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Intereconomics

*Suggested Citation:* Hartwig, Karl Hans; Welfens, Paul J. J. (1996) : Western European integration and Eastern European transformation, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 31, Iss. 4, pp. 170-180, <https://doi.org/10.1007/BF02928600>

This Version is available at:

<https://hdl.handle.net/10419/140551>

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Karl Hans Hartwig\* and Paul J. J. Welfens\*\*

## Western European Integration and Eastern European Transformation

*The process of EU integration has intensified in the 1980s and early 1990s. The desire of a number of central and eastern European countries to join the EU is often seen as a threat to the continuation of this process. How wide should the radius of EU enlargement be? Which forms of integration would be appropriate between the EU and different subsets of ex-CMEA countries?*

Economic integration has been a decisive force of international economic development after 1945 worldwide. The historical experience of the protectionist inter-war period, theoretical insights into the benefits of regional economic integration and the negative results of inward-oriented development strategies in Latin America and Africa in the 1960s and 70s are arguments in favour of regional integration schemes. These could be designed in various forms:

- ☐ as a free trade area in which the member countries exempt each other from tariffs, while maintaining individual tariffs vis-à-vis third countries;
- ☐ as a customs union in which there is free trade, while a common external tariff is adopted;
- ☐ as a common market in which additionally competition laws are harmonized and factor mobility is allowed;
- ☐ finally, as an economic and monetary union in which there is comprehensive policy coordination and supranational monetary policy, too.

After the collapse of the former Council for Mutual Economic Assistance (CMEA) the question arises in central and eastern Europe how external economic relations should be redefined within the region and vis-à-vis western Europe.

The EU has made considerable progress in economic integration since 1957 – or 1952 if one takes the Coal and Steel Union as the starting point: between 1957 and 1968 it moved towards a customs union and a common market, in 1992 the single

market was created and full capital mobility was established in the context of the first stage of European Monetary Union (mid-1990): France, Italy and Spain as well as other EU countries removed impediments to international capital flows which quickly put the EMS system under additional stress.

With the Maastricht Treaty of 1993 and the EFTA enlargement of 1995 the EU has deepened the integration process by adding the monetary union as an important element of EU integration and by extending the geographical coverage of the EU. The Community which started as a compact group of six founding members in 1957 has grown to a club of 15 whose members have adopted a rising degree of supranational economic policy and created a host of new EU institutions with relevance to policymaking in the Community; most recently the European Monetary Institute in Frankfurt and the European Environment Agency in Copenhagen. The evolution of the EU is, however, neither characterized by consistent economic criteria for the assignment of policy roles at the regional, national and supranational level, nor has the Community achieved sustained full employment and prosperity. With an ever larger Community the internal institutional, economic and political inconsistencies become a burden since any eastern enlargement will put the Community's politico-economic principles to a tough test. The basic assumption underlying the following analysis is that EU deepening and EU enlargement will be sustainable only if both the old member countries and the new member countries gain from further integration. While political arguments might be the initial stimulus for integration, mutual economic benefits of integration must exist if long-term political support for integration is to be achieved.

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With regard to the potential integration of eastern Europe with the EU there will be different forms of integration which are feasible for ex-CMEA member countries. Poland, Hungary and the Czech Republic have already submitted membership applications, the other two Visegrad countries are likely to follow, so that the EU-15 club could soon become a Community of 19. However, the range of potential candidates is apparently much wider since Romania, Bulgaria, the Baltic countries and the Commonwealth of Independent States (CIS) countries might wish to develop closer economic and political relations with the EU. The question arises as to how wide the radius of EU enlargement should be and which form of integration is appropriate between the EU and subsets of ex-CMEA countries. A major problem is the heterogeneity of the transforming economies whose per capita GNPs at purchasing power differ greatly (cf. Table 1) but which all have rather high education levels; at the same time energy intensities are very high compared to OECD countries. In the following analysis we focus on the integration process in the EU and evaluate to what extent and why the EU is likely to slow down the pace of any eastern enlargement. If the "western EU" has to devote

massive economic and political resources to stabilizing ex-CMEA countries while transforming economies fail to organize themselves in order to stabilize regional politico-economic cooperation, the EU could face a critical inability to reform its political institutions in a way which is consistent with increasing internal market dynamics.

### Deepening versus Enlargement

The process of EU integration has intensified in the 1980s and early 1990s: the completion of the single market programme has brought a wider mutual recognition of standards and regulations, but also increasing harmonization in this field.<sup>1</sup> The Maastricht Treaty has reinforced cooperation and coordination in economic policy. Finally, enlargement by the former EFTA countries Sweden, Finland and Austria was achieved in 1994. Thereafter political support for EU integration fell rapidly in most EU member countries. Several central and eastern European countries are eager to become EU members. By early 1996 the Visegrad countries (except for Slovenia), Bulgaria, Romania, Latvia and Estonia had declared their application.

Prior to these applications there was a transition stage in which financial aid and project financing helped Poland and Hungary, later also other ex-CMEA countries – the EU launched the programmes PHARE, TACIS, TEMPUS. In addition to this financial support, soft loans were extended to transforming countries. According to the 1995 EU summit in Cannes, financial support will continue over the next five years with a volume of ECU 6.7 bn.

