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EU Enlargement: External Economic Implications

The coming eastward enlargement of the EU has not prompted much debate about its external economic implications, quite in contrast to the fierce debates which accompanied previous enlargements. This article discusses the main economic effects of the CEECs' move from "association" to EU membership, and in particular the external impacts with respect to agriculture, industry and FDI. It also deals with the somewhat sensitive subject of US-CEEC bilateral investment treaties, as well as the prospects for catch-up growth by the accession countries.

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

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

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

The present article will deal with a range of external economic effects of enlargement, other than monetary ones.[1] First we shall attempt to find the reasons for the "silence" in the world of economic policy-makers outside Europe. We shall then discuss the three main topics of the external economic impact: industrial trade effects, the likely impact on FDI and agricultural trade effects, and follow this by commenting on the possibly sensitive subject of the bilateral investment treaties most candidates have concluded with the USA, which the Commission wants to see amended. Shifting to a longer-term perspective, we shall finally address the prospects for secular catch-up growth by the candidates in Central Europe and the deeper economic reform issues in an EMU of 25. These longer-run processes are also of importance to third countries.

Does "Silence" Mean External Support?

The "silence" in worldwide economic diplomacy about enlargement may have several grounds. Most probably, enlargement is widely supported because it is considered to be the "deepest" and most secure way of stabilising this once so bloody continent, of precluding any temptation to return to a form of planned economies or totalitarianism and, not least, of locking-in economic reforms and incentive structures promising to deliver prosperity. This support would seem to be implicit in many parts of the world and explicit in numerous declarations by the USA and Japan, or OECD countries more generally, as well as in ASEM. Interestingly, the de facto backing by international economic institutions such as the OECD,

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[1] For the latter, see D. Gros, M. Castelli, J. Jimeno, T. Mayer, N. Thygesen and A. Hobza: The euro at 25, Special report of the CEPS Macroeconomic Policy Group, CEPS, Brussels, December 2002; A. Hobza: CEE candidate countries on the way to the eurozone, WRR, Working Document W131, The Hague 2003. See also www.wrr.nl.

IMF and the World Bank, and of course, the EBRD, is expressed openly in many technical policy documents supportive of transition, reforms and/or growth. To our knowledge, there is no WTO document on enlargement, and the recent WTO Trade Policy Review on the EU scarcely pays any attention to it.

There is a business corollary. Business was quick, though prudent, in venturing into Central Europe right after the "winds of change" had turned away from communism. US business followed suit and is now present throughout the region. Japanese business has taken more of a wait-and-see attitude, but in some strongholds of Japanese industry such as cars this reticence has been replaced by entry and expansion. European big business (as represented in the ERT, the European Round Table of Industrialists) has been highly supportive of the pre-accession process, even providing flanking business initiatives as helpful corporate citizens in all candidate countries.[2] Irrespective of numerous concerns about corruption, fledgling market institutions and infrastructure, global business looks at enlargement mainly in terms of opportunities.

Perhaps more of a speculative rationale to explain "silence" is that few observers see a creditable alternative. Emerging out of a difficult and fragile transition process, itself aided by open market access (for industry and most services) in the Europe (association) Agreements, the prospect of EU membership has prompted an astounding discipline and determination on the part of the candidates. It goes without saying that there was no comparable alternative to this kind of lock-in and stimulus. Nowadays, on the other hand, having accomplished the adoption of the *acquis*, with many favourable consequences for transition too, the Europe Agreements can serve as a reasonable fall-back position in case ratification somehow fails. This is so because of the ratchet effects incorporated in the Agreements; in other words, the de facto sharing of a good deal of the internal market opportunities can be maintained. Nevertheless, this fall-back position would not be bound by the strict EC compliance system (run by the Commission and the national courts, all the way up to the EC Court of Justice) and would not provide for free agricultural trade, migration, cohesion-type transfers or access to Euroland. Although this fall-back position may still be far superior to what other transition countries enjoy – as the economics of transition literature has amply shown – it clearly does not satisfy the ambitions of the candidates. If good rule-making and discipline has indeed been engendered by pre-accession, it must have raised the credibility of the pre-accession process – and the credibility of the substantive accession negotiations. One is led to conclude that the world community has come to trust the EU in bringing about an enlargement which, on the whole, is seen as a win-win strategy for both Europeans and non-Europeans. Indeed, there are a number of obvious, major benefits. For example, the implementation of the *acquis* in accession countries will undoubtedly yield a host of benefits for third countries and their multinationals. These include, but are not limited to, an enormous geographic space operating under a common legal framework for commercial activities and harmonised or at least "mutually recognised" technical regulations on product quality and content; a single pan-European trade policy, which includes a unified tariff structure and administrative procedures, thus facilitating trade with third regions; the phasing out of the CEECs' Article 29 exemption on subsidies to producers in accordance with WTO rules, since they will lose their status of "transition" economies; a stricter application of intellectual property rules, reducing the piracy of brand names and products in the accession countries; the introduction of EU public procurement rules, in line with the WTO's Government Procurement Agreement, which will benefit third countries more than the status quo. The remaining questions are then about specific effects of enlargement, to which we now turn.

Impact on Industrial Trade and Direct Investment

From an analytical point of view, enlargement is the change from an industrial free trade area (the Europe Agreements) to a customs union. However, the candidates enter the internal market and this introduces additional potential benefits which are hard to model properly. If tariff differentials in a free trade area are modest and tariffs are absolutely low, the change-over to a low common-external-tariff customs union should not be expected to cause large changes. Thus, for industry, most of the adjustment driven by the free access to the EU goods market will be over *before* 2004. What then follows might be characterised by a further deepening of specialisation and vertical intra-industry trade, stimulated by foreign direct investment and sub-contracting. So the positive effects of enlargement for third countries will primarily depend on this long-run deepening and upgrading of specialisation. The early signs demonstrate a very dynamic adjustment process. After the massive shift towards trade

[2] See European Round Table of Industrialists (ERT): Opening up the business opportunities of EU enlargement, ERT position paper and analysis, Brussels 2001.

