

# **What Future for the Integration of the European Union and the Central and Eastern European Countries?**

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Economic relations between the European Union (EU) and Central and Eastern European Countries (CEEC) have intensified rapidly since the beginning of the 1990s.<sup>1</sup> This is true in both trade and direct investment, and much progress has been achieved in the way of economic interpenetration between the two regions. Back in the early 1990s, despite all the optimism that followed the collapse of the Berlin Wall, few observers would have predicted such an evolution. This study analyzes the evolution of trade and direct investment, examines the role of the association agreements signed by the EU and the CEEC in the increasing integration of the two regions, and closes with some considerations regarding future developments.

## **Trade between the European Union and the CEEC**

### *Overall trends*

Trade flows between the EU and the CEEC have increased spectacularly since the beginning of the 1990s. Between 1989 and 1996 EU exports to the CEEC (in current dollars) quadrupled while their imports from these countries trebled. Trade between the EU and the CEEC has really taken off since 1991, at which point the EU started running a large surplus with the CEEC. This imbalance, although moderate at first, grew very noticeably between 1993 and 1994, and reached about 9 billion dollars in 1995. In 1996, according to preliminary estimates, it reached almost 16 billion dollars, EU imports from the CEEC having nearly stagnated while purchases by the CEEC grew vigorously once again.

The growth of bilateral trade between the EU and the CEEC has, of course, far outstripped the overall progression of EU trade. Between 1989 and 1996, the EU's overall exports (in dollars) increased by only 70%, and its overall imports by 60%. Yet in 1995 trade between the two regions represented less than 1% of world trade, up from 0.4% in 1989. Moreover, the importance of each side in the overall trade of the other is greatly asymmetrical. Thus, in 1996 the CEEC accounted for only 2.5% of the EU's total trade (1% in 1989), while the EU accounted for over 60% of CEEC trade (35% in 1989).

One of the immediate consequences of the EU's growing importance in the CEEC's exports is that the business cycles in these countries will tend increasingly to resemble the West European economic cycle (if, of course, one can identify such a cycle beyond the specificities of

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<sup>1</sup> In this study, "CEEC" refers to the countries most advanced in the process of economic transition, namely Hungary, Poland, the Czech Republic and Slovakia, which are also known as the Visegrad countries. "European Union" refers to the fifteen countries that are presently members of the Union.

each country). Thus the stagnation of CEEC exports to the EU in 1996 apparently resulted from the low level of activity in most West European countries. Using an extremely simplified estimate, one can already consider that a 10% increase of EU imports leads, *ceteris paribus*, to an extra 1% growth in the CEEC's GDP.<sup>2</sup> The real impact is probably greater, because of the multiplying factors of the macro-economic circuit, not taken into account here. This relationship suggests a partial explanation for the slowdown of growth experienced by the CEEC in 1996 (European Commission, 1996). Of course, CEEC imports exercise much weaker influence on the EU economy. One can estimate that a 10% increase of the CEEC's imports directly induces the EU's GDP to grow by only 0.05% in static terms. This does not mean that the development of the CEEC will have no impact on Western European economies. If their growth continues steadily in the medium run, this can only have a demonstration effect likely to increase the EU's potential for growth. This was already the case in 1992-1993, when a strong increase in the CEEC's imports helped attenuate the recession in Western Europe.

Aside from trade flows, two other types of mutual influences between the two zones bear mentioning. First of all, in some sectors, Western firms have established production sites in the CEEC by means of subcontracting, outward processing trade, and direct investment. As a result, the impact on trade flows of an initial increase in final demand is all the greater since the trade of intermediate goods is multiplied. The more high value-added steps of the production cycle are performed by these sites (supplying a large market -- often the entire European continent), the more economic interdependence between the various countries is reinforced. This is indeed the case within the EU and will increasingly apply in the future to the relations between the EU and the CEEC.<sup>3</sup> A consequence of this type of industrial organization is that the CEEC could become more dependent on the EU's demand for intermediate goods than on its final demand. This would make the CEEC even more sensitive to the EU's business cycle, since business cycles in the intermediate goods sector are usually more marked than in industry as a whole (and, *a fortiori*, the overall economy). Another consequence of the growing share of the EU in the CEEC's foreign trade is that the latter must pay greater attention to their competitiveness, in terms of relative prices, in particular with regard to the evolution of the currency. Greater

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<sup>2</sup> The estimate is obtained from the following calculation: impact on the CEEC's GDP = share of exports in GDP (40% on average) x share of the EU in overall exports (60% on average) x growth of EU imports (10% is the hypothetical figure here).

