The Role of CEFTA in the Process of EU Enlargement

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PAPERS PRESENTED AT THE INTERNATIONAL CONFERENCE

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THE ROLE OF CEFTA IN THE PROCESS OF EU ENLARGEMENT

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* The author presented his paper in writing in advance but because of important reasons was unable to participate at the conference in person.
** The papers were distributed to the participants of the Conference

INTRODUCTION

Experts from twelve countries (Austria, Bulgaria, the Czech Republic, Denmark, Germany, Great Britain, Latvia, Lithuania, Poland, Romania, Slovakia* and Ukraine) and representatives of the Commission of the EU met in Prague on May 28-29, 1999 to discuss the role of the Central European Free Trade Agreement (CEFTA) in the process of European Union enlargement.

The international conference was organised by the Institute of International Relations, Prague, the Association for the Study of International Relations, Prague (a member of the Trans European Policy Studies Association — TEPSA) and the Delegation of the Friedrich-Ebert Foundation in Prague who also sponsored the event together with Investiční a poštovní banka, a.s., Prague, and Ceskoslovenská obchodní banka, a.s., Prague.

The two-day event was opened by Prof. Otto Pick, First Deputy Minister of Foreign Affairs and Chairman of the Association for the Study of International Relations.

Mr. David Ringrose, First Secretary of the Delegation of the European Commission in Prague, also delivered a welcoming address.

The Conference met in four sessions:

1. CEFTA's Role in the Process of European Union Enlargement
   Moderator: Mr. Jiří Šedivý, Institute of International Relations, Prague

2. Economic and Trade Potential of CEFTA
   Moderator: Mr. Miloslav Had, Association for the Study of International Relations, Prague

3. CEFTA States and Foreign Direct Investments — Current Situation and Prospects
   Moderator: Mr. Peter Havlik, The Vienna Institute for Comparative Economic Studies

4. Competitivenes of CEFTA Member States
   Moderator: Mr. Karel Zeman, Association for the Study of International Relations, Prague

The conference dealt with topical issues pertaining to the economic potential of the Central European Free Trade Agreement (CEFTA) which currently embraces seven states — Poland, the Czech Republic, Slovakia, Hungary, Slovenia, Romania and Bulgaria — and represents a market with 100 million consumers. The essence of CEFTA is to promote regional co-operation on the basis of free trade. When it was formed in December 1992 by Poland, Hungary, the Czech Republic and Slovakia it reflected the need for regional co-operation after the breakdown of COMECON. From the very beginning it was perceived as a complementary process to European integration. All CEFTA member states have applied for membership of the European Union and are preparing for its membership.

The results achieved so far through CEFTA demonstrate both its expanding potential as well as the limits which are linked to the character of economic grouping that represents the initial stage of economic integration. These results were one of the topics the conference dealt with.

The purpose of the conference was to analyse the present position of CEFTA as a grouping as well as the position and potential of individual CEFTA member states. Specific aspects and the role of CEFTA in a changing international environment were discussed. Particular attention

* The Slovak representative presented his paper in advance but was unable to participate in person.

was paid to the current situation and prospects of foreign investments in CEFTA member states, as well as their competitiveness.

The expected eastern enlargement of the European Union poses a question of the future development and role of CEFTA. The CEFTA member states which will join the European Union will cease to be members of CEFTA. Their relation with the remaining CEFTA member states will be covered by the Europe Association Agreements which these states concluded with the European Union. Thus, free trade of industrial goods among the enlarged European Union and the remaining CEFTA states will continue without limitations.

Papers presented at the conference and the discussions that followed were of high academic standard. Each speaker thus contributed to a better understanding of the issues which were on the agenda.

It was agreed that the proceedings of the conference be published in English to make the results of the conference available to wider interested public.

Miloslav Had
Executive Director
The Association for the Study of International Relations, Prague

OPENING CEREMONY — MAY 28, 1999, 9:45

Jiří Šedivý

Ladies and getlemen,

Good morning

My name is Jiří Šedivý and I am the Director of the Institute of International Relations, Prague. I would like to welcome you here on the occasion of the conference „The Role of CEFTA in the Process of the EU Enlargement? I would like to welcome Prof. Otto Pick, the 1st Deputy Minister of Foreign Affairs and also Chairman of the Association for the Study of International Relations, an NGO, which together with the Delegation of Friedrich Ebert Foundation in Prague co-organises this conference. I would also like to welcome Mr. David Ringrose, 1st Secretary of the Delegation of the European Commission in Prague.

Now I would like to give the floor to Prof. Otto Pick and then to David Ringrose for short welcome and opening speeches.

Prof. Otto Pick

I welcome you here with two hats on my head: First as Chairman of the Association for the Study of International Relations, which for a long time has been concerned with the problem of the future of CEFTA following the expected, anticipated and hoped for enlargement of the European Union; secondly as Deputy Minister of Foreign Affairs. You are here on these premises of Ministry of Foreign Affairs and we are very glad to be able to make them available for a conference of this kind.

The topic you have chosen for your conference is a very significant one. Obviously the Central European Free Trade Agreements has been a success in many ways. It has served the purpose of integrating the region. It has certainly lead to an increase of trade and of commercial exchanges. It is a foundation on which the resurrection of the so called Visegrad group is currently taking place. It has been an extremely successful venture.

Nevertheless, four of the countries which are members of CEFTA at the moment are in fact in line to pursue serious negotiations that would hopefully make them members of the EU some time in the future. It is going to happen one of these days and that puts the whole issue of CEFTA into the melting pot. It is therefore significant that a conference of this kind should at this stage of affairs start thinking about the future of CEFTA once the enlargement of the European Union will have taken place. We do have a precedent in EFTA, some time ago. I should add that the Czech Republic should be particularly concerned about these arrangements once the full membership of the European Union becomes reality — because we do have a customs union with Slovakia which poses a specific problem which we hope to negotiate about. At this moment I do not see how this problem can be solved to everybody?s satisfaction - there is always a cost. But I think that is also an issue to which this Association could address itself at some stage. I gather you have got a plethora of speakers, which is quite usual at conferences of this kind. And everybody has ? I am sure ? many valuable things to say. So I shall not keep you any longer.

Jiří Šedivý

Thank you very much, both gentlemen, for coming and opening the conference. Before we start the very conference let me thank the sponsors of this event on behalf of the Association and on behalf of my Institute. First the Delegation of Friedrich Ebert Foundation in Prague, a long term sponsor of the Association. Then Investiční a poštovní banka, a. s. (Investment and Postal bank) Prague and also Československá obchodní banka a. s. (Czechoslovak Trade Bank). Both are also well proven and reliable sponsors of various activities of the Association.

CEFTA: PAST ACHIEVEMENTS – NEW HORIZONS

Dušan ROVENSKÝ
Director of International Banking Relations, IPB, Praha

Mr. Chairman, Ladies and Gentlemen,

BEFORE I BEGIN I WOULD LIKE TO UNDERLINE TWO THINGS:

Firstly, that the bank I represent, IPB is a supporter of the Central European Free Trade Agreement, which it regards as a key instrument for promoting regional economic co-operation in Central and Eastern Europe. IPB Bank fully supports the efforts of CEFTA in the field of trade liberalization, as well as its search for new direction, which would give the Agreement the new impetus needed to keep it going into the next millenium. For this reason IPB Bank is honoured to be one of the sponsors of this conference.

Secondly, that since I am not an expert on CEFTA, my remarks are not intended to present an in-depth analysis of the Agreement. Rather they present a personal view of its past achievements as well as failures and attempt to give a brief outline of the directions CEFTA might take in the future.

THE AGREEMENT

Mr. Chairman,

One of the top priorities of political leaderships in the newly restored democracies which emerged in Central and Eastern Europe after the collapse of Communism, was rapid integration of these countries into Western European political, security and economic structures.

Countries of the region were encouraged by their Western partners to co-ordinate their efforts towards this ultimate goal and, in so doing, to show their ability for co-operation in both political and economic fields.

A tangible result of this endeavour has been the creation of the Visegrad Group in February 1991, whose declared goal was the co-operation between member states for advancing towards European integration.

In parallel with the Visegrad Group's efforts in the political field came its desire to forge closer economic ties. This desire resulted in an understanding reached in October 1991 on the creation of a free trade agreement encompassing the V3 (later V4) countries. The philosophy behind the creation of CEFTA was, inter alia, to create a structure which would enable CEE countries (which signed association agreements with the EU) to prepare themselves more effectively for EU membership.

CEFTA was officially signed in December 1992 in Krakow. In accordance with the Agreement provisions and in keeping with Article 24 of GATT, mutual trade both in industrial and agricultural products was to be promoted and harmonised through the gradual removal of existing trade barriers. The ultimate goal was the creation of a free trade area by the year 2001.

The Agreement went into force in March 1993. By that time it covered four countries, The Czech Republic, Hungary, Poland and Slovakia. CEFTA has always been open to new members, the conditions for membership being that the applicant country must be a European country, must have an Association Agreement with the EU, must be a member of WTO and that all the current CEFTA members agree with its accession.

Slovenia joined CEFTA in 1996, followed by Romania in 1997 and Bulgaria in 1998. At present

the Agreement covers an area of Central and Eastern Europe stretching from the Baltic Sea to the Adriatic, with a population of approximately 100 million people.

THE ACHIEVEMENTS AND DISAPPOINTMENTS

Mr. Chairman,

CEFTA has existed for more than six years. If we look closely at those six years we see a mixed bag of results, both significant achievements and considerable disappointments.

On the positive side there is the experience with the liberalisation of trade in industrial products, which had considerable dynamism mainly due to the adoption of three Additional Protocols in 1994, 1995 and 1996. However it must be added that this pace has dropped lately.

Presently only a small portion of industrial products (about 10%) is still subject to customs duties. Unfortunately this small group of products covers some of the key items (motor cars, textiles and steel). The complete elimination of customs duties is envisaged between 2000-2002. Hopefully this goal will be met.

Still less contended we can be with the elimination of trade barriers in agricultural products, where the move towards liberalisation and the removal of barriers has been somewhat slow. In much the same way as in the EU, trade in agricultural products has proven to be a very sensitive area, where domestic political considerations play a very important role in the governmental decision-making process. This is especially true of CEFTA members with a large agricultural sector and thus a large number of farmers/voters. The sensitivity of this issue has been documented by the fact that concessions cover only a limited and carefully selected group of agricultural products and as well as by the fact that, unlike in the industrial goods sector, no timetable has been set for the complete removal of tariffs.

Mr. Chairman,

While the Agreement has undoubtedly contributed to the development of regional economic co-operation in CEE it has fallen short of expectations. CEFTA has not really left a deep imprint on the economic scene of the region. What are the reasons for this?

Certain differences in accents could be noticed between the founding CEFTA members (V4 Countries), which are preoccupied with their EU accession talks, and other, more recent CEFTA members, who attach greater importance to CEFTA and are more enthusiastic about it.

This difference in accents has its roots in the past years, when some CEE governments had lukewarm attitudes towards not only CEFTA, but other forms of regional co-operation as well. This attitude was prompted by a rather short-sighted and, in effect, harmful notion born on the high wave of post 1989 euphoria, that the only sure and correct way to join the EU (and NATO) was through a fast individual dash, rather then through a collective effort. This policy was based on disregard for the interest of other countries of the region, as well as underestimation of the importance of regional economic and political co-operation.

Hopefully things might be changing as shown, for example, by the new interest expressed in the Visegrad Group and other regional co-operation instruments by the present Czech Government.

However, the political foot-dragging which has slowed down the activities of CEFTA in the past is only one side of the story, and can not be blamed by itself for the slow progress in implementing and further developing the Agreement.

While intra-CEFTA trade has undoubtedly increased over the past six years, especially in industrial goods, the volume is still quite low in absolute numbers and is far surpassed by the trade between CEFTA member states and the EU. This might be the result of the different conditions in the national economies of the CEFTA members, as well as their structure. Different accents in foreign trade priorities might be another reason.

NEW HORIZONS

Mr. Chairman,

The focus on the ultimate goal of EU membership by the CEE frontrunners is understandable. However, it should not obscure the importance of CEFTA as an arrangement, pooling all EU candidates from the region and preparing them for eventual full membership.

The tasks standing before CEFTA in the coming years are formidable. The ability of its members to deal with them successfully will, to a large degree, determine whether and how the Agreement will develop over medium- and long-term periods. Some of these tasks could be summarised as follows:

1) CEFTA members should focus on the continuing process of economic integration into the EU, while strengthening intra-CEFTA co-operation through the removal of remaining trade barriers. The trade in industrial goods should be fully liberalised by the year 2001 with as few exceptions as possible.

2) Special attention should be devoted to liberalising agricultural trade. Further possibilities in this field should be examined, taking into account the process of accession to the EU.

3) CEFTA countries should examine the possibility of bringing their co-operation from the trade in industrial and agricultural goods to a qualitatively higher level. Within this effort mutual contacts and exchange of information and views between CEFTA members should be encouraged, especially the discussion on improvement of the functioning of CEFTA. Of particular importance is the discussion on the interpretation of some CEFTA provisions and on preparation of new Rules of Procedure of the Joint Committee.

4) Last but not least, an intensive debate on the future of CEFTA should be encouraged, especially to determine how CEFTA will develop after the first group of its members joins the EU.

It is important that the process of EU expansion and the energy and attention which is devoted toward this ultimate goal, should not overshadow, nor brush aside regional political and economic co-operation in Central and Eastern Europe. Both the countries of the region which are expected to join the Union in the next wave of enlargement, and the ones which will follow later should prepare contingency plans for CEFTA, which will react to the situation after the EU enlargement.

This question is of fundamental importance to all, and should be discussed and analysed in the months and years ahead not only among CEFTA members, but also in Brussels. On the basis of this discussion and analysis new proposals should eventually emerge on the ways in which CEFTA will develop before and after EU enlargement and what role could be played in this process by EU members from Central and Eastern Europe.

It would be a great pity and a grave mistake if the EU members from CEE were to weaken or cut their links with CEFTA, in effect slamming the door on their former partners and concentrating only on their EU activities. Such a policy would be both unwise and short-sighted. It would certainly weaken the Agreement and strengthen the feeling of isolation among the remaining members.

That would be unfortunate, since the Agreement can play a very useful role even after some of its members join the EU. It can serve as a tool for deepening co-operation and integration among countries of the region, whose entry into the EU is a medium- or long-term affair. From this point of view CEFTA could play the role of a bridge between these CEE countries and the EU.

Eventually a careful thought should be given to the possibility of expanding the membership of CEFTA. The Baltic states are obvious candidates. Other potential candidates could include the republics of the former Yugoslavia, and from a longer perspective perhaps Ukraine and Belarus.

The Baltic states could be admitted quickly since they already meet the criteria for CEFTA membership. The question is, would they be interested in joining CEFTA since they have their own regional arrangement – BFTA?

Croatia, Bosnia and Herzegovina and Macedonia have shown keen interest in CEFTA and should be considered as prospective candidates as should (conditions permitting) Serbia and Montenegro.

Of course many of the countries mentioned currently do not meet the criteria for joining CEFTA, above all the criteria of EU Associated status. In some cases they might never meet all the required criteria. Should this prevent them from joining CEFTA? Perhaps eventually entry criteria could be modified to make them more flexible?

A new mechanism through which the four or five CEFTA members who will become EU members could maintain an above-standard relationship with CEFTA could be considered. Perhaps we could take some inspiration from the creation of the European Economic Area in 1992, which constitutes a basis for co-operation between the EU and EFTA after the majority of EFTA members joined the EU. Of course, CEFTA is no EFTA, but the principle of "bridge building" could apply in both cases.

Mr. Chairman,

Let me rest my case at this point. Besides giving a personal view of the achievements and failures of CEFTA over the past six years I tried to draw a brief outline of some of the ways in which the Agreement might be developed in the future. The aim was not to provide ready answers, but rather to provoke a debate. I am sure that other colleagues who will speak today and tomorrow will contribute their ideas to this debate and help to shape CEFTA's future. It is my firm belief that this conference will greatly contribute towards this goal.

CEFTA-COUNTRIES: MORE OR LESS RECESSION

Josef PÖSCHL
The Vienna Institute for International Economic Studies

GROWTH SLOWDOWN IN 1998 — EXCEPT FOR HUNGARY

This report concentrates mainly on CEFTA-5, the five more advanced transition countries: the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The whole region's aggregate GDP grew less in 1998 than in 1997, by 3.0% compared to 4.9% (Table 1).

Growth patterns differed considerably within the region (Figure 1). The Czech economy did not grow at all in 1998 — the GDP progressively declined over the year. In Poland growth continued, however at diminishing rates. In Slovakia, the growth rate dropped steeply from levels around 6% in the first half of 1998 down to 0.5% in the last quarter. In Slovenia recession tendencies were marginal, whereas in Hungary the quarterly growth rates even increased compared to 1997. A weighted average[1] of the countries' growth rates (Figure 2), shows a steady decline in the course of 1998, down to merely 1.6% in the last quarter.

Industrial output (Figure 3) mirrored the GDP slowdown. In the CEFTA-5 as a whole the growth rate of gross industrial production fell from 8.3% in 1997 to 5.2% in 1998[2].

Monthly data report for 1998 shrinking growth rates of industrial production and, towards the end of the year, even a decline (vis-à-vis the corresponding month of 1997). The exception was Hungary, where industrial output growth came down from very high percentage rates in the first half of the year to about 10% at year-end. The first country to report an output decline was the Czech Republic (September 1998), followed by Poland (October). Slovakia and Slovenia followed later. For Poland, this was the first interruption of industrial growth since 1992. The March 1999 figure, however seasonally non-adjusted, points to some recovery. First 1999 figures for the other countries do not indicate significant changes compared to December 1998.

WHAT WERE THE NEGATIVE INFLUENCES ON GROWTH?

The global economic cooling in the wake of the financial crises in Asia and Russia was one of the negative influences on CEFTA-5 growth rates. The German GDP grew 2.8% in the full year of 1998, but increased only 2.5% in the last quarter year-on-year and shrank 0.4% over the previous quarter.[3] Analysts expect for Germany a 1.5% growth rate in 1999. The slowdown of economic growth in the European Union and especially in Germany hit CEFTA-5 exports to the west.

The CEFTA-5 also exported less to Russia and other CIS countries after the Russian financial crisis. This may have had a non-negligible adverse impact on their GDP growth as well. A relatively high share of official exports from Poland (8.4%) went to Russia in 1997. This share decreased in 1998 to 7.4%, largely because of the drop in Russian imports after the rouble devaluation. The crisis also diminished the volume of unregistered exports, so that the Russian crisis could have significantly contributed to the surprising decline of industrial output in Poland in the last quarter of 1998.

Less growth in the EU and the Russian crisis explain the recession in CEFTA-5Cs only partially. A country, if not obliged to maintain an exchange rate peg, can always influence foreign

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[1] Poland produces roughly half of the region's GDP and is given a correspondingly high weigh
[2] Several years of high industrial growth in Poland helped industrial production in the CEFTA-5 as a whole to exceed in 1998 the 1989 level for the first time.
[3] Reuters, 4 March and 27 April 1999.

trade results: The central bank can manipulate nominal interest rates in a way which either causes appreciation or depreciation. The CEFTA-5Cs kept nominal interest rates high – even relative to expected rates of currency depreciation. In this way they attracted inflow of foreign capital, pushing their exchange rates to levels that produced high and rising current account deficits. As the experience of the last years shows, these countries can cope with some real appreciation but if it becomes excessive, trade and current account imbalances start to explode. Only Slovenia, by not liberalizing capital flows, avoided troubles of this kind.

Figure 5 shows changes in the real exchange rate vis-à-vis the DEM. Values above 100 mean a real depreciation of the currency compared to January 1997, and thus indicate that the prices of domestic commodities decreased relative to German prices.

Relative to German producer prices, Czech prices declined in 1997 and reached the lowest level during the fourth quarter, so far also the last one to record a positive GDP growth rate. Poland followed, less pronounced, a similar pattern, while in Hungary, Slovakia and Slovenia the real exchange rate appreciated in the course of the year 1997. In 1998, in all countries except for Slovenia the real exchange rate followed a J-shaped curve: First there was a tendency towards appreciation which was, probably in the context of the Russian crisis, followed by a reversal in this tendency later in the year. As a result, relative to the German level producer prices in January 1999 were significantly higher only in Slovenia, whereas in the other countries they had returned to the position held two years before.

High interest rates aimed at a reduction of inflation[4]. When in the course of 1998 inflationary pressure became very weak, nominal interest rates were allowed to go down, but in most cases less than proportionally, and real interest rates increased. In all CEFTA-5 except the Czech Republic, the real interest rates were significantly higher in 1998 than in 1997, as can be seen from Figure 4. Nominal interest rates still considerably above west European levels, coupled with the expectation of low producer price increases, supposedly had a negative impact on investment into fixed capital.

REASONS FOR DIFFERENCES IN THE DEGREE OF VULNERABILITY

All CEFTA-5Cs were exposed to the same negative influences from abroad, and their responses did not differ too much. Nevertheless, the results were heterogeneous. As we have seen, Hungary proved quite resistant, while the Czech Republic entered deep recession.

To nobody's surprise, companies in transition countries have a relatively weak financial background. This was so from the very beginning of transition. The companies' physical assets were of low technical quality or completely obsolete and their receivables often non-performing, and at the same time they were often heavily indebted. In most of the countries, economic policy did not do enough to improve the situation in the corporate sector, and the deep recession in the initial phase of transition made it even worse. The problem is of long-term nature, as it may take long time until CEFTA-5 companies develop a solid financial backbone.

In a few countries the situation improved essentially. Poland entered a growth process in 1992. The growth rate surpassed 5% in 1994, and from 1995 to 1997 it fluctuated between 6% and 7%. This high growth, combined with high, but decreasing inflation, produced high and increasing revenues and profits. The debt burden of the companies lost much of its weight, and they could improve their position in many respects. For example, they were able to finance their investment projects through retained profits rather than from costly credits. In 1998, labour productivity was 48% higher than in 1989. Poland put also emphasis on the consolidation of the banking sector. Not surprisingly, Poland has started to attract more and more foreign direct investors.

Hungary improved the situation of the corporate sector from the very beginning by attracting

[4] In some cases, especially Hungary, after the Russian crisis nominal interest rates were kept at high levels to protect the currency.

Figure 1 **CEEC-5: Quarterly GDP growth rates**
(year-on-year, 1997-1998)

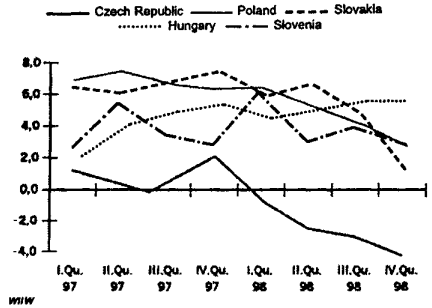


Figure 2 **CEEC-5: Average quarterly GDP growth rates**
(year-on-year, 1997-1998)

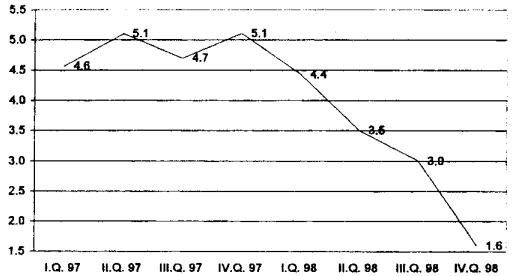
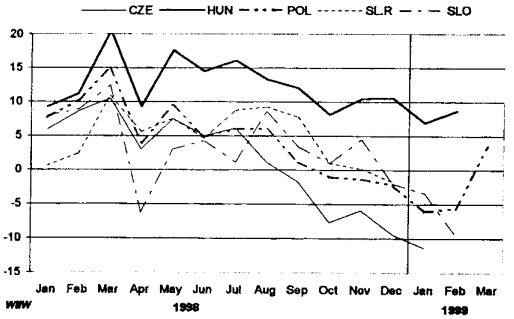


Figure 3 **Industrial production**
(annual change in %)



foreign investors. In a much higher proportion than in other transition countries, 'foreign investment enterprises' have become involved. Today, they are dominating most Hungarian industries. It is not by accident that Hungary achieved the highest labour productivity (71%) gains of the CEFTA-5Cs since 1989. Efficiency improved, and despite the recession in western Europe exports, especially exports of sophisticated goods, continued to grow at high rates[5]. This is why Hungary proved resistant against the negative influences mentioned above. Transition countries with a financially weak corporate sector are more vulnerable. They enter recession more easily, it turns out more severe, and they have more difficulty to recover from it. To make things worse, a deep recession weakens the companies' financial position further and may force them to rely on non-standard tactics as used in the initial phase of transition. At that time, the economy avoided a collapse in a very special way: When revenues rarely covered costs, many companies continued to produce without paying for inputs received and without getting paid for output they delivered. This phenomenon, widespread in less developed transition countries up to now, can re-emerge also in more advanced countries. Tax arrears, incapability to pay wages or social security contribution, non-servicing of debt can become more frequent.

Another non-standard tactic, too, can regain more significance as soon as a country finds itself in deep recession. Big companies, the traditional flagships of transition economies, are in most countries still in a privileged position: Whenever they make losses, the banking sector will provide them with new credits[6] — which is a clear indication that something is wrong with the banking sector[7]. In some countries — Hungary, Poland, Slovakia — this tactic lost significance: Some of these companies ceased to make losses, some where closed down or downsized, the remaining ones became a relatively small fraction of the total. In other countries this behavioural pattern did not lose ground, or diminished and re-escalated later, especially in connection with recession. In countries where this problem has a high profile, the rationing of scarce loans is inefficient, as the financial intermediaries channel loans primarily towards big loss-makers. Over time, both the financial and non-financial sectors become prone to crises. If the country falls into recession the problem can increase dramatically: The gap between cost and revenues of these privileged companies widens, and the banks come under pressure to channel even more loans to these loss-makers. Their capital adequacy ratio can become unbearably low.

In the Czech Republic over-ambitious economic policies in 1996/1997 led the economy into severe recession[8] which deepened in 1998 and proves to be very lasting. The Czech National Bank introduced new regulations in 1998, so that the banks could no longer continue to finance loss-makers. In that very moment it became the government's problem what to do with the big notorious loss-makers and the troubled big banks. The national bank's move led to a decline in the volume of credits in subsequent months — it exacerbated recession. The failure of some larger enterprises can trigger bank failures. The state will probably provide guarantees for bank credits to at least some of the big loss-makers. All this shows that the problem cannot be solved in the short term.

Similar things could happen in Slovakia. The current deep recession worsens the situation of the corporate sector. Firms will need financial support, and commercial banks may not be willing or allowed to grant credits, so that the government will have to get involved.

[5] Most of the purely Hungarian enterprises are still in a weak position. They have been marginalized - their performance has only a limited impact on the aggregate.

[6] Remarkably, monetary austerity provokes such companies to react in a way that would not be expected in a standard market economy. Higher interest rates imply that more funds are required for their servicing of the debt. Enterprises thus increase their borrowing, knowing that they will never pay the debt back out of their revenues.

[7] In the Czech Republic such borrowers frequently offered real estate as a collateral — knowing well that Czech regulations always protect the debtor. The voucher privatization, while praised as a quick, fair and popular method to get rid of the old system, has only permitted the survival of inherited structures.

[8] In 1996 the current account deficit started to widen rapidly. A chain of growth-killing policies were the response: the national bank increased the interest rate and in this way provoked nominal and real currency appreciation, and as soon as the growth slow-down led to a budget deficit, the government cut its expenditures.

Figure 4 **Minimum real interest rates**

(NB leading rate deflated with annual PPI, in % p.a.)

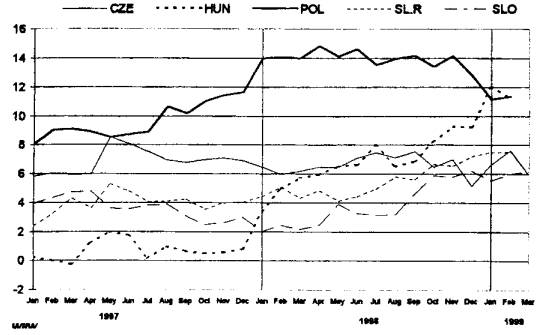
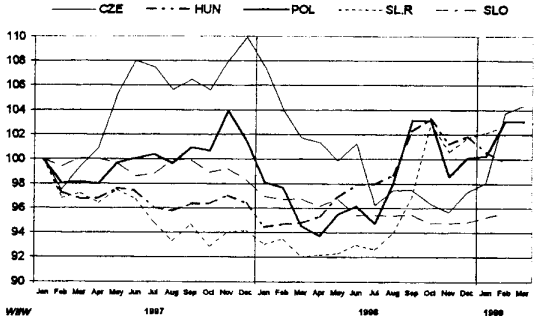


Figure 5 **Real exchange rates**

(national currency per 1 DEM deflated with PPI, Jan 1997 = 100)



The economic setback that some transition countries have experienced and some others could experience in the future results from the multilateral weakness of the corporate sector and a corresponding mismatch of their financial system. While analysts of transition countries in recent years have frequently mentioned the problem of bad loans in commercial banks, macroeconomic indicators do not adequately capture the connection these loans have with the economy. The focus on inflation, on the size of the government's debt burden and budget deficit as well as on the country's foreign currency reserves, external debt and current account deficit, may have diverted attention from an equally decisive, but less easily measurable feature at the enterprise level. The proportion of non-performing loans in total loans does not necessarily coincide with high external indebtedness of the country or with high debt of the state — in Slovakia it does, but not in the Czech Republic.

As soon as in a country financial troubles of the corporate sector have reached a certain dimension it becomes dangerous for the government and financial intermediaries to establish and enforce the rules of bankruptcy. We should not forget that even in developed market economies, bankruptcy is a measure of last resort, and that commercial banks try to give non-performing loans a low profile.

The Czech Republic was fast in achieving one-digit inflation rates, and this was frequently regarded as fast track towards nominal stability. But neither was this a sign of financial soundness nor did it boost real dynamics. On the other hand, the relatively slow disinflation in Hungary and Poland did not hinder GDP growth. Moreover, it made it easier for the corporate sector to get out of the debt trap, and thus helped to develop the financial institutions and markets on a sound basis.

A corporate sector struggling with financial problems cannot be very dynamic. The examples of Hungary and Poland seem to suggest that progress in restructuring is easier with massive inflow of FDI and in the framework of continuing high growth combined with rather high, but manageable inflation.

DIMINISHED INFLATIONARY PRESSURE

In the second half of 1998 the diminishing growth and, later, the drop of industrial output had an adverse impact on labour productivity: its growth weakened everywhere in the region (Figure 6). The Czech Republic and to a less extent also Poland even experienced a productivity decline, especially in January 1999, implying that the fall of industrial output was not paralleled by a proportional reduction of employment.

Unit labour costs (Figure 7) developed correspondingly: they fell or did not grow much in the first half of the year 1998, but increased strongly in the following months – especially in the Czech Republic and in Poland, but much less in Hungary. Consequently, the inflationary pressure became very low or even disappeared in the middle of the year, also due to the decline in world market prices for energy, raw material and agricultural products.

In 1998, all CEFTA-5 temporarily experienced stability or declines of producer prices, especially during the second half of the year (Figure 8). Producer prices in the Czech Republic were constant or even declining from August 1998. This has also been the case in Hungary and Slovakia from November. In Poland producer prices slightly fell during July and August.

In 1998, all CEFTA-5 also experienced a temporary halt or even decline of their consumer price indices. This happened more frequently in the second half of the year, especially in July and August.

Low growth or decline of labour productivity pushed unit labour costs upwards later in 1998, especially in the Czech Republic and Poland, but much less so in Hungary. The impact of this cost push on changes in producer prices was rather limited.

NO LASTING RELIEF FROM CURRENT ACCOUNT TROUBLES

Despite the slowdown of GDP growth and in spite of falling prices for imported energy, the aggregate trade deficit of the CEFTA-5 increased from USD 26.1 bn in 1997 to USD 28.6 bn in 1998. This resulted mainly from Poland's growing deficit from USD 16.6 bn to about USD 20 bn. In the Czech Republic and Slovenia exports grew faster than imports. In Hungary and Slovakia export revenues covered less than 90% of imports in 1998. In Poland the coverage was only 58%, but the country traditionally benefits from massive non-registered exports to its neighbours Germany, Russia and Ukraine.

The hike in the trade deficit caused also an increase in the aggregate current account deficit of the region. The deficit of Hungary and Poland and hence also the aggregate of the whole region passed the benchmark of 4% of GDP. The current account deficit was alarmingly high in Slovakia, 10.6% of GDP. Except for Slovenia, all of the CEFTA-5 recorded a deficit in 1998. The improved result of the Czech Republic was the outcome of low GDP growth and the currency crisis in 1997.

Figure 6 **Labour productivity in industry**
(annual change in %)

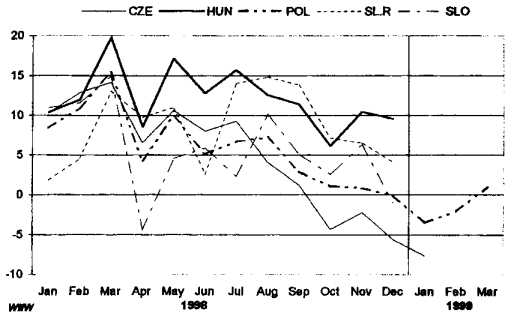


Figure 7 **Unit labour costs in industry**
(annual change in %)

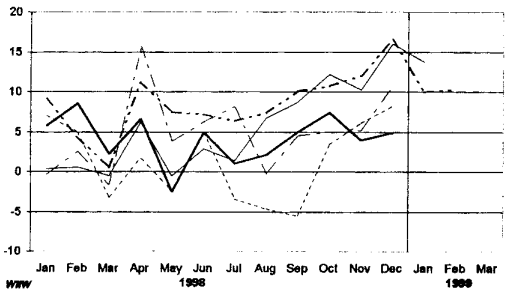
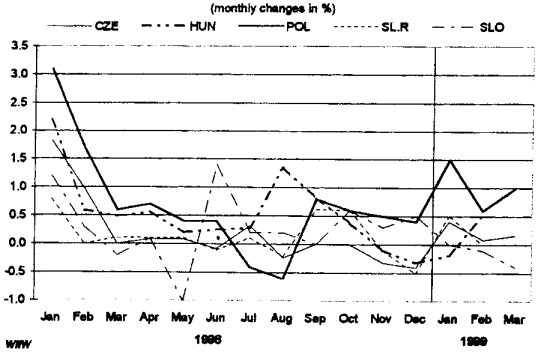


Figure 8 **Producer price inflation**
(monthly changes in %)



CEFTA-5: MIXED GENERAL PROSPECTS

In 1999, the drop of the Czech GDP could be less pronounced than last year (Table 1), and the economy could achieve some growth in 2000 — but uncertainty in this respect is high. The likelihood of an acute financial crisis would become smaller in the case of less GDP decline. Somewhat improved performance could follow from the fact that the Czech National Bank has lowered nominal interest rates. This may, at least in the short run, not increase domestic demand so much, but rather weaken the Czech koruna so that better foreign trade results could support growth. Also, fiscal policy has become less restrictive. The government's revitalization programme, targeting a consolidation of big companies, should have an additional positive short-term impact. To improve the fundamentals for sustainable growth, it would have to achieve, together with important other reform steps, an essential restructuring of the business sector.

Both in 1999 and 2000, the growth rate in Hungary could be close to 4%, and thus somewhat lower than in 1998. Less demand from the EU is likely to have a negative effect on both aggregate demand and current account, and growth will have to rely more on domestic demand. Deficits on the current account and in the state budget will remain sources of concern. The country's remarkable resistance against recessionary tendencies may be the outcome of the massive inflow of foreign direct investment in the past. So-called 'foreign investment companies', especially producers of machinery and equipment, have become highly competitive exporters.

Government policy in Poland deliberately slowed economic growth and has apparently achieved this target. The growth rate will be around 3.5% in 1999 and 4% in 2000. Weaker foreign demand from the West and the East should continue to have a negative effect on the growth rate. The present interest rate and hence also exchange rate policy challenges the competitiveness of Polish enterprises. Therefore, the current account deficit is likely to expand. The lowering of interest rates could, after some time, exert a positive influence.

The current government in Slovakia cannot continue to borrow and spend as much money as its predecessor. This implies a cut in aggregate demand that has already shown painful results. The GDP could stagnate in 1999, but shrink by abont 2% in 2000. The troubles of big, but structurally and financially weak companies will increase. If commercial banks will be accommodating to much, they will come into troubles, too, and sooner or later the government will be confronted with the problem. Because of the unbalanced current account, the currency will probably further depreciate. The servicing of the high debt will absorb much effort in the next few years.

Less foreign demand and perhaps less domestic demand because of a new VAT tax could slow growth in Slovenia down to between 2.5 and 3% in this and the next year. So far, the country has not liberalized cross-border flows of capital. Probably in 1999 and 2000 again it will be able to influence the exchange rate development in a way that leads to balanced current accounts.

To sum up, for the next two years CEFTA-5 growth prospects are mixed. While in 1999 GDP will drop in the Czech Republic and stagnate in Slovakia, it will rise at modest rates in Poland and Slovenia, and at a relatively high rate in Hungary. The whole region's growth rate could fall to 2%. Next year, it could recover to 3%. But projections for 2000 are subject to considerable uncertainty in the global economy.

In 1998 the rate of inflation did not move in a uniform direction. High GDP growth tended to be accompanied by declines in inflation while the Czech Republic's dramatic GDP drop was connected with increasing inflation. In 1999 a further reduction in inflation is likely in all countries except for Slovakia, where the government is performing overdue increases in regulated prices. Next year, inflation will probably decrease in most of the countries.

Even with lower energy prices alleviating the current account problem, high deficits continue to be a serious threat for the stability of even these more advanced transition countries. As long as their corporate sector is lagging behind, in a very broad sense, technologically, economic growth will be accompanied by balance-of-payments problems.

PROSPECTS FOR OTHER TRANSFORMATION COUNTRIES

In countries more to the east, economic transformation proved more difficult. Bulgaria, Romania, Russia and Ukraine are suffering from structural deficiencies. The financial system in these countries is in bad shape, and so are the bulk of financial and non-financial enterprises. GDP will continue to decline in 1999 and could, with good luck, come close to stagnation in 2000.

Former-Yugoslav countries except for Slovenia did not fully recover from the economic disintegration of the region and have been economically weak and vulnerable all the time. They were hit hard by the recent Kosovo crisis. The region could remain a source of instability for years. A viable political solution, followed by an economic recovery and reintegration programme, could help to avoid this.

Table 1

Overview developments 1997 - 1998 and outlook 1999 - 2000

	GDP growth				Inflation				Unemployment rate				Current account			
	Real, in %				CPI, in %				In %, end of period				in % of GDP			
	1997	1998	1999	2000	1997	1998	1999	2000	1997	1998	1999	2000	1997	1998	1999	2000
			forecast				forecast				forecast				forecast	
Czech Republic	1,0	-2,7	-1,5	2	8,5	10,7	4	5	5,2	7,5	10	11	-6,2	-1,9	-2,0	-3,3
Hungary	4,4	5,1	3,7	4	18,3	14,3	9,7	8	11,0	9,6	10	9	-2,1	-4,8	-5,5	-5,5
Poland	6,8	4,8	3,5	4	14,9	11,8	8	7	10,3	10,4	12	11	-3,0	-4,4	-5,1	-5,5
Slovak Republic	6,5	4,4	0.0	-2.0	6,1	6,7	10	10	12,5	15,6	17	18	-9,9	-10,1	-6,8	-4,8
Slovenia	4,6	3,9	2,5	3	8,4	7,9	7	6	14,8	14,6	14	13	0,2	0,0	-0,2	-0,2
CEFTA-5	4,9	3,0	2.0	3.0	.	.	.	.	9,9	10,4	.	.	-3,7	-4,1	-4,3	-4,6
Bulgaria	-7,0	3,5	-2	2	1082,3	22,3	2	3	13,7	12,2	14,5	15,5	4,1	-2,0	-7,5	-6,3
Romania	-6,9	-7,3	-5	0	154,8	59,1	50	40	8,9	10,3	13	15	-6,1	-7,9	-7,2	-6,7
Russia [1)]	0,8	-4,6	-2	1	14,8	27,6	90	30	11,2	12,4	14	15	0,9	0,9	4,2	5,4
Ukraine	-3,2	-1,7	-2	0	15,9	10,6	25	15	2,3	3,7	5	6	-2,7	-1,5	-2,5	-2,9
Croatia [2)]	6,5	2,7	-1,5	0	3,6	5,7	4	4	17,6	18,6	20	21	-12,2	-7,3	-8,3	-8,9
FYR Macedonia [1)2)]	1,5	2,9	0	0	4,4	0,8	4	5	32,2	34,5	36	36	-7,4	-8,2	-15,0	-15,5
FR Yugoslavia	7,4	2,6	-50	.	21,6	29,9	50	50	25,9	26,8	30	35	-11,6	-7,6	-16,7	.

1)Unemployment rate according to ILO definition. FYR Macedonia from 1998

2) Consumer prices correspond to retail prices

SUB-REGIONAL ECONOMIC COOPERATION IN CEFTA: PAST PERFORMANCE AND FUTURE PROSPECTS

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INTRODUCTION

It might be argued that two new trends in sub-regional cooperation in central and eastern Europe (CEE) have emerged over the last twelve months or so. On the one hand, recent governmental changes in the Czech and Slovak Republics may have paved the way for a new wave of cooperation among the 'Visegrad four'. In November 1998, while visiting Bratislava, President Havel spoke of his hopes for "close political cooperation and possibilities of broader sub-regional cooperation in what used to be called the Visegrad Group". The meeting of the Premiers of the Czech Republic, Hungary, Poland and Slovakia which took place in Bratislava on 14 May 1999 was convened for the very purpose of launching 'Visegrad 2'. On the other hand, though the EU pre-accession and sub-regional economic integration have proved complementary in many ways, as the many practical requirements of European Union accession are becoming increasingly clear during negotiations in progress it is also the case that this process threatens to disrupt existing or prevent potentially useful forms of sub-regional cooperation coming into being in CEE. This could be through the extension of the Shengen area, for example, which could compromise arrangements within the CEE-10[1] (particularly between the Czech Republic and Slovakia), along with the requirement that the CEE-10 take care not to introduce free trade or other arrangements with non CEE-10, which will have to be reversed upon accession.

In the five years since the original 'Visegrad Cooperation' between the Czech Republic, Hungary, Poland and Slovakia was put into cold storage, sub-regional cooperation in CEE has mainly proceeded in the framework of the Central European Free Trade Agreement (CEFTA) which came into force on 1 March 1993. CEFTA has since expanded to take in Slovenia (1 January 1996), Romania (1 July 1997) and Bulgaria (1 January 1999). Sub-regional cooperation in postcommunist CEE has existed in order to service relations with the Euro-Atlantic organisations these states are determined to join. Rather than an outcome of Visegrad cooperation, CEFTA represented a shift in the concept of sub-regional cooperation in which the implementation of a sub-regional free trade area replaced political cooperation and policy coordination as the most efficient way for those countries to collectively approach the EU. Since cooperation in the framework of CEFTA has been ongoing for more than six years and some governments in the region have been re-assessing their approaches to sub-regional cooperation, these facts alone justify some reflection on CEFTA's impact so far. Moreover, the very real potential for a new divide in Europe based on boundaries being drawn by the present strategy for EU/NATO enlargement is generating debate about the potential role of CEFTA and other sub-regional entities in Europe. Last (though not least), in these tragic times it is also necessary to recognise that there will be an inevitable need to include a regional cooperation dimension in the 'post-Kosovo' Balkan reconstruction strategy and this draws attention to the potential role and lessons of CEFTA and other sub-regional cooperation experiences in the 'new' Europe.

The first part of this article discusses the role CEFTA has so far played in the transformation and European integration processes in which CEE are engaged. In this respect CEFTA can be credited with a positive contribution to the rebuilding of economic ties in the region and modest inputs to the maintenance of good regional political relations and also to ('soft') security. In addition, CEFTA has also been serving as an important (and often understated) instrument for the EU pre-accession process. The second part considers how the function of CEFTA might develop during the period towards and beyond the first stage of the EU's eastward enlargement. Of the various scenarios which have so far been hypothesised, the possibility that CEFTA could evolve as a more pan European device to connect the more peripheral CEE states (outs) to the European integration process would seem to be the most valuable development path it could

[1] CEE-10 is the group of Europe Agreement states.

follow. The somewhat pessimistic conclusion is that at this stage the signs are that CEFTA is ultimately just another expression of the EU's current projected boundary. The main lesson may well be that CEFTA demonstrates that sub-regional economic co-operation in CEE can yield useful economic and political dividends and the principle question may not be whether CEFTA can extend to other sub-regions of post communist Europe but whether other sets of countries are cognate enough to be able to emulate the CEFTA model.[2]

CEFTA: TRANSFORMATION, SECURITY AND EU INTEGRATION EFFECTS

The trends in intra-CEFTA trade since 1993 (see data in Table 1) show that economic agents have responded to the improved trading environment between CEFTA countries and it is therefore virtually indisputable that CEFTA has succeeded in its baseline function of helping to rebuild the economic ties of its member states. In addition to the overall healthy trade growth, though the broad commodity structure of intra-CEFTA exchanges (Table 2) has remained constant as far as the proportions of industrial products (more than 90% of total) and food and agricultural products (less than 10% of total) are concerned, some other important developments in commodity structure should be mentioned. The increasing presence of goods of SITC 7 (machinery and equipment) is encouraging as it indicates the growing importance of goods with a higher technological content and entailing more sophisticated product processes.[3] There are clear differences between individual CEFTA countries however. The expansion of exports in SITC 7 applies most strongly to Hungary and then Poland, followed by the Czech Republic. The Slovak Republic is not only fourth in this respect but has in fact hardly registered any significant growth in this product category. Thus trade developments in CEFTA are also indicative of important differences in individual economic reform and transformation experiences.

The problems of intra-CEFTA agricultural trade are widely recognised but the extent to which this represents a significant failure of CEFTA is maybe overplayed. Useful increases in agricultural exports of the Czech Republic, Poland and above all Hungary have been registered. Furthermore, difficulties of agricultural trade in CEFTA are not isolated from the broader problems facing the CEFTA countries' agricultural sectors and the issue of agricultural products is usually at the core of trade disputes across the globe. It is important therefore to keep the CEFTA agricultural trade difficulties in perspective.

Along with trade, integration initiatives are usually associated with positive impacts on levels of foreign direct investment (FDI) entering the integration complex. Though accession to CEFTA has (at least according to official policy statements) indeed been based on expectations that the flow of inward investment will respond as a result[4], it cannot be demonstrated that regional free trade arrangements can outweigh important factors in the calculations of potential investors. On the other hand FDI is an important factor in integrating the CEFTA area, through its impact on the quantity, quality and diversity of the export capacity. The relatively small involvement to date of foreign investment in the Slovak economy (indicating that even a Europe Agreement let alone CEFTA cannot outweigh other calculations of potential investors) is particularly telling in respect of both the impact of CEFTA on FDI inflows and of FDI on intra-CEFTA trade patterns.

As well as regional economic re-integration, CEFTA cooperation has also generated advantages for the political sphere.[5] The non-economic impact of CEFTA corroborates ideas raised in the European Security literature by those analysts who have been arguing that sub-regional co-operation improves the security of participating states. This is not in the conventional sense of security (formation of military alliances etc.) but rather in terms of so-called 'soft'

[2] For a discussion of the problems of sub-regional cooperation among CIS states, for example, see Bremner and Bailes (1998).

[3] The analysis of the commodity structure of intra-CEFTA trade covers the period 1994-1997 and is restricted to the original CEFTA four only. Romania and Bulgaria had not joined CEFTA at that stage and Slovenia's time in CEFTA had still been rather short.

[4] See Dangerfield (1999).

[5] As well as the specific contributions to follow, an important aspect of the overall political function of CEFTA has been its role as 'holding operation' for multilateral political cooperation during the Visegrad Group's dormant period.

security issues (economic interdependence, organised crime, environment) and subtle influences on regional political relations and stability. As well as the more obvious fostering of deeper interdependence between the member states, CEFTA cooperation has provided a forum for dialogue at the highest level.[6] There has also been the need to upgrade and maintain good channels of communication because of CEFTA business. Also relevant is the fact that CEFTA candidacy is an incentive to maintain good relations with the incumbent CEFTA countries and to settle any problems which could compromise accession to CEFTA (e.g. Bulgaria's socialist-era debts to Poland and Hungary). Though its influence will be clearly limited as far as serious bilateral disputes are concerned, in all the above ways CEFTA can help foster good political relations in the region. According to Bailes (1997) sub-regional cooperation exerts an impact through its mere existence: "The largest contribution all these (sub-regional) groups make to security is probably at the unexpressed, existential level: the mere fact that their members belong somewhere, that they understand each other, that they can talk about their worries in the 'corridors', that they have telephone numbers to dial in a crisis. Beyond this all the groupings under study have made some strides (whether they recognise it or not) in 'soft security', by easing human and economic exchanges across frontiers and thus helping to build wider social foundations for stability and understanding."

Moving on to the more direct link between sub-regional cooperation in CEFTA and EU pre-accession, this is evident in several respects. The EU condition that future members also address their mutual integration is satisfied (this applies to the Baltic States too who have been implementing the Baltic Free Trade Area (BFTA) since 1994) and the real integration which will in any case come with EU membership is thus well underway. CEFTA has also provided a framework for the further development of economic cooperation which anticipates collective EU membership. As the CEFTA states' relations with the EU have gone through the various stages this too has broadened the parameters of CEFTA integration. When the Europe Agreements were put in place, for example, regional trade arrangements could follow suit. Later, following approval of the EC Commission 1995 White Paper on EU enlargement to CEE, the CEFTA countries were subsequently able to entertain a move to some elements of a common market without fear that regional economic cooperation would breach the limits demarcated by the current phase of the EU integration process. Hence in autumn 1995, following the Brno CEFTA summit, liberalisation of capital and services was accepted onto the CEFTA agenda with even free movement of labour having been discussed in this context. CEFTA co-operation also offers the valuable experience of intergovernmental processes and procedures (as policy makers) and this gives the 'state-building' newly independent countries in particular a chance to demonstrate their maturity in this respect. Due to all of the above, both past and present CEFTA candidates have validly viewed CEFTA as an important part of the route to EU membership. There are many reasons why CEFTA cannot act as a vehicle for the coordination of the CEFTA states' EU accession strategies, which will remain essentially national ones, but the above suggest that its contributions to the EU accession are clearly useful ones and CEFTA cooperation should be given more recognition as a bona fide component of that process.

CEFTA TOWARDS AND BEYOND EU ENLARGEMENT

Turning now to the question of the future role of CEFTA, as far as the existing members of CEFTA and potential members from the CEE-10 are concerned this is fairly straightforward. As indicated above, these countries can continue their integration by ongoing market integration and further developing their cooperation in ways that are compatible with their approach to full EU membership. This will obviously depend on whether they have the political will and the administrative and technical capacity to do so. They may be distracted or demotivated by the demands of EU negotiations and/or the need to attend to important matters arising out of the regional dimension of preparations to enter the EU (e.g. attention to border issues, the Czech-Slovak customs union etc.). Either way, deepening of integration among the existing CEFTA, even if it takes a multi-speed character, can only facilitate the EU accession and should yield real

[6] The Prime Ministers of the CEFTA countries meet annually at CEFTA Summits. In the case of certain countries (the Czech and Slovak republics during large parts of the Klaus and Mečiar regimes, for example) CEFTA summits were the only occasion their leaders were guaranteed to come face to face.

economic benefits. To reject this premise would undermine the very assumptions upon which the strategy of EU accession itself are based — the desirability of integration!

The other question connected to CEFTA's future, which is whether it can have a redefined role in the long term, especially when its core members are in the EU, is more complicated and inevitably speculative. A number of possible scenarios for CEFTA have tended to be put forward. First, it may wither away in the style of EFTA, which is a distinct possibility. Second, it could become a regional grouping inside the EU along the lines of Benelux or the Nordic Council. Apart from the problem of the division of the current CEFTA into ins and pre-ins, this function would surely lie with other groupings (of which the revitalised Visegrad Group is the most obvious). Third, (and this is where CEFTA could make the most useful contribution to the European integration process) might CEFTA enlarge to take in all current candidates, as well as ones which may emerge later, and continue as a bridge to the EU but with a more pan-European brief? Unfortunately, the current impediments to CEFTA enlargement beyond the CEE-10 restricts the likelihood of this scenario for now. Of the three non CEE-10 candidates (Croatia, FYR Macedonia and Ukraine) only Croatia has any realistic chance of a Europe Agreement in the (relatively) near future.[7] Equally disappointingly, the need for the CEE10 to align trade relations with those of the EU is currently preventing the existing CEFTA members from exercising their policy preferences to sign new bilateral free trade agreements with non-CEE-10 countries in the region.[8] This not only precludes formal expansion of CEFTA but also prevents the de facto incorporation of non-CEE-10 into CEFTA (and therefore into the broader European economic integration process) to the political and economic detriment of all countries involved. Finally, what about the prospect that CEFTA might even evolve as an alternative to the EU if more countries were able to join anyway (i.e. the accession rules were changed)? The main problems with this scenario are that the rump CEFTA members would not be likely to reject their stated EU ambitions and, together with the lack of necessary cognateness of the current CEFTA candidates, the shared problems of relative economic backwardness and retarded progress in economic reform would rule out serious integration deepening for a very long time. Thus it seems CEFTA could only become an extension of the European free trade complex rather than a genuine alternative to the EU.

CONCLUSIONS

The success of CEFTA has been apparent in terms of the rehabilitation of regional economic ties in central and eastern Europe, helping to maintain multilateral political interaction and practical assistance to the approach to the EU. As negotiations for full EU membership progress the CEFTA states are discovering reasons to intensify their own cooperation. Unfortunately, as things stand the same forces will restrict the further development of wider patterns of sub-regional cooperation in CEE, whether through the extension of CEFTA or bilateral arrangements. In the interests of a more inclusive rather than exclusive European integration process, action should be taken to ensure that the EU enlargement strategy does not close the door to economic cooperation between the current CEE applicants and those states in the region whose relations with the EU are less advanced.

[7] Even then, Croatia will face further delays because Lithuania and Latvia are slated as the next countries to join CEFTA.

[8] The Hungarian government has expressed its desire to sign free trade agreements with Croatia and Ukraine for example, but has also admitted the need to hold back on this because of the fear it could complicate the EU accession. See Dangerfield (1999).

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TABLES

Table 1 ***Intra-CEFTA Trade, 1993-1997***
$US millions

	1993	1994	Index 1994/ 93	1995	Index 1995/ 94	1996	Index 1996/95	1997	Index 1997/ 96	Index 1997/ 93
Czech Republic										
Export	3488.9	3258.5	93.4	4348.3	133.5	4943.6	113.7	4907.1	99.3	140.7
Import	2745.7	2718.1	99.0	3883.3	142.9	3886.4	100.1	3645.9	93.8	132.8
Hungary										
Export	461.6	565.2	122.4	757.4	134.0	1162.9	153.5	1387.2	119.3	300.5
Import	655.3	900.3	137.4	982.3	109.1	1253.8	127.6	1377.7	109.9	210.2
Poland										
Export	680.4	823.0	121.0	1244.9	151.3	1480.8	119.0	1738.1	117.4	255.5
Import	682.2	918.5	134.6	1624.0	176.8	2160.5	133.0	2652.2	122.8	388.8
Slovakia										
Export	2716	3057	112.6	3778	123.6	3656	96.8	3419	92.1	125.9
Import	2483	2226	89.7	2757	123.9	3225	117.0	2931	90.5	118.0
Slovenia										
Export				403.2		450.7	111.8	504.2	111.9	-
Import				633.7		615.8	97.2	704.9	114.5	-
Romania										
Export						293.6		341.7	116.4	-
Import						540.9		641.5	118.6	-

Note:

Data for Slovenia in 1995 and for Romania in 1996 included for comparative purposes

Table 2 *INTRA-CEFTA Trade by Commodity Structure (SITC) of Visegrad 4 , 1994 and 1997*

Exports of CEFTA States, $US million

	0	1	2	3	4	5	6	7	8	9	Total
1994											
Czech Republic	185.4	60.0	105.9	372.2	21.1	532.0	873.9	828.9	288.7	0.5	3268.6
Hungary	70.4	25.6	35.6	26.4	19.5	135.6	87.9	63.4	38	0	502.4
Poland	47.8	1.4	60.7	190.6	0.1	113.9	215.5	126.2	66.9	0.2	823.2
Slovakia	171.6	43.7	188.8	235.3	4.4	487.5	632.5	583.2	266.4	2.2	2615.6
Total	475.2	130.7	391.0	824.5	45.1	1269.0	1809.8	1601.7	660.0	2.9	7209.8
% of total exports	6.59	1.81	5.42	11.44	0.62	17.60	25.10	22.22	9.15	0.04	
1997											
Czech Republic	274.2	95.6	135.2	330.4	19.5	700.2	1390.3	1482.6	432.6	4.5	4865.1
Hungary	321.4	16.7	69.4	111.3	37.8	292	240.7	259.3	93.8	0	1442.4
Poland	145.5	0.8	58.6	258.3	1.1	229.5	504.2	293.9	166.8	0	1658.7
Slovakia	144.9	45	167	339.5	8.5	532.3	1218.3	666.6	237.8	0.9	3360.8
Total	886.0	158.1	430.2	1039.4	66.9	1753.9	3353.4	2702.4	931.0	5.4	11327.0
% of total exports	7.82	1.40	3.80	9.18	0.59	15.48	29.61	23.86	8.22	0.05	
Index 1997/94	186.5	121.0	110.0	126.1	148.6	138.2	185.3	168.7	141.1	187.5	157.1
Weighted Index 1997/94:											
Czech Republic	8.3	3.1	3.6	6.0	0.4	18.9	45.5	54.5	13.3	-	
Hungary	101.7	0.8	9.4	32.5	5.1	43.6	45.7	73.5	16.1	-	
Poland	26.7	0.0	3.4	21.1	1.5	27.9	71.1	41.3	25.1	-	
Slovakia	3.6	1.4	4.4	14.6	0.5	17.3	69.8	22.7	6.3	-	
Total	14.6	1.7	4.2	11.6	0.9	21.4	54.9	40.3	11.6	0.09	

Notes:

Hungarian data based on import data of Czech Republic, Poland and Slovakia
Formula for weighted index is as follows: Index 1994/97 x (% of total exports/100)

Key to SITC codes:

0 = food and live animals; 1 Beverages and tobacco; 2 Crude materials, except fuels; 3 = Mineral fuels, lubricants, related materials; 4 = Animal and vegetable oils, fats, waxes; 5 = Chemicals and related products; 6 = Manufactured goods, classified chiefly by materials; 7 = Machinery and transport equipment; 8 = Miscellaneous manufactured items; 9 = Others

Sources (Tables 1 and 2): Dangerfield (1999)

Table 3 *Cumulative foreign direct investment inflows, CEFTA and Croatia, 1997*

	$US billions	As % of 1997 GDP
Poland	26.0	15
Hungary	22.5	39
Czech Republic	8.0	11
Romania	2.8	8
Slovenia	2.4	14
Croatia	1.3	7
Slovakia	1.0	5

Source: *Business Central Europe*, November 1998, 18

Table 4 Status of Potential CEFTA Members

Candidate	WTO member?	Europe Agreement?	Guests at CEFTA summits?	Bilateral free agreements in force with existing CEFTA members?
Croatia	No*	No	1997	Slovenia (1/1/98)
Latvia	Yes	Yes	1996,1997	Slovakia (1/7/97) Czech Rep (1/9/97) Slovenia (1/8/96) Poland (May 1999)
Lithuania	No*	Yes	1995,1996,1997	Slovakia (14/11/97) Czech Rep (1/7/97) Poland (30/12/97) Slovenia(1/3/97)
FYR Macedonia	No*	No**	1997	Slovenia (1/7/96)
Ukraine	No*	No***	1996,1997	

Notes

*WTO applications currently being considered by accession working parties.
** FYR Macedonia's 'Trade and Cooperation Agreement' with the EU entered into force on 1/1/1998
*** Ukraine's 'Partnership and Co-operation Agreement' contains a provision for the two parties to discuss establishing a free trade area, but so far this is not on the agenda.

