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ECONOMIC ASPECTS OF EU ENLARGEMENT TO THE EAST

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Enlargement and deepening. From its inception in the early 1950s to date European economic integration has undertaken both *enlargement* and *deepening*; sometimes *widening* is also singled out, as a broadening of scope (Dewatripont 1995, pp. 2-4), but a totally new feature seems just another form of deepening (it is immaterial whether progress in a given direction takes place from scratch or from some positive level).

Deepening went from sectoral agreements for privileged trade (ECSC, Paris 1952; Euratom, Rome 1958) to a Customs Union (the European Economic Community, Rome 1958), to an Economic Union (the Single European Act of February 1986, with effect from 1 July 1987, complete with the Single Market on 1 January 1993), and via the ERM towards the Monetary Unification envisaged in the 1992 Maastricht Treaty. This also involves a common foreign and defence policy, as well as cooperation in the areas of justice and internal affairs. The prospect of political unification (*la finalite' politique*) comes last.

Enlargement has involved the growth of membership from the six founders (Benelux, France, Federal Germany, Italy) to fifteen, with several rounds of accessions: UK, Ireland and Denmark on 1 January 1973; Greece on 1 January 1981; Spain and Portugal on 1 January 1986; the latest round of 1 January 1995, with Austria, Sweden and Finland. The ex-GDR joined automatically and instantly by virtue of German re-unification in October 1990. Another dozen prospective members are in the pipeline; beside Cyprus and Malta, ten central European countries (CEC-10) are possible candidates: the Visegrad five (Hungary, Poland, the Czech and Slovak Republics, Slovenia), Bulgaria and Romania, and the three Baltic republics (see Nuti, 1994).

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The Italian experience. Italy has been always a staunch supporter of both enlargement and deepening, regardless of its short term interests. As already remarked at this Conference, joining the European project as a founder was an act of courage, not of careful calculation, on the part of a weaker partner who could have been squashed in the process. Subsequently Italy has had, in general, greater difficulties with deepening than with enlargement of European integration. The Southern enlargement (to Greece, Spain and Portugal) might have been an exception, in view of Italy's considerably greater similarity with those economies with respect to other member states; however Italy was not a net exporter in agriculture, and also benefited from the new European policies of inter-regional transfers (Structural Funds, etc.) introduced on the occasion of that enlargement precisely to compensate the losers. Ahead of the next round of enlargement, towards new members of central Eastern Europe, so far Italy - like the European Union as a whole - appears to have gained more - in terms of relative market penetration - than the new trade partners.

Italy's real difficulties instead, in the first half of the 1990s, have come from two aspects of European integration, namely: i) European deepening and in particular the ability to stay within the bounds of the ERM, let alone meet the Maastricht requirements of monetary unification; ii) enlargement to the ex-GDR, not *per se* but because of the mode of finance of German re-unification that brought it about, i.e. through government loans that drove up interest rates and strengthened the DM. The combination of Italy's inability to contain inflation differentials, which had already led to a steady real revaluation of the lira, and the DM interest and exchange rate trends following unification, in September 1992 led to Italy's precipitous and costly withdrawal from the ERM.

Integration: core and periphery. European enlargement and deepening has been accompanied by a continuous growth of trade integration as measured by intra-block trade flows, which for goods over the period 1960-90 almost trebled as a proportion of GDP, from 6 to 17 per cent, thus overtaking the share of extra-block trade which went from 9% to 12% over the same period. Integration in the market for services is still modest and even; immigration and foreign direct investment are internally small, but financial markets are very well integrated (Dewatripont 1995, Ch. 2).

On the eve of the 1995 enlargement, European integration appears to have evolved towards a "dual" industrial structure, with an inner *core* of "central" countries closely interconnected with Germany and a more loosely connected *periphery*. Thus empirical studies have shown that supply shocks for France, Belgium, Holland and Denmark have a high correlation (greater than 0.5) with German shocks, whereas the correlation is closer to zero for the "periphery", i.e. Italy, UK, Spain, Ireland, Portugal and Greece; for demand shocks the distinction appears to be

less marked, but is still present (See Bayoumi and Eichengreen, 1992).

