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Towards European Union Eastern Enlargement – Progress and Problems in Pre-Accession

Abstract

Since the Copenhagen and Essen Summits in June 1993 and December 1994, there has been a consensus on eastern enlargement. Central and Eastern European countries have been shown the green light in terms of accession. However, questions of when and how remain open for discussion. The main elements of the accession strategy appear in the Europe Agreements on economic cooperation, the White Paper on approximation of laws, the Phare programme of economic aid to the associated countries and structured dialogue.

At the moment, the aspirant members are not ready to take on the complex set of rules ranging from minimum social and environmental standards in the single market to the application of competition law.

In respect to transition development, markets already finction reasonably well in most CEECs. However, in several areas of economic activity, effective and transparent corporate governance and appropriate standards for conducting business still have a long way to go. This applies, in particular, to enterprise restructuring, strengthening of financial institutions, commercialisation of infrastructure and environmental protection. Furthermore, many changes in legal structures are still required. Regrading to macroeconomic stabilisation, progress towards stability continues, growth remains relatively strong and inflation has declined. Nevertheless, increasing trade deficits, real exchange rate appreciation and signs of a deterioration in international competitiveness may lower growth. In addition, expectations concerning wage increases, further liberalisation of administered prices, money supply growth caused by high interest rates, and growth of credits to enterprises are to fuell inflation in the future.

From the EU's point of view, the official framework for admission to the EU involves, among others, the Commission preparing an opinion (avis) on the applicant's ability to acceppt the body of EU law (aquis communautaire). Furthermore, the Commission must prepare a report on the EU's financial framework covering the early years of the next century and likely effects of enlargement. Finally, before enlargement can take place, the Intergovernmental Conference must succeed in streamlining EU decision-making and institutions, extending EU responsibility for joint foreign and defence policies and improving cooperation in home affairs matters.

The EU has grown to fifteen members through four enlargements. Monetary integration is currently scheduled for 1999 and given the amount of effort made, there seems no way turning back. Monetary union is considered a logical extension of the single market and therefore, enlargement cannot be pursued at the expense of monetary union. Only after monetary union has started functioning, concrete actions can be taken in terms of enlargement.

Keywords: Integration, Central and Eastern Europe, the Europe Agreements, The European Union, the European Monetary Union, eastern enlargement.

1 Introduction – what preparations for enlargement are being made?

The European Union was founded by six countries in 1957. Today it has fifteen members. It has moved from being a free market area to a customs union and common market. Presently, the Union is occupied with issues of monetary union, eastward enlargement, and whether the Union's institutional structure is flexible enough to expand eastwards and deepen in terms of economic and political integration.

Since the Copenhagen and Essen Summits in June 1993 and December 1994, there has been a consensus on eastern enlargement, and Central and Eastern European countries (CEECs)[1] have been shown the green light in terms of accession. However, questions of when and how remain open for discussion.[2] In recent years, enlargement has achieved considerable attention from economists and politicians throughout Europe. The increasing numbers of research projects, expanding literature, ongoing official and unofficial discussions among the 15 EU Member States and the 10 applicant countries all indicate growing interest. Everyone agrees that an economically strong and politically stable Europe is desirable, but the fundamental questions about the nature, speed, timing and cost of EU enlargement eastwards remain unanswered.

Enlargement is a complex issue. Much of the work to make enlargement possible is happening within the CEECs themselves. Their economies must succeed in closing the development gap with respect to the EU, implement required trade liberalisation measures according to the WTO, intensify intra-regional cooperation, and revise their national legislation. We see a burgeoning number of contacts among officials from applicant states, Member States, and the Commission. The main elements of the *accession strategy* appear in the *Europe Agreements* on economic cooperation, the *White Paper* on approximation of laws, the *PHARE programme* of economic aid to the associated countries and *structured dialogue*. The structured dialogue consists of meetings of heads of state and government and ministerial meetings. In addition, the accession of a country to the EU involves the Commission preparing an *opinion (avis)* on the applicant's ability to accept the body of EU law *(acquis communautaire)*. For those applicants judged ready, accession negotiations should begin within six months of the end of the Intergovernmental Conference (IGC); sometime around summer 1998. Before enlargement can take place, the Commission must also prepare a *best possible financial study* about the costs and benefits involved.

2 Towards market economy and catching up with the European Union

2.1 Transition – achievements and problems

Much of the burden connected with enlargement is carried by the CEECs themselves. At the moment, the aspirant members are not ready to take on the complex set of rules ranging from minimum social and environmental standards in the single market to the application of competition law.

From the economic analysis point of view, the CEECs have often been evaluated in terms of their achievements in the creation of market structures. The key terms have been *transition* and *stabilization*. The following overview on transition and stabilization is largely based on the Transition Report 1996 by the European Bank for Reconstruction and Development as well as on the World Bank's Development Report 1996.

- Transition means a movement from a central-

[1] Central and East European Countries (CEECs) include: Poland, Hungary, Czech Republic, Romania, Bulgaria, Slovkia, Slovenia, Estonia, Latvia and Lithuania.

[2] Four years ago at the Copenhagen summit, the European Council acknowledged "that the associated countries in Central and Eastern Europe that so desire shall become members of the EU" See: Commission of the European Communities (1994) The Europe Agreements and Beyond: A Strategy to Prepare the Countries of Central and Eastern Europe for Accession. COM(94) 320 final, COM(94) 321 final and COM(94)361 final.

ly-planned to a market economy, involving changes and creation of institutions, i.e. enterprises and legal structures.

