# EU ENLARGEMENT:
# EXTERNAL ECONOMIC IMPLICATIONS

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// Abstract

Unlike some previous EU enlargements (e.g. with the UK and with Spain/Portugal) the present EU enlargement to Central Europe has not prompted much, let alone a fierce, debate about the external dimension. This BEEP briefing discusses the main economic aspects of the external dimension, in particular whether there is a threat of (how much) trade diversion. Attention is paid to the three main topics of interest for third countries: industrial trade effects, impact on FDI and agricultural trade effects. Agriculture is arguably the most sensitive of the three, given the very high CAP border protection, and although large-scale trade diversion may eventually occur under certain scenarios (such as an unreformed CAP), these fears are greatly exaggerated in the short to medium term (5-7 years): the time frame considered is therefore all-important. This conclusion becomes less surprising if one takes a closer look at the current sorry state of agriculture in the CEECs. Separate sections treat the somewhat sensitive subject of U.S.-CEEC Bilateral Investment Treaties, as well as the long-term development perspective, which addresses the prospects for catch-up growth by the accession countries. In the end, non-European stakeholders in the accession process will greatly benefit from sustained catch-up growth by the CEECs, which are locking-in deep reforms due to EU accession.

**JEL codes**: F02, F10, F15

## Introduction

EU enlargement is already making headlines in Europe for at least 10 years. Recently, in the realisation that political decision-makers faced the moment of truth, debates intensified around issues such as the finalisation of negotiations in agriculture and its funding and the formulation of package deals which should prevent non-ratification in a Member State. The big-bang decision of taking in ten candidates by 2004 has meanwhile reduced lingering fears of a spectre of endless quarrelling between Member States, shifting the final decision again and again while poisoning the "end-game". It has also become more likely that, after some additional years of *acquis* adoption and catch-up growth, Romania and Bulgaria will accede in 2007 or so.

This fifth enlargement of the EU is no doubt the most spectacular one. This is due to the sheer number of countries (12, if not 13 sooner or later) and (for 10 of them) their emergence out of transition. It will render the Union pan-European and almost certainly increase the incentives for other European countries to join later.

For all these reasons, one would expect the rest of the world to watch the process carefully, if not anxiously. Surely, trading partners could be presumed to be pro-active in ensuring that the external implications are benign or be corrected in the right direction. International economic organisations might be thought to draft competing reports about the external economic implications of enlargement, or analytical and policy briefings for others. Not least, one might venture some hope that the EU itself, remembering the misleading campaign about Fortress Europe in the wake of EC-1992, would be sensible and diplomatic enough to set the record straight while anticipating the trouble spots.

Amazingly, however, none of these expectations turn out to be correct. When it comes to the external economic implications, this is a "*silent enlargement*". There is virtually no debate on the external implications, in sharp contrast with the enlargement of 1973 (the UK, Denmark and Ireland) and 1986 (Spain and Portugal). There are no strong overall accusations of Fortress Europe and, at most, few and minor diplomatic skirmishes on the external economic impact of the candidates adopting the *acquis* wholesale.

The present BEEP briefing will deal with a range of external economic effects of enlargement, other than monetary (for the latter, see Gros et al. (2002) and Hobza & Pelkmans (2002) ). The structure of the paper is as follows. Section 1 attempts to understand the reason for the "silence" in the world of economic policy makers outside Europe. Sections 2 and 3 discuss the three main topics of the external economic impact: industrial trade effects, the likely impact on FDI and agricultural trade effects. Section 4 brings up the possibly sensitive subject of the Bilateral Investment Treaties most candidates have concluded with the US, which the Commission wants to see amended. Section 5 assumes a more important longer term perspective in addressing the prospects for secular catch-up growth for the candidates in Central Europe and the deeper economic reform issues in an EMU of 25 and a steadily expanding Euroland. These longer-run processes are also of importance to third countries. Section 6 concludes.

## 1. **Does “silence” mean external support?**

The “silence” in worldwide economic diplomacy about enlargement may have several grounds. Most probably, enlargement is widely supported because it is considered as the most “deep” and secure form of stabilising this once so bloody continent, of precluding any temptation to go back to a form of planned economies or totalitarianism and, not least, of locking-in economic reforms and incentive structures promising to deliver prosperity. This support would seem to be implicit in many parts of the world and explicit in numerous declarations by the US and Japan, or OECD countries more generally as well as in ASEM. Interestingly, the de-facto backing from international economic institutions such as the OECD, IMF and the World Bank, and of course, the EBRD, is expressed openly in many technical policy documents supportive of transition, reforms and/or growth. To our knowledge there is no WTO document on enlargement, and the recent WTO Trade Policy Review on the EU scarcely pays attention to it.

There is a business corollary. Business was quick, though prudent, in venturing into Central Europe right after the “winds of change” had turned away from communism. US business followed suit and is now present throughout the region. Japanese business has taken more of a wait-and-see attitude, but in some strongholds of Japanese industry such as cars this reticence has been replaced by entry and expansion. European big business (as represented in the ERT, the European Round Table of Industrialists) has been highly supportive of the pre-accession process, even providing flanking business initiatives as helpful corporate citizens in all candidate countries (see ERT, 2001). Irrespective of numerous concerns about corruption, fledging market institutions and infrastructure, global business looks at enlargement mainly in terms of opportunities.

Perhaps more of a speculative rationale to explain “silence” as support is the TINA argument, TINA standing for There Is No Alternative. Emerging out of a difficult and fragile transition process, in itself aided by open market access (for industry and most services) in the Europe (association) Agreements, the prospect of EU membership has prompted an astounding discipline and determination on the part of the candidates. It is little known that the Europe Agreements (usually with some 120-130 articles) have only a single and brief, substantive article on the adoption of the regulatory part of the internal market *acquis*.[1] It merely consists of a list of headings of regulatory areas without any detail, or timetable. Similar lists can be found in some other association or FTA agreements with the EU. In the latter cases the follow-up tended to be weak, selective and shallow. In the case of the Europe Agreements, however, the follow-up was almost as steadfast as if the associates were EU members already, with extraordinary detail, large-scale technical assistance (in the PHARE programme), meticulous monitoring, widely published annual (so-called “Regular”) reports and permanent feedbacks to governments and other public agents.[2] This hegemonic approach does *not*, therefore, follow from the Europe Agreements and can only be explained by the strong desire to prepare for membership. It goes without saying that there was no comparable alternative to this kind of lock-in and stimulus. Nowadays, on the other hand, having

[1] See Pelkmans (1998), for detail.

[2] See the 1995 White Paper (COM (95) 163 of 10 May 1995 and its Annex specifying 899 directives and decisions in 23 chapters of the *acquis*; and the Regular Reports, published in the autumn of every year, last autumn published as SEC (2002) 1400 until 1412, attached to the Strategy paper of the Commission of 9th October (COM (2002) 700). These regular Reports, 2002, together add up to more than 1800 pages!

accomplished the adoption of the *acquis*, with many favourable consequences for transition too, the Europe Agreements can serve as a reasonable fall-back position in case ratification might somehow fail. This is so because of the ratchet-effects incorporated in the Agreements, in other words, the de-facto sharing of a good deal of the internal market opportunities can be maintained. Nevertheless, this fall-back position would not be under strict EC compliance systems (run by the Commission and the national courts, all the way up to the EC Court of Justice) and would not provide for free agricultural trade, migration, cohesion-type transfers or access to Euroland. The fall-back position may be far superior to what other transition countries enjoy – as the economics of transition literature has amply shown – but it clearly does not satisfy the ambitions of the candidates. If the TINA argument is right, it should raise the credibility of the pre-accession process – and the credibility of the substantive negotiations. One is led to conclude that the world community has come to trust the EU in bringing about an enlargement which, on the whole, is seen as a win-win strategy for Europeans and non-Europeans. For example, the implementation of the *acquis* in accession countries will undoubtedly yield a host of benefits for third countries and their multinationals. These include, but are not limited to, an enormous geographic space operating under a common legal framework for commercial activities and harmonized or at least “mutually recognized” technical regulations on product quality and content; a single pan-European trade policy, which includes a unified tariff structure and administrative procedures, thus facilitating trade with third regions; the phasing out of the CEECs’ Article 29 exemption on subsidies to producers in accordance with WTO rules, since they will lose their status of “transition” economies[3]; a stricter application of intellectual property rules, reducing the piracy of brand names and products in the accession countries; the introduction of EU public procurement rules, in line with the WTO’s Government Procurement Agreement, which will benefit third countries more than the status quo.