De Cecco and Perri (1996) distinguish between "industrial integration" measured by the degree of intra-industrial trade between economies characterised by similar industrial structure, and "trade integration" reflecting the absolute and relative importance of trade between countries. Their empirical analysis shows that the EU core countries agglomerated around Germany have a different industrial structure, concentrated in sectors characterised by medium and high capital intensity, whereas the peripheral countries attach a greater weight to traditional, low capital intensity sectors. They also find that intra-industrial trade with Germany has grown faster for the core countries, thus suggesting a *de facto* "two-speed" Europe. Trade integration, however, discriminates much less between the two groups of countries, showing however for 1987-92 a significant German trade diversion towards the Visegrad countries (Poland, Hungary, Czechoslovakia). These process throw light onto the relationship between enlargement and deepening: i) the polarisation of trade flows resulting from enlargement - but also implicit in the gravity pull between the two areas - causes asymmetry in shocks and therefore makes difficult the implementation of a fixed exchange rate between them; ii) the shift of German trade towards economies in transition has made it even more difficult.

European response to the transition. The revolutionary changes of 1989-90 in central eastern Europe, and of 1991 in the Soviet Union, evoked a response from the European Community (as it then was) which differed greatly - in terms of speed, effectiveness and scale - in the different areas of aid, trade access, enlargement. *By and large, aid was swift, effective and generous. Trade access had been significantly improved already on the eve of the transition and was extended further by Association Agreements; these measures were effective, but on a scale which - especially but not only with the benefit of hindsight - can undoubtedly be judged as ungenerous. Moves on enlargement to the centre-east of Europe were unreasonably delayed, ineffective and half-hearted.*

The swiftness of European *aid* to transition economies is shown by large scale emergency food and medical aid delivered in real time; by the Polish stabilisation fund, made available at the inception of the 1-1-1990 Plan to support a fixed rate of exchange; by PHARE and its rapid extension to other transition economies. The size of aid is impressive, of the order of 39 billion ECUS in 1990-94, or 68 per cent of G-24 total assistance, which corresponded to something like 2 per cent of recipients' GDP (comparable to post-War Marshall Aid which was 2.5 per cent of recipients' GDP; see the 1996 *World Development Report*, World Bank, June 1996, Washington). It was effective, as it included - beside the forms mentioned above - low interest loans, guarantees, both of which turn into a grant in case of

default; technical assistance; balance of payments support; investment in infrastructure and capacity re-structuring. The European Community took the lead among the G-24 and successfully bid for a coordinating role.

Trade access to the European Community was significantly improved already on the eve of transition, as a response to Gorbachev's *perestroika* and the generalised progress towards economic reform throughout the area. The EC effectively recognised CMEA with the Luxembourg "Joint Declaration" of June 1988, and concluded a new generation of General Trade and Economic Cooperation Agreements with CECs. Most importantly, already in 1989, the Community abolished for the reforming countries the specific restrictions that applied to state trading economies; suspended other quantitative restrictions generally applicable to other third countries and extended to them the Generalised System of trade Preferences (GSPs, which was already applied to Romania). While GSPs had been tailored to the needs of less developed countries and in parts were irrelevant to central eastern Europe (e.g. in their concern for tropical products), their extension was later regarded as the single most effective measure broadening trade access to the European Community for transition economies.

