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Economic and Social Gaps, New Hidden Borders in the Enlarged Europe?

DANIEL VAUGHAN-WHITEHEAD

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This paper was written for a meeting of the Reflection Group on the Long-Term Implications of Eastward Enlargement of the European Union: the Nature of the New Border, set up jointly by the Robert Schuman Centre and the Forward Studies Unit of the European Commission, and chaired by Professor Giuliano Amato. The European University Institute and the Robert Schuman Centre are not responsible for the proposals and opinions expressed by the author. For information on this and other projects on Eastern Europe at the Robert Schuman Centre, please contact Professor Jan Zielonka: zielonka@iue.it.

INTRODUCTION*

Europe is today facing two important challenges which will profoundly modify the functioning of the EU and its constituent national economies and societies: the adoption of the single European currency, the Euro, and the forthcoming enlargement of the EU to Central and Eastern Europe. However, while a consensus seems to have been reached with regard to the new European currency, the same cannot be said concerning the future membership of CEE countries. Although the importance of the enlargement has often been repeated by politicians, there seems to be considerably less enthusiasm among economists and specialists, which in turn seems to have led to more hesitation among policy-makers. Although this historic imperative is recognised by everyone, the present approach to enlargement appears to be far too narrow and mechanistic. While policy makers announce that the EU will soon enlarge its external border in an unprecedented way and nearly double the number of its member states, the enlargement process clearly continues to be confined to a series of administrative procedures and technical negotiations on the adoption by candidate countries of the Community "legal acquis". So far this approach fails to take necessary account of the huge economic and social discrepancies that prevail between Eastern and Western Europe, and is insufficiently supported by a more global and rallying vision on the type of Enlarged Europe that is foreseen for tomorrow.[1]

As a result, key questions remain without an answer. What are the current economic and social gaps between the two Europes? In what areas are they the deepest? What are the differences between applicant countries themselves that may influence and differentiate their integration capacity? We shall try to address such issues in the first part of this paper through a systematic assessment of the major differences that currently prevail between EU member states and candidate countries in terms of production and economic growth, employment, wages and living standards. We particularly focus on the ten countries that have signed association agreements with EU countries, that is, Bulgaria, the Czech Republic, Hungary, Estonia, Latvia, Lithuania, Poland,

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* A first version of this paper was prepared for the Meeting on *Socio-Economic Discrepancies in the Enlarged EU* (by the Reflection group on *Long-Term Implications of EU Enlargement: The Nature of the New Border*), held on 11 January 1999 in Brussels. I am grateful to the participants for their comments and suggestions. This paper was written when the author was working at the ILO team for Central and Eastern Europe (ILO-CEET) in Budapest. Since then, he joined the European Commission, Directorate General for Employment and Social Affairs, where he is dealing with the EU enlargement, especially in its social dimension.

[1] This approach seems to be considering the current EU enlargement process to the East as "just another accession" and has already been presented as "a serious economic error" by a few economists (see Eatwell et al., 1997, p. 20).

Romania, Slovakia, and Slovenia. The key question to address here is whether such differences, once accession is achieved on the paper, could not generate a sort of "hidden internal borders" within the newly enlarged European Union.

On this basis we try to identify in a second part what are the determinant factors and policies that may influence such process, that may potentially modify these gaps, making them smaller or wider. We discuss here the dynamism of the EU enlargement process itself, and how its specific features – speed, covered areas, accompanying policies, etc. – may influence the final outcome.

In a third part, we try to identify in a wider perspective the economic and social remodelling that the EU enlargement to the East may bring for Europe in the long run. How could it change the position of the EU vis-à-vis other strong economic powers such as Japan and the United States? And what may be the effects on EU neighbouring countries? We try in particular to discuss what changes the extension of the EU external border may bring, and what policy would be needed in this respect.

1. SOCIO-ECONOMIC DISCREPANCIES: TOWARDS AN "INTERNAL BORDER" BETWEEN THE TWO UNIFYING EUROPES?

The differences between EU countries and those of Central and Eastern Europe can be summarised under two headings: lower economic level and social deficit. These two dimensions are intimately related: the serious production crisis and consequent profound restructuring have resulted in an unprecedented fall in living standards. At the same time, the growth in poverty, increased social differentiation, and falling real incomes have in turn contributed to unbalanced and ill-founded economic development. We shall regroup these socio-economic discrepancies into four main categories: (i) economic growth, (ii) employment, (iii) incomes, and (iv) other social indicators.

1.1 CEE Economies Further Weakened by Production Crisis

The collapse of CMEA markets was the first important feature of the transition in Central and Eastern Europe, leading to a dramatic fall in production. Price liberalisation—resulting in a price shock—and very tight fiscal and monetary policies have contributed to further declines in production. Output fell dramatically—by around 20–40 per cent—in all countries in the region in the first two to three years of the transition (*Table 1*). The fall was even more dramatic if we take into consideration industrial output (*Table 2*).

Table 1 Annual changes in GDP, Central and Eastern European Countries (CEECs), 1991–2000 (in %)

	1991	1992	1993	1994	1995	1996	1997	1998	1999 *	2000 *
Bulgaria	-11.7	-7.3	-1.5	1.8	2.1	-10.9	-6.9	0.7	1.0	3.0
Czech Rep.	-11.5	-6.4	-0.9	2.6	5.8	4.1	1.0	-2.5	-0.5	2.0
Estonia	-	-	-8.5	-1.8	4.2	4.0	11.4	4.0	0.5	3.5
Hungary	-11.9	-3.1	-0.6	2.9	1.5	1.3	4.4	5.0	3.0	2.6
Latvia	-	-	-14.9	0.6	-1.6	3.3	6.5	3.6	1.5	2.5
Lithuania	-	-	-16.2	-9.8	3.3	4.7	6.1	4.2	3.0	4.0
Poland	-17.7	2.6	3.8	5.2	7.0	6.1	6.9	4.8	4.0	-
Romania	-12.9	-8.8	1.5	3.9	7.1	4.1	-6.6	-5.0	-1.0	2.0
Slovakia	-14.5	-6.5	-3.4	4.9	6.9	6.6	6.5	5.2	-2.0	1.0
Slovenia	-8.9	-5.5	2.8	5.3	4.1	3.1	3.8	3.6	3.0	3.5

* Estimates

Sources: National Central Statistical Offices, EIU Country reports and 1998–99 Profiles, IMF International Financial Statistics. 1999–2000 forecasts are from EIU.

Table 2 Annual Changes in Industrial Output, CEECs, 1991–2000

Industrial output	1991	1992	1993	1994	1995	1996	1997	1998	1999 *	2000 *
Bulgaria	-20.2	-18.4	-10.9	8.5	5.0	0.1	-13.1	-3.0	0.0	4.0
Czech Rep.	-21.2	-7.9	-5.3	2.1	8.7	6.4	4.5**	5.0	5.0	-
Estonia	-7.2	-36.0	-18.6	-3.1	2.0	-	13.8	-1.0	-	-
Hungary	-16.6	-9.7	4.0	9.6	4.6	3.4	11.1	12.6	8.5	4.0
Latvia	-1.0	-49.0	-33.0	-4.8	-0.9	3.3	5.9	2.0	-0.8	2.0
Lithuania	-6.0	-52.0	-	-	-	2.4	5.6	6.2	2.8	-
Poland	-8.0	2.8	6.4	12.1	9.7	8.3	10.8	5.4	7.1	-
Romania	-22.8	-21.9	1.3	3.3	9.4	8.3	-5.9	-7.0	-3.0	3.0
Slovakia	-19.4	-9.3	-3.8	4.8	8.3	0.4	2.4	4.6	-1.5	1.0
Slovenia	-12.4	-13.2	-2.8	6.4	2.0	1.0	1.3	1.5	1.9	-

* Estimates

** Figure of -2.7 per cent in D. Rosati et al., 1998, p. 46.

Sources: National Central Statistical Offices, EIU Country reports and 1998–99 Profiles, IMF International Financial Statistics. 1999–2000 forecasts are from EIU.

Table 3 GDP growth and GDP per capita, EU and CEE countries, 1997

	GDP/head (USD)	GDP growth (in %)
Austria	25,666	2.5
Belgium	23,843	2.9
Denmark	32,173	3.4
Finland	23,319	6.0
France	23,792	2.4
Germany	25,632	2.2
Greece	11,474	3.5
Ireland	20,021	9.8
Italy	19,919	1.5
Netherlands	23,094	3.4
Portugal	10,167	3.6
Spain	13,522	3.4
Sweden	25,720	1.8
UK	21,848	3.4
Norway	34,891	3.4
Bulgaria	1,198	-6.9
Czech Rep.	5,167	1.0
Estonia	3,127	11.4
Hungary	4,398	4.4
Latvia	2,238	6.5
Lithuania	2,574	5.7
Poland	3,502	6.9
Romania	1,532	-6.6
Slovakia	3,656	6.5
Slovenia	9,039	3.8
EU (15)	21,640	2.6
CEE*	3,106	3.1

* includes Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia.
Source: National Statistics.

These large falls in production, compounding the lower output which was already a feature of the postcommunist economies, opened up a significant gap in per capita GDP between Central and Eastern European countries and EU member states (*Table 3*). Of Central and Eastern European countries, Slovenia was the only one with a per capita GDP approaching the level of the poorest EU members, although it is still less than one-third of the level of the most prosperous EU members. Finally, the poorest Central and Eastern European countries have a per capita GDP below 10 per cent of the current EU average.

As shown in *Table 1*, Central and Eastern European countries are experiencing now a more rapid economic growth. Since 1993 GDP has increased by more than 30 per cent in Poland, 11 per cent in the Czech Republic, 9 per cent in Hungary, and 20 per cent in Slovakia. Such high GDP growth has given rise to a great deal of optimism concerning economic growth in Central and Eastern Europe. We should emphasise, however, that by 1997 GDP had still not reached pretransition levels. Another important feature of this rapid GDP growth is that per capita income levels remain well below those of even the poorest EU members.

We must emphasise that GDP growth figures are not sufficient indicators, and in some cases rather misleading for catching economic developments in CEE. As an example, it is on the basis of its annual GDP growth of 10-12 per cent in the years 1992-95, that Albania was presented as the most successful transition economies and was called the "Balkan tiger", or the "shining star" of the region, despite a fall of industrial output of more than 80 % in three years' time. The Albanian people' s rebellion in 1997 and institutional and political crisis, partly due to a combination of economic and social factors, has shown how fragile was this quick economic recovery. More recently, according to forecasts produced by the Economist Intelligence Unit (World outlook, 1998), Albania was placed again as the "fastest-growing economies in 1998", on the basis of a prediction of GDP growth of 12 per cent in 1998. To underline the absurdity of these figures, the country occupying the first rank was expected to be Bosnia, a country ravaged by the worst fighting seen in Europe since Second World War, where a 35 per cent GDP growth was predicted in 1998. This shows the need to complement GDP figures by other economic indicators, such as industrial growth, or value-added by sectors.

In fact, the differences between East and West are even more pronounced in respect of industrial production. Industrial output in early 1998 was, for instance, only 40 per cent of its 1990 level in Bulgaria and only 50 per cent of it in Latvia. Faster-growing economies such as Hungary and the Czech Republic only reached their pretransition levels in the course of 1997. The fall in Central and Eastern European manufacturing production has led to an artificial increase in the share of agriculture in GDP and to a striking increase in that of services.

Even if 'real' GDP is larger than 'official' GDP in the applicant countries when the significant informal sector is taken into consideration, the gap with current EU member countries has the proportions of an abyss and should undoubtedly be considered as a particularly important feature of the enlargement process to the East. We should also emphasise another crucial difference with previous EU accessions: the Central and Eastern European countries are presently conducting a unique transformation from centrally controlled economies to market economies. This alone would necessitate a different approach to their accession. Their commitment to large-scale privatisation and active restructuring are further specificities which must be fully understood by current EU members in their endeavour to prepare Europe's future competitiveness. Finally, unlike all earlier applicants, the Central and Eastern European countries have limited experience of competing in international markets, poorly developed commercial infrastructures, and inexperienced entrepreneurs.

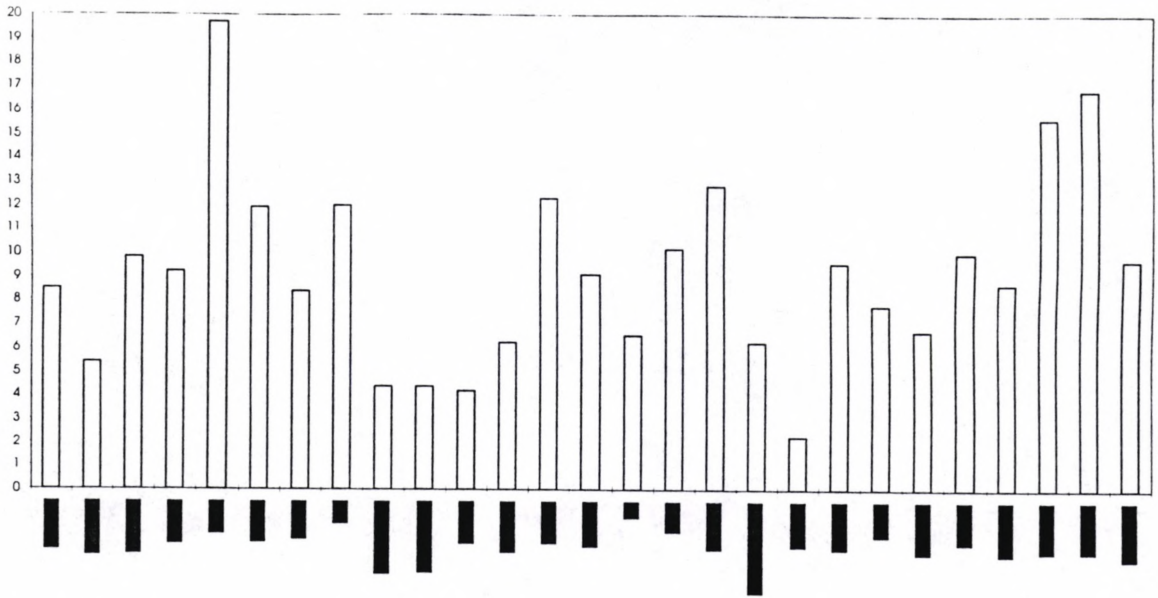
As if all this were not enough, the new applicants must accept greater and more far-reaching obligations than earlier applicants (with the exception of the most recent accessions of Austria, Finland, and Sweden): above all, they will have to take on board a more significant degree of economic integration, including monetary union (Eatwell et al., 1997).

