The Further Development of CEFTA Institutionalization, Deepening, Widening?

Warsaw, 1997

Is CEFTA developing in the direction of a higher level of international economic integration? Is a new (sub-)regional "common market" emerging in Central and Eastern Europe modelled on that of the EC? What are the possibilities and limits connected with this? What will be the probable economic and political consequences for the participating countries or, as the case may be, for the development of Europe as a whole? These are the central questions which were discussed and answered at the conference held in Warsaw on November 28-30, 1996.

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Introduction: Basic Question, Main Answers

As a reaction to the conclusion of their association accords with the EU (December 1991), the Czech Republic, Hungary, Poland and Slovakia have been endeavouring since March 1, 1993 to build a Central European Free Trade Area (CEFTA). Since then the economic cooperation of the CEFTA countries has increased considerably. The final stage of the free-trade zone in mutual trade in industrial goods was brought forward four years from its original date of 2001. Mutual agricultural trade was liberalized much more strongly than originally planned: in comparison with its starting point in 1992, the extent of protectionist measures was reduced here by more than one half. Through an amendment to the founding document in September 1995, CEFTA was declared an "open" grouping, and on this basis Slovenia became a member as of January 1, 1995. A new round of widening is clearly close at hand (Romania, Lithuania, Bulgaria). At the same time, free intra-regional exchange should be "deepened" beyond trade in goods to services, capital and labour. There are the first signs of a common trade policy toward third countries. In this context, the establishment of common institutions has been discussed for the first time since the beginning of this regional cooperation.

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Out of these, a whole series of individual problems and further questions arise. The example of western European integration shows that successful supranational cooperation depends upon the first steps, that is, upon the institutions and the process of decision-making. The size of the domestic market is certainly a necessary (but not a sufficient) prerequisite of attracting more foreign capital. Does CEFTA aim at a common Mediterranean or Black Sea policy (relations with Turkey, Egypt and Israel)? Can it make an economic contribution toward a resolution of the Balkan crisis? Can CEFTA widen eastward and in this manner contribute to an economic area encompassing all of Europe, beyond the potential borders of EU-Europe? How are these perspectives seen and judged in Kiev?

An important emphasis of the conference, in an economic as well as a political perspective, is the mutual relationship between the further development of CEFTA and efforts on the part of the present and potential members of CEFTA to achieve full membership in the EU. From the point of view of the individual CEFTA countries, a question may be posed: is "small, regional" integration a good exercise on the path toward EU membership? Does the coordination of economic policy within CEFTA serve large foreign policy and foreign economic policy aims of its members? From the point of view of Brussels, the Europe Agreements did indeed lend a decisive impulse to institutional and regional cooperation between the CEFTA countries. But here one must ask: has this happened and is this happening in order to make the eastern contractual partners more qualified for membership or is this a further attempt to gain time with respect to their own eastern enlargement and to put off the decision as long as possible?

Does CEFTA, if it continues to develop successfully, have an independent role to play in the Pan-European theatre? This could certainly be the case if, as a first step, only a few new members were admitted to the EU; CEFTA could then overcome or help to alleviate conflicts in relation to those countries that at first would have to remain "outside". Beyond this, CEFTA could provide an impulse for the revitalization of political coordination in the group of "Visegrád" countries. Finally, as one increasingly important component of the manifold, completely or partly overlapping structures in Central and Eastern Europe, CEFTA could make a significant contribution to more security in this region.

That is the background against which the Warsaw Office of the Friedrich Ebert Foundation organized this international conference on the further development of CEFTA. More than 40 participants from twelve countries discussed the institutionalization, deepening and widening of this grouping and intensively, and often heatedly, debated points of controversy.

Participants agreed on two points: (1) The main goal of CEFTA is that of supporting the efforts of the participating national economies to achieve full membership in the EU (as a "fitness/training centre" for the "big" integration). (2) The widening of CEFTA should remain subject to three conditions: associated relationship to the EU; membership in the WTO; and bilateral free-trade agreements with all CEFTA members. In order to prevent from the outset any politically motivated softening of these conditions of entry (as in the case of the introduction of the Euro in Western Europe), questions of widening may only be decided by a unanimous vote.

In contrast, there was a wide variety of opinions on all other aspects of the further development of CEFTA. Regarding its future, two extreme positions were taken: on the one side, CEFTA will be a purely economic (non-political) transitional solution which will lose its reason for existence when its members are accepted into the EU. On the other side, CEFTA could also continue to exist thereafter as a regional interest group within the EU, if the French proposal on allowing the formation of such groups inside of the widened Union is accepted at the IGC Maastricht II. In addition, a third middle position was taken: CEFTA should and could — given the necessary political will — play an important pan-European role if the acceptance of new members into the EU is to take place in steps; it could mediate on behalf of those candidates for entry who at first must remain "outside", and help reduce or ease conflicts.

The deepening and institutionalization of CEFTA was also discussed contentiously. CEFTA as a free-trade zone is, at a closer look, at best *in statu nascendi*; only after the bilateral trade in goods among its members is finally freed of the limitations which still

encumber it today should one begin to think about whether and how the cooperation is to be deepened and institutionalized — in one pessimistic opinion. According to a more realistic assessment, the bilateral liberalization attempts achieved up to now would have to be completed and secured through new fields of cooperation: financial services accompanying goods, export financing and credit insurance rules, recognition of rules on the origin of goods; for these, no common institutions would be necessary. Finally, the optimistic vision: CEFTA could grow into a new phase of development marked by an increasing demand for consultation and coordination, and this need would only be effectively satisfied through a minimum of institutional arrangements.

An especially good, topical and necessary example for such a concerted action of the CEFTA countries would be a common pre-accession strategy for negotiations with the EU. If it came to that, CEFTA could even develop into a catalyst for the eastern enlargement of the EU.

In connection with the acceptance of new members into CEFTA, Ukraine and Russia were at the centre of the discussion. The Ukrainian leadership repeatedly expressed its interest — economic and political — in membership in the free-trade zone. And Poland, which at the moment is preparing bilateral free-trade agreements with its eastern neighbours, wanted to support Ukraine in this. At present, one can only speculate on the Russian position on the eastern enlargement of CEFTA, as well as on the economic effects of this step for all national economies involved.

The economic and political joining together of the Central and East European countries continues to be heavily burdened by postwar history: the "Yalta Syndrome" and the "COMECON Syndrome" are still, in the seventh year following the social-political revolution, considerable hindrances to a thriving neighbourhood in this region. In addition, the "Yugoslav Syndrome" impedes cooperation of CEFTA with what are now the Balkan states. In this context, Lithuania is a positive exception: this country is attempting not only to become a member of CEFTA and thereby (and not on the Baltic or Nordic track) to reinforce and realize its desire for entry into the EU; beyond this, Lithuania wants to finally free itself of the label "Post-Soviet Republic" and to underline its affiliation with Central Europe.

Janusz Kaczurba

The impact of CEFTA

Four years since its inception, CEFTA is already well beyond the age of infancy. Originally designed as a "fitness centre" for candidates for future EU membership, CEFTA has demonstrated the ability to perform this function with notable success and to reach out beyond the original scheme. In so doing, the agreement of the present five members has contributed to improved trade performance among its constituent territories. In fact, this trade has progressed considerably faster than the overall external commerce of CEFTA countries. Such, at any rate, is the experience of Poland, where exports to the CEFTA region in 1995 increased by more than 50%, compared with 33% for the total sales abroad. Similar trade indicators seem to be noted also in other countries of the Association.

The original schedule of trade liberalization has been accelerated and the product coverage of mutual trade concessions is now quite comprehensive, although the list of exceptions is still excessively long. In fact, already some 80% of industrial tariff lines are now subject to zero level of customs duties. Further reductions are expected to be implemented in 1997. Thus, the CEFTA schedule of tariff liberalization is roughly two years ahead of the Europe Agreements. Agricultural tariff protection has been reduced by some 50%. A search is in progress for more sophisticated measures of trade stimulation in such areas as financial facilities and capital flows. New candidates for membership are now knocking on CEFTA's door.

At this juncture it is pertinent to ask what are the essential positive and negative factors behind this process.

Naturally, the single, most important driving force has been the common desire of the present five members to accelerate their formal accession to the European Union and its institutions. Governments and all other key players of the political spectrum of those countries, including major opposition parties, generally share the positive attitude toward European integration. This, in turn, implies the acceptance of mutual adjustment in economic and legal systems and procedures. Such process is greatly enhanced by the membership of all CEFTA members in the World Trade Organization (WTO) which now provides the most comprehensive legal and systemic framework within which economic and trade policies may be formulated and implemented with a view to securing their compatibility with the global trading environment. This, incidentally, explains why the original founding members of CEFTA have been so insistent on maintaining the EU relationship and WTO status as the key criteria for possible future enlargement of the Association.

Another important cohesive element of the CEFTA setting consists in overall similarity as regards the intensity and depth of the transformation process in the constituent member states.

(a) Due to the intensity of the initial structural reform of their national economies and the consequent radical approach to the reallocation of productive factors (particularly well illustrated by the "shock therapy" undertaken in Poland), CEFTA countries, with their 27% drop in the combined GDP, had experienced a stronger recessionary impact than most of Central and Eastern Europe. However, they have been rewarded for their boldness by being the first to emerge from the economic morass and have outclassed others in the speed of reorientation toward the West. This process has also involved a substantial change in the structure of the GDP as demonstrated by the dramatic growth in the share of services from 48% in Hungary and 35-37% in the other founding members of CEFTA in 1989, to 50-55% as early as 1993. It is worthwhile to note that such shifts have been largely at the expense of the agricultural sector.

(b) Trends in the labour markets constitute another measure of adjustment, as they indicate the movement from socially motivated low-performing employment to more efficient though fewer jobs. Here again, CEFTA members have suffered greater cuts than other countries of the region, with the total average number of employed declining by 16% between 1989 and 1993 before the trend had leveled off and started to turn the corner.

(c) As regards inflation, CEFTA countries have benefitted from their earlier efforts not to detach themselves totally from the realities of the external world: while their consumer prices had increased 13 times between 1989 and 1994, this increase — dramatic as it may be — pales in comparison with the average 78-fold rise in a consumer price index for Central and Eastern Europe as a whole. It now appears safe to assume that inflation has been largely brought under control in the CEFTA grouping.

(d) As a consequence of such evolution and compared to the remaining two subregions of Central and Eastern Europe (the Baltic subregion and the Balkans), CEFTA countries are now much closer to Western Europe in terms of the general level of economic development and major macroeconomic indicators, even if the distance to the medium West European standards is still agonizingly long.

The first tangible impact of CEFTA has been to stop the decline of mutual trade among its original four member countries. Such decline, precipitated by the breakdown of the COMECON and by the internal economic turmoil related to systemic adjustments in all countries of the region, was further enhanced by the insufficient degree of complementarity of national economic structures. This trend was strengthened, ironically enough, by the signing of the Association Agreements with the European Union and Free-Trade Agreements with EFTA states, which resulted in a major reorientation of the former intra-COMECON commerce toward Western Europe. Despite the interplay of all such factors, the total exchange among CEFTA members now seems to exceed their mutual trade under the COMECON.

By way of illustration I shall refer again to Poland's actual performance in CEFTA trade.

In 1995 the value of Poland's trade within the grouping more than doubled, to reach almost $3 billion, or 5.5% of the total. The expansion of exports to the CEFTA

region progressed at a rate which was some two thirds higher than the overall increase in Poland's sales abroad. Imports from CEFTA sources grew even faster — by 77%, twice as fast as general imports. The beneficial effects of CEFTA have been particularly evident in industrial trade. By contrast, there was little evidence of stimulating effects of CEFTA arrangements for Poland's agricultural exports, although such effects may be found in the total intra-CEFTA trade in farm products.

The expansion in mutual trade continued in 1996 as well. Polish exports to CEFTA partners have grown at about 17%, nearly three times faster than the total sales abroad. Imports into Poland have slowed down considerably, but the present annual rate is still at a handsome level of nearly 23%.

The rise and consolidation of CEFTA economies have encouraged greater, though still relatively modest, flow of foreign direct investment (FDI). A study by the Central European Economic Review, quoted by Polish media in 1995, suggests that CEFTA members outdistance other countries of the region in terms of such essential criteria of business and investment confidence as economic growth, relative price stability, political outlook, foreign exchange and currency reserves, general infrastructure, productivity and external trade performance. In two other aspects (privatization and the quality of the legal system) they are matched by a Baltic country. Only in terms of natural resources are CEFTA members relatively disadvantaged relative to some of their neighbours in the region. Thus, in terms of investment risk, the five present CEFTA members enjoy the best five ratings in the region.

In 1995, the total flow of FDI into Central and Eastern Europe was estimated at $13 billion, twice as much as in the preceding year. Most of this inflow was absorbed by CEFTA members which now account for some 70% of the aggregate pool of FDI in the region. As of mid-1996 the three leaders in the total accumulated value of FDI are all CEFTA members: Hungary ($13.1 billion), Poland ($10.5 billion) and the Czech Republic (6.2 billion).

Liberalization of CEFTA trade creates highly interesting prospects for foreign investors. After all, an unsaturated market of 65 million consumers in the middle of Europe, with growing incomes and rapidly changing consumption patterns, is a tempting target. As the CEFTA agreement contains provisions similar to those present in the agreements with the European Union and EFTA, prospective foreign investors can also expect the full harmonization of market conditions in both Central and Western Europe. A marked increase in new foreign investment in the last two years in all countries of the grouping is most certainly related also to this important factor, and is likely to accelerate even further.[1] A recent meeting of CEFTA trade ministers in Tokyo at the invitation of the Government of Japan seems to suggest that also conservative potential investors from the Far East appear to take a more positive approach to investment opportunities in the CEFTA region.

By lucky coincidence, the creation and consolidation of CEFTA occurred simultaneously with the concluding stages of the Uruguay Round and the establishment of

[1] See A.Rudka and Kalman Mizsei, *East Central Europe Between Disintegration and Integration: Is CEFTA the Solution?*, Institute for East-West Studies.

the World Trade Organization. All CEFTA countries, as GATT contracting parties and, subsequently, original members of the WTO, made their substantial contributions to the Uruguay Round package of trade concessions, fully commensurate with those of other negotiating partners. This has helped to further narrow down the scope of negative tariff differentiation vis-à-vis non-preferential sources of imports. The corollary of such development is, that the impact of increased intra-CEFTA trade on preservation of inefficient economic structures is likely to have been quite mitigated. Such impact, to be significant, would require that the tariff discrimination against "outsiders" be substantial, which happily is not the case (with some exceptions, especially in Poland's external customs tariff). Under such circumstances the growth of intra-CEFTA commerce does not entail the risk of unnecessary prolongation of uncompetitive capacities and structural dislocations.

As mutual trade grows, CEFTA countries are becoming increasingly aware of the need to improve the quality of its systemic infrastructure. One of the essential aspects concerns the development and facilitation of trade-related banking services. One of the ideas which have been floating amongst experts concerned the establishment of a common bank. The now prevailing view seems to be that, under the present circumstances, it would not be rational to pursue this initiative for a number of reasons: the costs of creating a common bank and its regional network would appear to be excessively high; such institution would take a very considerable time (relative to the assumed, limited life-span of CEFTA) to develop enough to be able to offer its clients competitive conditions of banking service, while the present system of settlements seems to be sufficiently effective in operational terms.

Such arguments, however, do not mean that there is much room for improvement of the presently existing relations between national financial institutions of member countries, so as to strengthen their position and increase their share in the CEFTA market for trade-related financial services. A recent conclusion made by experts to that effect and subsequently endorsed at the ministerial level, merits a prompt and intensive follow-up, especially in view of possible accession of new countries.

Another issue in the same category is the development of export finance and credit insurance schemes. In all CEFTA countries export support programmes are now being upgraded, although they still appear to be generally quite limited in terms of resources and the scope of actual operations. In Poland, for instance, the financial exposure of a major export credit insurance corporation is equal to less than 2% of the total value of export sales to all destinations. The leading role in fostering further development of such schemes will therefore have to be played by national institutions of member countries. A closer cooperation between such institutions of CEFTA members would appear to be well advised. One of the potentially interesting avenues, recently proposed by Hungary, might be to investigate the possibility of concluding bilateral reciprocal reinsurance agreements between such entities. At this juncture, just as in relation to many other issues covered by these comments, one should acknowledge the positive and helpful impact of PHARE assistance programmes.

Also on the agenda is the issue of liberalization of capital flows and trade in services. The progress of work conducted by experts with a view to intensifying mutual

interaction in these areas is expected to be reviewed later this year. It is safe to assume that CEFTA would be incomplete and grossly deficient without further substantial liberalization in this important segment of external economic relations.

Negotiations on bilateral recognition of product certification are well advanced. Work has been completed on new rules of origin to be adopted in line with the Essen Summit of the European Union. All CEFTA members ratified the convention on common transit procedures effective as of July 1, 1996.

Despite all these developments, the intention of the CEFTA Governments is not to detract from the original design of the grouping, which is transitional in nature and whose principal aim is to better prepare its members for negotiations of their entry in the European Union and for the future membership itself. There is a determined, common position that CEFTA is and should remain a non-politicized grouping of essentially bilateral agreements. Such basic approach implies the need to avoid unnecessary institutional arrangements which would be likely to succumb to a natural temptation to accumulate bureaucratic fat. This approach appears now to be shared by all member countries.

The relatively long list of positive aspects should not make us oblivious to a number of impeding factors. One of those is a "COMECON syndrome" which may demonstrate itself in certain caution with which CEFTA members approach their respective economic and trade policies. Virtually no efforts have been made to engage in a structured dialogue on individual macroeconomic policies and the impact which they may have for the performance of the Association as a whole.

CEFTA is and should remain open for new entrants. Nevertheless, its members have been right in deciding that the process of expansion should conform to well-defined and well-respected criteria, such as WTO membership and association with the European Union. Such standards must not be lowered. This approach is consistent with the initial aims of CEFTA: to create and consolidate a framework within which its members will learn how to interact with increasing intensity on the grounds of mutually recognized multilateral rules and on the basis of their multilaterally binding commitments undertaken vis-à-vis the entire world trading community, before they accept — hopefully not before long — even more unified and stringent disciplines of a united Europe.

Miroslav Adamiš

CEFTA: Integration Without Common Institutions?

The 1990s could be characterized by the existence of three important economic alignments of countries — the European Union, EFTA and CEFTA. In the first half of the 1990s the dominating role was played beside the EU by the EFTA and in the second half of the 1990s, after three EFTA countries have joined EU, the dominating role will be played by the CEFTA, taking also into account the start of the accession negotiations to the EU.

Each of these three alignments has it own development more or less independent and separate, however including some common features. EFTA was established as a reaction to the establishment of the European Communities in the 1950s, and it took too long to bring the two organizations closer together by creating the European Economic Area. CEFTA was established as a reaction to the fall of the iron curtain in the late 1980s and the willingness of the four countries to become closer to each other in their way towards the European integration. The history should not repeat itself and it should not take so long to integrate CEFTA or individual CEFTA countries with the European Union.

CEFTA: Integration without Common Institutions?

There are two views on CEFTA: from the inside perspective and from the outside perspective. Its members consider CEFTA as a transition stage toward the European integration and EU membership. The outside countries, that is those that do not belong to CEFTA, consider it as an economic alignment which should last in Europe for a longer time. They perceive a more important role for CEFTA in the future since, aware of the experiences of EFTA, they realize that the process of integration and accession may last longer than expected.

Therefore, whether one likes it or not, we have to look also to EFTA and take advantage of its positive experiences.

The goal and the objective of all CEFTA countries and also those countries wishing to join CEFTA is the same: to become members of the European Union. Only few of us realize that almost all accessions to the EU have come from the EFTA countries and that almost all future accessions to the European Union will come from the CEFTA countries. Therefore we should have a closer look at EFTA, the processes it had gone through, and the efforts it had made before the EFTA countries became EU members.

After this short introduction on EFTA let me clearly state that if CEFTA wants to be really recognized in Europe or world-wide, it would need to have, sooner or later, its own umbrella. Why are some countries against this umbrella right now? Is it only their strong conviction that CEFTA will not last much longer and it is a waste of time, money and resources to deal with this matter? Or is it reluctance to adapt or to accommodate to some decisions made on a common basis? These questions are very difficult to answer, but the countries interested should at least try. If it is the third problem, then it would be dangerous for the overall integration process.

In the future CEFTA will take over the position that EFTA held in the 1970s, 1980s and the early 1990s and will become more powerful, more important and more influential. There is no doubt as to that. But first CEFTA should really want to become more powerful, more important and more influential. On top of that in the near future CEFTA should assert its own interests in Europe, and this will be very difficult or even impossible without common institutions.

Some argue that CEFTA does not need common institiitions because CEFTA is not an institution but only an agreement. History, however, knows several examples of agreements which have had their own institutions. GATT, which has been an agreement for almost 50 years, has its own Secretariat without which it could have hardly achieved its results and successes.

Though CEFTA is an agreement on establishing a free-trade area in industrial and agricultural goods, there are new processes within CEFTA which require a common approach and tactics by all member countries. Let me mention only two of them, on which separate papers are to be found later on. These are the enlargement of CEFTA by admitting new countries and the extending of its range of interests to include new sectors, namely capital and services movement. Such processes require more coordination and the only expert coordination as it is up to now would be insufficient any longer. The first important step toward a common approach was made during the meeting of the Prime Ministers of the CEFTA countries in Slovakia, when it was agreed to adopt a common CEFTA position on the Ministerial Conference in Singapore.

The European Union has clearly declared that six months after the Intergovernmental Conference the accession negotiations with associated states will start. However, it has not been clearly stated that negotiations will start with all associated states together at the same time and it is not going to be surprising if a selective approach is taken in starting the accession negotations. If the latter is the case, then the Union should state its intentions in relation to those countries which will not be included in the negotiations. Of course, there are several options and alternatives the choice of which will depend on the Commission and the member states. One alternative could be the widening and enlargement of the EEA to include the EU, EFTA and CEFTA. A small step in this direction has been made on the diagonal cumulation negotiated between 29 European countries, which has no precedent in history.

Finally, let me summarize. When we look at CEFTA we should keep in mind those development which took place within EFTA. It would be misjudment to imagine that the process of the European integration is going to differ from that which the EFTA countries went through. There will be not much difference even if this process takes place in a totally different political environment. CEFTA should play the role of a training centre for its member states prior to their EU membership. But how can you train if

you have no facilities, no grass, no goal, no ball? How can you be prepared to delegate some of your powers to the Commission or the European Parliament immediately on the date of accession to the EU, if you have had no time or opportunity to train and get ready? The common institution should serve for the CEFTA countries as the grass, the goal and the ball on their way towards the European integration.

Fritz Franzmeyer

The Role of Common Institutions in Western European Integration

At first glance, this paper seems to be rather separated from the rest of the topics of the conference. However, there are connections to CEFTA integration in a twofold sense. First, it may be useful to study the institution building and the changing role of institutions of a community which will include CEFTA in the foreseeable future. (Yet the intention is not to give recommendations as to how CEFTA institutions, joint as well as national, should be adapted to the EU framework). Secondly, eastern enlargement will in turn have a heavy bearing on the institutional structure of the European Union itself. Or in other words, the concrete development of the Union will heavily depend on whether or not it succeeds in preparing for the absorption of a substantial number of — mainly small and less developed — new Member States under legal, political, financial and institutional aspects. The following sections will successively proceed toward a tentative answer to this question. First, a broad perspective will be given on the overall comparative integrational situations in the 1950s and in the 1990s. Next, the institutional structure of the European Union will briefly be introduced and the inter-institutional shift of power which took place under the influence of *zeitgeist* and specific events will be analyzed. In the remaining sections, some conclusions will be drawn as to the future structure of the Union with respect to a sensible vertical division of tasks (given the meaningful principle of subsidiarity), to the necessary institutional requirements prior to an eastern enlargement, and the probable institutional development (given the British opposition to and the lack of consensus of the other Member States on important institutional issues).

EARLY AND LATE EUROPEANS

It may not be a mere chance that the designers of this conference formulated the subtitle of my topic "from Monnet to Maastricht" and not "from Paris to Maastricht" or "from Monnet to Delors" or "... to Kohl" or to someone else. Monnet's name is the synonym for a programme, for a concept of integration with solid institutions and a clear perspective: that of the United States of Europe, and the Treaty of Paris was to him the "first stage to a European Federation". It was in the spirit of Jean Monnet that in 1955 at the Conference of Messina, the European Economic Community was generated as an extension of the sector-specific Iron-and-Steel Community to the entire economy — the only difference being a stronger market orientation compared to the administration of scarcity which had characterized the Treaty of Paris. The names of Robert Schuman, Konrad Adenauer, Alcide De Gasperi and Paul Henri Spaak are permanently associated with this idea of an ever closer link between the European peoples, the driving force behind which was Walter Hallstein, former secretary of State in the German State Department and then first President of the Commission of the European Economic Community until 1967.

In contrast, as far as Maastricht is associated with the names of persons, it is in an ambiguous manner. Helmut Kohl, the "grandson of Adenauer" and "last European", was the strongest promoter of parallelism in economic and political integration. It was he who, in 1989, insisted on the second Intergovernmental Conference aimed at preparing the Treaty on European Union. This IGC on Political Union (the other being on Economic and Monetary Union) was supposed to ensure the inclusion of external and internal policy of the member states into the integrated decision-making structure of the Community. But, to a large extent, these hopes were disappointed.

Beside Kohl, another name is that of Jacques Delors. He was, in the years 1985-94, the strongest President the EEC or the EC ever had. By his initiatives, he helped overcome a long-lasting period of stagnation in the process of European integration. Without him, neither the Single Market nor the Monetary Union, the policy on cohesion, the reform of agricultural policy or the medium-term financial perspectives, which eventually brought about fiscal discipline and consensus between the Council and Parliament, would have been possible. But when there was a chance to be elected President of France, Delors resigned. It may be that he had only had a small electoral basis and that his judgment on this was realistic. But given the alternatives, his election would have been the only and probably last chance of powerfully promoting the idea of a Federalist Europe together with the German Chancellor.

Anyway, aside from these two, there is no other charismatic European personality in view. On the contrary, in some member states the leaders of government are strongly in opposition to a transfer of national sovereignty to the European level. In others, there exists nothing but partial interests, be it in payments from the structural funds, in depriving the German Bundesbank of its power or in drawing upon European authority to compensate for a lack thereof at the national level. And the successor of Delors in the office of the Commission's president is a brave administrator of the Acquis Communautaire but not a driving force in the promotion of the Political Union.

VISION VERSUS VIABILITY

However, looking more closely at the details, one becomes aware that even with the founder personalities, the pure vision of a United Europe in which the present Commission would play the role of government, while the European Parliament and the Council would operate respectively as the lower and upper chamber, never existed. These were just the illusions of the European Movement and the desires of some members of the European Parliament. The ideas of, for instance, Adenauer, were not federalist but confederalist from the beginning. So were those of de Gaulle. He was not among the

"Fathers of the Treaty". Not long after he became President in 1958, he inspired the elaboration of a plan for a confederalist Europe which became known as the Fouchet Plan (including a revised successor plan). As early as 1954, the French Assemblée Nationale had rejected the plan for constructing a European Defence Community which would have been the cornerstone of a common external and security policy. In 1965, de Gaulle practiced the policy of the "empty chair" which was aimed at preventing a shift in relative power in favour of the European Parliament and ended in January 1966 with the "Luxembourg Compromise". This informal agreement reintroduced the unanimity vote in the Council for matters of a member state's "vital interests", thus making clear that the member states are the "Masters of the Treaty". This notion has, in most recent times, been re-affirmed by the Federal Constitutional Court of Germany which had to decide upon the question of whether or not the Treaty of Maastricht deprives the Federal Republic of its character of being a sovereign State, with consequences for its power to guarantee civil rights for its citizens.

The successive rounds of enlargement of the Community contributed to the gradual fading of the concept of a politically united, federal Europe. Although this concept had been conceivable among the six founding members, this was already no longer the case when Britain and Denmark joined, and it will be even less the case in a future union of, say, 25 members. Hand in hand with this fading, the economic attraction of the Community grew. Originally, the hypothesis was that economic integration would trigger political integration. But this "functionalist theory of integration" failed. The best example is the Common Agricultural Policy (CAP). It generated problems instead of solutions. Once it had been established, it gained momentum so that it was for decades impossible for decision makers to control its development. Rather, it proved necessary to compensate for one mismatch with another. The same danger exists at present with the structural funds and the rule of the Community's own resources. In all these cases, institutions and procedures are deeply involved. In this aspect, the failure of the functionalist integration theory is also a failure of the institutionalist integration theory. A prominent example of the latter is the European Monetary System. After a long period of exchange rate stability, the promoters of an institutionalist approach toward Monetary Union believed, up to the first half of 1992, in the anticipated *de facto* existence of EMU. This illusion was destroyed in an instant. In summer 1993, the whole system had to be suspended if not *de iure* then *de facto*. Already by the mid-1970s, hard economic facts had destroyed the plans for an institution-based construction of EMU up to 1980. Today, the institutional approach has clearly been shed in favour of the "coronation theory" which postulates convergence in national economic structures, behaviour and decision-making before the final institutional steps toward EMU can be taken. The same holds true for the integration of the tax and social systems as well as of policy fields with a high demand for regulation, like environmental policy or the control of the modal split in transportation.

Only in market integration did the institutionalist approach prove to be successful. Not only had it been possible to construct the customs union even faster than scheduled, but also to realize most of the Single Market which demanded the designing and passing of a huge package of directives, regulations and decisions in the short period of only seven years. If one tries to analyze this phenomenon, there are two main factors that can explain why in this case the institutionalist approach was successful: (1) the customs union as well as the Single Market were examples of "negative integration" in the sense of deregulation and liberalization. Obviously it is much easier to gain a consensus on the abolition of nationally differing impeding rules than on the shaping of "positive" common rules. In addition, a world-wide "paradigm shift" had taken place which favoured the deregulation approach. (2) Beginning with the famous "Cassis-de-Dijon" case, the European Court had, since 1979, passed some key decisions allowing, in a certain sense, for the extension of competition from the goods sphere to the goods-related rules sphere, thus putting the member states under pressure for mutual recognition of these rules which meant nothing other than deregulation

INSTITUTIONAL STRUCTURE IN BRIEF

This brings us to the role of the individual institutions in the Union's policy making. This has undergone significant change thus far. Let us, first of all and very briefly, summarize the institutional structure of the EU and its development. The Union has four main corporate bodies:

The **Commission** has the almost exclusive official right for initiatives concerning common legislation. The latter can have the form of regulations, directives or decisions and must be based on the respective Treaty. Also, the Commission has to apply and execute the Common primary and secondary law.

The **Council**, which consists of one member of each member state government, is the main legislative body. According to the specific nature of the legislation at stake, the Council meets as "General Council" (ministers of foreign affairs), "Council of Ministers of Economic and Financial Affairs" (ECOFIN), "Council of Agricultural Ministers" and so forth. Depending on the nature and bearing of the legislation, the number of "handling rounds" and the respective quorum differ. In order to make Council meet-ings efficient, they are prepared by the Committee of Permanent Representatives (COREPER) consisting of the ambassadors of the member states to the European Union.

The Council shares legislative responsibility with the **European Parliament**. Again depending on the nature and bearing of the specific legislation, there are stages for passing the issue with respect to the involvement of the European Parliament, the number of readings and the quorum necessary.

The **European Court of Justice** interprets the Common law. Not only governments or other public authorities but also citizens have a right of suit. In order for the Common law to be bindingly interpreted faster than would be the case by way of a full vertical range of appeals, any court of a member state can demand an "anticipated decision" from the European Court of Justice.

Beside the four main bodies there are two which must be mentioned here although they are only of minor importance: the **Economic and Social Committee** (ECOSOC) and the **Committee of Regions**. These bodies may elaborate political papers and recommendations, but they have only the right of being heard. In addition, there are plenty of committees and subcommittees attached to the Council or the Commission which have just a subsidiary function.

At the beginning of European integration, the Treaty of Paris and the Treaties of Rome provided for specific albeit similar bodies. With the so-called "Merger Treaty" of 1967, the institutional structures of the Treaties were integrated so that today there is only one Commission and one Council. Only the European Court of Justice and the European Parliament — the former "Assembly" — were responsible for all three communities from 1958 on. Since 1967, the collective term "EC", for European Communities instead of EEC, European Coal and Steel Community, and EAEC has been customary. By virtue of the Maastricht Treaty, again new names had to be learned: The Commission of the European Communities is now the European Commission (and not the Commission of the European Union or EU Commission, which reflects the fact that the second and third pillars of the Treaty were not integrated into the EC's institutional structure because of their intergovernmental nature). The former EEC Treaty is now the EC Treaty which, however, does not indicate an integration of the three Treaties but only that the former EEC Treaty has, with the inclusion of the chapter on Monetary Union, gained a new quality.

Before we can proceed toward an analysis of the changing role of common institutions in the process of integration, we have to mention one body which did not exist in the infant stage of the Communities: the European Council which consists of no less than the Heads of States and Governments, each of them being assisted by his Minister of Foreign Affairs, and the President of the European Commission, who is also assisted by a member of the Commission. The European Council which meets at least twice a year ("summits") has the task of pushing the Union's development forward and defining its general objectives. We will see that, on the one hand, without the European Council the Union would hardly have become as highly integrated as it is, but that on the other hand, the European Council represents the definite consensus on refraining from Monnet's initial vision of a Federation of European States.

POWER SHIFT FROM COMMISSION TO COUNCIL AND FROM COUNCIL TO EP

In Art. 148 of the EC Treaty, the majority vote is declared the usual form of decision-making in the Council. In special cases, the Treaty demands a "qualified majority". Unanimity voting is restricted to a small albeit important number of cases. The Council can — provided agreement with the European Parliament can be achieved if this proves necessary — reject a Commission initiative only unanimously. It is obvious that under these conditions, the Commission has a very strong position. Endowed with such power, it is no wonder that in the early stage of integration the Commission's self-portrait was that of the future "European Government". This illusion ended with the Luxembourg compromise. From January 1966 onwards, many initiatives which reached the Council were not decided upon. At that time, the COREPER, not even mentioned in the Treaty, became the most important body with the task of defining the possibility of a line of compromise or of creating a package of compensatory measures which would enable hesitant members of the Council to eventually agree. Other initiatives did not even come into existence because the Commission had reason to fear that unanimity could not be found; thus, it preferred not to show its lack of power. It is true that the European Parliament could have launched a "suit for inactivity", as it did many years later with respect to stagnating common transportation policy. But the Assembly was not even directly elected at that time and did not play a significant role in the EC's decision-making structure.

However, whereas the power of the Commission declined, that of the European Parliament gradually rose. Once it had been directly elected, the European Parliament began to organize itself into factions of different political orientation based on corresponding trans-national federations of national political parties. At the beginning, the power of the European Parliament consisted mainly of the right to dismiss the Commission which it, however, never made use of because its main opponent is the Council which cannot be affected by such measures.

But the European Parliament also has powers in relation to the Council. Both bodies together form the "budget authority", with the Council having the final responsibility for "obligatory" expenditures, the EP for "non-obligatory" expenditures. Over a long period of time, there was a never-ending struggle between both branches of the authority with respect to the scope of non-obligatory expenditures, the most important parts of which are the structural funds and research and development programmes. The EP used to plead for a stock-up, whereas the Council tried to contain this kind of expenditure given that (1) agricultural guarantee payments which formed the most important part of the obligatory expenditures could be less strictly limited, and (2) member states whose interests are represented by the Council had to raise the funds for financing both kinds of EC expenditures. On two occasions, no consensus could be reached at all, so that the European Parliament made use of its right to reject the respective budgetary drafts in total. The more the budget shifted from obligatory to non-obligatory expenditures, the stronger the position of the European Parliament relative to the Council became. The Council was only ready to tolerate this development under the condition of a binding medium-term financial forecast on the size and structural shift of the expenditure side of the budget which took the form of an inter-institutional agreement between Council, European Parliament and Commission. Of course, the inter-institutional agreement is only a second-best substitute for a standing mediation committee as it exists, for instance, between the Bundestag and Bundesrat in Germany and in any other country where the budgetary and/or legislative powers are divided between two houses.