Sources: Dangerfield, (1998); WTO Information Unit

EU ENLARGEMENT AND THE CEFTA

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FURTHER INTEGRATION IS AN INDISPENSABLE CONDITION

We all know — though it is not very popular to say so — that deepening the EU is the precondition for widening it. So, any delay in deepening the EU will necessarily hamper the process of widening it.

But even without the widening option, it appears that deepening the EU structures is unavoidable — following the logic of integration. Once the initial stages of integration are completed, further steps become necessary, mainly for two reasons: a) the new policy deprives some countries of the economic policy instruments by which they supported activities of certain social groups and b) the costs and benefits are very unequally distributed among the individual countries (the more countries, the more inequality).

In a common market where the free movement of production factors is introduced, production factors need not move in such a way as to bring about a better equilibrium. Setting up economic and monetary union further curtails the instruments available to national states — e.g. they are losing the possibility of influencing the equilibrium with partner countries via exchange rate and monetary policies.[1]

Thus countries realise that the cost of policies which are not co-ordinated tends to increase. Large flows of capital tend to shy away, trying to find cheap havens, etc. These new "imbalances" push partners either to further integration or they involve the danger of disrupting the whole process.

This logic is not to be found in the mainstream literature, however.[2]

Most authors prefer to look for what is called an Optimum Currency Area (OCA) - where more "hard data" can be used.

However, "enlargement is not only about transfers and narrowly defined economic benefits. Eastern enlargement is an essential pillar in Europe's post-Cold War architecture" (Baldwin - Francois - Portes, 1997, p. 128).

THE DANGER OF OVERBURDENING THE EU

The further development (transition) of the EU is certainly not a linear process bound to generate a definite outcome. Like any transition, it is prone to setbacks or unexpected turns.

Therefore various groups see the process of widening the EU as a danger, a danger to their security and welfare. They may be among the losers and are therefore opposing EU enlargement. It is not only regions and lobbying groups but also the EU as a supranational body that are subject to dramatic changes. The changes required at the supranational level are twofold: a) institutions have to be adapted to a larger set of members (20 or 25 instead of the former 6), and b) some of the political instruments have to be adjusted as well. As regards the political instruments, the focus is on two areas: the agricultural policy and the policy of cohesion and regional distribution.

THE CAP: A NIGHTMARE IN THE CONTEXT OF EU ENLARGEMENT

In every respect, the present agricultural policy is a nightmare, especially for people who advocate a free market. Regulations in the form of quotas, subsidies, guaranteed prices, etc.,

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[1] Willem Molle: The Economics of European integration, p. 432.
[2] Willem Molle: p. 402

with the objective of stabilising the market, lead to tremendous welfare losses for consumers and have created a system transferring money from consumers and taxpayer to farmers, to provide them with an appropriate income level. However, this system swallows about 50% of the EU budget (in 1997, ECU 88 billion). Some data show (see table) that this system is not sustainable in the case of enlargement.

According to EU statistics, the CEFTA countries (Poland, Hungary, the Czech Republic, the Slovak Republic, Slovenia, Romania and Bulgaria) would more than double the number of farmers in the EU (15), from 8 to 16 million persons.

Table: Importance of agriculture

	Land used for agriculture		Agricultural production		Employment in the agricultural sector		Trade		Food expen-diture
income	million hectares	% of total area	ECU bn	%	1,000 of GDP	% of employ-ment	% of total total	% of tota exports	% of hh. imports
Poland	18.6	59	4.648	6.3	3,661	25.6	12.2	11.1	30
Hungary	6.1	66	2.068	6.4	392	10.1	21.8	7.4	31
Czech Rep.	4.3	54	0.871	3.3	271	5.6	7.7	9.6	32
Slovak Rep.	2.4	49	0.512	5.8	178	8.4	5.9	9.3	38
Slovenia	0.9	43	0.250	4.9	90	10.7	4.7	8.2	28
CEFTA 5*)	**32.3**	**58**	**8.349**	**5.5**	**4,592**	**22.1**			
Romania	14.7	62	4.500	20.2	3,537	35.2	6.8	9.9	60
Bulgaria	6.2	55	1.131	10	694	21.2	20.7	10.6	48
CEFTA 7	**20.9**	**60**	**5.631**	**18**	**4,231**	**32.9**			
Lithuania	3.5	54	0.259	11	399	22.4	12.8	10.8	58
Latvia	2.5	39	0.232	10.6	229	18.4			45
Estonia	1.4	31	0.266	10.4	89	8.2	11.0	16.7	39
Baltics	7.4	43	0.757	10.7	717	19.4			
CEEC 10	60.6	56	14.7	7.8	9,540	26.7			

Area, production and employment figures are for 1993, trade and food expenditure 1994 EU = EU 12 for trade. Food expenditure in Hungary, the Czech Republic and the EU includes beverages and tobacco, while in Romania and Bulgaria, home consumption is included.

*) as measured by gross agricultural product (GAP)

It is obvious that widening the EU without changing the CAP is not possible, because all members refuse to increase their contributions above 1.27% of their GDP. Especially the net contributors, including Germany and Austria, have demanded that the burden should be relieved.

Besides the CAP, the **cohesion policy** must be changed, too. The Agenda 2000 ("For a Stronger and Wider Union") is proposing a greater concentration and that "at all events, total transfers from the Structural Funds and the Cohesion Fund to a present or future Member State should not exceed 4% of its GDP"[3].

From this supranational point of view, the losers would be the farmers and certain regions, today regarded as regions to be assisted with subsidies. However, the applicant countries' low gross social product (one third of the Union average) would reduce the EU average, thus jeopardising the preferential position of some of the assisted areas. According to the Agenda 2000, the effect of enlargement (from 15 to 26 EU members, based on 1995 data) would be an

[3] Agenda 2000: For a Stronger and Wider Union, p. 22.

increase of 34% in area, of 29% in population, of (only) 9 % in total GDP, and a drop of 16 % in per-capita GDP, to a level of 75% of the per-capita GDP of the EUR(6). Today (1998), however, the per-capita GDP at purchasing power parity of some of the countries applying for EU membership is close to that of some member states (like Greece, Portugal and Spain, which reach some 75% of the Community average): Slovenia reaches 68%, and the Czech Republic 63%, of the Community average[4]. This clearly shows the wide diversity among the CEFTA countries.

FURTHER FEARS OF WELFARE LOSSES AMONG EU GROUPS

The free movement of production factors within the Union gives rise to fears in certain EU regions. Austria's experience in connection with some of the applicant countries raises fears for the labour market. Possible migration flows may be expected to come especially from Poland and Romania. This causes the labour unions to veto a quick widening of the Union, and ask for derogations. Fears of possible groups of losers will make negotiations difficult, as they will try to insist on conditions to be met in such areas as social standards and environmental protection without the Eastern applicant countries being able to do so in time, for lack of funding. This will of course cause resistance on the part of Eastern Europe, too. Furthermore, there are fears among the EU population over the high cost of widening the Union. Therefore, enlargement including all CEFTA countries seems to be politically impossible in the present EU member states, solidarity among member states would be weak.

WIDENING THE EU STEP BY STEP?

In view of the problems set out above, some CEFTA countries will find it easier to be accepted as members by the EU, and some will inevitably encounter problems. One important point is the size of population and of the agricultural sector. Among the "first-round" countries, Poland is obviously a big problem. As far as the entire CEFTA(7) region is concerned, EU enlargement to include Romania and Bulgaria would involve high risk. Especially the large number of farmers would cause tremendous problems - for the EU but also within the countries themselves. Even if we assume that some changes in the CAP will be made, the high price level of agricultural products, combined with the (relatively) high income level of farmers, would cause a structural shift towards agriculture and increase food prices dramatically.

The heterogeneity of the CEFTA countries would further increase the present heterogeneity of the EU. The 11 Euro "ins", the "pre-ins" and various CEFTA countries would without any doubt lead to a further de-solidarisation in the EU and probably even reverse the process of integration.

This does not apply to the Optimum Currency Area concept, distinguishing stages of integration e.g. by the degree of openness of goods markets, openness of markets for production factors or forms of an integrated policy with respect to stabilisation and redistribution. As stated before, we follow the theoretical view of those (e.g. Hamada 1985) for whom these indicators are irrelevant as criteria of EU membership - to them, **a monetary union cannot be sustained without full political unification.**

The necessity of achieving a "full political unification" is seen as a consequence of the integration into a monetary union.

In view of the above stated heterogenity within the CEFTA as well as within the EU, this enlargement would most probably result in the necessary political unification becoming at best a long-term target. Moreover, the tendency of raisin-picking by different nations (and groups) would increase, leading to a wave of desolidarisation and thus endangering the whole integration process - probably starting with a collapse of the Euro.

Warnings that the declared objective of a united Europe could turn out to be an illusion are many, especially from the US side. In an article published in Foreign Affairs (Nov/Dec 1997) Martin Feldstein states: "if EMU occurs and leads to such a political union of Europe, ...the world

[4] EU: Reports on progress towards accession... Composite paper, p. 5.

will be a very different and not necessarily safer place". Milton Friedman adds, "I tell you, the euro will soon break up again". This is in line with the view expressed by the Belgian Minister of Finance (11 May 1999) who said that an "accelerated procedure for full membership of Bulgaria in the EU is impossible" and added that the same applied to Romania.

Seen from both sides, step-by-step enlargement seems to be a healthier way to build the united Europe. However, "what belongs together needs time to grow together".

Applicant countries of Central and Eastern Europe and EU Member States (basic data for 1995)

	Area	Population		GPD			Agriculture
				at current prices		purchasing power	
	1,000 km^2	milions	inhabitants/ /km^2	ECU bn	ECU/head. percentage of EU average	ECU/head. percentage of EU average	% of employment
Hungary	93	10.2	110	33.4	19	37	8.0
Poland	313	38.6	123	90.2	14	31	26.9
Romania	238	22.7	95	27.3	7	23	34.4
Slovak Rep.	49	5.4	110	13.3	14	41	9.7
Bulgaria	111	8.4	76	9.9	7	24	23.2
Czech Rep.	79	10.3	130	36.1	20	55	6.3
Slovenia	20	2	100	14.2	42	59	7.1
Latvia	65	2.5	38	3,4	8	18	18.5
Estonia	45	1.5	33	2.8	11	23	13.1
Lithuania	65	3.7	57	3,5	5	24	23.8
CE 10	**1078**	**105.3**	**98**	**4.0**	**13**	**32**	**22.5**
in % of EU 15	**33**	**28**	**85**	**1845.2**			**425.0**
Germany	357	81.5	228	178.4	131	110	3.2
Austria	84	8.9	96	844.8	128	112	7.3
Un. Kingdom	244	58.5	240	234.0	83	96	2.1
EU 15	**3236**	**371.6**	**115**	**6441.5**	**100**	**100**	**5.3**

CEFTA AND THE EU ENLARGEMENT PROCESS: AN ASYMMETRICAL BARGAINING EXERCISE

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INTRODUCTION

In March 1998, a majority of the CEFTA countries entered a critical stage in their journey to EU membership when they started negotiating the terms and timing for accession. At the Luxembourg summit in December 1997, the EU Heads of State and Government had decided to divide the enlargement process into a fast and slow track. In the fast track, EU would be starting the bilateral screening process with 5+1 applicant countries by the end of March 1998. This screening process would more or less automatically lead to real accession negotiations at a later, albeit, unspecified date. The four remaining applicant countries were relegated to a slow track which encompasses multilateral screening but with no automation of accession negotiations. The EU's decision effectively divided the CEFTA members into two camps: The Czech Republic, Hungary, Poland and Slovenia were selected for the fast track, whereas Rumania, Slovakia and Bulgaria (which joined CEFTA in July 1998) were chosen for the slow track.

The division of the CEFTA countries in the EU enlargement process raises a number of questions on the future coherence of the regional bloc. Most observers have pointed to the question of what will become of CEFTA when more than half of its members leave the arrangement, embarking on the first wave of EU accession which is expected to take place before the slow track countries catch up in the negotiation process. Given that the major, and more advanced economies belong to the fast track, the attractiveness of CEFTA will no doubt decrease dramatically after the first enlargement round. While this member-draining phenomenon may pose difficult and permanent problems for some of the future members of CEFTA, such as Croatia and FYR Macedonia, the present CEFTA members belonging to the slow track may regard it as a temporary problem, provided that the time span between the first and second enlargement wave is not too wide. After all, CEFTA has always been viewed as a temporary arrangement whereby Central and Eastern European countries develop and expand their mutual trade links before reaching their ultimate objective: membership in the European Union.

During the past few years, the Central and Eastern European countries have been engaged in a fierce competition to stay ahead in the race for early EU membership. The EU's decision in late 1997 to divide the applicant countries into two groups naturally created disappointment and anger in some of the countries relegated to the slow track group. But even among the fast track countries undergoing the bilateral screening and negotiation process, it seems to be an absolute priority at least to keep pace with, if not stay ahead of, the other members of the group.

This paper argues that while the anxiety and ambition of keeping pace with the fastest in the negotiation group may be rational seen from the perspective of the individual applicant country, the non-cooperative competition among the applicant countries is collectively irrational because undermines the bargaining position of the group as a whole. In other words, the applicant countries are facing a classical *collective action problem* in their accession negotiations with the EU. The basic reason is that the fierce race among the applicant countries to complete their individual accession negotiations undermines number of their most important power tactics by which they could otherwise improve their bargaining position: threat and tying hands tactics. Thus, the threat to walk away from the bargaining table unless the EU offers a better deal is likely to uphold the negotiations for an unspecified period of time. In this period, the applicant country will get further and further behind in the negotiation process. Tying hands tactics work in the same direction. In order to utilise the already narrow scope for negotiation, it is important that the CEFTA group co-ordinate their EU bargaining processes in a mutually beneficial way. This may however be difficult because powerful forces hamper co-operation.

In order to understand the hypothesis, it is necessary to outline the main features of the unusual asymmetrical bargaining process which characterises the EU's accession negotiations

with applicant countries, including some of the tactical ploys EU makes use of when seeking to exploit its preponderant structural power *vis-á-vis* applicant countries. These features will be described in the first section. The second section outlines some the most important bargaining tactics which applicant countries may use in order to improve their relatively weaker bargaining position. On the basis of the analysis provided in the two first sections, the final section explains why the CEFTA countries should cooperate, aiming at synchronising their EU accession negotiations and why such cooperation may be difficult to achieve.

1. THE EXTRAORDINARY ASYMMETRICAL BARGAINING PROCESS BETWEEN EU AND APPLICANT COUNTRIES: "THE ACQUIS, AND NOTHING BUT THE ACQUIS"

Accession negotiations in the EU are an extraordinary asymmetrical exercise compared with other international negotiations. Typically, the EU has an unusually strong structural power position due to economic and political-institutional factors. In accession negotiations, these factors are translated into behavioural power by means of various bargaining tactics. The main features of the EU-s structural and behavioural power will be outlined in the following.

Structural economic power asymmetries

The economic reasons are well-known in the international political economy literature: Asymmetrical structural power is simply a matter of relative market access.[1] Ever since the first enlargement negotiations took place in the early 1970s, the European Community has always negotiated with countries whose economic size was smaller than the EC group as a whole. The reason was simple: leaving the very long-term potential of the Russian economy aside, no European country matches the EC/EU block in terms of market potential. This asymmetry in market access has grown over time as several EC/EU accession rounds have been completed and the outsider group has steadily been drained of middle-sized and big economies. As Baldwin (1993) has pointed out, each EU accession leaves the outsiders relatively worse off. This may change the minds of countries which were otherwise happy to stay outside the EU. In other words, each accession tends to have a "domino effect" on neighbour countries, making the queue of applicant countries ever longer, and, eventually, the number of EU member countries ever bigger. Baldwin's "domino hypothesis" seems, at least partly, to explain the competition among the CEFTA countries for rapid EU accession.

Enlargement in terms of economic size (quantity) is, however, only one dimension of market access. Another dimension is the quality of market access. After all, there would be no point in joining the EU if this regional arrangement was no different or even less efficient than alternative arrangements. With the implementation of the Single European Act in the late 1980s and 1990s, the EU has attempted to create an economic arrangement which goes far beyond other regional arrangements in the world. The establishment of a truly single market facilitates stronger competition, specialisation and utilisation of economies of scale which ultimately will lead to higher economic growth and prosperity. For this reason, it is not surprising that the requests for EU membership really started to accumulate after the EC implemented the Single European Act in the late 1980s. The sweeping events in Central and Eastern Europe which took place in the same time enforced this trend. The fact that alternative solutions to EU membership have become less and less attractive for outsiders, leaves the EU with one of its most fundamental structural power resources in accession negotiations. According to Habeeb (1998) who has written influential books on asymmetrical bargaining, the relative attractiveness of status quo (a.k.a. BATNA = best alternative to no agreement) is the most important source of structural power in any asymmetrical negotiation. This view is supported by Moravscik (1993) in his application of bargaining theory to the EU negotiations.

Political-institutional factors

Asymmetric market access is, however, but one important source of the EU's extraordinary

[1] In fact, they were spelled out in one of the earliest books on modern international political economy, namely Hirschman (1945)

strong bargaining position vis-a-vis applicant countries. A number of political-institutional factors add to this position.

First, it should be borne in mind that when an applicant country gains access to the EU, it joins a club. The policies and the rules of the game of this club (in eurospeak: the *acquis communautaire and politique)* have been developed over time through normally very difficult and protracted negotiations between the present members of the club. The negotiations leading to the Rome Treaty (1957), the SEA (1985), the Maastricht Treaty (1991) and the Amsterdam Treaty (1998) have typically implied major institutional changes of the co-operative framework. Since these "grand bargaining" negotiations have operated under the consensus rule, it has been necessary to make complicated issue-linkages and side-payments (swaps and concessions) in order to facilitate a positive negotiation result.

The accession of new members potentially threatens to upset the fragile political equilibrium obtained by the present members of the club. If accession negotiations were open-ended in the sense that everything might be a negotiation issue, the EU members would have to reopen the very difficult agreements accomplished in the past. In this event, further accession rounds might not take place.

Behavioural power: Terms for membership

In the past negotiations rounds, the EU has exploited its inflexibility vis-a-vis the opening of internally negotiated policy packages to impose on applicant countries a number of tough terms for membership. Based on the experience from the preceding enlargement rounds, Avery (1994) mentions four principles guiding the terms for accession:

- No institutional changes: new members are fitted into the institutional framework using existing allocation keys such as the number of votes in the Council of Ministers, number of Commissioners, and seats in the European Parliament.

- No changes of the EU budget, including the major policies financed by the budget (i.e. Common Agricultural Policy and Structural and Regional Policy).

- Accession rounds have tended to take place in waves with more than one applicant country (the EC's first southern expansion is a notable exception).

- Applicant countries have to accept "all the acquis and nothing but the acquis". In other words, changes in the existing EU policies are not topics for negotiation. Applicant countries can only negotiate the transition period leading up to the full adoption of the existing acquis.

In the future accession rounds with the Central and Eastern European countries, it has been necessary for the EU to compromise on the first two principles. Thus, at the Essen summit in 1994, it was agreed that the main objective of the 1996-1997 intergovernmental conference was to make the EU institutionally fit for enlargement. This involved changes in the decision making procedures (including voting procedures), reform of the Commission, a cap on the number of seats in the European Parliament, and most importantly a re-weighting of votes in the Council of Ministers favouring the larger member countries. Furthermore, it was agreed that the EU should reform its budget, including the agricultural (CAP) and structural policies throughout 1997-99.

The reasons for the necessity of institutional reforms are ascribed to the sheer number of applicant countries, the majority of which are rather small in terms of population size. As has been shown in a number of studies, throughout the preceding accession rounds since 1973 the balance of power within the Council of Ministers has systematically been tilted in favour of the smaller countries (see e.g. Kirman Widgren (1995) and Hosli (1996)).[2] The sheer number of

[2] It is interesting to note that all the five major EU countries (France, Germany, Great Britain, Italy, and Spain), despite their differences, put up a united front in the 1996-IGC demanding a re-weighting of votes in the Council of Ministers.

applicant countries has also made it necessary to change the institutional procedures, reform the Commission, and so on. At the 1996-IGC, however, the member states failed to reach a compromise of the re-weighting of votes in the Council of Ministers and the size and distribution of seats in the Commission. These decisions have been postponed until a later mini-conference which is scheduled to take place in 2000-1.

The reasons for the necessity of budgetary reforms are even better known: the fact that the applicant countries are less affluent than the poorest present member states, and that a majority of the applicant countries have relatively large agricultural sectors, makes it impossible to fit new members into the existing budget. Instead of increasing the budgets, the member states decided to reform the CAP and structural policies. The reforms reached at the budget negotiations which were completed in March 1999 were at best partial as was the case with the institutional reforms. In fact, the EU might have to renegotiate the CAP after the new WTO trade round opens in Seattle in November 1999. The rather disappointing results obtained so far in the EU's internal reforms underline how difficult it is to re-open existing packages.

Among the four principles, the latter is clearly the most important and inflexible. In fact, in the ongoing accession round, the EU has even attempted to make the terms for transition periods more inflexible than in previous rounds. First, by adopting the so called *pre-accession strategy* the EU asked the applicant countries to start adopting the acquis before the selection of applicant countries for the fast-track was made. Although the applicant countries were left with a choice of whether or not to adopt the acquis, and in particular the speed with which they wanted to progress, they had *de facto* no other options if they wanted to be selected for the fast-track group. Second, the pre-accession strategy has recently been enhanced by the so-called *Accession Partnerships*[3]. According to this scheme, every applicant country receives a "training plan" which highlights the parts of the acquis the applicant country should fulfil in the short-and medium term, i.e. in the years up to accession. As with the pre-accession strategy, the applicants are free to ignore the advice, but again this is a hollow freedom because lack of compliance may slow the speed of the applicant's accession negotiations (Friis and Jarosz, 1999). Finally, the EU has repeatedly made clear that the duration of transition periods will be very limited for the Central and Eastern European applicant countries. For instance, Nikolaus van der Pas, the Director-General of the Task Force for Accession Negotiations of the European Commission has pointed out that the applicant countries should be aware that their margin of negotiation is very narrow (World Economic Forum, 1998). Transition periods granted to the applicant countries will be at a maximum of five years, and in no case will the EU accept extraordinary long transition periods such as the 17 1/2 year transition period granted to Spain for fisheries. On the same occasion, van der Pas also warned the applicant countries against "the trap of easy discussions of transitional periods".[4] Furthermore, van der Pas has repeatedly underlined the standard EU position that the timing of accession depends principally on the speed at which the applicants make themselves ready to become members and to apply the EU rules fully in practise.[5]

EU power tactics in the screening and negotiation stage

The actual conduct of the accession process underlines these remarks. On the surface, the current accession talks is business as usual guided by the "acquis, and nothing but the acquis"-principle. The accession process is divided into two stages: a screening phase which constitutes a pre-negotiation stage, and an actual negotiation stage.

In the screening stage, the 5+1 members of the fast track group is explained the content, extent, and point of 31 characters or areas of EU legislation. The purpose of this didactic phase is to identify issues for negotiations. It involves two kinds of enquiries: the first is to ascertain, chapter by chapter, whether the applicant country is prepared to accept the acquis (if it does not, then that is immediately identified as a negotiation issue). The second is to ascertain to what extent a candidate has the legislative and institutional arrangements already in place to

[3] See European Commission (1998)
[4] *European Report*, 21 January 1998, EU Enlargement; Questions Over Mechanisms Before Negotiations.
[5] See e.g. *European Report*, 28 July 1998, EU Enlargement: A November 1998 Start For Accession in 2002?

implement the acquis, or to identify what programmes and calendars are in place or planned to be so. The applicant countries are left with there possible responses:

a) the relevant legal norms exist in its legislation and are applied in practise;

b) the applicant lacks the equivalent legislation; the government has, however, committed itself to amending the legislation within a certain period of time, but no later than the planned date for accession to the EU;

c) the applicant lacks the equivalent legislation, and the government requests a transition period.

The second type of enquiry is clearly the most important because of "the acquis, and nothing but the acquis"-principle.

So far, that is until May 1999, the screening process has proceeded quite well from an EU point of view. In order to get the talks off the ground, the screening process started in April 1998 with seven "easy chapters", including science, research, telecommunications, information technology, education, training, culture, and audio-visual policy. In its report accompanying the Commission's draft proposal for EU Common Positions for negotiation of September 1998, the Commission noted an overall impression that the applicant countries were well-prepared, well-informed and "fully aware of the conditions for negotiations". The applicant countries had so far declared their willingness to take over the acquis and they sought for few and limited transition periods.[6] In fact, Estonia (the only non-CEFTA country in the fast-track group, excluding Cyprus) did not ask for any transitional periods on the seven chapters.[7] Later on, the screening process has mowed to the more difficult areas including agriculture and freedom of labour movement, and this has naturally made the screening process more complex and protracted. Nevertheless, the process is expected to be completed in June 1999.

While the screening process has progressed better than expected, it has taken somewhat longer than originally planned. This is not so much due to unforeseen difficulties encountered in the process, but rather because of a change in the EU Task Force's approach. Instead of merely explaining the EU policy rules and asking whether the applicant countries can accept and adopt them, the Task Force has gone further this time examining in-depth the candidates' individual achievements and deficiencies. This new approach underlines the EU's ambition of keeping tight control on the accession process, and it confirms van der Pas's remarks that the applicant countries should avoid falling into "a trap of easy discussions on the length of transitional periods." While the new approach may be defended as a more efficient way of conducting the accession process in the sense that it aims at avoiding problems in the real negotiations stage, it may also be seen as another tactical ploy by the EU to maintain a strong power position in the negotiations: the objective is to ensure that the candidate countries comply with the short transitional periods granted, and that the negotiations do not proceed too fast and easy. The candidates' ability to take on the acquis shortly after accession must be thoroughly examined. As van der Pas has noted: "If applicants say they can accept the acquis, but they cannot actually apply it, then there is not point in letting them accede".[8]

The actual negotiations of the first seven chapters completed in the screening process started in Autumn 1998. In the meantime, the applicant countries had competed intensively on who would be the first to submit its bargaining positions on the seven chapters to the Commission and Council of Ministers. Poland won this prize. Based on the papers of the applicant countries, the Commission submitted its proposals for the EU's Common Positions which were to be agreed on unanimously by the Council.[9]

[6] *European Report*, 3 October 1998, EU Enlargement: Technical Input From Commission on Negotiation Prospects.
[7] *European Report*, 28 October 1998, EU Enlargement; Negotiation Process Edges One Step Further Forward.
[8] *European Report*, 30 June 1998, EU Enlargement; Screening Is Slower But Than Anticipated.
[9] Note that this very restrictive voting rule adds to the EU's power position. In reality, an applicant country is not conducting bilateral negotiations. It is in fact negotiating with 15 countries which have to agree on a common position by consensus. Using Putnam's metaphoric approach, the unanimity rule limits the win-set of the EU which in turn strengthens its external bargaining power.

It is far too early to review the actual negotiations which have taken place so far. The reason for this is to be found in two other sets of power tactics, the EU employs in accession negotiations. First, the EU makes use of a "nothing is decided until everything is decided"-principle. This has also been confirmed several times during the present negotiation round. The motive behind this principle is to maintain room to manoeuvre once the negotiations enter the final stage. This makes it possible to reshuffle concessions made in the initial stages of negotiation in order do achieve a final package. In the present accession round in which the EU is negotiating with countries in transition, the principle seems even more rational from an EU point of view. The fact that almost all the applicant countries are in transition makes it necessary to carefully monitor the progress in adopting the acquis. If the adoption of the acquis has for some reason slowed down or encountered problems during the negotiation process, the principle makes it possible to recast the preliminary agreements at a later stage. Provided that the EU is in no hurry to complete the negotiations, such re-negotiations are likely to lead to worse terms for the applicant countries because their credibility in complying with the terms would be damaged.

In the final stage of negotiation, the EU has often employed a very subtle bargaining device called the *battering ram tactic* (Friis and Jarosz, 1999). The strategy works like this: Assuming that the several applicant countries have unclosed chapters when the negotiations enter the final stage, the EU strikes a final package deal, including concessions and issue-linkages on transition phases, with one applicant country. This deal is then presented to other applicant countries. Under conditions of asymmetrical information (no information exchange and coordination between the remaining applicant countries), this creates a lot of uncertainty among the other applicant countries. If a few of the latter accept the terms for accession modelled after the deal struck with the first country, there may be sufficient candidates for proceeding with the final accession. This will leave the rest of the applicant countries, unable or unwilling to close their chapter, out in the cold. For these reasons, applicant countries often compete intensively on closing their chapters in order to be singled out by the EU for its battering ram tactic. When a country is singled out, the other countries tend to accept the compromises offered by the EU. Thus, the battering ram tactics tends to be an extremely important source of behavioural power. It makes it possible for the EU to enforce the terms of accession in an even more definitive way. Unless the CEFTA countries start to coordinate their bilateral negotiations with the EU, there is every reason to expect that they will collectively obtain less favourable terms in the accession negotiations.

2. POWER RESOURCES OF THE CEFTA COUNTRIES

As noted by Habeeb (1988), countries that find themselves in an extremely asymmetrical dependence situations can make up for the weaker structural power position by skillfully utilising various bargaining devices. The recent and most advanced literature on international bargaining (a.k.a. double-edged diplomacy literature, see Putnam (1988), Evans, Jacobson and Putnam (1993)) lists a number of such tactics; tying hands (commitment), threat, reverberation, synergistic issue linkage, collusion among governments etc. A review of these tactics applied to the eastern enlargement round goes beyond this paper. It is, however, doubtful that applicant countries can exploit the majority of these tactics efficiently. For instance, the two most well-known tactics — tying hands and threat — are bound to be inefficient as long as the applicant countries do not possess a credible alternative to accession and as long as the applicant countries compete for closing their negotiations chapters. No one wants to be left behind. Because tying-hands and threat strategies stall the negotiations, they tend to be counter-productive from an applicant perspective, and thus non-credible.

Although it is clear that the bargaining space is very limited in EU accession negotiations, I suggest two tactics, not mentioned in the double-edged diplomacy literature, by which the applicant countries may, at least marginally, improve their terms of accession.

The first tactic is *cooperation* between the applicant countries, in particular in the end-stage of

the negotiations.[10] Although it is vital that individual countries do not have too many unclosed chapters when the negotiations approach the end-stage, it is equally important that the applicant countries synchronise their accession negotiations in a more cooperative way. The non-cooperative race for staying ahead of the accession game is undermining the already weak power position of the applicant countries since it compels them to accept the terms of the EU on a more non-conditional basis. Cooperation in the stages before the end game makes it possible for the group of applicant countries as a whole to obtain more favourable preliminary agreements with the EU. When the negotiations reach the end game, it is absolutely vital that the applicants cooperate, exchanging information about their bargaining positions and tactics on their unclosed chapters. The objective is to avoid that some of the applicant countries concede too easily to the battering ram tactic used by the EU. It may be sufficient that the CEFTA countries in the fast-track group cooperate. Provided that none of the slow-track candidates catch up, the EU would then not have sufficient candidates for launching enlargement if it was to pick a non-CEFTA country, e.g. Estonia, for the battering ram tactic. Although the CEFTA countries should not attempt to stall the negotiations indefinitely (using tying-hands and threat tactics that, as indicated, only work if the countries cooperate), they should coordinate their terms for closing their remaining chapters. Only in this case can they improve their bargaining situation.

The second tactic is *aspiration.* As mentioned by Habeeb (1988), a weaker country may improve its bargaining power by allocating more resources to the specific issues on which it has strong preferences for a favourable agreement. In other words, the applicant countries should prioritise among the individual chapters. This is a standard tactic in international negotiation that is basically a give-and-take situation. In EU grand bargaining negotiation, smaller countries are often able to influence the process by picking a few prioritised issues, which are then traded in the end game. However, it is important to stress once again that accession talks are qualitatively different. Unless the applicant countries cooperate, they cannot afford to wait until the last minute to reach a deal on their prioritised objectives. Because of the battering-ram strategy, applicant countries may want to reach such a deal at an earlier stage. This asymmetrical time pressure works to the advantage of the EU. For this reason, the bargaining tactic of aspiration also presupposes cooperation among the applicant countries.

Finally, it should be noted that the accession agreements reached by the CEFTA countries belonging to the fast-track group might set a precedent for the accession negotiations with the CEFTA countries in the slow-track group. This is because of the so-called *dead-weight catching tactic* the latter group can employ to ensure that their bargaining position does not deteriorate compared with that of the fast-track group. In their accession negotiations, the candidates of the slow-track group can credibly argue that they will not accept less generous terms than those offered to the fast-track group. It is also in the interest of the EU that the future membership of the applicant countries becomes pleasant. When the slow-track group eventually joins the club, the EU members risk obstructive behaviour on behalf of the new members if they were to be offered less favourable terms at the time of accession. Thus, the better the terms for accession obtained by the fast-track CEFTA-group, the more benevolent one should expect the bargaining environment to be for the slow track CEFTA-group.

3. CONCLUSION

EU accession negotiations are an exceptional asymmetrical exercise. In enlargement negotiations, the EU typically possesses a preponderant economic and political-institutional power base, which it exploits by means of various bargaining tactics. A number of these tactics have been discussed in depth in this paper, in particular the "acquis, and nothing but the acquis principle" (a tying hands-tactic) and the battering ram tactic (a threat tactic).

[10] This tactic is affiliated with the collusion of governments mentioned in the double-edged diplomacy literature, but it is, nevertheless, qualitatively different. Collusion of governments in this literature is thought to be cooperation between the negotiators on both sides of the table. The objective is to *expand the win-sets* to obtain an agreement. Here, collusion of governments is thought to be cooperation between the governments at the one end of the table — the applicant countries. The objective is to *prevent* an expansion of the applicant win-set, when the EU seeks to employ its battering ram tactics.

In the international relations literature, it is often pointed out that structurally weaker nations can improve their bargaining position by skilfully exploiting the instruments of bargaining tactics available to them. This paper has argued that the normal set of available tactics (tying-hands, threat, aspiration etc.) is very limited for EU applicants *unless* they cooperate. The reason is that the efficiency of these tactics liked with the tactics used by the EU. The paper has pointed out that the battering ram tactic is often so powerful that it undermines the efficiency of the bargaining tactics available to applicants. The main reason is that the battering ram as a threat tactic introduces an asymmetrical time-factor, which compels the applicant countries to compete to stay ahead in the race for closing the negotiation chapters. For various reasons spelled out in the paper, the power of the battering ram tactic can only be counterbalanced if the applicant countries cooperate.

Unfortunately, it is, however, doubtful whether the applicant countries will be able to follow this policy recommendation. First, the Central and Eastern European countries, including the CEFTA countries have little tradition of cooperating. For instance, with the Visegrad group, political cooperation has only resumed recently after years of impasse.[11] Second, the CEFTA group, and the group of applicants in the fast-track group, may be too heterogeneous in terms of their economic readiness for EU accession and their political priorities to cooperate. It is doubtful that some of the fastest applicants in the group will want to synchronise their accession negotiations with the slower applicants. Third, and related to this aspect, cooperation involves a moral hazard problem in the sense that it presupposes a high degree of trust within the group that some members will not attempt to slow down the enlargement process. Likewise, the group will have to overcome the *prisoner's dilemma situation* in which one country defects by rapidly closing its negotiation chapters in order to be picked for the battering ram.

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[11] *Financial Times*, 17 May 1999, East European states resume cooperation.

POLAND'S PLACE IN CEFTA AND EUROPEAN UNION ENLARGEMENT

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The emergence of the free trade areas (FTAs) of CEFTA[1] and BFTA,[2] now grouping ten countries of Central and Eastern Europe, was caused by both internal (systemic transformation) and external (reintegration with the world economy) factors. Despite the transitional nature of the two FTAs, as indicated by the course of the integration processes to date in this part of Europe, their very emergence should be regarded as a success of the countries involved — countries where the rational premises of integration outweighed the CMEA syndrome. This is also a success of the efficient EEC/EU policies, whose association agreements apply to the countries that set up the free trade areas, later transformed into economic areas, like the small EFTA. The ten countries of Central and Eastern Europe[3], which between 1994 and 1996 applied for European Union membership and set up the CEFTA and BFTA respectively, while undergoing a test in their preparation for EU integration, are their own tutors in regional integration; they meet with difficult challenges and have to make unpopular choices resulting from the transformation-integration interaction.

At present all the countries mentioned above are parties to at least two free trade areas — CEFTA, CEFTA countries and the REFTA, CEFTA countries and the EU, BFTA, BFTA countries and the REFTA, BFTA countries and the EU.

Even though moves are being made to extend liberalisation to allow the free flow of services and factors of production (capital and labour), with CEFTA countries now deeply involved in preparing for EU membership, and the significant level of liberalisation resulting from OECD membership and association with the EU, CEFTA[4] is likely to remain a free trade area for manufactured goods (with some exceptions), while even a selective liberalisation of trade in farm produce on a bilateral basis proves very difficult for countries of competitive patterns of agricultural production and trade.

As demonstrated in Table 1, CEFTA has been joined by nearly all the economies in transition situated in Central and Eastern Europe, very differentiated (in 1997) in terms of all the basic social and economic macro-indicators. Disparities in the level of their economic development are conspicuous, generally only half the level of the "fifteen" has been achieved; their share of foreign trade is also much lower (3.1% of European imports and 2.5% of its exports).

Foreign trade is essential in any economy; for countries in transition, restoring their economic and trade ties with the world economy, the exchange of goods and services with other countries is the basic indicator of their reintegration with Europe and the world and a prerequisite for economic growth and the very process of transformation.

[1] Central European Free Trade Agreement (CEFTA) signed on 21. 12. 1992 in Krakow, became effective as of 1. 01. 1994. Published in the 27 December 1993 Journal of Laws No. 130. CEFTA now covers the Czech Republic, Hungary, Poland, Slovakia, Slovenia, Rumania and Bulgaria.

[2] Baltic Free Trade Agreement (BFTA) signed in 1993 by Lithuania, Latvia and Estonia became effective in 1994 (starting the liberalisation of trade in manufactured goods); in 1995 negotiations were started on liberalising mutual trade in farm produce.

[3] Bulgaria, the Czech Republic, Lithuania, Latvia, Estonia, Poland, Rumania, Slovakia, Slovenia and Hungary.

[4] Kisiel-Łowczyc A.B.: CEFTA. Central European free trade area. Wyd. Uniwersytetu Gdańskiego, 1996.

Economic potential of CEFTA countries (1997)

Table 1

Aspect	CEFTA	POLAND	CZECH REPUBLIC	HUNGARY	SLOVAKIA	SLOVENIA①	RUMANIA②
Total area (km^2)	774250	312700	78900	93000	49000	2250	238400
	100%	40.4%	10.2%	12.0%	6.3%	0.3%	30.8%
Population (thousand)	88800	38600	10300	10100	5400	1900	22500
	100%	43.5%	11.6%	11.3%	6.1%	2.1%	25.3%
GDP (%) growth		6	1.3	3.9	6.0	2.0	- 6.6
Consumer price index		10	10.2	18.4	5.9	8.4	154.8
Unemployment (%)		9.0	4.9	10.4	13.0	14.7	8.8
Budget deficit (% GDP)		- 6.4	- 1.0	- 0.8	- 2.6	- 1.1	- 3.6
Foreign trade (USD bn)	215	68	50	40	19	18	20
%	100%	31%	23%	19%	9%	8%	9%
Balance of trade (USD bn)		- 16.6	- 4.4	- 2.1	- 1.5	- 0.9	- 2.9
Foreign debt (USD bn)		38.1	21.3	22.0	9.8	4.1	8.5
Debt to exports ratio (%)		148	97.0	116.0	84.1	40.9	112.0

[1] CEFTA member since 1. 01. 1996 [2] CEFTA member since 1. 07. 1997.

After CESTAT. Statistical Bulletin 1998/1. Warsaw, 1998, July

The close ties of Central and Eastern Europe (CEE) with recession-hit Western Europe between 1991 and 1993 resulted in growth of trade. At the same time the westward shift of the CEE trade took place at the expense of the intraregional trade — no equally significant change in the direction of trade streams took place in the early nineties. There is, however, a considerable disparity in the trade relations between the CEE and the CIS on the one hand, and Western Europe on the other. Imports from Western Europe accounted for 70% of CEE's (including CEFTA's) total imports, while CEFTA's share in West European total imports remained relatively low (3.5%).

Economic and trade links between CEE countries were most dramatically relaxed in the early period of transformation in 1989/90, as trade exchange with industrialised nations intensified; the process to slow down in 1993-94. This is demonstrated by the foreign trade of CEFTA countries, although the relative figures do not reflect the real scale of the process due to lower prices of fuel (by 12%), minerals (by 16%) and stagnant food prices.

The high share of foreign trade in the GDP of CEFTA countries shows how dependent they are on imports and exports, yet in global terms their share in the European total amounted to a mere 8% in 1994, even though CEFTA countries account for 60% of the population of Europe. This indicates that the trade of the countries of the region is rather poorly developed, although 1994 saw imports grow for the second year (by 13%) and exports rise by 17% — the first time since 1988.

The 1995 improvement in the foreign trade of CEFTA countries was the result of external factors (among others, the upward trend in the world economy, liberalised access to markets and

Table 2

Foreign trade of CEFTA countries in 1996 and 1997 (USD bn)

	IMPORTS					EXPORTS				
YEAR	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVENIA	SLOVAKIA	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVENIA	SLOVAKIA
1	2	3	4	5	6	7	8	9	10	11	12	13
1996	27.7	18.1	37.1	11.4	9.4	11.1	21.9	15.7	24.4	8.1	8.3	8.8
1997	27.2	21.2	42.3	11.3	9.3	10.3	22.8	19.1	25.7	8.4	8.4	8.8
Trade with the EU "15" (USD bn)												
	2	3	4	5	6	7	8	9	10	11	12	13
1996	17.3	11.3	23.7	6.0	6.4	4.1	12.7	10.9	16.2	4.6	5.4	3.6
1997	16.7	13.3	27.0	5.9	6.3	4.0	13.6	13.6	16.5	4.8	5.3	3.9
Trade with CEFTA countries (USD bn)												
	2	3	4	5	6	7	8	9	10	11	12	13
1996	4.0	1.2	2.2	0.5	0.6	3.3	5.1	1.2	1.5	0.3	0.5	3.7
1997	4.0	1.4	2.6	0.6	0.7	3.0	5.0	1.4	1.7	0.3	0.5	3.4

After CESTAT. Statistical Bulletin. 1998/1 Warsaw 1998 July

Table 3

Exports of CEFTA countries (% of total CEFTA imports)

CZECH REPUBLIC

YEAR	HUNGARY	POLAND	RUMANIA	SLOVENIA	SLOVAKIA
1996	7.7	23.8	1.4	4.5	61.5
1997	8.5	26.0	1.8	4.2	58.5

HUNGARY

YEAR	CZECH REPUBLIC	POLAND	RUMANIA	SLOVENIA	SLOVAKIA
1996	25.4	33.7	-	19.1	21.8
1997	23.2	36.8	-	20.9	19.1

POLAND

YEAR	CZECH REPUBLIC	HUNGARY	RUMANIA	SLOVENIA	SLOVAKIA
1996	54.5	19.9	4.7	2.8	18.0
1997	52.5	22.0	4.6	2.8	18.1

RUMANIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	SLOVENIA	SLOVAKIA
1996	6.0	58.4	18.0	7.4	1.2
1997	5.0	53.3	29.7	4.8	7.2

SLOVENIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVAKIA
1996	30.1	22.3	29.9	4.7	12.1
1997	29.2	23.9	30.8	4.8	11.2

SLOVAKIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVENIA
1996	73.7	10.9	11.5	1.5	2.4
1997	68.8	12.1	14.2	1.8	2.8

After CESTAT. Statistical Bulletin 1998/1. Warsaw, 1998, July

Table 4

Imports of CEFTA countries (% of total CEFTA imports)

CZECH REPUBLIC

YEAR	HUNGARY	POLAND	RUMANIA	SLOVENIA	SLOVAKIA
1996	6.8	19.9	0.4	3.8	65.4
1997	8.8	21.5	0.6	3.7	56.0

HUNGARY

YEAR	CZECH REPUBLIC	POLAND	RUMANIA	SLOVENIA	SLOVAKIA
1996	39.2	23.1	-	7.0	30.7
1997	37.0	26.0	-	7.9	29.1

POLAND

YEAR	CZECH REPUBLIC	HUNGARY	RUMANIA	SLOVENIA	SLOVAKIA
1996	51.6	19.1	3.2	6.8	19.4
1997	49.7	21.6	2.5	6.6	19.6

RUMANIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	SLOVENIA	SLOVAKIA
1996	15.2	53.4	15.8	4.7	10.9
1997	16.3	54.0	14.1	4.4	11.2

SLOVENIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVAKIA
1996	36.9	37.3	7.6	3.8	14.4
1997	33.2	41.5	8.3	2.3	14.7

SLOVAKIA

YEAR	CZECH REPUBLIC	HUNGARY	POLAND	RUMANIA	SLOVENIA
1996	81.8	6.7	8.2	0.5	1.7
1997	79.5	7.6	9.6	0.5	1.8

After CESTAT. Statistical Bulletin 1998/1. Warsaw, 1998, July

movement of capital, progressing regional reintegration in Europe) as well as internal ones (advances in transformation favouring foreign investment, recovered economic growth in CEFTA countries, higher competitiveness of goods, and lower production costs).

As demonstrated in Table 2, CEFTA enlargement in subsequent years (Slovenia in 1996, Rumania in 1997, Bulgaria in 1998) did not materially change the geographical pattern of foreign trade of the member countries; CEFTA imports from the EU in 1996 and 1997 amounted to 62% of the total imports of Poland, the Czech Republic, Hungary and Slovenia, 38% of Slovakia's imports, and 53% of Rumania's. Differences were greater for CEFTA exports to the EU, for Hungary, Poland and Slovenia ranging from 71% (Hungary) to 65% (Slovenia) and 64% (Poland); economic ties between the Czech Republic and Slovakia continue to be strong, supporting the extensive mutual trade; similar is the case of Rumania, although here the trend for limited regionalisation is strengthened even further by the lesser degree of the opening of the economy, less advanced transformation and poorer export/import opportunities (competitiveness, among others).

In Central and Eastern Europe Russia is the largest trade partner of CEFTA countries (for Poland also Belarus and Ukraine, where we rank second or third among major trade partners). Since the mid-nineties the intraregional CEFTA trade (cf. Tables 3 and 4) has been marked by growing turnover, as shown by the generally rising figures illustrating a country's share in the trade of its respective CEFTA partners, however with significant differences between individual countries. The figures contained in Tables 3 and 4 definitely prove the validity of the gravitational

Table 5

Polish foreign trade between 1990 and 1997 (USD billion)

Aspect	1990	1991	1992	1993	1994	1995	1996	1997
Total exports	14.3	14.9	13.2	14.1	17.2	22.9	24.4	25.8
industrialised nations	9.3	11.0	9.5	10.6	13.0	17.2	18.0	17.8
including: EU	6.8	8.3	7.6	9.0	11.9	16.0	16.2	16.5
other industrialised	2.6	2.7	1.9	1.6	1.1	1.2	1.8	1.3
Central and Eastern Europe	3.0	2.5	2.0	1.9	2.5	4.0	4.6	6.2
Developing nations	1.9	1.4	1.7	1.6	1.7	1.7	1.8	1.8
Total imports	9.5	15.5	15.9	18.8	21.6	29.0	36.9	42.3
industrialised nations	6.4	10.6	11.5	14.4	16.2	21.6	27.4	31.1
including: EU	4.3	7.7	8.4	10.8	14.1	18.8	23.8	27.0
other industrialised	2.0	2.9	3.1	3.6	2.1	2.8	3.6	4.1
Central and Eastern Europe	2.1	3.0	2.6	2.5	3.1	4.5	5.5	6.9
Developing nations	1.0	1.9	1.8	1.9	2.3	2.9	4.0	4.9
Trade balance total	+4.8	-0.6	-2.7	-4.7	-4.4	-6.1	-12.5	-16.5
industrialised nations	+3.0	+0.4	-2.0	-3.7	-3.2	-4.4	-9.4	-13.3
including: EU	+2.5	+0.6	-0.8	-1.8	-2.2	-2.8	-7.6	-10.5
other industrialised	+0.5	-0.2	-1.2	-1.9	-1.0	-1.6	-1.8	-2.8
Central and Eastern Europe	+0.9	-0.5	-0.6	-0.7	-0.6	-0.5	-0.9	-2.1
Developing nations	+0.9	-0.5	-0.1	-0.3	-0.6	-1.2	-2.2	-3.1

After "Polish Foreign Trade in 1997". Yearly report of the IKCHZ, Warsaw 1998.

theory of international trade, even for countries which are at the stage of building the structures of a market economy, with all the differences in the progress of transformation. In 1996 and 1997 trade ties were the strongest between the Czech Republic and Slovakia (in both directions) and between Rumania and Hungary; the Polish-Czech relations are 2-3 percentage points below. Further down, in relative terms, comes the trade interdependence between Slovenia and Hungary (with an upward trend), Hungary and the Czech Republic as well as Slovenia and the Czech Republic; the relations between the Czech Republic and Poland, Hungary and Poland (in both directions) stood at around 20 percentage points. An examination of the data on the share of other CEFTA countries in the total trade exchange within CEFTA shows no correlation between the level of mutual trade and the date of joining CEFTA. The degree of liberalisation of pan-European trade in manufactured goods is comparable, except the trade within the EU.

All CEFTA countries, although to a varying extent, have always had a negative trade balance (measured as a percentage of the value of their exports) in relations with nearly all trade partners from Western Europe. In trade within CEFTA a positive trade balance has since 1995 been attained by the Czech Republic, Slovakia and Hungary, while Poland, Rumania (in CEFTA since 1997) and Slovenia have each had a negative balance.

The period of transformation has brought considerable changes to the commodity pattern of CEFTA trade. The early years (1990-1991) saw a dramatic slump in the exports of machinery and transport equipment to the former CMEA countries. At the same time there was an increase in foodstuff and raw material exports to the West. In value terms the increase was the greatest for fossil fuels (from 14% in 1989 to 20% in 1991), but this was due to the shift in world prices, not to greater volume.

The 1992-1994 changes in the commodity pattern of trade nearly brought it back to the pre-1990 structure; a smaller share of fossil fuels and foodstuffs, and a greater share of machinery in imports, and a smaller share of foodstuffs and raw materials in exports. The subsequent years are marked by a fairly rapid growth of trade in industrial products, mostly consumer goods. However the 1989 level of exports of machinery and transport equipment has not been restored - their share dropped from 37% of total exports to 21% in 1994 and has not exceeded 23-24% ever since.

There is a high level of commodity concentration in CEFTA exports - foodstuffs, iron and steel, chemicals, textiles and clothing have exceeded 50% of total exports to Western Europe and NAFTA. For Poland and Hungary export of unprocessed food is of particular importance, mostly to the EU. Changes in the commodity pattern of CEFTA countries between 1993 and 1997 are insignificant and show a high degree of similarity.

Poland's position within CEFTA since the very emergence of this free trade area has been determined by a number of factors, such as the economic potential (the size of the market and its absorptive power, the size of production resources, the pace of economic growth); progress of transformation (regarded as an economic, social and political process); the opening to the world economy. It is the changes in external economic relations that played a major part in the transformation process; foreign trade, its consistent liberalisation and integration with formal structures of the world economy are an inherent feature of Poland's economic policies. In the reforming Polish economy exports should be the growth-stimulating factor, the more so as Poland has to repay its rescheduled foreign debt.

In the first year of transformation (cf. Table 5) the value of Poland's exports remained stable at around 14 billion USD, while imports grew steadily - from 9.5 bn USD in 1990 to 18.8 bn USD in 1993, aggravating its trade deficit. That period revealed the low international competitiveness and export capability of the Polish economy. Export capability of state-controlled manufacturing industries was largely reduced, while the export capability of new industries or new business entities had not yet developed well enough to keep exports at an unchanged level.

Since 1994 the level of economic activity has been growing, the business trend has been good; exports have been growing (by 60% from 1990 to 1997), however imports have been growing even more rapidly (by 170% over the same period), leading to even greater trade deficit.

Good economic performance and the emergence of the capital market in Poland, as well as

the new infrastructure of international treaties (Europe Agreement with the EU since February 1. 1994, a free trade agreement with EFTA countries since 1993, CEFTA agreement since 1993, WTO membership since July 1. 1995 and OECD membership since May 13. 1998) have resulted in more foreign capital flowing into Poland. Table 5 demonstrates that more than 80% of Polish foreign trade in 1997 was accounted for by trade exchange with the integration groupings mentioned above. The predominant position of the EU is evident, making us largely dependent on the business trends in the EU member countries; so is the steady increase in the share of CEFTA countries in Polish trade, although it is not very great in absolute figures.

Over the transformation period changes in the commodity pattern of Polish foreign trade have been going along different lines. The major exporting industries are wood & pulp (furniture), minerals and light industry (textiles). The share of electroengineering products fell from 30% in 1990 to ca. 20% in 1997 (see Table 6), although this is still better than in CEFTA as a whole. Polish major export items are labour-intensive goods based on non-renewable resources. The growth in the share of more technologically advanced goods was based on imported solutions, and their competitiveness was chiefly due to low labour costs, just like in the traditional industries. Resting the future competitiveness of Polish exports on low labour costs and low prices does not seem to offer a far-reaching perspective.

Poland's imports over the same period saw a decline in the share of machinery and equipment from 40.7% in 1990 to 30% in 1995, later rising to 38.5% in 1997. Fossil fuels and their products have a fair share — ca. 9%, as do chemicals — 15%. Consumer durables prevail in the imports of electroengineering products (67%).

The geographical and commodity patterns of Poland's trade with CEFTA countries in 1997 (Table 6) show a prevalence of manufactured goods in Polish imports, ranging from 83% (Slovenia) to 55% (Bulgaria and Hungary); and in exports, respectively, from 71% (Rumania) to 50% (Bulgaria). For farm produce, our major partners are Bulgaria[5] (37% in exports and 34% in imports), Hungary (26% in imports and 11% in exports) and Rumania (19 resp. 13 per cent).

The figures contained in Table 6 are evidence of a high concentration of industrial products (10 items account for more than 70% of imports or exports in some cases) and of significant dispersion of farm produce (except in imports from Hungary, Bulgaria and Rumania).

Another observation from the examination of commodity patterns of Polish exports to or imports from individual CEFTA countries is that they show great similarities. This, coupled with the calculations presented in Table 7, indicates that the importance of intrabranch trade within CEFTA is growing; the intrabranch trade to be understood as parallel import and export of the products of the same industry by a country or a group of countries. This type of trade mainly concerns manufactured goods, and is intensified by final product and demand diversification on the one hand, versus similar consumer tastes, similar pattern and level of their incomes, approximate prices of production factors, trade liberalisation that causes this proximity, geographical spread of products and technologies, and the large size of the internal market, on the other.

