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Strength and Advantages of Eastern Europe — EU's Net Gains from Accession

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Foreword

The International Institute for Applied System Analysis (IIASA) was founded in 1972 to promote collaborative research among scholars of what was in that time called East and West. Its founding national member organizations were from both of these regions.

The Economic Transition and Integration Project of IIASA deals with the transformation of former centrally planned economies to the market system. In its activity the project focuses especially on the international economic relations of the transition economies and their integration to the world economy.

Currently, ten transition economies have Association Agreements with the EU (the so-called Europe Agreements) and each of them aims at full membership in the EU in the near future. Four IIASA member countries (Hungary, Poland, Slovakia and the Czech Republic) and Slovenia have the greatest chances to begin official negotiations soon. In the coming years, the economic policy of these Central and East European countries (CEEC) will certainly concentrate on fulfilling the requirements for EU membership.

While research on EU accession has become intense, no or very few research projects encourage interaction among the countries that aspire to EU membership. Based on these considerations, IIASA has initiated a series of seminars that promotes the exchange of views and understanding among the transition countries aspiring to EU membership. In this project entitled *The Process of EU Accession — Preparation by Learning and Exchange* IIASA can also induce the utilization of recent experiences of those IIASA member countries that joined the EU in 1995 (Austria, Finland and Sweden). The organization of these seminars can also benefit from the research results of the Economic Transition and Integration Project of IIASA that accrued since it began in 1990.

This paper summarizes the results of the first seminar in this series entitled *Strength and Advantages of Eastern Europe: EU's Net Gains from Accession.*

The underlying idea of the seminar was the following. The East European applicant nations must clarify their position before starting negotiations about EU membership conditions. There is a widespread superficial view on EU enlargement according to which the new members only bring burden and additional costs for incumbent members. This is obviously not true: new members will add new qualities to the union in various dimensions. Helping to make East European applicants aware of their strength and weaknesses in the context of EU membership would certainly contribute to a smoother accession process. Moreover, the net benefits of enlargement should be viewed not only in terms of economics, but in a wider sense: issues such as political security, the quality of the natural environment should also be taken into account.

The seminar Strength and Advantages of Eastern Europe: EU's Net Gains from Accession was held at IIASA, Laxenburg on 5–7 December, 1996. Participants came from many countries but most of them were experts from five applicant countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia (see the Appendices for the program and list of participants of the workshop). This report summarizes the presentations and discussions of the workshop. The organizers of the workshop hope that with the distribution of this report more scholars, policy makers and experts will deliberate and discuss the net benefits and advantages associated with the EU's enlargement, and IIASA's initiative to enhance cooperation among applicant countries will get more support.

The report is structured as follows: the first section summarizes the most recent developments in the accession process of CEEC.

The second section provides a summary about different quantifiable benefits from the setting up and enlargement of integrations. This section also presents the recent trends in trade between the EU and CEEC. It shows that the initial fears of fully different specialization patterns in the two regions do not seem to be confirmed; rather, we can see that trade among EU member states and with the CEEC is becoming more similar. A significant feature of the relations among member states of the EU is the growing share of services trade. The CEEC may therefore expect a fast development of the service sector in trade during and after the accession to the EU. The last contribution in section 2 analyzes the comparable development observed after Spain's accession to the EU.

The third section provides a comparison of competitiveness between the EU as represented by Austria and the CEEC. The development of capital flows following accession may bring a crucial change for both old and new members. A possible scenario of surge in capital inflows following accession is analyzed in the subsequent subsection on the example of Spain.

Section 4 focuses on agriculture. Due to the sensitivity of agriculture in the member states of the EU and the CEEC, the integration of Eastern and Western European agriculture is often seen as the hardest problem for the enlargement. This section analyzes the possible approaches to reform of the Common Agricultural Policy (CAP) in the EU and its consequences for the new members.

Section 5 presents the relationship between environmental policy and EU enlargement. Currently, the proposal for integration of the CEEC into the EU is the strongest incentive for improving environmental standards.

Section 6 deals with policy and security issues, and section 7 is devoted to the general policy initiative needed to arrange successful negotiations for the enlargement process. Section 8 provides a brief summary.

This report was originally written by Jarko Fidrmuc and subsequently edited and complemented by János Gács.

Some Abbreviations

CAP:	Common Agricultural Policy
CEEC:	Central and Eastern European Countries
CMEA:	Council of Mutual Economic Assistance
EFTA:	European Free Trade Agreement
EU:	European Union. We do not use different abbreviations for European Community (EC) and European Union (EU). If nothing else is mentioned, we apply the EU12 and EU15 regional definitions before and after 1995, respectively.
FDI:	Foreign Direct Investment
GSP:	General System of Preferences
NAFTA:	North American Free Trade Agreement
RCA:	Revealed Comparative Advantage

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Strength and Advantages of Eastern Europe — EU's Net Gains from Accession

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1 Latest Developments in the Process of Accession — Updates from the Applicant Countries

In 1996, the most important developments were very similar in each CEEC. The questionnaire of the EU was the most important issue in the progress of the accession, since all CEEC had to prepare answers to the questionnaire. In the discussions at the workshop it was pointed out that the CEEC had to answer the questionnaire in a shorter period (within three months) than the EU needed for the preparation of these questionnaires (namely five months).

The preparation of the answers contributed significantly to the national analysis of the impact of the accession on the CEEC. Many details of the accession had to be taken into account including the preparation of experts for the negotiations and clarifying relations to other East European countries that will not join the EU in the first wave of the enlargement. In particular, the CEEC already formulated their proposal for the time schedule of the accession (see section 1.2) below.

In economic development, the CEEC showed also similar features. Growth in the CEEC was strong, except for Hungary. On the other hand, the problems on the monetary side (inflation) are more persistent than expected. The slowdown of the development in Germany and other EU member states is mirrored in the growing trade deficit of the CEEC. Increasing trade balance and current account deficits, however, could be covered by capital inflows. The high rate of capital inflows made sterilization necessary in all CEEC.

1.1 Czech Republic[1]

Currently the main goal of the Czech economic policy is the country's integration into the EU; this goal is shared by all Czech political parties without major differences. An important step towards the accession was the preparation of answers to the questionnaire of the European Union that the Czech Republic finished in the summer of 1996. The answers prepared by the Czech government concentrated on the gains and losses following from the accession. Currently, the most important problems seem to be the harmonization of laws and norms with the legal system of the EU.

The priorities of the Czech Republic are located in three areas:

1. Regional policy aiming at a reduction of relatively big regional differences, although regional development in general may still be seen as successful.

[1] This section summarizes the presentation on the recent developments in the Czech Republic by Petr Pomezný and the discussion of some problems of Czech economic policy in a subsequent session of the workshop.

2. Housing;

3. Export promotion in order to tackle the recently increasing trade deficit. The government of the Czech Republic does not share the opinions that were expressed by some analysts that the Czech currency should be devalued in order to improve the trade balance. According to the Czech government, the exchange rate of the koruna is still below its purchasing power parity. Therefore, a devaluation would rather lead to a conservation of some structural problems than improve the situation.

Market institutions in the Czech Republic are more or less in place and the government's policy is mainly aimed at improving the functioning of these institutions. The Czech Republic fulfills currently three out of four Maastricht criteria. The economic policy is mainly concentrating on the situation of the Czech banking sector and the deficit of the current account.

A new aim in the Czech policy is strengthening social peace. The focus on this aim corresponds also to the increased weight of the opposition in the legislation following the parliamentary election in 1996.

1.2 Hungary[2]

Hungary expects that the negotiations on Hungary's accession to the EU could start at the beginning of 1998 and could be finished in two years if both parties are well prepared. Finally, the ratification in all 15 member states and in Hungary as well as the referendum in Hungary could already be finished by 2002.