Thus, the state of the art in European decision-making today is indeed more modern and efficient in important parts of legislation than in budget-drafting. For in all fields of policy where the European Parliament has obtained a right of co-decision through the Maastricht Treaty, a newly created mediation committee will be put in action if a consensus cannot be reached up to the second reading of the respective issue. In all these matters, the EP now has the right to final rejection of a draft. This certainly does not mean equal participation in decision-making, but it does mean a significant progress in parliamentary control of the European Union, given that the procedure of co-decision comprises such important policy fields as the Single Market, free movement of persons, environmental action or research and development support. In any case this represents a remarkable increase in the European Parliament's power relative to the Council's, but it should not be forgotten that, nevertheless and paradoxically, the so-called "gap in democracy" has increased, too. This is because (1) the centralization of political responsibility at a European level is even greater than the transfer of power from the Council to the European Parliament, and (2) whereas national parliaments lose power of control through such centralization, the European Parliament is by far not yet an equivalent democratic body given that the respective electorates of the member states are represented to highly differing degrees, depending on the size of the population.

REVITALIZATION OF THE COMMISSION SINCE THE MID-1980S...

With the launching of the Single Market and, even more, the enforcement of the Maastricht Treaty, the Commission's power has also been revitalized. The main reason is that the majority vote has been introduced *de facto* in many fields of economic policy-making. The second reason is that deregulation demands a stricter control of competition which — the EU being the relevant market — can efficiently be executed only on a European level, i.e. by the Commission. The third reason is that the execution of the budget in the field of non-obligatory expenditures demands a much higher involvement of the Commission than do the agricultural guarantee payments which result from a combination of a price decision by the Council and farmers' reactions to it against the background of a given world market for agricultural products. The fourth reason is that the preparation and final regime of EMU demands multifold economic policy coordination, adherence to convergence programmes and avoidance of excessive deficits, which all have to be initiated and surveyed by the Commission.

It is true that in all these respects, the Commission's powers are poor as compared to those of the European Central Bank to be created by January 1, 1999, if a sufficient number of member states qualify for the third stage of EMU. It is also true that its powers are poor, too, as compared with the scheduled powers of the Werner Plan's Centre for Economic Policy Decisions. But never before in economic history had so much control and discretionary decision-making been concentrated with the Commission on the basis of supranational law in force. Moreover, the coordination of economic policy which hitherto was intergovernmental because member states had only to regard economic policy as a "matter of common interest", will in the future mainly take place as an interplay of two genuine bodies of the EU: the European Central Bank (ECB) which carries out a Common monetary policy, and the Commission which has to survey convergence performance and plays a promoting part in the enforcement of the "stability pact" passed at the Dublin summit in December 1996. Among the three main macroeconomic policy branches — money, balance of public finance and wages — only wage policy will remain a national playing field. It is an enigmatic phenomenon that member states voluntarily shifted power which they had until then possessed them-selves, towards a European level to such a large extent that they eventually proved their ability for "positive integration", too. The explanation is the complementary role which most member states ascribe to EMU with respect to the most important issue in "negative integration": the Single Market programme.

The struggle over the stability pact in late 1996 shows precisely the difficulties which especially the "policy-prone" countries such as France had with refraining from the power to shape the national budget along the lines of national priorities. In contrast, countries such as Germany, preferring ordnungspolitik to discretionary intervention, had an easier time. Indeed, France could strictly prevent "automatic sanctions" against countries with an "excessive deficit", but the room for manoeuvre within economic policy-making is fairly narrow, and it must be asked what meaning France's demand for a "European Economic Council" has, under these conditions (except for potentially targeting specific exchange rates of the euro vis-à-vis the dollar and the yen which may, however, prove difficult given the fact that the ECB has command over the most influential instruments at this end).

In making use of its power, the Commission can strongly rely upon the European Court of Justice which presently enforces European law mainly in the fields of labour mobility, social integration, services and public procurement: fields in which some member states are reluctant to transfer European directives into respective national law, or interpret these directives with more national reservation. At present, the Commission is even trying to enlarge its powers by extending its competence for trade policy to the services sphere, and to enlarge its control on expenditures by reactivating the financial instrument of Community loans aimed, for instance, at the extension of Trans European Networks (TENs) for which it has been given power of initiative by the Maastricht Treaty.

...PROVOKES CALL FOR SUBSIDIARITY

The growing concentration of power on a European level has provoked a counter-movement which raises its voice partly on the member state level and partly on a regional level. On a state level, especially Britain is extremely reluctant to further lose sovereignty. For this reason, it opted out of participation in EMU — as did Denmark — and it does not participate in the Social Protocol of the Maastricht Treaty. It claims perpetuation of national jurisdiction in matters of the Schengen Agreement on free movement of persons, and has announced resistance against the introduction of majority voting in CFSP as well as in the field of Justice and Home Affairs. Only some of these reservations, in particular in the social policy field, may change under the Labour government.

In France, too, there is plenty of reservation against further centralization on a European level. President Chirac uses the perception of a "gap in democracy" not to support proposals favouring the European Parliament but to urge closer cooperation between the member states' Parliaments. In CFSP matters, France suggests not the endowment of the President of the European Commission with power of representation and execution but rather the introduction of a new representative, Monsieur X or Monsieur CFSP, to be chosen by and responsible to the European Council.

In Germany, resistance against further European centralization is not unanimous. On the one hand, the federal government is a strong advocate of an extended majority voting even in the fields of external and internal security policy. On the other hand, the new article 23 of the German constitution only allows for a further development of the European Union which is, among other essentials, characterized by a federal structure and by subsidiarity. The article has strengthened the position of Parliament as well as that of the Bundesrat (representative body of the Laender) whenever government negotiates the transfer of responsibilities to a European level.

It is especially the German Laender that try to draw profit from the process of further Europeanization. The Bavarian Prime Minister welcomes the future "Europe of the Regions". He is convinced that many of the burning problems of our time must be solved as close to the citizens affected as possible. It is the regions which compete with one another. Only they themselves can determine their endogenous potential, their priorities and the "preference costs" with respect to alternative allocation of resources available to them. At the same time, much of the legislation affecting regions is being or has already been shifted from a national to a European level or has been abandoned by deregulation. As a consequence, regions transfer their lobbying activity from the capitals of their respective countries to the centres of European decision-making, and must struggle more and more on their own. The result is a shrinking of the powers of national governments in relative terms. In some spectacular cases, like the subsidization of Volkswagen in Saxony, controversies are being fought directly between the Commission and a regional government, with the national government being forced *nolens volens* to enter the boat.

This new role of the regions is supposed to be supported by the "Committee of Regions" created under the Maastricht Treaty. However, this body will hardly become a powerful instrument for defending or promoting the regions' interests. First, it can only produce statements or recommendations but has neither a right of initiative nor of participation in the legislation. Secondly, the European regions' interests diverge heavily, depending on the level of development as well as on the constitutional status within the respective nation's political and administrative structure. Whereas the representatives of the less developed regions mainly plead for a stock-up of the structural funds, those of the more developed, especially federal member states or member states with a significant decentralization, plead for a stronger regional influence on fiscal management and legislation. Given that in many countries there is no regionalization of decision-making at all, the vision of a "Europe of Regions" will hardly materialize in the foreseeable future. This does not withstand a shift of power toward the regions in countries where such decentralization already exists.

However, it is not only (some of) the regions that take recourse to the principle of subsidiarity. Member state governments suffering from a loss of power in the course of European integration also do so. Soon after the Maastricht Treaty had come into force, an *ad hoc* committee under the presidency of a former high German government official was established which had the task of identifying redundant European regulation. In addition, more and more voices call for redelegation of European policy competence back to the member states. This holds true for parts of regional as well as of agricultural policy, but also for industrial policy. Especially in Germany, there is widespread suspicion that the Commission could be tempted to inextricably mix up competition control with sectoral economic policy-making. For the same reason, the German government demands the creation of an independent European authority for competition control.

MORE PRUDENCE NEEDED IN DEFINING NEW EU RESPONSIBILITIES

All these reforms would reduce the initiative and executive power of the Commission, and it is no wonder that the latter is in strong opposition to them. Indeed, it seems to have little to fear. The outcome of the deregulation committee is modest, redelegation of agricultural and structural policies is not in sight, nor is the cancellation of the industrial policy chapter which had only in 1993 entered the EC Treaty. There is also no support (except from the Netherlands) for the German proposal on a competition control authority. Rather, new responsibilities are being claimed by the Commission. In particular, a new chapter on the promotion of employment and on increasing labour market performance will be introduced into the Treaty.

However, if on the one hand the Commission must not fear a renewed collapse of its powers, it has, on the other hand, little chance to push through the above-mentioned amendments. As far as high unemployment results from a lack of economic momentum, growth-oriented macroeconomic policy coordination would be the right answer. But here, both the Maastricht Treaty and the stability pact (despite the latter's euphemistic official appellation as a "pact on stability and growth") draw strict borderlines: monetary policy will have to be stability-oriented, fiscal policy has to look for budgetary consolidation, and wage policy remains a matter of industrial relations. In characteris-tic schizophrenia, the Commission promotes the raising of capital market funds for TENs in order to create jobs, and at the same time has, for EMU reasons, to admonish national governments to strictly stick to the fiscal convergence criteria. A European macroeconomic employment policy which has such poor instruments at its disposal or would, if it created them, come into conflict with other crucial objectives, is not credible and should not be established. As far as high unemployment results from institutional rigidities such as labour protection, lack of incentives to work or high indirect labour costs, the remedies lie with the national governments right from the beginning.

The European Union must withstand the temptation to attract competence which would hurt the principle of subsidiarity. Otherwise, its general attractiveness will shrink because national decision makers get rid of their responsibility, and people do not see their most pressing problems being solved but rather observe idleness at best, waste of resources at worst. Indeed, there are more important tasks that the Union should concentrate upon. In the economic sphere, one of the most important tasks seems to be the completion of the Single Market. One aspect is the creation and maintainance of EMU. The second is a certain harmonization of taxation — as little as possible but as much as necessary. The aim must be a "plain fiscal playing field" for competing enterprises of different nationalities within the EU. If cross-border tax evasion and, in consequence of it, a race in tax reduction could be avoided, a new scope for fiscal policy — be it in the social, the educational or the infrastructural policy fields — could be gained. This would clearly raise acceptance of further economic integration. The third aspect is the prevention of abuse of the Single Market for organized business crime, trade in drugs and illegal immigration. This implies more Common decision-making in the "third pillar" of the European Union, i.e. internal security policy — a requirement which governments seem to be increasingly aware of.

As to EMU, presently-existing agreements have to be enforced. With regard to taxation and internal security, the changes towards majority voting can only be made by the heads of state and government, first at summits of the European Council, and then, by introducing changes to the Treaty, in the framework of intergovernmental conferences. Insofar as the existing treaty would be sufficient and only unanimity is lacking, it would be the proper task of the Council of Ministers in its respective sector-specific composition to find the appropriate solution. But experience has shown that the ministers are imprisoned in their specific interests and technical debate so that all too often they prove unable to find the solution.

It was exactly this attitude of blockade which called for the creation of the European Council. Since 1969, all major developments have been catalyzed by it: the first direct election of the European Parliament, the first enlargement and the free-trade agreement with the EFTA, the system of its own resources, the creation of the Regional Fund and of a Common Technology policy, the EMS and the Delors Packages, the European Union and, last but not least, the future eastern enlargement. Only the European Council was able to have the necessary bird's-eye view and to negotiate "package deals" equilibrating the different national interests.

At the beginning, there was widespread fear that the European Council would deprive the Commission of its initiative power. The Single Act and the Maastricht Treaty have, however, managed to contain this danger. Moreover, the President and a further member of the Commission participate in the European Council's working sessions (albeit not in the "chimney talks"), and there is also an *ex ante* coordination with the president of the European Parliament.

VARIABLE GEOMETRY PROCEEDING

Yet, it should be clear that it is the confederation and not the federation model which is represented in the European Council's role as the key body of the Union: important ideas concerning integration would be produced on a member state level and, depending on the political weight of the respective country, made a political issue in the Council which in turn "commits" the Commission with the elaboration of concrete initiatives. The most recent example was the Commission regulation draft on the stability pact which was based on an original idea of the German minister of finance. This *de facto* shift in initiative power is being observed by the European Parliament with ostentatious disgust. By the end of October 1996, the European Parliament severely reproached the Commission for not making sufficient use of its codified rights vis-à-vis the Council. This structural bias of influence in favour of strong member states emerging from the very existence of the European Council is the greater the weaker the Commission's leading personalities are.

Within the European Council, the official role of a driving force used to be played by the respective half-year's national presidency. It can determine the priorities on the agenda, and it has, by reasons of national prestige, a special interest in making its period of institutional influence a "success". But, of course, in reality there are countries of generally stronger and those of generally weaker influence. The three protagonists are France, Germany and Britain. The particular French-German relationship has been crucial for the whole integration process from the beginning. Since 1962 it has been based on the bilateral "Elysée-Treaty" of friendship. Since then, these two countries have determined whether an issue is bound to fail or to succeed. Only when France finally agreed, could the UK be admitted. It was a German-French initiative from which the EMS and eventually EMU emerged. The outfit of EMU, *nota bene*, is German: the most important new institution of the European Union, the future European Central Bank, has been shaped according to the Bundesbank model.

In contrast, Britain's influence so far has mainly been exercized in blocking. The British do indeed claim to be "good Europeans", too. But their idea of Europe differs very much from that on the Continent. It is true that Britain, too, strongly advocates eastern enlargement. But whereas the Continent wants deepening first because the EU's difficulties in the field of an institutional reform increase in exponential relation to the number of its members, Britain, for this very reason, wants enlargement first. Indeed, a substantially enlarged Union would be condemned to political stagnation without the introduction of majority voting as a rule in all policy fields of major Common interest; it would be undemocratic without strengthening the European Parliament and simultaneously weighing the member states' vote in the Council according to the respective size of population; it would be inefficient without restricting the number of Commission members and strengthening the Commission's presidency; it would miss legal security without endowing the European Court of Justice with the power of final and binding jurisdiction in all matters of Europe-wide bearing. It is exactly these key requirements which Britain rejects. Although the other 14 member states are still far from a consensus on most of these issues, none of them has retired behind the walls of basic opposition. This fundamental dichotomy in integration policy and isolated British position made the president of the European Parliament even recommend Britain to quit the Union.

Under these circumstances, a principle of "structural flexibility", if established by the Maastricht II IGC, would have to be regarded as an *acquis*. It should allow for a deepening even without abolishment of unanimity voting. However, the deepening may take place only among a restricted number of member states. As the group of countries ready for deepening may differ from policy field to policy field, it is plausible that the Union will develop in the direction of "variable geometry". But it is as plausible that eventually, a core group of member states will emerge, which will participate in all policy fields already integrated. From a legislative point of view, it will be very difficult to deal with all these differentiations within one integrated treaty as is at present the case with the "ins" and "outs" of EMU. Therefore new institutions will arise almost inevitably, in which only the core countries are members. Otherwise the relations between these countries would be controlled on an informal basis rendering them intransparent and therefore even more exclusive.

Nevertheless, this should not do harm to the idea of the European Union as long as its objectives are unanimously defined. This has been the case with EMU and even with its complementary stability pact. It has not been the case with the social chapter, and it will not be the case with environmental policy, external and security policy, let alone under the condition of 27 members. Therefore, the integrational structure of Europe might eventually resemble that of the 1950s, only on a higher level of integration and in the absence of the iron curtain.

Paweł Bożyk

CEFTA on the Road to a Common Market

CRITERIA FOR INTEGRATION OF CENTRAL EUROPE WITH THE EU

The principal regional integration criteria are: compatibility of political systems, similar working mechanisms of the economy, matching economic infrastructure, territorial proximity, adequacy of economic capacities, comparable levels of economic and technological development, complementarity of economic structures (inter- and intra-industry), and developed mutual trade links [Bożyk, 1994, p. 161].

The weight carried by each of these criteria is not, of course, the same. Some are absolute prerequisites if integration is to be possible in the first place (compatibility of political systems, intra-industry complementarity of economic structures, similar working mechanisms); the fulfilment of others makes it easier to build up integration links (territorial proximity, adequacy of capacities, developed mutual trade links, etc.).

As regards chances of advancing integration with the European Union the VG (Vysegrád Group) countries come closer to meeting the above criteria than the rest of East and Central Europe. But this does not mean that there are no differences in this respect between Poland, Hungary, the Czech Republic and Slovakia.

POLITICAL SYSTEMS

All four VG countries have systems of parliamentary democracy in place which are modelled on those of the EU nations. They are not, however, identical: in the EU the political systems are more mature than in the VG. This is primarily due to the fact that in the former they have been functioning for tens of years and are founded on solid institutions, proven methods of selection of political leaders, tried and tested emergency warning systems, etc.

The immaturity of parliamentary democracy in the VG countries is manifested in the frailty of its mechanisms and the amateurism of politicians. The result is the appearance of pathological disorders which interfere with the normal functioning of political systems. Eradication of these takes the form of — more frequent than in the EU countries — parliamentary elections, changes in ruling coalitions, conflicts between the legislative and executive branches, etc.

Not that the situation is the same in all the VG countries. Relations between the legislative and the executive power are different in Poland and in Hungary, in the Czech

Republic and Slovakia. There are also differences in the political composition of the legislatures in each country. These discrepancies do not, however, disqualify any of the VG countries from applying for membership of the EU.

WORKING MECHANISMS OF THE ECONOMY

In all the VG countries the economy is driven by free-market mechanisms designed along the lines of those in the EU countries and functioning according to the same basic principles as in the model. What does differ is the systemic infrastructure, that is, the environment in which these mechanisms operate. This comprises the organization of the economy, its ownership structure, the operating principles of enterprises, and the social services system.

In the EU countries the systemic infrastructure has for many years been geared to the requirements of the free-market mechanism and assists its functioning. In the VG countries, on the other hand, much of the systemic infrastructure is still a relic of the centrally planned economy; in many cases it is out of tune with the requirements of a free-market economy and impedes its functioning.

Overhauling this infrastructure is a long-term undertaking since it is characterized by considerable rigidity. It is also a costly exercise, not only in economic terms, but also socially. The costs are especially heavy if the changes are swift and radical.

In view of this, the extent to which the systemic infrastructure has been remodelled varies in individual VG countries. Adaptation to the requirements of the free-market economy is most advanced in Hungary and Poland; in Hungary, because adjustment to market needs began as early as the late 1960s; in Poland, because a very rapid pace was set for the remodelling process in the 1990s.

The Czech Republic and Slovakia are endeavouring to harmonize a relatively slower remodelling of their systemic infrastructure with the speed at which working mechanisms are being transformed. Thus, instead of a free market, what we have there is a kind of mixed economy.

All in all, however, in none of the VG countries do the working mechanisms of their economies constitute any significant barrier to integration with the European Union.

GEOGRAPHICAL LOCATION AND COMMUNICATIONS LINKS

The VG countries are conveniently situated with respect to the European Union. Some of them share borders with EU countries. All of them have well-developed rail, road, telecommunications, air and other links. However, the modernity of these links falls short of EU standards. Their structure also differs from what is to be found in the EU countries.

Nevertheless, geography is a factor which clearly favours the VG countries' integration with the European Union.

ADEQUACY OF ECONOMIC CAPACITIES

The VG countries represent varying economic potentials. In terms of population, Poland is almost eight times larger than the Czech Republic and Slovakia, and almost four times as large as Hungary. Thus, while Poland can be classified in the medium-sized group of countries, Hungary, the Czech Republic and Slovakia belong in the small nations category.

In terms of economic capacities Poland is far superior to the other VG countries. It is richest in natural resources, including mineral deposits, waterpower, forests, arable land, etc. Hungary, the Czech Republic and Slovakia have only average or modest stocks of such wealth. Poland also produces the largest volume of industrial and agricultural goods.

Thus, from this point of view the country with the greatest attractions for the European Union is Poland. For here lies the biggest potential market for goods produced in the Union and here, too, opportunities for locating industry exist on a larger scale than in the other VG countries.

All things considered, the economic capacities of the VG countries are not a barrier to integration with the EU; they belong in a slot between the biggest and smallest in the EU.

LEVEL OF ECONOMIC AND TECHNOLOGICAL DEVELOPMENT

In this area, too, the VG meets the criteria laid down by the EU since the partners are the countries with the highest levels of development in East and Central Europe.

The most favourable placed is the Czech Republic which prior to World War II was ranked among the world's advanced nations with a production structure and external links comparable to Western Europe. However, during the central planning period it fell behind world progress. As a result, at the beginning of the 1990s the quality of production, technological standards and price competitiveness of Czech industry were clearly inferior to those in Western Europe.

National income per head in the Czech Republic stands in the mid-1990s at less than half the average for the European Union. But at the same time the level of national income per head is some 40% higher than in Poland; Hungary and Slovakia lie between the Czech Republic and Poland.

The order is almost exactly reversed with respect to the consumption patterns of the populations of these four countries. They most resemble those in the EU in Poland, which can be attributed to the Poles' longstanding fascination not only with Western culture but also its economic achievements and standards of consumption. All Western ways of doing things are rated much more highly in Poland than its own or its neighbours'. Czechs, Slovaks and Hungarians are by contrast far more objective in their assessments of their and other nations' consumption values since they are less susceptible to the demonstration effect than the Poles [Bobek, 1992, p. 26].

Between the VG countries there are, on the other hand, bigger differences in the technological standards of industry. The one in the best condition is Hungary, thanks primarily to the substantial progress made in this field in the 1980s (chiefly due to expansion of collaborative ties with leading industrialized countries, inward Western investment, imports of licences, etc.). The Czech Republic, traditionally the most technologically advanced country in East and Central Europe, dropped behind as a result of being cut off from inflows of modern technology in the 1970-90 period. However, in the 1990s it set about the task of swiftly making up these arrears; here it enjoyed the advantage (by comparison with Poland and Hungary) of being unburdened by external debt and was also assisted by a rapid growth of foreign direct investment.

Poland, on the other hand, failed to capitalize on the considerable modernization of production that took place in the 1970s; at the turn of the 1980s its industry was undoubtedly the most modern in Central Europe (over 50% of the technologies installed were replaced during the 1970s). Unfortunately, in the years 1982-93 almost complete severance of the flow of modern technologies into Poland resulted in serious disinvestment and a widening technological gap. However, Polish industry still has a large stock of efficient (though not state-of-the-art) Western equipment.

Slovakia is the least technologically advanced VG country, chiefly due to the fact that when it was a part of Czechoslovakia the bulk of civilian production was located in the Czech half and defence industry in Slovakia. In the latter field it has a significant technological potential but its utilization depends either on conversion or realignment of arms exports from Russia to the EU countries.

The technological disparities between the EU and the VG are not an insuperable barrier to full membership of the Union; they only put Poland, Hungary, the Czech Republic and Slovakia on different footings as regards the horizon and costs of entry.

COMPLEMENTARITY OF ECONOMIC STRUCTURES

Differences in the situation of individual VG countries are also to be found in the complementarity of their economic structures vis-à-vis the EU. This applies to both inter- and intra-industry complementarity.

As regards inter-industry complementarity, it is present to a greater extent in the case of raw materials, fuels and metals than agricultural products: in the satisfaction of its food demand the EU is self-sufficient and seeks outlets for its agricultural goods on the markets of third countries, whereas the majority of the Central European countries are net importers of foodstuffs from the EU. Their food exports to the Union are dominated by inessential items (some kinds of livestock and certain plant and animal products such as forest crops, fruit, etc.).

In satisfying EU raw materials demand the Central European countries are also at a disadvantage. In the first place, only some of them have natural resources (chiefly Poland); the rest are net importers of most raw materials. Secondly, exports of material-intensive products to the Union are subject to a number of restrictions, mainly of a non-tariff kind.

But in all the Central European countries productive capacities were built up in industries which are to an increasing extent being eliminated in the Union. These are labour-intensive, environment-polluting ("dirty") and other such activities: iron and steel, heavy industry, shipbuilding and the like. Here the countries with the greatest opportunities are Poland and Slovakia, provided of course that the EU countries decide on a

greater opening-up of their internal markets. So far they have kept both foodstuffs and steel and textile products in the "sensitive" category.

It follows, then, that it is in intra- rather than inter-industry complementarity that the Central European countries should explore the possibilities of deepening integration with the EU. As regards intra-industry complementarity, the most favourable circumstances are enjoyed by Hungary where the structure of production has for the past quarter-century been tailored to the shape of demand in EU countries, signs of which can be seen in industrial collaboration. At present this process is assisted by appreciable Western interest in direct investment in Hungary.

Potentially, the Czech Republic, Poland and Slovakia also have chances of expanding economic links with the EU along the intra-industry complementarity route. So far most has been made of these opportunities by the Czech Republic, and the least by Poland which has developed collaborative links with the EU on only a relatively minor scale.

MUTUAL TRADE LINKS

From the point of view of the EU's share of the total trade of the VG countries exchange between them could be placed in the category of developed integration links since it is bigger than trade within the group. Unfortunately, it does not embody integration links in the strict sense as it is to a large extent the result of the abrupt realignment of the geographical structure of the foreign trade of the Central European countries that followed the changes in the political system. Such swings have, for that matter, been a recurrent phenomenon.

Before World War II the Western European countries which now make up the European Union dominated Central European trade. After the war the change in the political systems in the countries of Central Europe was accompanied by a basic remodelling of the geographical structure of their trade which took the form of reducing to a minimum the share of countries with market economies and expanding the share of countries with centrally planned economies, though with the passage of time the share of EU countries began steadily to rise. In 1990 the change in the political systems in Central Europe was again accompanied by a realignment of the geographical structure of trade: in all the Central European countries the share of the EU countries doubled, in some cases increasing to even two-thirds of their overall trade.

This substantial increase in the EU share of the foreign trade of the VG countries was not accompanied by a concurrent increase in the VG countries' share of EU trade. In this field for many years there has been a deepening asymmetry, reflected in the sidelining of Poland, Hungary, the Czech Republic and Slovakia in EU trade.

Consequently, imports from Central Europe serve a supplementing purpose for the EU — diversifying the supply mix, making good shortages of certain goods, and so on. For Central Europe, on the other hand, imports from the EU are for the most part of basic significance.

Any more appreciable change in this situation in the process of integration will be impossible; nevertheless, some upgrading of the VG countries' status is essential. It could be achieved through an expansion of economic links based on intra-industry complementarity.

MAASTRICHT CRITERIA

In 1994 five criteria were laid down at Maastricht which have to be met by countries seeking membership of the EU:

— inflation within a margin of 1.5% of the level in the three countries with the lowest rates (1994: 3.4%);
— an interest rate at the level of the average yield of 10-year bonds in the three countries with the lowest rates of inflation (1994: 10%);
— an exchange rate determined according to the rules of the "currency snake" (±2.25%);
— a budget deficit no larger than 3% of GDP; and
— a public debt ratio of no more than 60% of GDP.

The VG countries fall short of meeting these criteria to varying degrees.

In the case of inflation the country furthest from the Maastricht target in 1994 was Poland where the rate was 950% above the designated limit. Second place was occupied by Hungary, third by Slovakia, and fourth by the Czech Republic. The Czech position was in this respect three times better than Poland's.

The interest rate in Poland in 1994 also exceeded the Maastricht limit by the largest margin; the difference amounted to 425%. The order of the other VG countries was the same as in the case of inflation (Hungary, Slovakia, the Czech Republic).

Poland's exchange rate in 1994 (following devaluation of the zloty) was 850% higher than the Maastricht limit. Next, in descending order, came Hungary, Slovakia and the Czech Republic.

As regards budget deficit Poland in 1994 exceeded the Maastricht limit by 90%, and in the case of public debt ratio by 115%. The places occupied by the other VG countries were the same as before (Hungary, Slovakia, Czech Republic).

A point to be noted is that performance in these fields has been gradually improving in Poland and the Czech Republic but has remained unchanged (and in some cases even deteriorated) in Hungary and Slovakia.

RATINGS OF VG COUNTRIES' FULFILMENT OF EU INTEGRATION CRITERIA

In terms of fulfilment of all the above integration criteria the VG countries can be listed in the following order: the Czech Republic, Hungary, Poland and Slovakia (see Table 1).

The chief points in favour of the Czech Republic are the Maastricht criteria, including its lowest inflation and interest rates, exchange rate stability, and relatively small budget deficit and public debt ratio. In contrast to the Czech Republic, Poland is the VG country which is furthest from fulfilment of the Maastricht criteria. Its inflation and interest rates are relatively higher than in the other VG countries and the shortfalls in exchange rate, budget and public debt ratio biggest.

On the other hand, the differences between Poland and the other VG countries as regards the first eight criteria are insignificant.

TABLE 1. Quantitative Measures of VG Countries' Fulfilment of EU Integration Criteria*

Criteria	Poland	Hungary	Czech R.	Slovakia
1. Compatibility of political systems	5	5	5	4
2. Similar working mechanisms of the economy	5	5	4	3
3. Matching economic structures	5	5	5	4
4. Territorial proximity	5	5	5	5
5. Adequacy of economic capacities	5	5	5	5
6. Comparable levels of economic and technological development	4	4	4	4
7. Complementarity of economic structures	5	5	5	3
8. Developed mutual trade links	5	5	5	3
9. Maastricht criteria:				
(a) rate of inflation	1	2	4	3
(b) interest rates	1	2	4	3
(c) exchange rate	3	3	5	3
(d) budget deficit	4	3	5	3
(e) public debt	1	3	5	4
Total score	49	52	61	47

* On a scale of 0–5; maximum possible score: 65.
Source: Estimates based on detailed expert studies

HORIZON AND COSTS OF EU MEMBERSHIP

Politicians in the VG countries wish to see them enter the European Union as early as possible. This springs from a belief that membership of the EU is synonymous with a growth of well-being in the newly-admitted countries. Potentially, it offers them the following principal benefits.

First, access to the very large and dynamically expanding market of the European Communities opens up the prospect of economies of scale and improvement of economic efficiency. There are many areas in which Polish, Czech, Hungarian and Slovak producers enjoy comparative advantage on the EU market, chiefly because of lower labour costs. For, although average productivity in the EU is higher than in Central Europe, human labour is lower paid in the VG countries than in the EU and as a result is cheaper.

Second, the increased competitiveness on the internal markets of the VG countries resulting from the opening of their economies to imports from the EU could act as a spur to growth. This is chiefly a matter of the structural changes that would have to be made in order to make better use of productive resources, accelerate technological advance, and adapt production to the demand on external markets.

Third, the VG countries could benefit from the stabilizing influence of association agreements with the EU on their economic policy. These agreements confront the Central European countries with the need for bringing their economic policies into line with EU standards through, inter alia, elimination of frequent changes in its goals and instruments and introduction of mechanisms and institutions modelled on those within the EU.

The belief of politicians in Central Europe that all these benefits will indeed be realized is based on analogies with the nations admitted to the EU before them and which after obtaining full membership raised the level of their development and improved many other indicators which now compare favourably with those in the VG countries.

Politicians in the EU countries are in favour of lengthening the horizon for admission of the VG countries to full membership. In their opinion all the above benefits can only materialize over a longer period and will depend on the fulfilment by the VG countries of a number of what for them are on the whole difficult conditions, including attainment of a higher level of economic development, adaptation of economic structures, elimination or at least a substantial reduction of the malaises afflicting their economies, such as unemployment, inflation, external debt, budget deficits, etc. This requires a profound remodelling of economies, which entails an increase in investment outlays on restructuring production, raising technological standards, etc.

Politicians in the EU countries believe that rapid admission of the VG countries to full membership could place them in a difficult economic situation in the shape of finding the VG countries' industrial and agricultural production unable to compete with EU goods. The consequence could be tendencies to cut back domestic production, rising unemployment and the many other ailments that would follow.

Declarations regarding the admission of the VG countries to full membership of the EU contain, therefore, a number of preconditions which require them to make changes in economic policy and the systemic infrastructure. Failing that, there is the danger, the EU argues, of entry resulting in disruptions of the economies of the VG countries.

In particular, the EU fears that the "integration shock" which would shortly follow the abolition of all restrictions in relations between the VG countries and the EU might be too much for the former. Reducing the damaging impact of this shock would call for considerable expenditures on the part of the EU countries.

A particularly high level of assistance would be required by agriculture which, especially in Poland, falls far short of EU standards as regards profit rates, organization structure, technical equipment, etc. Preliminary estimates put the needs in this field in the region of tens of billions of dollars per annum.

In these circumstances the following proposition can be advanced: the horizon for admission of the VG countries to full EU membership will be a function of how much assistance the Union is prepared to provide. The shorter the horizon, the greater the assistance that will be required, and vice versa. Otherwise, the VG countries will need a longer period of time to bring their economies into line with EU standards.

Two kinds of adaptation are involved: institutional and structural.

Institutional adaptation, which embraces the working mechanisms of the economy and economic policy, can be carried out more quickly than structural adaptation. It is

also less costly. It comprises constructing the institutions typical of market economies, creating a new legal system and training specialists to service this new system. In this field the arrangements to be put into place can be modelled on those in the EU, though this does not mean that in all cases they can be identical since allowance has to be made for civilizational and structural differences.

Structural adaptation is inevitably a longer process [Pajestka and Perczyński, 1993]. For it means a reorientation of the economic structure of the VG countries angled to the needs and possibilities of integration with the EU. It is also very costly since it entails development of wholly new kinds of production, modernization of the industries expanded in the past and protection of the activities which in the new conditions cannot withstand competition from the EU countries.

Structural restructuring can be carried out by various methods depending on the area of the economy [Pajestka and Perczyński 1993, pp. 8, 13]. In the first area restructuring processes can be left to the free operation of market forces. This area comprises, on the one hand, the kinds of production which can by virtue of high quality and technological standards compete with the EU countries, and on the other hand, such production which has no development prospects. The second restructuring area comprises production which requires promotion measures. This is a matter of both promotion of new industries and accelerating the expansion of existing ones. The means of effecting theses changes are investment, research and development, credit preferences, etc. This is the field in which the VG countries are looking to the greatest assistance from the EU, especially in the form of capital and technology. The third restructuring area comprises production which requires protection against competition from the EU countries. The reasons for such protection may vary and range from the strategic to the social.

It has been estimated that the first area on the average accounts for about two thirds of industrial production, the second for about 10%, and the third for about a quarter. The most favourable circumstances are enjoyed by the Czech Republic and Hungary; Poland and Slovakia are in a relatively worse condition. In the first two countries the percentage of industries requiring protection is smaller; in the latter two it is bigger.

JOINT OR SEPARATE ROUTES TO THE EU?

For the reasons indicated above there is no unequivocal answer to the question of whether the VG countries should enter the EU individually or together. Cases can be made for both.

The arguments in favour of separate entry are differences in the internal and external factors determining the bargaining position of each of the Central European countries vis-à-vis the EU (see Table 1).

The Czech Republic, conscious of its economic and civilizational advantages over the other VG countries, is decidedly in favour of individual entry. It assumes that the fact that the differences between its economic level and the EU are the smallest in the Group will enable it to negotiate the most favourable terms of membership. As a result the Czech Republic will be given the chance of catching up more quickly with the civilizational core represented by the most advanced EU countries. The entry of the whole VG en bloc would, the Czechs believe, mean forfeiture of their privileged status and a levelling downwards to the least favoured position.

Hungary's standpoint differs only slightly from the Czech. Hungary is aware of the privileged position it enjoys in the field of physical and institutional links with the EU as a result of many years of adjustment of its economic structure to the requirements of the EU market. Hungary's historical ties with EU countries (Austria) also enhance the attractiveness of its offer.

Poland is counting on being granted preferences in view of its leadership in market reforms and possession of the most substantial economic capacities in the VG. In Poland ownership restructuring processes have advanced furthest, economic mechanisms have been liberalized to the greatest degree, and state intervention reduced on the largest scale.

Slovakia is conscious of being the outsider in the VG. Its hopes of EU membership are based primarily on assistance from Germany with which it was traditionally linked by numerous economic and political ties.