The next trade access improvements came with the special Association Agreements, negotiated in 1991 with the Visegrad countries, effective ad interim in March 1992 pending a lengthy subsequent ratification, re-negotiated with the Czech and the Slovak republics after the CSFR split, and later extended to the other CECs, the Baltics, Slovenia. These Agreements - named "Europe" Agreements to distinguish them from earlier looser Association Agreements such as those with Cyprus or Malta - envisage the creation of a free trade area within ten years, in two five-year stages. With some exceptions, the Agreements abolish all quantitative restrictions on industrial imports, as well as tariffs on more than half EC imports, with remaining tariffs to be abolished within 5 years. The exceptions involve the so-called "sensitive sectors": textiles and coal, subject to a longer transitional period; iron and steel, for which improved Voluntary Export Restraints (VERs) have been arranged; agriculture, subject to "tariff quotas", i.e. increasing thresholds below which the Associates' exports meet a lower barrier.

Asymmetry in liberalisation allows the central European countries more time to reciprocate the European concessions of the first five years (Poland seven years, Hungary and Czechoslovakia nine years). However, transition economies having adopted an exceptionally liberal trade regime, asymmetry still allows for a higher initial degree of protection greater for European producers.

There is a standstill provision (no new customs or quantitative restrictions after the signing of the agreements - except for infant industries and restructured sectors in the east), but there is also anti-dumping

protection - effective in chemicals - and a general provision for contingent protection, in case of or threat of "serious injury" to a domestic industry, which in practice leaves implementation of the agreement to the continued cooperation of trading partners.

Ultimately, the inadequacy of trade access granted by the European Union is demonstrated by the large and sustained turn-round in the EU trade balance with the central eastern European partners (i.e. without the FSU), from a 1 billion ECU deficit in 1990 to a surplus of 6.5 billion ECU in 1994, first in global trade with the entire area, then also with each individual country *and* even in the so-called "sensitive" sectors.

Enlargement to the East. Back in January 1990, when the countries of central eastern Europe embarked together on the long and difficult transition towards the market economy and political democracy, the European Community could have given a substantial and costless boost to these processes. All the Community had to do was simply declare, without entering any irreversible commitment, these countries' eligibility *in principle* as members of the Community - if and when they met specific or yet unspecified economic and political conditions. This would have cost nothing, and effectively given nothing away, but undoubtedly would have boosted the morale of these countries' populations, strengthened their governments' resolve and commitment, encouraged foreign investors.

Regrettably no such a declaration was made in 1990, when its impact would have been maximum; Association agreements simply acknowledged - as a matter of fact - the associates' *unilateral* wish eventually to join the Community, without a shred of support or encouragement. Instead such a declaration had to wait until the Copenhagen Summit of June 1993 (see European Council 1993), when those countries with which the Community had reached Europe Association Agreements were regarded as potential members on three conditions: "functioning market economy, the capacity to cope with competitive pressure and market forces within the Union, and the ability to take on obligations of membership". By that time the announcement went not with a bang but a whimper; it was scarcely noticed and was then, anyway, a foregone conclusion.

Not only was the announcement effect totally wasted, but the new policy on accession was totally de-coupled from trade policy, which remained unchanged as spelled out in the Association Agreements. True, only those countries with whom the Community had or was going to sign Association (Europe) Agreements were to be considered as potential members, but then these Agreements had not been drafted and negotiated with accession in sight or in mind. The only enhancement of trade access, that accompanied the momentous decision to regard associates as potential members, was

bringing forward by six months (sic!) a number of marginal trade concessions.

The organisation and timing of the enlargement process still remains to be defined (see European Council 1994, 1995, and European Commission, 1995b). The Madrid European Council of December 1995 in practice decided that no political decisions on enlargement could be expected before the end of the IGC, i.e. probably until mid-1997 at the European Council in Amsterdam. Negotiations might begin possibly in early 1998, when Malta and Cyprus are also due for consideration. A commitment to treat applicants "on an equal basis" fails to recognise the significant differential progress of, say, Poland and Bulgaria towards meeting membership requirements.

Fears. The lack-lustre performance of the EU towards enlargement to the East is better understood considering the main fears and obstacles perceived - whether rightly or wrongly - to bar, postpone or qualify accession by potential new members.