with the EU (up to 1994), the initial dominance of labour-intensive final goods has reduced, and the share of technology and skilled-labour intensive products moved up from 37% in 1993 to 50% in 1997.[3] Quality upgrading is also found by Nielsen at a very high level of disaggregation, but the CEEC quality levels still lag greatly behind those of the EU.[4] Vertical intra-industry trade dominates East-West industrial trade, with the CEECs invariably supplying the low unit-cost goods.[5] The import side of Central Europe is extremely dynamic for capital goods (not including motor vehicles and their parts), nearly tripling between 1993 and 1998. These and other studies, combined with the flows of foreign direct investment, point to ongoing forceful restructuring and upgrading. It is guesswork to make inferences about the quality of factor endowments and applied technology in 2004 but there are good reasons to expect the starting position in the larger customs union to be radically different from the empirical basis of most of the meanwhile published literature on trade effects. Recent empirical work by Landesmann shows not only that significant annual productivity increases in manufacturing between 1993 and 2000 (between 5% and 15% annually, except for Bulgaria) were obtained, but also that medium-high tech sectors experienced much higher output growth rates in Visegrad countries and Slovenia.[6] In a decomposition based on skill intensities, Landesmann shows that all CEECs have increased the share of high-skill-intensive goods in their exports to the EU (1995 - 2000). If correct, it is good news for competitiveness, and ultimately catch-up growth. In any event, a reasonable guess would be that the candidates' share in EU-15 imports (already up from 3.4% in 1992 to 9.8% in 1999) would rise to 13% - 14% by the time of entry. Central Europe will begin to matter in EU trade.

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

Cases of trade diversion under the Europe Agreements can be suspected in cars and possibly in textiles and clothing. Will it worsen or improve with accession? Both sectors show extremely buoyant intra-European trade. Both are driven by fragmentation of the production process, a search for differentiated location according to comparative advantage, outsourcing and massive direct investment. The prime example *par excellence* of trade-led adjustment in Central Europe yielding growth and improving quality can be found in the phenomenal success of clothing and textiles trade growth: very high and sustained growth rates in EU–CEEC trade in this sector, a near-tripling of the share of CEECs in EU clothing imports to 17.5 % between 1988 and 2000 (competing against equally phenomenal growth rates of EU imports from e.g. China, Bangladesh, India and to some extent Turkey), more than a tripling of the CEECs' share of EU textiles imports to 13.8 % in that period, and a steady flow of FDI to the candidate countries.[7] To some degree this must be due to trade diversion, made possible behind relatively high CEEC tariffs and some restrictive MFA quotas of the EU. With enlargement this trade diversion will tend to fall because EU tariffs (9% - 12%) are generally lower than those of candidates, sometimes much lower. This tendency will be reinforced by the abolition of the last tranches of MFA quotas half a year after accession.

The potential car demand in the CEECs is high, projected to be above the rate of economic growth, since the ratio of people to cars is still high in the region. The majority of analysts expect demand in the CEECs to grow substantially by the 2010 horizon, with sales reaching a potential 2.4 million new cars per annum (15% of the EU average, compared to today's 6%).[8] It would thus seem that the car sector offers

[3] B. Kaminsky: How accession to the EU has affected external trade and foreign direct investment in Central European economies, World Bank, Washington DC 2001.

[4] J. Nielsen: Price-Quality Competition in the Exports of the Central and Eastern European Countries, in: INTERECONOMICS, Vol. 35, No. 2, 2000, pp. 94 – 101.

[5] C. Aturupane, S. Djankov, B. Hoekman: Horizontal and vertical intra-industry trade between Eastern Europe and the EU, in: Weltwirtschaftliches Archiv, Vol. 135, No. 1, 1999.

[6] M. Landesmann: Structural features of economic integration in an enlarged Europe: patterns of catching-up and industrial specialisation, European Commission, Economic Papers no. 181, Brussels, January 2003.

[7] W. Stengg: The textile and clothing industry in the EU, a survey, European Commission, Enterprise Papers no. 2, Brussels 2001.

substantial opportunities while becoming exposed to global competition. Since native Eastern European car producers, except for Dacia in Romania, are all but extinct (though this does not hold for trucks and buses), there is a large market to be tapped by foreign car producers. Profits are not only to be had in sales of new products, but also in used cars and repairs. The average age of a car in the candidate countries is 13 years (compared to 7.6 in the EU), meaning that there is a growing market for parts and maintenance/repair.

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

A discussion of the potential trade effects on the car industry should be based on an analysis of carmakers' strategies and, hence, changing positions of competitiveness over time.[9] One must keep in mind that certain car manufacturers deliberately chose, for various strategic reasons, not to plunge headlong into the CEEC market for cars (such as the Japanese). Japanese car manufacturers tend to supply components to their foreign subsidiaries, rather than to source them from local or regional suppliers. Japanese reticence has changed since Toyota's recent decision to engage in a $1 billion joint greenfield investment with French PSA. The strong position of the leading car companies in Central Europe today in many ways reflects their initial strategy. It is possible in some cases that effects which might be attributed to trade diversion in a conventional static analysis are in fact a result of car makers' respective strategies. Costs have gone down and quality has markedly gone up. If trade diversion is a concern, it has already occurred during the 1990s because the car tariffs of CEECs have been above 20% or even above 30%. The strategic move made by the west European car manufacturers who sought rapid entry and expansion (in conjunction with their national governments, which were directly involved in the negotiations, using the EU-accession bait, and from whom they received some support) in the very early stages of the transition may have obtained an overwhelming advantage for them through the quick realisation of economies of scale, learning-by-doing and a dominant market share. But it is also true that they have assumed considerable risks and invested in costly re-skilling and upgrading of suppliers, which engenders positive externalities. On the other hand, whereas the initial entrants are looking to exploit the market in CEECs, other manufacturers are more concerned with tapping into the candidate countries' lower wages for their global production system to reduce production costs.

The shift from the Europe Agreements to EU membership will amount to a cold shower for candidate countries because the EU car tariff is a mere 10%,[10] which is in contrast to the considerable protectionism, presumably as a form of industrial policy, on the part of some candidates (notably Hungary, Poland and Romania with car tariffs two to three times that of the EU). If anything, enlargement should be trade-creating in cars or alternatively, potential import competition will help to discipline local producers.

