The Global and Regional Outlook in Central Europe

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I Introduction

The process of regional integration in Central Europe[2] reveals two dimensions. On the one hand, integration efforts of Central European countries are just one example of integration processes in the contemporary world economy. As such, they are subject to the standard arguments of costs and benefits of regional versus global arrangements, and they can be discussed in terms of standard theories, starting with Viner's concepts of trade creation and trade diversion. On the other hand, there is a dimension specific to the region's conditions and developments which is characterised by an ongoing process of deep political, social and economic transformation in Central Europe. This underscores the suggestion that in the case of the former communist countries of Central and Eastern Europe, prospective EU membership is not just "another accession".

To reflect this dual dimension of regional and global issues in Central European integration efforts, the paper is structured as follows. In Sections Two and Three, the role of CEFTA is identified together with the macroeconomic situation of its member countries. Section Four presents the EU perspective and policies with regard to eastern enlargement of the EU.

II The Central European Countries' Perspective

Hierarchy of the Central European Countries' Aims

The emerging market economies of Central and Eastern Europe have

1 The views expressed in the paper are personal and should not be attributed to the Czech National Bank.

2 This paper is primarily concerned with CEFTA member countries, Czech Republic, Hungary, Poland, Slovakia and Slovenia, i.e. the CEFTA-5. Their developments are occasionally compared with the other countries which have signed the Europe Agreements, i.e. Estonia, Latvia and Lithuania, Bulgaria and Romania. For the ten countries together, we use the abbreviation CEEC-10.

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clearly demonstrated their interests in membership in global, regional and sub-regional institutions. At the time of writing:

- seven countries have been members of the WTO, with Bulgaria joining most recently in December 1996;
- nine countries have accepted the obligations of current account convertibility in accordance with Article VIII of the Articles of Agreement of the IMF;
- seventeen countries are members of the Council of Europe, nine are members of the Bank of International Settlements and three countries have already become members of the OECD.

At the same time, their trade and capital flows have become more intense compared to the start of transition. An increasing number of economies in transition have been able to raise funds on international financial markets and to obtain reasonable credit ratings from major rating agencies. These developments toward greater integration in the global economy and their institutional structures notwithstanding, the major objective for most Central European countries continues to be accession to the European Union. EU membership is seen as the most effective way to achieve economic development and guarantee social and political stability and security.

The Central European countries (CECs) have articulated a range of aims which could be achieved through accession to the EU, and these have an implied hierarchy. In our view, the ultimate goal of the CECs is not EU membership *per se*, even though these countries appear to be preoccupied with an early membership. Rather, the ultimate goal is to bridge the income gap, reach the developed market economies' level of institutional and social standards, and overcome the unfavourable heritage of previous – in particular post-war – developments and the resulting division of Europe. Authorities in the transition economies as well as domestic and external experts strongly believe that integration into the EU can lead to the attainment of these ultimate goals. It is also believed that, compared to other strategies, EU accession provides the best opportunity for achieving these goals in a smooth, rapid and inexpensive manner.

The pursuit of EU membership does not diminish the dominant role of the domestic environment and domestic growth factors in the countries' development. In the discussion on the most effective development paths, the East Asian case has often been highlighted (compare Sachs and Warner, 1996). Most of these countries, including Japan and more recently the "tigers", achieved high growth rates while maintaining tightly regulated trade and foreign exchange regimes. While the specific conditions which proved conducive to East Asian development are not present in Central Europe, arguments exist for the potential positive impact of

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Central European regional integration. In particular, in the pre-accession period the determination to become a member of the EU acts as an incentive for the endeavours of the potential candidate, and these endeavours are supported by the EU institutions. Moreover, after accession, the newcomers into the EU should enjoy the incentives and advantages of membership in an European-wide integrated area. If the conditions and timing of entry are properly established, the benefits of accession could definitely be expected to outweigh the implied costs of necessary adjustment. In this respect, the success which followed the EU entry of countries like Ireland, Portugal and Spain serve as an example.

On the whole, accession to the EU would be regarded as validating the attainment of the major goal of Central and East European economies: to go through transition and join the club of developed market economies of Europe.

It is this context in which the issues of Central European cooperation schemes and projects should be assessed. In our view the interest is, and should be, focused only on those arrangements, groupings and institutions which can be expected to facilitate easier and earlier EU membership and, as a result, provide better chances for achieving the ultimate goal of catching up. Thus the types and forms of sub-regional cooperation should not be viewed as an alternative to the EU enlargement process, but as a complement.

CEFTA: Its Role and Potential Impact

The original CEFTA members are former Czechoslovakia, Hungary and Poland (CEFTA-3), the so-called Visegrad countries. After the separation of Czechoslovakia, it was transformed into CEFTA-4, and Slovenia became the fifth member state in January 1996 (CEFTA-5).[3]

Powerful incentives existed for the formation of CEFTA:

- CEFTA members are neighbouring countries with traditional economic and cultural linkages, transport cost advantages and shared interests in infrastructure projects, environmental protection and region-wide investments;
- without a CEFTA-type institution, intra-regional trade would become increasingly less favourable compared to the advancing liberalisation of bilateral trade of individual associated countries with the EU;
- there are common interests of associated countries with respect to the

3 A number of specialised studies has been devoted to the assessment of CEFTA's institutional framework and to its developments. For a survey see Zdeněk Drábek's contribution to this volume.

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EU, in particular the strengthening of the bargaining position for the negotiations on the terms of the EU eastern enlargement;

– the CECs' capability and readiness to work towards the integration of individual countries into the European institutions and close cooperation within the region has been demonstrated.

Since its formation, CEFTA has been relatively confined, in principle, to the trade sphere. The time horizon of the liberalisation process of intra-CEFTA trade was initially set at the year 2001, with differentiated procedures and coverage of individual product groups. Moreover, a number of clauses enabled retrogressive measures of individual member countries. These institutional features constrained the potential effects of CEFTA. Apart from institutional weaknesses, CEFTA's impact has been constrained by:

(i) *the small internal market:* The Czech Republic, Hungary, Poland, Slovakia and Slovenia (CEFTA-5) comprise a market of only 67 million citizens, i.e. roughly one-sixth of the EU. Though its capacity and potential has been increasing, the gains from the small sub-regional free trade area have been relatively limited (see Table 1).

(ii) *the modest share of Intra-CEFTA trade:* As a share of total trade, intra-CEFTA trade has been rather low (see Annex Tables 1-5). The Czech and Slovak Republics were the only exceptions as a result of the close trade ties dating back to the former common state and, to some extent, also the customs union maintained since the separation of the federal republic, i.e. former domestic trade was reclassified as international. While the role of intra-CEFTA trade for Hungary, Poland and Slovenia amounted to only 4-8 per cent of their total trade, the figures for Slovakia exceeded 40 per cent in exports and 30 per cent in imports. In the case of the Czech Republic these were 20 per cent and 15 per cent respectively.

Table 1 CEFTA Size of Member Economies in 1996 and Share of Intra-CEFTA Trade

	Nominal GDP (billions of dollars)	**Population** (millions)	**CEFTA trade as % of total**	
			Exports	**Imports**
Czech Republic	52.1	10.3	22.9	14.6
Hungary	43.4	10.2	8.8	7.8
Poland	134.3	38.6	5.8*	5.8*
Slovakia	19.0	5.4	41.4	29.8
Slovenia	18.5	2.0	4.8	7.4
Total CEFTA	248.8	66.5	16.4	11.7

* I-III quarters.

Source: CESTAT, Statistical Bulletin.

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The share of intra-CEFTA trade has gradually been increasing in all member countries – except for the trade between Czech and Slovak Republics which continue to decrease in relative terms. The overall picture is thus one of a small, but significant increase in the role of sub-regional trade. For example, the share of Hungary's exports to CEFTA members rose from 5.2 per cent in 1993 to 8.8 per cent in 1996 while the share of Poland's exports to CEFTA members rose from 3.6 per cent to 5.8 per cent over the same three-year period. Compared to other regional blocks, however, the share of intra-CEFTA trade is marginal, and this suggests a relatively minor impact of CEFTA on development and growth potential of its member countries.

