

**The Emerging New  
Regional Order in  
Central and  
Eastern Europe**

Editor  
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## contents

Preface	vii
<b>1. Historical Perspectives</b>	<b>1</b>
Transformation and Structural Change: Central and Eastern Europe's Post-Communist Adjustment in Historical Perspective <i>by Ivan T. Berend</i>	3
Central European Discourses from Historical Perspective <i>by Taku Shinohara</i>	29
<b>2. Political and Economic Integration</b>	<b>47</b>
Enlargement of the EU: Dynamics and Problems <i>by László Csaba</i>	49
Is Russia Getting into the International Financial Market?: An Analysis of the Balance of Payments Statistics <i>by Akira Uegaki</i>	77
<b>3. NATO Enlargement</b>	<b>101</b>
Enlargement of NATO Eastwards and Slovak Security <i>by Ivo Samson</i>	103
Czech-NATO Relations: A Dynamic Process <i>by Jiří Šedivý</i>	129
Comments on the papers of Samson and Šedivý <i>by Takako Ueta</i>	147
Russia and the Enlargement of NATO <i>by Vitaly Zhurkin</i>	151

Western Europe and the Future of NATO <i>by Yoko Iwama</i>	161		
Comments on the papers of Zhurkin and Iwama <i>by Takako Ueta</i>	181		
Comments on the papers of Zhurkin and Iwama <i>by Kenichi Nakamura</i>	187		
<b>4. Regional Cooperation</b>	<b>191</b>		
Central Europe: Regional Cooperation and Beyond <i>by Andrzej Rudka</i>	193		
Austria's Foreign Policy after the Cold War <i>by Yoshikazu Hirose</i>	211		
Comments on the papers of Rudka and Hirose <i>by Takayuki Ito</i>	221		
Comments on the papers of Rudka and Hirose <i>by Miho Oshima</i>	229		
<b>5. Rethinking Borders</b>	<b>235</b>		
Ways of Managing Border Disputes in Present-Day Europe: The Karelian Question <i>by Pertti Joenniemi</i>	237		
Slovakia and Hungary: The Most Complicated Bilateral Relations in Central Europe: Focusing on the Gabčíkovo-Nagymaros Problem <i>by Susumu Nagayo</i>	259		
Comments on the papers of Joenniemi and Nagayo <i>by Hiroshi Momose</i>	278		
Comments on the papers of Joenniemi and Nagayo <i>by Stephen Kotkin</i>	285		
		<b>6. Socio-economic Processes</b>	<b>293</b>
		Society as an Economic Actor: The Three Patterns of Institutionalization (Systemic Change in Poland) <i>by Witold Morawski</i>	295
		Possibilities for and Limitations to a "Mixed Economy" in Post-Socialist Transformation: Reflections after Thirteen Years <i>by Tsuneaki Sato</i>	317
		Comments on the papers of Morawski and Sato <i>by Hiroyuki Okada</i>	357
		List of Contributors	372
		Program of the Symposium	376

## Enlargement of the EU: Dynamics and Problems

László Csaba<sup>\*1</sup>

The Madrid Council of December 1995 made it explicit: the European Union is definitely going to enlarge Eastward. The negotiations are likely to get started in tandem in both Malta and Cyprus, i.e. six months after the conclusion of the intergovernmental conference (IGC) in Turin. Following the deliberations of the Florence Council of June 1996 the IGC will have to finalise its draft proposal by the end of 1996, which gives ground for hope for completion by the second quarter of 1997. In other words, enlargement talks may already be underway in 1998, with the first new members acceding around 2002-2003. The latter date would imply that the fastest Eastern members will have waited for 12 years, i.e. as long as Britain, Denmark and Ireland, whose joining the EU was generally considered an extremely lengthy and controversial process.

This is going to be the fourth enlargement of the EU. As was documented in the previous cases, any such step has invariably been an act of high policy, although economic considerations have not been negligible either. The primacy of security and strategic considerations deserve mentioning insofar as discussion in the first half of the 1990s tended to be dominated by trade and financial issues, reducing a complex matter to simplistic cost-benefit analysis of a microeconomic type. This seems fundamentally wrong on the base of everything that we know about the history as well as the present nature of the three pillar post-Maastricht EU. Moreover, even allowing for a micro-approach, it is more often than not hard to delineate costs from benefits, especially if dynamic considerations are not neglected. For instance, the abolition of

quantitative restrictions or prohibitive duties on agricultural imports, or the abolition of procedural protectionism may hurt producer and employment interests in some regions, whereas it immediately results in consumer surplus, lower prices, i.e. across-the-board antiinflationary impacts, and improved competitiveness in all areas using these imports as their inputs. Thus applying even the simplest categories of standard economics requires caution, since elementary facts and categories are open to interpretation, or at least they are less than trivial.

