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Intereconomics

*Suggested Citation:* Bauer, Patricia (1995) : East-West economic cooperation: Interests involved, institutional possibilities and economic rationale, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 30, Iss. 6, pp. 285-293, <https://doi.org/10.1007/BF02926390>

This Version is available at:

<https://hdl.handle.net/10419/140520>

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Patricia Bauer\*

# East-West Economic Cooperation

## Interests Involved, Institutional Possibilities and Economic Rationale

*Beyond the existing forms of East-West cooperation in Europe such as economic assistance, loans, joint ventures and association agreements, both sides are looking for suitable ways of establishing more institutionalized relations. Already existing institutions, membership of which could be offered to the new market economies, are EFTA, the European Economic Area (EEA) and the EU. This article discusses the effects of membership for both eastern and western countries in the light of their differing interests.*

The dissolution of the socialist community of nations and the CMEA also meant the collapse of the institutionalized operating environment for socialist planned economies on a Soviet model. Since then, an all-embracing transition process has got under way in these societies. The former members of the CMEA have been seeking new ways of integrating themselves into the world economic system. At the same time that system, particularly the European pattern of trade, is undergoing structural changes as a result of the emergence of these new market economies in Eastern Europe. The relatively harmonized trading zone of the EU now stands face-to-face with new markets, but also with new production locations, in Eastern Europe. This has opened up new economic opportunities for the EU. At the same time, however, it harbours new risks to the stability of traditional economic structures. After all, these new market economies expect to be linked into western markets, even to the point of acceding to EU membership.

### Current State of the Transition Economies

This overall situation is such that both sides not only have a wish but are also in fact compelled to create an economic area spanning the whole of Europe. These, then, are the outlines of the central issue of what guise should be adopted for pan-European economic cooperation.

In terms of the development of their gross domestic product (GDP), the new market economies can be classified into three groups:<sup>1</sup>

□ *The vanguard.* While Poland's GDP has now been growing since 1992, the upswing expected to occur in 1993 in Hungary, the Czech Republic, Slovenia and Estonia (with rigorous reform policies) did not materialize. On the other hand, all of the countries in the vanguard group are estimated to have had positive GDP growth in 1994, ranging from 1% in Hungary to 4.5% in Poland. Thus the process of consolidation in these countries will have taken hold from 1995 onwards.

□ *Late starters.* These countries include Slovakia, Romania, Bulgaria, Latvia, Lithuania and Croatia, which are projected by the OECD and IMF to return to positive GDP growth for the first time during 1995,

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<sup>1</sup> As a flow quantity, GDP does not include any information on the stock of capital in an economy, nor on the institutional stage so far attained in the development of a market economy. When classifying countries into groups, however, one cannot ignore the substantial relevance of both these factors to an economy's future development. As a result, it is difficult to rank countries effectively within their groups, and groups will inevitably also contain exceptional cases. For example, in spite of the negative GDP growth expected there in 1995, Romania cannot be counted among the trailing group of countries since there are a number of qualitative factors distinguishing it from that group, in its capital stock, reform efforts and consequent macroeconomic indicators. Similarly, the tremendous efforts made by Latvia and Lithuania could theoretically place them among the vanguard group. This again shows that it is not enough to examine one indicator alone, as a closer look at the others bears out. One also has to consider that Estonia, though starting out in very similar circumstances, has managed the transition more swiftly and more successfully than the other two Baltic countries.

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ranging from 1% in Slovakia, Bulgaria and Croatia to 2% in Latvia and Lithuania. Romania is the odd man out in this group, having experienced a short period of growth (1%) in 1993 as stocks were built up again, but since estimated to have fallen back, and the country is projected to experience a 2.5% decline in GDP in 1995.

□ *The trailing group.* This group consists of Macedonia, Kazakhstan, Russia, Belarus, Ukraine, all of the CIS republics, Albania and Uzbekistan. Although the latter two countries have both registered GDP growth since 1993 (projected to 1995) 1 to 2% for Uzbekistan and between 5 and 11% for Albania – one nevertheless needs to consider the low level from which they started out, their agricultural orientation, and the fact that the market economy has not been effectively anchored in institutional terms, and for these reasons they are included in the “trailing” group.