- Stabilisation means achieving a low and predictable rate of inflation. Through the use of fiscal and monetary policy instruments, stabilisation policy also aims to prevent dramatic fluctuations in output and employment.

Transition and stabilisation are complementary elements. In order for transition to be successful and promote development, it must be accompanied by stabilization. It should be noted that there is neither a "perfectly functioning" market economy, nor one optimal path to transition.There can be and have been different paths to a market economy.

CEECs are often discussed as a single entity. Similar features can surely be found in their transition history, but there are also many country-specific elements in their convergence towards market economies.

In general, markets already function reasonably well in most CEECs. They have liberalised most of prices and external trade. Further, most of the restrictions on entry for new companies have been removed and currency arrangements liberalised. Reforms have been implemented in the financial sector and subsidies have been eliminated. Many have also completed privatisation of small-scale enterprises and progress has been made in privatizing larger enterprises.

However, in several areas of economic activity, effective and transparent corporate governance and appropriate standards for conducting business still have a long way to go. This applies, in particular, to enterprise restructuring, strengthening of financial institutions, commercialisation of infrastructure and environmental protection.

Enterprise restructuring should be carried out in conjunction with privatisation. Large-scale privatisation has suffered, however, from a lack of transparency. There are many cases management insiders and politically connected people involved in asset stripping and other dubious financial arrangements. Sometimes companies have been privatised without restructuring corporate governance, which, in turn, has led to inefficiency. In other words, privatisation alone does not necessarily guarantee success. In addition, it should be accompanied with the renewal of managerial structures.

In respect of financial institutions, many of the largest commercial banks are still owned by the state. Banks, both private as well as state-owned, continue to struggle with bad loans and other non-performing assets. A number of banking crises have taken place due to macroeconomic shocks, inexperience in lending, and poor banking supervision. Further, an uncertain economic climate has made banks unwilling to lend for the long term. Governments in some countries have been slow in implementing rescues or restructuring operations. These facts have contributed to the poor competitiveness of domestic banks vis-à-vis foreign banks.

Stock exchanges are now functional in most CEECs. Turnover is generally rather low and due to the lack of depth, quotations can fluctuate widely.[3] In addition, the population has not been very successful in accumulating sufficient savings that could be invested in stocks or bonds. Of course, it has often been the case that there have simply been no attractive, reasonable-yield securities available. Since many new private joint-stock companies have just started to operate, it will be some time before they begin to generate profits and thereby raise volume on national stock exchanges.

During the old system, enterprises were not particularly consumer oriented. Energy and labour were wastefully used and environmental issues were, to a large extent, ignored. These problems are still present and need to be corrected. CEECs should encourage a more commercial attitude that extends to both infrastructure and the environment. This means more cost-base pricing and more demand-oriented production. For EU membership, environmental regulations in CEECs must be gradually adapted and brought into line the EU. Prices, especially for energy and power, must reflect real resource costs. Investments will also be needed to clean up old environmental damage.

In a wider sense, one of the challenges in the

[3] See more: Central and Eastern Europe on the Way into the European Union, Bertelsman Foundation Publishers 1995.

CEECs is building a new role for the state, a shift from state control towards state support. The privatisation process has changed the state's role from a main employer to the role of a mediator. Obviously, the state is responsible for law and order, but it must also provide macroeconomic stability and basic legal and institutional infrastructure for markets. In the CEECs, some of the toughest challenges involve the tax system and tax administration. Further priorities include also providing an adequate social safety net as well as health and education systems. These sectors are interrelated. For example, weak tax administration and corruption in many CEECs has weakened the state. Decrease in revenues puts pressure on the financing social safety nets as well as pension, health and education systems. Lack of education and health, in turn, has hindered sustained economic growth. A poorly functioning pension system or a low level of social safety increase public distrust of government. People are less willing to pay taxes.

Savings play a crucial role. They form the base for investments needed for economic restructuring and growth. So far, transition economies have financed their investments mainly from domestic savings.[4] Given the fact that tax revenue has dropped (due to weak tax collection and administration) and expenditure pressures (resulted from the needs to develop social safety nets) are great, public sector savings are limited. Therefore, mobilisation and allocation of household savings need to be improved. In particular, the range of financial instruments and institutions through which these savings are transferred and further accumulated need improvement.

The transition process requires many changes in legal structures. The reform of the civil, trade, and economic codes, aiming at the adjustment to a market economy, is pushed forward in all countries. Since the CEECs want EU membership, their legal restructuring must take into account demands of the internal market of the Union. For example, there must be laws that help to create a secure and predictable framework within which businesses can operate. Compatible competition policies are also needed. In addition, a country must have effectively functioning laws relating to the operation of the financial system and laws that protect intellectual property rights. To provide guidance in this challenging task, the EU issued a "White Paper" on the approximation of laws in May 1995.[5] The paper includes 1) a general introduction to each area of legislation which describes objectives and methodology of Community legislation, 2) legal and organizational structures necessary to operate Community law and 3) the identification of key measures and proposed sequence for approximation within each area of legislation.

