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CENTRAL AND EASTERN EUROPE EUROPE : ECONOMIC ACHIEVEMENTS, EUROPEAN INTEGRATION PROSPECTS

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The European Counsel in Copenhagen in 1993 adopted the principle of European Union enlargement. A list of five candidates was established : Czech Republic, Estonia, Hungary, Poland and Slovenia, which constitute the “first wave” of Eastern and Central Europe countries. It has been decided in Helsinki in December 1999 to add Bulgaria, Latvia, Lithuania, Romania, and the Slovak Republic.

Those ten countries have achieved significant but unequal economic progress. The momentum of the negotiations and the timing of their accession to the European Union will depend on each country’s capacity to complete many complex reforms in a number of fields as environment, agriculture, energy, capital markets, banking regulation and supervision, health and social regimes…

I shall present my remarks under two headings :

- ♦ what is the situation of those countries in terms of economic and structural reforms ?

- ♦ what are the challenges, stakes and prospects of the EU accession negotiation ?

I. ECONOMIC DEVELOPMENTS AND STRUCTURAL REFORMS IN CENTRAL AND EASTERN EUROPEAN COUNTRIES CANDIDATES TO EUROPEAN UNION ACCESSION :

Two categories of countries can be distinguished :

1. The "first wave" of most advanced countries :

This group features Czech Republic, Estonia, Hungary, Poland and Slovenia.

a) From a macroeconomic standpoint, those countries have made noticeable progress since the fall of the Berlin wall towards economic stabilization and market reform.

Table I. shows that the hyper inflation figures in 1990-91 have given way to single digit rates in most of the countries.

One can also remark that fiscal deficits have been somewhat kept in check.

As far as growth is concerned after the very strong recession of the early nineties, **those countries have reached over the last four to five years rates of growth of 4 to 5 % a year**, except for the Czech Republic which has faced serious economic problems.

But one should also note (as seen in Table IV), that the favorable growth achieved has entailed significant current account deficits in some of those countries. For example, Poland has been facing, due to some fiscal slippage and a strong expansion in domestic credit a current account deficit of 7,6 % of GDP in 1999. The situation is improving.

This situation in itself is not alarming as long as external financing can be sustained and as long as inflation can be kept in check

In this respect, as Table III. shows, **foreign direct investment has been significant**. On a per capita basis, over the last ten years or so, Hungary has attracted more than 1,700 dollars in the form of net inflows of foreign direct investment. That says a lot on the openness of the Hungarian economy and on the quality of its economic reforms. Follow the Czech Republic (1,400 dollars per capita), Estonia (1,100), Poland and Slovenia (500).

Therefore, it is of the essence that those countries follow prudent fiscal and monetary policies, continue to progress on the route of structural reforms, and do not let their exchange rates get out of line in terms of competitiveness if they want to continue to attract the foreign capital which they very much need to grow on a durable basis.

b) <u>From a structural standpoint : one can observe that the most advanced countries have achieved significant progress towards market economy.</u>

As Table II. shows **privatization is now the name of the game**. While State owned entities controlled 75 to 90 % of those economies ten years ago, now the private sector accounts for 60 to 85 % of their GDPs (with the exception of Slovenia where the State sector still represents 50 % of the economy). One can also see that **trade liberalization and legal reforms are now well advanced**, Hungary leading the way followed by Poland and Czech Republic.

It is also remarkable -and a testimony to the efficiency of reforms- that **productivity in industry has very significantly increased over the last seven years**. Hungary with 13 % annual average increases in productivity over the period 1993-99, followed by Poland (12 %), and Czech Republic (11 %) are stricking examples of the positive results of structural reforms.

Another manifestation of the opening up of those economies is the dramatic redirection of their trade : from 25 % in 1990, the exports of those countries towards the West account now for about two thirds of the total.

As regards the sectorial trends, one can notice a number of interesting developments. While the re-deployment of the Central Europe’s trade initially took place in the so-called “traditional” specialised sectors (ferrous and non-ferrous metal processing, non-sophisticated consumer goods, agro-food products), **today we are observing the increase in sales of engineering products in certain countries and intra-branch exchanges**. These are an obvious sign of a technological upgrading and a narrowing of the differences between productive structures.

