Robert Schuman Centre

The Economic Accession Criteria for EU Enlargement: Lessons from the Czech Experience

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I. Introduction*

The Czech Republic is one of the ten Central and East European countries (CEECs) which has applied for EU membership.[1] In July 1997 the EC Commission presented its Opinions on the applications for membership; and in its communication, *Agenda 2000*,[2] it recommended that membership negotiations begin with the Czech Republic, Estonia, Hungary, Poland and Slovenia.[3]

At the December 1997 European Council in Luxembourg it was decided to open negotiations with these five countries and with Cyprus. This decision could, however, be modified prior to the first wave of enlargement if additional CEECs are considered ready for membership, or if some of the present front-runners appear to be backsliding. In particular, the order of the accession queue may be adjusted in the light of the regular reviews of the applicant countries carried out by the Commission.[4] The fact that any enlargement must be ratified by all EU member states suggests that there may be strong practical reasons to proceed with enlargement in groups rather than country by country.

The 1994 European Council at Essen decided in favour of a pre-accession strategy to help the CEECs prepare to join the EU. In Agenda 2000, the Commission proposed that this pre-accession strategy be reinforced by the adoption of "Accession Partnerships". These would entail additional assistance from the PHARE Programme,[5] as well as transfers to all ten CEEC applicants

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1 Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

2 EC Commission (1997a). For the sake of convenience this document shall be referred to in the text and notes as *Agenda 2000*.

3 Malta has suspended its application.

4 The condition that these are carried out on request of the applicant country implies that these reviews are not automatically annual.

5 The PHARE (Poland/Hungary Aid for Economic Reconstruction) Programme entails aid for economic and political transition and has been in operation since 1989. The name is somewhat misleading, since the Programme has been extended to all the CEEC applicant countries. Under the Accession Partnerships, assistance through the PHARE Programme would be more focused with, for instance, greater emphasis on the need to improve infrastructure, and administrative capacity.

through the Common Agricultural Policy (CAP) and Structural Funds prior to accession.[6]

The Copenhagen European Council of June 1993 laid down certain conditions for enlargement:

- *the applicant state must have a functioning market economy with the capacity to cope with competitive pressures and market forces within the Community;*

- *the applicant state must have achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;*

- *the applicant state must be able to take on the obligations of membership, including adherence to the aims of economic and monetary, and political union.*

The Copenhagen European Council also stipulated that enlargement is subject to the condition that the EU is able to absorb new members while maintaining the momentum of integration.[7]

The requirement that the applicant countries be able to fulfil "obligations of membership" is generally taken to mean their ability to adopt the *acquis communautaire*.[8] *Agenda 2000* (p. 45) presents a framework for this task which includes implementing the provisions of the Europe Agreements,[9] adopting the programme for regulatory alignment with the Single European Market as set out by the Commission's 1995 White Paper,[10] and taking on other aspects of the

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6 For a more detailed account see *Agenda 2000*, in particular its Table 4, p. 76.

7 European Council in Copenhagen, 21-22 June 1993, Conclusions of the Presidency, SN 180/93, p. 13.

8 The *acquis communautaire* is the body of EU legislation, practices, principles, and objectives accepted by the member states. It is composed of the Treaties (and, most importantly, the Treaties of Rome, the Single European Act, the Maastricht Treaty and, following ratification, the Amsterdam Treaty); legislation enacted at the EU level and judgements of the European Court of Justice; Justice and Home Affairs; Foreign and Security Policy and Treaties of the EU with third countries. The *acquis* has been accumulating over the years and now amounts to some 12,000 legislative acts.

9 All ten CEECs which have applied for EU membership have signed Association (Europe) Agreements with the EU. The Agreements include provisions for trade liberalisation (see Section IVb below), political dialogue and legal approximation (which is discussed in Section Va).

10 EC Commission (1995) *Preparation of the Associated Countries of Central and Eastern Europe for Integration into the Internal Market of the Union.*

acquis in areas such as agriculture and the environment. The applicant countries are also required to ensure effective implementation of the *acquis*, which entails substantial changes in their administrative and judicial capacities.

When accession negotiations began in March 1998 the Commission began to "screen" the applicant countries to assess their progress in taking on the *acquis,* and quickly learned that the scale of the task had been seriously underestimated. Both *Agenda 2000* and the Commission's proposals of March 1998 for the 2000-2006 financial perspective were based on the working assumption of five CEECs entering the EU in 2002. At present, there is a widespread (if unofficial) conviction on both sides that the first wave of Eastward enlargement will take place later.

One of the consequences of the screening process is that at least with regard to the first-wave countries, there has been a shift in emphasis towards fulfilling the "obligations of membership" and away from the other Copenhagen accession criteria. The speed and progress of accession negotiations now appears to depend primarily on the ability of a country to adopt and implement the *acquis*.

The question which then arises concerns the utility of the Copenhagen criteria. To clarify discussion of this question, we shall take a single CEEC as a case study. The Czech Republic has been chosen, not only because it is one of the front runners in the transition process (see also Tables 1 and 2 in the Appendix), but also because of its unique (and ultimately unsuccessful) experience among the CEECs in trying to maintain a fixed exchange rate over a long period.

To date relatively little research has been carried out on the problem of trying to reconcile the two main items on the EU agenda: EMU (Economic and Monetary Union) and enlargement. One of the aims here is to indicate the specific difficulties posed by EMU for the transition economies.

The present analysis is limited to the economic criteria for accession set by the Copenhagen European Council[11] and progress in taking on the *acquis*. Section II considers criticisms of the way in which the criteria are being applied, while Section III deals with the question of whether the applicant country has a functioning market economy. Section IV will discuss the ability of the applicant to cope with competitive pressures and market forces within the EU. Section V considers the task of taking on the obligations of membership, with Section Va dealing with the *acquis*, and Section Vb discussing the

[11] For a discussion which includes the political agenda see Senior Nello and Smith (1997).

objective of EMU. Section VI deals with the question of whether the EU can absorb new members while maintaining the momentum of integration, focusing on enlargement's implications for the EU's most costly policies, the Common Agricultural Policy (CAP) and the Structural Funds.[12]

II. The accession criteria

The accession criteria are presumably intended to provide some kind of objective basis for selecting those CEECs ready to join the EU, while indicating to the applicant countries the tasks they are expected to perform. However, the simple deduction that "when a CEEC meets the accession criteria it can join the EU" is misleading, for the EU reserves considerable discretion in deciding whether the accession criteria have been met.[13] This discretion arises from:

- the number of criteria;
- the wide-ranging and vague nature of certain criteria;
- the failure to indicate the relative importance of the criteria, and
- the expectation that a given CEEC demonstrate not only its ability to meet the accession criteria at a particular moment, but rather its ability to do so on a sustainable basis.

Although *Agenda 2000* and the Opinions on the applicant countries do provide an indication of how the Commission is interpreting the criteria, much ambiguity remains. This ambiguity means that countries excluded from accession negotiations or relegated to a lower place in the accession queue may argue that the lack of objectivity of the criteria permits political manoeuvring by the EU. In the absence of unambiguous criteria, when the EU relegates a country to signal the need for improved performance, it may provoke a backlash against European integration.[14]

Various instances of the ambiguous nature of individual criteria can be cited. For instance, it is not immediately obvious how to interpret the phrase that the CEECs should have a "functioning market economy" in order to cope with competitive pressures. If a "functioning market economy" is taken to refer to a textbook case in which adjustment is swift and painless, it is clear that it

12 Although not considered here in detail, the issue of reform of EU institutions is crucial in this context. For discussions of this issue see CEPR (1992), Baldwin (1994), and Senior Nello and Smith (1997).

13 It is interesting to draw a parallel with the other main programme of the EU (EMU), where criteria were also set and were subsequently interpreted in a discretionary way, even though there was far less scope for discretion than with the Copenhagen criteria.

14 Both Turkey and Slovakia represent negative examples in this respect.

will ensure capacity to cope with competitive pressures. However, in this case the extent of transformation required of the CEECs would be excessive, taking them far beyond the situation in present member states whose "functioning market economies" are subject to rigidities in both product and factor markets. The question therefore becomes one of the degree of adjustment which is necessary to ensure the "functioning" of a "market" economy.

Assessment on the basis of capacity to cope with competitive pressures within the EU is also extremely complex, requiring not just a comprehensive evaluation of present economic performance, but also predictions concerning future developments. An enormous amount of analysis is required in order to decide which sectors and which CEEC firms are likely to survive in an enlarged EU. In the absence of a complete picture of the situation, the assessment how well a CEEC will respond to competitive pressures involves a large element of guesswork.

Enlargement is also subject to the condition that the EU must be able to absorb new members while maintaining the momentum of integration. The EC has already experienced "Eurosclerosis" of the 1970s and early 1980s, when the energies of the Community were dissipated in arguments over the level of agricultural price support and the relative contributions of member states to the EC Budget. Because enlargement will require fundamental changes in the CAP, the EU Budget and the Structural Funds (though such changes would probably be necessary anyway), there is a real risk that the EU will return to a situation of internal dissension.

The onus is therefore on the EU to ensure that operable policies and institutions are in place <u>before</u> enlargement takes place, but the applicant countries must for their part adopt appropriate policies during the pre-accession period. As will be shown in Section VI, the difficulty lies in identifying which policies are "appropriate".

A further problem is the division of the tasks requested of the applicant countries into pre-accession or post-accession requirements. In some areas, such as social and environmental measures, the adjustment required of the CEECs prior to accession would seem excessive. [15]

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15 This issue is taken up briefly in Section V below. See Orlowski and Mayhew (1997) and Smith, A. et al (1996) for more detailed treatment.

III. Developing a functioning market economy

To assess the extent to which the CEECs have developed functioning market economies, *Agenda 2000* lists a number of conditions:[16]

- equilibrium between demand and supply is established between the free interplay of market forces; and prices and trade are liberalised;
- there are no significant barriers to market entry or exit;
- the legal system is in place;
- there is broad consensus about the aims of economic policy, and
- the financial sector is sufficiently well developed.

According to the Commission's Opinion, a functioning market economy is "largely in place" in the Czech Republic and, in particular:

> *" ...the privatisation process is almost complete....The legal and institutional features of a market system have largely been adopted: property rights are being defined....there are no significant administrative controls blocking entry to the market; and the banking sector has been reformed to some extent".* [17]

The Commission document does qualify this assessment, saying:[18]

> *"... it is not clear that all market institutions are as yet sufficiently strong or completely operational. Two main examples are the financial and capital markets".*

The Commission rightly points out that it is precisely in the requirement that market institutions should be operational that some of the major shortcomings in Czech performance arise. Although appropriate legislation is being passed relatively quickly, it is important to ensure that the legislation is enforced and operates effectively.

In two particular areas the implementation of legislation supported by appropriate institutions would appear incomplete in the Czech Republic:

- *Privatisation (and the definition of property rights).* Privatisation was not (or should not have been) considered an end in itself, but rather as a means to furthering other objectives, including that of increasing the efficiency of firms.
- *Transformation of the financial sector.* The Commission's Opinion points to this as a weak aspect of the Czech transition. However, it is useful to discuss

16 *Agenda 2000*, p. 42.