1.2 The Unemployment Shock

The sharp fall in production led to an immediate surge in unemployment which rose in less than three years from virtually zero in 1990 to double-digit levels (*Table 4*). Only the Czech Republic has so far got away with very low unemployment rates, although this appears to be the result of insufficient restructuring in large privatised enterprises, as shown by the recent rapid increase of unemployment rates (*Table 4*). In 1997 the long-awaited falls in unemployment finally occurred in a few countries, for instance in Poland (down to 10.4 per cent compared with 13.2 per cent one year earlier) and Hungary (down to 10.4 per cent compared with 11.1 per cent in 1996).

Figure 1 shows that unemployment rates in CEE (9.7 per cent on average for the 10 candidates) are already comparable with those prevailing in the EU (average of 10.2 per cent). We should also emphasise that the differences are also important among CEE countries, since they vary from less than 5 per cent in Estonia in 1999, to nearly 17 per cent in Slovenia.

Figure 1. Unemployment Rates in EU and CEE Countries, 1998



Sources: Eurostat, National statistical offices

Table 4 Unemployment Rates, CEECs, 1991–99

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Bulgaria	11.5	15.6	16.4	12.8	11.1	12.5	13.7	12.8	-
Czech Republic	4.1	5.1	3.5	3.2	2.9	3.3	4.8	6.2	9.2
Estonia	-	-	-	2.0	1.8	2.0	2.4	2.2	4.8
Hungary	7.4	12.7	12.6	10.4	10.4	11.1	10.4	9.6	10.3
Latvia	-	-	5.8	6.5	6.5	7.2	7.6	7.8	10.0
Lithuania	-	-	4.4	3.8	6.2	7.0	5.9	6.7	-
Poland	11.8	14.3	16.4	16.0	14.9	13.2	10.5	10.0	11.5
Romania	3.1	8.2	10.4	10.9	8.9	-	8.8	8.7	-
Slovakia	11.8	10.4	14.4	14.8	13.1	12.1	13.2	15.6	16.5
Slovenia	10.1	13.4	15.5	14.2	14.5	13.9	14.4	16.8	-

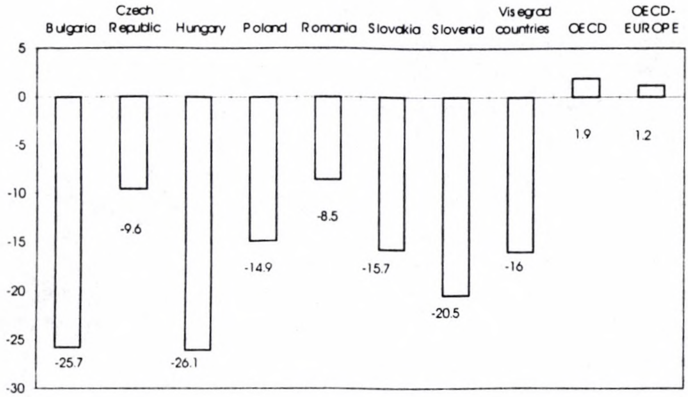
* estimates
Source: National Statistics.

We must add that unemployment rates in CEE do not give a full account of the situation of local labour markets yet. They are often calculated on the basis of questionable methodologies and unreliable data collection by local labour offices.[2] Moreover, by including only job-seekers they may reflect a trend towards non-registration,[3] and exclude other categories, such as those forced to take early retirement or those in receipt of disability pensions, whose number has sky-rocketed. Labour force participation rates are a good complementary measure in this regard. Detailed analysis shows their dramatic fall since 1990 (Burda, 1998, p. 5). *Figure 2* shows the dramatic fall in total employment in most Central and Eastern European countries between 1990 and 1994, averaging 16 per cent in the four Visegrad countries (Poland, Czech Republic, Slovakia, and Hungary), the absolute figure in Hungary being 26 per cent. This trend has continued, in striking contrast with the official decline in unemployment. Comparatively, total employment over the same period increased by 1.2 per cent in the European countries belonging to the OECD (see *Figure 2*).

[2] For instance in the case of Estonia, although official figures were giving a 2.2 per cent unemployment rate in 1998, figures calculated on the basis of ILO methodology estimated unemployment as 9.6 per cent of the working population (see *Economist Intelligence Unit*, Estonia, 1st quarter 1999).

[3] Registered unemployment is based on the data generated by local offices and is related to the advantages deriving from this status, such as access to job information, training programmes, and the provision of unemployment benefits. The ineffectiveness of local labour offices and active labour market policies, combined with the introduction of very tight eligibility criteria for unemployment benefits—as part of the new social safety net concept advised by the World Bank—in almost all Central and Eastern European countries, has led to a clear reduction in the number of registered unemployed.

Figure 2. Changes in Total Employment, CEE and OECD, 1990-94
(cumulative change over the period)



* End of year
Source: ECE, 1995.

The fall in employment has been particularly severe in industry. Regional unemployment differences have also increased: local unemployment in Central and Eastern Europe is now characterised by very high dispersion rates (Burda, 1998, p. 8).

Unemployment, a relatively new phenomenon in Central and Eastern Europe, is undoubtedly the worst development that the people of the region have had to face, since it simultaneously affects income, human capital, social status, living standards, morale—especially in societies in which work has traditionally been highly valued—and, as a result, health.

Moreover, since the beginning of the transition long-term unemployment has been a particularly significant feature, most unemployed persons remaining so for more than one year. Long-term unemployment seems to be continuing its growth. According to the ECE (1996), at the end of 1995 the proportion of long-term (over one year) unemployed varied between 31 per cent in the Czech Republic and 66 per cent in Bulgaria—in Poland and Romania the figure was 42–47 per cent, while in the other Central and Eastern European countries it was more than 50 per cent.

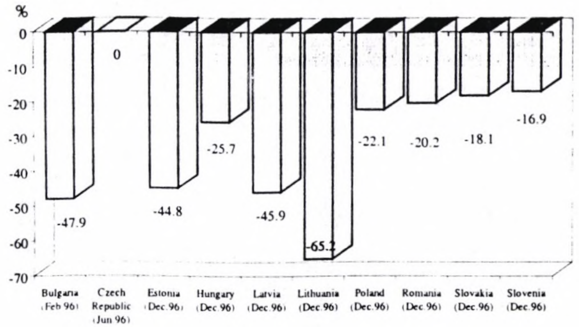
Ill-defined labour markets are thus a particular feature of the new applicants to the EU. It is doubtful that these countries will manage to increase employment levels significantly in the immediate future, even if they continue to register high GDP growth, mainly because there is still substantial overemployment (redundant labour) in many sectors.

The development of the black market has been particularly strong in Central and Eastern European economies. A central feature of the transition is overtaxation of the labour market—this has stimulated a large underground economy the extent of which has been described in a number of studies (Laky, 1998). While many of those officially unemployed are in fact working in the informal economy, they do so under precarious conditions, being excluded from the possibility of unemployment benefits and other social allocations should they lose their job. The extent of the informal sector is enormous throughout the region, and certainly represents a phenomenon potentially contributing to generate hidden borders with current EU members: in Hungary, for instance, it has been calculated to generate nearly half of GDP. Poland is another country where the black economy has expanded enormously. Many small- and medium-size enterprises have a core of officially reported workers supplemented by a second, unofficial group, enabling them to evade onerous tax and social liabilities, as well as to respond more quickly to demand fluctuations (Burda, 1998, p. 10).

1.3 The Sharp Fall in Real Wages and Incomes

One of the most worrying trends in Central and Eastern Europe is the sharp fall in living standards. The policy of price liberalisation launched in all countries at the beginning of the reform process led to an explosive inflationary surge which had an immediate impact on wages. Quite simply, wage rises lagged well behind, and when they did start to rise at rates comparable to price rises governments were encouraged to adopt a strict incomes policy. As a result, nominal wages fell well behind consumer prices and overall real wages fell rapidly and substantially in all the countries of the region. *Figure 3* shows that in 1996 all workers in Central and Eastern Europe—with the possible and very recent exception of the Czech Republic—were paid in real terms well below the wage levels which prevailed before the beginning of the transition: wages had fallen by around 26 per cent in Hungary, by around 17–22 per cent in Poland, Romania, Slovakia and Slovenia, and by 50 per cent in Bulgaria. Since then, although the situation improved slightly in Hungary and the Czech Republic in 1997–99, it continued to deteriorate in countries such as Romania and Bulgaria. By mid-1998, wages in Bulgaria had fallen in real terms by more than 70 per cent since 1991 (Tzanov and Vaughan-Whitehead, 1998). The Baltic countries have also experienced a sharp fall in real wages: 45 per cent in Estonia, 46 per cent in Latvia, and 65 per cent in Lithuania (in Russia, wages fell by over 70 per cent over the same period).

Figure 3 Changes in Real Wages, 1989–96 (Index 1989 = 100)



* For Bulgaria, index 1990 = 100

Sources: UNICEF (1998, p. 122) and Vaughan-Whitehead (1998, p. 25)

Besides the fall in real wages and incomes, the period since the late 1980s has been marked by substantial growth in wage differentiation between regions, sectors, and occupational and social groups. A few people have benefited tremendously from the changes, while the majority has sunk into destitution. In Hungary in 1993 the average income in the highest taxation bracket was almost 18 times the average income in the lowest taxation bracket: in 1988 the same ratio was only 3–4 times. Wage differentials in Poland increased by more than one quarter between 1991 and 1995. Workers at the lowest grades have been seriously affected by irregular adjustments of the minimum wage which, in almost all Central and Eastern European countries—with the possible exception of the Czech and Slovak Republics—have been allowed to fall well below the poverty line. Labour force fragmentation is particularly strong between workers in budgetary organisations—whose wages have been closely linked to the minimum wage—and those in other sectors.

Large disparities have also opened up between regions. In Hungary, for instance, three-quarters of the rural population belong to the three lowest income quintiles, while 40 per cent of the population of Budapest is in the highest income quintile (Szamuely, 1997, p. 17). This differentiation has caused widespread social discontent and it seems that the long-term danger of a fragmented labour force will be among the most serious labour and social policy questions for the remainder of the 1990s.

These very low wage levels—and so the enormous wage gap with the EU—constitute another reason for looking at Central and Eastern European accession in a different perspective. They certainly represent one major determinant of internal border(s) with current EU members in an enlarged Europe. According to *Table 5*, average wages in all Central and Eastern Europe continue to be much lower in USD terms than average wages in current EU member states.

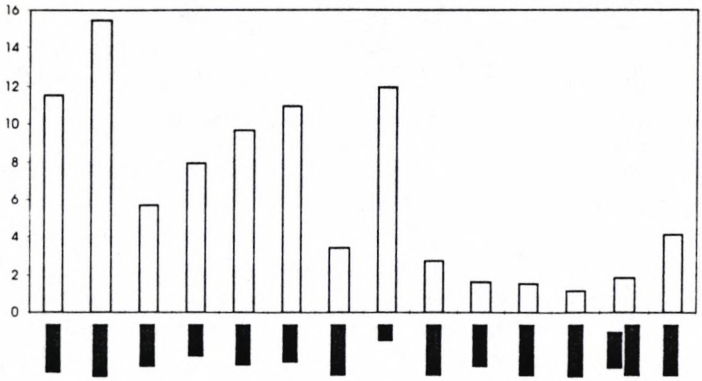
Table 5 Average Monthly Wages (in USD), CEE Countries, end 1998
(Gross wages otherwise indicated)

	National currency	Exchange rate for 1 USD	USD
Bulgaria	205,650 *Leva*	1,675	123
Czech Rep. (aver. 98)	11,818 Czech Crown	32.29	366
Estonia	4,185 *Kroons*	14.34	292
Hungary (aver. 98)	75,500 *Forints*	217	348
Latvia	140.8 *Lats*	0.57	246
Lithuania	1,041.1 *Litas*	4.00	260
Poland	1,369,000 *Zloties*	3,500	391
Romania	1,170,700 *Lei**	11,000	106
Slovakia	11,403 Slovak Crown	34.00	335
Slovenia	158,770 *Tolars*	161.20	985

* Net monthly wage
Source: National Statistics.

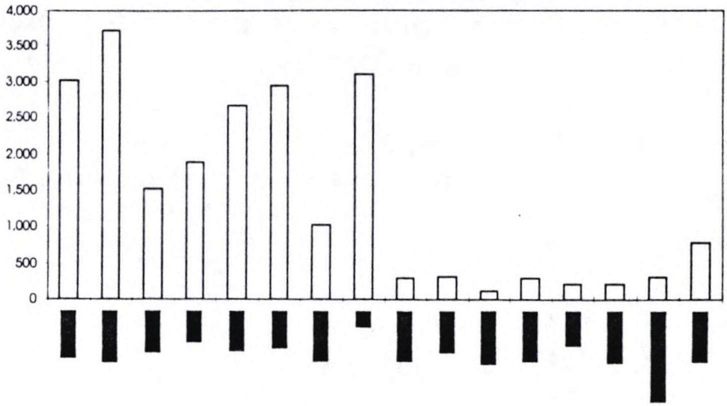
Figures 4 and 5 compare gross average earnings in industry in a few EU and CEE countries for two main categories of workers, manual and non-manual. They first show how less are the manual workers in CEE remunerated, with gross hourly earnings in Hungary for instance not reaching one fourth the average earnings of the manual labour force in UK, Belgium or Germany. We must add that these figures are probably underestimating the differences in net earnings, first because workers in CEE are not paid – if at all – for extra working time as in the EU, and second because income taxes are often much heavier in CEE than in EU countries. We will discuss in Sections 2.7 and 2.8 how much these wage differentials may motivate capital movements by EU companies towards CEE, as well as migrations of CEE labour force into the EU.

Figure 4. Average Gross Hourly Earnings of Manual Workers in Industry (in USD), CEE and EU Countries, 1997



Sources: Eurostat, Harmonised Statistics of Earnings; and national statistics

Figure 5. Average Gross Monthly Earnings of Non-manual Workers in Industry (in USD), CEE and EU Countries, 1997



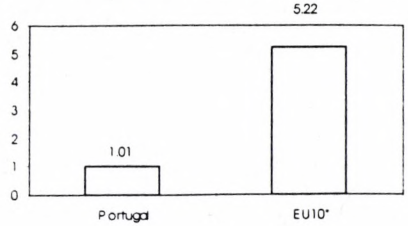
Sources: Eurostat, Harmonised Statistics of Earnings; and national statistics

It is important to note however that earnings differences were found to be even larger for skilled employees. In most EU countries, non manual workers are paid more than five times what their colleagues from CEE can get. Gross earnings for this category of workers in the country of CEE paying the best (Slovenia) remains well below the average earnings in the EU country paying the least (Portugal); this is not the case for manual workers, for whom a catching-up process has already started: *Figure 4* shows that manual workers are already better paid in Slovenia (USD 4.1 per hour) than in Portugal (USD 3.4). As for manual workers, differences in net earnings for non-manual workers may be even larger, not only because of heavier income taxes in CEECs but also because employees in the EU are also provided with a series of additional benefits and payments (such as profit-sharing, shares, individual bonuses) that are rarely the practice in CEE companies. These huge wage differentials for non-manual workers may well provoke an important mobility of this category of workers in the enlargement prospect, especially since these categories are traditionally highly-skilled in CEE and would be less discouraged than manual workers by cultural or linguistic obstacles (see section 2.8). This will vary of course by professions and skills, and their possible transposition from one country to the other, this process being more difficult for teachers for instance and easier for economists or engineers.