As the Wall Street Journal stressed in a recent article: “The West no longer holds a monopoly on brainwork. In fact, Hungarians are turning the old business model upside down.” **More and more frequently, research, technological innovation, product design are made in Hungary and other Central European countries**. Taking advantage of a highly trained and relatively cheap work force, international companies “today employ Hungarian programmers and engineers to design everything from light bulbs to buses and brake systems” whilst western plants often limit their contribution to assembling parts and designs. And **this may only be the**

beginning of a trend which could place Central Europe among the leaders of technological innovation.

2. Less advanced countries :

One can observe that in the second group of countries, which are facing a number of economic and political difficulties over the last years, results have been somewhat less satisfactory.

Romania has shown negative growth of 4 % over the period 1997-99 and Bulgaria zero growth. Romania is still facing double digit inflation (54 % in 1999). Bulgaria is now engaged, with a currency board system, in a strong macroeconomic stabilization process.

But the two other Baltic countries (Lithuania and Latvia) and the Slovak Republic are moving fast to catch up with the first group of countries (inflation and public deficit in check and satisfactory growth rates). One can also observe that foreign direct capital inflows per capita are significant in Latvia and Lithuania and picking up in the Slovak Republic where productivity growth has been rising significantly.

One word about Russia.

Russia is not a candidate to the EU, and won't be for the foreseeable future. Its weight in the Central European economies is only a fraction of what it was ten years ago. However, it is still the largest energy provider, and a recovery in the Russian economy can still provide a boost to exports from Central Europe.

The prospects of Russia have recently improved for two main reasons : one is the political stability brought by the new government, the other is the impact of oil prices on the fiscal and external accounts of the Russian Federation. The current good health of these accounts should not hide the immense need for reform.

Russia's economy is still very much a raw material based one, and it lacks a strong banking sector, a stable legal and tax framework, not to mention corporate governance and shareholders' rights which have not so far seriously been taken into consideration by either political or economic decision makers.

II. WHAT ARE THE CHALLENGES, STAKES AND PROSPECTS OF THE EU ACCESSION NEGOTIATION ?

1. The enlargement is a challenge for the present members of the Union:

a) First of all, the enlargement implies an institutional reform of the Union.

It is clear that the institutions governing the present 15 members of the Union must be adapted to met the needs of a Union including 25 members or more. Some of the most important problems to be resolved are the weighting of the votes in the executive Council, the reduction in the number of commissioners, the extension of decisions taken at a qualified majority…

These reforms are a precondition to enlargement.

b) The enlargement will entail additional costs for the Union and therefore a reallocation of resources among the members.

The ten candidates have standards of living significantly lower than those of the European Union. Their weighted GDP per capita represents only 30 % of the average of the present Union (the wealthiest candidate, i.e. Slovenia, has a GDP per capita that accounts for two-thirds of the average of the Union (5 to 10 % less than the poorest present members i.e. Greece and Portugal).

The accession of the ten candidates will increase the European Union population by more than 30 % whilst it would only increase its GDP by 5 %.

All this implies that the newcomers will be net users of European resources. As far as agriculture is concerned, the cultivated area of the present Union would increase by a third whilst the rural labour force would double due to enlargement.

In spite -or because- of this, the members of the Union have established the principle that they do not whish to increase in real terms the costs and taxes of the Union. The basic assumption is that enlargement has to find its way within the total ceiling of EU resources i.e. 1,27 % of the Union's GDP.

This, in turn, entails two consequences :

- **The Union must reform and trim the cost of its present mechanisms** (Common Agricultural Policy and structural policies). The orientation taken in 1992 from an agricultural price support system to a system of direct subsidies to poor farmers will have to continue. Similarly, regional and structural funds will have reallocate some of their resources from countries like Greece or Portugal to the newcomers.

- **Sufficiently lengthy periods of transition will have to be set up in order to allow for necessary adaptations**. It is clear, for example, that the Polish agriculture (which accounts for 27 % of Polish labour force but produces only 6 % of GDP) will have to go through a significant modernization process before it can fully access the agricultural policy mechanism.

But the enlargement is also a great opportunity for the European Union :

- Integration of a new market : **with more than one hundred million new citizens the European Union's population will almost increase by a third and will approach 500 million**. This will boost trade and activity. Enormous investment will have to be made notably in the private sector in the field of transport, energy, telecommunications, environment… in order to allow the accession process ;

- **The enlargement is a major engine for structural reforms in Central and Eastern Europe** ;

- **One should also have in mind the far-reaching consequences of a failure to enlarge**. EU accession is a major political objective for Central and Eastern European countries. After forty five years of communism, those nations have decided – and this is still the object of a strong political consensus even if there has been some erosion lately- to join the European Union, its values, its political and economical framework. One can imagine easily the consequences of a failure to enlarge.