Recognizing that OECD external financial support can only be a complementary element in systemic transformation, the EU concluded association treaties with Poland, Hungary and the former CSFR in 1991. Bulgaria and Romania followed in 1993, the Baltic states in 1995 (there were also negotiations with Slovenia). The so-called Europe treaties are not only aimed at improving economic relations between the partner countries. Another major aim is to influence the institutional framework in transforming countries in order to make sure that the economic order more closely resembles EU patterns.<sup>2</sup> While it is true that the Europe treaties do not contain a concrete time

**Table 1**  
**Energy Intensities and Social Indicators in**  
**Eastern Europe and the Former Soviet Union**

Countries	TPES/GDP ratios (tonnes oil equivalent per US\$ 000) 1992	PPP-GNP per capita in 1993 <sup>2</sup>	Secondary enrolment rate <sup>3</sup> in 1994
Czech Republic	1.70	7,550	88.5
Hungary	0.82	6,050	81.4
Poland	1.24	5,000	82.0
Slovak Republic	1.85	6,290	90.2
Slovenia <sup>4</sup>	n.a.	10,585	84.7
Estonia	1.70	6,320	84.6
Latvia	n.a.	5,010	81.2
Lithuania	n.a.	3,110	83.4
Albania	n.a.	999	n.a.
Belarus	1.29	6,240	84.2
Bulgaria	1.62	4,100	65.0
Moldova	n.a.	2,870	74.0
Romania	1.72	2,800	75.5
Russia	2.69	5,050	71.7
Ukraine	2.98	4,450	46.9
Armenia	n.a.	2,040	n.a.
Azerbaijan	4.33	2,190	76.0
Georgia	n.a.	1,750	75.9 <sup>a</sup>

<sup>a</sup> 1993.

<sup>1</sup> Total primary energy supply.

<sup>2</sup> PPP stands for purchasing power parity.

<sup>3</sup> Figures refer to net enrolment rates, defined as the percentage of the relevant age group enrolled in primary and secondary school education.

<sup>4</sup> 1995.

Source: EBRD: Transition Report 1995, Table 2.2 and Table 4.1.

<sup>1</sup> Where policymakers did not take the initiative, EU-wide industry standardization bodies did, e.g. in the field of electronics and telecommunications.

<sup>2</sup> K.-H. Hartwig and P. J. J. Welfens: EG-Osteuropa, in: P. Klemmer (ed.): Kompendium der Europäischen Gemeinschaft, Munich 1996.

schedule for EU accession, the treaty nevertheless mentions the goal of EU membership – a clause for which the East European partner countries pushed effectively. So it seems clear that there will be an eastern EU enlargement in the future.

The massive pressure of some transforming countries to join the EU has led to intensive discussions in the EU. One major issue is whether an eastern enlargement of the EU would not undermine the envisaged EU deepening. From an economic perspective there is no direct contradiction between enlargement and deepening since the latter primarily means reinforcing the “four freedoms” which should shape economic relations between member countries: free trade in goods; free trade in services; free capital flows; and free movement of people. In the context of an eastern enlargement there could be transitory conflicts in the medium term with respect to the principle of free capital movements which would expose fragile transforming economies to potentially destabilizing financial market shocks and to politically unwelcome high foreign direct investment inflows. Moreover, the free movement of people could be difficult to accept in EU countries which are proximate to poor transforming countries: Austria, Germany and Scandinavian countries could face massive immigration pressure in periods of cyclical or structural economic crisis in transforming countries which have achieved EU membership. However, one may also argue that free capital movement is a principle that can effectively discipline policy discretion in transforming economies, and that the free movement of people is no major long-term political problem as long as free trade and investment can contribute to a fast economic catching-up process in the transforming countries.

In order to achieve the four freedoms in EU countries it is crucial that impediments to such freedoms be removed and that supranational competences in economic policy are restricted to those areas where an individual country has no incentive to provide deregulation and economic freedom; e.g. because each country acting individually would be afraid of losing international competitiveness if measures are adopted in an isolated manner. Hence cooperation and coordination and even some form of supranational policy might be required if economic freedom is to be effectively provided and economic efficiency to be achieved. For example, the isolated, ecologically motivated, introduction of an energy tax is hardly feasible for an individual country as the inelastic demand for energy requires high tax rates

which in turn imply international distortions in the trade in energy-intensive goods. In some fields coordination of national policies is required in order to keep market access open or to deregulate markets, e.g. in telecommunications and energy. Ensuring market access, a supranational merger control, avoidance of international environmental pollution and the promotion of basic research are important fields of potentially efficient EU policy.<sup>3</sup> With respect to an eastern enlargement of the EU, putting emphasis on these fields would imply that the international division of labour is increasing and that prospects for higher growth and economic welfare gains are improving in a larger community. The new member countries would also gain by delegating traditional national policy competences to the supranational EU level.

Given the difficult transition situation in eastern Europe, the gain could be considerable in those fields in which domestic lobbying activities would otherwise slow down structural adjustment processes and bring about massive rent-seeking activities. However, in reality EU integration is not strongly shaped by consistent emphasis on the four freedoms which would allow EU enlargement and deepening to be combined in the long term. At the same time it is true that the transforming economies as a group have not fulfilled the requirements that are necessary to realize the four freedoms. Indeed, the divergent transition patterns often show a mix of measures which undermine the increasing realization of the four freedoms. In some countries this problem is connected with very low per capita incomes so that with respect to the ex-CMEA area – leaving aside the CIS – there is no foundation for a fast and simultaneous EU accession. Moreover, there are special problems related to the rather large size of agricultural employment and output in the transforming economies, except for the Czech Republic. The ex-CMEA countries – excluding the former USSR – have about 10 million people employed in agriculture (1/4 of employment), while agriculture in the EU accounts for 6% (share of employment) and 2.5% (share of GDP) respectively. The leading transformation countries Slovenia and the Czech Republic are expected to reach 80% and 75% of EU average income in 2010, respectively, while Romania and Bulgaria are expected to reach 29% and 36% respectively; this would be considerably lower than Greece with 51%.