The generally accepted Grubel & Lloyd formula has been applied to calculate the (I') index measuring the intrabranch trade of Poland with the other CEFTA countries between 1992 and 1997.

In 1993 this index had a mean comparable value for Poland's trade with CEE countries and with CEFTA countries, however it grew for trade with CEFTA countries as mutual trade in industrial products was liberalised and as transformation advanced in Poland and the countries in question.

The growing I' index, determining the intensity and trends in the pattern of intrabranch trade, also reflects the impact of innovation and technology, closely connected with the incoming FDI.

[5] Bulgaria was accepted by CEFTA countries in 1997, but has been a member since 1 January, 1998.

Table 6

Ten most important commodity items in Poland's trade with CEFTA countries in 1997
(USD bn)

		CZECH REPUBLIC				HUNGARY				SLOVAKIA				SLOVENIA				BULGARIA				RUMANIA			
		CN	IMPORTS	CN	EXPORTS	CN	IMPORTS	CN	EXPORTS	CN	IMPORTS	CN	EXPORTS	CN	IMPORTS	CN	EXPORTS	CN	IMPORTS	CN	EXPORTS	CN	IMPORTS	CN	EXPORTS
Industrial products		87	189.2	27	156.3	39	80.8	74	57.7	72	99.6	27	68.5	39	70.4	94	7.1	84	11.8	27	7.4	62	23.8	27	15.8
		84	140.0	84	73.9	85	50.1	27	33.2	84	50.1	29	21.9	48	14.9	85	5.5	30	2.4	84	7.1	84	3.9	85	6.6
		72	91.0	74	62.9	87	46.2	85	27.6	39	49.9	84	20.1	84	12.3	40	5.2	85	1.6	73	6.6	85	3.8	73	6.6
		34	78.0	72	58.6	30	32.3	72	27.0	27	35.8	85	18.7	85	12.0	29	3.9	55	1.0	85	2.6	34	2.3	84	6.5
		27	75.0	85	56.6	84	30.0	48	24.0	48	32.6	85	18.2	73	10.0	76	2.6	82	0.9	63	1.7	84	2.1	34	4.3
		39	73.8	28	40.9	76	19.0	84	20.0	29	26.5	87	15.3	33	9.3	48	2.4	87	0.7	30	1.7	76	1.9	29	4.1
		28	62.8	39	33.2	48	17.1	87	20.0	84	22.2	30	13.5	40	4.5	74	2.0	29	0.5	29	1.3	39	1.5	33	3.1
		73	60.8	94	32.8	83	13.4	73	17.7	48	19.3	73	9.4	48	4.3	72	2.0	61	0.4	70	1.2	29	1.0	39	2.9
		48	53.6	87	29.6	55	12.3	33	15.0	76	19.0	39	9.4	39	3.4	73	1.9	39	0.4	31	1.1	27	0.9	48	2.6
		85	46.6	73	26.3	29	11.3	30	13.6	73	17.6	74	9.3	76	3.2	28	1.9	57	0.4	26	1.0	30	0.9	40	2.3
			871.5		572.1		312.5		255.8		372.6		204.3		144.3		34.5		20.1		31.7		42.1		56.8
	% of total Polish imports/exports from/to individual CEFTA countries		66.1%		62.7%		54.6%		66.8%		71.7%		65.1%		82.7%		69.7%		55%		50%		62.5%		71.5%
Farm produce and foodstuffs		11	15.1	21	25.2	10	32.5	18	10.0	10	7.4	21	3.1	22	0.2	01	1.2	22	7.7	10	14.4	16	9.4	21	5.8
		17	14.7	18	8.8	20	21.3	21	9.5	11	7.1	19	2.8	04	0.2	21	1.1	24	2.5	02	6.7	12	2.3	18	2.3
		15	10.4	07	7.0	16	20.6	04	6.9	12	6.2	17	2.0	17	0.1	02	0.8	20	1.0	18	0.9	22	0.9	19	1.3
		19	6.0	20	5.9	12	17.3	19	4.8	20	2.9	16	1.9	16	0.08	20	0.3	07	0.5	21	0.5	04	0.7	17	0.4
		04	5.2	16	5.7	02	11.6	20	3.3	04	1.1	08	1.9	00	0.08	12	0.3	06	0.4	69	0.4	02	0.3	20	0.4
		12	5.2	17	5.4	21	10.3	16	2.6	01	1.0	07	1.5	10	0.07	19	0.3	04	0.3	04	0.3	07	0.1	16	0.3
		20	4.5	19	5.2	22	9.7	07	2.0	16	1.0	04	1.1	23	0.04	08	0.2	08	0.2	07	0.3	23	0.08	07	0.1
		21	3.3	08	4.6	16	8.7	03	0.9	23	0.6	20	0.7	12	0.04	07	0.2	12	0.1	17	0.1	19	0.06	04	0.06
		01	2.9	23	4.2	19	8.6	17	0.8	05	0.6	23	0.7	21	0.02	03	0.1	23	0.1	12	0.1	11	0.02	08	0.05
		22	2.6	04	3.6	07	7.7	02	0.7	02	0.6	09	0.5			19	0.06	09	0.1	19	0.06	03	0.01	02	0.05
			69.9		75.6		146.0		42.5		28.5		16.2		0.83		4.58		12.4		23.8		13.6		10.8
	% of total Polish imports/exports from/to individual CEFTA countries		5.3%		8.3%		25.8%		11.0%		5.5%		5.2%				9.25%		33.9%		37.5%		19.6%		13.6

Author's calculations based on GUS figures

Table 7

Poland's intrabranch trade with CEFTA countries between 1992 and 1997 (USD bn)

Year	Country	Poland's total	CEE① total	CEFTA	Czecho slovakia	Czech Republic	Slovakia	Slovenia⑦	Hungary	Rumania⑧	Bulgaria⑨
1992	imports	17 718.9	2 640.6	689.4	538.2			4.8	146.4	33.5	26.7
	exports	13 186.6	1 985.4	669.2	498.0	•	•	0.2	171.0	66.5	43.6
	I'		0.5743	0.4441	0.4441			0.0013	0.3165	0.2947	0.4547
1993	imports	18 834.4	2 531.4	759.3		350.3	161.4	82.1	165.5	20.0	21.4
	exports	14 143.1	1 868.8	697.1	•	342.5	166.7	13.5	174.3	36.4	31.7
	I'		0.4658	0.4769		0.4964	0.3726	0.2267	0.3787	0.3909	0.5415
1994	imports	21 569.1	3 062.7	1 009.8		501.7	196.1	91.3	220.6	17.4	20.4
	exports	17 240.1	2 498.9	841.7	•	456.1	183.3	18.7	183.6	31.6	45.2
	I'		0.5069	0.5299		0.5135	0.4224	0.2464	0.4722	0.4224	0.2904
1995	imports	29 049.7	4 476.9	1 728.3		891.7	380.8	103.6	352.2	25.3	27.2
	exports	22 894.9	3 953.7	1 277.4	•	698.2	279.4	32.5	267.4	57.6	46.1
	I'		0.5603	0.57		0.5319	0.5209	0.347	0.4556	0.3469	0.4804
1996	imports	37 136.7	5 624.7	2 160.5		1 150.5	432.5	151.5	426.0	70.6	32.4
	exports	24 439.8	4 966.2	1 480.8	•	847.4	289.9	43.2	310.2	73.8	47.9
	I'		0.5262	0.5770		0.5373	0.4972	0.4136	0.4717	0.2195	0.5113
1997 till 30.06.97	imports	19 998.7	2 971.5	1 211.3		628.5	254.1	79.5	249.2	28.6	15.7
	exports	12 220.8	2 737.7	820.7	•	455.3	178.5	23.0	163.9	29.2	34.1
	I'		0.5200	0.6056		0.5671	0.4866	0.3684	0.4915	0.2806	0.3289

① includes Lithuania, Latvia, Estonia, CEFTA countries, all CIS countries; ② from 1.01.1996; ③ from 1.07.1997; ④ from 1.01.1998
Authhor's calculations based on GUS figures

Although the I' index for Poland's total trade with CEFTA countries shows an upward trend, it is only for its two major CEFTA partners, Hungary and the Czech Republic, that it has been growing consistently. The I' index calculated for the other CEFTA countries shows changes that are unsteady and not always positive.

In reviewing the opinion of the European Commission on EU membership applications, applying the criteria of the Council of the European Union (Copenhagen, June 1993), Agenda 2000 recommended that EU accession negotiations be started with Poland, the Czech Republic, Hungary, Slovenia (CEFTA), Estonia (BFTA) and Cyprus.

Seven years after the agreement was signed, which was provisionally applied from March 1993, and which formally took effect on 1 July, 1994, the answer to the question about the future of CEFTA and its further role in Pan-European integration seems even more difficult and ambiguous than it was before Poland, the Czech Republic, Hungary and Slovenia had been invited to negotiate their EU membership, and before the former three had become NATO members. The invitation was extended to the countries that are not only leaders in transformation in this part of Europe, but also whose economies are the core of CEFTA. Together, they represent a dominating economic potential in this free trade area (in terms of their area, population, foreign trade turnover and foreign investment); they are the cornerstones of trade liberalisation among the post-communist European countries and a gravity point for those countries. The relative advantages derived by Poland, the Czech Republic, Hungary and Slovenia from the mutual adjustment of their respective economies through CEFTA membership raise no doubt, either.

The free trade area and the resulting level of adjustment, so far mostly through trade, help to meet the requirements of EU membership. This includes the presence of competitors from Europe and the world as well as competition within CEFTA between companies from member countries. This is a kind of practical exercise for those companies before CEFTA countries fully open up to the EU. The anticipated change of status of some of the CEFTA countries mentioned above versus the EU, which according to an optimistic scenario is a mid-term prospect, may however change the motivation shown so far by the remaining CEFTA countries to apply the substance of the evolution clause, which Poland has always advocated.

A question arises whether the premises for other postcommunist countries, now outside CEFTA, joining the grouping (the subject aspect of the evolution clause) will be as strong as before. A positive answer relies on the fact of the EU invitation to negotiate for the countries that are mutually best adjusted, most experienced in difficult negotiations within CEFTA, whose companies compete with one another. Can the question about prospects for CEFTA be answered at all without reference to the effects of the Amsterdam Treaty (Maastricht II) for the European Union, and to the European Commission review (AVIS) of the CEFTA countries' applications (made under membership requirements agreed by the Council of the European Union in Copenhagen in June 1993)? Furthermore, if a certain level of adjustment has been reached within CEFTA and owing to CEFTA, another question arises - will other postcommunist countries (except Lithuania, Latvia and Estonia) be able to meet the requirements posed by the EU before future members without such experience, without the required level of adjustment, and without an open, market economy?

What will be constituent in making the decision about future CEFTA enlargement; the provisional, transitional nature of this structure or the mutual attractiveness and complementarity, as greatly reduced as CEFTA's economic potential grows smaller? The relatively strong economic links between countries of Central Europe and the need to prepare for future EU integration, which CEFTA countries have achieved because their firms were set up and had to operate within this domain, should make other countries join CEFTA. In making any predictions we have to consider the role of other European free trade areas that are institutionally linked with CEFTA countries and have an impact on them (BFTA, EFTA). In view of the European and global economic realities of 1999 one may say the following:

- CEFTA will not lose the rationale for its existence as its major members join the EU (at a still unspecified date);

- if the integration to date, through trade, prices and competition (adjustment within CEFTA treated as a stage in adjusting for EU membership), has been efficient, enhanced by the dynamic of EU foreign investment, then perhaps following the footsteps of Poland, Hungary, the Czech Republic and Slovenia is the best solution for the countries from this part of Europe that remain outside CEFTA.

CO-OPERATION BETWEEN BALTIC COUNTRIES AND CEFTA COUNTRIES IN THE CONTEXT OF EU ENLARGEMENT

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Latvia is one of the European "transition" countries, which does not participate in the CEFT Agreement, but it is one of the partners in the Baltic Free Trade Agreement. Assuming that trade agreements are concluded when economic relations are active, as well as the role of FTA's in the acceleration of economic relations between involved countries, the question arises – why do several different blocs appear among countries with similar status and future visions?

From the very beginning of the transition period countries striving to get rid of their former economic and political systems were, intentionally or not, accepted as countries of two groups: Central European countries (CECs) and former USSR countries (Eastern European countries - EEC). In the last group Baltic countries have been always distinguished, but without special indications about other belonging. There are some reasons for such a division:

- political status: with some exceptions CECs have always been independent states, EECs became independent (or regained independence) only in the early nineties, and are members of CIS, but the Baltic States are not involved in any community of states,

- economic status: CECs have a much higher starting level, EECs have a low starting level, but within the group the Baltic countries demonstrate fast transition and development. As a result, the Baltic States have surpassed the economic development level of all the EECs and even some of the CECs.

Therefore, the Baltic states have some essential differences which distinguish them from the group of EECs, but they are not included in the group of CECs. This encouraged separatism between the three groups of countries, and three blocs, formalised through political and special trade agreements.

The answer to the question – are CECs and Baltic countries really so different? - is "certainly no". On the contrary, countries of both groups have a lot in common:

- face the same economic and institutional problems,

- have the same heritage from the former system (changed mentality and human values, ineffective economics, etc),

- spent about the same period under the Soviets, which was imposed by an outside power, and this period was much shorter than in the case of the core socialistic countries,

- have a living generation which lived in the conditions of a market economy before World War II,

- have a similar development path, development problems and reform patterns,

- have declared their intention to join the EU as soon as possible and all have been appointed as candidates to the EU.

Especially with regard to EU integration the separatism of countries having similar goals and similar problems may appear rather surprising. Examples from the past and theoretical research (1) justify, that countries may benefit from acting as groups in negotiations with other countries, especially if the partner is also a group of countries. No doubt, ten countries of the same bloc are a more powerful partner in negotiations with 15 countries than one country, three countries or even three blocs of countries.

From this point of departure a whole group of questions arises. What does it mean for economic development and EU integration that ten member countries have been split into two blocs, which are institutionalised by means of two separate bloc FTAs? Does the very existence of two FTAs influence the behaviour of particular countries? Do countries try to merge forces to approach Europe as a united, bigger and more powerful bloc? How do two blocs or particular countries co-operate in the process of EU enlargement?

These problems will be discussed in this paper from the position of Latvia in three aspects:
1) the actual state of Latvia's integration with the EU,
2) the role of the Baltic FTA in the process of EU enlargement,
3) the role of CEFTA in the process of EU enlargement with respect to Latvia.

ACTUAL STATE OF LATVIA'S INTEGRATION WITH THE EU

Institutional relations between Latvia and the EU began on 27. 08. 1991 when the European Community recognised Latvia as an independent state. The next step was the conclusion of the Agreement on Trade and Commercial and Economic co-operation between Latvia and EU on 11. 05. 1992 (changed to Agreement of Free Trade and Trade Related Matters on 18. 07. 1994), and conclusion of an Association Agreement between Latvia and the European Union on 12. 06. 1995. On 27. 10. 1995 Latvia submitted an official application, expressing its wish to join the EU. In June 1997 the European Commission published "Agenda 2000" which assessed that Latvia is not acceptable for immediate negotiations for membership. Still, on the basis of that document on 12. 12. 1997 the Council of the European Union invited all 11 candidate countries to pre-accession talks with different intensity. On 01. 02. 1998 the Association Agreement between Latvia and the EU came into force. May 1998 was the beginning of the screening process of the acquis communautaire of the EU. On November 11, 1998 Latvia received the Progress Report prepared by the European Commission.

The actual state of the integration process may be characterised by progress in structural, nominal (accordance with Maastricht criteria) and real convergence (2).

Structural convergence means progress in adopting a market-based system. Latvia has begun reforms aiming at implementation of market mechanisms in almost all areas where market principles can operate, including the social sector. The liberalisation of the whole economy (except some services) was done at the very beginning of transition and competition was implemented. The privatisation process in Latvia was not very fast, but now it is almost completed. Recently the privatisation of large enterprises has been discussed. The private sector accounts for about 2/3 of the country's GDP.

Latvia has made progress toward macroeconomic stability, at least in areas controlled by the Maastricht criteria. The country has a stable currency, a moderate fiscal deficit (which unfortunately changed into the maximum 3% of GDP in 1999), and low public debt. The level of inflation in Latvia is low, but it is still high by requirements of Maastricht criteria. For all that some important macroeconomic problems can be mentioned, such as a growing current account deficit.

Real convergence is characterised by the income gap between Latvia and the EU average. (See Table 1, Table 2)

Latvia has achieved remarkable progress in economic development since the beginning of the nineties, still economic indicators are very low (3). In 1997, Latvia produced 0.18% of total EU 15 GDP according to purchasing power (current prices). GDP per capita according to purchasing power standards in Latvia made up just 26.8% of EU average in 1997, and constituted 16.2% of Luxembourg's level (highest in EU) and 38.9% of Greece's level (lowest in EU). However, both indices are growing which indicates progress in reducing the gap in living standards. Latvia spends less than EU countries for social security and welfare (respectively 14.3% in Latvia and 18.6 – 30% in EU countries except Ireland and Portugal). Determined by a low level of GDP and even a lower share in government spending, the Latvian social security system is far from EU patterns. (See Table 3)

These figures clearly indicate that Latvia has a long way to go before accession to the EU could become a reality. To shorten the accession period Latvia needs:
- to significantly improve economic performance,
- to get support from other countries.

Though the accession process is slow, there is no reason to delay economic co-operation between Latvia and EU countries. This may be characterised by three indicators: exports, imports (See Table 4 and Chart) and FDI with regard to EU countries.

Foreign trade with EU countries made up 48.9% of total Latvian exports (up from 44% in 1995) and 53.2% of total Latvian imports (up from 49.9 in 1995). Main trade partners are Germany (13.8% of exports, 16% of imports), Sweden (respectively 8.3% and 7.7%), Finland (1.5% and 9.7%) and the UK (14.4% and 3.3%). The UK and Germany are largest trade partners behind Russia in exports, and Germany is the first largest partner in imports.

It is understandable that the share of Latvia in exports and imports of EU countries is not large – just 0.04% in exports and 0.07% in imports from Latvia. Latvia has a negative foreign trade balance with all EU countries, except UK.

The most important export commodities are wood and wood articles, textiles and textile articles. Some more important import commodities are machinery and mechanical appliances, electrical equipment, transport vehicles, textiles and textile articles (exports increase imports), products of the chemical and allied industries.

EU countries are among the largest foreign investors in Latvian economy (Denmark, Ireland, UK, Germany, Sweden and others). (See Table 5)

Economic co-operation of Latvia with other countries, and also integration with the EU, depends on Latvia's economic potential.

Macroeconomic stability is one of the most important characteristics of a country's potential. Latvia has a stable currency, low inflation (8.4% in 1997, 4.7% in 1998), and positive GDP growth rates – 8.6% in 1997, 3.6% in 1998).

The industrial structure in Latvia is forming similar to that in European countries unless the high share of agriculture is considered. Reconstruction of industries is not complete, and different patterns can be mentioned there. In the service sector new industries or modernisation prevail, while industry and agriculture try to restructure existing enterprises.

The current account balance shows that Latvia is still not competitive in the international markets. Latvia still has high average annual interest rates in credit institutions, which hamper development. Still Latvia has an open economy with exports making up 52% of GDP and imports making up 60.6% of GDP. Total amounts of exports and imports are increasing, but are still low.

ROLE OF THE BALTIC FTA IN THE PROCESS OF EU ENLARGEMENT

The institutional background of Baltic co-operation is a wide spectrum of intergovernmental institutions and BFTA. Co-operation is organised on a regular basis, but is not very fruitful. From time to time Baltic countries fall into heated discussions about economic issues.

It is worth saying that despite a good institutional background, the governments of the three countries are not very active in organising favourable conditions for Baltic co-operation. Only when political events become critical, Baltic institutions provide for co-ordination and a common approach thus strengthening the position of each country.

In fact, there is not a common strategy of EU integration (as well as integration with NATO): each Baltic country strives to be closer to the negotiation table. The result is that Baltic countries find themselves in very different positions with regard to both integration processes. Estonia is

appointed for the first EU enlargement round, while Lithuania is among the sure candidates to NATO. Latvia's position is unclear with respect to both processes.

Each of the Baltic countries strives for success by all means, ready for compromises, which perhaps would not be painful, if countries acted together. Instead of internal co-operation, Baltic countries try to get support from Nordic countries (Estonia's example shows that it works).

In economics, however, the co-operation of Baltic countries is increasing. BFTA influences the process in a dual way. On the one hand it facilitates trade, but on the other hand, it forms an environment for conflicts, as it concerns countries with different economic conditions (less liberalisation and intensive state support give preferences in trade). Countries with more liberalised economies try to protect their markets and thus eliminate the effectiveness of the free trade agreement.

Therefore, the governments of the Baltic States have to uniform economic conditions among their countries, but this process is moving slowly.

On the contrary, development of FDI from one Baltic country to another has been impressive in recent years.

It is worth mentioning that a lot of obstacles hampering the co-operation of the Baltic states have disappeared, for instance, industrial structure varies from country to country, capacity of markets is gradually increasing, investment resources are also increasing. The recent trend is concentration of economic activity in the Baltic area (computer industry, financial services, and insurance).

Estonia plays the role of the pioneer in Baltic integration. It is possible that Estonia's activity in other Baltic countries will increase, and this will be due to increasing interest in Baltic countries from Nordic countries (Finland, for instance). If economic co-operation increases, it is vital for Estonia that Baltic countries are joined to the EU as a bloc, which falls into Latvia's interests. This may improve Baltic co-operation in negotiations with the EU.

From the point of view of EU enlargement, the Baltic FTA forms a mini-pattern of the European common market. Existing and effective operation of FTAs in candidate countries helps them to adjust to the EU model before these countries become members.

ROLE OF CEFTA IN THE PROCESS OF EU ENLARGEMENT WITH RESPECT TO LATVIA

Unfortunately CEFTA is not a very important factor in the EU enlargement process for Latvia. At least there is no evidence that co-operation between CEFTA and BFTA countries as blocs is somehow organised or institutionalised (agreements between blocs, negotiations, meetings of supragovernmental delegations). However, Latvia has concluded separate free trade agreements with almost all CEFTA countries (Poland in 1997, Czech Republic in 1996, Slovakia in 1996, and also Slovenia in 1996), but not with Hungary.

Also economic co-operation between Latvia and CEFTA countries is very limited, perhaps only Poland is an exception. CEFTA countries are not among the most remarkable investors in the Latvian economy. Information about CEFTA countries, as well as co-operation in the early stage (exhibitions, trade fairs etc.) is not satisfactory. Existing co-operation is run purely by businesses, the governments up to now have been rather irrelevant in this process. The situation is changing, however, and during the last few years we feel more activities from the side of governments, embassies and trade organisations.

The neutrality policy towards CEFTA countries seems wrong if one remembers the two main goals of Latvia in the integration process with the EU: to improve economic performance and to get more support from other countries. There are several reasons why closer co-operation with CEFTA countries is useful for Latvia:

- economic co-operation with countries with better economic performance is always useful,
- trade conditions with CEFTA countries are more familiar,

- markets are closer, more secure, in new markets it is easier to find favourable market niches,
- Latvia may benefit from the exchange of experience in negotiations with the EU, as CEFTA countries are approaching this problem on the basis of a serious theoretical background, which Latvia lacks entirely.

It is Latvia which has to initiate more activities towards CEFTA countries. Latvia has to take into account and try to neutralise the main factors hampering co-operation:

- lack of investment resources,
- orientation on EU countries,
- low confidence in partners, less evident business opportunities and, perhaps, higher risks,
- limited, but growing market capacity,
- inherited mentality to get more benefits by acting separately.

From the point of view of EU enlargement better economic co-operation between CEFTA and Baltic countries may even further equalise the economic environment before accession which would provide for less of a shock at the moment when borders open. If economic co-operation between all candidate countries increases, it may eliminate pressure on the markets of the Western countries.

CONCLUSIONS

1. CEE "transition" countries appointed for membership to the EU have been separating into two blocs, which are institutionalised by two FTAs: CEFTA and BFTA.

2. There is no reasonable background for such a division, still it influences the behaviour of countries so that they concentrate economic and political activities within groups and act separately towards other countries and processes, including integration with the EU.

3. Latvia has demonstrated remarkable progress during recent years, which improves its position in the EU enlargement process, still the gap between living standards in Latvia and EU countries is too large and the competitiveness of the economy must be improved.

4. For this reason Latvia has two important things to be done; to improve economic performance and to get more support from other countries in the EU enlargement process. This can be done by activating economic and political co-operation among candidate countries.

5. Within the bloc of Baltic countries there is limited co-operation in the field of EU integration, but economic co-operation and the intensity of FDI flows are increasing.

6. Co-operation between Baltic States and CEFTA countries is not satisfactory.

7. Latvia would benefit from increasing economic co-operation both with other Baltic countries and CEFTA countries, especially with regard to the EU enlargement process.
8. Closer co-operation between member states would allow them to act as a more powerful bloc in the process of EU enlargement.

9. On the other hand, closer co-operation of all candidate states would facilitate faster and more simultaneous adjustment to EU conditions (common market requirements), and eliminate pressure on EU markets.

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Table 1

GDP per capita at current prices and exchange rates

	ECU				EU = 100				
	1993	1994	1995	1996	1997	1993	1994	1995	1996	1997
Bulgaria	1100	1000	1300	900	1100	7	6	8	5	6
Romania	1000	1100	1200	1200	1400	6	7	7	7	7
Latvia	**700**	**1200**	**1400**	**1600**	**2000**	**4**	**7**	**8**	**9**	**10**
Lithuania	600	1000	1200	1700	2300	4	6	7	9	12
Estonia	900	1300	1800	2300	2800	6	8	11	13	15
Poland	1900	2000	2400	2700	3100	12	12	14	15	16
Slovak Rep.	1900	2200	2500	2800	3200	12	13	14	15	17
Hungary	3200	3400	3300	3500	3900	20	20	19	19	21
Czech Rep.	2800	3200	3800	4300	4500	18	19	22	24	23
Slovenia	5400	6100	7200	7500	8100	34	36	42	41	43
Cyprus	8900	9800	10400	10700	11400	56	59	60	59	60
Total CC	1900	2100	2300	2600	2900	12	12	14	14	15

Source: Eurostat, 1998/28. Statistics in Focus. Economy and Finance. "The GDP of the Candidate Countries of Central and Eastern Europe and Cyprus – Initial figures for 1997 and new calculations in real terms"

Table 2

Gross domestic product according to purchasing power standards in ECU in Latvia in percents of relevant indicators of EU countries

	1995	1996	1997
Total compared with total of EU	0.17	0.17	0.18
Per capita compared with:			
- EU average	24.9	26.0	26.8
- highest (Luxembourg)	14.8	16.0	16.2
- lowest (Greece)	37.4	38.2	38.9

Source: Latvia and European Union countries. Central Statistical Bureau of Latvia. Riga, 1999.

Population in Latvia = 0.66% of EU = 15

Tabulka 3

Spending on social needs in Latvia, EU countries in percents of GDP

	Latvia	EU = 15
R&D	0.7	1.2 – 3.3
Education	5.8	4.4 – 7.3
Health care	3.9	5.1 – 10.8
Social security and welfare	14.3	18.6 – 30.0 (except Ireland – 13.7 and Portugal – 14.7
Defense		

Source: Latvia and European Union countries. Central Statistical Bureau of Latvia. Riga, 1999.

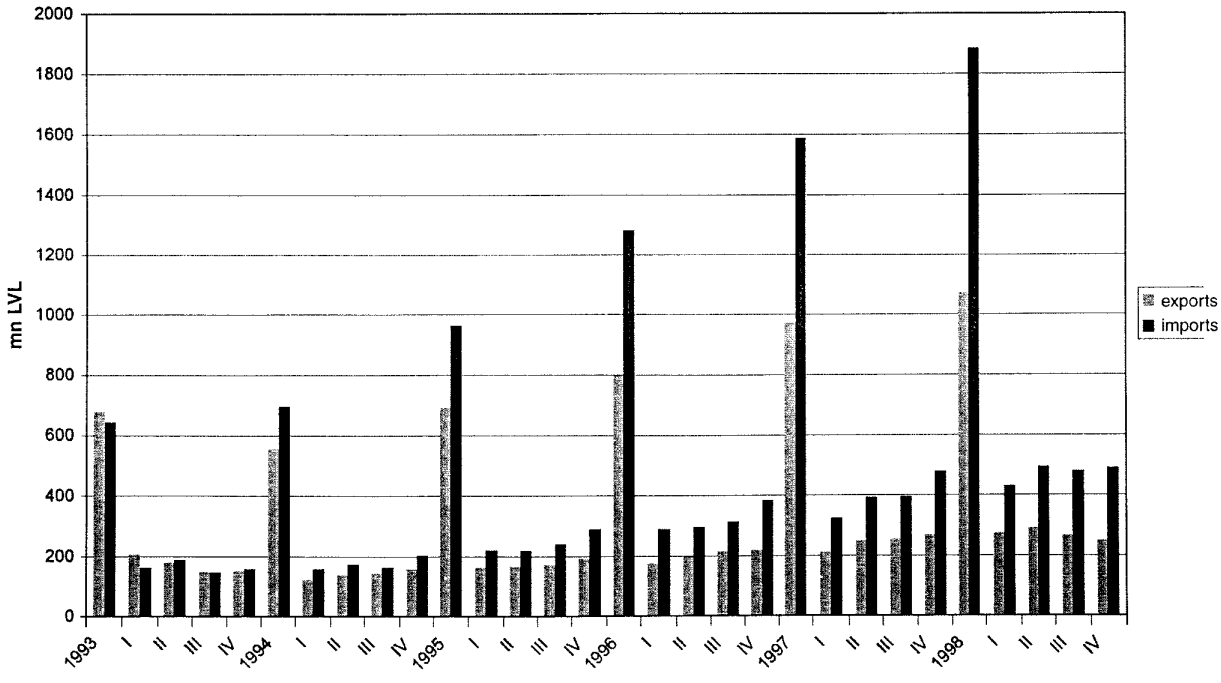
Foreign trade with EU, CEFTA countries and Baltic States mln US dollars

Groups of countries	Exports		Imports		Main commodity in 1998	
	1997	1998	1997	1998	Exports	Imports
Total	1 672	1 811	2 721	3 192	Wood	Machinery
EU, total	817	1 026	1 446	1 763	Wood	Machinery
Austria	5	11	22	40	Wood	Machinery
Belgium	20	20	51	70	Wood	Machinery
Denmark	65	93	95	121	Textiles	Machinery
France	21	31	57	84	Wood	Plastics, rubber
Greece	0.5	0.4	4	5	Mineral products	Prepared foodstuf
Italy	15	33	84	115	Textiles	Machinery
Ireland	8	11	13	17	Wood	Machinery
United Kingdom	240	245	89	99	Wood	Machinery
Luxembourg	0.02	0.02	0.5	1	Wood	Prepared foodstuf
Netherlands	40	63	103	114	Wood	Machinery
Portugal	0.7	0.7	2	3	Textiles	Textiles
Finland	26	39	264	304	Wood	Machinery
Spain	6	11	20	26	Wood	Prepared foodstuf
Germany	230	283	435	535	Wood	Machinery
Sweden	139	187	209	229	Wood	Machinery
CEFTA						
Poland	20	32	87	112	Wood	Machinery
Hungary	2	2	21	23	Prepared foodstuffs	Plastics, rubber
Czech Republic	6	6	26	43	Stone, plaster, cement, glassware, ceramic pr.	Transport vehicles
Slovakia	4	3	14	12	Textiles	Base metals
Romania	0.2	0.3	0.7	1	Textiles	Prepared foodstuf
Slovenia	2	4	3	3	Wood	Plastics, rubber
Bulgaria	0.4	0.8	8	10	Machinery	Prepared foodstuf
BALTIC STATES						
Estonia	70	82	163	212	Plastics, rubber	Base metals
Lithuania	126	134	173	201	Plastics, rubber	Mineral products

Source: Foreign Trade of Latvia. #4,1998. Central Statistical Bureau of Latvia. Riga, 1998.

Chart

Exports and imports, total mn LVL



Tabulka 5

Foreign investment stock in the company capital of enterprises registered in Latvia by investing country at end of period, thsd LVL

Groups of countries	1996	1997	1998
Total	377 649	552 452	646 162
EU			
Austria	8 745	8 245	8 052
Belgium	631	739	676
Denmark	99 400	100 038	100 189
France	405	229	615
Greece	11	112	
Italy	616	550	787
Ireland	12 026	26 334	34 785
United Kingdom	27 602	33 262	48 759
Luxembourg	31	63	34
Netherlands	5 630	11 379	16 567
Portugal	193	16	130
Finland	10 372	16 290	28 231
Spain	1 543	2 364	2 313
Germany	17 791	48 422	54 141
Sweden	18 474	26 750	44 465
CEFTA			
Poland	836	307	186
Hungary	51	25	25
Czech Republic	232	348	347
Slovakia	34	90	30
Romania			
Slovenia	1	1	1
Bulgaria	779	810	718
BALTIC STATES			
Estonia	5 357	21 951	21 673
Lithuania	660	503	1 096

Source: Investment in Latvia. Central Statistical Bureau of Latvia. Quarterly bulletin, #4/1998. Riga, April 1999.

BULGARIA'S ACCESSION TO CEFTA AND CEFTA'S ROLE IN THE EU ENLARGEMENT

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In international economics the integration of the world market has been considered as a main factor for acceleration of economic development. The liberalisation of foreign trade and the encouragement of foreign investments have special significance being the most important elements of a succesful economic policy. The communities in which the integration processes are cultivated, create optimal conditions for liberalisation — in Europe such communities are the European Union, EFTA and CEFTA.

As a small country Bulgaria is highly dependent on international trade. The foreign trade exchange represents over 90% of the gross domestic product (GDP). Imports have important significance providing the country with raw materials, fuels and semi-processed production and exports generate employment and income. In this respect the liberalisation of trade and the reduction of trade barriers serves as a guarantee for the investors for the long-term engagement undertaken by the country in providing stable terms of trade.

The reasons for Bulgaria's accession to CEFTA can be discovered in the period even before the Agreement had been concluded. After the beginning of the political and economic reforms in the early 90s, a re-structuralization of the Bulgarian foreign trade took place both in geographical and in product composure.

For instance before the transition, in the protective structure of the Council for Mutual Economic Assistance (CMEA), machinery and transport equipment was the most important commodity group in mutual trade of the CEECs with a share of over 50%; its share in exports to the EU amounted to a mere 14%. By the mid-1990s the same commodity group (machinery and transport equipment) had lost its substantial position and its share in intra-CEFTA trade dropped to far below 20%, while its share in exports to the EU increased to over 20%.

As far as the geographical structure is concerned, before the transition 80% of Bulgarian trade was intended for the countries in the CMEA. Until 1989 the annual Bulgarian trade exchange with CEECs amounted to 3.5 billion USD and after Bulgaria had lost its main markets in Central and Eastern European countries the mutual trade with the later CEFTA members dropped to historical low levels in 1991/92. In 1997 the turnover with CEFTA was 413.33 millions USD, in 1998 487 millions USD, the exports comprising 3.5% of all exports. At the same time the trade with OECD countries reached 60% of the total trade exchange thus converting developed industrial countries into main partners of Bulgaria.

When the Central European Free Trade Agreement (CEFTA) was signed in Krakow in 1992 establishing more favourable terms for trade between its members, Bulgaria felt itself naturally isolated from this market. CEFTA was not just a free trade agreement created to gradually establish a free trade zone by the year 2001 and to promote the development of mutual economic relations between members through the expansion of trade, providing fair conditions of competition. CEFTA included free access to an almost 100-million person market and provided full participation in the decision making process on expanding world trade by removing tariffs and non-tariff barriers as well. CEFTA gives an opportunity to launch co-ordinated steps into promoting and making more open the member-countries as a whole new attractive market.

On the other hand, the Central and Eastern European countries quickly reoriented their external economic relations primarily towards the countries of the European Union — for instance Bulgaria's exchange with the EU countries is 50% of the total foreign trade. The Europe Agreements established the framework for comprehensive economic co-operation between the CEECs and the EU and the conclusion of CEFTA in December 1992 was possible only one year after the Europe Agreements had been completed. Accession to the European Union has become a target of first importance for most of the CEECs.

From the internal market point of view, quick integration in the EU would expose national producers and goods to a very strong challenge, and this market pressure could affect the economies in transition. This is the reason for the Europe Agreements to provide for a gradual liberalisation of trade in industrial products, asymmetrical concessions in trade in agricultural products, *gradual liberalisation* of trade and services, and detailed regulation of several other important issues of economic co-operation.

In some important aspects the CEFTA Document follows the structure of the Europe Agreements. Thus CEFTA can be evaluated as a preparation for EU membership as it was stressed in the Prime Ministers' Declaration from 11-12 September 1998 and which the Czech Minister of Industry, Trade and Tourism called an "EU boot camp". As the largest free trade agreement in Europe CEFTA is designed to develop market conditions in Central and East Europe and may prepare and facilitate the accession of candidate countries of the region into the EU. Nevertheless the common policy is the element, which could change CEFTA as an important stage in European integraton. But the assumption of CEFTA was to be a mere free trade agreement, based on Article XXIV of the GATT, and not an integration organization.

There are more elements which approach or copy the European Union practice: the co-operation in customs administration, the multilateral cumulation among CEFTA countries and the Pan-European diagonal cumulation of origin, the decisions in the field of state aid, opening of government procurement markets, intellectual property rights, sanitary and phytosanitary measures. But CEFTA purposes are much less ambitious than those concerning the targets and means of co-operation with the European Union.

Bulgaria's accession to the CEFTA expands its texts with 10 Additional Protocols establishing gradual elimination of customs duties on a bilateral basis between Bulgaria, on the one side, and the other 6 CEFTA members, on the other side: those are Protocols No. 22-26 for the industrial goods and 27-31 for the agricultural products.

INDUSTRIAL GOODS

As follows from CEFTA objectives Bulgaria will establish a free trade area in industrial products by, at the latest, the end of the transitional period, January 1, 2002. At present eighty percent (80%) of industrial goods are imported free of duties since the agreement has become effective – as of January 1, 1999.

Slower liberalisation is envisaged for only a limited number of industrial goods which will continue to be taxed until 2002. Gradual reduction of customs duties is envisaged for textiles, chemical production, ferrous metallurgy, tyres and electric bulbs — branches which need some kind of protection due to their re-structuralization. The reduction scheme for most of the other goods envisages reduction of 40 percent during the first year, 60 percent during the second and 80 percent during the third year. Customs duties are expected to be fully abolished by the beginning of 2002.

The CEFTA countries offer Bulgaria favourable conditions for export of chemical products, forklift trucks, cash registers, lathes, farming machinery, electric engines and hoists. The average reduction of export duties is 9.6 percent, which means that the then current rate of 15 percent was reduced to 5.4 percent at the beginning of 1999.

The liberalisation of the industrial goods takes place under different schemes depending on the referent country:

The trade with industrial products between Bulgaria, on the one side, and Czech Republic and Slovakia, on the other side, has been free since 1 January 1999. With Hungary the transitional period will end in 2000, providing for sensitive products 30% from the basic custom duties in 1999 and 15% in 2000.

With reference to trade with Poland and Romania a free trade zone will be established in 2002 and with Slovenia - in 2000, supplying a special treatment for selected sensitive products of 30% or 10% of the basic custom duties.

At this moment Bulgaria does not apply charges having an equivalent effect to export customs duties except on raft and sided timber which will be abolished from 1 January 2000. For some products — textiles, crude petroleum, metals, coal, coke and computer software a registration is needed. In imports a safeguard measure on electric lamps and lighting fittings is the only one applied by Bulgaria.

AGRICULTURAL GOODS

In the sector of agriculture Bulgaria has agreed on a bilateral basis for a slower reduction of customs duties for so-called *sensitive goods*. The duties will remain unchanged or reduced within special tariff quotas, or lower customs duties will be given for unlimited quantities. Bulgaria has arranged customs duty reduction for exports of large amounts of wine, tobacco, cigarettes, fresh fruits and cheese. Usually the duties for these goods will be 50 percent lower than the most favoured nation treatment approved by CEFTA countries. The duties for these goods will be between 15 and 25 percent. For example, Bulgaria has agreed to export 85,000 hectolitres of wine at duties twice as low as the standard. The average wine export for Poland is 90,000 hectolitres.

The negotiations for the customs duties of the sensitive goods are difficult, because every country is trying to get reduced duties for more export goods. I will demonstrate this with an example: when Bulgaria was about to join the CEFTA, Poland requested a group of goods, that were on the list of medium sensitive goods, to be put on the list of sensitive goods. In the end, the other CEFTA members accepted a limited version of Poland's request with the exception of 4 groups of goods (poultry, tomato paste, apple juice and pickled cucumbers) which will be valid until 1 January 2001.

As the other CEFTA members Bulgaria has adopted the possibility to impose safeguard measures. Until present CEFTA practice has shown that the agriculture sector is the most sensitive and could justify the limited concessions granted in the sector as well as the frequently resorted to safeguard measures as an instrument of protection.

With the accession to CEFTA the general question of the possibilities for entering new markets raises the issue of the competitiveness of Bulgarian goods in comparison with the other countries. Experts estimate Bulgarian customers still have low purchasing power and there is no real danger to excessive increase of imports from CEFTA-members as there is no potential for this. For instance, the price of farming production in these countries is close to Bulgarian prices and, given transport costs, the products will not be cheaper than Bulgarian ones.

The real effect of Bulgaria's accession to CEFTA cannot be determined yet because of the insufficient statistics information. In advance it can only be summarised that the removal of trade barriers will have a positive effect on Bulgaria's surplus with the CEFTA countries. The arguments in support of this are the tendency in the trade with CEFTA countries during the last years and the changes in Bulgaria's trade with members with which free trade zones have been concluded before the accession.

TRADE WITH CEFTA COUNTRIES

For the period 1994-1998 the trade exchange with CEFTA countries increased by 17%. As most significant must be given the trade volume with Hungary, which in 1998 was 3 times above the turnover in 1991. Total trade with the Czech Republic and with Slovakia shows considerable growth as well.

Since the free trade agreement entered into force in January 1997 imports from Slovenia rose from 7 million USD to 18 million USD in 1998. Bulgarian trade exchange with Slovenia expanded considerably — exports rose by 240% and imports doubled and at present Bulgaria has a trade surplus with this country.

The statistic data shows that there still exists room for expanding mutual trade and not all

possibilities were utilised. There is potential for imports from CEFTA countries to increase at the expense of the restructuring of the imports from the European Union due to the same regime of liberalisation.

As far as the topic of investments is concerned it can be stressed that Bulgaria's accession to CEFTA creates the possibility for higher investor interest. One of the CEFTA purposes, besides the development of mutual trade exchange, is to encourage cross border investments within the region. The problem of free movement of capital has not been considered in the frame of CEFTA but Bulgaria is expecting that the open market will increase the capital flows from member countries and, on the other hand, from third countries due to more attractive opportunities for access to the intra-agreement market.

REMARKS ON THE DEBATE DURING THE SESSION I (MAY 28, 1999)

Maurice GUYADER,
Principal Administrator, DG1A, European Commission, Brussels.

"I would like to make the following remarks on the debate of this morning:

1. I came to Praha to get further information on the level of effective co-operation between CEFTA countries, but I understand from the interventions of this morning's session that CEFTA members are focusing more on their own integration into the European Union, rather than developing relations amongst themselves within the CEFTA agreement.

In general, trade between CEFTA members is still at a rather low level, because of a certain lack of complementarity between some of the countries involved.

This situation of underdeveloped inter-relations is understandable in this transitional period and in the framework of the far-reaching Europe Agreements that each CEFTA member has with the E.U.

However, the importance of the Europe Agreements and of the links with the E.U. should not lead to a neglect of the necessity of co-operation within CEFTA.

Both liberalisation and integration processes must be closely inter-connected and it is essential that relations amongst CEFTA members be deepened at the same time. This will, ultimately, facilitate their integration into an enlarged Union.

2. These processes are particularly important in the case of attracting large Foreign Direct Investments.

Indeed, a potential investor (foreign in particular) will be looking not only at the national market, where he decides to establish his business, but also at the neighbouring ones, either for purchasing intermediate goods, components, etc...or for exporting the finished products and, in most cases, for both.

In these conditions, liberalising trade amongst CEFTA members will contribute to attracting more investments, therefore to increasing economic modernisation and growth and ultimately to facilitating economic integration.

3. As to what could happen when certain CEFTA members join the Union before others; this should not create problems, since the new Union members will then (through their membership) apply the Europe Agreements, with their ex-CEFTA partners, not yet in the Union. So the Europe Agreements, which will at this time be full free trade agreements on industrial products, will be adapted to this new situation, as happened with the previous enlargement.

4. Finally, as regards any other agreements amongst CEFTA members or between them and third countries which do not have Europe Agreements, these will have to be renounced on the accession date, as stated by the E.U. during the accession negotiations.

5. To summarise, I think co-operation between CEFTA members has to be strengthened as an important step in the process of preparation for accession to the Union.

In this respect, this morning's meeting was encouraging and I will certainly help improving relations between CEFTA members and supporting their integration into the Union".

TRADE DIVERSION IN 'LEFT-OUTS' IN THE EASTWARD ENLARGEMENT OF THE EUROPEAN UNION

THE CASE OF SLOVAKIA[1]

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1. INTRODUCTION

Slovakia was created as an independent state from the former Czechoslovak federation on January 1, 1993. Generally, it was expected that independence would help to stabilize the general (political) situation in Slovakia at some costs of the economic development. As opposed to the Czech Republic, the integration of independent Slovakia into the European Union and NATO was often expected to be more difficult than it would have been in the case of Czechoslovakia, mainly due to the country's lesser economic development.

On the one hand, Slovakia experienced surprisingly good economic development between 1993 and 1997. The growth rate of GDP (6.5 % in 1997) was one of the highest in Europe, while inflation could be stabilized at 6.1 % in 1997, which was virtually the lowest price increase of all Eastern European countries. However, the development of the current account (deficit of about -10 % of GDP in 1996) and state budget deficit are persistent problems of the Slovak economic policy. This repeatedly created concerns regarding sustainability of Slovakia's economic policy in the medium and long term.

On the other hand, the increasing political tensions were increasingly criticized by the European Union and the USA. These concerns were viewed as the major barrier to the integration of the Slovak Republic with Western European and Atlantic structures despite the relatively good economic development. In Summer 1997, NATO decided not to invite the Slovak Republic to join the organization. Moreover, the European Commission came to the opinion on Slovakia's application for membership into the European Union that: "... *Slovakia does not fulfill in a sufficient manner the political conditions set out by the European Council in Copenhagen because of the instability of Slovakia's institutions, their lack of rootedness in political life and the shortcomings in the functioning of its democracy. This situation is so much more regrettable since Slovakia would satisfy the economic criteria in the medium term and is firmly committed to take on the aquis, particularly concerning the internal market even if further progress is still required to ensure the effective application of the aquis.*" (European Commission, in the Summary of the opinion on Slovakia's Application for membership of the EU).

Nevertheless, the Slovak Republic can be included in the first wave of Eastward enlargement of the EU if it makes significant progress with respect to the political criteria. The parliamentary elections in September 1998 created sound conditions for Slovak participation in the first wave of the enlargement, although this could not yet change the position of the European Commission in its regular report on progress towards accession published already at the beginning of November. As a result, the Slovak delegation cannot participate in the accession negotiations with the six membership candidates (Cyprus, the Czech Republic, Estonia, Hungary, Poland, and Slovenia). Furthermore, Slovakia has been significantly delayed fulfilling the Copenhagen criteria, which are seen as a precondition for full membership. In particular, the European Commission states that: *"Slovakia has made little progress in developing the necessary administrative and judicial capacity to effectively implement the acquis. Civil service legislation has been delayed, progress in judicial reform has been limited and recommendations in the Opinion to reform, strengthen and establish new institutions in the internal market area have not been followed up."* (European Commission, Regular Report on Slovakia's Progress towards Accession). Based on these contradictory developments, this contribution tries to analyze the

[1] The author would like to thank Andreas Wörgötter, Georg Winckler, Robert Holzmann, Katarzyna Zukowska-Gagelmann, Katharina Helmstedt, Jaroslav Fidrmuc and Jan Fidrmuc for helpful discussions and comments.

impact of different Enlargement scenarios (participation and exclusion of Slovakia in the first wave of the Eastward enlargement of EU) on the Slovak economy.

Slovakia can be seen as a bench-mark example for trade effects resulting from the division of the Eastward Enlargement of the European Union into several steps. The Slovak economy is already strongly integrated into the broad European economic area as defined by all free trade agreements of the EU. Although the share of Slovakia's exports to the EU15 is rather low in comparison to other European countries (58 % of total exports without the Czech Republic in 1995), the Slovak Republic reaches the second highest export share (85 % of total exports including the Czech Republic in 1995) into European countries including the EU, EFTA and all associated countries. Therefore, Slovakia is likely to have the highest share of exports to the single market in Europe when Hungary, Poland and the Czech Republic will join the European Union.

The structure of the paper is as follows. The next section provides a literature survey. The third section estimates gravity equations for the major SITC one-digit commodity groups. The fourth section simulates Slovak trade with its most important partners including the Czech Republic, six selected EU-countries (Austria, Germany, France, Italy, the UK and the Netherlands), Hungary, and Poland. The fifth section discusses the projections of Slovak trade by SITC commodity groups until 2010 under the accession and the non-accession scenarios. The last section summarizes conclusions.

2. EXPLANATION OF TRADE VOLUME BY GRAVITY MODELS

Gravity models (Linnemann, 1966, and Linder, 1961) relate trade flow between two countries to the importer's demand, the exporter's supply and the trade costs. The importer's demand and the exporter's supply are substituted by countries' gross domestic products (GDP) as well as GDP per capita. Trade costs (transport and transaction costs) are measured by geographical distance. Baldwin (1994) presents an excellent literature survey on the estimation and theoretical foundation of the gravity models. Markusen (1986) and Markusen and Wigle (1990) presented models of trade between capital abundant and labor abundant countries with non-homothetic preferences (capital intensity in production is correlated with high-income elasticity of demand). They show that the differences in natural abundance and economies of scale determine the direction of trade, while the non-homothetic preferences explain the volume of trade.

Gravity models for the assessment of Eastern European trade were used by Hamilton and Winters (1992), who used this approach for the estimation of the trade potential of Eastern Europe (including the former Soviet Union). This approach prevailed for the assessment of the trade potential of Eastern Europe and was followed by Holzmann, Thimann, and Petz (1994), Baldwin (1993, 1994), Holzmann and Zukowska-Gagelmann (1996), and others. Moreover, Hamilton-Winter's trade projections are used as standard reference in the analyses of the integration of associated countries into the EU, including for example Gasiorek, Smith, and Venables (1994).

Independently from this development, the process of transcontinental integration in Western Europe and Northern America re-opened questions related to the movement of factors, location of production, and the relation of center and periphery. Krugman (1991a) introduced new models of economic geography, which stressed the role of transport and transaction costs for trade flows between regional economies with increasing returns to scale. The models of economic geography provided plenty of theoretical arguments also for the gravity models. Moreover, Krugman (1991b) showed the importance of history in the determination of trade patterns within this framework.

In the specification of the estimated equation, the gravity models are extended by a series of variables, which help to explain bilateral trade flows. The geographic distance (distance between the capital cities of trade partners) is usually supplemented by dummies for adjacent countries. Other dummies are used for trade blocks and preferential areas. These dummies are supposed to have a positive coefficient meaning that countries within preferential areas trade more than predicted by their GDP and distance, alone. Bayoumi and Eichengreen (1995) interpret the

coefficients of dummies, indicating the membership of both partner countries into a preferential arrangement, as the trade creation effect. Furthermore, they introduced additional dummy variables indicating that only one trading partner participates in a particular preferential arrangement. The negative coefficient of these dummies corresponds with the trade diversion effect.

The gravity models provided surprisingly good predictions of trade between OECD and Eastern European countries. Hamilton and Winters (1992) foresaw the level of trade with Eastern Europe several times higher than before the opening up. According to Kaminski, Wang and Winters (1996) comparison, exports of OECD countries to Eastern Europe actually increased two to three fold between 1991 and 1994.

The earlier studies used obviously aggregate trade flows for the estimation of the gravity models. Nevertheless, the theory and arguments of gravity models (aggregate demand and supply and transport costs) can also be used for commodity groups. This extension was advised by Smith (1992) in the discussion of Hamilton's and Winter's results, that additional information could be received by the application of the gravity models to specific commodity groups.

3. EFFECTS OF COMMON HISTORY IN GRAVITY MODELS

I estimate gravity models from 1989 for total trade and seven SITC one-digit groups (excluding SITC 1, 3, 4 and 9 which account only for low shares of total trade) on a set of 23 OECD countries (excluding the newly admitted OECD countries like Mexico and Korea) providing 462 observations. I include GDP (denoted by Y), GDP per capita (y) of both importing (indexed by M) and exporting (X) countries as well as the distance (d) between the capitals of these countries. All these variables are in logs. Four dummies on EC12 (EC), EFTA (EF), free trade agreements between the European Union and EFTA (EA), and common borders (CB) reflect the free trade areas in Europe and the neighboring countries. Moreover, I include several dummies for pairs of countries with above-average trade relations including Austria and Germany (A), Ireland and the UK (I), Belgium and the Netherlands (B) and Norway and Sweden (N). All these countries have common or very similar or even the same languages and they are neighbors with a long tradition of bilateral relations. In two additional cases, namely Canada and the US (C) and New Zealand and Australia (Z), the corresponding dummy variables also cover the effects of free trade areas. I apply the estimated coefficients for these pairs of countries to analyze the trade between Slovakia and the Czech Republic following the division of the Czechoslovak Federation. The equation can be stated as follows:

$$X=\beta_0+\beta_1 Y_m+\beta_2 Y_x+\beta_3 y_m+\beta_4 y_x-\beta_5 d+\beta_6 EC+\beta_7 EF+\beta_8 EA+\beta_9 CB+\beta_{10} A+\beta_{11} I+\beta_{12} N+\beta_{13} B+\beta_{14} C+\beta_{15} Z. \qquad (1)$$

The results of my estimations are reported in Table 1. The estimates provide a surprisingly good approximation of trade, as can be seen in high coefficients of determination for total trade (0.89) and total trade with industrial commodities (0.84). The coefficient of determination is between 0.75 and 0.81 for the individual commodity groups of industrial products, and only slightly lower for agricultural products (0.64) and raw materials (0.55). Furthermore, the estimated coefficients for GDP of both trade partners and the distance have positive and negative signs and are significant for all commodity groups, while the coefficient for GDP per capita is not significant in several cases.

Free trade areas in Europe had a strong and positive effect on trade. After a transformation of logs to levels, we can see that the trade between two EU-countries is about double that of the trade value without the participation in EU. Trade creation effects of other free trade areas are significantly lower. EFTA countries traded on average "only" one third above the normal trade levels. The highest positive effect of the EU is not surprisingly in the agricultural sector. Trade with agricultural products is nearly four times higher within the EU than between two other countries. The dummy for the EU is not only significant for raw materials. The preferences within EFTA as well as the free trade agreements between EFTA and the EU concentrated on industrial products (except for chemicals). The trade volume between two neighboring countries is higher by about one third, although the dummy for common borders is not significant for industrial products.

The estimated coefficients for countries with above-average trade relations (corresponding to similar language and geographical position) show surprisingly small differences. As estimated for the total trade of the selected European countries, these coefficients vary only between 0.64 (Austrian trade with Germany) and 1.10 (Belgian trade with the Netherlands), with Irish trade with UK and Norwegian trade with Sweden being closer to the upper part of this interval. This implies that the factors like common language and history have very high, permanent and positive effects on bilateral trade, although relations between these countries may be controversial in many aspects. Austrian trade with Germany is about two times higher than the potential level excluding these specific factors. Norwegian trade with Sweden is higher by a factor of 2.5. Belgian trade with the Netherlands is even as high as triple that of the estimated value of the bilateral trade volume. Moreover, these coefficients are relatively stable for all selected commodity groups.

The differences between these pairs of countries can be explained by their integration strategies. Austria did not participate in the EU together with Germany and had, therefore, to suffer more significant erosion of the bilateral trade than Ireland and the UK and Belgium and the Netherlands both participating in the EU, but also that of Norway and Sweden both participating in EFTA. This hypothesis can be further confirmed by larger differences of the coefficients estimated for the particular commodity groups. In particular, Austrian trade with Germany was not significantly higher for agricultural products, raw materials or chemicals, while trade of machinery products and finished goods was as high as trade between Belgium and the Netherlands. This again corresponds to the liberalization pattern between EU and EFTA. The role of common history is even higher for the overseas OECD countries. The trade between Australia and New Zealand is higher by a factor of ten.

4. SIMULATIONS OF SLOVAKIA'S TRADE WITH SELECTED COUNTRIES

I simulate the development of Slovak trade with six selected EU countries (Austria, France, Germany, Italy, the UK and the Netherlands) and three Central European neighbors (Hungary, Poland, and the Czech Republic) on the basis of estimated gravity models for major SITC one digit commodity groups as defined by equation (1). In 1996, the selected six EU-countries (EU6) accounted for 91.2 % of Slovakia's exports to EU. The selected six EU-countries together with the Czech Republic, Poland and Hungary accounted for 78.1 % of Slovak total exports in 1996. Moreover, Slovak exports to other countries will be less influenced by the different scenarios of the Eastward enlargement of the European Union owing to similar rules in the European Union and Slovakia.