Thus, if each of the VG countries were to "go it alone", the order of entry into the EU would be as follows: Czech Republic, Hungary, Poland, Slovakia.

However, the EU is in favour of a different solution: joint admission of all the VG countries to full membership. There are a number of reasons for this.

First, there is the need to avoid what is not always justified competition to be the first to enter. For the advantages of one VG country over the others in some fields is offset by shortcomings elsewhere which reverse the order. From the EU point of view they are not of basic significance. For the EU the most important consideration is that all four of the VG partners belong to the group of countries transforming their economies from a central planning to a free-market system. Because of this the whole group, according to EU representatives, has many features in common.

Secondly, there is the need for the EU to work out a single approach to all the transforming economies following their admission to full membership. Ground is being gained by the view that even after entry the countries of East and Central Europe will have to be treated specifically and differently than other EU members.

Thirdly, there is the possibility of the VG countries' "integration shock" being cushioned by means of expanded intra-Group links. The severity of the shock will differ depending on whether the Central European countries are admitted one by one or as an economically fused group with trade between them accounting for a substantial percentage of their total trade and with built-up specialization and collaboration links.

For these reasons the EU has for some time been recommending the VG to develop "mini" regional integration. This was the basic motive behind the conclusion of the CEFTA agreement.

FORMS OF VG MINI-INTEGRATION

Mini-integration is here defined as the process of fusion of a territorially or institutionally circumscribed group of countries. Territorial restriction may take the form of reducing integration to a sub-region; institutional restriction, of reducing integration to certain economic mechanisms.

In practice there can be found various examples of mini-integration. They include EFTA, NORDEK and others [Encyklopedia..., 1975, p. 364]. The overwhelming majority of them have been treated as a stepping-stone to the realization of long-term objectives (e.g. entry into the European Union).

Mini-integration should be distinguished from "maxi" integration (or integration *sensu stricto*) which is not circumscribed either institutionally or territorially. Within the maxi-integration framework any country can be admitted to membership that fulfils the integration criteria. At the same time the institutional forms of integration can be developed on a more comprehensive scale.

Consequently, mini-integration can be treated as an alternative to maxi-integration as its basic objective is not advancing the frontiers of civilizational progress, especially economic and technological, which is one of the underlying purposes of maxi-integration, but expanding economic links within a sub-region.

In the East and Central European region mini-integration can be undertaken in a number of sub-regions: Central Europe (Visegrád Group), the Baltics (Lithuania, Latvia, Estonia), and the Balkans (Bulgaria, Romania, New Yugoslavia, Albania). The distinguishing features of the states in each of these sub-regions are ethnic, cultural, infrastructural and economic ties which make them gravitate towards one another.

All the VG countries meet the regional integration criteria. First and foremost, they have compatible political systems, interlocking economic infrastructure, adequate economic capacities, comparable levels of economic and technological development, complementary economic structures (inter- and intra-industry), developed mutual trade links and similar economic working mechanisms. These are natural spurs to expansion of economic links between them.

Deepening and accelerating the formation of these links requires introduction of the proper integration mechanisms. Theoretically speaking, there is the possibility of reinforcing the existing free-trade area mechanism with more sophisticated forms of cooperation.

A free-trade area can be the loosest form of mini-integration, confined to abolition of tariffs and quotas in trade between the countries of the sub-region. In the VG it applies solely to industrial products. Poland, Hungary, the Czech Republic and Slovakia have at the same time retained an autonomous internal tariff and pursue their own independent trade policies towards third countries.

If the VG countries were to introduce a single external tariff (vis-à-vis third countries), in other words, if they were to form a customs union, their degree of freedom in economic policy, and especially foreign trade policy, would be further limited. A customs union would unify the tariff policies of the VG countries towards countries outside the group. At present there is complete autonomy in this field. Only in relations with the EU is there some kind of convergence of policies, but it is a consequence of the EU's similar treatment of the VG countries rather than any prior arrangements between Poland, Hungary, the Czech Republic and Slovakia.

Through the trade diversion and trade creation effects a customs union would further the development of economic links between the VG countries. In the first case, a growth of trade would be a result of the diversion of purchases from countries with lower production costs but outside the union to countries which are members, provided of course that the external tariff exceeded the differences in production costs. In the case of the trade-creating effect it would come about as a result of the abolition of tariffs and other barriers to trade between them and introduction of a common external tariff. Abolition of tariffs within the Group would lead to the possibility of offering certain kinds of goods produced in the VG countries at more competitive prices than previously on the markets of EU countries.

Even greater benefits in the field of developing economic links can be expected from the formation of a common market of the VG countries which would mean not only the abolition of tariffs in internal trade and introduction of a common tariff vis-à-vis third countries, but also fee movement of capital and labour within the mini-integration group. This would create a better environment for the undisturbed operation of the free competition mechanism and so greater adaptation possibilities than in the case of a free-trade area and customs union. Through optimum allocation of labour resources, economies of scale and more rapid technological advance the VG countries would be able to deepen economic cooperation, maximize its benefits and become more competitive vis-a-vis the EU. Establishment of a common market would, however, require unification of price policies within the VG.

A more sophisticated institutional form of mini-integration among the VG countries would be a monetary union comprising, in addition to a free-trade area, customs union and common market, coordination (or unification) of the monetary policies of the members. Such coordination would cover restriction (to within a specified band) of fluctuations in exchange rates, creation of joint foreign exchange reserves, introduction of a single currency within the group, credit assistance, and other measures.

Another form mini-integration between the VG countries could take would be economic union comprising, in addition to a free-trade area, customs union, common market and monetary union, coordination (or unification) of particular fields of economic policy, both overall and in individual sectors of the economy. Complete union would arise only if all areas of economic policy of major significance to the functioning of the common market were covered by a single or coordinated policy and if there were also a common currency and supra-national economic authority.

The ultimate form of mini-integration would be political union, meaning the coordination (or unification) of both the internal and foreign policies of the VG countries.

Harmonization of the above forms of mini-integration with the forms of maxi-integration depends on consistency of the mechanisms in place. If these are market mechanisms the simpler forms of mini-integration will chime with the more sophisticated forms of maxi-integration. This is illustrated in Figure 1.

From a theoretical point of view, this correlation could also exist in reverse — in a situation in which mini-integration has assumed an institutionally more sophisticated form than before.

In the light of the considerations presented here it can be seen that there are no substantive restrictions between mini-integration of the VG countries and maxi-integration within the EU framework. The basic barrier to such mini-integration are political factors.

Figure 1

Relationship between the Institutional Forms of Mini- and Maxi-Integration

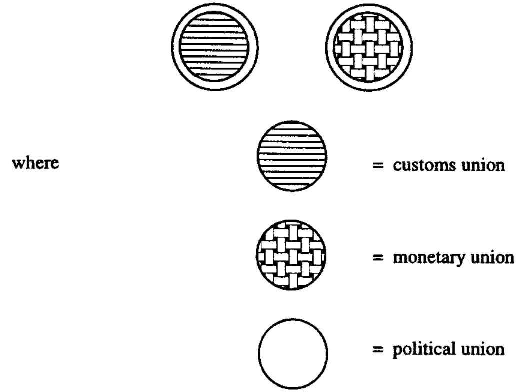
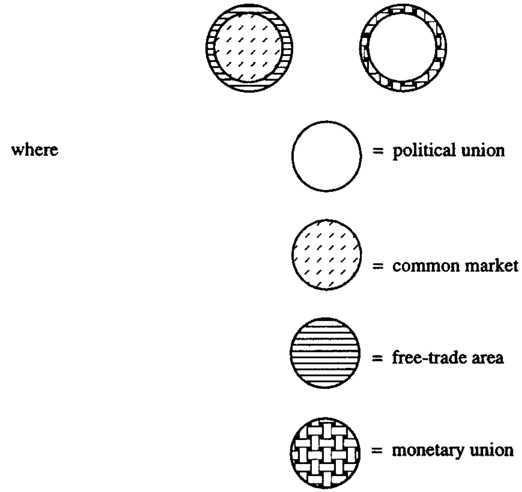


Figure 2

Relationship between the Institutional Forms of Mini- and Maxi-Integration



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A Common CEFTA Capital Market: An Attraction for Foreign Investors

INTRODUCTION

CEFTA as a form of regional economic integration has come to the point where it will have to redefine its identity and reconsider its future strategy. CEFTA faces challenges of deepening and widening to which an appropriate solution will have to be found. The future of CEFTA is undoubtedly determined by its relations to EU integration and particularly its Eastern enlargement. CEFTA may opt for a process of deepening modelled on EU-type integration or it will remain a free-trade area of a transitional character like EFTA, with member countries clearly defining their accession to EU as their primary goal. Deepening the economic integration of CEFTA means introducing new elements of higher forms of economic integration, which go beyond the concept of a free-trade area to include some elements of a common market. One of the possible directions in the deepening of CEFTA is to consider the creation of a common CEFTA capital market by completely liberalizing capital flows among its member countries.

This paper analyzes the possibilities of creating a common CEFTA capital market and its potential to attract foreign investment, needed in the processes of privatization, restructuring and modernization of these countries. In the first part of the paper, we analyze the present stage of liberalization of capital movements in CEFTA countries and in the international (IMF, OECD) and regional (EU) context in which liberalization of capital flows is framed. This gives us some background to discuss possibilities and limitations of the idea to create a common CEFTA capital market. The second part of the paper deals with the issue of how regional economic integration like CEFTA and its common capital market in particular, can be instrumental in attracting additional foreign investment, particularly in the form of the foreign direct investment.

PART I: CREATING A COMMON CEFTA CAPITAL MARKET

A COMMON CAPITAL MARKET AS A WAY OF DEEPENING THE PROCESS OF ECONOMIC INTEGRATION OF CEFTA

CEFTA as a lower form of economic integration has in recent years undoubtedly demonstrated its usefulness. It justified its existence by liberalizing trade flows within the region, which resulted in increasing trade among these countries. However, as a free-trade area, which is the lowest form of economic integration among a group of countries, CEFTA now faces two challenges, its widening and its deepening. (Some issues in widening and deepening of CEFTA are dealt with in Rudka and Mizsei, 1995) The issue of widening is in a way similar to that of the EU Eastern enlargement. A problem which CEFTA is likely to meet in this process is the issue of homogeneity among member countries. Present members can be considered as relatively homogeneous in terms of the level of their economic development and the stage of their reforms in the transition process, at least compared to other candidates for the future CEFTA membership, which are expected to be much less homogeneous than the original member countries. The lesson from this for the creation of a common CEFTA capital market is that it is much easier and meaningful to consider a common capital market among the present CEFTA member countries than among future member countries whose capital markets can be expected to be less developed and liberalized. This gives a certain time dimension to the idea of creating a common capital market of CEFTA countries. In fact, CEFTA countries should speed up the process and consider creating a common capital market among the present member countries, if they opt for this form of deepening their economic integration.

On the other hand, the scope and dynamics of creating a common CEFTA capital market depends on the process of Eastern enlargement of the EU. As the present members of CEFTA defined their intention to become full EU members as soon as possible as their primary strategic goal and as at least some of them, if not all, are the most serious candidates for the EU accession in the first wave of its Eastern enlargement (sometime around the year 2002), the concept of a common CEFTA market may prove not to be a very lasting one. It is very likely that CEFTA will share the fate of EFTA. In this case, it will remain more or less a transitional form of regional economic integration of a second rank (at least compared with the EU), with the function of being some kind of a waiting room (or a fitness club) for the countries waiting for the EU membership. CEFTA's actual potential would in this case depend, among other things, on the ratio between outgoing and incoming member countries, which does not seem promising for the process of deepening of CEFTA, including for the creation of its common capital market. Anyway, the future EU membership of the present CEFTA countries places serious conceptual limitations and timing constraints on the idea of a common CEFTA capital market.

The deepening of CEFTA's economic integration as a way to redefine CEFTA's identity obviously starts from imitating, at least in some respects, the integration process of the EU. The integration process of the EU reached the stage of a common market with their famous four freedoms (movement of goods, services, people and capital). Presently, it is in the stage of a transition to the highest form of economic integration, the economic and monetary union (EMU). Within the EU, a single capital market is the result of free capital flow among member countries, which is one of the four freedoms of the single market. It somehow complements the other three freedoms, which is most clear in the case of services, particularly financial services. Free capital movements are a precondition (a necessary but not a sufficient condition) for the liberalization of financial services. On the other hand, liberalized financial services

enable cross-border capital movements. Therefore, it is safe to say that liberalization of capital movements must go hand in hand with the other freedoms of the single market. As regards the transition to the EMU, liberalization of capital flows by eliminating all capital controls among member countries is a prerequisite for any monetary integration and for the creation of the EMU in particular. In fact, the first stage of the three-stages approach to the transition to the EMU focused exactly on creating a single capital market in EU countries by lifting all residual capital controls in the member countries.

The lesson for CEFTA in its ambition to create a common capital market is that the creation of a common capital market should not be viewed *per se*, outside the broader context of the integration process as a whole. Integration of capital markets normally follows integration in goods and services markets and builds upon their respective freedoms. On the other hand, it normally proceeds the process of monetary integration, which is even more demanding. Therefore the real question for CEFTA is to decide how far it wishes to go or how far it can go in the process of economic integration. Will it extend its present (partial) freedom of movements of goods also to services? For creating a common capital market it is mandatory to liberalize financial services as well. Therefore, a common capital market should be proceeded or at least accompanied by financial integration, i.e. liberalization of financial services (banking, insurance, transactions with securities). Could CEFTA evolve into a higher form of economic integration, such as a common market? The concept of a single capital market requires a look even further ahead. Once a single capital market within a region is established, there are good reasons to go further in the direction of an economic and monetary union. In fact, some would argue that only EMU gives the process of capital liberalization its ultimate sense. Obviously, such a goal is much too ambitious for CEFTA, even in a reasonable time perspective. However, without clear ambitions as to how far to go in economic integration, i.e. which of the four freedoms to build upon, and without an ambition to aim for an economic and monetary union, the idea of creating a common capital market of CEFTA countries somehow "hangs in the air". The question remains whether it makes sense to proceed with a concept of the common capital market *per se*, with CEFTA basically remaining a free-trade area. The answer to this question is obviously beyond the scope of this paper, so it will be assumed that a common CEFTA capital market can be created *per se*, without considering the broader context of the CEFTA future. The issue which is discussed in the first part of the paper is whether such a common capital market realistically can be established, while the second part discusses the issue whether a common capital market can bring additional benefits to member countries, in the first place by attracting additional investment from outside the region, and from a viewpoint of an individual member country, also from within the region, i.e. from the other CEFTA countries.

CAPITAL CONTROLS AND LIBERALIZATION OF CAPITAL MOVEMENTS

In theory, liberalized capital flows within an area contribute to an efficient allocation of savings into investment, therefore capital controls are in principle welfare reducing. However, in the presence of a distortion, as a second best solution they can eliminate this distortion and increase welfare (Dooley, 1995). In practice, many market failures and distortions are usually present, and capital controls can hardly be precisely targeted to deal with individual distortions. It is therefore conventionally assumed that countries should aim at liberalizing their capital flows and eliminating their capital controls as soon as circumstances allow it.

From the point of view of one country there are obvious advantages of having an open capital account (liberalized capital movements with the rest of the world). This should lead to a better allocation of capital, where savings are directed to most productive investment. Free capital flows enable free flows of financial services in and out of the country. This exposes domestic financial intermediaries to the foreign competition and forces them into innovations and better efficiency. Consumers profit by having a wider range of financial products at lower prices, and can diversify their portfolios internationally. Liberalization of financial markets brings specialization and economies of scale to the domestic financial sector. Free capital flows support credibility of a country and make its access to international financial markets easier.

On the other hand, there are some risks involved in having an open capital account, so that a country may wish to maintain capital controls. First, capital controls in general give a country more room for leading independent monetary and other macroeconomic policies. More specifically, there are various reasons for capital controls. In the circumstances of scarce domestic savings and urgent needs to accelerate economic growth with more investment, a country may use capital controls to restrain capital outflow, so as to prevent the use of domestic savings to finance foreign investment. This is a typical consideration in developing countries, which are occupied primarily with preventing long-term capital outflows. Another reason for maintaining capital controls can be found in the volatile nature of short-term capital flows. Short-term capital flows can have destabilizing effects on domestic macroeconomic policies, as they can cause large swings in exchange rates or monetary reserves. Large-scale capital flows can cause a balance-of-payments crisis or a financial crisis and can put pressure on the process of economic reform in the case of transition economies. Once capital movements are liberalized, a reintroduction of capital controls may have a harmful effect on the credibility of a country.

Developing countries typically keep capital controls out of fear of capital flight, i.e. movements of short-term capital, sometimes of a speculative nature, out of the country. A recent experience in most Central European transition economies is, however, short-term capital inflow, which is the result of successful macroeconomic stabilization and reform, and is mostly due to the interest rate differential. Part of it represents a reversal of previous capital flight out of the country. There is, however, an inherent danger of reverting these capital flows in the future. Countries in question mostly reacted with other measures of economic policy to these short-term capital inflows (such as sterilization of foreign exchange inflows, increased flexibility in the exchange rate policies, etc.), but occasionally also used capital controls (such as a non-interest bearing deposit on short-term capital inflows in Slovenia, Lavrač and Stanovnik, 1995). The experience of the EMS crises in 1992 and 1993 and the Mexican crises has demonstrated that huge short-term capital flows of a speculative nature can move from a country to a country, particularly in the case of a misaligned exchange rate. Speculators then face a one-way bet which enables large profits with minimum risk. The economies in transition are

probably for the moment not yet seriously exposed to large international speculators (perhaps as these countries are too small and too unpredictable for large institutional investors and as their capital markets are still to some extent closed), but are vulnerable to short-term flows of their own residents or of their neighbours. Large short-term capital outflows or inflows can cause serious problems in a small monetary area with an underdeveloped financial market, which is a typical case in the CEFTA countries.

In the last period, starting in the 1980s, there is a world-wide trend of liberalization of capital markets, with the result that capital markets become more and more integrated and that capital controls are losing their importance. This trend is taking place within an international (IMF, OECD) and regional (EU) framework and is due to some infrastructural changes in the capital markets, such as in communications and information technology, and to some innovations, like derivative instruments, which are growing in importance. One of the consequences of these changes in the world capital markets is that capital controls, even if countries want to maintain them, are becoming less effective. If they have a strong motive, transactors can find ways to avoid capital controls, particularly if current account convertibility exists. In this case, capital flows can be disguised as trade flow, through leads and lags in international trade, over- and underinvoicing in trade, transfer pricing of the multinational companies in their cross-border transactions, etc. Capital controls thus become less effective in isolating domestic financial conditions from those in international financial markets and in providing more independence to domestic macroeconomic policies.

Capital controls can take various forms. The most important form of capital controls are exchange restrictions. They restrict payments with respect to capital transactions and represent capital account inconvertibility. Capital controls can also take other forms, like dual exchange rates, administrative or legal measures such as reporting, permissions, licensing, differential tax treatment and measures, which by taxing or subsidizing capital flows change the costs of capital transactions (see Mathieson and Rojas-Suarez, 1993).

It is useful to distinguish among various forms of capital flows. The OECD Code of Liberalization of Capital Movements groups all capital transactions in five broad categories: (a) direct investment; (b) real estate operations; (c) portfolio investment (including operations in securities on capital markets, operation on money markets, other operations in negotiable instruments and non-securitized claims, operations in collective investment securities; (d) credit operations (including trade credits, financial credits and loans, sureties, guarantees and financial back-up facilities); and (e) other capital operations (operations of deposit accounts, operations in foreign exchange, life assurance, personal capital movements, physical movements of capital assets and disposal of non-resident-owned blocked funds).

Analytically it is useful to distinguish long-term from short-term capital flows. It is usually assumed that long-term capital flows are more welcome, as they are more stable and are often, as in the case of foreign direct investment, related to productive investment. Therefore, they should be less exposed to capital controls. On the other hand, short-term capital flows of the financial nature are more volatile and reversible in nature, which may cause more problems. In sequencing their capital market liberalization measures, countries usually first liberalize capital movements of a long-term productive nature, such as foreign direct investment and some capital transactions, related to normal trade flows, such as trade credits and suppliers credits. Next they go to liberalize portfolio investment, which is in principle considered to be of a long-term nature, but in fact it is not necessarily so, since with developed secondary capital markets and derivative instruments they can actually be quite liquid. In the last stage, short-term capital flows of a financial nature, such as deposits, banknotes, short-term credits and loans and money market instruments are liberalized.

In general, the process of liberalizing capital movements and of integrating capital markets has been relatively slow. In the 1960s and in the 1970s, most of the industrial countries and a large majority of developing countries maintained capital controls and capital markets were fragmented. Industrial countries liberalized their capital accounts only in the 1980s, in the context of international (IMF, OECD) or regional (EU) initiatives. From the early 1980s, capital account convertibility exists in industrial countries and cross-border capital transactions are practically not exposed to capital controls. In the following, the paper reviews these international and regional initiatives particularly in as much as they have an impact on the timing and sequencing of the process of capital liberalization in the CEFTA countries.

IMF AND CAPITAL ACCOUNT CONVERTIBILITY

Official currency convertibility according to the IMF rules is embodied in its Article VIII. A currency is considered as officially convertible if a country in question has accepted Article VIII obligations. IMF concept of convertibility is limited to current account convertibility. A country must refrain from any exchange restrictions with respect to current transactions. As a transitional regime, countries which cannot submit to Article VIII standards can temporarily (with indefinite duration) remain on Article XIV status, which allows the use of existing current account restrictions, but not the introduction of new ones. There was a general trend in the transition countries to move to official convertibility in the last years. As for the CEFTA countries, Poland accepted article VIII obligations in June 1995, Slovenia in September 1995, the Czech Republic and Slovakia in October 1995 and Hungary in January 1996. The introduction of official current account convertibility was a precondition for entering the OECD for the three CEFTA countries which joined the OECD (Czech Republic, Hungary and Poland).

On the other hand, IMF has no competence over capital account convertibility. The concept of full convertibility, which would include current as well as capital account convertibility, is not a formal, but only a practical or analytical concept. IMF rules allow capital controls in the form of exchange restrictions in capital transactions. However, IMF supports any unilateral moves towards capital account convertibility and has welcomed the progress in capital account convertibility in industrial countries, which occurred in the framework of OECD and EU efforts at capital liberalization.

Developing countries are treated somewhat differently. Some of these countries have to some extent liberalized their capital transactions, so that one can speak of *de facto* capital account convertibility, while others made less progress and maintain extensive capital controls in their capital accounts. IMF supports their further liberalization of the capital accounts, but warns against premature capital account opening, and rather suggests a phased approach, with first meeting the necessary preconditions for capital account convertibility. These preconditions include stable macroeconomic policies (fiscal, financial, exchange rate policies) and sufficient development of domestic financial markets (for preconditions of capital account convertibility, see Fischer and Reisen, 1992). Recent developments in the process of liberalization of capital markets and of integrating capital markets world-wide have brought new dimensions to the issue of capital account convertibility for the IMF. The question is whether IMF should stick to its concept of official currency convertibility limited to current account convertibility, or should it adjust to the changed circumstances by including capital convertibility in its Article VIII, i.e. adopt full currency convertibility as its concept of official currency convertibility (Quirk and Evans, 1995).

CEFTA countries as a group have made major steps towards meeting the conditions for a full capital account convertibility, but, at this stage, these conditions have not been fulfilled wholly in every respect. It could be concluded that instant full liberalization of capital movements would be premature and that a phased approach — further successive deregulation along with additional progress on macroeconomic stability and financial sector development — would be appropriate (Backe, 1996). In practice, as of today, capital flows of the CEFTA countries are, as we will see in the following, rather liberalized, so these countries have a certain degree of *de facto* capital account convertibility.

OECD AND LIBERALIZATION OF CAPITAL MOVEMENTS

Three of the CEFTA countries are already members of the OECD, while the other two are waiting for their membership, which may take some time. The Czech Republic joined the OECD in December 1995, as did Hungary, and Poland joined it in July 1996. OECD adopted as early as in 1961 the Code of Liberalization of Capital Movements and it amended it several times to include additional liberalization measures. According to these Codes OECD member countries and any candidates for the future OECD membership must adhere to the principle of liberalized capital movements and have to liberalize their capital regulations substantially.

A member country should in general aim at full freedom of capital movements, but concrete obligations are determined case by case, according to the circumstances of the country. Transitional regimes are available for countries whose economic and financial situation does not allow full capital liberalization, as it could lead to serious balance-of-payments or financial disturbances. A country can place reservations on those capital transactions which cannot for the moment be fully liberalized. Although reservations do not have a time limit, the tendency should be to move to less reservations, according to an agreed timetable. Once withdrawn, reservations cannot be reintroduced. On the other hand, there are safeguard clauses in case of serious balance-of-payments or financial disturbances, which allow a country to have derogations on the accepted liberalization measure, but they have to be approved by the OECD and are limited to six months. OECD encourages successive lifting of reservations and prefers that member countries use temporary derogations.

Foreign exchange regulation of the three CEFTA members of the OECD and the reservations they have placed with respect to the OECD Code of Liberalization of Capital Movements show the following picture (this section follows Backe, 1996):

I. Capital inflows:

(a) direct investment: restrictions are minor, relating only to few sectors;

(b) real estate: operations by non-residents are usually restricted, except for operations related to inward direct investment;

(c) portfolio investment: restrictions are minor or non-existent as regards the purchase of foreign shares, other securities of a participating nature, domestic debt instruments and collective investment securities by residents, while the admission of domestic securities on foreign capital markets has been liberalized only partially. Transactions with respect to other types of portfolio investment (money-market securities, negotiable instruments and non-securitized claims) continue to require permission in most cases;

(d) credit operations, trade and suppliers credits extended by non-residents to residents are liberalized. The same is true of medium-and long-term financial credits and loans as well as of financial back-up facilities, sureties and guarantees;

(e) other capital operations have largely been liberalized. There are some restrictions on the operation of deposit accounts by non-residents.

II. Capital outflows:

(a) direct investment: there are no restrictions on outward direct investment;

(b) real estate operations: vary from being restricted in Hungary, to partial liberalization in Poland and to full liberalization in the Czech Republic;

(c) portfolio investment: some differences regarding outward portfolio investment exist, especially with respect to the right of residents to acquire securities abroad. In the Czech Republic, residents can buy quoted and unquoted foreign securities (equities and debt securities, including money market securities) through authorized resident banks. In Hungary, such transactions are restricted, except for government papers, issued by OECD countries and for equities with the highest rating. In Poland, resident companies (but not natural persons) are allowed to freely invest in bonds and treasury bills with original maturity of at least one year; a full liberalization of outward portfolio investment with respect to capital market securities is expected to take place by the end of 1996. Both in Poland and Hungary outward investment in money market securities is restricted, and in all three countries the same is true for other negotiable instruments and non-securitized claims. The admission of foreign securities and other instruments to the domestic capital markets requires approval in the Czech Republic and in Hungary, while in Poland it has been liberalized up to a certain amount;

(d) credit operations, trade and suppliers credits are liberalized. Outward financial credits, sureties and guarantees as well as financial back-up facilities remain largely restricted;

(e) other outward capital transactions have largely been liberalized. The main remaining restrictions are the repatriation requirement for foreign exchange acquired abroad by residents, the operation by residents of accounts with foreign banks and the sale and purchase by residents of domestic currency abroad.

When comparing the capital movements regulations in the three CEFTA members of the OECD, it turns out that the main features of their present exchange systems are quite similar. Nevertheless, in details several differences can be observed. If we compare this with the situation in Slovakia and Slovenia, it can be concluded that in Slovakia, the liberalization of capital movements is still in a fairly early stage, with direct investment remaining the only seriously deregulated area, while in Slovenia, the capital account has been partially open on the inflow side from the beginning of monetary sovereignty in 1991 and there has not been any major formal deregulation recently, except for some incremental liberalization steps (Backe, 1996). Another source (Borish, Ding and Noel, 1996) claims that in Central Europe, relatively free capital movements are found in Slovenia, while there has been gradual liberalization in the other CEFTA countries.

EU AND CAPITAL MARKET INTEGRATION

Membership in the EU implies obligations for member countries to liberalize capital movements within the EU, and further with EFTA countries within the EEA and to a large extent even towards the rest of the world. For CEFTA countries as the first candidates for the future membership in the EU in the first wave of its Eastern enlargement, the obligations with regard to liberalization of capital movements are defined in their Association Agreements.

At first, liberalization of capital flows was not in the centre of attention in the process of European economic integration. Later on, capital movements were successively liberalized, as much as it was needed for the proper functioning of the common market. Two directives on liberalization of capital movements were adopted in the 1960s, but progress remained modest and many barriers hindered free movement of capital across borders. A major breakthrough was the Directive of 1998, which liberalized all remaining capital controls. It required the elimination of all capital controls by the year 1990. Some member countries (Spain, Ireland, Portugal, Greece) were given a transitional period till 1992 (1995 is the case of Greece) to comply with the Directive. At present, capital flows within the EU are in fact liberalized, capital controls do not exist, so that we can speak of a single EU capital market. The requirements of the 1998 Directive were included in the Maastricht Treaty on the EU. Needless to say, liberalization of capital flows in the EU was considered as a major step in the three-stages approach to creating the EMU and as a precondition for the future introduction of a single currency.

Association Agreements (AAs) of CEFTA countries define transitional periods in which they should liberalize their capital flows. The transitional period is typically 10 years, divided in two sub-periods of five years (in case of Slovenia, which signed its AA in 1996, much later than the others, the transitional period of six years is divided in two sub-periods of four and two years). AAs of the CEFTA countries became effective in 1994 (Poland and Hungary) and 1995 (Czech Republic and Slovakia) or are expected to become effective in 1997 (Slovenia). AAs require immediate liberalization of foreign direct investment (including repatriation of profits and capital) and of capital flows related to normal trade transactions at the time when AAs become effective. Associated countries commit themselves to refrain from introducing any new restrictions on capital movements. In case of emergencies such as balance-of-payments crises, safeguard clauses allow temporary measures of six months duration. Associated countries assume the obligation to further liberalize capital movements. In the second phase of the transitional period, they should adopt the complete EU regulation of capital transactions and take measures for the full application of the EU rules on capital movements (for more details, see Kalman and Rudka, 1995, and individual AAs of the CEFTA countries).

The White Paper on the preparation of associated countries of Central and Eastern Europe for integration into the internal market of the EU of 1995 includes measures of liberalization of capital flows as a way of preparing these countries for the competition on the internal EU market. It defines stage I measures, which are considered essential for the proper functioning of the internal market. These measures mostly relate to long and medium-term capital transactions. CEFTA countries with their present level of capital liberalization are close to meeting these standards. Stage II measures, which relate to short-term capital flows, are more demanding and will require more time for adjustment.

CREATING A COMMON CEFTA CAPITAL MARKET: SOME OPEN ISSUES

A common capital market is created in a process of liberalization of capital movements when all capital controls and other barriers (administrative, fiscal, infrastructural) to free capital flows among countries of a region are eliminated. As CEFTA countries have in the process of stabilization and reform of their economies, as well as in the process of their inclusion in international organizations (IMF, OECD) and in preparations for future regional integration (EU) already to a considerable extent liberalized their capital flows, one could say that some elements of a common capital market between them already exist. A true common capital market of CEFTA countries, however, would exist if capital could move completely freely among these countries, but, on the other hand, there were capital controls in capital movements with other countries or regions. In this case capital flows in and out of the CEFTA region would be discriminated against intra-regional CEFTA capital flows. Of course, the more the capital movements in the CEFTA countries have already been liberalized, the less there is room for such a regional discrimination.

The present CEFTA member countries will most probably soon become EU members. At least some, if not all of them, will be included in the first wave of Eastern enlargement of the EU. This gives a certain time dimension to the possibilities for creating a common CEFTA capital market. If they decided to create the common capital market, they should speed up the process, since not much time is available. If present CEFTA members, because of their future accession in the EU, leave CEFTA and some new-coming countries substitute them, it can be expected that these newcomers would be much less homogeneous than the present members in terms of economic development, stage of their reforms in the transition process and level of liberalization of capital flows. It would probably be more difficult and certainly less meaningful to create a common capital market within such a regional grouping.

Some of the present CEFTA member countries are already in the OECD and must comply with its regulations on capital movements, while others are still waiting for OECD membership. All of them are associated members of the EU and are preparing for future EU membership. However, the timing of signing their AAs, their coming into effect, and transitional periods included in the AAs differ among individual CEFTA countries. Although there are considerable similarities in the level of liberalization of capital movements of these countries in relations with the EU, there are still some important differences in the level of openness of their capital flows to the EU.

If CEFTA countries created a common capital market and liberalized capital movements among themselves completely, but at the same time there were differing levels of capital controls in relation to the EU among them, this could cause some undesired consequences. Those more protected would be, through a common CEFTA capital market, more exposed to free capital flows with the EU than they intended. Let us assume that a CEFTA country A restricts short-term capital movements with the EU (but not against other CEFTA countries, since there is a common capital market among them), and that a CEFTA country B has liberalized short-term capital flows with the EU. Country A can now, through capital liberalization of the CEFTA common capital market, import undesired short-term capital flows from the EU. The side effect of CEFTA liberalization of capital transactions could in that case be the situation in which all CEFTA countries would be exposed to the level of capital liberalization of an individual CEFTA member country with the highest level of liberalization. In fact, a higher level of protection against undesired capital movements could become redundant and for the CEFTA countries it would make sense to harmonize their liberalization of capital movements towards the EU.

This looks very similar to the trade problems of the free-trade areas in general, which are due to the fact that this lower form of economic integration does not require a common external trade policy. In the trade area this problem can be dealt with by using the rules of origin. In the case of capital flows it would be hard to imagine the concept of some kind of rules of origin. Because of the intangible nature of capital transactions it would look rather strange and most probably could not be applied in practice.

With all these limitations in mind, a common capital market of the CEFTA countries could still be created. The complete opening of the capital account transactions among these countries would be a good preparation for the their future EU accession and for their future liberalization of capital movements with the EU, where they can expect more risks from their capital account opening. Generally, it is considered that mutual cooperation of the CEFTA countries is not harmful to their inclusion in the EU (Rudka and Mizsei, 1995), which in the long term remains their main strategic goal. A common capital market can be seen as a larger and more attractive open market by foreign investors, as discussed in the second part of this paper.

Creation of the common CEFTA market would be easier and more meaningful if domestic capital markets of the individual CEFTA member countries were more evenly developed. Development of domestic capital markets is related to macroeconomic stability and to the process of privatization in these countries. Without going into details, Table I gives some insight into the current differences in the level of development of equity and bond markets of the individual CEFTA member countries. (This section follows Borish, Wei and Michel, 1996).

TABLE I. Equity and Debt Markets, End 1995 (mn US$)

	Czech	Slovak	Hungary	Poland	Slovenia
Equities Market					
Market Capitalization	17,992	5,329	2,850	4,564	306
Mkt. Cap./GDP (%)	40.3	30.6	7.1	3.9	1.7
Trading Volume	4,713	840	764	4,861	341
Number of Listed Shares	86	21	42	65	18
Bond Market					
Market Capitalization	3,302	1,135	6,091	5,235	338
Bond Mkt. Cap./GDP (%)	7.4	6.5	15.1	4.4	1.9
Turnover	2,617	521	1,276	1,654	176
Number of Listed Bonds	23	32	38	13	16

Source: Borish, Ding and Noel, 1996

Equity and bond markets in all five CEFTA countries are in their early stages of development. This is true from the standpoint of depth of markets, presence of institutional investors (insurance companies, pension funds, mutual funds), infrastructure and regulation (on regulation of domestic CEFTA capital markets see Pohl, Jedrzejczak and Anderson, 1995). CEFTA countries have made progress in developing their capital markets, although their markets remain small in terms of capitalization, turnover and range of products. There are considerable differences in the development of the capital markets in the individual CEFTA countries. In Slovenia, Hungary and Poland, stock markets are low in capitalization by world standards, while capitalization in the Czech Republic and in Slovakia approaches EU norms. Institutional investors have been slow to emerge in Hungary, Poland and Slovenia, or are relatively small (Czech Republic, Slovakia). Bond markets are underdeveloped in the Czech Republic, Slovakia and Slovenia or dominated by government to finance high levels of debt and fiscal deficits (Hungary and Poland).

