Floor Discussion of the Drábek Paper

Gains and Losses

Miroslav Hrnčíř began by requesting Zdeněk Drábek to clarify the underlying assumptions of the models that try to assess gains and losses of EU enlargement.

"What type of gains are included in the model? Certainly, the expected gains for the EU countries are marginal and the expected gains for the applicant countries are much greater. But I think a time horizon should be added to the evaluation of the gains and losses for both groups of parties. I therefore would like you to identify more precisely what is included in these models."

Zdeněk Drábek responded that he viewed a lot of econometric calculations with a great degree of caution. "In this case, I used the Francois, Portes and Baldwin numbers because they happen to be the most comprehensive and they give the argument a somewhat quantifiable dimension. Still, the share of trade of the Central and Eastern European countries with the European Union is small, between 2.2 and 2.6 per cent, and it is obvious that the EU cannot gain very much. There will be differences among countries. Austria will probably benefit more than Spain or Portugal, and Germany will be affected differently than Great Britain. We don't need a general equilibrium model to reach this conclusion. These general equilibrium models clarify the trade restrictions and then input these into the model to arrive at a number, so one answer is that they attempt to determine what might happen if a tariff equivalent is changed. The model itself is dynamic and the intention is to capture not only the static gains, but the dynamic gains as well; this is the advantage of general equilibrium models. Hopefully, when the IGC is concluded, we will begin negotiating the accession, and instead of focusing on economic gains as a main argument, I would suggest dealing with other issues which are more important and more tangible as gains such as security, politics, environment, immigration and so on.

Since I am already talking about numbers, I would also like to respond to Roberto Lago's reference to the issue of the cost of enlargement. Our knowledge about estimated costs of agriculture supports, in particular, has improved greatly. The numbers that were produced for 1994 were apparently based on unrealistic assumptions. Today, most people would argue

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

that the cost of enlargement will be between 12 and 20 billion ECU. Baldwin suggests 17 to 18 billion ECU. Anything above 20 billion ECU is highly unrealistic. The other important element in these estimates is that they are based on assumptions about what the European Union will do as well. It is now assumed that the EU will reform its current policy. The problems that Baldwin encountered in his estimates were the assumption about pricing policies in the European Union and our knowledge about yields and general productivity in agriculture in Central and Eastern Europe."

With regard to expected gains of EU enlargement, Frans van Loon stressed the importance of investments in the CEECs. "The lowering of the perception of risk that will follow accession would be one of the major economic effects, and the lowering of the barriers will result in a vast increase in foreign direct investment. We have seen it elsewhere in the world. The main change in composition of capital flows, whether in Latin America or Asia or the rest of the world, is in the foreign direct investment portion, and this is what drives big business in the banking and financial world. Looking at the way large investments are being made in the world now, I would suggest that two major basesexist. One is the drive into emerging markets, and the other is concentrations and the re-engineering of all those massive structures. If you put these two things together in the context of Central and Eastern European countries joining the European Union, it is possible that rather massive investments will take place within the new European Union, and this should be one of the main determinants in calculating the gains to the current member countries."

Stephany Griffith-Jones commented on the link between increased FDI flows and EU membership. "I think there is excessive optimism about how much FDI will be generated upon joining an important trade region like the EU. The extent to which increased FDI flows depend on individual country performance is underestimated. For example, when Spain and Portugal joined the EU, FDI indeed increased, but in the case of Greece increase was very small because the economy was not so well managed. For investment flows to increase, macro and micro policies must be in very good shape. We can also draw on the Mexican experience in joining NAFTA. When Mexico joined NAFTA, there was an incredible optimism among Mexican policymakers that some of the mistakes they were making in macro policy somehow didn't matter because they were going to be part of NAFTA. The peso crisis illustrated that the situation was quite the opposite. So good economic policies are needed to attract foreign investment.

On a related point, many seem to believe that certain things in macro policy must be done because they are preparing for the EU. For example,

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it is believed that inflation must be lowered quickly even if it results in costs in terms of exchange rate values. While lowering inflation is an important policy objective, I am not sure that it should be driven by these kinds of considerations. The policy objectives should evolve in terms of the internal coherence of the macro-policy stance instead of by objectives of preparing for accession to the EU – which remains uncertain in terms of dates."