We should also emphasise that there are large differences among CEE countries themselves, average gross monthly wages for non-manual employees varying from less than USD 130 in Bulgaria and Romania up to USD 366 in the Czech Republic and even USD 985 in Slovenia, who has clearly taken the lead of CEE countries in terms of wages and incomes. These differences should be taken into consideration when discussing about the possible effects of the enlargement.

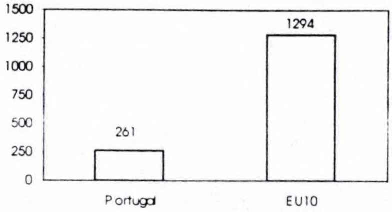
The huge average differences between CEE and the EU are undoubtedly another distinctive feature of the EU enlargement process to the East. It is interesting to observe what were the differences prevailing between the EU countries and Portugal – currently the EU country paying the lowest earnings – before its accession to the EU.

Figure 6. Average gross hourly earnings, manual workers, EU and Portugal before its EU accession, 1985 (last quarter)



*EU10 excluding Greece for which data are not available
Source: Eurostat

Figure 7. Average gross monthly earnings, non-manual workers, EU and Portugal before its EU accession, 1985 (last quarter)



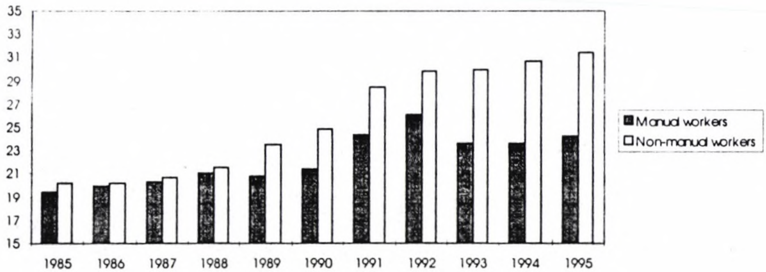
*EU10 excluding Greece for which data are not available
Source: Eurostat

Figures 6 and 7 show that earnings in Portugal at the end of 1995 were approximately 20 per cent only of the average in other EU countries, both for manual and non-manual workers. On the one hand, this difference does not seem to be much larger than the current average difference between the CEE and EU countries presented in *Figures 4 and 5.* On the other hand, other indications point to basic differences: first, the average in *Figures 6 and 7* do not include Greece (for which there are no available data on earnings), which would have decreased the earnings gap between Portugal and EU average; second, the average for CEE conceal great differences by individual countries (for instance between Slovenia and Romania) so that in fact, the earnings gap with the EU is comparatively to Portugal at the moment of its accession much larger for a majority of CEE countries; if we take for example Hungary which is not among the CEE countries paying the least, earnings for manual workers and non-manual workers are respectively 17 per cent and 8 per cent lower than average earnings of the same categories in Germany; the same categories in Lithuania would already be paid much less, only 7 per cent and 5 per cent their German colleagues of the same categories. Third, there seems to be a larger gap prevailing for non-manual workers in CEE: while the earning gap with the EU in 1985-86 was comparable for manual and non-manual workers of Portugal (19 and 20 per cent the EU average), the current situation of non-manual workers in CEE is particularly unfavourable, with average earnings below 13 per cent the average in the selected EU countries, compared to manual workers which are paid around 22 per cent the EU average.

Of course, the above figures should be progressively complemented by additional data giving more details by country, category of workers, sectors of activity, and our only intention at this stage is to provide some tentative trends.

Nevertheless, and whatever the differences in wages and incomes, it is also important to try to identify what type of catching-up process could operate after accession. As an indication, we provide in *figure 8* earnings differences between Portugal and the EU since its accession in 1986. It shows a rather slow adjustment process, earnings in Portugal having increased only from 20 per cent to 30 per cent of the EU average in a period of almost 10 years, although the process seems to have been slightly faster for non-manual employees.

Figure 8. Catching-up Process in Average Gross Earnings between Portugal and the EU, 1985-99 (average of Portugal/EU10* in %)



*EU10 excluding Greece for which data are not available
Source: Eurostat

From this experience, we can predict that the catching-up process of earnings will also be rather slow in CEE. Earnings in CEE will not come close to EU average before 15-20 years time, and there are enough foundations for expecting that they will remain significantly below that average, as Portugal today with regard its EU partners. On the other hand, the process may be quicker for CEE compared to Portugal for a series of conditions specific to CEE. First, because starting earnings are much lower in CEE, and the differences with the EU thus significantly larger for most countries in the region; second, because CEE have achieved their price liberalisation in a few years time which continues to have effects on price increases, and should lead to a faster increase in nominal wages (especially when we know that earnings declined in real terms since 1990); third, the fact that 10 candidates will join the EU may create more inter-relations in earnings in CEECs that may follow the same upward trend. The massive arrival of foreign companies in CEE – which traditionally pay above the national average – will also play a role in wage harmonisation across Europe.

However, even if we can expect a relatively faster catching-up process for CEE countries compared with what happened in Portugal, there are no reasons to believe that the comparative labour costs advantage of CEE countries will vanish overnight. Differences between CEE countries themselves are also expected to progressively increase.

1.4 Growth of Poverty and Social Differentiation: Contrast with the EU

The wage developments described above are particularly worrying in light of the fact that wage levels under the old regimes were already artificially low, and extensively complemented by a wide range of social benefits and services—encompassing education, holidays, housing, and health care—which have been severely curtailed or even eliminated in most countries in the region. This attempt to transform the social sector in most Central and Eastern European countries, making it more market-oriented and self-financing, is another peculiarity of the enlargement.

The people of Central and Eastern Europe have experienced a significant deterioration in social welfare, most governments in the region having cut expenditure and implemented a series of restrictive social policy measures. Governments first tightened eligibility criteria for unemployment benefits and other social allowances, which are now directed towards so-called 'target groups', a notion quite contrary to the principle of social protection for all citizens which prevails in the EU. The traditional social functions of enterprises have also been reduced: for example, social benefits are no longer channeled through the enterprise. Off-budget financing of social security has also been introduced: contribution rates for both employers and employees have been introduced in order to bolster the financial viability of various social security provisions. In fact, a large part of the financial burden has been shifted to employees, with moves towards 'insurance-type' schemes and citizens increasingly responsible for making adequate provisions for sickness, invalidity, old age, and unemployment. Autonomous voluntary mutual benefit funds have been set up in Slovakia, Hungary, and other Central and Eastern European countries, mainly in the context of pension reform.

These trends, combined with growing unemployment, have led to spectacular growth in the number of people living below the poverty line. In Poland, 36 per cent of all employees were found to be below the poverty line in 1994. According to household surveys, the number of people living below the subsistence minimum in Hungary increased from one to more than three million between 1990 and 1995, exceeding one-third of the population in 1996. In Bulgaria, not only wages but also all types of social benefits fell by more than 70 per cent in real terms between 1991 and 1998: as a result, the percentage of the population living below the poverty line increased from 36 per cent in 1992 to more than 70 per cent in 1998. More than 50 per cent of Romanian citizens were living below the subsistence minimum in 1996.

The gap has also continued to grow between EU and Central and Eastern European countries with regard to health. Undoubtedly, health care has undergone the most dramatic changes of any social protection system, with far-reaching cuts to both benefits and services. As a result, life expectancy has fallen in all Central and Eastern European countries (UNICEF, 1995, 1997, and 1998): for example, by 1993 the life expectancy of males in Hungary had fallen to nearly 8 years below the EU average. The difference with the EU average is also striking in Romania (-6 years), Poland (-4.6 years), and Bulgaria (-4.3). Expenditure on health care has fallen dramatically according to household surveys carried out in Hungary, but also in Poland, Bulgaria, and Romania. Far from solving the budget deficit crisis, increased health problems contribute to the development of an even greater financial burden.

Other key welfare indicators also point to a deepening of the crisis. Perhaps the most dramatic is the continuous fall in the main demographic indicators related to family formation and reproductive behaviour. In 1995 all Central and Eastern European countries experienced a decrease in marriage rates, especially those in which poverty growth was the highest, such as Bulgaria. Furthermore, in most transition years no country in the region has recorded an increase in the birth rate, while total fertility has gone down almost everywhere. The average number of children per family fell from 1.9 in 1989 in Bulgaria and Romania to 1.2 and 1.3 respectively in 1995. Other indicators, such as mortality rates, have also generally worsened since the beginning of the transition, especially in the Baltic countries. However, mortality rates have started to decrease slightly in some Central European countries, with the principal exception of Romania and Bulgaria. Crime rates have also increased, reaching high levels in Hungary, the Czech Republic, Bulgaria, and Estonia.

2. EU ENLARGEMENT AS A REMEDIAL PROCESS? DETERMINANT FACTORS AND POLICIES

The particular social and economic features of Central and Eastern Europe and their contrast with those of the EU have led a number of economists to focus on the uniqueness of this new enlargement process and the need to consider it as something more than 'just another accession'.[4] As yet, this work has not had much impact on the debate, which is still dominated by the portrayal of

[4] See, for instance, Eatwell et al., 1997.

enlargement as an expensive challenge to the West, demanding reform of the CAP and of the structural funds so that EU budget constraints are not breached" (Eatwell et al., 1997, p. 20). The aim of part 2 is to present a wider range of the economic effects of the enlargement process, and on this basis, to present the determinant factors and policies that may contribute to limit the gaps or erase the potential internal border(s) described in part 1. For being able to do this however, we must dedicate special attention to economic and trading relationships between CEE and EU countries, as well as providing a comprehensive assessment of the profound economic and social effects that accession would have on the applicants' economies.

2.1 Economic Growth: The Slow Process of Catching-Up

Not Attainable before Accession . . .

Closure of the gap in per capita GDP will require years. Despite the fact that some applicants are growing at substantially higher GDP growth rates than existing EU members—thus reducing the GDP gap every year—and that a convergence process may be at work (Boone and Maurel, 1998), this will not be enough to close the existing gap before accession. According to most forecasts, even with optimistically high GDP growth in Central and Eastern Europe and a constant 2 per cent growth in the EU, closure could not be attained before 2015. *Table 6* presents the two catching-up scenarii given in Richter (1998). Similarly, for Eatwell et al. (1997, p. 29), even in a relatively developed Central and Eastern European country such as Poland, "if they achieve a growth rate substantially higher than the existing members, it will be two or three decades before they catch up with the relative position of Greece today".

These very low levels of per capita income and the gap with current EU levels constitute the first good reason why this process should not be considered as 'just another accession' and should not be implemented in accordance with the established accession routine, as used for the earlier accessions of Greece (1981), Spain and Portugal (1986), and Austria, Sweden, and Finland (1995). For economists, it is this "comparatively low level of income per head and lack of social market institutions that make the extraordinary character of this accession" (Eatwell et al., p. 22). It has obvious implications in a number of areas, such as the EU budget, labour mobility, capital mobility, and social regulations.

Table 6 Catching up scenarii, CEECs, 1998–2015

CEEC catching-up scenario "A"		CEEC catching-up scenario "B"
Catching up to 75% of the average level of the European Union in 2015	**Target**	Catching up to 100% of the average level of the European Union in 2015
1. In the EU 2% annual GDP growth (at current purchasing power parity) in 1998–2015, with zero population growth. **2.** In the CEECs zero population growth and the following average annual GDP growth rates (at current purchasing power parity) in 1998–2015:	**Assumptions**	**1.** In the EU 2% annual GDP growth (at current purchasing power parity) in 1998–2015, with zero population growth. **2.** In the CEECs zero population growth and the following average annual GDP growth rates (at current purchasing power parity) in 1998–2015:
3.4%	Czech Rep.	5.1%
6.1%	Hungary	7.8%
6.9%	Poland	8.6%
5.2%	Slovakia	6.9%
3.4%	Slovenia	5.1%
10.1%	Bulgaria	11.8%
9.2%	Romania	10.9%

1998	1999	2000	2001	2002	2003	2004	2005	2010	2015		1998	1999	2000	2001	2002	2003	2004	2005	2010	2015
59	60	61	62	63	63	64	65	70	75	Czech Rep.	60	62	64	66	68	70	72	74	86	100
38	40	42	43	45	47	49	51	62	75	Hungary	39	41	44	46	49	51	54	57	76	100
34	35	37	39	41	43	45	47	59	75	Poland	34	37	39	42	44	47	50	53	73	100
45	46	47	49	50	52	54	55	64	75	Slovakia	45	48	50	52	55	57	60	63	79	100
58	59	60	61	61	62	63	64	69	75	Slovenia	59	61	63	65	67	69	71	73	86	100
21	23	24	26	28	30	33	35	52	75	Bulgaria	21	23	25	28	31	33	37	40	63	100
24	25	27	29	31	33	35	38	53	75	Romania	24	26	28	31	33	36	40	43	66	100

Source: Richter, 1998, pp. 40–42

The course of the transformation of the GDR into five new German *Länder* is rather worrying: despite massive financial transfers, unemployment remains high and economic growth very moderate. There is reason to believe that the enlargement will give rise to a whole series of economic problems and requires substantial changes in a number of sensitive areas.

Moreover, GDP growth seems to be slowing down in most successful Central and Eastern European countries in 1998–99, while Romania and Bulgaria have yet to experience recovery.

. . . But Likely to Accelerate Afterwards

The gap in GDP between Central and Eastern Europe and the EU has raised concerns about the significant financial transfers that would be needed to reduce it, especially in a context of slow economic growth in the EU (likely to remain limited to 2–3 per cent per year). However, this probably does not take into account the significant growth potential in Central and Eastern Europe, seemingly indicated by recent increases in GDP growth (much higher than in any of the EU countries). Such growth could be extended to the EU and amplified through a rapid enlargement process.

The ten Central and Eastern European countries would enlarge the total territory of the EU by one-third, increasing the population by 106 million people (about 30 per cent). Operating on such a scale would bring important new sources of competitiveness to EU member countries, offering an enlarged and rapidly expanding market, investment opportunities for investors, and the chance to diversify sources of supply. By creating such economies of scale, it would decrease costs and so generate higher profits. For the countries of Central and Eastern Europe, there would be an opportunity to obtain access to the very large EU market, a huge source of supply, and a source of both direct and portfolio investment, technology, and know-how. The enlargement could therefore bring substantial benefits to Europe as a whole.

If the enlargement to the East is achieved quickly, the dynamic nature of CEE markets may well lead most countries in the region to overcome their backwardness relatively soon.

