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**EC INTEGRATION WIDENING TOWARDS EASTERN EUROPE:
Reconciling the Political and Economic
Rationale of Supporting the
Transformation Process**

by

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I. Introduction

When the Socialist system of central planning collapsed within a very short time span of two years (end 1989-end 1991), Western European countries, individually as well as collectively, were confronted with a trade-off between the political and economic rationale of supporting the transformation process through integration widening.

Politically, there were important arguments to support this process through strong signals, such as rapid institutional association to the EC legal framework, massive financial transfers to the East, and free trade conditions. Such signals were expected to prevent political turmoil and social unrest in Eastern Europe from becoming a threat to political stability in neighbouring Western Europe. Furthermore, they were believed to discourage large-scale labour migration, to control the Eastern military potential and its conversion into civil use, and to mitigate the threat of other negative cross-border externalities such as the poor safety standards of nuclear energy plants in Eastern Europe.

The economic rationale, however, had a number of arguments to ask for more cautiousness in integration widening, for more gradualism and for weaker signals. Such arguments pointed to the limited absorptive capacity of Eastern countries in institutional terms as well as in terms of human capital endowment, to the scrap value of the existing physical capital stock if this stock would be exposed too rapidly to world market competition, and to the large amount of financial transfers needed to minimise the adverse social effects of economic transformation accelerated by integration widening.

Unlike in East Germany where the political rationale of shockwise integration widening clearly dominated over the "gradualist" strategy recommended by many economists, controversies between the political and economic rationale of integration widening towards Eastern Europe were less pronounced. The first generation of Eastern European countries under transformation (CSFR, Poland, Hungary) while being accepted as associates with options for future membership was given sufficient control over important policy buffers like the national exchange rate policy, monetary policies or the national regulatory framework. The same holds true for the second generation of countries (Bulgaria, Romania, Albania, Baltic states) which do not yet enjoy the status of associates, not to speak of CIS states which are still excluded from any type of institutional access to the EC framework.

However, the political rationale of moving rapidly towards integration widening has also influenced the EC-Eastern Europe relations. This emerges from the extraordinarily short period of negotiating the so-called Europe Agreements between the EC and the first generation countries within one year only. Without considerable pressure from the political side such speed would have not been possible as economic disputes on the timetable of bilateral trade liberalisation and on the exclusion list went deeply into the nitty-gritties of individual products (particularly in agriculture), not to speak of other non-trade-related issues.

The purpose of this paper is to discuss first whether the relative dominance of the political rationale in the negotiations made the Europe Agreements more meaningful and substantive in their economic substance than they had been if the economic rationale of carefully balancing vested interests of domestic producers, consumers, taxpayers and third countries had prevailed. This discussion includes the first generation countries as well as the other Eastern European countries (Chapters II-IV).

In a second step (Chapter V), the third country implications are highlighted. Finally, it is shown that the EC will follow a selected approach of concentric circles in integration widening by differentiating between the first, second and third generation of Eastern European associates.

II. Integration Widening towards the First Generation Countries (CSFR, Poland, Hungary): Much Ado about Nothing?

Western Europe is a "natural" trading partner of the three countries. Historical trade patterns from the inter-war period as well as the simulation of "normal" trade patterns using gravity models (with economic size and distance the major determinants of the direction of trade) suggest that Eastern European countries would direct the largest share of their exports to Western Europe. Havrylyshyn and Pritchett [1991] estimate that about 75 per cent of Eastern European exports (including countries like Romania but not Bulgaria) would normally be directed to Western Europe. It is important to note that the type of institutional affiliation with Western Europe (preferential trading arrangement, free trade agreement or full membership), does not affect the geographical trade patterns but the degree of outward orientation of Eastern Europe (exports/GNP). This degree would be higher if the affiliation would become closer. In other words, most trade would be anyhow with Western Europe. The effects of integration widening would be mirrored in the ratio between export demand and domestic absorption of the Eastern European countries and not in the share of Western Europe in their exports.

In this respect, the three Europe Agreements of December 1991 with the Czech and Slovak Federal Republic (CSFR), Poland and Hungary (in the following called "the associates") including their trade policy parts which came into force by so-called Interim Agreements on 1 March 1992, have to be submitted to a

double test. First, do they provide an external anchor which supports the transformation process in the three countries in such a way that exports become less discriminated against production for the domestic market than without the institutional affiliation? Secondly, if the incentive system is actually moving towards more neutrality between export demand and domestic demand, has the EC really opened its markets to ensure that this export supply is absorbed by the Community?