As a part of this medium-term integration policy, Hungary prepares for the accession mainly in the following three areas:

1. Fulfillment of the Association Agreement in the second phase of trade liberalization between the EU and Hungary, when the asymmetry in the reduction of trade barriers applied during the initial years has to be abolished.

2. Preparing the answers to the EU questionnaire.

3. Anticipating the effects of joining the EU.

Hungary already fulfills the majority of the preconditions for entering the EU as defined in the Copenhagen documents. The approximation of the Hungarian legal system to that of the EU has already made progress and can be finished by the time of the expected accession. In 1995, 65% and 60% of Hungarian exports and imports were related to the EU, respectively. Moreover, machinery makes up 35% of Hungarian exports to the EU. This share, that is the highest among the CEEC, points at the improved competitiveness of Hungarian exports. The human side of accession, however, requires effort: the lack of qualified civic servants for the negotiations as well as for the representation of the country in the EU institutions could become a barrier to accession. Therefore, Hungary is now preparing experts for the EU.

FDI is actively supported by the Hungarian government. As a part of this policy, Hungary extended privatization to the so-called strategic sectors. FDI is expected further improve the competitiveness of Hungarian products.

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[2]The following section is based on the presentation on recent developments in Hungary by András Inotai.

An important aim of the government is the creation of conditions for growth in the next few years. It is perceived, however, that growth has to be based on investment activity and should not be consumption driven.

In the accession negotiations the most important topic for Hungary will be the position of agriculture and trade in agricultural products. While agriculture is of primary importance for Hungary the cost of adjusting Hungarian agriculture to the EU market could be lower than this cost would be in the other CEEC.

Concerning the introduction of the free movement of labor, Hungary expects a long transition period following EU accession.

Hungary is expected to be a net recipient from the budget of the EU. Hungary's favorable experiences with the FDI indicate a high capital absorption capacity of the Hungarian economy that will ensure a high effectiveness in the use of transfers from the EU budget.

Another priority for Hungary is the creation of regional cooperation between the EU (including its new members) and the countries that will not enter the EU in the first wave. The importance of this question for Hungary is determined by security considerations, trade relations of Hungary to other East European countries, and the large Hungarian minorities in countries that are not expected to join the EU simultaneously with Hungary.

1.3 Poland[3]

In the last five years, Poland experienced the highest growth in Eastern Europe. The fast development of the Polish economy continued in 1996. The increasing deficit of the trade balance that emerged in the last two years could be covered by capital inflows.

As for relations with the EU, recently the main attention was paid to preparing the answers to the EU questionnaire, and to fulfilling the membership criteria formulated in Copenhagen. Poland showed good progress in harmonizing the legal system with the norms of the EU, although some problems have been detected in other areas.

One of the problem areas is environmental standards of the EU that have to be applied in the CEEC. The introduction of these standards may worsen the competitiveness of Polish products.

Preparations for the next election may delay progress in some areas of EU accession such as the security system.

1.4 Slovakia[4]

The aim of the Slovak Republic is to take part in the first wave of EU enlargement. Hence, Slovak authorities concentrated on preparing the answers to the EU questionnaire. Although the opposite is often expressed in international media, all major government and opposition parties share the goal of an early EU accession. It is true, however, that significant differences exist in this respect between different political subjects, including the junior coalition members.

Nevertheless, the Slovak Republic shares the expected time schedule of enlargement expressed by the presenter on Hungary with starting negotiations in 1998. The most important gains for the Slovak Republic from the accession to the EU will be increased market access, and better security and political guarantees.

[3] This section recapitulates the presentation on recent developments in Poland by Ewa Synowiec and the subsequent discussion.

[4] This section summarizes the presentation on Slovakia by Igor Kosír.

The harmonization of the Slovak legal system with the laws of the EU has already showed progress. Actually, about 80% of Slovak legislation is already compatible with the EU legislation.

Furthermore, the accession of the Slovak Republic is enhanced by its sound economic development in recent years. In 1995 the growth rate reached the highest figure in Europe with 7.4% and was expected to be again above 7% in 1996. Inflation was expected to stabilize to only slightly more than 5% in 1996. Unemployment is high but declining; it was expected to be 12% in 1996. This positive standing of the Slovak economy has only slightly deteriorated in 1996 when the trade deficit increased to an estimated 8% of GDP.

1.5 Slovenia[5]

The situation of Slovenia is rather specific because it only recently succeeded to negotiate the Association Agreement with the EU. As a result, the Association Agreement between the EU and Slovenia is still in the ratification process. Therefore, the relations between the EU and Slovenia are still regulated by the Cooperation Agreement.

Nevertheless, Slovenia applied for membership together with the other CEEC. Therefore, Slovenia also received and answered the EU questionnaire in 1996. In view of an early start of accession negotiations, Slovenia already started an information campaign on the EU. Concerning the possible problems following from the accession to the EU, Slovenia worries mainly about the lack of human resources for the negotiations.

The Slovene economy was slowly developing in 1996. Growth is based mainly on the expansion of investments and domestic demand. The prospects for the Slovene economy are optimistic as far as no new significant shocks are expected in the next few years.

2 Strength Reflected in Trade

2.1 Net Benefits from the Creation/Expansion of Integrations[6]

There are many stages of economic and political integration starting with a *preferential trade agreement* followed by a *free trade area* and (complete and incomplete) *customs union*. All these trade arrangements are restricted to the goal of increasing liberalization of trade in goods and services. Countries participating in these arrangements do not commit themselves to liberalize the movement of their production factors. Economic policies of these countries also remain uncoordinated.

Further stages of the economic integration (including *common market, economic union and monetary union*) aim mainly at liberalizing the movement of production factors. *Economic and monetary union, political union* and *full union* focuses on improving the coordination of policy among the member states.

Recently we can observe an increasing number and importance of trade arrangements and integration proposals in the world. However, the two most important of these include mostly the developed economies in Europe and Northern America. Integrations of these two continents control about 60% of world trade.

The foundations of the EU were laid down by the Treaty of Rome in 1958 that included six nations (Belgium, France, Germany, Italy, Luxembourg and the Netherlands). According to the classification presented above, the Treaty of Rome introduced an incomplete customs union which was extended to customs union after the introduction of CAP in

[5]This section summarizes the description of recent developments in Slovenia by Marija Adanja and Bojan Radej.

[6]This section recapitulates the presentation by János Gács.

1968, and to the incomplete common market in 1970. The remaining West European nations created the EFTA. However, former EFTA members Denmark, Ireland and the UK joined the European Community in 1972. Furthermore, the EU was extended by Greece in 1981 and by Spain and Portugal in 1986. Through the reunification of Germany in 1991, the EU was again enlarged by the former GDR. In 1993, a common market and economic union was introduced through the single market and the European Economic Area (in the latter with the exception of food products). In 1995, Austria, Sweden and Finland joined the EU. As part of the next enlargement, the Association Agreements signed between 1992 and 1996 with ten East European economies will introduce a free trade area between the EU and the CEEC by 2000.

The base for the integration later called the North American Free Trade Agreement (NAFTA) was provided by the free trade agreement in the automobile sector between the USA and Canada in 1965. This trade arrangement was extended to most industrial goods in 1988. Finally, Canada, Mexico and the USA signed the NAFTA in 1993 that should introduce a free trade area among these countries by 2000. The enlargement of NAFTA by some developed Latin American countries is also expected in later years.

The analysis of the economic impact of integrations usually focuses on static and dynamic effects. The investigation of static effects usually deals with trade and welfare effects.

The standard analysis of the customs union identifies two possible trade effects of a customs union: trade creation and trade diversion. Trade creation involves a shift in domestic consumption from a high-cost domestic source to lower-cost imports from the other participants of the new customs union. Trade diversion involves a shift in consumption from a low-cost third country source to a higher-cost import from the partner countries in the union, as a result of the elimination of tariffs on imports from the partner. Trade creation improves the efficiency of the home country because it releases resources for use in industries where it has a comparative advantage. In contrast, trade diversion is damaging the home country because of the switch to a higher-cost import. The numerous quantitative analyses of earlier EU enlargements showed that trade creation was much more important than trade diversion (except for trade in agricultural products).