17 EC Commission (1997b, p. 29).

18 EC Commission (1997b, p. 29).

explicitly the consequences of the slow transformation of financial and capital markets, because the Czech experience illustrates its possible implications for the overall process of economic and political transition.

A. Privatisation and the problem of corporate governance

The operation of the Czech economy is profoundly affected by a system of complex and confused ownership relations arising from the incomplete nature of the privatisation process, as well as by the predominant role played by the banks in the Czech economy.

In the Czech Republic privatisation relied on a variety of techniques including property restitution, direct sales, auctions and public tenders, as well as the mass privatisation scheme through the voucher system. The voucher scheme was a "self-consciously Czech undertaking" (Vachudova, 1998, p. 15) designed by Klaus's economic team, and was even discouraged by certain Western actors such as the IMF and World Bank.

The mass privatisation scheme appeared to offer advantages in terms of speed,[19] distributional fairness, and popular support. Although it meant foregoing government revenue, the voucher scheme seemed a way of overcoming the shortages of domestic liquid assets and of bypassing some of the difficulties in valuing state enterprises.

The privatisation of most large-scale state enterprises took place in two waves.[20] The first was launched in the former Czechoslovakia in 1992 and was complete by mid-1993. In the Czech Republic it involved sales of shares as well as the transfer of shares in some 988 firms through a voucher scheme.[21] The second wave began in the Czech Republic in 1994 and aimed at privatising a further 2000 firms through a mixture of sales and a voucher scheme.[22]

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19 For a more detailed discussion of this issue see Estrin, Nuti, and Uvalic (1998). As these authors illustrate, in general the implementation of mass privatisation schemes was much slower than expected.

20 For a description of these developments and a recent survey of privatisation in the CEECs see Uvalic and Vaughan-Whitehead (1997).

21 Unless otherwise stated, the statistics on privatisation are taken from European Bank for Reconstruction and Development (1997a, 1997b and 1997c).

22 As Estrin, Nuti, and Uvalic (1998) describe, the government prepared and published a list of enterprises to be privatised. Apart from the 3% equity which had to go to a restitution fund, in principle an enterprise could propose that the remaining 97% of its equity be privatised through the voucher scheme. According to Coffee (1996, p. 120) Czech enterprises used voucher privatisation to distribute 64% of their total stock value in the first wave of mass privatisation, and almost 70% in the second wave.

From being one of the most state-dominated economies of the Eastern bloc (together with the former GDR), by mid-1997 the private sector accounted for some 75% of Czech GDP. Although the amount of property privatised through the voucher scheme was lower than expected, it still amounted to some 25% of total state assets privatised (Takla, 1994, p. 161).

Initial fears that voucher privatisation would lead to excessive dispersion of ownership were not borne out, largely due to the role of the Investment Privatisation Funds (IPFs).[23] It is estimated that some 72% of privatisation vouchers were placed with the IPFs and used to buy shares in the first wave of mass privatisation, and 63% in the second wave (Estrin, Nuti and Uvalic 1998). Most of the investment funds were held by state-dominated banks and insurance companies. After the first wave of voucher privatisation, the IPFs become shareholders of a large number of enterprises, including financial companies and each other.[24] Cross-ownership was widespread, and this together with legal loopholes tended to encourage insider trading and fraud. [25]

The term "tunnelling" was coined to describe the financial operations by which the assets of IPFs, banks and enterprises were channelled to other firms owned by the same people. In this way, the managers were frequently able to enrich themselves at the expense of the legal owners, such as the shareholders of an IPF (Vachudova, 1998, p. 16).

A related shortcoming of the Czech method of privatisation concerns corporate governance of firms. In small firms, the owner is usually also the manager, and so corporate governance is relatively straightforward. The difficulty arises with larger firms, where the divorce between ownership and control necessitates monitoring to ensure that managers act in the best interest of the firm. The ability of owners to remove managers may also be required to ensure the efficient operation and restructuring of the firm.

There are two main models of corporate governance. The Anglo-American model relies on efficient financial markets with shareholder bids and the prospect of take-overs as a means of disciplining managers.[26] The German-

23 These could take the form of either joint stock companies or mutual funds.

24 The cross-ownership is partly the result of the restriction on the IPFs ownership to not more than 20% of the shares of a company, and the requirement that the holding in any one company cannot exceed 10% of the IPF's portfolio.

25 According to *The Economist* (19 April 1997), some 750,000 people or 7% of the population suffered losses as a result of the activities of the IPFs.

26 If managers are thought to be incompetent or inefficient this may be reflected in lower share prices. A persistently poor capital market performance may encourage a take-over bid.

Japanese model relies more on the relations between firms and their owners (often banks, which may hold a significant amount of shares) to monitor the behaviour of managers and the performance of the firm. [27]

The pattern which has emerged in the Czech Republic fails to correspond to either of these models. Lack of transparency has meant that trading on the Czech stock exchange has been thin, so discipline operating through transactions on financial markets has yet to emerge.[28] Complex ownership relations and weak regulation create few checks on the activities of the IPFs. The managers of investment funds are often less concerned with the profit maximisation and restructuring of the firm in which they own shares, than with siphoning off capital and appropriating profits. [29]

The lesson to be learnt from the Czech experience is not that voucher privatisation *per se* leads to problems of corporate governance. Countries such as Poland, Hungary or Croatia which have relied more heavily on direct sales have not achieved better results. Across the region, the shortage of domestic capital meant that sales took place at preferential conditions, often to employees or managers (often members of the *nomenklatura)*. These new owners were frequently less concerned with the maximisation of profits than with the survival of their own firm and the entrenchment of their own position, if necessary by lobbying politicians and bureaucrats.

The lesson is rather that until the financial system is adequately developed and an effective regulatory system is in place, difficulties in limiting

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Competitive product markets also limit the scope for X-inefficiency of the firm and hence the extent of damage that unconstrained managers may wreak (Estrin, 1997, p. 5).

27 In 1990 some 80% of firms in Germany had one shareholder with at least 25% of equity (Estrin, Nuti and Uvalic, 1998). The system of *keiretsu* involves an important role for financial institutions and cross-ownership in the monitoring and control of companies in Japan (Rothacher, A. 1993). The *keiretsu* (which means series, or group) may be vertical or horizontal. The horizontal *keiretsu* cover all the main activities required by the manufacturing process (finance, insurance, transport, warehouses, distribution, etc.) and all these services are provided exclusively by members of the group. Vertical *keiretsu* control key sectors of the Japanese economy such as automobile production and electronics. It is partly due to this system that the current banking crisis has such far-reaching consequences in the Japanese economy.

28 In 1997 measures to improve the regulation of capital markets were announced, including daily reports issued by the Securities Centre to improve the transparency of trading on domestic equity markets.

29 Owners can be assumed to have an interest in increasing the net worth of the firm, which implies the maximisation of profits. Managers are likely to be more concerned with their own goals such as job security, pay, fringe benefits, power and so on. A problem of asymmetry of information arises as the legal shareholders may not know enough to assess whether the managers are acting efficiently, or even honestly (Estrin, 1997, p. 4).

managerial discretion and ensuring effective corporate governance are likely to persist. Statements to the effect that economic transformation is complete (such as that of Václav Klaus at the end of 1995) would therefore seem premature.

B. The consequences of slow transformation of financial and capital markets

Reform of the financial system in a transition economy entails the creation of a two-tier banking system, with the establishment of an independent central bank, a commercial banking system, and financial markets for bonds and shares. In 1990 legislation was introduced to end the monobank system in the former Czechoslovakia, and in 1993 the Czech National Bank was established as a replacement for the former state bank of Czechoslovakia.

The Czech banking sector has grown rapidly, and in 1996 included 55 licensed commercial banks.[30] However, between 1994 and 1996 11 Czech banks failed. There have also been numerous financial scandals and instances of negligence and fraud, which were among the causes of the resignation of Prime Minister Václav Klaus and the fall of his centre-right coalition government in late 1997. The two underlying sources of the fragility of the financial system are the failure to introduce much-needed regulation of the emerging financial market; and the unclear pattern of ownership in the partially privatised system, which led to perverse incentives and conflicting objectives.

Commercial banks in the Czech Republic consist of banks created through the separation of commercial activities of the former central bank, and of smaller, new banks frequently set up by enterprises at least in part to meet their own financial requirements.

A problem for the small, new commercial banks was that their management was sometimes "more interested in the financial problems of the enterprise which owns the bank than in preserving the bank's viability and increasing its profits" (OECD, 1996, p. 51). The slow development of sound accounting practices and the absence of an effective supervisory system meant that the precarious situation of some of these banks was often not immediately understood.

For several years the banks emerging from the former mono-bank system were only partially privatised, and the state continued to play an important role in the largest of these banks through the National Property Fund (NPF), or state

30 European Bank for Reconstruction and Development (1997a and 1997c).

agency responsible for privatising state assets.[31] Serious moves to fully privatise the main Czech banks had to wait until 1998.[32]

A major problem faced by the banks emerging from the mono-bank system was the legacy of "bad debts" of state enterprises that these banks inherited. Moreover, during the early years of transition all banks tended to take on dubious assets in order to increase their market share.[33] Enterprises were indebted to banks, and the banks were often called upon to decide who should receive state financing. As a result, in some cases the banks acted as owners, creditors and auditors of the newly "privatised" enterprises (Vachudova, 1998, p. 6).

There have been various interventions by the Czech authorities to meet the problem of bad debts, including a law in 1995 allowing banks to obtain tax relief on provisions against bad loans.[34] Apart from their high budgetary cost, these interventions encountered the problem of *moral hazard* in that the reluctance of banks to take on bad assets may be lessened by the prospect of being bailed out.[35]

Widespread diffusion of bad debts may also render the instruments of monetary policy less effective.[36] Even when monetary policy is tightened, the banks may continue to support state enterprises which are backed by

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31 The NPF maintained a minority ownership of 47% in *Komercní banka,* 43% of *Ceská Sporitelna* and 33% in the *Investicní a Postovní banka* (European Bank for Reconstruction and Development, 1997a, p. 147).

32 A 36% share in *Investicní a Postovní Banka* was sold to the Japanese Investment Bank, Nomura, and *Agrobanka* was sold to GE Capital. A tender was due to be issued for the sale to one investor of 51 per cent of the state's 66 per cent share in *Ceskoslovenská Obchodní Banka (CSOB).* Proposals for the privatisation of the other two largest banks, *Komercní Banka* and *Ceská Sporitelna* were still being discussed (*Financial Times,* 14 May 1998). The process of privatisation was slowed down by the debate about whether the state should first recapitalise the banks and take over their bad debts, and by the dispute concerning the share of Slovak holdings in the *Komercní* and *Ceskoslovenská Obchodní* banks.