Development Alternatives for CEFTA

In the future, CEFTA could develop along three alternative lines. The first alternative concerns whether CEFTA should limit cooperation to a free trade area or expand into other spheres. This alternative relates to the decision on whether to build a more institutionalised arrangement or maintain a relatively loose and interim group. The lessons from the pre-transition situation provide strong arguments against the highly institutionalised integration of Central European countries. The experience from COMECON institutions proved counterproductive since, in reality, those institutions effectively separated member countries and their enterprises from world market criteria and behaviour patterns; there was no necessity to adjust and, consequently, no timely reaction was initiated, for example, to oil price shocks.

This explains the spontaneous and unanimous decision to dismantle COMECON in 1990, and the remaining distrust for the revival of any similar regional groupings in Central Europe in the initial stage of transition. The inertia of previous trade patterns implies low technical standards and the production and trade of inferior quality goods. Therefore, any such groupings are viewed as counterproductive to the interests of restructuring and re-entry to world markets. Moreover, any sub-regional initiative in Central Europe would have had the connotation of the "poor men's club" viewed with scepticism – especially when proposed by Western observers.

This line of reasoning also applies to the repeated proposal to introduce a parallel to the European Payments Union (van Brabant *et al.*, 1992). The experience of payments union in Western Europe was certainly positive; in the 1950s it contributed to the restoration of trade and to economic recovery. Moreover, it became a vehicle for the restoration of currency convertibility. However, conditions in Central Europe in the early 1990s were

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entirely different. Unlike post-war Western Europe where current account convertibility was restored only at the end of the 1950s, the economies in transition mostly opted for a move to currency convertibility at the very start of their transition. This was a noteworthy achievement which distinguishes Central European transition from post-war Western Europe, as well as other parts of the world economy, where the restoration of convertibility took much longer (Cooper, 1997).

The influence of the pre-transition experience has diminished in the course of time. The institutional framework in the CECs has undergone radical change and acquired the potential for sub-regional cooperation. In this context, various ideas have recently been suggested, for example, for policy coordination and joint institution-building (van Hagen, 1996).

Views on the desirability of closer sub-regional cooperation have diverged not only over the course of time but also across individual CEFTA member countries. While the Czech authorities have tended to confine CEFTA to the trade sphere, other CEFTA members have expressed their readiness to supplement free trade with other areas. In their view, a path parallel to the gradual deepening of EU integration since the early 1950s could be followed.

The second alternative for CEFTA development concerns whether it should be enlarged or should maintain its relative homogeneity and further deepen its cooperation. In September 1995, the representatives of CEFTA member countries met in Brno, the Czech Republic, and passed the resolution which provided for the enlargement of CEFTA and stipulated the conditions for the accession of other European states (Article 39a of the Agreement on CEFTA).

The recently enhanced role of CEFTA in the European integration perspective has resulted in increasing interest in CEFTA membership. Apart from the Baltic states – particularly Estonia – Romania and Bulgaria are prospective candidates. In a September 1996 meeting in Bratislava-Jasná in the Slovak Republic, representatives of CEFTA-member governments consented to begin negotiations with Romania. Romania has been a party to GATT since 1971 and a founding member of WTO. Romania has also concluded an Association Agreement with the EU thus meeting the preconditions for CEFTA membership. Romania will become the sixth member of CEFTA in July 1997. This newest member of the club will add another 22.7 million citizens (consumers) and $33.5 billion to aggregate GDP.

The third alternative for CEFTA development concerns trade liberalisation. To a great extent, the quantitative and tariff barriers in mutual trade will be removed in line with the gradual elimination of these barriers on EU and EFTA imports. This scenario implies the creation of parallel con-

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ditions in intra-regional trade to those in trade with Western Europe. While such an approach is more or less embedded in the present CEFTA Agreement, its implementation might not keep pace with EU trade liberalisation given the various provisions and exclusions involved.

The Impact of CEFTA

The gains from CEFTA formation can only be identified in a tentative way, and given the aforementioned constraints, they should not be unrealistically exaggerated. CEFTA was created to encourage the development of trade within the Central European sub-region by removing trade barriers between member countries. The share of intra-CEFTA trade on total trade of its members, though steadily increasing, remained relatively limited in the examined period (see Table 1 and Annex Tables 1-5). This does not imply, however, that it was unimportant.

The assessment of the gains from CEFTA trade must be discussed in the relevant historical context. Mutual trade of participating countries was artificially inflated under the COMECON regime via strictly planned targets, and this was at the expense of trade with other parts of the world economy. The dismantling of COMECON institutions presented the opportunity and – at the same time, the necessity – to re-orientate the majority of trade of former COMECON countries. On the whole, this re-orientation has been a remarkable success though differentiated across individual countries. In 1995, almost two-thirds of Central and East European exports went to Western market economies compared with 43 per cent in 1989. The most important and dramatic element of this shift has been trade with the EU. Compared to only about one-third of Central and East European exports in 1989, the EU accounted for more than 60 per cent in 1995.

It may be argued that some enhancement of mutual trade among the emerging market economies of Central and Eastern Europe should occur, and judging recent trends in intra-CEFTA trade, this has already been taking place. The available evidence suggests that the mutual trade potential of economies in transition was not utilised in the early 1990s. The main reasons were transition and necessary institutional changes. Once these changes were consolidated, the prospects for utilising regional trade potential became more favourable. In this respect, CEFTA's role seems to be of increasing importance.

The increasing share of intra-CEFTA trade, the trend toward CEFTA enlargement and the deepening of CEFTA markets has alleviated the constraints experienced in the past, particularly the market size constraint. It is likely that CEFTA economies will form an increasingly important export

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market in the medium term – not only for each other but for EU members and others as well. The expansion of intra-regional free trade should also help strengthen the CEFTA economies' medium-term growth prospects since both economic theory and empirical evidence suggest that openness to international trade is beneficial for growth. The factors behind the recent CEFTA revitalisation are, therefore, likely to play an important role in the development potential of the countries in the region over the next decade.

III Macroeconomic and Institutional Developments in CEFTA Countries

In transition economies, macroeconomic, systemic and institutional conditions have been stage-specific. They have undergone profound change within a relatively short time span. The distinguishing features of each stage resulted from macroeconomic and institutional changes and the interaction of the two.

The First Transition Stage: the Challenge of Liberalisation and Macroeconomic Stabilisation

During the early 1990s, disinflation and macroeconomic stabilisation had priority in all CEFTA member countries. During price, foreign trade and foreign exchange liberalisation, the governments were faced with previously "hidden" inflationary potential inherited from the past as well as inflationary pressures generated in the course of transition itself. The aim was to avoid surging price levels and vicious circles of wage and devaluation spirals from developing when price ratios went through profound adjustment. Accordingly, the restrictive stance of macroeconomic policies was necessary.

The Case for Exchange Rate Based Stabilisation in the Early 1990s

Following the stabilisation programmes applied elsewhere in the world in the 1970s and 1980s, particularly those sponsored by the IMF, some transition countries opted for a nominal anchor strategy for stabilisation. The role of the key nominal anchor, and therefore the key in stabilising price levels and the inflationary expectations of economic agents, was attributed to the stable nominal exchange rate pegged to the basket.

The exchange rate anchor is a transparent commitment – comprehensible and controllable by the public. Exchange rate based stabilisation was

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therefore expected to provide important advantages compared to other alternatives such as money based stabilisation. As the demand for money was almost unpredictable due to discontinuities and shocks inherent in the initial stage of transition, the assessment of the proper volume of monetary aggregates was subject to a high margin of error. Accordingly, these could not have been expected to be a reliable anchor option.