Empirical investigations showed a doubling of trade for the first six members of the Common Market in 1955–1969 compared to the hypothetical case that the EC would not have been set up. The first enlargement (with the UK) brought a 50% growth of intra-trade while the enlargement with Spain and Portugal only a 10–15% increase. This decline of integration impacts was due to the more liberal trade base from which new members joined the EU in the 1970s and 1980s.

Welfare effects of an integration are analyzed in relation to three groups: consumers, producers, and tax payers. The classic welfare analysis of the creation of a free trade area with the rest of the world shows a clear welfare gain for the country concerned.

Quantitative investigations were as a rule not very successful to show significant welfare effects of creating or enlarging integrations. They are usually at the level of 1% of GNP but for instance the effect of the accession of the UK allegedly led to a meager 0.11% growth of GDP in the UK. The analysis of welfare effects usually suffers from methodological problems and from the lack of reliable data.

The theoretical literature also discusses several kinds of long-term restructuring effects, such as accumulation effects; increased competition and efficiency; economies of scale; effects on size, growth and learning curve of companies; and increased industrial interwovenness.

While the estimation of dynamic effects meets also numerous theoretical and practical difficulties the impact of the most recent extensions or deepening of integrations can be justified by their tangible dynamic effects, rather than by their insignificant static trade and welfare effects.

For instance, according to the Cecchini report, the aggregate effects of the introduction of the single market in the EU was expected to be 5.3% of the total GDP. The removal of production barriers was the most important source of benefits with 2.2% of GDP. Economies of scale and increased competition contributed by 1.65% and 1.25% of GDP, respectively. The impact of removing the non-tariff barriers was expected to be almost negligible (0.2% of GDP).

The experience of former extensions of integrations predict that the coming accession of East European countries to the EU would bring substantial gains for the new members. The largest gains are expected for small countries that are open to international trade. The existing members of the EU would not lose either. Past experience show no losses for incumbent members from extensions, and most recent calculations also indicate that the coming extension of the EU would bring some welfare gains for the EU15, not to mention the huge benefit in the field of security.

2.2 Empirical Experience of Net Benefits in Western Europe from Trade with the CEEC[7]

A cross-country investigation of aggregate trade data reveals a spectacular growth of trade flows between the CEEC and the EU in recent years. For example, Austrian exports and imports with the Czech Republic, Slovakia, Hungary, and Poland grew at an annual rate of nearly 20% between 1989 and 1994. In general, substantial regional differentiation and large variations across commodities were revealed in a number of studies.

At the beginning of transition, all the EU countries' trade with the CEEC was significantly different from the structure of their total trade. On the other hand, the West European economies worried that after a radical liberalization of trade with CEEC they would lose whole industries in the competition with cheap imports from the CEEC. This concern does not seem to be confirmed after six years of economic reforms and opening of markets, although exports of the CEEC have moved slightly toward labor-intensive and/or less processed products.

The opening of Eastern Europe was the precondition for rapid changes in the regional structure of East–West foreign trade. The share of Central and East European countries in the EU's total exports and imports nearly doubled between 1988 and 1994. While the share of Central and East European countries in overall EU trade is still moderate on average (below 5%), trade with Eastern Europe accounts for more than 10% of trade of the neighboring regions of CEEC (Austria, Germany, Italy and Greece).

Within the EU Austria has the highest share of exports to Eastern Europe. Austria joins the four largest EU economies to form the leading EU exporters to and importers from Eastern Europe in volume terms. Germany, Italy, France, Austria, and the UK account for three quarters of the Union's trade with Eastern Europe. While Austria shows a high exposure to imports from Central and Eastern Europe, Austrian exports to the CEEC are even higher than the imports from this region. The findings for Austria may predict the impact of trade liberalization with the CEEC on other EU members.

The index of revealed comparative advantage ($RCA_i = (X_i - M_i)/(X_i + M_i)$ where X_i and M_i are exports and imports of sector i) is widely used for the analysis of trade

[7] This section follows the presentation by Jarko Fidrmuc and his study "East–West Trade in Transition; The Case of Austria", co-authored by Christian Helmenstein and Peter Huber.

flows of industries. The RCA index measures the commodity-specific degree of comparative advantage by one country compared to other countries. In general, EU countries have large positive RCA values in the SITC categories 6, 7, and 8 with the CEEC. In the SITC categories 2, 3, and 4 EU countries seem to have a comparative disadvantage. This development corresponds to the initial expectations of the EU's specialization on capital-intensive and human capital-intensive products, while the CEEC were assumed to specialize on labor-intensive and resource-intensive commodities. However, recently all SITC categories show strong dynamics in the CEEC. During the reforms the comparative disadvantage of many EU countries in agriculture (SITC 0) has changed towards a slight comparative advantage.

One-digit SITC groups, however, are too highly aggregated to identify the industries with comparative advantages. This is illustrated by the fact that the revealed comparative advantages are not uniformly retained at the SITC two-digit levels.

The RCA-index may be directly converted to the Grubel-Lloyd index by just expressing $GLI_i = 1- \mid RCA_i \mid$ that is used to address intra-industrial trade, $GLI_i = 1- \mid X_i - M_i \mid / (X_i + M_i)$. Therefore, the recent changes and fluctuations of the RCA-indices may indicate an increasing importance of intra-industry trade.

Based on the analysis of SITC two-digit commodity group trade flows of selected EU countries (such as Austria, Germany, Italy, Sweden and the Netherlands) with the CEEC, we can see that the overall growth was accompanied by the growth of intra-industry trade. This means that East–West trade is becoming increasingly similar to intra-EU trade. However, intra-industry trade between the EU and CEEC is rather low when compared with intra-EU trade. This result underlines the fact that cooperation between the EU and the CEEC on the branch level is still considerably less developed than within the EU despite its growth since 1989. Therefore, we expect a growth of intra-industry trade to be persistent during the next few years. A continuation of this development should also contribute to overcome reservations about the EU's Eastern enlargement related to possible loss of employment in certain industries.

From the CEEC point of view, the frequently expressed concern that the East European economies might be captured in low-wage/low technology equilibria appears to be overstated. Although the needed adjustments in response to the opening of Eastern Europe are high in both Eastern and Western Europe, the growing shares of intra-industrial trade suggest that many potential losers in the EU also benefit from new trade opportunities. The considerable contribution that the growth of intra-industry trade has made to overall trade growth hence indicates less significant production losses in Western Europe than suggested by earlier estimates. The effect of these developments on employment, however, remains to be studied.

The discussion following the presentation by Fidrmuc stressed that the adjustment costs of opening and integration of the CEEC into the EU are expected to be lower when intra-industrial trade accounts for the major part of trade growth. FDI is also contributing to the increase of intra-industrial trade. Some participants, however, pointed out that other studies found significant differences among the CEEC with many East European producers specializing on low-value added products. It was also emphasized that if one further disaggregates commodity groups, major quality differences appear and the observed pattern of trade does not fulfill the strict definition of the intra-industry trade (trade with the same products). Nevertheless, such differences can be reduced in later years.

2.3 Service Trade — Trends in the EU after 1992[8]

The importance of services has been steadily growing in industrialized countries due to two reasons: first, in response to growing income, reduction of working time, and changes of tastes, the share of leisure in total consumption increases. Second, deep structural changes take place in the manufacturing industry, such as placing service activities into separate companies (outsourcing).

At the beginning of the 1990s, the share of services in gross value added was about 63% both in Japan and in the EU; the USA with its 75% of gross value added was the most service-intensive economy. Spain's share of services (66% of gross value added) was slightly above the EU average.