I analyze three scenarios of the process of European integration: no Eastward enlargement of the European Union, early accession of all CEECs (Hungary, Poland, Slovakia and the Czech Republic), and the exclusion of the Slovak Republic from the first wave of the enlargement. All scenarios assume a full convergence to trade potentials until 2010 without explicitly modeling accession dates and transition periods. Tables 2 to 6 present average annual growth rates of Slovak exports to the selected countries between 1997 and 2010 according to the specified scenarios.

In the non-enlargement scenario, I assume that trade relations between EU and CEECs will be largely comparable to the former free trade agreements between the EU and EFTA-countries. This foresees significant liberalization of Slovak trade with the EU except for the agricultural products. In technical terms, I apply the coefficients estimated for trade relations between the EU and EFTA to Slovak trade with the selected EU-countries. Similarly, Slovakia's trade with Hungary and Poland is assumed to approach the extent of trade liberalization between EFTA-countries, while EU's trade with the associated countries is modeled as trade between the EU and EFTA.

However, the trade flows between the Czech Republic and Slovakia are more similar to the current EU regulations. Therefore, the coefficient estimated for EU instead of that estimated for EFTA-countries is applied for the computation of trade potential between Slovakia and the Czech Republic. In addition, the bilateral trade between the successor states of Czechoslovakia is assumed to converge on the highest trade relations in the EU (Belgium and the Netherlands).

This means that the trade level could stabilize at about triple the volume according to Czech and Slovak aggregate outputs and the distance between countries. This is a relatively restrictive assumption given the high level of Slovak trade with the Czech Republic. My estimates of the trade potential between Slovakia and the Czech Republic for 1996 indicate that the current level of trade is about nine times higher than its potential. Only Slovak exports of agricultural products and raw materials to the Czech Republic are close to the potential level. Nevertheless, my assumption of declining importance of the Czech Republic for Slovak exports is largely confirmed by recent developments (see description below).

In the second scenario (enlargement), I simulate the effects of a simultaneous accession of all four CEECs (including Slovakia) into the EU. The potential level of Slovak trade with the EU is given by the estimated coefficients for dummy variable for EU membership. Similarly, the Slovak exports to Hungary and Poland will grow as a result of the extension of the single market to all Central European countries. Trade with the Czech Republic is simulated as in the non-enlargement scenario.

The last scenario assumes the exclusion of Slovakia from the first round of Eastern enlargement. Trade levels with EU countries are simulated like in the non-enlargement scenario. Trade potentials with other CEECs including the Czech Republic are given by European Agreements, which are modeled as the former free trade agreements between EU and EFTA. Moreover, the exclusion of Slovakia from the first wave of eastward enlargement of the EU strengthens the erosion of the traditional trade relations with the Czech Republic. I assume that the additional potential of bilateral trade will decline to the level given by the coefficient estimated for Austria and Germany.

I assume a continuation of growth of GDP in CEECs and in the EU in the period of simulations (1997 to 2010). These assumptions were based on the long-term forecast of IHS for Austria (including the assumption on development of selected European countries), the forecasts of the EU and OECD, Šujan and Šujanová (1997), Welfe et al. (1997), and Haluška, Olexa and Orságová (1997). All scenarios are characterized by the same set of assumptions on economic growth, although Baldwin, Francois and Portes (1997) argue that the cumulated growth gain in Eastern European countries (due to the accession to the EU) could reach from 1.5 % to 18.8 % in the long run. This restrictive assumption was adopted in order to analyze the direct effects of the enlargement on trade of the EU with CEECs (that is, the effects of trade liberalization) and to exclude the indirect effects through stronger growth in entrant countries.

Following the opening of Eastern Europe, the countries of the European Union became the most important trade partners of Slovakia. This development was driven by the convergence to trade potential. Already, the Slovak trade with EU6 reached the potential level. In turn, trade with Hungary and Poland declined in response to output declines in these countries and the dissolution of the COMECON. Slovak trade with Hungary and Poland also equals the trade potentials with these countries, while Slovak trade with the Czech Republic is significantly higher.

There is still significant potential for increasing trade flows through liberalization of trade barriers and GDP growth (see Tables 2 to 6). In the non-enlargement scenario, Slovakia's total exports to EU6 will grow by 9.2 % annually, between 1997 and 2010 (after average annual export growth by 25.8 % in 1995 and 1996).[2] Under the accession scenario, annual growth of exports to the selected EU-countries will reach 15.3 % (6.1 percentage points above the basic scenario).

Further insights can be obtained from inspection of simulation results for SITC commodity groups. The gravity models simulated relatively well Slovakia's exports to the six selected EU-countries with intermediate products (SITC6) and consumer products (SITC8), while Slovak exports of chemicals (SITC5) and machinery products (SITC7) to EU6 are significantly above the levels predicted by gravity models. Surprisingly, Slovak exports of raw materials (SITC2) and

[2] All growth rates referred throughout this contribution are average annual growth rates either for the realized trade in 1995 and 1996 (that is, the average of the growth rate in 1995 respective to 1994 and the growth rate in 1996 respective to 1995) or for the simulation period (1997 to 2010).

agricultural products (SITC0) are only a fraction of the estimated levels. These departures from trade projections are consistent with the expectations on trade bias due to foreign direct investment (VW investment in Bratislava), lack of resources of raw materials and the low productivity of agriculture in Slovakia.

The expected growth in the EU and Slovakia will significantly increase the volume of trade of all commodity groups in the coming years (see Table 2). We can see significant variance of simulated growth rates by commodity groups due to different utilization ratios and income elasticities. It is difficult to evaluate whether the potential for export growth of agricultural products (SITC0) with the highest predicted growth, as well as raw materials, (SITC2) can be realized without a sound production basis, but also the exports of intermediate products (SITC6), consumer products (SITC8) and chemicals (SITC5) could grow by about 10 % according to the non-enlargement scenario and 15 %-20 % annually between 1997 and 2010 according to the enlargement scenario. The growth of Slovak exports of machinery (0.7 % per annum in the non-enlargement scenario compared to the average annual growth rate of 55.8 % in 1995 and 1996) is lowered by the already high realized level and can be kept only by further liberalization of Slovak trade with EU6 (average annual growth by 10.0 % following the accession).

The shape of the European integration will substantially change the relations to Central and Eastern neighbors. Slovak exports to Hungary will increase by 3.0 % annually in the non-enlargement scenario. The first wave of the enlargement will also liberalize the trade between new EU-members and the 'left-outs'. In particular, Slovak exports to Hungary could increase by 1 percentage point annually (average annual growth by 4 % between 1997 and 2010) according to the exclusion scenario. Not surprisingly, growth gains are much higher if Slovakia joins the EU together with Hungary. Then, the Slovak exports to Hungary are simulated to increase by 6.1 % per annum (that is, 3.1 percentage point above the non-enlargement scenario). The potential growth is slightly higher for the Slovak exports to Poland, which already increased by 50.2 % on average annually in 1995 and 1996. Slovak exports to Poland could grow by 6.9 % annually in the non-enlargement scenario, 8.0 % in the exclusion scenario, and 10.2 % in the enlargement scenario (including Slovakia).

Trade with Central European countries could exhibit much lower differences by commodity groups. Agricultural products, which were not yet liberalized within CEFTA, could reach the highest growth rates (see Tables 3 and 4). Slovak exports of finished products (SITC8) to Hungary could increase above average (annual growth above 10 % in all three scenarios). Slovak exports of intermediate products (SITC6) to Poland also face high growth potential (annual growth rates of about 10 % in all scenarios).

Slovakia's trade with the Czech Republic could face the most significant changes (see Table 5). The relatively high level of current trade, results in a strong tendency to export declines in the next years according to all scenarios. The average growth of Slovak exports to the Czech Republic of 4.6 % between 1995 and 1996 is surprisingly high in comparison to much worse results, according to the individual commodity groups. This bias is likely to come from trade with fuels (average growth rates of 16.7 % between 1995 and 1996), which is not explained with my models. However, the models predicted trade with other products relatively well. My simulations predict an average decline of Slovak exports of industrial products to the Czech Republic by -2.7 % annually, under either common participation in eastward enlargement of EU or in the non-accession scenarios (including no eastward enlargement and the exclusion of Slovakia from the first wave of eastward enlargement of the EU). The size of this decline roughly corresponds to the average annual decline of Slovak exports of industrial products to the Czech Republic between 1995 and 1996 (-4.0 %).

The omission of Slovakia from the enlargement is likely to result in significant export declines by commodity groups. The most dramatic development is simulated for agriculture, where the agricultural exports of Slovakia to the Czech Republic could decline by -7.3 % annually instead of significant growth of 11.0 % per annum. The declining development of Slovak agricultural exports to the Czech Republic was observed already after the split of Czechoslovakia (-10.7 % in average between 1995 and 1996). Slovak exports of industrial products (SITC5-8) to the Czech Republic could face export losses by up to 4 percentage points in the exclusion scenario.

The liberalization of Slovak exports to Hungary and Poland can largely compensate the export losses to the Czech Republic (see Table 6) in the exclusion scenario. Thus, the exclusion of Slovakia from the first wave of the enlargement of the European Union could result in export growth to all six EU-countries and three Central European countries lower only by about half a percentage point per annum. The largest impact can be expected for agricultural exports, where growth difference could reach 3 percentage points, while the growth losses are below one percentage point for all other commodities. Only exports of machinery will decline by 1.0 % per annum in the exclusion scenario, while the export growth of other products would continue also after the exclusion of Slovakia from the first wave of the enlargement.

5. CONCLUSIONS

The trade potential of Slovakia can be estimated on the basis of gravity models (Hamilton and Winters, 1992), which relate exports to GDP of both countries and the distance between the countries. The effects of the preferential trade areas are included through dummies for particular country groups into the estimation equation. The earlier simulation of gravity models provided excellent forecasts for the development of trade between Eastern European countries and selected OECD countries.

I simulate Slovak trade with its major trade partners in the European Union (Austria, France, Germany, Italy, UK and the Netherlands) and in Central Europe (Hungary, Poland and the Czech Republic). I formulate three scenarios including no eastward enlargement of the European Union, the simultaneous accession of all four Central European countries into the European Union and the exclusion of Slovakia from the first wave of the enlargement. The formulation of these scenarios is derived from evidence based on the former trade relations between the EU and EFTA.

I demonstrate that Slovakia trades more intensively with the Czech Republic than any other pair of countries in Europe, including countries with a common history or similar languages (Ireland and the UK, Belgium and the Netherlands, Sweden and Norway, and Austria and Germany). I argue that a significant part of this extraordinary trade relation will largely erode if only one country participates in the first wave of eastward enlargement of the European Union. In turn, the accession of Hungary and Poland into the European Union will significantly liberalize Slovak trade with these countries even in the case of exclusion of Slovakia from the first wave of enlargement. I show that Slovak export losses in relation to the Czech Republic will be largely compensated by trade liberalization with Hungary and Poland. Nevertheless, the average annual growth of Slovakia's total exports to the selected nine countries could be higher by 5 percentage points between 1997 and 2010 if Slovakia joins the EU together with other Central European nations.

The example of Slovakia can be seen as an example of the trade effects of the enlargement of the European Union by the few associated countries on the 'left-outs.' The simulation of trade creation and trade diversion effects on Slovakia, which has more intensive trade relations with the Czech Republic than any other two associated countries, shows that the trade diversion effects (shifts of EU's trade from 'left outs' to new member states) could be compensated by the trade creation effects (liberalization of trade between 'left outs' and new member states of the European Union by Europe Agreements). This result supports the speeding-up of the integration of the best-performing countries into the European Union, instead of integrating as many membership candidates as possible. However, transition periods would be appropriate to restrict trade diversion in 'left outs' in specific sectors (for example agricultural trade between Slovakia and the Czech Republic).

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Table 1: Estimation of gravity equation

	Total trade SITC0-8	Industrial prod. SITC5-8	Agricult. prod. SITC0	Raw materials SITC2
Constant	-6.495	-8.063	-6.633	-2.127
	(-7.765)	(-6.015)	(-2.859)	(-1.103)
GDP of importer	0.821	0.855	0.745	0.940
	(30.831)	(19.837)	(13.159)	(13.769)
GDP of exporter	0.799	0.990	0.477	0.504
	(32.636)	(25.171)	(7.235)	(7.963)
GDP per capita, importer	0.089	0.076	0.738	-0.283
	(1.573)	(0.757)	(3.672)	(-2.079)
GDP per capita, exporter	0.355	0.267	-0.020	0.232
	(6.038)	(3.441)	(-0.177)	(1.564)
Distance	-0.571	-0.680	-0.636	-0.631
	(-10.291)	(-6.679)	(-5.483)	(-5.053)
EC12	0.751	0.981	1.350	0.329
	(6.356)	(4.733)	(5.299)	(1.340)
EFTA	0.333	0.907	-0.607	-0.136
	(1.932)	(3.065)	(-1.795)	(-0.303)
EU-EFTA	0.468	0.876	-0.340	0.325
	(3.712)	(3.754)	(-1.337)	(1.167)
Common border	0.303	0.119	0.496	0.552
	(3.199)	(0.931)	(2.754)	(2.696)
Austria-Germany	0.640	0.689	0.150	0.244
	(3.844)	(6.626)	(0.207)	(0.541)
Ireland-UK	1.070	1.134	1.273	0.433
	(12.467)	(6.582)	(6.346)	(2.537)
Norway-Sweden	0.923	0.709	0.974	1.463
	(7.473)	(3.833)	(3.687)	(3.256)
Belgium-Netherlands	1.100	1.091	0.983	1.060
	(8.233)	(6.034)	(4.371)	(2.687)
Canada-US	1.208	1.331	1.457	1.691
	(10.975)	(8.412)	(5.103)	(7.636)
N. Zealand-Australia	2.508	2.886	3.216	3.184
	(26.687)	(16.113)	(11.630)	(12.496)
Adjusted R^2	0.8948	0.8398	0.6381	0.5497

Table 1 (Continued)

	Chemicals SITC5	Interm. prod. SITC6	Machinery SITC7	Consumer prod. SITC8
Constant	-12.435	-5.458	-17.740	-10.620
	(-6.343)	(-3.799)	(-9.566)	(-6.340)
GDP of importer	0.865	0.937	0.800	0.825
	(14.956)	(20.227)	(13.849)	(16.756)
GDP of exporter	0.864	0.866	1.145	1.071
	(16.420)	(19.396)	(22.895)	(24.003)
GDP per capita, importer	-0.010	-0.063	0.018	0.639
	(-0.064)	(-0.496)	(0.161)	(5.852)
GDP per capita, exporter	1.032	0.091	1.076	-0.316
	(8.718)	(1.111)	(8.426)	(-2.808)
Distance	-1.007	-0.752	-0.679	-0.682
	(-7.482)	(-7.415)	(-4.932)	(-5.936)
EC12	0.704	0.977	1.228	1.233
	(2.555)	(4.923)	(4.236)	(5.014)
EFTA	-0.114	1.349	0.866	1.149
	(-0.307)	(4.670)	(2.119)	(3.227)
EU-EFTA	0.160	1.114	0.816	1.025
	(0.540)	(4.985)	(2.529)	(3.815)
Common border	0.104	0.220	0.042	-0.017
	(0.576)	(1.471)	(0.228)	(-0.091)
Austria-Germany	0.389	0.614	0.997	1.015
	(1.527)	(4.244)	(4.160)	(5.491)
Ireland-UK	0.985	0.830	1.416	1.674
	(6.446)	(3.179)	(2.316)	(8.144)
Norway-Sweden	0.787	0.696	0.662	0.805
	(4.472)	(3.244)	(3.138)	(2.061)
Belgium-Netherlands	0.733	1.196	0.914	1.324
	(2.399)	(6.386)	(3.153)	(5.768)
Canada-US	0.518	1.279	1.752	0.929
	(2.700)	(6.069)	(5.547)	(4.991)
N. Zealand-Australia	2.679	3.482	2.946	3.232
	(7.762)	(19.813)	(11.178)	(16.588)
Adjusted R^2	0.7478	0.7995	0.8084	0.7926

Note: The covariance matrices of the coefficients are corrected for possible heteroscedasticity. T-values within parentheses, the number of available observations is 462 for all commodity groups.

Table 2: Projections of the Slovak exports to EU6, average annual growth rates

SITC Groups	Description	Realized 1995-1996	Non-enlargement 1997-2010	Enlargement 1997-2010	Exclusion 1997-2010
SITC 0-8	Total Exports	25.79	9.24	15.26	9.24
SITC 5-8	Industrial prod	19.45	8.83	16.73	8.83
SITC 0	Agricultural prod.	-4.93	22.39	34.77	22.39
SITC 2	Raw materials	10.61	14.42	17.14	14.42
SITC 5	Chemicals	6.83	9.13	14.76	9.13
SITC 6	Intermediate prod.	3.28	10.91	18.93	10.91
SITC 7	Machinery	55.79	0.72	9.95	0.72
SITC 8	Consumer prod.	17.10	10.28	20.42	10.28

Note: EU6 include Austria, France, Germany, Italy, UK, and the Netherlands. The Slovak Exports to EU6 in the exclusion scenario are modeled under the same assumptions like in the non-enlargement scenario.

Table 3: Projections of the Slovak exports to Hungary, average annual growth rates

SITC Groups	Description	Realized 1995–1996	Non-enlargement 1997–2010	Enlargement 1997–2010	Exclusion 1997–2010
SITC 0-8	Total Exports	5.01	2.97	6.10	3.97
SITC 5-8	Industrial prod.	1.56	6.59	7.16	6.36
SITC 0	Agricultural prod.	2.72	10.31	26.85	12.43
SITC 2	Raw materials	-4.56	-0.92	2.42	2.40
SITC 5	Chemicals	4.52	2.79	8.97	4.82
SITC 6	Intermediate prod.	-1.82	7.72	4.90	5.93
SITC 7	Machinery	10.57	3.66	6.37	3.29
SITC 8	Consumer prod.	-4.18	13.23	13.91	12.23

Table 4: Projections of the Slovak exports to Poland, average annual growth rates

SITC Groups	Description	Realized 1995–1996	Non-enlargement 1997–2010	Enlargement 1997–2010	Exclusion 1997–2010
SITC 0-8	Total Exports	50.17	6.94	10.18	7.98
SITC 5-8	Industrial prod.	34.27	7.54	8.11	7.30
SITC 0	Agricultural prod.	68.52	8.24	24.47	10.33
SITC 2	Raw materials	36.45	13.26	17.08	17.05
SITC 5	Chemicals	15.53	-1.34	4.59	0.61
SITC 6	Intermediate prod.	36.45	11.98	9.04	10.11
SITC 7	Machinery	62.84	3.49	6.21	3.12
SITC 8	Consumer prod.	41.29	7.21	7.86	6.27

Table 5: Projections of the Slovak exports to the Czech Republic, average annual growth rates

SITC Groups	Description	Realized 1995-1996	Non-enlargement 1997-2010	Enlargement 1997-2010	Exclusion 1997-2010
SITC 0-8	Total Exports	4.61	-0.96	-0.96	-6.07
SITC 5-8	Industrial prod.	-3.98	-2.69	-2.69	-6.14
SITC 0	Agricultural prod.	-10.66	11.03	11.03	-7.27
SITC 2	Raw materials	-6.98	4.29	4.29	-1.64
SITC 5	Chemicals	1.42	-5.73	-5.73	-11.52
SITC 6	Intermediate prod.	-10.88	-2.08	-2.08	-5.14
SITC 7	Machinery	0.20	-6.64	-6.64	-8.81
SITC 8	Consumer prod.	2.67	-0.19	-0.19	-3.80

Note: The Slovak exports to the Czech Republic in the enlargement scenario are modeled under the same assumptions like in the non-enlargement scenario.

Table 6: Projections of the Slovak exports to selected countries, average annual growth rates

SITC Groups	Description	Realized 1995-1996	Non-enlargement 1997-2010	Enlargement 1997-2010	Exclusion 1997-2010
SITC 0-8	Total Exports	15.60	5.98	10.88	5.48
SITC 5-8	Industrial prod	8.70	5.93	12.39	5.55
SITC 0	Agricultural prod.	-5.84	15.42	24.83	12.33
SITC 2	Raw materials	1.89	10.30	12.73	10.20
SITC 5	Chemicals	4.69	3.28	8.14	2.91
SITC 6	Intermediate prod.	-2.14	7.78	13.95	7.23
SITC 7	Machinery	27.81	-0.71	6.97	-1.03
SITC 8	Consumer prod.	12.45	8.05	16.86	7.64

Note: The selected countries include Austria, France, Germany, Italy, UK, the Netherlands, Hungary, Poland, and the Czech Republic.

HUNGARY'S EXPERIENCE WITH AGRICULTURAL TRADE IN CEFTA: DEVELOPMENTS, PROBLEMS AND POSSIBILITIES

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MOTIVATIONS

The main economic **aim** why Hungary decided to sign the Central European Free Trade Agreement in December 1992 was:

- to increase foreign trade turnover with the neighbouring Central European countries from their historically low level in 1991/1992, and to prevent the further contraction of intraregional trade;
- to boost mutual trade based on the more or less similar level of economic development, on the partial complementarity of economic structures, on geographical proximity, on wellestablished, traditional economic links with due respect to fair competition;
- to counterbalance the trade diversion effect of the association agreements signed by the Central European countries with the EU in December 1991, and the re-orientation of the foreign economic relations towards the Western countries;
- to promote the country's accession to the EU.

The main **means** for achieving the above objectives is essentially the liberalisation of foreign trade turnover among the member countries by gradually reducing and eliminating tariffs and non-tariff barriers in order to achieve free trade in industrial goods.

Though in the case of agricultural products no free trade was envisaged by the original CEFTA Agreement, presently the less sensitive agricultural goods (live animal, all fish, oilseeds, etc.,) are traded duty-free without a quantitative limit; in the case of another group of agricultural goods (meat products, different fruits and vegetables, some cereals, etc.) CEFTA-wide unified, lower than MFN tariffs are applied without any quantitative restrictions; for the third group of commodities - which play a significant role in the individual countries' agricultural exports and imports - bilateral agreements were signed to reduce tariffs with or without quantitative limits on an asymmetrical basis. However, there are certain agricultural products, which are not covered by any trade concessions, neither by tariff reductions nor by quota increases.

In the case of Hungary the share of agricultural products imported from the CEFTA countries duty free, with multilateral concessions, with bilateral concessions and without concessions is almost the same, around 25%.

DEVELOPMENTS SO FAR

As presently within the CEFTA all industrial goods and 80% of agricultural goods are covered by preferential trade concessions, and 90% of industrial goods are traded freely, this — plus the enlargement of the CEFTA — had a significant trade creation effect: mutual trade among the CEFTA countries increased dynamically and the share of CEFTA in each others' exports and imports has increased.

In the case of **Hungary** (see Table 1) between 1993 and 1998 Hungarian exports to the CEFTA increased 4.44 times, while Hungarian imports increased 2.7 times. Consequently, the share of the CEFTA in the Hungarian exports increased from 6.8% to 8.9%, and in the Hungarian imports from 5.7% to 6.9%. The balance of foreign trade began to show an improving tendency.

Table 1

Hungary's foreign trade with the CEFTA (USD million)

Year	Exports	Imports	Balance
1993	459	650	–190
1994	563	896	–333
1995	757	982	–225
1996	1049	1257	–208
1997	1705	1534	171
1998	2039	1766	273

Source: Statistical Yearbook, 1998, Central Statistical Office, 1999, Budapest

As far as **Hungarian agricultural trade with CEFTA** is concerned (see Table 2), Hungarian agricultural exports to the CEFTA increased 2.7 times between 1991 and 1998, and the share of the CEFTA increased from 4.8% in 1991 to 12.7 % in 1998. This significant increase – besides the enlargement of the CEFTA – can be explained by the fact that Hungary follows an export-oriented agricultural development policy. Consequently, it is in her interest to find expanding markets for its agricultural and food products. Since as a consequence of the demise of the CMEA and the economic and financial crisis in the former Soviet Union, a part of her traditional Eastern European markets was lost and as the EU – in spite of signing the Association Agreement – failed to provide an expanding market, Hungary's main endeavour became to regain the lost Eastern European markets, including the markets of the neighbouring countries. In order to achieve this goal Hungary revitalised her traditional relations.

Table 2

Hungary's agricultural trade with the CEFTA-countries (USD million)

Year	Exports	Imports	Balance	Share in exports (%)	Share in imports (%)
1991	129	31	98	4.9	4.7
1992	192	28	164	7.2	4.0
1993	168	38	130	8.4	4.7
1994	218	44	174	9.3	4.1
1995	311	37	274	10.6	3.7
1996	354	32	322	12.9	3.4
1997	406	73	333	14.2	6.7
1998	352	91	261	12.7	7.6

Source: own calculations based on data of the Ministry of Agriculture and Rural Development

The **increase** of the Hungarian agricultural and especially food **exports** to the CEFTA can also be explained by the activity of **foreign capital** and **MNCs** in Hungary: as is known, by now more than 60% of the Hungarian food industry has been privatised by foreign capital and big international firms. FDI was attracted to Hungary not only by the natural and factor endowments of the country, like the market, the raw materials, the cheap and skilled labour force, etc., but by the proximity of the CEFTA-markets as well. All the more, as the production capacity of the MNCs active in Hungary exceeds the size of the Hungarian market, consequently their products are intended to be sold on the neighbouring countries' markets as well. Hence, the MNCs active in Hungary are very much interested in the enlargement of the CEFTA and in further trade liberalisation in order to make use of the economies of scale. It might as well be said that one of the driving forces behind CEFTA co-operation is the activity of foreign firms and MNCs.

Furthermore, **Hungarian capital** is also becoming more and more active in the different CEFTA countries, which also has a trade creating effect: while in 1996 USD 15 million Hungarian capital was exported to the CEFTA countries, in 1997 the Hungarian capital exports directed to this region reached USD 58 million. Sub-contracting in the food industry also contributes to the expansion of mutual trade.

While Hungary's **agricultural exports** to the CEFTA-countries increased dynamically, her agricultural imports stagnated till 1996, and started to increase in 1997 and 1998. One of the possible reasons for the stagnation and the low value of agricultural imports from the CEFTA countries is the fact that Hungarian agricultural imports from the EU have increased dynamically since signing the Association Agreement, consequently these imports crowded out the imports from the neighbouring countries. However, one should not forget that in most of the cases the competitiveness of CEFTA countries is lagging behind the EU and that the EU agricultural exports were heavily supported.

As a consequence of Hungary's dynamically increasing agricultural exports to the CEFTA countries and her stagnating and lately slowly increasing agricultural imports from the region, Hungary managed to maintain and even increase her **positive trade balance** in agricultural products. While in 1991 our agricultural trade balance has not reached USD 100 million, by 1997 the surplus exceeded USD 330 million. It should be noted that Hungary marked a surplus in the trade with all the CEFTA countries.

MOTIVES FOR AND OBSTACLES TO TRADE EXPANSION

The main catalysts behind the expansion of Hungarian agricultural trade with the CEFTA countries was not so much the reduction and/or elimination of tariffs and non-tariff barriers. Moreover,

* the search for less demanding though expanding export markets,
* the disappointment with the Association Agreement signed with the EU, the unsatisfactory export growth, the insufficiently expanding markets and improving market access,
* the inflow of foreign capital and the activity of multinational companies in the Hungarian food industry,
* the Hungarian capital exports and direct investments in the neighbouring CEFTA countries,
* the starting economic growth and conjuncture in Central Europe, which generated import demand,
* the poor performance of agriculture in some CEFTA countries (like in Poland), which also generated import demand, and
* the overvalued national currencies

all played a decisive role in the expansion of the Hungarian agricultural exports.

However, there are **obstacles** which could hinder the further rapid expansion of Hungary's trade with the CEFTA partners. These are as follows:

* the reluctance of some of the CEFTA countries to dismantle trade barriers and/or their inclination to erect new ones;
* the disagreement among the member countries concerning the interpretation of the safeguard and market protection regulations of the CEFTA;
* the preferences given to their EU relations and western purchases;
* the relatively lower competitiveness of their agricultural products: partners outside CEFTA offer agri-food products that are more competitive in terms of both prices and quality;
* just because of close geographical proximity, a comparable level of economic development, and a similar structure of agricultural and agri-food processing sectors, the commercial offer of the CEFTA countries is complementary to a small degree only (similar production structure, small differences in the production costs), and actually the offer is rather highly

competitive among the CEFTA partners (with the exception of such goods as wines or some fruits that cannot be grown in some of the CEFTA countries due to the climate);
* the lack of exportable surpluses in some countries;
* weak or undeveloped intra-industry and intra-enterprise co-operation, and
* the high share of intermediary trade due to the lack of proper trade financing.

FUTURE PROSPECTS AND EU ACCESSION

It is quite probable that the **mutual trade** of the CEFTA-countries will further increase due to their increasing domestic demand generated by economic growth, due to the further liberalisation of foreign trade and due to the establishment of the **Pan-European cumulation zone** in 1997.

Furthermore, the mutual trade of the CEFTA countries could also increase by the mere **enlargement** of the free trade area, as happened in the case of Slovenia's joining (January 1996) and in the case of Romania's (July 1997) and Bulgaria's (January 1999) accession. There are some other countries (Lithuania, Latvia, Macedonia, Croatia, the Ukraine, etc.) which have indicated their interest in joining the CEFTA, but they are unable to meet the criteria of accession. Namely, according to CEFTA regulations, conditions for gaining the status of a new partner are that the applicant has to be a member of the WTO and must have signed the Association Agreement with the European Union.

The original CEFTA Agreement was intended to limit its scope to industrial free trade plus concessions in the trade of agricultural products. Since 1992, however, attempts have been made to **enlarge the scope of co-operation.** The Czech Republic initiated the liberalisation of trade in services. The first agreements on liberalisation of services may involve mutual acknowledgement of technical certificates and measurement results. Poland suggested the liberalisation of labour force migration, but the idea was not accepted. Another Polish recommendation was to establish a CEFTA bank in order to finance regional investment projects. Slovakia repeatedly suggested the setting-up of CEFTA headquarters in order to institutionalise co-operation. None of these recommendations have been supported so far.

As the limits to free trade within CEFTA will be reached by the year 2000-2001, the question should be raised: what is the next step? In principle, there are three possibilities for the future development of CEFTA: **widening** co-operation by enlargement, **deepening** the integration by extending co-operation beyond mutual trade and/or **improving** co-operation within the present frame. Possibilities for the latter could be to decrease the relatively high share of intermediary trade, especially in the field of agricultural products by improving the financing of agricultural trade.

While CEFTA is getting to be more and more attractive for the presently non-CEFTA members, there is an imminent **danger.** What will happen to CEFTA and to intra-regional co-operation if it consists of or will be enlarged with such countries (like Slovakia, Romania, Bulgaria, not to mention Croatia or the Ukraine, etc.) which do not belong to the first group of candidates for EU accession? Will there be a split of interest among the CEFTA members even prior to accession or it will occur only afterwards? What will happen to CEFTA if in the first years of the next century most of its founders (hopefully the Czech Republic, Hungary, Poland and Slovenia) will join the EU? Will it be the end of the CEFTA?

As the main goal of the present CEFTA member countries is to become full-fledged members of the EU, there is a danger that with the selection of the first wave of candidates and with starting negotiations with them, an unbalanced situation will emerge within the CEFTA. The countries belonging to the first wave will most probably focus their attention to a higher degree on the EU, while less attention will be paid to the further development of CEFTA co-operation.

At the same time, the countries not having a chance to become EU members in the medium term will be more interested in CEFTA co-operation in order to be incorporated into the international division of labour. The split of interest will be present both prior and subsequent to EU accession.

SOCIAL, ECONOMIC AND TRADE POTENTIAL OF LITHUANIA

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After a long period under the conditions of the Soviet regime, Lithuania like many of the other countries of Central and Eastern Europe is making efforts to overcome social and economic backwardness, in order to adapt to the behavioral and moral patterns of a more democratic economic system. It is obvious that the mentality of people makes a tremendous impact on the behavioral patterns, functioning economic and social systems of the societies. During the 50 years under Soviet rule, the social culture of Lithuania developed with the enforcement of a sovietized ideological, political, social and institutional environment. The turn to democracy and market economy created a demand for adaptation to a new environment. The primary objective of this paper is to identify some indications of the legal and economic adaptability of Lithuania to the democratic environment of Europe and for the cooperation within Central European Free Trade Agreement (CEFTA), European Union (EU), World Trade Organization (WTO). A further assessment of Lithuania's readiness for cooperation with advanced businesses is also presented. The secondary objective of the paper is to provide an overview concerning the level of compatibility.

Four areas within legal and economic development during the period after the declaration of Lithuania's independence are reviewed in this paper.

I. TRADE LEGAL ENVIRONMENT

There are several levels of trade environment in Lithuania: local, regional (bilateral and multilateral) agreements and environment under the WTO regulations.

More than twenty national laws and nearly the same quantity of regulations compile the local trade legitimate basis of Lithuania. Legislation process in Lithuania over the years of independence is coordinated with the requirements of the EU.

Bilateral and multilateral agreements create a specific regional trade environment. Lithuania's bilateral free trade agreements are already in force with the Czech Republic, Hungary, Poland, Slovakia, Slovenia, Estonia, Latvia, Turkey, Ukraine, Bulgaria, Romania and other countries. Lithuania's free trade agreement with the EU is a good example of regional trade legal environment. For the moment Lithuania negotiates for entering WTO.

II. EFFORTS IN THE FIELD OF STATE PROPERTY PRIVATIZATION

Lithuania's privatization program has been at the core of the county's economic reforms. The first phase of privatization for the vouchers has already finished. This has not only economic but also social and moral meanings. During recent years, attention of the most active members of society was focused on the means of increasing their private property through the privatization of state-owned property. In 1990-1998, there was a trend of making money through the specific kind of business activities. There was no necessity to produce anything in order to gain profits. The process of privatization in order to obtain former state property, was conducted with no necessity to satisfy the needs of members of the society. Personal enrichment was completely based on the Soviet type of morals and behavior, i.e. getting access to the distribution of common property or funds granted as opportunities to increase one's private income without relevant investment and efforts.

In 1997 the privatization for the vouchers was completed, then followed the phase of the privatization of State and Municipal property for money. In November 1997, the Parliament of Lithuania adopted a new Law on the Privatization of State and Municipal Property. Under this

law, the state and municipal owned property can only be sold for currency. The law also concedes all investors (local and foreign) the same rights in acquiring state property.

The Lithuanian State Property Fund (SPF) was created in early 1998 as an executive institution responsible for the privatization of the remaining part of the state and municipal property. In 1998-1999, the Lithuanian Government has plans for privatizing a broad range of companies valued at close to 8 billion litas (2 billion USD).

The following companies, which were partly privatized by the end of 1998, were Mazeikiai Oil Refinery, Lithuanian Fuel Co, Birzai Pipelines, Lithuanian Tellecom. Lithuanian Airlines are on the list for privatization.

There are 6 methods of privatization in Lithuania.

- **Public subscription for shares:** The price is determined by the interaction of supply and demand. Shares can be sold on the National Stock Exchange of Lithuania (NSEL) through a state brokerage company or at a sale organized by the SPF.
- **Public auction:** Assets are sold to the bidder who has offered the highest price at a public auction.
- **Public tender:** Assets are sold to the bidder who offers the best proposal in a written tender, taking into account all the conditions of the privatization plan.
- **Sale by direct negotiation:** If only one bidder takes part in an auction or tender, or if no other bidders meet the criteria set by the privatization plan, the assets may be sold by direct negotiations between the SPF and the bidder.
- **Lease with the option to buy:** A public tender can be held for bids to lease assets for up to 25 years. The annual lease payment is determined by the privatization agreement.
- **Transference of the state or municipal control of an enterprise** by issue of convertible bonds or new shares from additional contributions, which may result in the reduction of state- or municipality-owned voting shares in the authorized capital of the company.

III. FOREIGN TRADE.

During the collapse of the Soviet union there were many initiatives and efforts to make big money through international trade activities. International commodity trade was the most profitable. The international trade of commodities flowing from East to West (oil, metal) and from West to East (basic consumer products) was highly lucrative, in the unstable social and economic environment. Border control of newly established countries was weak and many products were smuggled without any tax payments. Such kind of international trade activities were undertaken by the more aggressive and active individuals of the society along with the participation of ex-soviet functionaries. However, the reforms implemented by the state on control of the foreign trade restrained the quantity of illegal imports.

The foreign trade of Lithuania has been steadily increasing for the past years. Export of goods over the first half of 1998 constituted 2.1 billion USD and import of goods (calculated at f.o.b. prices) was 2.8 billion USD. During the first half of 1998 Lithuanian export volumes increased by 8.7% compared to the same period in 1997, while import volumes increased by 13.2%. Lithuanian imports still exceed exports and the trade balance remains negative. The trade balance of Lithuania with Baltic states and CIS in 1996-1998 was positive.

Table 1. **Foreign trade of Lithuania by direction, 1996-1998**
(Growth rates in per cent, trade balances in billion dollars)

Country and trade partner groups	EXPORTS			IMPORTS			TRADE BALANCE		
	1996	1997	1998	1996	1997	1998	1996	1997	1998[a]
World	24	15.1	8.7	24.9	23.8	13.2	-1202	-1784	-1024
ECE transition economies	34.1	13.8	5.5	8.2	16.3	8.9	-110	-182	-124
Baltic States	56.3	9.3	18.8	38.7	29.9	33.9	143	104	38
CIS	33.3	17.4	2.8	-2.2	10.4	-2	26	135	89
Eastern Europe	1.8	-11.7	n/a	43.5	29.1	28.7	-279	-421	-251
Developed market economies	10.3	15.4	16.8	43.5	31.9	21.8	-1010	-1537	-896
European Union	12.1	13.8	12.8	42.7	35.7	23.8	830	-1368	-820
Developing countries	17.5	44.6	-17.6	79.6	13.2	-46	-82	-66	-5

a) January-June
Note: Growth rates are based on trade values in terms of dollars

International trade of Lithuania with EFTA countries group remains low, but has a tendency to grow. In the year 1998 Lithuanian export to EFTA countries equaled to 3,93% of all export capacity, while imports volume were more then twice of export extent - 9%. (see Table 2)

Table 2. **The structure of commodity export and import of Lithuania by country group** (per cent)

	EXPORT		IMPORT	
	1997 I half	1998 I half	1997 I half	1998 I half
Total	*100,0*	*100,0*	*100,0*	*100,*
European Union	32,9	33,7	44,3	46,7
EFTA	1,4	2,3	1,7	2,1
CIS	46,4	43,4	31,3	26,3
Estonia and Latvia	10,8	11,8	3,0	6,5
Other countries	8,5	8,8	19,7	18,4

As we can see from the table 2 CIS and EU countries groups are the major trade partners of Lithuania. However, the trade with CIS countries has tendency to decrease while the trade with EU slightly increases. Trade and business of Lithuania with EFTA countries are still weak. Such situation rises for two reasons. Firstly, EFTA countries have not so much energetic resources and raw materials as CIS countries do, secondly, EFTA countries have not so well developed market as EU countries do. In such situation development of the trade relations can and should be based on the trade with industrial and final consumer goods.

IV. FURTHER PROSPECTS.

Since the sources of enrichment from the privatization and trade without government control are narrowing, more money, efforts and energy is going to be invested in the business based on the marketing principles. It means that business objectives is going to be reached by meeting consumers and customers needs. Positive shifts have been observed within the investment structure in the last several years (see Table 3).

Table 3. **Investment volumes and structure in the tangible assets of Lithuania**

	1994		1995		1996		1997	
	million LTL	per cent	million LTL	per cent	million LTL	per cent	million LTL	per cent
Total	2311.3	100.0	3162.8	100.0	4379.9	100.0	5488.3	100.0
Constructions	1005.5	43.5	1211.7	38.3	1539.6	35.2	1867.4	34.0
Equipment	486.4	21.0	876.6	27.7	1341.7	30.6	1785.0	32.5
Devices, machinery,inventory and vehicles	769.7	33.3	1009.3	31.9	1454.0	33.2	1795.7	32.7
Other expenditure	49.7	2.2	65.2	2.1	44.6	1.0	40.2	0.8

Data of the table 3 show that total investments in the tangible assets of Lithuania in 1994-1997 increased more than two times. Investment into constructions over the same years increase 1.8 times, into equipment 3.7 times and devices 2.3 times.

Growing of local and foreign investments, GDP growth rates by 5-6 per cent show positive changes in the economy and society of Lithuania. It makes a good base for farther development of the country and stabile movement toward joining European Union.

CONCLUSIONS

The legal environment of Lithuania is benevolent towards its entry to European Union and CEFTA.

The economy of Lithuania has been steadily and rapidly growing in the past years creating a lucrative climate for international trade and investment development.

The down sloping extent of trade with Russia is compensated by expanded trade with European Union and other countries. Nevertheless, Lithuanian businesses with CEFTA countries take a minor part and have been barely increasing compared to overall Lithuanian international trade.

CEFTA countries form instantly growing economic and trade area, which is very attractive and prospective for Lithuanian international trade growth.

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UKRAINE AND EUROPEAN INTEGRATION PROCESSES

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LADIES AND GENTLEMEN!

First of all, I would like to express my gratitude to the hosts and organizers for the invitation to participate in this Conference and their hospitality. It is a great possibility, being here, to give our opinion of the perspectives of CEFTA, its role and position in enlarging and integrating Europe.

But the main task of our participation in this Conference is to emphasize once more our choice to be a full member of the European family. We consider CEFTA as a very important structure in Europe and believe that close and productive cooperation between Ukraine and the countries of CEFTA will accelerate our integration into Europe.

That is why, Ukraine, watching the formation of a new trade regime near its borders, realizing the great potential of CEFTA, expedience of bilateral and multilateral cooperation between our countries does not want to be outside the orbit of European processes and declared its willingness to be a member of CEFTA.

We know the requirements for those countries, which want to join CEFTA. There are three major conditions, which we have not completed but should be done in purpose to have a real chance to be a CEFTA member. First: membership in GATT/WTO, second: existence of bilateral Free Trade Agreements with all CEFTA members and third: obtaining observer status in European Union.

It is not a short and easy way but we are full of determination to pass it as soon as possible.

Now, I would like to draw your attention to those efforts which Ukraine is making to complete the above-mentioned terms.

Firstly, I will mention in short on our bilateral economic cooperation.

Lately, the trade turnover between Ukraine and the CEFTA countries has considerably increased and reached 10 percent of the full value of Ukrainian international trade in 1998.

Analyzing the indexes of trade turnover from 1992 to 1998 we can point out that constantly increasing turnover with most of our trade partners of CEFTA last year rapidly decreased. It is not a tendency but rather a temporary situation caused by the global financing crisis, especially in Russia.

We are also not satisfied with the investment cooperation. Ukraine has huge potential and needs about $40 billion of investments. But investors are afraid to enter the Ukrainian market.

Now, there are some problems in the economic and investment climate but the president and the government of Ukraine are making all possible efforts to improve this situation and make it stable. The law of Ukraine on the foreign investment regime was adopted in 1996. This law guarantees equal rights for domestic and foreign investors, for protection and repatriation of investments etc.

We believe, our countries have great unrealized potential in economic cooperation and our efforts directed on the liberalization of the trade conditions and rules will help us to reach economic prosperity as well as political and social stability in our common house called Europe.

We have to realize the exceptional strategic location and economic potential in order to meet the challenges of the globalization age adequately with dignity, to adapt to its requirements and ensure peace, stability and security in the region. This is our common mission for the future.

TRADE TURNOVER BETWEEN UKRAINE AND THE CEFTA COUNTRIES 1992 —1998.

$, Million

	1992	1993 (93/92)	1994 (94/93)	1995 (95/94)	1996 (96/95)	1997 (97/96)	1998
Poland	189.6	221.3 (+16.7%)	358.1 (+61.8%)	714.5 (ca100 %)	827.2 (+15.8%)	949.7 (+14.8%)	**799.3**
Hungary	259.9	189.0 (–27.3%)	247.2 (+30.8%)	412.7 (+66.9%)	494.9 (+19.9%)	581.7 (+17.5%)	**458.6**
Slovak Republic	–	130.1	257.5 (ca100 %)	317.6 (+23.3%)	392.9 (+23.7%)	482.9 (+22.9%)	**415.1**
Czech Republic	–	104.4	173.6 (+66.3%)	264.2 (+52.2%)	340.8 (+29.0%)	404.5 (+18.7%)	**380.1**
Bulgaria	497.1	228.5 (–54.0%)	278.5 (+21.9%)	289.5 (+3.9%)	255.0 (–11.9%)	303.4 (+18.0%)	**305.8**
Romania	66.5	172.3 (ca160 %)	188.6 (+9.5%)	314.0 (+66.5%)	230.0 (–26.8%)	242.9 (+5.6%)	**208.8**
Slovenia	–	11.1	33.0 (ca200 %)	35.3 (+7.0%)	40.7 (+15.3%)	73,4 (+80.3%)	**65.5**

Ukraine is ready and constantly initiates negotiations about the possibility of bilateral trade liberalization.

So, the Memorandum on measures directed toward trade liberalization between Ukraine and Poland was signed on 23 of January 1997.

Concrete propositions about eliminating technical, tariff and non-tariff barriers etc. as a result of this Memorandum should be prepared for governments of our countries. For this purpose seven working groups have been created. Four meetings of working groups took place.

Similar Memorandums have been signed with Hungary (November 1997) the Slovak Republic (March 1997), the Czech Republic (September 1998).

The next important requirement for CEFTA membership is to be an EU observer. It is very important that Ukraine feels EU support in our willingness to become a full member of the EU in the future.

The European choice of our state is caused by our comprehension of the necessity of integration to the EU as an important factor of state independence, safety, political stability, economic development and social consent in a society.

Current relations between Ukraine and the EU are based on a wide political and legal base. The Agreement on partnership and cooperation between Ukraine and EU signed on 14 June 1994 and ratified on 10 November 1994 became a basis of bilateral relations.

This Agreement entered into force on 1 March 1998 and provided a wide range of political, economic and humanitarian matters and is the legal basis of full-fledged integration of Ukraine into Europe.

The Agreement became an important landmark in the evolution of relations between Ukraine and the EU since Ukraine gained its independence in 1991. It was a significant stage on the way

to recognizing Ukraine not as part of the former Soviet Union but a sovereign Central-Eastern European State, which should be a full member of European society and an important factor of stability and security in Europe.

Economic cooperation occupies a significant part in relation to Ukraine-EU relations. Today, the trade turnover between Ukraine and the EU averages out about 30 percent of the full international trade of Ukraine in 1998.

DEVELOPMENT OF UKRAINE-EU RELATIONS GOES ON IN THE FOLLOWING FIELDS:

providing of mutual benefit conditions for goods access on Ukrainian and the EU market in order to balance foreign trade gradually;

revision of anti-dumping investigation maintained by EU;

providing of most preferable regime for EU investments in Ukraine and for Ukrainian exporters on the EU market;

help for Ukraine on the way to joining GATT/WTO;

implementation of single standards of state support for domestic producers;

mutual elimination of quotas for imports and exports.

During 1994-1998 great achievements have been reached in Ukraine-EU understanding and we are approaching the resolution of major problems in bilateral relations.

The first session of the Council for cooperation between Ukraine and the EU took place on 8-9 June 1998. During this session Ukraine officially declared its wish to become an associated member of the EU.

The Strategy of Ukraine integration into EU was adopted by the Decree of the President of Ukraine on 11 June 1998. This strategy determines the main directions of state institutions' effort to achieve the status of an associated member of EU, first, and full membership in future.

The next important step on the way to Ukraine's integration into the EU was the Decree of the President of Ukraine signed on 9 February 1999. This Decree affirms a range of measures directed toward adaptation of Ukrainian legislation to EU requirements.

Among others important events of the integration process I should highlight the establishment of the Ukrainian-Polish Conference, the first meeting of which took place in Poland on 29 march 1999. The work of this Conference directed toward acceleration of both countries' movement to the EU.

When discussing the future of Europe and the place of Ukraine in it, I would like to stress that we cannot leave without heeding the prospects for developing versatile forms of regional cooperation, a good example of which may be the Black Sea Economic Cooperation (BSEC).

Allow me to give you a brief overview of ideas concerning developing the cooperation of Black Sea region countries from the time of signing the Istanbul Declaration to the entry into force of the status of the BSEC as of a full-fledged international organization.

This structure was born 1992 upon the initiative of Turkey, when the heads of state and government of Azerbaidjan, Albania, Bulgaria, Armenia, Georgia, Moldova, Russia, Romania, Turkey and Ukraine confirmed the interest of their nations in joint solving both regional and, in some measure, internal problems by signing the declaration concerning the establishment of the Black Sea Economic Cooperation. The idea of building the multi-vector cooperation of Black Sea region countries became a real expression of contemporary tendencies of international economic cooperation.

The above initiative, as underlined in the Declaration of the participating countries, was initiated, first of all, in order to create necessary preconditions for a large-scale integration of the Black Sea region into the world economy.

The Declaration provided for comprehensive all-embracing and bilateral cooperation in different fields of economic development: industry, agriculture, transport, trade, communications, medicine, ecology, tourism and customs regulations. The Declaration also identified the support of duty-free trade, private business, free movement of capital and services, creation of free-trade zones, commercial information exchange, new technologies, real harmonization of the programs for protection of the Black Sea from pollution.

The BSEC is, first of all, a mechanism for the interaction of government and business which has to provide for the development of comprehensive economic cooperation of participating countries within the framework of a course to full-scale integration into the all-European economic space.

It is necessary to underline the exceptional role of business structures, which have proved to be an original locomotive of the Black Sea initiative, in expanding the scale of cooperation. In this context it seems expedient to create the most favorable conditions for them, also through the way of interaction of business circles into the Business Council of the BSEC.

Ukraine is also making its contribution into the enlargement and enhancement of cooperation within the BSEC framework. Specifically, it has proposed to set up a common investment space, common market of investment projects, and harmonize the legislation of the BSEC countries with the aim of eliminating the obstacles in the way of mutually beneficial cooperation.

A decisive moment in the development of the initiative for enhancing cooperation among countries of the Black Sea region was the signing, in June 1998 at the Yalta Summit, of the Charter of the BSEC Organization — the document which transforms the existing intergovernmental mechanism of cooperation into a regional economic organization of its own.

The signing of the Charter of the BSEC Organization is not only a formal act, which creates an international legal framework for the transformation of the Black Sea initiative into an organization. It is, first of all, the recognition of the correct course towards the development of mutually beneficial good-neighbourhood relations based on principles specified by the Istanbul declaration.

This is a good example of regional cooperation based on principles of mutual benefit. An interest of many countries to get observer status in BSEC shows us the real perspectives of this organization.

At the end, I would like to stress the following. In the world, where integration tendencies prevail, creation of regional and sub-regional organizations or initiatives is a tool for achieving our common goal – a full-scale accession to the system of world economy. In this content we recognize the important role of CEFTA in Europe and believe that in the future Ukraine, being among other CEFTA countries, will become a full member of a united Europe of the 21st century.

Thank you for your attention.

FOREIGN DIRECT INVESTMENTS: CZECH REPUBLIC, HUNGARY AND POLAND IN NINETIES

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1) Speeding-up of the world economy globalization has been stressing the role of foreign investments which has been supporting concentration processes aiming at raising competitiveness and penetration to new markets. Moreover, foreign financial sources are inevitable for sustainable long-term economic growth in transition economies of Central Europe since domestic sources are still very limited. Foreign investments have been thus playing an important role in addressing the capital shortage related to low domestic savings and limited financial intermediation. Foreign direct investments (FDI) have been playing key role in this respect, being the only part of foreign capital staying in the domestic economy permanently. Evidence for emerging markets in general indicates that FDI inflows complement rather than substitute for domestic investment — in other words, one dollar's worth of FDI may generate more than one dollar's worth of investment in the economy. FDI contributes to the transition and economic performance across the region in three major ways:

- FDI may directly increase capital accumulation,
- FDI raises the productivity of the enterprise sector and benefits export performance,
- FDI generates technological and organisational benefits for domestic suppliers and competitors.

2) The total inflow of foreign direct investments to Central and Eastern Europe and Rusia exceeded USD 60 bill. to the end of 1997. Across the region, privatisation policies have been a significant determinant of trends and fluctuations of FDI flows. This makes for the main part of the difference in the FDI inflow between the Czech Republic and Hungary. Table 1 indicates that the total inflow of FDI per capita was doublefold in Hungary than in the Czech Republic as well as the ratio between FDI and GDP up to 1997. The early start of the Hungarian cash-based privatisation programme largely explains the FDI inflows after the onset of the transition. In the period 1993 - 1995, privatisation proceeds in Hungary accounted for 85 % of FDI inflows into the region. In the latter year, FDI inflows into the Czech Republic also experienced a significant increase, driven by the privatisation of the SPT Telecom and a large oil refinery (jointly accounting for 60 % of inflows in 1995). Comparison of the Czech Republic with Poland shows that the cumulative 1990 - 1997 inflow of FDI to Czech Republic per capita was twice as high than to Poland, the ratios to GDP being comparable.

3) Data on sectoral distribution of FDI to Eastern Europe and Russia reveal that manufacturing remains the single largest sector, accounting for 40-60 % of the FDI in individual countries. However, FDI into the service sectors has been becoming increasingly important as a result of liberalisation and privatisation in telecommunications and electricity distribution. In the Czech Republic, Hungary and Poland substantial foreign investments have been also taking place in financial services.

Total inflow of FDI to the Czech economy amounted to USD 10.5 bill. until the end of 1998. More than two thirds of FDI belong to manufacturing industry, measured by share on total equity. Within the manufacturing industry the car industry has the leading position with controlling approximately two thirds of production and one third of labour force.

The European Union accounts for most FDI flows into the region. In central Europe it accounted for more two thirds of all FDI inflows. In the Czech case, Germany has the leading position followed by the Netherlands and USA (see Table 5) .

4) The benefits from FDI are not only derived from its quantity, but also from its quality. Most important area is enterprise restructuring and productivity, corporate governance and marketing activities. Foreign investors tend to restructure companies more quickly than state-owned or domestically privatised firms. Aggregate evidence for the Czech Republic, Hungary and Poland shows that foreign-owned enterprises invest more, operate more capital intensively and have higher labour productivity than the domestic entreprise sector.

Czech studies indicate that companies with foreign participation pay better wages (in average by 25 %). These companies therefore attract more qualified workers so that their position is supported by human capital as well. Domestic companies reach only about 65 % of labour productivity compared to companies under foreign control. Foreign-owned enterprises in the whole region also export more, which is particularly important in the present context, since it suggests that current account deficits may be transitory.

5) The ratio between the current account deficit and net inflow of foreign direct investments represents an important indicator of manageability of external imbalance. The generally acknowledged "safe ratio" is 50 %. Development of this indicator in the Czech Republic and Hungary present Figures 1 and 2. This indicator did not reach safe levels in 1996 and 1997 in the Czech Republic, but has been improving rapidly during 1998 due to both developments on the current account and quite strong inflow of foreign direct investment. The net inflow of FDI was more than two times higher than the current account deficit in 1998.

In Hungary, safe level was not reached in 1994 only. In the period 1995-1998 the FDI inflows were able to cover the current account deficits fully or almost fully. Poland manifested surpluses on the current account in 1992, 1994 and 1995. The deficit in 1996 did not reach half of the FDI inflow. 1997 and 1998 show some deterioration; level of the indicator (ratio between FDI and current account deficit) reached 72 % in 1997 and estimate for 1998 amounted to only 62 %, which suggests possible problems for the future.

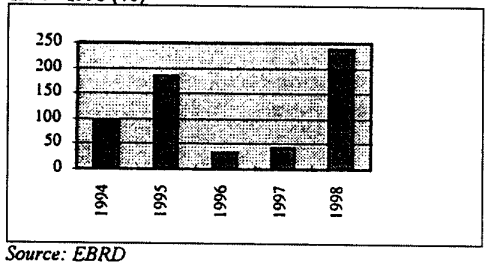
6) The FDI inflow implies also certain costs. Repatriation of profit burdens the current account (namely the balance of incomes) as well as some costs associated with the FDI inflow deteriorate the balance of services due to so called other services (including banking, insurance, advertisement, law etc.). These two factors represent permanent burden for the current accounts in the transition economies, their impact however not being very significant.

7) Some more details about FDI in the Czech Republic. Analyses made by KB showed that the FDI 1993-1997 inflow manifested increasing trend with constant seasonality: the values of the inflow were low in the first and second quarters, third quarters witnessed speeding up and the last quarters showed highest inflow (see Figure 3). The 1998 development confirmed these findings; therefore it was hasty to talk about dangerous slowdown of the FDI inflow, as many Czech economists did in spring and summer of 1998. Our favourable forecast from June 1998 was even exceeded, total 1998 FDI inflow reaching USD 2.5 bill (CZK 82 bill). The change in the structure of investment is notable as far as the size of investment is concerned.

8) The adoption by the Czech Government of the system of incentives in 1998 helped to reduce the comparative disadvantage to other CEFTA countries. However, the potential of the Czech Republic in this respect is much higher and the Government should promote the FDI inflow by finishing privatisation of Czech banks and other non-financial companies under the NPF control. Notable recovery of FDI inflow in 1998 may be also a consequence of West European economic slowdown: the tendency to export capital is much stronger in the period of recession than in the period of strong economic growth, which had confirmed recent years.

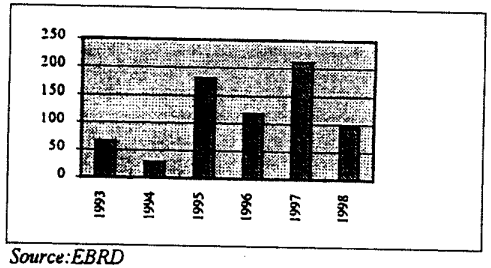
Given the importance of FDI for restructuring and long-term sustainable economic growth, credibility of the country is of vital importance. The *sine qua non* are both political and economic stability. Keeping both the external and internal imbalance within generally acceptable limits (which is not so easy as the recent years have shown) is therefore crucial. Establishing of the appropriate legal and institutional framework for the economy is inevitable, as well.