From the EU's standpoint, there is a tendency to directly associate the costs currently borne by European industry to reinforce its position in the global economy with the costs of Eastern enlargement. We must stress, however, that the competitive pressure is being caused less by Eastern enlargement than by global competition. In the global quest for competitiveness, the enlargement represents a unique opportunity rather than a supplementary threat. The opening of CEE markets to both goods and capital has already allowed competitive gains in decisive sectors—such as automobiles—where European enterprises have clear difficulties keeping up with their American and Japanese rivals. In other words, the EU needs—and is already making use of—CEE markets in order to improve its competitiveness.

In this regard, the high costs of a failure to enlarge must be mentioned, just as the costs of a failure to achieve European integration were assessed before the single market was agreed (see Cecchini report, 1992). The longer enlargement is postponed, the more costs will rise and potential benefits decrease. For both Central and Eastern Europe and Europe as a whole it is thus desirable to help the former to join the EU in a relatively short period of time.

2.2 Trade: Intensified Flows between the Two Regions

The Association Agreements were a first major step towards the integration of Central and Eastern European countries into the EU. They provided for the abolition of all quantitative restrictions and tariffs on industrial exports to the EU from the applicants, with the exception of such 'sensitive' products as agricultural produce, chemicals, steel, and so on. An analysis of the subsequent effect of these agreements on trade will help us to get some idea of the implications of further enlargement.

From CMEA to EU

Before the transition, the bulk of the applicants' trade was with the Soviet Union and Eastern Europe, exports being mostly of machinery and imports mostly of raw materials and fuel. The collapse of these CMEA markets forced a rapid reorientation of trade. The Association Agreements with the EU have clearly helped in this process, redirecting trade towards the EU. Since the beginning of the transition in Central and Eastern Europe, its trade with the EU has intensified, more than doubling over the period. On average more than 50 per cent of the exports of every country in Central and Eastern Europe is directed towards EU markets (*Figure 10* in section 3.1). Bulgarian products seem to be particularly competitive. The structure of these exports is still biased towards raw materials and manufactured goods with low levels of processing, but there have been significant changes. In recent years, the fastest growth rates in Central and Eastern Europe have been registered by export-oriented industries, in particular those that have managed to penetrate new markets in the EU. For instance, this was the case in 1997–98 for timber-related and textile industries in Latvia.

A Balance in Favour of EU Partners

It is important to emphasise, however, that the EU has benefited most from the opening of CEE markets. While in 1996 the ten Central and Eastern European countries accounted for about 8 per cent of EU imports, the EU generated 37 per cent of its total trade surplus from this relationship. Between 1989 and 1994 EU exports into the CEE regions increased by 171 per cent, whereas the growth rate in the opposite direction amounted to only 116 per cent (Inotai, 1998). In 1997 the imbalance with the EU was particularly high in the Czech Republic and Slovenia. Hungary for instance had performed rather well in 1998, with EU countries absorbing 72 per cent of Hungary's total exports in the first half of the year. Hungary recorded a trade surplus of USD 35.4 million with the 15 EU countries, on the basis of a 26.6 per cent rise in exports and a 17.8 per cent increase in imports. However, the fact that a great part of these exports (but also imports) came from EU companies located in Hungary shows the extent to which EU and CEE countries' trade interests and future are interconnected. It shows also the possible drawbacks of a dependency on foreign investment: a slowdown in direct foreign investment in 1998 and 1999 contributed to increase trade deficit again.

This excess of EU exports over EU imports in Central and Eastern Europe constitutes an EU trade surplus which is increasing in volume every year, resulting in dangerous trade deficits in almost all Central and Eastern European countries (*Table 7*). According to Eatwell et al. (1997, p. 41) the total trade surplus of the EU vis-à-vis Central and Eastern Europe in 1996 approached 10 billion Ecu.

This has led economists to state that trade with the EU has contributed much to the high levels of unemployment in many of the applicant countries (Eatwell, et al., 1997, p. 47). In 1996 EU exports to Central and Eastern Europe grew by 21 per cent, while imports from the region increased by only 5.7 per cent, a situation that further deteriorated in 1997–99.

The commercial advantage of the EU will continue to grow for the next few years. The calculations of economists point towards a trade potential of between 20 and 50 per cent. They also predict that the share of Central and Eastern Europe in the foreign trade of the EU will reach 15 per cent of trade outside the EU by 2002 (Inotai, 1998). EU enlargement to the East will further contribute to EU trade expansion. At the same time, it could also help companies from Central and Eastern Europe to reinforce their low competitiveness which is one of the main causes of their trade deficit. CEE enterprises undergoing restructuring are not always up-to-date and do not have the necessary technology to provide goods of EU standard. They also lack marketing skills and have difficulty reaching international markets, especially the EU. A rapid accession process could provide the necessary technological transfers and networks for Eastern enterprises to expand further.

Table 7 Trade Balance, CEECs, 1993–2000 (in million USD)

	1993	1994	1995	1996	1997	1998	1999*	2000*
Bulgaria	-885	-17	-121	-188	-395	-135	-284	-375
Czech Rep.	-471	-1,366	-3,685	-5,877	-4,639	-2,540	-2,304	-2,664
Estonia	-144.9	-355.2	-673.6	-1,057	-1,187	-1,308	-1,237	-1,308
Hungary	-4,021	-3,716	-2,433	-2,652	-2,037	-2,200	-2,800	-2,500
Latvia	3	-300	-579	-798	-937	-1,000	-1,050	-1,150
Lithuania	-155	-205	-698	-896	-1,148	-1,600	-1,350	-1,000
Poland	-	-0.800	-1,800	-8,200	-11,300	-11,800	-13,400	-13,100
Romania	-1,128	-411	-1,577	-2,470	-1,978	-2,000	-1,700	-1,900
Slovakia	-912	109	-229	-2,283	-1,481	-1,630	-1,290	-
Slovenia	-154	-338	-954	-882	-772	-774	-1,077	-1,259

*1999–2000 forecasts are from EIU
Source: National Statistics.

Competitive Risks for Central and Eastern European Countries

The long-term mutual advantages notwithstanding, the development of trade could involve competitive risks for both groups of countries, but particularly for Central and Eastern Europe. First, because its industries are less competitive and below EU standards, and second, because it is much more dependent on trade with the EU than its EU partners. Agriculture and coal mining seem to be particularly vulnerable. The only way of avoiding structural imbalances in these sectors would be to open up EU markets as soon as possible. As an experts' report concluded (Eatwell, et al., 1997, p. 47), the exclusion of agriculture and other sensitive sectors from the free-trade commitment has had the direct result of increasing the superior competitiveness of EU firms and of contributing to the high levels of unemployment in many of the applicant countries. According to Polish estimates, Poland's trade deficit with the EU has meant the loss of 1.2 to 1.4 million jobs, whereas in the EU the trade surplus has resulted in job creation (Kabaj, 1997); according to the German Institute for Economic Research trade with Central and Eastern Europe preserved or created 60,000 workplaces in Germany in 1993.

For some economists, such persistent trade deficit is not dangerous, since it reflects a combination of EU financial support for the transition process, significant foreign direct investment flows, and increased consumption in Central and Eastern European countries partly due to higher GDP growth. On the other hand, a persistent trade deficit may also give rise to a number of legitimate concerns. First, it may represent a serious obstacle to generalised economic growth in Europe as a whole by leading progressively to a further deterioration of purchasing power in the region, thus limiting import growth and interrupting the potential gains from trade exchanges. Without enlargement, which would help Central and Eastern European countries to compensate with other economic and welfare benefits, this second scenario could well become a reality. Second, although it is true that current account deficits can be financed by capital inflows, too great a reliance on the latter is dangerous since they may cease in response to changing economic conditions.[5] If enlargement does not take place fairly soon capital flight may well occur. Third, the extent of the trade deficit is worrying since it has already motivated many governments in the region to implement deflationary policies. This happened in Hungary in 1995. Successive devaluations—which have the direct effect of rendering exports more competitive and imports more expensive—have helped CEE countries to limit their trade deficits: this was the case, for instance, with the devaluation of the Czech crown in May 1997. The Polish Government also devalued in July 1998. Although there are good reasons to assume that CEE governments will wish to continue the policy of competitive devaluation, this will become more and more difficult as Central and Eastern European countries experience the real appreciation of their currencies. Integration into the EU and a commitment to Economic and Monetary Union will eventually deprive Central and Eastern European countries of the instrument of competitive devaluation, with clear implications for their competitiveness and trade balances. It may also seriously affect restructuring efforts. These costs for CEE economies must be taken into account by current EU members when formulating the conditions of enlargement. In particular, other economic benefits will have to compensate for this lost flexibility in respect of exchange rates.

2.3 Foreign Investment: A "Levelling up" Role

Since the beginning of the transition, significant foreign investment flows have been directed towards Central and Eastern Europe. Stocks of total foreign direct investment in the ten CEE candidate countries had reached approximately USD

[5] Albania represents a good example, since it has relied too heavily on foreign investment since the beginning of the transition: after the political and institutional crisis of early 1997 foreign investment suddenly fled the country, laying bare the extremely underdeveloped domestic production sphere.

41 billion by the end of 1996. Two-thirds of that originated from EU members. As shown in *Table 8*, Hungary, Poland, and the Czech Republic have been the prime beneficiaries.

Table 8 Foreign Direct Investment Inflows in CEE, 1992–98 (in million USD)

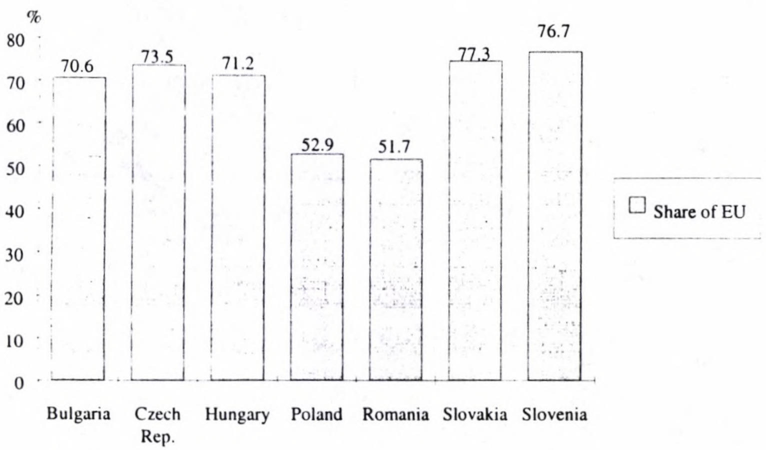
	1992	1993	1994	1995	1996	1997	1998
Bulgaria	-	40	105	90	109	504.8	363.9
Czech Rep.	-	564	762	2,531	1,394	1,258	1,300
Estonia	82.3	162.2	214.4	201.5	138.1	130.5	-
Hungary	1,479	2,350	1,144	4,519	1,982	2,079	1,935
Latvia	-	45	214	180	382	418	275
Lithuania	-	30	31	73	152	355	793
Poland	678	1,715	1,875	3,659	4,000	5,678	8,230
Romania	-	87	341	417	263	1,229	-
Slovakia	-	-	185	181	666	200	384
Slovenia	-	113	128	176	185	321	140

Source: National Statistics, IMF.

We must emphasise the crucial role that foreign investment seems to be playing in the catching-up process. In a context of production crisis, foreign investors not only provide fresh capital and introduce the newest technologies, they also provide access to external markets. In this way they represent the best means of adapting local production to international standards. They also play a key role in improving export performance and reducing the enormous trade deficit with which most Central and Eastern European countries are confronted. It is significant that only Hungary, which has accumulated most foreign capital since the beginning of the transition, was able to improve its terms of trade in 1997 and early 1998: it is estimated that 70 per cent of Hungary's industrial exports in 1996 came from foreign-owned firms; since mid-1998 lower foreign investment has rapidly contributed to worsen the trade deficit. Similarly, in the Czech Republic foreign investors have contributed to increasing exports in machinery and transport equipment to developing countries. An important factor was the increase in sales of Skoda cars following the takeover by Volkswagen and the implementation of major new investment. This was also the case in respect of exports to the EU in Latvia, Lithuania, and Estonia, which were mainly driven by foreign investors, generally from neighbouring Scandinavian countries.

On the other hand, the possibility of benefiting from local comparative advantages such as a cheap and skilled labour force is a very important factor in improving the competitiveness of major EU companies. It is sufficient to note the importance of their new industrial location within the framework of their global world strategy to better understand their role. For example, Audi's new factory in Hungary is aimed at supplying European markets with their new models at the best competitive price. Similar motivations have attracted Philips and other multinational companies to Hungary and other countries in the region. Industrial relocations of this kind can lead, as we will see in Section 2.7, to employment losses in current EU member states. However, they can also positively influence their labour markets. According to estimates, economic growth in Austria without relocations in Central and Eastern Europe would have dropped by approximately 0.5 per cent in 1998 and 1999, with direct effects on the Austrian labour market (Inotai, 1998, p. 28). This aspect is particularly important in the current context of very slow economic growth in the EU.

Figure 9 EU Share in Foreign Investment in CEECs, End 1996 (in %)



Source: Hunya, 1998

Such effects will be multiplied when the accession countries become full members of the EU. Many companies have already located part of their industrial production in the expectation of Eastern enlargement. According to *Figure 9*, between 50 and 75 per cent of foreign investment in Central and Eastern Europe has been made by EU enterprises.

The commencement of official negotiations gave foreign investors a boost, with its promise of future full membership. It should lead to more capital movements. It would not be theoretically relevant to try to identify whether such movements, led by the need to become more competitive, would have taken place anyway, even without the prospect of Eastern enlargement.[6] The important thing is that enlargement and the extension of the single European market to Central and Eastern Europe could multiply the positive economic effects expected from such capital movements. They would also constitute the best guarantee that these capital inflows would not vanish overnight and steer foreign capital into longer term assets. On the other hand, delaying the process would reduce potential profits, especially for those European companies that have calculated on the EU membership of the host countries. It would also lead to an increased risk of sudden capital outflows with serious destabilising effects. The fact that more than 90 per cent of net capital flows have concentrated in the first round candidate countries is a good indication that the prospects for accession contribute considerably to the credibility of CEE countries.

Despite all the positive effects that foreign investment could have, in helping both Central and Eastern European countries to catch up with economic developments in the EU and EU members to gain in competitiveness, we should also emphasise that in many cases foreign investment can be highly detrimental to local economic growth. This is particularly the case when foreign investors establish new production facilities in Central and Eastern Europe without a long-term development strategy, but rather to accumulate short-term profits by taking advantage of cheap labour costs. In this case the foreign investor often imports all its raw materials from the home country, processes it using cheap and generally low-skilled local labour, and then exports the totality of its production to EU markets. Foreign investment of this kind contributes nothing to the development of local production in the direction of higher value-added processing and generally flows out of the country when the price of the labour force increases: they may accentuate potential hidden borders between applicant countries and current EU member states. Such investments have been found to have serious adverse effects, even in the poorest countries in the region which are in desperate need of fresh capital.[7] The enlargement process should contribute to limiting foreign investment flows of this nature by motivating

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[6] This argument has been often put forward to play down the importance of the enlargement process for EU enterprises.