This assessment is confirmed by other macro-economic indicators:

*Unemployment*, held artificially low by state subsidies (to form “unemployment on the job”) inevitably increases as enterprises are privatized or wound up. Hence the labour market provides a reflection of the pace of reform, with higher unemployment rates signifying swifter implementation of reforms. It is estimated that the vanguard countries experienced their peak under-employment in 1994, whereas the late starters can expect it to go on

increasing this year and beyond. The countries in the trailing group still have low rates of official unemployment, which indicates that uncompetitive businesses are being kept alive by means of government subsidies and loans.<sup>2</sup>

The proportion of administratively determined prices is now quite low in all reforming countries. However, the monopolistic patterns of production have not been eliminated to the same degree, and these give rise to persisting inflationary pressure. Accordingly, *inflation rates* in all reforming countries were over 20% in 1993, and none of them will have an inflation rate below 5% in 1995. The root causes of this inflation lie in a high level of employment coupled with low productivity, the power of monopoly organizations to fix prices, and the activities of governments in financing both enterprises and their own budget deficits, partly simply by printing more money. As a result of rising prices imports have also been growing more expensive, so purchasing power has been declining in the new market economies. Here too, though, there are substantial differences from country to country: the vanguard countries and some of the late starters are endeavouring to cut down their inflation rates, while the CIS and other countries in the trailing group are struggling with hyperinflation.<sup>3</sup>

Large, persistent *budget deficits* are common to almost all reforming countries. Even because of inflationary pressures alone, it is vitally necessary to consolidate government budgets. The only way of achieving that is to exercise strict discipline on the expenditure side and to improve both tax law and collection on the revenue side. However, curbs on expenditure inevitably also lead to new social problems which, in turn, can give rise to political instability. With the exception of Hungary, the vanguard countries had the lowest levels of government debt even in 1993. Estimates and projections for 1994 and 1995 predicted some easing of the situation, or no substantial increases in the borrowing requirement, in the leading countries. On the other hand, the IMF and OECD were expecting the most drastic deficit increases to occur in Russia and other CIS countries. Deficit funding by these governments poses a substantial burden on the capital markets and is detrimental to domestic investment.<sup>4</sup>

Table 1

**Real Percentage Change in GDP against the Previous Year**

Country	1992	1993	1994*	1995*
Poland	2.6	3.8	4.5	5.0
Czech Rep.	-7.1	-0.3	2.0	4.0
Hungary	-4.5	-2.3	1.0	3.0
Slovenia	-6.0	1.0	2.0	3.0
Estonia	-31.6	-2.0	3.0	5.0
Slovakia	-9.5	-4.9	-2.0	1.0
Bulgaria	-12.4	-6.2	-3.0	1.0
Romania	-13.6	-1.0	-3.5	-2.5
Latvia	-32.9	-15.0	-1.0	2.0
Lithuania	-35.0	-20.0	-0.5	2.0
Croatia	-23.6	-7.0	-3.0	1.0
Macedonia	-13.4	-16.1	-10.0	-5.0
Kazakhstan	-13.0	-16.0	-24.0	-8.0
Uzbekistan	-9.5	1.0	2.0	2.0
Russia	-18.5	-12.0	-16.0	-4.0
Belarus	-10.0	-9.0	-29.0	-10.0
Ukraine	-16.8	-14.2	-24.0	-10.0
Albania	-9.7	11.0	7.0	5.0

\* Estimate for the whole year based on the first three quarters' figures.

\* Projection based on the latest available data.

Sources: IMF, UN, OECD.

<sup>2</sup> UN Economic Commission for Europe: Economic Survey of Europe in 1993-1994, New York 1994, pp. 86 ff.

<sup>3</sup> Ibid., pp. 7 f. and 74 ff.

All of the transition economies have seen major currency devaluations. That has put them in a more favourable trading position and made them more attractive to foreign investment. As time has progressed, the picture has become more varied. The Baltic countries, Slovakia and the Czech Republic now have stable *exchange rates* relative to the western countries. The currencies of Hungary, Poland and Slovenia are depreciating moderately, while those of the CIS, Romania and Bulgaria have been depreciating drastically. Almost all of the currencies in the transition countries are now at least partly convertible, thus allowing foreign exchange into the economy. The availability of foreign exchange has led to a reorientation of trade patterns. On the one hand, the far-reaching trade liberalization has led to a large-scale drop in *foreign trade* overall, while at the same time generating swift trade diversion to and from the developed market economies. Over half of the trade conducted by the transition countries as a group in 1993 (1994 figures are only available as estimates) was with western industrial countries. The profile of types of goods traded by the new market economies is now beginning to firm up: 50% of the goods imported are now capital goods (including cars); an increasing proportion of production inputs imported is a manifestation of the contract-processing activities now developing. Meanwhile, the main exports are labour-intensive finished goods (e.g. furniture and textiles) and raw materials.<sup>5</sup>