First, there was fear of reversibility of systemic change. Until the dis-integration of the Soviet Union in December 1991 such fear was unwarranted but plausible; if there was only a "window of opportunity" this could be enough for a hasty German re-unification but not for a European unification. A fear of reversal is no longer plausible in central eastern Europe today, even after the electoral come-back of reformed communists in Lithuania, Poland, Hungary, Bulgaria, even the Czech Republic, and even on the eve of the 1996 Russian presidential elections. Suffice to see how unperturbed domestic and financial markets have been with respect to such changes.

Second, there was fear of unfair competition from countries characterised by grossly undervalued currencies, rock-bottom real wages, state aid to exporters, excess capacity in the same sectors as Europe, and excess inventories; this fear was sufficient to discourage trade access, let alone enlargement. Such fear was also plausible at the time but not warranted by later events. The competitive edge given by gross undervaluation was greatly offset initially by the introduction of exceptionally liberal trade regimes, and later eroded by rapid real revaluation, which made real wages also rise fast. State aid to exporters was in some cases (notably in agriculture) much higher in the EU than in its eastern trade partners. Excess capacity in "sensitive" sectors, mirrored in the east, sometimes failed to materialise (again, in agriculture, outside Bulgaria, Hungary and Estonia) or did not prevent intra-sectoral trade; indeed - as we noted above - the EU improved its trade balances not only overall but also in these sectors. The unloading of excess stocks occurred on a massive scale in the former Soviet Union, which for instance disrupted the international market for

aluminium in the first half of the 1990s, but was not a major factor of trade with the eastern associates.

Third, there was the fear that - even if the EU as a whole had benefited from greater integration to the east, individual member states might have experienced a net loss. While net gains from trade expansion have been uneven, net losers are hard to identify *within* member states, let alone *across* them.

In fairness, the same fears - at any rate the last two, if not the first - had significantly cooled the Visegrad countries' initial enthusiasm for expanding trade within their own Central European Free Trade Area. The February 1991 treaty did not came into operation until March 1993 after the Czech and Slovak split and was initially closed to outside members, though it was recently extended to Slovenia. Agriculture was more protected in trade within CEFTA than with the EU; the schedule leading to a free trade area was much slower than envisaged in the Europe Agreements. So much so that there have been calls for the EU to multilateralise negotiations for trade access and membership, in order to induce a more cooperative approach of the new partners among themselves (Baldwin 1994). Instead of the customary MFN, a *Least* Favoured Nation clause would have been appropriate, for the EU to treat any of these countries no better than they treated each other.

Obstacles. There were also, and there still are, genuine obstacles. First, the cost of extending CAP to countries where agriculture - with the exception of the Czech republic - had a significant weight (on average 25% of employment and 8% of GDP, against the corresponding figures of 6% and 2.5% respectively for the EU). The cost of extending to the CEC-10 the provisions of CAP in its present form have been calculated by the European Commission to be of the order of 12 bn ECUs per year "after a period of transition and adjustment" (European Commission 1995b), on the assumption of enlargement in the year 2000. Others have estimated a much higher cost (37 bn per year according to Baldwin 1994). Moreover the extension of CAP to the CEC-10 would add, say, some 20% to their consumer price index and raise the overall average food surplus in the enlarged EU - by reducing their consumption even if their production was inelastic with respect to prices: their current prevalent position of net importers of agricultural products cannot be projected into the next century.

Second, there is the cost of extending to the new members the budgetary transfers to which they would qualify under structural funds, cohesion funds and other headings. Central eastern European countries are both populous and relatively poor: in 1993 they represented only 8.6% of total GDP in the Union of twelve (at purchasing power parities i.e. even without the downwards bias of undervalued exchange rates) against a proportion of 29.4% for their population (Barta and Richter 1996). Therefore the cost of regional

transfers would also be substantial; together with that of CAP, this would represent an additional burden of the order of 1-1.5 per cent of the Union's GDP. Paradoxically these transfers are perceived in the CECs as a main attraction of membership (see Barta and Richter 1996) whereas from the western viewpoint they clearly are a truly major obstacle.