Nevertheless, as the experience of a number of emerging market economies has suggested, stabilisation could be accomplished with different nominal anchors. In fact, Begg has argued that controlling any relevant nominal variable may be effective as long as the changes in monetary values are multiples of those in real ones (Begg, 1996). This was the case in the initial stage of transition when changes in monetary and real magnitudes widely diverged. Once stabilisation was successfully accomplished, i.e. once changes in real variables were no longer so small in comparison to monetary ones, the proposition became irrelevant.

With the benefit of hindsight, it can be claimed that stabilisation policies in CEFTA member countries during the initial period of reforms were successful. Inflationary pressures eased after the initial price level surge, though with differentiated time spans and intensities across individual countries (see Table 2).

Table 2 Consumer Price Inflation in CEFTA Countries
(percentage change relative to preceding year)

	1990	1991	1992	1993	1994	1995	1996
Czech Republic	9.9	56.7	11.1	20.8	10.0	9.1	8.8
Hungary	28.9	35.0	23.0	22.5	18.8	28.2	23.6
Poland	585.8	70.3	43.0	35.3	32.2	27.8	19.9
Slovak Republic	10.6	61.2	10.0	23.2	13.4	9.9	5.8
Slovenia*	549.7	117.7	201.3	32.3	19.8	12.6	9.7

* Retail prices.
Source: National statistics.

The other side of the coin was a deep and protracted contraction of economic activity in the first transition years. Table 3 presents the growth performance of CEFTA member countries which fared relatively better among economies in transition during 1990-96. The data reveal two entirely different phases. The first phase is characterised by a steep decline in economic activity while the second exhibits a revival of positive growth rates. Compared to expectations and predictions, the contraction of economic activity in the initial stage was deeper and more protracted. This

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was the case in all CEFTA countries regardless of the adopted transformation strategy and policies and in spite of differences in macroeconomic and institutional conditions at the outset.

Table 3 GDP Growth Rates in CEFTA Countries
(percentage change relative to preceding year)

	1990	1991	1992	1993	1994	1995	1996*
Czech Republic	-1.1	-14.2	-6.4	-0.9	2.6	4.8	4.4
Hungary	-3.5	-11.9	-3.0	-0.8	2.9	1.5	0.5
Poland	-11.6	- 7.0	2.6	3.8	5.2	7.0	6.0
Slovak Republic	-2.5	-14.5	-6.5	-3.7	4.9	7.4	6.9
Slovenia	-4.7	-8.1	-5.4	1.3	5.3	4.0	2.5

* Preliminary figures.
Source: National statistics.

Recession was no less severe in the Czech and Slovak Republics despite the relatively favourable macroeconomic situation of former Czechoslovakia at the start of transition (see Table 3). And while Hungary did not embark on the stringent stabilisation programme of the Polish and Czechoslovakian type, it still experienced a parallel downturn in economic activity. The evidence tends to support the consensus on the specific, structural character of recession in transition economies in the early 1990s or, as phrased by Kornai, a "transformational" recession. Its structural nature was reflected in price level developments. In a cyclical type of behaviour, recession would be expected to result in price level stabilisation or in diminished inflation rates. Contrary to this, the decline in economic activity in transition economies was accompanied by a price level rise after the implemented liberalisation. On the other hand, the follow-up period of economic recovery and growth acceleration was accompanied by declining inflation levels, and not the other way around (compare Table 2).

The Follow-up Stage: From Transformational Recession to Sustainable Growth

In macroeconomic terms, after the period of structural recession of 1990-1993, the performance of CEFTA member countries made remarkable progress to economic recovery and accelerated growth rates. To identify and assess this performance, we compare CEFTA member countries (CEFTA-5) with other associated countries, i.e. with those which concluded Europe Agreements with the EU (CEEC-10).

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Growth Performance

In 1995, the aggregate economic growth of CEEC-10 increased to 5.2 per cent, and most associated countries recorded higher growth than in the previous year. Particularly high growth rates – around 7 per cent – were recorded in Slovakia, Poland and Romania while Hungary, Latvia and Slovenia experienced a certain slowdown. In Slovenia, the appreciation of the domestic currency (the tolar) discouraged exports with an accompanying adverse impact on growth. In Hungary, restrictive policies of the stabilisation programme launched in 1995 were targeted to tackle the country's expanding current account and budget deficits. The resulting slowdown brought an improvement in the existing imbalances and this, in turn, formed the foundation for faster growth in coming years.

In addition to current account and trade balance constraints, the fragility of financial systems proved to be the other primary constraining factor in transition economies. The outbreak of banking crises in Latvia and Lithuania adversely affected their growth potential.

Compared to 1995, average GDP growth in CEEC-10 was expected to slow down to just below 5 per cent in 1996 and 1997. The primary cause for this slowdown in most CEEC-10 is the lower contribution of net exports to growth. Though economic recovery was initially sparked and supported by increasing exports, the current revival of growth in most of the associated countries is driven primarily by domestic demand. Given the continued relative slowdown in Western Europe, which has become the major export market for associated countries, domestic demand has evidently remained the primary contributor to growth in 1996. The same tendency is expected in 1997 as well.

The European Commission Services' forecasts of the growth rates for CEEC-10 are as follows:

A slowdown, albeit a marginal one, was envisaged for the group of associated countries in 1996 and 1997 compared to 1995 (see Table 4). The CEFTA countries were expected to remain in the lead, maintaining relatively robust rates of growth exceeding 5 per cent. At the same time, a tendency toward more balanced development dynamics within CEFTA seems to be emerging. Accelerated growth is envisaged in the case of Hungary, while the fast growers, Poland and Slovakia, were expected to slow down from their record 7 per cent growth rate in 1995.

Inflation Record

Inflation rates in CEFTA countries have also been reduced considerably, although substantial differences among individual countries remain

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Table 4 **Gross Domestic Product of CEEC-10 in 1994-1997***
(real percentage change)

	1994	1995	1996	1997
Bulgaria	1.4	2.7	2.1	1.7
Czech Republic	2.6	4.8	5.5	5.9
Estonia	3.2	4.5	4.0	3.8
Hungary	2.9	1.7	2.1	3.5
Latvia	1.9	-1.6	1.2	2.2
Lithuania	1.0	2.5	1.0	2.5
Poland	5.2	7.0	6.0	5.5
Romania	3.9	6.9	4.5	5.2
Slovakia	4.9	7.4	5.5	4.6
Slovenia	5.3	4.2	4.4	4.6
CEEC-10	4.0	5.2	4.7	4.9

* 1994-95 actual, 1996-97 predicted.
Source: European Economy, Supplement C, No. 1, May 1996.

(compare Table 2). The Czech Republic, Slovakia and Slovenia were the first transition economies to achieve single-digit inflation rates. Hungary, on the other hand, was the only country where inflation accelerated in 1995 as a consequence of a considerable depreciation of the domestic currency (forint) and of indirect tax increases.

Predictions are that most CEEC-10 countries would be able to reduce average yearly inflation to below 20 per cent in 1997 (see Table 5). This means that relatively high growth rates of economic activity in the region

Table 5 **Inflation in CEEC-10 in 1994-1997**
(real percentage change)

	1994	1995	1996	1997
Bulgaria	81.7	62.0	33.0	30.0
Czech Republic	10.7	9.1	8.5	7.4
Estonia*	33.6	28.9	20.0	18.0
Hungary	19.6	26.4	23.0	18.0
Latvia*	28.1	26.0	18.5	14.0
Lithuania*	44.6	37.0	28.0	19.0
Poland	32.2	28.0	21.0	17.0
Romania	129.7	33.1	24.0	20.0
Slovakia	13.6	9.7	6.5	6.0
Slovenia	18.5	12.6	8.7	7.0
CEEC-10*	38.9	23.7	17.7	14.3

* GDP deflator.
Source: European Economy, Supplement C, No. 1, May 1996.