The CEEC show significantly lower shares of services, therefore, a rapid growth of the service sector may be expected in the process of accession of the CEEC into the EU. A similar development could be observed in Spain after its entrance into the EU.

In comparison to goods, services have the following four characteristic features:

1. Services are non-storable. The production and consumption of services have to take place simultaneously at the same time and in the same location.
2. Many services are non-tradable.
3. The quality of services cannot be assessed prior to the consumption due to their intangible nature; this feature leads to problems of asymmetric information.
4. Services are regulated in most countries due to the existence of market failures (associated with imperfect competition, imperfect information, externalities, natural or public monopolies, etc.).

These specific properties of the services imply a physical proximity between providers and users of services. Therefore, it is difficult to disentangle trade in services from factor flows. In certain services (financial and professional services) providers and users do not need to move, whereas in other services (tourism) users have to move. On the other hand, trade with some services (engineering, accounting, advertising, consulting or distribution) requires the temporary or permanent movement of factors. The first type of trade with services is referred to as commodity trade, while the second type is called factor trade. The factor trade of services is often associated with FDI.

Empirical analyses suggest that the conventional trade theory also applies to trade in services. Under perfect competition in the service sector, the liberalization of trade in services is welfare enhancing. However, the case of imperfect competition remains largely unexplored in the literature. Nevertheless, factor endowments seem to be an important determinant of trade patterns in services. High-income countries are relatively specialized in banking, insurance and communications, while low-income countries are relatively specialized in hotels, catering, distribution and construction.

In 1980, the import of services represented 13.4% of total import in the EU, while it stood at 15.4% and 16.8% in the USA and Japan, respectively. In the middle of the 1990s, the import of services reached 18% in the EU and the USA and 28% in Japan.

The share of export of services has been stable in the EU (20%) and Japan (11%) since 1980, while in the USA it increased from 20% in 1980 to 27% in the middle of the 1990s. Consequently, the EU and the USA show a significant trade surplus while Japan has a trade deficit in services.

[8]This section summarizes the presentation and discussion of the paper "Service Trade — Trends in the EU after EU92" by Carlos Martinez.

The import penetration has not increased dramatically in any of the analyzed major regions during the last 15 years, although we can observe significant differences: the import of services represent 7.7% of gross value added in the EU, 3.7% in Japan, and only 2.5% in the USA.

The export intensity of the service sector was also stable in the EU with exports of services representing about 9.5% of total gross value added. The export intensity showed a decreasing trend in Japan, while the opposite was observed in the USA.

Intra-EU trade in services has grown much more than the total trade in services during the last ten years. Of the EU's total figures, the extra-union exports of services accounted for 60% of the EU's total exports of services in 1985 and 50% in 1994. Similarly, the share of extra-EU imports of services of the EU's total imports of services declined from 53.2% in 1985 to 48.6% in 1995. In this process of increasing intra-trade intensity in services it is difficult to distinguish the effects of creating a single market from the impact of new technology and internationalization in the service sector.

The intra-union trade in services is closely related to FDI. Actually, 63% of investment flows between the member states is targeted to the service sector. This dramatic development has been associated with an increased number of mergers and acquisitions.

From the point of view of future developments in the CEEC it is worth looking at the past experiences of Spain.

Spain started with low imports (9.5% of total imports) and high exports of services (38% of total exports). Following the accession of Spain into the EU, the imports of services followed the same evolution as in the EU, but they still remained below the union's average. Simultaneously, the exports of services (mainly tourism) declined to 30% of total exports in 1995. Nevertheless, the surplus in trade in services is significant.

We can observe a growing trend in the import penetration of services, although the import penetration to Spain's service sector is still below the EU average. In contrast, the export intensity of Spanish services is slightly higher than in the EU. Mainly trade with other member states of the union is increasing due to both the integration into the EU and the opening of markets in the EU. The share of the extra-union exports of services declined from 42.6% in 1980 to 24.4% of total exports in 1990. Simultaneously, the share of extra-union imports of services fell from 52.3% in 1980 to 37.6% of total imports of services in 1994. The intra-union trade in the service sector has been supported by the strong investment activity after the accession. Between 1986 and 1991, total FDI in Spain grew five-fold.

The Spanish case reveals that the CEEC may experience major changes after their accession to the EU with respect to the importance of trade in services, regional structure of exports and imports of services, and FDI related to the service sector.

The discussion after the presentation by Mr. Martinez was mainly devoted to the development of different types of services and the relation between trade in services and FDI. It was pointed out, that the individual EU countries cannot be compared with the USA and Japan due to the different size of these economies; EU countries are more comparable to former EFTA-countries, although the latter are too small for such comparisons. Transport services and airlines had significant effects on the development of trade in services.

3 Investment and Competitiveness

3.1 Capital Movements to European Integration: The Spanish Experience[9]

Similar problems as those associated with capital inflows and outflows in Spain can be currently observed in the CEEC. Therefore, it is possible to draw some implications from the Spanish experience for the forthcoming incorporation of the CEEC into the EU.

The accession of Spain into the EU coincided with an exceptionally marked cyclical upturn and progress of the integration among the member states (creation of the single market, liberalization of capital flows, integration of financial markets in the member states, etc.). Therefore, it is difficult to distinguish between surges in capital inflows linked to the integration and to other events.

The reasons for the capital inflows to Spain are remarkably similar to the causes of current developments in the CEEC. In the literature, the following five basic reasons explaining capital inflows into Spain (or more generally to emerging markets) were identified:

1. A change in economic policy that improves its credibility, whereby international financial markets anticipate better macroeconomic results;
2. monetary tightness that raises the level of interest rates;
3. external influences (economic development in source countries);
4. contagion or the so-called band-wagon effects (e.g., capital inflows into neighboring countries or change in risk premia that determine the international distribution of capital); and
5. direct investment linked to companies' decisions to locate economic activity in the single market of the EU.

The first and the last factors are associated with more permanent capital inflows, while the other factors are more temporary and vulnerable to changes in the related underlying factors.

In general, the effects of foreign capital are undoubtedly beneficial for the target country: they reduce the financing constraints linked to the balance of payments. Furthermore, they contribute to the investment that the target country needs for its convergence to the rich countries. Finally, they prompt the modernization of the financial sector and improvement of its efficiency.

However, along with their unquestionable positive effects, sizable capital inflows may entail certain drawbacks. First, they are often associated with a current account deficits that may have adverse long-term consequences. Second, capital inflows are not sustainable if they are used to finance consumption rather than investment. Third, they often induce monetary control problems and inflationary pressures. These are particularly serious in countries involved in integrating with countries with a tradition of price stability (as in Spain and in the CEEC). Fourth, capital inflows are usually associated with an appreciation of the real exchange rate. This may be especially serious for countries striving to lower trade barriers and compete with more powerful economies. Finally, capital inflows increase the vulnerability of a country and its economic policy to the potential reversal of these flows due to either domestic or external factors.

[9]This section references the presentation and discussion of the paper "Capital Movements to European Integration: The Spanish Experience" by Santiago Fernández de Lis.

In Spain, the overall effect of the capital movements was clearly positive, although they created some problems. From the CEEC point of view, the main lesson is that if fiscal policy is not adjusted, the loss of competitiveness associated with the inflation differential will lead to an abrupt turn-around in capital flows and to an exchange rate crisis. If this coincides with a cyclical deceleration, the costs of adapting to the new situation will be greater.

Between 1986 and 1992, Spain's balance of payments recorded capital inflows totaling USD 102.5 billion, an annual average of USD 14.6 billion or 3.7% of the GDP. Although capital outflows were liberalized partially and increased significantly in this period, the capital account was clearly in surplus. That translated into a growth of reserves, because of a current account deficit smaller than the new inflows. Direct investment accounted for about a third of total private capital inflows between 1986 and 1989. Portfolio investment was also significant, while short-term capital inflows were moderate. In 1990 and 1991, purchases in bonds and long-term loans gained in importance.