33 OECD (1996, p. 52).

34 Earlier measures include the Czech and Slovak Ministries of Finance directly taking over loans amounting to 13.3 billion kcs from the *Investicní a Postovní banka* in 1992. In 1994 the Czech government allocated 7 billion kcs for *Agrobanka, Komercní banka* and *KOB* to write off bad loans of state enterprises to be restituted to former owners.

35 To meet these difficulties, Rodlauer (1995, p. 104) argues that an effective strategy to tackle the problem of bad debts should: strengthen enterprise discipline and discourage firms from taking on further bad loans; create a new banking philosophy whereby banks choose and monitor clients carefully; and evolve an overall framework for dealing with bad debts which includes bank recapitalisation through the state budget.

36 See Zecchini (1995) for a description of how this may occur.

government guarantees. Substantial increases in the price of credit may therefore fail to limit credit expansion and may mean that small private firms are crowded out as an increasing share of credit goes to the large state enterprises.

The existence of bad debts may also have contributed to the high interest rate spread between credits and deposits in the Czech Republic, thereby adding to the cost of borrowing to set up new firms or restructure existing ones, and slowing down the transition process.

In 1996, the Czech National Bank announced measures to consolidate the banking system and improve the balance sheets of smaller banks. Banks were required to increase their share capital to cover problem loans. In 1998, a Securities and Exchange Commission was established in order to bring greater transparency to the stock exchange and reduce the opportunities for insider trading. Legislation was also passed to force investment funds to sell off portions of their holdings, and banks were ordered to separate their asset management businesses from their lending operations and to reduce the maximum share they can hold in industrial enterprises to 50%.[37] However, it was generally agreed that rebuilding confidence in the Czech capital market would be a lengthy process as it required changes not only in legislation, but also in institutions and commercial attitudes.

A question linked both to the issue of corporate governance and to the role of the banks is the significance of barriers to market entry or exit. Anti-trust measures can play an important role in this context. The Europe Agreements committed the CEECs to adopting competition policies compatible with those of the EU, an objective which was further specified in the 1995 White Paper.[38]

Here as elsewhere, EU pressure to force measures which are unpopular, but essential to the transformation process, may provide reforming governments with a useful excuse. The need to bring legislation in line with that in EU countries in areas such as the control of state aids can provide CEEC governments with a strong justification for resisting rent-seeking by producers.

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37 *Financial Times*, 14 May 1998.

38 The White Paper refers to Articles 85, 86 and 90 relating to competition rules, and Article 92 concerning state aids. Although taking on a ready-made legal system avoids a long process of trial and error may have advantages, it also runs the risk that the imported system will not suit the specific needs of the transitional economy.

IV. Coping with competitive pressures within the EU

It is anticipated that with removal of trade barriers upon accession to the EU, many firms in the CEECs whose output was formerly destined for the domestic or eastern markets will be unable to survive. This problem is addressed by the Copenhagen criterion on competitive pressures.

In assessing whether an applicant country meets this criterion, what is required is no less than a comprehensive, sector-by-sector analysis of the present economic performance of that country and its likely future performance in an enlarged market. This is a mammoth task requiring analysis on the scale of the Cecchini Report. Although discussion of capacity to cope with competitive pressures occupies a large part of the Commission's Opinions on the applications of the CEEC countries, the analysis is inevitably piecemeal and incomplete.[39]

Given the unavailability of satisfactory analyses, the question arises as to whether the ability to assess a CEEC on the basis of this criterion truly matters. The risk is that if too many CEEC firms are unable to compete in an enlarged EU market, widescale bankruptcies and unemployment could result. This would lead to widening income disparities and could add to migratory pressures in an enlarged EU. The proposed ceiling on transfers under the Structural Funds (according to which transfers cannot exceed 4% of the recipient country's GDP) means that financial assistance from the EU would be relatively limited. Moreover the stabilisation programmes of these countries and their ultimate aim of taking on the objective of EMU means that tight financial discipline is likely to continue. There therefore seems a strong case for further research on the issue of competitiveness in order to identify appropriate indicators of progress in preparing for accession.

A. Indicators of ability to cope with competitive pressures

Agenda 2000 (p. 43) lists a number of factors which should be taken into account in assessing the ability of CEEC firms to compete in a wider EU market:

- the existence of a functioning market economy with a sufficient degree of overall macroeconomic stability;
- sufficient human and physical capital, including infrastructure;

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39 A further difficulty arises from the standardised and rather bureaucratic language used to assess the applicant countries in the Opinions. For example, individual CEECs are described as achieving "substantial success" or needing "further progress" or "substantial efforts", expressions with the ring of a school report.

- the extent to which government policies influence competitiveness through trade policy, competition policy, state aids etc.;
- the degree of trade integration achieved before enlargement, and
- the share of small and medium enterprises in the economy.

A number of items which the EU should take into account, could be added to this list.

- the degree of restructuring and modernisation of declining industrial sectors such as coal, steel and agriculture;
- success in developing industries characterised by growing demand and high technology which are at the core of an information society;
- ability to adopt internationally accepted norms and standards;
- widening of the industrial base and the diffusion of small and medium enterprises;
- progress in privatisation and the introduction of an adequate legal framework with regard to property rights, contracts, competition and company law;
- the evolution of the banking and financial sectors;
- demonopolisation and/or the development of a suitable regulatory framework for sectors dominated by former state-owned enterprises, such as energy and telecommunications;
- the introduction of measures to encourage research and development;
- developments in wages and productivity;
- measures to promote investment, and, in particular, foreign direct investment (FDI), and
- exchange rate developments.[40]

Apart from the Commission's Opinion, other studies of these issues in the context of the Czech Republic include those carried out by the OECD (1996), the European Bank for Reconstruction and Development (1996, 1997) and the Economist Intelligence Unit (1996). The following conclusions emerge:

- The shortcomings of the privatisation process and the role of the banks and IPFs (described above) may have slowed down the restructuring process. Banks are reluctant to force companies controlled by their funds into bankruptcy, while investment funds hesitate to sell companies for fear of losing contracts and loans for their bank. This might help to explain the relatively low level of bankruptcies and an unemployment rate of only 3.5% in 1996, and 5% in 1997.[41]

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40 This issue is discussed in more detail in Section V below.

41 In a transition economy a low unemployment rate may either reflect slow progress in labour-shedding or ability to absorb labour in the growing private sector.

- Like the other CEECs, the Czech Republic faces the task of reducing the share of GDP represented by sensitive sectors. The sensitive sectors are generally defined as: agriculture, textiles, clothing, coal, footwear, steel and chemicals.[42] These are the sectors which tend to be characterised by overproduction at a world level, and the present EU members are committed to concerted efforts at reduction of capacity in sectors such as steel and agriculture.

  As can be seen from Table 3, raw material processing, including metallurgy, continues to play an important role in the Czech economy.[43] The Czech Republic has the advantage *vis-à-vis* the other CEECs of a relatively small and declining role of the agricultural sector, accounting for only 5% of GDP in 1997.

  Czech production of textiles, clothing and leather has declined since 1989. Privatisation of these sectors has proceeded rapidly, and foreign direct investment has played an important role in modernising production methods. To date relatively low labour costs and widespread use of OPT (outward processing trade) have enabled the Czech Republic to maintain exports to the EU (see Section IVb below).

- FDI is playing a crucial role in increasing productivity in certain sectors such as information technology, telecommunications, the machinery and equipment industries and the automobile industry.[44] Tables 4 and 5, and Figure 1 of the Appendix provide data on FDI in the Czech Republic. A significant share of this FDI has been concentrated in a small number of

42 The inclusion of chemicals among the sensitive sectors is justified by the large share of EU anti-dumping measures in this sector, but it is not accepted by all authors. For instance in CEPR (1992) chemicals are not included in the list of sensitive sectors.

43 The steel industry provides an interesting example of difficulties which may be encountered in the restructuring process. According to the OECD (1996), after rapid increases in output and exports in 1994, Czech production of crude steel grew by only 1.4% in 1995, while exports fell by 15% and imports grew by 69% in the same year. Two of the major Czech steel companies which were still state owned were working at only 50% of capacity in 1995. The reduced domestic production reflected disagreements over how to reduce capacity in the Ostrava Region and restructure before privatisation, as well as disputes with potential foreign investors over the future role of the state in the Czech steel industry. Subsequently a modernisation programme was agreed with backing from the International Financial Corporation of the World Bank for *Nova Hut*, the largest Czech producer, while an agreement on rationalisation of capacity was reached for the *Vitkovice* steelmaker (*Financial Times,* 1 December 1997).

44 FDI can play a crucial role in assisting structural adjustment as it generally involves a transfer of technology, management techniques and of marketing skills. Other firms in the CEECs may imitate these new techniques, enabling them to percolate through the economy.

very large investments. Two notable early cases were the investment of VW in Skoda Auto,[45] and Philip Morris in the tobacco industry. At the same time, according to the OECD,[46] there was foreign participation in as many as 13,000 enterprises in the Czech Republic.

- In some sectors, relatively cheap labour has enabled exports to continue despite low productivity. However, wage increases exceeded productivity improvements in the early 1990s,[47] though there was a reversal of this trend in 1997.[48] In 1997 Czech wages were second only to those of Slovenia among the CEECs.

  Incomes policy was introduced as an integral part of the IMF-agreed stabilisation programmes in the CEECs, but has proved extremely controversial. [49] For instance, after being modified in previous years, tax-based wage regulations in the Czech Republic were finally abolished in 1995. The system had involved enterprises being penalised if wages rose more than 5%; but, according to the OECD (1996), this threshold became a target even for firms which could not afford such increases.

- Until May 1997, nominal currency stability combined with higher inflation than in other OECD countries led to a loss of competitiveness of Czech exports due to real appreciation of the koruna.

- The Czech transport infrastructure is better than that of other CEECs, but increased capacity for road and air traffic remains necessary. Expansion and modernisation of the telecommunications networks is underway, but will take some time to complete.

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45 Following the take-over of Skoda Auto by VW, in 1995 car production reached 200,000 units, almost half of which were exported to the EU (EC Commission, (1997b, p. 67).

46 OECD (1996), p. 76.

47 Part of the difficulty arises from the relatively low jobless rate (5.5% at the end of March 1998), particularly in Prague, where the unemployment rate was 1.19% in March 1998 (Economist Intelligence Unit).

48 In 1997 productivity grew by 6.2% and real wages by 5% (Economist Intelligence Unit).

49 The model for IMF-agreed stabilisation programmes in the transition economies was the Polish Balcerowicz Plan which came into effect from 1 January 1990. Subsequently other transition countries (including Czechoslovakia, Bulgaria and Romania at the beginning of 1991) introduced similar stabilisation programmes. The main elements of these programmes were: rapid and almost complete price liberalisation; restrictive monetary and credit policies; tight fiscal discipline, and the wide scale elimination of price subsidies; substantial trade liberalisation; incomes policies; privatisation; and the reform of the banking and financial systems.

- Further measures to improve the environment are urgently required, but these could increase production costs.