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notwithstanding, inflation was expected to be further suppressed. However, the rate of its envisaged reduction was modest compared to previous advances. This proved to be a more widespread phenomenon of the current stage, i.e. maintaining the rate of disinflation became more demanding and less feasible. The existing levels of inflation, however differentiated across individual countries, seemed to be built into the expectations of economic agents. In relative terms, CEFTA countries continued to fare better; Slovakia, Slovenia and the Czech Republic not only expected to maintain their one-digit inflation rate, but to improve it. Nevertheless, even in the case of the Czech Republic, progress was not entirely satisfactory and a substantial distance to the EU standard remained.

Trade Performance and Balance of Payments Constraints

Though differentiated across individual countries and time periods, a tendency toward trade and current account deficits has been a general feature of CEFTA members. In the case of Hungary, the surging current account deficit together with a budget deficit peaked in 1993 and 1994 when it reached around 9 per cent of GDP for two consecutive years (see Table 6). A stabilisation programme with tough austerity measures had to be introduced in 1995 to cope with the twin deficits. Though a crisis was avoided, the price for balancing external and public sector's accounts was quite high in terms of depressed growth rates, significant cuts in real wages, currency depreciation and increased inflation (Kornai, 1997).

A similar situation developed in the Czech Republic in 1995 and in the Slovak Republic in 1996. In the Czech Republic, trade deficits were covered through service balance surpluses up to 1994, but since 1995 current accounts have turned increasingly red. In 1995, the current account deficit amounted to about 3 per cent of GDP while in 1996 it soared to 8.6 per cent. If policy corrections are not made, the trade gap is likely to widen further in 1997 making current account developments and the entire macroeconomic situation extraordinarily vulnerable.

The weak point in Czech developments was the lagging domestic supply side response linked to the slow pace of restructuring and improvements in corporate governance together with deficient legal norms. In these conditions, dynamic domestic demand fed by soaring private consumption and domestic investment was transmitted into an increasing current account deficit (see Table 6).

As can be inferred from data in Table 7, this trend was a common phenomenon in transition economies. Trade balance developments primarily reflected trends in domestic demand. In 1994, low domestic demand combined with enhanced export performance secured a significant improve-

Table 6 Foreign Trade (Goods and Services) and Current Account Balance of CEFTA Countries

	1990	1991	1992	1993	1994	1995
A. (percentage of GDP in market prices)						
Exports						
Czech Republic	52.4	57.5	56.6	56.7	52.5	49.5
Slovakia	26.5	46.3	70.3	61.6	65.2	62.7
Poland	25.0	23.5	23.7	22.9	24.0	24.9
Hungary	31.1	32.8	31.4	26.4	28.9	34.9
Slovenia	90.8	83.5	63.1	58.5	59.0	58.7
Imports						
Czech Republic	51.1	50.7	56.2	54.5	52.9	54.5
Slovakia	35.5	49.3	74.3	67.1	59.7	59.4
Poland	17.8	25.4	22.2	22.0	23.0	24.8
Hungary	28.5	33.7	31.7	34.6	35.4	37.0
Slovenia	78.5	74.3	56.2	57.9	56.7	60.2
Trade Balance						
Czech Republic	1.3	6.8	0.4	2.2	-0.4	-5.0
Slovakia	-9.0	-3.0	-3.9	-5.5	5.5	3.3
Poland	7.1	-1.9	1.5	1.0	1.0	0.2
Hungary	2.6	-1.0	-0.3	-8.2	-6.5	-2.2
Slovenia	12.2	9.3	7.0	0.6	2.2	-1.5
B. (annual percentage changes)						
Exports						
Czech Republic	-7.0	-9.8	6.8	7.5	0.2	8.0
Slovakia	–	33.4	47.4	-0.2	14.1	3.2
Poland	–	12.7	10.8	3.2	13.1	18.4
Hungary	-5.3	-3.1	2.1	-10.1	13.7	13.4
Slovenia	–	–	–	-0.9	10.8	6.0
Imports						
Czech Republic	3.2	-21.7	22.0	10.4	7.8	19.2
Slovakia	–	-14.7	47.1	-0.8	-3.5	6.7
Poland	–	56.2	1.7	13.2	11.3	22.8
Hungary	-4.3	5.4	0.2	20.2	8.8	-0.7
Slovenia	–	–	–	17.3	10.5	13.0
Current Account Balance						
Czech Republic	-1.8	7.0	-0.3	0.4	-0.1	-2.9
Slovakia	-5.0	-6.8	0.2	-4.4	4.8	1.0
Poland	13.9	-0.9	-0.3	-2.7	-1.0	-0.1
Hungary	1.1	1.2	-0.6	-8.9	-9.4	-3.2
Slovenia	–	–	–	0.0	3.7	0.7

Source: V. Nachtigal, "Czech Economy in the First Half of 1990s", Institute of Economics, Czech National Bank, 1996.

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ment in trade balances in most CEEC-10 countries. However, the trend reversed again in 1995. The recovery of domestic demand revitalised imports and worsened trade balances in CEEC-10 countries. As the data in Table 7 indicate, a further deterioration was envisaged for 1996 and 1997.

Table 7 Trade Balance of CEEC-10 in 1993-1997
(in percentage of GDP)

	1993	1994	1995	1996	1997
Bulgaria	-8.2	-0.2	3.3	3.6	4.4
Czech Republic	-1.0	-2.5	-8.7	-10.4	-11.0
Estonia	-5.4	-15.5	-20.4	-17.8	-13.0
Hungary	-8.4	-8.8	-5.8	-4.5	-3.9
Latvia	-7.3	-11.1	-11.9	-11.1	-10.3
Lithuania	-10.9	-7.9	-5.5	-5.5	-6.3
Poland	-2.7	-0.9	-1.6	-2.0	-2.7
Romania	-6.2	-3.2	-6.2	-4.2	-3.6
Slovakia	-7.4	0.6	0.3	-1.3	-2.6
Slovenia	-1.1	-1.3	-4.5	-4.6	-5.5
CEEC-10	-4.3	-3.0	-4.1	-4.2	-4.6

Source: European Economy, Supplement C, No. 1, May 1996.

The export performance of associated countries has become a key development challenge. If not corrected, trade and current account deficits will be a major point of vulnerability of their economies, effectively constraining their growth potential and their process of catching up to the EU standard.

Institutional Developments

In addition to macroeconomic changes, the transition economies have also undergone profound institutional change in a relatively short time span. To identify and assess these changes, we have used the concept of financial openness as an organising criterion. Accordingly, we distinguish rudimentary and advanced stages of financial openness, though no clear-cut dividing line can be drawn, and in reality, some features of each stage overlap.

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1. The Stage of Rudimentary Financial Openness

In this stage, which occurs in the first transition years:

- only an "internal" form of currency convertibility was introduced in CEFTA countries. It was initially confined to the free access to foreign exchange for import purposes and was gradually extended to other types of agents and current account items. Nevertheless, according to international standards, domestic currencies remained non-convertible;
- external liberalisation, however radical compared to previous rigid regulations, was limited to current account items. Capital flows continued to be strictly regulated;
- domestic financial markets and financial intermediation were only in their infancy stage. Their underdevelopment and persistent rigidities were reflected in the limited range of marketed products, low responsiveness of economic agents to monetary and credit policies and in scarce correlation between money market and clients interest rates.

A review of these features in light of more current conditions, reveals the depth and speed of institutional and systemic changes which were taking place.

2. The Stage of Advanced Financial Openness

In this stage:

- the move from internal to external currency convertibility on current accounts was implemented in compliance with Article VIII of the Articles of Agreements of the IMF. As a result, the CEFTA countries' currencies entered the "club" of convertible currencies;
- liberalisation was extended to some major forms of capital flows, i.e. beyond the provisions of Article VIII of the IMF. This substantial advance on the liberalisation front paved the way for the Czech Republic, Hungary and Poland to become members of the OECD.

The Exchange Rate Regime

A wide range of exchange rate arrangements – from currency board systems to floating options, more or less managed – were adopted by the emerging market economies of Central and Eastern Europe. This regime differentiation evolved even though the initial characteristics of these countries were highly similar.