Foreign Direct Investment

FDI flows were quite strong during the second half of the 1990s. As Brenton & di Mauro have shown, FDI in the more advanced candidates was greater than one should expect given the actual level of income, market size and relative proximity.[11] The determinants of future FDI flows into Central Europe are perhaps even more difficult to establish than elsewhere. Bevan & Estrin find as key determinants country risk, unit labour cost, host country size and other gravity factors.[12] In turn, country risk is influenced by private sector development, industrial development, budget (im)balance, reserves and the degree of corruption. They show that more FDI boosts credit ratings with a

[8] J.-J. Boillot: Revue élargissement spécial automobile, in: Missions économiques, MINEFI-DREE, dossier no. 25, September 2002.

[9] For a detailed explanation of car manufacturers' strategies in the CEECs, see R. Van Tulder, and W. Ruigrok: The integration of central and eastern European Europe in car production networks, in: Actes du GERPISA, No. 25, Université d'Evry, 1999.

[10] Though the average EU tariff on automotive imports is 7%, individual components only face a 4.5% tariff, passenger cars 10% and larger vehicles nearly double that.

[11] P. Brenton, F. di Mauro: The potential magnitude and impact of FDI inflows to CEECs, in: Journal of Economic Integration, Vol. 14, No. 1, 1999.

[12] A. Bevan, S. Estrin: The determinants of foreign direct investment in transition economies, CEPR Discussion Paper No. 2638, London, December 2000.

lag, which in turn boost FDI again. This suggests virtuous circles but also rivalry in attracting FDI between the lagging and advanced candidates. The perception or expectation that chances for long-run catch-up growth are good will act as a major stimulus for FDI, which in turn will contribute to the realisation of that economic growth. It is for this reason that business attaches so much significance to *actual*, not possible, EU membership.[13] They regard the EU as a credible – even if far from perfect – enforcer and stabiliser of the regime change and wish to see the seal of approval. The Spanish and Portuguese accession led to a true explosion of FDI inflows for about four years, before returning to the 1986 level. It might be added that the subsequent entry into Euroland would further boost FDI, although little hard empirical work seems to underpin this expectation. Soft indications for this statement include the massive business support for the euro precisely on the grounds of predictability and low long-term interest rates. An additional argument that tends to be overlooked is the stability of market access and of currencies *inside* Central Europe. FDI is known to respond positively to such regional facilitation of market access, since the critical mass for scale might now be accomplished by sales to a subset of CEECs rather than supplying the CEECs individually by exports from Western Europe.

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

Agricultural Trade

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

Transition, Farm Structure and Competitiveness

The transition of agriculture in the accession countries is a study in extremes. Before the demise of the USSR, many farms in the CEECs were modelled after the large Soviet-era collectives and cooperatives (Poland was the main exception), each holding vast plots of land and hiring hundreds of workers. Once the transition process got started, the situation reversed, due to rapid privatisation and land restitution. As a result, individualisation ensued: workers were dispersed, assets were sold or stripped, and the average farm was left with very little capital. Today, subsistence and semi-subsistence farming is still widespread in the CEECs, outdoing its EU equivalent by a factor of 3 or 4.[15] The weight of the agricultural sector in national output appears to be far more imposing in accession countries than in the EU. According to Liapis and Tsigas, agriculture accounts for over 11% of GDP, against 3% in the EU; labour employed by the sector exceeds 22% of the total labour force, versus 6% in the EU.[16] Total agricultural area is 38% of that in the EU. Currently, 9.5 million workers are employed in agriculture in the candidate countries, whereas only

[13] European Round Table of Industrialists (ERT): The east-west win-win business experience, Brussels 1999; ERT, 2001, op. cit.

[14] UNCTAD: World Investment Report 2002, New York and Geneva, September 2002.

[15] See S. Tanic, T. Sipiläinen, S. Bäckman, J. Sumelius: Description of current farming systems in Central and Eastern European countries. Sustainable agriculture in Central and Eastern European Countries (CEESA). Project under EU 5th Framework Programme, Budapest 2001.

[16] P. Liapis, M. Tsigas: CEEC accession to the EU: a general equilibrium analysis, in: Regional Trade Agreements and U.S. Agriculture/AER-771, Economic research service, United States Department of Agriculture, Washington DC 1998.

Table 1
Agricultural Trade of Selected Transition Countries

	Net agricultural trade with EU (US$ m)	
	1993	2000
Bulgaria	-14.3	18.0
Czech Rep.	-113.3	-621.5
Estonia	-31.8	-184.3
Hungary	621.5	530.4
Latvia	-7.9	-163.4
Lithuania	3.3	-124.0
Poland	-254.6	-324.8
Romania	-332.9	-135.5
Slovakia	-77.5	-192.9
Slovenia	-82.6	-237.1

Sources: OECD and authors' calculations.

7.1 million tend to a much larger cultivable area in the Community.

Because social safety nets are still far from comprehensive in the region, farmers are unwilling to take the risk of engaging in economic pursuits off the farm. If they do muster up the courage to seek employment elsewhere, they often hold tracts of land as security. Added together, these idle land holdings represent huge areas which are underused and unproductive. Consolidation is constrained because the willingness of farmers to form cooperatives and associations is still impaired by the imperfect application of the rule of law and enforcement of property rights. The political economy of the transition has generated a set of incentives for the individual farmer whereby he perceives small farm size as the surest means of maximising his welfare. While it may be true on an individual scale, collectively this behavioural pattern spells disaster for external competitiveness.