Joan Pearce was concerned with the comparison of the EU to free trade areas. "The European Union represents a much higher degree of integration. If it were only a free trade area, this discussion and the pre-accession strategy would be something totally different. It is important to remember that there is a limit to how far you can draw comparisons. Second, the European Union and the European Commission are well aware of the importance of the applicant countries catching up with the rest of the European Union – accession will be a failure if they do not. Therefore, we must be sure that any arrangements made in terms of macroeconomic policy do not impede this catching-up process."

Inna Šteinbuka elaborated on Drábek's remark about assessing yields and productivity in agriculture in Central and Eastern Europe. "If the estimates of gains and losses are critically sensitive to assumptions about the rate of capital accumulation, have you estimated the share of investment goods in the imports to CEFTA countries? In the Baltic countries, the share of investment goods is quite small and the dynamic is not encouraging. Considering that the share of investment goods reflects investment inflow to some extent, what is the situation right now in CEFTA countries, and what do you expect to happen in the near, medium and long run?"

Zdeněk Drábek answered that the situation in Central and Eastern Europe was exactly the opposite of the Baltics, according to official figures. "The share of investment in imports in the Czech Republic has grown dramatically. Rather complacent policymakers cite this as a reason for not worrying about the rising current account deficit. They believe that the rise in the deficit is due to growing imports, and imports are growing because ofthe heavy investment-goods component of imports, which is something temporary and necessary for countries at this stage. This is the official position. But some doubt the figures on shares of investment which are provided by official authorities, so it remains controversial."

Albrecht Von der Heyden suggested that while the Central and Eastern European countries might gain considerably more with accession than the EU countries, this should not be the only or even the main factor. "We may be impressed by the development of trade and investment during the first period of the Europe Agreements, but it is also important to look at

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other challenges for both the European Union member states and the countries of Central and Eastern Europe. For example, Central and Eastern European structures need to be reformed in order to be competitive. On the other hand, there are also challenges facing the European Union, for example with regard to the problem of unemployment. If you look at these aspects in the short term, increased competition from Eastern Europe might be disadvantageous for West Europe, especially in the border regions. But I think that we should try to convince our people that the new challenges which pressure us to be more competitive will be to our benefit in the long run in terms of increasing our worldwide competitiveness. For the present EU members, it is a good opportunity to become more competitive in relation to the dynamically growing economies of Southeast Asia and other parts of the world. So I see a lot of advantages apart from the direct costs of financing."

András Inotai had some additional comments with regard to the issue of gains and losses. "First, there is an asymmetrical gain to Central and Eastern Europe in comparison with the European Union. But we should not start talking about who will gain more when accession occurs because substantial gains on both sides have been realised since 1989-1990 and these must be included in the analysis. Second, if you compare the different inter-regional and intra-regional trade flows, there are two dynamic flows that can be compared with the highest ranking Asian or trans-Pacific flows. One is between the European Union and the CEECs, and the second is in the intra-CEFTA trade. My third point is that during periods of high growth in Western Europe, the impact of trade with CEECs is relatively unimportant, but the situation is different if there is a recession. We have calculated that the 1993 recession would have been 0.2 per cent deeper in Germany if they had not had trade with Eastern Europe. Of course all these gains are differently distributed among different countries.

Furthermore, we have to be very careful when we consider the Central and Eastern European countries as a group because they are not a group. There are at least three major differences which may remain for the next few years. One is the level of development. The development gap as measured in per capita income between the Czech Republic, Slovenia or Hungary and some of the other countries in transition is at least as great as the gap between these countries and Austria. Second, there is a substantial differentiation process going on regarding dynamics. And third, there are major differences between CEFTA countries when we compare not only macroeconomic but also microeconomic developments – and microeconomics is a key issue of successful adjustment to the European Union. I will not deny the importance of macroeconomic figures, but macroeconomic figures may hide a number of microeconomic problems which soon-

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er or later have to come to the fore. In view of all this, my question is: To what extent can regional trade agreements really contribute to decreasing the growing differentiation among the Central and Eastern European countries? Are they able to do this or will theopposite happen?"