[7] This type of foreign investment has had a particularly negative effect in Albania, where it contributed to the economic and social crisis of early 1997. For a detailed assessment, see Vaughan-Whitehead, 1999. Similar behaviour from foreign investors has been observed in Bulgaria and Romania, but also other CEE countries.

long-term foreign investment, generating integrated markets, and progressively increasing CEE labour costs to EU levels.

2.4 Domestic Markets: The Missing Pillar

Despite the importance of foreign investment, the catching-up process will not take place without the appropriate development of local markets. Trade deficits have also increased in Central and Eastern Europe because of the absence of local producers, progressive economic recovery leading systematically to import demand growth rather than increased domestic production.

As pointed out by the OECD (1995, p. 147): "Foreign investment is no substitute for domestic policies that encourage entrepreneurship and investment, because FDI is most likely to flourish under conditions that are also attractive for domestic investors."

Indeed, developing local markets are important assets for foreign investors. The potential advantages for EU operators from the development of consumer demand are enormous. Modernisation of local producers would also increase their demand for capital goods from the EU. In other words, "the emerging CEE markets could provide a . . . kind of compensation for [the] EU's worsening international position" (Kiss, 1997, p. 13).

If domestic markets and local production are to be boosted, two major conditions must be urgently implemented: (i) a progressive increase of living standards and consumption; and (ii) an improvement of credit facilities for the production sphere, with the banking sector acting as a credit intermediary. These two conditions would involve the relaxation by most governments in the region of their restrictive monetary and incomes policies, implemented on the advice of international monetary institutions, namely the IMF and the World Bank. Although inflation should clearly remain a priority, especially in view of the enlargement and the prospect of Economic and Monetary Union, it is also clear that the restrictive monetary policies adopted in recent years in Central and Eastern Europe have asphyxiated its production sector, which is ironic when we consider that these countries have mainly faced a production crisis (Vaughan-Whitehead, 1998). It is also necessary to take measures to boost investment, including favourable tax treatment of business profits and improved credit conditions for entrepreneurs, especially small- and medium-size firms.
Similarly, as documented in Part 1, the restrictive incomes policies so far implemented have resulted in excessive falls in real wages and living standards, something which must change if increasing local demand finally becomes a policy priority in the region.

Rapid enlargement should facilitate such policies by reducing the cost of credit for small entrepreneurs, leading to greater economic growth and higher living standards for consumers.

2.5 Agriculture: Short Term versus Long Term Interests

Most EU fears have so far focused on the integration of Central and Eastern European agriculture. Because of their agricultural potential, their relatively low agricultural prices, and the share of agriculture in GDP, the application of the current CAP and structural and cohesion funds to CEE economies would be very costly. It is very likely that the new members can expect substantial net transfers as members of the EU, invaluable for improving infrastructure, restructuring the economy, and stimulating investment. The net budget cost to the EU has been estimated at over 10 billion Ecu, or approximately 15 per cent of the estimated EU budget in 1999.[8]

This vision, however, is much too simplistic, and again neglects the enormous advantages that the integration of Central and Eastern European countries could bring to the EU as a whole in this highly sensitive sector. We should first emphasise that trade imbalances between the CEE and EU countries are particularly significant in agriculture, with growing food imports in Central and Eastern Europe. Agricultural goods represent nearly 10 per cent of EU exports to Central and Eastern European countries, compared to less than 5 per cent of EU imports. Since the beginning of the transition EU countries have re-orientated part of their agricultural production towards Central and Eastern Europe. EU agribusiness has gained significant additional markets from trade liberalisation in Central and Eastern Europe, but CEE agriculture has failed to gain additional markets in the EU. This sector is playing a key role in the growing trade deficit of most Central and Eastern European countries with the EU. In 1995 the agricultural trade surplus of EU(12) with Central and Eastern European countries (the ten candidate countries plus Albania, Croatia, Bosnia-Herzegovina, Yugoslavia, and Macedonia) was 1.1 billion Ecu (Eatwell et al., 1997, p. 34); in the intervening time it has only deteriorated further.

Although this situation is advantageous for EU countries, it is having a serious affect on CEE agriculture, delaying its reform even further and so hampering its potential growth. It is undoubtedly one other determinant of "hidden borders" between applicant countries and current EU members. In future, this could only lead to more of the financial transfers that the EU countries are so afraid of. It has also led to a dangerous increase in food prices

[8] See, for instance, Baldwin et al. (1997).

—which is particularly problematic in countries where expenditure on food is already over 50 per cent of total household expenditure— that contribute to enlarging the percentage of the population living in poverty.

Rapid liberalisation of the EU agricultural market would facilitate the CEE catch-up process in agriculture; besides having an important share of GDP, this is crucial for the maintenance of living standards.

At the same time, in the course of privatisation, many EU multinationals in agribusiness have managed to acquire dominant positions in the food industries of Central and Eastern Europe. They have already started to build up a vertical production chain in the region and are preparing for the enlargement, from which they expect significant profits. This is a clear indication of the importance of Central and Eastern European agriculture to EU countries.

Moreover, it is obvious that the Common Agricultural Policy cannot continue with enforced production quotas and must be reformed in the direction of lower costs, a change which the accession of Central and Eastern European countries could only assist.

2.6 The Social Dimension: Risks and Prospects

In light of the social difficulties that still prevail in Central and Eastern Europe and the economic developments expected from the enlargement process, it is also important to analyse the main social effects that could emerge when CEE countries join the European Union. We shall try to distinguish between the employment effects and other social phenomena, such as living standards, labour conditions, and labour standards.

First, it is obvious that the economic and social discrepancies described in Part 1 could result in serious social problems if they were allowed to proceed. Fall in real wages and living standards, the disappearance of social services that previously were generously provided, and cuts in social protection could increase the risk of industrial relocations from the EU to Central and Eastern Europe and could also generate significant worker migration to the EU where wages and social standards are much higher.

With regard to employment, the enlargement process could have a range of both positive and negative effects. First, it can be expected to result in new job creation by providing new investment opportunities and increasing global economic growth within the EU. Dynamic trade exchanges are also a direct way of creating higher profit margins, and of converting them into new jobs.

Productivity improvements can also lead to increased employment. Capital movements are another way in which large European corporations can gain in competitiveness, so contributing to the global improvement of the employment situation in the new Europe.

At the same time, it is obvious that the enlargement will entail serious adjustments of local labour markets. In many cases, the free circulation of capital, labour, and goods will not have the same benefits for current EU members and for new EU members from Central and Eastern Europe. Let us look at a few examples. (i) In respect of terms of trade, for instance, the increasing EU trade surplus with CEE countries has had a positive influence on employment in the EU, but a detrimental one on CEE labour markets. (ii) Migratory movements of workers from CEE to EU countries, with their competitive features—skills, low costs, flexibility—could indirectly affect a not insignificant proportion of the current EU workforce. On the other hand, these same migratory movements could relieve the tensions on local labour markets in Central and Eastern Europe. At the same time, a substantial 'brain drain' could seriously harm the intellectual capacity of CEE countries and result in a fall in their employment, while contributing to enhance the competitiveness of EU enterprises. It could also have a negative effect on European competitiveness as a whole if the migration of skilled labour is not directed towards western Europe, but towards other continents. (iii) The question of industrial relocation is extremely complex. While it can help to reinforce the competitive position of EU enterprises, so theoretically helping them to improve their employment situation, the creation of new factories in the East could be accompanied by closures in current EU member states. Employment creation in Central and Eastern Europe would then be achieved at the expense of jobs in other EU countries, the shift in production being accompanied by a shift in employment, even if this movement can reveal to be beneficial for the global employment situation in Europe. All employment effects, especially within the framework of the high unemployment rates in both Central and Eastern Europe and the EU, would directly affect social developments. Massive movements of capital or labour, that many regroup as "social dumping risks"—although often based on fair competition and comparative advantages—could also rapidly influence the future shape of Social Europe. In the next three sections, we discuss these social aspects in more details.

2.7. Capital Relocations: Possible Social Implications

Important Movements Already Taking Place

A number of factors seem to indicate that the risk of industrial relocations to CEE countries would be greater than those expected when the southern European countries (Spain, Portugal, and Greece) joined the EU.[9]

1) Wages are much lower and wage differentials with EU countries are therefore much higher: in Part 1 we detailed the huge gap with the EU, citing an average monthly wage in the ten CEE countries at the end of 1998 of less than USD 350. This gap will continue to exist for the foreseeable future.
2) Employers' contributions and social standards are often much lower in CEE countries.
3) Central and Eastern Europe benefits not only from very low wages, but from a highly educated and skilled labour force (with for example an impressive number of engineers and technicians, which has always been one of the region's main assets).
4) Foreign investors can build on existing successful local industries. This is the reason why industrial relocations could take place to Central and Eastern Europe in a much larger number of sectors and activities than sometimes believed.

Numerous EU companies have already relocated part of their activities to Central and Eastern Europe. We might mention Philips, the Dutch consumer electronics giant, which has 11 factories in Hungary alone, in eight different cities, manufacturing everything from CD players and cassette decks to PC monitors.[10] According to the chairman of Philips Hungary, these relocations are part of the parent company's global restructuring programme that will cut 6,000 jobs and shift some facilities from Western Europe to Hungary. The existence of a labour force which is cheap as well as skilled has been the most attractive factor for Philips. It has also benefited from local expertise, starting as it did with a co-operation project with the Hungarian electronics company Videoton before becoming independent. The same happened with IBM, Blaukpunt, and many other European multinationals.

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[9] According to a study prepared by the EC, *Cellule de Prospective*, industrial relocations motivated by the European Single Market were expected to be limited to a small number of traditional, low value added and labour intensive sectors, as it seems to have effectively happened. See Vaughan-Whitehead (1992).

[10] 'Why Philips has 11 Hungarian factories', interview with W. van der Vegt, Chairman of Philips Hungary, in *Budapest Business Journal*, 21–27 October 1996.

Industrial relocations will take place on an even larger scale when CEE countries become members of the EU, taking advantage of the possibility for EU companies to locate their production in any member country for the purpose of feeding any other member country. We must stress, however, that the high probability of such painful labour force adaptations should not be seen as a consequence of the enlargement process as such. The high unemployment rates all over Europe are less a consequence of an enlarged single market than a reflection of Europe's difficulties in keeping international competitiveness, and also the rigidity of local labour markets. The new growth expected from the enlargement to the East (described in Part 2) can only help employment in Europe in the long run. Avoiding or postponing employment adjustments would only lead enterprises to lose potential comparative adjustments and weaken the position of Europe in world markets.

Moreover, we have also seen that industrial relocations, if implemented within the framework of an enlarged Europe, could only promote integrated rather than fragmented markets in Europe, so leading to higher competitiveness (see Part 3). As clearly stated by the chairman of Philips Hungary, "if Philips had no possibility of shifting certain categories of production from Western to Eastern Europe, it might have to abandon entire industries".

Limiting the Social Costs

Since foreign investment in Central and Eastern Europe by EU companies and, unavoidably, industrial relocation of production facilities are already realities of an integrated Europe it is important at least to minimise their social costs for EU countries, particularly because such movements will accelerate as enlargement looms ever closer.

Industrial relocations would not necessarily entail a high social cost, especially in terms of unemployment, if the necessary conditions are put in place. First, it is clear that, while we should not suppress the comparative advantages of CEE industries, wage and social differentials should be progressively reduced; we develop this policy issue in section 2.9. Second, social costs could be limited if industrial relocation took place on a small scale and were distributed over a wide variety of sectors. This scenario seems unrealistic at the moment, however, given that the social trends described in Part 1 are weakening the assets that CEE economies would need (skilled labour force, high productivity, strong internal markets) to remain in higher value added production. This process entails the risk of massive movements of capital, attracted mainly by lower wages and social standards, especially in traditional sectors which are generally labour intensive, with a high risk of increasing unemployment in other EU countries. This tendency is reinforced by the fall in domestic demand in Central and Eastern Europe, which motivates industrial relocations with the sole aim of benefiting from low labour costs and with the intention of exporting the whole of production instead of developing local markets. This clearly could reinforce internal "hidden borders" and promote the evolution of a fragmented European economy—a two-speed Europe—with low-skill production being carried out in the East and high-skill production in the West. Again, a rapid enlargement process would contribute to minimising such fragmentation and accelerate the shift towards integrated trade (see Section 3.1). International trade union co-operation—either through bilateral contacts or through European work councils—could also play an important role in preventing such developments. At the same time, the action of CEE governments is also essential to attract and direct foreign investment in a large number of sectors. Unfortunately, CEE countries—in their desperate need for capital—have so far not shown much initiative in this direction and have preferred to shower an impressive range of advantages and incentives on investors of all kinds, whatever their activities and strategic intentions. Labour regulations also have a role to play in limiting the number of industrial relocations motivated by the relative lack of legislation, labour standards, and social monitoring in Central and Eastern Europe.

2.8 Labour Migration: Risks of Massive Movements?

One of the principal advantages that CEE countries hope to gain from accession is the right for their citizens to seek employment anywhere in the EU.

The Possible Extent of the Process

The possibility of a massive labour migration represents one of the main fears of EU members—among other things, in their view, this would entail substantial employment losses for their current labour force. This is the reason why many EU trade unions have argued for delaying the free movement of labour as long as possible, either by deferring membership or by insisting on a long transition process before free movement of labour comes into effect.

Some member states, notably Austria and Germany, have also insisted on transitional restrictions on labour mobility, even after accession has taken place.[11]

[11] Paradoxically, it is precisely those member countries that have registered the greatest benefits from the opening up of Central and Eastern Europe that have asked for such transitional restrictions.

From the EU side, the risks of massive migration have certainly been exaggerated, and so have undoubtedly taken a disproportionate place in the discussions on the enlargement process. On the other hand, almost all economists and policymakers in Central and Eastern Europe have sought to minimise the labour movements that might be expected as a result of the enlargement process. They have put forward a number of factors that could limit migration, such as divergent professional qualifications, language barriers, and cultural and psychological obstacles. A lack of demand for labour from EU countries has also been cited by a number of labour economists (Inotai, 1998). However, although massive migration should not be foreseen, we believe that the potential of the migration process is significant. This would depend less on the factors cited above than on economic and social developments that will occur in CEE countries over the next few years.

Economic growth is crucial in this connection, and we should distinguish between CEE countries themselves. The larger economic growth becomes in CEE countries, the narrower the gap will become between current members and future EU members. For instance, the more favourable situation of Slovenia, considered the richest of the current candidates for EU accession—its GDP is not far below those of Greece and Portugal—should in theory mean that less migration can be expected from it than from countries which still face appalling economic problems, such as Romania and Bulgaria. In this regard, although we have seen that it is likely to remain for a long time, the experience of past enlargements suggests that the wealth gap would decrease much more quickly after accession, an argument which provides further support for a rapid enlargement process.