2.2 Macroeconomic stabilisation and convergence with the EU

CEEC progress towards macroeconomic stability continues and growth remains relatively strong.[6] It is worth noting that since CEECs have become more and more open economies, they are also increasingly influenced by developments in Western Europe and other parts of the world economy. For example, Western Europe now accounts about 50–70 % of the total exports of East European economies. This means that these economies are increasingly sensitive to changes in Western demand and in world market prices for primary as well as other traded goods. They are also increasingly dependent on foreign, private capital flows to finance their growing current account deficits.[7]

Despite the indicators of positive economic growth, the latest development shows that overall growth has slowed from 1995 in many CEECs (see Table 1a.). According to OECD, the first half of 1996 marked a slowdown of GDP growth, industrial output and exports in CEECs. Towards the end of the year, growth, however, picked up again.[8] For most CEECs, strong expansions in do-

[4] EBRD, Transition Report 1996.

[5] Commission of the European Communities, White Paper, COM(95) 163 final/2, Brussels 10.5.1995.

[6] This chapter is mainly based on the data provided by the EU, OECD, EBRD and The Economist Intelligence Unit.

[7] Economic Bulletin for Europe, Volume 48 (1996), United Nations, Geneva 1996.

[8] OECD Economic Outlook (60), December 1996.

Table 1a **GDP, real percentage change**

	1994	1995	1996	1997	1998
Hungary	2.9	1.7	1.2	2.7	3.5
Poland	5.2	7.0	5.9	5.1	5.4
Czech Rep.	2.6	4.8	5.0	5.3	5.5
Slovakia	4.9	7.4	5.0	4.6	4.5
Romania	3.9	6.9	4.5	4.2	3.4
Bulgaria	1.4	2.6	–7.6	–3.1	1.1
Estonia	–2.7	2.9	4.1	4.5	5.2
Latvia	1.9	–1.6	2.0	2.2	2.9
Lithuania	1.0	2.4	1.1	2.7	2.8
Slovenia	4.9	3.5	3.5	4.1	4.5

Source: European Commission, Forecast Summary, 10 October 1996.

mestic demand and weakening of economic growth in Western Europe have led to large trade deficits (see Table 2.). In particular, the sluggish economic growth in Germany, the main trading partner for most of the CEECs, is one of the deter mining factors for the lower growth. In addition, real exchange appreciation and signs of a deterioration in international competitiveness affect the situation.

In many countries, monthly wages have been growing faster than productivity. This puts pressure on labour costs. Productivity growth, in turn, has been hindered by delays in industrial and enterprise restructuring.

Although overall growth has slowed from 1995, it is still satisfactory, and in many countries above the EU average (see Table 1b). This is an important factor from the economic convergence standpoint. As long as CEECs continue to grow faster than the EU, their economies will converge and catch up with the EU.

Inflation has declined in most CEECs, with the exception of Bulgaria and Romania (see Table 3). Nevertheless, inflation remains clearly above Western levels. So far, reducing inflation has been achieved by tight monetary policy and improved credibility of the central banks. In addition, falling world prices for many imported goods and appreciating real exchange rates have helped bring inflation down. Inflation is still fuelled, however, by expectations concerning wage increases, further liberalisation of administered prices, money supply growth caused by high interest rates, and growth of credits to enterprises.

Unemployment rates in CEECs remain quite high although they have fallen from almost 13 % on average in September 1995 to below 12 % in September 1996.[9] Measurement of unemployment remains, however, problematic due to inaccuracies in the statistics. Hidden unemployment (particularly in large enterprises) and growing numbers of discouraged unemployed workers leaving the labour force make measuring unemployment more difficult. In the future, given the scale of enterprise restructuring ahead in most transition economies, there is little prospect of rapid reduction in unemployment.

Increased financial and macroeconomic stability and progress in reform have positively affected capital flows to the region. However, investment flows have been unevenly distributed across the region (see Table 4a.). According to the

[9] Economic Bulletin for Europe, Volume 48 (1996), United Nations, Geneva 1996.

Table 1b **GDP, real percentage change**

	1993	1994	1995
EU-15	–0.6	2.7	3.1
Belgium	–1.7	2.3	2.7
Denmark	1.5	4.4	3.3
Germany	–1.1	2.9	3.0
Greece	–0.5	1.1	1.6
Spain	–1.1	2.0	3.1
France	–1.5	2.7	3.1
Ireland	4.0	6.3	6.9
Italy	–1.2	2.2	3.3
Luxemburg	2.1	3.0	3.3
Netherlands	0.3	2.5	3.2
Austria	–0.1	2.7	2.7
Portugal	–1.2	1.1	3.0
Finland	–1.6	3.9	5.3
Sweden	–2.6	2.2	2.8

Source: Eurostat Yearbook 1996

EU's Statistical Office, Eurostat, EU countries invested more than ECU 8 billion in Central and Eastern Europe countries (CEEC) in 1992–1994 (see Table 4b). This accounted for 13 % of all EU direct investment to the rest of the world. Germany was the biggest investor in Eastern Europe, accounting for 42 % of the EU total, followed by Austria with some 20 %, the Netherlands with 13 % and France with 7 %. Most of the EU investment (88 %) went to Poland, the Czech Republic and Hungary.[10] Lately, although current account and trade deficits have increased, CEECs have had no dramatic difficulties in financing them. Although the net capital inflow of roughly US$ 6 billion in Eastern Europe in the first half of 1996 was smaller than in the first half of 1995 (US$ 9 billion), enough foreign capital has been flowing in to finance deficits. A large and increasing share of the total capital inflows are from private sources, which indicates increased integration of CEECs into the international financial markets as well as their improved status on those markets.[11]

2.3 Some country specifics

As observed earlier, ten CEECs have many similar features in respect of their economic development

[10] Euro-East, November 1996-monthly no.49, Europe Information Service.