<sup>3</sup> See A. Henriot, "Réflexions sur le cycle européen" *Le Figaro*, 6 March 1997.

interdependence in matters of trade flows also means an increased need for convergence of economic policies.

### ***Geographic Structure***

The main feature of trade between the EU and the CEEC is a very high degree of concentration. Within the EU, Germany clearly comes out as the main trade partner of the CEEC, accounting for nearly 50% of the trade between the two regions. Italy (with 10% of the trade), Austria and France lag far behind. This geographic structure has not changed much, since these same countries were already the CEEC's main partners at the beginning of the decade. This suggests a very high intensity of trade relations between the CEEC and Germany, since the latter weighs much more heavily in the EU's trade with the CEEC trade than in its overall trade. The same can be said of Austria, because of its strong relations with Hungary; countries like Belgium or the Netherlands (and France, in a way), on the contrary, show a low intensity of trade with the CEEC.

As regards trade balances, the largest surpluses derived in 1995 from trade with the CEEC have been ascribable to Italy, Austria and France (1 billion dollars). It seems that Italy's performance resulted from the favorable Lira exchange rate, which maintained price-competitiveness until the spring of 1995. The weakness of Germany's trade surplus, on the contrary, points to the degradation (until recently) of German industry's price-competitiveness.

Among the CEEC, Poland is the first trading partner of the EU, followed by the Czech Republic, Hungary and Slovakia. In recent years, however, the share of Poland and Hungary has tended to shrink, probably partly as a result of an unfavorable evolution of their prices relative to export (de Boissieu and Henriot, 1995). All the CEEC have a trade deficit with the EU, but the imbalance is much more pronounced for the Czech Republic and Poland.

### ***Sectoral Breakdown***

The sectoral structure of the CEEC's trade is difficult to analyze, because of the various changes that have affected it in recent years. These range from the structural upheavals in these economies to the changes in the final demand, both in the CEEC and the EU, tied to macro-economic trends. Certain conventional indicators, such as indices of comparative advantage, turn

out therefore to be of limited interest, since inherited factor endowments are less and less useful in explaining the structure of trade. A dynamic analysis is therefore in order.

Manufactured goods account for 85% of the EU's exports to the CEEC and 75% of the EU's imports from the region.<sup>4</sup> However, the share of agricultural products in Hungary's exports to the EU, remained at 20% in 1993 before falling to 14% in 1994, and energy and agricultural products account for a quarter of Poland's exports to the EU. Textiles, chemical and mechanical engineering products are the main goods exported by the CEEC to the EU. The increasing importance of the latter category points to a gradual emergence of a specialization that is no longer in low value-added goods alone, but also in goods with greater technological content. A more detailed analysis suggests that clothes are the main products sold by the CEEC on Western European markets C an interpretation supported by more recent data (Eurostat, 1995). Other products, such as furniture, electrical products, leather and shoes also occupy a significant place in the CEEC's exports to the EU. Similarity indices reveal considerable resemblance among the CEEC's export structures. This similarity among the CEEC is even greater than that found among the trading countries of South-East Asia or North Africa (Lemoine, 1994a), which suggests that a high degree of competition between the CEEC can be expected.

Textiles, chemical products and capital goods are the main goods imported by the CEEC from the EU, and within the textile sector, threads are the main imported good. The share of textiles is also preponderant in the CEEC's sales to the EU, which points to the emergence of intra-sectoral trade (understood here in the broadest sense) as a result of subcontracting activities. The same can be said about the share of engines in the CEEC's exports to the EU. In the automobile sector, the weight of finished goods (*i.e.*, vehicles) is also important, which points to the existence of various forms of trade (direct exports by domestic firms, exports of parts as a result of direct investment, etc.).