If competitiveness is defined as capturing larger shares of export markets, the competitive position of CEEC agriculture is not a favourable one: since the transition, the trade balance in the sector vis-à-vis the EU has not only been negative (for all countries except Hungary and Bulgaria) but, surprisingly, is also *deteriorating* (see Table 1), which is the inverse of the expected outcome. The fact that the trade balances are for the most part negative may be a reflection of initial conditions, as EU export subsidies in agriculture were high in the early stages of the transition, distorting agricultural trade. Moreover, EU protection (remember, there was no agricultural East-West free trade) under the Europe Agreements was much stricter than that of candidates. However, given that both are falling rapidly now, it is surprising to find that the agricultural trade balance is deteriorating for CEECs. Therefore, it is likely that earlier studies overestimated the competitiveness of Eastern European agriculture.[17]

Studies indicating that surplus production of milk in the most advanced CEEC-6 would exceed one million tonnes in 2003 have proven to be exaggerated.[18] The sector is painfully fragmented, particularly in Poland, and dairy farms are no exception. Not only are the small plots of land supposedly consecrated to milk production often used for other purposes besides dairy farming, but small producers also cannot provide proper feed or reasonable housing conditions.[19] They lack adequate machinery and necessary equipment. There has been little investment in agricultural capital since the transition because profitability has been hurt by inflation and by expensive factors of production, especially in non-tradables. Currently, profitability in agriculture is so low that it has led to decapitalisation, thereby leading to rising unit costs.[20]

Labour productivity in the agricultural sector is far below the EU average (e.g., by some measures, an EU farmer is more than twelve times as efficient as his Polish counterpart), reflecting a large surplus of agricultural labour. Poulinquen estimates that in order to reach a *mere half* of the average EU farm productivity, sector restructuring in the CEECs will entail dismissing more than 4 million agricultural workers.[21] Clearly, the 10-20% of GDP accounted for by the sector is not consonant with the 15-30% of the labour force employed in agriculture. The greatest problem facing CEEC agriculture, apart from the dearth of capital, is the inability to shed unproductive workers. Agricultural employment in the CEECs is not on a steady down-

[17] For example, it has been known for a while that of all agricultural produce in the CEECs, only wheat has some semblance of being competitive. However, even the somewhat positive results for wheat must be qualified by the fact that the figures are aggregated for the region and are not weighted by country size or relative importance in that sector.

[18] See for example European Commission: Agricultural situation and prospects in the Central and Eastern European countries, summary report, Brussels 1998.

[19] M. Gorton, S. Davidova: The international competitiveness of CEEC agriculture, in: The World Economy, Vol. 24, No. 2, 2001, pp. 185-200.

[20] A. Poulinquen: Competitiveness and farm incomes in the CEEC agri-food sectors, independent study requested by the European Commission, DG Agriculture, Brussels 2001.

[21] A. Poulinquen, op. cit.

[22] Likewise, the share of agriculture in GDP in *all* accession countries has *increased* between 1990 and 1998. See C.G. van Kooten, L.H.G. Slangen, P. Suchanek, R. van Oosten: Agricultural transition in Central and Eastern European countries: an empirical analysis, paper presented at Sustainable agriculture in CEECs: The environmental effects and needs for change, Nitra, Slovakia, 10-16 September 2001.

Table 2
Main Customs Duties Reciprocally Allied Between Three Transition Countries and the EU in 2001

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

Source: EBRD: Agriculture and rural transition, in: Transition Report 2002, London 2002.

ward trend, as many had anticipated would be a corollary of the transition. On the contrary, it has increased in all countries between 1990 and 1998.[22] The driving force behind this somewhat surprising phenomenon is quite likely to be that the agricultural sector acts simply as a disguise for unemployment.

Land productivity as measured by yields is also far from Community averages. If agriculture is highly labour-intensive, as is the case in the CEECs, yields may hide the fact that labour productivity is low. Swinnen shows that sugar beet yields across the region in 1997 were only 50% of their 1989 level;[23] in the Visegrad countries, oilseed yields fell by 20-30% over the same time frame; as for coarse grain yields, for the most part they reached their 1989 levels, save for Romania and the former Czechoslovakia, which stagnated at 70-80% of the 1989 index level.

Exchange rates create problems as well. The projected continued appreciation of CEEC real exchange rates will further hurt competitiveness for the agro sector. Due to the Balassa-Samuelson effect, the rising price of non-tradables in CEECs stimulates the exchange rate onto a path of appreciation.[24] This effect is only temporary, since sometime in the not-too-distant future, the real exchange rates of CEECs will attain their equilibrium levels and will stabilise, at least according to theory. Estimating fundamental equilibrium exchange rates, Coudert and Couharde find that despite a recent path of appreciation, most CEEC exchange rates are still significantly undervalued, often by as much as 20%.[25]

Welfare Effects

It is often suggested that, since EU agricultural tariffs (for temperate zone products) are very high, major trade diversion will emerge or further increase upon EU enlargement. On the face of it this seems quite obvious, since the main culprit, i.e. the CEECs' adopting the EU's higher common external tariff, can easily be identified. However, it is the belief of the present authors that legitimate and understandable concerns about trade diversion in agriculture arising from accession are only relevant in the long run, *not* in the next 5-7 years.

The time-frame considered is therefore all-important. Reasons for this conclusion are twofold: first, pessimistic forecasts of large-scale trade diversion are often based on the assumption of rapid and significant restructuring, characteristics simply not commensurate with the current situation of the accession countries' agro sector;[26] second, one cannot eliminate the possibility of both unilateral (CAP reform) and multilateral (Doha) reform of agricultural trade by the EU. Doha is likely to stall if the EU does not make significant concessions in agriculture. As for the CAP, it is likely that the mid-term review will lead to changes (e.g. decoupling) and that the candidate countries' farmers will get (slowly rising) income payments. Finally, the planned milk reform (2005-2007) will be implemented (yet there are powerful pressures to go slowly on this), whilst sugar protection will eventually be undermined by the EU Everything But Arms initiative for the 48 poorest countries of the world.