<sup>3</sup> J. Stehn: Vier Freiheiten für alle, in: Frankfurter Allgemeine Zeitung, No. 105, 6 May 1995, p. 15.

### Basic Points of Departure

A very important integration impediment to enlargement is the entire Common Agricultural Policy (CAP) and the EU cohesion policy (regional policy and redistributive policy) which amount to major subsidy programmes that contribute to government budget deficits. Since most prospective EU member countries have relatively large agricultural sectors, EU subsidies related to the Common Agricultural Policy would rise massively, which in turn would cause conflicts over EU budget financing. For example, under status quo conditions Polish EU membership in 2000 would imply budget effects of ECU 19 bn.<sup>4</sup> Agricultural EU expenditures are likely to double after an EU enlargement with the Visegrad countries.

Budget problems are not only related to the CAP but also to structural funds and the cohesion fund created in 1992 which is allocated to countries with less than 90% of average EU per capita income. In 2010 all Visegrad countries would be eligible to structural funds while in 1995 only Spain, Portugal, Greece and Ireland were major recipients of EU structural funds. After a broad eastern EU enlargement these western EU countries, except for Greece, could face the risk of a net budget contribution position. While exact estimates concerning the budget burden of an eastern enlargement are impossible, it seems plausible to expect additional EU outlays between ECU 10 and 30 bn., which would be a considerable increase over the ECU 70 bn. EU budget in 1994.

Other impediments to integration are the relatively ambitious requirements and standards adopted in the context of the single market programme. Ambitious standards and harmonization policies impose adjustment costs for new members. Furthermore, the EU has adopted protectionist measures for so-called sensitive markets. While it is true that the Europe treaties basically open EU markets to transforming

economies, there remain market access barriers and risks which mainly concern those industries in which firms from transforming economies have comparative advantages. Agriculture, textiles, leather and apparel as well as the steel industry (Table 2) are facing trade barriers and the risk of antidumping duties; these goods account for a considerable share of transition countries' exports to EU countries.

Trade concessions were also limited for agricultural products. Indeed, the EU is a net exporter of agricultural products vis-à-vis most transforming economies such that the pattern of trade expansion is counter to comparative advantages. However, in eastern Europe farmers were also coping with lack of capital, difficult credit market conditions and sometimes too small land plots. The biased trade pattern in agriculture might even become reinforced in the late 1990s since the transition period of the Iberian southern EU enlargement ended in 1995, so that Spain's and Portugal's agricultural products enjoy full access to all EU markets and benefit from the comprehensive CAP system (export subsidies, guaranteed intervention prices) and the agricultural structural funds. Trade diversion at the expense of eastern Europe could occur.<sup>5</sup>

Barriers to integration in the field of sensitive products would become less important over time if the central and eastern European countries could increasingly produce "mobile Schumpeter goods"; mobile Schumpeter goods are characterized by a high technology content and the option of regionally separating research and development activities from the production process; by contrast, immobile Schumpeter industries are characterized by high technology, while industrial production and R&D activities – the latter with clear comparative advantages for the OECD countries – are difficult to separate across countries. In such sectors transforming countries could attract foreign direct investment which would both stimulate the technological catching-up process and contribute to exports of goods and services.<sup>6</sup> However, even if transforming countries could attract considerable

**Table 2**  
**Share of Sensitive Goods in Exports of**  
**Selected Transition Countries to the EU, 1992/93**  
(in %)

	CSFR	Hungary	Poland	Romania	Bulgaria	Russia
Iron & Steel	11	4	12	7	7	3
Chemicals	8	9	6	4	7	4
Leather, textiles, apparel	17	23	21	49	38	1
Agricultural products	4	18	11	5	18	2

Source: EBRD:Transition Report, London 1994, p. 117.

<sup>4</sup> H. Dicke: The Envisaged Accession of Poland to the EC and its Implications for the Common Agricultural Policy in the EC, Working Paper No. 684, Institut für Weltwirtschaft an der Universität Kiel, 1995.

<sup>5</sup> K.-H. Hartwig and P. J. J. Welfens, op. cit.

<sup>6</sup> H. Klodt: Perspektiven des Ost-West-Handels: Die komparativen Vorteile der mittel- und osteuropäischen Reformländer, in: Die Weltwirtschaft, 1993, pp. 424-440; R. Heinrich: Der Außenhandel zwischen der Europäischen Union und Ostmitteleuropa, in: LIST Forum zur Wirtschafts- und Gesellschaftspolitik, 1994.

foreign direct investment in mobile Schumpeter industries there would be export risks vis-à-vis the EU, which could mobilize the protectionist safeguard clauses of the Europe treaties and anti-dumping clauses. The Europe treaties stipulate that EU countries can exclude goods from eastern Europe if domestic firms would suffer serious distortions from import competition or if certain industries and regions would suffer from higher imports.