## 2. Impact on industrial trade and direct investment

### *Industrial trade*

From an analytical point of view, enlargement is the change from an industrial free trade area (the Europe Agreements) to a customs union. However, the candidates enter the internal market and this introduces additional potential benefits which are hard to model properly. If tariff differentials in a free trade area are modest and tariffs are absolutely low, the changeover to a low common-external-tariff customs union should not be expected to cause large changes. Thus, for industry, most of the adjustment driven by the free access to the EU goods market will be over *before* 2004. What then follows might be characterised by further deepening of specialisation and vertical intra-industry trade, stimulated by foreign direct investment and sub-contracting. So the positive effects of enlargement for third countries will primarily depend on this long-run deepening and upgrading of specialisation. The early signs demonstrate a very dynamic adjustment process. After the massive shift towards trade with the EU (up to 1994), the initial dominance of labour-intensive final goods has reduced, and the share of technology and skilled-labour intensive products moved up from 37% in 1993 to 50% in 1997 (Kaminsky, 2001). Quality upgrading is also found by Nielsen (2001) at a very high level of disaggregation, but the CEEC quality levels still lag greatly behind those of the EU. Vertical intra-industry trade dominates East-West industrial trade (Aturupane, Djankov & Hoekman, 1999), with the CEECs invariably supplying the low unit-

[3] See European Commission Memo/03/72, Brussels, 27 March 2003

cost goods. The import side of Central Europe is extremely dynamic for capital goods (not including motor vehicles and their parts), nearly a tripling between 1993 and 1998. These and other studies, combined with the flows of foreign direct investment, point to ongoing forceful restructuring and upgrading. It is guesswork to make inferences about the quality of factor endowments and applied technology in 2004 but there are good reasons to expect the starting position in the larger customs union to be radically different from the empirical basis of most of the meanwhile published literature on trade effects. Recent empirical work by Landesmann (2003) shows not only that significant annual productivity increases in manufacturing between 1993 and 2000 (between 5 % and 15 % annually, except for Bulgaria) were obtained, but also that medium-high tech sectors experienced much higher output growth rates in Visegrad countries and Slovenia. In a decomposition based on skill intensities, Landesmann shows that all CEECs have increased the share of high-skill-intensive goods in their exports to the EU ('95 - 2000). If correct, it is good news for competitiveness, and ultimately catch-up growth. In any event, a reasonable guess would be that the candidates' share in EU-15 imports (already gone up from 3.4% in 1992 to 9.8% in 1999) would rise to 13% - 14% by the time of entry. Central Europe will begin to matter in EU trade.

At a disaggregated level, the (short-run) positive effects for outsiders hinge on the reduction of trade protection. The accession to the EU (industrial) customs union will on the whole be beneficial to outsiders since tariffs of all candidates (except Estonia, which has no industrial tariffs) will fall to the EU rates which, on average, amount to 5.3% (applied rates). As is known, few countries actually pay these tariffs due to many preferential agreements or GSP. But for Japan and the US, it means that the average tariff reduction is often half the current rate of candidates or more. Customs union theory amounts to a warning that a shift from tariff-ridden trade to a customs union, even with low tariffs, can still (sometimes) lead to trade diversion. But in Europe, industrial intra-trade is already tariff free and hence the external tariff reductions will generally boil down to a pure improvement of market access for the US and Japan (and others).

Cases of trade diversion can be suspected in cars and possibly in textiles and clothing. Both sectors show extremely buoyant intra-European trade. Both are driven by fragmentation of the production process, a search for differentiated location according to comparative advantage, out-sourcing and massive direct investment. The prime example *par excellence* in trade-led adjustment in Central Europe yielding growth and improving quality can be found in the phenomenal success of clothing and textiles trade growth: very high and sustained growth rates in EU– CEEC trade in this sector, a near-tripling of the share of CEECs in EU clothing imports to 17.5 % between 1988 and 2000 (competing against equally phenomenal growth rates of EU imports from e.g. China, Bangladesh, India and to some extent Turkey), more than a tripling of the CEECs' share in EU textiles imports to 13.8 % in that period, and a steady flow of FDI to the candidate countries (Stengg, 2001). To some degree this must be due to trade diversion, made possible behind relatively high tariffs and some restrictive MFA quotas. With enlargement this trade diversion will tend to fall because EU tariffs (9% - 12%) are generally lower than those of candidates, sometimes much lower. This tendency will be reinforced by the abolition of the last tranches of MFA quotas half a year after accession.

The potential car demand in the CEECs is high, projected to be above the rate of economic growth, since the ratio of people to cars is still high in the region. As an example, Romania averages 8.3 persons per car, as opposed to the EU average of 2.1. The majority of analysts expects demand in the CEECs to grow substantially by the 2010 horizon, with sales reaching a potential 2.4 million new cars per annum (15% of the EU average, compared to

today's 6%, (Boillot, 2002). It would thus seem that the car sector offers substantial opportunities while becoming exposed to global competition. Despite the potential, demand is still somewhat precarious and not very robust, shown by the effect that the global economic slowdown in 2001 had on car sales in Poland, cutting them by almost 40% from 519,000 to 325,000. This fall was succeeded in 2002 by a further 20% drop. Since native Eastern European car producers, except for Dacia in Romania, are all but extinct (though this does not hold for trucks and buses), there is a large market to be tapped by foreign car producers. Profits are not only to be had in sales of new products, but also in used cars and repairs. The average age of a car in the candidate countries is 13 years (compared to 7.6 in the EU), meaning that there is a growing market for parts and maintenance/repair.

The region circumscribed by the accession countries holds several advantages that make it an attractive market for assembly and production. Combining low cost-production (bargaining power of unions is substantially weaker and labour costs in the manufacturing sector of CEECs are roughly a quarter of those in Germany) with a high market potential and proximity (both in geographic and economic terms) to the large EU car market (13 million new car sales in 2000), the CEECs provide various ways for car manufacturers to integrate them into their global strategy. In recent years, due to a number of foreign investments (some one-fifth of the FDI stock in candidate countries is related to car manufacturing), the components industry has flourished in Eastern Europe. 50 of the world's 100 largest parts manufacturers are now located in the Czech Republic. Cost advantages are likely to stay around for a while, as the CEECs' income per capita will converge very slowly to those of the EU.

The automobile industry is generally recognised to be one of the most globalised. In recent years, the tendency has increasingly been to resort to sub-contracting and outsourcing, importing many components. Several countries, mostly Poland, Hungary and Romania, have been targeted as demand markets, not for export-orientation. The countries which have exported the greatest amount of their auto production are Slovakia (95%), Slovenia (92%) and the Czech Republic (85%), compared with last-place Romania (23%).

Bordenave and Lung (1996) hypothesize that the pan-European car market will decentralise over time, in keeping with a tendency towards a continental vertical division of labour. This case has been borne out partially, namely, by those firms which have opted to complement their range of cars with production of downscale variants for the poorer CEEC markets (Fiat, VW) or those which have shifted production of their traditional low-end models to the East. This is not to say that the CEECs are incapable of producing quality products: Hungary has enjoyed tremendous success as the host of Audi motor production.

The breakdown of market share in the CEECs by manufacturer in 2001 clearly indicates that the first movers obtained the largest volume of sales and accrued greater advantages from backward linkages. Vertically integrated firms rushed into Eastern Europe, the four main ones being Opel, Fiat, VW and Renault. Their strategies aimed at capturing the largest market share possible in volume terms, so it was vital for them to get in early. Instead of greenfield investments, only takeovers were planned in the early years of the transition (Van Tulder and Ruigrok, 1999). The advantage of backward linkages mostly accrued to the primer movers. Volkswagen has a very clear lead in this category and enjoys an unrivalled position in terms of market share[4].

[4] Market shares are: VW (28.1%); Renault (14.9%); Fiat (11.7%); PSA (11.1%); Daewoo (6.6%, though now bankrupt); Ford (3.6%); Suzuki (3.2%).

A discussion of the potential trade effects on the car industry should be based on an analysis of carmakers' strategies and, hence, changing positions of competitiveness over time[5]. One must keep in mind that certain car manufacturers deliberately chose, for various strategic reasons, not to plunge headlong into the CEEC market for cars. Several reasons point to Japanese reluctance to move into Eastern Europe, at least initially. Sinn and Weichenrieder (1997), argue that the CEEC market was simply "too small" for Japanese investors and incompatible (at least initially) with the *Keiretsu* tradition of close links with Japanese suppliers. Japanese car manufacturers tend to supply components to their foreign subsidiaries, rather than to source them from local or regional suppliers. Japanese reticence has changed since Toyota's recent decision to engage in a $1 billion joint greenfield investment with French PSA. The strong position of the leading car companies in Central Europe today in many ways reflects their initial strategy. It is possible in some cases that effects which one might attribute to trade diversion in a static analysis are in fact a false interpretation of car makers' respective strategies. Costs have gone down and quality markedly up. If trade diversion is a concern, it has already occurred during the 1990s. To the extent that Asian and American car manufacturers are more efficient than continental European ones, the strategic move made by the four European "prime movers" (in conjunction with their national governments, which were directly involved in the negotiations, using the EU-accession bait, and from whom they received much support) in the very early stages of the transition may have obtained an overwhelming advantage for them through the quick realisation of economies of scale, learning-by-doing and a dominant market share. But it is also true that they have assumed considerable risks and invested in re-skilling and upgrading of suppliers, which engenders positive externalities. On the other hand, whereas the prime movers are looking to exploit the market in CEECs, other manufacturers are more concerned with tapping into the candidate countries' lower wages into their global production system to reduce production costs.