B. The degree of trade integration achieved before enlargement

As a result of the provisions of the Europe Agreements, a free trade area in manufactured products (and to some extent services) will be in place before enlargement, though the treatment of agricultural products has been less favourable.[50] The Europe Agreements permit the continued use of "contingent protection", or anti-dumping and safeguard measures in EU-CEEC trade, and this has been the source of great contention with the CEECs. The EU has made it clear that it will not consider eliminating its commercial policy instruments until the CEECs have applied the *acquis communautaire* governing competition policy and state aids fairly comprehensively.

The creation of a customs union with acceptance of the Common Commercial Policy (CCP) and full integration into the Single Market will have to wait until accession. A major difference between a free trade area and a customs union is that the former requires rules of origin. These may be complex to administer, and the regulatory uncertainty to which they give rise means that market access is conditional.

Accession to the EU therefore implies improved treatment with regard to rules of origin, contingent protection, and access to EU markets for agricultural products (though, as discussed below, the details of how the CAP is to be extended to new CEEC members has yet to be worked out).

Tables 6-9 of the Appendix present data on Czech trade. As can be seen from the tables, after 1995 there was a deterioration of the Czech trade and current account deficits. This was largely due to real appreciation of the koruna, an economic slowdown in the main Czech export markets, and higher imports as a result of strong household demand driven by wage increases. In 1997 there was some improvement, and the annual trade deficit of $4.7 billion was substantially less than forecast.[51] This improvement was due to the recovery of west European economies, which increased Czech exports, and to the depreciation of the currency (by 12% in May 1997 when a floating exchange rate was introduced).

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50 In most cases the Agreements fixed a quota, rising in time, of EU imports of various agricultural products from the CEECs on which import levies and tariffs are gradually reduced. In general the concessions entailed a 10% increase in quota each year for the first 5 years, with a levy or tariff reduction of -20%, -40% and -60% in the first three years, subsequently frozen.

51 *European Economy*, Supplement C, April 1998.

From Table 7, which disaggregates trade according to major category, we see that machinery and transport equipment and miscellaneous manufactured articles appear to have been performing best, and this trend appears to have been confirmed in 1997.[52] It also appears that the Czech Republic is succeeding in shifting to higher value added exports in these sectors.[53]

Though a more disaggregate and detailed analysis would be necessary, it appears that many of the firms and sectors with a positive export experience have either managed to attract FDI (automobiles, televisions and certain other telecommunications products etc.) or produced in accord with special arrangements (such as outward processing in the case of textiles and clothing).[54] According to a survey carried out by Czechinvest in November 1997, foreign groups accounted for about 40-50% of Czech exports of manufactured goods.[55]

A further important development in Czech trade with the EU is the rising share of intra-industry trade, which rose from 61% in 1994 to 65% in 1995.[56] This is generally explained in terms of imperfect competition and economies of scale. As economies become more advanced they tend to become more similar in terms of technology and resources. As a result, intra-industry trade arising from economies of scale in the production of differentiated products tends to become more important relative to inter-industry trade based on comparative advantage.

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52 *European Economy,* Supplement C, April 1998.

53 *Financial Times,* 1 December 1997.

54 In 1996, on the basis of Eurostat data, the CEEC(10) accounted for 47.8% of the EU's outward processing trade with third countries for a value of 6.1 billion ECU. The Czech Republic accounted for 16.6% of EU outward processing trade with the CEEC (10) and was in third position after Poland (30%) and Hungary (18 %), being closely followed by Romania (16.5%).

55 *Financial Times*, 1 December 1997.

56 Intra-industry trade can be defined as the simultaneous export and import of products which are close substitutes for each other, or, in other words, two-way exchange of goods within standard international trade classifications. The estimates are taken from *Eurostat Statistics in Focus. External Trade 1996,* Nos. 7. and 13. The difficulties with this concept are discussed in Section Vb below. The estimates in the text are based on the Grubel Lloyd intra-industry index:

$$\frac{(X_i+M_i) - |X_i-M_i|}{(X_i+M_i)} \times 100$$

The index is calculated using the SITC divisions 00 to 99. Its value varies between 0 (the two countries are specialised in different product categories indicating inter-industry trade) and 100 (the countries are specialised in the same product chapters indicating intra-industry trade).

V. Taking on the obligations of membership

A. Progress in adopting the *acquis communautaire*

Though a detailed analysis of the ability of the Czech Republic to adopt the *acquis* is beyond the present scope, a brief discussion of the issue is necessary in view of the growing importance it is assuming as accession negotiations proceed.[57]

In *Agenda 2000* the Commission outlined a three-stage framework for the adoption of the *acquis* on the part of the applicant countries:[58]

- implementation of the Europe Agreement, in particular with regard to trade, national establishment, intellectual property and public procurement;

- progress in transposition and effective implementation of the measures set out in the 1995 White Paper and, in particular, those relating to key aspects of the Single Market such as banking, public procurement and taxation, and

- ability to take on other aspects of the *acquis*. Areas singled out for attention include the environment, agriculture, energy, industry, telecommunications, transport, social affairs, customs administration and Justice and Home Affairs.

The Commission has also referred to the need to go "beyond the *acquis*" in certain areas such as nuclear safety and criminal justice.

Ability to implement the *acquis* requires modernisation of the administrations of the applicant countries as well as "properly trained and remunerated administrators" (*Agenda 2000*, p. 46). It is also necessary to ensure that regional and local government will be able to put EU measures (such as the Structural Funds) into effective operation.

The judicial system must be reformed to ensure enforcement of law, which will entail retraining (or replacing) certain judges. The courts must be in a position to apply EU law upon accession, and should accept its underlying principles, such as the primacy of EU law over national legislation. The difficulty of this task should not be underestimated, since, as Hoskova (1998)

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57 For more complete treatment of the ability of the Czech Republic to take on the *acquis* see EC Commission (1997b).

58 *Agenda 2000*, p. 45.

describes, some of the CEEC constitutions contain terms such as the "sovereignty of the people" or "sovereignty of (national) law" which appear to run counter to the aim of transferring part of the state's sovereignty to a supra-national organisation. [59]

According to *Agenda 2000* (p. 46), the Czech Republic has run into difficulties in implementing the Europe Agreement. Particular difficulties have included the introduction of an import deposit scheme, which had to be suspended in August 1997 after heavy criticism from both the EU and World Trade Organisation (WTO).[60]

With regard to the White Book, the Czech Republic was said to be "making satisfactory progress", and Table 10 in the Appendix indicates the situation with regard to transposition of White Book measures in 1997.

In its inimitable language, *Agenda 2000* (p. 46) maintained that "efforts needed to be continued" if the Czech Republic is to adopt the main part of the *acquis* in the medium term. Agriculture, energy and the environment were singled out as demanding "particular efforts".

In *Agenda 2000*, the Commission ruled out the possibility of partial adoption of the *acquis*, and thus in principle removed it from the agenda of negotiators. The simple adoption of the entirety of the *acquis* seems to have become the primary condition for accession. However, this position would seem questionable on a number of counts:

- Present EU members and the CEECs are treated differently. Previous enlargements have been accompanied by modifications to the *acquis*, and on frequent occasions present member states have challenged parts of the *acquis*.

59 This is also true of some of the constitutions of present EU member states. Also on this point there seems an asymmetry between the obligations the EU expects the applicant countries to take on with regards to the *acquis*, and what is tolerated from existing member states.

60 As described in European Bank for Reconstruction and Development (1997b), the Czech Republic has adopted a policy of relatively rapid trade liberalisation, and in 1997 the average level of tariffs on imports was reduced from 3.8% to 3.2%, in line with commitments in the Europe Agreement and to the WTO. The Czech import deposit system was introduced in April 1997. The system covered about 30% of Czech imports, and required importers to make a deposit of 20-60% of the value of imports. The deposit was returned after 180 days, but acted as a *de facto* import tariff estimated at 1-3% (*Agra Europe East Europe*, September 1997).

- Taking on EU legislation wholesale may not always be in the best interests of transition. As Grabbe (1998, p. 5) argues, development goals and accession requirements may not always be synonymous. As EU requirements for membership have become more detailed, and aid has been focused on accession requirements, the EU's emphasis seems to have been increasingly on ensuring conformity to its norms.

- In some areas there are difficulties in establishing the actual content of the *acquis*. For example, Justice and Home Affairs poses difficulties as most of the provisions adopted under this pillar are not legally binding. Further uncertainties arise from the Amsterdam Treaty's commitment to bring the Schengen Agreement under the auspices of the EU. The *acquis* is constantly evolving and presents a moving and not always clear target for the CEECs.

- The insistence that the CEECs take on all of the *acquis* diverts attention from the need to establish a hierarchy in the tasks to be performed. In particular, more care should have been taken in dividing the tasks between the pre- and post-accession periods.[61]

B. Adherence to the aim of Economic and Monetary Union

1. The Maastricht criteria

As the Commission's Opinion points out, it is premature to judge whether the Czech Republic will be able to participate fully in the third stage of EMU at the time of its accession. [62] This will depend on whether structural transformation has progressed far enough to enable the Czech Republic to meet the Maastricht convergence criteria on a sustained basis. [63]

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61 For example, legal approximation of social policy is aimed at ensuring the operation of a "level playing field" and avoiding the risk of social dumping. However, Smith, A. et al. (1996, pp. 5-6) argue that social and environmental policy areas should probably not be harmonised prior to accession. Doing so would require the CEECs to accept tighter obligations than existing member states. For example, in 1989 the UK opted out of the Social Charter, and many derogations have also been granted for expensive environmental regulations.

62 EC Commission (1997b. p. 113).

63 The Maastricht Treaty spelt out five criteria:

i) Successful candidates must have inflation rates no more than 1.5% above the average of the three countries with the lowest inflation rate in the Community.

ii) Long-term interest rates should be no more that 2% above the average of that of the three lowest inflation countries. This is to ensure that inflation convergence is lasting, because otherwise higher expected future inflation in a country would be reflected in higher long-term interest rates.

iii) The exchange rate of the country should remain within the "normal" band of the exchange rate mechanism (ERM) without tension and without initiating depreciation for two

Difficulties arise in assessing whether the CEECs meet these criteria. The specific characteristics of transition economies means that appropriate data is not always available. For instance, the Maastricht criteria refer to public debt, but the legacy from the past means that in general official statistics in the CEECs are for <u>foreign</u> debt. The underdeveloped long-term capital markets in many of the CEECs means that data on long-term bonds is generally not available for these countries. Statistics illustrating the Czech experience are set out in Table 11.

However, there are also more fundamental difficulties in applying the Maastricht criteria to the transition economies, due in particular to the problem of "inertial" inflation (Andreff, 1997), and the implications of excessive fiscal discipline in these countries.

Inertial inflation can be defined as that arising factors related to economic transformation. Economic transformation may contribute to inflationary pressures in a number of ways: through price liberalisation, the dissolution of the CMEA trading system (and the consequent increase in energy prices), devaluation and increased public spending on infrastructure and unemployment benefits, wage indexation, and, in some countries, servicing of the public debt. As a result there may be increased inflationary expectations, which could prove self-fulfilling.