[11] Economic Bulletin for Europe, Volume 48 (1996), United Nations, Geneva 1996.

Table 2 **Trade balance, % of GDP**

	1994	1995	1996	1997	1998
Hungary	–8.8	–5.8	–4.5	–4.0	–3.5
Poland	–0.9	–1.5	–3.0	–3.0	–4.0
Czech Rep.	–2.5	–8.6	–10.7	–11.5	–11.6
Slovakia	0.6	0.3	–7.5	–9.7	–10.8
Romania	–3.2	–6.2	–4.2	–3.7	–3.6
Bulgaria	–0.2	1.0	2.9	2.8	2.7
Estonia	–15.3	–19.1	–27.7	–27.8	–25.4
Latvia	–10.4	–10.5	–10.3	–9.6	–8.7
Lithuania	–4.7	–3.5	–2.7	–3.2	–4.0
Slovenia	–2.4	–5.2	–6.6	–6.4	–6.1

Source: European Commission, Forecast summary, October 1996

Table 3 **Inflation (private consumption deflator)**

	1994	1995	1996	1997	1998
Hungary	19.6	26.4	24.0	20.0	15.0
Poland	32.2	27.8	20.0	17.0	12.0
Czech Rep.	10.7	9.1	8.8	7.8	6.8
Slovakia	13.6	9.7	5.8	6.0	5.5
Romania	129.7	33.3	35.0	30.0	25.2
Bulgaria	81.91	53.8	110.0	100.0	25.0
Estonia*	40.2	34.0	24.0	17.0	15.0
Latvia*	28.1	26.0	17.0	13.0	10.0
Lithuania*	51.3	27.8	19.0	14.0	12.0
Slovenia	20.3	13.6	10.0	7.4	8.8

(*) GDP deflator
Source: European Commission, Forecast summary, October 1996

Table 4a **Cumulative FDI , Million dollars**

	1994	1995	June 1996
Estonia	444	648	682
Latvia	371	551	699
Lithuania	73	145	192
Bulgaria	247	337	386
Czech Republic	3381	5943	6401
Hungary	6941	11394	12136
Poland	1617	2751	3938
Romania	548	967	1059
Slovakia	523	680	742
Slovenia	425	602	646

Source: United Nations, Economic Bulletin for Europe, Volume 48 , Geneva 1996

Table 4b **EU outward FDI 1992–1994, percentage share**

	1992	1993	1994	92–94
USA	38.9	57.1	29.8	42.7
Japan	2.5	-5.1	1.4	–0.8
Rest of the World	58.6	48.0	68.8	58.0

Source: Eurostat

and structural progress. Some differences, however, exist and are worth mentioning.

Hungary's economy has continued to make economic progress after a little slow down at the beginning of last year. The latest economic upturn has been led primarily by rising foreign demand, since domestic real wages have been shrinking and reduced domestic consumption. Inflation has maintained its gradual deceleration, industrial output is recovering and the budget deficit has been kept on course. Due to economic recovery, Hungary's trade deficit has become smaller. However, current account deficit remains. Real appreciation of the forint last year has also worsened the trade performance and contributed to a current account deficit. Favourable foreign direct investment flows have, to a large extent, helped to balance the current account. One of the most important elements in Hungary's economic development has been ministerial change in the government. These changes have contributed to health of the economy by improving both efficiency and implementation of economic reforms.

In *the Czech Republic*, last year's GDP growth turned out to be slower than originally expected. Nevertheless, the Czech economy continues to grow. The main pillars of the latest development have been domestic demand and industry. In addition, monetary policy has been kept tight, and inflation brought down. This has been achieved through the fixed exchange rate and limiting the money supply growth. However, some inflationary pressures are emerging: wages are growing faster than productivity. In addition, the money supply has been increasing as a result of the increase in domestic credit to enterprises. From a fiscal standpoint, budgetary policy has been successful and therefore budgets have been more or less in balance. The external side of the economy seem to be the most troublesome. The trade deficit is increasing because export growth is still slower than import growth. In respect of exports, the Czech Republic is quite reliant on Germany. As long as the German economy remain weak, there are some limitations on export growth. Further, real appreciation of the currency has also contributed to lower exports. Strong import growth, in turn, is high because of the increase in domestic consumption (higher real wages) and investment demand. The current account remains in deficit, but has partly been covered by direct as well as portfolio investments. The capital inflows are still favourable, but their composition is changing from short-term capital towards foreign direct investment and long-term capital.

In *Bulgaria*, the economic crisis continues. The causes of the fall in economic activity include a shortage of raw materials in critical industrial sectors and the poor creditworthiness of many enterprises. Moreover, inflation has been increasing and control of the budget deficit remains problematic. Many of the country's banks have stopped operating due to a lack of confidence and nonperforming assets. As a result, confidence in the banks has been, to a large extent, lost. Deposits have been withdrawn and exchanged for foreign currency. At the same time, the central bank's reserves have continued to decline while the national currency, the leva, has become extremely volatile. Weakened exports and increased domestic demand have contributed to the trade deficit. High interest rates present the government with severe difficulties in servicing domestic and foreign debt. All in all, the economic crisis has slowed down the entire reform process. In particular, problems have caused delays in payments of needed IMF and the World Bank loans aimed at restructuring the economy. In order to strenghthen economic situation, Bulgaria's parliament finally approved a law to establish a currency board from July 1.