Per Magnus Wijkman stressed that Eastern enlargement is essentially a political issue and not an economic one. "Nevertheless, economic calculus does point to some important policy implications, and these have been well illustrated in the paper and by the discussion. The first implication is the unequal negotiating power between the applicant countries and the European Union. We should not be surprised at the imbalance in the benefits because these are primarily small countries. One obvious implication of this is not to put all of your eggs in one basket. CEFTA is not an alternative to EU membership, it is a complement to membership. If one is serious about EU membership, then free trade among the Central and Eastern European countries is something that should occur as well. The necessary institutional arrangements should not be viewed as a net burden since they can be an indication of credibility. I would quickly add, however, that this should be viewed as part of the negotiation process and there should be a quid pro quo in response to this unequal balance. The key is to acquire allies within the European Union – not necessarily countries, but other actors such as interest groups. Foreign direct investment in the East European servicing of the Western markets could be a very powerful instrument in breaking up the unbeatable coalition, as Baldwin has discussed, of taxpayers and consumers who are opposed to this kind of market opening, especially in the sensitive sectors. Foreign direct investment requires a rapid progress of transition and stable rules. A key priority is getting foreign direct investment. This would create an interest group which might favour rapid accession and thus increase Eastern Europe's position in negotiations.

Finally, this economic calculus which suggests small benefits from trade liberalisation and large budgetary costs for the EU is disconcerting because it could mean that there will be no eastern enlargement. The policy implication is that one has to reform the European Union from within. The EU has to do something for eastern enlargement to occur and that is reform, essentially of the agricultural policy but also of the structural funds. There are adjustments to be made on both sides and one should not take the European Union system as a given on the policy conclusions."

Joan Pearce warned against placing too much emphasis on economic costs and benefits. "Using 1995 data, the GDP of all 10 applicant countries amounted to 4 per cent of that of the European Union. All 10 of these countries together are roughly equivalent to the Netherlands, and there is a limit to how much you can expect of countries with a combined GDP of

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that size. We hope and expect that they will be growing significantly faster than the economists have foreseen so that this percentage will be somewhat higher by the time the accession takes place. But even if you think of a large growth differential, it is still not going to be substantial. This being said, I would plead against attaching too much importance to this question of costs and benefits. It is very exciting for econometricians, but what is its purpose in the political context of enlargement? If it is to persuade the constituencies in the European Union that they should favour enlargement, then frankly, I don't think it helps very much.

If we look back on the enlargement to include Spain and Portugal, I don't recall anybody trying to convince the then European Community of the economic benefits of enlarging to include Spain and Portugal. To the extent that costs and benefits were discussed, they were discussed in terms of sectoral interests such as fishing interests and citrus growers. My guess is that once we really get down to the nitty gritty of negotiating accession, this is the kind of debate that will matter politically, and not whether there willbe an overall contribution of 1 or 2 per cent of GDP to the European economy in aggregate. Per is absolutely right that we should focus on those types of interest that could be favourable toward enlargement."

She then added two comments on the issue of foreign direct investment. "One of the reasons that foreign direct investment has been disappointing in most countries of Central and Eastern Europe is precisely because of this hub-and-spoke arrangement of trade agreements. If you are an investor who wants to serve both the market of the European Union and of Eastern Europe, then you are better off locating in the European Union because by locating in one of the East European countries, you would gain privileged access to that country's market and the markets of the EU, but you would not gain privileged access to the countries of Central and Eastern Europe. To some extent, CEFTA offsets this problem, but the fact remains that all of the incentives for foreign investors in terms of market access are to locate in the European Union rather than in Central and Eastern Europe. The second thing I would say about foreign direct investment is: by all means make strenuous efforts to attract it, but not by some of the means that have been used in CEE countries in the past such as offering protective markets, because that simply will not work. Foreign investors know that once a Central or Eastern European country becomes a member of the EU, that protection will disappear."