Beyond a strictly quantitative approach, the evolution of the CEEC's trade with the EU also provides some indication of the economic transformations that are underway. At least two aspects deserve to be developed here. First, one can qualitatively assess the CEEC's trade on the basis of the unit value of trade flows. An increase can mean two things: a decrease in competitiveness or a move up market. Some studies report a rise in the unit value of the CEEC's exports in sectors such as textiles, which can be interpreted as the result of increased quality and

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<sup>4</sup> For further details, see Table 1.

extended partnerships between local and Western European firms based on subcontracting agreements or joint ventures (Lemoine, 1994a). There exists an alternative approach, which consists in calculating the average unit value of trade (EEC, 1995a). This presupposes that if the unit value of exports exceeds that of imports (for a given category of goods), a country is seen as specializing in high value-added goods.<sup>5</sup> With the exception of Hungary, the ratio of unit values of the CEEC's trade with the EU is less than one.<sup>6</sup> One can explain this by saying that the goods exported to the EU by the CEEC are of lesser quality than those imported from the EU. On the contrary, in the case of Hungary, this ratio has considerably increased since the end of the 1980s and is now greater than one. Note, however, that these calculations are affected by exchange rate movements, which can influence export and import prices and, therefore, the structure of trade.

A second indicator of the degree to which countries in transition are integrated in the international economy is the share of intra-sectoral trade in their overall trade. A high level of intra-sectoral trade means that the country in question is capable of trading goods similar to those produced by the developed countries (in this case, Western Europe). Inter-sectoral trade, by contrast, is initially based on factor endowments. Calculations by international organizations (EEC, Eurostat) show that the share of intra-sectoral trade between the EU and the CEEC in their overall trade of manufactured goods grew considerably between 1988 and 1994, and is greatest for the Czech Republic and Hungary.<sup>7</sup> That being said, the share of intra-sectoral trade in the EU's trade with the CEEC remains much smaller than in the EU's overall trade flows, even if some EU member countries participate in less intra-sectoral trade than do the CEEC. One of the reasons for the increasing share of intra-sectoral trade in EU-CEEC trade is that ties between Western and local firms have greatly intensified through various channels, including outward processing trade and foreign direct investment.

The emergence of an outward processing trade (OPT) is a major feature of the development of trade between the EU and the CEEC, especially in certain sectors. This type of trade can be easily identified as that subject to a specific customs regime.<sup>8</sup> About a quarter of CEEC exports to the EU fall under this category; in textiles, the share of OPT even exceeds 80%.

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<sup>5</sup> In fact, the production of goods with high unit value could also lead to low added value, if it entails increased consumption of intermediate goods, especially if these are imported.

<sup>6</sup> See Table 2.

<sup>7</sup> See Table 3.

<sup>8</sup> 8. There is outward processing trade when a client in the EU provides a subcontractor in the CEEC with parts for assembly, and the finished good must eventually be imported back to the EU.

Germany dominates this type of trade: German imports represent 70% of the EU's total purchases of processed textiles and clothing. Germany's preponderance predates the liberalization of trade between the EU and the CEEC, while Italian imports have grown significantly, rising from 0.4% in 1988 to 8% in 1993.

Two strategic motivations can stimulate this traffic: it can offer access to markets that are otherwise protected by customs barriers, but most of all, the Western firm engaging in it is often seeking gains in competitiveness through a reduction of labor costs. This brings us back to a debate, very lively in Western Europe in recent years (in France and Germany in particular), over the de-localizing of part of the industrial structure. The fears in this debate have been mostly over this shift's consequences for labor.

The main reason for the increased outward processing trade between the EU and the CEEC lies in the difference between the labor costs in the two regions, but the availability of a relatively qualified workforce capable of sufficient productivity levels also plays a major role. Geographical proximity is also an important advantage for the CEEC. This type of partnership between Western firms and local enterprises has been chosen over direct investment also because of its greater flexibility. For the CEEC, OPT has had some undeniably positive effects, first among which are an increased access to technology and the development of managerial skills. However, such arrangements also make the CEEC rather dependent for exports on the decisions of the Western clients, which can be a source of increased fluctuations.

## **Recent trends in Foreign Direct Investment in the CEEC**

### ***Main Characteristics***

Since the beginning of the 1990s, Hungary has been the main target country for foreign direct investment (FDI).<sup>9</sup> Its cumulated flows reached 11.4 billion dollars in 1995 (*i.e.*, twice the amount received by the Czech Republic), while Poland attracted only 2.7 billion dollars in FDI.<sup>10</sup> Non-harmonized data for 1996 confirm the increase of FDI in the CEEC, with Poland apparently starting to catch up. The return of economic growth has been one of the elements stimulating

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<sup>9</sup> One of the main difficulties to be faced here lies in adequately defining FDI. The main source of information is balance of payments statistics, but they often exclude reinvested profit, and some countries merely publish net FDI flows without distinguishing inward and outward flows.