Finally, there is the question - only too easily neglected - of the new members readiness to be exposed to the full blast of EU competition, in view of the sheer institutional and structural fragility of economies with a very young system. In particular, financial markets appear to be thin, shallow and volatile, most vulnerable to EU competition.

Prospects. The obstacles listed above can be overcome in principle, but not without raising other objections and difficulties. CAP can be transformed, eliminating price support and establishing a compensatory income support for farmers. At that point farmers in the new members could not claim the same compensation for the loss of a price support which they never enjoyed (this point is misunderstood by Dewatripont 1995: "Naturally this problem arises irrespective of whether the CAP is applied by means of income or price support", pp. 84-85). Moreover, income support for farmers could then be transferred to the responsibility of member states in the name of *subsidiarity*, thus eliminating the item from the EU budget (though this may require raising transfers to poorer member countries in order to reduce the ensuing inequality). Although CAP is usually regarded as an insurmountable obstacle to EU enlargement, it is more likely that an unstoppable enlargement should turn out to be an insurmountable obstacle to the maintenance of CAP.

Alternatively, an inordinately long transition period could be envisaged for CAP. In practice, this is happening already, with proposals for the enlargement (by 50%) of tariff quotas and the further abatement (to 10%) of such tariffs. As long as CAP is in force access to the EU market simply displaces EU domestic sales; as tariffs tend to zero and quotas stop biting, ultimately the costs tend to be just as high as those of the full extension of CAP to those countries. Other alternatives are not very credible - such as no CAP for new members; or CAP with prior greater restructuring, modernisation, diversification, integrated rural development in the CECS (See European Commission 1995a).

Structural funds and other transfers are harder to treat. The case for not extending such transfers to the new members would be much less strong than for a reformed CAP; a reduction of such transfers (already poised to grow in the next few years) would raise opposition by the member states which now enjoy them, which might pose a veto to enlargement on those terms. But quantitatively these transfers are a much smaller burden, of the order of between half and one

quarter of the cost of CAP according to the various estimates, which should not be insurmountable. Alternatively, one would have to wait for a more sustained catching up process to raise living standards in the CECs to within a smaller distance from the EU average.

In the end, it may turn out to be as hard, or harder, for the new members to reach a sufficient robustness of their financial systems, readiness to withstand the competition of the EU giants, and an ability to absorb capital inflows without ill effects. Deepening and consolidation of market institutions in the CECs is a widely under-estimated pre-condition of EU enlargement to the East - though it is clearly spelled out in the conclusions of the 1993 Copenhagen Council under "capacity to cope with competitive pressure and market forces within the Union".

Enlargement and monetary unification. Last but not least, how is enlargement going to be squared with monetary unification? The Copenhagen Council referred to "ability to take on obligations of membership, *including economic and monetary union*" (emphasis added), although this could be considered as a prospective and not an immediate ability to meet the Maastricht criteria. On the one hand, officials from Poland and the Czech republic are ready to point out that they are closer to fulfil some of those criteria, of fiscal if not of monetary convergence, than many of the present EU members; on the other hand, the same officials also very much doubt whether monetary unification will actually happen - at any rate before enlargement. In the EU, conversely, enlargement is still seen as a more distant occurrence than monetary unification, as it certainly was in the original schedule. Yet the recent trends of EMU postponement and parallel acceleration of enlargement have probably already reversed the likely sequence of the two events.

It is hard enough to maintain that the European Union is an optimal currency area, or to try and turn it into one through complex mechanisms of convergence and cohesion. With a dozen additional members, the same tasks would become truly massive. If enlargement is not going to involve a further postponement of EMU, it will certainly complicate transitional arrangements and demand more flexible forms of European integration than otherwise would have been the case. An enlarged Union might also reach different decisions, about questions of timing and substance, then the pre-enlargement EU. The time has come for these questions to be publicly raised and debated.

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