The first question is much more difficult to answer than the second one as the Agreements impact indirectly and qualitatively on the internal transformation process through many tentative and intangible channels. Furthermore, this impact will take time and thus will not materialise immediately.

To mention two of the channels, the EC acknowledges that the final objective of the Agreements is full membership. To achieve this target, the three countries' existing and future legislation has to approximate that of the Community. For this purpose, the Community offers a wide basket of measures of economic co-operation, industrial co-operation, investment promotion, monetary co-operation, education and training in all relevant sectors, plus financial assistance through the G-24 PHARE programme and the European Investment Bank plus balance of payments support. An Association Council is going to screen the approximation process permanently. While this Council speaks with a soft voice, it carries a big stick in terms of judging on the appropriateness (or inappropriateness) of the approximation process and thus on the chances of full membership.

To conclude on this point, there is probably more external support for the CSFR, Poland and Hungary than any non-member country including the ACP countries has ever received from the

Community.¹ But this support is still purely complementary and not substitutive to strong own efforts of the associates. The uphill task of economic transformation rests with the associates themselves.

The second channel is more straightforward and operates through opening the three countries' markets to EC suppliers. Here, some inconsistencies and loopholes can be observed. The free trade provisions are asymmetric in the sense that the associates can postpone the sensitive issues of opening their markets to the end of a ten-years period. Given the fact that markets are more strongly protected in Eastern Europe than in the Community², it is likely that the three countries will face an "adjustment jam" at the end of the period if they use the options of postponing trade liberalisation.

Important sectors like real estate, banking and insurance enjoy infant industry protection and a number of general and special safeguards and escape clauses introduce inequalities between sectors as far as the adjustment pressure is concerned. While the motives to protect the associates against external shocks of immediately strong competition should not be generally discredited, what gives rise to concern is the degree of fine-tuning in discretionarily segmenting privileged sectors from non-privileged ones. In doing so, the countries encourage strong

¹ The EC part in financial assistance under PHARE (Pologne Hongrie Assistance pour la Reconstruction Economique) committed for 1990 and after (credits, investment and credit guarantees, grants and assistance) amounted to 4070 Mill. US\$ EC member states' aid and 690 Mill. US\$ community aid for Poland (2240 Mill. US\$ and 1200 Mill. US\$ for Hungary, respectively) [Mihalyi, Smolik, 1991]. Recipients of EC developing countries' aid are tempted to put these figures into perspective with the Lomé IV volume of financial resources of 12 000 Mill. ECU (equivalent to 15 300 Mill. US\$ at 1990 conversion rates) to be shared among 69 countries and 450 Mill. people.

² This does not only hold for NTBs like different standards but also for tariffs. In Poland, for instance, the average weighted import duty for industrial products is 18 per cent compared to 6 per cent in the EC [Kawecka-Wyrzykowska, 1992].

elements of rent-seeking to become active already at an early stage of economic transformation. This is inconsistent with the conditions under full membership.

Coming to the second test criterion, that is the opening of EC markets to exports from the associates, there are some remarkable improvements over previous preferential trade agreements. The most important one is the inclusion of goods from the hard core of EC agricultural and industrial protectionism like meat, grain, rootcrops and dairy products, as well as of iron, steel and coal. While these products are still subject to quotas with reduced variable levies, tariff quotas or other restrictions, one cannot deny that the Agreements have facilitated market access in sectors in which the associates are likely to become competitive soon.³ It is important to note that breaking a small hole into the wall of agricultural protectionism was achieved under political pressure against the resistance of vested interest groups.

Furthermore, quotas for textiles and clothing have been lifted substantially, especially for outward processing which is a starting point for linking EC companies to counterparts in the associates and for future joint ventures and foreign investment (see Table 1 for a time-table of phasing out EC restrictions against imports from the associates).

It is just in strongly protected sectors where the associates were able to translate preferential access into gains in trade shares. For instance, between 1988 and 1991 the share of the three associates in extra-EC imports of agricultural products increased from 3.4 to 4.8 per cent, in textiles and clothing

³ In some products like meat of sheep, goats, pigs and chicken, or milk powder, countries like Hungary and the CSFR are already among the leading third country suppliers.