The inflow of foreign capital was used to finance investment rather than consumption. Therefore, it contributed to the high GDP growth rate that was above the EU's average in this period.

However, some problems related to capital inflows were also observed: capital that was attracted by high interest rates induced a growth in money supply. The attempts to sterilize this excess supply prompted further rises in interest rates that in turn attracted more foreign capital. As a result, inflation remained high in comparison to the EU's average. This led to a strong real appreciation of the peseta and loss of competitiveness of Spanish producers.

The Spanish authorities responded with various measures: first, they introduced controls on capital inflows, although this step was contradictory to the commitment to liberalize these flows. Second, they set limit on credit growth. Third, the peseta was linked to the Exchange Rate Mechanism (ERM) in June 1989. It is difficult to assess the effects of entry to the ERM, but it is likely that this move prevented either an even more pronounced strengthening of the peseta or a greater building up of reserves necessary to maintain the peseta's actual rate.

The reversal of the capital flows in the period 1992 and 1993 is attributable to various external factors (the German reunification and the resulting differences between the business cycles in Germany and other member states, uncertainty in respect to the coming of monetary union, speculative capital movements) and domestic reasons (loss of competitiveness). Between August 1992 and July 1993, Spain experienced a net capital outflow of nearly USD 15 billion. Nevertheless, this amount was remarkably lower than the inflows recorded in the previous period.

The Spanish authorities reacted to the capital outflow by two devaluations of the peseta in September and November 1992 and by widening its fluctuation band in July 1993. Finally, the most recent period is marked by a return to normal capital movements.

The discussion following the presentation by Fernández de Lis was mainly devoted to the possible lessons for the CEEC from the Spanish experience. It was emphasized that Spain had good experiences with the FDI that were attracted also due to the government's liberal approach to FDI and privatization. With respect to net EU transfers, since Spain was a net contributor initially and only later became a net receiver from the EU budget, one can assume that the size of net EU transfers had not much impact on the capital inflows to Spain.

3.2 Experience of FDI in Eastern Europe[10]

According to UNCTAD, in 1994 FDI in the CEEC accounted for only USD 6.3 billion of total USD 226 billion of FDI flows in the world economy. The CEEC received only 2.8% of FDI flows in the world economy while, for comparison, China received about 12% (USD 27 billion) of these flows in 1994. The cumulated stock of the FDI in the CEEC is also marginal. According to estimates, less than USD 30 million was invested in Eastern Europe including the former Soviet Union. Moreover, these flows of FDI concentrated heavily on a few countries, i.e., Hungary, Poland, the Czech Republic and Estonia. Hungary accumulated far more capital than any other country in the region. The total cumulated stock of FDI accounts for about 30% of GDP in Hungary, 14% in Estonia, 13% in the Czech Republic, 7% in Poland and less than 5% in all other Eastern European countries. This documents two general observations on FDI in Eastern Europe. First, the countries with the highest FDI are not countries with the lowest wage level in the region. Second, foreign companies have substantial direct influence on the economic development in only four countries of the CEEC.

However, FDI still could have significant positive effects on the development in transition economies. First, FDI must have contributed significantly to the investments in transition economies including the introduction of new technologies. Foreign owned companies accounted for about a third of total investment in Hungary, and over 10% in Poland and the Czech Republic in 1994. Second, FDI (both greenfield investments and take-overs through privatization by foreign investors) created new capacities and employment opportunities. Third, FDI improved the balance of payments of transition countries. This latter macroeconomic effect is especially important for countries with significant debt burden. Finally, FDI creates additional revenues for the state budget through privatization revenues.

Earlier studies showed that FDI followed often previous commercial links with firms in the CEEC. The primary motive of investors was to capture local market shares. Reduction of production costs (as an independent determinant) was less important. Both types favored political stability and good pre-investment relations to local partners.

In the discussion following the presentation, Miklós Szanyi explained Hungary's good FDI performance by several factors, such as the Hungarian government's active policy of foreign investment promotion, and the early openness of the Hungarian economy for foreigners (trade, tourism and investment). Alena Zemplínerová[11] quoted results of her study on the FDI in the Czech economy: data show that foreign firms performed better than Czech firms between 1992 and 1995. The better performance of foreign-owned firms had the following reasons. First, foreign investors were investing in better firms. Second, the investment is higher in firms with a foreign owner than in Czech firms. Therefore, the firms with foreign investment are modernized faster. Third, they have higher productivity and foreign firms are also paying wages 20% above the Czech average. However, foreign investments are low in labor intensive industries. Finally, the firms with high FDI are often more export-oriented than the average Czech firm.

[10] This section summarizes the presentation and discussion of the paper "Experiences of Foreign Direct Investment in Eastern Europe: Advantages and Disadvantages" by Miklós Szanyi.

[11] An analysis of FDI into the Czech Republic can be found in the paper "Czech Trade Policy Within the European Framework" by Alena Zemplínerová which was distributed at the workshop.

3.3 Export Competitiveness in the Manufacturing Industry of the CEEC[12]

The rapid reorientation of trade of the CEEC has been the outstanding feature in the first half of the 1990s. In 1989, the EU accounted for only about 25% of CEEC exports. By 1995, between 40% (Bulgaria) and 80% (Slovenia) of the exports were conducted with the EU (including former EFTA-members), and the regional structure of CEEC trade basically returned to their pre-World War II patterns. This development was supported by trade liberalization in the CEEC (abolition of the state's foreign trade monopoly, introduction of current account convertibility), the dissolution of the CMEA, the suspension of most quotas on imports from the CEEC to the EU, the inclusion of the CEEC in the GSP system, and subsequently by tariff concessions for industrial products contained in the Association Agreements.

However, an asymmetry exists between the importance of East-West trade relations for the CEEC and the EU. While the EU accounts for the bulk of CEEC exports, these countries have only marginal importance for the EU. Despite recent growth, the CEEC accounted for only slightly more than 6% of EU imports of manufacturing products in 1994. Therefore, any trade measure has a much larger impact on the CEEC than on the EU, and fluctuations in the West European business cycle have a great impact on the CEEC.

Trade liberalization in the EU including the asymmetry of the Europe Agreements in favor of the CEEC could not offset the generally low export competitiveness and supply-side bottlenecks of the CEEC. Recently, trade deficits of the CEEC increased significantly. Manufacturing trade of the CEEC with the EU has turned from a slight surplus in 1990 to a deficit of ECU 5.1 billion in 1993 and ECU 5.0 billion in 1994 that further increased to ECU 6 billion in 1995. In 1994, the highest trade deficit was incurred by Poland (ECU 1.9 billion) followed by the Czech Republic (ECU 1.5 billion) and Hungary (ECU 1.3 billion). The emergence of trade deficits in virtually all CEEC reopened the question of their competitiveness in comparison to the EU. Key features of competitiveness is addressed below through the analysis of the similarity of export and import structures of the EU and the CEEC, through the investigation of market share development, revealed comparative advantage, labor productivity, and unit labor costs. The calculations were made on three-digit data for 108 NACE industries.

We should keep in mind that the period for which data is available (1989 to 1994) is too short and too turbulent (including both transformational recession and the recent recovery) for the analysis of long-term comparative advantage.

The distance measure is defined as $D_{ij} = \sqrt{\sum_k S_j^k (S_i^k - S_j^k)^2}$, where S_i^k and S_j^k are the shares of industry k in total exports in years i and j. Using distance measures of the structure of foreign trade (exports and/or imports) in 1989 and 1994, one can see that the exports of the CEEC experienced huge structural shifts during this period. These structural changes were stronger than those observed on the import side. The most pronounced structural shifts occurred in Romania and Bulgaria, while the lowest adjustment was seen in the former Czechoslovakia.