In the absence of significant reforms, trade diversion will undoubtedly be large. There is substantial academic literature on the impact of enlargement on third countries' agriculture and the EU's agro-commitments of the Uruguay Round.[27] Its thrust is that there are real risks of violating the WTO constraints and that there will be considerable trade diversion in several product groups. If the CEECs adopt EU tariff peaks, third country exports of beef, sugar and wheat to the CEECs, facing EU tariffs of 125%, 125% and 92% respectively, are likely to decline, except in certain countries. The United States (bovine meat, non-wheat grains), the Cairns group and Mercosur countries, particularly Argentina (bovine meat, non-wheat grains) and Paraguay (beef) and Brazil (sugar) are trade

[23] J. Swinnen: Transition and integration in Europe: implications for agricultural and food markets, policy and trade agreements, in: The World Economy, Vol. 25, No.2, 2002.

[24] For a technical explanation and an attempt to estimate the effect for Central Europe, see Annex of J. Pelkmans, D. Gros, J. Nunez-Ferrer: Long-run economic aspects of the EU's Eastern Enlargement, WWR Working Documents, The Hague, September 2000.

[25] V. Coudert, C. Couharde: Exchange rate regimes and sustainable parities for CEECs in the run-up to EMU membership, CEPII working paper no. 2002-15, Paris, December 2002.

[26] J.-C. Bureau: Enlargement and reform of the EU common agricultural policy: impacts on the western hemisphere countries, interim report, contract #3502, Inter-American Development Bank, Washington DC 2002.

[27] See, for instance, J. Swinnen, op. cit.

partners likely to suffer setbacks due to trade diversion from EU enlargement. Although EU protection is extremely high, so that one should expect a range of CEEC agro-products to receive higher protection after 2004, there are also products for which protection in candidate countries turns out to be higher. The Czech Republic is a prime example, with higher tariffs in sugar, butter, skimmed milk powder, beef, pork and poultry (see Table 2).

If the current levels of protection are extrapolated into a post-accession world, simulations indicate that third countries could suffer setbacks in terms of lost export opportunities. However, as we shall explain below, such projections are inherently dubious and different studies often yield conflicting results.

Marsh and Tarditi suggest that surpluses of exportable agricultural products in the CEECs will strongly increase by 2013.[28] If correct, extending the CAP eastwards would mean running the risk of violating WTO constraints on exports subsidies and therefore stalling the Doha Round. Market price support in accession countries is expected to increase by 150%, from 14% of the international value of production to 35% (according to March and Tarditi), and payments to producers will nearly quadruple, from 10% to 36% of the same value. This introduces a large potential for trade diversion, even in the event that no significant export surpluses emerge. While Marsh and Tarditi's conclusion rests upon a partial equilibrium analysis using the assumption that the price elasticity of supply is 0.3 over a 10-year period, it is very doubtful whether 0.3 is a realistic assumption. Neither the aforementioned authors nor the present authors can know with any reasonable certainty the true responsiveness of supply in the accession countries to post-2004 CAP prices in the EU-25. What is certain is that the projected surpluses under the Marsh and Tarditi scenario could easily be depleted over the same time frame if the elasticity were only a little lower (say, 0.25 or 0.2). Based on the considerable evidence provided thus far in our paper, we suspect that the snail's pace of farm restructuring in the CEECs will severely limit the ability of the agricultural sector to respond to price increases, so that even increased protectionism will not automatically translate into the rapid marketing of exportable surpluses.

A recent Commission forecast indicates that in 2007, marketable surpluses for many agricultural products in the CEECs will be but a fraction of EU-15 surpluses, despite a significantly higher proportion of labour in agriculture and a larger total number of agricultural workers.[29] (The ratios are projected to be as low as 1/17 for beef, 1/15 for coarse grains, 1/7 in non-wheat grains, 1/7 for cereals, 1/6 for pork, 1/6 for poultry and 1/5 for milk). The WTO commitments of the CEECs mean that the leeway for export subsidies in agriculture is quite restricted. As a whole, the CEEC-region is obligated under WTO law to limit the quantity of subsidised exports to 1.7 million tonnes of cereals, 0.3 million tonnes of beef, 0.65 million tonnes of milk and 0.3 million tonnes of sugar.[30] Because the post-

CGE-Based EU Enlargement Welfare Effects in Agriculture

Liapis and Tsigas conclude that, taken as a whole, EU enlargement will be beneficial for third countries, generating a *net* welfare gain to the order of $1.6 billion, and $6.8 billion if the CAP is reformed. But agricultural exports to the EU will not be left untouched, as significant trade diversion could occur: in the dairy sector, for example, total US and EU-15 exports are projected to fall by 22.50% and 15.44% percent respectively. What is dubbed "rest of world" will see exports decline by 21.90%. The biggest losers will be the CIS: respective impact on exports in non-wheat grains, non-grains, livestock, meat and dairy products is estimated to be -13.70, -12.90, -12.40, -9.22 and -9.68 percent.

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

[28] Given their assumptions on demand and supply elasticities and of quota reforms, hence no production limits on milk and sugar. See J. Marsh, S. Tarditi: International impact of the new Common Agricultural Policy, report to Consumer International, April 2003.

[29] European Commission: Analysis of the impact on agricultural markets and incomes of EU enlargement to the CEECs, Brussels, March 2002.

[30] J.-C. Bureau, 2002, op. cit.

[31] See e.g. European Commission: Enlargement and agriculture: successfully integrating the new Member States into the CAP, Issues Paper, SEC (2002) 95 of 30 January 2002.

transition restructuring in agriculture in Central Europe is far from over, the medium-term effects of extending the CAP are not nearly as worrying (for outsiders) as one might have expected given a healthy agro-food sector.[31]

The box summarises two studies by Liapis and Tsigas, and Frandsen et al., who have tried to capture the welfare effects for the rest of the world arising from EU enlargement.[32] Their conclusions are that trade diversion is likely to be quite substantial in some product areas, but that in the aggregate, the accession of CEECs to the EU will be beneficial for the rest of the world. It must be noted, however, that these results and those generated by computable general equilibrium models in general must be treated with great caution, since they are very sensitive to both the choice of parameter values and to an array of assumptions, such as markets clearing immediately, perfect competition etc., which are unrealistic (especially for less developed regions and economies in transition). Many assumptions had to be made which simply do not reflect the current lack of competitiveness of the agricultural sector. Recent data only serve to reinforce this assertion. Therefore, the present authors doubt the applicability and economic value of these studies, at least for the short to medium run.