The evolution of labour markets in Central and Eastern Europe will also be important. The persistence of high unemployment, for instance, mostly long-term and affecting mainly unskilled manual workers with little education, could become a major factor behind migratory movements if economic growth fails to create sufficient new jobs. This movement would clearly also add to unemployment problems in the EU and so weaken trade union resistance to employers' demands for lower wages and lower welfare provisions.

The effects of the other social and economic discrepancies described in part 1 will also be important in this connection, and we must again emphasise the fact that these discrepancies are much larger than those which characterised previous EU enlargement processes, even those involving southern European countries. Very low living standards, impoverishment wages, insufficient social protection, and the absence of a real economic take-off could well push a substantial portion of the labour force to look for work in other EU countries. It is clear that these risks could be progressively minimised if social standards and wage levels in Central and Eastern Europe were generally improved.

Significant Variations in Expected Risks of Migration

For the reasons mentioned above, the risks will differ considerably from country to country in Central and Eastern Europe. Persistent adverse economic and social conditions in Bulgaria, for instance, do not offer much hope to many workers and their families, and to young people wishing to enter the labour market, and could motivate labour movements on a large scale, while the situation in Hungary, where foreign investment is creating new job opportunities, should minimise the problem.

Labour movements may also affect particular categories of workers, for instance employees from the budgetary sector who continue to receive miserable wages despite their high average qualifications. Wage differentials – as we saw above – that are particularly large for non- manual employees between EU and candidate countries may also generate an important migration of skilled employees from CEE, especially among the most mobile categories or professions (young skilled employees, engineers etc.).

For manual workers, large movements may come from the most vulnerable and discriminated-against categories in the transition process, such as ethnic minorities which are very numerous in some CEE countries. Around 600,000 Hungarians are living in Slovakia in difficult social and economic conditions. The persistence of high (and long-term) unemployment rates among these categories—in Hungary, for instance, according to unofficial statistics, Gypsies would suffer from a 46 per cent unemployment rate compared to 10 per cent among the majority population—will in all likelihood motivate them to look for alternative jobs in other EU countries.

The significant populations of these countries is another factor which points to the danger of large emigration in the future.

In general, movements of capital reduce migration pressures both for manual and non-manual workers, so emphasising once again the role of foreign investment. Wider distribution of foreign investment in Central and Eastern Europe—which so far has been concentrated in Hungary, Poland, and the Czech Republic—would represent a positive development in the effort to prevent labour movements from poorest CEE countries. This issue also underlines the need to open up the enlargement process to the majority of CEE countries rather than to a few privileged candidates (see section 3.4).

No Grounds for Delaying the Enlargement Process

Despite these clear risks, the high probability of migratory movements is not an argument for delaying the enlargement process, but for accelerating the catching-up process, something that could be realised only by means of full integration of CEE countries in the European community.

Every delay in the catching-up process could exacerbate the danger of migration. The example of mass migration from Albania—albeit brought on by an extreme situation, although against a background of merely symbolic wages and a lack of local prospects—seems to show that such movements can emerge overnight when social and economic conditions rapidly deteriorate. It is also important to note that the mass migration of Albanian workers in March 1997 was rapidly absorbed by the Italian labour market, both the formal and the informal, and so constituted a real substitute for the local labour force. It was immediately followed by a fall of 40 per cent in the number of seasonal contracts for locals in certain areas of *Mezzogiorno*. Similar developments, of course on a minor scale and motivated by other factors, could well emerge in other CEE countries, including those that are currently negotiating their accession to the EU. This also proves that the demand for immigrant workers is not absent in EU countries, and that it could increase even further if the financial situation of EU enterprises, in a context of economic stagnation, deteriorates over the next few years. Here again we see the importance of economic growth, in both regions of Europe, for limiting the risks of social dumping, another argument in favour of rapid enlargement.

We should also emphasise that the debate on labour migration from Central and Eastern Europe has so far failed to take much account of either the costs of enlargement for the applicant countries or the benefits for EU members. According to Burda (1998), the price of EU membership, even if attenuated by rapid accession, would be much too high for CEE labour markets. While it would yield significant economic advantages, it would also entail the additional burden of structural adjustment, as inefficient producers in agriculture, high-tech manufacturing, and services would be squeezed. Unemployment would therefore increase. In such a context, free movement of labour is an important adjustment mechanism within an economic and monetary union, and "it would be quite absurd to expect the applicants to join a monetary union without allowing them free movement of labour" (Eatwell et al., 1997, p. 55).

Labour mobility could also have advantages for the recipient countries. An inflow of young workers likely to pay social security contributions for many years would make a useful temporary contribution to maintaining the level of pensions in countries with rapidly ageing populations, such as Germany and Italy (CEPR and IEWS, 1996, p. 9). A new, skilled labour force could also provide dynamism and innovation in the EU's stagnating economies (although it would represent a net loss in human capital for Central and Eastern Europe).

Some economists and businessmen from the EU have tried to emphasise the positive aspects, insisting on the important asset that such mobility could represent for European industry. According to Dr H. Glatz of Daimler-Chrysler: "Labour mobility is simply a by-product of globalisation, and a particularly useful one in that it supplements the drive for competitiveness."[12]

2.9 Improving Working Conditions and Labour Standards

Even more worrying than the increased risk of social dumping in an enlarged EU is that of *generalised social deprivation* in Central and Eastern Europe, with significant economic and political implications for the EU as a whole. A continuous decline in the living standards and consumption levels of CEE citizens would inevitably generate a fall in economic growth in the enlarged European single market. On the political side, nearly every recent election in Central and Eastern Europe has shown how social discontent can lead directly to political instability and to the rapid growth of nationalist movements. A continuous fall in living standards and an increased risk of social dumping would also directly threaten the survival of the European social model.

EU member countries should therefore press the applicants to increase their wages and social expenditure and to raise their labour market regulations to EU standards. There is a need for a balanced and progressive strategic policy in this regard, and there are several arguments to take into account:

1) On the one hand, it is important to raise wages in CEE countries: first because, as we stated in Part 1, they have fallen in real terms throughout the transition, so leading to increased destitution; second, because it must be an EC objective to progressively increase wage levels, but also to improve labour conditions in Central and Eastern Europe to EU levels. Persistent low wages below the minimum social requirements (for instance, fixed below the poverty line) as well as the absence of social regulations, such as individual labour contracts or poor working or environmental conditions, would rightly be considered as unfair competition (or social dumping) by current EU members.

[12] Interview in the *Economist Intelligence Unit*, Briefs, 2 December 1998.

2) At the other extreme, it is important to avoid the example of eastern Germany (the former GDR) in which rapid harmonisation of wage rates—implemented under pressure from the German trade unions—to western German standards led to dramatic restructuring, closure of enterprises, and job destruction. CEE countries must be allowed to preserve their labour-cost advantage in order to ensure their economic growth and in order to retain a role in the European integration process. This is also an important factor in convincing Central and Eastern Europe of the good will of the EU.[13] This is also in the interest of EU companies in the perspective of world-wide competition and globalisation. Moreover, at the other extreme, any rapid adjustment in wage levels in Central and Eastern Europe would lead merely to further expansion of the informal sector, with the implementation of even lower social norms and payment conditions, so endangering European integration even more.

Certainly, wages and core labour standards should be treated in a differentiated way. While CEE countries should by no means be permitted to opt out of EU social policy, wage policy harmonisation should be considered as a long-term objective. Substantial economic growth in Central and Eastern Europe would lead naturally to higher wage growth.

3. NEW BORDERS, NEW PROSPECTS FOR A REMODELLED EUROPE

After having identified some of the possible effects expected with eastern EU enlargement, we discuss in part 3 what implications this process may bring for Europe in the longer term. On the economic side, we discuss how the removal of internal borders may change the nature of competition in Europe, and modify consequently EU's position in international markets, especially vis-à-vis its main competitors, Japan and the United States. For that economic growth to be sustainable however, we also emphasise that a number of adjustments are required both at the sectoral and regional levels. We also present what could be the distinctive social features of Europe, if basic conditions were fulfilled to face current disbalances between the EU and CEE. Finally, we try to explain why a careful thinking is needed with regard the new external border of the EU and its policy with regard neighbouring countries. In particular, we discuss why no rosy future for enlarged Europe could be foreseen if based on the

[13] Cynical approaches such as the one expressed by Burda (1998, p. 18) should be avoided: "Cynically, because EU newcomers can produce at significantly lower labour costs, it might be in the interests of existing EU countries to adopt measures (under the aegis of the European Social Charter) which inhibit direct wage competition".

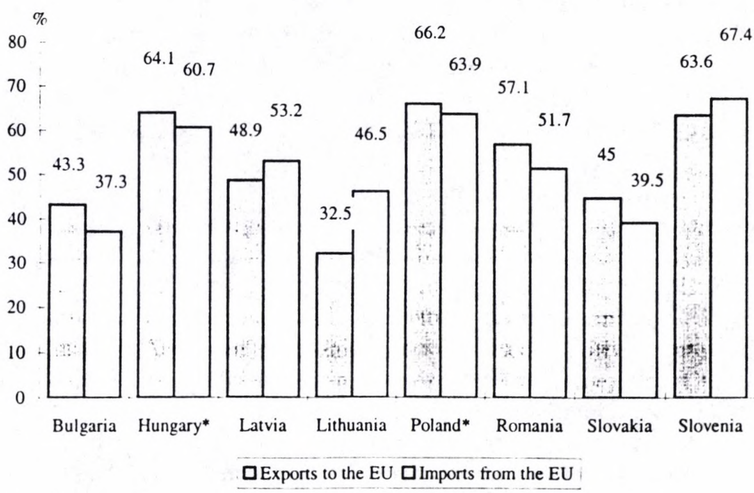
fragmentation of Central and Eastern European countries among themselves, nor political stability achieved in the region in the absence of an extensive project around European integration that would involve and commit all countries of the region.

3.1. Integrated Markets: Enlarged Europe's Economic Strength

More trade within the EU (intra-industry trade)

Since the association agreements between CEE and EU countries, there has been a rapid growth in mutual trade, especially in manufacturing. *Figure 10* shows the EU share of both the imports and exports of Central and Eastern European countries, indicating that Central and Eastern Europe is already an integral part of EU operations; EU companies are extending their production networks toward CEE as part of their internationalisation strategy. In the case of the Czech Republic, more than 60 per cent of its imports come directly from the EU, and 58 per cent of its exports go there. Hungary, Poland, and Slovenia are also important for EU trade, since more than 60 per cent of their imports come from EU countries (*Figure 10*).

Figure 10 Trade of CEE with the EU, 1997 (% of total value)



* 1996

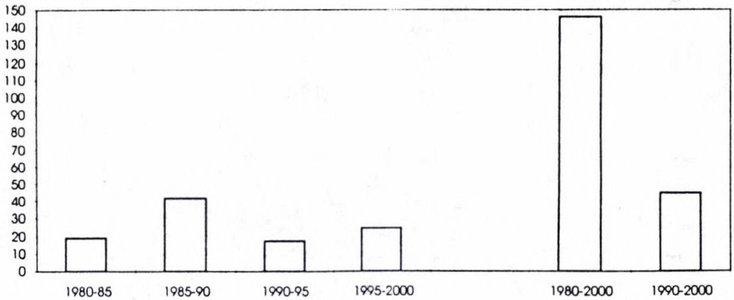
Source: National Statistics.

This growth of trade is expected to further increase in the years of the enlargement, to reach significant volumes in the years 2010s. If we had to integrate from tomorrow the intense trade flows between the current EU and CEE countries presented in *Figure 10*, we would observe an immediate positive effect on EU intra-trade flows. In fact, trade between the EU and Central Europe involves a relatively high level of intra-industry trade, which is typically associated with similar relative factor endowments. It even exceeds the level displayed between certain EU member-states (Hoekman and Djankov, 1996, *Table 16*).

In this regard, eastern enlargement will not only have a positive influence on bilateral trade, but also on economic growth within the EU. According to some estimates, an annual import growth rate of 10 per cent in Central and Eastern Europe would increase growth in the current EU member countries by, on average, 0.1 to 0.5 percentage points (Inotai, 1998). These advantages should increase exponentially along a progressive shift from segmented to integrated markets. The effects of previous accessions, especially from Southern economies, and of the achievement of the Single Market Programme can already give us an approximate idea about the gains to be expected after EU enlargement to the East. According to the assessment made by both the EC (1996) and independent experts (Allen et al., 1998), the existence of the Single Market since early 1993 has led to substantial economic gains: (i) direct positive trade or demand effects due to the reduction of trade barriers, with an increase in the intra-European share of world merger and acquisitions activity (from 10 per cent in 1985–90 to 29 per cent in 1991–93), an increase in the proportion of intra-EU imports (trade creation), and the substitution of non-EU imports by intra-EU imports (trade diversion); and (ii) more indirect or competition effects due to the reduction of prices (estimates suggest a yearly reduction of 0.2 percentage points in prices from 1987 onwards) and of price–cost margins due to the elimination of trade costs (price-costs margins would have fallen by nearly 4 per cent since 1992 across manufacturing sectors) as well as a considerable reduction in price dispersion. This increased price competition seems t have contributed to the improvement of the overall competitiveness of EU companies on external markets.

There is also evidence that the single market has transformed not only the intensity of competition, but also its nature, with a switch from segmented to integrated markets (Allen et al, 1997, p. 466). The distinction between segmented and integrated markets is relatively simple. When there is market segmentation between countries, companies set prices in each national market independently. Liberalisation of trade and removal of tariffs generate more trade within the EU (so-called EU intra-trade presented in *Figure 11*) and also lead to large-scale production by fewer companies, with as a direct consequence a cut in price-costs margins within the EU. Markets are theoretically fully integrated when producers treat the EU market as a single market in which they have to adopt a unified pricing strategy, although this remains theoretical and difficult to reach even in EU single market. Within an integrated system, companies will locate their different stages of production in different countries according to comparative advantages. This should lead to an increase in intra-trade flows between EU countries with the possibility for a country to import a lot from its partners in one stage of the production process but to compensate this deficit by exporting a lot in a different stage of production in the same sector. The high level of intra-industry trade between CEE and EU companies so far confirms that the integration of CEE in the European economy will not be based on sectoral specialisation but rather take place within industrial sectors. In this regard, this process is different from industrial specialisation of Asian New Industrialised Countries.

Figure 11: **Estimated Intra EU Exports of Goods and Services at Constant Prices, 1980-2000**



Source: EC, Data base Ameco, DGII

Foreign investment and regional economic integration

Besides increasing trade movements - and similarly to the increase of intra-European capital movements observed along the achievement of the Single Market - eastern enlargement should lead to an increase in mergers and acquisitions between the two Europes: the fact that between 50 to 75 per cent of foreign investment in Central and Eastern Europe has been made by EU enterprises is already a clear sign of EU enterprises' eager to take opportunity of these new markets within their world strategy. Yet the relative importance of foreign investment in GDP reached levels comparable to those prevailing in the Asian countries most successful in attracting foreign capital (Lemoine, 1998).