A common capital market of the CEFTA countries would be easier to create and more meaningful if monetary, fiscal and exchange rate policies of these countries were more coordinated. At the moment, monetary, fiscal and exchange rate policies of these countries are quite different and there are no ambitions to coordinate them. Uncoordinated exchange rate policies can cause problems not only to their trade, but also to their capital flows if they liberalized the capital movements within the region. As they have an ambition to become EU members as soon as possible, they are in the longer term also preparing for monetary integration within the EU (but not among the CEFTA members). In this respect, they are for the moment far from coordinated. Some have a floating, others a fixed or a crawling peg exchange rate regime. Some fulfil the fiscal Maastricht convergence criteria with a substantial margin, while other hardly meet them or do not meet them at all. Some succeeded in bringing the inflation rate to a single digit figure, others have it at the level of above 20% yearly.

Last but not least, the issue of common institutions on a common CEFTA capital market should be dealt with. In capital markets integration some common institutions

are in fact not needed or foreseen. What is important is the freedom of capital flows across the borders within the region. A possible common institution could be a kind of a regional development bank, but according to its modest capital it would probably play a minor role on the common capital market. Some kind of supranational monetary institution like the IMF or the future European Central Bank would not be acceptable, since these countries for the moment insist on their monetary sovereignty. The integration of domestic equity markets into an institutionalized common stock market would be too ambitious, since even in the EU, national stock markets are not institutionally integrated. While more coordination on capital market regulations in individual CEFTA countries might be welcome, a supranational regulative institution would not be welcome, since individual domestic capital markets of these countries are at different levels of development and therefore face different problems. To conclude, we do not see much future for any common institutions on a common CEFTA capital market. Probably the most important common institutions on a common CEFTA capital market will be those which will emerge spontaneously on the market — transnational CEFTA banks.

PART II: CEFTA INTEGRATION PROCESS AND FOREIGN DIRECT INVESTMENT (FDI)

The impact of regional economic integration on FDI has attracted quite some attention in the literature (for instance, Dunning 1993; Cantwell, 1992) but nothing at all has been said explicitly about CEFTA integration process as a potential attraction for foreign investors. The obvious starting point in analyzing the issue of FDI and CEFTA integration process is that the predominant part of FDI in CEFTA countries comes, and will come in the foreseeable future, from the European Union (EU) with which all the CEFTA countries have the so-called European Agreements (EAs). CEFTA countries are, thus, associated members of another, much deeper integrated and economically much more powerful economic integration which is also the major source of FDI in CEFTA countries. Therefore, the major question relating to the impact of CEFTA integration process on FDI seems to be whether this process offers new/additional opportunities to potential strategic investors from the EU which will stimulate them to locate more FDI in CEFTA countries. In other words, does CEFTA integration process offer something to EU investors that is not yet offered to them by individual CEFTA countries and by the EAs? The reference points in our attempt to tackle the above issue will be (a) salient features of exiting FDI in CEFTA countries; and (b) application of other regional economic integrations' experiences with FDI to specific circumstances in CEFTA countries.

FEATURES OF FDI IN CEFTA COUNTRIES

At the beginning of the transition process the total amount of FDI in the then socialist countries was by and large negligible[1], but the expectations of Central and Eastern European (CEE) countries about the inflows of FDI and about the possible role of FDI in

[1] Average annual inflow in all socialist countries in1983-87 was only $20 million (see Table 1).

their transformation process were rather high, one could say unrealistically high. Tables 1, 2 and 3 show that although FDI inflows in CEE countries in the 1990s recorded a sharp increase they remained to represent a marginal share of world-wide FDI flows and that FDI were heavily concentrated on CEFTA countries, Hungary, Poland and Czech the Republic in particular[2]. The reasons for the domination of CEFTA countries

TABLE 1. FDI inflows in CEE countries

	Value (in $ bn)	Share in world total (in %)
1983-87	0.02	0.02
1988-92	1.36	0.77
1990	0.30	0.15
1991	2.45	1.55
1992	3.77	2.24
1993	5.59	2.70
1994	5.89	2.60
1995	12.08	3.80

Source: UNCTAD, World Investment Report 1996

TABLE 2. End-1995 FDI stock in CEE countries

	Value (in $ mn)	Share (in %)
Czech Republic	5,008	14.9
Hungary	9,934	29.6
Poland	7,389	22.0
Slovakia	1,140	3.4
Slovenia	438	1.3
CEFTA Total	23,909	71.2
Other CEE countries	9,656	28.8
TOTAL	33,565	100.0

Source: UNCTAD, World Investment Report 1996

TABLE 3. Importance of FDI for CEFTA countries

	FDI inflows per capita in $, 1995	FDI inflows as % of GFCF [1], 1994	FDI stock as % of GDP, 1994
Czech Republic	242.8	9.1	7.0
Hungary	346.0	13.9	15.6
Poland	65.4	13.5	5.1
Slovakia	46.7	-	7.2
Slovenia	66.8	-	2.4

Source: UNCTAD, World Investment Report 1996

[1] GFCF = gross fixed capital formation.

[2] In absolute terms (amount of FDI) the only other major recipient country is Russia (huge market and natural resources). In relative terms (FDI per capita and as a share of gross fixed capital formation and GDP) Estonia and Latvia also received relevant amounts of FDI.

as major recipients of FDI among CEE countries lie in their (a) advanced stage of market reforms, and consequent relatively superior economic, legal and political stability; (b) proximity to the major investing countries (especially Germany and Austria); (c) relatively higher stage of development; and, in the case of Hungary, also the privatization concept which did not give any serious preferential treatment to the residents (Rojec and Jermakowicz, 1995). Obviously, CEFTA countries have been the major FDI recipient countries among CEE countries until now and there is no major reason to believe that this will change in the future.

As far as the major investing countries in the CEFTA region are concerned, Table 4 is very persuasive in showing that investors from EU countries are by far the predominant. With the exception of Slovakia, investors from other CEFTA countries are of rather low importance for individual CEFTA countries. The importance of Czech investors in Slovakia is inherited from the time of Czechoslovakia and, thus, does not adequately reflect the actual situation[3]. Also, when companies from CEFTA countries invest abroad, their major destination seems to be EU and not other CEFTA countries[4]. It is rather safe to predict that in a foreseeable future EU countries will remain the major source of inward FDI in CEFTA countries. As far as outward FDI of CEFTA companies is concerned one can expect increase in both directions, EU and other CEFTA countries. Since EU is the major market for CEFTA companies they will have to increasingly establish their direct presence there, mostly in the form of trade and service affiliates. On the other hand, not many of CEFTA companies possess ownership specific advantages which would be good enough to establish manufacturing affiliates in the EU, but there is more room to do that in other CEFTA countries. All in all, EU will continue to be the dominant source of inward and destination of outward FDI of CEFTA countries.

INTEGRATION PROCESS AND FDI: EXPERIENCES OF SOME REGIONAL ECONOMIC INTEGRATIONS

According to Dunning (1993, pp. 474-504), in discussing the likely impact of regional integration on FDI activity into and out of the integrated area one should distinguish between primary or initial effects and secondary or consequential effects. The primary effects are that because of the integration: (a) *ceteris paribus*, intra-regional trade becomes more attractive than extra-regional trade, which stimu-

[3] With the dissolution of Czechoslovakia once internal Czechoslovak joint ventures became international Czecho-Slovak joint ventures. We do not dispose of a detailed country breakdown for investors in the Czech Republic, but one can guess that there are also some inherited Slovak investments in the Czech Republic.

[4] The only real exception to this is that, in the 1991-93 period, Hungarian companies invested as much as half of their total outward FDI to the Commonwealth of Independent states (UNCTAD, 1995, p. 10). As already mentioned, high share of CEFTA in the case of Czech outward FDI is the consequence of their inherited investments in Slovakia. Similar is the case of Slovenia, where 37.3% of end-1995 outward FDI stock is in the other countries of former Yugoslavia (see Table 4 for details).

TABLE 4. **Share of EU and CEFTA in total inward and outward FDI of individual CEFTA countries on January 1, 1995 (in %)**

	Inward FDI from		Outward FDI to	
	EU	CEFTA	EU	CEFTA
Czech Republic	more than 63.9	less than 10.5	29.4	39.8[1]
Hungary[2]	73.6	less than 2.9	more than 16.0	5.0[3]
Poland	63.0	0.3	58.1	0.4
Slovakia	65.3	15.7[4]	n.a.	n.a.
Slovenia[5]	70.0	0.03	36.1	0.8

Source: UNECE, Statistical Survey of Recent Trends in Foreign Investment in East European Countries, 1995a; UNCTAD, Foreign Direct Investment in Central and Eastern Europe, 1995; Bank of Slovenia.
[1] 39% in Slovakia.
[2] Data for Hungary relate to flows in the 1991-93 period.
[3] 50% of Hungarian outward FDI in the period of 1991-93 went to the Commonwealth of Independent States.
[4] 15.2% from the Czech Republic.
[5] Data for Slovenia are for the end of 1995.
[6] 37.3% of Slovenian outward FDI is in the other countries of former Yugoslavia.
n.a. = not available

lates multinational enterprises (MNEs) from outside the integrated area to replace exports with FDI (defensive export-substituting investment), i.e. with sales of regionally based affiliates; (b) and a new configuration of locational advantages among member countries of a regional integration appears which urges MNEs to adjust existing investments in the region to reflect free intra-regional trade (reorganization investment). If in the first case FDI inflows in the region will increase, in the second case, for the region as a whole, FDI gains in some countries will be offset by FDI losses in others. "However, it is the secondary effects of integration which, in the long run, are likely to be of the greatest importance for the international allocation of economic activity. These arise both from the restructuring of such activity between countries, sectors and firms within the integrated area, and from the new opportunities for firms to increase their technical and scale efficiencies by reducing production and transaction costs" (Dunning, 1993, p. 482). The secondary effects will lead to increased FDI in regionally based affiliates and to increased sourcing by MNEs in the region. The application of this general framework suggests that the relevant questions of CEFTA's integration process impact on FDI relate to: (a) the general level of MNE activity in the region, (b) replacing exports by FDI as an alternative mode of market servicing; (c) geographical distribution of FDI within CEFTA; and (d) to the restructuring effects of FDI in view of the changes in the regional division of labour within MNE affiliates.

FDI effects of economic integration vary between countries, industries and firms and depend on the way in the which such integration affects the relationship between these units and those outside the integrated area (Dunning, 1993, p. 482). For CEFTA, where the bulk of FDI comes from outside the region, the effects on this relationship are of even much higher importance. Therefore, in analyzing other integrations' experiences with FDI it is convenient to distinguish among economic integrations by

two characteristics. The first is different degree of integration, which ranges from rather informal cooperation to a monetary and fiscal or even political union, while the second relates to the kind of countries which are members of the integration. Here one can distinguish among integrations of developed countries (EU, for example), integrations of developed and developing countries (NAFTA, for example) and integrations of developing (or transition) countries (ASEAN, CARICOM, PTA, MERCOSUR, etc.). Broadly speaking, CEFTA could be classified into the third type of "developing countries" integration but all the CEFTA countries are also associated members of the EU which is similar to "hub and spoke" type of integration like NAFTA[5].

EU is probably the most widely studied case of integration effects on FDI. Integration processes in the EU have represented an important incentive for intra- and extra-EU FDI flows, and also resulted in certain specific structural characteristics of FDI in the EU countries. Tables 5 and 6, displaying data on FDI in and out of the EU in the period after 1980, show a radical increase of FDI flows between 1985 and 1992, a period which was marked by the adjustments of MNEs to the requirements of the EU internal market, which started in January 1993. Announcement of the internal market in 1985 urged investors from outside but especially those from inside the EU (at that time EC) to radically intensify their investment activity in the EC region. The share of intra-EU inward and outward FDI considerably increased (see Table 6) and there were in the first place EU MNEs which have tried to accommodate and take advantage of the forthcoming deepening of integration. Intensive merger and acquisition activity was the major vehicle of MNEs to anticipate the internal market situation. Another illustration of positive economic integration effects on FDI in the EU case is the increase of FDI inflows in countries which subsequently joined the EU in the immediate post-accession period. Thus, the joining of Portugal and Spain in 1986 represented a turning point in the inward FDI in these two countries (see Table 7).

The major impetus given to FDI in the EU by the internal market scheme points to the crucial relevance of different stages of integration for FDI flows: the deeper the integration the more important are the effects on the amount of FDI flows and even more so on the character and various structural characteristics of MNE activity. FDI in the EU was long primarily geared to producing goods for the domestic markets of the host countries in place of exports from the investing countries. Because of border and other non-tariff barriers to intra-EU trade, there were few cross-border transactions either between the EU-affiliates of MNEs or between these and their parent companies. The creation of the internal market in 1993, which eroded intra-EU barriers, was the crucial turning point for FDI. By lowering the costs of exporting within the EU or from the home country of a non-EU MNE, the internal market reduced the incentive for intra-EU MNE activity, but at the same time, by reducing transfer costs between EU countries, it allowed MNEs to coordinate their EU production facilities better and to serve a much wider market (Dunning 1993, pp. 483-484). This directly led to intensified intra-

[5] Taking into account that most of CEFTA countries' foreign trade and FDI flows is with countries outside the integration area, i.e. with the EU.

TABLE 5. FDI flows to and from the EU as percentage of world flows in 1980-95 (in %)

	Inward FDI	Outward FDI
1980-84	30	46
1985-89	33	47
1990-92	48	53
1993-95	34	42

Source: Yannopoulos, Multinational Corporations and the Single European Market, 1992, p. 339; UNCTAD, World Investment Re 1996, p. 227, 233.

TABLE 6. Share of EU in total inward and outward FDI flows of EU countries in 1982-91 (in %)

	Inward FDI flows			Outward FDI flows		
	1982-84	1985-87	1988-91	1982-84	1985-87	1988-91
Belgium-Luxembourg	61.0	65.9	77.1	107.1	61.2	78.2
Denmark	6.9	-21.1	39.2	29.3	48.4	64.3
France	50.3	48.4	62.8	35.2	41.9	61.9
Germany	40.9	62.3	62.6	35.2	32.0	59.9
Greece	n.a.	50.0[1]	n.a.	n.a.	n.a.	n.a.
Ireland	n.a	n.a.	n.a.	n.a.	n.a.	n.a.
Italy	36.9	455.0	49.1	38.5	60.4	57.9
Netherlands	41.3	48.8	58.8	60.0	43.0	53.2
Portugal	47.5	66.4	72.4	54.5	-161.5	83.4
Spain	39.1	47.8	62.7	21.3	49.5	57.2
U K	-49.8	39.7	38.0	-4.2	17.1	32.1

Source: OECD, International Direct Investment Statistics Yearbook 1993.
[1] 1987 data only.
n.a. = not available.

TABLE 7. Increase of FDI flows in Portugal and Spain after their accession to the EU in 1986; in million US$

	Portugal	Spain
1981	175	1,711
1982	146	1,787
1983	141	1,628
1984	196	1,773
1985	253	1,950
1986	239	3,451
1987	466	4,571
1988	922	7,021
1989	1,737	8,424
1990	2,610	13,841
1991	2,448	10,502
1992	1,837	8,058

Source: UNCTAD, World Investment Report 1993.

EC investment (cross investments between MNEs from different EU countries in the same industry), and in the relocation and reorganization of EU operations of MNEs, being already established in the EU (increased degree of geographical specialization across affiliates and changing inter-firm relationships). The following EU internal market effects for FDI, put forward by Cantwell (1992), seem especially relevant:

- With a difference from earlier stages of EU integration when MNEs competed by serving one another's domestic markets either by FDI or trade, in the internal market era regional corporate networks and alliances of MNEs from a range of national origins serve a common EU market. This process creates new patterns of specialization among EU trading partners and helps to increase the overall level of EU trade. In the EU, FDI is now more a complement to than a substitute for trade.
- Within most MNEs integration is increasingly intra-regional (intra-EU) at the expense of inter-regional integration. Corporate networks have normally been constituted at a regional level, integrating affiliates located in the EU. Consequently, MNE trade and specialization is developing fastest within the EU. Since similar processes are underway in the other two members of the Triad (US and Japan) as well, the international integration of affiliate networks has essentially involved a process of regionalization and has entailed the development of regional strategies.
- The geographical structure of regional MNE networks in the EU reflects and reinforces patterns of locational hierarchy across countries[6].

NAFTA (North American Free Trade Agreement) represents a case of economic integration which differs from EU in two basic aspects. Firstly, NAFTA is not an internal market but only a free-trade area and, secondly, it is a kind of "hub and spoke" agreement with the US as the hub and Canada and Mexico as the two spokes. In a certain sense one can make a parallel with EAs of CEE countries (spokes) with the EU (hub). NAFTA is a kind of extension of the Canada-US Free Trade Agreement signed in the beginning of 1989. The Agreement liberalizes MNE activity in a number of ways. According to Dunning (1993, pp. 495-496), the Agreement has a positive effect on FDI flows: "Many US MNEs are already treating North America as an integrated market and are rationalizing their operations accordingly. Non-US MNEs are also likely to increase their FDI in Canada now that they are assured duty-free access to the US market. In the case of Canadian FDI in the US, it is expected that the Agreement will slow down its rate of growth, because the major motive of Canadian MNEs to invest in US

[6] Dunning (1993, pp. 484-486) says that there is some evidence of certain concentration of FDI in the high technology sectors in the larger and/or more technologically advanced economies (UK, Germany, Italy and France), while investment in other sectors is more widely dispersed. According to him, economic integration, by offering wider locational choice to companies to produce within the integrated region, promotes both centripetal and centrifugal effects. In sectors where there are important economies of the clustering of related and supporting industries, it encourages centres of excellence. However, economic development and reductions in intra-firm communication and transport costs may sometimes help create new clusters of activity.

has been market access in the face of rising US protectionism. The Agreement reduces the rationale of such FDI."

Foreign affiliates in Mexico had begun a fundamental restructuring process before the creation of NAFTA. The process was accompanied by substantially increased FDI flows from the US and Canada to Mexico[7]. This increase involved not only existing affiliates but also new entrants. At the same time, Mexican FDI stocks in the US almost doubled in 1994[8]. The result has been a more intense production integration of Mexico with the US and a reorganization of US MNEs' corporate networks through which foreign affiliates in Mexico have become fully integrated into a regional production structure. The deepening integration of the Mexican and North American economies has had a distinctively manufacturing flavour, with foreign manufacturing affiliates shifting from a stand alone, domestic market orientation towards a regionally integrated production system. This investment led integration provided a major impetus for the NAFTA negotiations which, in turn, reinforced the regional production integration already taking place (UNCTAD, 1995, 76-80). Therefore, although NAFTA would be unlikely to have the same consequences for intra-regional FDI as EU's internal market (non-elimination of non-tariff barriers, differences in size, economic structure, income levels, etc.), it is likely that NAFTA will bring about a substantial restructuring and reorganization of MNE activity, both within the newly integrated region and between it and other countries. NAFTA may also be expected to lead to greater inflow of non-American FDI in the region to supply the US market, and greater Mexican investment in the US (Dunning, 1993, p. 497).

Integration among developing countries has so far been less FDI accelerating and has not succeeded in attracting a serious attention of MNEs. Dunning, who analyzed MNE activities in five regional integration schemes of developing countries — Andean Common Market, ASEAN, CARICOM, PTA and Maghreb — suggests that one of the reasons might be relatively smaller size of markets in developing countries which has reduced the gains of integration for MNEs. Economic effects of these integrations have been generally short-lived and limited in scope; as a result, they have not led to the creation of large unified markets and consequent marked expansion of intra-regional trade, neither have they had a significant influence on inward FDI. Foreign MNEs continue to view these integrations as collections of small, unrelated markets. There is no real evidence to link the observed trends in FDI into these regions with economic integration. Other economic and socio-political factors not directly related to integration were much more important (Dunning, 1993, pp. 497-500).

TABLE 8. FDI inflows into integration groupings of developing countries as percentage of total regional inflows of FDI (in %)

	1965-70	1971-75	1976-80	1981-85	1986-88
Andean in Latin America	8.4	6.4	1.8	13.8	6.4
ASEAN in Asia	69.0	72.9	61.6	56.0	29.8
Maghreb in Africa	35.9	8.5	34.6	11.6	3.9
CARICOM in Latin America	22.7	8.3	4.7	3.9	1.6
PTA in Africa	–	–	21.6	9.6	9.5

Source: Dunning, Multinational Enterprises and the Global Economy, 1993, p. 499.

[7] Between 1989 and 1994, US FDI stocks in Mexico increased by 125%, while Canadian FDI flows increased fivefold over the same period.

[8] From $1.2 billion at end 1993 to $2.2 billion at end 1994.

POTENTIAL IMPACT OF CEFTA INTEGRATION PROCESS ON FDI: MESSAGES FROM OTHER REGIONAL ECONOMIC INTEGRATIONS

Experiences of various types of economic integration suggest two preconditions for a positive impact of integration process on FDI flows. The first is the viability and general scope of an integration scheme as such, and the second is the major role of intra-integration FDI. CEFTA is yet to prove its viability (especially vs. the EU) and to define its character (broadening or deepening the integration), while the existing and (foreseeable) future FDI flows in CEFTA will only to a less important degree be of a intra-CEFTA character. All these certainly limit the positive potential impact of CEFTA integration process on FDI. In this framework, however, much depends on the strategic advantages which MNEs perceive may follow from CEFTA[9]. Here a number of specific and differentiated effects of the integration process for FDI appear:

The first is a differentiated effect of economic integration on market-seeking and factor cost advantages-seeking FDI[10]. For market-seeking FDI, it is important that any economic integration, and CEFTA is no exception, increases the attractiveness of intra-regional vs. extra-regional trade. On one hand this encourages MNEs from outside the integration to swap exports by FDI and consequent sales of local affiliates. On the other hand, however, liberalization of intra-regional trade also encourages MNEs, which are already established in the region and may have a number of affiliates in more countries, to concentrate their activities to exploit economies of scale. All in all, for market-seeking FDI CEFTA integration process represents a stimulus for FDI inflows and puts smaller CEFTA countries on more equal footing with the larger ones. In this regard broadening of CEFTA would have a more important impact than its deepening.

For factor cost advantages-seeking FDI it holds that where trade is freer, MNEs have more scope to organize an international division of labour, that is regionally integrated corporate networks (see Cantwell, 1992, p. 3). In other words, an integration process increases scope for factor cost advantages-seeking FDI according to national comparative advantages of individual countries, because the more integration, the lower transaction costs, which increases FDI. For factor cost advantages-seeking FDI deepen-

[9] For instance, whether MNEs perceive that the benefits arising from liberalized markets will exceed the costs of a reduction in a favoured position, which such companies enjoy by selling in protected markets (see Dunning, 1993). There have been cases (the best known in car manufacturing) when after entering a certain CEE market, western MNE put pressure on the host government to protect it from import competition.

[10] In market-seeking FDI foreign investors are motivated primarily by a host country market, while in factor cost advantages-seeking FDI by more favourable factor prices in a host country and/or possibility to increase, for whatever reason, MNEs total efficiency.

ing of CEFTA integration process would have been more important than broadening. The more CEFTA itself will be integrated and the more it will be integrated in the EU, the greater will be the scope for factor cost advantages-seeking FDI. The amount of factor cost advantages-seeking FDI in CEFTA will crucially depend on the application of the rules of origin; the broader the cumulation of origin country-wise — within CEFTA and even more on the relation EU-CEFTA — the more scope for factor cost advantages-seeking FDI. The recent decision that in a near future for 29 European countries (15 EU Member States, 10 CEE countries associated members of the EU and 4 EFTA countries) the so-called Pan-European cumulation of rules of foreign will be applied, is an important step in this direction[11].

This leads us to the issue of the impact of the type of integration on FDI. The experiences of the EU indicate that the higher the level of integration the stronger the impact on FDI. A simple free-trade area could even produce adverse effects because some companies might decide to service the integration market via exports rather than FDI and sales of affiliates. Therefore, the impact of CEFTA integration process on FDI depends also on the future character of integration processes of CEFTA, on its deepening or broadening. The more CEFTA will develop as a kind of alternative to the EU the more effects on FDI will be alike those in the EU. On the other hand, the more CEFTA will develop (or just broaden) as a transitory waiting room for the EU, the lesser will be its effects on FDI.

Any integration process urges the restructuring and regroupings on the firm level (rationalization, closing down of plants, greater focus on own core business activities, etc.) because the firms need to adjust to the new situation. In this regard two aspects are relevant. The first is that the restructuring and regrouping is typically done via the merger and acquisition activity[12]. One can expect that CEFTA integration process, and even more the integration of individual CEFTA countries in the EU, will additionally accelerate merger and acquisition activities in CEFTA. These activities will be intensive primarily because of the acceleration effects of the process of consolidation of ownership (post privatization) in all CEE countries. It is especially in this regard where common CEFTA capital market could foster FDI. The second aspect of MNEs restructuring and regroupings as a consequence of CEFTA integration process would be a further concentration of FDI in the best locations within CEFTA.

CONCLUSIONS

CEFTA countries can create a common capital market if they completely liberalize capital movements among themselves, while retaining the existing capital controls towards other countries. Common institutions would not be needed, a freedom of capital

[11] More on the issue of rules of origin in the European Agreements and factor cost advantages-seeking FDI see in Baldwin, 1994. Baldwin claims that the bilateral character of the European Agreements leads to a concentration of FDI in the "hub" (EU) and will discourage investors from the EU to locate factor cost advantages-seeking FDI in the "spokes" (CEE countries).

[12] More on that, for example, in Acocella, 1992.

flows within the region would be enough. The creation of a common CEFTA capital market would not hurt the process of integration of these countries in the EU, which remains their main strategic goal. However, if we judge from the trade flows, capital flows among CEFTA member countries can be expected to remain small.

There are some open questions with respect to the creation of a common CEFTA capital market. Most of them have to do with the future identity of CEFTA and with the process of Eastern enlargement of the EU. Will CEFTA remain a free-trade area or will it go further? Creation of a common capital market has to be accompanied by other freedoms, particularly by the liberalization of financial services. Next, a common capital market makes more sense if there is an ambition to proceed with the integration process towards economic and monetary union.

The processes of Eastern enlargement on one hand and the widening of CEFTA on the other put some time limitations on the possibilities to create the common CEFTA market. The existing CEFTA members, who should be fit for capital market integration, will soon join the EU, while potential newcomers are expected to be far less suitable for capital market integration.

There is not much room for a discriminatory treatment in favour of intra-regional capital flows in CEFTA compared to the capital flows with other countries or regions, as CEFTA countries have to a considerable extent already liberalized their capital account transactions.

It would be easier and more meaningful to create a common CEFTA capital market if the domestic capital markets in these countries were more evenly developed and if their monetary, fiscal and exchange rate policies were more coordinated.

A problem which can result from a common CEFTA capital market and from the fact that the level of liberalization of capital flows of individual CEFTA countries toward the EU (and for that matter, toward any other country or region) is not the same, is (similarly to the problem of rules of origin in a free-trade area) that a country with a higher level of protection of its capital transactions will be forced to accept the lowest level of protection in CEFTA, or, alternatively, the level of capital liberalization will have to be harmonized within CEFTA.

Altogether, due to the above mentioned considerations, the scope of a common CEFTA capital market seems rather modest. The possibilities for its creation and its potential will crucially depend on the process of EU Eastern enlargement and on the solutions in redefining CEFTA's future identity.

Experiences of other economic integrations speak in favour of increased FDI flows as a consequence of integration process, at least in the case of integrations in which industrial countries are involved, either alone or in combination with developing countries. Economic integrations of developing countries have not succeeded in attracting sizeable FDI as a consequence of integration process. Although successful economic integrations usually attract FDI from outside the integration as well, the major impact of integration process on FDI relates to intra-FDI flows. The Czech Republic, Hungary, Poland, Slovakia and Slovenia are at the same time associated members of EU and full member states of CEFTA. They are the "spokes" in their ("hub and spokes" type) integration with EU, i.e. most of their foreign trade and FDI flows is with the countries of EU and major impulses for their restructuring and development are coming from their economic cooperation with the EU. There is no reason to believe that this will change in a foreseeable future. Therefore, the primary impact of integration process on FDI in CEFTA countries is that of CEFTA countries' associated membership in the EU, while integration process of CEFTA as such is more of a supportive character to that.

Future investment flows in CEFTA countries will be determined by the following major factors:

- Growth trends in major investing countries in general and in particular growth trends in their FDI outflows. Doubling of FDI inflows in CEE countries in 1995 correlated with an almost 40% increase of world-wide FDI inflows. FDI inflows in CEE countries are even more dependent on trends in world-wide FDI flows because CEE countries are not a "prime rate" investment location, and the amount of FDI inflows in CEE countries is in a certain sense a residuum after the FDI needs of the "prime rate" (Triad countries) locations are fulfilled.
- The second factor which is a kind of necessary condition for foreign investors to consider investment is the speed and the scope of market reforms, stability of the legal and economic system and also political stability of CEE countries.
- The third factor is the end of the distribution phase of privatization and the beginning of "privatization of privatization" (consolidation of ownership) in CEE countries which can bring an important acceleration of foreign acquisitions in CEFTA countries. Namely, after the end of the distribution phase of privatization strategic foreign investors will face a changed situation which will stimulate them for acquisitions: (a) new owners (individual external shareholders and investment funds) will show high propensity to cash their shares; (b) newly privatized companies will rather urgently need fresh capital (payments of internal buy-out instalments, restructuring and modernization); (c) prices of shares in CEFTA countries' capital markets will drop as soon as trading with companies privatized in the mass privatization schemes starts; (d) government agencies as foreign investors' negotiating partner will be replaced by the new owners.
- Not the least important among the major factors is factual and institutional integration of CEFTA countries in the EU network. Although the status of associated membership is not the one which would bring the full EU integration process impact for FDI in CEFTA countries, like the one which happened in Spain and Portugal after they became members of the EU, there is a number of reasons to believe that gradual integration of associated countries in the EU will increase FDI in the CEFTA region[13].

[13] For instance: (i) that non-European MNEs will increasingly treat CEFTA countries as a part of a broader EU area. If internal EU market has led to the increasing regionalization of EU industry and EU MNEs, in the future this trend will be spread to CEFTA as well; (ii) that FDI from EU into CEFTA countries is increasingly of a factor cost advantages-seeking type which integrates CEFTA affiliates into corporate networks of MNEs from EU. The latter coincides with the growing regionalization of EU industry via mergers and acquisitions and strategic alliances and partnerships (Yannopoulos, 1992, pp. 347-348).

CEFTA integration process could play a useful supportive role to these major factors. CEFTA could especially strengthen FDI flows which have been already stimulated by the advantages of CEFTA countries' associated membership in the EU. More specifically, CEFTA integration process could further increase the attractiveness of member countries for foreign investors by: (a) increasing the size of the market which could attract additional market-seeking FDI; (b) liberalizing flows of inputs among CEFTA countries (lower transaction costs), which could attract factor cost advantages-seeking FDI and increase the integration of CEFTA affiliates into MNEs European (or even global) corporate networks; and (c) creating new opportunities which could increase intra-CEFTA FDI. CEFTA integration process would, however, also have some other effects on FDI and MNE activity, e.g.: (a) concentrating FDI in already most attractive CEFTA locations; (b) increasing competition for FDI among CEFTA countries; (c) rising the proportion of mergers and acquisitions to greenfield FDI because of the "reorganization of investment" within CEFTA; and (d) decreasing the existing number of market-seeking FDI, because MNEs will now be able to service the whole CEFTA market from one location.

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Jan Winkler

CEFTA Enlargement: Small Steps or a Big Leap?

CEFTA REFLECTS THE ECONOMIC DIMENSION OF DEVELOPMENT IN CENTRAL/EASTERN EUROPE

CEFTA has by now become an integral part of the daily life of Central and Eastern Europe, a daily life which is dominated by several major tasks:

— *overcoming the legacy of the past* (i.e. moving beyond outdated practices and concepts both domestically within the respective countries and *au dehors*, in relations between the individual countries of the region);

— *getting one's act together* (politically — strengthening democracy, increasing political awareness of the public, creating relevant institutions and making them work, etc.; economically — productivity of labour, fiscal soundness, monetary stability, ownership rights, capital markets; socially — developing necessary social structures and institutions, healthcare, social security, etc.);

— *fostering political and economic progress in order to approach Western standards as soon as possible* (GDP, GDP per capita, standard of living, modern technologies, environmental preservation and protection, etc.); and

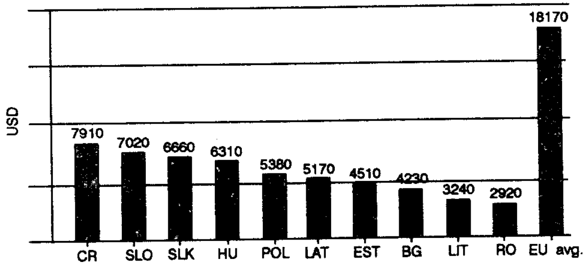
— *furthering integration into European/international structures* (the actual mix individual countries go for varies, but basically revolves around the following institutions: EU, NATO, OECD, WEU, WTO, IMF/WB and the Council of Europe).

These are the main preoccupations on the minds of most of the politicians and, indeed, ordinary citizens in the CEE countries. These also are, however, complicated tasks and each country encounters both generic and very specific difficulties when accomplishing them. It is obvious that a wide cooperation and partnership enable the CEE countries to share experience, exchange opinions and exploit existing synergies. Hence cooperative structures seem as a very relevant instrument for the further development of CEE countries and for a successful accomplishment of their mid-term goals related to achieving Western standards and integration into the existing Western cooperation structures.

Approaching Western standards means by and large improving the potential of the CEE national economies and bringing them to the level compatible with the countries of EU. Comparing the productivity of CEE economies, one can see that the current CEFTA members represent most advanced countries in the region. Nevertheless, differences between even the most advanced countries of CEE and EU are quite significant and overcoming them is likely to require much time and effort. Equally important is reducing the differences between countries within CEE. The following chart shows GDP per capita in purchasing power parity for all CEE countries:

TABLE 1

GPD per capita
(in USD, at PPP)



Source: Hospodářské noviny, October 7, 1996

Economic cooperation in the region is therefore crucial. CEFTA is a concrete example of an efficient (at least potentially) form of such a cooperation. By reducing barriers to trade between countries of Central/Eastern Europe, CEFTA promotes economic growth in its member states.

CEFTA IS A STRICTLY ECONOMIC ENTITY

In the beginning there was an informal grouping of Poland, Hungary and then-Czechoslovakia which came to be called the Visegrád Group. It served as a regional forum for high-level political discussions and soon became a multilateral supplement to the intensive bilateral relations that had developed between the three, and later four countries. As the four countries have progressed on their way towards the cooperation structures of the West, the political *raison d'être* of the Visegrád platform has diminished. Hence a new platform had to be designed to deal primarily with issues of economic character. The Central European Free Trade Agreement signed in 1992 is not an institutional successor to the Visegrád forum although it was conceived by the very same countries. It has become an important instrument of regional cooperation aimed at eradicating existing barriers to free trade. That, however, is not the only purpose of CEFTA.

The move to the founding of CEFTA stemmed from a persuasion that a geostrategic position or sheer will alone were not sufficient qualifications for an EU membership if they were not supplemented by a properly functioning and effectively compatible socio-economic system in an applicant's country. Furthermore, it stemmed

from a realization that a competitive dash for EU membership would represent a negative-sum game, as opposed to the positive-sum character of a cooperative effort aimed at joint progress towards EU accession. Thus the idea of a multilateral organization was born. The three countries then acted upon the premise that a mutual cooperation programme should be based on the principle of the highest common denominator of all possible practical cooperation opportunities, rather than on vague declarations, empty gestures and fruitless meetings of politicians. The result of such effort has been CEFTA, as a platform for expansion of regional trade, devoid of any political party-linked, or value-specific dimension.