### Situation in Central and Eastern Europe

Since the early 1990s the postsocialist countries of central and eastern Europe have been going through a difficult adjustment process.<sup>7</sup> Not only are they facing the burden of inefficient socialist economic policy and investment decisions, but they are also coping with structural changes and shocks which absorb productive resources and therefore create conflicts over political priorities and income distribution issues. The results have been dramatic declines in output, high inflation rates – sometimes hyperinflation – high current account deficits and considerable budget deficits (cf. Table 3); the latter became dramatic in 1994 in Hungary. Exceptions to this negative development – including the absence of massive unemployment – were the Czech Republic, Estonia and Lithuania, which benefited from prudent policy decisions, favourable starting conditions and relatively strong external support. In Russia, the Ukraine and Belorussia there were also limited unemployment problems in the first half of the 1990s, but this mainly points to a backlog in systemic transformation, i.e. a lack of structural change and, as a corollary, the artificial survival of inefficient state firms which enjoy the financial benefits of a soft budget constraint stemming from continually increasing state credits (hyperinflationary financing of the budget deficit).

Only in 1994 there was a turnaround in economic development in the Visegrad countries. Poland, which

recorded economic growth already in 1993, moved ahead with more than 5% economic growth. Except for Hungary, which is facing the consequences of a restrictive policy motivated by balance of payments problems, the Visegrad countries face favourable prospects for output growth in 1995/96. Nevertheless, the per capita income of transforming countries reaches only 15% of that of their EU neighbours, and even Hungary and the Czech Republic reach only about 20% of the West European average per capita income of \$ 19,000; figures look more favourable if evaluated at purchasing power parities. However, the fact remains that the eastern border of Germany marks a severe economic divide within Europe. With respect to Bulgaria and Romania, there are estimates which let one expect that both countries will record per capita income levels in 2000 that are 25% below those at the beginning of the transformation process.<sup>8</sup> Both countries have revised initial plans for EU membership application and some date after 2000 looks more realistic than short-term moves. There is some risk that there will be an increasing intra-European economic division within Europe.<sup>9</sup> Poland and Hungary expect membership at the turn of the century. The Czech Republic's government looks

**Table 3**  
**Economic Situation in Selected CMEA Countries**

	Po-land	Czech Rep.	Slovak Rep.	Hun-gary	Slove-nia	Roma-nia	Bul-garia	Russia
Real GDP <sup>1</sup>								
1993	3.8	-0.9	-4.1	-0.8	1.3	1.3	-2.4	-12.0
1994	5.0	2.6	4.8	2.0	5.0	3.4	1.4	-15.0
1995 <sup>2</sup>	6	4.5	4.5	1	5	3	1	-5
Gross industrial output <sup>1</sup>								
1993	7.3	-5.3	-10.2	4.0	-2.8	1.3	-10.9	-16.0
1994	11.9	2.1	7.0	9.1	6.4	3.1	4.5	-21.0
1995 <sup>2</sup>	12	4	5	4	5	5	2	-5
Consumer prices <sup>1</sup>								
1993	35.3	20.8	23.2	22.5	32.3	256.0	72.8	896.0
1994	32.2	10.0	13.5	18.8	19.8	136.8	96.0	302.0
1995 <sup>2</sup>	28	10	12	30	15	45	75	180
Budget balance, in per cent of GDP								
1993	-2.9	0.7	-7.5	-6.0	0.3	-0.7	-11.4	-9.5
1994	-2.7	0.6	-4.0	-8.0	-0.2	-4.0	-6.8	-11.0
1995 <sup>2</sup>	-3.5	0	-4	-6	0	-2.5	-6	-7.5
Current account, in US \$ bn.								
1993	-2.3	0.4	-0.6	-3.5	0.1	-1.2	-1.1	2.6
1994	-0.9	0.3	-0.1	-3.9	0.5	-0.2	0.2	5.8
1995 <sup>2</sup>	-1.5	-0.5	-0	-3	0.5	-0	0	5

<sup>1</sup> Changes over the previous year in per cent.

<sup>2</sup> Estimates based on data from international and national institutions.

Source: Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Jahresgutachten 1995/96, Stuttgart 1995, p. 35.

<sup>7</sup> See, for example, H. Siebert, (ed.): Overcoming the Transformation Crisis, Tübingen 1993; P. J. J. Welfens: Market-oriented Systemic Transformations in Eastern Europe. Problems, Theoretical Issues and Policy Options, New York 1992; K.-H. Hartwig and H. J. Thieme (eds.): Transformationsprozesse in sozialistischen Wirtschaftssystemen, Heidelberg 1991; A. Köves and P. Marer (ed.): Foreign Economic Liberalization, Transformations in Socialist and Market Economies, Boulder Co. 1991.

<sup>8</sup> RWI: Konjunkturbrief No. 3, Essen 1995; WIFO Datenbank, Vienna 1995.

<sup>9</sup> WIIW: Transition Countries: Economic Developments in Early 1995 and Outlook for 1995 and 1996, Part I & II, Research Reports No. 219 and 220, Vienna 1995.

more flexible, but it seems clear that the Visegrad countries favour an early eastern EU enlargement.

Those countries which made early and bold moves towards a market economy have realized the biggest progress with respect to economic catching-up. Certainly, no ex-CMEA country could avoid a deep initial drop in output, but making the right decisions in favour of establishing a market economy relatively quickly paid off. It is true that systemic transformation is an extreme exercise in changing the economic, social and political regime – ultimately whole nations are involved in this systemic shift, and there is no ideal and certain trajectory for heading towards a market economy.