Whether there initially was trade diversion or not, the chances for any further diversion are slim. Foreign manufacturers are already "in." The shift from the Europe Agreements to EU membership will amount to a cold shower for candidate countries because, as opposed to considerable protectionism on the part of some candidates (notably, Hungary, Poland and Romania), presumably as a form of industrial policy, the EU car tariff is a mere 10%[6]. If anything, enlargement should be trade creating in cars.

***Foreign direct investment***

FDI flows have been quite strong during the second half of the 1990s. As Brenton & di Mauro (1999) have shown, FDI in the more advanced candidates was greater than one should expect given the actual level of income, market size and relative proximity. The determinants of future FDI flows into Central Europe are perhaps even more difficult to establish than elsewhere. Bevan & Estrin (2000) find as key determinants country risk, unit labour cost, host country size and other gravity factors. In turn, country risk is influenced by private sector development, industrial development, budget (im)balance, reserves and the degree of corruption. They show that more FDI boosts credit ratings with a lag, which in turn boost FDI again. This suggests virtuous circles but also rivalry in attracting FDI between the lagging and advanced candidates. The perception or expectation that chances for long-run catch-up growth are good will act as a major stimulus for FDI which in turn will contribute to

[5] See Van Tulder and Ruigrok (1999) for a detailed explanation of car manufacturers' strategies in the CEECs.
[6] The EU tariff structure is escalating. Though the simple average of EU automotive imports is 7%, parts only face a 4.5% tariff, passenger cars 10%, trucks and buses just around 20% (EU-TARIC 1995, Diehl 2001).

the realisation of that economic growth. It is for this reason that business attaches so much significance to *actual*, not possible, EU membership (ERT (1999); ERT (2001)). They regard the EU as a credible – even when far from perfect – enforcer and stabiliser of the regime change and wish to see the seal of approval. The Spanish and Portuguese accession led to a true explosion of FDI inflows for about four years, before returning to 1986 levels. One might add that the subsequent entry into Euroland would further boost FDI although little hard empirical work seems to underpin this expectation. Soft indications for this statement include the massive business support for the euro precisely on the grounds of predictability and low long term interest rates. An additional argument that tends to be overlooked is the stability of market access and of currencies *inside* Central Europe. FDI is known to respond positively to such regional facilitation of market access, since critical mass for scale might now be accomplished by sales to a subset of CEECs rather than from Western Europe.

World FDI flows declined sharply in 2001. The 2002 World Investment Report (UNCTAD, 2002) notes a fall of 59% (!) for developed destinations and 14% for developing countries. However, the inflows to Central Europe remained stable (+2%), and this testifies to the confidence business has in enlargement. It is widely expected that, after 2004, FDI flows to Central Europe will go up sharply, at least for a number of years, and this despite the drying-up of privatisation projects.

## 3. **Agricultural trade**

The agricultural sector merits special attention, since third countries' concerns about the negative economic impact of enlargement has focused primarily on the eastward extension of the CAP. The present authors have come to the conclusion, much to their surprise, that in the short to medium run, EU enlargement will *not* lead to any significant trade diversion, despite the CAP's expansion east. We draw this conclusion from the stark reality of farming inefficiency in the CEECs: in the aggregate, the farms are simply not competitive. The lack of external competitiveness of CEEC farms can be summed up in the following: they cannot benefit from scale economies because of fragmentation; they do not benefit from technological progress, since the sector is party to very little investment and is actually being decapitalised; they do not benefit from technical efficiency gains because of sedentary peasant farming and far too slow consolidation; their export opportunities are limited because of poor product quality. None of these characteristics have, in itself, much to do with protectionism. They are the unfortunate outcome of a very problematic transition which will need another half a decade or more. In this section, we proceed as follows. First, we set out to explain the lack of competitiveness of the CEECs as a function of their initial conditions. Next, we demonstrate just how uncompetitive the farming sector in the CEECs still is today. Finally, we discuss the welfare effects on third countries, in order to discern whether or not fears of significant trade diversion are justified against the backdrop of the present sorry state of agro-supply in Central and Eastern Europe.

### ***Transition and farm structure***

The agricultural sector in CEECs is far more imposing than in the EU. According to Liapis and Tsigas (1998), agriculture accounts for over 11% of GDP, against 3% in the EU; labour employed by the sector exceeds 22% of the total labour force, versus 6% in the EU. Total agricultural area is 38% of that in the EU. Currently, 9.5 million workers are employed in agriculture in the candidate countries, whereas only 7.1 million tend to a much larger

cultivable area in the Community. If relative resource endowments would express potential comparative advantage, then the CEECs do have advantages with 0.57 ha per capita, against 0.36 in the EU (Bureau, 2002).

Agricultural employment in the CEECs is not on a steady downward trend, as many had anticipated would be a corollary of the transition. On the contrary, it has increased in all countries between 1990-98 (**See Table I**)[7]. The driving force behind this somewhat surprising result is quite likely to be that the agricultural sector acts as none other than a decoy for unemployment.

The transition of agriculture in the accession countries is a study in extremes. Before the demise of the USSR, many farms in the CEECs were modelled after the large Soviet-era collectives and cooperatives (Poland was the main exception), each holding huge plots of land and hiring hundreds of workers. Once the transition process got started, the situation reversed, as rapid privatisation and land restitution constituted the policy of choice. As a result, individualisation ensued: workers were dispersed, assets were sold or stripped, meaning that the average farm was left with very little capital. Yet espousing a capitalist approach need not always breed success if institutions and infrastructure are underdeveloped. As Lerman (1999, p12) puts it, "individualization is not a sufficient condition of success." On the contrary, it can, in certain cases, be even more detrimental from the purview of efficiency than large-scale collective farming. Such seems to be the case in some regions of current-day transition countries.

**Table I: Per capita GDP and share of agriculture in GDP and total employment, change in agricultural value added, and population in agriculture by country, 1998**

| | Per cap. GDP | Share of agriculture in GDP | | Share of agriculture in employment | | growth in value added | % pop. in agriculture |
|---|---|---|---|---|---|---|---|
| Country | $US 1997 | 1998 | Δ90-98 | 1998 | Δ90-98 | | |
| Bulgaria | 4809 | 18.8 | 1.062 | 24.7 | 1.380 | -0.5 | 7.6 |
| Croatia | 6749 | 7.0 | 0.686 | 2.4 | 0.667 | -2.5 | 8.5 |
| Czech | 12362 | 1.8 | 0.621 | 5.4 | 0.458 | 2.6 | 8.2 |
| Estonia | 7682 | 3.8 | 0.447 | 6.8 | 0.527 | -5.0 | 11.4 |
| Hungary | 10232 | 5.2 | 0.800 | 5.4 | 0.412 | -3.8 | 12.0 |
| Latvia | 5728 | 4.5 | 0.213 | 15.7 | 1.013 | -6.8 | 11.9 |
| Lithuania | 6436 | 10.0 | 0.362 | 21.4 | 1.202 | -3.0 | 14.9 |
| Poland | 7619 | 4.2 | 0.356 | 26.9 | 0.989 | -0.2 | 19.5 |
| Romania | 5648 | 16.0 | 0.734 | 35.6 | 1.228 | 0.6 | 15.9 |
| Slovakia | 9699 | 4.4 | 0.595 | 8.2 | 0.683 | -1.6 | 1.9 |
| Slovenia | 14293 | 3.4 | 0.680 | 12.0 | 1.043 | -0.1 | 9.0 |
| Ukraine | 3194 | 10.5 | 0.430 | 22.5 | 1.154 | -6.3 | 15.9 |

*Source: van Kooten et al. (2001); Hagedorn et al. (2000); Tanic et al. (2001)*

[7] Likewise, the share of agriculture in GDP in *all* accession countries has *increased* between 1990 and 1998.

Labour productivity in the agricultural sector is very low, reflecting a large surplus of agricultural labour. This conclusion is an obvious deduction from the comparison of two ratios: percent of the labour force in agriculture versus percent of agricultural output in GDP. The numbers for the accession countries are stark: the 10-20% of GDP accounted for by the sector is not consonant with the 15-30% of the labour force employed in agriculture. The greatest problem facing CEEC agriculture, apart from the dearth of capital, is the inability to shed unproductive workers; often, these will retreat to a family farm when confronted with urban unemployment. In other words, the opportunity cost of taking up farming, particularly for the unskilled and elderly (Gorton et. al, 2001), is very low, unless other rural employment opportunities can be created. Because there is a lower bound on the farm size necessary to sustain a family, generating off-farm income is critical for farmers holding small plots of land. Subsistence and semi-subsistence farming is still widespread in the CEECs, outdoing its Community equivalent, which, at 12-15% of agricultural production pales in comparison, by a factor of 3 or 4 (**See Table II**). The fact that very small farms are so numerous in Eastern Europe suggests that there is either massive rural poverty or that land is held as security without being put to productive use, or a combination of both.