Table 1 - EC Tariff and Quota Dismantling Granted in Europe Agreements

	Share in EC imports from Eastern Europe	Date of full duty elimination and mode of reduction	Quantitative restrictions
Non-sensitive industrial goods	1990: 66% medium-term: 48% long-term: 63%	March 1992 one step (a few items by 1993)	None
Iron and steel	1990: 5% medium-term: 4% long-term: 4%	January 1997 four steps of 20%, then two steps of 10%	None
Textiles	1990: 7% medium-term: 4% long-term: 7%	January 1998 2/7th in 1993; then five steps of 1/7th	Quota increase of about 200% in 1992 over original MFA quota for 1991. Additional outward processing quotas equivalent to 100% of increased quotas for 1992. Full phase-out by January 1998.
Other sensitive industrial goods	1990: 14% medium-term: 27% long-term: 13%	January 1997 five steps of 15%, then 25%, duty-free GSP quotas for about 50% of imports, growing at 20%	None
Agricultural products	1990: 8% medium-term: 17% long-term: 13%	Not specified Reductions of tariffs on some non-CAP products, typically up to 50%	Preferential access for CAP products, except cereals, at 50-75% reduced variable levies and tariffs with 8% quota growth, levy reductions phased over three years

Note: Medium-term = structure of EC imports from Spain in 1990,

Long-term = structure of intra-EC trade in 1990.

Source: G. Pohl and P. Sorsa, The European Integration and the Developing World. The World Bank, Geneva Office, January 1992, p. 95.

from 3.7 to 5.2 per cent, and in iron and steel from 6.8 to 9.0 per cent. Gains in trade shares are more impressive for relatively open sub-markets like Germany.

As concerns the heavily restricted imports after outward processing (OE), the three associates comprised 46 per cent of extra-EC imports of shoes under OE regimes in 1991 compared to 26 per cent in 1988 (from 27 per cent to 36 per cent in clothing CN 62) [Langhammer, 1992]. In March 1992 when the Interim Agreements came into force, OE and MFA quotas were lifted again substantially thereby giving the associates a clear advantage in market access vis-à-vis developing countries and other Eastern European countries.

Such concessions visibly contrast with the refusal of the EC to open its labour market. Apart from offering some modest options to negotiate bilateral agreements on a limited number of East European guest workers between individual EC member states and the associates, labour mobility was not on the agenda.

It is the other side of integration widening that with the almost complete collapse of intra-Eastern European trade (including the CIS), the EC has gained a new market for its capital goods. EC shares in the associates' imports are rapidly rising, and the upper limits of import growth are only set by the assessment of Western countries concerning the sustainability of the associates' current account deficit.

Early successes on EC markets, however, cannot obscure the fact that the Europe Agreements are still far from paving the way to integration widening in terms of full membership. So are the associates from meeting the economic and institutional requirements. Unlike twenty years ago when the first enlargement was implemented, integration widening is no longer confined to becoming a member of the customs union. Today integration widening

means membership in a common market (including factor mobility and free trade in services) as well as complying with the basic objectives of the Maastricht Agreements (heading for the economic and monetary union plus entry into the process of political integration).

With macroeconomic instabilities still shaking the associates and with ongoing rapid depreciation of the obsolete physical capital stock, the economic rationale calls for the gradual implementation of the free trade area which later on would be upgraded to a customs union. This is exactly what the Europe Agreements envisage.

Yet, as mentioned before, the political rationale of integration widening could be in favour of accelerating the speed of accession (accompanied by much higher financial and political commitments of the EC) if the gradual approach would fail to stabilise economic transformation, to contain social unrest at the Eastern border of the Community and to discourage migration.

III. The Second Generation Eastern European Countries: The Mortgage of being Latecomers and Backyarders

In negotiating the Europe Agreements with the three countries which geopolitically and culturally are classified as Central European countries, the community has driven a wedge between the former CMEA countries. For the Community, Eastern Europe comprises Bulgaria, Romania, Albania and the former USSR republics but not the CSFR, Poland and Hungary. In fact, by all standards the former countries cannot contest the scores which the latter group has already achieved. The process of democratisation and economic transformation has been more disruptive and fragile, the endowment with physical and human capital is poorer, the level of per capita income is generally lower, inflationary tendencies are stronger, traditional economic

Table 2 - Basic Indicators of Economic Performance in Central and Eastern Europe, 1991 (1)

	Bulgaria	Czech and Slovak Federal Republic	Poland	Romania	Hungary	CIS	Russia
GDP	-23.0	-15.0	-9.0	-13.5	-8.0	-17.0 (2)	-9.0
Industrial production	-24.0	-23.0	-11.9	-22.0	-19.0	7.8	-2.2
Inflation	475.0	58.0	70.0	223.0	35.0	86.0	92.0
Unemployment (per cent of labour force; December 1991)	10.5	6.6	11.4	5.0	8.3	-	-
Per capita GDP (1990 US\$ at PPP; Luxembourg 1988 = 100)	35.0	51.1	25.2	19.0	38.1	32.6	-

(1) Percentage change of the previous year.