Despite this and the fact that initial economic situations differed among the ex-CMEA countries, one may tentatively identify some core requirements for successful transformation, some of which can be inferred from the analysis of requirements for a functional market economy;<sup>10</sup> the minimum requirements were incorporated in successful transition policies.<sup>11</sup> These requirements refer to principles of government behaviour, such as the rule of law based on democratic legislation, restrictions on the power of industrial (lobbying) groups, limited power of the state and an emphasis on the government's limiting its role in the economic sphere by putting its main emphasis on the design of an appropriate institutional framework providing incentives for work, savings, investment and innovation. In addition to this, there should be six ingredients ("basic principles"): establishing functional competition in markets that determine equilibrium relative prices; price level stability; private property; freedom of contract; full liability of decision-makers; and open markets. In addition to these basic principles, there are complementary principles which aim at maintaining an economic order consistent with the requirements of functional markets and allow market failure to be corrected. Corresponding measures include social policies in those cases in which the generally accepted ideas of justice would be violated by market-determined results or in cases of extreme

social conflicts which might undermine the foundations of the market economy.

Among the Visegrad countries, Poland and the Czech Republic have been most radical in adopting a comprehensive transition to a market economy. The shock approach to transformation had its costs in the short term but there is little doubt that the medium and long-term benefits of a radical approach (in combination with political stability) dominate. Countries with unclear transformation policies were less successful and the associated poor economic record indeed impaired the transition process of trading partners in the ex-CMEA countries. As regards fiscal and monetary policies it is also apparent that only the Visegrad countries are likely candidates for successfully coping with the Maastricht convergence criteria.

## Significance of Monetary Union

The Maastricht Treaty has emphasized macro-economic policy convergence as a requirement for membership in the monetary union. A deficit to GDP ratio of no more than 3%, a debt to GDP ratio of no more than 60% and low inflation and interest rates (not more than 1.5 and 2 percentage points respectively above the average of the three countries with the best inflation record). Moreover, two years prior to monetary union membership, there should be no devaluation of the currency. The convergence criteria will be difficult to meet for a majority of the EU-15 states at the end of this century,<sup>12</sup> but at least there is a slight chance that some old and some more recent members could form a core group of countries starting monetary union. Eastern Europe's transforming economies certainly need exchange-rate flexibility, not stable nominal rates which lead to real appreciation because of high inflation. With respect to eastern European countries, it will be very difficult to meet the Maastricht convergence criteria, with the possible exception of the Czech Republic.

The more important effects of envisaging monetary union are in western Europe. The debt-ratio and deficit criteria of the Maastricht Treaty imply restricted policy options for fiscal policy which could hamper the effectiveness of stabilization policies. This could be a serious problem in those countries in which – for internal or external reasons (e.g. orientation towards US policy) – monetary policy adopts an undesirable cyclical policy course. Consistent fiscal policies in

<sup>10</sup> W. Eucken: *Grundsätze der Wirtschaftspolitik*, 6th edition, Tübingen 1952.

<sup>11</sup> T. Apolte and D. Cassel: *Dezentralisierung durch "kapitalistische Marktwirtschaft": Radikaler Systembruch*, in: K.-H. Hartwig and H. J. Thieme (eds.), *op. cit.*, pp. 111-152; A. H. Gelb and C. W. Gray: *The Transformation of Economies in Central and Eastern Europe. Issues, Progress and Prospects*, World Bank Policy and Research Series, No. 17, New York 1991; P. J. J. Welfens, *op. cit.*; OECD: *Reforming the Economies of Central and Eastern Europe*, Paris 1992.

<sup>12</sup> P. J. J. Welfens (ed.): *European Monetary Integration*, 2nd rev. and enlarged edition, New York and Heidelberg 1995.

western Europe might be difficult to achieve in the medium term, especially as long as high unemployment rates, long duration of unemployment rates and continued inflexibilities of labour markets are persistent. Fear of impotency of fiscal policies could reinforce trade unions' and declining industries' resistance to structural change and the call for rising subsidies and external protectionism. If the EU cannot restore labour market clearing in the single EU markets it seems doubtful that political support for eastern enlargement will be broad and sustainable in most EU member countries.

### Requirements for Integration

Transition countries which envisage EU membership have to take into account various requirements which have to be met for membership application and active future EU membership in an integration which organizes a positive sum game for its members. An international positive sum game can be expected if for old and new members there is a net benefit from trade creation and foreign direct investment creation; the latter is often neglected in the literature, but it is important since gains from specialization and economies of scale can be fully mobilized only – especially in the non-tradables sector – if two-way foreign direct investment takes place such that the marginal products of capital are equalized across borders. Moreover, old and new members together must be able to pursue their political goals more effectively than in the situation prior to integration ("political autonomy gain" or gain in power), which requires benefits from closer political cooperation and supranational policymaking respectively. There are thus economic and policy requirements as well as intra-eastern European integration requirements which have to be met if an eastern enlargement is to be a positive sum game for EU-insiders and for new member countries, the latter being small countries in economic terms and therefore in the position of price-takers in world markets.