CEFTA has been developing not only internally but also vis-à-vis other CEE countries. By now CEFTA has come to include Slovenia as well while few more applicants queue right behind its door. The accession of Slovenia on the basis of an agreement of November 1995 can serve as evidence that the CEFTA countries are serious about their interest in sensible enlargement of the Agreement. This development on one hand proves that CEFTA was a step in the right direction and on the other hand poses many questions as to the right form and role it should assume in the CEE politics in the near and further future. And it is precisely this question that has to be a centrepoint of any responsible discussion about the proper strategy of CEFTA enlargement.

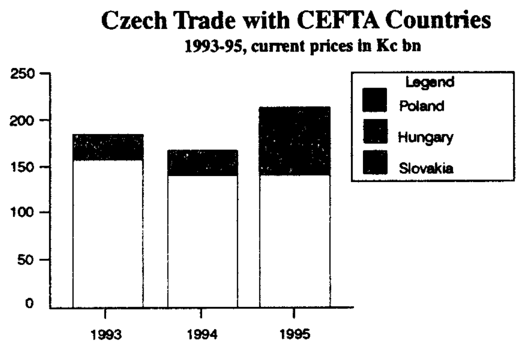
From what has been said so far, one can see that the existing members (or at least the Czech Republic) are not interested in transforming CEFTA into an organization with political character, an organization whose further life would be subject to political criteria. As much as the purpose of the political cooperation under the auspices of the Visegrád Four platform was to overcome the unified "bloc" approach of the Western partners dealing with CEE, assigning a strong political dimension to the cooperation within CEFTA is not desirable.

CEFTA'S RECORD TO DATE

The first results of CEFTA were quite impressive. But the initial 60% annual growth in trade exchange among CEFTA countries was due to a low initial level of exchange and to the immediate impact of liberalization of tariff and non-tarrif barriers right after the founding of CEFTA. The current growth rate is more modest and more realistically reflects the state of free trade in the region. The record of CEFTA today does not, indeed, inspire much joy, nor satisfaction. Despite the commitment of its members to remove barriers to trade in industrial and agricultural products beginning January 1, 1997, CEFTA is far from becoming a truly free-trade area. For each country is allowed to maintain its market protected in the so-called "sensitive" products. The Czech Republic keeps a list of at least 30 such commodities, and so do other members. It is certainly not necessary to mention that the protected commodities are those for which a free-trade area would make much sense. The youngest member in the party, Slovenia, also has not done much to help ameliorate the situation. Thus despite all the declarations, good intentions and relatively liberal regimes in industrial goods, CEFTA at present cannot be regarded as an effective free-trade area. In many cases, not even the most rampant obstacles to free trade have been lifted — for instance, Hungary maintains a general 6% import duty, in Slovakia this amounts to 7.5%, Poland heavily protects its market in certain important groups of products, such as petrol, spare parts for cars, etc.

No wonder then that the actual trade exchange among CEFTA members stays far behind the potential level. In 1993-95 trade between the Czech Republic and its CEFTA partners grew only modestly, the growth only just copying the inflation. It is only the trade between the Czech Republic and Poland that grew more dramatically, although from a very small basis (see Table 2).

TABLE 2



Source: Statistical Yearbook CR, 1993, 1994, 1995

THE THEORY OF FREE TRADE AREAS

Possible explanations of the sorry state of free trade among the CEFTA members can be found in the realm of the members' domestic politics, but perhaps also on a more systemic level. It is the very theory of international trade that may help us better understand the present and perhaps even the future of CEFTA[1].

Free-trade arrangements represent only one specific form of so-called biased economic integration. Under biased economic integration economic theory entails a regime of reduction of economic barriers within a group of countries but not between those countries and the rest of the world. According to the extent of actual cooperation between the member states, biased economic integration can take several forms:

— biased tariff reduction (commodity/product-specific reduction of tariffs);
— discriminatory tariff preferences (overall tariff reduction among members);

1 Ethier, Wilfred J., *Modern International Economics*, W.W. Norton, New York 1992, pp. 523-532

— free-trade area (elimination of tariffs, not only reduction);
— customs union (common external tariffs);
— common market (customs union plus free movements of production factors);

and

— economic union (common economic policies of member states).

In this hierarchy, CEFTA aspires to become an integration right in the middle of our table — a free-trade area, i.e. not only a tariff-reduction arrangement, but not a fully-fledged common market either.

Recent history does not in general abound with examples of successful long-term existence of regional free-trade areas. They usually either failed soon after their launching (West Indian Federation, Uganda—Tanzania—Kenya, LAFTA) or developed very soon into a higher form of economic (or even political) integration:

— ASEAN (common market as of 1976);
— EFTA (substantial integration into EEC/EU);
— (part of) LAFTA (Andean Pact, Central American Common Market).

A major drawback to a free-trade area is the need to regulate internal trade despite the abolition of internal tariffs. If this were not done, individual members would not be able to maintain their own tariffs on goods from non-members, as such goods would enter the free-trade area exclusively through the member with the lowest tariffs.

There seems to be an important link between economic and political integration processes. Oftentimes it is a political integration that brings about subsequent economic integration, and achieving the latter may be a significant motive for pushing ahead with the former. The creation of the United States is the case in point here, but more examples could be readily found. On the other hand, and more appropriate at this forum, the imperfect political union of the Austro-Hungarian Empire failed to arrive at a successful customs union. A reversed process of implicated integration, one where economic union precedes a political union and may be even intended to help foster the latter, is more rare although for our purposes perhaps more relevant. Besides the obvious living example of the EU which developed from what originally was a customs union, one can also name here the case of the German Zollverein (1818-34).

THE OPTIONS FOR CEFTA'S FUTURE

Given its record to date and given what history and theory teach us about economic integration, CEFTA faces these days several important questions. What kind of answers it finds to those questions will determine to a very large extent the fate of CEFTA in the future.

Of those questions the most important one is that of the future development of CEFTA. There seem to be three essential directions in which CEFTA should head: enlargement, further integration and internal improvement. Each of the three represents a future of its own. Furthermore, however, there is a possibility of combining any two or perhaps even all three into some kind of a comprehensive strategy.

Enlargement itself raises the question of an optimal rate of enlargement. Clearly there is certain speed limit concerning the enlargement of an entity like CEFTA. If and when the limit is exceeded, enlargement becomes counterproductive. Intuitively, the optimal rate of enlargement is such that allows at the same time as many new members as can be effectively integrated without the internal rules of CEFTA to be compromised or softened. Hence we come to the concept of organic growth — CEFTA has to and will grow in size, but the growth cannot be faster than the internal "digestion" mechanism of CEFTA makes it possible.

Frankly speaking, CEFTA digestion today is in great disarray. It can, however, be treated. The cure is called "deepening". Deepening is a word which has become almost a *terminus technicus* in modern Europe. Alas, there is more to it than the contemporary EU jargon makes us believe. Indeed, the EU meaning of the word makes sense and could be regarded as a palliative to the current state of CEFTA. CEFTA could (and some argue that it should) seek a way out of its current doldrums through a process of further, "deeper" integration. As we have seen, there are more advanced forms of economic integration possible — a customs union, a common market, and even an economic union.

There is, however, another way of interpreting the term "deepening". One just has to recall the numerous practical obstacles to free trade in CEE — all the sensitive lists, imports surcharges, certificates of origin, etc. It was Disraeli who once said that no one can practice free trade until the man with whom one wants to trade is equally liberal in his economic conduct. Hence it may make sense to propose a "deepening" of CEFTA not in the EU sense but in the Disraeli sense — not as a further intensification of integration but as an improvement of the already existing level of integration.

ENLARGEMENT VS. FURTHER INTEGRATION OF CEFTA

The actual dilemma, therefore, is not only whether to enlarge CEFTA at all but also whether to develop it further into a higher form of regional integration. That dilemma can be depicted in the following matrix:

Enlarge?

Develop Further?	Y	N
Y	EU II.	V–4 (V–4+) Exclusive Club
N	?	Status Quo

Clearly it is not in the interest of the CEE countries, applicants for an EU membership, to develop some kind of "EU II" — a bloc of CEE countries that would be in fact developing as an alternative to EU and whose members could still hope for an

eventual EU membership, but only by way of integrating the whole "EU II" into the "real" EU. Similar concepts were not unheard of several years ago, but I believe we have already moved beyond those days.

Similarly, it is not in the interest of the current CEFTA members to seal the free-trade area exclusively to themselves in its current form. The current state of CEFTA is a sorry one as has been shown and anything seems to be better than a status quo which brings little benefits compared to its economic as well as political costs.

We are therefore realistically left with only two possible alternatives. It is the option of developing CEFTA into a kind of exclusive club of the CEE countries whose early EU membership seems as a safe bet and who will probably enter EU at the same time (perhaps a safe one). If limited to those countries, a "bloc" approach that I shunned earlier, would indeed make sense, provided that EU accession will indeed be simultaneous. There is even a precedent to go by. When de Gaulle did not want to let the English into the EEC, they started an EEC-bis, or EFTA. There is even a precedent for the situation when a member of such CEFTA would choose not to join EU with the others (or would not be admitted, which comes to the same). Neither Norway nor other EFTA members seemed to encounter too many problems in 1973 when Norway decided not to join the EC with the others.

The second option is to plunge into an adventure and go for the "question mark" alternative. That would mean stick with the current level of integration depth and admit new applicants to join the CEFTA arrangement. For the alternative one hardly finds too many precedents so we have to rely on our own analysis. Let me make one thing clear. When characterizing the option by a question mark, I did not mean to imply anything more than the fact that here we move into new, uncharted waters. Let's assume this alternative to be viable and look into it in a bit more detail.

IS FREER TRADE BETTER?

Economic integration of any type leads to a more or less significant reconfiguration of trade patterns amongst the integration members as well as between the members and the outside world. Any of such changes can be described by one of the following terms[2]:

— trade creation (within the integration);
— trade diversion (from extra-integration to intra-integration exchange); and
— trade modification,

The term trade creation describes an intuitively obvious fact that as a result of any biased integration, each integrated country can concentrate more on producing the goods in which it has a comparative advantage relative to the other members of the integration. That leads to the expansion of trade within the integration, which in turn generates mutual gains.

The term trade diversion also stands for quite a logical process. Upon the creation of a biased integration, certain trade formerly conducted among the now integration members and the others will be diverted into trade exchange among integration members. This is necessarily a change for the worse because it enhances trade ineffi-

[2] Ethier, Wilfred J., op. cit. pp. 523-532

ciency. If third-country suppliers (i.e. integration non-members) used to sell their products to now-members when all countries competed on equal terms (before biased integration was created), it must have been that the third-country suppliers were able to supply given products more favourably.

Hence trade creation is beneficial and trade diversion is harmful. Which one dominates depends upon circumstances: the larger the extent of the integration (in terms of integration participants) the more likely it is to be beneficial because less trade will be diverted away from non-participating countries and trade creation benefits will outweigh the efficiency losses due to trade diversion. If, however, the integrating countries did not use to be major trade partners to each other, integration is likely to be harmful, because it will cause excess harm from trade diversion. Trade diversion is not an issue if trade amongst integration participants has always concerned vastly different goods than the trade between participants and non-participants.

In addition to trade creation and trade diversion, biased economic integration brings about also trade modification. That is to say that trade among integration members and third countries changes depending on the relative position of complements and substitutes in the foreign-trade portfolio of each integration member. If trade integration increases intra-integration exchange of goods that are substitutes to imports from third countries, external trade of the integration is reduced and the integration has a trade diversion, i.e. trade inefficiency increasing effect. If, however, imports from non-integration members are complements to goods traded within the integration, their level may actually increase as the price of the goods traded within the integration decreases and demand subsequently grows. In that case, trade modification is generally beneficial.

What relevance do all these theoretical concepts have when it comes to the question of CEFTA's enlargement? Let's look at the trade patterns of CEFTA members in 1995 (see Table 3). The numbers below show percentages of each particular country's trade with its partners in the West, in CEFTA countries, in other transforming countries and in the Third World.

It can be assumed that the trade with advanced Western economies (which plays a major role in the foreign trade of all five CEFTA members according to the above numbers) is realized mostly in types of goods different from those exchanged within CEFTA or between CEFTA members and other transforming countries. Hence the possibility of trade diversion from the West to within CEFTA should not become an issue, for the time being that is. If, however, it were to happen for one reason or another, it would have to be interpreted as a negative trend. Reasons for such an interpretation are rather obvious, the most important one seems to be linked to the quality standards. More important is the likely diversion of exchange between CEFTA members and other transforming countries. As of 1995 the trade with CEFTA partners was lower than that with other transition economies for all CEFTA members except the Czech Republic and Slovakia. Here we can expect more considerable changes in the patterns and terms of trade in many commodities. That in itself does not have to be neither good or bad.

Trade creation within CEFTA is likely and desirable. Unfortunately, the current regime of exceptions and "sensitive products" lists do not make possible full expansion of intra-CEFTA trade. Worse than that, the existing barriers stifle precisely those trade patterns whose development would be most desirable — mostly in agricultural products, but also in engineering products and fast moving consumer goods.

TABLE 3

in % of all trade	The West	CEFTA partners	Other transition economies	LDCs
Czech R.	63	20	11	6
Slovakia	47	39	9	4
Hungary	71	8	16	5
Poland	75	6	8	10
Slovenia	76	6	13	5

Source: Information of Ministry of Trade and Industry CR, 1996

THE CRITERIA OF ORGANIC GROWTH

In order to guarantee that the enlargement of CEFTA will be carried out in a manner conducive to CEFTA's organic growth, there must be clear conditions of accession. There are three underlying formal criteria for participation in CEFTA which illustrate the premises upon which the Agreement was concluded and which can easily play the role of such conditions:

The WTO condition. Members of CEFTA are obliged to honour the conditions of WTO membership and aim at gradual removal of trade barriers between the member states in line with the GATT/WTO rules. This condition should guarantee that bilateral economic relations among CEFTA members will develop in the most efficient manner. Such efficiency in this context is assumed to be guaranteed by the fact that the WTO conditions are generally regarded as an integral part of contemporary world trade. Thus the liberalization of trade in CEE can be conducted according to the generally accepted rules and does not have to undergo the frustrations of the so-called "third way" seekers.

The EU association condition. Each CEFTA member must have an association agreement with the EU which demonstrates that the ultimate goal of the founding countries remains to be a completion of economic transformation in each country to the extent necessary for accession to the EU. CEFTA rules thus not only demonstrate readiness and willingness of its members to foster cooperation, but indirectly develop readiness of its members for integration into the EU structures.

The consensual enlargement rule. CEFTA rules assume further enlargement of the Agreement only with a full consent of all present members. This condition is to guarantee that changes to CEFTA will not happen at the expense of any of the participating countries or contrary to its interests. In this way CEFTA should contribute to the stability and prosperity of the whole CEE region.

Last but not least, there is also the obvious condition of *mandatory bilateral free-trade agreements* between a new entrant and existing CEFTA members. Until all such agreements are concluded and implemented, one cannot really speak of a new membership. (There, however, exists the status of an associated CEFTA member which is preconditioned by the same general conditions and by an existing bilateral free-trade agreement with at least one CEFTA country.)

PUTTING CEFTA IN ORDER IS IMPERATIVE

Setting conditions for new applicants is a necessary but not sufficient condition of CEFTA's future success. The existing members also have to do their homework in putting CEFTA in order. Hence it is clear that a process of enlargement will have to be linked to a process of correction of current CEFTA. As we have seen, CEFTA at present is a free-trade area which is not. If CEFTA is to be enlarged, harmonization of the processes of its external and internal progress will become crucial. We can use one more matrix to illustrate the situation:

		Enlarge: Gradually	Enlarge: Big Leap
Correct	First	St. Augustine	...and pigs will fly
Correct	Later	WHY?	H_2SO_4

Of the four possible combinations, one seems to be clearly the most lethal. The effects of a sudden wide enlargement combined with a deferral of an internal improvement of CEFTA would be comparable to the effects of sulphuric acid. After such a move, CEFTA would probably slowly but inevitably dissolve into a mere formal arrangement with little bearing on the everyday lives of its member countries, old and new.

It does seem, after all, that any CEFTA enlargement should be preceded by its thorough internal reform. For even if CEFTA is not to be enlarged by a Big Leap but rather by Small Steps, it makes precious little sense to enlarge CEFTA in its current shape — we have seen that CEFTA today is CEFTA that is not.

Hence we come to an important conclusion: CEFTA should first be improved and made a truly functional free-trade area if it is to survive as more than just a political gesture of a few CEE governments. Once straightened up, CEFTA should indeed start thinking about welcoming new members if such a thing will still be topical. And only at that point will CEFTA have to make the final call between gradual and massive enlargement. From where we stand now, the combination of soon embetterment and subsequent

massive enlargement, i.e. creation of a functioning free-trade area encompassing much of CEE in a process which is not too hasty and yet not over-protracted, seems too much as a fairy tale. But who knows, one day even the pigs may fly, as the English say. The main problem here which renders this alternative little plausible is that any new member of CEFTA will have to satisfy clearly defined conditions. At present, such conditions include membership in WTO, association treaty with EU and free-trade agreements with every country already in CEFTA. If CEFTA develops into a better functioning free-trade arrangement, those conditions are likely to get stricter and more numerous.

The last option is a combination of gradual enlargement deferred for the moment until the current CEFTA members work out the existing imperfections of CEFTA. I know this approach of committing oneself to "enlargement but not yet" is a bit peculiar and may resemble St. Augustine who was once characterized as a person whose main prayer goes along the following lines: "Lord, please make me perfect, but not yet." Nevertheless, this option seems to me as quite viable. On one hand, it allows for straightening up what is wrong with CEFTA today, on the other hand it does not seal CEFTA from other CEE states, once CEFTA becomes real CEFTA. And who knows, maybe the gradual enlargement once under way will progress at such a speed that it will amount in practice to a Big Leap. That, however, depends no longer on CEFTA but on the applicants who themselves will have to do their own homework before qualifying for membership in such a new CEFTA.

CONCLUSION

All these arguments may very well sound reasonable — or they may not. One way or another, they can be discussed on a rational basis, using elementary analytical procedures. The issue of CEFTA enlargement is, however, also a political matter. We all know all too well that it will not be only a purely economic and strategic argumentation that will decide the future of CEFTA. The final outcome will depend very much on the decision of the politicians whose exclusive choice is to say which interests will come first. That amounts to a dilemma whether one can put the cart of political interests before the economic-minded horse or not. It also amounts to solving the only question that really matters: Ukraine yes or not. But that would be a topic for another paper.

Vladimir Gligorov

The Role of CEFTA in the Balkans

The processes in the Balkans and those in Central Europe have diverged radically in the period of transformation. One important reason for this is the different approaches to trade, or rather free trade. While the breakdown of the so-called socialist system was accompanied by liberalization measures in Central Europe, it brought restrictions to trade in many of the Balkan countries.[1] Can CEFTA, the free-trade agreement of the Central European countries, play any role in the Balkans? The question is important because Central Europe and the Balkans are connected, geographically, politically and culturally. To answer it, at least four aspects have to be taken into account: (i) what is CEFTA; (ii) where are the Balkans; (iii) what can they do for each other; and (iv) what is the influence of others (that of the European Union in particular)? In this short paper I will deal with these questions in turn and then draw some general conclusions.

WHAT IS CEFTA?

CEFTA is a free-trade agreement of five countries: Poland, the Czech Republic, Slovakia, Hungary and Slovenia. It has been set up for two main reasons:

— to facilitate trade among the member countries, and
— to serve as a training ground and a waiting-room before the integration into the European Union.

Given that, CEFTA can be called a combination of a regional agreement and a club. The former it is only partly, because CEFTA has not been created in response to the existing trade complementarity of most of its members which usually goes together with territorial proximity; indeed, it is not at all clear whether trade divergence is one of the aims of CEFTA. As for the latter, it is not altogether a club because it consists of countries that are territorially connected, i.e., it is some kind of a regional club. Because of that, it is founded on a vague idea of a region, that should entail the existence of gains from the preferential trade arrangement, and on some idea of a club with a common strategic policy objective (e.g., integration into the EU).

In view of the above, CEFTA can move in one direction or the other, or in both. It can deepen the free trade agreements and widen the membership on a regional basis.

[1] For more on this see Gligorov (1996a).

Alternatively, or in addition, it could enlarge by taking in countries interested in using CEFTA as a corridor to get closer to integration with the European Union. These two possibilities make CEFTA both attractive and ambiguous. On the one hand, membership in CEFTA can be seen as a good reference for further integration. On the other hand, the very existence of CEFTA brings in incentives for the deepening of that very integration. The ambiguity may be that the latter deepening process may be seen as competing with the former process of widening.

This ambiguity is inherent in every type of regionalism. Once a free-trade arrangement is contemplated, it will lead both to the consideration of the area that it should apply to and to the discussion as to the policy coordination that it might support. If an arrangement is seen as only a transitory one, as it seems to be the case with CEFTA, then the regional aspect may not be all that important. Indeed, if the club is shying away from any deeper policy coordination initiatives, that may lead to it being much more open to new members than in the case of the adoption of a regional approach. But, in that case, it may not be very useful as a testing ground for further integration.

These dilemmas with CEFTA have consequences for the role it could play in other countries and regions. If CEFTA were to remain a loose preferential trade arrangement of countries that have concluded association or other agreements with the EU, as intended, the role it could play in the trade strategies of the other countries and regions would be rather small. If, and this is unlikely, the integration proceeds to deepen, then the policy objectives would have to be considered. One possible development could rely on the old Rosenstein-Roden idea of the big push. That would involve not only trade policy coordination but the coordination of the monetary and fiscal policies too. The role that such a development might possibly play is hard to assess in view of the fact that the primary interest of the member countries is to get closer to the European Union.

WHERE ARE THE BALKANS?

The role of CEFTA, as of everything else for that matter, in the Balkans depends on one basic prior question: Where are the Balkans? This question makes sense because:

- the Balkans are regionally divided, and
- the Balkan region extends into a number of other regions.

The regional division has been almost always a characteristic feature of the Balkans. Just before the current transformation, the Balkans were divided into the Soviet zone and the zone of the West with the area of former Yugoslavia being somewhere in between. With the disintegration of both the Soviet Union and Yugoslavia, the whole region disintegrated even further.[2] The disintegration is so intense that some countries do not consider themselves as belonging to the Balkans at all.

In addition, regional interpenetration is important in the Balkans. Greece is a member of the European Union; Romania, Bulgaria and Slovenia have association agreements with the European Union (though the agreement with Slovenia has yet to be ratified); Slovenia is a member of CEFTA; Macedonia and Albania have cooperation agreements with the European Union; the Republic of Bosnia and Herzegovina is under an intensive programme of reconstruction with significant involvement of the European Union, but also of the United States and the Islamic countries; while Yugoslavia (Serbia and Montenegro) is still under the regime of sanctions that prohibit them to normalize their relations with the international community.

[2] On this see Gligorov (1994).

This interpenetration notwithstanding, it is important to notice two things.

First, the free-trade idea is not looked at favourably in this region. The reasons are mainly political. On the one hand, the Balkan states fear for their independence whenever regional integration is mentioned. On the other hand, many governments in the Balkans consider tariffs and other trade charges and surcharges as one of the important sources of their public revenue. For these reasons, the integration of the Balkans with another area or areas could have positive impact both on the familiarization with the idea of free trade and on restraining the excessive use of tariffs. In that sense, CEFTA could be one of the regional integrations that could play a positive role in the process of liberalization and integration in the Balkans.

Secondly, a number of countries in the Balkans are not altogether clear what long-term strategy of regional integration they would want to adopt. Three main alternatives could be discerned.

There are countries that seem determined to join the European Union. At the moment, there seems to exist the necessary political consensus on that strategy in Slovenia, Romania, Macedonia and Albania.

There are those which seem to be indecisive for one reason or another. This is probably the case with Croatia.

Finally, there are those that would be ready to opt for an alternative solution if there were one. This is, at the moment, probably the case with Bosnia and Herzegovina, Yugoslavia and Bulgaria.

In those cases where the attraction of the EU is not so clear or where there is an interest in an alternative regional integration, CEFTA could play a certain though not necessarily an altogether important role. One cannot hope that CEFTA could either provide some important push for the adoption of the free-trade attitude in the Balkans or that it could be perceived as an important alternative to other regional integrations.

Generally speaking, then, the regionalization of the Balkans, both internally and externally, is far from clear and predictable at this point.

ARE THERE COMMON INTERESTS?

Central Europe and the Balkans are connected in terms of security, economy and culture.

Probably the most important thing to be observed is that Central Europe has an important border with the Balkans. Indeed, a number of Balkan countries either are or consider themselves to be Central European countries. Slovenia, Croatia, Serbia and Romania are Central European countries. The Republic of Bosnia and Herzegovina considers itself as a Central European country too. Greece, of course, is a Western European country. If one considers the intense relationship between these countries and the rest of the Balkans, the interpenetration of Central Europe and the Balkans is quite significant.

There is no doubt that this relationship is important for the security of both regions. The Balkans are practically saturated with security problems, some of which have significant spillover effects on Central Europe.[3] Certainly, the wars in former Yugoslavia influenced significantly the whole of the Balkans but also much of Central Europe. Indeed, the future security arrangements in Central Europe will have to take into account the fact that this region has a long border with the Balkans.

Apart from their common interest in security, there are trade and economic interests in general. These may be somewhat asymmetric because Central Europe is located between the Balkans and Western Europe. This fact may have an influence on the growing interest in some integration with Central Europe displayed by the Balkan countries. The extent of this interest is hard to judge from the current level of trade and economic relations. However, as soon as the Balkan economies start to grow, trade and other economic complementarities with at least some of the Central European countries will become more transparent.

Finally, there are common interests that reflect cultural connections. This cannot be treated here in any detail. It is, however, not to be disregarded that there are ethnic, linguistic, religious and especially historical interpenetrations. One has to take into account the role of minorities, of mixed communities and regions as well as historical connections and common interests among a number of Balkan and Central European countries. Without going into detail, if one takes into account the fact that former Yugoslavia was both a Balkan and a Central European state, one can get a rather clear idea of the integrative and divisive role of these cultural and historical factors. The reasons for the creation of this state as well as for its disintegration, are indicative for the overall relations between the Balkans and Central Europe.

THE ROLE OF THE THIRD PARTIES

As it was already noted, CEFTA is a temporary arrangement that should facilitate the integration of its member states into the European Union. Because of that, the role it can play in the Balkans or anywhere else depends very much on the policy of the European Union. In the case of the Balkans, for security reasons, there is also a significant influence of the United States and of other international factors and organizations. These influences cannot be neglected.

The policy objectives of the EU and of the US are to be found in the so-called EU regional approach and in the USA's initiative for South-East cooperation. These policies or initiatives are not altogether clearly defined, though they do signal the understanding in the EU and in the US that the security, economic and political problems in

[3] On security issues in the Balkans see Gligorov (1996b).

the Balkans and in at least a part of Central Europe cannot be solved without some kind of their internalization on the regional level.

The EU regional approach has developed over a period of time and is in all probability going to continue to develop. For the moment, its main aim is to buttress security in the Balkans and especially in Bosnia and Herzegovina. However, in the longer run, it should help economic and political coexistence and cooperation in the whole region. The EU regional approach has mainly Croatia, Bosnia and Herzegovina and Yugoslavia (Serbia and Montenegro) in mind. However, as already mentioned, it relates to the region of former Yugoslavia as a whole and even more broadly to the Balkans and to South-East Europe. The main idea is that the countries concerned cannot hope to improve their cooperation with the EU if they are not willing to cooperate among themselves. Indeed, the regional policy of the EU makes regional cooperation a precondition for further EU cooperation and integration.

The response of the countries involved has been mixed. Yugoslavia has responded positively.[4] The initiative has received a cautious positive response in Macedonia where it is seen in a wider context of South-East and Central Europe. Similar response has come from Sarajevo (Bosnia and Herzegovina). On the other hand, Slovenia is interested in the normalization of trade with the former Yugoslavia countries, but not in any other type of cooperation and integration.

The most determined opposition has come from Croatia and, in a different way, from the Serbian Republic of Bosnia and Herzegovina. The response of the Croatian government has been that it has nothing against regional integration, only that it has a different form of integration in mind, i.e. that it would rather integrate into CEFTA and EU. This brings in a conflict because Croatia cannot proceed with the integration into EU without honouring the latter's regional policy and, in addition, it cannot enter CEFTA before it improves her relations with the EU.

The Serbian Republic, on the other hand, indirectly opposes the EU initiative because it refuses to integrate both into Bosnia and Herzegovina and with anybody else before it integrates with Serbia. The latter integration is something that should be circumvented by the EU regional approach. So, while in principle, the Serbian Republic welcomes the policy of regional integration, it has a different kind of integration in mind.

The US initiative of South-East cooperation is also not altogether transparent. There has been some talk about a panel that the countries involved would be attending. The purpose of this panel would be to provide a platform where the issues of regional and all other kinds of cooperation could be discussed. Its participants would come from both the Balkans and Central Europe. At the moment it is not clear who will be invited to the panel and how it is to operate, but one can anticipate that the experience and the presence of CEFTA could play a useful and potentially important role in the whole process.

[4] See Kovac (1996).

CONCLUSION

The tone of this paper has been generally pessimistic. It does not seem that CEFTA could play all that significant a role in the Balkans. This is because it is not altogether clear what CEFTA is, where the Balkans are and what the mutual interests are. On the other hand, the general uncertainty as to the future of integration process in Europe points to the possibility that the role CEFTA can play in the Balkans may gain in importance especially because the outside interest in regional cooperation may become more pronounced.

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Zbigniew Madej

Is It Possible for CEFTA to Be Enlarged Eastward?

INTRODUCTION

CEFTA is an open organization. This was officially declared in the third year of its existence at a meeting of the prime ministers of the Czech Republic, Hungary, Poland and Slovakia in Brno in September 1995. Over a year after that declaration, the openness formula was confirmed in practice when, on January 1, 1996, Slovenia was admitted as the first new member.

The CEFTA constitutional provisions contain no restrictions as regards the directions of its development. It can be expanded to all points of the compass, but in practice the possibilities are limited to the north and the south, and possibly also to the east. A little is already known about the north and the south, as the three Baltic states (Estonia, Latvia and Lithuania) and two Balkan nations (Romania and Bulgaria) have been seeking admission to the organization for some time now. Less is known about the situation in the east and things look much more difficult there. In fact, there is no agreement as to whether Ukraine is the only possible candidate, or whether Belarus and perhaps other countries also come into consideration. Nor is the public at large aware whether there has already been some initiative in this regard on the part of CEFTA, its eastern neighbours or Western circles. Some observers might even be scared to consider the very idea, because the question would immediately pop up: "And what is Russia going to say to that?"

POLITICAL DETERMINANTS

The Ukrainian authorities have been displaying interest in CEFTA for some time now. Incidentally, they combine them with broader political suggestions, e.g., for making East-Central Europe a nuclear-free zone and making the region engage in constructive action to promote peace and good-neighbourly relations throughout the Eurasian continent. Ukraine is also seeking the membership of the European Union and explains that this is its strategic priority. There is no official position of CEFTA or the EU on this subject yet but preliminary promises have been made by some members of either group. One of them came from Poland. In a joint declaration signed by the President of the Republic of Poland and the President of Ukraine in Warsaw on June 26, 1996, the sides declared the following:

"The Republic of Poland and Ukraine shall grant each other support in their strivings for the earliest possible integration with European economic and political institutions and security structures while taking into account their state interests. In particular, the sides shall regularly exchange experience related to practical steps leading to integration with the EU."

The declaration also refers to the question of the enlargement of NATO, which is very important but also extremely difficult.

"The Presidents of the Republic of Poland and Ukraine showed understanding for the position of the other side on the question of the enlargement of NATO. They agreed that no country may veto the sovereign decision of another country to accede to a defensive alliance of its choice. The process of enlargement of NATO should be an evolutionary and open one and it should contribute to the consolidation of political stability and security in Europe."[1]

It is also worth noting the position of European Union representatives on the question of Ukraine's aspirations. On May 21, 1996, foreign ministers of Italy, Ireland and France and the EU Commissioner adopted a political declaration in Rome in which they declared the following:

"The European Union regards the independence, territorial integrity and sovereignty of Ukraine as questions of fundamental importance to European security ... and it also undertakes to support Ukraine in its evolution toward market economy. ... The European Union is of the opinion that the implementation of the Interim Agreement, and next also of an Agreement of Partnership and Cooperation are priority targets in its relations with Ukraine in the years ahead."[2]

Three conclusions follow from the above quotes:

— first, that the accession of Ukraine to CEFTA has already become a public matter, which is being officially raised by the heads of the states concerned;
— second, that Ukraine and Poland — and, for that matter, other countries too — regard CEFTA membership as something that is consistent and complementary with the strivings of East-Central European countries for admission to the European Union and other Western structures;[3] and
— third, that European Union representatives welcome and appreciate the democratic and market-oriented changes in Ukraine and expect the development of suitable forms of Ukraine's ties with the Western structures in more distant future.

[1] All the quotations are taken from the joint declaration of the President of the Republic of Poland and the President of Ukraine, published in *Biuletyn Ukraiński* No. 3 (27), May-June 1996, p. 18, Ośrodek Studiów Wschodnich (Eastern Research Centre).

[2] Joint declaration of the European Union on Ukraine (Rome, May 21, 1996). *Biuletyn Ukraiński*, No. 3 (27), p. 18.

[3] CEFTA-EU relations are discussed by Maciej Perczyński in a paper entitled "Przemiany w handlu zagranicznym z krajami grupy wyszehradzkiej na tle powiązań gospodarczych Polski z Unią Europejską." Szkoła Główna Handlowa, Warsaw 1995.

However, these are not sufficient premises for Ukraine's admission to CEFTA. Any country seeking to accede to this organization must fulfil the following three conditions:

(1) accede to the General Agreement on Tariffs and Trade (WTO) and then obtainpreliminary approval of that organization;
(2) sign an association agreement with the European Union; and
(3) obtain the acceptance of all CEFTA members.

Ukraine does not fulfil any of these conditions at present. It could therefore be said that it is in the preliminary reconnaissance phase, when the intentions of the party concerned are presented and the reactions of appropriate organizations are examined. On the other hand, it has been known that the process of Ukraine's accession to WTO is on the right course. It is going to be supported by other Central European WTO members and a similar promise has been obtained from the European Union. The fulfilment of the second condition, i.e. the signing of an association agreement with the EU, is more difficult and could take a lot of time. But this happens to be the decisive precondition.

It should be remembered, however, that Ukraine is a member of the Commonwealth of Independent States (in fact, one of the three founders of the group set up in Białowieża on December 8, 1991). While the CIS constitutional documents do not forbid the members to join other political or economic groups so long as they are not hostile to CIS, it would still be a delicate matter and it would set a precedent. No other CIS country has asked for admission to CEFTA so far. It is true that Ukraine has not joined the Economic Union formed within CIS in 1993. It only became an associate member, which indicates that it does not want to form too strong ties with the CIS economic structures, but the matter does not merely concern Ukraine's actions but also the position of other members, especially Russia.

In the summer of 1996, the Russian authorities published an important document entitled "National Security Policy of the Russian Federation for the Years 1996-2000". In it, they wrote that "the main objective of Russia's policy toward CIS is the establishment of a stable union of sovereign states, integrated in economic and political terms and capable of aspiring for a high place in the international community, possibly as an autonomous subject of world economy and politics".[4]

The said document also contains a characteristic warning addressed to the rest of the world: "Russia poses no threat to vital interests of other states and shall deem actions aimed at the goals listed below as a realistic threat to its own national interests: (a) infringement on its territorial integrity and state sovereignty; (b) the weakening of its ties with the new independent states in the former Soviet territory and with the countries of East-Central Europe, with other states and international organizations; (c) the erosion of its role in the solving of global and regional international problems; (d) the weakening of its positions in world economy and politics."[5]

[4] Polityka Bezpieczeństwa Narodowego Federacji Rosyjskiej na Lata 1996-2000. *Biuletyn Rosyjski* No. 2, June-July 1996, Ośrodek Studiów Wschodnich, Warszawa, p. 9

[5] *Op. cit.*, p. 11.