An analogous analysis of correlation coefficients of trade structures in 1989 and later years reveals that the structure of exports returned partially back to the old pattern in all CEEC except for Hungary in 1994.

The distance measures between export and/or import structure in the EU and the

[12] This section summarizes the paper "Export Competitiveness in Manufacturing Industry of CEEC" by Peter Havlik which was distributed at the workshop. Due to illness, Peter Havlik could not participate at the workshop.

CEEC show that CEEC export other commodities than those prevailing in the total imports of the EU. While Czechoslovakia and Hungary seem to adjust their export pattern to the demand of the EU in recent years, while the difference for Poland, Bulgaria and especially Romania is even getting larger. Actually, only the Czech Republic (followed by Slovenia) is coming close to the pattern of EU import demand.

Furthermore, a comparison of the similarity of exports of the CEEC reveals increasing similarity of exports for Czechoslovakia, Hungary, and Poland between 1989 and 1994. Therefore, these countries (and Austria) might increasingly compete in the same products. On the other hand, their export structure is increasingly diverting from the export structure of Bulgaria and Romania.

The emergence of two groups of countries in Eastern Europe is also visible in their specialization on the EU market. In general, one can observe a broad export specialization pattern in the CEEC on labor-intensive industries and away from capital-intensive branches, although there are many exceptions from this general rule. The energy-intensive industries belong to the declining branches. Besides, there are considerable differences between the individual CEEC. In Slovenia, labor-intensive industries are, for example, losing position due to relatively high unit labor costs. More sophisticated industries show also a surprising improvement of their indices of comparative advantage during the reform period.

Between 1989 and 1994, the following three-digit NACE-industries of the CEEC recorded the largest gains in market shares in the EU: iron and steel (NACE 221), nonferrous metals (224), cement (242), petrochemicals (252) tools and finished metal goods (316), insulated wires and cables (341), electrical machinery (342), motor vehicles (351), knitting industry (436), footwear (451) and clothing (453). These industries were also confirmed by the analysis of revealed comparative advantage (see also section 2.2).

At current exchange rates, wages in the CEEC are only a fraction of the EU level. However, labor productivity is also lower in the CEEC. Another part of the advantage of low wages and undervalued currencies is eliminated by the quality gap between Western and Eastern products (including marketing, packing, delivery conditions, service level).

The aggregate productivity in the CEEC (real GDP at purchasing power parities per employed person) reaches the highest level in Slovenia (54% of the Austrian level in 1993), followed by the Czech Republic (40%), Slovakia (37%), Hungary (33%) and Poland (28%).

In 1995, unit labor costs (calculated as a ratio of nominal annual wage and productivity and divided by the nominal ECU exchange rate) represented the following shares of the Austrian level: in Slovenia 61%, followed by Poland with 36%, Hungary with 33%, the Czech Republic with 28% and Romania with 25%.

4 Agriculture in the CEEC: Possibilities, Preconditions and Consequences of EU Accession[13]

The integration of agriculture of the CEEC to the EU will be one of the most sensitive issues due to the crucial importance of agriculture in both the CEEC and the EU. The CEEC have significant advantages in the agricultural production in comparison to the EU. The agricultural area of the CEEC represents 22%, the arable land area 30% of the EU

[13]This section summarizes the presentation and discussion of the paper “Agriculture in the CEEC: Possibilities, Preconditions and Consequences of the EU Accession” by Judit Kiss. The analysis deals with the Visegrád countries, therefore in this section CEEC refers to the Visegrád four countries (Czech Republic, Hungary, Poland and Slovakia).

figures, while the population and total GDP (in nominal exchange rates) of the CEEC correspond to just 17% and 2.4% of EU population and output, respectively.

Despite recent declines in their agricultural production the share of agriculture in GDP in the CEEC is more than twice as high as in the EU with 5.7% and 2.5%, respectively. Moreover, total agricultural employment in the four CEEC (4.5 million employees) is more than half of the total agricultural employment in the 15 EU countries (8.2 million employees).

Data, however, also reveal the low productivity level of agriculture in the CEEC in comparison to the EU: labor productivity is around 14-times higher in the EU than in the CEEC. Furthermore, there are significant differences in labor productivity between the CEEC with the highest labor productivity in Hungary and the lowest in Poland. Consequently, agricultural production in the CEEC could significantly increase and/or a significant out-migration from the agricultural sector may follow the catching-up of the labor productivity level with those in the EU. However, the increase of labor productivity in the CEEC necessitates significant agricultural investment.

Land productivity differences are less significant than labor productivity gaps, with land productivity in the EU being 5.9 times higher than in the CEEC. Land productivity is higher in Hungary than in the other CEEC.

Between 1989 and 1994 the real aggregate agricultural output of the CEEC declined considerably; the decline varied between 20% (in Poland) and 35% (in Hungary). There are a great number of factors underlying this sharp decrease of agricultural production including the drop in domestic and external demand, loss of traditional markets in Eastern Europe and the former Soviet Union, growth of agricultural imports from the EU, increasing gap between input and output prices, restructuring of agriculture, etc.

Currently, the drop in agricultural production seems to bottom out in Slovakia and Hungary, while the contraction continues in the Czech Republic. In Poland, agriculture experienced a first recovery in 1993 that was followed by a fall in crop production due to drought in 1994.

According to forecasts for agriculture in the CEEC, supply and demand could adjust to the transition shocks by the end of 1990s. Growth in income will lead to a certain recovery of demand for agricultural products. This will mainly include livestock products; the pre-transition levels of per capita production will be not reached, though. In the production of crops, the share of cereals and oilseeds, which have a higher export potential than in the pre-transition period, will increase. The export potential of dairy products, however, is significantly lower than in the pre-transition period. Price differentials between the EU and the CEEC will continue despite their reduction for certain products.

The EU is the most important trade partner of the CEEC in agricultural products: more than 50% of agricultural trade of the CEEC is related to the EU. However, the EU's agricultural exports to the CEEC represent only 8% of total agricultural exports of the EU, and the EU's agricultural imports from the CEEC constitute only 5% of total agricultural imports of the EU.

The Association Agreements only partially improved the market access for the CEEC in the EU. Certain agricultural products were not included in the preferences granted by the EU, while in other cases the non-tariff barriers (quotas, variable levies, minimum prices, etc.) and/or insufficient concessions squeeze the agricultural products of the CEEC out of the EU market. On the other hand, some opportunities could not be utilized by the CEEC due to the lack of exportable commodities and/or low competitiveness of their products.

On the other side, the Europe Agreements allow the EU to provide subventions to exports to the CEEC. Furthermore, the CEEC lifted import restrictions and non-tariff barriers in the course of their transformation.

The insufficient liberalization of agricultural trade by the Europe Agreements and various domestic factors led to the stagnation of agricultural exports of the CEEC to the EU and growth of imports from the EU resulting in a worsening of the trade balance in agricultural commodities. Between 1989 and 1994, the agricultural trade balance of the CEEC turned from a surplus of ECU 988 million into a deficit of ECU 250 million.

Since the CEEC face significant trade deficits, they look for possibilities to increase their agricultural exports. A necessary pre-condition for this is to increase their domestic production in order to produce exportable surpluses. Further requirements are the introduction of an export promotion system, better financing conditions, improvement of quality, packing, and fulfillment of sanitary and health requirements of the potential markets. In addition, certain efforts could be made to upgrade the Association Agreements to include the extension of concessions, elimination of quotas or introduction of their convertibility within product groups, and elimination or reduction of export subsidies on the EU's exports to the CEEC.