<sup>10</sup> .Since the development of FDI in the CEEC dates back to the beginning of the 1990s, cumulated flows can basically be considered as stocks.

FDI in recent years, while in several countries, the increase in FDI has occurred in parallel with the privatization process.

The share of FDI in the GDP for 1995 is estimated to have reached 10% in Hungary and 5.5% in the Czech Republic. Despite this recent expansion, FDI flows in absolute terms have remained modest and below expectations, especially as compared to those observed in Asia or Latin America.<sup>11</sup> Several reasons can explain these relatively limited results. FDI flows toward the CEEC have only very recently taken off, and the CEEC form a relatively small market (as compared to Asia, for instance), which limits the possibilities for investment. Moreover, systemic transformations have been fairly slow at times, in particular in the privatization process, while there have long subsisted uncertainties over the legal structure. The attractiveness of the CEEC as targets for FDI has nonetheless been confirmed by recent studies (Hatem, 1995).

West European firms account for most FDI in the CEEC. In the beginning of 1995, the EU's share in incoming FDI reached 75% in Hungary, 70% in the Czech Republic, and 65% in Poland and Slovakia. Germany is by far the main investor country in terms of the number of operations, with about a quarter of all the transactions.<sup>12</sup> In Hungary, Austria is also very active. In terms of the amounts invested, Germany remains the main investor, except in Poland, where the United States comes first. However, overall results have been greatly influenced by a small number of large-scale operations (e.g., Volkswagen in the Czech Republic or Fiat in Poland), and this is also true with regard to the sectoral distribution of FDI. In terms of the number of operations, FDI is concentrated in the service industry, especially trade, but in terms of the amounts invested, the manufacturing industry is the main target. As for the shape taken by FDI, 60% of it goes to joint ventures or acquisitions, and 40% to the creation of production or commercialization units (EEC, 1994).

### ***Explanatory Factors***

We will not analyze in detail the impact of FDI for the target countries, nor motivations for investors, subjects that have already been investigated in numerous studies. Several studies have been devoted to the topic (Borensztein *et al.*, 1995, Kojima and Ozawa, 1984). We shall

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<sup>11</sup> Per capita FDI is of course greater in the CEEC, given the difference in population, but the ratio of FDI to GDP seems to us much more indicative of a country's attractiveness. In terms of stocks, the ratio of FDI to GDP would be about the same for Hungary as for China

<sup>12</sup> See Table 4.



only mention a few of the reasons that have prompted EU firms to invest in the CEEC. The first factor is the difference in salary costs (in terms of unit production costs, *i.e.*, taking into consideration productivity, not just wages). Direct investment tends to improve access to the market, especially when custom barriers remain. Having a free-trade zone covering the entire region is all the more advantageous since each country, taken individually, represents a relatively small market. In some cases, investors are considered by their clients to be local producers, thereby gaining further ability to penetrate markets (for instance in the automobile sector). Finally, the cultural and geographical proximity of the CEEC to the EU gives them an advantage over other destinations such as Asia. One should note, however, that all of these elements function primarily over the medium run. In the short term, as noted earlier, Western European firms have often chosen more flexible arrangements, such as subcontracting. Likewise, one can also recognize important advantages that FDI offers to the CEEC. From a macroeconomic point of view, FDI stimulates employment and investment and, therefore, growth. Foreign investors contribute to improving the managerial skills and techniques of the local staff. Local partners can benefit from the experience of Western firms in matters of distribution. More fundamentally, FDI can cause the emergence of comparative advantage if the investments are concentrated in certain key sectors, such as automobiles. Multinational corporations can also form local networks, working with small-to-medium-size enterprises, thereby increasing the latter's competency and helping them enter foreign markets.

All these advantages are illustrated by the key role played by foreign investors in the exports of the target countries. In Hungary in 1995, for instance, exports by foreign companies accounted for over 50% of the country's total exports, and up to 80% of the exports in some sectors. Moreover, 45% of the foreign companies made at least 25% of their turnover on exports (OECD, 1995). FDI, nonetheless, can have some disadvantages for the target country. With regard to macro-economic policy, the desire to attract foreign capital can lead to high real interest rates, causing an overvaluation of the currency. Some studies also reveal behavior on the part of some investors that harms target countries. The system of multinational groups for setting transfer prices, for instance, can lead to tax losses. Another problem is that the purchase of local firms often results in initial layoffs, etc. Lastly, foreign companies can, in some cases, displace local producers.