Because their export structure is fundamentally different from that of accession countries, a few regions should emerge unscathed from the enlargement process in agriculture. Countries lining the Mediterranean's southern and eastern basins compete much more with Italy, Spain and Greece than with the accession countries in agricultural produce. The one exception is Cyprus, which has a very similar export structure to several Mediterranean non-member countries, particularly Israel.[33] But given Cyprus' small size, the effective trade diversion for the region is negligible.

In the 660 agricultural product categories where CEECs and Latin America/Caribbean (LAC) overlap, the LAC region has a revealed comparative advantage in 92 positions, accounting for 78% of LAC exports to the CEECs.[34] The possibility of trade diversion arising between South America and the CEECs is rather slight by the calculations of the above study, since only 4% of Latin America's exports in value terms shared revealed comparative advantage with the CEECs at the 8-digit level. However, the present authors recommend that such studies measuring potential competition as an overlap of export structure be treated with caution. The problem with revealed comparative advantage using ratios of export shares is that these measures incorporate the effects of existing protection. When protection is high, as it currently is in agriculture, the revealed comparative advantage ratios become heavily distorted.

Least developed countries and ACP countries are likely to gain, since they will benefit from the eastward extension of trade privileges such as the Everything But Arms initiative (duty-free access for 48 LDCs to the EU market for all goods) and Cotonou (the reformed Lomé group arrangement, extended until 2020 in 2000; all non-reciprocal tariff preferences in place until 2007), since CEECs must integrate them into their trade schedules to conform to the *acquis*. As such, Africa is not likely to suffer from trade-related effects of EU enlargement, since most of its countries benefit either from EBA or Cotonou (its only Cairns' group member is South Africa).[35]

Implementing the *acquis* also means that the CEECs will lose an edge over their competitors from third countries, who will – more often than not – not have to adopt the same environmental, social and technical standards required of companies operating within the EU. With respect to sanitary and phytosanitary questions, product quality and hygiene are often below the SPS measures imposed by the EU. It must also not be forgotten that once the CAP does extend to the candidate countries, they will have to incorporate environmental concerns into their national agricultural strategies in conformity with "greening" the CAP.[36]

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

Sensitivities about Bilateral Investment Treaties

Candidate countries have signed bilateral investment treaties (BITs) with a host of countries. In this they simply follow a conduct practised by all OECD coun-

[32] P. Liapis, M. Tsigas, op. cit.; S. Frandsen, H. Jensen, D. Vanzetti: Expanding fortress Europe: agricultural trade and welfare implications of European enlargement for non- Member regions, in: The World Economy, Vol. 23, No. 3, 2000.

[33] A. Tovias: From 15 to 21: The impact of the next EU enlargement on Mediterranean non-member countries, paper presented at the FEMISE conference, Marseilles, 17-18 February 2000.

[34] A. Jessen (ed.): Closer European Union links with Eastern Europe: implications for Latin America, Institute for European-Latin American Relations, Madrid 1997.

[35] The EU-South Africa FTA specifically excludes the sensitive commodities of sugar and meat; under the agreement, only 61.4 % of the country's farm products will gain unrestricted access to EU markets.

[36] OECD: Agricultural policies in transition countries: trends in policies and support, Paris 2002.

tries. The incentive for an active policy of welcoming foreign investors is even greater than for other OECD countries as candidates (rightly) consider a steady inflow of FDI to directly as well as indirectly propel their growth rates for a long period of time. According to UNCTAD, bilateral investment treaties may help foster a favourable investment climate, building confidence among, and sending a positive signal to, investors.[37] However, the vast literature on FDI has indicated that proximate determinants of FDI focus much less on the absence or presence of BITs, than on cost factors and openness to trade, market size, per capita GDP, human capital, location and internalisation opportunities, and exchange rate movements. The answer may be that in the competition for attracting scarce resources of foreign direct investment, even slight edges may lead to significant gains. In this light, any country which does not adopt measures implemented by its neighbours may lose out. Such seems to have been the reasoning of the CEECs.

Many of the Central European BITs with the USA were signed very shortly after the collapse of the Soviet Union, at a time when even Austria, Finland and Sweden were still not members of the EU. Given the geo-political context of the initial transition, it was not clear what the future would hold, let alone that the CEECs would accede to the EU. The US claims that it signs BITs so that its investors are treated fairly and to protect US interests abroad. The relatively low number of BITs signed by the USA and their geographic distribution (the majority involve CEECs and the CIS), suggests that they are an instrument to obtain access for US investors in heavily regulated markets where political risk is elevated.[38] In fact, according to UNCTAD, more than a third of worldwide BITs involve CEECs (653 out of 1941). It is possible that the CEECs may have been arm-twisted into signing liberal BITs with the USA, as the result of unequal bargaining power between them.[39] With respect to investment treaties, one outcome is that strong countries develop a hub and spoke system, benefiting from numerous bilateral investment treaties signed on unequal terms, without having to reciprocate.

It is surprising to notice that the European Commission has raised objections to the candidates' BITs with the USA (and apparently not to BITs with other countries). The reason is unlikely to be that these BITs with the USA are especially restrictive. National treatment is a leading principle in such BITs and, in this respect, the compatibility with a fundamental treaty article (Art. 48, EC, formerly Art. 58, EC) which also stipulates national treatment would seem to be ensured. EU opposition to US BITs in Central Europe is two-sided: economic and legal.

From an economic perspective, the liberal BITs signed between the CEECs and the USA could threaten the integrity of the internal market. Interviews suggest that this possibility only arises in a few sensitive cases. The main EU concern is that in areas which, today, predominantly fall outside the competence of the EU and remain within the bounds of national regulation, a situation could arise whereby a US company is favoured over an EU competitor, even within the context of an enlarged internal market. Obviously, the integrity of the internal market would be violated by such an arrangement – especially if the EU would later legislate in this area – and is therefore unacceptable to the Commission.