Contingent protection was the topic of a further comment by Joan Pearce. "I would like to recall that the conclusions of the Essen Council in December 1994 did make an undertaking to begin dismantling some of the EU protection in line with the application of EU competition policy in the Central and Eastern European countries. The signs are that there has not

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been a great deal of progress in that direction, but while the institutions of competition policy have been established in those countries, the application of competition policy is not yet very effective. Bernard Hoekman at the World Bank is involved in some work at present which is looking in great detail at enterprise levels of the performance of competition policy in these countries. Interestingly, this tends to show that in most cases, these countries have used a liberal trade policy as a substitute for a firm competition policy."

Open Regionalism and CEFTA

Barbara Stallings placed some of the comments in a broader perspective. "First, both in Asia and in Latin America, it is believed that sub-regional integration is very much a complement to a broader kind of integration. The phrase that is used both in Asia and Latin America is "open regionalism", which views regional integration as a step toward working within a broader international context. If you look at the dynamics of different parts of the world in the last decade, some of the most dynamic areas have emerged in the developing countries of Asia and Latin America, especially the southern trade region in Latin America, the Mercosur group. One of the ways that sub-regional and regional integration schemes have been seen as complementary has to do with the necessity of looking at microeconomic foundations. How was the competitiveness of these countries increased and how were they made more capable of exporting a higher value-added type of good? In the Latin American and Asian cases, this has been done through a staged approach. The first stage was to export to your neighbours who are somewhat less competitive, but this was only a step toward being able to export to a much larger market. For example, Chile viewed membership in Mercosur as absolutely vital in order to increase its ability to export industrial goods to the Mercosur countries, as well as to the United States and even to Asia and Europe.

I support this idea of including investment as part of the calculation and not just to rely on trade. When the calculations were made on the value of a hemispheric integration in the Western Hemisphere, the idea was that trade gains would be quite small, but that the big gains would come from investment – the inflows to Latin America as well as the benefits that US firms would realise from investing in Latin America. I assume that there would be some similarities in the European case."

Barbara Stallings concluded by presenting a particularly interesting viewpoint on sub-regional cooperation. "You should look at the growth triangles in the Asian case. One needn't talk about either European-wide integration or Central and Eastern European integration, but look at the

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smaller cooperation possibilities around some kinds of natural resources. In the Asian case, these have been the most dynamic. There may be some parts of Central and Eastern Europe working together with parts of Western Europe that might have special advantages."

Mark Allen added some specific comments about the creation and role of CEFTA. "The political reasons for the lack of support of integration arrangements among former Soviet countries are obvious. No one wanted to recreate another Comecon, but also since the major political objective was to get into Western systems, these countries feared that if they established their own institutions, the West would say, 'Well, you've got your own CEFTA arrangements and defence arrangements so you can just organise things there.' There was a conscious attempt to avoid setting up arrangements which might have been quite sensible from the economic point of view, and all effort was directed toward European Union accession.

I was struck by the sentence at the end of Zdeněk Drábek's paper which suggested that most findings indicated that CEFTA had a net trade diversionary effect. This is a rather surprising finding if it is true. Capitalist integration should take place on the elimination of obstacles to trade between countries. This is the open regionalism that Barbara Stallings was talking about. Clearly, it is a rather anomalous situation in this part of the world to have opened up toward the European Union while being faced with increased barriers among the individual countries in the area. There seems to be a strong case for extending tariff liberalisation in the region, particularly in the direction of the Ukraine, which could be one of the dynamic economies.

What sort of institutional arrangements would promote the reduction of barriers in this part of the world? On the one hand, you could agree on a bilateral basis to eliminate tariffs on mutual trade. But the tariffs are already relatively low in this part of the world, and the obstacles to trade are often in the non-tariff barrier area – not so much in quotas but in standards and customs procedures. If we look at the EU, the major impetus in the past 10 years has been the single market policy which is designed to go well beyond tariff or quota elimination between countries, and deal with all of the other smaller aspects that make trade between countries difficult. These problems loom fairly large in relationships between individual Central and East European countries. It might be worthwhile to establish an institution as a reference point on what actions are necessary for the settlement of disputes. Perhaps this can be done in conjunction with the EU arrangement for handling microeconomic trade disputes.