The volume of *capital investment* has fallen steadily since 1990 in almost all of the new market economies. In 1993, only Poland, Slovenia and Hungary showed positive investment growth in 1993 (of 1.0%, 11.1% and 2.6% respectively over the previous year). In those countries, the right conditions had been created to strengthen the confidence of investors in the stability of the market. It is this circumstance in particular that sets the vanguard group of countries, which have applied their efforts to combating inflation,

stabilizing their budgets and reforming their institutions, apart from the rest of the transition countries.<sup>6</sup>

### Economic Interests and Restrictions

The economic needs of the new market economies can be deduced from the indicators discussed above: reducing unemployment, damping down inflation, consolidating budgets, stabilizing their foreign-trade and balance-of-payments positions, and increasing investment (esp. foreign investment). The first three of these objectives depend upon the latter two, i.e. on the volume of investment and the opportunity to engage in trade. And they in turn are dependent on the level of confidence in the stable development of the countries concerned.

The new market economies with their need for stability stand face-to-face with an economic area which they regard as the epitome of these ideas, namely the EU.<sup>7</sup> The EU's overall per capita GDP of US \$ 15,063 in 1993 was approximately four times the overall figure for the transition countries, of \$ 3,807 per capita. Even if the EU is assumed to grow at only 1% (or \$ 150) per capita in the years ahead, the gap between these two economic groups is set to grow tremendously, as the transition economies as a single group still have negative growth. Even if they were to manage positive growth of 3% per annum in the coming years, in absolute terms that would still be lower (at just \$ 115 per capita per annum) than that of the EU.

Singling out Eastern Europe, the per capita GDP in 1993 does come out higher at \$ 4,488, but that is still just over one third of the EU figure. If these countries' GDP is assumed to grow at the rate currently being achieved in Poland, of 4% per annum (\$ 180 per capita) while that of the EU grows at 1%, they will have higher absolute growth than the EU, but starting

<sup>4</sup> Ibid., pp. 118 f. Western industrial countries, too, have an annual struggle to keep down their borrowing requirement when they pass their budgets. In the EU, an upper limit of 3% of GDP has been placed on the volume of new public borrowing as a convergence criterion for entry into Stage 3 of EMU. Very few of the EU's members meet this criterion. The public-sector borrowing requirements of individual member states range from 10% to 2% of GDP (cf. Eurostat 1995). However, net value-added in the EU economies is considerably greater than in the transition economies, which is why new government borrowing has a less dramatic impact there on money market rates and on private-sector investment. Even so, the EU's central banks in general and the Deutsche Bundesbank in particular, and also employers' associations issue regular warnings that public borrowing should be reduced because of its detrimental effects.

<sup>5</sup> On closer examination, this is an over-simplification, especially as regards Poland, Hungary and the Czech Republic with their advantageous geographical situations and output profiles. For details of production and export structures in particular new market economies, see UN Commission for Europe, op. cit., pp. 58 ff.

<sup>6</sup> Ibid., pp. 4 and 71. The only prominent exception is the Czech Republic, which experienced a sharp decline in investment in 1993 (down 11.5% on the previous year).

<sup>7</sup> A critical view of the European model and the tendency to measure its success in terms of the queue of countries knocking at the door, discussing some negative effects of EU expansion for Europe as a whole, is given by Gerda Zellentin: Die Schimäre des europäischen Superstaats, in: Blätter für deutsche und internationale Politik, No. 6, 1992, pp. 698-708, esp. p. 706 where she focuses on the negative effects of the EU such as over-production, environmental destruction and a loss of democracy, as undesirable development perspectives for the new market economies.

from a so much lower level it is clear what a difficult task it would be for them to catch up.<sup>8</sup>

Despite this, the most developed among the new market economies have signalled their wish to join the EU. The Union also views itself as an anchor of stability for Europe as a whole, radiating prosperity and security for the whole continent. It has an interest not only in preserving its own internal stability but also in the trading opportunities which are already arising and will arise in time to come from the presence of the new market economies.

Not only the political but also the economic map of Europe and their associated problems are distinctly shaped by the tensions between the hopes and expectations of prosperity and peace in the new market economies and the desire to preserve existing prosperity and to expand trade, coupled with a fear that the transition countries might be politically destabilized, in the EU.