Zhou (2002) has characterised this phenomenon as an economic ill accompanying privatisation and liberalisation. Because social safety nets are still far from comprehensive in the region, farmers are unwilling to take the risk to engage in economic pursuits off the farm. If they do muster up the courage to seek employment elsewhere, they often hold tracts of land as security. Added together, these idle land holdings create vast spaces, which are underused and unproductive. In addition, farmers' willingness to form cooperatives and associations is still impaired by the imperfect application of the rule of law and enforcement of property rights. The political economy of the transition has generated a set of incentives for the individual farmer, whereby he perceives small farm size as the surest mean to maximise his welfare. While it may be true on the individual scale, collectively, this behavioural pattern spells disaster for external competitiveness. The structural problems imbedded in the accession countries' agriculture sectors is in large part due to the unwillingness of these peasant-size family enterprises to respond to economic change.

**Table II: Average size of farms in hectares* and share of total agricultural land (%)**, by farm type and country, 1998**

| Country | State | Corporate | Cooperatives | Family | Household |
|---|---|---|---|---|---|
| Bulgaria | *2614* | | *743* | *24.3* | *0.4* |
| | (20.9) | | (39.0) | (33.4) | (6.6) |
| Croatia | | 1194 | | *5.1* | *0.5* |
| | | (14.0) | | (55.8) | (2.8) |
| Czech | *863* | *668* | *1349* | *18.0* | |
| | (0.4) | (28.6) | (31.9) | (30.8) | |
| Estonia | | *450* | | *21.7* | *n.a.* |
| | | (24.9) | | (51.7) | (13.2) |
| Hungary | | *177* | *726* | *8.9* | *0.4* |
| | | (15.2) | (22.2) | (58.4) | (4.2) |
| Latvia | *91* | | *301* | *13.7* | *6.2* |
| | (0.2) | | (3.9) | (59.3) | (36.6) |
| Lithuania | | *372* | | *7.6* | *2.2* |
| | | (17.6) | | (42.5) | (21.5) |
| Poland | *616* | *712* | *204* | *7.0* | *0.4* |

| | | | | | |
|---|---|---|---|---|---|
| | (6.7) | (4.4) | (2.7) | (76.6) | (2.0) |
| Romania | | *3020* | *233* | *2.1* | |
| | | (11.2) | (33.2) | (55.6) | |
| Slovakia | *3546* | *1154* | *1583* | *11.4* | |
| | (0.6) | (25.1) | (54.1) | (7.9) | |
| Slovenia | | *364* | | *5.2* | *0.6* |
| | | (7.7) | | (91.2) | (1.1) |
| Ukraine | *922* | *2655* | *313* | *26.0* | *0.5* |
| | (11.0) | (79.3) | (0.3) | (2.6) | (6.8) |

*Source: Tanic et al. (2001)*
**Italics represent hectares*
***Parantheses represent the percentage of agricultural land taken up by various farm types*

Though Hughes (1998) presents evidence that farm size is now converging upon a unimodal distribution, as opposed to the bimodal one which prevailed until recently, the process of consolidation is agonizingly slow, meaning that technical efficiency gains will only be accrued at a snail's pace. Gorton et al. (2001) estimate that the annual rate of withdrawal from the sector in Poland is a paltry 0.7%. One must keep in mind, though, that in all CEECs, the percentage of the labour force working in agriculture is actually *increasing*.

The ageing population will also negatively impact on agricultural competitiveness. Some CEECs have even lower total fertility rates than their western European counterparts. As a result, farming is becoming even more fragmented. The number of 1 to 2 hectare farms has actually increased from 378,300 to 449,500 since 1990 in Poland (Gorton et al., p4), reflecting a greater number of pensioners working 1+ hectares of land to qualify for their farmers' pensions.

***International competitiveness***

How to measure international competitiveness? The problem, of course, is that competitiveness is difficult to define. To conceptualise it is to come up with a single index or figure, which may or may not accurately reflect the true state of affairs. Economists have widely varying definitions. If competitiveness is defined as capturing larger shares in export markets, the competitive position of CEEC agriculture is not a favourable one: since the transition, the trade balance in the sector vis-à-vis the EU is not only negative (all countries except Hungary and Bulgaria), but surprisingly, is also *deteriorating* (all countries except Bulgaria and Romania), which is the inverse of the expected outcome (**See Table III**). But this measure is itself problematic. The fact that the trade balances are for the most part negative may be more a reflection of initial conditions, as EU export subsidies in agriculture were high in the early stages of the transition, distorting agricultural trade. Moreover, EU protection under the Europe Agreements was much stricter than that of candidates. But given that both are falling rapidly now, it is surprising to find that the agricultural trade balance is deteriorating for CEECs. What went wrong? Essentially, earlier studies and politicians seem to have overestimated the competitiveness of Eastern European agriculture, at least for the medium-run. As a recent survey by the United States Department of Agriculture explains (AER-806, p16), "most of the transition economies […] have adopted agricultural reform programs less ambitious than those that would be consistent with the forecasters' predictions."

| **Table III: Agricultural trade for selected transition countries** | | |
|---|---|---|
| | Net agricultural trade with EU ($US millions) | |
| | 1993 | 2000 |
| Bulgaria | -14.3 | 18.0 |
| Czech Rep. | -113.3 | -621.5 |
| Estonia | -31.8 | -184.3 |
| Hungary | 621.5 | 530.4 |
| Latvia | -7.9 | -163.4 |
| Lithuania | 3.3 | -124.0 |
| Poland | -254.6 | -324.8 |
| Romania | -332.9 | -135.5 |
| Slovakia | -77.5 | -192.9 |
| Slovenia | -82.6 | -237.1 |

*Source: OECD (2002)*

Studies such as Commission (1998), indicating that surplus production of milk in the most advanced CEEC-6 will exceed 1 million tonnes in 2003, have proven to be exaggerated. The sector is painfully fragmented, particularly in Poland, and dairy farms are no exception. For example, Gorton and Davidova (2000) note that in 1996, the average dairy herd sizes in Romania and Bulgaria were a miniscule 1.8 and 1.4 cows, respectively. In Poland, dairy farms are a bit larger, though still tiny compared to western standards: the average number of cows totalled 3.4 on 5.2 hectares. Not only are the small plots of land supposedly consecrated to milk production often used for other purposes besides dairy farming, but small producers also cannot provide proper feed or reasonable housing conditions (Gorton et al., 2001). They lack adequate machinery and necessary equipment. The upshot is, of course, that the quality of CEEC agro-food products seriously suffers, a further nail in the coffin of competitiveness.

The evidence in Pouliquen (2001) on (in)efficiency is stunning. Labour productivity measured as value added per worker in Poland and Romania is but 8% and 6% of the EU level. Semi-subsistence farming accounts for no less than 93% of total agricultural value added in the Visegrad countries plus Estonia and Slovenia. Most impressive is the fact that in order to reach a *mere half* of the average EU farm productivity, sector restructuring in the CEECs will entail dismissing more than 4 million agricultural workers. Profitability has been hurt by inflation and expensive factors of production, especially in non-tradables. Due to the lack of profitability, there has been little investment in agricultural capital since the transition, meaning that fixed assets are depreciating rapidly with little prospect of replacement. Currently, profitability in agriculture is so low that it has actually led to decapitalisation, thus contributing to rising unit costs (Pouliquen 2001, p6).

Gordon and Davidova's (2001) research indicates that the arable sector in the CEECs is better off than the livestock and meat industry, which is not saying much, because the production of livestock and meat products is so far from being competitive. Their analysis is based on a domestic resource cost (DRC) analysis, an index whose value determines the international competitiveness of a sector. An index value below one suggests some degree of competitiveness on world markets. To put things in perspective, these authors estimate that only 12.5% of livestock production registers values below one, against 76% for wheat

production. It has been known for a while that of all agricultural produce in the CEECs, only wheat has some semblance of being competitive. However, even the somewhat positive results for wheat must be qualified by the fact that they are aggregated for the region and are not weighted by country size or relative importance in that sector (Poland and Slovenia, for example, did not have a single instance of DRCs below one in crop production). Like all indices, DRCs have their drawbacks and are sensitive to the selection of exchange rates, international prices and shadow prices for non-tradable inputs (Gordon and Davidova, p187). In addition, these estimates could be overly optimistic, since often, in their sample selection, national agricultural ministries' datasets are skewed towards large farms, but small farms account for a majority of agricultural production in the CEECs. Measures of international competitiveness based on costs will also overstate the efficiency of CEEC agriculture, since they implicitly assume equal food quality. If one relaxes this unrealistic assumption, the picture becomes much bleaker.