It would appear that there are two sensitivities. First, one set of issues relates to specific services sectors that are exempted in the GATS' schedules of commitments submitted by the EU (and, incidentally, by some other countries as well) from national treatment. In fact, the real bones of contention consist of audio-visual services (mainly TV, in the light of the "TV without frontiers" directive which comprises selective measures of protection for EU-origin production) and air transport (here, the problem goes back to the "open skies" agreements the CEECs have signed with the USA and which have long been suspected of being incompatible with EC law, that is, with the internal market).

In air transport the "mercantilist" tradition is only slowly being replaced by ordinary conditions of market access and (lightly regulated) competition. Thus, despite the full liberalisation of the provision of intra-EU air transport services, so-called air-services-agreements between EU Member States and third countries were never transferred to EU-level agreements. The fear of Member States has long been that the European Commission would not renegotiate such agreements with proper attention to all the rights and benefits currently enjoyed by the respective incumbent airlines (who make most of their turnover on such

[37] UNCTAD: Chairman's summary at the closing of the plenary meeting, Expert's meeting on existing agreements on investment and their development dimensions, Geneva, 28-30 May 1997.

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

[39] Prof. M. Sornarajah noted at the UNCTAD experts' meeting (see footnote 37) that while demanding national treatment for US investments at the pre-investment phase, the US often does not reciprocate this provision.

international routes). Since all airlines having rights under third country agreements are keen to have wide access to the huge US domestic air services market, the US "open skies" agreements were signed by many EU Member States. The upshot was that this provided the US companies with commercial possibilities in the internal market that EU airlines did not have, whereas, at the same time, the USA merely provided multiple entry but no cabotage, let alone a right to acquire US airlines. The candidates, by signing such "open skies" agreements, now find themselves in the same conundrum as the Member States which did so. In November 2002 the ECJ ruled that the "open skies" agreements are incompatible with Community law.[40] It remains to be seen whether and how the Commission can now better negotiate the common Atlantic aviation space that was blocked by the uncertainty on the ECJ rulings. It would seem that, in these negotiations, the renegotiation of the agreements of the candidates is a natural component of the overall package.

Taking a closer look seems to suggest that the potential dispute has more to do with the litigation and negotiating habits in the "lawyers' paradise" of international services than with significant economic effects. To begin with, the USA has ensured certain exceptions as well. As an example, the BIT with Lithuania exempts the very sectors for the USA that are said to cause US concern in the EU-15 and the candidates, namely the US airlines and audiovisual sectors(!) Furthermore, the so-called "cultural exception" in audiovisual services in the EU has never prevented US industry from conquering and maintaining extremely high market shares in TV, video and film services in Europe. The factual difference between the economic interests of US industry in the candidates today and after EU membership should therefore not be expected to be great.

On the legal side, Commission officials Julie Raynal and Roderick Abbott in recent speeches target in particular the provision of national treatment at the pre-investment phase in US investment treaties with the CEECs.[41] Since no EU country has this provision in any of its treaties, and since EU internal market legislation only allows it to be granted among member states, such a difference in treatment between existing EU members and aspirants would be unacceptable.[42]

Of course one it might simply be argued that, once the candidates are EU members, the *acquis* will always override BITs concluded under international law including GATS, but legal specialists are not unanimous in adhering to this position. Specifically, the EU is concerned over dispute settlement procedures regarding concessions. A concession is a contract between a sovereign state and a national of another state. If ever the host country decides unilaterally to change the terms of its agreement with the foreign investor, it breaks an obligation bound by international law.[43] Applied to the US-EU BIT quarrel, CEECs cannot adopt the *acquis* in certain areas without violating an agreement enshrined in an international treaty, since the BITs were signed before the adoption of the *acquis*. In the case of a dispute, BITs ensure that the case goes before a neutral international arbitration body, rather than the courts of the host country, ensuring an unbiased ruling. Rather than taking the risk of one day losing in a court decision, the Commission requires that the BITs be made fully compatible with the *acquis* or cancelled unilaterally.

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

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

[40] Ruling of 5 Nov. 2002; see www.curia.eu.int for cases C-466/98 to C-476/98.

[41] Julie Raynal spoke at a recent OECD conference on BITs, Dubrovnik, 28-29 May 2001; Roderick Abbott, then Deputy Director General for Trade at the European Commission, gave an address at the Paul H. Nitze School of Advanced International Studies, Washington DC, 22 October 2001.

[42] R. Abbott, op. cit.

[43] P. Comeaux, N.S Kinsella: Reducing political risk in developing countries: bilateral investment treaties, stabilization clauses, and MIGA & OPIC investment insurance, in: Journal of International and Comparative Law, NYU Law School, 1994.

The Long-term Economic Perspective

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

After the large output falls of the beginning of transition, the candidates have shown that rather basic recommendations about sound economic policy, combined with the gradual introduction of the *acquis communautaire* and the full access to the EU markets, does bring catch-up growth. Between 1995 and 2000, 7 of the 10 CEECs were catching up despite Russian turbulence and lingering transition problems. And the cases of retrogression were clearly limited to countries paying the price of half-baked reforms and/or very sloppy macro-economic policies (Bulgaria, Romania and the Czech Republic). All three are now in the process of overcoming these setbacks, with Romania and Bulgaria currently on a catch-up rate of 2-3 percentage points or more (if the EU remains trapped at a miserable 1% for a while). However, the real issue is a long-run one: does the Union welcome the growth dynamos of the near future or must it face the risk of getting stuck with a bunch of new Mezzogiorno's? It is only since 2000 that Central European catch-up is accelerating and positive for all ten CEECs which are candidates. In the year 2003 economic growth can be found in Central Europe, not in Western Europe. The latest growth forecasts of the candidates from Central Europe by the European Commission date from April 2003 and for the year 2004 vary from 3.7 % for Poland and 3.9 % for the Czech Republic to 5.0 % for Romania, 6.0 % for Latvia and 5.1 % for Lithuania and Estonia.[44]