In Hungary for instance, foreign direct investment was equivalent to two-thirds of total investment in manufacturing industry.

Foreign investment, under the condition that it does not concentrate on low-value-added segments, is a driving force for achieving a well-integrated production process between the West and the East. This process is already under way under the pressure of the multinational companies located there. So far, exports from CEE have been concentrated mainly in energy and labour-intensive products such as clothing, footwear and leather goods, while their imports consist mainly of machinery and manufactured consumer goods. They have, however, started to export more technological goods. Already up to 42 per cent of Hungarian exports are occurring in machinery, while Slovenia and the Czech Republic are increasingly specialising in high-technology goods. This shows that the process is not only dominated by what is called "outward processing trade" (OTP) normally motivated exclusively by costs considerations and aimed at producing exports entirely from imported designs and materials, especially in traditional labour intensive sectors, such as textile and clothing. Although OTP – which generally relies more on sub-contracting than on foreign investment – had a crucial role at the beginning of the transition to lead CEECs' exports, over most recent years, there has been a shift in the composition of CEE manufacturing exports to the EU away from sectors most dependent on OTP (such as clothing, leather goods, and shoes). For instance, the share of OTP in Eastern Europe' exports to the EU soon declined, falling from over 20 per cent in 1992-93 to less than 15 per cent in 1995 (Lemoine, 1988). This shift reflected the stronger performance of CEE engineering sectors (including machinery, electrical machinery, and transport equipment), and the establishment of more durable relationship with foreign firms through direct foreign investment. Multinational companies, for instance in Hungary, have contributed to the exports of automobiles, machinery, and electronic goods. OTP seem to have been already moving away from the CEECs with higher wages (especially Slovenia and Hungary) to the Balkan countries.

The present sectoral distribution of foreign direct investment indicates that the comparative advantages of CEE countries are emerging in capital intensive, as well as natural resource-intensive, rather than labour-intensive sectors. In Poland, Czech Republic and Hungary for instance, foreign direct investment has been the most intense in the three main sectors: cars and transport equipment, food, and chemicals.

We should mention that these trends have helped CEE countries to perform rather well in comparison with the first tier of Asian Newly Industrialised Countries, with higher growth of exports of manufactured industrial goods (Lemoine, 1998). This result is promising for avoiding "internal hidden borders" to develop in an enlarged Europe. It is also meaningful for the future of the EU and its international competitiveness. Central Europe however remains far below New Industrialised Countries exports in engineering or electrical-machinery. But these industries have recorded accelerated growth rates of output and exports in recent years, and one can hope that these sectors will become more competitive. For instance, the surge of transport equipment exports from Central and Eastern Europe, which overtook NICs' exports over the recent years, provides evidence that the region can rapidly expand its competitiveness in capital-intensive industries provided that foreign investors contribute to the restructuring and the up-grading of local capacities.

So far, and with a few exceptions, CEE countries in their intra-industry trade with the EU seem to be still too concentrated on lower price and lower quality segments. This could rapidly change if foreign investors would increasingly rely on local expertise and networks of local suppliers - not only for low value-added segments but also for activities requiring significant Research and Development. This makes particularly sense in the prospect of an "enlarged single market" with no borders and with low transportation costs which should naturally induce companies to locate their different stages of production according to local specific industrial strengths and local innovation capacities.[14] This combination could become beneficial not only for the production sector of Central and Eastern Europe, but also for the service sector; underdeveloped under communist regimes, the service sector is increasingly important in transition economies, since increased growth and intensified intra-industrial production - as well as growing foreign investment - generate strong and persistent demand for services (Inotai, 1998, p. 20).

No doubt integrated markets could become the future source of competitiveness for EU companies. Studies on the effects of the single market by sectors have shown the differences in impact according to which we are in the scenario of segmented or the one of integrated markets (Allen et al. 1998). For these two scenarii, they have tested both the demand and competition effects expected from the single market: the direct demand effect is the fall in the share of consumption and production of local goods that local producers have to bear because of new foreign competitors' arrival with stronger competitive basis; the competition effect is the reduction of price-cost margins for producers - and therefore the reduction of prices for consumers - that the liberalisation of trade and possible economies of scale suddenly allow. In both

[14] For a discussion of this process in Southern countries in the prospect of the Single Market, and a description of a few case studies, see Vaughan-Whitehead (1991).

scenarii, of segmented and integrated markets, the single market was found to bring an initial decline in home market shares for local producers, which was however overturned as firms adjusted their price-cost margins (thus becoming more competitive). But the two effects were clearly attenuated in segmented markets, in which the large market share of home companies allows them to keep high price-costs margins (especially when they are in a monopolistic position) so that the initial loss of home shares was smaller than in the scenario of integrated markets where companies in some sectors experienced large loss in home shares, of more than 10 percentage points for example in metals and rubber. However, the greater the initial demand effect - and the loss of home share - the greater the incentives of home companies to carry out necessary restructuring and to reduce their price-costs margin in order to become more competitive.

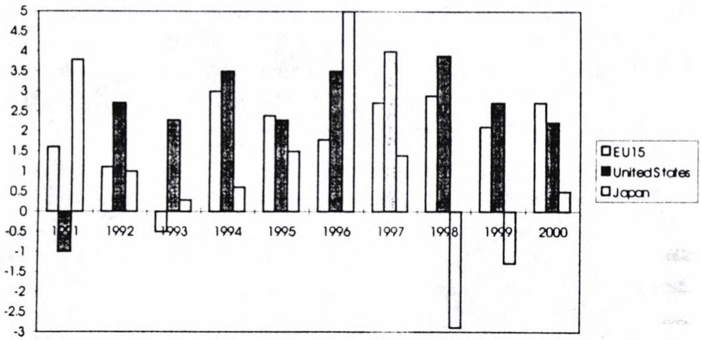
Companies in sectors where the integrated markets scenario prevails, have an incentive to react immediately, which prepares them better to tight competition and which allow them to benefit much more from the competition effect, especially large in the long run.

Although studies so far have emphasised that the global decrease in production costs and the increase in EU intra-trade flows would generate higher economic growth in the EU, we should remain cautious about the interpretation about such positive results. Obviously, greater exploitation of comparative advantage, smaller profit margins and larger scale economies all serve to improve economic welfare. A the same time however, rare are the studies having captured long-term results, for the simple reason that insufficient time has elapsed since the Single Market came into existence. It is therefore an area which requires much more empirical research and more concrete estimates on the long-term economic effects.

Prospects of economic growth

Nevertheless, in order to have a first measure of economic welfare in the EU, it is interesting to have a look at a simple comparison of GDP growth in EU countries and United States and Japan since 1991 (*Figure 12*). After significant differences in GDP growth rates between the United States and the EU, US growth overtaking EU growth by nearly as much as 3 percentage points in 1993 and 2 points in 1996, the gap seems to be reducing progressively over most recent years. This could be a sign of a progressive improvement in the structures of EU trade and global economy. Forecasts also point to a GDP growth in the EU exceeding that of the US in the year 2000 (*Figure 12*), which may already reflect, at least partly, the positive impact of the access of EU firms to CEE markets.

Figure 12. GDP Growth (in annual percentage increase), EU, United States, and Japan, 1991-2000



* Estimates for 1999 and 2000 are from EC, DG II, Spring 1999, Economic forecast.
Source: Eurostat.

Moreover, potential growth coming from CEE itself is very large. When we know that accession negotiations with CEECs are taking place within a rather slow economic growth in EU countries, of 2.1 in 1999, and that at the same time, CEE countries despite their difficulties seem to be registering much higher GDP growth, we can have a better idea of the boost that Eastward enlargement could give to the European economy as a whole.

This must be analysed in a world context: although Japan has been seriously weakened because directly hurt by the Asian crisis, analysts predict a new rapid take-off of the Japanese economy. At the same time, United States have shown that their economic growth was solid and based on good performance of American companies. In such a competitive context, the EU needs to gain in competitiveness in the next years to come, with CEE markets offering the perfect opportunity for it.

3.2. A Success Dependent on Sectoral and Regional Adjustments

We must say that the enlargement should lead to important restructuring, not only in CEE but also in the EU. We saw that some sectors will be able to react to their initial decline in their home-market brought by enhanced competition by reducing their price-cost margin which may enable them to reverse the initial loss. Others however will experience a dramatic loss in home share - especially if their base import penetration was low because traditionally protected - that they may not be able to overturn, especially if restructuring is difficult and costly. One common weakness in most studies on the effects of the Single Market Programme, and now on the effects of Eastern EU enlargement, is that authors generally neglect the short- and medium-term adjustment costs that follow from substantial restructuring.[15] But these costs are real for local actors and they often represent the reason why policy-makers and the public shy away from measures of deregulation and trade liberalisation that promise substantial long-term efficiency gains. This sectoral assessment must be done for each EU states but also be addressed at the EU level.

Social problems will also not be solved without taking into account in a more systematic way the costs of the enlargement for Central and Eastern Europe and its peoples. Regional inequalities could well increase rapidly within new member states, which require appropriate policy measures, not only at the national but also EU level. The structural economic changes demanded of new applicants go together with skills that are becoming redundant, jobs that are disappearing, unemployment, and declining standards of living (Szamuely, 1997, p. 6). The EU should be aware of this and provide for special aids and more understanding during negotiations about particular sectors and industries. The importance of agriculture for CEE countries, for instance, should be acknowledged. CEE countries should also be encouraged not only to move towards service economies, but also to retain strong industrial sectors, even in activities that may compete with current EU members. Such solidarity, if turned into global economic integration, could only increase overall EU competitiveness. By contrast, if the enlargement precipitates severe economic disruption or even further impoverishment in Central and Eastern Europe, no amount of political goodwill can make it succeed.

Significant solidarity will also be required to overcome the costs that the enlargement to the East—for instance, in terms of infrastructure—will involve for the EU. We have seen that CEE economies will undoubtedly remain below the standards of most European countries at least for the next 10 years, so that their joining will involve long-term transfers from EU countries, so representing a heavy burden for the EC budget. It is obvious that it will not be possible to finance Eastern enlargement without increasing the EU budget above its present 1.27 per cent of member states' GDP. There is a clear need to increase the current budget or to implement deep reforms of European policies and

[15] This is also the case in the study by Allen et al, 1998.

practices,[16] or both. Solidarity between the EU and applicants is particularly needed with regard to the enlargement of structural funds and CAP transfers to CEE countries, so that the necessary infrastructural investments and industrial developments take place in the applicant countries, without generating systematic demands for substantial compensation from current EU members.

3.3. The General Increase of Welfare, unless Sacrificed for Rigid Economic Criteria

The above mentioned studies have also found that the welfare effects are positive. Under increasing returns of scale, integration yields a utility gain to the consumers through higher product diversity and price decreases, as well as an efficiency gain through an increase in competition. Expected higher growth is also expected to bring higher welfare.

Although all sectors and countries may initially experience a welfare loss, due to the fall in their perceived home market share, in the long run welfare effects are found to be substantial, especially under the scenario of integrated rather than segmented markets, for which companies have to radically change firms' behaviour if they want to survive competition. However, results also point to an important variance in the distribution of these welfare gains across the EU economies. The larger welfare gains would seem to be experienced by the smaller economies who are suffering the most in the short run from the loss of home shares because they are traditionally protectionist and not used to be confronted to large imports. These initial difficulties however would induce them to react radically, with high restructuring, with as a final effect, the reversal in the initial loss of market shares at home (Allen et al., 1998). This seems to be the case for countries such as Denmark, Ireland, Greece and Portugal, whilst already opened large economies such as France would have less incentives to react, and therefore would get lower returns in the long term. For all countries however, the overall effect on welfare is positive, with gains rising the greater the degree of integration.

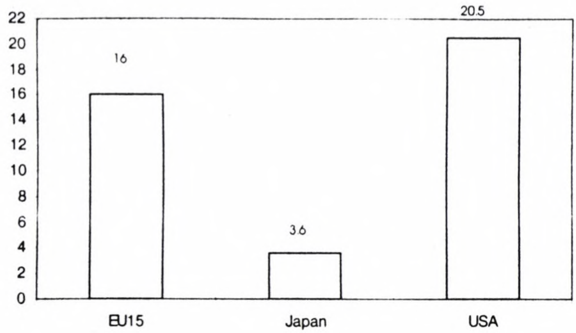
A slow progress over the years

Figures on income per capita are often used as a first indication for welfare, since high economic growth is expected to be reflected in terms of living standards. The figure on income per capita in the EU shows a progressive increase over the years – although smaller than in the US – thus showing that successive waves of accession did not have a detrimental effect in this regard,

[16] In fact, Eastern enlargement would constitute an indirect stimulus to the reform of policies such as the CAP, the structural funds, and even the institutional and policy-making systems.

even when they incorporated countries with lower economic and social developments (*Figure 13*).

Figure 13. Progression of Income (GDP/capita) in the EU Compared to USA and Japan, 1990-2000



* At 1990 market prices
Source: Data Base Ameco, EC, DG II.

Table 9. Average Income (GDP/capita) in the United States and Japan compared to the EU (index EU15= 100), 1961-2000

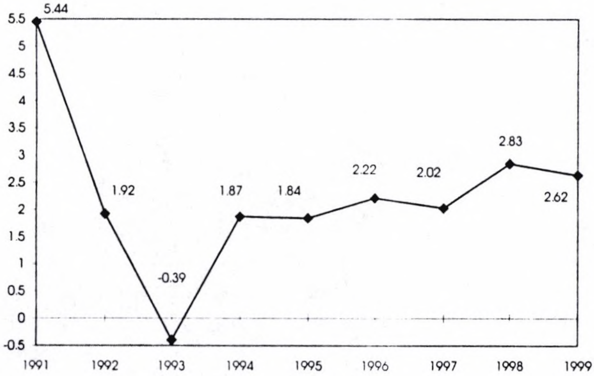
	United States	Japan
1961-70	162.6	74.3
1971-80	148.9	95.0
1981-90	147.2	105.8
1991-96	145.2	118.6
1997	150.0	118.0
1998	151.1	111.1
1999	150.5	106.6
2000	148.6	104.2

Source: Eurostat

At the same time however, *Table 9* shows that income per capita in the EU remains well below the average of the USA and slightly below Japan. It somehow reflects the good health of the American economy, and points to the need to use the new possibilities offered by the enlargement for reinforcing the long-term progression of income and earnings in the EU. Conversely, we can predict that average income per capita in the EU may well continue to lose ground compared to its progression in the United States if it misses or delays its enlargement eastward. The rather slow growth of private national consumption

– with annual changes not higher than 3 per cent – is an additional indicator of the rather slow progress of social welfare in the EU in the last ten years (*Figure 14*).