Figure 1: Ratio between FDI and Current Account Deficit in the Czech Republic, 1994 - 1998 (%)



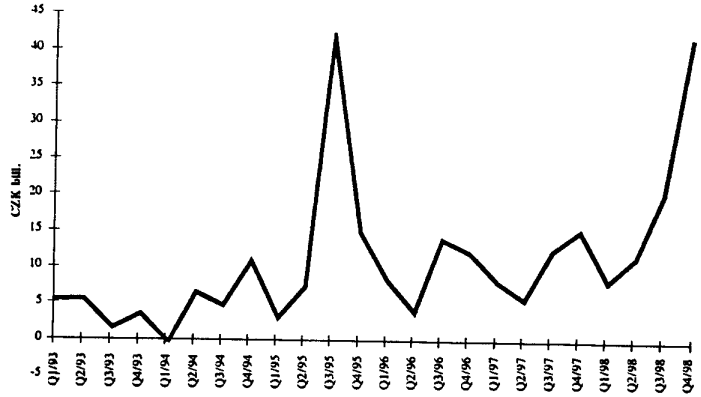
Source: EBRD

Figure 2: Ratio between FDI and Current Account Deficit in Hungary, 1993 - 1998 (%)



Source:EBRD

Figure 3: The Development of Foreign Direct Investments in the Czech Republic (CZK bill.)



Source: Czech National Bank

Table 1: Comparison of FDI inflow, Czech Republic, Hungary and Poland

Country	Cumulative inflow of FDI 1989-mid1998 (USD bill.)	FDI per capita , 1989 - mid 1998 (USD)	FDI (in % of GDP) 1997
Czech Republic	7.5	823	2.4
Hungary	18.0	1765	4.6
Poland	22.6	581	2.2

Source: EBRD

Table 2: FDI Inflows into the Czech Republic, Hungary and Poland, 1991 - 1997 (yearly values, USD mill.)

Country	1991	1992	1993	1994	1995	1996	1997
Czech Republic	**0.594**	**0.999**	**0.561**	**0.862**	**2.558**	**0.143**	**1.300**
Hungary	1.460	1.48	2.35	1.14	4.52	1.98	2.1
Poland	0.291	0.678	1.72	1.9	3.7	4.5	3.0

Source: Czech National Bank, EBRD

Table 3: FDI in the Czech Republic, Individual Industries (yearly values, USD mill.)

Industry	1991	1992	1993	1994	1995	1996	1997	1998
Total	**593.8**	**999.3**	**561.0**	**862.4**	**2558.5**	**1428.4**	**1300.4**	**2539.6**
Transport and communications	0.0	0.0	0.0	63.1	1351.6	183.7	0.6	295.2
Consumption industrial goods and tobacco	38.6	274.1	241.6	59.1	179.6	162.2	169.7	n.a.
Banking and insurance	64.0	100.0	54.8	132.3	65.5	33.2	297.5	471.6
Construction	0.0	211.1	64.0	107.8	68.2	121.0	38.1	n.a.
Chemistry	41.6	69.0	19.1	43.6	89.8	337.0	50.8	n.a.
Food industry	0.0	175.9	34.9	71.1	121.6	73.0	91.8	120.8
Transport equipment	420.3	16.5	9.8	265.9	308.2	20.7	16.1	n.a.
Trade and services	19.0	47.3	39.8	35.0	147.5	282.8	166.8	724.7
Others	10.3	105.4	97.0	84.5	226.5	214.8	469.0	927.3

Source: Czech National Bank

Table 4: FDI in the Czech Republic, individual industries (cumulative values, USD mill.)

Industry	1991	1992	1993	1994	1995	1996	1997	1998
Total	**593.8**	**1593.1**	**2154.1**	**3016.5**	**5575.0**	**7003.4**	**8303.8**	**10843.4**
Transport and communications	0.0	0.0	0.0	63.1	1414.7	1598.4	1599.0	1894.2
Consumption industrial goods and tobacco	38.6	312.7	554.3	613.4	793.0	955.2	1124.9	n.a.
Banking and insurance	64.0	164.0	218.8	351.1	416.6	449.8	747.3	1218.9
Construction	0.0	211.1	275.1	382.9	451.1	572.1	610.2	n.a.
Chemistry	41.6	110.6	129.7	173.3	263.1	600.1	650.9	n.a.
Food industry	0.0	175.9	210.8	281.9	403.5	476.5	568.3	689.1
Transport equipment	420.3	436.8	446.6	712.5	1020.7	1041.4	1057.5	n.a.
Trade and services	19.0	66.3	106.1	141.1	288.6	571.4	738.2	1462.9
Others	10.3	115.7	212.7	297.2	523.7	738.5	1207.5	n.a.

Source: Czech National Bank

Table 5: FDI in the Czech Republic, Individual Countries (yearly values, USD mill.)

Country	1991	1992	1993	1994	1995	1996	1997	1998
Total	**593.8**	**999.3**	**561.0**	**862.4**	**2558.5**	**1428.4**	**1300.4**	**2539.6**
Germany	442.4	157.6	82.0	417.3	568.1	248.8	391.3	537.6
Austria	37.3	40.4	55.0	79.5	87.5	207.7	95.0	244.7
USA	54.4	288.1	255.0	39.4	101.2	252.0	99.2	257.8
Italy	1.5	66.0	11.9	11.5	42.8	89.6	-35.9	n.a.
Belgium	33.1	87.6	32.0	32.4	25.1	57.1	55.8	n.a.
Switzerland	1.6	79.7	13.5	39.3	679.5	55.3	47.0	n.a.
France	15.7	223.1	34.0	76.9	167.7	19.9	101.8	n.a.
the Netherlands	7.8	5.0	29.6	5.8	737.0	258.8	133.8	608.3
Others	0.0	51.8	48.0	160.3	149.6	239.2	412.4	891.2

Source: Czech National Bank

Table 6: FDI in the Czech Republic, Individual Countries (cumulative values, USD mill.)

Country	1991	1992	1993	1994	1995	1996	1997	1998
Total	**593.8**	**1593.1**	**2154.1**	**3016.5**	**5575.0**	**7003.4**	**8303.8**	**10843.4**
Germany	442.4	600.0	682.0	1099.3	1667.4	1916.2	2307.5	2845.1
Austria	37.3	77.7	132.7	212.2	299.7	507.4	602.4	847.1
USA	54.4	342.5	597.5	636.9	738.1	990.1	1089.3	1347.1
Italy	1.5	67.5	79.4	90.9	133.7	223.3	187.4	n.a.
Belgium	33.1	120.7	152.7	185.1	210.2	267.3	323.1	n.a.
Switzerland	1.6	81.3	94.8	134.1	813.6	868.9	915.9	n.a.
France	15.7	238.8	272.8	349.7	517.4	537.3	639.1	n.a.
the Netherlands	7.8	12.8	42.4	48.2	785.2	1044.0	1177.8	1786.1
Others	0.0	51.8	99.8	260.1	409.7	648.9	1061.3	n.a.

Source: Czech National Bank

FOREIGN DIRECT INVESTMENT IN EAST-CENTRAL EUROPE

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Foreign direct investment appears as one of the brightest spots in the economic transformation of east-central Europe. Figures from different countries consistently show that firms under foreign ownership are performing better in most important measurable indicators. Analyses of the effects of different forms of privatisation often suggest that sale to a foreign owner is the firmest basis for future success. From this can follow the argument that maintaining high rates of growth depends on measures to attract more inward investment.

The argument in this contribution is that attracting inward investment is important and valuable, but the issue is not simply one of finding the best means to attract more FDI. Experience elsewhere shows that measures geared specifically to attracting multi-national companies are hardly ever adequate to ensure the development of a modern, advanced economy. The problem for policy makers is also to find the best means to attract the right kind of FDI and to ensure that it brings the maximum possible benefit to the host economy. Although this would appear a crucial issue both for researchers and policy makers, it becomes clear from international comparisons that there is no simple answer.

COUNTRY COMPARISONS

Comparisons between countries show no simple relationship between economic development and FDI. A comparison across Asian 'tiger' economies is particularly remarkable, showing examples of what could be considered two extreme approaches to inward investment. Singapore has experienced consistently high levels of inward direct investment, running at around 10% of GDP through the 1980s and early 1990s and giving an inward direct investment stock to GDP ratio of over 50%. For South Korea the comparable figures were under 1% and barely over 2% respectively (calculated from UNCTAD, various). South Korea's difficulties may have been exacerbated by dependence on borrowing rather than FDI, but the point remains that there are alternative roads to development. Modern, high-tech industries could be developed with the appropriate policy framework by the assimilation of technology by domestically-owned firms or by the attraction of the right kind of FDI (Myant, 1999b).

Three further points can be made on this international comparison.

1. Both 'extreme' strategies require an active role from the state and some key elements are very similar, with the need for an excellent infrastructure and high levels of education, geared towards the development of similar kinds of modern industries. The numbers in higher education in South Korea increased from 0.6% of the population in 1970 to 4.2% in 1992.

2. Evidence shows how few countries can attract enough FDI to make this a basis for growth. Most FDI both comes from and goes into countries that are already developed. Those that can grow, or achieve a substantial restructuring, on the basis of inward investment generally have good starting conditions, in terms of language, location, skill levels and government policies.

3. Even where FDI is sought as a major part of an economic development strategy, it almost always appears to be inadequate on its own. There are criticisms that it can lead to the persistence of a dual economy, with a highly competitive, high-growth foreign-owned sector while the domestically-owned sector appears to have gained little (eg for Ireland, OECD, 1994b). Recently there has been a greater emphasis on encouraging the development of domestically-owned firms across EU countries.

East-central Europe does not fit into either of the two 'extreme' versions outlined above. Inward direct investment has reached levels that are very respectable when set against GDP compared at current exchange rates. Figures cannot be taken too precisely in view of the difficulties in

defining FDI and of interpreting a stock built up over a period of time with changing exchange rates and price levels. Nevertheless, by 1997 the average foreign investment stock across the five original CEFTA countries was 17.0% of GDP. For Hungary the figure was 39.4%, for Poland 11.8%, for Slovakia 7.7% , for Slovenia 14.8% and for the Czech Republic 15.4% (Knell, 1999). The figures would be reduced and the ordering changed slightly if PPPs are used, with the Czech Republic and Slovakia looking somewhat less impressive. For comparison, the figure for the UK in 1992 was 16% while for Ireland and Holland it was 10% and 27% respectively. Using figures for the percentage of employment in foreign-owned firms in manufacturing alone for 1996 shows Hungary on 36.1, Slovakia on 11.7, Slovenia on 10.1 and the Czech Republic on 13.1. For comparison, it is estimated that about half of Ireland's industrial employment is in foreign-owned firms while the figure for Scotland in the early 1990s was slightly over 20%.

Three comments are relevant on these figures.

1. Inward investment is concentrated into similar sectors in all countries. It is strong across the region in motor vehicles. It is also particularly strong in Hungary in electronics and parts of the chemical industry. Broadly speaking, investment has come in those sectors that are dominated by multinational companies elsewhere in the world.

2. Hungary's position appears from these figures to be quite exceptional, appearing high even by western European standards. It is possible that Hungary has created the best basis for the future, with more evidence of a switch towards modern sectors of manufacturing based around inward investment, but that has yet to be clearly reflected in overall economic performance.

3. These figures partly reflect preferences of investors, but they also reflect clear policy differences. Czech privatisation took a form that at first effectively limited foreign ownership to firms that did not require major restructuring: in many other cases foreign bidders were effectively kept out. Voucher privatisation has subsequently created scope for entry by acquisitions while governments were slow to develop measures to attract investment on greenfield sites. Hungarian privatisation gave more scope for the entry of foreign firms. Greenfield investment also appears to have been more important in Hungary and Poland than in other CEFTA countries. Some surveys suggest that these forms predominated in Poland at least in the early years (OECD, 1994a). A common form in Poland, clearly encouraged by government policies, has been an assembly plant for the domestic market using a large share of imported components.

FORMS OF FDI

Assessing the impact of FDI within a country is inevitably difficult as there is no way of knowing what would have happened without it. It is also fairly obvious that distinctions should be made between different types of investment.

One line of division is between acquisitions and greenfield investment, although there is overlap where an acquisition becomes a basis for a major restructuring. Greenfield investment is generally viewed most positively as it brings employment, output and export potential, but there may be some loss to the local economy if there are limited supplies of skilled labour, and the investment may have been expensive to attract. Studies of inward investment by takeovers and mergers suggest that they bring benefits of improved financial techniques, better management and marketing skills, but these may be a outweighed by a reduction in linkages into the local economy (Young, Hood & Peters, 1994).

Another line of distinction is between investment in a plant to fulfil a single role within a multinational company's plans, such as production of a particular component or assembly for a definite market, and investment in a subsidiary that has greater autonomy, including for example responsibility for research or marketing within a particular area. Concern over the prevalence of the first type in UK regions led to the once-popular notion of the 'branch-plant syndrome'. Branch plants were associated with de-skilling and the absence of 'head-office' functions. They were also the most likely to close when the parent company experiences difficulties, particularly when a branch plant was simply an addition to a firm's production capacity elsewhere (Fothergill & Guy,

1990). As a result, regions relying on inward investment may find themselves continually having to attract replacements for those firms that close their operations.

In so far as inward investment in east-central Europe was linked to privatisation, it typically took the form of acquisition of a going concern, albeit one facing difficulties. The list of benefits noted in studies elsewhere from this kind of inward investment therefore apply with much greater force. The danger remains the breaking of links with the domestic economy and conversion into an isolated branch plant.

BROADENING THE BENEFITS

FDI is not evenly spread across all sectors. Theory on multinational companies generally suggests that they will invest and manufacture rather than trading with a country where there are definable 'firm-specific advantages'. These include access to specific technology, brand names, image, access to a sales network and managerial ability to organise production. The impact on the local economy will also vary with firms bringing technology and organisational innovations most likely to boost export potential.

Recent thinking on competitiveness has emphasised the importance of firms cooperating and learning from each other (eg Porter, 1990). The key questions then become the extent to which the inward investor links into local economic networks, brings benefits to other firms and possibly even becomes the nucleus for a 'cluster' of successful firms in related activities.

'Spillover' benefits have rarely been studied in detail. A novel attempt uses a methodology tested in developing countries. East-central Europe shows a fairly consistent aggregate productivity gap, with domestic-owned firms running at around half the productivity of those under foreign ownership when a gross output figure is used. Spillovers ought to be reflected in convergence. There appears to be no such general trend, although it may be occurring in some sectors (Knell, 1999).

The exact mechanisms of gains from spillovers require further research. They are likely to vary between sectors. In some cases there may be direct technology transfer, for example into component suppliers, but in others benefits are less direct. Firms in the food and drink industry, for example, may bring specific products, financial strength and a famous brand name, but they rarely bring new technology: that is typically embodied in equipment that is universally available. Thus in the Czech Republic there has been some inward investment in milk processing, with Danone manufacturing yoghurts. Remarkably, they have adapted the product to Czech tastes: the benefits to the domestic economy are at best small and might have been available had the milk-processing industry undergone a more effective restructuring under domestic ownership. Similarly in brewing, foreign-owned firms do little different from those under Czech ownership. They have not obviously encouraged innovative methods in production, marketing, organisation or other aspects of management activity, although they benefit from greater financial strength (Myant, 1999a). There is therefore little likelihood of substantial spillovers.

Two sectors with much greater potential for spillovers are motor vehicles and electronics. In both of these a final product depends on a large number of components and hence on complex networks of supplying firms. There is therefore great potential for wider benefits to the domestic economy. There is also the possibility that the domestic economy may not be able to reach the required standard and the inward investment will remain a branch plant assembling a final product and liable to close when the firm faces difficulties.

Precisely such cases have led to a recognition of the importance of 'clusters' around inward investment, but it seems extremely difficult to devise appropriate, specific policy measures. Development agencies can try to promote contacts between local and incoming firms but, very often, creating a 'cluster' means attracting more, related inward investment. Motor manufacturers are more likely to seek local sourcing, but often from branches of multinational companies. Electronics firms seem happier to import parts over long distances.

The Czech motor industry is an example of the difficulties in maintaining, let alone developing,

a 'cluster'. The initial conception when Volkswagen took over the Škoda car manufacturer was that this would lead to investment in the parent company and maintain and increase output from existing component suppliers. Networks from the past would broadly be maintained and Volkswagen seemed keen to encourage improvements in its component suppliers, often helping them to find foreign partners. In the longer term, however, the inherited structure could not be maintained, particularly in view of Volkswagen's strategy of common sourcing of parts. Škoda output is anyway insufficient to support sophisticated component manufacture and successful firms had to look to expand their markets. The result, then, has been a more complex pattern in which Škoda uses a large share of imported components while many of its former suppliers have found markets with other manufacturers. A 'cluster', in the simple sense of a self-contained network, was not a realistic target.

POLICY OPTIONS

There is a long history of countries and regions devising particular financial incentives to inward investors, but the available evidence from surveys and econometric studies suggests that they are not particularly important in determining a firm's decision (Young, Hood & Peters, 1994). Other factors dominate, such as location, infrastructure and the quality of the labour force. Nevertheless, the quality of the direct incentive package is important in deciding between sites that would otherwise be equal. There is therefore a lot of competitive bidding. Countries in east-central Europe have been catching up with western Europe in this respect.

There may be a tendency within the EU for the level and form of incentives on offer to converge in line to some extent with constraints imposed by competition policy. Poland will be expected to phase out special enterprise zones by the year 2003. It has so far established 17 such zones with 20 years of generous tax incentives. The most successful, in Katowice, has attracted a major investment by General Motors in an engine plant, but some others appear to have attracted no investors at all.

As has been indicated, attracting FDI, ensuring that its potential to help the domestic economy is exploited to the full both depend to a great extent on a policy framework that also helps domestic firms. They are not alternatives. Nevertheless, choices do have to be made between broad strategies. The 'Korean' road is probably not feasible in the high-tech sectors. Development of modern consumer electronics and motor vehicle industries depends on the attraction and maintenance of inward investors and on the means to encourage them to link into the domestic economy and educational and research infrastructure where possible. In other sectors, however, the need for FDI is not always obvious and there can be real benefits in developing one's own domestic firms where possible. FDI can be an important part of economic development, but it is not a substitute for other forms.

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THE ROLE OF FOREIGN DIRECT INVESTMENT IN THE PROCESS OF TRANSFORMATION OF THE CEFTA COUNTRIES[1]

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The main objectives of the presentation are, on the basis of global FDI flows, to characterize the features of the flows into Central and Eastern European countries, first of all into CEFTA countries; to analyze FDI inflows and stocks into CEFTA countries in 1997 (1998 respectively) according to the territorial origins of investors, industries into which FDI has been coming, etc. Apart from conditions under which increasing FDI inflows could be attracted, the interdependence of FDI inflows and the process of privatization in the CEFTA countries has also been analyzed. The contributions of FDI inflows to CEFTA countries' economic growth and restructuring has been offered as well. FDI inflows as a criterion of transformation success and as a source of increasing standards of living has been investigated in the presentation as well. The CR, host country and investor have also been interpreted. Investment incentives in the CR and other CEFTA countries are mentioned.

1/ FOREIGN DIRECT INVESTMENT (FDI)

There are many definitions of foreign investment in economic theory. I would like to add the approach under which foreign investment could be judged as the acquisition by governments, institutions or individuals in one country of assets of another /1/. Foreign investment is defined to cover both direct investment and portfolio investment and includes both public authorities and private firms and individuals. For a country in which savings are insufficient relative to potential demand for investment, foreign capital can be a positive factor stimulating higher growth. Foreign direct investment (FDI) is a specific form of international capital flow, more long-term, more company-related than portfolio investment. Direct investment may be a means of financing the balance of payments deficit which might occur in response to an increase in domestic demand. Direct investment often involves the setting-up of subsidiary companies for the domestic production of goods or services which previously were imported from the parent company.[2]

[1] This presentation is based on information from the World Investment Report /1998/, The Vienna Institute for Comparative Economic Studies, other information mentioned in a lot of various specialized journals - primarily foreign sources and on my personal experience and knowledge which I obtained during my work in the Foreign Department of the Czech National Bank. I have collected the results of several articles I published in the Czech journals *Banking* and *The World of Economy* in the past several years. Statistics concerning FDI Inflows to CR were received through the assistance of the CNB.

[2] Eurostat and OECD /2/ have defined FDI as: *Foreign Direct Investment* means 10% or more of the foreign investor's share in a company's fixed equity. One of the conditions is the investor's continued interest in the company and his share in the management of company. The foreign investor needn't own the controlling share or the biggest share in the company's equity. Apart from the non-resident share of fixed assets, the other components of the FDI are reinvested profit and other capital, including credit relations to the foreign investor. FDI structure could be expressed as: FDI = fixed assets + reinvested profit + other capital.
Fixed assets include the non-resident's share of the fixed equity of a company, shares of subsidiaries and associated companies and — in cases of foreign companies inland — the amount repaid to the National Property Fund within the framework of privatization.
The content of the component *reinvested profit*, is the foreign investor's share (in relation to the direct equity share) in profit (loss), reduced by repaid dividends. It is possible to express the account of reinvested profit as follows: Reinvested profit = current year's profit after taxation + non-distributed profit - current year's loss - preceding years' uncovered loss - dividends. *Other capital* includes borrowing and lending, including obligations and suppliers credits among direct investors and companies in which they have equity share, branches and associated companies. These credit relations are picked up in inter-company claims and liabilities.

2/ GLOBAL FDI FLOWS

Worldwide FDI inflows continued their climb in 1997 for the seventh consecutive year. They increased by 19 percent to a new record level of $400 billion, while outflows reached $424 billion. The developed countries with more than two-thirds of the world inward FDI stock and 90 per cent of the outward stock, dominate the global picture, but their dominance is being eroded. Developing countries accounted for nearly a third of the global inward FDI stock in 1997, increasing from one-fifth in 1990. Developing countries have made the biggest gains in flows of FDI during the 1990s. Their values as well as shares of global inflows increased from $34 billion in 1990 (17 per cent of global inflows) to $149 billion in 1997 (37 per cent of global inflows).

3/ FDI INFLOWS INTO CEE COUNTRIES

Central and Eastern European economies (CEEE) broke their stagnant FDI trend in 1997 — the first year the region as a whole kept up a positive GDP growth rate in the 1990s — by receiving record FDI flows of $19 billion, 44 per cent more than in 1996. This shift took place after a decline of 10 per cent in 1996. Despite this turnaround, Central and Eastern Europe's share in world inward FDI inflows is still low: 5 percent in 1997, 1998 respectively. Central and Eastern Europe's share in world inward FDI stock is still low: 1.7 percent (1.8) in 1997 (1998). Apart from other reasons, this is explained by the fact that the majority of the countries opened up to inward FDI recently. That's why their accumulated FDI stocks are low. However, 53 percent of the 1996 world inward FDI stock had been accumulated before 1990 when the CEEE joined the rest of the world in actively seeking FDI.

FDI inflows increased in 12 countries of the region in 1997. The Russian Federation, Romania, Poland and Bulgaria experienced the largest growth of FDI in absolute terms, as compared with flows in 1996. FDI inflows decreased in 5 countries. The Czech Republic registered a decline (1997) in inflows for the second year since the 1995 peak. The Czech Republic, Hungary, Poland, Romania, the Russian Federation, Slovenia and Ukraine together account for almost 90 percent of the region's inward FDI stock (1997).

4/ FEATURES OF THE FDI INFLOWS TO CEFTA COUNTRIES DURING THE 1990s

By the end of 1997, Poland had become the region's leader in terms of inward FDI stock, followed by Hungary. Monitoring data on home country shares in FDI in individual host countries, the United States was in 1997 the biggest single source of inward FDI stock in Central and Eastern Europe (CEE), followed by Germany and the Netherlands. The primary sector accounts for a low share of inward FDI. Secondary and tertiary sectors are important in the region's inward FDI. The tertiary sector accounts for a leading share of inward FDI in Hungary, the Czech Republic[3] and Slovenia. Manufacturing dominates FDI in Poland and Romania. Most of the inward FDI was attracted by services, finance, commercial activities and transport & communications. FDI plays a role that can be considerable as, for example, in Hungary.

Generally speaking, the principal determinants of the location of FDI are the policy framework, business facilitation measures and economic environment. As to experience of emerging markets and some CEE countries a political and economic (both macro and micro level) stabilization outlook and a suitable legal environment have been the most important factors which could attract FDI inflows[4]. Apart from them new market possibilities, skilled and flexible labour sources, taxation, favourable cost-factors have to be mentioned.

Many other factors could impact on the economic environment as well. In connection with it a monetary stabilization has to be stressed. Monetary turbulence and the following currency depreciation can cause the depreciation of conditions for foreign investors. A long-term persistent inflation differential[5] can cause external imbalances, monetary turbulence and currency depreciation. It has usually resulted in inflation. The cycle, started by inflation and ended by inflation can discourage investors from investments.

5/ RELATIONS BETWEEN FDI INFLOWS AND TRANSFORMATION IN CEFTA COUNTRIES DURING THE 1990s

The uneven distribution of FDI among countries within CEFTA is caused by various factors. The countries in the region differ in terms of the stage of transformation to market-based economies. The Czech Republic, Hungary, Poland and Slovenia have been the most successful reformers. It can be expected that this group is more attractive to foreign investors than those countries which are still facing transitional uncertainty. During 1993-97, the course of FDI inflows to the region was clearly dominated by the most successful reformers[6]. They also include countries that had gone far in privatization open to foreigners. Investment related to privatization has been a prevailing form of inflows for many countries. Investment outflows from CEE increased more than three times in 1997 (compared with 1996 level), to an estimated $3.4 billion.

The ratio of FDI stock to GDP for CEE countries falls behind both the world average and the average for developed countries and the average for the developing regions. With FDI stock per capita, the CEE region is also behind both the world average, and the average for all developed countries (1996) and behind the average for the developing countries taken as a whole. With the ratio of FDI inflows to gross capital formation (1994-96 average) the CEE countries' average is above both the world average and the average of developed countries and about the same as the average for developing countries.

In connection with the FDI inflows to the CEEE one problem has emerged. A lot of FDI has been invested in non-sophisticated sectors. The actual level of the value added share in these sectors has been low. Under this condition FDI inflows could fix a technological retardation for the future. Contrary to this fact some FDI inflows are invested in the sectors which have provided more sophisticated products and services (for example, banking). In order to overcome the backwardness the CEE countries have to attract more FDI inflows to the more sophisticated sectors in the future.

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[3] The CR is a host country and an investor, as well. Residential outward FDI stocks as of 31. December 1998: $573.2 mil. The biggest outwards (as of 31. 12. 1997): Slovak Republic (30.5 %); Germany (12.0 %); Seychelles (8.0 %); British Virgin Islands (5.8 %); Poland (4.1 &) and Cyprus (4.0 %). Key industries (as of 31. 12. 1997): wholesale trade (46.5 %); other trading services (14.7 %); finance (11.2 %); transport facilities (5.9 %); retail trade (4.7 %) and other services (2.8 %). Inward FDI stocks in the CR as of 31. December 1998: $11.974 billion. Of which (as of 31. 12. 1997): Germany (31.0 %); The Netherlands (27.8 %); Austria (9.5 %); USA (6.5 %); France (6.0 %) and Great Britain (5.0 %). Key industries (as of 31. 12. 1997): non-metal mineral products (10.5 %); finance (9.9 %); foods and drinks (9.7%); communications (8.9 %), motor cars production (8.4 %) and wholesale trade (5.2 %). For more details see Tables 8, 9, 10 and 11.

[4] As to some foreign investors the system of government incentives doesn't belong to the most important factors which could attract FDI. First of all, they have prefered the stable political and economic environment.

[5] The higher inflation differential could be expected in the region during the following several years. The CEEE price level has to be converted to the higher EU price level. The higher inflation could be imported to the CEE countries by the higher world prices of the sophisticated technological equiopments. The future implementation of the Single European Internal Market's technical norms and social standards could result in the higher costs and prices, as well.

[6] In the beginning of the transformation most east-central European governments believed in the fast privatization of publicly owned productive assets. After eight years of experience the privatization speed doesn't seem so important as the quality of the privatization. The privatization method which can attract more FDI and can contribute to the real restructuring of economy is considered to be the best privatization method.

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Table 1: Foreign Direct Investment in CEECs: Inflow 1994-97 and stock end-1997

	Inflow USD mn				Inflow 1997 as % of fixed capital formation	Stock 1997	
	1994	1995	1996	1997		USD mn	as % of GDP
Czech Republic	869	2562	1428	1300	8.1	6763	13.0
Hungary	1319	4571	2069	2307	22.5	17529	39.3
Poland	1493[1]	2511[2]	4000[3]	5678[4]	19.7[5]	15305[6]	11.5
Slovakia	185	181	666	200[7]	2.7	1410	7.2
Slovenia	377	414	190	600[8]	14.3	2400	13.7
Bulgaria	214	164	303	510	51.0	1252	12.5
Romania[9]	568	313	609	1210	18.0	2800	8.1
CEEC-7	5025	10716	9264	11805	.	49859	.

Sources
- WIIW database, based on official data.
- World Investment Report 1998

[1] Project with more than USD 1 mn invested capital. Since 1996 including re-invested profits. 1997 including small ventures: USD 6600 mn.
[2] dtto
[3] dtto
[4] dtto
[5] dtto
[6] 1997 stock including small ventures and adjusted to international methodology; stock measured by local method USD 20.7 bn.
[7] Estimated.
[8] Estimated.
[9] Inflow based on FDI registration, stocks include only equity.

Table 2: FDI stock by major investing countries, end-1996, per cent

	Czech Republic	Hungary[10]	Poland[11]	Slovakia[12]	Slovenia	Bulgaria	Romania
Germany	27.5	23.8	12.7	20.9	14.1	28.0	9.4
Austria	7.3	14.5	2.6	21.7	34.3	5.1	2.7
USA	14.4	17.1	24.7	2.3	1.3	6.7	8.0
Netherlands	14.5	9.5	7.9	7.4	2.0	10.3	8.0
Switzerland	12.1	2.3	3.0	0.9	3.5	6.4	3.2
France	7.8	7.8	7.5	5.9	7.5	1.8	6.8
Italy	.	3.8	10.2	2.0	7.4	.	.
United Kingdom	.	5.8	4.2	13.4	4.7	7.5	5.0
Other countries	16.4	15.4	27.2	25.5	25.2	34.2	56.9
EU	73.5	71.2	52.9	74.6	76.7	70.6	51.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Sources

- National statistics.
- World Investment Report 1998

[10] Data based on sample survey, covering two thirds of the FDI stock.
[11] Investment projects with more than USD 1 mn capital.
[12] Unrevised data.

Table 3: Estimated distribution of enterprise assets between privatization methods, per cent, up to 1997

	Sale to domestic investor	Sale to foreign investor	Equal access voucher	Insider: MBO and ESOP[13]	Other[14]	Still state property
Czech Republic	10	10	40	5	5	30
Hungary	12	45	0	3	20	20
Poland	2	10	18	20	10	40
Romania	5	5	20	10	0	60
Slovakia	3	7	25	30	5	30
Slovenia	3	7	20	20	20	30

Sources

- National statistics.
- World Investment Report 1998

Table 4: Net private capital flows to leading emerging market economies /billions of dollars/

	Private flows Net	Direct equity	Portfolio equity	Private credits
1997	260	116.5	24.0	119
1998	150	108.6	2.4	39
1999	140	104	19	17

Source: Institute of International Finance

[13] MBO – privatization to management; ESOP – privatization to employees.
[14] Other methods include: restitution, transfer to social security funds and local organizations, liquidation.

Table 5: Emerging Markets Economies' External Finance /billions of dollars/

	1995	1996	1997
Current account balance	-85.4	-95.7	-76.2
External financing net	**269.0**	**331.7**	**298.2**
Private flows, net	*228.4*	*326.8*	*259.6*
-Equity investment	106.5	130.5	140.5
--Direct equity	82.1	94.8	116.5
--Portfolio equity	24.4	35.7	24.0
-Private creditors	121.9	196.3	119.1
--Commercial banks	99.4	121.0	24.8
--Non-bank private creditors	22.5	75.2	94.3
Official flows, net	*40.7*	*4.9*	*38.6*
-International financial institutions	20.5	7.0	27.2
-Bilateral creditors	20.2	-2.2	11.4

Source: Institute of International Finance

Table 6: The Czech Republic FDI outwards stock as of 31 December 1997 (thousand CZK)

Country	Stock in CZK	of which (%)	Country	Stock in CZK	of which (%)
Total FDI abroad	**18 989 388**				
- Slovakia	5 800 076	30.5			
- Bulgaria	37 803	0.19	- Ukraine	476 155	2.51
- Hungary	91 072	0.48	- Bahamas	107 280	0.56
- Poland	770 340	4.1	- Seychelles	1 518 915	8.0
- Romania	102 318	0.54	- Germany	2 287 230	12.0
- Slovenia	715 317	3.77	- Austria	438 593	2.31
- Russian Federation	181 990	0.96	- USA	277 017	1.46

Source: Czech National Bank (March 1999)

Table 7: The Czech republic FDI inward stock as of 31 December 1997 (thousand CZK)

Country	Stock in CZK	of which (%)	Country	Stock in CZK	of which (%)
Total FDI in the CR	**319 820 250**				
- Slovakia	6 694 598	2,09	- Ukraine	227	
- Bulgaria	66 178	0,02	- Bahamas		
- Hungary	196 392	0,06	- Seychelles		
- Poland	3121		- Germany	99 285 107	31,04
- Romania			- Austria	30 396 669	9,50
- Slovenia	243		- USA	20 639 112	6,45
- Russian Federation	384 907	0,12			

Source: Czech National Bank (March 1999)

"STANDORT"

A Tool of Analysis for the Evaluation of the Economic Performance not only for Germany but also for the CEFTA Countries?

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INTRODUCTION

There are strong political reasons to enlarge the European Union as planned, but it cannot be denied that only countries having reached a certain degree of economic development and strength will be accepted as members. These countries should be aware of differences between the leading European countries in discussing and judging the performance of their economies. While most of the countries discuss these issues under the heading of "competitiveness" of the economy, Germany follows a different approach. For many years, the political and economical debate has been mostly conducted under the general headline of what is favourable or not for the "Standort Deutschland". Sometimes this concept is translated into English by "business location" or "attractiveness for investors". But neither of these translations is able to give a full impression of what aspects are involved in the German debate. The most important of these aspects is that of the perspective for the future, i.e., that you have to create a whole framework of conditions for the economy today if you want the best performance tomorrow. Another important feature is the astonishing degree to which the "Standort-debate" has become part of German thinking which hardly can be compared to concerns about the competitiveness of the economy in other European countries.

The paper highlights the most important aspects of the concept of "Standort" and discusses the main differences to the concept of "competitiveness".

1. "Standort Deutschland"

The German Federal government hosts a webpage on the internet at "www.Standort-Deutschland.de"[1]. It says not only "Welcome to the Federal Republic of Germany" but also "Invest in quality - Germany". Germany is praised here as "the ideal base for taking on Europe's high yield markets, including the EU's member countries, the fast growing countries in central and eastern Europe and Germany itself". Germany is proudly labelled as "the continent's largest and most profitable market".

The existence of such a page and this introduction already tells much about the concept of "Standort Deutschland". It is the description of Germany as an attractive business location. In describing selected features of the country, the government wants to attract foreign investors - and to retain investors in Germany.

The webpage wants to tell potential investors about the business opportunities awaiting them in Germany and how to exploit these opportunities. According to the government these are the 10 most important reasons to do business in, with and from Germany:

- **"Germany is Europe's powerhouse:** Germany is the world's third largest economy. Number one in Europe. Producing more than one quarter of the European Union's gross domestic product and with the second highest rate of investment among the world's seven leading economies, Germany is on course to sustain this position of economic strength in the decades to come".
  Hence, Germany's size and economic strength suggesting that investors cannot go wrong investing in such a successful economy.

[1] This Internet presentation was compiled on behalf of the Federal Ministry of Economics and Technology and in close cooperation with the economics ministries and the economic development corporations of the federal states. Responsible agency: The Federal Center for Foreign Investment in Germany of the Federal Ministry of Economics and Technology.

- **"Made in Germany:** A highly-productive business community turning out high-quality, highly reliable products. The main characteristics of this kind of business community is its diversity". On the one hand "it is comprised of a mix of large-sized companies whose names are household words throughout the world; innovative medium-sized ones, many at the cutting edge of their respective markets; and small-sized firms oriented towards serving their highly-specific segments". On the other hand, "the business community is also comprised of a wide diversity of sectors. They supply all of the products and services needed by today's manufacturers and service providers. They also yield a never-ending range of business opportunities. Wages are not low in Germany. Much higher, however, are the country's rates of productivity and levels of product quality and reliability. These achievements ensue from the world-class qualifications and motivation held and shown by our country's workforce. Coupled with the large amounts of creativity and flexibility shown by the companies they work for, these achievements also explain the respect and good prices commanded by the products bearing the words "Made in Germany".
  After some preliminaries and detours, the German government deals with one of the main factors which might deter foreign investors, the high labour costs. The argument in favour of Germany here is the high productivity and world-famous quality of products made in Germany.

- **"At the centre of Europe:** Germany has a population of 82 million. That's more than any other country in the European Union. And these persons are outfitted with large amounts of purchasing power. It all adds up to Europe's largest market. That's why the world's companies flock to sell in Germany. Why they also choose to sell from Germany has a lot to do with geography and infrastructure. Germany borders on nine countries. They and the rest of Europe's major markets are within easy reach from Germany. And that's thanks to our high capacity, high speed rail and road grids. Several of the fast-growing markets linked to these grids are in central and eastern Europe, a region which has long been a major trading partner of Germany. With the inclusion of the region's inhabitants, the European market now totals 700 million consumers".
  This is the location argument in its most traditional form. Germany is the largest country in Europe and — being geographically very central — the country from which firms can directly serve more customers than from any other European country.

- **"Trading centre:** Exports have long been the engine of economic development in Germany. A powerful engine. Germany is currently the world's second largest exporter. Including motor vehicles and industrial systems, chemicals and electronic devices, these products are sold in virtually all of the world's countries. Many of these products are premiered at the large number of international trade fairs and exhibitions held each year in Germany. Attended by buyers from the whole world over, these trade fairs—including CeBIT, the IFA consumer electronics fair or Hanover's Industry Trade Fai—are often the largest in their sectors. In fact, more "world's largest" trade fairs are held in Germany than in any other country. A new fair will be staged in Hanover at the turn of the millennium-Expo 2000. The motto of this world's fair is "people, nature and technology".
  This argument invites foreign investors to become part of the German success story of being a very successful exporting nation. The underlying assumption is here that even non-German firms will become successful in export as soon as they have chosen Germany as a base. The additional argument comes from Germany having the marketing knowledge for this success shown by the size of its trade fairs.

- **"Infrastructure:** Transporting the large numbers of persons and great amounts of goods through the country - and throughout Europe and the rest of the world - are the country's high-capacity, high-speed rail, road, water and air grids. How good are Germany's roads? So good that the term "autobahn" has become a synonym for smoothly moving superhighways. Led by the ICE (InterCity Express) trains, Germany's rail grid covers the entire country, as does its network of waterways. They link the country with the North and Black Seas, and, beyond them, to world's oceans. Germany is a country of ports, including Hamburg (the world's seventh largest point of container transloading), and airports. Number one in terms of persons and freight passing through it is Frankfurt, continental Europe's largest. Germany also has another kind of density: of on-line connections. No other country in Europe has so many computers linked on-line to the world's data communication grid. Transporting the bits and bytes throughout the country and to the rest of the world is a network of glass-fiber and ISDN links".

Infrastructure is another standard argument for attracting foreign capital. Again, the German government is here underlining factors like size and quality, carefully not about costs or prices.

- **"Research:** Germany is the greatest single source of new technologies in Europe. But the number of inventions issuing from the country is not the sole reason why our country is considered to have one of the most innovative business communities in the world. This reputation stems, rather, from the individual and collective impact of these innovations, which are developed by Germany's research community. This community, in turn, maintains close working relationships with our country's companies. These relationships ensure that the innovations become state-of-the-art products capable of making their ways on their markets. These markets include those for motor vehicles, industrial equipment and systems, chemicals, medical technologies and the rest of the sectors in which Germany has long been a major force. Also comprised are the country's new mainstays: ICT (information and communication technologies), environmental technologies, laser and plasma-based systems, microsystems, and biotechnologies. The position of strength which Germany has in all of the above markets is indicated by two key figures: our country is the largest exporter of manufactured goods in the world. We rank number three in the world in the importing and exporting of technology-intensive products".
  Again, the government's presentation carefully picks up bits and pieces of facts, even adding-up exports and imports of technology-intensive products to use this composite as an indicator for a high level of research in Germany. But there are many people in Germany today expressing doubts and concern about losing ground in the field of R&D.

- **"Skilled personnel:** State-of-the-art technological systems are great-as long as you have the persons to operate them, persons who can get the maximal use out of them. And that's why Germany has always invested heavily in its systems of education: to make sure that they turn out persons with the qualifications and with the motivation making them capable of producing. The country's large stock of such high-achievers represents its most important resource. These persons' qualities and qualifications go a long way towards explaining the continuing success of Germany's business community. These high-achievers began their schooling in Germany's elementary and secondary schools, which provide their students with the basic skills and knowledge needed to prepare themselves for careers in today's world. Many of the persons then attended Germany's "dual system" of vocational education. A role model for the entire world, this system pairs extensive in-classroom learning with on-the-job training. Many others are graduates of the more than 300 universities and polytechnics in Germany".
  Skilled personnel is called here the country's most important resource and indeed, there is a very good reputation of the qualification of the German workforce and the German term "Wertarbeit" even became a household name in many countries. In this respect the government does not have much to prove and this explains why they are not pushing so hard here as on other arguments already brought forward.

- **"Promotion:** The pace of technological transformation keeps on picking up. To help Germany's companies and business areas stay at the forefront of these changes, the country's public sector has come up with a wide range of individual investment support programs and policies. These provide domestic and foreign-owned companies with loan sureties, tax breaks and other forms of support for investment and business development. A number of areas in the country, especially those in eastern Germany, have levels of development and output below the country-wide averages. The programs have been designed to remedy this situation on a step-by-step basis".
  Again, the government is quite reserved in praising its efforts of promoting firms. They have to be well targeted to help technological change and work against regional disparities. It is not part of the German politics of "Standort" to grant subsidies per se, or to attract foreign investments.

- **"Stability":** The name "Germany" has long been synonymous with "stability". This innate association has arisen from the country's political system and its unswerving adherence to the principles of parliamentary democracy, and from the absolute rule of law prevailing in our country. The association has also stemmed from the low rates of inflation turned in by our steadily-performing economy. These rates, in turn, have partially stemmed from our currency, whose stability of value is proverbial. "Stable" is also the term applied to describe labour

relations in our country. Rather than battling each other, employees and employers work together in our country. They do so to realise a commonly-held objective: to foster the well-being of the country's companies. This consensus has been of great benefit to the companies, which have very rarely had to contend with the loss of income and/or output resulting from strikes. They do so to realise a commonly-held objective: to foster the well-being of the country's companies. This consensus has been of great benefit to the companies, which have very rarely had to contend with the loss of income and/or output resulting from strikes".
Here again, the German government seems to bring forward arguments in favour of its own country in contrast to countries like the UK which is said to be able to attract FDI successfully with a deregulated labour market and low wages. This term of a "non-adversarial society" which is quoted here to convince - especially Anglo-Saxon - investors has obviously been, by the way, invented just for this English version because it is to be found neither in the German version nor commonly known to Germans in other contexts.

- **"Quality of life:** Germany is a great place to do business in and from. It's also a great, healthful place to live in. And that's largely thanks to the environmental protection policies implemented by our country's government. The clean beaches, 'breathable' air, 'swimmable' lakes, green forests and the other components of our healthy environment are products of these policies. Going out in the town is also a great pleasure in Germany. And that's because of the wealth of cultural activity in our country-our hundreds of world-class museums, theatres, operas and concert halls. Another pleasure: going around the country, viewing with your own eyes our majestic cathedrals, mighty fortresses and other remnants from our two millennia of history. Germany is also a great place for athletes, be they of the every-day or once-in-a-while persuits. We have plenty of swimming pools, tennis courts, golf courses and rinks of all kinds in the country. We also have plenty of tall mountains and raging rivers, for those who like to test their mettle in the great outdoors".
  Again, this is a point which the government is stressing pretty much because, unlike many other countries, Germany does not rank very high among countries famous for their quality of life. It might seem to be a little bit surprising to link much of the quality of life to the policy of environmental protection but here again the government is picking-up a widely shared opinion that Germany has a high level of regulation in this field which might make life difficult for investors. By assigning to it much of the attractiveness of the country as a place for living the authors of the webpage implicitly try to turn it into a positive feature of the country.

After having reviewed what the essence of "Standort Deutschland" is in the words of the Federal government we can draw some conclusions. The question of the quality of the "Standort" differs from the question of international competitiveness which is more frequent in most of the other countries mainly by the point of view. Competitiveness mainly deals with the actual success of products and services which are currently produced on the markets. This success is measurable here and now by indicators like the structure of international trade or surpluses made in it (Löbbe 1994: 36.) "Standort", however, highlights rather the potential of economic success which might only occur in the medium- or longer run. A whole variety of conditions for this possible success are presented as the framework in which the investing enterprises can act (Löbbe 1991: 61.) In other words, this is the German way of putting supply-side factors on the agenda of economic policy and introducing them into the public debate about how Germany could maintain or even improve its economic performance.

The quality of the "Standort" hence can be defined as the economically relevant supply conditions of a country or a region. These conditions are influenced by factors like the availability of production factors, technical know-how, geographical situation, quality of infrastructure, the legal and social framework and other factors like those influencing the quality of life in general or the preferences or attitudes of consumers. Indicators for the quality of the "Standort" can be the growth of the productive potential or capacity, the propensity to invest, a high level of employment or the attractiveness for foreign capital (Löbbe 1994: 39.)

2. ACCEPTANCE IN GERMANY

The concept of "Standort" cannot be sufficiently explained if you do not take into account how widely spread this point of view has become in almost all parts of the German society and to

which degree it has become the focus not only of debates about economical and political issue. No matter if you are pro or con, in Germany, you have to discuss your point in relation to the quality of Germany as "Standort".

In preparation of this presentation I've checked the library of RWI and found about 250 entries of books and articles published in the last ten years with reference to "Standort". Here are some randomly chosen examples[2]:

- "Protection of nature in the light of Standorttheorie",
- "Industriestandort Bundesrepublik Deutschland: quality of "Standort" and international competitiveness",
- "Chance for the Standort Deutschland: a plea",
- "Against the debate concerning Standort Deutschland - in a capital oriented fashion. ..",
- "Consequences of the enlargement of the EU on the production Standort Deutschland for textiles and clothing",
- "The economic and social Standort Bundesrepublik Deutschland in the process of European integration",
- "Report of the Federal Government regarding the future safeguarding of Standort Deutschland",
- "Relocation of jobs abroad, weakness of Standort or survival strategy?"
- "Standortfaktor environment protection: harm of the competitiveness of enterprises or chance?",
- "The GDR as Standort for investments - the view of West German enterprises",
- "Will Germany remain Standort for the textile industry?",
- "The importance of energy prices for the Industriestandort Deutschland",
- "Safeguarding the Chemiestandort Deutschland as a challenge of a future industry policy",
- "Human capital as Standortfaktor",
- "China as trading partner and production Standort for German SME",
- "Germany in the Standortkrise",
- "Direct investmests - an indicator of Standortqualität",
- "Fainess in Standort competition?",
- "Strategies and opportunities of the Bundesrepublik Deutschland in the international Standort competition",
- "Service Standort Berlin",
- "Standort identification 1990: a new orientation of coal policy!,
- "Globalisation of the economy, Standort competition and co-determination",

[2] For reference see Literature.

- "The social system as Standortfaktor",
- "Research Standort Germany",
- "Industry Standort Germany",
- "New energy and ecological taxes as patent recipe for the Standort Germany",
- "Standortprobleme of craft firms in Duesseldorf",
- "Culture - a Standortfaktor in regions with problems?",
- "The village as housing Standort: an analysis of migration into rural regions",
- "The role of multinational enterprises in the international Standort competition",
- "The Standortproblem seen from the point of view of banks",
- "The importance of transformation countries for the Standort North-Rhine Westphalia: an analysis of risks and chances",
- "Environment protection and Industriestandort",
- "Tourismusstandort Deutschland in the global competition",
- "Innovationsstand Deutschland",
- "Insurance taxation as Standortproblem".

This long list of titles of scientific publications and studies made for public authorities shows that in the last ten years almost every aspect of the debate on issues of economic policy has been conducted with reference to Standort Deutschland, which is the attractiveness for investors or the sound framework of conditions for doing business in Germany. The list contains discussions of the general strengths and weaknesses of the German economy in general and of certain sectors or regions, what influences specific factors like qualification, R&D or taxation might have, what role international changes like the transformation in middle and eastern Europe could play to influence Standort Deutschland etc.

But before closing it has to be underlined that this commitment to Germany as Standort is not limited to the scientific and political community alone. Although it is true that you easily find the aspect of Standort for example in the official Policy Statement of Germany's new Chancellor or in the coalition treaty leading to the new government, in speeches and press releases of politicians and ministers of the government and of the opposition — from the Christian Democrat opposition leader to the former communist party PDS. You will find the claims for a "better economic policy" of the association of German employers on the internet by searching for Standort as well as the basic programme of the DGB, the association of German unions. But you will also find the announcement of a symposium on "Musik Standort Deutschland" held by the association of German composers, churches organising workshops under the title Standort Deutschland, associations and strike-committees of university students writing political dictionaries explaining the notion of Standort, the concerns of banks regarding the introduction of the EURO are brought forward as caring for Standort Deutschland. You will also find the association of German Do-it-yourself and Garden markets publishing a newsletter in which it tells the reader that the Standort Deutschland is better than most people think. You can find an essay of a priest in a student paper of a high school in Berlin contemplating that Standort policy is cruel for the long-term unemployed. Your internet search will also give you several hits telling you how our friendly sponsor of this conference, The Friedrich-Ebert-Foundation (FES), gets involved in the discussion about Standort Deutschland. Here are some headlines: "FES: the education crisis threatens Standort Deutschland", or the FES discusses the pros and cons of the German labour market under the titles "Germans are no Americans" and the safeguarding of Standort Deutschland for the automotive industry and the decline of the Japanese industry and

technology policy as a role model for Germany in a study entitled "Industry policy for the Innovationsstandort Deutschland — beyond the Japanese success model". But the impact of the Standort debate goes even much deeper into the German society, even into the arts. Also the Kabarettist (political stand-up comedian) Gerhard Polt has released a new CD called "Der Standort Deutschland" and the poet Justus Baer-Bleiching comments on the Standort debate in a cycle of expressive poems which you download from the internet.

I want to end my presentation at this point hoping that you could get a little impression of how concerned Germany has become over the last years about its economic attractiveness and that perhaps the social cohesion of the German society which is commonly regarded as a major strength of the country is one of the most important factors in making this debate — or should I rather say movement — possible on the one hand and was reinforced by it on the other hand.

What is my conclusion, the answer to the question in the title of this presentation? Can "Standort" be a tool of analysis for the evaluation of the economic performance of CEFTA countries? I wanted to make you aware that such "tools" like "competitiveness" or "Standort" are not purely technical which can be transferred easily from the context of one society to another. I'm looking forward to hear your opinions. Do you think that the concept of "Standort" is an appropriate tool for the political and economical debate in your country as well?

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AN EMPIRICAL NOTE ON TRADE LIBERALIZATION AND STRUCTURAL ADJUSTMENT IN TRANSITION ECONOMIES

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INTRODUCTION

The objective of this study is to examine empirically whether trade liberalization — such as through integration into the European Union (EU) — supports the structural change in transition economies (TEs) that is required to catch-up to best-practice competition. Our working hypothesis is that improving the competitiveness of TE firms on larger EU markets is arguably the most important challenge for the eastern transformation processes, especially when seen against the backdrop of the burdens inherited from socialist-type central planning.

Structural convergence is, hence, a necessary prerequisite for reaping over the long haul the benefits potentially accruing from EU membership for all partners involved. By this we mean in particular the growing capability of firms in transition economies (TEs) to wage constructive competition in the Single European Market, given their factor endowment and cultural, historical, and social specificities. These competition conditions are not only circumscribed by the EU's acquis communautaire but they also result from the fact, which we deem to be important, that multinational firms already accustomed to competing in the present Single Market, let alone its dynamic evolution, possess greater capabilities than TE firms. EU accession, in a normative sense, must therefore trigger such convergence in the above mentioned meaning. The literature considers, albeit often implicitly, the liberalization of trade as a sufficient prerequisite for overcoming the structural weaknesses.

The following considerations are organized as follows: First, I provide a definition of structural convergence/divergence under the conditions of free trade. The definition is rather simple: structural convergence reflects itself in an increasing share of horizontal product differentiation in intra-industry trade while divergence reflects increasing vertical structures.

The second step provides the methods of decomposing horizontal and vertical intra-industry trade. Third, some empirical results are provided by means of two sets of differently liberalized trade items we could identify according to the European Agreements.

1. INTRA-INDUSTRY TRADE AND PRODUCT DIFFERENTIATION

The usual concept to explain the link between structural adjustment on the firms' level and trade is product differentiation. Product differentiation is the usual explanation for intra-industry or two-way trade (IIT). In the first generation of IIT models IIT dynamics were identified with structural adjustment towards a higher level of economic development. Another implication of first generation IIT economics is the idea of 'painlessness'. Among economists the idea is generally accepted that IIT dynamics ensure that, at the macroeconomic level, the reallocative and distributive effects are less severe than those associated with inter-industry trade (Greenaway and Miler, 1987).

As Celi and Segnana (1998) pointed out, the idea of 'painlessness' — crucial for most of the literature of IIT — tends to assume that product differentiation is a phenomenon of a *horizontal* character; that is to say, it is differentiation based on the attributes of a product in a given quality level rather than on differences in quality levels. Horizontal differentiation is the exchange of similar levels of technological sophistication within the same industry branch. The differentiation stems primarily from alternative designs, colors, packaging, or other features that individualize goods and services. With similar quality and technology, the opening of markets allows industries to realize increasing returns to scale; hence, prices of similar products should converge if they significantly differed before.

However, the "second generation" of IIT models focuses upon the coexistence of horizontal

(HIIT) and vertical (VIIT) components. Vertical differentiation rests upon the exchange of basically the same goods but at different qualities, different prices, and produced by different technologies, resulting in different shares of value added in output of imported and exported goods. These second generation models show that the forces underlying the vertical differentiation mechanism are not the same ones that operate in horizontal differentiation in an attempt to divorce the question on trade in differentiated products from the strong assumption that all varieties were produced under identical technical conditions. Furthermore, the idea of painlessness associated with IIT dynamics becomes weaker if the product differentiation is vertical, that is to say, if products differ in quality.

In conclusion, vertical product differentiation differs from horizontally differentiated models in both its assumptions and its predictions. On the demand side vertical IIT is determined by a group of high-income individuals in both countries who buy high-quality products and a group of low-income consumers who demand low-quality products. On the supply side the models assume constant returns to scale and operate in perfectly competitive markets. As a result, the models predict that the pattern of trade within industries is determined by comparative advantages. The more capital-abundant country exports high quality varieties because it has comparative advantages in these varieties while the less productive country exports the low quality varieties. As income differences rise, the number of varieties exported by the less productive country rises. Thus these models predict that the volume and share of IIT are positively related to the extent to which income distribution overlaps, and may be positively related to differences in per capita GDP.

Although theoretical models have demonstrated that the separation between horizontal and vertical IIT is important, there is no study which provides a satisfying analysis of vertical IIT under free trade regimes. All studies view IIT and its components without discrimination between more and less liberalized trade items. In reality, trade of each single item is subject to explicit and/or implicit trade barriers, and, the results of regression of IIT variables and factor variables might be distorted. The following approach follows most usual techniques for disentangling VIIT from IIT, however, makes an attempt to separate free from less free trade between the EU and the TEs.

2. THE METHODS

2.1 Country and product coverage

The empirical part of the study concentrates on four countries: the Czech Republic, Hungary, Poland and Slovakia. The European Agreements (EA) provided a well-known set of steps and ways of trade liberalization.

We choose the data from the Combined Nomenclature (CN) of EUROSTAT. This allows for decomposing product groups regarding their different levels of liberalization. The EA for the above mentioned four countries present a complete list of 8-digit CN chapters when describing the extent and dynamic of agreed trade liberalization. Because statistical calculation according to our method cannot be done at the 8-digit level we choose the 4-digit level. EUROSTAT reports import value data based upon c.i.f. prices and export value data based upon f.o.b. prices. For both cases, the official cost of protection (import tariffs) should be excluded.

In order to achieve a picture of the extent of liberalization on the four-digit level as exact as possible we selected for panel A all those items the EAs fix symmetry; the information source was Annex IVa of the EAs. For the Czech Republic, we found 100 4-digit items, for Hungary only 29 items, for Poland 81 items and for Slovakia 100 items.

Panel B includes 137 four-digit items of the CN chapters 50-63. This is mainly textiles, clothing, footwear etc. whose trade was not overwhelmingly liberalized from the very beginning (with few exceptions). Liberalization was planned to be completed six years after the agreement came into effect in March 1992. Of course, both panels still include some items which rather belong to the other one or even to neither of them, however, this product setting seems close to the reality of liberalized and less liberalized trade.