The (short-run) interests of the EU and the CEEC in the process of accession may be considerably different: the CEEC want to increase their agricultural exports to the EU market (however, without opening the EU market for third countries), while the EU would like to increase its agricultural exports to the CEEC without opening the internal market and providing (too high) financial help for them. Since the interests are not compatible due to either the exclusion of the CEEC from the common market or to high budgetary costs of Eastern enlargement, five options are currently being discussed:

1. Adoption of the current common agricultural policy (CAP) for the CEEC leading, however, to an additional annual budgetary burden in the EU between ECU 23 billion and ECU 42 billion;

2. Introduction of a radical reform of CAP; this would meet resistance of farm lobbies in the present member states;

3. Replacement of the CAP by a dual CAP system or by a two-tier agricultural policy; this would not fulfill the expectations of the CEEC, and would be politically unsustainable and incompatible with the single market principle;

4. Re-nationalization of the CAP (meaning that each member state would have the responsibility to provide agricultural subventions) with similar effects as in the previous point;

5. Long transitional periods that shift the needed decisions to later periods.

Currently, none of these five approaches seems to be feasible and/or acceptable for both partners. Nevertheless, it is likely that a gradual and mutual adjustment and harmonization process will take place in order to create pre-conditions for the Eastern enlargement of the EU.

In the intensive discussion following the presentation by Judit Kiss, it was mentioned that agricultural trade is actually gaining importance among the CEEC. Several participants stressed that the reform of the CAP is not a new but an old problem of the EU. The CAP reform has a political character: agriculture has a marginal effect on GDP and consumers' expenditures in the EU, but it has a high political importance.

5 Environment: Eastern Europe's Potential Environmental Threat to Europe with and without EU Membership[14]

Environmental concerns and the anticipation of EU enlargement were among the reasons for political changes in the CEEC before 1990. In fact, the introduction of EU compatible legal regulations, governmental, market and technological systems would automatically improve the environmental problems in the CEEC. Furthermore, the combination of both aims leads to an interesting alliance between the environmentalists and business, (especially business which is export oriented) to support the approximation of the EU. Actually, the same legal environment helps in the CEEC to achieve access to the EU market and improve environmental conditions.

Both the EU and the CEEC have the following common goals in the approximation process:

1. coherence of environmental regulatory conditions for economic activities in the CEEC with those in the EU;
2. realistic terms of agreement regarding environmental compliance between the EU and future members;
3. preparing future members for their rights and obligations in the EU.

Generally, the existing environmental legislation in CEEC is more or less approximated to EU norms. It is, in many cases, similar to EU directives, but may be not sufficiently precise. In some cases, legislation is lacking or is fundamentally different from the EU approach.

The situation in individual areas of environmental protection is as follows:

1. Most CEEC have new environmental framework laws that include most of the basic elements of EU environmental legislation;
2. There is close compliance with the EU's legislation in the field of nature conservation due to a long tradition of conservation in the region and the application of many international legal instruments;
3. Air protection is recognized as the main priority area because of its direct impact on human health;
4. Water quality protection shows many conceptual similarities with the EU, and the technical differences are being eliminated relatively quickly;
5. Less attention is given to chemicals, industrial risks, biotechnology and waste management in the legislation of the CEEC;
6. There is a lack of regulations regarding product standards as opposed to ambient level regulations.

In contrast to progress in the regulatory framework, the enforcement of environmental legislation is still insufficient in most CEEC. The improvement of the enforcement capacity is probably the most critical item of the approximation agenda in the CEEC because if legislation can not be enforced, it has only little or even no impact on the behavior of actors

[14]This section summarizes the presentation of the environmental issues by Jernej Stritih.

in the country. Therefore, the legal system compatible with the EU is not implemented until its enforcement is ensured.

While the CEEC is behind the EU in terms of certain regulations and in enforcement, the CEEC definitely have some advantages in comparison to the EU. Lifestyle in the CEEC is less wasteful than in the West, although the consumption pattern is approaching the West European style of life in recent years. The CEEC is characterized by higher biodiversity than the countries of the EU. The recent changes in the CEEC offer more opportunity for an environmentally conscious restructuring than in the EU countries and the East European countries provide a better field for policy innovations than the countries of the EU.

According to preliminary estimates, the costs of implementing EU standards in the CEEC will be high. However, these costs could not be avoided either if these countries did not join the EU. On the other hand, there is scope for various kinds of international cooperation in sharing costs.

In the discussion following the presentation of Jernej Stritih it was mentioned that a multiplicity of EU assistance schemes should be used to remedy the existing environmental damages in the CEEC and for supporting environmentally friendly restructuring.

6 Political and Security Issues[15]

Security issues involve a number of questions related to the process of enlarging the EU and NATO. These include the relation between enlarging the EU and NATO, military and non-military aspects of the security policy, the position of the CEEC to the current reform of the EU, relation between security policy and minorities, migration, position of third countries, etc.

Currently, there are no military threats either to the EU or the CEEC. In fact, the non-military threats are more important than the military ones. Therefore, the expansion of the EU has positive implications for the security of both sides. In fact, the Europe Agreements have already dealt with some security issues.

Migration has an increasing importance in the security policy. The candidate countries are, as a rule, not source countries of illegal migration to the EU. Their integration to the EU, however, would improve the security of both the old and the new members due to the existence of migration roads through Central Eastern Europe. Since 1991, Hungary returned 2.5 million people that tried to enter illegally. The CEEC serves as a filter against migration pressures. Borders need more protection measures, however, these were restricted by the budgetary situation in Hungary. After the accession, the CEEC would have better means to deal with illegal migration.

The positions of the individual CEEC are only slightly different from each other. The Czech Republic stresses the first pillar of the EU, while security issues are considered less important. Nevertheless, through its application for EU membership the Czech Republic accepted the broader, non-economic aspects of the EU. On the other hand, NATO enlargement is the process which is seen as the main source of security guarantees, especially because of the presence of the USA in NATO. This view of the USA's role in Europe is also shared by other CEEC.

István Szőnyi stressed the importance of the CEEC for the relation between the EU and the USA. If there will be no progress in EU enlargement although NATO will be enlarged, the USA will be left alone with total responsibility for security in Europe. However, the

[15] This section summarizes the talks by Stanislav Stach, István Szőnyi and Antoni Kaminski on security issues.

non-enlargement of both the EU and NATO would have even worse consequences: it would show that the West European nations are unable to take responsibility for the future of Europe. Both scenarios would significantly undermine the principle of international solidarity and could induce the USA to show less interest for Europe.

In the process of the decision making reform in the EU, the Czech approach in general prefers majority voting, although with different positions provided for individual countries. However, the veto right should be further applied for security issues.

According to the Hungarian point of view, security policy is closely related to the position of minorities. The importance of this issue, however, seems to be over-emphasized currently by the EU. Nationalism, in fact is declining in the CEEC; the expected growth in the next few years will improve the income situation of the population in the CEEC and thus reduce nationalism. Moreover, there have been no military conflicts among the Central European nations in the past decades. Nevertheless, it is clear that the integration process will also help to stabilize the relations of minorities in Eastern Europe because it would imply a commitment to solve the existing problems.

The Polish approach to security is strongly influenced by Poland's geographical position between Germany and Ukraine. Germany stresses its strong interest in the integration of Poland to the EU. The threats for the security of Poland are seen rather in criminality and terrorism than in danger to the national identity.

The general discussion stressed that the enlargement of the EU would be an important contribution to European security. The EU enlargement would be instrumental also in tackling the budgetary costs incurred after the accession to NATO. In the Czech Republic for instance, currently, military expenditures account for 2.5% of GDP. The upgrade to the NATO standard would, however, require an increase of military expenditures to at least 3.5% for about six years. The budgetary burden would have a significant social impact. Accession to the EU could contribute to these investments into European security both by improving the economic conditions through enlargement and by providing subsidies to the new members to reduce the social impact of more military expenditures.

7 Forming Consistent Transformation and Integration Policies for an Enlarged Europe[16]

The enlargement of the EU is one of the most important tasks facing the whole world. This enlargement will have to be based on solidarity within as well as between nations, otherwise the enlargement will fail. However, its failure is actually possible due to nationalist ideology, intolerance, and populism.