2. The negotiation :

a) Principles and procedures.

The process has started in December 1998 with the first wave of five candidates.

The "pre-accessions strategy" consists in combining reforms by the candidate countries and some financial assistance by the Union. The idea is to help the candidates before accession to conform with the "acquis communautaire".

The procedure is based on the negotiation with each country of an "accession partnership". These partnerships outline the list of priorities -short and medium term- which have to be met before accession. The partnerships also lay out the amount of resources that will be allocated to each candidate (total of 3 billion Euros per year starting in year 2000). This financial assistance is conditional upon progress achieved in terms of reforms : it can be suspended in case of non satisfactory performance.

Each country is being assessed continuously according to its performance and will become member of the Union when it will have met the obligations that apply to all member states. Negotiations are conducted on a bilateral basis between the Union and each candidate.

b) State of the negotiation.

Thirty one chapters cover the whole spectrum of structural reform. Fifteen chapters have already been either settled or under discussion and significant but unequal progress has been reached. Hungary and Poland have been particularly successful in their negotiations. But it has to be observed that the most difficult chapters (like agriculture, regional policy, institutional reforms…) have yet to be covered.

c) Timetable.

Contrary to the wish of certain candidates the European Council has not fixed a timetable for the enlargement nor an objective date for the first accession. What the fifteen countries have agreed upon is that the European Union would be ready from the end of 2002 to accept new members if three conditions are met :

- sufficient financial resources,
- completion of the institutional reform of the Union,
- satisfactory bilateral negotiations on accession.

Ideally if all conditions are met, first accessions could be ready for the end of 2002. Given the usual delays for ratification first accessions could become effective in 2004. But this is a purely theoretical notion and things may well take more time.

One has to add that economic and monetary Union is an integral part of the accession process. Accession implies indeed that the new members commit themselves to participate in the monetary Union (as long as they meet the convergence criteria fixed in the Maastricht Treaty). But the observance of those criteria is not a necessary condition for acceding to the European Union.

Therefore candidates will very probably enter the Union first and the monetary Union later on.

I don't think that one should focus too much in terms of a precise timetable. I have tried to show the complexity of the negotiations and the financial stakes at hand. Each country will have to negotiate thoroughly and, at least in some fields, some will have to go through transition periods.

All in all, I am optimistic on the economic prospects of most of those countries. They have gone far in terms of macroeconomic stability (even if some of them are facing overheating problems), they have opened up their economies, increased their productivity, privatized and liberalized their systems. **They are certainly more advanced on market liberalization than Western European countries ten years after the end of second world war.**

But a lot remains to be done for the candidates to be fully part of the market economy. One can stress in particular the importance of :

- strengthening the banking sector,
- and building local financial markets.

Is it worth going through the additional constraints of EU membership ? My answer is *yes* for four main reasons.

1. there is a fundamental political reality : after 45 years of communism, those countries want to be part of the "European family" ;
2. adhering to the European "acquis communautaire" (one of the most advanced corpuses of laws and practices in the world) is providing the region a strong boost for institutional building ;
3. one should also note that those Eastern European countries can influence the EU more than Western countries can influence themselves (this is true for the reform of the common agricultural policy and of the present institutional setting) ;
4. the volatility in exchange rates throughout the world and its negative impact on small and open economies provides an irresistible push towards Euro integration. The world is indeed moving towards larger economic trade and financial zones.

Table I. Macroeconomic achievements :

A. most advanced countries	**Inflation**			**Fiscal Deficit**		**Economic Growth**		**GDP/per capita in dollars**	
	1990 or 1991 %	**1999**	**2000 forecast %**	**1990 or 1991 %**	**1999 %**	**1990 or 1991 %**	**Average 1997/99 %**	**1991**	**1999**
Poland	249	9,8	7,5	- 6,7	- 3,5	- 11,6	5	2.037	3.900
Hungary	33	11	6,2	- 3	- 5,6	- 11,9	4,5	3.230	4.730
Czech Republic	52	2,5	5	-2,8 (89)	- 3,8	- 11,5	- 1	2.400	5.400
Estonia	303	3,9	4,8	- 5,2	- 4,7	- 13,6	4,5	707	3.600
Slovenia	247	8	5,5	- 0,3	- 1	- 8,9	4	6.333	9.779