Although external discipline and "borrowed" credibility"[64] can play a useful role in CEECs (such as Bulgaria) where fiscal deficits are too high, as Tanzi (1993) explains there are various ways in which excessive concern for budgetary discipline might hinder transition. For example, if state enterprises lay off workers, government spending on unemployment benefits is likely to rise. To avoid this increase in spending, governments might encourage firms to

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years. At the time of the Maastricht Treaty the "normal" band referred to the margins of +/-2.25%, but since August 1993, in some circles it is now taken to refer to +/-15%.

iv) The public debt of the country must be less than 60% of GDP.

v) The national budget deficit must be less than 3% of GDP.

The last two are referred to as the "fiscal" criteria and are subject to an escape clause. A country may be granted a waiver if the gap between the actual and reference situation is "exceptional and temporary" or if the excess in public deficit or debt is declining "continuously and substantially". How seriously these criteria are being taken by candidates is evident from the case of Poland, where the constitution of 1997 introduced rules fixing the maximum levels of public deficit and debt at the Maastricht levels.

64 If governments exploit the temporary trade-off between inflation and unemployment and raise inflation to reduce unemployment, agents will come to expect them to do so and will predict a higher level of inflation. What is needed is a way of making commitment to lower inflation credible, and an independent European Central Bank committed to price stability may perform this function and bring about a lower rate of inflation. In this way the inflation-prone country may "borrow" credibility.

continue hoarding workers, which could render restructuring and privatisation more difficult. If a country devalues its exchange rate, its interest payments on foreign debt measured in domestic currency will rise, adding to government expenditure. If the foreign debt is large, a rigid limit on the budget deficit might cause the government to delay exchange rate adjustment.

Also on the revenue side is the possible trade-off between fiscal discipline and progress in transition. Transition entails reform of the fiscal system by replacing turnover taxes with taxes on income and value added, and by widening the tax base. The growth of a new, greenfield private sector (sometimes referred to as "organic" privatisation) was accompanied by widespread tax evasion. Attempts to crack down on tax evasion could force many of these small new firms from the market .

The creation of adequate social safety nets is a central element of the transformation process and this could lead to a substantial increase in government deficits. Failure to introduce appropriate measures could lead to hardship in the more vulnerable sections of society such as large families and pensioners.

2. Joining EMU

Even as non-participating countries, the CEECs would be obliged during Stage Three of EMU to follow rules relating to fiscal discipline, liberalisation of capital movements, and the coordination of economic policy.[65] Their central banks would participate in the European System of Central Banks (ESCB), and they would be obliged to ensure the independence of their central banks and accept the primary objective of price stability. Non-participating countries would, however, be allowed to conduct their own monetary policy, and would not be subject to the guidelines of the European Central Bank (ECB). Member States with derogations would have to participate in some form of exchange rate arrangement with participating countries, but they would not have to completely fix their exchange rate to the euro.[66]

Even if they do not participate fully in Stage Three, the CEECs would thus have to accept demanding obligations with regard to price stability and exchange rate stability. The lessons learnt in implementing the IMF-agreed macroeconomic stabilisation programmes in the CEECs could prove useful in this context. Although the IMF generally expressed a preference for fixed

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65 See Daviddi and Ilzkovitz (1996) for a discussion of this issue.

66 The most likely institutional framework would be a new European Monetary System (EMS II). Whatever form this takes, countries not fully participating in EMU are unlikely to be allowed to devalue their exchange rates unilaterally.

nominal exchange rates, the regime actually chosen varied from country to country.[67]

The Czech case proves a good example of the difficulty of attempting to peg the nominal exchange rate in a transition economy.[68] Initially (as was also the case in Poland) the magnitude of the devaluation prevented the exchange rate from acting as an effective anchor. Subsequently, nominal currency stability and a higher rate of inflation than in OECD countries undermined the cushion which an undervalued exchange rate provided in the early years of transition. The real appreciation of the exchange rate was not matched by increases in productivity, and Czech firms began to lose competitiveness. Strong speculative pressure emerged and the Czech Central Bank attempted to fight the speculative attacks using foreign exchange intervention and an increase of interest rates.[69] However, in May 1997 it was forced to switch to a managed float based on a target rate of 17-19.5 koruna per D-Mark.

In 1994 and 1995 the combination of a fixed exchange rate and the high interest rates implied by tight monetary policy also led to massive capital inflows into the Czech Republic. Poland and Hungary also experienced capital inflows, which increased the demand for domestic currency and rendered money supply targets harder to meet. As a result, for a time all three countries experienced pressure for currency appreciation despite rising current account deficits.

As Gabrisch (1997, pp. 577-580) explains, there are two reasons why the CEECs could encounter additional problems in trying to maintain fixed nominal exchange rates after accession. Firstly, the difficulties experienced by certain CEECs as a result of capital inflows could be repeated after enlargement as a consequence of transfers to these countries from the CAP and Structural Funds. Secondly, on the basis of OECD calculations there are considerable price disparities between the EU and the CEECs.[70] As might be expected, the greatest

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67 Initially Romania and Bulgaria decided to float because they lacked foreign exchange reserves, though on a number of occasions their central banks had to intervene. Bulgaria subsequently switched to a currency board, as did Estonia and Lithuania. Poland, Hungary, Slovenia and (from May 1997) the Czech Republic opted for managed floating.

68 A currency basket peg was first introduced in 1991. The composition of the basket was changed in 1992, and again in 1993 when the koruna's exchange rate was based on a basket made up of the dollar (35%) and D-mark (65%). Full convertibility of the koruna was implemented from 1 October 1995. The fluctuation band of +/- 0.5% was increased to +/- 7.5% in February 1996.

69 It is estimated that some $2 billion in reserves was spent in an attempt to maintain the fixed exchange rate system, (*Financial Times,* 1 December1997).

70 Macroeconomic price disparities are generally calculated with the help of purchasing power parities (PPPs). PPPs measure the cost of a comparable basket of goods and services in national currencies using the exchange rate. The comparative price level index is given by the reciprocal of the so-called exchange rate deviation index, i.e. the ratio of the exchange rate to

differences are generally in non-tradables, but among tradables, sectors such as agriculture and clothing with relatively high levels of protection are also the sectors with the largest price disparities.[71] With ongoing trade integration and the introduction of fixed nominal exchange rates in the CEECs after the enlargement, price adjustment to the higher EU levels could be reflected in real appreciation of CEEC currencies.

One of the arguments used in favour of EMU is that with high levels of integration the exchange rate instrument becomes less effective as an absorber of asymmetric shocks, i.e. disturbances which affect the countries involved in different ways. The exchange rate instrument operates by changing the relative price of output between two countries.[72] However, in the case of devaluation the domestic price of imported goods will rise. A higher level of integration between two countries (or groups of countries) implies a larger share of imported goods, so devaluation is likely to have a greater impact on the consumer price index in the importing country. The higher prices reduce real wages, and may lead to requests for increased nominal wages in the importing country. If these are granted, part of the effect of the devaluation is likely to be offset, with prices rising and output in the importing country failing to return to the level it had prior to the asymmetric shock. There is even a risk that repeated devaluations may lead to a wage-price-devaluation spiral.

As Tables 8 and 9 show, since 1989 the level of CEEC trade with the EU has been rising rapidly. Pressure for increases in nominal wages has also been growing in all these countries, and so it seems likely that wage-price reactions may reduce the effectiveness of the nominal exchange rate instrument in these countries. However, this should not be taken to imply that the exchange rate loses all of its usefulness in the CEECs. In practice wage and price reactions are unlikely to be immediate, and, as Artis (1994, p. 353) argues, at the very least devaluation can give governments a breathing space to introduce other policies.

PPP. According to Gabrisch (1997, pp. 579-580), with Germany as 100, the comparative price level indices at 1993 GDP were as follows: Hungary 50, Poland 38, Slovakia and the Czech Republic 28, Bulgaria and Romania 25, Estonia 23, Latvia 22 and Lithuania 16.

71 Taking Austria as 100, according to Gabrisch (1997, p. 580) the overall comparative price index for Poland in 1993 was 39.9, but, for example, the index was 44.3 for food, 47.1 for clothing, 19.2 for rent and energy, 49.7 for furniture and household effects, 22.8 for medical treatment, 55.5 for transport and telecommunications, 27.7 for recreation and education and 51.5 for other goods and services.

72 For instance, assuming that France is relatively intensive in the production of wine, and Germany is relatively intensive in the production of beer, an asymmetric shock could take the form of a health scare which leads consumers to start drinking more beer in place of wine. To meet this situation, assuming a system of fixed but adjustable exchange rates, the French franc might be devalued against the German D-mark, rendering French output cheaper relative to German output.

A further question which arises is whether a higher level of trade integration between the EU and CEECs will make asymmetric shocks more or less likely. A higher level of integration will probably lead to some convergence of consumer tastes and preferences. If this is the case, on the demand side the shocks would be more likely to affect all the partners, reducing the role for a shock-absorber such as the adjustment of exchange rates among the member states.

The implications for the production side are less clear. If integration leads to specialisation according to a Ricardian concept of comparative advantage, the economies of the EU member states will become less similar and thus more vulnerable to asymmetric shocks. At the same time, the growing share of intra-industry trade between the EU states and the CEECs could signify that the economic structures of the member states of an enlarged EU are converging and thus ever less likely to be affected by asymmetric shocks.

However, even here the issue is far from being clear-cut, since what appears as intra-industry trade may in fact disguise huge differences in quality. The concept of intra-industry trade has been challenged as being merely a statistical phenomenon since, in general, the measured level of intra-industry trade decreases as the level of disaggregation of data increases. What is needed in this context is further research into the distinction between vertical intra-industry trade (involving quality differences) and horizontal intra-industry trade (which is trade in genuinely similar products).

The cost of foregoing the exchange rate instrument will also be less if it could be replaced by alternative mechanisms. Such mechanisms could include wage-price flexibility and factor mobility, as well as EU or national measures such as regional or budgetary policy, which could be used to compensate regions or countries which have been adversely affected.

Wage-price flexibility implies that in the case of a permanent adverse asymmetric shock the real wages and relative prices in the affected country or region (if the production is concentrated in a particular area) will fall. There will be a strong incentive for workers to move to regions or countries where real wages are higher. Similarly, if there is sufficient capital mobility, capital will be attracted to regions where the remuneration of investment is higher. If factors of production were sufficiently mobile, this process would continue until differences in the remuneration of factors between regions were eliminated.

Much progress has been made in increasing factor mobility in the European Union, in particular with the 1992 Single Market Project; but while a considerable degree of mobility of capital has been achieved, this is far from being the case for labour. Labour mobility is also one of the most sensitive aspects of enlargement, given the widespread fear in existing EU member states that it could lead to large-scale westward migration and downward pressure on wages and higher levels of unemployment in the EU (15).[73] For this reason, there has been much debate about whether to introduce a transition period before allowing full labour mobility after the eastward enlargement, even though this runs counter to one of the fundamental tenets of the Internal Market Programme.[74]

In the case of a single country, if the demand for a good whose production is concentrated in a particular region falls, transfers from the government budget can compensate regional producers for the loss of income. At least in theory, EU regional or budgetary policies could be used in an analogous way to offset the repercussions of asymmetric shocks between the member states. However, both the size of the EU Budget (with a ceiling of 1.27% of EU GDP) and the limit of 4% of GDP on transfers through the Structural Funds (see Section VIb) severely restrict the ability of the EU to carry out this kind of stabilising role between member states in an enlarged EU.