Figure 14. Annual changes in private national consumption (in volume terms), EU15, 1991-99



Source: Eurostat

The European "Social model"

At the same time however, we should emphasise that the American model has also been characterised in the last decade by the progressive reduction of social protection elements that are constituting an important component of social welfare, with a trend towards purely privately based social protection systems. This contrasts with the elements of welfare system that continue to prevail in some EU countries, and that represent an important distinctive feature of the European social model. No doubt the increase in social welfare expected with the enlargement in the long run will closely depend on the maintenance of such a model: this could help resist the pressure for removing most social allocations and social protection systems that CEE countries have unfortunately experienced in the first years of transition.

This should lead us to monitor social welfare in Europe also from a series of indicators of human development, concerning for instance employment, health, housing and living standards. In this regard, we must emphasise that the improvement of GDP per capita in CEE in the first years of reforms has not always corresponded to the improvement of such social and human indicators (see worrying social trends described in Part 1 with regard unemployment, wages, health etc.).

After the 'shock therapy' and very restrictive macroeconomic stabilisation programmes implemented in the first years of reform, more consideration should be given to problems such as the growth of poverty, growing income differentials among the population, as well as social security, pensions, and social protection reforms. We have seen that the burden on ordinary people in Central and Eastern Europe has up to now been much too high. When the second wave of structural transformation occurs, and public support can no longer be guaranteed, this could rapidly lead to a strong rejection of the accession process. This risk of losing domestic consensus on membership will increase as the enlargement process is further delayed.

International monetary institutions such as the IMF and the World Bank have an important role to play in this process. After having been the main advocates of tight economic policies in the early years of reform it is time they recognise the value, not only in social but also in economic terms, of economic policies which provide more credit to the production sector, allow domestic markets finally to take off through the development of higher living standards and consumption patterns, and at last focus on human resource development as a key element for enhancing competitiveness and productivity.

This is important for Europe as a whole. Neo-liberal economic theories and lack of adequate social protection in CEE could create an alternative to social market economies that prevail in most EU countries and thus lead to serious economic and social implications. This is the reason why it seems to be time to give more attention to the monitoring of human and social indicators also in EU countries, which seem to be increasingly focusing on the fulfilment of the economic criteria as defined in the Maastricht Treaty. Eastward enlargement may be a good opportunity for this.

In this regard, the EU must deliver the right message to candidate countries on the social dimension of EU membership. The adoption of the *Acquis Communautaire* is a priority, and has been rightly stressed by the EC during the first phase of negotiations. This approach, however, appears to be much too bureaucratic. It should be followed by more information and exchange about EU practices of social dialogue, collective bargaining and employment policies. More globally, the adoption of a sort of 'political declaration' addressed to Central and Eastern Europe by EU governments on the importance of the social dimension in the EU could represent an invaluable initiative, usefully complementing important EC documents such as the Agenda 2000 report (EC, 1997).

At the same time, EC action should also be pragmatic and lead to concrete results, in particular sectors and regions, since long-term welfare effects of the enlargement process will also directly depend on the adjustment costs at the sectoral and regional levels described in the previous section. Not paying attention to adjustment or restructuring costs, which can destroy whole regions and local communities – especially in CEE where many regions have been dependent on one single industry or even one company for decades – could just undermine the welfare gains expected from eastern EU enlargement. In this regard, we must emphasise how does the European model of social dialogue and collective bargaining differ from the systems prevailing in the United States and Japan. While the "European model" combines a decentralisation of collective bargaining to company level, with an important development of sectoral agreements, in the USA and Japan, there is virtually no institutional framework for social partners to discuss at the level of particular sectors or industries. Since bargaining at sectoral level can play a crucial role along restructuring, bargaining in Europe must be regarded as the preferred means of accompanying and controlling structural change without entailing major social conflicts. Moreover, the intense social dialogue process taking place at the European Community level for individual sectors – with the work of various committees – is another way of ensuring best industrial adaptations. The involvement of social partners of candidate countries in this social dialogue that takes place at the European level could greatly help to reach the benefits expected from the enlargement without too many and too heavy costs in particular industries or sectors. Social dialogue taking place at regional level must also be developed, and be integrated much more in the European social dialogue structures. No doubt the future of European social welfare also directly depends on these two – sectoral and regional– dimensions.

3.4. A Regional Pole of Political Stability: Rallying around European Integration

The benefits of the enlargement, although certainly positive for the EU as a whole, will vary from country to country, region to region, and sector to sector. In this section we try to identify which countries seem to be benefiting the most from the intensified EU relationship with Central and Eastern Europe before discussing what changes the enlargement process should bring in the long term this regard. We also try to extend this analysis beyond the ten candidate countries, to neighbouring countries.

Enlarging the Range of EU Beneficiaries

Evidence collected so far clearly identifies a few EU members as the main beneficiaries of the opening up of Central and Eastern Europe since 1991. Countries which are geographically close, as one might expect, profit more than others. Germany and Austria for instance seem to be particularly privileged in this respect. EU member states which have carried out significant preparatory work in the region—such as Germany and the Netherlands—also seem to benefit more from the process.

Germany, with the special motivation of integrating East Germany into a unified new state, is undoubtedly the greatest beneficiary.[17] Within the EU, it is the main trading partner of the Central and Eastern European countries: in 1995 it took approximately 30 per cent of East European exports and was the source of 23 per cent of East European imports. Far behind Germany, Italy and Austria also have significant trade with Central and Eastern Europe.

Rapid enlargement could greatly contribute to diversifying this partnership and its benefits. The inclusion of the Baltic countries in the EU, for instance, would strengthen the role of the Nordic countries (mainly Finland and Sweden, but also Denmark). Italy would also benefit from its proximity to Slovenia and other Central and Eastern European countries.

The situation appears to be more complex for less competitive and geographically more remote EU countries, such as Spain, Portugal, Greece, and Ireland. Although these economies could also gain from the process by increasing their trade with the new partners this may occur on a large scale only after the enlargement has been realised, in contrast with neighbouring countries which began to develop their position in the wake of liberalisation. All current EU members will therefore not benefit from the enlargement process at the same time and in equal measure. Up to now, enterprises from southern EU member countries have been reluctant to invest in the emerging transition countries of the East.

According to a study of Spain by Martin (1995) the Central and Eastern European countries are not a threat to the Spanish economy since they have opened up to exports and investment from Spanish firms, a process that will be further accelerated after these countries join the EU. Although it is likely that some Spanish exports to the EU—like exports from other Southern economies

[17] A number of studies have shown that the correlation between Germany and Central and Eastern Europe is higher than that between Germany and most other EU countries. See, for instance, Boone and Maurel (1998, pp. 21–22).

that specialised in similar sectors, such as textiles and shoes—will be substituted by exports from Central and Eastern European countries, the advantages for the Spanish economy will be significant, especially if Spanish firms set up production centres in these countries. As described in Section 3.1, small countries may be expected to be relatively fast in adapting their economies and enterprises.

We may therefore predict that the enlargement process and the removal of borders with CEE will not limit its benefits to immediate neighbouring countries, as is currently the case, but spread them throughout the European Union. The new borders should therefore bring new prospects for all current EU member states.

To convince oneself of the changes that the enlargement could bring, it is sufficient to look at the trading patterns between Austria and Central and Eastern Europe before Austria joined the EU. At that time, Central and Eastern European countries were unilaterally oriented towards Germany: diversification started as soon as Austria joined the EU, with Austria becoming a major partner for CEE countries while a number of other EU countries also profited. Southern European countries could also benefit, as calculated by Baldwin et al. (1997). Even those EU countries that do not trade much with Central and Eastern European countries will thus have new opportunities through Eastern enlargement.

We should also underline that the enlargement may also widespread some of the social risks that the process may bring. This is the case for immigration which has been mainly directed so far towards the two main bordering countries Austria and Germany: nearly 80 per cent of the working-age population who immigrated so far from CEE into the EU reside in those two countries, while their share in other EU countries is negligible. The enlargement process would have for direct effect to spread immigrants from CEE more evenly across EU countries and regions.

Against Fragmentation among Central and Eastern European Countries: Extending the external border

At the same time, the enlargement process should not be allowed to result in differentiation between the first countries that join and those that follow if we do not want economic gaps to increase in the region and the emergence of unnecessary tensions.

At the moment, more than 80 per cent of EU foreign trade with the ten associated countries is carried out with the five Central European economies

(Inotai, 1998, p. 15). More than 90 per cent of foreign investment in the region has gone to Hungary, Poland, and the Czech Republic. The ceiling for trade growth with the most developed Central and Eastern European countries—such as Slovenia, Poland, and Hungary—will soon be reached, another good argument for finding new partners in the region.

The EU should therefore consider with extreme caution which countries will not be made members in the first round. The rejection or serious delay of a membership application may have serious negative consequences for the economic and political development of the countries concerned. This could open up a gap between the first group of countries allowed in and those in the second group, especially those facing economic difficulties such as Romania and Bulgaria. The economic and social gap prevailing between the two groups is likely to grow rapidly, with the more advanced countries catching up with the West as a result of integration, while the others would continue to struggle for economic recovery and social improvement. The ultimate risk is a backlash in the second group of applicants, derailing their accession. It may lead to growing discontent of local populations against the EU project as a whole, with the clear political risks of populism and nationalism, and a choice of other direct partners, such as Russia. Concrete measures should therefore be taken to promote the future membership of those CEE countries that are not part of the first group. In this regard, we should emphasise that the success and timing of the first accession process will have a determining effect on the accession of further Central and Eastern European countries, a feature which constitutes another essential difference with earlier accessions.

At the same time, a strategy should be devised (by means of commercial and other economic and political arrangements) for countries unlikely to be admitted even as part of the second group. Albania, for instance, despite its geographical position in Europe, its privileged trading relationships with Italy and Greece, its deep problems of all kinds (economic, social, political), and its importance for ensuring the peace in the Balkans and in Europe, has been entirely overlooked, not only in respect of membership, but also the signing of association agreements. Other countries whose prospects of future membership are poor—including such different cases as Bosnia and Ukraine—should also not be made to feel isolated. Those who are left outside for the time being must be given a place at the European table that minimises the risk of political backlash. A strong economic framework should be established for handling the legitimate concerns of excluded countries such as Russia, Belarus, Ukraine and Moldova (Kempe, 1998) and making them feel they are part of the process of European integration.

CONCLUSION

We have seen that there are a number of reasons for predicting that the newly enlarged EU might be characterised by a new type of internal borders, of an economic and social nature, that would replace previous political borders between Western and Eastern European countries. Huge economic discrepancies continue to prevail when we extend our economic analysis beyond such crude macroeconomic phenomena as GDP growth, inflation, and registered unemployment to include other indicators of economic activity such as industrial production, labour force participation, and the informal economy. After more than nine years of transition, the social deficit in Central and Eastern Europe is also gaping, as witnessed by the dramatic fall in real wages and living standards that local populations continue to endure, something which has yet to be adequately documented. We saw however that there are also significant economic and social gaps between candidate countries themselves, so that differentiation is essential. It is for instance highly probable that some new arrivals will succeed to converge towards the group of well-off EU countries, thus progressively breaking up the mapping of economic and social discrepancies well beyond the current East-West distinction. However such differentiation should not lead to over-optimistic assessment on the convergence process between applicant countries from the East and the EU average. We have seen that the catching up process could only be gradual, and would in any case not be achieved by 2015 in the most optimistic scenario of 5-10 per cent economic growth that even the front-running states have recently met great problems to sustain. At the same time, the progression of most new arrivals will continue to be jammed by economic and social backwardness. Moreover, global economic results in many candidate countries often conceal huge regional differentials – another determining factor of hidden internal borders – with the coexistence of very modern areas around capitals that already reach EU standards with remaining areas that continue to be totally underdeveloped.

The existence of such important economic and social discrepancies sheds a new light on the significance of the enlargement process. It shows how rapid enlargement would help CEE countries to catch up and to improve their living standards. A closer analysis also helps us to better understand that its economic effects would be much more positive for current EU members and for Europe as a whole than the current literature on the enlargement would lead us to believe. The massive benefits that EU companies currently seem to derive from investment and trade in Central and Eastern Europe are the best visible sign of this new source of dynamism. The analysis also shows that there has also been a clear underestimation of the costs that this integration process would involve for CEE countries, particularly in terms of restructuring, unemployment, and social adjustments. This calls not only for a rapid accession process—ensuring that these countries improve their competitiveness and gain in economic and social cohesion—but also that it takes place on more favourable terms, so avoiding any serious disruption of CEE economies. Steady economic development in Central and Eastern Europe would also constitute the best way of preventing the region from using social dumping as its only competitive tool, and also of limiting massive labour and capital movements resulting from growing social differentials between the two regions. This would in turn contribute to preserve the EU's *social acquis*. In other words, enlargement eastward does not only provide us with the historical chance to unify the two Europes after decades of splitting, but should also help us to remodel Europe's economic and social shape. It is in this sense that a quick and "fair" accession process would greatly contribute to diminish the risk of hidden internal borders in the enlarged European Union.

Finally, we saw how the change of borders may be beneficial for the EU externally, not only to strengthen its competitive position on International markets, but also to ensure the political stability and economic and social cohesion within the European continent.

In a context of EU economies weakened over the past years by economic slowdown and high unemployment, Eastern enlargement offers the EU a chance to find the necessary economically integrated space to acquire that degree of supplementary markets, and of economic growth for becoming more powerful on International markets. A lack of International confidence in the strength of the European economy was undoubtedly reflected in the progressive fall in the value of the new European currency, the Euro, and the corresponding relative re-appreciation of the US dollar due to the relative stability of the US economy and the good financial situation of American enterprises. This should motivate us to urgently assess all the economic costs for the European Union of a failure to enlarge.

We also saw that the external border must be extensive in order to avoid risks of fragmentation among CEE countries. Such external border must also be kept flexible for those neighbouring countries that will probably not join the EU, through a series of common policy areas and association and cooperation agreements that would make them also feel part of the European integration process and help avoiding sources of political instability on the European continent. In the long term, the avoidance of social explosions, economic crises, and political backlashes is essential for the enlargement of the EU and successful European integration. The enlargement process therefore should not only be quick, but also encompassing.

The special context and difficulties in which CEE countries find themselves today, however, require policies with a clear orientation towards social solidarity: in the first place, within CEE countries' national boundaries, in order to limit growing income differentials and social fragmentation; secondly, between Eastern and Western Europe, with a significant effort from the EU to understand CEE countries' needs and to complement short-term financial considerations with a longer-term perspective; and finally, from the "enlarged EU" in bridging the gap with neighbourhood countries.

Such solidarity in the context of negotiations on EU enlargement to the East would represent the best way of ensuring the long-term interests of this enlarged European Union, not only in political stability or economic growth, but also in respect of the type of society that we would like to see emerging in Europe.

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