2.2 Decomposing intra-industry trade

The IIT index Y of an individual commodity (group) was calculated on the basis of the Grubel-Lloyd (G-L) equation:

$$Y_i = 1 - \frac{|X_i - M_i|}{X_i + M_i} \qquad (1)$$

Y = GL index
X = export value
M = import value

Y = 0: complete intersectoral specialization
Y = 1: complete intra-industry specialization

Individual indices calculated according to equation (1) were agregated using the weights of each commodity group in overall trade as follows:

$$Y = \sum_{i=1}^{N} a_i Y_i \qquad (2)$$

a = share of commodity group i in overall trade
N = number of commodity groups

The well-known aggregation problems were neglected (see the appropriate arguments in Vona, 1991), we use the unadjusted Grubel-Lloyd index.

The usual methodological approach for disentangling HIIT and VIIT is the measurement of price and quality gaps in trade with similar goods. The concept applied on any aggregate level are Relative Unit Values (RUVs). We calculate RUVs from unit values of EU imports (UVMs) from and EU exports (UVXs) to the TEs considered.

$$RUV_i = \frac{UVM_i}{UVX_i} \qquad (3)$$

UVM = unit value of imports = value of imports/volume of imports
UVX = unit value of exports = value of exports/volume of exports.

Though being a problematic[1] measure for price/quality gaps, we calculate the unit values based on metric tons in the EU's trade with the above-identified four TEs for 1993 and 1996 in order to disentangle vertical from total IIT. We take unit values based on metric tons because the EU's Combined Nomenclature (CN) offers no alternative option. On the 8-digit level a calculation of unit values was not possible in most cases. This was the main argument for choosing the 4-digit level. Even then, a complete set of observations was not available because of the lack of data on metric tons in some cases.

VIIT is defined as the simultaneous export and import of the CN four-digit categories provided UVM remains within a specified range; we decided to set it at 15 percent either side of unity. True, this range is an arbitrary choice and does not sound very generous, especially in view of TEs

[1] A high-quality product may be made of heavier material so that ist value per ton is lower than that of an inferior-quality item. It is not clear how relevant this problem is for TEs. For more discussion of unit values see Greenaway, Hine, and Milner, 1994, p. 81.

whose firms might be newcomers on new markets and might be faced with market penetration problems even if quality is high. However, other authors have proceeded in a similar fashion when tackling the kind of research questions addressed here (for example, Abd-el-Rahman, 1991, Greenaway, Hine, and Milner, 1994). Aturupane et al. (1997, p. 16-20) explored why the results are not very sensitive to the choice of range.

RUVs may reflect cost or quality and technology gaps. In order to find out, which commodity items of our panels belong to items whose quality matters in competition and which ones are ruled by costs, we employ a test suggested by Aiginger (1997): *If unit values reflect costs and the product is homogeneous, then countries with lower costs should be net exporters in quantities and countries with higher costs should be net import countries. If a country is a net exporter in quantities, despite the fact that it has higher unit values, then this must be due to quality differences.*

3. EMERGING STRUCTURAL PATTERNS IN TRADE BETWEEN THE EU AND TRANSITION ECONOMIES

3.1 IIT shares

IIT shares differ significantly between the four countries (Table 1). Further, there is evidence of a general increase of shares in both panels. In panel A, the increase seems to be stronger than in panel B with Poland the exception. For Poland, the aggregated IIT share of completely liberalized trade items declined. The strongest increase of IIT can be observed for the Czech Republic and the Slovak Republic.

3.2 RUVs

The calculated relative unit values in most categories turn out to be outside the specified range (Table 2). Only 14 percent of all items for which RUVs could be calculated for 1997 qualify for our classification of HIIT and, 86 percent for VIIT. This result is especially true for items whose trade was completely liberalized between 1993 and 1997 (panel A). In both panels, the share of items within the range increased between 1993 and 1997.

Weighted with the shares in overall trade, the mean price gap is higher (or: the RUV is lower) in panel A for both years compared with panel B. The price gap to the detriment of the TEs (RUV < 0.85) tends to erode in panel A for the Czech and Slovak Republics (the index is increasing) and to deepen for Hungary and Slovakia (with the index falling). In panel B, three out of four countries show a tendency of a smaller price gap with Poland being the exception.

Table 1

Unadjusted Grubel-Lloyd indices[a] for EU[b] trade with four TEs from selected CN chapters (30-90)

	Czech Republic		Hungary		Poland		Slovakia	
	A[c] 100 items	B[d] 136 items	A 29 items	B 136 items	A 81 items	B 136 items	A 100 items	B 136 items
1993	0.296	0.507	0.402	0.364	0.236	0.168	0.215	0.203
1997	0.497	0.563	0.539	0.372	0.172	0.229	0.352	0.230
change in %	+67.9	+11.1	+34.1	+2.2	–27.1	+36.3	+63.7	+13.3

a Calculated as a weighted average according to the panel size.
b EU-15.
c Almost completely and symmetricly liberalized trade.
d Less liberalized trade, CN chapters 50-63.

Source: Own calculation based on EUROSTAT 1997, CD-ROM.

Table 2

Weighted RUVs[a] in trade of the EU[b] with four TEs from selected CN-chapters (30-90)

	Panel A[c]		Panel B[d]	
	1993	1997	1993	1997
Czech Republic	0.403	0.649	0.731	0.795
Hungary	0.590	0.566	0.990	1.071
Poland	0.499	0.444	1.044	0.879
Slovakia	0.282	0.637	0.990	1.071

a Unit value of import (UVM) divided by unit value of export (UVX); the quotient multiplied with the share of the item in total trade and cumulated over all items.
b EU-15.
c Panel B: 136 items x 4 countries; panel B: Czech Republic and Slovakia each 100 items, Hungary 28 items, and Poland: 81 items.
d See also endnote 2.

Source: Own calculation based on EUROSTAT 1997, CD-ROM.

3.3 VIIT shares

In total IIT, between 59 and 99 percent was vertical in 1997, using the specified 15 percent range for RUVs (see Table 3). The unweighted mean was at 81 percent, and only slightly lower than four years ago (84 percent). For comparison, Abd-el-Rahman (1991) calculated the VIIT share for France to account for about one third of total IIT for the period 1985-1997, hence, at a significantly lower level. Greenaway, Hine, and Milner (1994) calculated for the United Kingdom a 70 percent share of VIIT in total IIT for 1988. According to them, the incidence of vertical IIT is lowest where EC member states are concerned and highest in the case of geographically distant trading partners — mostly developing countries or newly industrialized countries.

In completely liberalized trade (Panel A), the VIIT share was significantly higher (at more than 90 percent) than in less liberalized trade. Between 1993 and 1997, the share of VIIT decreased somewhat for the Czech Republic, Poland, and Slovakia, and increased in the case of Hungary.

Table 3

VIIT indices[a] in EU[b] trade with four TEs, 1993 and 1996 from selected CN chapters (30-90)

Issue	Years	Czech Republic		Hungary		Poland		Slovak Republic	
		A[c]	B[d]	A	B	A	B	A	B
VIIT index (g-L)	1993	0.228	0.362	0.368	0.241	0.227	0.130	0.211	0.148
	1997	0.473	0.352	0.533	0.282	0.163	0.135	0.322	0.152
in percent of G-L IIT	1993	97.3	71.4	91.5	66.2	96.6	77.4	98.1	72.9
	1997	95.3	62.5	98.9	75.8	95.9	59.0	91.5	66.1
	change in p. p.	–2.0	–8,9	+7.4	+9.6	–0.7	–18.4	–6.6	–6.8

a Weighted IIT indices without the range of 0.85>RUV<1.15.
b EU-15.
c Panel A: 4-digit items of CN chapters 30, 33-38, 84, 86, 88-90.
a Panel B: 136 4-digit items of CN chapters 50-63.

Source: Own calculation based on EUROSTAT 1997, CD-ROM; see also Annex Table.

Somewhat more convergence than in panel A can be observed in panel B — again with the exception of Hungary. In three out of four countries the VIIT share fell remarkably in less liberalized trade; industries might have had time to readjust relatively away from vertical trade.

3.4 Quality gaps and cost advantages

Using the above explained method all items which RUV satisfies the condition 0.85>RUV>1.15 were tested for deficits or surplus in trade with the TEs:

If RUV<0.85 and the EU realized a surplus in trade, the EU is assumed to have a quality advantage. In this case, the EU exports goods of high quality and imports goods of low quality. The intra-industry trade is ruled by quality and technology.

If RUV>1.15 and the EU realized a deficit in trade, the TE is assumed to have a quality advantage. In this case, the EU exports goods of low quality and imports goods of high quality. Again, the intra-industry trade is ruled by quality and technology.

If RUV<0.85 and the EU realized a deficit, the TE is assumed to have a cost advantage. Intra-industry trade is determined by factor endowment and other cost specific factors.

If RUV>1.15 and the EU realized a surplus, the EU is assumed to have a cost advantage.

As a result, the EU has an overwhelming quality advantage in items which trade was completely liberalized between March 1992 and 1997 (see Table 4). The quality advantage of the EU tends even to increase in panel A. The exception is the Czech Republic. However, the lower quality advantage of the EU was not linked with an increase of the TE's quality

Table 4

Distribution of Grubel-Lloyd indices
G-L VIIT = 100

Country	Year	VIIT (0.85<RUV>1.15				
		total	Quality advantage		Cost advantage	
			EU	TE	EU	TE
		Panel A – completely liberalised trade				
Czech Republic	1993	100	81,8	2,4	2,2	13,5
	1997	100	71,9	0,5	9,7	0,5
Hungary	1993	100	36,3	0,0	1,6	62,1
	1997	100	72,1	0,2	0,5	27,2
Poland	1993	100	61,7	0,1	3,9	34,4
	1997	100	96,7	0,3	0,3	2,8
Slovak Republic	1993	100	56,1	0,1	0,7	43,2
	1997	100	72,5	0,0	19,2	8,2
		Panel B – less liberalised trade				
Czech Republic	1993	100	37,4	9,2	2,0	51,5
	1997	100	51,6	7,9	6,2	34,4
Hungary	1993	100	28,4	66,9	2,2	2,6
	1997	100	19,6	59,5	8,8	12,1
Poland	1993	100	45,1	42,5	4,5	8,3
	1997	100	28,4	22,7	9,8	39,5
Slovak Republic	1993	100	69,8	13,6	2,0	14,4
	1997	100	40,0	37,6	1,2	21,0

Source: Own calculation based on EUROSTAT 1997, CD-ROM.

advantage. In the Czech case, the cost advantage of the EU increased. In all other cases, the increase of the quality advantage of the Union was linked to a remarkable decline of the previous cost advantage of the TE. To put it differently: the trade structure has changed: there is a clear competition between cheap TE and high quality EU products, and cheap products were crowded out.

In panel B, we find a mixed picture: (1) The EU's quality advantage eroded again the Czech Republic being an exception. (2) The Slovak Republic was able to improve its competitive position quality considered. (3) The cost advantage of three out of four countries improved – cheap products from TEs competed high quality products from the EU out. (4) In trade with the Czech Republic, the picture is similar to panel A.

4. CONCLUSIONS AND POLICY IMPLICATIONS

The data do not signify a major structural convergence after trade liberalization in three out of four TEs. Under free trade, the European Union concentrates on quality superiority. The TEs cannot even gain competitiveness in items where they have a cost advantage. Hence, structural divergence is the overwhelming impression.

Policies in TEs neglected the positive role a government may play in creating the conditions for best-practice competitiveness. All in all, technological modernization may be contingent on an activist government bent on pushing through desirable changes in economic structures without, of course, harking back to the type of state-socialist planning and administrative steering that, in the end because of the fundamental inability or unwillingness of the leadership to adapt, proved to be so ruinous for these countries. In our view, given the considerable risk of market failure and the lack of proper prerequisites for functioning markets in TEs, appropriate policy measures can bolster the competitiveness of the emerging new enterprise sector in TEs through purposeful modernization, preferably with greater involvement of foreign capital and technology.

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FOREIGN TRADE AND COMPETITIVENESS OF CEFTA MEMBER STATES IN THE EUROPEAN INTEGRATION PROCESS

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INTRODUCTION

In the initial stages of transformation the countries of Central Europe (CECs) had to realize a process through which the countries of Western Europe preferred intraregional cooperation as a condition or assumption of a real reintegration of Europe. One of the priority aims of the intraregional cooperation was the need to coordinate the efforts and measures associated with the preparation process to EU accession and the next aim was to support mutual trade. We can say that in both cases this was the orientation towards supporting the integration processes in Europe and a sort of supplementary instrument (in the form of CEFTA) assisting in the entry of CECs to the EU.

Later on, when discussions ran on more explicit conditions of EU enlargement, a question was raised as to whether the CEFTA (a subregional grouping) should be a temporary supplement or an alternative to the EU?

The aim of this paper is just to present some arguments from the field of foreign-trade relations proving that the CEFTA can be but a temporary supplement within the re-integration process in Europe, but in no case any alternative to the EU.

1. INTENSITY OF MUTUAL TRADE AMONG THE CECs-5

There's no doubt that foreign-trade relations are one of the significant factors, but also signs of integration processes within the world economy. Due to this, also the support for mutual trade along with the coordination of measures connected with the EU pre-accession process were another pole of the key targets presented as an initiation gift to the Central European Free Trade Agreement - CEFTA in 1992. Namely the volume of mutual trade among the original signature countries (CSFR — later CR and SR, Hungary and Poland — Visegrad Four) represented about 2 bil. $ at that time, i.e. only 58 % of the 1988 volume (Table 1.1).

Table 1.1

Mutual Trade of the Visegrad countries within 1988 - 1992 (mil. $)

Exporting countries	Importing countries							
	CR + SR		Hungary		Poland		Total	
	1988	1992	1988	1992	1988	1992	1988	1992
CR + SR	xxx	xxx	475	496	916	508	1 391	1 004
Hungary	536	246	xxx	xxx	331	144	867	390
Poland	1 000	473	381	176	xxx	xxx	1 381	649
Total	1 536	719	856	672	1 247	652	3 639	2 043

Source: Compiled according to (Tóth L.G., 1994)

Decline in mutual trade of the mentioned countries in the Central European region was caused by rapid changes in the institutional and economic-political framework of intraregional trade, of which the most significant ones were as follows:

- strategic re-orientation of external economic (political as well) relations allowed by European

agreements providing asymmetric effects of opening the markets predominantly in favour of transition economies,

- introduction of payment among the previous COMECON countries in hard currencies and in world prices, and the possibility of free choice among the trade partners in accordance with the national and economic interests within the liberalisation of foreign trade,

- insolvency of some previous COMECON countries (mainly the succeeding states of the former USSR),

- a clear-cut decline in domestic demand on investment which led to a decline in the sale of investment goods, namely within mechanical engineering,

- low competitiveness of products within the market of Central and Eastern Europe and undersaturated domestic markets in quality products of Western markets (Outrata R., 1998).

In 1992 the intraregional (central European) trade reached the bottom (the lowest level since 1988) and since then the value of mutual trade of CEFTA countries (CECs-5) has been growing steadily. While in 1992 the foreign-trade turnover of CECs-5 was estimated at 9 bil. $, in 1997 it already represented 12 bil., which means a 33 % increase. The highest turnover of foreign trade in absolute and relative terms was registered by trade of all countries with Poland. On the contrary, decline in this indicator appeared between the CR and Slovakia, both in exports and imports. A similar tendency was seen also in the development of the share of countries of destination in total exports of the exporting CECs-5, which is illustrated in the Table 1.2.

Table 1.2

Share of countries of destination in total export of exporting CECs-5

Exporting country	Year	Country of destination					CECs-5 in total
		CR	SR	Hungary	Poland	Slovenia	
CR	1995	xxx	13,9	1,7	4,5	1,1	21,2
	1997	xxx	13,3	1,9	5,9	1,0	22,1
SR	1995	35,2	xxx	4,6	4,4	1,1	45,3
	1997	27,0	xxx	4,8	5,6	1,1	38,5
Hungary	1995	1,5	1,5	xxx	2,4	1,8	7,2
	1997	1,7	1,4	xxx	2,7	1,5	7,3
Poland	1995	3,1	1,2	1,2	xxx	0,1	5,6
	1997	3,7	1,3	1,6	xxx	0,2	6,7
Slovenia	1995	1,6	0,6	1,4	1,2	xxx	4,8
	1997	1,8	0,7	1,5	1,9	xxx	5,7
CECs total	1995	.	.	.	.	.	14,8
	1997	.	.	.	.	.	14,2

Source: CESTAT; own calculations

The significantly higher shares of the CR and the SR in their total exports to CECs-5 compared to the other CECs-5 countries are due to the lasting intensive economic ties between the two parts of the former CSFR which remained CEFTA members as independent states.

Despite the absolute growing intraregional trade of CECs-5 and favourable conditions created by the Central European Free Trade Agreement its dynamics compared with the economically

advanced countries, i. e. mainly to CECs trade with EU, is showing a slower pace and declining share (Table 1.3).

Table 1.3

Dynamics and share of foreign-trade turnover of CECs-5 with themselves and with EU in 1995 - 1997

CECs	Index of change of foreign--trade turnover 1997/1995 with		Percentage share of foreign-trade turnover with			
			CECs		EU	
	CECs	EU	1995	1997	1995	1997
CR	102,0	105,8	18,5	17,7	61,1	60,7
SR	85,6	122,2	42,9	33,4	35,4	39,4
Hungary	127,9	134,4	7,6	6,9	70,7	66,8
Poland	138,3	125,1	5,9	6,2	67,0	64,0
Slovenia	110,1	95,6	5,8	6,4	68,4	65,6
Total above	104,4	117,8	13,8	12,0	62,7	61,4

Source: CESTAT; own calculations

In this connection a question comes to the fore, what perspective does the trade among the CECs and its future dynamics have? It would be possible to consider the impact of a favourable prosperity in these countries and in the world, the impact of measures of economic policy etc. However, the main factors which will impact further development of trade among the CECs will, according to analyses, be the structural barriers on the one hand and backwarded competitiveness on the other. It is to be mentioned that the CECs inherited both factors from the period of centrally planned economies.

STRUCTURAL TRADE BARRIERS AMONG THE CECs

Structural trade barriers among the CECs which may become a real obstacle to higher dynamics of economic cooperation among these countries, can be in principle seen in the insufficient commodity differentiation of the export specialization profile and thereby also in the production of individual CECs. In other words, the CECs have a very similar export specialization (production specialization), i. e. they are mostly specialized in similar groups of commodities or they are not specialized in similar commodities. This is confirmed by export specialization indices of individual CECs calculated in 2-digit level of SITC in Table 2.1.

The Table 2.1 includes into the export specialization profile of the given country that commodity group (accentuated in bold), the specialization index of which is $\geq$ 1,5. We can see in the table that the specialization commodities are in fact the commodities in 6 and 8 SITC in all CECs, and in these commodities there are also minimum chances to substantially increase trade within the CECs in the future. There are no chances in the 7 SITC, where only two 2-digit SITC groups reach a sufficiently significant degree of specialization which might also bring competitive advantages in trade within the CECs.

Some chances of further trade development among the CECs from the view point of needed differentiation of specialization could therefore be found in those commodity groups where the share of the number of specialization markets in the total number of countries (CECs) is relatively lower (in the case of CECs it is 20 to 40 %). This criterion is fulfilled by the commodity groups as folows: 54 — medical and pharmaceutical products, 58 — plastics, 64 — paper, 66 — non-metallic mineral manufactures, 75 — metal working machinery, 79 — other transport equipment and 85 — footwear.

Table 2.1

Export specialization index by main SITC commodity groups in CECs, 1995

2-digit SITC	CR	SR	Hungary	Poland	Slovenia	Number of specialized countries	Number of specialized countries / total number of countries, %
54 medical products	0,64	1,14	**1,50**	0,71	**2,79**	2	40,0
55 perfume, clearing mat.	1,14	0,71	0,29	1,00	1,43	0	0,0
58 plastics	1,16	**2,21**	**2,26**	0,42	0,68	2	40,0
62 rubber manufactures	**2,14**	**4,43**	**1,57**	1,29	**3,43**	4	60,0
63 cork and wood manuf.	**3,17**	**2,17**	**1,83**	**4,17**	**6,33**	5	100,0
64 paper, paper pulp	1,18	**2,35**	0,77	1,35	**2,94**	2	40,0
65 textile yarn, fabrics	**2,03**	1,39	0,68	0,74	1,26	1	20,0
66 non-metal min. manuf.	**2,18**	**1,91**	0,82	1,23	1,09	2	40,0
67 iron and steel	**3,56**	**6,37**	1,11	**2,33**	1,41	3	60,0
68 non ferrous metals	1,00	**1,50**	**2,00**	**3,75**	**2,00**	4	80,0
69 manuf. of metals	**2,58**	**1,84**	1,47	**2,32**	**2,21**	4	80,0
71 power gener. machines	0,88	0,71	0,33	0,67	1,08	0	0,0
72 mach. for particul. industries	1,20	0,50	0,63	0,63	0,47	0	0,0
73 metal working machines	**2,67**	**1,83**	0,67	0,67	1,17	2	40,0
74 general industrial mach.	1,128	0,85	0,80	0,59	1,08	0	0,0
75 office machines	0,21	0,05	0,57	0,02	0,02	0	0,0
76 telecom. & record. equip.	0,16	0,27	0,92	0,19	0,38	0	0,0
77 electrical machines	1,01	0,51	1,37	0,63	1,30	0	0,0
78 road vehicles	0,81	0,47	0,58	0,55	1,28	0	0,0
79 other transp. equip.	0,54	0,69	0,04	**1,81**	0,19	1	20,0
82 furniture	**2,11**	**2,44**	**2,00**	**6,56**	**6,11**	5	100,0
84 apparel & cloth. accessor.	0,69	0,86	**2,29**	**2,89**	**2,29**	3	60,0
85 footwear	1,11	1,44	1,44	0,89	**1,78**	1	20,0

Source: Trade database, UN; own calculations

However, this commodity structure of foreign-trade potential within the CECs is far from the demand structure which can be expected in the future development of these countries. This will orientate more and more to investment goods providing implementation of modern technologies and productivity growth as well as to durable consumer products. But these products are neither at present and perhaps nor will be in the near future available on the CECs' markets. Owing to this, the orientation of external demand of CECs towards markets of the economically advanced countries is fully objective and reasonable.

Concerning the export specialization, the situation in the CECs is in contrast to the situation for instance in the EU. Analysis of the EU market (Table 2.2) showed that the commodity differentiation of export specialization profile here is significantly higher with the average share of the number of specialized markets in the total number of markets in a given commodity group

Table 2.2

Export specialization index by main SITC commodity groups in the EU, 1995

2-digit SITC	Austria	Belg/Lux	Denmark	Finland	France	Germany	Greece	Ireland	Italy	Netherland	Portugal	Spain	Sweeden	U. K.	Number of special countries	% of number special countries
54	**1,571**	**1,786**	**3,214**	0,357	**1,786**	1,429	0,500	**3,429**	1,143	**1,643**	0,146	0,929	**2,357**	**2,429**	8	57,1
55	0,714	**1,571**	**0,857**	0,286	**3,857**	1,286	0,857	**3,000**	1,000	1,143	0,429	1,286	0,571	**2,143**	5	35,7
58	1,421	**3,000**	0,421	0,895	1,158	**1,737**	0,421	0,263	1,211	**2,579**	0,579	1,211	0,421	1,053	3	21,4
62	0,714	0,571	0,286	0,143	0,714	0,714	0,286	0,429	0,714	0,429	0,143	0,714	0,714	0,571	0	0,0
63	**2,667**	1,167	**2,833**	**4,167**	0,833	0,667	0,666	0,167	0,667	0,667	**6,000**	0,833	**2,000**	0,333	5	35,7
64	**3,882**	1,176	0,765	**14,294**	1,353	1,471	0,529	0,294	1,000	1,353	**1,941**	1,000	**5,882**	0,941	4	28,6
65	1,129	**1,548**	0,548	0,290	0,935	0,935	**1,548**	0,419	**1,806**	0,645	**2,258**	0,968	0,323	0,742	4	28,6
66	1,273	**3,909**	0,636	0,500	0,864	0,682	**1,773**	0,318	**1,727**	0,409	**2,000**	**1,636**	0,409	**1,500**	6	42,9
67	**2,296**	**2,296**	0,593	**2,037**	1,407	1,296	1,222	0,148	1,370	0,926	0,370	**1,630**	**2,074**	1,148	5	35,7
68	**1,563**	**1,688**	0,375	**1,563**	1,063	1,188	**3,438**	0,125	0,688	1,063	0,125	1,063	1,063	1,250	4	28,6
69	**2,421**	0,947	**1,368**	0,842	1,158	1,632	0,842	0,526	**2,053**	1,105	1,421	1,368	1,526	1,053	3	21,4
71	**2,417**	0,333	0,833	1,125	1,375	1,167	0,542	0,292	0,833	0,417	0,708	0,833	**1,542**	1,875	2	14,3
72	**1,933**	0,733	**1,333**	**1,867**	0,867	**1,967**	0,200	0,200	**2,333**	0,700	0,267	0,500	1,167	1,200	5	35,7
73	0,833	0,333	0,167	0,083	0,333	0,500	0,000	0,000	0,833	0,167	0,000	0,333	0,833	0,333	0	0,0
74	**1,692**	0,718	**1,897**	1,128	1,179	**1,872**	0,256	0,462	**2,077**	0,667	0,538	0,897	**1,590**	1,179	5	35,7
75	0,295	0,318	0,409	0,614	0,750	0,568	0,045	**4,864**	0,523	**1,727**	0,045	0,386	0,295	**1,841**	3	21,4
76	0,946	0,541	0,757	**2,351**	0,622	0,595	0,189	0,541	0,324	0,486	0,838	0,622	**2,351**	1,189	2	14,3
77	0,986	0,408	0,465	0,634	0,986	1,169	0,394	1,056	0,859	0,817	1,296	0,662	0,662	1,141	0	0,0
78	0,769	1,418	0,209	0,308	1,121	**1,538**	0,066	0,044	0,846	0,440	0,901	**2,165**	1,121	0,824	2	14,3
79	0,423	0,154	0,846	**1,385**	**2,231**	0,962	0,346	0,115	0,500	0,577	0,308	0,885	0,808	1,192	2	14,3
82	1,667	1,111	**5,000**	1,000	0,889	1,111	0,086	0,333	**4,000**	0,667	1,333	1,333	**1,889**	0,667	4	28,6
84	0,657	0,457	0,771	0,200	0,571	0,429	**4,857**	0,343	**1,771**	0,457	**4,686**	0,371	0,143	0,571	2	14,3
85	1,111	0,111	0,556	0,222	0,444	0,222	0,444	0,111	**3,556**	0,333	**8,111**	**2,333**	0,111	0,333	3	21,4

in the EU ranging roughly around only 20 % compared to 60 % in the CECs. Higher commodity differentiation also means a higher diversity of commodities available on a given market. Therefore, the large similarity in the export specialization profile of the CECs compels these countries to seek trade partners outside the CECs' markets.

3. COMPETITIVENESS - AN ISSUE OF ALL TRANSITION ECONOMIES

Another relevant factor which forms and very likely will for a long time create a serious barrier to CECs' trade acceleration is the relatively low economic competitiveness of these countries.

Numerous analyses have already confirmed the low level of competitiveness of transition countries in Central Europe when compared with the advanced Western countries (Outrata R., 1997), though the situation in this respect is different in regard to individual countries. Despite this, it would be useful to recapitulate the total state of competitiveness in transition countries in Central Europe compared to EU countries on the basis of selected relevant criteria (indicators) which might serve well as a starting point for the formulation of an appropriate support policy.

According to the rating of the *World Economic Forum* based on the so called multicriterion approach, particular transition countries of Central Europe found themselves as to competitiveness level rather in the second half of the total number of assessed countries (Table 3.1).

Table 3.1

Positioning of selected transition countries by competitiveness level

Country	Rank of assessed countries	
	1996	1997
Czech Republic	35./49	32./53
Hungary	46./49	46./53
Poland	44./49	50./53
Slovenia	not assessed	not assessed
Slovak Republic	not assessed	35./53

Source: The Global Competitiveness Report 1997, Executive Summary, World Economic Forum

Though competitiveness of transition countries in the given period did not increase radically according to the multicriterion approach, the position of the Czech Republic and Hungary in relation to the number of assessed countries showed definite improvement. Poland worsened its position, Slovakia maintained a position close to the Czech Republic and Slovenia in the years 1996-1997 was not assessed at all.

Another global or macroeconomic view at the competitiveness level is given by the indicator *Unit labour costs* (ULC).

As can be seen in Table 3.2, ULC were growing in all analyzed transition countries over the whole period of 1996-1998, thus creating conditions for potential reducing the price competitiveness.

However, because in 1996 and 1997 in all studied countries the nominal exchange rate decreased simultaneously, the real competitiveness decline substantially did not come. A turn happened in 1998, namely in the Czech Republic, Hungary and Poland, when currency appreciation, reduction of productivity differential and real decrease of competitiveness came.

Table 3.2

Unit labour costs development in the industry by selected transition countries

(Annual average percentage change)

Country	1996	1997	1st half of 1998
Czech Republic	14,7	9,1	2,9
Hungary	16,4	12,3	15,7
Poland	15,8	8,3	13,1
Slovenia	11,8	6,2	5,4
Slovakia	12,0	7,5	4,4

Source: CESTAT; own calculations

These conclusions are based on the calculation of another global indicator of competitiveness - relative real effective exchange rate (REER) in the table 3.3.

Table 3.3

REER[1] and corrected REER in selected transition countries

Country	REER			Productivity differential			Corrected REER		
	1996	1997	1st h. 98	1996	1997	1st h. 98	1996	1997	1st h. 98
Czech Rep.	1,035	0,840	1,144	1,018	1,002	0,966	1,017	0,838	1,184
Hungary	1,019	0,942	1,144	1,073	1,040	1,016	0,950	0,906	1,126
Poland	1,004	0,923	1,130	1,040	1,057	1,023	0,965	0,873	1,105
Slovenia	0,955	0,890	1,056	1,023	10,20	1,025	0,934	0,873	1,030
Slovakia	0,957	0,955	1,040	1,042	1,046	1,045	0,918	0,913	0,995

[1] REER was calculated on the basis of annual data and in terms of relative annual change by help of formula as follows:

$REER_{t,t-1} = [(CPI_{t,t-1})_d : (CPI_{t,t-1})_f] * (NER_{t-1} : NER_t)$

$REER_{t,t-1} > 1$ indicates change towards real appreciation of currency,

< 1 indicates change towards real depreciation of currency.

Source: Economic Survey of Europe, No.1, 3 , 1998, Economic Commission for Europe , UN, p. 116 (for the years 1996-97); CESTAT (for the 1st half of 1998); own calculations

The tendency of relative REER development for the whole investigated period 1996 - 1st h. 1998 is shown in the table 3.4.

Table 3.4

REER and corrected REER (by productivity differential) in selected transition countries in the period 1996 - 1st h. 1998)

Country	REER	Productivity differential	Corrected REER
Czech Republic	0,995	0,98	1,015
Hungary	1,032	1,13	0,913
Poland	1,047	1,12	0,930
Slovenia	0,898	1,07	0,839
Slovakia	0,954	1,14	0,837

However, when the competitiveness assessment on the basis of relative REER is made and mainly when the value of relative REER (according to the used formula) exceeds the number one, it means the competitiveness of an economy declines, it is necessary to include in this assessment framework the comparison of the productivity rate of growth relation, the so called productivity differential. The productivity differential expresses the relation between productivity rate of growth in the compared domestic economy and in foreign partners' economies.

As we can see from the tables 3.3 a 3.4, in all analyzed periods productivity differentials have largely pronounced positive relations in almost all the selected countries. Thus, when in the case of currency appreciation the productivity differential is taken into account (corrected REER), one can make the conclusion that a certain disadvantage due to currency overvaluation might be counterbalanced by an advantage in the form of a positive (>1) productivity differential. As is evident in tables 3.3 and 3.4, the REER indicator corrected by productivity differential, mainly for Hungary, Poland and the Czech Republic, where the evidence of currency appreciation in the investigated period has occurred, enables us to conclude that these currency appreciations did not necessarily lead to the loss of competitiveness.

It is difficult to estimate is whether productivity growth impacted by production costs is only being reduced, or whether simultaneously product quality is being increased as well. The third possibility is, that productivity growth is predominantly a result of hidden unemployment being released.

As one of the key indicators that characterises real quality competitiveness can be regarded the indicator of unit value of exports (Uvexp) and imports (Uvimp) and thereof derived relations of price and quality competitiveness (Aiginger K., Wolfmayr Schnitzer I., 1996).

According to this concept, countries with low unit costs of homogeneous production are usually net exporters of quantity (Qexp) and conversely. If a country is a net exporter of quantity at a simultaneous high unit value, then it is the result of quality differences in commodities. So the relation:

Uvexp<Uvimp–>Qexp>Qimp — indicates prevalence of price competitiveness,

Unexp>Uvimp–>Qexp>Qimp — indicates predominance of quality competitiveness.

We couldn't apply this concept for all transition countries due a lack of detailed data, but it was applied to Slovak industry (Outrata R., 1997). Analysis according to this concept shows

Table 3.5

Share of quality segment group within engineering industries in selected transition economies, 1994, %

Country	Mechanical engineering			Electrical engineering		
	Quality group			Quality group		
	I	II	III	I	II	III
Czech Republic	23,8	28,5	47,7	26,5	16,2	57,4
Hungary	27,6	35,3	37,1	18,8	22,5	58,7
Poland	27,9	26,6	45,5	16,7	26,5	56,8
Slovak Republic	8,2	34,9	56,8	15,1	7,9	77,0
EU	32,5	34,0	33,5	30,8	34,8	34,4

Note: Quality group I - high product quality
II - medium product quality
III - low product quality

Source: Landesmann M., Burgstaller J., 1997, Annex A

unambiguously that Slovak industry can gain a stake at the world market only due to price competitiveness, not due to qualitative competitiveness.

Another methodological approach to measure the quality effect of productivity is Landesmann's analysis of vertical product differentiation on the basis of price gap identification and quality segmentation (Landesmann M., Burgstaller J., 1997).

The results of the Landesmann approach application concerning share of quality segmentation in engineering industries as in most representative sophisticated manufactures are provided in the table 3.5.

In general we can say that the competitiveness of transition countries in 1996 and 1997 did not record any substantial success in overwhelming the considerable gap in relation to the competitiveness in advanced economies. Transition countries constantly maintain their position in the last third of the list of countries assessed by the World Economic Forum and the low

Table 3.6

RCA Indicator in CECs and in the EU by main SITC commodity groups in 1995

Commodity group	CR	SR	Hungary	Poland	Slovenia	CECs	EU
0+1 foodstuffs	-15,4	-32,8	133,6	14,6	-73,9	23,2	-13,2
5+6 chemical and semiproducts	+12,2	+52,0	-34,6	+3,0	+16,9	0,0	+9,4
of which:							
54 medical products	-102,2	-66,1	-27,6	-113,1	77,3	-58,8	19,1
58 plastics	-12,8	64,7	60,6	-147,6	-90,1	-23,2	0,0
62 rubber manufactures	40,5	148,8	20,1	11,8	98,1	51,1	0,0
64 paper, paper pulp	-4,9	-59,8	-93,2	-33,0	82,1	7,7	14,8
65 textile yarn, fabrics	50,6	54,2	-99,9	-119,5	8,0	-31,4	10,2
66 non-metal min. manuf.	98,1	96,5	0,0	25,1	18,2	55,2	20,2
67 iron and steel	65,2	123,5	-6,5	196,9	-14,7	65,5	13,4
68 non ferrous metals	-44,6	-4,1	-6,1	152,9	28,8	46,4	-23,4
69 manuf. of metals	42,6	129,6	-10,2	48,8	24,1	31,2	19,7
7 machines a equipments	-20,9	-42,2	-16,1	-34,9	-6,4	-24,0	13,0
of which:							
71 power gener. machines	48,0	34,8	-22,3	-17,2	8,0	6,1	16,7
72 mach. for particul. industries	-40,5	-114,2	-55,2	-86,2	-105,0	-67,1	59,8
73 metal working machines	28,8	-16,7	-22,3	-81,1	0,0	0,0	37,7
74 general industrial mach.	-39,0	-39,5	-47,8	-97,5	-6,9	-51,7	139,5
75 office machines	-151,6	-283,3	-154,0	-336,7	-317,8	-207,9	-31,4
76 telecom. & record. equip.	-157,6	-74,2	9,2	-127,3	-25,1	-69,3	0,0
77 electrical machines	-10,5	-26,7	31,2	-20,1	63,0	3,1	0,0
78 road vehicles	17,7	-20,9	-10,7	-1,9	-8,3	-1,6	12,5
79 other transp. equip.	103,0	109,9	-219,7	315,7	0,0	143,5	51,1
8 miscellaneous	2,6	33,3	36,0	74,9	70,7	43,1	-7,3
of which:							
82 furniture	64,2	148,2	58,8	228,6	152,2	147,6	16,7
84 apparel & cloth. accessor.	28,8	109,9	120,4	221,7	105,0	132,6	-43,3
85 footwear	69,3	117,9	69,3	69,3	98,1	78,8	0,0

Source: Trade database, UN; own calculations; own calculations

differential of productivity in 1998 insufficiently covers the growth of inflation differential and the decline of the nominal exchange rate. We may also state that shifts in competitiveness of transition countries were largely based on changes in price competitiveness (Outrata R., 1997). The quality competitiveness growth, when both the unit value of exports and at the same time the quantity of exports are growing and a positive trade balance is being achieved, has not become the main trend in competitiveness increases in transition economies.

In addition to this global gap, in all analyzed transition countries there exist gaps in commodity structure competitiveness too, though in some countries we can see more success in catching up than in others. These structural gaps in competitiveness follow mainly from the fact that transition countries achieve comparative advantages rather in less processed products (SITC 5, 6 and partly 8) than in the sophisticated final products registered mainly in the SITC 7 group. That is confirmed by the values of the calculated indicator *Revealed Comparative Advantage* (RCA) in table 3.6.

The higher competitiveness of CECs in comparison with the EU in less processed products and lower competitiveness in sophisticated ones in principle corresponds to the CECs specialization model. But it does not enable the substitution of competitive advantages among the CECs which is common among the CECs and economic advanced countries. In fact, it is an example of the structural weakness of the CEFTA countries' competitiveness.

However, the structural weakness of competitiveness generally has a negative impact on the global economy. The predominance of less processed products in total comparative advantages due to relatively lower value added does less to contribute to economic growth. Similarly, due to lower income elasticity of the mentioned products, there exists a risk of unstable and hardly sustainable growth in the opened transition economies, where the growth is driven mainly by exports. After all, relatively higher direct and indirect import intensity typical for production of less processed products, decreases the net exchange rate revenue considerably.

Structural gaps in competitiveness can be observed also in the lower share *of intra-industry foreign trade* in relation to the inter-industry one. It is generally confirmed (by means of Grubel-Lloyd index—GLI, see Table 3.7) that the predominance of intra-industry trade as a result of intensive vertical and horizontal product differentiation toward improving product quality, is realised mainly between economically advanced countries. On the contrary, the share of intra-industry trade is lower between economically advanced countries and less advanced (for example transition) countries and the inter-industry share is higher (the GLI value is on a lower level).

Table 3.7

Grubel-Lloyd index[1] in the transition countries and the EU

SITC commodity group	CR	HU	P	SL	SR	EU
5 chemicals	0,70	0,67	0,53	0,72	0,65	0,91
6 intermediates	0,66	0,76	0,46	0,66	0,43	0,89
7 machines and equip.	0,81	0,75	0,54	0,68	0,61	0,85
8 miscellaneous	0,82	0,60	0,30	0,57	0,56	0,89

[1] GLI is calculated as a weighted average of 3-digit SITC GLI (weight is the export share)

Source: CESTAT; Database on International Trade, 1995, UN; own calculations

While catching up, transition economies thus face the task of getting as near as possible to the total level and structural profile of competitiveness of Western European countries before gaining EU membership.

SUMMARY

Since 1992, when it reached its minimum in modern history, the trade between the CECs-5 has been developing positively, because it has grown annually by 7,8 % nominally. Undoubtedly, this may also be attributed to the Central European Free Trade Agreement, according to which by the end of 2001 all customs barriers are to be eliminated, mainly in imports of industrial products.

In parallel with the above agreement, the CECs' foreign trade is also influenced by the European agreements, which through their asymmetry appear to be competitive towards the Central European Agreement. This makes some barriers even more distinctive, which tends to hinder and in the future perspective would further hinder a more dynamic growth of trade among CECs or CEFTA countries.

Coming from the recent discussions on EU enlargement, when the question was raised whether CEFTA should be considered as a complementary group or an alternative to EU, we could raise a hypothetical question, whether foreign trade as one of the most important factors of the integration processes could have reached substantially higher shares than it has up to now (14 % on average), let's say up to today's EU level (round 60 %).

The answer to this question depends on two basic determinants. The first is the composition of CEFTA member states and this is connected namely with the political will-power of the concerned countries to become members of a group which would be an alternative to the EU and very likely an element leading to dividing Europe into a more advanced part and less advanced and relatively backward one. The second determinant is not less important and it consists of the objective assessment of the development potential of the CECs in relation to the catching-up processes, which have in connection with the re-integration of Europe just started.

If we consider only the second economic determinant, then two main objective factors may appear as obstacles to the acceleration of foreign trade in the above mentioned rate.

The first factor is the insufficient commodity differentiation of production or export specialization profile among the individual CEFTA countries. This has been inherited by these countries from the past development within their centrally planned economies and it still exists due to the relatively smaller CEFTA market, which does not enable as high a diversity of specialization as in the EU. The insufficient commodity differentiation of the export specialization profile in CEFTA member states paralyses the growth of more marked mutual competition advantages, among themselves.

The second factor is the low competitiveness of CEFTA countries in comparison with economically advanced countries. This factor is particularly important with commodities, which in CECs are mostly not commodities of specialization, i.e. largely with sophisticated products, the demand of which cannot be satisfied by domestic production. And this is just the case of CEFTA countries.

Through the analysis of both mentioned factors we have tried to set relevant arguments that the CEFTA group in the present structure has no chances for being an alternative to the EU, but only a temporary supplement or a bridge to entering the EU, which, however, could act in co-ordinating functions associated with EU pre-accession, but has not been acting in this respect, for the time being.

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EQUILIBRIUM, GROWTH AND COMPETITIVENESS IN THE CONTEXT OF THE TRANSFORMATION PROCESS:

THE SPECIFIC ROLE OF BANKS IN THE CZECH REPUBLIC

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The problem of a certain contradiction between the goals of growth and equilibrium are relevant for all CEFTA economies and their transformation processes. Historical circumstances and specifics determined their approach to the problem and found then expression in chosen economic policies. These policies (or their absence) have resulted in a greater or smaller effectiveness and competitiveness of the individual CEFTA economies. However, even general macroeconomic features, e.g. not fully completed transformation of the market system's functioning, can influence substantionally the inter-relations between the growth and stability and the resulting determination of the national-economy effects.

Trying to identify the role of main factors being in play, we demonstrate it on the case of the Czech economy.

1. GENERAL STARTING POINTS

- **Stability** (based on equilibrium, the attribute of which is a certain required structure) and **growth** belong to the basic macroeconomic characteristics. Sometimes they are considered to be opposing goals. However, they are inter-related categories which should be taken together as components in a balanced system.

- In fact, **growth** means surpassing what was done before which **disturbs the existing stability.** Therefore, the growth should respect certain given circumstances, or transform them as its own attribute: It may not drive the development in the **"bottlenecks",** where it would be blocked itself by the disequilibrium situation caused. It should therefore be a **"long-term sustainable" growth,** respecting internal contradictions - and at the same time unity - of both macroeconomic categories (meaning in fact a continuous achievement of optimum national-economy results under the given conditions).

- Stability and growth, in spite of being fundamental **macroeconomic** characteristics, are the results of not only the market development of the national-economy relations as such or their influencing through **macrointerventions** (especially the monetary policies, foreign exchange policies, etc.), but it concerns the functioning of the whole economy. The market decision-making of entities in the **microsphere** or political-economic measures influencing their situation through the functioning of market tools, base with their consequences the respective resulting (summary) national-economy characteristics. However, when looking for relevant forces and the degree of their influencing the macroeconomic development, attention is focused usually (or especially) only on the sphere of the "phenomenally primary" determinants, e.g. on the effects of **monetary policy** and its influence on the available **quantity of money** in the economy by changes in its **price** (interest rates) and on the **price of foreign exchange** (exchange rate).

- However, even in this regard it is necessary to see that it is not only a matter of the **central bank and its policy** as the monetary centre. The effects of the money supply changes and the price of money leads to the microsphere through further economic entities, i.e. especially **commercial banks,** whose activities arrange the concrete "dispersion" of available funds to the individual actors of economy, thus influencing its possibilities, competitiveness and results.

- With a certain simplification it could be said that whereas the growth of the economy is a matter of monetary policy of the central bank, i.e. especially of a bigger or smaller inflow of

financial means to the economy,[1] **stability, equilibrium and balance** of the economy are influenced by the activities of commercial banks to a large extent.

- The available quantity of money (influenced by the regulatives of credit engagement, capital adequacy, etc.) is allocated by commercial banks into the economy, its individual segments, branches and entities according to the degree of need and scarcity (expressed also by the degree of the expected appreciation of funds). An optimum allocation of funds by banks should so result under otherwise identical circumstances in approaching the **equilibrium shape of the whole economy's structure,** aimed at its stability.

- Generally, a quite natural aspect is at the same time the **pro-growth** effect of the respective credit activities of commercial banks: If it concerns financial means allocated to economic activities short of funds, where they appreciate to an adequate extent, this means a contribution not only to equilibrium and stability, but also to the **growth ratio** of the whole economy.

- The respective granting of a credit by a commercial bank (but in actual fact also the non-approval of a credit project and the non-granting of a credit) influences thus not only the **restructuring processes** of the economy (in the direction to equilibrium and continually renewed stability of its shape), but also the (resulting) process of its **growth.** In this regard each commercial bank is co-responsible for the economy's stability and growth (as a "by-product" of its credit activity, in spite of its orientation to its own profit primarily). The actual macro-results influence and verify the degree of success of the bank's decision-making, as to how they determine (acknowledge in the market) the financial results of individual elements of the whole economy, in which the bank has invested, i.e. **business enterprises.** It is actually a process of a gradual search for the volume and structural orientation of bank investments in firms which would be consistent with macro-needs, where the mediating market mechanism serves to highlight errors and mistakes. (An accompanying circumstance of the above-said is that some of the granted credits prove to be "bad" credits in this context.)

- Moreover, what has been said here generally, relates to the conditions of developed market economies with well-functioning national-economy (especially bank) systems. In economies in transformation affected both by the "heritage from the past" and (thus) by certain system imperfections, the determinants and national-economy interrelations are rather different.

2. LIMITS OF BANKING SYSTEM TO INFLUENCE STABILITY AND GROWTH UNDER THE CONDITIONS OF ECONOMIC TRANSFORMATION

For clarifying the role of commercial banks and their certain limitation in transforming economy the specific case of the Czech Republic may be used very well.

- Similarly to all post-Communist economies, Czech banking also had to face the **problem of "bad debts"** inherited from the past (which burdened above all the banks existing earlier). The transformation process also meant, however, the emergence and accumulation of new "bad debts" connected especially with privatization:

  – **The voucher form of privatization** as a more or less cost-free transfer of shares to citizens did not create and did not bring the required capital, because it was only an ownership re-allocation of the already existing property.

  – Privatization done through more **traditional forms** also had, however, its problematic financial and capital consequences. Under the understandable non-existence of own capital (and the then existing reservations about privatization by foreign capital) it was realized "through debt". It permanently burdened the financial position of privatized business enterprises.

[1] The fiscal policy or economic policies of other central, macroeconomically relevant institutions may also have similar effects. Moreover, in the present economy money supply as such is not only an exogenous variable, influenced by the central bank and its policy, but it is a correlate of the function of the economy as a whole, as we will discuss later, when evaluating the influence of the present system, institutional and legal framework, in which the economy has been developing.

  – The fundamental burden of financing of privatization lay (due to the non-existence and subsequently non-functioning of the capital market) on the shoulders of **commercial banks;** in fact, they were sometimes even driven to this position by the representatives of the government.

  – Under cicrumstances when bank credits acted as the main financial source, a significant **vulnerability to the development of interest rates,** used as an instrument of monetary policy by the central bank, must necessarily be observed in the whole economy. Their recent high level necessarily played, among others factors, an important role in negatively affecting the financial positions of business enterprises. And on the contrary, the development in the enterprise sphere has influenced and influences the whole banking system by feedback (how under these circumstances what were originally "good" credits passed to the category of "bad", unprofitable credits, burdening then the balance sheets of banks).

- This development was accompanied (or, more exactly, in many aspects determined) by forces **beyond the banking system.** These can be summarized as problems caused by an uncomplete legislative, control, legal and penal system, functioning in the framework of an economy in transformation.

- From the point of view of the above-mentioned interaction of the development of the enterprise sphere and the banking system, it concerns above all the difficult enforceability and realization of **creditor rights,** including the smooth utilization of the institution of bankruptcy for loss-making business enterprises. The Czech economy based on debt, the development of which has been and is conditional on **bank credit,** has been, however, unable - even after long-term negative experience - to build up a system framework ensuring a smooth functioning of the respective financial relationship (with regard to a decrease of riskiness of crediting, ensuring returnability of funds, etc.).

- These forces were reflected also in **impairment of the "classical" relationship** through which commercial on banks mediate the impact of monetary policy of the central bank to the real economy with the respective positive (stimulating or stabilizing and balancing) reaction in the corporate sphere:

  – The functionality and effectiveness of the process of business crediting enterprises by banks is conditional on the existence of the systemic possibility - and on the other hand the determination and will of the banks - to go far enough to enforce their rights that they make a indebted and non-prospering firm go **bankrupt.** (From the point of view of the whole economy this means a defacto "pro-growth" and "balancing" solution.)

  – The hitherto situation in the Czech Republic was characterized not only by the bad legislative treatment of the institution of bankruptcy, but it was also (or mainly) influenced by some accompanying implementation circumstances. Due to the amount of losses of creditors who are repaid only a small percentage of their claims, due to the length of the respective proceedings, bankruptcies and settlements are for banks only the **solution of the "last resort".** Banks dislike them.

  – These circumstances have a very negative impact on the very **quality of credit activity of banks.** Banks have sometimes provided and provide further funds to the indebted business enterprises in order to keep them alive and not to lose the possibility of return of such "frozen" credits. As a result, on the one hand the situation in the sphere of bad debts is reproduced, on the other hand the possibilities of banks to credit progressive and promising projects are limited. This means the bad allocation of even newly provided financial means and their suboptimal - or even unprofitable - utilization. It applies to this effect that granting of the highest possible volume of credits to business enterprises is not (need not be) a positive act under the given circumstances. It is the same if we proceed from the needs of stimulation of growth or from necessity of balancing of the economy determined by its restructuring.

- The recent Czech experience shows that the overall - macro-economy - system and

functional framework can impair the "classic" relationship and reactions between the activities of the central bank and the commercial banks also as far as the impact on the **volume of the provided credits.** The linkages between the central bank and the commercial banks may function effectively (they may intermediate the impact) only in the **direction toward the restrictive policy,** not (which is another aspect of the preceding item of our deliberation) toward the policy of **stimulating growth.** This is evidenced by the fact that a significant "price reduction of money" (where the Czech National Bank has decreased among others the two-week repo-rate from 15 % to 6.9 % in several steps since mid-year 1998) and a decrease of the rate of obligatory minimum reserves of commercial banks which enabled them to use additional funds in the value of several ten of billions of Czech Crowns, has not been reflected in economic activities at all, and it has not **acted for the benefit of growth** in the least hint so far.

- It is conditional especially (or primarily) on the **attitude of commercial banks** who started to behave prudentially under the described systemic and economic conditions aggravating the situation (or they made their existing criteria stricter) depending on the situation that

  – in many cases they have no guarantee for the adequate appreciation and return of their funds, as far as the condition of the credited business enterprises or quality of their projects and management are concerned (which, by the way, is closely interconnected, when the main negative determinant is the low level of effective corporate governance);

  – by providing a credit, banks often in fact lose control over their funds (as a result of the already mentioned inadequate legal protection of the enforceability of claims, impossibility to convert the provided guarantees in kind into cash, etc.);

  – by this all (and moreover by possible deterioration of the financial position of the clients in the time after credit is granted, connected with recession) the share of classified credits for which banks have to generate loan loss provisions and reserves has been increasing. In this way they lose further - although not "lent" - funds which they otherwise would have available.

- The present low (and in terms of the growth rate even decreasing) credit activity of commercial banks is caused primarily by **general, system-relevant and not only monetary and political factors.** Under this point of view, the ways, possibilities and limits of interaction between macroeconomic measures and policies and the development of the microsphere under the specific terms and conditions of economies in transformation have to be assessed (and probably also designed) otherwise. From this point of view, assigning "guilt" to the Czech National Bank in the fall of growth of the Czech economy and in what is called a **"credit crunch"** seems rather dubious.

3. THE PROBLEM OF DISPARITY IN THE DEVELOPMENT OF THE MONETARY AND REAL SPHERES

In the above context also identifying, understanding and evaluating the specifics seem important, which predetermine general possibilities, the depth and breadth of mutual interaction between the **banking (monetary and financial) system as a whole** and the sphere of **material production and business.** The point is especially, what space they determine for the transfer of impulses and mutual induction of the related market reactions among them, etc. which afterwards to a larger or smaller extent result in certain growth rates and a certain well-balanced state of the whole economy.

A specific expression - or rather result - of the above indicated systemic and institutional imperfections is, in this regard, a certain **disconnection** of organically binding and, under normal conditions, mutually closely influencing fundamental spheres of the economy, i.e. the **monetary (financial) sphere** and the **sphere of the real economy** (sphere of production and distribution). Their (to a certain extent disparate)

development projects then as an important factor, acting relatively independently in influencing the whole economy.

The rise and deepening of the disparity of the relationship between both spheres is also a historically-based matter. The main determinant was the starting "transformation situation" of the Czech economy, which conditioned the fictitiousness and unreality of the development of the relations of the major part of its financial sphere:

- The basis lay in **unrealistic evaluation processes** of the good assets in their re-allocation in the process of voucher privatization and subsequently in the course of share trading; as a consequence, really "fictitious capital" arose from the respective assets.

- An analogous state, however, was also created by the development of privatized business enterprises transferred through more traditional forms of privatization based on debt. It was sometimes under the terms and conditions which appeared to be **fictitious,** as well, when faced with actual value. Despite this, the system framework allowed the respective entrepreneurs to continue their activities, become more and more indebted and appropriate (undeserved) profit even in cases where there was no real basis for it at all (where "profit" was many times taken from additional credits provided by the bank sphere, or where it was based on the siphoning of funds).

- Such fictitiousness of assets (the over-estimated level of their prices and unreal valuing of the results realized on their basis) was further reproduced. It was maintained and confirmed by the following **unrealistic evaluations for the purpose of acquiring credits,** where such assets acted as guarantees. It "penetrated" (among others just through these credits connected with them) the banking system and the whole economy with negative consequences. (Among others, these overvalued assets - being applied to production - did not bring any actual profit which would correspond to their nominal financial expression.)

Here we get to the point of intersection of the historically developed characteristics of a fictive financial expression of real assets from the sphere of production, as well as of the impact of the monetary policy of the Czech National Bank as an exogenously acting factor towards the sphere of production. The size of the above indicated disparity between monetary and real relations and processes in the Czech economy has been and is under the existing conditions (in a different context and moreover from the "other side") influenced just through the level of interest rates as a factor based in the monetary sphere.

As far as the recent high interest rates are concerned, they have affected the Czech economy and its real sphere in several respects:

- Their level was in actual fact **beyond the capability** of the production sphere. Regardless of the amount of the nominal financial expression of assets, it was burdened inadequately in relation to the **real** value basis. The production results, the valuation of which has already been autonomous and objective, i.e. independent of the non-real characteristics at the beginning of privatization, have not corresponded to the high-set price of money. Very often production could not adapt its budget requirements and was unable to cover even the interest obligations from its result, let alone the principal amounts of investments. (Regardless of the desirability of tightening of the funding and budgeting regime of business enterprises, including normalization of their access to external sources, it represents nowadays, under the conditions of an overall recession, a big problem from the point of view of **survival of the indebted enterprises.** This phase of "cleaning" - in fact restructuring - of the production and commercial sphere was experienced by other CEEC economies earlier, when the economic, social and political impact was not so weighty as it seems to be now by us.)

- Whereas the high interest rates burdened the sphere of material production and commerce unreasonably and decreased (or even impaired) its profitability, they quite naturally ensured profit from **investment in the financial sphere.** Under the given conditions, through this use

of funds it was (and still is) possible to realize positive results more easily (and especially with a lower risk) than through **productive utilization of capital.**[2]

- This led to the general **preference for investments in financial assets and activities,** in actual fact to a **distortion of the allocation function** of the whole financial system: Money (capital) was allocated from savers to the economy in other ways and to other places than what corresponded to the actual needs for growth and equilibrium, to the needs of restructuring and modernizing production. (It is probably possible to say that a significant part of required funds will thus not get to the production sphere at all and experiences a certain non-productive "self-motion" only in the closed framework of the financial and banking system. This is evidenced by the high share of interbank deposits, the large holdings of Czech National Bank Treasury Bills, state bonds, etc. in the portfolios of commercial banks instead of credits in the entrepreneurial activities.)