Point (b), on action leading to the weakening of Russia's ties with the former Soviet republics that are now independent states and with the countries of East-Central Europe, deserves special attention. The question that comes to mind is whether the Russian authorities will not decide that Ukraine's admission to CEFTA could weaken its economic contacts with Russia, thus prejudicing Russia's national interests.

On the other hand, it is also possible to consider another scenario, one in which Russia will take a kind view of economic ties of CIS and its individual members with all of East-Central Europe and consequently also with CEFTA, because it is interested in that region. After all, there were attempts to revive the COMECON in a revamped form and later (in September 1996) there came an official declaration about Russia's willingness to cooperate with CEFTA. By combining the endorsing of economic ties with a firm objection to the enlargement of NATO, the Russians could try to demonstrate to the world that they are not against all organizations from outside their zone of influence but only against organizations of a military nature. Therefore it cannot be ruled out that as the tension between Russia and the West over NATO gets worse, CEFTA could be the one that benefits from the discord between these two forces and it could expand eastward by admitting Ukraine.

ECONOMIC CONSIDERATIONS

From the very beginning of this analysis, a question has been waiting to be asked: is CEFTA really interested in the eastward expansion of its influence, will it try to admit Ukraine even at the cost of aggravation of relations with Russia? Why should it be doing so, what economic and political benefits does the organization itself and the Czech Republic, Hungary, Poland, Slovakia and Slovenia stand to gain. What would be the benefits of such expansion to the European Union and, finally, in what way is Ukraine itself going to benefit from the admission?

What is now Ukraine was once (in the 11th century) the cradle of the Orthodox faith and of everything Russian, but it was precisely Russia, not Ukraine, then. The name "Ukraine" only began to spread in the 17th century; in Slavic languages, the name denoted something situated "on the outskirts", "near the boundary". At the time, this signified both the borderland of the Roman Catholic faith and the Western culture on the one hand and the edge of the Russian Orthodox faith and Byzantine culture, whose centre had in the meantime moved to Moscow.

Present-day Ukraine is a highly complex phenomenon. About one third of the population (especially in eastern Ukraine) is in favour of unification with Russia. Some 70% of the Ukrainians are in favour of a lasting political alliance (but not unification). It is mainly the Ukrainian authorities and part of the intelligentsia as well as the very active émigré Ukrainian communities in Western Europe that are looking to the West and East-Central European structures. When discussing Ukraine's admission to CEFTA, it is necessary to take all these groups into consideration. It is also important to reckon with the Ukrainians' national ambitions, the country's young statehood and everything that makes up the subjectivity of that community.

Ukraine occupies an area of 603,700 sq. km, which is 50,000 sq. km more than the area of the five CEFTA member countries, and its population exceeds 52 million, which is equal to just over 78% of the combined population of the five. This means that the admission of Ukraine to CEFTA would more or less double the latter's area and population. One might therefore say that a vast new market would open up before the CEFTA countries, but two additional questions arise at the same time:

Is this a market with short- or long-term prospects, deep or shallow?

Is the Ukrainian market inaccessible to the Czech Republic, Hungary, Poland, Slovakia and Slovenia without the enlargement of CEFTA?

Let us take a closer look at Ukraine's economic situation. For seven years, the country has been in the grip of an extensive economic crisis. It is estimated that its 1996 GDP was in real terms equal to some 45% of the 1989 level. This is a worse decline of output than has been seen in Russia or Belarus. Only in the Transcaucasian countries (especially in Georgia) did the situation deteriorate even more than in Ukraine.

This decline has been accompanied by high inflation for several years. There were several attempts to bring it under control but success was only recorded in the middle of 1996. The suppressing of inflation and introduction of the new currency (with the hrivna replacing the karbovanets) was a big accomplishment of the Ukrainian authorities. However, the confidence in the new currency and in economic stability remains low. The rate of dollarization of the Ukrainian economy still amounted to 36% or so in the middle of 1996.

Economic reforms are proceeding in Ukraine at a slower pace than in Russia. Not even the so-called small privatization has been completed and the privatization of big enterprises is in the early stages. The privatization certificates (vouchers) are bearer securities and may not be traded, so they do not contribute to the development of the securities market.

Kolkhozes and sovkhozes continue to predominate in Ukraine's agriculture. There are still few private farms (some 35,000, of an average size of 22 hectares), and they account for less than 2% of the total farmland.

That being so, does it make sense to recommend Ukraine to anyone? The answer is yes. Naturally, it is necessary to take the economic and political risk into consideration but one should also notice the opportunities. Ukraine is opening up as a vast market, both now, while the crisis continues, and for the future.

Let me deal with the crisis first. Statistics show that in all the East European countries the drop in output has been much deeper that the drop in retail sales. From the macroeconomic point of view, it was a case of the GDP and accumulation falling by a bigger margin than consumption. This is understandable even without going into deeper economic analyses, but in a period of crisis, when poverty looks one in the eye, the first expenditure to be cut is spending on machinery and industrial equipment, while one has to feed the family, buy clothes, heat the apartment, get indispensable medicines, etc. In the years 1990-95, the decline in investment spending in Ukraine amounted to some 70% while the drop in consumption was a "mere" 35-40%. In Russia, things looked much the same way. Also in Poland the drop in investments was bigger than the drop in the GDP and in consumption. This is a general regularity, which can also be observed in time of crisis in the Western economies.

It has been estimated that the real demand of the Ukrainian population exceeds the domestic production of agriculture and processing industries by some 25-30% (although the matter deserves a more detailed study). The gap is filled by Ukrainian imports, whose patterns has clearly shifted to the benefit of consumer goods. These are precisely classical crisis-time imports, which will continue until they are replaced by domestic production. This import gap in Ukraine (as well as in Russia, Kazakhstan, Belarus and other countries) was splendidly sensed by exporters from CEFTA countries, which is why their exports to the eastern markets have been growing much faster than to other destinations since 1994. One contributing factor was a certain limitation of the chances of exporting the goods to the West. At present, consumer goods predominate in these exports, rather than machinery and industrial equipment, which played that role until 1989. It should also be remembered that the bulk of the demand for imports in the east is not met by companies from the CEFTA countries but by West European, US and Far Eastern suppliers.

How long are the Ukrainian crisis imports likely to continue? If a recovery started in the Ukrainian economy in 1997 and the GDP started rising at a rate of 5% a year, the level of the GDP from before the crisis could be reached by the year 2011. With growth at 4% (which appears more realistic), Ukraine would have to wait for its GDP to return to pre-crisis level until 2014.

This would mean that there is a prospect of a very long period of making up for the crisis years, a period that could last for 15 to 18 years. However, this does not mean that Ukraine will be condemned to the so-called crisis import all that time. The emerging from the crisis will be combined with shifts in the pattern of the country's GDP in favour of consumer goods. This is the area where the economic recovery will begin and where the growth rate is going to be the highest. It can be expected that in four to five years, Ukraine will attain 60-70% of the pre-crisis level of production of consumer goods and that two or three years later it will attain the 1989 level, and with a more modern pattern at that. This means that the crisis import of consumer goods to Ukraine will continue until 2000 or 2002. This will be followed by the second stage, in which crisis imports will give way to what might be called normal imports.

Ukraine, similarly as Russia and many other former Soviet republics, is entering a period of mass consumption for the first time in its history. Some manifestations of such consumption could admittedly be witnessed in some centres even before the age of really existing socialism but were subsequently frozen through the huge industrialization effort. At present, as the country undergoes transition to market economy, mass consumption is going to develop, following the pattern of Western countries. This means that after the emergence from the crisis (or even during that process) Ukraine will have to join in regular international exchange of consumer goods.

To sum up, it may be said that exporters oriented to the eastern market have long and promising prospects ahead of them: first the crisis prospects and then post-crisis prospects. This is precisely when the problems of complementarity of the economies of the CEFTA countries and Ukraine will be revealed in full, as will be their comparative advantages in individual areas and the problems of competitiveness of those economies.

Let us now move to capital goods. For the time being, Ukraine is not investing much and is not a significant importer of such goods. However, this will change after

the year 2000. If economic recovery begins in 1997 (or 1998), then for the first three years it will be based first of all on better use of the existing manufacturing capacity which is at least 50% underused at present. Poland and other CEFTA countries experienced a similar prelude to the overcoming of the crisis.

However, it will not be possible to use the old capacity in full, first of all because the pattern of human needs is changing, necessitating a change of the manufacturing potential as well, and second, because the existing capacity has simply become obsolete. It has not practically been replaced since 1990, which means that many of its elements are in poor repair and in three to four years, this can only get worse. On this basis, I predict that after the year 2000 a huge modernization of Ukrainian industry will get under way. Domestic companies will be involved in it but there will also be vast opportunities for enterprises from CEFTA countries and from all over the world. The big and wealthy firms will stand the biggest chance because in most cases capital goods are sold on credit terms, but there will also be room for smaller players, provided they start thinking about the huge technological restructuring of the Ukrainian economy already now. This will pose diverse technological, commercial and financial problems requiring additional studies but it is worth making the effort because the restructuring will be a long-lasting process. Therefore it is possible to devise export plans running more than ten years ahead with the Ukrainian capital goods market in mind.

The question will inevitably arise how Ukraine finances the imports of consumer goods and how it is going to pay for the imports of industrial equipment in the future. It does not have too much natural resources so it will be hard for it to follow the Russian example. Russia is paying for its imports with raw materials because it has to, although it fears that it will be relegated to the role of a supplier of such materials to Western economies. Ukraine is not formulating this problem in such categorical terms but this is not to say that it is not facing any dangers or that it is in a better situation. It could use foreign credits, which it is already using at present to finance consumer imports, and it could try to attract foreign capital by offering shares in its enterprises. The use of both sources of funds would require a definite acceleration of privatization processes, including the privatization of land ownership, although this could pose serious problems.

This means that the opportunities to boost exports to Ukraine outlined above are only hypothetical for the time being. The chances are there but the funds are missing. Ukraine will probably continue to avail itself of aid coming from international organizations but this is not likely to get the Ukrainian economy going. The only effective lever can be domestic effort, assisted by private foreign capital. Will the eastward enlargement of CEFTA help Ukraine use that lever? A little, perhaps, but certainly not much.

First of all, this would liberalize its external trade, meaning the elimination or reduction of obstacles to the flow of goods, people and capital between Ukraine and the CEFTA countries. This will be a repetition of what was achieved in mutual relations between the Czech Republic, Hungary, Poland and Slovakia in the years 1992-95. The pattern has been worked out already, it is possible to identify goods of various sensitivity, divide them into groups A, B and C as required and proceed to gradually lower tariff barriers.

Second, this will facilitate the exchange of experience with regard to domestic liberalization and market-oriented reforms.

However, this will not greatly facilitate the flow of capital to Ukraine because there is simply too little of it in the CEFTA countries. On the other hand, this could send a positive signal to those who have more capital, telling them that Ukraine is gaining greater credibility by entering well-known economic structures.

Russia will not become CEFTA member in the foreseeable future, yet it has to solve — and will somehow surely solve — the problems of consumer and investment imports and of import of capital. Ukraine would also have to try and solve these problems as well even if it did not accede to CEFTA, but in that case it would probably face some more problems.

Let us consider therefore if CEFTA (and the West) could cope without the Ukrainian market. The Ukrainian market is not one that has no alternative. After all, the Russian, Belarussian, Kazakh and many other markets are not that much different. The CEFTA countries have identical or similar comparative advantages in relation to each of those markets. Therefore a switch would be possible if some obstacles of a political or economic nature should crop up. However, few sellers complain about an excess of markets, so the above question does not suggest that the Ukrainian market should be ignored, merely that the matter should be elucidated from various angles. If we were to draw a positive programme, it has to be said that the CEFTA countries should care about all the eastern markets, including the Ukrainian one, which is situated next door, is vast and offers good prospects for the future.

One can get the impression that there is excessive faith in the new Western structures, such as the EU or NATO, in all East European countries, and among the candidates for admission to CEFTA there are also somewhat exaggerated hopes connected with that organization.

It should therefore be remembered that CEFTA was set up in December 1992 but the liberalization of trade between the Czech Republic, Hungary, Poland and Slovakia really gathered pace in 1994 and 1995, when domestic growth impulses appeared in each of those countries.[6] Therefore if one tried to look for causes and effects (while remembering about feedback), it should be noted that the domestic growth impulses in the CEFTA countries caused the growth of trade between those countries and accelerated external liberalization. They were the reason, not the effect, or rather it was the domestic impulses that played a greater role. It seems — and this should be forcefully emphasized — that the same should be expected in Ukraine. These impulses were sufficiently strong to ensure that the CEFTA countries are returning to the Eastern markets (insufficiently liberalized as they are), their exports to the East are growing faster than exports to the West, and the pendulum is slowly moving east as a result, after swinging excessively far to the west in the years 1990-93. If it were possible to move CEFTA eastward with this tide and if institutional transformations ensuing from CEFTA were ties with the new pro-Eastern trend in trade represented by thousands of exporters from CEFTA countries, it would be possible to obtain a synergic effect of the whole undertaking.

[6] For better insight in trade between CEFTA countries, Cf. Paweł Bożyk: "Miejsce handlu wzajemnego w handlu globalnym krajów CEFTA", in: *CEFTA a integracja ekonomiczna w Europie*, Szkoła Główna Handlowa, Warsaw 1996.

The eastward (as well as southward and northward) enlargement of CEFTA should also be associated with the major transit routes crossing central Europe from east to west and from north to south. This concerns gas pipelines, railways and motorways from Russia to Western Europe and the motorways and trade routes from Scandinavia to southern Europe and the Black Sea region. Many of these routes have been mapped out already, without waiting to see if CEFTA is enlarged or not. In addition, Euroregions have been set up in border regions of CEFTA members and the neighbouring countries. The conclusion that comes to mind is that the enlargement of CEFTA could facilitate these undertakings, although it is also known that they have been set up earlier and could grow without CEFTA assistance just the same. If so, what is the role of that organization in such undertakings?

It is difficult to say how long the preparations for Ukraine's admission to CEFTA might take. Its admission or otherwise will depend more on political conditions than on economic considerations, on whether the most important players decide that the admission is desirable from the point of view of European and global policies.

If the admission were to materialize in two or three years' time, CEFTA would by then be a structure characterized by free (duty-free) flow of goods and services. For Ukraine (and other possible additions) this stage of integration will not probably be attainable right after admission. The conclusion that follows from it is that CEFTA, similarly as EU, may become a structure moving at various speeds.

As an intermediate and preparatory step, CEFTA might conclude an agreement with Ukraine; it could be reached fairly soon, e.g. within a year, while the prospect of membership would only be considered at some later date. Such solutions are widely used in the contemporary world.

PHILOSOPHICAL REFLECTIONS

It is worth noting that the introduction of new figures on the map of Europe, such as CEFTA, or the shifting of old ones, such as EU or NATO, is taking place at a time of renewed expansion of liberalism, which proclaims to be an anti-constructivist philosophy, while all the attempts to introduce some world or European order is a typical constructivist endeavour. Therefore it should come as no surprise that people who appreciate philosophical doctrines, but also know the requirements of real life feel somewhat ill at ease. This concerns not only active members of liberal parties but also people who try to rise above partisan divisions. On the one hand, they would like to remain faithful to the doctrine or at least to appreciate its values and the greatness of its two luminaries, Hayek and Popper, who elevated spontaneity and criticized constructivism, while on the other hand they realize that the transformations in the East could not take place spontaneously, and without a plan adopted in advance and without its architects, CEFTA would not be formed and the new image of Europe would not be shaped. Instead, there would likely be chaos and anarchy, instead of peace and order. Most people are aware of this, which is why they expect the state authorities, the Church leaders and international organizations to get down to work. Few people count on spontaneity and unaided growth. But this is not passive anticipation but demands of activity, assistance and a peculiar fear of loneliness in the time of transformations (the syndrome of the deserted).

So what are the ways out? Liberalism, or at least the main current of the liberal philosophy represented by Hayek and Popper, is an ideology of the existence of a human being in an open society rather than a theory of building macrostructures. It can come in handy as a direction finder for individual persons in a fully shaped or nascent subjective society, but will be of little use in shaping huge social structures. Popper and Hayek are philosophers of two worlds: the democratic (free) one and the totalitarian (enslaved) one, good and evil, or even the philosophers of the emergence of one and the other, but they are not philosophers of the transformation of an evil world into a good one. Besides, many enemies of the evil world were content with "destroying the evil" without caring about what was going to happen next. This is why in the period of transformations, it will be necessary to reach for side streams of liberalism and other than the liberal doctrine, especially with regard to huge national and international structures.

However, the problem is not restricted to the transformations in the East. The dispute over constructivism and spontaneity has gone on for over a century and Hayek and Popper were taking part in it until quite recently. Their merits in the critique of totalitarian systems are part of the lasting heritage of the human mind but they also extended their criticism to the advocates of state intervention in the West and to modern architects of European structures. As recently as four years ago (in October 1992), Karl Popper joined in the great debate over the Maastricht treaties and he plainly announced that the European Community was misconceived and was bound to end in a disaster.[7]

[7] Marcello Pollo's interview with Karl Popper for *La Stampa*, reprinted in *Forum* No. 43 of October 25, 1992, Warsaw, "Europa źle poczęta".

Volkhart Vincentz

Ukraine and CEFTA

UKRAINIAN FOREIGN TRADE: RESULTS AND POLICIES

The economic crisis during transition in Ukraine is deeper and longer than in most states of Eastern Europe. But similar to many other transition economies exports are one of the few bright spots in the Ukrainian economy. Although GDP has declined since 1990 every year and industrial production was in 1996 less than 45% of the level of 1990, exports have been growing since 1994. The export performance is even more remarkable if one considers the regional distribution. The share of exports to non-CIS countries climbed from about 35% in 1993 to more than 45% in 1996. Export to this region grew in the first half of 1996 by 10% compared to the first half of 1995. This demonstrates that Ukrainian exporters used the new trade possibilities although the legal, organizational and financial framework in the country rather impeded market-oriented restructuring. The success of exports is clouded only by an unfavourable commodity structure. The already high share of raw and semi-processed materials in exports is increasing further. It is not labour-intensive goods that drive Ukrainian exports but rather products of the favourite branches of socialist industrial policy: metallurgy and chemicals.

Despite the favourable export performance the external sector remains one of the most serious problems of the Ukrainian economy. Ukraine needs about 1-1.5 billion US dollars annually to balance its current account. The high import bill for energy (about half of total imports) will continue to cause a deficit in the Ukrainian current account balance in the next years. Therefore, the government is under considerable pressure to reduce energy imports and/or support export expansion.

It is only since 1994 that Ukrainian politics has really acknowledged the difficult situation arising from the external sector. Before, the problem was in a way ignored and dealt with by accumulating rapidly debts against the energy suppliers: Russia and Turkmenistan. Since the reforms of autumn 1994 it has been understood that the external sector has to be liberalized and state intervention would not help to improve the situation. The liberalization of Ukrainian exports and imports has progressed since Kuchma was elected president. By and large in the last two years the Ukrainian economy has opened up to the competition from abroad: the exchange rate has been unified, many hindrances to exports (quotas) have been abolished, imports have been liberalized. Nevertheless, the liberalization of the external sector is not completed yet. There are still indicative prices for some export goods and a range of — sometimes not even announced — rules and regulations that contradict a market-driven foreign trade system.

The official point of view with regard to trade policy is clear. Ukraine wants to join the international trade organizations (GATT/WTO) and strives for bilateral trade agreements granting access on equivalent terms. The currency will become convertible (according to article 8 of IMF) in the near future.

Most foreign as well as domestic specialists propose for Ukraine an outward oriented strategy that is built around a liberalized trade system. Competition from the world market and the resulting pressure on the export as well as the import-substituting industry are considered essential for the development of market economy in Ukraine. Actually Ukraine is most closely interlinked to the world market. Imports amount to about half of total GDP and the export share is only slightly less. Only few countries in the world have such high shares of exports and imports.

But not all political forces praise the ties to the world market or the future gains from increased participation in the international division of labour. Calls for more protection of domestic producers have been heard. Similarly, for certain goods, such as grain, stopping of exports was requested in order to secure internal supply. Populist claims that the people's wealth is sold off by underpriced exports are frequent. Although the official policy aims at closer integration into the world market, parliament and parts of the administration have repeatedly tried to retard trade liberalization and supported protectionism.

Thus, the conclusion of binding international agreements on trade is also an important instrument for internal politics. International agreements fix steps towards liberalization that parliament can hardly reverse later. These agreements serve also the purpose of self-binding the existing and future governments. The agreements with the IMF play an important role in this respect.

TRADE BETWEEN UKRAINE AND CEFTA

Trade between Ukraine and the CEFTA countries as well as potential members of CEFTA is presented in Table 1. The overall trade relations with CEFTA amount to about 6% of Ukrainian trade. Ukraine's most important trading partner within CEFTA is Poland. It absorbs most of Ukrainian exports and delivers by far the most imports. Ukrainian trade with CEFTA developed in 1996 almost twice as fast as overall trade. Exports to CEFTA rose by astonishing 91% and imports increased even faster. These data prove the high dynamic of the trade with CEFTA, although the share of trade is still limited. But of course existing trade does not necessarily give too many clues to potential trade that might develop in a free-trade zone.

UKRAINE — CEFTA: WHAT IS TO BE GAINED?

In the document on "Concepts of the foreign trade policy of Ukraine" that is currently under review in parliament, the trade relations with the CIS and Baltic states are mentioned at the first place. After the EU and the G7 the document deals with the CEFTA and the CEE countries.

TABLE 1. Ukrainian Foreign Trade in goods and services (mio US-$)

	1. half of 1995	1. half of 1996	Share in trade with Europe 1996	Share in total trade 1996	Rate of growth I. 96/I. 95
		Export			
Poland	52.60	64.11	4.2%	1.1%	21.9%
Slovenia	0.47	0.51	0.0%	0.0%	8.5%
Slovakia	67.58	79.37	5.2%	1.4%	17.4%
Czech Rep.	28.80	40.51	2.6%	0.7%	40.7%
Hungary	78.43	90.39	5.9%	1.5%	15.2%
C E F TA	227.88	274.89	18.0%	4.7%	20.6%
Bulgaria	48.78	61.07	4.0%	1.0%	25.2%
Romania	36.74	34.42	2.2%	0.6%	–6.3%
Europe	1190.29	1530.47	100.0%	26.1%	28.6%
total	4584	5858.82		100.0%	27.8%
		Import			
Poland	99.84	163.89	8.2%	2.6%	64.2%
Slovenia	4.7	6.33	0.3%	0.1%	34.7%
Slovakia	24.67	51.73	2.6%	0.8%	109.7%
Czech Rep.	40.3	74.4	3.7%	1.2%	84.6%
Hungary	46.25	73.16	3.7%	1.2%	58.2%
C E F TA	215.76	369.51	18.6%	5.8%	71.3%
Bulgaria	21.84	40.47	2.0%	0.6%	84.5%
Romania	11.46	10.54	0.5%	0.2%	–8.0%
Europe	1155.57	1989.57	100.0%	31.4%	72.2%
total	4777.65	6337.33		100.0%	32.6%
		Saldo			
Poland	–47.24	–99.78			
Slovenia	–4.23	–5.82			
Slovakia	42.91	27.64			
Czech Rep.	–11.5	–33.89			
Hungary	32.18	17.23			
C E F TA	12.12	–94.62			
Bulgaria	26.82	20.6			
Romania	25.28	23.88			
Europe	34.72	–459.1			
total	–193.65	–480.51			

Source: Min Stat Ukraini, Zovnishnya torgiviya tovarami y 1 pivrichchi 1996 roku

In a way the order of the mentioned regions reflects the priorities of Ukrainian trade policy.

In 1994 and 1995 Ukraine signed almost a dozen free-trade agreements with countries of the former Soviet Union. However, only the agreement with Russia and the

Baltic states were actually put into force. Notably, in 1996 there was not a single free-trade treaty among Central and East European countries with any CIS country.

Ukraine negotiates with different Central European countries to explore possibilities for mutual free-trade arrangements. In the beginning of 1997 a memorandum about measures for a future free-trade agreement was signed with Poland. The Ukrainian foreign trade ministry expects similar memoranda with Hungary, Slovenia and the Slovak Republik. The Czech Republic, known to be less enthusiastic about CEFTA, was not mentioned.

As for the motifs to join CEFTA the above mentioned document states the similar economic structure between the regions. The traditional links should be revitalized especially in the areas of metallurgy, machine building for transport, agricultural machines, chemical industry and light industry. In addition research and development in various areas is mentioned as a promising field of cooperation whose products can be jointly marketed in third countries, for example Russia.

Such statements border the well-known rhetoric about revitalization of the destroyed former (socialist) division of labour and the great scientific potential. Relying on former trade links would not suffice to develop a growing mutual trade. Four areas will be mentioned that determine the prospects of trade between Ukraine and CEFTA. We will shortly consider them in order to be more specific about the general truth that any country gains from the removal of trade barriers.

According to one of the basic principles trade is governed by differences in factor endowments among countries. Compared to the countries of the EU all CEFTA countries as well as Ukraine would be considered as low wage economies that specialize in labour intensive — often low skill — production. Compared to CEFTA, wages are lowest in Ukraine: about a quarter of those in Poland. But this does not necessarily establish comparative advantages of Ukraine against other CEFTA countries in labour intensive production. The costs of production are determined not by wages alone but by unit costs, i.e. wages divided by productivity. Differentials in productivity can easily compensate for rather small wage differentials. Judging by the existing trade pattern between Ukraine and CEFTA countries, wage differences among the countries do not seem to be a major determinant of the export and import structure. Only some labour-intensive production, which, in addition, is highly mobile, as the sewing industry, moved in reaction to small changes in wages further to the East as wages increased in the CEE countries. Similarity in factor endowments does not rule out comparative advantages, but they will concentrate in a rather small bundle of products, in which competition among CEFTA and Ukraine would become stiffer if trade barriers are reduced.

Similarity exists not only with respect to factor endowments but also **in the level of development** as measured by per capita income. Again Ukraine would rank at this scale at the bottom of the CEFTA countries, but compared to Western Europe, Central Europe is a relatively homogeneous group. International observations tell us that trade among similar countries is higher than among states with great differences. The success of the EU confirms this statement. Similar countries engage more intensively in so-called intra-industry trade, i.e. they exchange similar things, such as Volkswagen against Peugeot or components of machines against other machinery parts. This might also work within the CEFTA. The consumer industry is among the first to develop products

suited to the medium income level of these countries. Consumer imports from Poland that match the needs of the Ukrainian population with respect to price and quality are widespread. Processed food as well as (labour-intensive) textiles from Poland and other countries have succeeded in gaining large shares on the Ukrainian market. But similarity as a driving force of intra-CEFTA trade has its limits. All countries are developing fast and the industrial structure is changing accordingly. Intra-industry trade, mostly related to machine building, is directed to Western Europe rather than to the CEE countries.

If Ukraine joined, CEFTA's population would almost double. In these terms the sales market of CEFTA would increase drastically; but calculated in terms of GDP the membership of Ukraine would mean an increase of 20-30% only. Nevertheless the **size of the market** is an important argument for a free-trade zone. All CEE economies suffer from high over-capacities. If they could be used better this would decrease the average costs of production and thus might help to gain competitiveness. If CEFTA's internal demand could be satisfied to a larger extent from the domestic industries of the region, this might improve simultaneously the prospect for exports. Unfortunately, large underutilized capacities exist in Ukraine in similar branches, e.g. coal, metallurgy and agriculture, as in other CEFTA countries.

Capacities and resources are also believed to exist for **technologically advanced production**. But again the division of labour in this area will be among East and West and less between East and East. Sophisticated technology products are built increasingly in multilateral cooperation. The CEFTA as well as the CIS states need considerable amounts of technology transfer, which is done most easily through joint ventures. In case of Ukraine foreign capital flows only slowly, the technological potential remains widely untapped because restructuring and reorganization of industry has just begun. Western firms are reluctant to make a partnership with a huge conglomerate whose property rights are unclear. There are few reasons to believe that CEFTA firms would be more willing to take these risks with Ukrainian firms. Using the technological potential means first of all going ahead with decentralization and privatization in Ukraine.

To sum up: A widening CEFTA would gather economies — at least if compared to Western Europe — of great similarity (industrial structure, factor endowment, level of development). This provides for some potential in mutual trading. At the same time it would stimulate the competition among the CEFTA members in their relations with Western Europe. This might lead to conflicts; especially insofar as these countries compete in their exports of the inherited raw intensive industries. On the other hand, improved trading possibilities and competition of consumer products as well as components of all kinds would result in higher welfare and better supply in the region.

CEFTA AND THE EU

Beyond these economic reasons for trade liberalization CEFTA appeals to its members as a vehicle to enter the EU. Membership in CEFTA is a preliminary step toward EU compatible economic rules. Although the chances that all CEFTA countries will join simultaneously the EU are dim, CEFTA will be a bridge towards the EU for the waiting members. On the other hand, the larger CEFTA will be, the more difficult would be the negotiations for membership of the EU. Despite this CEFTA seems prepared to expand as the expected accession of Romania demonstrates.

The CEFTA agreements demand the membership in GATT as well as a Europe agreement with the EU. Ukraine has neither of them. Although Kiev points out that these conditions might be waived in special negotiations, it is unlikely that their essence can be weakened. How would a membership of single CEFTA countries in the EU be possible, if they but not the EU have a free-trade agreement with third countries?

Ukraine might join the GATT/WTO in 1998. This is also the date for which a review of the "Cooperation and Partnership Agreement" with the EU is foreseen and possibly negotiations about a Europe Agreement can be started. Thus, it will still be some years before Ukraine fulfils the existing requirements for CEFTA membership. If this time is used to consolidate the successes in stabilization, to start a serious restructuring and to streamline and adjust the administration to European standards, as it has already begun, then Ukraine could belong to an all European free trading system at the turn of the century.

Last but not least, it is important for Ukraine to negotiate already now with CEFTA, to stay in touch with the quickly changing trade relations of her neighbours. Ukraine has to respond on its own to these changes. Therefore the acquaintance with the ongoing process of the integration of the East into the EU is vital for Ukraine.

Sándor Richter

CEFTA as a Catalyst for Future EU Membership?

INTRODUCTION

To the question raised in the title, whether CEFTA may be regarded as a catalyst for future EU membership, my personal answer is yes and no. This "no" refers to the past and present. Neither the purpose of establishment nor the practice of the CEFTA cooperation allow the conclusion that it served as catalyst for future EU membership of the partners. However, full membership of the CEFTA partners in the EU is still a couple of years away and the opportunity to elaborate a joint pre-accession strategy by the CEFTA partners is still open. In this sense CEFTA may still become a sort of catalyst for its members' future EU membership.

EXTERNAL ECONOMIC RELATIONS: IN THE SHADOW OF THE STRONGER PARTNER

In order to play the role of a catalyst for future EU membership CEFTA should have a strong position relative to the European Union in the external economic relations of the partners concerned. This is regretfully not the case. As data from Tables 1-6 indicate the share of intra-CEFTA trade in total trade of the CEFTA countries is small, especially in comparison with the overwhelming share of trade with the European Union. Data for 1985 demonstrate that even in the "good old" COMECON times the share of mutual trade of countries which later became the members of the CEFTA (except for Slovenia) was not especially high. High share of trade with the COMECON in the mid-1980s was explained, first of all, by the high share of trade with the Soviet Union (and, though less so, with the German Democratic Republic). By 1995 the share of mutual trade achieved or approached the level of 1990, the last year in the traditional COMECON system, but the potential for a quick further gain in relative significance of the intra-CEFTA trade is rather limited.[1]

[1] Richter, S. and Tóth, G. L. "Perspectives for Economic Cooperation among the Visegrad Group Countries" WIIW Reprint Series No. 156, Vienna, November 1994, pp. 10-13.

The CEFTA-EU inequality is even more overwhelming beyond trade. CEFTA countries, and their firms and banks raise foreign credits in the highly developed western industrial economies. None of the CEFTA countries possesses a banking system and capital market which would be in a position to offer significant financial resources to clients from other (e.g. CEFTA) countries. Foreign direct investment also is a nearly one-way street with huge inward investments in individual CEFTA economies by firms from highly developed western economies, while outward investment by firms from individual CEFTA countries is either almost non-existent or modest (Hungary). FDI flows within the CEFTA are meagre, except projects in the Czech-Slovak bilateral relations, partly inherited from former Czechoslovakia and a few Hungarian projects in Slovakia.[2]

The conclusion is that in external economic relations the unequal strength of the two partners, the European Union and the CEFTA countries, respectively, does not allow the interpretation of CEFTA as a catalyst for EU membership.

INSTITUTIONS OF COOPERATION

At first glance as a regional cooperation CEFTA could be ideal to prepare its members for accessing to a much larger integration bloc. But CEFTA was, at the very beginning, hardly anything else than a free-trade agreement based on bilaterally balanced lists of commodities regulating the speed of transition to free trade. The Europe Agreements are much more ambitious and broader based documents than the CEFTA document which contains, within a single Title, 42 Articles. The Europe Agreements have nine Titles and 122 Articles (Poland), 124 Articles (Hungary), and 119 Articles (Czech Republic), respectively. Of these nine titles No. III, "Free Movement of Goods" practically covers the contents of the whole CEFTA document. The Titles missing from the CEFTA document are the following:

I. Political Dialogue
II. General Regulations
IV. Movement of Workers, Establishment, Supply of Services
V. Payments, Capital, Competition and other economic provisions Approximation of Laws
VI. Economic Cooperation
VII. Cultural Cooperation
VIII. Financial Cooperation
IX. Institutional, general and final provisions

Nevertheless in its Preamble the CEFTA document refers to the Visegrad Declaration of February 15, 1991 and the Kraków Declaration of October 6, 1991, which urged political and cultural cooperation of the three countries signing that document.

[2] Hunya, G. and Stankovsky, J. "Foreign Direct Investment in Central and Eastern Europe and the Former Soviet Union". WIFO-WIIW, June 1996, Vienna; partly estimated data provided by the central banks of the countries concerned, published in the Business Central Europe, April 1996, p. 39., Monthly Report 7/1996 of the National Bank of Hungary.

Even if the CEFTA document were as ambitious as the Europe Agreements, it would be difficult to imagine that CEFTA cooperation plays the role of a catalyst in fields other than trade due to the much greater economic and political weight of the European Union compared to CEFTA. But in view of the lack of ambition this is out of the question.

There are fields, e.g. harmonization of law, where exactly the opposite process can be observed, and where relations to the EU serve as a catalyst in intra-CEFTA cooperation. Each CEFTA member is obliged to harmonize its laws with the European Union, and if they do so, indirectly they complete harmonization within the CEFTA, as well.

Although there has been a progress since the CEFTA was called into being and its stipulations came into force (in terms of acceleration of the removal of trade barriers, more gracious concessions in agriculture, starting negotiations on services), the institutional dimension of the cooperation is still missing. Whether this dimension is necessary or not, is a justified question, but in the context of the catalyst role of CEFTA only one aspect of the problem is important, namely that the CEFTA countries have had only a limited opportunity to practice consensus-seeking and decision-making. Permanent joint institutions pending similar institutions in the European Union or EFTA would mean a step forward in this respect.

MIGRATION

An important step to enlarge the scope of CEFTA cooperation could be an agreement on free movement of labour in the region. Although there was such a Polish proposal, other CEFTA members were unwilling to support this idea. This is all the more remarkable, as due to the more or less similar wage level in the four of the CEFTA members and taking into consideration the high transaction costs migrants have to reckon with, no really significant intra-regional movement of labour can be expected. What should then those EU members think, where the wage level is roughly ten times higher than in the CEFTA countries? If CEFTA members are frightened by the idea of opening their labour markets for migrants from other CEFTA countries, although the motives to migrate are pretty weak, is not this an indirect indication of dangers the rich EU members have to face if they agree to open up their labour markets after the CEFTA countries become full members? Free movement of labour in CEFTA, if allowed, would not be a catalyst for EU membership. Extent of flows of migrants could not serve as basis for any extrapolation of CEFTA-EU flows due to very different wage levels in the two regions. But it could diminish, to some extent, the EU's fears and suspicion in this field.