73 Much of the recent literature suggests that migration in an enlarged EU will be on a manageable scale. This conclusion emerges either from a comparison with labour flows from South to North Europe over the 1950-70 period (CEPR, 1992) or from an analysis of the factors underlying the decision to migrate (Faini, 1995, and Faini and Venturini, 1994). Individuals have a preference for living in their own country for social, cultural and linguistic reasons, so an individual will only undertake migration when the wage differential is large enough to offset the non-monetary costs of migration.

74 The so-called "four freedoms" of movement of goods, services, labour and capital.

VI. The condition that the EU must be able to absorb new members and maintain the momentum of integration.

A. The Common Agricultural Policy (CAP)

In order to ensure that enlargement does not slow the integration process, *Agenda 2000* called for radical reform of the CAP. In March 1998, the Commission presented a modified version of the proposals, which entailed continuing in the direction of the 1992 MacSharry Reform.[75] The March proposals called for cuts in intervention prices for cereals by 20%, dairy products by 15% and beef by 30%, with farmers in the EU (15) being compensated for these price cuts through direct payments.[76]

An alternative proposal (Buckwell et al, 1997) recommends less reliance on compensatory payments (which should be temporary as they are, after all, meant to compensate for a one-off price cut) and increased use of payments to farmers for their role in rural development and environmental protection.

According to the estimates presented in Agenda 2000, the costs to the EU budget of extending the reformed CAP to the 10 CEECs would amount to 17.8 billion ECU over the 2000-2006 period.[77] However, *Agenda 2000* leaves a number of questions open with regard to agricultural policy.[78]

- When, whether, and what form of CAP reform will be introduced? In the past the EU farm lobby has proved itself extremely resistant to CAP reform. On this occasion as well it seems likely that EU farmers will organise

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75 Central elements of this reform were a 29% reduction in the target price for cereals and the introduction of direct payments to compensate farmers for their loss of income. In the case of large farmers the compensatory payment was conditional on the set-aside (i.e. leaving idle) a percentage of their land (initially 15%). The reform package also included measures for other product groups, such as a 15% reduction in intervention prices for beef, and the use of premiums per head of cattle to compensate farmers and to encourage less intensive means of beef production.

76 It was also proposed to continue milk quotas until 2006 and to set compulsory set-aside of land at zero.

77 This would consist of 0.5 billion ECU (rising to 0.6 billion ECU from 2002) in pre-accession aid, while new member states would receive a total of 6.2 billion ECU for market organisation measures (in particular for the dairy sector) and 7.6 billion ECU for rural development accompanying measures over the 2002-2006 period (*Agenda 2000*, p. 73).

78 Estimates of the cost of extending an unreformed CAP to the CEECs (which are generally presented on an annual basis) are far higher. For instance, according to Baldwin (1994), extra CAP spending as a result of the accession of the Visegrad Four, Bulgaria and Romania would be in the order of 23.2 billion ECU per year. For a survey of these estimates see Senior Nello and Smith (1997), p.76.

vigorous opposition to cuts in guaranteed support prices, even if these are accompanied by compensatory payments.[79]

- Will agriculture be subject to a transition period after enlargement, given the fears of EU farmers that they will not be able to cope with increased competition? Proposals to introduce a transition period are generally aimed at allowing CEECs more time to adjust to the higher levels of agricultural prices and the more stringent veterinary requirements and standards in the EU. In 1997 farm-gate prices in the CEECs were only in the order of 40-80% of EU levels, though the gap is narrowing.[80] However, it is difficult to see how transitional measures could operate without border controls between the EU(15) and the CEECs, which would (at least in principle) run counter to the Single Market.

- Why did *Agenda 2000* place so little emphasis on measures to improve farm structures, thereby missing an occasion to correct the long-standing imbalance between market and structural policies in the EU?

- Why are the proposals in *Agenda 2000* relatively detailed for certain products (cereals, dairy products etc.), but suggest little more than general aims for others (such as the Mediterranean products)?

- Will an enlarged EU manage to maintain its Uruguay Round commitments, in particular those regarding limitations on subsidised exports? [81] In the Uruguay Round, the CEECs were bound to zero, or very low, levels of export subsidies. A large share of CEEC agricultural exports are directed to the former Soviet Republics, but in the absence of export subsidies an increase in CEEC agricultural prices to EU levels is likely to undermine this export market.

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79 It is generally agreed that no reform will be attempted before the German elections of September 1998, and even subsequently the importance of the German farm vote for the CSU/CDU, in particular in Bavaria, could prove a major obstacle to change. Two of the main agricultural exporters in the EU, France and the Netherlands, may have an interest in reform as a necessary condition for reaching agreement in the next WTO negotiations, where pressure for further liberalisation of international agricultural trade is expected. For an analysis of the role of the farm lobby see *inter alia* Senior Nello (1984, 1997).

80 For a discussion of the differences in farm prices between the CEECs and EU, and of the prospects of convergence, see Buckwell et al (1994) and *Agenda 2000* (p. 50).

81 According to this agreement, the Aggregate Measure of Support (AMS) for agriculture had to be reduced by 20% compared with a base period of 1986-88, all non-tariff barriers on agricultural imports had to be converted into tariffs and reduced by 36% in the case of industrialised countries, while export subsidies had to be reduced by 36% in value and 21% in volume over six years and using a base period of 1986-90.

- Will direct income payments be extended to farmers in CEECs joining the EU? At least initially, the payments were introduced as compensation for the loss of income resulting from the reductions in price support implied by the MacSharry reform. As the Commission's Agricultural Strategy Paper and *Agenda 2000* argue, farmers in CEECs will not experience price cuts, and the application of these payments only to farmers could increase income disparities (*inter alia* favouring those who have already benefited from restitution programmes) and create social unrest. Moreover, extension of these payments to the CEECs would seem to run counter to the obligations of the GATT Uruguay Round.[82] There would therefore seem to be a case for concentrating expenditure on rural development and protection of the landscape, as Buckwell et al (1997) suggest.

- What will happen if the CAP is renationalised and member states pay a growing share of direct subsidies to farmers? Given the severe budget constraints in the CEECs this could imply less funds available for agriculture than in existing EU members.

To ensure that enlargement does not risk slowing the momentum of integration, the applicant countries also have the task of adopting appropriate policies during the pre-accession period. During the early years of transition, there was much debate about whether the CEECs should introduce CAP-like policies such as price support and production quotas in the interest of harmonising their agricultural policies with those of the EU. However, both the Commission's 1995 Agricultural Strategy Paper and *Agenda 2000* advised against introducing such measures, and there are strong reasons of economic rationality against doing so:

- The CAP is undergoing change so the CEECs would be harmonising their agricultural policies to an unknown and moving target.
- Because CAP-like policies tend to freeze existing production structures, they place too little emphasis on structural adjustment. They are thus particularly inappropriate to economies in transition.
- CAP-like measures which rely heavily on price support (with the expenditure on export subsidies and/or public stocks of surpluses this necessitates) are too costly for most CEECs.

The Czech Republic liberalised prices for agricultural products in 1991, though some temporary controls on food prices were maintained. Agricultural policy

82 According to the "Peace Clause" of the Agreement, until 2003 the MacSharry compensatory payments were excluded from the requirement to reduce domestic support (i.e. they were placed in the "blue box"), provided support levels were not increased above 1992 levels.

instruments similar to those of the CAP were introduced, but the level of support was far lower. A system of guaranteed prices or state purchases was introduced for major products such as milk, bread, wheat and beef. Export subsidies to reduce domestic surpluses were used for milk. Tariffs or import levies were applied to certain sensitive products including live cattle, live sheep, meat, butter and potatoes.

The low level of support reflected the Czech government's commitment to creating a market-orientated agricultural sector. According to the OECD, the percentage producer subsidy equivalent (PSE)[83] for the Czech Republic declined from 69% in 1986 to 53% in 1990, 25% in 1993 and was as low as 10% in 1996. During the 1990s the Czech PSE has remained well below that of the EU (which declined slowly from 50% in 1986 to 43% in 1996). In 1996 it was also below those of Poland (28%), Hungary (11%) and Slovakia (19%). [84]

According to the Commission's Opinion, the main difficulties still facing Czech agriculture include low yields, poor quality, the food industry, environmental consequences, and inadequate market information. The problems of regional disparities, upland farming and the damage from the 1997 floods could be added to this list. Nonetheless, the Commission concluded that the Czech Republic would be able to apply the CAP to its agricultural sector "without significant problems in the medium term".

B. The Structural Funds

The European Council in Edinburgh set the EU's total budget for economic and social cohesion at 0.46% of EU GDP for the period 1993-99. In Agenda 2000, the Commission proposed maintaining that percentage, spending 275,000 million ECU (at 1997 prices) on the Structural and Cohesion Funds for the years 2000-2006, as compared with 200,000 million ECU over the 1994-99 period. 45,000 million would be earmarked for enlargement. This would consist of 1 billion each year for the CEECs over the 2000-2006 period as part of the pre-accession strategy, and 38 billion from the Structural and Cohesion funds for the new member states. As a result, by 2006 the Structural Funds for enlargement would account for about 30% of all transfers through the Structural Funds.[85]

83 The PSE is the measure generally accepted in making international comparisons of the level of agricultural support. It is defined as the subsidy that would be necessary to replace all the agricultural policies used in a country and leave farm revenue unchanged.

84 *Agra Europe East Europe*, November 1997.

85 *Agenda 2000*, p. 63.

The estimated transfers resulting from an extension of the Structural Funds to the CEECs on present criteria would represent an extremely high percentage of the GDP of these countries.[86] *Agenda 2000* therefore proposed placing a ceiling of 4% of the GDP of the recipient country on the size of transfers under the Structural Funds.

Extension of the Structural Funds to the CEECs also requires changes in the way in which the Funds operate.[87] *Agenda 2000* proposed reducing the number of Objectives to three. Objective 1 would apply to regions whose GDP is less than 75% of the EU average. Objective 2 would concern regions with major economic and social restructuring needs. Objective 3 would be a "horizontal" measure designed to develop human capital, and applying in all regions not covered by Objectives 1 and 2. Its aim would be to help member states adapt and modernise their education, training and employment. In *Agenda 2000* the Commission refers to a "phasing out mechanism" for regions currently eligible for transfers under Objective 1, but which would be above the 75% threshold in an enlarged EU.