- Interest rates, by establishing with their relatively high levels a large interest differential vis-à-vis neighbouring partners' economies, induced an **inflow of foreign funds** aimed at a high appreciation. Their objective - as short-term financial means - was and is logically the financial sphere of the Czech economy under the given conditions. It had certain consequences in the relation to our discussed problem:

  - This actual inflow of speculative capital, motivated otherwise than productively, strengthened the above-indicated tendencies for separation of the development of the financial values and relations from the needs of the development of the sphere of material production and goods circulation.

  - The coming foreign speculative capital did not mean any pro-growth impulse for the production sphere due to its character and "short-term stay" (with foreign investors taking, however, a share of the profit generated in the domestic economy). This capital inflow is problematic also from the point of view of establishing and strengthening the equilibrium of the economy as a desirable consequence of setting of high interest rates; in fact, the objectives of the internal and external economic equilibrium got into a certain system discrepancy with the results - in some regards a counter-productive - of the respective restrictive policy (see the necessity to neutralize inflation pressures caused by the inflow of funds to the economy, in the form of "sterilization" of these funds and strengthening of the anti-inflation policy which, however, induced its further subsequent inflow).

  - This found its expression also in the specific influence on the **development of the exchange rate of Czech currency.**

Just the exchange rate of the Czech currency (CZK) is the **most striking external manifestation of the separation of the monetary relations from the real sphere of economy.** Its development had and still has very little in common with the development of the real sphere and its decisive indicators ("fundamentals"). It is conditional to the decisive extent on the monetary, financial sphere and its relations, especially on the level of interest rates (more exactly on the interest differential) making the Czech currency attractive for foreign speculators. Even under conditions of declining Czech GDP, falling labour productivity, contracting volumes of production in industry and construction, etc., the exchange rate of Czech Crown reacted in an inadequate - we wish to say even "perverted" - way: Its development (which was striking above all in the year 1998) was far from following the size of falls of these national-economy figures or from the degree of general pessimism of expectations of what would happen further in the real

[2] Just opening the problem of the disparity of the development of the monetary and real sphere of Czech economy, we do not deal with further concrete forces, which are determining it. It concems partially general factors characteristic for each development market economy, the Czech specifics of the so far "non-established" systemic framework being, however, very important. Among others, the circumstances in the Czech capital market, transactions of investment companies and funds with shares coming from voucher privatization may be mentioned, which bring quite real profits for some entilies on fictitious bases (and moreover, it was sometimes the case even at variance with legal – or at least ethical – norms).

sphere of Czech economy.[3] In the background of its relative stability, there is just the **determination by interest rates** (which even after their drastic decrease are attractive for foreign investors due to decreases of interest rates in their own countries) and the **high liquidity of Czech currency** which is traded in large amounts also outside the Czech Republic. This liquidity, together with the relatively low volatility of the exchange rate characteristic also for the period after the transition of Czech currency to a floating system, is the basis for a **low-perceived riskiness of possessing Czech currency.** It stimulates the interest of foreign investors, which subsequently influences the exchange rate, etc., etc. We have here therefore the case of a certain "perpetual motion machine", functioning relatively independently of the development in the sphere of material production and goods circulation. (Or it would be more adequate to say, from the point of view of our main topic, that it is rather a "circulus vitiosus", a vicious circle, which, by its effects, confirms the existence - and at the same time makes breaking it difficult - of the limits separating the monetary and real sphere of the Czech economy, making impossible their smooth positive interaction.)

[3] The index of change of the average nominal exchange rate of CZK for the given year in relation to the preceding year was in 1997 only 1.012 DEM (1.168 in USD), in 1998 1.003 in DEM (1.018 in USD), where it suprisingly kept its relatively high position especially in the second half of the year. Only this year has brought a higher measure of CZK weakening (the index for January to May was 1.042 in DEM and 1.171 in EUR).

COMPETITIVENESS OF THE ROMANIAN ECONOMY: WHAT WENT WRONG?

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Inconsistencies in the reform programme and deep-rooted inherited disequilibria are at the core of the weakening competitiveness of the Romanian economy. The balance of payments has deteriorated further in the last couple of years due mainly to slack progress in both reform and privatisation at the micro-economic level. Moreover, the accelerated pace of liberalising external flows has enhanced the above mentioned weaknesses.

In recent months, the Romanian authorities succeeded in putting together a policy mix aimed at improving competitiveness and rapidly curbing disequilibria via stepping up reforms at the micro-economic level and pursuing prudent and consistent policies at the macro-economic level.

Despite the complex and controversial nature of competitiveness due to its different definitions—that focus either on the balance of payments or on the combination of balance of payments developments and domestic performance—this concept is widely believed to be the ability of an economy to ensure growing sustainable welfare. Regardless of the definition accepted by experts, the factors underlying competitiveness are generally acknowledged and can be classified into three categories, according to which this concept breaks down into the three renowned components: price competitiveness, quality competitiveness and technology competitiveness.

The competitiveness of an economy in the present external environment grows more important as economic globalisation involving stronger inter-relationships between markets and higher production interdependence gains ground. One of the effects of globalisation is the bias towards creating regional integration areas that picked up momentum during the 90s. Regionalisation can be instrumental in expanding domestic markets and boosting competitiveness as well as in synchronising government policies (product standardisation, environment issues, competition policy, labour force standards). For CEFTA member countries, the final objective of which is EU membership, regionalisation is also regarded as an instrument for enhancing the credibility of policies and the stability of the respective countries as well as a means to strengthen their negotiation power in international relationships. These are some of the main reasons that determined Romania to join the CEFTA in July 1997.

From this standpoint, I have not intended to make a thorough approach to the complex challenges posed by the competitiveness of the Romanian economy, but to identify the main causes and explain the reasons behind its worsening in the past years, particularly as regards the trade relationships within the CEFTA.

DEVELOPMENTS IN ROMANIA'S EXTERNAL SECTOR

The Romanian economy has been facing a dangerously widening current-account shortfall in the past few years as a result of the worsening trade balance, which has particularly been hurt by several factors, as follows:

1. the sluggish exports that, after recording a step increase by 1995, have hovered around USD 8,000 million since 1996;

2. the ongoing upturn in imports that saw a relatively steady increase after having risen as much as USD 3,000 million in 1995, i.e. 45 percent;
3. maintenance of a below-par coverage of imports through exports between 1990-98, which fell to a 76.1 percent low in 1998.

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* The views expressed in the paper are those of the author and do not necessarily reflect those of the National Bank of Romania.

These unfavourable developments had a negative impact on the balance of payments that worsened sharply and on the current account that posted a 7.9 percent deficit-to-GDP in 1998, a record high for the past eight years (Chart 1).

Once Romania joined the CEFTA, its trade deficit worsened further due to dismantling of customs duties against the background of an insufficiently restructured economy. More specifically, the following developments were recorded:

1. an as much as 19 percent rise in Romania's imports from CEFTA member countries in the very first year of its membership (Romanian imports from these countries soared 81 percent in the latter half of 1997 compared with the first one) and a 61 percent surge a year later. Consequently, their share increased steadily from 4.7 percent in 1995 to 5.7 percent in 1997 and to 8.8 percent of total imports in 1998 (Chart 2);

2. a much slower growth of Romanian exports to CEFTA countries, i.e. 16.6 percent in 1997 (up 48 percent in the second half of 1997) and merely 7.6 percent in 1998, affecting only marginally Romania's export composition by country; exports to CEFTA countries as a share of total exports expanded from 3.6 percent in 1996 to 4 percent in 1997 and to 4.4 percent in 1998;

3. the share of trade deficit with CEFTA members in Romania's trade deficit rose to 12.7 percent in 1997 (the year when Romania joined the CEFTA) and to 22.6 percent in 1998; the USD 591 million worth trade deficit in 1998 overran by far the value of Romanian exports to these countries, i.e. USD 369 million.

CAUSES OF ROMANIA'S LOW ECONOMIC COMPETITIVENESS

The poor performance of Romania's external sector as a whole and within the CEFTA was the consequence and, at the same time, an indication of the low competitiveness of the Romanian economy relative to both the CEFTA market and other markets where the Romanian goods face the competition of exports from CEFTA countries and elsewhere.

The major obstacle to the rise in competitiveness has been the insufficient structural adjustment of the Romanian economy. Even though the stalemate or the errors in implementing government policies added to the structural difficulties of the economy, the downturn is deeply-rooted in the former "socialist industrialisation"-style of the Romanian economy and in the voluntaristic and highly autarchic manner in which it had been conducted. Thus, the ever growing degree of international specialisation and globalisation of output during the 60s was associated with a continuous pullout of Romania from the international trade channels. Our economy had therefore to pay tribute to an overly diversified production system that had been created by completely ignoring the principle of comparative advantage.

Assuming that structural adjustment cannot be accomplished without harmonisation of Romania's economy with the world economy, which involves the openness of the former, the Romanian authorities have chosen fast-track liberalisation of foreign trade exchanges; consequently, it was assumed that economic exposure to foreign competitiveness would be one of the engines of restructuring. Unfortunately, several factors stood behind the snail's-pace restructuring of enterprises, such as untimely domestic and external liberalisation measures, delays in both privatisation and putting in place a regulatory and legal framework for market-adjustment mechanisms, and manufacturers' reluctance in response to external constraints.

The short-sighted behaviour displayed by enterprises, namely the distortion of their key function (as long as they have been taking aim at wage maximisation) carried on, entailing high costs, low productivity, and an output structure that failed to meet demand. The structure of the economy further saw a large percentage of monopolies benefiting from soft budgetary constraints (building up tremendous arrears and losses) as well as the prevalence of large energy-intensive industries, which rely mainly on imports. Against the background of the ongoing turmoil, the Romanian economy has continued squandering resources on imports and exports that mismatched market demand. This behaviour was at odds somewhat with the hasty removal of customs barriers.

Against this backdrop, the external competitiveness of the Romanian economy and therefore its current account were hit by various factors, fluctuating from one period to another and mutually reinforcing to impact on Romania's foreign trade.

COMPETITIVENESS THROUGH LABOUR COSTS

Analysis of the factors affecting the Romanian economy competitiveness highlights the relatively strong correlation between current account and labour cost developments. Accordingly, the dismal performance of the balance of payments in recent years was due to non-correlation between wage policy and the results in economy as a whole and in industry since the growth rate of USD-denominated wages compared to an "equilibrium" year, i.e. 1994, posted significant above-par values. (Chart 3). The rise in USD-denominated wages had a perverse impact once the opening up of the Romanian economy took hold, resulting in an oversized demand for imports

COMPETITIVENESS THROUGH CURRENCY VALUE

Starting in 1994, when I consider that a relative balance in the exchange rate of the Romanian currency was struck, the exchange rate in itself put downward pressures on foreign trade balance, as follows:

- although pointing to a limited elasticity relative to exchange-rate movements, exports were severely hindered by the steadfast strengthening of the local currency in real terms—as measured by PPI—that averaged at a record high of around 25 percent in 1998 (Chart 4);

- imports moved in line with the real-term currency strengthening—as measured by both PPI and CPI—to hit an all-time high of 30 percent last year.

OTHER FACTORS AFFECTING COMPETITIVENESS

The poor competitiveness of our economy was also hurt by a low amount of foreign direct investment (FDI) in Romania during the transition years. FDI plays a key role in an economy's competitiveness thanks to its ability to replace domestic macro-economic investment in particular, but also to enhance enterprises competitiveness by way of management, marketing, and know-how transfers. From this viewpoint Romania sloped in last among CEFTA member countries (Bulgaria excluded) when it comes to the cumulative amount of FDI per capita between 1990-98; at end-1998, this index was over 10.5 times lower than in Hungary (USD 1,604 per capita).

In addition, tax-related factors added to our external imbalance. *Inter alia,* the different approaches to implementation of subsidisation policies in CEFTA member countries caused the current-account deficit to widen. It is noteworthy that, in certain agrifoodstuffs-exporting countries, the high level of subsidisation of the farming sector gave a boost to the Romanian imports of farming products.

MEASURES AIMED AT NARROWING THE CURRENT-ACCOUNT DEFICIT

Given the dangerous widening of the current-account deficit and particularly the overburdening foreign debt service in 1999 and 2000, the narrowing of the current-account deficit is a prerequisite for lasting stabilisation and recovery of the Romanian economy. I do not dispute the headway made towards external liberalisation; obviously, resumption of protectionist practices. However, efforts should be made to enhance the competitiveness of the Romanian economy on world markets. In furtherance of this goal, the measures that are being taken address the deep-rooted lack of competitiveness.

Since the most potent cause behind the external imbalance is the snail's-pace restructuring of the economy, enterprise restructuring is the top priority. Among the measures that are being carried out, I would mention the following:

- sharp reduction in losses and subsidies in the state-run sector; thus, 46 coal pits accounting for almost one third of losses in the mining sector as well as several large companies that failed to lure investors are being closed down;

- fast-track privatisation, which has already been initiated; in the first quarter of 1999, 585 enterprises have been privatised (of which 35 large ones) accounting for 5.7 percent of the SOF's share capital. It is worth mentioning that 8 percent of the SOF's share capital was privatised throughout 1998, while between 1990-97 a mere 10 percent of the SOF's capital went private.

The objective of improving Romania's competitiveness on world markets also requires the co-ordination of economic policies addressing both macro- and micro-economic issues. In fact, the economic programme already in progress aims at consistently addressing weaknesses that I referred to above through:

- a real depreciation of the leu was unavoidable. In order to limit its inflationary impact, both monetary and fiscal policies have been tightened up;

- another key element has been a tight income policy that addresses both excess domestic demand and external competitiveness of the Romanian products. In this respect, any nominal increase in wages in the loss-making enterprises was ruled out, while the inflation target was set between 32 and 35 percent in 1999. State-owned enterprises that failed to respond to the tight budgetary constraints are being forced out of the market via legal proceedings;

- tax adjustment; the consolidated general government deficit for this year was set at around 3 percent of GDP, the balance on the primary deficit being envisaged to display a surplus;

- restructuring of inefficient industries, the input demand of which has become inelastic.

I have to stress that, in recent months, most of the measures presented above have already been put in place and that the picture is quite an encouraging one. For instance, after seven months of real depreciation of the leu (i.e. during September 1998-March 1999), at the start of April, the Romanian currency has stabilised even in nominal terms, and forex market developments pinpoint a significant improvement in the balance of payments.

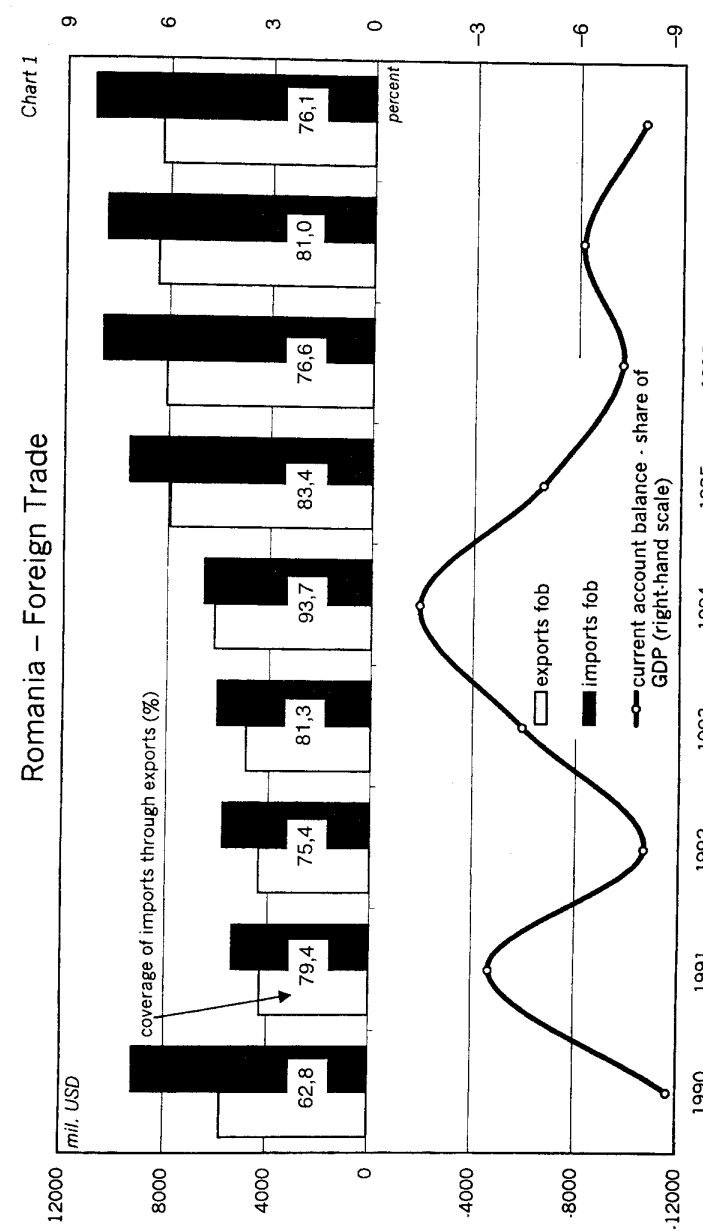


Chart 2

Foreign Trade with CEFTA Countries

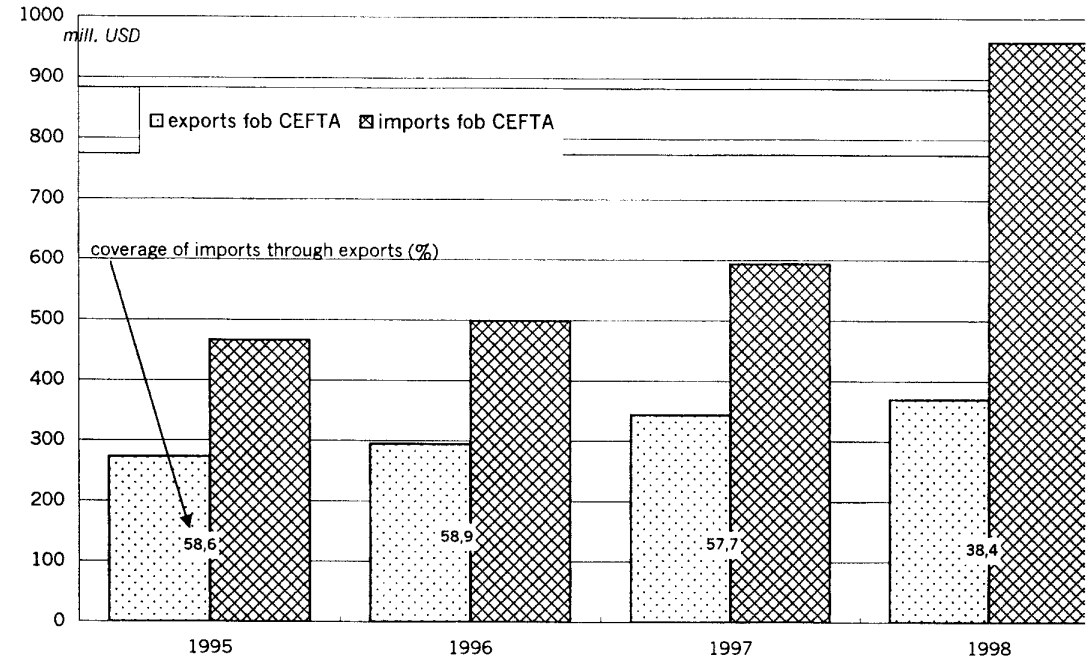


Chart 3

Industry - wages and ULC

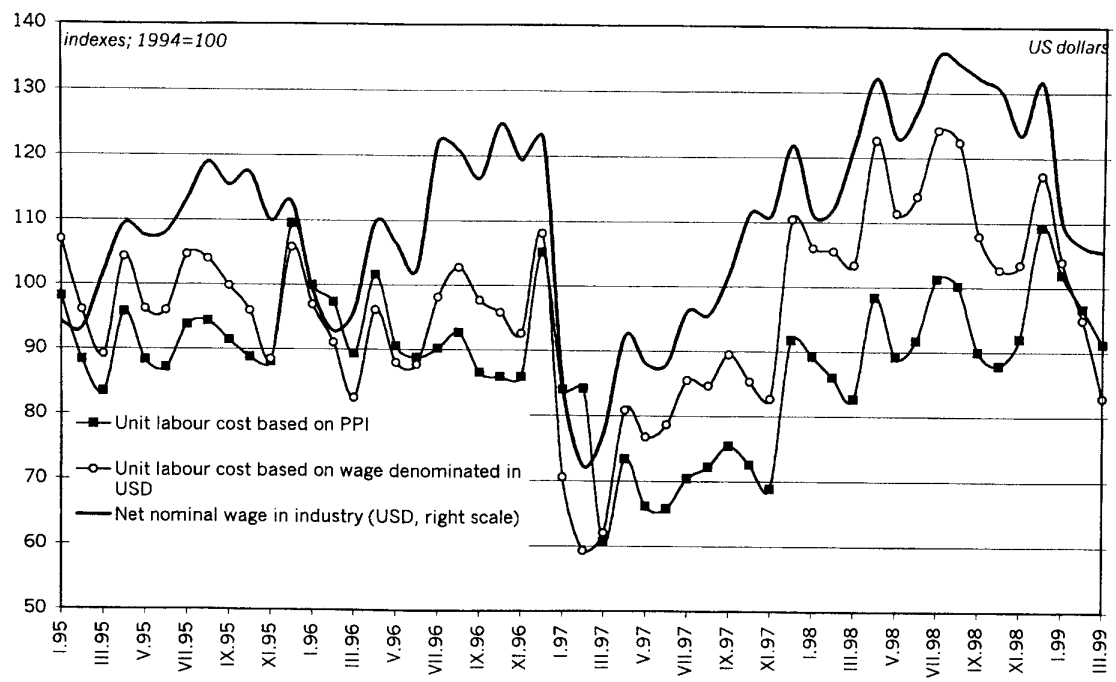
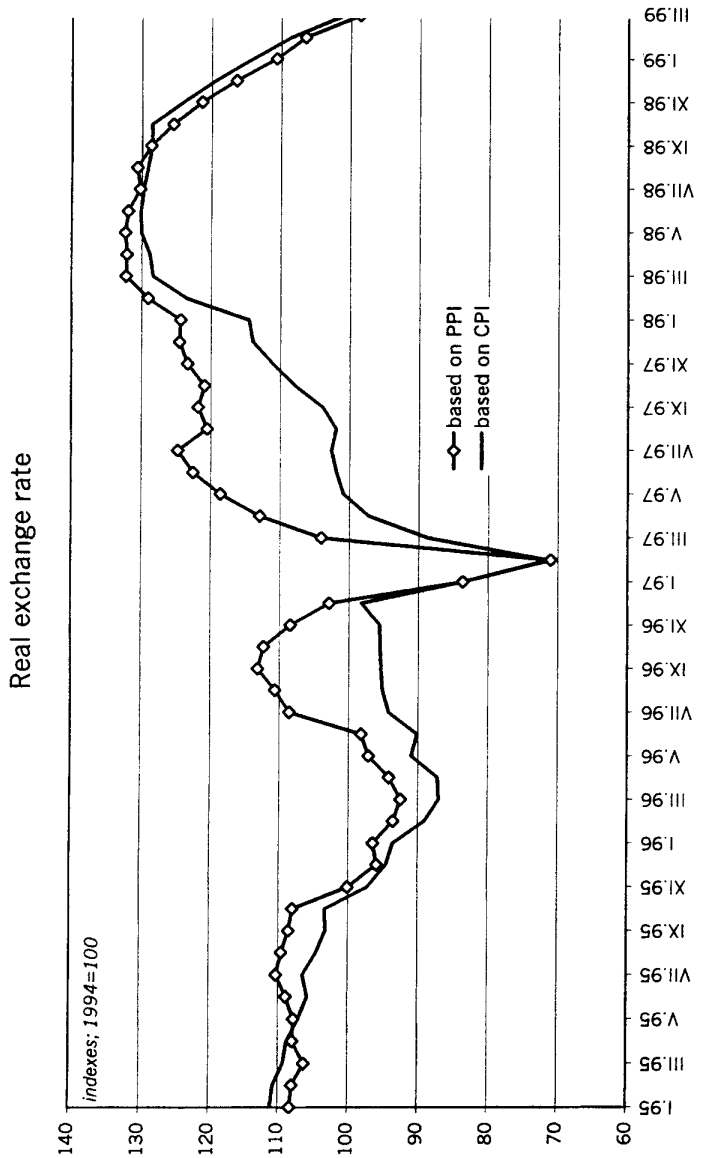


Chart 4



COST AND TRADE COMPETITIVENESS OF CEFTA COUNTRIES

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INTRODUCTION

This presentation evaluates the international cost and trade competitiveness of Central and Eastern Europe at both the macroeconomic and industrial branch levels. We start with a review of wage and labour productivity developments and present new unit labour cost estimates. A detailed analysis of export competitiveness, reflected in the changing composition and factor content of manufacturing industry trade with the European Union, follows. The final section summarizes the main findings from the ongoing research on the impact of foreign direct investment on restructuring, and provides also some policy recommendations.

LABOUR COSTS AND PRODUCTIVITY

Even the most advanced transition countries have average wages which are only a fraction of those in Western Europe (the average monthly gross wage, converted with current exchange rates, amounted in 1998 to only ECU 280-320 in the Czech Republic, Hungary and Poland and to ECU 850 in Slovenia). This is much less than in more advanced EU countries such as Austria, Germany, France or the Netherlands (all around ECU 2000), though Slovenian wages are not much lower than wages in either Greece or Portugal. Wage developments display diverging patterns, not only among the individual transition countries, but also when measured either in domestic or in foreign currency. Initially, the 'competitive devaluations' resulted in considerable wage cuts in foreign currency, but subsequently the international wage competitiveness deteriorated. Despite a clear tendency towards real appreciation, all CEFTA countries maintain a 'competitive' exchange rate. The Czech koruna remains more undervalued than either the Polish zloty or the Hungarian forint, not to mention the Slovenian tolar (the latter has been the strongest currency in the region). This would imply that in all these countries there is room for additional wage increases and/or currency appreciation. However, unless accompanied by quality and productivity improvements, a too strong currency appreciation may lead to current account problems – as the recent experience of Hungary (1995) and the Czech Republic (1997) illustrates.

Domestic real wage developments vary with the price deflator used. Real product wages have been growing faster than real consumer wages, though both indices increased less than those of wages expressed in foreign currency. This indicates rapidly rising wage costs for producers which employees (as consumers) did not feel too much in their pockets. Moreover, (nominal) money wages were growing much faster than labour productivity, indicating rising wage costs in domestic currency. Unless compensated by currency depreciation, rising domestic wage costs resulted also in deteriorating international cost competitiveness. This was the case in all CEECs after 1989, though in Hungary and in Slovenia the growth of wage costs was much less pronounced than in the Czech Republic and Poland. The Czech devaluation (in 1997) and wage restraint (in 1998) somewhat helped to reduce the excessive wage costs growth of the previous years. Adjustments have so far been much weaker than those applied in Hungary during 1995-96. A deterioration of the Polish wage cost competitiveness might require similar policy responses in the near future as well.

Wage levels in the CEEC manufacturing industry are not much different from averages for the whole economy. But there are considerable (and mostly growing) wage differences across individual manufacturing industry branches. Hungary and Poland show the highest wage dispersion while the Czech Republic has the smallest wage spread. In all CEECs, there has been an increase in the wage dispersion after 1989. Compared with the manufacturing industry average, wages have been generally declining in the textiles and leather industries while, on the other hand, rapidly growing relative wages are observed in the paper and printing industry, in the

coke and refined petroleum industry, as well as in chemicals. In most CEECs, relative wages increased also in the highly successful (and foreign dominated) transport equipment industry – apparently without adversely affecting its competitiveness.

Existing productivity gaps partly eliminate the cost advantages arising from the low wages. What really matters are the *unit labour costs (ULCs)*, defined as the ratio of wage costs to labour productivity. Aggregate ULCs (ECU adjusted) rose during the 1990s especially in Poland and in the Czech Republic, i.e. productivity lagged considerably behind the growth of ECU wages. ULC growth was much less pronounced in Hungary and Slovenia. In the manufacturing industry, international ULCs have been generally growing less rapidly than in the economy as a whole (in the Czech Republic, Poland and in Slovenia), or the ULCs' drop was here much more pronounced (in Hungary) than in the whole economy. An outstanding feature have been impressive ULC improvements in almost all branches of Hungarian manufacturing after 1992 (ULCs in the Hungarian manufacturing industry dropped by 7% per year during 1993-97), sharply contrasting with deteriorating labour cost competitiveness of most industries in the Czech Republic and Poland – at least until 1996. Another startling feature are remarkable ULCs' improvements (mainly thanks to huge productivity increases) in the transport equipment, electrical and optical equipment industries in all CEECs. This provides another piece of clear evidence for efficiency gains brought about by foreign management .

A comparison of ULC levels across countries requires *internationally comparable productivity level* estimates in order to eliminate not only exchange rate fluctuations, but also cross-country differences in the base year price level. Rough estimates show that, despite considerable increases during 1990-98, even in 'high-wage' Slovenia average PPP-based ULCs were only around 60% of the Austrian level in 1998 (about 50% with indirect wage costs included), followed, after a large gap, by Poland (40%), the Czech Republic (30%) and Hungary (28%). Assuming that the relative price levels in the manufacturing industry (and, even more ambitiously, also in its individual branches) are the same as over the whole GDP, one can get a tentative picture for *ranges in sectoral ULC levels* in the manufacturing industry, again relative to Austria. The lower ULC range results from (higher) productivity estimates obtained with conversion using PPP for the whole GDP (Table 1a), the upper range from (lower) productivity estimates when using PPPs for gross fixed capital formation (PPPCAP – Table 1b).

In the Czech Republic, the international ULCs in the manufacturing industry measured in ECU have been growing rapidly until 1996, due to both sluggish productivity growth and rapid wage increases which were even magnified by currency appreciations. In contrast, Hungarian and Polish manufacturing industry productivity was growing fast: about 15% per year during 1993-97 in the case of Hungary, somewhat less in the case of Poland. In Hungary, international manufacturing industry ULCs dropped by more than 30% between 1993 and 1997; Polish data suggest an increase by about 7% per year after 1995 (and a slight decline in 1997). A more intensive involvement of foreign investors in the Hungarian manufacturing industry brought about large efficiency gains, visible also in the improved labour costs competitiveness, in several branches ULCs have even dropped below the level of the Czech Republic and Poland by 1996. The growth of Slovenian manufacturing industry ULCs has been modest (less than1% per year on average during 1993-97), but their level is still about twice as high as in the remaining three CEECs.

EMERGING TRADE SPECIALIZATION PATTERNS

Labour costs advantages should give the CEECs an important competitive edge above all in labour-intensive industries. On the other hand, there is still a shortage of capital and the skills required in a market economy in most CEECs. A detailed 'shift and share' market analysis reveals that about 70% the CEECs' 1993-97 export increment (of more than ECU 17 bn) can be attributed to 'competitive gains' of market shares in the EU, whereas the effect of 'general demand growth' was much smaller (less than 30% of the total export increment) and the 'structural effect' was even negative. The largest 'competitive gains' were recorded in a heterogeneous mix of industries, but contrary to the initial period of 'passive restructuring' (roughly until 1993), a larger number of more sophisticated branches now appears on the top: motor vehicles (NACE 351), electrical machinery (342), tools and finished metal goods (316),

Table 1a

International comparison of total labour costs in the manufacturing industry

1996, PPP for GDP, Austria 1995 = 100

		Czech Republic	Hungary	Poland	Slovenia[1)]
D	Manufacturing	21.0	22.7	24.7	51.5
DA	Manufacture of food products; beverages and tobacco	19.3	26.0	25.3	52.6
DB	Manufacture of textiles and textile products	26.0	43.1	36.5	70.4
DC	Manufacture of leather and leather products	30.5	56.2	37.4	67.4
DD	Manufacture of wood and wood products	23.2	26.1	25.2	55.0
DE	Manufacture of pulp, paper & paper products; publishing & printing	17.0	24.3	19.6	44.8
DF	Manufacture of coke, refined petroleum products & nuclear fuel	13.1	30.7	16.2	22.0
DG	Manufacture of chemicals, chemical products and man-made fibres	15.2	26.2	24.5	49.1
DH	Manufacture of rubber and plastic products	18.4	16.5	18.6	41.5
DI	Manufacture of other non-metallic mineral products	22.5	26.9	28.0	58.3
DJ	Manufacture of basic metals and fabricated metal products	21.5	19.9	24.8	48.4
DK	Manufacture of machinery and equipment n.e.c.	31.4	28.0	32.0	46.2
DL	Manufacture of electrical and optical equipment	25.6	19.6	22.8	60.3
DM	Manufacture of transport equipment	20.9	16.4	30.8	38.8
DN	Manufacturing n.e.c.	22.1	27.6	21.3	39.8

Table 1b

International comparison of total labour costs in the manufacturing industry

1996, PPP for gross fixed capital formation, Austria 1995 = 100

		Czech Republic	Hungary	Poland	Slovenia[1)]
D	Manufacturing	31.7	36.4	33.3	61.6
DA	Manufacture of food products; beverages and tobacco	29.2	41.8	34.0	62.9
DB	Manufacture of textiles and textile products	39.3	69.3	49.2	84.3
DC	Manufacture of leather and leather products	46.0	90.4	50.3	80.7
DD	Manufacture of wood and wood products	35.0	42.0	33.9	65.9
DE	Manufacture of pulp, paper & paper products; publishing & printing	25.7	39.1	26.3	53.6
DF	Manufacture of coke, refined petroleum products & nuclear fuel	19.8	49.4	21.8	26.3
DG	Manufacture of chemicals, chemical products and man-made fibres	23.0	42.2	33.0	58.8
DH	Manufacture of rubber and plastic products	27.8	26.5	25.1	49.6
DI	Manufacture of other non-metallic mineral products	34.0	43.3	37.7	69.8
DJ	Manufacture of basic metals and fabricated metal products	32.4	32.1	33.4	58.0
DK	Manufacture of machinery and equipment n.e.c.	47.4	45.1	43.1	55.3
DL	Manufacture of electrical and optical equipment	38.6	31.5	30.7	72.2
DM	Manufacture of transport equipment	31.5	26.3	41.5	46.4
DN	Manufacturing n.e.c.	33.3	44.4	28.7	47.6

Note: 1) Indirect labour costs estimated as 24% of total labour costs for all branches.

Sources: WIIW estimates based on national statistics, Wirtschaftskammer Österreichs, OECD, EUROSTAT and UNIDO.

radio and TV sets (345), parts and accessories for motor vehicles (353) all recorded the largest competitive gains. On the other hand, there have been some industries incurring 'competitive losses', again either over the whole period 1989-97 or, suffering from a sort of adverse restructuring effect, only after 1993. Clear losers were in the whole period parts of the food processing industry (such as fruit and vegetables, fish and meat processing) in Hungary and Poland. This is largely due to the still existing EU trade barriers in the agro-food trade. But in the more recent period (1993-97), competitive losses are being recorded also in clothing, footwear and furniture (as well as building materials and cement in the Czech Republic) – all industries which were viewed as highly competitive in the period before.

RCA patterns did not change much during the later phase of transition: the biggest RCA values have still been observed in 'traditional', less sophisticated industries such as cement, wood, textiles, clothing, footwear and metals, whereas comparative disadvantages (negative RCA values) are located mainly in machinery, equipment, electrotechnical, pharmaceuticals industry as well as in a number of food industry sub-branches. Also from a dynamic perspective, there were just a few industries with improving (rising) RCA during the 1993-97 period. Correlations between RCA values and x-factor intensities reveal a clear pattern: most CEECs display highly significant positive correlations between RCA values and labour- and energy-intensive industries while having comparative disadvantages (negative correlations with RCA values) in skill-, R&D- and capital-intensive industries. Interesting developments can be discerned especially in the more recent period:

- high, and mostly statistically significant, positive correlations of RCA values with labour-intensive industries. In Hungary, there seems to be a move away from this specialization pattern after 1993 while it continues in the Czech Republic and in Slovenia; it even increases in Poland. A persistence of this specialization pattern could lead to problems in view of high, resp. growing, ULCs in Slovenian and Polish manufacturing industries;

- mostly negative (though statistically not significant) correlations between RCA values and R&D intensity. Moreover, the gap is clearly narrowing in Hungary and the Czech Republic, less so in Poland;

- an even larger gap in skill-intensive industries (highly significant negative correlations with RCA values in most CEECs). There are again remarkable improvements in Hungary, Slovenia and in the Czech Republic. In the two former countries the skill gap is not statistically significant anymore;

- somewhat diminishing comparative disadvantages in capital-intensive industries after 1993 in Hungary (declining negative correlations of capital-intensity with RCA values) and persisting (and statistically significant) comparative disadvantages in Poland. This would suggest that the comparative lack of capital in Hungary is becoming less visible (effect of FDI inflows);

- a markedly less pronounced specialization in energy-intensive sectors (declining positive correlations with RCA values) in the Czech Republic and Poland.

FDI, RESTRUCTURING AND COMPETITIVENESS

In the first years of transition, FDI was attracted by newly liberalized markets and by the sale offers of selected strategic companies. Efficiency seeking investments were initially seldom. With time passing, the market access has become less important and the cost factors started to prevail. By the end of 1998, about half of almost USD 60 bn invested by foreign companies in the four CEECs was invested through privatization-related acquisitions. Some 10-20% were green-field investments, the rest being investment into already existing foreign investment enterprises (FIEs). Mass privatization by vouchers, sales to insiders, or management buy-outs have hindered foreign acquisitions, whereas in direct tenders foreigners usually outbid domestic investors. The main method of privatization has thus boosted FDI in Hungary, was neutral in Poland, and hindered it in the Czech Republic and Slovenia. As of end-1998, the stock of FDI reached USD 9.4 bn in the Czech Republic, USD 19 bn in Hungary, USD 28.5 bn in Poland and USD 2.5 bn in Slovenia.

The foreign investment enterprises (FIEs) are generally larger than domestic companies in terms of employment, and even more so in terms of nominal capital or assets per company. The highest share of FIEs by all available indicators has been reached in Hungary where the foreign penetration is on average 2 to 3 times larger than in Poland and in the Czech Republic. The foreign sector shows rapid expansion not only in terms of growing capital and sales, but also in terms of employment. The recent recession in the Czech Republic may have widened the gap between the crisis-ridden domestic and booming foreign sector, leading to a further increase in the foreign penetration. Survey data show that labour productivity in FIEs is on average up to two times higher than in domestic enterprises in all CEECs. At the same time, FIEs pay, on the average, by 20-30% higher wages than domestic companies. This would imply that the general ULCs advantages identified above are becoming even more pronounced in FIEs. The productivity advantage exists in both technical terms and in terms of higher output value due to higher sales prices. If the FIE sector is very different from the domestic, the two segments of the economy may find it difficult to co-operate and the foreign sector functions as an enclave. FIEs invest more than domestic companies and have thus a positive effect on the economic growth and restructuring. Investment data also suggest that foreign investors rapidly restructure the acquired manufacturing firms. Production restructuring is usually connected with lay-offs. Foreign penetration thus may increase unemployment in the short run, but also generate more new jobs later. Investments of FIEs are mostly financed by retained profits, which thus may not be repatriated on a massive scale. Although the current account data sometimes show an increasing profit repatriation, the FIEs' reinvestment of profits is also growing. As long as CEECs remain favourable locations for FDI in terms of expected profit, there is no reason why most profits should be repatriated. The effects of FDI are thus far from unequivocal, a number of negative aspects can be quoted as well. Also short-term problems may emerge due to fast restructuring in terms of capacity destruction and lay-offs of the workforce. These may generate not only social and regional inequalities, but growing foreign trade deficits as well.

The presence of foreign capital in CEEC manufacturing industries is very uneven. The main branch with above-average foreign penetration is manufacturing of transport equipment (DM), most notably motor vehicles. This is the industry where FIE shares in capital and sales are usually the highest in CEECs. The second branch generally dominated by the sales of FIEs is manufacturing of electrical machinery and equipment (DL). Next comes the food industry (DA) which has about average foreign penetration rates in all CEECs. High shares of FIEs thus appear in both domestic-oriented branches like food, beverages and tobacco, and in predominantly export-oriented industries like motor vehicles and electrical machinery.

Foreign penetrated industries have been highly competitive in exports. Labour productivity gaps between foreign and domestically owned enterprises are evident at the level of individual industrial branches as well. Low productivity (growth) usually occurs in industries/countries with lower than average foreign penetration. On the other hand, the highest productivity gap (improvement) can be associated with above average foreign penetration in a branch. There has been a very fast trade restructuring going on. In the more recent period, a number of sophisticated branches of CEECs' manufacturing industry became competitive as well. The Hungarian move away from specialization on labour-intensive industries (and some closure of skill- and R&D gaps) illustrates positive effects of foreign investments on restructuring. On the other hand, a slower pace of trade restructuring identified in the Czech Republic, Slovenia (and even some deterioration in Poland) is not only detrimental to their competitiveness, but could lead to problems in integration and catching up with the EU as well.

SUMMARY
OF OPINIONS EXPRESSED AT THE END OF SESSION IV

Compiled by Miloš Štěpánek,
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1 DELIBERATE DELAY IN JOINING THE EU

Because the level of productivity in many countries (maybe with the exception of Hungary or Slovenia) is rather depressing and some structural weaknesses of the CEFTA countries are well known, would it not be an advisable strategy within CEFTA integration to adopt a more delayed accession into the EU single market strategy?

Certainly not! There are no direct relations between membership in the EU and the restructuring of the CEFTA countries. Processes of integration in trade, investment, etc. are going on even now irrespective of earlier or later membership in the EU. From this point of view membership in the EU does not have a great importance. Thus delay is not a strategy.

2 POSITION OF DIFFERENT COUNTRIES IN TRANSFORMATION

Three or four advanced CEFTA countries include Slovenia and Poland. The Czech Republic lost the leading position, has fallen back, is having problems now. Hungary is now first. Is this the consequence, that Hungarian transformation has relied almost entirely on foreign capital as the most significant feature?

There is also evidence of a satisfactory Unit Labour Cost development in Slovenia and that ULC is lower in other countries. Why do the Slovenians have success in this aspect and not the others?

Slovenia has had ca 30 years of limited experience with social market economy which was not the case of many other transformation countries. The importance of the pre-1989/90 reforms, or social market reform experiments, has been largely underestimated in the transforming countries. One of the lessons of the decade of transition is that these social market reform experiments of the 70's and 80's were very helpful in developing market-oriented behaviour, that cannot be created by one stroke. This is surely a part of the explanation for Slovenia?s relative success.

The cost competitiveness of the Czech Republic has worsened from 1990 to 1999. At the beginning of the transformation the depreciation of the exchange rate of the Czech crown was sharper than would have been adequate to the economic level of the country. Czechoslovakia had in 1990 the highest GDP per capita per employed person; but the lowest dollar wages. By now it equilibrated and the Czech ULC level is nearly the same as the Hungarian, and very near to that of Poland and Slovakia. Empirical analysts point out that during the decade this initial advantageous starting point — formed by depreciation of currency and other factors —

equilibrated with other transforming countries. Now the Czech cost and wage competitiveness is developing worse than in Hungary.

It is necessary to take into account the structure of the economy and it's adjustment to new markets. The problem is that the Czech Republic — as the former GDR — played another role in the former COMECON market. Both had a very high share of machinery, heavy machinery, metallurgy etc. But to compete in these more sophisticated branches with developed EU economies is far more complicated than to compete with simpler, not so sophisticated products with not so much value added. Therefore such enterprises are in great trouble and are the candidates for revitalisation programmes. These large machinery enterprises Škoda Pilzen, ČKD Prague, ZPS Zlin cannot compete without joining with foreign capital. The Czech experience suggests that the success of Hungary in deep restructuring may lie in higher share of foreign capital.

Hungary has taken the option of foreign investment. It became more foreign capital friendly than other countries, because it needed foreign capital to finance the deficit of the balance of payment current account.

One of the most significant features of the Hungarian experience was the external constraint that the country faced from the very beginning. It was a good incentive for policy makers to find better policies and open doors faster than others.

3 INFLUENCE OF THE BULGARIAN CEFTA MEMBERSHIP ON TRADE WITH ROMANIA

The accession of Bulgaria into CEFTA: What kind of impact it can have on Rumania's trade within CEFTA? How strong may be the bilateral trade potential between the two countries?

Bilateral trade between Bulgaria and Romania is low and was low not for the reason of high barriers or any type barriers whatever. The war in Yugoslavia was more detrimental to both countries trade than the accession of Bulgaria to CEFTA.

4 UNIT LABOUR COSTS

There was an attempt made in Prague to calculate the ULC for the Czech Republic using methods on the basis of GDP/per employed person measured by purchasing power parity and wages. Compensation for employees was made according to the national accounts statistics to be comparable with the EU and its members. The figures show a picture similar to the one presented at this conference. Compared to the EU the level of GDP/per employed person in the Czech Republic was 51% in 1997; compared to Germany it was 48%. But the average wages per head, - or to be more precise: average compensation per employee measured by exchange rate - was only 16% in 1997. In comparison to neighbouring Germany we get only 1/3 of ULC. That means that the problem of the Czech Republic's economy is not in the wage-, cost- or price competitiveness so much as in quality competitiveness, or say in non-price competitiveness. It is our main problem and the main problem of all CEFTA countries.

5 IMPACT OF THE EU ON LABOUR MARKETS

This aspect was not specifically tackled in any paper presented at the conference. Traditional trade theories mention factor proportions, according to which you can say: If you have trade, you have some pressure on wages, because the countries are differently equipped with factors, labour etc. But in the new versions of trade theories you have the second generation of vertical or inter-industry trade models focusing on vertical intra-industry trade. The driving force for this kind of trade structure is technology, or technological change. In this way we can also explain the pressure on wage and wage differentiation in western countries including the US as a question and consequence of technology change. This way it is discussed in the literature and, of course, opinions broadly differ about factor proportion theory vs. technology change.

6 WORKERS AND FOREIGN COMPANIES

Is it good or is it bad, this influence of international companies? Hungarian development was a success story for profit makers. Was it also a success story for the workers? If you read statistical data correctly, the Hungarian workers lost. Is this true? Is this right sort of question to be posed?

The income of the Hungarian workers stagnated last year. Wages are declining. The question is what would happen if Hungary did not have foreign investment? There might be even larger decline and Hungary would probably go bankrupt.

7 FOREIGN DIRECT INVESTMENTS (FDI)

Is it necessary for a successful transformation of the CEFTA countries to have many foreign or western investors? A lecture today connected the success of Hungary with the FDI; one transparency presented a comparison of economic growth correlating with the degree of foreign ownership. The opposite position was formulated by Martin Myant, who strongly questioned too much reliance on foreign capital.

The evaluations of FDI influence — are they balanced? Everybody is trying to express the good sides, good examples and positive consequences of FDI for all countries which are receiving capital. But we can't forget that the owner (exporter) of the capital decides to what country, to what branch, to what industry and how to locate this capital. This is a one sided seeing and one-sided evaluation. Very often it is not in line with the expectations of CEFTA countries. They wish for capital to come with high-tech into labour intensive industries etc. Is this the best solution for a country which generally suffers from the lack of capital, lack of new technologies? The investment should also push and create economic growth, and reconstruction in the sectors which are strategic for the economy. We cannot evaluate FDI only as positive.

What is different about FDI compared with normal domestic investment? The domestic investor also makes the decision where to invest. And you cannot blame the foreign investors or companies that they do not follow the intentions of the country. If they did this would be a planned economy, where you can force and push your domestic investors to go in the direction which they do not want, not taking into consideration their economic calculations but the country's interests.

We have empirical evidence. We can observe practically in all transforming economies, that enterprises, specially large enterprises, which do not have any kind of co-operation with foreign investors are usually in big trouble. The foreign owned sector doesn't need to be 100% owned foreign. But so called foreign investment enterprises are usually very successful in all countries. We have numerous examples from the Czech Republic, from Slovakia and of course from Hungary, Poland and other transforming countries as well. It is very difficult to restructure medium and large enterprises in CEFTA countries without access to capital, without access to new markets, without new management, know-how, technology etc. At the same time, foreign investments are not the only way, a panacea, the only solution of the transformation programme.

There are many stumbling blocks or difficulties. One of the problems is — and again the Hungarian example shows it — that at some time the repatriation of profits will start. And it has already started in Hungary last year. It is a new phenomenon, a surprise for Hungary. It leads to the deterioration of the balance of payments. One has also to think about policies, how to counter-act. The companies are reinvesting a part of their profits. The foreign investors — like every investor — are interested in profit. At one point the profit repatriation will start. And Hungary — which has been a pioneer in foreign investment attraction — has also to be the pioneer to point out this new aspect. The other transforming countries will feel such problems at some later time.

The advantageous impact of FDI are not only in growing wages. A much more important advantage is the contribution to restructuring and improved efficiency. And from the medium- and long-term points of view a more sustainable growth can be anticipated.

One of the difficulties is the difference between the foreign and domestic sector, which are

developing quite contrarily and there is a certain danger that the gap between foreign owned enterprises and domestic enterprise will grow. This is one of the problems even in Hungary, that the domestic sector is suffering from.

It is too early to say, what will happen when the repatriation of capital, of profits will start. It may not create a serious problem, provided that the restructuring of the economy was successful, and that the quality competitiveness is there.

8 QUALITY COMPETITIVENESS

There is a new direction of research for the future — competition in quality. All CEFTA countries have a long-term industrial tradition, well educated and skilled workers. Competition with low wages is not a long-term perspective. Therefore more importance must be given to factors of non-price competitiveness. This is a conclusion from long-sighted serious analysis.

CEFTA countries and the Czech Republic especially do not have problems in cost or wage competitiveness, but in quality. For improving quality and competitiveness FDI as well are of enormous importance.

No significant example is known where there should have been substantial quality improvement without the help of FDI, management, marketing, technology improvement etc. Research regarding the changes in quality competitiveness is being done. And Hungary, again, shows the greatest improvement in quality competitiveness indicators, the unit prices of the Hungarian exports improved quickly, much faster than in other CEFTA countries.

9 SEVERAL FINAL OBSERVATIONS

A story goes, that an economist was asked about the implications of the French revolution. He replied that "It is too early to say". We may also say: It is too early to say what the implications of CEFTA membership are, the existence of CEFTA itself, and the duration of it.

However, some of the questions asked can be answered clearly: it is good to open the economy! To integrate the economy with the EU using CEFTA as a kind of door to the EU is also positive, without any doubt, for all the countries, including those with a deficit! FDI are definitely useful! Even if it doesn't increase the wages all the time or from the very beginning. Even if it is not quite clear, what influence repatriation of profits will have in due time.

But it is important to bear in mind that neither of those things are in themselves sufficient. They are — all of them — a part of a big puzzle, you may say, a big policy structure.

Some external constraint is usually — for the policy makers — stronger than other incentives and helps them to react more appropriately, to have more consistent policies to different disequilibria. What they should not do is to remain at only opening the economy; but they should make consistent fiscal, monetary, income policies and structural policies as well. The government should, of course, not dictate that industry A or industry B be developed. But at least it should create conditions, line the playing field for longer term perspectives.

At the end of the day, all the countries — front-runners and those further back — have more or less the same kind of education, similar cultural background. What differentiates the countries are mostly the policies followed by their governments in the aftermath of the fall of the communism. The fact, that some of them acted toward FDI — toward opening their economies — faster and better than the others probably proved to be crucial. The restructuring of the economy is important, quality competitiveness is important. But this is the conclusion: We should do each of these things and more and more.

CLOSING REMARKS

Miloslav Had

LADIES AND GENTLEMEN

Allow me to make several closing remarks as a member of the Executive Board of the Association for the Study of International Relation which co-organised this conference.

First of all I would like to thank all of you for attending this conference and taking an active part in its deliberations. We very much appreciate that you were willing to send us beforehand your written contributions which helped greatly in preparing the conference.

In four sessions all the planned issues were discussed. I think we all benefited from the presentations and discussions. The views which were presented enriched our knowledge not only of CEFTA, its potential, its future, but also of other regional groupings, namely the economic co-operation of the Baltic states. Important contributions to this conference were the presentations which explained the policy and positions of individual countries, both member-states and non-member-states of CEFTA.

Of course, the underlying and very important aim of the conference was to assess the future development of the European integration process, namely the enlargement of the European Union. I think that in this direction also this conference contributed to our knowledge.

Today's session on the competitiveness of CEFTA member-states contributed, in particular, to better understanding of this very important and complex issue which is of utmost importance to all countries of this region.

As the co-organisers of the conference, we would like to put together the material which we have at our disposal and with your permission we intend to publish it as soon as possible and to disseminate it not only to the participants of the conference but also to the interested audience - to the officials which are working on this issue and to the academic institutions. I would therefore take this opportunity to ask you for your permission to proceed this way.

Before I close, I would like to say that we are very glad that Mr. Maurice Guyard from the DG1A of the European Commission in Brussels could come to this conference. I think it can help him in his work which is closely connected with the present intricate stage of enlargement.

I would like to thank the co-organisers of this conference: the Institute of International Relations in Prague and the Prague Delegation of the Friedrich-Ebert Foundation. And our thanks also go to our sponsors — the Friedrich-Ebert Foundation in Prague, Československá obchodní banka and Investiční a poštovní banka — who are two of the most important banks in our country. Without their financial assistance this conference would not have taken place.

I would like to thank the staff of the Association — Mr. Štěpánek, Mr.Viktora, Mrs. Dražilová — who worked very hard in order to make this conference possible.

CEFTA COUNTRIES – IMPORTANT TRADING PARTNERS OF THE CZECH REPUBLIC

CZECHTRADE
Czech Trade Promotion Agency, Prague

Since its inception, the Central European Free Trade Agreement (CEFTA) has not only been developing internally, it has also been developing relations with the other countries of Central and Eastern Europe. CEFTA represents an important and efficient instrument for the expansion of trade relations and intensification of co-operation among its member countries. This is evidenced by the growth of mutual trade which displayed high dynamics, especially so immediately after the first liberalisation measures had been implemented. The present growth rates are more modest, and reflect the current situation in the development of free trade in the region as well as the situations of the individual economies.

Not all CEFTA member countries are equally active in approaching the issue of liberalisation. Thus, liberalisation has not progressed at the rate which had been originally envisaged.

A standard situation exists at present mainly with respect to manufactures, except those which are generally acknowledged to be most sensitive; manufactures are being imported practically free of duties and other trade barriers. Full liberalisation of trade in manufactures is envisaged by 1 January 2000 and, with respect to selected commodities and certain countries, by 1 January 2002. An important task in accomplishing this objective will consist of the intensification of bilateral and multilateral consultations aimed at the prevention and/or limitation of protection measures to only an indispensable level.

As far as agricultural products are concerned, the CEFTA agreement does not aim at full liberalisation of mutual trade. The degree of liberalisation that has been achieved is already causing economic problems in certain countries economic problems, resulting in the introduction of protection measures, such as quantitative restrictions, and in the cancellation of preferential tariffs with respect to certain commodities. The process of elimination of administrative barriers to trade or mutual acceptance of certificates and tests has also been only partly successful.

In connection with the alleviation of the impact of protection measures on the development of agricultural trade and with the intensification of co-operation in this field, the need is being stressed for the resolution of emerging problems by way of consultations and through a search for a conciliatory settlement. The Czech Republic attaches special importance to a bilateral approach in the intensification of the liberalisation of agricultural trade with Poland, Hungary and Slovenia and possibly also with Romania. Great importance is also attached to the preparation of a complete review of the existing systems of concessions, to common agricultural and commercial policies as well as to the common agricultural and alimentary database.

Future expansion of trade relations among the CEFTA countries depends also on more intensified negotiations of agreements concerning certification as well as on mutual acceptance of tests and accredited laboratories*), on the interpretation of certain articles of the CEFTA agreement with a view to the acceptance of common rules for its implementation, on the elaboration of the so-called "horizontal provisions" of the CEFTA agreement concerning, for example, state subsidies, economic competition, public orders, etc., on the elimination of subsidies in mutual trade in products in respect of which tariff concessions had been granted, and on the organisation of common conferences on investment opportunities in the CEFTA countries as well as on other activities aimed at the promotion of trade among the CEFTA countries and trade with third countries.

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* The member countries are expected to mutually exchange proposals on such agreements by 30 June 1999, and agreements should be concluded by 31 December 1999.

Meetings of representatives of the CEFTA countries have always provided an opportunity for recapitulation of the achievements of this organisation as assessed by individual countries, in our case of its contribution to the Czech Republic, to its economy and foreign trade. With the aim of arriving at an objective assessment, we cannot neglect certain important facts and tendencies which deserve our attention.

These include above all the process of the enlarged membership of the CEFTA with the accession of Slovenia and Romania and, as of 1 January 1999, Bulgaria. Taken together, these three countries represent a market of approximately 33 million inhabitants (the CEFTA countries as a whole form a market of almost 98 million), and interested in membership are also other countries of Eastern Europe. The relatively large size of this market could enhance export and import opportunities with respect to certain raw and other materials, semi-finished products and could undoubtedly influence rational decision-making by producers with a view to production optimisation and efficient co-operation.

Worth noting is also the so far favourable growth of trade turnover (both exports and imports) between the Czech Republic and the CEFTA countries - as compared with 1995, Czech exports to the CEFTA countries increased in 1998 by almost 38 % and Czech imports from these countries by somewhat less than 20 %, the fact that trade with the CEFTA countries maintained a significant share (17 % in 1998) in total foreign trade turnover of the Czech Republic (above all in total Czech exports — the share in 1998 represented almost 20 %, in total imports 14 %) and the regular achievement of a favourable balance in this trade; in 1998, the surplus represented 23 % of Czech exports to the CEFTA countries. Trade with this region thus substantially alleviates our chronical problem which consists of the high deficit of the overall foreign trade of the Czech Republic.