In *Romania*, GDP growth in 1996 was positive. Lately, industrial output has grown, whereas agricultural performance has been less satisfactory. Despite positive growth, insufficient progress towards structural adjustment and a loosening of macroeconomic policy have increased inflation and budget deficit. Growing private consumption and further increases in energy as well as fuel prices are to create inflationary pressures in the future. There are still many large loss-making enterprises which still account for a major share of industrial output. Due to their low productivity and ineffectiveness, they also put a heavy burden on the budget. Foreign trade seems puzzling since both exports and imports have weakened despite economic recovery. The fall in imports has partly been caused by shortages of foreign exchange available to finance trade. Exports has suffered from the decline of some of the main export markets and poor competition. In addition, the national currency (leu) is still considered to be overvalued despite depreciation in 1996. The net effect resulted in a current account deficit. Low foreign exchange reserves have lately contributed to energy shortages. Nevertheless, Romania's external debt remains relatively low, but is expected to grow in the future as the use of syndicated loans on the international capital market increases.

Poland's economic performance remains satisfactory and has recovered from the slowdown in early 1996. Domestic demand growth, strong corporate earnings and increasing investment consumption have been the main engines of growth. Since the beginning of 1996, monetary policy in Poland has changed from interest rate targeting to the control of reserve money. The great volatility of exchange rate (zloty) has discouraged the inflow of capital and by that way made it easier to control money supply. Inflation, however, remains, troublesome. In order to curb inflation, the depreciation of the zloty has been kept below the domestic rate of inflation. As a result, the real exchange rate of the zloty has continuously appreciated in recent years.There are still wage-increases to be made, which will encourage domestic consumption. Wage increases together with administered price adjustments can create inflationary pressures in the future. Due to export slowdown and strong domestic import demand, trade deficit has widened substantially. Cross-border shopping, on the other hand, has largerly reduced the overall current account deficit. The net inflow of FDI tripled last year compared to previous year and became the most important determinant of the capital account. FDI is expected to increase further in the coming future when number of delayed privatization projects are completed.

The *Slovak* economy continues to grow, but there are fears of overheating. The growth has mainly been generated by domestic demand. One of the worrying factors are worsening of current account due to declining exports. In particular, reduced demand for iron and steel products in the EU have affected exports. Increased imports and weakened exports have turned trade balance and current account negative. So far, Slovakia has not been able to attract significant amounts of foreign direct investment so the current account deficit must be financed by other ways. Also, the financing capacity of the domestic financial sector has been limited due to a debt problem, i.e. non-performing loans in the domestic banks. The recently tightened monetary policy has contributed to the gradual decline of inflation, which still remains lower than in most other transition countries. However, inflationary pressures still exist due to more expansionary fiscal policy, increased administered energy prices, economic growth, and the high growth rate of money supply. Therefore, the central bank has taken a number of measures to prevent inflation. Among others, interest rates have been raised and reserve requirements have been increased.

In *Slovenia*, slowdown in economic activity started in the second half of 1995 and continued in 1996. Nevertheless, Slovenian economy grew in 1996 and was mainly driven by growth in services and agriculture. Rapid wage growth has been pushing up producer prices and making exports less competitive. Export demand has been further weakened by appreciation of currency and stagnated demand in the Western Europe. Slovenia is a small economy which is highly dependent on external trade and, therefore, good export performance is crucial. Both trade balance and current account are negative. However, the overall balance of payments position is stable as there has been a surplus on the capital account due to strong portfolio investment. Last year's successful Eurobond issue has brought in capital. In respect of inflation, some volatility has been observed. During last year, inflation has both accelerated and slowed. The main inflationary pressures have been caused by increases in administrative prices, wage growth, and the exchange rate depreciation, which, in turn, pushed up the price of imports. Fiscal policy has been cautious and deficits have been kept low. Monetary policy has been tight and the main monetary policy tool is the exchange rate. High interest rates, from time to time, have also reflected tight monetary policy. Recently, slowing inflation, has allowed interest rates to come down.

In *Estonia,* last year's GDP growth turned out to be slightly less than in the previous year. Industrial output has been slowly recovering, whereas agricultural output is still falling. Although extremely liberal trade policy has been very beneficial to Estonia, lack of competitiveness in Estonian industry and economic slowdown in Western Europe have lowered export demand for Estonian products and therefore caused slower economic growth. Increasing domestic demand together with stagnated exports have resulted in a widening trade deficit. The current account is negative. One of the main principles of Estonian policy making has been to maintain a stable currency. This has been carried out through a currency board regime, which fixes the exchange rate (8 kroons = 1 DM) and any changes in that rate must have parliamentary approval. The currency board system together with a law limiting the government loan taking abroad have contributed to a solid monetary and fiscal policy. As a result, Estonia has remained attractive to investors and capital has been flowing into the country. Although foreign direct investment weakened last year, other investments are flowing through the banking sector. This has helped cover the trade deficit.

Latvia is recovering from a banking crisis in 1995. Now the banking sector is reviving and industrial output is gaining strength. At the moment, domestic demand, investment and expanding trade are driving growth. Import demand has increased faster than exports, leading to a trade deficit. Inflation has been slowing steadily making it possible for interest rates to come down. Foreign direct investment is accelerating. Despite lower inflation, there are still some administered prices (housing and health care) which, once liberalised, will fuel inflation in the future. Significant progress has been made also in getting the government budget deficit down. Financial markets are recovering, and the government is now better able to finance its deficit.