(2) GNP.

Source: KOPINT-DATORG (1992); AMEX Bank Review 1991, p. 4.

relations to Western Europe are weaker, and, finally, the countries suffer from locational disadvantages as they do not share common borders with Western Europe.⁴

Although the Community allowed these countries to participate in some of the financial and economic privileges,⁵ these privileges mean little if they are compared to what is offered in the Europe Agreements. But what matters more is the fact that the supply constraints are much more severe in Bulgaria and Romania (not to speak of Albania) than in the associates. As a result, shares in extra-EC imports have either stagnated on the very low level during the 1988-91 period (Bulgaria: 0.1-0.2 per cent) or even declined (Romania: from 0.6 to 0.3 per cent).

To bridge the gap between the first and second generation countries, the EC has started negotiations with Bulgaria and Romania in 1992 on a similar type of institutionalised relations as the Association Agreements. However, it is very likely that in the new agreements with the Baltic states, Albania, Romania and Bulgaria, the EC will deny the explicit reference to future full membership given in the preamble of the Europe Agreements. As a result, these agreements would be comparable to those negotiated with Cyprus, Malta and Turkey in the sixties and seventies.

How large wealth differentials become within a widening European integration if a country like Romania is taken as a yardstick is highlighted by the following comparisons. The per capita income (measured at purchasing power parities) of the poorest EC country, Portugal, is 43 per cent of the income of the richest country, Luxembourg. If the income of the poorest associate,

⁴ Some basic indicators of economic performance are presented in Table 2.

⁵ As concern trade policies, the Community has lifted quotas and has improved the GSP coverage. Financially, the G-24 economic reconstruction programme PHARE which initially was confined to Poland and Hungary (before being widened to the CSFR) was extended to Bulgaria and Romania (and also to former Yugoslavia).

Poland, is measured in terms of the Luxembourg reference figure, the gap amounts to 25 per cent, and it widens to even 19 per cent, if the poorest second generation Eastern European country, Romania, (leaving Albania aside) is included (Table 2). Should EC integration be widened to these countries, the Community would ultimately change its nature from an initially efficiency-oriented to an equity-oriented integration scheme in which transfer policies would gain much more political weight.

IV. The Successor States of the USSR: No Candidates for Integration Widening

The unprecedented and unanticipated collapse of the USSR and its disintegration into fifteen entities (including three non-CIS Baltic states) has given rise to a revision of the formerly very reluctant stance of the Community towards trade with Russia and the other states. Under the old system, trade was not only very much restricted through EC import quotas, both Community-wide and on the national level (the latter ones especially against energy imports) but perhaps even more on the EC export side because of security reasons (COCOM). Since 1989 many quotas against USSR-originating goods were lifted under a ten-years trade and commercial co-operation agreement with the former USSR (December 1989). All specific EC quantitative restrictions were to be eliminated by the end of 1995 at the latest, except for a limited number of products deemed sensitive (GATT, 1991, p. 73). After December 1991 the EC has found it obviously difficult to formulate new policies for trade relations with the CIS which increasingly drifts away from a customs union. The chaos in goods pre inspection, rules of origin and customs valuation as well as the suspicion of dumping might be technical reasons why by mid-1992 even the GSP status has still been denied to CIS products. Anyway, such concessions would be without much substance because the CIS states predominantly export non-dutiable items like primary commodities.

Among the former USSR republics the three Baltic states are likely to hold the best cards in their hands as far as their chances are concerned to be considered as first candidates for integration widening. Experience suggests that small resource-poor economies are traditionally better prepared to launch and implement substantive reforms to open their markets than large resource-rich economies. Early attempts of Estonia, for instance, to peg its new currency against the Deutschmark, supports this experience though this policy might be too painful (in terms of real income decline) to be sustainable. But beyond such entry into a first round of an asymmetric free trade area with the Baltic states, there is no scope for predictions.

While the process of institutionalising trade relations to the other former USSR republics is as volatile as every single economic factor in this area of the world, there is much evidence that integration widening is not on the agenda no matter how often political rhetorics touch upon it.

V. Integration Widening towards Eastern Europe without full Membership: A Violation of the Non-Discrimination Rule?

It is controversial whether the Europe Agreements violate the GATT principle of non-discrimination because of inconsistency with Art. 24 GATT. While an economist like Lester Thurow interprets Art. 24 in a legalist way and thus argues that "associate membership in the common market is 1,000 percent illegal under the GATT" [Thurow, 1991, p. 5] because it would not lead to a political union, other researchers pragmatically look upon the trade-diverting effects as the major criterion [Jacquemin, Sapir, 1991, p. 169]. They argue that EC-Eastern Europe trade relations are determined by "natural" proximity factors such as geographical distance and cultural similarity (that is, along the gravity model type of arguments à la

Havrylyshyn/Pritchett) and that therefore trade diversion effects would be less relevant.