Poland and former Czechoslovakia represent those emerging market economies of Central and Eastern Europe which opted for a fixed exchange regime at the start of transition. This choice was particularly

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appropriate given the key role of a fixed exchange rate in the IMF-type stabilisation programmes adopted by these countries.

In the case of former Czechoslovakia, the policy of nominal exchange rate stability was initiated in 1990. It was aimed at anchoring the stabilisation process after sweeping price and foreign exchange liberalisation in the beginning of January 1991. However, no binding commitment was publicly made to keep the introduced fixed exchange rate regime and the given exchange rate level unchanged, neither indefinitely nor for any pre-announced period. Nevertheless, the regime pegging the domestic currency to the basket was maintained in the Czech Republic until the end of February 1996, i.e. for 62 consecutive months despite the separation of former Czechoslovakia and its common currency, the Czechoslovak koruna. Such long-run exchange rate stability has indeed been exceptional in a transition economy – especially when compared to some OECD member countries. At the end of February 1996, keeping central parity untouched, the exchange rate fluctuation band of the Czech koruna was widened to ±7.5 per cent.

Unlike former Czechoslovakia, most emerging market economies of Central and Eastern Europe, including Slovenia, Bulgaria, Russia and almost all other CIS countries, adopted a managed float, i.e. a flexible type of exchange rate regime from the beginning of transition. Slovenia and Bulgaria opted for managed floating primarily because of the lack of foreign exchange reserves. In their "starting" conditions, the fixed exchange rate regime appeared unsustainable.

Sooner or later, others found it necessary to depart from the initial fixed exchange rate. These were, among others, Poland and Hungary. Poland started its transition in 1990 with a fixed rate pre-committed to a specified period. That regime was replaced by an adjustable peg system in May 1991 and by a crawling peg in October 1991. Later, the band was widened to 7 per cent (May 1995). Thus Poland joined some other emerging market economies, including Israel, Colombia, Chile and Mexico, in introducing a crawling band system.

The Hungarian authorities traditionally pursued a policy of small, irregular, discrete re-alignments (devaluations) with respect to the basket. The objectives of the policies, however, changed in the course of time. Over several periods, the devaluations just corrected for the inflation differential, i.e. a real exchange rate was held stable in principle; in others, some real exchange rate appreciation was allowed to occur. Within the framework of the initiated stabilisation programme, starting from March 1995, the previous policies of occasional minor adjustments were replaced by a pre-announced crawling.

Instead of this more flexible arrangement, a currency board system was

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introduced by Estonia (1992) and Lithuania (1994). This regime imposed a fixed exchange ratio on the "pilot" currencies (German marks and US dollars respectively) and implied sacrificing the central bank's authority to devise and calibrate monetary policies. These newly independent Baltic countries, which are very small, open economies, lacked the institutions and experience in monetary management. Inflation was reaching hundreds of per cent in Estonia and more than a thousand per cent in Lithuania in the early 1990s. The currency board was thus viewed as a good way to radically reduce inflation.

After a period of a floating rate, Russia introduced a "trading corridor" for the rouble in mid-1995. This was replaced by a version of a formal crawling band in July 1996. With a margin of about ± 6 per cent, the rouble exchange rate was targeted to depreciate at 1 to 1.2 per cent per month with respect to the US dollar.

These examples suggest that country-specific priorities and constraints proved to be key factors in exchange rate regime choice at the start of transition and in follow-up changes as well. As could be expected, most transition economies adopted exchange rate arrangements somewhere between irrevocably fixed and freely floating rates. To satisfy competing requirements of stability and competitiveness, exchange rate policies were typically compromise solutions, such as an adjustable peg, a crawling peg and various forms of managed floating. Polar regimes seemed inappropriate for transition economies except, possibly, for the short run. In this respect, the evident viability of the currency board experiments of Estonia and Lithuania provided an interesting counter experience.

The Openness of CEFTA Countries

Except for Poland which can be classified as a medium-size economy, CEFTA countries are small economies. Accordingly, the share of trade and service flows on their GDPs has been rather high. In the transition years 1990-1995, the highest share of both exports and imports on GDP was reached by Slovenia and Slovakia, the two smallest CEFTA countries (see Table 6).[4] In 1995 their export and import flows of goods and services amounted to about 60 per cent of their GDP. The Czech Republic's ratio was only slightly less, but with a widening gap between export and import ratios. The degree of openness of the three mentioned CEFTA countries exceeding 50 per cent was rather high, surpassing that of countries like

4 The figures for Slovakia and Slovenia in 1990-1992, as shown in Table 7, are evidently biased due to the fact that both countries were then part of a wider federation. The available data calculated ex post are therefore less reliable.

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Austria, Sweden, Portugal and Greece in which the ratios fluctuated between 25 and 40 per cent (compare Nachtigal, 1996). On the other hand, the trade/GDP ratios of Hungary and Poland matched in broad terms those of comparable West European countries.

We can infer from the trade/GDP ratios that CEFTA member countries became very open economies.[5] This characteristic suggests that the dynamics of their economic activities must have been highly sensitive to their export performance and competitiveness.

Competitiveness and its Determinants

Though the various concepts of country competitiveness and their assessment are subject to discussion and critique (compare Krugman, 1994), the very issue of price and non-price competitiveness and their causal factors are of crucial importance for the prospects of any open economy, including CEFTA countries.

In Table 8, the position of three Central European countries, Czech Republic, Hungary and Poland is assessed compared to four EU countries with relatively inferior competitive records among EU members.[6]

Table 8 Comparative Competitiveness Record

Countries	Factors of competitiveness, positions in 1996								Country position	
	Domestic economy	Internationalisation	Government	Finance	Infrastructure	Management	Science & technology	People	1995	1996
Czech Republic	34	34	34	33	35	39	43	28	38	34
Hungary	43	30	40	43	24	38	36	33	40	39
Poland	40	42	43	44	45	37	37	30	44	43
Spain	33	25	35	25	23	33	30	26	27	28
Italy	28	21	45	27	29	26	24	25	28	29
Portugal	42	32	32	29	39	41	35	32	31	36
Greece	39	35	42	39	41	43	39	29	39	40

Source: The World Competitiveness Yearbook, IMD, 1996.

5 This conclusion must be qualified for a lower level of GDP compared to the West European average. It explains why per capita export performance in CEFTA countries continued to be only a fraction of the volume reached in comparable EU countries.

6 Data are taken from the World Competitiveness Report which provides a multi-dimensional assessment of competitiveness based on the evaluation of 8 groups of factors (as applied in Table 8) covering 378 criteria. Two-thirds are "hard" statistical data, and one-third is "soft" data of a qualitative nature based on surveys. In the covered sample of 45 countries in 1995 and 46 countries in 1996, three CEFTA countries were included.

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While the Czech Republic, Hungary and Poland are not among the global forerunners, their positions can be compared to Spain, Italy, Portugal and Greece. There were, however, some remarkable differences across individual CEFTA countries. The Czech Republic's least favourable assessment is in science and technology (43), while in Hungary finance (43) is unfavourable and science and technology is considered relatively more advanced (36). In the Polish case the most unfavourable assessments were given to government (43), finance (44) and infrastructure (45). On the other hand, the human factor "people" of the CEFTA countries is, as could be expected, evaluated more favourably – in principle, at the same level as in the compared group of EU members.

Capital Flows and CEFTA Countries

Prior to the start of transition in CEFTA countries in 1990, capital flows were strictly controlled and their macroeconomic importance was rather limited. Transition brought a reversal: both the volume and forms of capital flows expanded and diversified within a few years. Since the early 1990s, capital inflows into CEFTA countries became a major factor of economic development but, at the same time, a major policy issue as well.

The progressing transformation and external opening of former centrally planned economies offered new investment possibilities. On the one hand, incentives to invest were related to successful stabilisation, the restoration of currency convertibility, and the advancing privatisation and liberalisation of external flows and the domestic economy. On the other, capital inflows were also stimulated by a rather constrained domestic supply of financing, particularly of long-term credits, and by a much wider interest rate differential compared to developed market economies. Thus capital inflows resulted both from the success of stabilisation as well as from the implied imbalances and constraints inherent to the transition.