Over the 1993-1999 period, the entire territory of Ireland, Portugal and Greece fell under Objective 1, and this is also likely to be the case for the CEECs entering the EU. According to *Agenda 2000* (p. 138), in 1995 GDP per capita in the Czech Republic amounted to 3,490 ECU: second only to Slovenia among the CEECs, but still well below the 7,770 ECU of Portugal, which had the lowest level of GDP per capita in the EU(15) in 1995.[88] Although there are important regional differences within the Czech Republic, with GDP in Prague over 50% higher than the national average, the GDP of the Prague area is still only 75% of the EU(15).[89]

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86 According to a study carried out by the Commission (1996b), these transfers would amount to 15% of GDP for Hungary, 18% for the Czech and Slovak Republics, 25% for Poland, and roughly 50% for Romania and Bulgaria.

87 The main aim of the Structural Funds is to assist the less-developed regions of the EU, and for this purpose six objectives were identified: (1) the less-well developed areas of the Community, which are defined as those whose GDP per capita is less than 75% of the EU average; (2) regions affected by the decline of traditional industries; (3) combating long-term unemployment (more than 12 months) and (4) helping workers adjust to technological change; (5a) assisting the structural adjustment of agriculture; (5b) aid to rural areas; (6) regions with a low density of population in the extreme north of Finland and Sweden.

88 These estimates should, however, be treated with caution. According to *PlanEcon* (vol. 14, 1998) official statistics underestimated Czech GDP by some 11% in 1996 and 14% in 1997. This is because the production of many new, small private enterprises fails to show up in official statistics, while many firms understate their output to pay less taxes. This represents an inversion of the tendency under the previous system, when firms overstated output levels to meet plan targets.

89 These estimates are taken from Hallet (1997).

The Commission's proposals seem more geared to the priority of releasing funds for the applicant countries than to the need to improve the operating efficiency of the Funds themselves. A number questions therefore remain open:

- It is unclear that the present main recipients of the Structural Funds in the EU (15) are prepared to accept the reallocation of part of the transfers to the CEECs.[90]

- The predictions concerning growth rates in the EU(15) and CEECs which underlie the estimates presented in *Agenda 2000* appear optimistic.[91]

- The ceiling on transfers of 4% of the GDP of the recipient country would have the perverse effect that the poorest countries (i.e. those with the lowest GDP) would receive the least.[92]

- On equity grounds, the *Agenda 2000* proposals appear questionable. As Gianzi (1998, pp. 202-203) illustrates, there are substantial differences in the proposed per capita transfers for the EU(15), the CEECs joining the EU, and those remaining as "pre-ins. The *Agenda 2000* proposals would entail an estimated transfer of roughly 235 ECU per capita for the 37.5% of the EU(15) population expected to benefit from Objectives 1 and 2 over the 2000-2006 period.[93] Excluding Ireland,[94] according to *Agenda 2000* proposals, the three countries currently benefiting from the Cohesion Fund would receive 344 ECU per capita over the 2000-2006 period. Assuming that the five CEEC front-runners join in 2002, *Agenda 2000* envisages that they would receive roughly 120 ECU per capita each year for the 2002-2006 period. This is well below the 1999 allocation of 400 ECU per capita for Greece and Portugal, but well above the 5 billion ECU (16.7 ECU per capita

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90 This reallocation of structural spending could be avoided by raising the ceiling on contributions to the EU Budget, but there is unlikely to be the political willingness, in particular, on the part of Germany (the main contributor) to do so.

91 An average growth rate of 2.5% per year is assumed for the EU(15)and 4% for the CEECs.

92 Although if a poorer country is larger as, for example, Poland or Romania, it will get more in absolute terms.

93 This estimate is calculated dividing 230,000 million by 37.5% of the EU (15) population of 374 million, reflecting the Commission proposal that the percentage of the EU population benefiting from regional measures should be reduced from 52% in 1997 to 35-40% over the 2000-2006 period. However, the estimate fails to take account of the fact that there will also be transfers under the new Objective 3 which, as a horizontal measure, is also likely to benefit the EU population in other areas. The estimate is also based on the assumption that the share of the population benefiting from regional measures remains unchanged over the 2000-2006 period.

94 Ireland exceeded the Cohesion Fund threshold of 90% of the average GDP of the EU in 1997.

each year) proposed in *Agenda 2000* for transfers under the Structural Funds to the five CEEC back-markers for the 2000-2006 period.[95]

- The new Objective 2 will cover rural development regions (formerly Objective 5b), regions suffering from industrial decline (formerly Objective 2) and urban centres, and the advantage of grouping regions with such different requirements is not immediately obvious.

- The condition of partnership in implementing structural measures also poses difficulties for the extension of the Structural Funds to the CEECs.[96] Partnership entails cooperation between the Commission and national, regional and local authorities in programming structural spending. The principle of subsidiarity holds that where possible regional authorities should be responsible for the implementation of structural measures. However, the legacy of communist centralisation left the Czech Republic (like the other CEECs) with little experience of regional devolution of authority. The previous system provided only for artificially-created planning regions designed to implement the plan on a territorial basis. As a result, relying on regional and local authorities to implement structural measures could imply extremely high costs of coordination and administration. There may even be a case for relying more heavily on instruments such as the PHARE Programme or the Cohesion Fund which operate at the national level. This would also allow the beneficiary countries more flexibility in meeting the dilemma of whether to concentrate assistance on regions with the best prospects of catching up ("poles of development"), or whether to give priority to channelling aid to the poorest, most backward areas. [97]

- A further principle which could create difficulties for the CEECs is additionality, which aims to ensure that EU funds do not simply replace national expenditure. Additionality requires that EU measures are accompanied by matching funding from the member states of up to 50%. *Agenda 2000* proposes flexibility in the application of this principle to the CEECs.

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95 Though, according to the Agenda 2000 proposals, the 5 back-markers would also benefit from 7.5 billion ECU through the PHARE Programme, and 2.5 billion ECU for agriculture. This would bring the total pre-accession transfers to these 5 countries to 50 ECU per capita each year over the 2000-2006 period.

96 See Brenton and Gros (1993) for a more detailed discussion of these issues.

97 Some countries are taking steps to meet these shortcomings. For example, in summer 1998 Poland passed a series of laws creating a new system of 16 regions with substantial decentralisation of power and elected assemblies at the regional level.

Also with regard to the Structural Funds, it is difficult to identify "appropriate" policies for the CEECs during the pre-accession period. The priority should be on growth and the catching-up process (thereby reducing the difficulties of extending the Structural Funds to these countries), but it is not always evident how this is best achieved.

According to Baldwin (1994), in order to reach a per capita income of 75% the EU average, the Czech Republic would take 14 years with an annual growth rate of 5%, and 24 years with a growth rate of 3%. In 1997 following the currency crisis the Czech Republic introduced two austerity budgets. It was argued that these were necessary to regain credibility, but the estimated growth in Czech GDP for 1997 was only 1%, falling well short of the 4% annual growth rate forecast for the CEECs in Agenda 2000, or the estimates presented by Baldwin.

Conclusions

What may we say about the Copenhagen economic accession criteria the light of the Czech experience? With regard to the requirement that the applicant state should have a "functioning market economy", the Czech case demonstrates that it is not sufficient simply to establish institutions and an appropriate legal framework. What is essential is to ensure that legislation is enforced and that market institutions operate effectively. From *Agenda 2000* and the Opinions, a blueprint of what the Commission would like to see as a "market economy" also emerges, though it remains an open question how far the present EU(15) member states meet those requirements.

Turning to "capacity to cope with competitive pressures", assessment of an applicant country on the basis of this criterion would require a comprehensive, sector-by-sector analysis of present economic performance, and likely future developments in an enlarged EU. Further research is required in this area, but the enormity of the task is such that there may even be a case for arguing that competitiveness is a concept which lends itself to analysis at the level of the firm or even the sector, but not the country level.

Discussion of the "ability of the applicant country to take on the obligations of membership" was limited here to the ability to take on the *acquis communautaire* and the question of adherence to the aim of Economic and Monetary Union.

Implementation of the *acquis* is likely to prove a lengthy and complex process, so the enlargement timetable will probably slip. The working assumption of *Agenda 2000* and of the Commission's proposals of March 1998, that the first wave of Eastward enlargement to five countries could take place in 2002, would seem excessively optimistic.

Even if the five CEECs negotiating to join the EU do not participate fully in the Stage Three of EMU, it seems likely that the rules relating to fiscal discipline, capital movements, and exchange rate arrangements will create difficulties. The Czech Republic was the only CEEC to maintain a fixed exchange rate over a long period, and even it was forced to switch to a managed float in May 1997. Huge capital inflows attracted by high interest rates have rendered monetary targets difficult to realise. In some measure, such problems stem from the specific characteristics of transition economies and, in particular, their tendency towards relatively high inflation. Under these conditions, an attempt to maintain a fixed nominal exchange rate may lead to real appreciation of the currency and loss of competitiveness. Moreover, excessive concern for budgetary discipline may slow the transition process, and risks bringing hardship to the more vulnerable sections of society.

If the timetable for enlargement slips, pressure for reform of the EU's two main cost-intensive policies, the Structural Funds and the CAP, will decrease. As argued above, the proposed reforms of the Structural Funds set out in *Agenda 2000* seem more geared to releasing funds for the applicant countries than to ensuring the effective functioning of the Funds themselves. A delay in enlargement would at least have the advantage of allowing more time to analyse how social and cohesion transfers could be better targeted.

Though enlargement is used politically as an argument to reform the CAP, there are other strong arguments in favour of change. External pressures include the commitments of the GATT Uruguay Round (in particular with regard to export subsidies), and the next WTO negotiations (which are likely to entail further liberalisation of international agricultural trade). Internal pressures for reform emerge from the burden of agriculture on the EU budget, and the failure of the CAP to reduce the disparities in income between poorer and richer farmers, and between Mediterranean and Continental agriculture. A new approach is necessary in which farmers are not only considered as producers (often simply adding to surplus stocks of foodstuffs), but are valued for the role they can play in rural development and environmental protection. A reformed CAP should be aimed at furthering these wider objectives in the whole of Europe, not just the EU(15).

While the onus is on the EU to reform its policies and institutions such that enlargement does not slow "the momentum of integration", the CEECs must also adopt appropriate policies to prepare for accession. The primary difficulty here lies in identifying "appropriate" policies. For instance, the introduction of CAP-like measures based heavily on price support and supply restraint does not seem suitable for the CEECs. In order to facilitate participation in the Structural Funds, it is necessary to tread a fine line between priority for growth and catching-up, and maintaining sufficient fiscal discipline to ensure credibility.