Empirical evidence suggests truth to be "in the middle of road". Proximity factors are ineffective if quantitative restrictions decide on the access to the market. This is the case for sectors like textiles and clothing and CAP products. Of course, trade diversion is low in the latter products because EC markets have remained as closed for third country suppliers after the Europe Agreements as they were before. Thus, imports are likely to be expanded at the expense of marginal domestic supply. However, imports from the associates in meat and dairy products still account for less than 2 per cent of domestic supply. Textiles and clothing on the other hand constitute real access advantages for the associates as quotas were lifted more rapidly and more substantially than for other third country suppliers. To translate such advantages into gains in import market penetration ratios, the associates must be able to exhaust the quotas. The 1991 EC trade data for import permits under MFA categories (prior to the extended quotas under the Interim Agreements) yield relatively high average utilisation rates in so-called hyper-sensitive categories (MFA categories 1-8) only for the CSFR (about 94 per cent) while they were much lower for Poland and Hungary as well as for Romania and Bulgaria [Langhammer, 1992, Table A1]. As utilisation rates vary strongly by individual MFA categories, average rates are not overly conclusive.

Should these rates increase for 1992 and the following years and should an improved market access be denied to third countries (the latter as a result of a failure to dismantle import barriers multilaterally under the GATT), trade diversion could become a more serious issue than today. Yet, it is likely that it will be confined to the first generation countries being the more competitive suppliers than the other countries.

Complaints of third countries ("impairment and nullification of benefits under the GATT") will lead to more specific tests of GATT consistency. In general, however, the EC may resort to Art. XXIV: 5(c) GATT which labels a period of ten years as "reasonable" for the implementation of a free trade area. Except for the agricultural sector, the Interim Agreements heading for a Free Trade Area within this period would therefore be GATT consistent in legal terms.

VI. Conclusions

EC integration widening in the nineties is no longer a process which is limited to the geographical extension of the free trade area. Nor is full membership confined to the accession to the customs union or the common market. Candidates for full membership must also meet non-economic criteria like multi-party democracy, political stability and cohesion, or ethnic homogeneity. Fitting into the framework of a future political union, is an essential prerequisite of membership. But even if such prerequisite are fulfilled, this does not imply a fixed time schedule of guaranteed accession. Integration widening is also conditioned by the success of integration deepening. Unless there is full endorsement of the Maastricht Agreements by the electorate of the Twelve, integration widening towards new members will be postponed.

Among the Central and Eastern European countries, the political rationale favours the acceleration of a process towards full membership for Poland and Hungary after the accession of the EFTA countries. The economic rationale will be reluctant to support such acceleration. Such reluctance would be justified with the high amount of transfer payments needed and the concomitant change of the Community from an efficiency-oriented scheme to an equity-oriented one.

The divorce of the Czech and Slovak parts of the CSFR will probably lead to a reassessment of the political implications of the Europe Agreement with the former CSFR. Both economically and politically, a bone fide credit to apply the conditions of the Europe Agreement to a Czech Republic seems larger than with respect to an economically more backward and politically unknown Slovak republic. The more this republic would become economically and politically unstable, the more it is likely that it would be denied equal treatment as the Czech Republic.

The second group of Eastern European countries will have no chance for a privileged associated status (including an option for full membership). Free trade provisions for the industrial sector will be subject to special regulations taking into account the infant industry character of the domestic industries in these countries.

Finally, there is no model of integration widening available for the CIS states. This is not only due to political disorder and economic backwardness. Even in the narrow field of tariff concessions, barriers to integration widening are numerous. For instance, conceding GSP treatment and special trade preferences is ineffective if the bulk of export supply is in non-dutiable primary commodities. As all individual CIS states are not yet clearly defined customs areas, the EC may shy away from any sort of trade concessions at the moment in order not to give incentives to circumvent EC customs regulations against individual third countries, for instance in textiles. On the other hand, the CIS itself is paralysed and has no competence as a negotiation partner.

To conclude, in the medium run integration widening will be confined to the three associates. Political rationale will be in favour to accelerating this process towards full membership while the economic rationale will call for more cautiousness. Ultimately, it is the success of integration deepening in the EC-12 and

of the political and economic transformation in the associates
which determines the speed of shifting EC borders to the East.

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