Since traditional economic integration theory shows that compared to large countries (here the EU-15 group as a whole), small countries will gain more from integration, i.e. trade creation plus exploitation of economies of scale, it is clear that economic integration gains are asymmetrical in favour of new member countries. One caveat is that taking into account foreign direct investment flows and assuming that capital markets are imperfect, EU foreign investors in eastern Europe could appropriate economic rents abroad better than eastern European

investors could do in the EU; here we assume that multinational companies are more likely to develop firm-specific advantages in large EU countries which easily allow exploitation of static and dynamic economies of scale in large home markets and facilitate the spreading of high R&D costs over a large market volume. As regards political cooperation and efficiency of supranational policymaking, a growing number of countries is not easily organized within the present decision-making structures in the EU, and this problem is reinforced by the issue of political instability in most postsocialist countries.

The EU-15 group of market economies can be joined only if a market economy is fully developed in the transforming countries and if requirements for a significant politico-economic gain can be achieved. Those requirements are:

- ☐ privatization and economic opening up;
- ☐ full employment;
- ☐ internal policies/instruments compatible with EU rules;
- ☐ macroeconomic policies consistent with EU convergence criteria;
- ☐ the redesigning of regional economic relations in eastern Europe.

The first two requirements are economic requirements in a strict sense, while the third and fourth are directly related to EU membership. The fifth requirement is based on the assumption that only some ex-CMEA countries will become EU members, which will leave an economic and political division within eastern Europe that hardly would be acceptable for the EU if politico-economic relations between new members and permanent outsiders could not be reorganized in a way that reinforced stability in the ex-CMEA area.

### Economic Requirements

The fundamental economic requirement for the integration of transforming countries with the EU – be it in the form of explicit EU membership or membership in the European Economic Area (equivalent to EU membership without a share in supranational decision-making and without access to EU structural funds) – is that privatization and economic opening up be fully realized. In Poland, Romania, Hungary and Bulgaria it took until 1995 before mass privatization programmes were effectively launched; in Poland, privatization of



existing state companies was rather slow, but there were considerable grass root dynamics of newly created companies. The share of the private sector in Bulgaria's GNP was only 24% in 1994, and the prospects of the majority of loss-making state-owned firms being privatized quickly are limited (only about 300 out of 3500 firms to be privatized were in private hands in 1994). Without Czech-style voucher coupon privatization there is no way to fast comprehensive privatization and the nurturing of capital markets. Without private owners of industrial capital, banks and houses, there will be continued inefficiencies in production, distribution, investment and trade. Without full economic opening up the pressure of import competition is missing, but also the drive to raise the export proceeds needed to pay for rising imports of western investment goods which are necessary for modernizing the capital stock and for capital deepening. Economic opening up – as already stipulated in the Europe treaties – will require that,

after a transition period, the Visegrad countries, Bulgaria and Romania accept the right of establishment of EU firms and remove restrictions on EU foreign investors.

Romania and Bulgaria will face sustained problems with respect to the current account deficit,<sup>13</sup> and this is partly due to the slow privatization of the export industry and the lack of foreign direct investment inflows. Hungary's high current account deficit is also critical, but even more so is the structure of the domestic banking system, the restructuring and privatization of which was much neglected in the first half of the 1990s – much in contrast to Poland and the Czech Republic. Economic opening up will bring about a rising degree of openness in terms of the trade to GDP ratio and the foreign direct investment to GDP ratio as well as higher volatile portfolio capital

<sup>13</sup> WIW, op. cit.

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## Privates Bankvertragsrecht im EG-Binnenmarkt

The European Community is increasingly developing into a Community of commercially relevant civil law. The focus of scholarly and practical interest is now on the structures of the "European civil law" which is developing in the form of a synthesis of national and European law. This monograph provides a thorough analysis of the law applicable as regards the law of contract on the banking industry, and particularly the law on card-controlled payment transactions, which is a highly advanced sector. Guidelines for the future development of the law of contract in the banking industry are developed on this basis, and they have a general importance, which goes beyond this particular field, for the future shape of civil law in the Community can scarcely be overestimated. This volume offers both guidance for the practitioner of banking law and suggestions for scholarly discussion on this important field.

1996, 184 pp., softback, 58,- DM, 423,- öS, 52,50 sFr; ISBN 3-7890-4130-0  
(Studien zum Handels-, Arbeits- und Wirtschaftsrecht, Bd. 42)

■ remainder as in German text



**NOMOS Verlagsgesellschaft**  
**76520 Baden-Baden**

movements. Following the results of the gravity equation approach<sup>14</sup> (cf. Table 4) one may expect a rising trade orientation towards western Europe.

The ratio between actual and potential trade reaches up to 5 in the case of the former CSFR vis-à-vis the EU; figures are even higher for the export opportunities to EFTA countries. By contrast, the corresponding ratios for regional trade within the former ex-CMEA area (with or without the ex-USSR) are close to, or below, unity so that trade diversion can be expected in the course of the economic opening up of the transforming economies.

Surveys by the OECD<sup>15</sup> showed that EU barriers to imports are not the only impediments to rising east European exports. The lack of infrastructure, so far heavily biased in favour of CMEA links, uncertainties stemming from the transformation process and the lack of long-term policy stability, especially in the field of monetary and foreign exchange policy, create risks that impair the expansion of east-west trade as well as capital formation and hence growth in eastern Europe. Underdeveloped financial market institutions restrict export growth since highly developed financial services are particularly important for the international trade business.