The EU has evolved to strengthen the capabilities of European nations to withstand those tendencies. Since its foundation, the EU is, in the deepest sense, a political project. The project of European integration now faces new tasks: to deepen cooperation in more complex issues, to introduce a common currency, and to achieve a historically unprecedented enlargement.

Despite all the uncertainties, we can believe that the enlargement of the EU will happen, but we do not know any another details: who, when or how. Despite the many solemn declarations and the overall rapid and positive changes taking place in the applicant countries, the enlargement in any specific sense is not given. Neither the potential new members, nor the present members, are set on a safe course to manage the enlargement.

[16] This section summarizes the talk and paper entitled as above by Mats Karlsson.

The CEEC often seem to take the enlargement for granted because anything else, according to their views, would be betrayal that surely cannot happen again. In fact, much could happen that would postpone enlargement, or lock some or even all applicants out from the deep integration. Currently, the public in the CEEC is supporting the integration into the EU. However, the negative side of the economic balance of entering the EU will be highly visible, easily exploitable, and thereby may undermine public support. Furthermore, the enlargement by the EFTA-countries showed the complexity of the entrance negotiations including the specifics of security policy, policy dealing with issues of significant social interest (e.g., alcohol policy in Sweden), but also many seemingly minor issues (e.g., wet snuff in Sweden). Although these examples are not applicable to the CEEC, other specific issues may emerge in the process of negotiations.

Concerning the present members, the inter-governmental conference and the monetary union both place their governments under strain. However, for the enlargement to happen it will have to be supported by the populations in these countries. West European governments and EU administrators have to show their citizens the consequences of enlargements and the intrinsically win–win situation characterizing enlargement.

Furthermore, some countries will not become members in the first round either because they do not meet the conditions following from the membership despite starting the negotiations at the same time as the other CEEC, or because they have no prospects for the membership in the foreseeable future (e.g., Russia and Ukraine). However, those who are left outside must have a structured link in order to include them into the community of the European nations. This link has also to minimize the risk of political backlash in the countries not included in the first wave of the enlargement.

Finally, the EU has to be enlarged in a way that will improve its working. Old and new members will have to share the institutions of the EU: the commission, the ministerial councils, and the European Parliament. To manage the enlargement, we will have to deeply share the values in which the EU is rooted.

8 Summary

In 1995–1996, the countries that have the highest chances to start accession negotiations with the European Union soon (the Czech Republic, Hungary, Poland, Slovakia and Slovenia) showed palpable developments: output sustained its balanced growth, while the regulatory framework of the economy was gradually being prepared for harmonization with the EU.

The experience of earlier integrations and enlargements of integrations show that economic benefits associated with integrations are not easy to identify. While at the early stage of integrations trade creation and static welfare benefits dominate, enlargements in the later stage bring advantages that unfold in dynamic processes but are not easy to discern. While benefits are more obvious for the countries that join integrations, calculations never showed losses from enlargements for incumbent members.

The rapid growth and structural shift in trade between Austria and the CEEC may indicate similar developments with other EU members in the period following CEEC accession to the European Union. The trade structures of some of the East European countries are slowly already converging to West European structures. Due to their currently low wages and undervalued exchange rates the CEEC are highly specialized in the exports of labor intensive products. The fear of the CEEC trade's capture in low wage/low technology equilibria, however, does not seem to be justified: the growing role of intra-industry trade may make it possible to intensify East–West trade without major crowding out of industries in the West, and without too extreme specialization of the East on labor intensive production.

The experience of Spain and other relatively less developed countries' accession to the EU suggests that following the accession the CEEC will experience a surge in their service trade. Much of inward FDI will be attached to services, and the export of services will need an increase in outward investments. The reorientation of services trade toward the (old and new) members of the union can also be envisaged.

It is also the Spanish experience that is indicative for the coming cross-border flows of capital between the CEEC and current EU members. Several factors already attracted substantial capital to the more stable CEEC; with EU membership the surge of capital may intensify and the governments and central banks must find the right policy-mix to utilize the needed external capital beneficially and without threatening macroeconomic balance.

Agriculture seems to be a problem area for the future accession, particularly because of the higher importance of agriculture in the CEEC and the rigid system of agricultural subsidies in the EU. The EU kept its protection strong against East European agricultural and food exports and there is no clear proposal yet for the incorporation of the CEEC into the present system of CAP of the EU. Creative solutions and mutual adjustment and harmonization are needed to change the sensitive area of agriculture to benefit efficiency and sustain political stability.

The preparation for EU accession will lead to more controlled environmental protection in Eastern Europe benefitting both these countries and their neighbors. Regulation is gradually catching up with western patterns, while law enforcement still needs much improvement in the new framework that lacks the mechanics of the command economy. Eastern Europe already possesses some advantages that the EU would benefit from: these are the less wasteful consumption patterns and lifestyles, greater bio-diversity, and more openness to policy innovations in environmental protection.

The enlargement of the European Union would improve security conditions for both the old and the new members. It would lead to more controlled migration, harmonized ethnic relations, coordinated prevention of organized crime and terrorism. The enlargement of NATO and the EU should be viewed in a common scheme because one enlargement does not replace the other, but, in various ways, they can support each other.

APPENDIX I

Program for the Workshop on

Strengths and Advantages of Eastern Europe — EU's Net Gains from Accession

IIASA, 5–7 December 1996

Thursday, 5 December

13:30 Opening of the Workshop: Gordon MacDonald, Director, IIASA

13:45 Introduction: János Gács

14:00 Latest Developments in the Process of Accession — Updates from the Applicant Countries:
- Czech Republic: Petr Pomezny
- Hungary: András Inotai
- Poland: Ewa Synowiec
- Slovakia: Igor Kosír
- Slovenia: Marija Adanja

14:30 Questions and Discussion

15:00 Coffee Break

15:30 Consistent Transformation and Integration Policies for an Enlarged EU
Mats Karlsson

15:50 Discussion

SESSION I: Strength Reflected in Trade — *Chair:* András Inotai

16:20 Survey of Literature on Net Benefits from the Creation/Expansion of Integrations (Theoretical Assumptions and Empirical Evidence)
János Gács

16:40 Empirical Experience of Net Benefits of Western Europe from Trade with Eastern Europe
Jarko Fidrmuc

17:00 Discussion

Friday, 6 December

SESSION I: Strength Reflected in Trade continued

09:30 Service Trade — Trends in the EU After EU 92
. Carlos Martinez

09:50 Discussion

SESSION II: Agrarian Market

10:20 Comparative Costs of Agricultural Production in Eastern
. Europe and EU
. Judit Kiss

10:40 Discussion

11:10 Coffee Break

SESSION III: Investments, Competitiveness

11.40 Capital Flows Related to Integration in the EU and Their
. Effects: The Spanish Experience
. Santiago Fernández de Lis

12:30 Lunch

14:30 Discussion

15:00 Experiences of Joint Ventures in Eastern Europe: Advantages
. and Disadvantages
. Miklós Szanyi

15:30 Discussion

16:10 Coffee Break

SESSION IV: Environmental Issues

16:40 Eastern Europe's Potential Environmental Threat to Europe
. Without and With EU Membership
. Jernej Stritih

17:00 Discussion

Saturday, 7 December

SESSION V: Political and Security Issues

09:30 Panel Discussion: *Changing Security Conditions Following the Accession*
. Panel Discussion: *of Eastern European Countries*
. Talks by Stanislav Stach, István Szőnyi, and Antoni Kaminski

10:30 Discussion

11:30 Coffee Break

12:00 Concluding General Discussion

13:00 End of Workshop

APPENDIX II

List of Participants for the Workshop on

Strengths and Advantages of Eastern Europe — EU's Net Gains from Accession

IIASA, 5–7 December 1996

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