### *The Role of EU-CEEC Association Agreements*

Association agreements between the EU and the CEEC have undoubtedly been one of the reasons for the sharp increase in trade between the two regions since the beginning of the decade. It remains difficult, however, to isolate their impact from that of the general system of preferences (GSP) that was granted to transition economies in 1990 and 1991 in the context of the EU's Phare program. Indeed, sales from the CEEC to the EU took off before the commercial components of the association agreements came into force. More generally, several other factors have influenced the realignment in CEEC's trade: the dismantling of the Council of Mutual Economic Aid (CMEA) the disappearance of the administrative institutions that were in charge of foreign trade before 1990, the emergence of the private sector, the opening of the CEEC to FDI, the initial decline in domestic demand (which forced local companies to turn to foreign markets), the various exchange rate policies, etc. In addition to the above, other more psychological and political considerations have led the CEEC away from their former relations with the East.

### *Positive Effects*

Notwithstanding the caveats noted above, the association agreements have had an important impact on the bilateral relations of the EU and the CEEC. With regard to economic growth, the acquisition of market shares in the EU has allowed the CEEC B dependent as they now are on foreign trade B to mitigate the fall in production that resulted from the collapse of Eastern markets. The considerable growth of sales to the EU since the beginning of the 1990s has thus contributed several points to the economic growth of the CEEC. Indirect effects, in terms of economies of scale or job creation, have been just as important. Even if there have been other factors, the countries that were first included in association agreements are also those whose trade was transformed most markedly.<sup>13</sup> The association agreements accelerated the geographic restructuring of the CEEC's trade and, more recently, helped consolidate this reorientation of trade (which, in some ways, can be viewed as strategic in terms of interdependence, the development of new opportunities and the start of intra-sectoral trade). The share of the EU in the trade of Eastern European countries still varies considerably from country

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<sup>13</sup> Hungary and Poland were the first two countries to enter into association agreements with the EU.

to country.<sup>14</sup> The share for Romania and Bulgaria is considerably below the average for the region, while the increased importance of the Eastern countries in the EU's exports (their share went from 5.8% in 1989 to 9% in 1995) was mostly attributable the CEEC countries. The share of these countries in the EU's exports now clearly outweighs that of Russia.

From a sectoral point of view, the CEEC countries have deeply restructured their trade. Because of restrictive practices on the part of the EU and the failure of national policies, the share of agricultural products in total exports has diminished considerably, while the share of mechanical engineering products has grown markedly. Trade in so-called sensitive products have evolved in various ways: the share in overall sales of textiles-clothes has grown, whereas that of steel has shrunk somewhat. Romania and Bulgaria, however, have not witnessed such trends: generally speaking, labor-intensive sectors (especially textiles) still occupy a preponderant share in their trade with the EU, which reflects a rather clear difference in specialization between them and the CEEC.

Another important aspect of the association agreements has been the improvement of the CEEC's competitiveness, at least in West European markets. The agreements ended a long period during which there was discrimination against the CEEC on account of their foreign trade being state-controlled. Granting CEEC and other partners equal treatment has made it possible to overcome initial structural distortions. In fact, one could argue that on Western European markets, the CEEC benefit from a Apositive discrimination,@ as compared to their Asian or Latin-American competitors. The association agreements also provide exporters from the CEEC with a stable and predictable framework over the long run, which has strengthened their competitive position against the EU's other providers, in particular East Asia. Finally, even if there is no exact correlation between trade policy and the level of FDI, experience shows that a favorable, stable institutional context, such as that provided by the association agreements, can contribute to the attractiveness of a region to investors.

### *Mixed effects*

Some of the effects of association agreements on trade have not been entirely positive. Two examples may be mentioned.

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<sup>14</sup> Eastern Europe is taken here to include the CEEC mentioned in the introduction, along with Romania, Bulgaria, Slovenia and the former Soviet republics.