Historical experience shows that open markets and free trade cannot be maintained if high and sustained unemployment rates occur in market economies. Since all ex-CMEA countries, except for the Czech Republic, have high unemployment rates it is important that measures be taken to reduce them. Infrastructure projects which stimulate capital

formation and hence economic growth as well as retraining schemes for unemployed people could be useful in reducing the unemployment rate and preventing long-term unemployment becoming a permanent problem in transforming countries. Given the potential of political radicalism among young people it is also particularly important to avoid high rates of youth unemployment. Unemployment insurance systems should be designed in an incentive-compatible manner such that there is a feedback between collective bargaining pressure for high and undifferentiated wages and ensuing high unemployment rates – i.e. regions with above national average unemployment rates should face higher than average unemployment contribution rates.<sup>16</sup> Without full employment there is a sustained risk of political radicalization and political instability in western Europe.

### Policy Requirements

Developing a set of internal policies and instruments that is consistent with EU rules and the Maastricht criteria will be a major requirement for integration with the EU. This requirement will bring about several side constraints for policymakers, some of which might actually be welcomed by policymakers facing domestic pressure for protectionist short-term interventions. For example, subsidy policies of EU member countries are subject to EU scrutiny so that many subsidy schemes turn out to be incompatible with EU laws. This might be a welcome excuse for policymakers in transforming economies to restrict subsidy programmes and thus to limit government expenditures in a way that might otherwise not be politically feasible. This holds because the domestic environment in transforming economies is one in which big and influential firms face declining demand and restructuring problems and therefore are naturally inclined to lobby for rising subsidies. EU competition rules will apply already in the 1990s in eastern Europe since the Europe treaties contain some clauses on this. The application of tough EU competition laws could limit options with respect to restructuring industries by mergers and acquisitions in some cases.

**Table 4**  
**Potential Exports of Transformation**  
**Economies in 1989**  
(\$ bn., except for ratios)

	CSFR	Hungary	Poland	Romania	Bulgaria	Russia
EU-12						
Actual (A)	2.6	2.6	4.0	2.5	0.5	15.1
Potential (B)	12.5	4.5	8.5	3.0	3.9	31.2
Ratio A/B	4.8	1.7	2.1	1.2	2.6	2.1
EFTA						
Actual (A)	0.8	0.9	1.0	0.2	0.1	4.4
Ratio A/B	5.5	1.7	2.0	3.2	7.3	2.0
Ex-CMEA Partners						
Actual (A)	6.6	4.1	5.2	4.2	n.a.	n.a.
Ratio	0.6	0.5	0.7	0.4		
Ex-CMEA (without CIS)						
Actual (A)	2.7	1.8	2.2	1.8	n.a.	n.a.
Ratio	1.0	0.8	0.8	0.4		

Source: R. Baldwin: Towards an Integrated Europe, London 1994.

<sup>14</sup> For example, C. B. Hamilton and L. A. Winters: Opening up International Trade with Eastern Europe, Economic Policy, 1992, No. 14, pp. 77-166; R. Baldwin: Towards an Integrated Europe, London 1994.

<sup>15</sup> OECD: Barriers to Trade with the Economies in Transition, Paris 1994.

<sup>16</sup> P. J. J. Welfens: Growth and Full Employment in the European Union, Volkswirtschaftliche Diskussionsbeiträge No. 201, University of Münster 1994.

Opening up the telecommunications industry to competition could also become a major problem since monopolistic state-owned telecommunications operators could face the need to reduce the workforce and adopt drastic measures for raising productivity.<sup>17</sup>

The Maastricht convergence criteria are constraints for future EU members which should partly be taken into account prior to membership; especially as regards the debt to GDP criterion and the deficit to GDP criterion. The debt to GDP criterion would be a minor restriction if it could be assumed that high economic growth will be achieved in transforming economies in the next decade, but this is uncertain. The 3% deficit to GDP limit is a useful pragmatic limitation for democratic welfare states in which pressures for rising government expenditures systematically outweigh impulses to reduce expenditures. Since the average taxpayer has a much weaker lobby than compactly organized industrial lobbying groups, there is a need to limit expenditures via a deficit rule so that rising government revenues have to be achieved if higher expenditures are to be legitimate.

In the EU, countries have different interests in stabilizing eastern Europe and the former USSR. Germany certainly has a prime interest since it is a direct neighbour and major trading partner of eastern Europe; France and Italy also have strong trade and investment links with eastern Europe, some of which indeed might further expand as privatization of state firms and state banks in France and Italy creates a bigger pool of firms which, driven by sharp competition at home and in the internal market, aggressively pursue options to develop new markets in eastern Europe. Austria, Sweden and Finland, the new members of the EU, also have a strong commercial and political interest in the ex-CMEA area. The relative absence of the UK in eastern Europe – both with respect to trade and foreign direct investment – is noteworthy and is one feature of Euro-fatigue in the UK. British engagement in eastern Europe might become stronger if network industries such as telecommunications, energy, water, gas and railways are privatized; the UK was the first EU country which introduced privatization and competition to network industries in the 1980s so that British firms which are successful competitors and enjoy ownership specific advantages could be among

the first foreign investors in infrastructure business in eastern Europe. However, there are few signs that privatization and competition in infrastructure is on the political agenda in transforming economies.