### Options for Economic Cooperation

The forms of East-West cooperation in Europe are institutionalized to varying degrees, and include such instruments as economic aid, loans, joint ventures and association agreements. Beyond these existing forms, though, the new market economies have shown their interest in more institutionalized relations. The institutions already in existence in Western Europe which could be offered to the new market economies are EFTA, the European Economic Area (EEA) and the EU. The effects of membership both for western and for eastern countries will be examined below in the light of their differing interests.

The key issue in this context is the pace of transition, this time not in terms of the internal shaping of the economic system,<sup>9</sup> but in terms of an economically sensible pace at which to integrate the new market economies into the world economy in general and the European economic system in particular. In this light, immediate full membership of the EU can be regarded as a shock treatment, whereas step-by-step cooperation by way of EFTA or EEA membership represents a more gradualist strategy for integration.

<sup>8</sup> All details on the absolute value of GDP and on growth rates are taken from United Nations: World Economic and Social Survey, New York 1994, pp. 259 ff. The growth rates assumed in the author's own calculations discussed here are extremely pessimistic for the existing EU and extremely optimistic (taking Poland's rate, the highest rate of growth throughout the new market economies, as the basis) for the transition economies.

### Shock Therapy: Immediate Full Membership of the EU

The key characteristics of the EU's economic system are the four freedoms of the Internal Market and the common objective of Economic and Monetary Union (EMU). The accession of the transition economies to EU membership within a short timescale – or at least of the vanguard group followed in stages by the remaining reforming countries – would allow these areas of liberalization to benefit all of this extended European economy, in both East and West. The benefits which would be expected are:

□ On the basis of the *status quo*, the most striking impact would be the absence of trade restrictions of any kind, thus opening up a huge marketplace for all goods and services from Eastern Europe. The goods currently classed as "sensitive" would have unimpeded access to the EU's market. A glance at the export profile of the vanguard group of transition countries shows that, in 1991, precisely these classes of goods accounted for the lion's share of the export volume of the associated new market economies, ranging from 28.5% in the Czech Republic to 42.8% in Hungary. Quite evidently, these are areas in which the new market economies have a comparative advantage thanks to their lower labour costs relative to the EU, and those advantages could be borne out still more strongly if these countries were granted full membership. In an enlarged EU, one could expect the price of goods in these sectors to fall, thus providing welfare gains to consumers and leading on to competitive advantages to producers. In the special case of the agricultural market, the new member countries would adopt the existing CAP mechanisms. Their protection from the world market and the price guarantees they received would assure healthy profit margins for Eastern European agricultural exporters. That would entail substantial transfer payments coming out of EU coffers, which could strengthen economic growth in the transition countries by way of positive income effects.

□ Capital markets and a banking system modelled on those of the EU, which would be one of the conditions for entry, would provide more secure expectations for Western investors in the new market economies, thus eliminating one of the main obstacles to the expansion of investment so far. That would renew the

<sup>9</sup> For the fundamentals, see Hansjörg Herr, Andreas Westphal: Die Transformation von Planwirtschaften in Geldwirtschaften – Ökonomische Kohärenz, Mindestschwelle der Transformation, außenwirtschaftliche Strategien, in: discussion papers des WZB, FS I, 9/1990.

capital stock in these economies, providing both a quantitative and a qualitative boost to growth in the East.

□ Participation of the new market economies in the EU Structural Funds would bring enormous benefits to them. The EU has set aside approximately ECU 60 billion for this area in 1995, making about 80% of the total EU budget of ECU 76.5 billion. The Institute of World Economics in Kiel has run a simulation<sup>10</sup> to calculate how many additional funds the EU would have to contribute if it were extended to include the currently associated states. If the present output profile of these countries were to remain unchanged, the additional burden on the EU budget would come to ECU 15 billion. The Structural Fund would have to be increased by 25%, from ECU 60 to ECU 75 billion. All of the new entrants would be net recipients from the Fund. If the estimated contributions of ECU 2.5 billion made by the new members are taken into account, there remains a net sum of ECU 12.5 billion to be found out of EU coffers. This would constitute approximately 16.5% of the overall budget, which would then increase to ECU 89 billion. Taking the GDP of the EU of 15 member states in 1995 to be a total of approximately ECU 6,000 billion, that would mean that member states had to contribute an average of 1.48% instead of 1.28% of their GDPs to the EU budget. Given the low overall level of the budget, it would appear perfectly feasible to finance these additional costs if the political will to do so were present.