These agreements have caused substantial changes in trade policies, in particular through a dismantling of customs barriers, which improved access to West European markets. In 1990, considerable obstacles to trade, including customs duties, taxes, and quotas, remained in place for most of the goods exported by the CEEC. In 1993, only 50% of Hungarian exports, 39% of Czechoslovak exports, 36% of Polish exports, and only 17% of Romanian exports enjoyed free access to the market. Between 23% and 40% of the trade, depending on the country, also benefited from low customs barriers. The bulk of this reduction of barriers came from the removal or reduction of the average tariff. But the share of goods hit by high tariffs has not declined so rapidly, and there have even been increases in some cases, including Czechoslovakia and Romania). In 1993, the share of products sold to the EU that were subject to high excise taxes still reached 37% for Romania, 25% for Bulgaria, 10% for Hungary, 18% for Poland and 11% for Czechoslovakia. These figures are highly correlated with each country's share of agricultural exports. In early 1997, most of these barriers were removed, but their persistence since the early 1990s had hampered the development of exports, economic growth and, more generally, structural transformations.

By making outward processing trade easier, the association agreements have had an ambiguous impact. Granted, they generated additional trade; but the impact on the balance of trade, which must be gauged in terms of value added, is much more limited than the increased exports may suggest. Moreover, the integration of subcontractors in Western European networks may have caused a decline in the local production of intermediate goods.

### *Negative Effects*

Although the association agreements have initially had some undeniably positive effects, certain clearly negative aspects cannot be overlooked, in particular in a medium-run perspective. Agricultural trade is the main area for which the association agreements have failed to favor the CEEC. Indeed, after the trade liberalization undertaken by both sides, CEEC agricultural exports rapidly reached the EU's Asensitivity threshold@. Moreover, CEEC producers have been unable to compete with the system of assistance to agricultural exports in place in the EU, which caused them to suffer losses in their traditional markets like the former Soviet Union. In fact, in recent years, there has developed an asymmetry in favor of the EU for the trade of agricultural goods. They are indeed the only category of goods for which the share of the CEEC in the EU's imports

has diminished, from 8.6% in 1990 to less than 6% in 1995. In the meantime, the EU's sales of agricultural goods to the CEEC have increased considerably. The Eastern countries as a whole, including the former Soviet Union, accounted for over 20% of the EU's trade in 1995 (making it the EU's second trading partner after the United States), against only 12% in 1990. If we take into account the two regions' natural endowments and their production and export structures, it becomes apparent that their agricultural trade has been distorted to the EU's advantage. Thus all the CEEC, except Hungary, ran a deficit with the EU in their agricultural trade (about 300 million dollars in 1995), whereas in 1990, they ran a surplus of nearly a billion dollars. In the long run, this could affect production and the specialization structure for a long time, which would be detrimental to rural labor and could endanger the modernization of the CEEC's agricultural sector.

Moreover, partly as a result of the evolution of agricultural trade, the CEEC as a group have developed a considerable trade deficit with the EU. This shows that the preferences in favor of the CEEC that was supposed to result from the association agreements, in particular as regards the pace of trade liberalization, was not enough to limit the risks of grave imbalances. Of course, this trade imbalance can be explained by the growth differential between the two regions, but different strategies and tools of economic policy should be integrated in the association agreements, so as to limit the risks caused by a major trade deficit of the CEEC.

Another negative aspect lies in the increase of protectionist pressures. The EU introduced temporary restrictions on the import of steel in the fall of 1992 and on agricultural goods in the spring of 1993, just as the association agreements had taken effect. The impact of this was moderate on a macro-economic level, but it was much greater for the producers concerned, not to mention Brussels' credibility. More recently, one has also witnessed the development of protectionist pressures in the CEEC, encouraged by the appearance of external imbalances, by the difficulties for the CEEC to compete with the subsidized agricultural exports from the EU, and by some Central European industrialists' desire to re-conquer their domestic market. There has also developed a kind of lobbying on the part of those who view an overvalued currency as a potential threat to the CEEC's internal and external market shares.

Finally, since 1992 the association agreements have facilitated the CEEC's trade with the EU, but they have also caused intra-regional trade to regress more than necessary.

## **Prospects for Trade between the EU and the CEEC**

### *Evaluating the Potential*

Despite the unprecedented growth of trade between the EU and the CEEC since the beginning of the 1990s, it is worth asking whether a potential for growth still exists or whether, on the contrary, one can expect a slow-down after this initial catch-up phase. The use of gravitational models, despite some shortcomings, makes it possible to answer these questions partly (see Lineman, 1966 and Bergstrand, 1985, 1989, for details). These models, indeed, evaluate the trade potential between two partners as a function of different criteria (GDP levels, distance between the countries, and the existence of common borders). Most studies of this type conclude that there is potential for the EU's exports to the CEEC to grow. Applied to France, studies estimate that (depending on the initial hypotheses) sales to the CEEC are currently at 10-70% of their potential (Adam and Boillot, 1995). By contrast, other studies reveal that the CEEC's exports to the EU have already reached their potential: they are at about 70% of the potential for Poland and the former Czechoslovakia and 80% for Hungary. Indeed, on the German market, sales by the CEEC already exceed the potential (Festoc, 1995). From this point of view, the catch-up phase seems to be over. This implies that CEEC membership in the EU would not be likely to lead to a sharp increase in CEEC exports to the West European markets.