On many smaller farms, the use of intermediate inputs such as high-quality fertilizer, critical for land productivity, has fallen following price liberalization. Faced with declining purchasing power, farmers are forced to cut back on production costs, hurting soil fertility and resulting in leaner yields per hectare. According to Ecosoc, fertilizer use has fallen by 87% in CEECs between 1987-1998 (Ecosoc, 2002) . In addition, most fertilizer production in CEECs is simply exported (Brenton and Ferrer, 1999), due to a dearth in demand. On the other hand, on some large corporate farms, the opposite is happening. As quoted in Gorton and Davidova (2001), Köckler and Quiring (1997) indicate that large-scale farmers may have fallen prey to the temptation to focus on short-term gains, rather than sustainable agriculture. As a result, the intensive use of fertilizer, pesticides and other chemicals and aggressive farming techniques have damaged the soil, meaning that what competitiveness has been achieved often comes at the price of sustainability.

Gorton et al. (2001) find that there is an inverse relationship between domestic resource cost and farm size. Some of the reasons why larger farms are more productive are cited in Hughes (1998, p9). They include: more efficient resource management, low cost production through scale economies, better risk management (product diversification, storage capacity to hedge price risk) better access to credit (because small plots of land often are not accepted as collateral (Brenton and Ferrer, 1999 p.16), improved input supply and higher political bargaining power (subsidies, favourable legislation). In other words, the fragmentation of CEEC farms (and all that accompanies it: loss of scale economies, decapitalisation) may go a long way in explaining the uncompetitive position of the sector. Part of the low labour productivity in the CEECs stems from the rapid liberalisation and privatisation of the farming industry. In Poland, only 35% of the total cultivated area is accounted for by farms larger than 15 hectares. As noted by Macours and Swinnen (1999, p1) "the shift to individual farming had a negative impact on average labour productivity as substitution of labour for capital inputs and fragmentation of asset use more than offset the efficiency gains due to increased marginal labour productivity." Many economists have blamed the slow transformation of the agricultural sector in the East on the inability of small, peasant-style enterprises to generate structural change.

Land productivity as measured by yields is also far from Community averages. Low as these figures may be, they are probably optimistic. Hughes (1998) argues that yields per hectare are a poor measure of agricultural efficiency, because yield per hectare is also a function of labour. If agriculture is highly labour-intensive, as is the case in the CEECs, yields may hide the fact that labour productivity is low. Swinnen (2002) shows that sugar beet yields

across the region in 1997 were only 50% of their 1989 level; in the Visegrad countries, oilseed yields fell by 20-30% over the same time frame; as for coarse grain yields, they reached for the most part their 1989 levels, save for Romania and the former Czechoslovakia, which stagnated at 70-80% of the 1989 index level.

Exchange rates create problems as well. The projected continued appreciation of CEEC real exchange rates will further hurt competitiveness for the agro sector. Due to the Balassa-Samuelson effect[8], the rising price of non-tradables in CEECs stimulates the exchange rate onto a path of appreciation. This effect is only temporary, since sometime in the not-too-distant future, the real exchange rates of CEECs will attain their equilibrium levels and will stabilize, at least according to theory. Estimating fundamental equilibrium exchange rates (FEER), Coudert and Couharde (2002) find that despite a recent path of appreciation, most CEEC exchange rates are still significantly undervalued, often by as much as 20% **(See Table IV)**.

**Table IV: Calculated real exchange rate misalignments in (%) relative to the euro for CEECs**

| | 2000 | 2001 |
|---|---|---|
| Slovenia | 8.3 | 8.8 |
| Czech Republic | -23.6 | -18.9 |
| Hungary | -17.7 | -11.9 |
| Slovak Republic | -25.7 | -24.1 |
| Poland | 6.6 | 21.5 |
| Estonia | -6.1 | -4.7 |
| Lithuania | 10.9 | 12.0 |
| Latvia | 2.8 | 0.8 |
| Romania | -33.4 | -33.4 |
| Bulgaria | -32.2 | -29.9 |

*Source: Coudert and Couharde (2002)*

***Welfare effects***

It is often suggested that, since EU agricultural tariffs (for temperate zone products) are very high, major trade diversion will emerge or further increase upon EU enlargement. On the face of it, this seems quite obvious, since the main culprit, i.e., the CEECs' adopting the EU's higher common external tariff, can easily be identified. Trade diversion will undoubtedly be large, but it is not always clear whether it will be due to the EU tariffs, or the CEEC tariffs, or both once turned into a common tariff. Although EU protection is extremely high, so that one should expect a range of CEEC agro-products to receive higher protection after 2004, there are also products for which protection in candidate countries turns out to be higher, sometimes even higher than the highest EU tariff peaks. The Czech Republic is a

[8] See Annex of Pelkmans, Gros and Nunez-Ferrer (2000) for a technical explanation and an attempt to estimate the effect for Central Europe.

prime example, with higher tariffs in sugar, butter, skimmed milk powder, beef, pork and poultry (**See Table V**). However, in the Doha round, EU agro-tariffs are bound to fall considerably – the question is therefore one of timing. It is also likely that the CAP mid-term review will lead to changes (e.g. decoupling) and that the candidate countries' farmers will get (slowly rising) income payments. Finally, the planned milk reform (2005-2007) will be implemented (yet, there are powerful pressures to go slowly on this), whilst sugar protection will eventually be undermined by the EU Everything-But-Arms initiative for the 48 poorest countries of the world.

**Table V: Main customs duties reciprocally applied between three transition countries and the EU in 2000**

| Country | Agricultural commodities (% equivalent to proportion of tax) | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Wheat | Oilseeds | Sugar | Butter | SMP | Beef | Pork | Poultry |
| Czech | 76 | 27 | 172 | 166 | 108 | 182 | 64 | 99 |
| Hungary | 32 | 0 | 68 | 102 | 51 | 72 | 52 | 39 |
| Poland | 21 | 60 | 60 | 68 | 37 | 34 | 39 | 43 |
| EU | 46 | 0 | 169 | 136 | 70 | 108 | 38 | 25 |

*Source: EBRD Transition Report (2002)*

There are three reasons why legitimate and understandable concerns about trade diversion in agriculture arising from accession are only relevant in the *long run*, *not* in the next 5-7 years. First among these is the very low efficiency of CEEC agricultural production, but other factors include real exchange rate appreciation and differences in revealed comparative advantage (especially at the 8-digit level, as classified in tariff schedules bound by the Uruguay round). Often, pessimistic forecasts of large-scale trade diversion are based on the assumptions of rapid and significant restructuring and gains in efficiency based on crude estimates (Bureau, 2002), which is simply not commensurate with the current situation of fragmentation and agonizingly slow reform. Similarly, simulations of trade diversion are very problematic, first of all because the supply responses to protection are still so weak in the CEECs (as explained above), and also because they cannot foresee possible CAP reform or the removal of certain restrictions on agricultural trade in the Doha Round. One must also keep in mind that although far less important, EU accession of candidate countries does not represent a one-way street in terms of trade diversion: third countries will see some reduction in protection, since CEEC tariffs are higher than those of the EU in some categories. It is also likely that EU accession will help the growth prospects of the candidate countries, and the higher aggregate demand for imports that results may mitigate the loss of market share through trade diversion.

**Box I** summarizes two studies by Liapis and Tsigas (1998) and Frandsen et al. (2000), who have tried to capture the welfare effects for the rest of the world arising from EU enlargement. Their conclusions are that trade diversion is likely to be quite substantial in some product areas, but that in the aggregate, the accession of CEECs to the EU will be beneficial for the rest of the world. It must be noted, however, that these results and those generated by computable general equilibrium models in general must be treated with great caution, since they are very sensitive to both the choice of parameter values and to an array of assumptions, such as markets clearing immediately, perfect competition, etc., which are typically unrealistic (especially for less developed regions and economies in transition).

Another caveat is that the results are based on outdated data, which for CEEC agriculture is very problematic indeed. Many assumptions had to be made which simply do not reflect the current lack of competitiveness of the agricultural sector. Recent data only serve to reinforce this assertion. Therefore, the present authors doubt the applicability and economic value of these studies, at least for the short to medium run.

**Box I: Computable general equilibrium models of EU enlargement welfare effects**

In their study, Liapis and Tsigas (1998) conclude that taken as a whole, EU enlargement will be beneficial for third countries, generating a *net* welfare gain on the order of $1.6 billion, and $6.8 billion if the CAP is reformed. But agricultural exports to the EU will not be left untouched, as significant trade diversion could occur: in the dairy sector, for example, total US and EU exports are projected to fall by 22.50 percent and 15.44 percent, respectively. What is dubbed "rest of world" will see exports decline by 21.90%. The biggest losers will be the CIS: respective impact on exports in non-wheat grains, non-grains, livestock, meat and dairy products is estimated to be -13.70, -12.90, -12.40, -9.22, -9.68 percent.

In another computable general equilibrium framework, Frandsen et al. (2000) measure the welfare effects the enlargement will have on third countries. They estimate a model using the Global Trade Analysis (GTAP; see Hertel, 1997). Overall, the welfare effects for third countries is positive and amounts to $US 400 million. Some regions are worse off, but the majority, including China, Middle East/North Africa, Japan, Central America and Sub-Saharan Africa realise small gains, on the order of less than 0.11 per cent of their GNP. The losers tend to be the countries in the Cairns group, probably because of the expanded application of the EU beef tariff peak.