□ The political and economic stabilizing function which the EC already exercised at the time of its southward expansion would also have a contribution to make towards consolidating reforms in Eastern Europe and strengthening the confidence of the general public and of investors in the new system.

## Reservations about EU Entry

On the other hand, the reservations voiced even against the entry of just the vanguard group of countries have to be viewed in terms of the political and economic interests of the existing Community and its members. Some of the disadvantages for current EU members are simply the reverse side of advantages for Eastern European countries:

□ The East's comparative advantage in terms of labour costs could threaten jobs in the West. Geographical shifts in production in various sectors of the economy (machine tools, textiles, contract processing, straightforward technical products), could give rise to sectoral and regional fall-offs in

employment and investment in the West.

□ It is doubtful whether this effect would be made up for by the impact of the availability of a larger market for more technically sophisticated products from the West. The possible boost to growth and modernization in the East might also act as a damper on profit margins for such products, due to heightened competition in an enlarged EU.

□ Even today, it has to be assumed that only some of the EU's member states will meet the convergence criteria in time for the start of EMU. If the Union were expanded eastwards, it is likely that none of the new member states would be able to fulfil the criteria for the foreseeable future, thus pushing the attainment of the original objectives of EMU further away into the distance.

There could also be disadvantages for the countries in the East:

□ If the EU were to take on the role of subsidizing agriculture and heavy industry in the transition economies, the much-needed boost to modernization would not actually take place. As a result, the best-qualified members of the workforce would be likely to migrate to the West. This "brain drain" would make it less likely that output could be restructured and, as a result, the existing production structure would be hardened. Thus the benefits from the EU's expansion would be confined to the East's becoming the "extended shop-floor" of the West. Qualitative growth in the shape of technological restructuring would not occur.

□ If the existing production structure were to be perpetuated in this way, the new members could not expect any improvement in their terms of trade. Consequently, they would be unable to reduce their foreign debt burden. The EU's finances would have to bear the stress of the new member states' becoming persistent net recipients. Only in the event of the new market economies participating in the regulated agricultural market would it be possible for goods from the East to be sold at constant prices, thus helping to stabilize the current account of their balance of payments. But that in turn would heighten the incentive to farmers to produce more. This would be the wrong signal for the market to give as far as modernizing the transition economies is concerned,

<sup>10</sup> Jürgen Stehn: Stufen einer Osterweiterung der Europäischen Union, in: *Die Weltwirtschaft*, No. 2, 1994, pp. 212 ff. The author's own calculations which follow are based on official EU statistics (Eurostat 1995).

as indeed it is the wrong signal now in Western Europe. However, one would assume that granting full EU membership to these countries is more likely to spell the end of the Common Agricultural Policy as we know it today.

□ In addition to the objective of EMU, the new member states would also have to fundamentally recognize and implement the Treaty of Maastricht. In other words, they would also have to adopt the EU's social and environmental standards. Thus full membership would raise unit labour and production costs in the acceding economies, diminishing the current advantages of the Eastern countries as a production location. This effect and the deterioration in the terms of trade need to be weighed against the growth in the volume of trade when policy-makers in the transition economies weigh up the pros and cons of full membership.

The net result is that the EU can be presumed not to have any great interest in exposing its producers and workers in "sensitive areas" to increased competitive pressure, in postponing the EMU project for many years to come, and on top of that having to come up with additional funds from its budget, without the positive effects of trade expansion being clear at this stage. Conversely, it can hardly be in the interests of the potential new entrants simply to become the "backyard" of the Western countries. The very production advantages which the Eastern nations currently enjoy could be substantially watered down by EU membership, and this could lead them off their modernization path.

Quite evidently, the disadvantages of EU entry for the transition economies do not flow from the liberalization moves taking place within the Union, but essentially from what is known as positive integration, i.e. the politically initiated synchronization of policies.<sup>11</sup> Entry candidates will have to put the EU's social, legal and other standards into effect, thus generating considerable costs. This gives rise to non-tariff barriers to trade (covert protectionism) which – even with open borders – render market access more

difficult and could gobble up the new member countries' cost advantages.

It is above all these outward barriers put up by the EU which neglect the needs of the new market economies in favour of those of the existing EU. Apart from that, the transition countries would probably only be admitted as full EU members if they accepted quotas on trade in sensitive areas.<sup>12</sup> So full integration is not actually desirable even from the transition economies' point of view.