JOINT INVESTMENT PROJECTS IN INFRASTRUCTURE

CEFTA has not been a catalyst for future EU membership as initiator of regional infrastructure projects in transport, energy and telecommunication. Although expert groups have been meeting to discuss infrastructure related problems, actual cooperation in the development of infrastructure has been taking place in bilateral agreements. Without permanent institutions and a jointly developed vision about the region's future no such coordinating role can be expected from CEFTA.

JOINT ACCESSION STRATEGY OF THE CEFTA COUNTRIES?

WHAT IS A PRE-ACCESSION STRATEGY GOOD FOR?

There is no doubt that principally it is the eastern applicants' eminent interest to join the European Union. This statement is true from a historical perspective and in general. But how advantageous the accession will be for the new members in the short and medium run and in practical terms, will largely depend on modalities of accession. It is an eminent interest of the applicants to join the EU in the optimal time and under the optimal conditions. Benefits and losses resulting from EU membership may change in a wide spectrum, and even the case of much higher losses than benefits is among the possible outcomes. Recognition of one's own interests in various issues of accession and the ability to achieve such terms of accession which are as close as possible to the optimal ones may determine, at least in short and medium run, the real benefits any applicant will be able to win from accession. In order to identify a country's specific optimal modalities and to establish the conditions for successfully representing them each applicant needs a national pre-accession strategy.

The struggle for the optimal conditions of accession will take place primarily in the bargaining with the EU prior to and during the accession talks. But the national concept of optimal accession conditions must also be defended in the struggle with the domestic opposition to EU accession and, in certain cases, against other eastern applicants for membership in the EU.

It is hardly imaginable that an applicant may attain conditions which are close to the optimal requirements for the given country without a national accession strategy. A joint pre-accession strategy may be helpful to achieve certain targets of the applicants but it may in no way substitute national strategies. Any possible joint pre-accession strategy will be necessarily subordinated to national strategies. The joint pre-accession strategy may not be anything else than a sort of common denominator of each individual country's specific programmes. A common denominator for individual countries will have to be agreed upon in three main areas: vis-à-vis the European Union, the domestic opposition to EU accession and other eastern applicants for EU membership.

Certainly the main area of a joint pre-accession strategy may be relations to the EU. The first field of cooperation may be the search for the country's specific optimal accession conditions. A permanent communication between the academic circles and administrations in charge of EU enlargement in the CEFTA members may help each individual country to identify its optimal set of conditions that may be partly identical with, partly different from compared to those of the other applicants' optimum.

For those issues which are identical for all EU applicants from CEFTA, or for a group of them, it will have to be analyzed whether it is expedient and possible to coordinate negotiation strategy and tactic. The CEFTA members may fix a position in the case of a given issue which is the subject of bargaining, and stick to it during the accession talks. In other cases commonly accepted limits may be set within which a position may be fixed, according to the individual countries' needs. Finally, cornerstones may be imposed setting the limits of concessions provided by any of the Central and East European countries.

In the fight against the domestic opposition to EU accession or to some aspects of it the government of the CEFTA country in question may cooperate by exchanging information and arguments with the others. A joint promotional campaign for the enlargement may also be feasible.

For the moment the EU has ten eastern associated members, of which five are in the CEFTA. Accession negotiations will likely start with at least three or four eastern applicants, but perhaps with ten. In any case, simultaneous negotiations with more applicants provide an opportunity to play out the eastern applicants against each other. Concessions provided by one eastern applicant of "soft" negotiation strategy may easily serve as precedent in talks with applicants of harder negotiation strategy. This possibility makes the elaboration of joint "behaviour rules" for the CEFTA and possibly for other eastern negotiators expedient in order to prevent non-coordinated concessions by one or more applicant countries. Such a coordination may involve all or a group of countries. Certainly the bigger the group is the more difficult such a coordination will be. Nevertheless the leverage of a bigger group vis-à-vis the EU would be greater.

A joint pre-accession strategy necessitates permanent contact among interested parties. Most probably occasional meetings are not sufficient for a really effective coordination. The alternative solution may be either frequent regular meetings of delegations of the countries involved or an institutionalized form of cooperation with a council for coordinating pre-accession and accession strategies. The council should have a small staff with basically organizational function and should prepare the meetings of expert groups both from among the academic circles and the administration in the eastern countries.

TIME HORIZON OF CEFTA COOPERATION CONCERNING ACCESSION TO THE EU

Although most of the political rhetoric has been and will likely be about the date of formal accession, there is another date which will be of no less importance. This is the date when the last (important) derogation will be phased out. Formally the eastern applicants will be full members on the day of accession. From an economic point of view full membership will be achieved no sooner than the elimination of the last (important) derogation. The horizon of a possible joint pre-accession strategy is broader than the period up to formal accession. There may be distinguished four periods in CEFTA members' accession cooperation:

(1) Up to the start of the accession talks (first stage of pre-accession strategy)
(2) From the start of the accession talks up to the formal accession (pre-accession strategy, second stage)
(3) From formal accession to the end of the last important derogation (post-accession strategy, first stage)

(4) From phasing out of the last important derogation (post-accession strategy, second stage).

No doubt no. 2 would be the most important period of the four. No. 4 is in such a remote future that it has no practical significance yet. Although period no.1 of accession cooperation has already come but, except for informal information exchange between the academic experts of the countries concerned at conferences and other meetings and cautious political declarations by Hungarian and Polish politicians about the necessity and willingness of the two countries to cooperate on the EU accession process, no progress can be observed towards an institutionalized cooperation within CEFTA or within the group of the ten associated eastern countries in the issue of EU accession.

ACCESSION DATE AND DEROGATION

In order to identify the fields where a joint pre-accession strategy would make sense, it is necessary to know the main issues at stake in the bargaining process at the accession talks.

A key question of the negotiations will be the date of accession. Date of accession cannot be approached separately apart from the problems of derogation. Although the quickest possible accession is a politically motivated target of each eastern applicant, the earliest possible deadline will not be necessarily the optimal one. The question is to what extent the EU will be ready to accept the requests for derogation by eastern applicants. If the EU is relatively generous, then the way will be free to an early accession, as the bulk of the adaptation to EU internal rules of the game may take place after the formal accession. A less relaxed EU approach to eastern requests for derogation would compel the applicants to complete the whole adaptation process prior to formal accession. This second scenario necessitates the postponement of the date of formal accession.

Derogation requested by the EU may also influence the date of formal accession. Too hard (in perception of the eastern applicants) or unacceptable requests by the EU may force the eastern applicants to leave the negotiations or talks may be blocked for a longer time. Lack of such requests would accelerate the talks.

Most probably derogations requested by both sides will be subject to bargaining and may be linked with each other in one way or another. Compromise by linkage of mutual derogation may bring the date of accession closer.

Coordination of the accession strategy of the CEFTA members concerning the date of accession will not be possible before the decision is made which countries will be involved in the preliminary accession talks: all the ten associated countries, or only a group of countries out of the ten. In the former case all eastern applicants, in the latter the members of the group selected for the first round of enlargement may enter the pre-accession cooperation.

Next an attempt will be made to review some of the key areas where derogation will be requested either by the eastern applicants or by the EU or, perhaps, by both sides.

SUBJECTS TO BARGAINING

Transfers

One if not the main argument of opponents of the EU's eastern enlargement in the European Union has been the estimated high cost of transfers the new members will be entitled to if they become full members soon and under the present rules of the game. There are wildly differing estimates about the possible extent of these transfers, some of them horrifying. Eastern experts and politicians argue that alleged costs are exaggerated. As no one knows what the allocation system of the various EU funds will be like after 1999, no serious calculation can be made about the potential costs of transfers. The fear of costs which would explode the EU's budget will likely make the EU try to minimize costs of transfers by derogation.

Transfers will cause headache to eastern applicants, as well. Due to the principle of additionality transfers from the Structural Funds necessitate an equal extent of financing from the budget of the recipient country. Additionality may become a powerful barrier to access to EU resources. Although the eastern applicants will be entitled to huge transfers by the present regulations in the EU, none of them can afford a powerful increase of budget deficits through inflated expenditures attached to investment projects supported by EU transfers.

The EU's reluctance caused by fear of unpredictable costs through net transfers and the eastern applicants' likely partially blocked access to the hoped for resources due to problems with additionality call for a linkage and a two-way derogation. The eastern applicants may agree to accept a ceiling of net transfers either in absolute terms or in terms of their GDP's percentage while the EU may agree to a derogation from the strict rule of 50% additionality and lower the rate.

A joint pre-accession strategy of the CEFTA members would necessitate a coordinated standpoint of the countries involved. First, the acceptance of the linkage between the two-way derogation should be principally accepted, then the extent of the ceiling on net transfers and the extent of the reduction requested compared to the 50% additionality. It should be agreed whether the same keys should be applied to each eastern applicant or different ones.

Migration

Another reservation of the EU about the eastern enlargement has been the fear of mass migration from the east. Perhaps this is the number one problem related to a possible eastern enlargement for the wider public, in the light of high West European unemployment rates.

Migration may be an important source of foreign exchange for the eastern members, and a source of modernization through return of migrants with improved skills obtained in a highly developed environment. However, unlimited migration would lead to brain drain, too. The EU will probably require derogation for opening its labour market either in certain professional groups of the labour force or generally. On the other hand, eastern countries may apply for a special tax on migrants' income earned in the 15 present EU members to recompense losses of education costs spent on migrants.

A joint strategy of the eastern applicants may comprise an agreed maximum length of time being excluded from migration and scenarios of gradual opening of the EU's labour market. If they agree to accept the special tax on migrants' income, it should be unified, or else migrants from eastern countries with higher tax rates would be discriminated compared to migrants from lower tax eastern countries.

If the eastern applicants were able to come to terms concerning a unified length of period without migration they accept, it is still an open question whether the EU would be ready to renounce differentiation between the applicants. Namely the threat posed by migration from Slovenia with its two million inhabitants and relatively high standard of living cannot be regarded equal to that from Poland with its close to 40 million people.

Domestic market protection

Full membership of the eastern applicants without derogation means unlimited competition both for old and new members. This may cause headache for both sides even if industrial free trade were in force by that time.

It is difficult to foresee the consequences for trade in agricultural and food industry products which are not part of the free-trade agreements. Moreover, EU reforms in the Common Agricultural Policy are more than probable. Modalities of integration of the eastern applicants' agriculture into the EU will be one of the main challenges negotiators will have to face during the accession talks.

CEFTA countries exposed to full competition by imports may suffer serious losses if they are obliged to take over immediately all valid EU internal regulations, e.g. those for environmental protection. Many of the eastern firms should either close down or implement huge investment in order to comply with the strict EU environmental regulations. This may have an adverse effect on their competitiveness both on domestic and foreign markets.

Unlimited access to landed property in the potential new eastern members by EU investors may lead to political and social tensions with regard to huge price discrepancies between landed property in the West and East.

Unrestricted presence of EU banks in the eastern applicants' financial system may hurt local banks which are far from being able to compete with the huge competitors from the EU.

Moreover, once the eastern countries are full members, trade with the EU partners will have to be regarded as home trade, which means that no traditional trade policy measures (safeguard clause, anti-dumping processes) to stop deterioration of the trade balance can be applied any longer.

It seems that there will be sufficient reason to discuss various forms of derogation both by the EU and the eastern applicants under the heading "protection of the domestic market". That would make permanent consultations among CEFTA countries and other eastern applicants useful and expedient.

TABLE 1

CSFR
Share of individual countries and groups of countries in total CSFR trade

	Total	Poland	Hungary	Romania	Bulgaria	Soviet Union	Group A	Group B	Group C	EU (12)
EXPORTS										
1985	100	7.7	4.7	2.0	3.0	43.7	12.4	17.4	61.1	9.1
1989	100	8.5	4.0	1.8	2.3	30.5	12.5	16.6	47.1	18.2
1990	100	6.2	4.1	1.2	1.4	25.2	10.3	12.9	38.1	26.9
1991	100	7.3	4.3	1.0	0.6	19.6	11.6	13.2	32.8	40.7
1992	100	3.8	4.4	0.9	0.6	10.9*	8.2	9.7	20.6	49.5
IMPORTS										
1985	100	8.0	5.8	2.1	3.2	46.0	13.8	19.1	65.1	8.6
1989	100	8.6	4.8	1.7	2.2	29.7	13.4	17.3	47.0	17.8
1990	100	8.6	3.4	0.7	1.2	21.6	12.0	13.9	35.5	24.0
1991	100	4.7	1.9	0.3	0.5	29.9	6.6	7.4	37.3	34.6
1992	100	3.6	1.6	0.1	0.2	24.6*	5.2	5.5	30.1	44.0

* Former USSR

Notes: Group A: The Visegrad Group countries (Hungary, Poland); Group B: Group A + Bulgaria and Romania; Group C: Group B + Soviet Union/successor states.

Sources: 1985-1991: Jahrbuch des Außenhandels der Tschechoslowakei; 1992: Aktualni Statisticke Informace Nr. 10 (Foregin Trade).

TABLE 2

CZECH REPUBLIC Share of individual countries and groups of countries in total Czech trade														
EXPORTS														
	Total	Slovakia	Poland	Hungary	Slovenia	Romania	Bulgaria	Russia	Group A/1	Group A/2	Group B	Group C	EU (12)	EU (15)
1993	100	21.5	2.7	2.2	0.9	0.3	0,4	4.5	5.8	27.3	6.5	11.0	42.3	49.4
1994	100	16.4	3.9	2.7	1.2	0.3	0,4	3.9	7.8	24.2	8.5	12.4	45.7	54.1
1995	100	16.2	5.4	2.1	1.4	0.3	0,4	3.5	8.9	25.1	9.6	13.1		55.2
IMPORTS														
	Total	Slovakia	Poland	Hungary	Slovenia	Romania	Bulgaria	Russia	Group A/1	Group A/2	Group B	Group C	EU (12)	EU (15)
1993	100	17.5	2.5	1.4	0.4	0.07	0.11	9.9	4.3	21.8	4.48	14,4	42.7	52.3
1994	100	14.2	2.8	1.1	0.5	0.07	0.10	8.4	4.4	18.6	4.57	13,0	45.1	55.7
1995	100	13.1	3.1	1.0	0.6	0.06	0.08	8.9	4.7	17.8	4.84	13,7		56.4

Notes: Group A/1: Hungary, Poland and Slovenia; Group A/2: Group A/1 +Slovakia; Group B: Group A/1 + Bulgaria and Romania; Group C: Group B + Russia
Sources: Statistical Yearbooks of the Czech Republic; Czech Statistical Office: External Trade of the Czech Republic 1-12/1995.

TABLE 3

SLOVAK REPUBLIC Share of individual countries and groups of countries in total Slovak trade														
EXPORTS														
	Total	Czech Rep.	Poland	Hungary	Slovenia	Romania	Bulgaria	Russia	Group A/1	Group A/2	Group B	Group C	EU (12)	EU (15)
1993	100	42.4	2.9	4.5	0.7	0.4	0.3	4.7	8.1	50.5	8.8	13.5	24.0	29.5
1994	100	37.4	2.8	5.5	0.7	0.4	0.2	4.1	9.0	46.4	9.6	13.7	28.8	35.0
1995	100	35.2	4.4	4.6	1.1	0.5	0.2	3.8	10.1	45.3	10.8	14.6		37.4
IMPORTS														
	Total	Czech Rep.	Poland	Hungary	Slovenia	Romania	Bulgaria	Russia	Group A/1	Group A/2	Group B	Group C	EU (12)	EU (15)
1993	100	35.9	1.9	1.3	0.4	0.11	0.17	19.5	3.6	39.5	3.88	23.4	20.6	27.9
1994	100	29.6	2.4	1.7	0.4	0.12	0.16	18.0	4.5	34.1	4.78	22.8	26.2	33.4
1995	100	27.5	2.8	2.2	0.5	0.12	0.12	17.0	5.5	33.0	5.74	22.7		34.7

Notes: Group A/1: Hungary, Poland and Slovenia; Group A/2: Group A/1 + Czech Rep.; Group B: Group A/1 +Bulgaria and Romania; Group C: Group B + Russia.
Sources: Statisticke cisla a graphy, 1994 and 1995; Statisticky Urad Slovenskej Republiky, Bulletin 12/1995.

TABLE 4

HUNGARY
Share of individual countries and groups of countries in total Hungarian trade

EXPORTS

	Total	CSFR	Czech Republic	Slovak Republic	Poland	Slovenia	Romania	Bulgaria	Russia*	Group A	Group B	Group C	EU (12)	EU (15)
1985	100	5.7			3.8		1.7	1.4	33.6	9.5	12.6	46.2	15.9	22.6
1989	100	5.1			3.2		1.5	0.7	25.1	8.3	10.5	35.6	24.8	33.6
1990	100	4.1			1.7		1.8	0.3	20.2	5.8	7.9	28.1	32.2	42.1
1991	100	2.1			2.1		1.3	0.3	13.4	4.2	5.8	19.2	45.7	58.6
1992	100	2.7			1.3		1.8	0.4	13.1	4.0	6.2	19.3	49.8	62.3
1993	100	3.3	1.9	1.4	1.8	1.6	2.1	0.3	10.7	6.7	9.1	19.8	46.5	58.1
1994	100		1.8	1.3	2.1	1.8	1.9	0.3	7.5	7.8	9.2	16.7	51.0	63.7
1995	100		1.6	1.7	2.6	2.0	2.8	0.3	6.4	7.9	11.0	17.4		62.7

IMPORTS

	Total	CSFR	Czech Republic	Slovak Republic	Poland	Slovenia	Romania	Bulgaria	Russia*	Group A	Group B	Group C	EU (12)	EU (15)
1985	100	5.0			4.7		1.8	1.5	30.0	9.7	13.0	43.0	21.8	29.9
1989	100	5.2			3.3		1.6	0.9	22.1	8.5	11.0	33.1	29.0	39.7
1990	100	4.7			2.4		0.9	0.8	19.1	7.1	8.8	27.9	31.0	43.1
1991	100	4.1			1.9		0.6	0.3	15.3	6.0	6.9	22.2	41.1	56.7
1992	100	4.3			1.6		0.6	0.2	16.9	5.9	6.7	23.6	42.7	60.0
1993	100	4.0	2.1	1.9	1.2	0.5	0.7	0.2	19.5	5.7	6.6	26.1	40.1	54.4
1994	100		2.4	2.4	1.3	0.6	0.8	0.2	12.0	6.7	7.7	19.7	45.4	61.1
1995	100		2.4	2.4	1.6	0.6	0.8	0.1	11.8	7.0	7.9	19.7		61.5

* 1985-1992 former USSR
Notes: Group A: CEFTA (5) (Czech Republic, Slovak Republic, Poland, since 1993 Slovenia); Group B: Group A + Bulgaria and Romania; Group C: Group B + Russia (former USSR).
Sources: Külkereskedelmi Statisztikai Évkönyv; Statisztikai Havi Közlemenyek 1/1996.

TABLE 5

POLAND
Share of individual countries and groups of countries in total Polish trade

EXPORTS

	Total	CSFR	Czech Republic	Slovak Republic	Hungary	Slovenia	Romania	Bulgaria	Russia*	Group A	Group B	Group C	EU (12)	EU (15)
1985	100	6.2			3.2		2.6	2.7	28.4	9.4	14.7	43.1	23.2	29.0
1989	100	5.5			1.6		1.1	1.6	20.8	7.1	9.8	30.6	32.1	39.6
1990	100	3.9			0.9		0.9	0.7	14.5	4.8	6.4	20.9	45.1	52.7
1991	100	4.6			0.7		0.3	0.2	11.0	5.3	5.8	16.0	55.6	64.2
1992	100	3.8			1.3	0.02	0.5	0.3	5.5	5.1	5.9	11.4	58.0	65.7
1993	100		2.4	1.2	1.2	1.06	0.2	0.2	4.6	5.9	6.3	10.9	63.2	69.2
1994	100		2.7	1.1	1.1	1.19	0.2	0.3	5.4	6.1	6.6	12.0	62.7	69.2
1995	100		3.1	1.2	1.2	1.56	0.3	0.2	5.6	7.1	0.5	6.1		70.0

IMPORTS

	Total	CSFR	Czech Republic	Slovak Republic	Hungary	Slovenia	Romania	Bulgaria	Russia*	Group A	Group B	Group C	EU (12)	EU (15)
1985	100	6.0			3.0		2.6	2.0	34.4	9.0	13.6	48.0	20.4	25.3
1989	100	5.7			1.6		1.0	1.3	18.1	7.3	9.6	27.7	33.8	42.2
1990	100	3.1			0.8		0.3	0.5	17.0	3.9	4.7	21.7	43.5	51.1
1991	100	3.3			0.9		0.1	0.6	14.1	4.2	4.9	19.0	49.9	59.0
1992	100	3.2			0.9	0.03	0.2	0.2	8.5	4.1	4.5	13.0	53.2	62.0
1993	100		1.9	0.9	0.9	0.44	0.1	0.1	6.8	4.1	4.3	11.1	57.2	64.7
1994	100		2.3	0.9	1.0	0.42	0.1	0.1	6.8	4.6	4.8	11.6	57.5	65.3
1995	100		3.1	1.3	1.2	0.36	0.1	0.1	6.7	6.0	6.2	12.86		64.6

* 1985-1991 former USSR
Notes: Group A: CEFTA (Czech Republic, Slovak Republic, Hungary, since 1993 Slovenia); Group B: Group A + Bulgaria and Romania; Group C: Group B + Russia (former USSR).
Sources: 1985-90: Rocznik statystyczny handlu zagranicznego; 1991-94: Rocznik statystyczny; 1995: Central Statistical Office, Handel zagraniczny 1-12/1995.

TABLE 6

SLOVENIA

Share of individual countries and groups of countries in total Slovenian trade

	Total	CSFR	Czech Republic	Slovak Republic	Hungary	Poland	Romania	Bulgaria	Russia*	Group A	Group B	Group C	EU (12)	EU (15)
EXPORTS														
1989	100	1.6			2.4	2.5	0.22	0.48	13.7	6.5	7.2	20.9	51.3	58.0
1990	100	2.0			1.5	1.4	0.35	0.27	13.3	4.9	5.5	18.8	57.9	64.8
1991	100	1.5			0.9	2.9	0.20	0.26	8.1	5.3	5.8	13.9	63.8	70.9
1992	100	1.4			1.1	1.0	0.11	0.25	3.4	3.5	3.9	7.3	54.9	60.9
1993	100		0.9	0.50	1.4	1.4	0.31	0.74	4.1	4.2	5.3	9.4	57.4	63.2
1994	100		1.2	0.44	1.4	1.4	0.18	0.21	3.9	4.4	4.8	8.7	59.2	65.6
1995	100		1.6	0.62	1.4	1.3	0.25	0.16	3.7	4.9	5.3	9.0		67.2
IMPORTS														
1989	100	2.5			2.1	2.27	0.42	0.40	7.9	6.9	7.7	15.6	56.9	66.9
1990	100	2.1			1.6	1.25	0.19	0.17	6.4	5.0	5.3	11.7	58.3	69.0
1991	100	2.6			1.5	0.49	0.16	0.35	7.0	4.6	5.1	12.1	60.2	71.1
1992	100	1.9			2.5	0.29	0.15	0.49	4.1	4.7	5.3	9.4	50.1	59.6
1993	100		1.9	0.47	2.5	0.22	0.24	0.35	3.1	5.1	5.7	8.8	55.7	65.6
1994	100		2.4	0.79	2.6	0.31	0.28	0.39	2.0	6.1	6.8	8.8	57.1	69.2
1995	100		2.6	0.87	2.8	0.40	0.35	0.24	2.5	6.7	7.3	9.8		68.9

* 1985-1991 former USSR

Notes: Group A: CEFTA (Czech Republic, Slovak Republic, Hungary, Poland); Group B: Group A + Bulgaria and Romania; Group C: Group B + Russia (former USSR). From 1992 including trade for processing.

Sources: 1989-1994: Statistical Yearbooks of Slovenia, 1995: Bank of Slovenia, Monthy Bulletin 5/1996.

Justas Paleckis

The Lithuanian Road Through CEFTA into the EU?

Membership of the European Union is not only Lithuania's vision of the future, but also a great challenge and a concrete task. This factor becomes most important in targeting economic and political reforms. It may also help neutralize the negative influence of inexperience and other social restrictions. Determination to integrate into the European Union comes from two reasons: economic and security (or security and economic). Lithuania is not as wealthy as Switzerland and not as secure as Norway, and therefore it cannot keep aside of the European integration. The decision about membership of the EU was first of all a political one.

The emotional factor of joining the family of democratic European countries has until now played an even greater role. All main parties and political forces in Lithuania support the course towards the European Union. As disclosed by public opinion polls, Lithuania in one of the most pro-EU countries: according to the "Eurobarometer", 86% of the population is in favour of this course.

In Vilnius it is believed that Lithuania on the whole satisfies the criteria for EU membership as set out by the Heads EU meeting in Copenhagen. Lithuania is a stable, legal state in which human and national minority rights are guaranteed and protected. Treaties of good-neighbourly relations are being ratified with all neighbouring countries.

Lithuania has in essence already met yet another of the Copenhagen criteria: the market economy is in operation. Private business accounts for approximately 70% of Lithuanian production. Inflation decreased from over 1000% in 1992 to 13.1% during 1996. The budget deficit in 1995 made up 2.4% of GDP. It has been estimated that during 1996 the GDP grew by 3-4%. The national currency has not devalued since it was first reintroduced in 1993.

A programme of harmonization of Lithuanian law with European law is in progress and administrative reform is also in full swing. In Lithuania, the European civil servant corps is thus in the process of formation. The Lithuanian eastern border will also serve as the eastern border of the EU. This is why particular attention is being focused on securing the border, on continuing the fight against illegal migration and organized crime.

At present accession to CEFTA is one of the priorities of Lithuanian foreign policy. CEFTA is valued as a good practical preparation for membership in the European Union. In the case of Lithuania, the approach to CEFTA is also connected to some extent with political and security reasons. Lithuania's accession to CEFTA will once again confirm Lithuania's Central European identity and will pave the way for rapprochement with Central Europe for the other two Baltic states.

When speaking about Lithuania's road to the European Union, one must bear in mind that five or six years ago the majority of the political elite in Vilnius imagined only one main direction: through the Scandinavian countries. The alternative course through Poland and the other Visegrad states was almost precluded due to some prejudices and suspicions from the past and the unregulated Lithuanian-Polish relations.

Fortunately, this attitude was overcome. In the spring of 1994, Presidents L. Wałęsa and A. Brazauskas signed the Treaty on Friendly Relations and Good-Neighbourly Cooperation in Vilnius, in spite of some opposition from nationalist forces in both countries, who demanded the fulfilment of various preconditions. Following the example of the French-German and German-Polish reconciliation, the historical reconciliation between these nations was achieved.

The necessity to expand cooperation with Poland and the other Visegrad countries was also understood on time in the other Baltic republics. At the Meeting in Palanga (Lithuania) on March 25, 1994, the three Baltic Presidents stated:

"We stress the fact that contacts between the Baltic and Visegrad states in the political, economic and security building areas can play a greater role in mutually beneficial cooperation. We express our readiness to intensify the dialogue in all fields and on all levels with the view to facilitating the integration of the Visegrad and Baltic States into European political, economic and security structures. An important step in this direction will be the conclusion of a free-trade agreement between Baltic and Visegrad countries. We welcome the initialled Lithuanian-Polish Treaty on Friendly Relations and Good-Neighbourly Cooperation. We express our belief that this Treaty and similar treaties will be a politically significant achievement toward establishing confidence and promoting integration on the European North-South axis — between the Baltic and Visegrad countries."

In this statement the North-South axis has been mentioned. One can imagine that Lithuania and the other Baltic countries can be to some extent the bridge between Central European states and Nordic countries. The project of 'Via Baltica' and others can be promoted and developed in this direction.

Today, two and a half years after the signing of the Lithuanian-Polish treaty, all main political forces in Lithuania stress their will to promote and enhance cooperation with Poland. It is also generally accepted that the most promising way to the EU together with the Northern direction leads through Warsaw, Prague and other capitals of Central Europe.

One has to stress that Lithuania, in contrast to Latvia and especially Estonia, has no close historical, ethnic, cultural, linguistic, or religious ties with Scandinavian countries. Nevertheless, Scandinavian political and economic support for the Baltic states and cooperation between Nordic and Baltic countries ('5 + 3') is of great importance. On the other hand, Lithuania traditionally had much closer ties than the other two Baltic states with continental Europe, especially with Poland, Germany, Czechoslovakia, Austria, and even Italy. In any case, of the three Baltic states only Lithuania describes itself as a Central European state.

In the years 1994-95, the idea of maintaining the closest cooperation with the Visegrad states gained increasing support in Vilnius. Lithuania's aim was to gain recognition by Western and Eastern countries as a Central European state, reaching the same level as Poland, Hungary, the Czech Republic and Slovakia, especially as pertaining to problems of European and transatlantic integration. In fact, Lithuania, together with her two Baltic neighbours, achieved the same status in the EU (associated countries), WEU (associated partner) and other organizations.

As the Visegrad sub-regional group is becoming more and more amorphous, Lithuania's attention has begun to focus more on the CEFTA organization. Two main reasons determined this approach: political (to be on the same level with Central European states and to escape the label of a "post-Soviet Union republic") and economic (to develop an interest in the free-trade agreement and to maintain traditional markets).

The Lithuanian parliamentary elections in October-November 1996 yielded a large majority for the right-wing and centre parties. The Conservative Union (70 seats out of the 141 Seimas seats) and Christian-Democratic Party (16 seats) signed a coalition agreement. But after this shift from the left to the right no dramatic changes in the foreign policy of Lithuania are expected. This proves that there is an agreement among all major political parties as to the principles of foreign and security policy. The main of these principles is membership in the EU and the NATO, including accession to CEFTA.

Lithuania's turnover with CEFTA countries is increasing steadily — from US$255 million in 1993 to US$351 million in 1995. However, the share of CEFTA states in the whole turnover, which grows very rapidly, especially with the EU states, is decreasing: 7.15 % in 1993 and 6.38% in 1995. The trade balance with all CEFTA states is negative (see Appendix).

While developing intensive political and economic cooperation with Poland, Lithuania has secured in this country its "advocate" within CEFTA. The involvement of Lithuania in this organization, one can suppose, is in line with the political and economic interests of Poland.

At meetings of the three Baltic Presidents and Prime-Ministers during 1995-96, Vilnius made efforts to involve both Riga and Tallinn in cooperation with CEFTA. Latvia showed considerable interest in this direction, but Estonia apparently remains more devoted to the Northern option.

At the meeting of the heads of governments of the CEFTA countries Lithuania was represented by its foreign minister in 1995 and by its prime minister in 1996. Vilnius entirely supports decisions of the last CEFTA summit in Slovakia which concentrated on the deepening and widening of cooperation and encouraging the free movement of people, capital and services. At this meeting Lithuania was referred to as a potential CEFTA state.

As to the preconditions for joining CEFTA (associated membership in the EU, free-trade agreements with all CEFTA member states, membership in the WTO), Lithuania has fulfilled the first — associated membership in the EU.

The free-trade agreement with Poland was signed on June 28, 1996, with Slovenia on October 4, with the Czech Republic on October 14, with Slovakia on November 27,

1996. The FTA negotiations with Hungary are currently in progress. Lithuania proposed to start negotiations on this subject with Romania.

Lithuania has been negotiating with the World Trade Organization, keeping in mind that the obligations to the WTO are unchangeable. Vilnius aims at achieving the most favourable conditions, especially as to taxation on agricultural products. The end of the negotiations with the WTO will probably coincide with the acceptance of Lithuania into CEFTA which is expected in Vilnius in 1997-98.

Lithuania has always favoured closer collaboration with the countries of Central Europe in their efforts to join the EU. Wishing to intensify these contacts, in February 1996 Lithuania submitted a position paper on the improvement of the structured dialogue where the Associated Countries were invited to better coordinate their participation in the structured dialogue.

In May 1996, Lithuania and Poland submitted a joint paper on the enhancement and intensification of the political dialogue of the Associated Countries. The document was positively received by the EU.

In the last period especially close bilateral consultations with a view to sharing the experience on the preparation for the EU membership are being held with Poland, Latvia and Estonia. There is increasing understanding and mutual assistance in this field with the Czech Republic, Hungary, Slovenia and Slovakia.

There are no substantial differences of opinion in Lithuania about the future of CEFTA. This is understandable because the primary aim of Vilnius is to become a member of this organization. Membership would provide one more piece of evidence of Lithuania belonging to the "club" of the Central European states, and an expression of the hope that free-trade agreements, movement of people, capital and services encourage strengthening of democracy, economic growth and the process of reform.

Every country approaching an international organization — in our case CEFTA — looks first of all for matters that are relevant to its needs. Therefore, it is to be expected that after gaining all possible advantages from free trade and economic cooperation Lithuania will try to gain the understanding and backing of CEFTA countries for its security needs. It is a well-known fact that even in Finland, which is a relatively stable and secure state, security matters prevailed to some extent over economic aspects when this country acceded to the EU.

As to the official position of Lithuania, Vilnius firmly supports the "common start" option for all EU associated members for pre-accession negotiations. Of course, the end of negotiations and membership in the EU can and obviously will differ in time depending on concrete and objective merits of each of the applicants.

Addressing the international audience in the summer of 1996 in New York, the President of Lithuania A. Brazauskas said:

"We know well what we want: a life in a stable and secure democratic world. We also know how to implement these goals — by becoming members of the EU and NATO. We can neither regret nor apologize for the fact that somebody in the East or West does not like our legitimate interests or our very existence and causes problems because of that."

In its striving for these fundamental foreign policy goals, Lithuania demonstrates its determination to foster the values of stability and confidence within the region and its internal policy. Lithuania maintains good relations with all neighbouring states, has

no disputes over territorial issues, respects the rights of ethnic minorities and actively participates in international missions and projects.

Vilnius hopes that CEFTA countries will understand the importance of the "common start" position for Lithuania and the other Baltic countries, especially as relates to security issues. If the Baltic states are not admitted to NATO in the first wave, the security vacuum in this region could be increased due to non-admittance of one or two Baltic countries to the negotiations on the full membership in the EU. It is very likely that after joining CEFTA Lithuania will also be inclined to discuss, at least in an unofficial way, some security matters in this circle.

As to "common start" possibilities, Vilnius is certain that as regards the process of reforms and economic development, all three Baltic states are approximately on the same level. Inflation is at its lowest in Latvia. Estonia and Lithuania lead in the process of privatization. Estonia has attracted the largest share of foreign investment per capita. According to *Eurostat* calculations, in 1994 the GDP per capita in Lithuania was the highest of all the Baltic States — US$3,771 in real terms at purchasing power (parity). The figures for Estonia and Latvia were US$3,740 and US$3,193 respectively. In 1995 the increase in Lithuania (3.1%) was larger than in the other Baltic States.

Nevertheless, it is to be expected that CEFTA, which was created as a kind of waiting-room for the Brussels doors, will survive even after its members join the EU. It is possible that the future CEFTA will follow to some extent the evolution of the EU predecessors: ties in some economic branches, wide economic cooperation, then cooperation in political, security and other fields.

Naturally, CEFTA cannot be the "mini-EU" within the European Union. Central European countries, however, which found themselves in the Soviet sphere of influence for 50 years, and which earlier formed a specific region between the West and East, will have a lot in common for the many decades ahead. Even after joining the EU, the CEFTA countries will undoubtedly have some views in common on the representation of their interests.

The French proposal at the IGC — namely concerning the creation of legal possibilities to form groups of countries within the EU with the aim of fostering their economic and other special interests — opens the doors to such development: provided that the CEFTA countries are willing and able to deepen their cooperation in this transition period.