### *Hopes and Fears for the Development of Trade*

If, overall, the CEEC have not reached the same degree of openness (as measured by the weight of exports and imports in their GDP) as the small countries of the EU,

then there must remain possibilities for the expansion of external trade, in particular in the dismantling of some protections, especially in the CEEC. Indeed, there are several reasons for optimism, including further changes in the structure of EU-CEEC trade, such as 1) the intensification of intra-sectoral trade and a move up market; 2) FDI which will generate additional trade, first by stimulating the CEEC's imports, then their exports; 3) the continued modernization of the transition economies; 4) trade flows stimulated by the infrastructure privatization, which will prompt new investments by West European firms; 5) the improvement of transportation and communications links; and 6) the demand within the CEEC, which should continue to increase vigorously. The emergence of a new European periphery, reaching from Slovenia to Hungary through Slovakia, the Czech Republic, Poland and even the Baltic states,

should thus have positive effects on regional trade. This region is witnessing higher levels of growth, improved productivity and dynamic exports, all the while attracting substantial amounts of FDI. The EU cannot ignore this region in the medium run, since it will constitute an essential element of European trade and of the division of labor within the continent.

These positive perspectives are not, however, without risks and uncertainties, and optimism should be tempered by two elements. Several factors may deepen the trade imbalance. First, the second five-year period in the application of the association agreements will lead to an asymmetrical dismantling of customs barriers, which will increase the openness of the CEEC to imports from the EU. The modernization process will require additional imports, but will allow exports to increase only after some time. As a result, the temporary financing of trade deficits could become a major political problem during this crucial pre-accession period. Two important measures available to Brussels would be to liberalize the EU's agricultural imports from the CEEC and adopt a strategy of financial support according to the subsidiarity principle, which would also allow it to limit the cost of enlargement by spreading financial transfers over the periods before and after accession.

The influence of protectionist lobbies in the CEEC and the EU cannot be ignored. As the CEEC gradually become efficient competitors, protectionist tendencies will likely develop in EU countries, especially in so-called sensitive sectors. In particular, the persistence of a double-digit unemployment level in most of the EU countries and the CEEC could become the main obstacle to trade. The flow of workers from the CEEC to the EU is negligible or strictly controlled, as in Germany and Austria. The question remains of how the mutual development of both regions can unfold, taking into consideration the possible relocation of production units from the EU to the CEEC.

## **Conclusion**

The apparent contradiction between the regionalization of trade flows and the globalization of capital markets constitutes the main challenge with respect to the risks entailed by the maintenance of possible barriers to trade between the CEEC and the EU at the dawn of the twenty-first century. Until recently, Western Europe differed from the United States and Japan, in that it did not systematically take advantage of the opportunities provided by differences in labor costs between developed and developing countries. This can partly explain the EU's recent

loss of its share of world markets. From this point of view, the emergence of the CEEC provides Europe with a unique opportunity to catch up with the United States and Japan. At the same time, the eastward expansion of the EU could exacerbate the already difficult problem of unemployment in Western Europe. The situation is made even more complicated by the fact that this intra-European division of labor involves the CEEC's large reserve of qualified and motivated workers. There exists today no answer to these challenges. However, it must be clear that the issue lies not only in the future of relations between the EU and the CEEC, or in the prospects for intra-European trade flows, but also in the prospects for Europe in the next century as a region of rapid economic growth. This should be taken into consideration in the negotiations on the eastward enlargement of the European Union.