Appendix 1

Tables and Figures

Table 1: Basic Data on the Czech Republic (1995)

	Area	population	GDP at current market prices			GDP at PPP		
	1000 sq. km	million	billion ECU	ECU per head	ECU per head as % EU average	billion ECU at PPP rates	ECU per head at PP rates	ECU per head as % EU average
Czech Rep.	79	10.3	36.1	3490	20	97.2	9410	55
CEEC (10)	1078	105.3	234	2220	13	582.0	5530	32
CEEC (10) as % EU (15)	33%	28%	4%	13%		9%	32%	

Source: EC Commission (1997a) *Agenda 2000*, p. 138

Table 2: Changes in Key Macroeconomic Variables in the Czech Republic

	1991	1992	1993	1994	1995	1996	1997	1998 (est.)
GDP	-14.2	-6.4	-0.9	2.6	6.4	3.9	1.0	1.9
GDP CEEC (13*)	-11.0	-4.4	0.5	3.9	5.2	4.0		
Inflation (annual change in CPI)	56.5	11.1	20.8	10	9.1	8.8	8.4	9.5
gross fixed capital formation % increase over previous year	-17.7	8.9	-7.7	17.3	22.3	8.7		
Unemployment rate**			3.9	3.8	3.6	3.5	5.2	5.5##
Nominal wages and salaries (previous year = 100)			125.3	118.5	118.5	118.0	113.4	
real wages and salaries (previous year = 100)			103.7	107.7	108.6	108.5	105	
US ($ exchange rates (average of period)		28.29	29.15	28.78	26.55	27.14	32.67	32.9#

* CEEC (10) plus Albania, Croatia, and the FYR (former Yugoslav Republic) of Macedonia
#July 1
March

** ILO(International Labour Office) methodology
Source: OECD (1996), Eurostat, EC Commission (1997b), *Financial Times*, 1 December 1997, EIU (Economist Intelligence Unit) 1998 and CERGE (Centre for Economic Research and Graduate Education of the Charles University) 1998.

Table 3: Main Production Sectors of Czech Industry in 1995

	% industrial production (value added)	% industrial employment
Raw material processing (including metallurgy, cement, glass, ceramics, paper and wood)	21	22
Metal, mechanical and electrical products	15	20
Agri-food	12	8
Construction	12	16
Chemicals	12	5
Automobile industry	6	6.5
Information technology	4.5	2
Textiles, clothing and leather	3.5	10
Pressure equipment, medical and meteorological equipment	2.5	
Pharmaceuticals	2	0.5
Total	90.5	92.5
Other sectors	9.5	2.5
Total industry	100	100
Industry (excluding construction) as % GDP	34%	

Source: EC Commission (1997b) p. 66

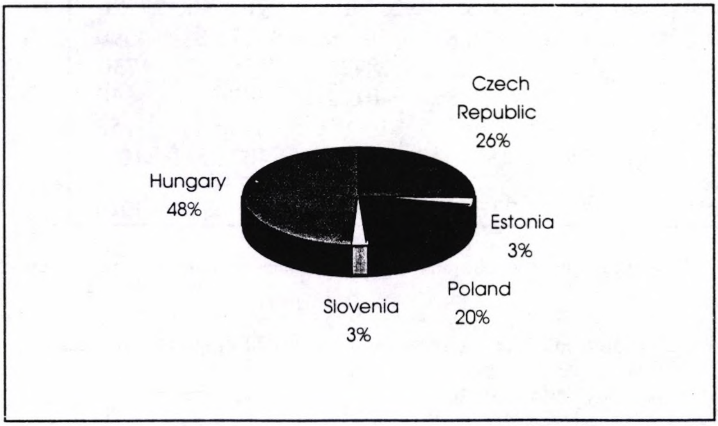
Table 4: FDI Inflows to the CEECs

millions of dollars

	FDI Inflows 1995	FDI Inflows 1996	Cumulative Stock 1989-96	FDI inflows per capita 1996 ($)	Cumulative inflows 1989-96 per capita
Czech Republic	2720	1264	7120	123	692
Hungary	4410	1986	13260	195	1300
Poland	1134	2741	5398	71	140
Slovakia	134	177	623	33	117
Slovenia	170	180	731	90	372
Bulgaria	82	100	425	12	51
Romania	404	210	1186	9	52
Estonia	199	110	735	71	477
Latvia	165	230	644	92	258
Lithuania	72	152	285	41	76
Croatia	81	389	615	73	129
Albania	70	90	298	28	93

Source: European Bank for Reconstruction and Development, 1997 Transition Report

Figure 1: Share of CEEC(5) in Cumulative FDI Inflows 1989-1996



Source: European Bank for Reconstruction and Development, 1997 Transition Report

Table 5: FDI in the Czech Republic

Second quarter of 1997

Origin of investment		Sector of investment	
Germany	27.8%	Transport and communications	20.6%
Netherlands	14.8%	Consumer goods and tobacco	14.3%
US	14.6%	Automobile industry	13.9%
Switzerland	11.3%	Trade and services	9.0%
France	7.3%	Chemical industry	8.2%
Austria	7.1%	Banks and insurance companies	8.2%
Others	17.1%	Others	25.8%
Total	$2094 million		

Source: *Financial Times* of 1 December 1997, which bases its estimates on Czechinvest

Table 6: The Czech Balance of Payments
million US ($)

	1994	**1995**	**1996**	**1997**
Exports of goods (f.o.b)	14016.4	21462.4	21702.5	22530
Imports of goods (f.o.b)	-14905.3	-25140.3	-27674.3	27120
Trade balance	-888.8	-3677.8	-5971.8	-4590
Services net	733.0	1842.0	1785.1	1730
Income net*	-20.2	-105.2	-679.9	-630
Current account balance	-49.7	-1369.1	-4476.4	-3156
Capital and financial account (excluding reserves)	3371.1	8232.6	4072.3	1092
Reserve assets**	-2371.6	-7458.1	828.0	1767

* Net income includes direct, portfolio and other investment income and compensation of employees

** Change in reserve assets in a year. + signifies an increase and - signifies a decrease.

Source: EC Commission (1997b), p. 120

Table 7: The Structure of Czech Foreign Trade

% total imports or exports

	1992	1993	1994	1995	1996
Imports by SITC					
(1+2) food and live animals, beverage and tobacco	7.5	7.3	8.2	6.3	6.5
2 Crude materials, inedible	5.8	5	4.9	4.5	3.7
3 mineral fuels and lubricants	15.5	11.1	10	7.8	8.7
4 animal and vegetable products etc.	0.3	0.4	0.4	0.3	0.3
5 chemicals and related products	9.8	12.1	13.1	11.8	11.8
6 manufactured goods classified chiefly by material	10.3	15.9	16.5	20.3	19.3
7 machinery and transport equipment	41.5	36.1	35	37.1	38.2
8 misc. Manufactured articles	9.3	11.7	11.9	11.9	11.5
9 goods not elsewhere classified	0	0.4			
Exports by SITC					
(1+2) food and live animals, beverage and tobacco	8.8	7.8	6.5	5.6	5.1
2 Crude materials, inedible	6.5	6.1	6.8	5.2	4.7
3 mineral fuels and lubricants	5.7	6.2	5.7	4.3	4.5
4 animal and vegetable products etc.	0.1	0.2	0.3	0.2	0.2
5 chemicals and related products	9.2	9.5	10	9.3	9.1
6 manufactured goods classified chiefly by material	32.3	29.9	30.5	32.2	28.8
7 machinery and transport equipment	25.4	27.6	25.9	30.4	32.7
8 misc. Manufactured articles	12	12.7	14.3	12.8	14.9
9 goods not elsewhere classified					

Source: EU Commission (1997b), p. 121

Table 8: The Increase in the CEEC Share of EU Trade

	% Increase in EU (12) exports 1989-1995	% Increase in EU (12) imports 1989-1995	% total extra-EU exports 1989	% total extra-EU exports 1996	% total extra-EU imports 1989	% total extra-EU imports 1996
Czech Rep. And Slovakia	436.0	309.4	0.6	2.9	0.6	2.3
Of which: Czech Rep.				2.2		1.7
Hungary	126.4	151.0	0.7	1.6	0.6	1.5
Poland	241.8	187.6	1.0	3.2	0.9	2.1
Bulgaria	25	332.1	0.4	0.3	0.1	0.3
Romania	414.5	28	0.2	0.6	0.6	0.7

Source: Own calculations on the basis of Eurostat data.

Table 9: The Increase in the EU Share of the Total Trade of Selected CEECs over the 1989-95 Period

	% total exports 1989	% total exports 1997	% total imports 1989	% total imports 1997
Czech Rep. and Slovakia	18.2% (EC) 4.6% (Austria) 6.6% (GDR)	60.2% (Cz Rep.) 47.3% (Slovakia)	17.8% (EC) 5.5% (Austria) 7.8% (GDR)	51.8% (Cz Rep.) 39.5% (Slovakia)
Hungary	24.8% (EC) 6.4% (Austria) 5.4% (GDR)	75%**	29% (EC) 8.6% (Austria) 6.2% (GDR)	63.4%**
Poland	31.8% (EC) 0.5 (EFTA)	65.3%#	34.2% (EC) 0.7% (EFTA)	63.1%#
Bulgaria	5.5% (EC) 1.5% (EFTA)	37.6%	10.3% (EC) 3.9% (EFTA)	43.1%
Romania*	28.5% (EC) 3.2% (EFTA)	55.6%#	13.8% (EC) 1.3% (EFTA)	52.2%#

* Earlier data is for 1988

** January-February 1998
# 1996
Unless otherwise stated the statistics are for EC 12 in 1989 and EU 15 in 1995.

Source: *Economist Intelligence Unit* (for Hungary, the Czech Republic and Slovakia), own calculations on the basis of PlanEcon and EC Commission, 1994b, (Romania and Bulgaria), own calculations on the basis of *Rocznik Statystyczny* (Poland).

Table 10: Transposition of the 1995 White Book Measures into National Legislation

Sectors in the White Book	Measures in the White Book	Measures adopted in the Czech Republic
1. free movement of capital	4	1
2. free movement and safety of industrial products	165	60
3. competition	4	3
4. social actions and policies	29	22
5. agriculture	203	57
6. transport	55	27
7. audiovisual	1	1
8. protection of the environment	45	13
9. telecommunications	16	3
10. direct taxation	4	2
11. public procurement	6	5
12. financial services	21	11
13. protection of personal information	2	0
14. company law and accounting	11	7
15. civil code	2	1
16.mutual recognition of qualifications	18	2
17. intellectual property	11	7
18. energy	15	2
19. customs union	201	173
20. indirect taxation	75	4
21. consumer protection	11	6

Source: Hamende, B., *Est-Ovest* No. 5, 1997, pp. 38-47

Table 11: The Czech Republic and the Maastricht Criteria

	Maastricht criteria 1997	Czech Republic 1993	Czech Republic 1995	Czech Republic 1997
public deficit % GDP	3% GDP	surplus of 1.4% GDP	surplus of 1.8% GDP	0%
public debt % GDP	60% GDP	29%*	10.7%*	8%
inflation (average increase in CPI)	3.1%	20.8%	9%	8.4%
interest rates	8.5**	16.5##	9.5%# 12.8%##	10.5%# 12.5%##

Source: Senior Nello, S.M., and Smith, K.E. (1997), based on IFS (International Financial Statistics) and EIU (Economist Intelligence Unit) data.

*Given difficulties in finding comparable data on public debt (the Maastricht criterion), foreign debt has been used here.

** long term government bond yield (forecast 1997)
# Central Bank lending rate
##Lending rate

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