Despite the evolving wave of capital inflows into CEFTA member countries in the mid-1990s, from the real economy point of view, the volume of capital inflows appeared lower than desired and lower compared to the volumes flowing to emerging market economies in other parts of the world economy.

IV The European Union Perspective

Two projects will keep the EU on the move in the years to come: the formation of the European monetary union with the introduction of a single currency, and the EU eastern enlargement.

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With regard to the latter, observers in transition economies as well as outside point to some ambiguity in the EU approach. While policy steps have been taken toward early accession and there are signals from the EU of their wholehearted support of the transition process, until recently there was a lack of any binding commitments from the EU to the accession of former centrally planned economies of Central and Eastern Europe. Critics have repeatedly pointed to the reluctance of the EU authorities to stipulate concrete conditions and a working timetable for the accession. As a result, any discussion of eastern enlargement must include factors behind the EU stance.

EU Policies Regarding Central and Eastern Europe

EU policies on association and prospective membership of the emerging market economies of Central and Eastern Europe have been subject to thorough assessments (see de Largentaye, 1993; Nuti, 1996; Drábek, 1997). The Europe Agreements acknowledged the associates' desire to eventually join the EU. However, they provided no explicit assistance to the associated countries to support their development toward market economies and political democracies. It was only in June 1993 in Copenhagen that the European Council decided "that the associated countries in Central and Eastern Europe that so desire shall become members of the Union", and general conditions for their membership were explicitly formulated. Accordingly, associated countries were to be regarded as potential members providing they had established:

- a political democracy and stable institutions;
- a legal regime securing human rights and the rights of minorities;
- a functioning market economy;
- the capacity to sustain competitive pressure and market forces within the Union;
- the ability to take on the obligations of membership, including political and economic goals of the Union.

In principle, the conditions stipulated for membership required the acceptance and implementation of the EU's *acquis communautaire.*

In June of 1993, there was also explicit reference to the pre-conditions on the side of the Union, for the first time. The key issues were related to the capacity and the readiness of the Union to absorb new members.

The European Council summit in Essen in December 1994 offered the Central and East European countries a "structured dialogue". At the same time it confirmed that "the Union's capacity to absorb new members, while maintaining the momentum of European integration and respecting its internal cohesion and fundamental principles, is also an important con-

sideration". Later on the European Commission, focusing on legal dimensions of the preparations for membership in the single market presented the associated countries with a set of tasks in the "White Paper on the Eastern Enlargement".

The European Council summit in Cannes of June 1995 invited the associated states to participate in the discussion for the first time. And the European Council summit in Madrid in December 1995 discussed the cost of enlargement in terms of the Common Agricultural Policy (CAP) and reaffirmed its commitment to enlargement as "both a political necessity and a historic opportunity for Europe".

The EU Stance Towards Eastern Enlargement

With regard to political and security aspects, early enlargement has been supported by all the EU member countries. Like the eastern countries themselves, the EU also has a major interest in the security and political stability of Central and Eastern Europe. Indeed, this has perhaps been the principal consideration. Moreover, the EU member countries have felt a commitment to provide assistance to that part of the continent which suffered most from the post-war division of Europe.

Unlike political and security dimensions, the economic issues of the eastern enlargement are less straightforward, if not controversial. It is this dimension in particular which has been the source of apparent ambiguity in the EU position and policies. In avoiding (premature) clear-cut commitment for eastern enlargement, the EU policy has developed in a step-wise manner with obvious reluctance to binding decisions and commitments.

This approach has been supported by certain rational arguments. First, it was quite obvious that not only benefits but also costs would be involved, for newcomers and for incumbents as well. While both groups of countries were interested in reaping the benefits of an extended free trade area and capital mobility and of new trade and investment opportunities, the expected economic gains from eastern enlargement did not loom particularly large for the existing EU members.[7] Moreover, these gains were most likely only in the medium and long term, while the costs of adjustment and budgetary expenditures related to the EU funding were a matter of immediate concern.

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7 It was argued that economic gains from eastern enlargement are likely to be rather small due to the limited size of their markets while trade and investment flows have been increasing anyway. The counter arguments pointed to the dynamic perspective compared to the static gains, to the increasing depth of eastern markets in the course of time and to the resulting enhancement of the productive potential and of competitiveness of the whole region.

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Nevertheless, the conditions related to the eastern enlargement are specific and, accordingly, the experience from the past accessions is hardly relevant. In the case of the emerging market economies of Central and Eastern Europe, the EU is dealing with a group of countries in which the institutional frameworks have developed in an entirely different manner from the *acquis communautaire* for decades.

Table 9 GDP per Capita in 1993: CEFTA and EU Countries

A) multilateral comparison*, PPP base				
Austria = 100				
EU-15			89.6	
	of which:	Spain		68.5
		Portugal		61.4
		Greece		55.7
CEFTA-5			29.7	
		Slovenia		48.2
		Czech Republic		44.1
		Hungary		31.2
		Slovak Republic		30.2
		Poland		24.4
B) bilateral comparison, current exchange rates**				
Austria = 100				
		Slovenia		27.9
		Czech Republic		13.3
		Hungary		16.4
		Slovak Republic		9.1
		Poland		9.8

* Based on European Comparison Programme (ECP).
** Bilateral comparisons with Austria.
Source: Bulletin, Czech Statistical Office, 12/1995.

As follows from Table 9, the income level gap between the EU average and the (relatively advanced) group of CEFTA-5 countries was much wider than for any of the previous newcomers. This is the case in spite of reservations about the potentially biased calculations due to the sweeping price ratio adjustments under way. In PPP terms, which are more favourable compared to current exchange rates, the per capita income level for CEFTA-5 in 1993 was 29.7 per cent of the Austrian level, while the EU (15) average was 89.6 per cent of that level. On the other hand, the position of the most advanced CEFTA countries, Slovenia and the Czech Republic, with 48.2 per cent and 44.1 per cent respectively, was not greatly inferior to those of Portugal (61.4 per cent) and Greece (55.7 per cent).

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A number of factors, specific to economies in transition, have made the feasibility of eastern enlargement a rather complicated issue for the EU authorities. The very assessment of its likely costs and benefits is only very tentative and hypothetical given the entirely different institutional framework of Central and East European countries. Sweeping changes are under way but they currently lack a track record comparable to member countries. This uncertainty in assessing costs and benefits is linked to the uncertainty in appraising whether and when the countries in transition would be advanced enough to comply to the rules and regulations governing the Single European Market and its competition standards.

The importance of this type of uncertainty for understanding the potential course of eastern enlargement has been highlighted by van Hagen (van Hagen, 1996) who argued that there could hardly be any track record for CECs concerning their commitment to EU membership, their capability to comply with the requirements of the Single Market or the irreversibility of their market-oriented policies. As a result, the argument of the optional value of waiting has been suggested. This implies that the postponement of the Central and East European accession is warranted, when adjustment reaches a more mature stage.

The costs and benefits of eastern enlargement would not be equally distributed, in fact, the opposite is true. Distributional asymmetries are likely to be common among existing members, between existing members and new members, and across different sectors and over time. Germany, as a neighbour of the potential candidates, would certainly be more affected and reap more benefits both in security and economic terms than the Mediterranean countries for example.

An asymmetry would also exist in EU budgetary costs. Entry into the EU of ten potential candidates (with a Europe Agreement) would imply a substantial expansion of the Union's budget. Though we do not attempt any quantitative assessments (see e.g. Bárta and Richter, 1996), both the current beneficiaries of the regional policies (via structural and cohesion funds) and the Common Agricultural Policy as well as the net contributors would be affected. The distributional issue is likely to be highly sensitive. Given the pressure throughout the Union to reduce budgetary deficits to meet the Maastricht criteria and the difficulties experienced in cutting welfare expenditures, any additional significant burden on net contributors is hardly viable – especially in the current race for qualifying for the single currency. The drive toward fiscal consolidation to meet the EMU criteria and the requirements of the stability pact applies to the beneficiaries as well, namely to Ireland, Spain and Portugal. The potential cuts in their fund inflows, or even the shift in their position from net recipients to net contributors, would carry the risk of their – at least implicit – veto to accession.