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Table 1 Sectoral structure of trade between the EU and the CEEC

EU exports to the CEEC (percent)

	CEEC		Hungary		Poland		Former Czechoslovakia	
	1989	1994	1989	1994	1989	1994	1989	1994
Manufactured goods	84.9	87.9	92.1	90.4	77.2	84.6	87.8	89.6
Mechanical engineering	26.1	20.2	23.8	18.1	23.9	19.2	32.6	22.8
Chemical Products	21.7	18.0	22.8	17.1	19.1	19.7	24.3	16.7
Textiles	9.1	11.7	12.3	13.0	9.2	13.3	4.7	9.1
Vehicles	5.7	9.4	7.5	11.6	6.3	8.6	2.3	8.8
Electronics	8.0	9.3	8.8	10.6	5.9	7.6	10.4	10.3
Foodstuffs	11.8	8.6	5.5	7.4	18.3	10.2	9.6	7.6
Wood, paper	5.2	8.1	6.5	8.9	4.2	7.9	5.0	7.7
Electrical products	3.9	7.5	5.1	8.0	3.0	5.1	3.9	9.7
Energy	0.9	2.0	0.4	1.0	1.6	3.6	0.4	1.1
Iron and Steel	3.7	2.5	3.7	2.0	5.0	2.4	1.5	2.8
Non-ferrous	1.7	1.3	1.5	1.1	1.1	1.0	2.9	1.8
TOTAL	100	100	100	100	100	100	100	100

EU imports from the CEEC (percent)

	CEEC		Hungary		Poland		Former Czechoslovakia	
	1989	1994	1989	1994	1989	1994	1989	1994
Manufactured goods	59.8	78.7	58.5	76.1	53.9	75.3	69.7	83.9
Textiles	13.0	18.2	16.4	19.2	11.0	19.6	12.4	16.1
Chemical products	14.6	13.2	13.6	11.7	12.1	10.7	19.2	17.0
Foodstuffs	23.5	11.8	30.3	17.6	24.6	12.4	14.9	7.6
Mechanical engineering	7.5	11.8	7.6	12.8	7.0	9.5	8.3	13.3
Woo, paper	7.1	10.2	4.8	5.2	6.0	12.4	10.9	10.9
Energy	12.1	6.1	7.1	3.4	16.5	9.6	10.9	4.1
Electrical products	3.4	7.1	4.6	11.8	3.0	4.2	2.5	7.2
Vehicles	2.8	5.7	0.9	3.1	3.4	6.1	3.9	7.0
Iron and Steel	7.9	6.6	5.7	4.2	6.2	4.9	12.6	9.8
Non-ferrous	5.1	4.7	5.6	3.9	7.7	7.3	1.0	2.4
Electronics	1.2	3.0	1.6	6.0	1.0	1.7	1.0	2.3
TOTAL	100	100	100	100	100	100	100	100

Source: *Harmonised Accounts on Trade and the World Economy (CHELM) Database*, Centre d'études prospectives et d'information internationales (CEPII), Paris

**Table 2 Ratio of Unit Values of the CEEC's Trade with the European Union**

	1988	1991	1993	1994
<i>Czechoslovakia</i>	1.74	0.77	-	-
<i>Czech Republic</i>	-	-	0.91	0.64
<i>Slovakia</i>	-	-	0.71	0.76
<i>Hungary</i>	0.71	0.96	1.01	1.13
<i>Poland</i>	0.88	0.78	0.76	0.74

Source: *European Commission (1995 a)*

**Table 3 Intra-sectoral Trade between the EU and the CEEC**

	1988	1991	1993	1994
Czechoslovakia	0.38	0.464	-	-
Czech Republic	-	-	0.568	0.587
Slovakia	-	-	0.402	0.431
Hungary	0.393	0.487	0.501	0.504
Poland	0.332	0.341	0.376	0.385

\* Grubel and Lloyd Index.

Source: European Commission (1995 a)

**Table 4 Countries of Origin of FDI in the CEEC (in millions of dollars)**

Czech Republic* cumulated flows	Poland** cumulated flows	Hungary** FDI stock
Germany 1349.6	United States 653.1	Germany 2197.9
United States 699.1	Germany 631.3	Austria 1961.2
France 527.9	Netherlands 371.2	United States 1331.4
Austria 254.2	Italy 166.3	Netherlands 1111.1
Switzerland 155.7	Switzerland 154.2	France 507.7
Italy 124.2	United Kingdom 147.8	Italy 465.8
United Kingdom 88.1	Austria 123.5	United Kingdom 419.1
Netherlands N/A	France 105.3	Switzerland 383.1
<hr/>	<hr/>	<hr/>
Total 3714.3	Total 2839.7	Total 9907.7

\* on 7/1/95

\*\*on 1/1/95

Source: European Commission (1995b)