### Redesigning Regional Economic Relations

Reorganizing trade and investment relations with ex-CMEA countries will be a requirement for EU membership if one assumes that an eastern EU enlargement should not leave a sharp and destabilizing politico-economic division within eastern Europe. It is difficult to organize regional trade expansion since there are considerable political frictions in the ex-CMEA area and because transforming countries faced a first adjustment stage in which output sharply declined. Moreover, in eastern Europe there is a natural short-term lack of (new and old) credible firms and viable banks with experience and reputation in foreign trade. This reduces intra-regional trade in the first transition stage. However, there should be a considerable medium-term potential for regional trade expansion once functional capital markets and a set of competitive firms have been established; moreover, with high prospective regional growth, there are new opportunities for increasing regional trade. In addition to this one should take into account the real appreciation effects which are to be expected after the first successful transition stage. As firms from ex-CMEA countries are trying to penetrate price-sensitive markets in the EU and as real exchange rate appreciations impair further export growth, international outsourcing towards low wage east European partner countries will become attractive for firms from the Visegrad countries. The Visegrad countries will increasingly look for cheap input sources in neighbouring transforming countries. To the extent that the transition process in these neighbouring countries is making progress, one may anticipate that prospects for rising trade between Visegrad countries and their eastern neighbour countries are improving.

If the EU-15 group is not to understand eastern enlargement as taking in the Visegrad countries while footing the political bill of a less stable remaining ex-CMEA area, the Community will require that the Visegrad countries develop politico-economic concepts that stabilize the whole ex-CMEA area. There are genuine regional interests in eastern Europe in several fields: trade, infrastructure, and environmental protection, for example. One may well create regional institutions which will be in charge of developing coordinated policies in certain fields.

<sup>17</sup> P. J. J. Welfens and G. Yarrow (eds.): *Telecommunications and Energy in Systemic Transformation*, Heidelberg and New York 1995.

Finally, there is a risk that a massive economic divide within eastern Europe would stimulate westward migration from the poorer transforming economies – especially those with small foreign direct investment inflows – to the Visegrad countries (and Germany) which in turn would find it difficult to absorb a massive influx without political and economic disruptions.<sup>18</sup> This should create a natural interest in the Visegrad countries to actively consider the impact of integration and transformation policies on neighbouring countries; moreover, successful transforming countries in the Visegrad group might actively become engaged in schemes that support the transformation process in other ex-CMEA countries. To the extent that the Visegrad countries were able to develop regional political leadership and reinforce their internal economic and political relations (similar to the Benelux countries) new EU member countries from the Visegrad group would become more influential in an enlarged EU. In Brussels, those countries and country groups are politically relatively influential which have economic weight and which prove to be important for the EU's external policy interests. The proven ability of transforming countries to cope successfully with regional policy problems and to support the transition process in Russia and the Ukraine (e.g. by achieving a solution for old ex-USSR debts and by open trade strategies) could be a viable political asset for EU membership negotiations.

### Summary and Conclusions

The analysis has shown that EU internal developments are not generally in line with requirements for open markets in western Europe. The apparent inability to solve the unemployment problem and industry specific pressure for protectionism in the EU point to a systemic weakness of the western European integration process. Integration generated considerable economic benefits in the EU but has failed to solve the short-term trade off between high productivity growth and full employment; moreover, with the single market and rising per capita income there is a potentially increasing scope for market forces which, however, are difficult to implement in many spheres – most notably in the field of social security policies.

With the demise of the political discipline in the EU that was generated by common fear of the USSR, the political systems in several member countries have become less stable, while political nationalism has become respectable again. The EU has failed to develop a clear notion of common European interests – possibly except for strenuous relations vis-à-vis Japan. As long as economic policymaking at the national level does not develop a twin focus on both the national and the supranational interest one must consider the EU as a fragile institution which might well disintegrate under internal or external stress in the long term. Considering supranational policy impacts would come naturally onto the agenda if policy assignment to the national and the supranational EU level were more in line with comparative advantages, so that EU club membership ultimately would generate significant and tangible economic benefits. There is one intra-EU development which lets one expect an increasing incentive for national policymakers to consider intra-EU spillover effects and the repercussion effects on the national economy: rising intra-EU trade, which was stimulated strongly by the internal market programme.

Since it is unclear how wide the radius of a future eastern EU enlargement will be, one can argue that EU institutions should be reformed in a way that would allow both smaller and larger eastern enlargements of the EU to be accommodated. Given the fact that the CIS/Russia will not want to join the EU (nor would it be welcome to do so), any eastern enlargement raises the question how a larger EU could organize its relations with Russia in a way that is consistent with a pan-European market economy with prosperity, economic freedom, stability and peace.

Creating a pan-European market economy remains the big challenge of the 1990s.<sup>19</sup> There are few economic projects that could create improved east-west links in Europe. Massive infrastructure investments in Europe could be an important step to the extent that improving infrastructure has pro-competitive internationalization effects as transportation costs fall, but it also has employment-creating effects in the construction industry which are most welcome in the difficult transition stage in eastern Europe. Building a new Europe could mean creating a Europe with a double divide: an economic rift between old EU member countries and new EU members from the Visegrad group on the one hand and a rift between the Visegrad countries and the other ex-CMEA countries on the other hand.

<sup>18</sup> P. J. J. Welfens: *European Monetary Integration*, op. cit.; P. Jasinski and P. J. J. Welfens: *Privatization and Foreign Direct Investment in Transforming Economies*, Aldershot 1994.

<sup>19</sup> R. Tilly and P. J. J. Welfens (eds.): *European Economic Integration as a Challenge to Industry and Government*, Heidelberg and New York 1995.