I think that the negative evaluation of CEFTA is overdone, and with the lack of political support for CEFTA, it is not surprising that more haven't

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taken advantage of CEFTA as a broader market area to capture. There are signs that investors are beginning to do this, andI suspect that non-European investors in particular are taking advantage of the CEFTA arrangements for their investment.

Finally, this is going to be a very dynamic region of the world. While politically, we can suggest that this dynamism can only be achieved inside the context of the EU, economically, it might be a different case. In Spain and Portugal, trade liberalisation, structural economic change and foreign investment were tremendously important. The Central and Eastern European countries have already undergone unilateral trade liberalisation and structural change. There are currently much more open international capital markets, and huge amounts of money are sloshing around looking for a home. Though membership in the EU might provide additional confidence that these changes are permanent, there are also options outside the Union. If macroeconomic policymaking is made more difficult by being members of the Union, it may not be a total disaster if they did not join – they may still become a very dynamic region of the world such as Southeast Asia has become."

Reply by Zdeněk Drábek

"It is interesting that there has been a lot of discussion about CEFTA. My paper does not cover CEFTA as much I would have liked, but please remember that my paper reviews the literature, and to that extent it reflects very much the interest of researchers. In fact, it is astonishing how little analytical work on CEFTA and the integration of CEE countries I have found – and some of what I have found is already outdated. There is now a better understanding on the part of many politicians that there must be some form of cooperation among these countries. There are already attempts to take steps in this direction. Poland and the Czech Republic have agreed to cooperate in the acquisition of military technology. And there are tangible steps toward the resolution of border issues between the Czech Republic and Poland. Many of these initiatives are still marginal and frequently they have not been implemented. A number of Central and Eastern Europeans and West Europeans have been trying to get the CEE governments to talk about, for example, economic issues. When I was still working for the Czech government and Premier Klaus discovered this, he wrote to me and said, 'It is all fine as long you are doing it as a private initiative; but don't count on my support'. The reality is that it remains difficult to get some of these politicians to realise that there must be more cooperation. Politicians often want to do things on their own terms.

No one knows for certain whether trade within the sub-region is trade

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diverting. What often forms the basis of arguments for those writing about this topic is that there has been an impetus in these countries toward a positive discrimination in favour of sub-regional arrangements within CEFTA. This would mean discrimination against third countries and maybe even the EU. This is what they have in mind when they argue about trade diversion. But today we are, hopefully, witnessing a general lowering of trade barriers simultaneously with the evolution of a regional arrangement. In this sense, I would expect a great deal of trade creation even within the sub-region. Having said this, however, I think that there are strong arguments for maintaining the positive orientation toward the EU. These countries must remain in a competitive environment with industry exposed to competition as quickly as possible.

All of the comments on foreign direct investment are very good points. While I entirely agree that one of the major benefits of enlargement or closer integration should be theadditional incentive for FDI, I also agree with Stephany Griffith-Jones that enlargement is not a sufficient condition – other things must also be in place. In fact, the studies that have tried to envision the impact of enlargement make precisely this point. Baldwin, Francois and Portes estimate that gains arising from tariff concessions could lead to a contribution to the CEE of roughly 1 per cent annually to GDP. But they also say that if you assume the real benefit of enlargement to be capital accumulation, then the benefits will shoot up to 19 per cent of GDP.

With regard to gains to the European Union, we cannot alter the discussion of economists or politicians and thereby lessen their interest in the costs of enlargement and the minimal gains to the EU. While economic gains may not be large in the short run, once the institution works, the gains will be larger. Per Magnus Wijkman reminded me of a second, equally important argument. I have essentially assumed no fundamental change in the European Union. In fact, the existing EU system is already too costly for the members and the decision-making processes are too cumbersome. This will have to be changed, so the process of enlargement will probably be a process of double adjustment. Negotiations will have to take this into account."

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