Foreign trade between Czech Republic and CEFTA countries[1)]

	1995	1996	1997	1998	1998 January - March	1999 January - March
	CZK billion					
Czech exports	122.71	135.68	159.42	169.27	44.21	35.43
Czech imports	109.53	109.57	128.65	131.09	33.48	28.73
Trade balance	13.18	26.11	30.77	38.18	10.73	6.70
For illustration purposes: Total Trade balance of the Czech Republic	-95.72	-157.72	-139.27	-79.51	-15.36	-18.46

[1)] Based on actual membership

The positive effect exerted by the favourable balance of trade between the Czech Republic and the CEFTA countries on the overall deficit of the balance of payments was especially felt in 1998, when CEFTA's membership was enlarged thanks to the accession of Romania. The CEFTA countries represented the only geographical group with respect to which Czech foreign trade closed with a surplus. Its total value exceeded the surplus generated in 1997 by CZK 7.40 billion. The largest increment was generated in trade with Poland (by CZK 2.93 billion), followed by Romania (by CZK 2.42 billion), Slovakia (by CZK 2.30 billion) and Slovenia (by CZK 0.56 billion). The surplus generated in trade with Hungary remained practically at its 1997 level (CZK 2.39 billion). The accession of Bulgaria to CEFTA will obviously enhance both Czech exports to the CEFTA countries and the effect of this trade on the balance of trade between the Czech Republic and the CEFTA countries.

Another aspect which is worth noting is the differentiated trends of Czech foreign trade with individual CEFTA countries, and especially the strong influence of trade with Slovakia which has, however, been able to draw on the "heritage" of the common state. This trade segment has been somewhat slowing down recently in favour of trade with the other CEFTA countries, especially with Poland (with the largest economic potential), but also with Hungary. In 1998, trade turnover with Slovakia declined, while trade with all the remaining CEFTA countries

maintained favourable growth parameters; total trade turnover between the Czech Republic and the CEFTA countries, except the Slovak Republic, rose by 16.4 % above its 1997 level (as compared with the growth of 4.3 % when including Slovakia), and exceeded the overall growth rate of Czech foreign trade.

Foreign trade of the Czech Republic with individual CEFTA countries

Country	Exports 1997	Exports 1998	Imports 1997	Imports 1998	Trade balance 1997	Trade balance 1998	1998 share in total Czech exports	1998 share in total Czech imports
	CZK billion						Percentages	
Hungary	13.56	16.18	11.25	13.79	2.31	2.39	1.9	1.5
Poland	41.45	48.10	27.61	31.33	13.84	16.77	5.7	3.4
Romania	2.91	5.42	0.76	0.85	2.15	4.57	0.6	0.1
Slovakia	93.30	90.56	72.08	67.04	21.22	23.52	10.6	7.2
Slovenia	6.62	7.47	4.82	5.10	1.80	2.37	0.9	0.5
Unspecified	1.58	1.53	12.13	12.98	-10.55	-11.45	0.2	1.4

As compared with 1997, the value of trade turnover significantly increased in 1998 in trade with Poland (by CZK 10.38 billion) as well as with Hungary (by CZK 5.15 billion) and Romania (by CZK 2.60 billion); in the case of Slovenia, the increase amounted to CZK 1.13 billion. These increases in combination with the decline registered in trade with Slovakia brought the value of trade between the Czech Republic and the Slovak Republic closer to the value of trade between the Czech Republic and the remaining CEFTA countries as a whole. While in 1997 trade between the Czech Republic and Slovakia exceeded the trade turnover with the remaining CEFTA countries by 35 %, in 1998 this percentage dropped to only 10 %.

The room for increased activity of the Czech Republic in the markets of the CEFTA countries has recently depended also on economic development of these countries (which is presently with respect to many indicators more favourable than in the Czech Republic), above all by the growth of gross domestic product (as compared with 1997, the growth rate in 1998 represented 5.1 % in Hungary, 4.8 % in Poland, 4.4 % in Slovakia and 3.9 % in Slovenia; in the case of Romania, its GDP continued to fall by 7.3 % below 1997) and by the growth of industrial output (in the period under review in Hungary by 12.6 %, in Poland by 4.8 %, in Slovakia by 5.0 % and in Slovenia by 3.7 %; a decline by 17 % was registered in the case of Romania), including the forecasts for the nearest future of these main economic indicators. Based on the available information, GDP is expected to increase in 1999 as compared with 1998 in Hungary by 3 - 4 %, in Poland by 4-4.5 %, in Slovakia by 3 % and in Slovenia by 3 %, and industrial output, for example in Hungary by 6 % and in Poland by 5 %.

The position of the Czech Republic in the markets of most CEFTA countries is inadequately modest so that there is a realistic and promising possibility to strengthen this position for mutual benefit. Based on the data by CESTAT — Statistical Bulletin, the share of trade with the CEFTA members in foreign trade relations of individual countries is highly differentiated, a fact which undoubtedly has an important bearing on the degree of their interest in the expansion of this trade which is desirable for a number of objective reasons. One should not neglect mainly the relatively short transport distances, similarity of present economic problems, rather similar consumption habits, historical economic relations (which date back to the pre-war period), etc.

The share of the CEFTA countries in exports and imports of individual CEFTA countries in 1998 (data on total exports and total imports of individual CEFTA countries expressed in US dollars appear in the Annex — Table 1) is presented in the table below (for the sake of comparison, the data for the preceding years are shown in the Annex — Table 2):

Country	Exports to CEFTA countries USD mill.	In percentages of total exports	Imports from CEFTA countries USD mill.	In percentages of total imports
Czech Republic	5,246	19.9	4,063	14.1
Hungary	2,039	8.9	1,766	6.9
Poland	2,026	7.2	2,974	6.3
Romania	369	4.4	1,040	8.8
Slovakia	3,397	31.8	3,239	25.0
Slovenia	588	6.5	725	7.2

The Czech Republic has played a dominant role in mutual trade among the CEFTA countries (which is, however, strongly influenced by the above mentioned effect of trade relations with Slovakia), which is documented by the data presented in the Annex and in the table below:

	Czech Republic	Hungary	Poland	Romania	Slovakia	Slovenia
	The most important partner CEFTA country in 1998					
	in % of exports/imports from/to CEFTA countries as a whole (=100)					
Exports	SK 54	RO 26	CZ 51	HU 59	CZ 64	PL 31
Imports	SK 51	CZ 31	CZ 49	HU 53	CZ 74	CZ 36

Major trends in foreign trade relations with respect to this grouping seem to point to the following:

Czech Republic — **in exports as well as imports** the share of Slovakia tends to weaken in favour of Poland and Hungary;

Hungary — **in exports** the share of the overwhelming majority of the CEFTA countries tends to decline in favour of Romania;

in imports the share of Slovakia tends to decline; the strongest orientation is towards the Czech Republic;

Poland — **in exports and imports** a dominant position continues to be occupied by the Czech Republic. In exports, the orientation towards Hungary and Romania tends to strengthen;

Romania — **in exports and imports** strong orientation towards Hungary; in imports the share of the Czech Republic tends to grow;

Slovakia — **in exports and imports** the dominant position of the Czech Republic gradually weakens in favour of Poland and Hungary;

Slovenia — **in exports** dominant positions belong at present to Poland (tends to strengthen), Czech Republic (tends to weaken) and Hungary (tends to strengthen);
in imports the dominant position of Hungary tends to weaken in favour of the Czech Republic and Poland.

As distinct from the commodity structure of the overall foreign trade of the Czech Republic with all the countries of the world and especially with the developed market economies, the commodity structure of Czech trade with the CEFTA countries is obviously more favourable. With respect to practically all major commodity groups, the value of Czech exports either exceeds or oscillates close to that of Czech imports.

Commodity structure of trade between Czech Republic and CEFTA countries

SITC commodity groups	Czech exports to CEFTA countries			Czech imports from CEFTA countries			Partial trade balances		
	1995	1997	1998	1995	1997	1998	1995	1997	1998
	CZK billion								
0+1+4 - Alimentary raw materials and food products	10.80	12.52	15.01	7.60	10.01	11.67	3.20	2.51	3.34
2+3 - Non-edible crude materials and fuels	14.95	15.03	14.82	13.56	15.83	14.33	1.39	-0.80	0.49
5 - Chemicals	17.86	22.99	23.80	17.31	18.57	18.02	0.55	4.42	5.78
6 - Manufactures goods classified chiefly by material	37.35	45.37	50.77	37.60	40.23	43.70	-0.25	5.14	7.07
7 - Machinery and transport equipment	31.94	49.39	49.33	22.79	28.93	30.20	9.15	20.46	19.13
8 - Miscellaneous manufactured articles	9.77	13.98	15.40	10.62	15.04	13.14	-0.85	-1.06	2.26

A considerable lead of exports over imports has for a long time been typical for one of the structurally most important segments of Czech trade with the CEFTA countries - trade in **machinery and transport equipment**. The high surplus of the partial balance of trade (during the recent two years, the surplus represented approximately two-fifths of the engineering exports to the CEFTA countries) has been generated under the conditions of the growing engineering exports (as compared with 1995, exports rose by 54 % in 1998) to as well as the growing engineering imports (by 33 % during the same period) from the CEFTA countries. Although the surplus generated in trade in engineering products with the CEFTA countries somewhat declined in 1998 as compared with that of 1997 (by CZK 1.33 billion), its absolute value of CZK 19.13 billion belonged to the highest among the other partial trade balances. It represented an important positive contribution to the favourable balance of Czech trade with the CEFTA countries, and to a considerable degree alleviated the deficit of the overall engineering trade of the Czech Republic which amounted in 1997 to almost CZK 55 billion and in 1998 to more than 15 billion. The share of exports of engineering products to the CEFTA countries in total Czech engineering exports amounted in 1998 to 14 % (in 1997 to 18 %), and the share of engineering imports from the CEFTA countries in total Czech imports represented 8 % (in 1997 it was 9 %). Responsible for the deceleration of the growth rates of trade in engineering products with the CEFTA countries in 1998 (and, consequently, for the decline of its share in total engineering trade of the Czech Republic) was the decline in engineering trade with Slovakia. As compared with 1997, exports of machinery and equipment to the Slovak Republic fell in 1998 by 10 %, exports to the other CEFTA countries increased by 16 %; in imports, the decline with respect to Slovakia was even deeper (18 %), while imports from the other CEFTA countries increased by 28 %. The largest single commodity item of Czech engineering exports to the CEFTA countries is represented by road vehicles which amounted in 1998 to 43 % of engineering exports to the CEFTA countries and approximately to 13 % of total Czech exports to these countries; the largest item of Czech engineering imports was represented by electrical machinery, apparatus and appliances.

Similar trends are being observed in trade with the CEFTA countries in **chemical products.** While total Czech trade in chemical products keeps falling into a deep and growing deficit (CZK 47 billion in 1998 as compared with CZK 26 billion in 1995), surpluses prevail in this partial balance of trade with the CEFTA countries and have an obvious tendency to grow (CZK 5.78 billion in 1998 as compared with CZK 0.55 billion in 1995). Trade with the CEFTA countries thus tends to partially improve the overall trade balance. The share of chemical products in Czech exports to and imports from the CEFTA countries oscillates around 14 %. The structure of exports of chemical products is rather broad - the CEFTA countries share by more than one-third in total Czech exports of chemical products (36 % in 1998); their share in imports is considerably lower (16% in 1998). Major items of Czech exports of chemical products to the CEFTA countries include organic chemicals, essential oils and resinoids and perfume materials, polishing and cleaning preparations, medicinal and pharmaceutical products and plastics in non-primary forms; imports include mainly medicinal and pharmaceutical products, inorganic and organic chemicals.

The enhanced role of trade with the CEFTA countries in this important and dynamic group of products depends mainly on producers interested in rational expansion of markets as well as on the utilisation of imports from the CEFTA countries for no less rational satisfaction of the needs of the domestic market.

Edible raw materials, foodstuffs, beverages, tobacco and tobacco products, too, belong to the commodities whose exports to the CEFTA countries regularly exceed imports from these countries. It should be added, however, in this connection that this is a result of a continuous growth of trade turnover (in 1998 an increase by 45 % above 1995 was registered, which is a positive fact) rather than unilateral growth of Czech exports. The growth rates of Czech trade in foodstuffs with the CEFTA countries considerably exceeded the overall dynamics of Czech trade with this grouping as well as that of total Czech trade in these products. The share of foodstuffs in total Czech trade with the CEFTA countries rose to almost 9 %. Of total Czech exports of foodstuffs in 1998, the markets of the CEFTA countries absorbed 38 %, and of total Czech imports of these products, more than one-fifth originated in the CEFTA countries. Czech exports to the CEFTA countries include mainly meat and meat products, coffee, tea, cocoa and products thereof, cereals and cereal preparations, tobacco and tobacco manufactures; major items of Czech imports include fruit and vegetables, cereals and products thereof.

The fact that mutual trade in foodstuffs tends to grow (in spite of certain partial problems arising among the CEFTA countries in this segment of mutual trade) is of great importance for the Czech Republic, whose products stand a realistic chance to further increase the penetration of the large market of the CEFTA countries.

A key role in foreign trade relations of the Czech Republic with the CEFTA countries is being played by **manufactured goods classsified by material,** a group of commodities which represents (together with raw materials and fuels) the material base for the Czech manufacturing industries. This group of products maintains a strong position in Czech exports (30 % in 1998) to, as well as in Czech imports (33 % in 1998) from the CEFTA countries. The group of manufactured goods classified by material is characterised by favourable growth rates in trade with the CEFTA countries (in 1998, trade turnover rose by 26 % above that of 1995) and by the lead of Czech exports over Czech imports. The surplus generated by trade in manufactured goods classified by material amounted in 1998 to 14 % of Czech exports of these commodities to the CEFTA countries. Main commodities of mutual trade are iron and steel, on the part of Czech exports also textile yarn, fabrics, made up articles and manufactures of metals, while on the part of Czech imports these are non-ferrous metals, paper, paperboard and articles thereof. Of total Czech exports, 23 % of manufactured goods classified by material went in 1998 to the CEFTA countries, and imports of these commodities from the CEFTA countries represented the same percentage.

Trade in **miscellaneous manufactured articles** (products designed primarily for personal consumption) between the Czech Republic and the CEFTA countries displays a relatively dynamic growth (as compared with 1995, mutual trade in these products increased in 1998 by nearly 40 %), and aims to increase both exports and imports, i.e. at a practically balanced partial balance of trade. The share of this group of commodities in total Czech trade with the CEFTA countries represents less than 10 %. In 1998, the Czech Republic succeeded in increasing exports of miscellaneous manufactured articles to the markets of the CEFTA countries, but imports of these products from these countries declined. This, however, seems to be a temporary phenomenon as the decline of the volume of retail trade (in other words, of household consumption) resulted in the decline of imports from the CEFTA countries, and most probably contributed also to the increase of Czech exports of consumer goods.

There is undoubtedly ample room for the expansion of trade in consumer goods with the CEFTA countries. This trade could enrich the range of products in the domestic markets as well as extend the offer to various price brackets (especially in view of the trend towards intensification of income differentiation). All partner CEFTA countries, however, should create the necessary prerequisites in the form of an effective offer in retail networks. So far, the fastest growing in retail trade are the sale chains in the ownership of companies from Western Europe which understandably prefer their own supply sources.

The group of non-edible raw materials and fuels represents approximately 9% of Czech exports to the CEFTA countries and 11 % of Czech imports from these countries. The relatively low growth rates of Czech trade in these commodities with the CEFTA countries (trade turnover only increased in 1998 by 2 % above the level registered in 1995) have resulted in a decline of the share of these commodities in foreign trade relations with the CEFTA countries. Trade in these products is under the strong influence (especially in the case of fuels) of prices and heavily depends on the performance of the domestic economy. Trade in raw materials and fuels has recently been characterised by tendencies aimed at an equilibrium of this partial balance of trade. In 1998, a significant decline was registered in Czech imports with the simultaneous (but minor) decline of Czech exports. This fact resulted into an improvement of the partial balance of trade which shifted from a deficit in 1997 to a surplus in 1998. The share of the CEFTA countries in total Czech exports of raw materials and fuels represents nearly one-fourth, and the share of imports of these commodities from the CEFTA countries in total Czech imports of these commodities represents 15 %. Major commodity items of Czech exports include coal, coke and briquettes, and of Czech imports petroleum, petroleum products and related materials.

* * *

A more detailed analysis of structural trends points to the existence of ample opportunities for further expansion of mutual trade among the CEFTA countries. However, the growing competition (especially by the developed market economies, which has already forced the Czech Republic out of the CEFTA markets with respect to a number of products) should also be taken into account.

Although positive tendencies have so far prevailed in foreign trade relations between the Czech Republic and the CEFTA countries, we should not neglect the possibilities to also use other forms and activities of Czech central bodies, enterprises and their associations, chambers and mainly the banking sphere, which are being much more widely used in trade with other regions, even at the price of a negative balance of trade. It is in this confrontation that the results achieved should be evaluated.

Annex
Table 1

Foreign trade of individual member countries of CEFTA

Country	Exports			Imports			Trade balance		
	1996	1997	1998	1996	1997	1998	1996	1997	1998
	USD billion (current prices)								
Czech Republic	21.91	22.78	26.36	27.72	27.17	28.82	-5.81	-4.39	-2.46
Hungary	15.70	19.10	23.01	18.14	21.23	27.71	-2.44	-2.13	-2.70
Poland	24.44	25.75	28.23	37.14	42.31	47.05	-12.70	-16.56	-18.82
Romania	8.08	8.43	8.30	11.43	11.28	11.82	-3.35	-2.85	-3.52
Slovakia	8.83	8.25	10.67	11.12	10.26	12.96	-2.29	-2.01	-2.29
Slovenia	8.31	8.37	9.05	9.42	9.37	10.10	-1.11	-1.00	-1.05

Source: CESTAT, Statistical Bulletin

Table 2

Shares of CEFTA countries in foreign trade of individual CEFTA countries[1)]

Country	The shares of trade with CEFTA countries in total foreign trade of individual CEFTA countries					
	Exports			Imports		
	1996	1887	1998	1996	1997	1998
	Exports, imports total = 100.0, percentage shares					
Czech Republic	22.8	22.1	19.9	14.6	14.9	14.1
Hungary	7.4	7.3	8.9	6.9	6.5	6.9
Poland	6.4	6.7	7.2	6.0	6.3	6.3
Romania	3.6	4.1	4.4	4.7	5.7	8.8
Slovakia	42.1	41.0	31.8	29.7	29.1	25.0
Slovenia	5.7	5.7	6.5	6.8	7.4	7.2

[1)] Calculations in USD, current prices

Table 3

Foreign trade of individual CEFTA countries with CEFTA as a whole

	Exports			Imports			Trade balance			Import coverage by exports	
	1996	1997	1998	1996	1997	1998	1996	1997	1998	1996	1998
	USD billion (current prices)									Percentages	
Czech Republic	5.00	5.03	5.25	4.04	4.06	4.06	0.96	0.97	1.19	124	129
Hungary	1.16	1.39	2.04	1.25	1.38	1.77	-0.09	0.01	0.27	93	115
Poland	1.56	1.74	2.03	2.23	2.65	2.97	-0.67	-0.91	-0.94	70	68
Romania	0.29	0.34	0.37	0.54	0.64	1.04	-0.25	-0.30	-0.67	54	35
Slovakia	3.72	3.38	3.40	3.31	2.99	3.24	0.41	0.39	0.16	112	105
Slovenia	0.47	0.48	0.59	0.64	0.69	0.73	-0.17	-0.21	-0.14	74	81

Source: CESTAT, Statistical Bulletin

CzechTrade, Prague

ECONOMIC OUTLOOK FOR THE CZECH REPUBLIC

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1. BASIC DETERMINANTS OF FUTURE DEVELOPMENT

1.1 Internal Economic Environment

Removing the basic and long-term causal factor which have led to a gradual loss of economic dynamics (see our Economic Outlook from February) is the main condition of the desired change in the Czech economy development trends.

However, a political consensus is essential for the speedy implementation of **necessary measures oriented on system, institutional and legislation improvement** and for the adoption of adequate economic policies. From this point of view, the present political arrangement in the Czech Republic can be judged as a complicated one which only hampers the adoption of long delayed changes necessary for completion of the transformation process.

Despite this, some of the steps taken by the present government should be recognized as these not taken by the previous governments, but only alluded to, in particular:

- an attempt to formulate **a medium-term framework of economic policy** (particularly already realised in the currency and fiscal sphere)
- creation of partial **sector policies**
- **acceleration of privatisation** of state shares in banks, distribution companies (in the power and gas industry), completion of the privatisation of Telecom and other areas
- the endeavour to settle open **property issues with the Slovak Republic**
- greater **support for the integration of the Czech Republic into the EU.**

However, a certain problem can be seen in the marked stress on the predominance of **stimulating the demand side of the economy** and the **deficit of public finance** related herein.

Yet the important determinant is the future development of **domestic supply** as well as a true counter-pole to demand which affects the effective result of possible impulse to growth. The extent to which Czech producers are capable of satisfying the increased demand will not only affect the **growth** of the Czech economy, but also its **balance.** This does not so much concern the quantity aspects, the extent of the possibilities of "covering" the volume of increased demand (there are sufficient free or not fully utilised production capacities in the Czech Republic), but the possibility of satisfying this demand with the desired structure, prices and quality of products and services. The inadequate supply of Czech products (i.e. imbalance of the internal market) will mean that domestic demand will not only spill over to foreign countries and will cause relevant positive growth effects in trading partner economies instead of the Czech Republic, but will also reinforce the overall external economic imbalance of the country by increasing imports and inducing the growth of the balance of trade deficit.

Apart from realising the need to improve the **system, institutional and legislative framework** as a necessary prerequisite for increasing the functional capability of the entire production sphere (when, for instance, a whole series of laws or their amendments were included in the government's legislative plan for this and next year), the government approached the problem of tackling partial relevant solutions. This particularly concerns the so-called revitalisation program which, among other things, should start up the process of **recovery of the supply side of the economy.**

1.1.1 Revitalisation Program

The hopes placed in this program are often over-stated due to the over-estimates of the initial intentions and declarations made by the Ministry of Industry and Trade. The specific impact of

revitalisation on industry will be determined by the **starting date** of revitalisation and its **financial extent,** the success rate of actual **restructuring** (which represents only phase four of the program scheduled over 6-12 months) and the final date for its **completion** (max. 1. 1. 2003). In the event of successful implementation of the program it may be expected that no collapse will occur due to production stoppage in selected companies (and other entities related herein). This should also have a positive impact on employment, acceleration of the restructuring of production and ownership relations. Other effects may also be mentioned such as the partial cleansing of credit portfolios of involved banks, the creation of space for new credit, and providing a stimulus for a further influx of foreign capital.

However, the success of the program is determined by overcoming some important bottlenecks which include above all

- problems with the selection of an agency administrator
- dealing with the relationship between the state and the agency administrator (defining the mode of their co-operation)
- elimination of "pre-restructuring agony" of companies relying on state aid
- ensuring non-confliction with obligations to the EU
- replacing the present indebted owners and current inefficient managements respectively.

1.2 External Economic Environment

The extent of the successful improvement (if at all successful) of the system, institutional and legal framework, in which the internal economy of the Czech Republic is developing and functioning, will also affect it "externally":

- a change in the situation of companies, their performance rate and ability to compete, conditioned by their restructuring, in the medium-term will be reflected in the sphere of **foreign trade** and the **balance of trade**

- a positive change in development in this sphere (and subsequently in the entire economy) as well as in the new quality of the Czech **capital market** (if this is achieved), may revive the trust of foreign investors which will be reflected in an influx of **necessary foreign capital**

- this development will also appropriately affect the **stability of the Czech currency** and its **exchange rate,** and this with a feedback which will affect the relevant monetary aspects (interest rates, prices and the resulting rate of inflation).

The determinants from the external economic environment can be affected only to a lesser extent by the internal economy (indirectly, through its own reaction and adaptation), i.e. they function *de facto* like **objective factors.** They may take on the character of long-term developing factors as well as shock events:

- the first case is the **cyclical development** of the world economy when economic cycles in trading partners' economies considerably affect Czech exports; in the nearest future this will mostly mean a negative effect as it is expected that there will be a lower rate of growth basically in all countries which have a considerable share in Czech exports; any improvement is a question of later years; (moreover generally, as a worldwide phenomenon, a long-term surplus in supply over demand is expected as one of the phenomena of globalization of the world economy)

- what is more serious (and practically unpredictable) is the possibility of further instances of **regional financial crises;** apart from devastating impacts on capital markets, the stability of the national currency, its exchange rate and other important aspects, the outbreak of a crisis may cause not only a reaction of "turning inward" of the individual affected economies (and thus also a restriction of their imports etc. with an impact on Czech foreign trade), but also, in an extreme case, this situation could escalate into a global economic crisis, i.e. a worldwide recession. (Once the greatest fears did not materialise of a world economic crisis as a consequence of the "Russian crisis" of August 1998 and the infectious economic crisis

in Brazil, the markets settled down and the risks for the future do not appear to be as threatening as in 1998.)

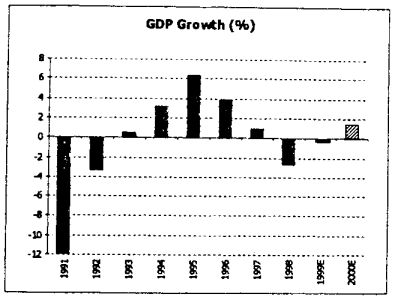
Specific conditions for interaction between the internal and external environment of the Czech economy are now determined by its (associate in the present, full in the future) **membership in the European Union,** with the prospects of membership in the **European Economic and Monetary Union** (EMU). This planned "definitive entry into Europe" unconditionally requires the already mentioned improvement of the system, institutional etc. framework of the Czech economy not only so it complies with **European standards,** but also for reasons of creating possibilities for **achieving the relevant "performance parameters" and aspects,** including meeting the required criteria.

2. EXPECTED DEVELOPMENT OF SELECTED MACRO-AGGREGATES

2.1 Economic Growth

The Czech economy found itself in deep recession last year (GDP fell by 2.7 %) and it is highly probable that this development will continue in the first half of this year. The reasons for this unsatisfactory trend rest above all on the **microsphere level,** its efficiency and adaptability (which was unsatisfactory in the given conditions) and up until recently also the implementation of an inadequate mixture of **restrictive economic policies.**

Household consumption and the creation of gross fixed capital and reserves contributed equally to the economic decline in 1998 (each decreasing 1.2 % from a total 2.7 % decline). The only growth registered was in government consumption, incl. non-profit organisations, (effect +0.2 %) and particularly an improvement in net exports (+0.8 %). Contributions of separate components of domestic demand — see graph 2.



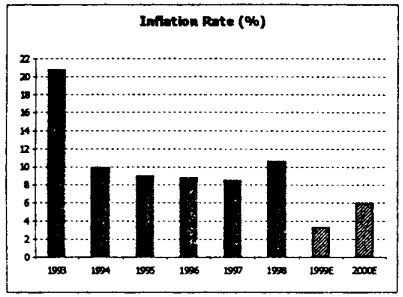
We expect that GDP will continue to fall in the first half of the year. However, a change for the better is envisaged in the second half. In total, GDP is expected to **stagnate or** even to drop again (but no more than 1 %) in 1999. **Domestic demand** should rise (compare the trend of domestic demand and GDP — see graph 1). We believe this to be well-founded, above all, by the **growth of real wages and an expansive fiscal policy.** Wage growth will considerably exceed the rate of inflation, however its impact on the disposable income of the population will be partially offset by a further increase in unemployment. Wage developments and the expectations of the population reflected in the propensity to save will be critical factors this year which, at the worst, may lead to worsening unbalancing trends in the economy.

This year should also see an alleviation in the fall of investment activity and in 2000 there should be a real growth in the creation of gross fixed capital. In view of the substantial dependence of the business sector on debt financing, the revitalisation of investment activity will be closely connected with the rejuvenation of bank credit expansion and the functioning of the primary capital market.

The **continuation of a trend toward declining industrial production** is expected on the supply side of the economy at least throughout the first half of this year and the recovery of growth in industrial production only in the second half of the year. A further decline in production should be prevented by the government's restructuring program focused on selected large companies in the economy.

2.2 *Inflation*

The hitherto record low values of the consumer price index (in April 1999 2.5% year-on-year; see graph 3) are the result of disinflationary process which intensified in the second half of last year. Moreover this result is indicative of the movement of **regulated prices,** as **net inflation** (i.e. year-on-year CPI after the exclusion of the effects of deregulation and administrative measures) even reached a negative value in year-on-year terms (–0.2 %). A decline in food prices for a number of months year-on-year in April (-4.3 %) contributed substantially to this price development which came as a result of the growing competition in the retailing sector, lower import prices, a favourable foreign exchange rate and decrease in domestic demand (the stated factors apply to the dynamics of the CPI in general).



Some of the factors which, until recently, had an effect on the decline in prices, are currently bringing potential inflationary pressure: (i) CZK weakened against DEM and USD (in May this year as compared with December last year it fell by 6.8 % and 17.1 % respectively), (ii) an increase in oil prices occurred. The main, if temporary, obstacle to the full projection of the effect of the crown depreciation was insufficient home demand. However, the revitalisation of its growth is anticipated due to growth in real wages and expansionary fiscal policy. Weak food prices remain the risk factor for any possible price growth.

This year's development of regulated prices, as a significant part in the movement of prices (last year regulated prices grew at an average rate of 25.5 %) will be substantially less dramatic in comparison with last year. The question which remains is the actual extent of deregulation because up till now no final decision has been made on the increase in the prices of electricity and gas planned for July, this year. So far it would appear that most likely the government will not make use of the current favourable price situation to undertake any major steps, and it will probably postpone these until next year. (The latest new factor in the development of CPI determination is the increase of the consumption tax on fuel and cigarettes, approved by Parliament on May 21. It will be effective in the second half of the year and should bring more than CZK 4 bn revenue for the state budget. Its possible impact on the CPI is estimated at 0.3 %). We expect that the rate of inflation this year will range between 2.9-3.5 %.

A return to higher values of price growth is expected next year which will be encouraged by price developments on world markets as a consequence of the anticipated revival of the world economy. The rate of inflation in 2000 should range between 5.5-6.5 %, however it is still not known what the extent of the deregulation measures will be. The Czech Ministry of Finance expects that its effect in 2000 will be 2.4 % as compared with 1.5% in 1999.

2.3 *Balance of Payments*

The deficit in the **current account of the balance of payments** decreased substantially last year to -1,9 % of GDP after -6,2 % in 1997. The reason was a sharp decline in the balance of payments deficit (by 42 %) and a slight increase in the surplus of the balance of services (by 9 %) as a consequence of a restriction in tourism abroad. The balances of incomes and current transfers positively contributed to the decrease. The deficit of the current account therefore returned to a point well below the psychological limit of 5 % of GDP and was fully covered by the influx of foreign direct investment.

The **net influx of foreign capital** into the Czech Republic in 1998 was about 2.5 times higher than in the previous year (corresponding to 4.8 % of GDP). This was dominated by **foreign**

direct investment (2.5 bn USD), subsequently by **portfolio investment** (1.0 bn USD, with a substantial proportion of investments in shares and property). The net outflow of **other investments** (-0.9 bn USD) was particularly a consequence of the repayment of long-term foreign credits (4.1 bn USD).

This year should see a slight worsening in the **trade deficit** (to about 85 bn CZK) which will then be reflected in a growth in the current account deficit. Therefore in connection with the already mentioned smaller increase in nominal GDP, there will be a slight increase in the share of the current account deficit in GDP as opposed to the original estimate. The deficit would then range between -(2.0-1.4 %).

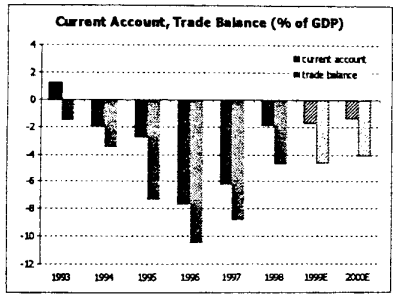
On the contrary, 2000 should see an improvement in foreign trade, i.e. in a decrease in the current account deficit (up to –1.6 %, or – 1.0 % of GDP).

The main determinants of this development are the following:
- low domestic demand
- low foreign demand in 1999 but growing demand in the following year
- slight growth of raw material prices, particularly oil.

2.3.1 Foreign Trade

The closing of the gap between exports and imports led in 1998 to a substantial **decrease in the deficit** of foreign trade. A significant part of this decline may, however, be attributed to price movements (i.e. improvement of the Terms of Trade, 107.2 % index).

The **growth in importance of Germany** as the Czech Republic's dominant trading partner is characteristic for the development of foreign trade (for the first three months of this year 40 % of Czech exports went to the German market and the share of this country represented 35 % of Czech imports). At the same time the marginalisation of the importance of trade exchange with the Slovak Republic continued (share in exports 7.1 % and in imports 5.7 %). The Czech economy is basically determined by the economic performance of Germany. The expected slow-down in growth there (according to a forecast of the European Commission, the German economy will only grow by 1.7 % this year and by 2.4 % in 2000) will therefore act as a limiting factor for Czech export expansion. Moreover in this connection it is important that in the first quarter of 1999 approximately 47 % of exported machines and transport equipment (as the most successful Czech export article) went to Germany.



Just to complete the picture we may add that the expected economic stagnation of the Slovak economy (we expect a growth in GPD ranging between 0.0-2.0 %, of course, with a substantial restriction in import demand) will also restrict the volume of our trade with this country.

2.3.2 Foreign Debt

The development of Czech foreign debt may be assessed as favourable. At the end of December 1998, gross foreign debt was 24 bn USD (i.e. 40.4% of GDP) when, as compared to the first quarter, there was no shift in the relative level. In comparison with selected countries of the former eastern block, Czech foreign debt is very low in terms of its share per inhabitant (which is determined by the higher economic performance of the Czech Republic).

No significant changes have taken place in the **breakdown of debt components:** most of the debt consists of liabilities of companies (48.3 % as opposed to 47.1 % in 1997), the subsequent liabilities of banks (45.5 %, or 44.4 %), the state and the Czech National Bank's (ČNB) share was minimal (year-on-year it even went down by 2.3 %). The debt time structure remained favourable (64 % long-term debt, 36 % short-term). The share of short-term debt in exports decreased last year to 30 %.

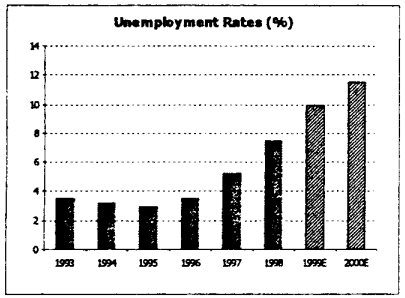
The growth of foreign debt in the next period will be significantly **restrained by repayments of existing credit** (4.3 bn USD for long-term liabilities in 1999), by a considerably reduced **credit differential** (when in the first quarter of 1998 it was still 12.7 % in relation to DEM, then in the first quarter of 1999 it was only 5.0 %), **the development of the exchange rate of CZK** and the **status of domestic entities** on the international financial market after last year's reduction in the rating of the Czech Republic by Standard & Poor's (to A-) and IBCA (to BBB+).

Therefore we do not expect a deviation of gross foreign indebtedness in the next period from the current relative values. The question remains the possible increase of state indebtedness in resolving the so-called hidden debt and the financing of further infrastructural investment.

2.4 Unemployment

Unemployment has grown continuously since 1996 and is becoming a **serious problem for the economy.** (The fall in the rate of unemployment from the record 8.4 % to 8.2 % which came about in April this year was only a seasonal fluctuation not deviating from the current trend.)

The low rate of unemployment which had existed in the Czech Republic since the beginning of economic reform was due to the absorption ability of the basically newly emerging tertiary sphere. The second basic reason was, of course, failure to resolve the problem of adapting the businesses sphere to the new conditions which would be connected with the process of the liquidation of non-prospective enterprises or the elimination of over-employment. The catalyst of this process only became the economic recession into which the economy fell last year.



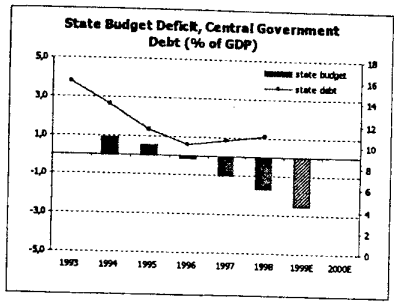
Restricted demand for work is reflected in the high rate of growth in the share of unemployed per one vacancy. If, at the start of 1998, the ratio of job applicants per one vacancy was 4.6, in March of this year it was already 13.1. Another significant feature of unemployment is the growing gap in the differences of unemployment between individual regions.

In our opinion the rate of unemployment will continue to grow and at the end of this year should be about 10 %, at the end of 2000 it is expected to range between 11-12 %. It means a **continuation in the trend of a decline in employment** even next year: we expect that economic growth in its period of revival will be less demanding on the labour-force, this means that the growth in work productivity will accelerate. This development may positively restrain the wage requirements of employees (trade unions) by making them choose between maintaining employment and wage growth. The fear of unemployment will also act as a significant factor for deferring consumption, i.e. the creation of household savings. (In 1998 the rate of household savings was 13 %.)

Under current conditions part of the unfavourable effects of the acceleration of growth of unemployment in the Czech Republic is also its fiscal and financial aspects: the negative impact on tax collection (direct and indirect) and insurance premiums, additional social security and health insurance costs paid by the state for the unemployed.

2.5 State Budget

Although state finance was developing relatively favourably in the first four months of the year (the deficit reached –2.4 bill. CZK), it is already clear that the originally approved **budget deficit** at 31 bn CZK will not be attained. The reason is the difference in macro-economic parameters serving as a basis for the budget calculations and real economic development. The effect of a lower than planned rate of inflation and economic stagnation (as opposed to the expected growth of +1.8 %), which will be projected in the smaller volume of tax income, will lead to a **growth in the deficit,** which may fluctuate around 50 bn CZK (the Ministry of Finance now allows for 47 bn). To complete the picture it may be added that economic development will also be "favourably" reflected in budget expenses, of course with substantially less intensity (above all in the form of a delay in the indexing of pensions).



It must be expected that the losses of Konsolidační banka in 1998 of approx. 14.4 bn CZK will also be included in budget expenses. An important role will be played by the approval of the Fuel and Cigarette Consumption Tax Bill (and by the cut from 35 % to 31 % in the Corporate Tax Rate, effective on Jan. 1, 2000).

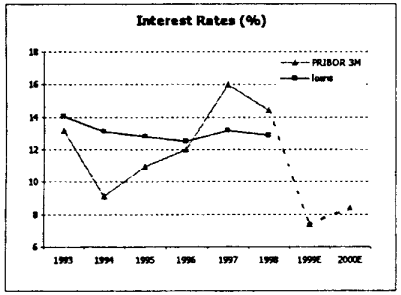
So the government is faced with a decision of whether or not to take certain **cost-cutting measures,** which are all the more sensitive in a period of economic recession when budgetary expansion should become one of the possible solutions. Moreover reaching a solution is complicated by the restricted space for implementing additional savings with regard to the high share in so-called **mandatory expenses** (e.g. transfers to the population this year represent 40 % of budgetary expenses).

On the other hand, any higher PBSR (Public Sector Borrowing Requirements) should not create greater pressure in financing the public sector as currently the banking sector is in the position of having a **surplus of disposable resources.** It is "forced", as a consequence of limited alternative investment opportunities, to maintain these funds within the framework of repo transactions in the ČNB (in April it was 205.8 bn CZK, i.e. 11.6 % of GDP for 1998). Moreover, the current government debt is low, in comparison with CEEC countries or the EU, even while taking into account the so-called hidden debt. At 31.12.1998 the official central government debt was 194.7 bill. CZK, i.e. 11% of GDP; with the added hidden debt as estimated by the IBRD at 270 bn CZK, the stated share is 26.2 % of GDP (in comparison with selected countries – see table 2).

2.6 Monetary Policy

The concept of monetary policy was and continues to be based on observing targets of so-called **net inflation** (in simplified terms: CPI after the exclusion of the effects of administrative measures and changes in regulated prices). It is debatable to assess the success rate of monetary policy last year as the fixed target of 5.5-6.5 % in December last year was in fact "too conservative", when the level of net inflation was only 1.7 %. This result was affected by the relatively favourable development of the main determinants of inflation, particularly external ones. None the less, it must be stated that the main channel facilitating the impact of external factors (which are outside the jurisdiction of the central bank) in the conditions of a small open economy as is the case in the Czech Republic, is the **exchange rate.** This, due to a substantial interest differential and its subsequent decrease (which proved attractive for domestic bonds and debentures in the short term), strengthened and facilitated the process of disinflation.

The central bank from mid 1998 up to the present date markedly reduced its key **interest rates** (two-week repo rate from 15 % to 6.9 %, the discount rate from 13 % to 6 % and the lombard rate from 19 % to 10 %). ČNB also decided to reduce the rate of **minimum reserves requirements** from 9.5 % to 5 % and further intends to reduce this rate to as little as 2 % from 7 October this year (moreover in future the MRR should be interest-bearing).



Despite the substantial fall in the level of client interest rates, **real interest rates** remain (as expressed on the basis of adapted expectations) high for loans (10 % for newly provided credits in the first quarter of this year as opposed to 8.9 % in the same period last year). According to our opinion and with regard to inflationary expectations in the following months, the ČNB however has already considerably or even totally exhausted the space for further cuts in interest rates.

In the long-term **monetary strategy** published at the beginning of April this year, the ČNB outlined its currency targets up to 2005. It expects that in the last year of this period, the net rate of inflation will be 2 % +/- 1 % and should reach this target with an annual reduction in the net inflation index by 0.5 % (of course this does not necessarily have to be a linear trend). Although last year domestic price levels reached approx. 38 % of German levels (according to data of the Czech Ministry of Finance), the target of the ČNB may appear highly ambitious in view of the necessary prospective **adaptation to price levels in the EU** (changes exist even here, of course they are substantially smaller). The net inflation index however does not include prices of so-called non-tradable regulated items where the price gap is highest and its effect on a monetary target is only indirect.

2.6.1 Credit Determinants

One can discuss whether the reaction of the central bank to developments in the economy last year was fast enough. What cannot be discussed at all, however, is the ability of the ČNB to **induce a higher volume of credit provided by banks.** The slowing down and the subsequent fall in credit activities of commercial banks (-0.8 % in March in 1999 in year-on-year terms) was not a consequence of the interest policy of the central bank, but rather a change in the credit policy of commercial banks which was caused by

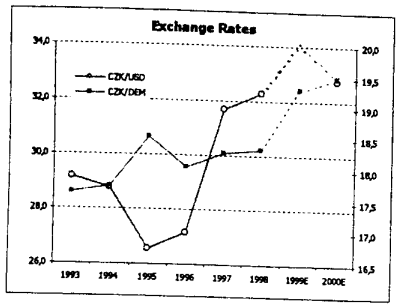
- the burden of **classified loans** in the banking sector (in December last year this was 302.1 bn CZK, i.e. 29.4 % of total loans, of course with the exclusion of loans held by Konsolidační banka and Slovenská inkasní jednotka)
- the persistent **bad quality of the legal framework of the economy** (e.g. bankruptcy laws) and the related problematic **enforcement of the creditor's rights**
- the lack of good quality **creditable projects.**

So the ball lies in the court of the legislators and executives (and has for many years because this it not a new problem, but a chronic phenomenon). The partial solution to the high encumbrance placed on banks by classified loans should also be facilitated by the already mentioned revitalisation program (see part 1.1.1)

2.6.2 Exchange Rate

The crown **strengthened** for most of last year and in October it was approaching close to the

original parity (of the end of 1990) which meant that the real assessment of CZK as a result of the inflation differential was also expressed by the development of the nominal exchange rate. A change in this trend occurred right at the end of the year and especially during this year. However, since the end of last year the crown has already lost 11.7% against its original basket (65 % of DEM and 35 % of USD). The **original real over-appreciation was slightly reduced,** which should favourably affect the price competitiveness of domestic producers on the domestic and foreign markets.



Although the present level of the foreign exchange rate can be regarded as favourable, the possibility must be taken into account of a short-term strengthening of the crown as a consequence of a further influx of foreign capital. However, its effect should be restrained by the expected capital outflow in the form of debt service (the ČNB expects that the debt service relating only to long-term debt will reach approx. 5 bn USD in 1999 and 3.6 bn in the following year).

All in all, however, we expect that the crown will continue to **weaken slightly** or that it will stay at its current level.

3. APPENDIX

Tables

1. Basic Economic Indicators for the Czech Republic and Estimate for 1999
2. Economic Indicators of Selected Central European Countries

Graphs

1. GDP Growth and Domestic Demand (constant prices, same period last year = 100)
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4. Foreign Trade Balance (CZK in bn) Increase of Exports and Imports (in % to the same period of the previous year)
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6. Interest Rates (monthly averages)
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10. Classified Loans (CZK in bn, share in %)

Basic Economic Indicators for the Czech Republic and Estimate

Table 1

		1994	1995	1996	1997	1998	latest figures		1999E	2000E
GDP	change in %	3.2	6.4	3.9	1.0	**-2.7**	**-4.1**	Q4' 98	**0.0**	**1.0-2.0**
Consumer prices (CPI)	average, %	10.0	9.1	8.8	8.5	**10.7**	**7.1**	IV' 99	**3.0-3.5**	**5.5.6.5**
Consumer prices (CPI)	end of period, %	9.7	7.9	8.6	10.0	**6.8**	**2.5**	IV' 99	**4.3-5.5**	**5.5-7.0**
Producer prices (PPI)	average, %	5.4	7.6	4.8	4.9	**4.9**	**0.2**	IV' 99	**1.2-1.5**	**2.5-4.0**
Trade balance	CZK in bn	-44.4	-105.9	-155.8	-151.2	**-79.5**	**-22.1**	I-IV' 99	**-(90.0-80.0)**	**-(80.0-70.0)**
Current account	% of GDP	-2.0	-2.7	-7.6	-6.1	**-1.9**	**-3.6**	Q4' 98	**-(2.0-1.4)**	**-(1.6-1.0)**
Gross foreign debt	USD in bn	10.7	16.5	20.8	21.4	**24.0**	**24.0**	Q4' 98	**24.0-25.0**	**25.0-26.0**
Employment	change in %	1.1	0.8	0.4	-0.8	**-1.4**	**-1.5**	Q4' 98	**-2.5**	**-2.0**
Unemployment	end of period, %	3.2	2.9	3.5	5.2	**7.5**	**8.2**	IV' 99	**10.0**	**11.0-12.0**
State budget	CZK in bn	10.4	7.2	-1.6	-15.7	**-29.3**	**-2.4**	I-IV' 99	**-50.0**	**N/A**
CZK/EUR	average	n/a	n/a	n/a	n/a	**n/a**	**37.32**	I-IV' 99	**37.5-38.1**	**37.8-39.1**
CZK/DEM	average	17.7	18.5	18.1	18.3	**18.3**	**19.08**	I-IV' 99	**19.2-19.5**	**19.3-20.0**
Money supply (M2)	change in %	19.9	19.8	9.2	10.1	**5.2**	**9.9**	III' 99	**6.0-7.0**	**7.0-9.0**
3M PRIBOR	average, %	9.1	11.0	12.0	16.0	**14.4**	**7.8**	I-IV' 99	**7.0-7.5**	**7.5-9.0**
Deposit rate	average, %	7.1	7.0	6.8	7.7	**8.1**	**5.6**	I-III' 99	-	-
Lending rate	average, %	13.1	12.8	12.5	13.2	**12.9**	**9.7**	I-III' 99	-	-
Margin	average, %	6.1	5.8	5.7	5.5	**4.8**	**4.1**	I-III' 99	-	-

Source: ČNB, ČSÚ, MF ČR
1999 and 2000 - estimate

estimate
reality

Economic Indicators of Selected Central European Countries

Table 2

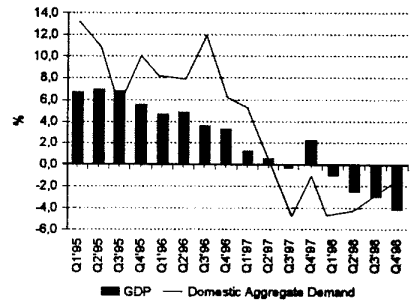
		CZECH REPUBLIC			SLOVAK REPUBIC			POLAND			HUNGARY			SLOVENIA		
		1996	1997	1998	1996	1997	1998	1996	1997	1998	1996	1997	1998	1996	1997	1998
Gross Domestic Product	change in %	3,9	1,0	-2,7	6,6	6,5	4,4	6,0	6,8	4,8	1,3	4,6	5,1	3,5	4,6	3,9
Industrial Production	change in %	2,0	4,5	1,6	2,5	2,7	5,0	9,0	11,2	4,8	3,4	11,1	12,6	1,0	1,0	3,7
Construction	change in %	5,3	-3,9	-7,0	4,4	9,2	-3,5	7,8	19,4	11,6	2,7	9,7	13,1	13,2	7,7	N/A
CPI	average in %	8,8	8,5	10,7	5,8	6,1	6,7	19,9	14,9	11,8	23,6	18,3	14,3	9,9	8,4	7,9
PPI	average in %	4,8	4,9	4,9	4,1	4,5	3,3	12,4	12,2	7,3	21,8	20,4	11,3	6,8	6,1	6,0
Real Wages	change in %	8,8	1,8	-1,3	7,1	6,6	2,7	6,1	7,3	15,3	-5,0	4,9	3,6	4,9	3,0	1,6
Unemployment Rate	ILO methodology	3,5	4,7	6,5	11,1	11,6	11,9	12,3	11,2	10,6	9,9	8,7	7,8	7,3	7,4	7,9
Employment	change in %	0,8	-0,6	-1,5	0,8	-1,1	-1,2	1,9	1,4	1,2	-0,3	-0,1	1,4	-0,5	3,2	-0,6
Current Account	% of GDP	-7,6	-6,1	-1,9	-11,2	-10,0	-10,1	-0,9	-3,0	-4,3	-3,7	-2,1	-4,8	0,2	0,2	N/A
Gross Foreign Debt	USD in bn	20,8	21,4	24,0	7,8	9,9	11,9	40,6	38,1	N/A	27,6	21,7	23,2	4,0	4,2	4,9
Foreign Exchange Reserves	USD in bn	12,4	9,7	12,5	3,4	3,2	2,9	17,8	20,4	N/A	9,7	8,4	9,3	2,3	3,3	3,6
State Budget	% of GDP	-0,1	-1,0	-1,6	-4,4	-2,6	-2,7	-2,4	-1,3	-2,4	1,2	-4,0	-3,6	0,6	-1,2	N/A
Central Governement Debt	% of GDP	10,0	9,6	11,9	23,9	19,9	23,4	45,2	42,7	43,1	71,2	59,1	60,6	30,8	30,9	N/A
Exchange Rate	average	27,1	31,7	32,3	30,7	33,6	35,2	2,7	3,3	3,5	152,7	186,8	214,4	135,4	159,7	166,1
Deposit Rate	average in %	6,8	7,7	8,1	9,1	10,5	13,0	20,5	22,8	15,4	20,1	17,6	15,4	15,1	13,2	8,8
Lending Rate	average in %	12,5	13,2	12,9	13,4	18,4	19,3	22,0	24,5	18,2	24,0	20,8	18,8	22,6	20,0	16,2

Source: CESTAT, NBS, WIIW, IMF, REUTERS

1

GDP Growth and Domestic Demand

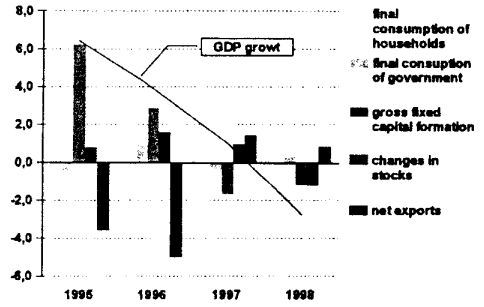
(constant prices, same period last year = 100)



Source: ČSÚ

2

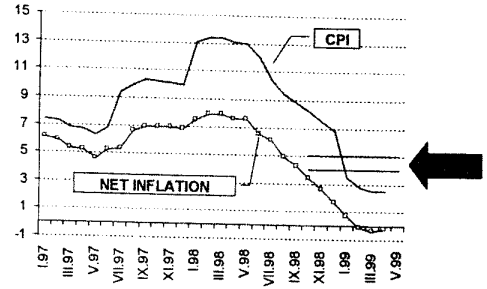
GDP Growth: the Influence of Its Components (in %)



3

Consumer Price Index

(same period of last year = 100)

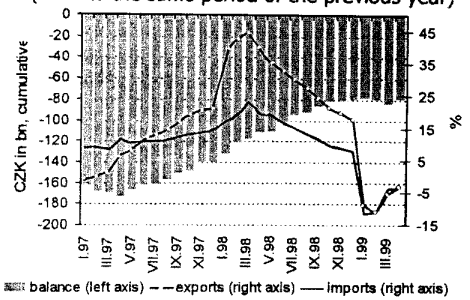


Source: ČSÚ

4

Foreign Trade Balance (CZK in bn)
Increase of Exports and Imports

(in % to the same period of the previous year)

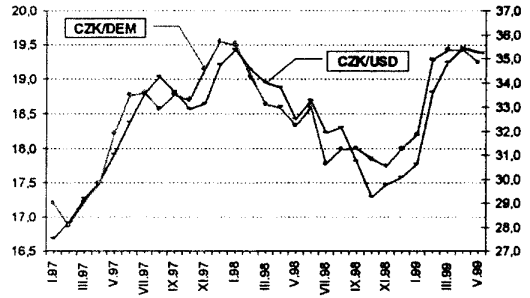


Source: ČSÚ

5

Exchange Rate of CZK

(CZK, average rate midpoint)



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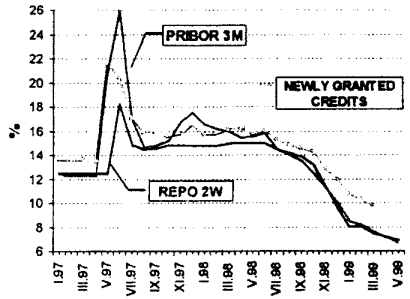
6

Interest Rates

(monthly averages)



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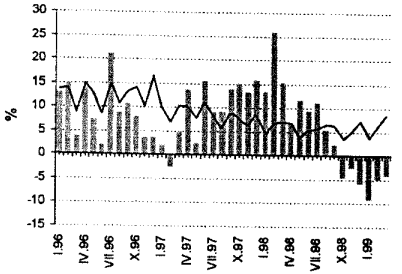
7

Labour Productivity and Real Wages

(same period of last year = 100)



Labour Productivity — Real Wages (nominal - PPI)

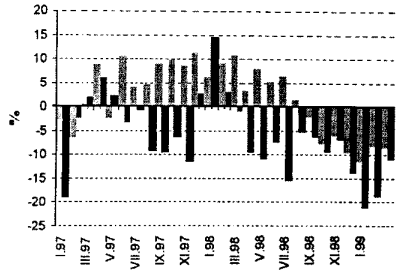
Československá obchodní banka, a.s.

Source: ČSÚ

8

Industrial Output, Construction work

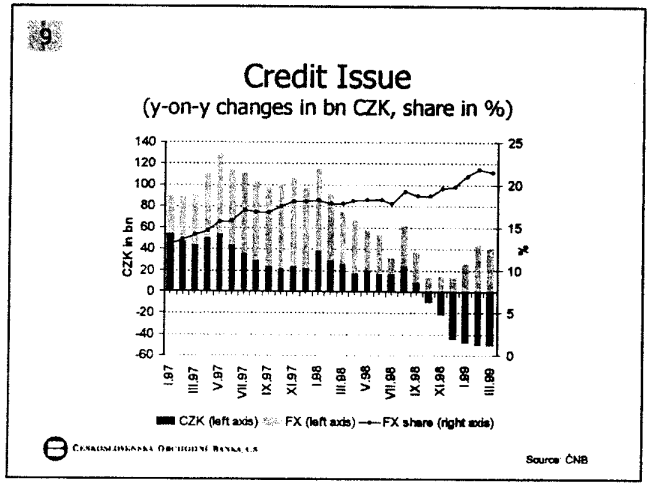
(same period of last year = 100)

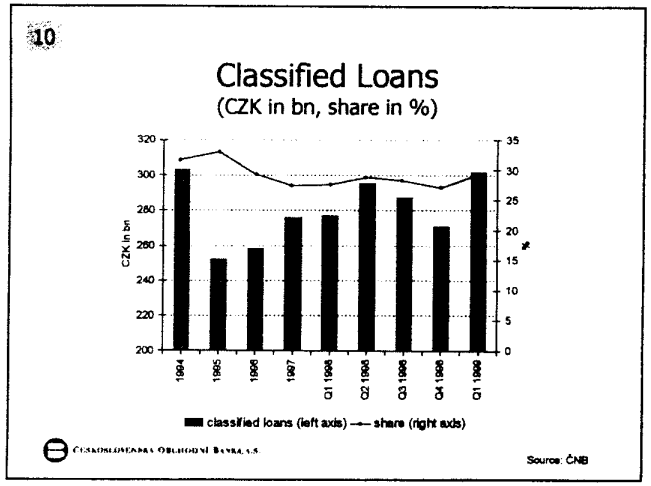


Industry ■ Construction

Československá obchodní banka, a.s.

Source: ČSÚ





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