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This points to the importance of the adjustment process both on the side of the associated countries as well as within the EU. Though the costs and benefits will remain a multi-dimensional issue distributed asymmetrically with different weights for incumbents and potential newcomers, their interests could be made more compatible.

EU Features Which Are Unfavourable to Eastern Enlargement

Some specific features of the EU could interfere with the goals of eastern enlargement. These include its current institutional arrangement, the type of governance and specific policies such as CAP and regional policies.

Compared to Europe's main competitors, especially the United States and NAFTA and the East Asian countries including Japan, the "tigers" and China, the EU development potential and competitive position are constrained by a overly generous West European welfare model, relatively slower technological advance and labour market rigidities resulting in a structurally (not only cyclically) high level of unemployment.

The consequences of those features for associated countries have been indirect, but not negligible. The fear of cheap labour competition from the emerging market economies of Central and Eastern Europe evidently contributed to the introduction of restrictive arrangements in sensitive product groups and in agricultural products which were the main items CECs could supply, particularly at the start of transition (Rollo and Smith, 1992; Hrnčíř, 1994). Though the asymmetry in the timetable of trade liberalisation in favour of associated countries was adopted, contingent protection provisions in case and/or threat of serious injury to a domestic industry together with anti-dumping protection in fact counterbalanced the potential advantages of asymmetrical phasing-out of tariffs for associated countries. Moreover, contingent provisions remain in place even after trade liberalisation is completed.

Unlike the timetable for the liberalisation of capital movements, the Union and the Europe Agreements did not provide access to workers from the associated countries beyond what was guaranteed bilaterally by its member states. The tensions and rigidities in EU labour markets were evident causal factors despite the public declaration of the commitment to the four freedoms of movement (goods, services, labour and capital).

Though the welfare heritage of economies in transition proved to be a considerable burden itself (i.e. the recent experience of Hungary and the resulting austerity programme of 1995; see Kornai, 1997), the imitation of the West European welfare model would hold possibly disastrous consequences for associated countries. The maintenance of such a generous model has proved to be increasingly demanding for the EU members

themselves in spite of their relative wealth.

Another group of obstacles to enlargement is related to the EU internal arrangements, particularly the type of decision-making processes and the governance in the Union. The EU's rules were originally drawn up for six rather than fifteen members, and adherence to the rules with ten additional members would result in a cumbersome and barely feasible decision-making process. It seems to be widely accepted that in any case, and even more with the perspective of eastern enlargement, new rules need to be agreed upon. These include the introduction of qualified majority voting in some areas of decision-making, the enhancement of institutional efficiency and the formulation and implementation of common policy positions with regard to budgetary matters.

Given the existing income gap between the associated countries and the EU, the costs of EU policies, namely of the CAP and regional policies, is too high to be borne by the member countries. This conclusion becomes even more clear given current endeavours of the EU member countries to meet the Maastricht fiscal criteria for EMU.

Eastern enlargement appears to be too burdensome without remedying present EU internal issues of governance and decision-making and without reforms in implementing and funding CAP and regional policies. These issues are among the most important for the Inter-Governmental Conference (IGC) which opened in Turin in March 1996 and is scheduled to complete its work in June 1997. The position of the European Commission before the start of IGC was quite clear, "there can be no question of trying to accommodate further enlargements with the present arrangements" (European Commission, 1995).

In our view, these challenges should be identified and interpreted in a broader perspective of EU integration. The EU has gone through a number of stages since its establishment in the 1950s. It has widened and deepened, and current ambitions are evolution into a monetary union and a single currency scheduled for the beginning of 1999. In addition to economic and monetary spheres, there are also suggestions for further cooperation in policy formation in areas such as foreign policy, security and defence, the legal system and judiciary, and social policy. However, substantial disagreement with regard to the entire process of the integration deepening exists, reflecting the two competing concepts of European development: a federal Europe versus a Europe of sovereign states.

The IGC is charged with the task of agreeing on how to proceed with deepening the integration among the existing EU members. At the same time, the agreed institutional changes and reforms should allow for the eastern enlargement. At the special meeting of the European Commission in Dublin in October 1996, the Irish Prime Minister, then President of the

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Council, declared "we will be ensuring that the changes we make in the IGC are adequate to provide a basis for an enlarged European Union".

Indeed, the EU deepening versus enlargement has been a persistent problem since the very beginning. The EU's reluctance to make any binding commitments with regard to the accession of the associated countries, its time horizon and concrete conditions must be seen primarily in terms of the controversial requirements of integration deepening versus enlargement. Given the large number and diverse range of potential CEEC members and their lower level of development, EU authorities and member countries are concerned that early accession would inhibit the process of deepening economic and political integration. As stated by European Commission President Santer, "without institutional reforms there can be no enlargement or if there were the Union would be paralysed." (Presidency Press Conference in Dublin, October 5, 1996).

Accession of the Associated Countries to the EU

Despite considerable advances since the start of transition, the associated countries of Central Europe are currently facing the reality of substantial differences with regard to their EU counterparts.

The existing gap is a multi-dimensional issue which may be structured into:

(1) *the income gap* identified especially as a difference in GDP per capita;

(2) *the institution gap* reflected in existing imperfections in the legal environment, lower efficiency in law enforcement, lagging standards of financial and labour markets' institutions and functions, and in safety, health and environmental protection;

(3) *the macroeconomic gap* which can be illustrated in comparison to the Maastricht convergence criteria. Though this gap differs widely across individual associated countries, and some appear to meet the fiscal criteria (budget deficit and debt) better than a number of current EU members, all of them remain far from inflation targets and long-term interest rate targets;

(4) *the performance gap* reflected in much lower levels of labour and integral productivity and the deficient quality and technical standards of goods and services compared to West European levels;

(5) *the credibility gap* which results from the fact that potential newcomers undergo a sweeping transformation in political, social and economic fields. As a result they necessarily lack a longer track record of sustained commitment to political democracy and market institutions comparable to most EU members.

While the extent of these gaps inevitably determines the prospects and

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time horizon of the possible accession, we share the view that the capacity of each country to adjust, pursue and carry out such policies which effectively react to the existing constraints and narrow the implied gaps is even more important (compare Pearce, 1995). The diverging experiences of countries such as Ireland and Portugal on the one hand and Greece on the other are quite instructive in this respect.

Entry negotiations should not only be concerned with the time horizon of accession but also with the strategy of making as easy and inexpensive as possible. It would be unrealistic to expect any significant compromise from the EU with regard to compliance to the *acquis communautaire*. At the same time, the EU authorities and most of the existing member countries are evidently unwilling to contemplate eastern enlargement without internal EU reforms. The prospects of potential newcomers are therefore critically dependent on the progress of the present IGC.

It is obvious that the main burden of adjustment and narrowing the gap with EU standards falls on the associated countries. These costs will have to be borne individually by each candidate. A too rapid introduction and enforcement of EU regulations may be rather costly since it might erode certain advantages that the associated countries have on the markets due to their less stringent regulations. These regulations should be enforced, but at a pace commensurate with each country's capacity to adjust. This should warn against the temptation of a hasty and premature accession. Further economic restructuring and progress in factor markets, institutions and efficiency are evidently necessary before the economies in transition become less vulnerable and able to withstand the EU competition. This suggests the importance of a balanced trade-off between speed and costs of the adjustment.

A well targeted pre-accession strategy shared by both candidates and incumbents would enhance the credibility of the future accession and, consequently, enable the economies in transition to reap some benefits of wider markets and investment opportunities before the entry itself is accomplished. In this respect, reliable access to EU markets is of utmost importance. At the present stage, when the shift to the dominance of private property and market oriented pricing has been accomplished in most of associated countries, the contingent protection clauses and rigorous anti-dumping procedures have become a factor of unnecessary uncertainty. This would be a good area for the EU to demonstrate, without significant cost and damage, a more broad-minded approach in meeting the needs of the associated countries.