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

As briefly touched upon above, there are increasingly clear indications of powerful underlying microeconomics of catch-up growth. Landesmann has accomplished a very detailed analysis of competitiveness indicators which should promote growth.[45] In addition to the points mentioned before, he shows that given a decomposition of manufacturing in (e.g.) labour intensive and technology driven sectors, the disparities between the export performance to what is called the EU-North of the CEECs and that of the EU-South are rapidly shrinking for Visegrad and Estonia as far as tech-driven sectors are concerned while Romania, Bulgaria, Latvia and Lithuania now tend to grow rapidly, at least partly, on the basis of labour intensive sectors from which the EU South is moving away. When focussing on low-skilled intensive sectors a similar pattern develops (except for Latvia). In the shorter term both specialisations can yield considerable growth but in the longer term Romania and Bulgaria will undoubtedly have to refine their focus on higher value-added output in such sectors. A clear and impressive example that this may well happen is in a key sector for these countries, namely, textiles and clothing. In the CEPS/EPPA study the long-run strategies and foreign direct investment plans of many German and Italian textiles and clothing firms were studied and the uniform response is the intention of a steady and considerable stream of FDI in CEECs, with the expectation of increasing sophistication.[46] Already in 2001 the Italian textiles and clothing industry (co-)owned a respectable total of some 1000 firms in Bulgaria alone. It seems reasonable to believe, therefore, that the fragmentary signals about catch-up growth are not merely straws in the wind despite the numerous problems ahead.

Nevertheless, the favourable environment and positive signals notwithstanding, there are lingering doubts about catch-up growth. They have both practical and deep analytical grounds. Practical arguments include the egalitarian inclination in the domestic politics of the transition countries, which has caused intolerably high social mark-ups on wages (not seldom higher than in Western Europe, which used to be the highest

[44] European Commission: Evaluation of the 2002 pre-accession economic programmes of candidate countries, Enlargement Papers No. 14, November 2002.

[45] M. Landesmann, op. cit.

[46] EPPA/CEPS: Die Auswirkungen des ATC-Quoten abbaus auf die Deutsche Textilindustrie, Brussels 2002.

in the OECD) and considerable deficits in the pensions systems today (i.e. before ageing is beginning to hit). Other worrying observations include the hesitation to go all the way in the restructuring of ailing sectors in the presence of high structural unemployment, the deep skill mismatches of many long-term unemployed in a rapidly changing labour market, and the expected exit from agriculture with a questionable absorption capacity of industry and services. In the latter case, the economically unwise but (for the farmers and enough politicians) politically attractive decision of the EU has been to make the CAP so generous for CEEC farmers that far too many human resources remain in subsistence agriculture, dragging down growth for the candidates' economies. Last but not least, one could add the weaknesses in financial services and capital markets in actually serving the needs of local investors at low interest rates and the overall fear that implementation and market related institutions in Central Europe are so feeble that markets suffer from uncertainty, hence less growth.

The analytical reasons boil down to the controversies in economics about the long-term determinants of growth.[47] In other words, as the Romanian economist (and former finance minister) Daniel Daianu has put it, should we rely on "an apparent mythical belief" in EU circles that a well functioning competitive market economy will ensure a catch-up growth trajectory?[48] Can Ireland be imitated by all, or will many mimic the Greek tragedy before 1997, or are they capable of pursuing the reasonable Iberian middle-road? It seems obvious to the present authors that the EU can simply no longer tolerate the pre-1997 Greek underperformance combined with opportunism and bad implementation. EMU is a huge improvement in that respect and Greece has responded in kind.

But economic growth in the EU and a healthy enlargement cannot be limited to the Central Europeans. The entire new EMU of 25 faces a need for economic reform, in particular micro-economic reform in agricultural, services and labour markets. These reforms would also help in reducing the costs of shocks in Euroland that can no longer be cushioned by (national) currency realignments. It is possible, but by no means obvious or automatic, that enlargement will prompt such large-scale reforms.[49]

Conclusions

The external economic impact of enlargement has not attracted a great deal of interest in the public or indeed academic debate. The present article shows that, on the whole, the move to an EU of 25 is a win-win process for insiders and third countries alike. The case for this favourable view is first of all based on the economic and political stability that is greatly helped by the EU as an anchor and (benign) hegemon. It is widely realised outside Europe how precious this stability is for countries emerging out of the difficult and tortuous process of transition. EU membership ensures it to be even more credible and durable. Worldwide support for the lock-in effect of the very wide ranging *acquis* and its enforcement and the technical and other aid provided by the Union translates into implicit support for enlargement. The case is strengthened by the generally low protection of the EU in the industrial goods market, thereby reducing trade diversion. The major exception is in agriculture where border protection for temperate zone products will further increase and only continued reforms as well as concessions in the WTO Doha round may provide a perspective for improving access for third countries in the future. In some specific agro-products trade diversion can be serious and perhaps some WTO constraints for the EU are at risk. However, we show that in the short-to-medium run these dangers are very limited if not absent. Agriculture in Central Europe turns out to be inefficient, and the roots of this predicament are deep. The supply response to protectionism – higher prices and income support – will be very modest during the first (say) 5-8 years.

The expected impact on FDI inflows is highly positive and does not come at the expense of outside countries. The skirmishes about bilateral investment treaties can probably be resolved in best-endeavour trade negotiations between the USA and the EU-25. In any event, this will have to be done for air transport. The greatest positive stake outsiders have in enlargement is the success of a sustained strategy of catch-up growth by the candidates, helped by the EU market environment as well as the Union funding. It is in particular on this strategy that emphasis should be laid for the next two decades or so since, in the final analysis and given the fulfilment of the political conditions for membership, the EU enlargement is all about prosperity. And prosperity in Central Europe is also a boon for third countries.

[47] A number of pertinent questions are raised in J. Pelkmans: Economic implications of enlargement, Bruges European Economics Policy (BEEP) briefing no.1, 2002, College of Europe, Bruges. See also http://www.coleurop.be/eco/BEEP.htm.

[48] D. Daianu: Is catching up possible in Europe? in: Romanian Journal of European Affairs, Vol. 2, No. 1, 2002.

[49] See J. Pelkmans, op. cit.; W. Kok: Enlarging the European Union: achievements and challenges, report of Wim Kok to the European Commission, Florence (IUE) and Brussels, 26 March 2003.