## A Gradualist Strategy: EEA Entry

The entry of these countries into the European Economic Area could offer them the following advantages relative to the *status quo*:

□ Adoption of the single market by joining the EEA would bring all of the advantages of the four freedoms along with it. These advantages were set out above when examining full EU integration, namely growth in trade volume, in investment, and hence also in employment and in economic prosperity. At the same time, the import markets would be opened up for goods and services from the EU.

□ The additional option of cooperation in research, environmental and social policies could also have a positive impact. The hoped-for transfer of capital goods of a high technical quality this offers as a prospect would then coincide with a well-trained, or readily trainable, workforce. Environmental and social-policy standards could be introduced on a phased basis, with advisory back-up from the EU.

□ Trade within Eastern Europe could also be enlivened by the application of the single-market rules.

□ The EEA is the closest available springboard into the EU proper.

Most of the disadvantages of EEA membership parallel those of full EU integration:

□ Competition among workers in Europe would increase; it is not certain whether the eastward shift in investment activity and the welfare gains thus achievable would not be overshadowed by job losses in the West, which could then threaten the modernization drive in Eastern Europe. The East-West brain drain should also be taken into account, as a competitive factor for highly paid experts in the West.

□ The transition economies would not gain access to markets for their agricultural produce, and their

<sup>11</sup> For an explanation of negative and positive integration in the EC/EU and a critical reflection on the limits to positive integration, see Fritz W. Scharpf: Mehrebenenpolitik im vollendeten Binnenmarkt, in: MPIFG discussion papers, No. 4, 1994.

<sup>12</sup> This view is shared by Kai Hirschmann, Elsbietta Hirschmann and Otto F. Bode: Internationalisierung und die osteuropäische institutionelle Integration, in: ditto (eds.): Weltwirtschaftliche Anpassung und Öffnung der osteuropäischen Reformstaaten. Transformationskosten – Handlungsstrategien – Ökologische Modernisierung – Konsumentenverhalten – Humankapital, Berlin 1993, pp. 7-15.

farmers would be placed at a disadvantage while those within the EU were protected. Hence the new market economies' membership of the EEA would leave one of the EU's fundamental and most sensitive policy areas untouched, which is why this option would be attractive from the EU's own point of view. The disadvantages suffered by the new market economies would be greater in this instance than if they were to gain full membership.

□ Because no transfers to the new market economies would be made from the Structural Funds, all costs of measures to develop the economy would have to be borne by the transition economies themselves. The costs would be particularly high if agricultural production needed to be restructured because farmers were unable to find markets for their produce. This too is a disadvantage for the transition economies which can be counted as an advantage from the EU's point of view.

□ Because the EEA does not go as far as a customs union, there is no equivalent to the protection mechanisms used by the EU. The overall effect of this is to weaken the trading position of the Eastern European economies relative to the EU while strengthening the EU's position as an economic power in Europe.

The net result of the mutual opening up of the internal market would be to create unilateral trading advantages for the Western economies. They would retain the ability to protect their sensitive agricultural sector, bringing clear disadvantages for the East. For the Eastern economies, on the other hand, there would be insufficient opportunity to exert control over their own prosperity on such a basis. Hence this option, once again, is not geared to reciprocal needs but essentially serves those of the EU. Although the new market economies' entry into the EEA would substantially enlarge the trading area, the EU's key barriers to market entry would not be dismantled.

## Effects of EFTA Entry

The advantages if the transition economies were to join EFTA<sup>13</sup> or to develop and extend CEFTA<sup>14</sup> would be that these economies would not be orienting themselves exclusively to the EU, and would be placing trade liberalization in the forefront:

□ Entry into EFTA (or expanding CEFTA both geographically and qualitatively) would set up a free-trade area in Eastern Europe. That would generate a substantial reduction in transaction costs within this group of countries, which in turn would allow an

expansion in trade to get under way among the transition economies. The advantage for Western European exporters would lie in the economies of scale they could achieve in a larger market.

□ The new market economies would obtain free EU market access for all of their manufacturing sector by way of bilateral trade agreements. There would be no exceptions for "sensitive products". Thus the Eastern countries would be able to use their comparative labour cost advantage to the full, as these areas of their economies engaged in competition with those of the EU. That in turn would create a more effective allocation of resources embracing all producers, also leading to reductions in consumer prices.

□ A free trade area would be more attractive to investors than the *status quo*. Investors do not just make their assessments on the basis of production costs, but also of the size of the local market, and the costs of developing it (including customs duties, laws and regulations, etc.) The opportunity to invest in one transition economy while simultaneously gaining problem-free access to the markets of the others makes investment a more attractive proposition, and thus makes it more likely.