Like its Baltic neighbour, *Lithuania* is also recovering from a 1995 banking crisis. Restructuring in the banking sector is on the way and industrial production and retail sales are recovering. Inflation is still relatively high, but declining. One problematic area in the Lithuanian economy has been the highly indebted energy sector which has contributed to the substantial increase of Lithuania's foreign debt. Currently, the World Bank and Lithuanian authorities are working together in order to restructure the energy sector. The World Bank has offered loans which are used to cut the production costs of energy and to lower the energy-intensity in the industry. Strengthened domestic demand has led imports to grow faster than exports. This, together with a real appreciation of the litas against Western currencies, has led to an increase of the external deficits. Fiscal policy has been relatively tight. Since Lithuania has a currency board system, monetary financing of government debt is ruled out, which, in turn, has forced the authorities to conduct a credible fiscal policy. Currently, Lithuania is planning to abandon the currency board regime, which will allow to adjust the exchange rate to changing economic conditions as well as create new challenges for the economic policy making in the coming future.

3 Evaluation of the Europe agreements – achievements and obstacles

All ten associated countries of Central and Eastern Europe have addressed their membership application to the European Union. As a stepping stone to the membership, all ten associated countries have also signed Europe Agreements with the EU[12] (see Table 5). Apart from three Baltic states and Slovenia, ratifications have been completed and the Europe Agreements are in force.

Europe/Association Agreements acknowledge the interest of a partner country in becoming a full member of the EU. These are preferential agreements designed to establish a close, long-term association between the EU and individual CEECs. The driving goal for these agreements is to create a climate of mutual confidence necessary to an Internal Market and stability favouring political and economic reform in the CEECs. Moreover, Europe is to be strengthened by enabling partners in Central and Eastern Europe to participate in a wider process of European integration. Given this, parties shall try to encourage a climate for trade and investment, improve the transparency of Community financial support and promote two-way flow of information and cooperation. At a practical level, the above-mentioned objectives imply intensifying political dialogue, removing of trade barriers (customs duties, quantitative restrictions and measures having equivalent effect) and gradual harmonisation of principles covering movement of workers, establishment of firms and supply of services. Further, concrete actions include liberalization of payments and capital as well as harmonisation of competition policies. Finally, the agreements call for improvement of protection of intellectual, industrial and commercial property rights and approximation of legislation to that of the Community.

Last autumn, the European Commission prepared what it calls a reference document evaluating the pre-accession strategies.[13] The evaluation sets out what the Europe Agreements have - achieved and in what respect they could still - achieve more. The Commission points out that meetings so far held with Association Councils, Association Committees and Sub-Committees with each of the countries with which Europe Agreements are in force have been recognised as valuable.[14] Due to these meetings, more problems

[12] Europe Agreements are sometimes called also as Association Agreements.

[13] European Commission, Euro-East No 49-November 1996.

[14] The Association Council consists of the members of the Council of the EU, members of the Commission of the EU and members appointed by the associate country's government. The Association Council supervises

related to the implementation are being resolved, often in ways that satisfy both parties. In addition, meetings at less-official levels such as technical / expert meetings are bearing fruit. These actions must continue also in the future. By bringing decision makers and other experts of these countries closer to each other, mutual understanding should be improved.

The Commission stresses that exchange of information and consultation should be increased in order to resolve (or avoid) trade problems. The Commission also draws particular attention to standards and certification, where approximation of laws, implementation and enforcement mechanisms need improvement.

Reform of the banking sector, agriculture and restructuring of companies need to be further developed as well. In respect of the banking sector, the results are satisfactory. The White Paper and PHARE give support in establishing the legal framework and infrastructure for a sound financial sector. In modernisation of agricultural structures, uncertainties about property ownership and price liberalisation still seem to hinder progress. Moreover, although many small and medium sized companies in CEECs are creating business and increasing competition, there are still many large companies to be privatized. In addition, a change of ownership has not always guaranteed greater productivity and therefore enterprise restructuring combined with privatisation is crucial in all applicant countries.

Finally, the Commission encourages the CEECs to participate in a growing number of EU programmes such as education, training and young people's programmes. In respect of the PHARE programme, the Commission notes that it has become the Union's principal financial instrument to support for membership. Between 1995–99, the PHARE budget is ecu 6,693 million. In all, PHARE will have delivered a total of ecu 11 billion in assistance to the applicant countries over the ten years from 1989–1999.[15] It will continue to focus on the individual needs of each applicant country. Given the experience so far, controls on spending need to be tightened up to avoid any waste of resources. In addition, responsibility for implementation in the associated countries will be decentralised further. Finally, PHARE will soon become active also in the area of justice and home affairs.

4 Commission opinions, the ICG, and financial framework

Even without a definite timetable from the EU, one can observe that enthusiasm for the EU drives CEECs forward. Membership appears to be the (only) objective that will set conditions both in macroeconomic and structural policies in the coming years. From the EU's point of view, the official framework for admission to the EU involves, among others, the Commission preparing an *opinion* (*avis*). It is a study on the applicant's ability to accept the *acquis communautaire* (the rights and obligations deriving from the EU treaties and laws) in all areas of the Union's activity.[16] The opinions include a detailed description of the political and economic situation in each applicant country. They also include an analysis of the progress each applicant can be expected to make before accession. The most important are a recommendation concerning the opening of negotiations and an indication of possible problems that may arise in accession negotiations are also mentioned. (This forecasting element in the Opinion can be crucial particularly in borderline cases of applicants.) Finally, the opinions take into account not only the changing situation in applicant countries, but also evolution of the European Union itself. The opinions will most likely be published around half July 1997. For those candidates judged ready, negotiations should begin within six months of the

the implementation of the Agreement and examines any major issues arising within the framework of the Agreement and any other bilateral or international issues of mutual interest. The Association Council can be assisted by an Association Committee.