Such opportunities can be threatened by the tendency prevailing in Central European states to overlook their close neighbours and see only Brussels, Berlin, Paris, London. They will also very much depend on the readiness of those countries that join the EU first to maintain some modified forms of cooperation with the rest of CEFTA.

If we take into consideration the present list of the EU associated countries, Estonia, Latvia, Lithuania, Poland, Slovakia, Hungary, Romania have something special in common. The eastern borders of these states will in the future form the eastern borders of the European Union. This aspect can also be one of the subjects of discussions and agreements within CEFTA.

It should also be mentioned that at present the Baltic countries have a visa regime with Russia and other CIS countries, while CEFTA states have a visa-free regime with the CIS. In the future, a common EU approach will probably prevail.

The problem of the enlargement of CEFTA has not been discussed in Lithuania yet. Parallel with improving and strengthening relations with Warsaw, Vilnius was eager to develop cooperation with Kiev. Therefore, it can be expected that Lithuania will support the special relationship between CEFTA and Ukraine. Since winning the parliamentary elections in the autumn of 1996, the right-centre coalition has made some steps, showing its interest in maintaining and developing relations with Russia. It is therefore very likely that Vilnius will not oppose possible agreements between CEFTA and Russia, which would reinforce trade and other economic links.

It is very likely that the Kaliningrad enclave of the Russian Federation, before being surrounded by the EU countries in the nearest future, will be surrounded by CEFTA states, namely Poland and Lithuania. This fact will probably cause many complications in the CEFTA-Russian Federation relations. It may also help promote some kind of special relations between CEFTA and the Kaliningrad region — closer than with other regions of Russia. The law on the creation of special economic zones in the Kaliningrad region provides some possibilities in this area.

In general, it may be concluded that in aiming at the strategic goal — the membership in the EU — Lithuania's political elite in recent years has more precisely defined in which of the most important sub-regional bodies the country wants to participate. These main interests lie in the cooperation of the Baltic Sea countries (Baltic Sea Council) and the cooperation of the Central European states (CEFTA).

* * *

The problems of the transition period are numerous and serious in all Central European countries. However, bearing in mind everything that has been achieved to-date, the logic of economic development approaching the European Union and the availability of financial and technical assistance from Western countries, economic growth appears to be guaranteed. It will depend a lot on the ability of the Central European countries to develop and deepen cooperation among themselves and to participate in regional and sub-regional cooperation.

With economic growth and security reinforcing one another, each country's security will thus increase. This will be important for every Central European state, especially for Lithuania.

	1993		1994		1995		Export-import ballance 1995	Growth of turnover 1995/94, %	Investment of CEFTA in Lithuania, thousand $
	million $	% from turnover	million $	% from turnover	million $	% from turnover			
Poland	191.1	5.37	201.6	4.56	229.4	4.08	–19.4	13.8	7.250 (2.4% from all investm)
Czech	31.7	0.88	48.2	1.09	57.3	1.02	–37.4	18.9	1,300 (0.4%)
Slovakia	–	–	16.1	0.3	19.9	0.35	–15.6	23.4	300 (0.1%)
Hungary	29.7	0.83	37.7	0.85	43.5	0.77	–16.3	15.3	124 (0.0%)
Slovenia	2.6	0.7	6.3	0.14	9.0	0.16	– 8.0	43.6	3 (0.0%)
Total	255.1	7.15	309.9	7.00	359.1	6.38		15.9	8.997 (2.9%)

András Inotai

Impacts of the European Union on Regional Cooperation in CEFTA

INTRODUCTION

My topic is the reverse of what Sándor Richter was talking about, namely the mirror image of EU-CEFTA relations, to what extent the European Union proved to be the pressure group or the main actor for Central European or CEFTA cooperation.

I would like to make three general comments in order to understand what we are really talking about.

First, the EU-CEFTA relation, and I would even extend it not just to CEFTA but to all candidate countries, is a very typical relation between policy-making and policy-taking countries. The EU is the policy-maker and the CEFTA and the other candidate countries are the policy-takers. This situation, however, should not be understood as if the policy-takers were in an exclusively passive role, or relations were one-sided. Nevertheless, the balance, or even more, the imbalance, between policy-makers and policy-takers has to be always kept in mind.

Secondly, all CEFTA countries, and in particular all candidate countries, are on a lower level of development than the EU countries, and also than the EU average, of course. Thus, the problem becomes even more complicated by this developmental gap. It is a general experience that catching up with less or medium developed countries has never proved to be successful if countries on the same level of development cooperated intensively without cooperating first of all with better developed countries. So we need the more developed countries in order to catch up. It means once again that there is a dominant position of the more developed countries vis-à-vis the less developed countries. In fact, it is a centrum–periphery relation.

Thirdly, there is the matter of historical heritage: of the fact that because of the changing fortunes of history, Central and Eastern European countries proved to be unable to create their own anchor, be it the stability anchor, or be it the economic modernization anchor within the region. This anchor has always been imposed on them from outside by very different methods, with very different pressures, but always with the same outcome, that the stability and the modernization anchor was located outside the region. And that is once again the case after the fall of the Berlin Wall.

Just at the beginning, I would like to emphasize that despite all these impediments, all these imbalances, it does not mean that there is no room for regional cooperation. Just the opposite is true, because the policy-taker position of CEFTA should be considered as an argument to use each and all opportunities to make regional cooperation stronger. It is the same as what happens to somebody who is poor and gets only a fraction, a very small amount of money. This is not an excuse that "nice but with that amount of money I cannot do anything". Poor people (and countries alike) have to spend even small amounts much more efficiently than rich people do. It holds also for Central and Eastern European cooperation.

Of course, this cooperation is in most cases a reaction to impacts coming from the more developed and more powerful external factors. Moreover, in most cases this reaction does not manifest itself as a group answer; it comes as a national answer, a member country's answer, and only indirectly there is an impact on the group behaviour, or on the group level. So the sequencing is pressure or actions coming from the European Union to the national level, and from the national level to the regional one. In most cases, however, it remains on the national level, so that the national reaction can be identified more easily than the regional answer.

This paper is structured in the following way:

The first chapter deals with two basic and erroneous approaches of the EU toward Central and Eastern European cooperation in general and to CEFTA in particular; next, direct positive impacts of the EU on regional cooperation among CEFTA countries will be addressed. The third chapter focuses on negative impacts, while the fourth chapter illustrates the most important ambiguous effects. The final chapter draws some conclusions and provides some remarks about the future.

TWO ERRONEOUS WESTERN APPROACHES TO SUBREGIONAL COOPERATION

Originally, the EU's approach to Central and Eastern Europe was based on two, in my view, very unfortunate, and what is more important, untimely and wrong hypotheses: first, the gravity model and secondly, the training-ground theory.

The gravity model assumes that neighbouring countries generally have more intensive economic and other links with each other than with far away countries. To some extent it is true that geographic proximity is an important factor of cooperation, but not always, and certainly not in the case of the transforming countries, and particularly not in the first stage of the transformation. First, because the gravity model has been developed for countries which are on a high level of development with very strong, historically developed linkages within the region, which is not the case in Central Europe. Secondly, there are also countries whose economic development is predictable, where most factors influencing the development pattern can be considered reliable. So, these countries can shape plans for longer periods, which is certainly not the case in Central Europe, where dramatic developments in the early 1990s were considered of temporary character. Last but not least, in today's world economy the gravity model has lost a part of its validity, even among developed countries. If you look at the philosophy of new regionalism, you can easily find examples that countries at different levels of economic development and political systems, as the United States and Mexico for instance, are forming the same bloc or the same economic cooperation framework, which is certainly not to be explained just by the gravity theory.

Even more problems are connected with the training-ground theory. The training ground is based on a very clear logical sequencing from national autarky to regional cooperation, and from regional cooperation to global competitiveness. That is the pattern that has never worked in the last 50 years in the world economy. There have been several attempts at that, mainly in Latin America, and also in some other parts of the world, including, of course, the Soviet-dominated Central and Eastern Europe. Widespread experience clearly shows that the opposite approach **did** work. In the Asian (Far Eastern) model, countries first focused on global markets, and once they became strong and competitive enough, they had a lot of potential to use also for regional cooperation. This proved to be the right sequencing, and this pattern provides the right sequencing also for Central and Eastern Europe.

So the way towards substantially more and qualitatively better (different) regional cooperation leads through EU membership. EU membership is therefore a precondition for qualitatively better cooperation, and it is not regional cooperation which should be considered as a precondition for membership.

Of course, I do understand the EU's approach to Central and Eastern Europe in transformation, because, for obvious security reasons, Western European politicians wanted to stop or to resist further fragmentation and falling apart in the transforming region. They wanted to channel the whole transformation process into a predictable pattern. In addition, and to some extent correctly, the EU considered regional cooperation as a basic proof of EU maturity of these countries.

However, there were two other, not very much or, at least, not very openly expressed EU interests. One was that the participation and higher share in the larger regional market was very much in the interest of EU companies and also of other multinational firms. Trade-related and other barriers among Central and Eastern European countries were not in the interest of Western Europe, because the opening domestic markets were generally too small. Secondly, the EU's insistence on more regional cooperation has been interpreted in most successfully transforming countries as an effort on the part of the European Union to limit the competitive pressure originating from the transformation and reorientation process, and try to use a newly created Central and Eastern European economic community as the main absorber of such a pressure. The surprisingly rapid growth of market shares of the CEFTA countries in some product segments of the EU market in general, and of some national markets in particular, has given further support to this assumption.

THE EU'S DIRECT POSITIVE IMPACTS ON CEFTA COOPERATION

We have to start with a general remark. There has already been a pressure, mainly a benign pressure, mainly a hidden pressure coming from the European Union on regional political stability based on good and institutionalized relations among neighbouring countries. But the most important and quantitatively measurable developments occurred in the economic field. They include trade, foreign direct investment, overall general economic policies and partly also cooperation fostered within the framework of the PHARE programme.

(1) Trade. The Association Agreements have definitely made an important impact on subregional cooperation, because one year after having signed the Association Agreements with the European Union, the Central European countries (Czechoslovakia, later the Czech and Slovak Republics, Hungary and Poland) signed the CEFTA agreement, which was very much in line with the EU Association Agreements. It has the same timing and more or less the same structure, although the sensitive products are differently qualified. Also, when in Copenhagen the European Union accelerated the process of abolishing the quotas on sensitive products, the CEFTA followed suit and has accelerated this process as well. In the case of Hungary, and its still regulated imports, the so-called global quota system has special conditions both for the EU and for the CEFTA countries. In selected sensitive areas import quotas are fixed every half a year. Within the global quota for imports, the EU accounts for 50% and also CEFTA has a fixed percentage of this quota to be filled.

The next important positive impact came from the rules of origin. The Association Agreements stipulate that better or free market access can only be given to those products which have a local content of at least 60% (in some exceptional cases 50%). Local content was qualified as the cumulative value of domestic inputs, inputs imported from the European Union, and inputs imported from the CEFTA countries. So, in theory at least, the rules of origin have increased the propensity to cooperate in the region. In the first years, the economic potential and the overall structural requirements were still unable to make full use of this possibility within CEFTA. However, most recently, the dynamic development of intra-CEFTA trade cannot be disconnected from the impact of the Association Agreements. The EU's impact will be even stronger once the CEFTA countries become full members of the integration.

In addition, we should not forget the indirect impacts of trade relations with the EU. More dynamic and higher level trade with the European Union, the CEFTA's key trading partner, has a positive impact on growth. Higher growth rates positively influence domestic demand, which, in turn, increases imports, including imports originating in other CEFTA countries.

At the same time, and in the longer run, much more important is the already visible pattern of specialization within the region. It is one of the most interesting trends that the individual CEFTA countries are not any more only competing with each other in Western markets. There is an increasing differentiation in their export patterns, and the process, of course, is far from being finished. As a result, possibilities for intra-industry trade will be rapidly growing within the region. Obviously, one of the main engines of this development is foreign direct capital increasingly located in Central Europe.

(2) Foreign direct investments (FDI) play a crucial role. They may affect regional cooperation in very different ways. They may have just one location in the region, and then spread their economic and trade activities from there to other countries (headquarters approach). But they may have also locations in each of the member countries, with two different strategies. First, FDI may fundamentally be interested in preserving the domestic market of each of the transforming countries, which is not leading to regional cooperation (landlocked approach). Secondly, and more importantly, FDI-induced production and services may specialize in the individual countries and lead to growing intra-firm trade based on differentiated products. In this case, FDI is likely to become

one of the main engines of subregional cooperation, generated by multinational companies. In the case of such a pattern there are some dangers if domestic companies cannot catch up and increase their share in subregional cooperation. Nevertheless this development pattern is well known in the modern economic history of the Far East or of Latin America.

Until now, the main pattern of FDI in Central Europe seems to follow the "headquarters approach". Considering the ten biggest foreign investors in each of the four CEFTA countries (data from Slovenia were, unfortunately, not available), only one of these ten first multinationals is the same in the four countries. It seems to strengthen the hypothesis that these countries are already playing a role in the strategic thinking of multinational companies as potential regional headquarters.

(3) Forced and rapid adjustment to the EU rules, in my view, makes the most important positive and "homogenizing" impact. It generates a process of almost "unconscious subregional harmonization". Unconscious because it is not the result of deliberate regional coordination of preparing for membership or of adjusting to the EU, to the Acquis Communautaire and to the other requirements of the EU. Every country is adjusting in its own way, but in the final outcome we will have, in case of successful adjustment of course, practically the same economic policy framework. The same framework will create, or will provide us with, the necessary condition of working together more intensively in the future.

In this sense special attention may be paid to the Economic and Monetary Union (EMU). Although the future and the socio-economic consequences of the EMU are far from clear, its strong impact on the medium-term economic strategy of the CEFTA countries cannot be denied. To be sure, the fulfilment of the Maastricht criteria is not a precondition for becoming full member of the EU. However further economic policy coordination in line with these criteria is certainly indispensable well before accession.

(4) The PHARE programme was mainly designed for national requirements, and has always been used according to national priorities. There were just but a few regional projects, mainly paid from the multi-PHARE programme. Looking back at the last years, this approach had a rather limited impact, particularly regarding cross-border infrastructural projects. Let me just mention one example which is not a very successful one. The old idea to rebuild the Danube bridge between Hungary and Slovakia, which was destroyed during World War II, needed several years to materialize (The bridge has not been in operation yet.)

Cross-border cooperation financed by PHARE proved much more successful between an EU and a transforming country (German-Czech and German-Polish border development). In turn, it paid much less attention to genuine cooperation among Central (and Eastern) European countries.

NEGATIVE IMPACTS

Without entering into a detailed analysis, only some, mainly trade-related issues have to be mentioned in this section.

(1) The limited liberalization on the EU side in the first years, particularly regarding sensitive products and the sustained regulation of trade in agricultural commodities, have limited, and are still limiting or reducing, the potential of subregional trade. The lack of free-market access negatively affects growth, export income, import demand, specialization and trade policy practices. To some extent, EU protectionism has been translated to and implemented in the subregional framework. Unfortunately, there have been very few cases of joint CEFTA actions to protest against any kind of EU protectionism. All countries of the region have concentrated on their particular and short-sighted interests. (Another sign of the lack of willingness to develop genuine regional cooperation.)

(2) There have been different association agreements signed by transforming countries belonging to the same regional grouping. Such a development has certainly not been very beneficial to regional cooperation. While CEFTA countries have followed more or less the same line, major differences have emerged in the Baltic region, mainly between Estonia on the one hand (full free trade in industrial products from the beginning) and the other two Baltic countries (gradual liberalization). Obviously, these differences have had an impact also on the harmonization of national trade policies within the subregional framework.

(3) Partly different geographic orientation of trade relations among countries belonging to the same subregional grouping may have been detrimental to regional cooperation. Once again, a case in point is not CEFTA, where EU trade is clearly centred on Germany, but the Baltics, where differences between the Scandinavian and the continental European orientation are manifest.

(4) Rapid trade liberalization of the transforming economies has given substantial benefits to more prepared, more competitive and financially stronger EU firms which make use of the situation and crowd out traditional Central and Eastern European suppliers. In this way, the EU, although not deliberately, has contributed to the disruption of subregional cooperation. A special way of the crowding-out process is represented by a large number of Western (mainly EU) intermediaries, who play an important role in subregional trade. Still, 30% of Hungarian-Polish trade is carried out through mainly German and English intermediaries. Certainly, the activity of intermediary companies, to some extent, increases the potential of regional cooperation. To some extent, however, by substituting genuine links by third-country activities and gains, it reduces the real potential of subregional trade.

(5) At least in some sectors, the crowding-out effect proved particularly harmful, as it has produced the breakup of vertical linkages of the division of labour among the CEFTA countries from the old COMECON times. Part of these production linkages are unable to face international competition. Much more damage has been done than the necessary costs of transformation would have entailed; part of these linkages could have been maintained if we had a much better and more reasonable politics on our side, and a better coordinated policy between the CEFTA and the European Union. A special case in point is the textile-clothing sector, where, as a result of tariff-free entrance, clothing products using EU textile inputs were freed, from the beginning, from all trade barriers. Generally, this led to the practical disappearance of the national textile industries, and, in all cases, to the abolition of national and/or subregional cooperation between the textile and clothing sectors.

(6) Regional quotas in sensitive sectors, determined as the sum of national quotas, could have also contributed to more regional cooperation. This issue is, however, already déjà vu, because most of these quotas on sensitive industrial products have been abolished.

(7) Substantial damage has been made by the subsidized agricultural exports of the European Union to the region, which have destroyed essential capacity of cooperation in the region, not only within the CEFTA, but between the CEFTA countries, on the one hand, and other Central and Eastern European countries (including the successor states of the Soviet Union) on the other hand.

(8) CEFTA countries have made policy errors, when, in their subregional framework, they followed the enforcement of the Association Agreement with a certain time-lag only. This failure has been aggravated by the fact that the years 1992-93 represented a key period of transformation, when many new patterns emerged and entered a stage of (structural) consolidation. After two or three years of fundamental asymmetry between collapsing Eastern exports and liberalizing Western imports, another asymmetrical year followed, characterized by the presence of an agreement with the EU and the absence of another similar agreement among the associated countries of Central Europe. As a consequence, and due to better market access conditions, EU companies could take possession of many key areas before, at least theoretically, the same opportunity would have been provided to subregional companies.

Finally, the different timing of the two trade agreements have further aggravated the powerful asymmetry of market positions and competitiveness between EU and CEFTA firms. All CEFTA countries offered their national markets first to the European Union which was an offer to the policy-maker region accounting for 50 to 70% of the total trade of the transforming countries. A year later, as a similar agreement with the CEFTA was on the agenda, we encountered growing resistance coming from different lobbies in all CEFTA countries. It was the first repercussion of too liberal and too quick trade liberalization in the unique framework of the transformation process. Resistance to further liberalization automatically hit intra-CEFTA trade policy, not only because it was a "late-comer", but also because of obvious bargaining power considerations. Everybody realized that it would be harmful to protest against imports generated by the European Union, for the latter was the policy-maker with a substantial retaliatory power. In turn, everybody became very reluctant regarding the liberalization of CEFTA trade, a small portion of total trade, with rather limited impact on domestic production (except for a few sensitive areas), but an area were domestic leverage could be enforced.

AMBIGUOUS IMPACTS ON CEFTA

In a number of areas, the impact of the EU has both positive and negative effects on regional cooperation, influenced also by the development level and economic policies of the individual transforming countries.

One interesting case is the role of foreign direct investments. As we have already indicated, FDIs can substantially contribute to regional cooperation. At the same time, they may also increase regional competition among countries for obtaining vital foreign investments. Although some experts have come up with the idea of implementing a regional treatment of FDI, at least within the CEFTA framework, such a policy has not worked in any other integration grouping either (take as an example the FDI treatment of the Andean Group in the early 1970s). National economies, even those closely cooperating in many areas and institutionally integrated (as the EU member countries), have their own national FDI policies and are not ready to abandon them in favour of regional harmonization. As a result, FDIs are both fostering regional cooperation and increasing regional competition for additional financial and technological resources.

There is, however, one area where a more coordinated attraction and utilization of international funds should be envisaged. The development of infrastructure would already need a comprehensive regional approach instead of fragmented and more costly, uncoordinated national development concepts.

Another ambiguous impact stems from the quality and speed of the adjustment to the EU. On the one hand, as I have already mentioned, adjustment considerably facilitates the framework of more regional cooperation. On the other hand, however, the adjustment capabilities of the individual countries are largely different. Everybody is today in a race in Western Europe regarding EMU. In Central and Eastern Europe everybody is in a race to cope with the conditions of the Acquis Communautaire. However, the national capabilities are very different. And what happens if one of these countries, or several of them fail to cope with the conditions? The counterproductive effects are substantial, not only for the country which fails, but for regional cooperation as well. A particular aspect of adjustment differences lies in the political sphere, because even the CEFTA countries seem to have a different level of sensitivity concerning national sovereignty.

A third ambiguous development is represented by the growing development gap between different regions of the same country. Similar to cross-country developments, the process of adjustment to the EU also produces growing differentiation within the same country. Some parts of the associated country are better prepared, have more resources to mobilize, have access to more qualified and/or more flexible labour, are provided with better infrastructure, etc. than others. Regional cooperation is strengthening this process in both directions. If more developed regions of the neighbouring CEFTA countries are part of the same regional development centre, their adjustment to the EU simultaneously fosters regional cooperation (e.g. the Vienna-Bratislava-Győr triangle). In contrast, neglected neighbouring regions in two or more countries contribute not only to national but also to regional differentiation and may become serious barriers to regional cooperation. In order to avoid the highly negative and costly consequences of such a situation, regional funds should be made available both by the EU and the associated countries (which is, unfortunately, not the case).

Fourth, the EU's attitude towards subregional cooperation in Central Europe is not free from ambiguities either. On the one hand, the EU has emphasized in most official declarations related to Central Europe how much importance Brussels attaches to more substantive regional cooperation. However, the spirit of this political goal has not always been supported by practical steps either by the EU or by the member countries. (There is a number of examples of the negative impact of the EU on subregional cooperation.) In addition, various possibilities of genuine regional cooperation failed because EU-financing has not been available. Also "artificial competition", a kind of regional "beauty contest", very much fuelled by different Western European circles,

has added to more regional competition with negative impacts on cooperation. It is not clear at all whether all EU countries are really interested in more regional cooperation (excepting the unlikely case, when regional cooperation means more regional autarky and less competition of Central European products on Western European markets). It is even less certain whether individual EU member countries (and different interest groups within these countries) would be similarly interested in more regional cooperation.

Finally, and most importantly, the most ambiguous impact may derive from the EU's treatment of the Central and Eastern European region during the critical years of the pre-accession period. As already mentioned, there is a deeply rooted suspicion in the CEFTA countries that any concept or pressure imposed from outside in favour of more subregional cooperation could be interpreted as the lack of willingness of the EU to let candidate countries join the EU — of course, on their own merits. The fear of bloc treatment has been strengthened most recently when the EU started to underline the heavy costs of Eastern enlargement, always based on the assumption that all ten candidate countries would join at the same time (which has never been a realistic scenario). It has to be understood that the more the EU is pressing for equal treatment of the whole region, the less the Central and Eastern European countries will be ready to cooperate, because any step towards cooperation would be considered as counterproductive to membership and fostering the EU's bloc approach. Moreover, at least in the more advanced CEFTA countries, bloc treatment is interpreted as an argument to postpone enlargement.

Obviously, in political terms, the EU is not in an easy position, because the nomination of countries belonging to the first wave of enlargement may create additional regional conflicts (between members and non-members of the first enlargement process). In order to break this deadlock, a clear and long-term EU enlargement strategy is required with utmost urgency. Such a grand design, as developed after World War II for Western Europe, could abolish or at least substantially reduce fears, offer clear prospects for all countries of the region and substantially enhance regional cooperation. (It is unlikely that, in the absence of such a grand design, cooperation among Western European countries in general, and between France and Germany in particular, would have been feasible after 1945.)

CONCLUDING REMARKS AND PROSPECTS

(1) A new quality of regional integration is not a precondition for but a consequence of the EU membership. There is no doubt about a huge growth potential in regional trade. According to our calculations, subregional trade, which now accounts for 8% in the total trade of Hungary, may be raised to 12 to 14% without any difficulty. The example of Spain and Portugal before membership and after membership is most evident. For various reasons (institutionalized framework, high level of flexibility, human factor, geographic location, etc.) Central Europe has a much better foundation for regional cooperation than the Iberian Peninsula had before membership. The CEFTA region will become a very rapidly developing region within the European Union and one of its future growth engines.

(2) As Eastern enlargement, according to my best knowledge, will happen in different groups, we need a common strategy. By "we" I mean the European Union and the first round members. We need a common strategy on how to deal with the rest of Central and Eastern Europe. And we have to do it today and not tomorrow when it will be too late. We have to create a credible framework for those who will remain outside, because even if we have the best framework equipped with infrastructural projects, with enhanced PHARE, with cross-border cooperation etc., we will not be able to avoid two dangers. One is that internal destabilization cannot be ruled out in those countries which will not become members, because the (populist) opposition in these countries will immediately say, "our government was so bad, it was so weak that it could not even negotiate membership". Secondly, there is an external problem. All those countries which will be left out of the first round, without a framework agreement serving as a credible umbrella, will provide attractive cases for some countries which would like to have a dominant position in that part of Europe. I do not believe that even the best agreement will be able to eliminate this danger completely, but we can substantially reduce this danger by concluding such an agreement.

Lastly, the CEFTA countries are against any kind of bloc treatment. I would like to emphasize that even in the worst times of Soviet domination, Central and Eastern Europe did not constitute a bloc. Despite having the Warsaw Pact and COMECON, Poles and Hungarians, Czechs and Romanians, Russians and East Germans were very different in their mentality, character and attitudes. As a consequence, any attempt at a bloc treatment by Brussels would not facilitate, but on the contrary, would reduce the willingness to cooperate, because of the general fear that a bloc treatment would close the door for EU membership for a long time or forever.

What should Central European countries do in order to strengthen regional cooperation?

First, they have to follow EU rules closely in order to avoid gaps between adjustment to the EU and further development of regional cooperation.

Secondly, joint infrastructural designs should be put on the agenda urgently.

Thirdly, although negotiations on accession will be carried out on an individual basis, there are minimum conditions for better leverage for all candidate countries. These include not only regular consultation on mutually important issues but also a firm resolution that the Central European countries will not undermine each others' position in negotiating with Brussels.

Fourthly, in a more positive approach, also some common attempts to influence the decision-making process in the EU may be expected in such vital areas as labour flows, the future of structural funds, the reshaping of the common agricultural policy or the new institutional framework of the Union.

Finally, and more urgently, a positive regional (Central European) communication strategy should be designed, for the enlargement of the EU will not only be highly motivated by political and security considerations but, necessarily, also by regional aspects. It is not country A or country B which will join the EU during the next enlargement process, but a certain and probably well defined region. Therefore, national communication strategies should give more opportunity to regional approaches which are likely to upgrade national attempts. The main joint message should concentrate on the manifold benefits the EU is expected to enjoy once (the first wave of) Eastern enlargement materializes.

Marek Grela

CEFTA and Pan-European Political and Economic Cooperation

The establishment and development of CEFTA has a clear historical context. The 1990s definitely bring to an end the almost half-a-century of a divided Europe. For Poland it all started with the beginning of transformations of the political system in 1989, the peaceful revolution in other countries of Central Europe, the pulling down of the Berlin Wall, the unification of Germany and, last but not least, the disintegration of the Soviet Union and the establishment of a Community of Independent States. All this was accompanied by some dramatic events, as experienced i.a. by Romania. The process of emancipation of the Baltic States was by no means easy. The disintegration of Yugoslavia led to a bloody, cruel and protracted war which has been extinguished with great difficulty thanks to a joint effort on the part of Europe and North America.

The consolidation of the two parts of the divided Continent was based on the new democracies recognizing the universal values and principles: the rule of law and respect for human rights, parliamentary democracy and open-market economy. The countries of Central Europe, which were the first to change their political system, found themselves in a geostrategic vacuum between the disingrated post-Soviet world and the West which in the early 1990s watched with some consternation the pace and depth of these transformations. The new European order was not generated according to a preconceived grand design nor on the basis of agreements between the contracting parties — the main protagonists in the cold-war rivalry. It was a spontaneous yet peaceful process. However, like any process of historic change on such a scale, it brought with it a threat of destabilization and conflict.

For nearly half a century the countries of Central Europe had been subject to the tough, arbitrary rules of Yalta. The imposed political and economic strait jacket, limited sovereignty, severed historical and civilizational links with the rest of Europe and the situation on or near the military confrontation line made Central Europe a *sui generis* territory of "special status". That, it would appear, contributes to reluctance to maintain a "Central European separateness", the radical change of circumstances notwithstanding. In his paper Minister Kaczurba mentioned the "COMECON syndrome". There was also the "Yalta syndrome".

Having in mind Jean Monnet's famous words: "Nothing is possible without men; nothing is lasting without institutions" it has to be emphasized that new democracies of Central Europe did not aim at basing their new place in Europe on regional institutions adapted to their exclusive needs.

First, they did not see such a need after their experience of the bloc-division of Europe.

Secondly, they were afraid that marginalization — which resulted from their subordination to the Soviet Union — might be replaced by marginalization of a different type, in the form of a "no-man's land" or "twilight zone" between the stable and prosperous West and the East in the midst of turmoil.

Thirdly, the new democracies of Central Europe did not want to lose the opportunity for the development of European integration as a result of the historic changes. They saw in this a real chance for their permanent co-participation in the process. Hence the development and the future of CEFTA to a considerable extent became dependent on the dynamics and trends of European integration — on the deepening and widening of the European Union.

The present CEFTA member states formulated their priorities in foreign policy relatively early on. As early as the beginning of the 1990s, even before CEFTA came into existence, the countries of Central Europe — Poland, the Czech Republic, Slovakia and Hungary — regarded the link with western institutions such as the Council of Europe, the European Union, Western European Union (WEU), NATO and OECD as their political priorities.

At the beginning the acceptance of integration aspirations aiming in that direction was not all that obvious. The western world was rather cautious in the matter of Central Europe's participation in western economic, political and military institutions. To some extent this was understandable: time was needed to adjust the existing institutions of the West to the challenges of the new situation. At the same time signals were sent to encourage Central European countries to develop their own mutual economic and political cooperation. It is no longer a secret that these signals were received with a dose of scepticism. The Central European states were afraid that these moves would lead to the consolidation of a "special status" of the region and that the proposed "local" institutional solutions would become a substitute — "something instead" — of the participation in the well-established and efficient Euro-Atlantic institutions.

However, the above description of the *status quo* has to be accompanied by the statement that in the new geopolitical situation the countries of Central Europe had some special interests in common which demanded consultation and cooperation. This found expression in the meeting at Visegrad and in subsequent meetings between the four countries and intensive bilateral contacts devoted to the matters of security in the region, neighbourly relations, and regional cooperation. This was accompanied by joint activity within the framework of the Central European Initiative and — on the part of some Central European states — in the work of the Council of the Baltic Sea States.

It is no coincidence that only a clear prospect of a special relationship between Central and Eastern Europe and the EU in the form of European Agreement (on association) and — some time later — a prospect for the widening of the Union eastwards as well as expanding NATO as a guarantor of European stablity made possible, or at least facilitated cooperation within CEFTA.

The connection between cooperation within CEFTA and the pursuance of the membership in the European Union is very clear. The Declaration of the Prime Ministers of CEFTA countries issued in Poznań (November 25, 1994) clearly emphasizes that one of the main criteria of CEFTA membership is the signing of an association agreement with the European Union. It also stresses the paramount importance of economic cooperation in the fields covered by the Europe Agreement between CEFTA member states and those of the European Union.

Membership of CEFTA is intended, among other things, to facilitate membership of the Union. It is a kind of training for EU membership, and CEFTA has been aptly described by a European politician as a "fitting room". It is also a matter of reaching some standard of multilateral cooperation for the area which in the not too distant future is to become the eastern and south-eastern part of the European Union.

The importance of CEFTA goes beyond the matter of doing homework by the countries preparing for membership in the EU. CEFTA brings palpable economic advantages to its members. Economic ties between countries of Central Europe have been renewed after a period when they had been strained or severed following the disintegration of the COMECON and the change of economic systems. It is the question of reconstructing cooperation in market-economy conditions, not of reconstructing the previous structure of these ties.

The newly established free-trade zone has resulted in the development and shifts in trade. In 1996 the share of CEFTA countries in Polish foreign trade grew, though it is not high (circa 6%). Some 60% of this accounts for the Polish-Czech exchanges. Trade between Poland and Hungary is also increasing. On the whole, trade with CEFTA countries is growing faster than Poland's average foreign trade, faster even than that with the countries of the EU.

Trade inside CEFTA can be expected to continue growing at a rate higher than the average rate of the total foreign turnover of Central European states. Such expectations are founded on the still low level of exchange, complementarity of respective economies, geographical proximity and the development of cross-border cooperation.

The CEFTA countries were successful in their system transformation and belong to the dynamically developing markets. Membership of CEFTA accelerates liberalization of trade between member countries and introduces an additional dose of competitiveness which is useful for the economic condition and inevitable restructuring of various sectors of the economy. It must be pointed out that liberalization also applies to such sensitive fields as agriculture.

The enlarged market of Central Europe increases the attractiveness of the region from the point of view of foreign direct investment. With increasing frequency multinationals establish themselves in the region of Central Europe with the aim of concentrating on the whole market of the region rather than local markets — with plans of development and expansion farther to the East. This also applies to investors from outside Europe, who establish their branches in CEFTA countries with a view to the future — that is, to a common European market covering over twenty countries. The influx of foreign capital is a confirmation of the stability of the region and its economic prospects.

There is no doubt that trade within CEFTA is favourable to economic growth of its member countries and indirectly to the political and social stability of the region, while the stabilty of the whole of Europe — West and East — depends on stability in Central Europe.

The very name CEFTA indicates its territorial boundaries. However, the geographical criteria do not always fit the political or economic concepts. Interest in joining CEFTA or establishing some form of contact with it is growing on the part of third countries. Some of them, such as Romania, Bulgaria and the Baltic States — have concluded agreements on association with the EU. Others — e.g. Ukraine and Croatia — do not meet this criterion for CEFTA membership. Interest in CEFTA springs from both political and economic sources. First, there is fear of marginalization and a new division in Europe. Secondly, there are financial and trade considerations. The problem is one of imports from the EU being treated by CEFTA countries differently than the less privileged imports from eastern neighbours, the countries in which transformation is less advanced. The issue of supporting economic transformation and political stabilization in the countries along the eastern borders of CEFTA is now on the agenda. In this sense one can talk of CEFTA playing a pan-European role.

The time factor is important. All CEFTA countries are candidates for EU membership. These countries assume and have good reasons to count on the fact that negotiations on accession will begin within a year or so, i.e. six months after Intergovernmental Conference. Accession, or at least the conclusion of negotiations, is likely to take place in the years 2000-2002.

Membership of the European Union will mean the renouncing of all economic agreements, that is withdrawal from CEFTA. Can it be assumed that CEFTA's role will be merely that of an instrument of transition, or will the present cooperation have some continuity and influence on the countries of the region also in the following decades?

As an answer to the above question three hypotheses can be advanced.

The first concerns future cooperation among the present CEFTA members who will find themselves within the borders of the enlarged EU. It cannot be assumed that even then the process of cooperation initiated by CEFTA, e.g. technical cooperation or consultations, will continue to develop. As demonstrated by practice to-date, in the EU there is room for pragmatic regional cooperation, the proof of which are the Benelux countries and the Nordic countries belonging to the Union.

The second hypothesis refers to the future of CEFTA after the first expansion of EU. It seems that CEFTA will remain, though in a changed line-up, an important regional free-trade zone and will have stronger economic links with both the (enlarged) European Union and the eastern part of the Continent.

The third hypothesis concerns the gradual shaping of the pan-European free-trade zone which will encompass, as far as industrial goods are concerned, the extended European Union, EFTA, CEFTA (in a changed line-up) as well as other countries such as Ukraine, Belarus and Russia, when the latter three countries adopt regulations and procedures of the World Trade Organization.

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