For the Mediterranean non member countries (MNMCs) and Asia, trade diversion in agriculture is a minor issue. MNMCs compete in agricultural products much more with Italy, Spain and Greece than with the accession countries. The one exception is Cyprus, which has a very similar export structure to several MNMCs, particularly Israel (Tovias, 2000). But given Cyprus' small size, the effective trade diversion for the region is negligible.

According to Jessen, ed. (1997), in the 660 agricultural product categories where CEECs and Latin America/Caribbean (LAC) overlap, the LAC region has a revealed comparative advantage in 92 positions, accounting for 78% of LAC exports to the CEECs. The possibility of trade diversion arising between South America and the CEECs is rather slight by the calculations of the above study, since only 4% of Latin America's exports in value terms shared revealed comparative advantage with the CEECs at the 8-digit level. However, the present authors recommend that such studies measuring potential competition as an overlap of export structure be treated with caution. The problem with revealed comparative advantage using ratios of export shares is that these measures incorporate the effects of existing protection. When protection is high, as it currently is in agriculture, the revealed comparative advantage ratios become heavily distorted.

It is clear that third countries will lose market access in the accession countries, once the CEECs adopt a tariff schedule in agricultural products conforming to the EU common trade policy (Jessen, ed., 1997). Countries not involved in the enlargement will seek compensation. There is substantial academic literature on the impact of enlargement on third

countries' agriculture and the EU's agro-commitments of the Uruguay Round.[9] Its thrust is that there are real risks of violating the WTO constraints and that there will be considerable trade diversion in several product groups. If the CEECs adopt EU tariff peaks, third country exports of beef, sugar and wheat to the CEECs, facing EU tariffs of 125%, 125% and 92%, respectively, are likely to decline, except in certain countries[10]. The United States (bovine meat, non-wheat grains), the Cairns group and Mercosur countries, particularly Argentina (bovine meat, non-wheat grains) and Paraguay (beef), Brazil (sugar) are the most likely of trade partners to suffer setbacks due to trade diversion from EU enlargement.

A recent Commission (2002b) forecast indicates that in 2007, marketable surpluses for many agricultural products in the CEECs will be but a fraction of EU-15 surpluses, this despite a significantly higher proportion of labour in agriculture and a larger total number of agricultural workers. (The ratios are projected to be as low as 1/17 for beef, 1/15 for coarse grains, 1/7 in non-wheat grains, 1/7 for cereals, 1/6 for pork, 1/6 for poultry, 1/5 for milk). The WTO commitments of the CEECs mean that the leeway for export subsidies in agriculture is quite restricted. As a whole, the CEEC-region is obligated under WTO law to limit the quantity of subsidised exports to 1.7 million tonnes in cereals, 0.3 million tonnes of beef, 0.65 million tonnes of milk and 0.3 million tonnes of sugar (Bureau, 2002). It is not so much the eastward expansion of the CAP *per se* that is a problem for third countries and developing regions, rather than the CAP itself. In other words, the marginal contribution of EU enlargement to CAP-related negative welfare effects on third countries is slight. Because the post-transition restructuring in agriculture in Central Europe is far from over, the medium-term effects of extending the CAP are not nearly as worrying (for outsiders) as one might have expected given a healthy agro-food sector.[11] A more radical CAP reform has not been implemented, although attempts to commit the Council to it by 2006 have not been rejected. However, the CAP budget ceilings after 2006 have been tightened.

Marsh and Tarditi (2003) suggest that surpluses of exportable agricultural products in the CEECs will strongly increase by 2013[12]. If correct, extending the CAP eastwards would mean running the risk of violating WTO constraints on exports subsidies and therefore stalling the Doha Round. Market price support in accession countries is expected to increase by 150%, from 14% of the international value of production to 35% (according to March and Tarditi), and payments to producers will nearly quadruple, from 10% to 36% of the same value. This introduces a large potential for trade diversion, even in the event that no significant export surpluses emerge. Though this might result from their comparative static framework, such a conclusion has little practical meaning without adding a time dimension. It is clear from the above sections on farm restructuring and competitiveness as well as from interviews, that the dynamics of supply responsiveness in agriculture will unfold only very slowly and with significant lags. In other words, increased protectionism will not automatically translate into the rapid marketing of exportable surpluses, if only because the supply response will be far from immediate. While Marsh and Tarditi's conclusion rests upon a partial equilibrium analysis using the assumption that the price elasticity of supply is 0.3 over a 10-year period, it is very doubtful whether 0.3 is a realistic assumption. Neither the aforementioned authors nor the present authors can know with any reasonable certainty the

[9] See, for instance, Swinnen (2002), Fuller et. al (2002), Weyerbrock (1998) and Frandsen, Jensen & Vanzetti (2000).
[10] Here, we suggest another look at Table V.
[11] See e.g. European Commission, 2002a
[12] Given their assumptions on demand and supply elasticities and of quota reforms, hence no production limits on milk and sugar.

true responsiveness of supply in the accession countries to post-2004 CAP prices in the EU-25. What is sure is that the projected surpluses under the Marsh and Tarditi scenario could easily be depleted over the same time frame if the elasticity were but a bit lower (say, 0.25 or 0.2). Based on the considerable evidence provided thus far in our paper, we suspect that the snail's pace of farm restructuring in the CEECs will severely limit the ability of the agricultural sector to respond to price increases. In other words, the supply elasticity is likely to be quite low for the next 5-8 years.

The question now is whether future reform can combine a constrained budget (for income payments) and (much) lower trade protection. History and political economy teach that third countries better not be optimistic. Beyond the medium run, it is worrying, conditional of course on CAP reform and Doha.

Least developed countries and ACP countries are the most likely to gain, since they will benefit from the eastward extension of trade privileges such as the Everything But Arms initiative (duty-free access for 48 LDCs to EU market for all goods) and Cotonou (the reformed Lomé group arrangement, extended until 2020 in 2000; all non-reciprocal tariff preferences in place until 2007), since CEECs must integrate them into their trade schedules to conform to the *acquis*. As such, Africa is not likely to suffer from trade-related effects of EU enlargement, since most of its countries benefit either from EBA or Cotonou (its only Cairns' group member is South Africa).[13]

Implementing the *acquis* also means that the CEECs will lose an edge over their competitors from third countries, who will—more often than not—not have to adopt the same environmental, social and technical standards required of companies operating within the EU. With respect to sanitary and phytosanitary questions, product quality and hygiene are often below the SPS measures imposed by the EU. One must also not forget that once the CAP does extend to the candidate countries, they will have to incorporate environmental concerns into their national agricultural strategies in conformity with "greening" the CAP (OECD, 2002).

The large swings in the nominal values of vehicle currencies in which the international value of commodities is often quoted should be a greater cause of concern for non-CEEC agricultural exporters than the possibilities of short to medium-run trade diversion generated by EU enlargement. Combined with the volatility of resource- and climate-determined agricultural prices, the volatility in exchange rates could easily wipe out the gains that accrue to the CEECs through enlargement or vice-versa.

All the above helps to explain why the current enlargement is, for the most part, a "silent" one. The severe lack of competitiveness plaguing CEEC agriculture is minimizing the risk of trade diversion for at least a number of years ahead.

[13] The EU-South Africa FTA specifically excludes the sensitive commodities of sugar and meat. South African farmers are upset that under the agreement, only 61.4 % of the country's farm products will gain unrestricted access to EU markets. In contrast, South Africa must phase out tariffs on 95 % of agricultural imports from the EU over a 10-year period.

## 4. Sensitivities about bilateral investment treaties

Candidate countries have signed many bilateral investment treaties (BITs) with a host of countries. In this they simply follow a conduct practiced by all OECD countries. The incentive for an active policy of welcoming foreign investors is even greater than for other OECD countries as candidates (rightly) consider a steady inflow of FDI to directly as well as indirectly propel their growth rates for a long period of time. Why did Central European countries sign such a plethora of BITs soon after the collapse of the Soviet Union? According to UNCTAD, bilateral investment treaties may help foster a favourable investment climate, building confidence among, and sending a positive signal to, investors.[14] However, the vast literature on FDI has indicated that proximate determinants of FDI focus much less on the absence or presence of BITs, than on cost factors and openness to trade (Nunnenkamp, 2002); market size (Agarwal, 1980); per capita GDP (Loree and Guisinger, 1995); human capital (Hymer, 1960; Noobakhsh, Paloni and Youssef, 2001); location and internalization opportunities (Dunning, 1981); exchange rate movements (Jun, 1996). The answer may be that in the competition for attracting scarce resources of foreign direct investment, even slight edges may lead to significant gains. In this light, any country which does not adopt measures implemented by its neighbours may lose out. Such seems to have been the reasoning of the CEECs.