[15] European Commission, Enlargement: Questions and Answers, Brussels, 30 July 1996.

[16] See European Commission, Enlargement; Questions and Answers, Brussels, 30 July 1996.

Table 5 **Europe Agreements**

Country	Europe Agreement signed	Agreement in force	EU application	Negotiations	EU entry
Hungary	1991	1994	1994	1998–200?	+2 ?
Poland	1991	1994	1994	1998–200?	+2 ?
Czech Rep.	1993	1995	1996	1998–200?	+2 ?
Slovakia	1993	1995	1995	1998–200?	+2 ?
Romania	1993	1995	1995	1998–20??	+2 ?
Bulgaria	1993	1995	1995	1998–20??	+2 ?
Estonia	1995	1997?	1995	1998–200?	+2 ?
Latvia	1995	1997?	1995	1998–20??	+2 ?
Lithuania	1995	1997?	1995	1998–20??	+2 ?
Slovenia	1996	1998?	1996	1998–200?	+2 ?

Source: European Union

end of the *Intergovernmental Conference.*

The EU Member States launched the ICG late in March 1996 and it was expected to last 12–15 months. In general, the IGC has three tasks: (1) streamlining EU decision-making and institutions, (2) extending EU responsibility for joint foreign and defence policies, and (3) improving cooperation in home affairs matters. At the moment, expectations concerning progress on security and foreign affairs are little, while some progress on home affairs is more likely. All in all, the negotiations should result in some progress on internal reforms in order to maintain momentum for European integration, including enlargement. Currently, it seems that the ICG may not be able to conclude before 1998. If so, the earliest possible start for membership negotiations would be half 1998. How long will the negotiation process last? Previous accession negotiations indicate a minimum of two to three years. This, however, assumes no major problems during discussions and no delays in ratification.

Although the IGC will have to conduct its work in the perspective of an enlarged EU, it will not solve problems of enlargement as such. Indeed, some opinions state that (for example Sir Leon Britain, EU trade commissioner; Financial Times 3 February 1997) too much attention has been paid lately to the date of enlargement, and not enough to the economic and institutional changes which it would require of the EU and applicant countries. At the Copenhagen summit in June 1993, the Union's own capacity for enlargement was explicitly named as a precondition for a next round of accessions.[17] In other words, from the EU's point of view, there is an understanding that no decision on culmination of the enlargement process can be taken until all the financial implications of the membership are known. Neither is enlargement possible until the Union has made the required institutional changes.

[17] Central and Eastern Europe on the Way into the European Union, Bertelsmann Foundation Publishers, 1995.

In addition to opinions, the Commission must prepare a report on the *EU's financial framework.* The present financial framework, which was established by the Edinburgh European Council in December 1992, expires at the end of 1999. The next financial framework will cover the early years of the next century and take into account the likely effects of enlargement. Given the magnitude of the European Union together with enlargement process, one can argue that exact implications are impossible to estimate or measure with complete accuracy. Despite that, some calculations must and have been made.

The costs and benefits of enlargement have quite often been divided into five different categories: economic and political gains, budget costs, voting and migration effects. In respect of the costs, most of the calculations have concentrated on the *budgetary implications* of enlargement. According to the Commissions's calculations, enlargement would involve a Community contribution, in current circumstances, of ecu 60 billion a year only for the Visegrad Countries (the Czech Republic, Hungary, Slovakia and Poland). This would, at least double the contribution requirement for each current Member State.[18] In particular, transfer payments for agricultural and regional support (which together account currently around 80 % of EU's annual budget) would increase dramatically. The Commission suggests that by 2010, the CAP (*Common Agricultural Policy*), which already costs ECU 40 billion a year, will cost about ECU 12 billion more as a result of membership for the 10 Eastern European countries.[19] In respect of the *Structural Funds*, it seems that all ten associated countries will get the support since their per capita GDP is far below that of EU's. The current regional development system allows a region to claim subsidies if its per capita GDP is less than 75 % of the EU average. In 1994, Eastern European countries' average GDP per capita was less than 25 % of the EU's average. Even the most optimistic forecasts suggest that it could take between 25 and 50 years to reach the average income of the EU.[20] The Commission estimates that the creation of a structural policy involving the old and new member states would call for an average budget of ECU 37 billion a year; that is ECU 9 billion on top of the ECU 28 billion a year for the 1991–1999 period.[21]

Another cost-creating element is connected with migration. Full membership of the Union could cause large-scale East-West *migration.* High unemployment, wage differentials and youth unemployment would stimulate outflows from the East. Particularly, a brain drain could have serious impact on eastern growth. On the other hand, increased productivity and economic growth in the CEECs could increase labour demand in their region. That, in turn, would tend to bring wages in East and West closer together and no large-scale migration would occur.[22]This unpredictable feature of migration remains one of the concerns connected with enlargement.

In respect of the gains resulted from enlargement, the *political benefits* seem to be rather clear. Enlargement is expected to further stabilize the political climate in Europe by enabling everybody to join the "European Club".