□ As modern sectors of the economy developed, they would find appropriately trained people available to work in them who did not have the alternative of emigrating to the West.

□ The EU's agricultural market would remain unaffected.

Yet this strategy, too, carries disadvantages with it, all of which apply to the new market economies:

□ Via the bilateral agreements the EU can impose anti-dumping rules and thus prevent free market access for sensitive goods from the East.

<sup>13</sup> Now that all of EFTA's other member countries have joined the EU and EEA, it appears implausible at first sight that the transition economies would be particularly interested in trading with the one purely EFTA country remaining, namely Switzerland, which is relatively unattractive as far as its geographical location and population size are concerned. The purpose here is simply to discuss the principle of EFTA membership, which is why the expansion of CEFTA is treated as an equivalent thereto. EFTA's one advantage relative to CEFTA is that its free-trade structures are already in existence whereas those of CEFTA, assuming that its underlying principles are taken seriously, still need to be considerably developed.

<sup>14</sup> The Central European Free Trade Association includes all of the Visegrad countries, and came into being on 1st April 1993. However, the mechanisms agreed at that time do not fulfil the promise inherent in the association's name. Although a start has been made on liberalizing trade, the markedly slow pace of liberalization which has been contractually agreed for a number of product groups means that the co-signatory nations can hardly be said to have aimed rapidly to attain free trade. Indeed, the individual terms of the agreement offer clear evidence of their desire to protect their domestic industries, thus running counter to the very idea of free trade.



□ Agricultural produce from the transition economies would continue to be subject to EU import rules.

□ It is not fundamentally certain how stable an EFTA/CEFTA with its centre of gravity in Eastern Europe would be. This would depend on precisely which countries joined the organization. The grave difficulties the trailing group of countries are experiencing in their attempts to institutionalize the structures of a market economy suggest that these countries ought not to be admitted from the beginning. If they were, the security of expectations in the free-trade area would be substantially diminished; yet on the other hand, if they were not the prospective market would be reduced in size.

Once again, the net outcome is not unequivocally favourable in the sense of EFTA/CEFTA being the optimum concept for economic cooperation in Europe as a whole. And here too, the EU turns out to have the determinative influence on the volume and quality of trade. Nevertheless, it should be stressed that the retention of human capital, since the free movement of labour would not be possible, is of special strategic significance for the trading area under review. Only with the aid of a well-qualified workforce can the urgently necessary modernization measures be adequately carried through in the new market economies. So it is possible that the EU's protectionism *vis-à-vis* Eastern Europe could actually help promote restructuring and qualitative growth in the region, provided that the flow of inward investment from the West is not stemmed but reinforced by the progress of the reform process.

## The Case for Integration in Stages

Given the economic actualities and policy arguments, the strategy of a gradual integration into the Western economic system has to be regarded as the most favourable option. That implies adopting the latter's liberalization measures to the greatest possible extent, but leaving out the regulatory elements which would arise from a closer attachment to the EU for the sake of avoiding undue cost increases. That in turn would ensure that the new market economies' comparative factor cost advantages could be upheld for a longer period. Entry into EFTA or an expansion of CEFTA to act as a free trade area or customs union for Eastern Europe are therefore the most sensible steps to take in the short

to medium term to achieve economic restructuring in Europe as a whole.<sup>15</sup>

In spite of the differing levels of development among the transition economies as a group, and the risks to stability those differences imply, either the entry of all the new market economies into EFTA or the geographical expansion of CEFTA to cover all of the former CMEA members, including the successor states to the old Soviet Union, could be a step towards establishing a second economic area side-by-side with the EU. This appears a worthwhile move because it would be quite some time before the transition countries could be integrated into the EU, particularly as the main emphasis within the Union is currently on deepening, ahead of the 1996 inter-governmental conference. By the time the countries aspiring to membership have brought their economies up to a level suitable for joining the Union, they will have lost valuable time for their general development. That time ought to be used to build up trade among one another, and the positive welfare effects of such trade should be made use of. Measures to liberalize trade among the new market economies would make inward investment into this economic area substantially more attractive. Capital and labour could move freely within this area and would not be subject to national borders. This holds the prospect of greater welfare gains than the bilateral trading links with the EU in their current form. The trade agreements which would then be concluded with the EU would provide free market access for all finished goods from Eastern Europe. Although the barriers for sensitive goods would remain in force, the overall effect would nevertheless be one of an expansion in trade to the benefit of the new market economies relative to the *status quo*.