Many of the Central European BITs with the US were signed very shortly after the collapse of the Soviet Union, at a time when even Austria, Finland and Sweden were still not members of the EU. Given the geo-political context of the initial transition, it was not clear what the future would hold, let alone that the CEECs would accede to the EU. The US claims that it signs BITs so that its investors are treated fairly and to protect US interests abroad. Neil Watkins of the Preamble Center (Washington, DC), noting the relatively low number of BITs signed by the US[15] and their geographic distribution (the majority involve CEECs and the CIS), suggests that they are an instrument to obtain access for US investors in heavily regulated markets where political risk is high. In fact, according to UNCTAD, more than a third of worldwide BITs involve CEECs (653 out of 1941). One cannot ignore either the strategic context (in economic terms), where the respective bargaining power of the countries negotiating a BIT must be taken into account. It is possible that the CEECs may have been arm-twisted into signing liberal BITs with the US, as the result of unequal bargaining power between them[16]. With respect to investment treaties, one outcome is that strong countries develop a hub and spoke system, benefiting from numerous bilateral investment treaties signed on unequal terms, without having to reciprocate.

It is surprising to notice that the European Commission has raised objections against the candidates' BITs with the US (and apparently not against BITs with other countries). The reason is unlikely to be that these BITs with the US are especially restrictive. National treatment is a leading principle in such BITs and, in this respect, the compatibility with a fundamental treaty article (Art. 48, EC, formerly Art. 58, EC) which also stipulates national

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[14] Chairman's Summary at the closing of the plenary meeting. *Expert Meeting on Existing Agreements on Investment and their Development Dimensions*. UNCTAD, Geneva, 28-30 May 1997

[15] As of January, 2001, the US had ratified 31 BITs, with another 14 still pending, as opposed to Germany's 124.

[16] Professor M. Sornarajah noted at the UNCTAD experts' meeting (see footnote 12) that while demanding national treatment for US investments at the pre-investment phase, the US often does not reciprocate this provision.

treatment would seem to be ensured. EU opposition to US BITs in Central Europe is two-sided: economic and legal.

From an economic perspective, the liberal BITs signed between the CEECs and the US could threaten the integrity of the internal market. Interviews suggest that this possibility only arises in a few sensitive cases. Suppose that in the future an EU directive is adopted, imposing certain restrictions on foreign broadcasting companies providing services in the EU. In an enlarged EU, the directive would obviously apply to CEECs, where Poland, for example, has signed a BIT with the US, granting American broadcasting companies rights which violate the directive. The main EU concern is that in areas which still predominantly fall outside of the competence of the EU and remain within the bounds of national regulation, a situation could arise whereby a US broadcasting company (or airline) is favoured over an EU competitor, even within the context of an enlarged internal market. Obviously, the integrity of the internal market would be violated by such an arrangement, and is therefore unacceptable to the Commission.

It would appear that there are two sensitivities. First, one set of issues relates to specific services sectors that are exempted in the GATS' schedules of commitments submitted by the EU (and, incidentally, by some other countries as well) from national treatment. In fact, the real bones of contention consist of audio-visual services (mainly, TV, in the light of the "TV without frontiers" directive which comprises selective measures of protection for EU-origin production) and air transport (here, the problem goes back to the "open skies " agreements the CEECs have signed with the US and which have long been suspected not to be compatible with EC law, that is, with the internal market).

In air transport the "mercantilist" tradition is only slowly being replaced by ordinary conditions of market access and (lightly regulated) competition. Thus, despite the full liberalisation of the provision of intra-EU air transport services, so-called air-services-agreements between EU Member States and third countries were never transferred to EU-level agreements. The fear of Member States has long been that the European Commission would not (be capable to) renegotiate such agreements with proper attention to all the rights and benefits currently enjoyed by the respective incumbent airlines (who make most of their turnover on such international routes). Since all airlines having rights under third country agreements are keen to have wide access to the huge US domestic air services market, the US "open skies " agreements were signed by many EU Member States. The upshot was that this provided the US companies commercial possibilities in the internal market that EU airlines did not have, whereas, at the same time, the US merely provided multiple entry but no cabotage, let alone, a right to acquire US airlines. The candidates, by signing such "open skies" agreements, now find themselves in the same conundrum as the Member States which did so. In November 2002 the ECJ ruled that the "open skies" agreements are incompatible with Community law as any serious student of the internal market could have expected.[17] It remains to be seen whether and how the Commission can now better negotiate the common Atlantic aviation space that was blocked by the uncertainty on the ECJ rulings.[18] It would seem that, in these negotiations, the renegotiation of the agreements of the candidates is a natural component of the overall package.

Taking a closer look quickly seems to suggest that the potential dispute has more to do with the litigation and negotiating habits in the "lawyers' paradise" of international services

[17] Ruling of 5 Nov. 2002; see www.curia.eu.int for cases C-466/98 to C-476/98
[18] See European Commission press release IP/03/281, 26 February 2003

than with significant economic effects. To begin with, the US has ensured certain exceptions as well. As an example, the BIT with Lithuania exempts the very sectors for the US that are said to cause US concern in the EU-15 and the candidates, namely the US airlines and audiovisual sectors (!) Furthermore, the so-called 'cultural exception' in audiovisual services in the EU has never prevented US industry to conquer and maintain extremely high market shares in TV, video and film services in Europe. The factual difference between the economic interests of US industry in the candidates today and after EU membership should therefore not be expected to be great.

On the legal side, Commission officials Julie Raynal[19] and Roderick Abbott[20] in recent speeches target in particular the provision of national treatment at the pre-investment phase in US investment treaties with the CEECs. Since no EU country has this provision in any of its treaties, and since EU internal market legislation only allows it to be granted among member states, such a difference in treatment between existing EU members and aspirants would be unacceptable (Abbott, 2001).

Of course one might simply argue that, once the candidates are EU members, the *acquis* will always be overriding BITs concluded under international law including GATS but legal specialists are not unanimous in adhering to this position. Specifically, the EU is concerned over dispute settlement procedures regarding concessions. A concession is a contract between a sovereign state and a national of another state. If ever the host country decides unilaterally to change the terms of its agreement with the foreign investor, it breaks an obligation bound by international law (Comeaux and Kinsella, 1994). Applied to the US-EU BIT spat, CEECs cannot adopt the *acquis* in certain areas without violating an agreement enshrined in an international treaty, since the BITs were signed before the adoption of the *acquis*. In the case of a dispute, BITs ensure that the case goes before a neutral international arbitration body, rather than the courts of the host country, ensuring an unbiased ruling. Rather than taking the risk of one day losing in a court decision, the Commission requires that the BITs be made fully compatible with the *acquis* or cancelled unilaterally.

Recognizing that political risk in the accession countries has become slight, the US is nowadays less concerned with expropriation and nationalization of its investments, than with other possible grounds of dispute, especially in intellectual property, licensing and distribution. Given national treatment, there is no reason to expect EU provisions for investment protection to be any worse than those accorded by the CEECs bilaterally, save possibly in the pre-investment phase. US resistance to the EU call for abrogation of US-CEEC BITs could be purely political then, since the US feels its BITs are singled out amongst many other ones.

The implementation of the *acquis* is likely to make Central and Eastern Europe the soundest investment climate in any of the emerging markets. This is what matters for US business and their returns on investment. The annulment of the BITs will probably be only of symbolic importance, and the resulting economic impact is likely to be minimal. As for US fears that CEECs may not fully implement EU investment rules, they are not only exaggerated; remedies exist against non-implementation and non-enforcement under EC law, also for EU-incorporated US business.

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[19] Julie Raynal spoke at a recent OECD conference on BITs (28-29 May 2001, Dubrovnik, Croatia)

[20] Roderick Abbott, then Deputy Director General for Trade at the European Commission, gave an address at the Paul H. Nitze School of Advanced International Studies (22 October, 2001, Washington, DC).

## 5. The long-term economic perspective

In the longer run, and given the accomplished “new security architecture of Europe”, *enlargement is about prosperity*. A successful enlargement is one which stimulates a catch-up economic growth rate, higher and better sustained than in other scenarios. Such a successful enlargement clearly would be a win-win result for Europeans and non-Europeans alike.