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Annex Tables

Annex Table 1 Czech Republic – Territorial Composition of Foreign Trade
(percentages)

	1993	1994	1995	1996*
Imports from main partners				
Germany	25.4	25.5	25.8	30.3
Slovakia	17.4	14.2	13.1	9.8
Russia	9.8	8.4	8.9	7.3
Austria	7.8	8.1	6.9	5.9
Italy	4.7	5.1	5.8	5.9
others	34.9	38.7	39.5	40.8
Imports from CEFTA countries				
Hungary		6.3	5.6	10.7
Poland		15.6	17.6	19.3
Slovenia		–	–	3.7
Slovakia		78.1	76.8	66.3
Share of CEFTA on total imports		19.0	16.0	14.7
Exports to main partners				
Germany	26.0	29.4	31.8	36.6
Slovakia	21.5	16.4	16.2	13.9
Austria	6.0	7.1	6.5	5.9
Italy	5.0	4.4	4.0	3.3
Poland	–	–	5.4	5.4
Russia	4.5	3.9	–	–
others	37.0	38.8	36.1	33.9
Exports to CEFTA countries				
Hungary		6.3	5.6	7.0
Poland		15.6	17.6	23.9
Slovenia		–	–	4.9
Slovakia		78.1	76.8	63.3
Share of CEFTA on total exports		23.0	21.0	22.6

* I-III quarters.
Source: CESTAT, Statistical Bulletin 1996.

From: Regionalism and the Global Economy: The Case of Central and Eastern Europe
FONDAD, The Hague, 1997, www.fondad.org

Annex Table 2 Hungary – Territorial Composition of Foreign Trade
(percentages)

	1993	1994	1995	1996*
Imports from main partners				
Germany	21.6	23.4	23.4	23.4
USSR	22.2	–	–	–
Russia	–	12.0	11.8	12.4
Austria	11.6	12.0	10.7	9.6
Italy	6.0	7.0	7.9	8.1
United States	3.9	–	–	–
United Kingdom	–	4.0	–	–
France	–	–	3.9	4.2
others	34.7	41.6	42.3	42.3
Imports from CEFTA countries				
Czech Republic		38.8	37.1	39.3
Poland		21.6	25.3	23.8
Slovenia		–	–	7.2
Slovakia		39.7	37.5	29.7
Share of CEFTA on total imports		6.2	6.4	7.7
Exports to main partners				
Germany	26.6	28.2	28.6	29.4
USSR	15.3	–	–	–
Austria	10.1	10.9	10.1	10.5
Italy	8.0	8.5	8.5	8.2
Russia	–	7.5	6.4	5.8
United States	4.2	–	–	–
United Kingdom	–	4.3	–	–
France	–	–	4.0	3.8
others	35.8	40.6	42.4	42.3
Exports to CEFTA countries				
Czech Republic		35.1	27.4	24.3
Poland		39.4	44.5	33.4
Slovenia		–	–	21.3
Slovakia		25.5	28.1	21.0
Share of CEFTA on total exports		5.3	5.9	7.7

* I-III quarters.
Source: CESTAT, Statistical Bulletin 1996.

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Annex Table 3 Poland – Territorial Composition of Foreign Trade
(percentages)

	1993	1994	1995	1996*
Imports from main partners				
Germany	28.0	27.4	26.6	24.5
Italy	7.8	8.4	5.8	5.9
Slovakia	–	–	13.1	9.8
Russia	6.8	6.8	8.9	7.3
United Kingdom	5.8	5.3	–	–
Austria	–	–	6.9	5.9
United States	5.1	–	–	–
Netherlands	–	4.6	–	–
others	46.5	47.5	39.5	40.8
Imports from CEFTA countries				
Czech Republic		54.6	56.6	54.9
Hungary		24.0	21.7	18.2
Slovenia		–	–	7.1
Slovakia		21.4	21.7	19.8
Share of CEFTA on total imports		4.3	5.1	5.7
Exportsto main partners				
Germany	36.3	35.7	38.3	34.8
Netherlands	5.9	5.9	5.6	5.0
Italy	5.2	4.9	4.9	6.1
Russia	4.6	5.4	5.6	6.9
United Kingdom	4.3	4.6	4.0	–
France	–	–	–	4.4
others	43.7	43.5	41.6	42.8
Exports to CEFTA countries				
Czech Republic		55.4	56.1	56.6
Hungary		22.3	21.3	21.2
Slovenia		–	–	3.1
Slovakia		22.3	22.8	19.1
Share of CEFTA on total exports		4.8	5.2	6.0

* I-III quarters.
Source: CESTAT, Statistical Bulletin 1996.

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FONDAD, The Hague, 1997, www.fondad.org

Annex Table 4 Slovak Republic – Territorial Composition of Foreign Trade
(percentages)

	1993	1994	1995	1996*
Imports from main partners				
Imports from main partners				
Czech Republic	35.9	29.6	27.5	25.6
Russia	19.5	18.0	17.0	18.0
Germany	11.4	13.4	14.4	14.5
Austria	6.2	5.8	5.1	4.6
Italy	3.0	4.4	4.7	5.7
others	24.0	28.8	31.3	46.1
Imports from CEFTA countries				
Czech Republic	91.4	87.1	83.2	83.2
Hungary	3.4	4.9	6.7	6.2
Poland	5.0	7.0	8.4	7.9
Slovenia	–	–	–	1.7
Share of CEFTA on total imports	39.3	34.0	33.1	30.7
Exports to main partners				
Czech Republic	42.4	37.4	35.2	31.5
Germany	15.2	17.1	18.8	20.8
Austria	5.0	5.3	5.0	6.1
Italy	–	4.3	4.8	4.9
Russia	4.7	4.1	3.8	–
Hungary	4.5	–	–	–
Poland	–	–	–	4.7
others	37.0	38.8	32.4	32.0
Exports to CEFTA countries				
Czech Republic	85.0	81.8	79.6	75.5
Hungary	9.1	12.0	10.3	10.6
Poland	5.9	6.2	10.0	11.3
Slovenia	–	–	–	2.4
Share of CEFTA on total exports	49.9	45.7	44.3	41.7

* I-III quarters.
Source: CESTAT, Statistical Bulletin 1996.

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Annex Table 5 Slovenia – Territorial Composition of Foreign Trade
(percentages)

	1993	1994	1995	1996*
Imports from main partners				
Germany	25.0	23.7	23.2	22.1
Italy	16.2	17.2	17.0	16.7
Croatia	9.1	6.8	6.1	6.2
Austria	8.5	10.3	9.7	9.1
France	8.0	8.4	8.4	9.7
others	33.2	33.6	35.6	36.2
Imports from CEFTA countries				
Czech Republic	36.7	39.4	39.0	39.6
Hungary	49.8	42.7	42.1	37.3
Poland	4.2	5.0	5.9	7.9
Slovakia	9.3	12.9	13.0	15.2
Share of CEFTA on total imports	5.1	6.2	6.7	6.4
Exports to main partners				
Germany	29.5	30.3	30.2	29.1
Italy	12.4	13.5	14.6	13.1
Croatia	12.1	10.8	10.5	10.9
France	8.7	8.6	8.2	7.7
Austria	5.0	5.5	6.4	6.6
others	32.3	31.3	30.1	32.6
Exports to CEFTA countries				
Czech Republic	21.4	26.8	32.7	32.5
Hungary	33.6	32.1	28.5	23.2
Poland	33.5	31.3	26.0	31.5
Slovakia	11.5	9.8	12.8	12.8
Share of CEFTA on total exports	4.3	4.5	4.8	5.5

* I-III quarters.
Source: CESTAT, Statistical Bulletin 1996.

From: Regionalism and the Global Economy: The Case of Central and Eastern Europe
FONDAD, The Hague, 1997, www.fondad.org

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