgaria
10:40	Discussion	
11:10	*Coffee Break*	
11:40	**SESSION III:**	FDI – The Effects of NATO and EU Membership on Investments from Non-EU Investors
	Matija Rojec:	The Prospects of FDI (from EU and Non-EU Countries) in the Countries Joining EU and NATO
	Tsuneo Morita:	Past Experience and Expectations with Respect to EU Enlargements from the Point of View of Japanese Investors
12:20	Discussion	
12:50	*Lunch*	
14:40	**SESSION IV:**	Integrated European Capital Market and the Impact of the Euro *Chair*: **Petr Pomezný**
	Nuno Cassola:	The Portugese Experience with Capital Flows After Accession
15:00	Discussion	
15:20	**SESSION V:**	Technological Cooperation: EU Programs Limited to Europe or Broader Schemes?
	Benno Schmidt-Küntzel:	The Opening up of EUREKA to Globalization and to the Request of European Industry
15:40	Discussion	
16:00	*Coffee Break*	

16:30	**SESSION VI:**	Agriculture
	Władysław Piskorz:	Chance and Challenges of EU Accession: Poland's Farming Sector Perspective
	Judit Kiss:	Is CEFTA a Substitute or Supplement to EU Accession? The Case of Agricultural Trade
17:10	Discussion	
17:40	End of Session	
19:00	*Dinner*	

Saturday 6, December

09:30	**SESSION VII:**	Will There Be a Tripolar World? New Regionalism and the Eastern Enlargement — *Chair*: **András Inotai**
	Peter Nunnenkamp:	Trends and Future Prospects of Trade and FDI *within* Europe and *between* Europe, America and Asia
	Jacob Kol:	Are Trading Blocks in the World Economy Emerging? — Empirical Data and Economic Policy Evaluation
10:10	Discussion	
10:40	*Coffee Break*	
11:10	**Björn Hettne:**	Globalization and Regionalization in Central and Eastern Europe
11:30	Discussion	
11:50	Concluding General Discussion	
13:00	*End of Workshop and Lunch*	

APPENDIX II: List of Workshop Participants

List of Participants
for the Workshop on

European Union vs. the Rest of the World
Complements or Substitutes for Central and Eastern Europe?

Hotel Mercure Buda, Budapest, Hungary, 4–6 December 1997

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Ministry for Foreign Affairs
Sweden

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Banco de Portugal
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Mr. Gianfranco Cicognani
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Italian Embassy
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Hungarian Academy of Sciences
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Agricultural Policy Analysis Unit
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