After the large output falls of the beginning of transition, the candidates have shown that rather basic recommendations about sound economic policy, combined with the gradual introduction of the *acquis communautaire* and the full access to the EU markets, does bring catch-up growth. Between 1995 and 2000, 7 of the 10 CEECs were catching up despite Russian turbulence and lingering transition problems. And the cases of retrogression were clearly limited to countries paying the price of half-baked reforms and/or very sloppy macro-economic policies (Bulgaria, Romania and the Czech Republic). All three are now in the process of overcoming these setbacks, with Romania and Bulgaria currently on a catch-up rate of 2 % - 3 % points or more (if the EU remains trapped at a miserable 1 % for a while). However, the real issue is a long-run one: does the Union welcome the growth dynamos of the near future or must it face the risk of getting stuck with a bunch of new Mezzogiorno’s? Recent extrapolations of the post – 1995 experience suggest that catch-up to only 75 % of the GDP per capita of the EU-15 will take one, two or three decades dependent on the country and ignoring the relatively high income case of Slovenia. It is only since 2000 that Central European catch-up is accelerating and positive for all ten CEECs which are candidates. In the year 2003 economic growth can be found in Central Europe, not in Western Europe. The latest forecasts for annual medium term growth rates (2002 - 2005) of the candidates from Central Europe by the European Commission date from November 2002 and hover between 3.6 % for Poland and 3.7 % for the Czech Republic up to 5.1 % for Romania, 5.3 % for Latvia and 5.5 % for Lithuania and Estonia.[21]

The mighty combination of EU “lock in” of reforms in candidates and policy stimulus, not to speak of the dynamic benefits of market access and competitive exposure in an EU – 25, generates a pro-growth environment. It is not comparable to East Germany where irresponsible wage increases far ahead of productivity and a lack of local ownership, combined with what the late Rudy Dornbusch called both the “good” and “bad” institutions of Germany, have prolonged structural unemployment and deterred investors. It is not comparable to industrializing developing countries in general as they cannot hope to enjoy such forceful “lock in” (not even Mexico in NAFTA), such strong guidance in economic policy, such powerful and long term assistance and such market access, indeed free movement (implying a *right* to access).

As briefly touched upon in section 2, there are increasingly clear indications about powerful underlying microeconomics of catch-up growth. Landesmann (op. cit.) has accomplished a very detailed analysis of competitiveness indicators which should promote growth. In addition to the points mentioned before, he shows that given a decomposition of manufacturing in (e.g.) labour intensive and technology driven sectors, the disparities between the export performance to what is called the EU-North of the CEECs and that of the EU-South are rapidly shrinking for Visegrad and Estonia as far as tech-driven sectors are concerned while Romania, Bulgaria, Latvia and Lithuania now tend to grow rapidly, at least partly, on the basis of labour intensive sectors from which the EU South is moving away.

[21] European Commission (2002), Evaluation of the 2002 pre-accession economic programmes of candidate countries, Enlargement Papers no. 14, November

When focussing on low-skilled intensive sectors a similar pattern develops (except for Latvia). In the shorter term both specialisations can yield considerable growth but in the longer term Romania and Bulgaria will undoubtedly have to refine their focus on higher value-added output in such sectors. A clear and impressive example that this may well happen is in a key sector for these countries, namely, textiles and clothing. In the CEPS/EPPA study[22] the long-run strategies and foreign direct investment plans of many German and Italian textiles and clothing firms were studied and the uniform response is the intention of a steady and considerable stream of FDI in CEECs, with the expectation of increasing sophistication. Already in 2001 Italian textiles and clothing industry (co-)owned a respectable total of some 1000 firms in Bulgaria alone. It seems reasonable to believe, therefore, that the fragmentary signals about catch-up growth are not merely straws in the wind despite the numerous problems ahead.

Nevertheless, the favourable environment and positive signals notwithstanding, there are lingering doubts about catch-up growth. They have both practical and deep analytical grounds. Practical arguments include the egalitarian inclination in the domestic politics of the transition countries, which has caused intolerably high social mark-ups on wages (not seldomly higher than in Western Europe, which used to be the highest in the OECD) and considerable deficits in the pensions systems today (i.e. before ageing is beginning to hit). Other worrying observations include the hesitation to go all the way in restructuring of ailing sectors in the presence of high structural unemployment, the deep skill mismatches of many long-term unemployed in a rapidly changing labour market, and the expected exit from agriculture with a questionable absorption capacity of industry and services. In the latter case, the economically unwise but (for the farmers and enough politicians) politically attractive alternative is a too generous CAP keeping far too many human resources in subsistence agriculture and dragging down growth for the candidates' economies. Last but not least, one could add the weaknesses in financial services and capital markets in actually serving the needs of local investors at low interest rates and the overall fear that implementation and market related institutions in Central Europe are so feeble that markets suffer from uncertainty, hence less growth.

The analytical reasons boil down to the controversies in economics about the long term determinants of growth. A number of pertinent questions are addressed in Pelkmans (2002). In other words, as the Romanian economist (and former finance minister) Daniel Daianu (2002) has put it, should we rely on "an apparent mythical belief" in EU circles that a well functioning competitive market economy will ensure a catch-up growth trajectory? Can Ireland be imitated by all, or will many mimic the Greek tragedy before 1997 or are they capable of pursuing the reasonable Iberian middle-road? It seems obvious to the present authors that the EU can simply no longer tolerate the pre-1997 Greek underperformance combined with opportunism and bad implementation. EMU is a huge improvement in that respect and Greece has responded in kind.

But economic growth in the EU and a healthy enlargement cannot be limited to the Central Europeans. The entire new EMU of 25 faces a need for economic reform, in particular micro-economic reform in agricultural, services and labour markets. These reforms would also help in reducing the costs of shocks in Euroland than can no longer be cushioned by (national) currency realignments.

[22] EPPA/CEPS (2002), Die Auswirkungen des ATC-Quoten_abbaus auf die Deutsche Textilindustrie, Brussels

Japan and much of Europe share a low capacity of economic reform nowadays. CAP reform over the next two decades seems likely to come back every five/six years or so until decoupling and (sufficient) decentralisation of income payments is accomplished and external protection has become low. The reforms in services, including network services, go slow and, beyond squeezing out the worst elements of cost inefficiency, progress has become difficult. This is even true for the critical sector of business services (despite its higher than average growth rate)[23]

The reforms of labour markets are an evergreen amongst European economists. It ranges from Giersch' "eurosclerose" of 20 years ago until the recent, sensational call by a CEPR team led by prof. Boeri (CEPR (2002)) to make accession conditional upon the existence of a decent social safety net while at the same time letting the EU contribute to this net via the structural funds. The Boeri group goes even further and argues for a European safety net (!), based on a European minimum guaranteed-income scheme (which would be nationally differentiated, to be sure) so that systems competition would only take place above that level. We shall not go into the merits and financing of those systems nor into the details of all kinds of labour market flexibility proposals floated by many economists, the EU and the OECD. The Luxemburg process, dealing with the so-called European employment strategy since 1998, has attempted to approach it via the so-called "open method of coordination". One observes that all the hard reform issues remain excluded from this very soft cooperation. The benchmarking has done little to convince German or Italian vested (labour) interests to mend their ways. Would enlargement make the difference? The answer is that only a combination of three changes might get Europe somewhere: making intra-EU labour mobility across borders easier (a topic carefully neglected until in 2001 the Commission finally came with serious suggestions to remove barriers to cross-border labour mobility - see European Commission, 2001 ), greater flexibility with the host country control principle – see WRR (2001) - and some acceptance of the fundamental idea that the cumulation of regulatory protection in the labour market *and* a generous safety net without any trade – off between the two can be excessive and hence hinder the attainment of goals that the EU (hence its Member States !) have set. If this triptych is not accepted - and it will be an uphill struggle - chances are that, gradually, Central Europe will transform into a copy of Western Europe. The upshot will be sluggish growth in the continent while labour markets will fail to clear. If this agenda could even be partially implemented, as about half of the EU countries are favouring and are already doing to a degree, enlargement might infuse some extra dynamism.

[23] See the Commission report on the internal market for services, COM (2002) 441 of 30 July 2002.

## 6. **Conclusions**

The external economic impact of enlargement has not attracted a great deal of interest in the public or indeed academic debate. This can be traced back to the curious habit of mankind that bad news is both much more and more deeply analysed than good news. The present article shows that, on the whole, the move to an EU of 25 is a win-win process for insiders and third countries alike. The case for this favourable view is first of all based on the economic and political stability that is greatly helped by the EU as an anchor and (benign) hegemon. It is widely realized outside Europe how precious this stability is for countries emerging out of a difficult and tortuous process of transition. EU membership ensures it to be even more credible and durable. Worldwide support for the lock-in effect of the very wide ranging *acquis* and its enforcement and the technical and other aid provided by the Union translates into implicit support for enlargement. The case is strengthened by the generally low protection of the EU in goods market, thereby reducing trade diversion. The major exception is in agriculture where border protection for temperate zone products will further increase and only continued reforms as well as concessions in the WTO Doha round may provide a perspective for improving access for third countries in the future. In some specific agro-products trade diversion can be serious and perhaps some WTO constraints for the EU are at risk. The expected impact on FDI inflows is highly positive and does not come at the expense of outside countries. The skirmishes about bilateral investment treaties can probably be resolved in best-endeavour trade negotiations between the US and the EU-25. In any event this will have to be done for air transport. The greatest positive stake outsiders have in enlargement is the success of a sustained strategy of catch-up growth by the candidates, helped by the EU market environment as well as the Union funding. It is in particular on this strategy that emphasis should be laid for the next two decades or so since, in the final analysis and given the fulfillment of the political conditions for membership, the EU enlargement is all about prosperity. And prosperity in Central Europe is also a boon for third countries.

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