In case of *economic gains*, both benefits and costs are likely to occur. In theory, economic gains of enlargement are due to trade liberalization, effective distribution of factors of production and capital accumulation. Although trade between the EU and CEECs has grown, trade with CEECs remains, however, a small fraction of the EU's overall trade (about 2.5 %). Moreover, according to one estimate, an extra 100 million eastern European citizens would increase the population of the EU by 25 %, while contributing only 5 % of the EU's wealth creation.[23] These facts indicate that the overall economic

[18] Europe Documents, No 6638, 8 March 1996, European Commission.

[19] Euro-East, No 51, January 1997, European Information Service.

[20] Euromoney, July 1996.

[21] Euro-East, No 51, January 1997, European Information service.

[22] See more: Baldwin Richard, Towards an Integrated Europe. Centre for Economic Policy Research CEPR, London 1994.

[23] Europe Documents, No 6638, 8 March 1996, European Commission.

gains to the EU are likely to be modest and less than the gains received by CEECs. Currently, Germany, Italy, France and Austria account for three-quarters of EU trade with the East. This, in turn, indicates that gains from liberalizing trade and market integration are likely to be unevenly distributed within the EU. Most EU countries have abundant capital, technology and marketing know-how to succeed and operate in competitive markets, while many newly-formed and newly-privatized eastern companies do not. However, countries in Southern Europe (Greece, Spain and Portugal) seem to be strongest in traditional, labour-intensive sectors which are also common in CEECs. Therefore, industries in southern and Eastern Europe would rival, rather than complement, each other.

Finally, enlargement would also require reorganization of the current *voting* system. The increase in the number of small countries due to enlargement will call for a correction against the present favoured status of smaller members, because currently small countries have proportionately more votes than larger countries. In addition, there would likely be more qualified majority voting to speed up the decision-making process as a whole.

To summarize, the European Union must solve problems connected with achieving a proper distribution of the benefits from enlargement while avoiding negative externalities. In addition, the EU should reach some sort of certainty of newcomers policy preferences which should also be in line with those of the EU.

5 First EMU, then enlargement?

The range and scope of the issues of enlargement have expanded in directions that have, perhaps, surprised policy makers as well as many EU observers. Building Europe as a wider and more cohesive area both in economic as well as political and security terms has proven to be much more difficult task that was first expected. A wide range of diverging views on the EU's desired future have not made the situation any easier. As observed, the ICG's outcome will have major implications on the future. Failure to deal with the problems that the EU faces, mainly decision making and institutional efficiency, could very well paralyse both deepening and widening development. That, for example, would then give a negative signal to eastern economies leaving them without a "future goal". A successful outcome in the ICG, on the other hand, would allow the EU to move ahead with deepening its integration. At the same time, it would facilitate enlargement and by that means give eastern economies a tempting motive to carry on their development towards functioning market economies and stable democracies.

The EU has grown to fifteen members through four enlargements. Monetary integration is currently scheduled for 1999 and the common currency is scheduled for 2002. Naturally, the main concern of Member States is whether they will qualify for monetary union and fulfill the required convergence criteria on inflation, interest rates, budgetary balances, debt levels, and exchange rate stability.[24] Given the amount of effort made, there seems no way turning back. Monetary union is considered a logical extension of the single market and therefore, progress needs to be made despite differences in opinions or the variations in policy commitment to achieving that stage. What is then the order between monetary union and enlargement? First, it should be clear, that enlargement cannot be pursued at the expense of monetary union. Widening should be realized only once the deepening process has been successfully established. In other words, after monetary union has started functioning, concrete actions can be taken in terms of enlargement. Nevertheless, EMU and particularly convergence criteria related to it can play some role (although not the most crucial one)

[24] In short, inflation cannot exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. Interest rates cannot exceed by more than 2 percentage points that of, at most, the three best performing Members States in terms of price stability. Exchange rates can fluctuate according to the margins provided by the Exchange Rate Mechanism of the European Monetary System, currently 15 % to both directions. Finally, budget deficit should not exceed 3 % of GDP and general government debt should not exceed 60 % of GDP.)

also in the pre-accession process. From the associate country's point of view, these can be viewed as medium and longer-term goals for economic policy making.

There has also been considerable debate on the options for the enlargement, i.e. how many countries will be accepted at the same time. The extreme cases (i.e. situations where all CEECs or no CEECs are accepted) have been ruled out. It is quite likely that not all countries in the group will fully meet the requirements at the same time. As a result, one option could be to divide the applicants into two (or more) groups according to their economic development and progress towards harmonization. This grouping-approach involves, however, several risks.[25] First, it will become administratively heavy: Maintaining an internal market and having possibly two groups in the Monetary Union together with two or more groups involved with enlargement is most likely costly and sticky system. In addition, the competition between the applicant countries may lead to a substantial decrease in their willingness to develop their mutual intra-regional economic and political cooperation. Second, grouping could also decrease harmonisation efforts in both groups; in the first group because of feeling that they are already more or fewer members, and in the second group, because membership seems too far a way. Group-approach is also politically very sensitive solution and would most likely result in many negative reacti-ons.

One of the least discussed options for enlargement is probably non-enlargement. In practice, it could be a form of cooperation, where each member country independently decides the level and intensity of cooperation with each associate country in question. This approach, could work as a temporary arrangement, but will not likely succeed in the longer run.

Given the aforementioned uncertainties, it is justified to ask whether EU enlargement is that likely. Have CEEC chances to become EU members really improved? Various interpretations can be made from statements by the Commission, individual memberstates and applicant countries themselves.

[25] See more, Coming to Terms with Accession, Forum Report of the Economic Policy Initiative, No 2, CEPR 1996.

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