There is also a strategic aspect to this which should not be underestimated. EFTA membership or an expanded CEFTA including a customs union would throw some additional weight into the ring against the dictation of trading terms by the EU. It ought to be beneficial to the self-esteem of the transition countries if they could build up a certain amount of negotiating power relative to the EU in this way, and trading agreements with the West could be thrashed out on a rather different basis. That would give them the possibility of also applying tariff and non-tariff barriers against access by EU suppliers to their own markets. Such measures could be used to protect the modernization process within their trading zone. Because people would not be free to move between the trading blocs to take up work, this would ensure

<sup>15</sup> The same view is taken in Kai Hirschmann, Elsbietta Hirschmann, Otto F. Bode, *op. cit.*, p. 14.

that the skilled labour required for qualitative growth would be fully utilizable in such a free trade area. Yet at the same time, the opportunity for technical cooperation with the EU to boost the modernization process would be retained.

It is essential to consider that long-term, stable growth can only be achieved on the basis of a modernized capital stock. In the short and medium terms, the new market economies have to finance such modernization by further expanding their foreign trade, whereas in the long term they need to attract both capital and labour from their own regional resources. The main focus of attention during the transition should therefore be on the impact of economic policy for the longer-term future. Looked at in this light, conditional cooperation can actually be preferable to total liberalization. That is to say, an element of protectionism can serve development ends, along the lines of the Listian infant-industry argument where tariffs serve to keep cheaper foreign competition at bay while development phases are implemented which are vital to the economy at large. Once the modernization has been put into operation, the country concerned can engage in free trade. In the present-day context, the key modernization steps are the development of a tertiary sector and industries of the future.

Hence there are two main reasons why complete EU integration would not be a desirable step for the new market economies:

□ The fact that certain sectors of the economy are subsidized in the EU creates the wrong signals in the marketplace, since producers fail to see the need to give up economic activities which have long since ceased to be efficient. The strong producing areas of the transition economies, which at present are still competitive on international markets, would respond in a similar way to the EU's agricultural and coal & steel industries under this sort of regime. That is to say, they would still be kept operating even when they are no longer competitive. Because the economies we are dealing with in this instance typically have the lion's share of their GDP taken up by those sectors, they would be hit all the harder, in the long run, by a failure to modernize.

□ It is still an open question whether the EU will be prepared – and if so, when – to abandon its exclusiveness by taking on board another wave of new members, particularly since an increasingly heterogeneous membership would make decision-making within the club all the more difficult. Moreover, given the present level of economic development in

the new market economies it is by no means clear when their role as net recipients within the EU would come to an end. It is doubtful whether the EU's solidarity with Eastern Europe stretches to the point that it would be willing to accept the structural and financial burdens concomitant with the complete integration of these economies. So even if swift entry into the EU were achieved, it would only be conceivable on special terms relating to the "sensitive" sectors, and these would considerably water down the hoped-for improvements in economic welfare. Indeed, it would be hard to identify what set this arrangement apart from the EFTA trading model in qualitative terms. Yet at the same time, the transition economies' comparative advantages would be diminished as a result of the rules and regulations involved in positive integration.

As a general principle, any form of cooperation – in this case, free trade – is preferable to non-cooperation. The closer the cooperation, the greater and more rapid the welfare effects can be expected to be. Nevertheless the immediate, full integration of the new market economies – whether or not special terms are negotiated – would certainly lead to increased costs or welfare losses both for the EU and for the new entrants, as a result of positive integration and tougher competition. Putting these new admissions into practice therefore requires an act of political will on the part of the EU, which would essentially have to bear the costs associated with positive integration. Such a political will cannot be seen to exist at present. In political terms, then, the only prospect still open to the new market economies is that of gradually staged cooperation, unless they want to remain with the *status quo*, waiting doggedly for the day when EU entry finally becomes a realistic proposition.

To go down the path of gradual cooperation, decision-makers will be called upon to exert a good deal of both political and economic effort. Their task will be to develop lasting political dialogue to reduce the prejudice against cooperation among this group of countries which built up during the socialist period of forced integration, and to set about securing and enhancing these countries' common prosperity.

In the short and medium term, entry into EFTA or the establishment of a CEFTA covering all of the new market economies has the potential to act as the instrument which will pave the way for the transition economies on their road towards a full market economy, prosperity, and ultimately EU membership, including its political dimension.