B. Less advanced countries	**Inflation**			**Fiscal Deficit**		**Economic Growth**		**GDP/per capita in dollars**	
	1990 or 1991 %	**1999 %**	**2000 forecast %**	**1990 or 1991 %**	**1999 %**	**1990 or 1991 %**	**Average 1997/99 %**	**1991**	**1999**
Lithuania	345	0,3	3,5	- 5,4	- 8,6	- 21 (92)	+ 4	289	2.890
Latvia	262	3,2	4,2	- 0,8	- 3,8	- 35 (92)	+ 4,5	578	2.622
Bulgaria	339	6,2	7	-10,9(93)	- 1	- 11, 7	0	872	1.315
Romania	228	54	30	- 4,6(92)	- 3,1	- 13	- 4	1.245	1.695
Slovak Republic	58	14	10	- 7 %	- 3,6	- 14,6	+ 4,5	2.052	3.793

<u>Table II. Structural reforms :</u>

<u>A. Most advanced countries</u>	**Privatizations % of private sector in GDP**		**Trade liberalization (scale (1))**	**Legal reforms (scale (1))**	**Productivity in industry**
	1990 %	**1999 %**	**1999**	**1999**	**1993-99 Average yearly changes %**
Poland	30	60	3.3	4	12
Hungary	25	85	4+	4	13
Czech Republic	10	75	3	4	11
Estonia	10	70	4	3,5	na
Slovenia	15	50	3.3	3	8

<u>B. Less advanced countries</u>	**Privatizations % of private sector in GDP**		**Trade liberalization (scale (1))**	**Legal reforms (scale (1))**	**Productivity in industry**
	1990 %	**1999 %**	**1999**	**1999**	**1993-99 Average yearly changes %**
Lithuania	10	70	4	3.5	Na
Latvia	10	65	4	3-	12
Bulgaria	10	65	4	4	2,5
Romania	15	60	4	4	7
Slovak Republic	10	75	4+	2,5	6,5

(1) Scale : 1 to 4+ : (4+ : equal to minimal international standards).

Table III. Foreign direct investment (net inflows in Million US dollars)

A. Most advanced countries	1992	1993	1994	1995	1996	1997	1998	1999	Cumulative 1989-99	Cumulative per capita 1989-99
Poland	284	580	542	1,134	2,741	3,041	4,966	6,642	20,047	518
Hungary	1,471	2,328	1,097	4,410	1,987	1,653	1,453	1,414	17,770	1,764
Czech Republic	983	563	749	2,526	1,276	1,275	2,641	4,912	14,924	1,447
Estonia	-	156	212	199	111	130	574	233	1,615	1,122
Slovenia	113	111	131	171	178	295	154	40	1,135	568

B. Less advanced countries	1992	1993	1994	1995	1996	1997	1998	1999	Cumulative 1989-99	Cumulative per capita 1989-99
Lithuania	-	30	31	72	152	328	921	478	2,012	545
Latvia	-	50	279	245	379	515	303	366	2,135	880
Bulgaria	42	40	105	98	138	507	537	739	2,265	273
Romania	73	87	341	417	263	1,224	2,040	800	5,264	235
Slovak Republic	100	107	236	194	199	84	374	701	2,111	391

NB : Russia : cumulative flows 1989-1999 = 10,344 (per capita = 71).

Table IV. Current account balances (in % of GDP)

A. Most advanced countries	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999 estimates**
Poland	1,1	- 0,7	0,7	4,5	- 1	- 3,2	- 4,4	- 7,6
Hungary	0,9	- 9	- 9,4	- 5,6	- 3,7	- 2,1	- 4,9	- 4,2
Czech Republic	na	1,3	- 1,9	- 2,6	- 7,4	- 6,1	- 2,4	- 2
Estonia	na	1,3	- 7,3	- 4,4	- 9,1	- 12,2	- 9,2	- 6,2
Slovenia	7,4	1,5	4,2	- 0,1	0,2	0,2	0	- 3

B. Less advanced countries	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999 estimates**
Lithuania	-	- 3,2	- 2,2	- 10,2	- 9,2	- 10,2	- 12,1	- 11,2
Latvia	-	19,1	5,5	- 0,4	- 5,4	- 6,1	- 11,7	- 10,2
Bulgaria	- 4,2	- 10,1	- 0,3	- 0,2	0,2	4,2	- 0,5	- 5,5
Romania	- 8	- 4,5	- 1,4	- 6,3	- 8,8	- 6,8	- 7	- 3,4
Slovak Republic	-	- 5	4,8	2,3	- 11,2	- 10	- 10,1	- 5,7