Then why enlarge? As Commissioner van den Broek (1996) put it recently, there are basically selfish interests of the current EU members which are at stake. First, this is the cheapest way of stabilising the neighbouring region. Even allowing for a moment for the unrealistic assumption of keeping everything (such as rules of distribution and sums received by present recipients) constant, the cost of an Eastern enlargement is put at 26 bn écu, roughly 0.5 per cent of the GDP of the present member-states, or one-eighth of the US defence budget (Ludlow, 1996, pp52-3). But regardless of the numbers involved, keeping people from migrating, capitalising on the natural propensity to stay at home unless dislocated by war or extreme economic hardship is, of course, the lowest possible cost crisis-management strategy for the welfare states of Europe.

A second consideration is the changing economic health of the transforming countries. The Central European Visegrád Five already constitute a market of 80 m people, or more realistically, judged by their import volumes, a market twice the size of Russia. Economic growth has resumed, with Poland being the fastest growing economy over the last couple of years and other economies, unlike Russia's, having already entered the phase of sustainable growth. Direct foreign investment has already gathered momentum, with per capita FDI in Central Europe already in 1995 having overtaken Chile or Malaysia (Hunya, 1996). In other words, the relocation of industries to

lower wage but highly skilled countries is already well underway. Given these countries' remarkable success in reorienting their trade from East to West, following standard integration theory, microeconomic integration is already in a well advanced stage. In other words, accession would only mean a mere institutionalisation of an already well established *liaison*.

Third, geographical factors should not be underestimated. With the decay of the Yalta order, Central Europe returns to its place determined not only by its economic fundamentals, but, at least as significantly, also by its historic and cultural heritage. It is extremely important, as the core of the EU is the single market with its four freedoms. Freedom of labour is an explosive issue only if and insofar as it acts as a bridgehead for the "clash of civilisations", i.e. if people with widely diverging perceptions and value systems migrate. Furthermore, as the establishment of NAFTA neatly demonstrated, global powers do need a kind of a backyard if they are to stand the challenge of growing internationalisation and competition. As the 21<sup>st</sup> century is generally seen as being dominated by the Pacific Basin, it is imperative for the EU to prepare adequately for this new challenge and integrate the areas that may contribute to its enhanced competitiveness in more than one dimension.

Last but not least, Eastward enlargement puts the issue of systemic change on the agenda of the EU. This is most obvious in the case of decision-making, but it is also apparent in the financing of such established and fundamental arrangements as the CAP and the welfare state, including regional and cohesion funds at the Union level, all which render major overhauls imperative. The calculations over what an Eastward enlargement would cost serve the usual (favourable) educatory role of any long term forecast; they deliberately aim at shocking decisionmakers in order to alert them to the need to change unsustainable practices. This factor may become crucial as the sluggish implementation of farm reforms, or the stalemate on the issues of majority decisionmaking, or even in terms of

meeting the Maastricht criteria clearly demonstrates. The challenge from the East may thus accelerate changes that are long overdue.

So why to join the EU? This question is normally discussed in terms of financial transfers, basically focusing on the numbers generated by official channels. This is fundamentally wrong. First, economic history in this and the last century equally shows that any society, succeeding in catching up, has to rely basically on its own savings and investment capacity. Even in such outward-oriented societies as in East Asia, over 80-85 per cent of investment had to be financed from domestic savings, and only the rest could be covered from external sources. Second, in contemporary economies, it is foreign direct investment (i.e. typically private rather than official) which really matters. Financial liberalisation has resulted in the absolute predominance of private transactions over governmental ones. Thus the rules of the game are set for any newcomer, especially with limited economic might.

On the other hand, international evidence (Hamar, 1995) indicates the useful role integrational arrangements play in channelling private capital to less developed countries. The Spanish and Portuguese, and more recently the Polish and Hungarian experience is also indicative of the potential inherent in such a step. If 1989 saw \$300m invested in Hungary, 1995 closed with over \$4.4bn, i.e. nearly fifteen times as much. While per capita assistance to Hungary has been negligible over the last few years, the stock of FDI is put at \$14bn, official reserves at \$10bn, and private savings are put at \$3bn, in mid-1996. If one recalls that the \$50bn, proposed as the Grand Bargain with the then-Soviet-Union, was considered as extreme, it is obvious that focusing on official transfers is a relatively safe way of getting on the wrong track and gaining fundamentally false impressions over what is or is not available in terms of financing a given economy in the medium term.

Therefore it does not seem convincing if the EU is called

upon to provide a pre-accession modernisation assistance in the form of large official funds. The idea, originating with Austrian chancellor Franz Vranitzky, and also taken up by the European Commission's plan of launching 14 trans-European large projects in infrastructure, therefore seems to miss the point. So what, if not assistance and transfers, is the point of joining the complex machinery of the EU? First and foremost: the EU is an anchor of democracy and also of the European-type of social market economy, which is the target model for which the vast majority of the electorate of Central Europe has repeatedly voted. By having launched a lengthy process of harmonisation of laws with the EU, the transforming countries have gained a focus of orientation, which might be quite helpful in deciding the detail of "which capitalism". This thesis is actually symmetric. As Balázs (1996, pp 25-58) documents in detail, the Treaty of Rome was conceived so as to make it relatively easy for European democracies to accede, whereas any other external relation be kept at an arms-length; thus any idea of graded membership or go-between is practically impossible to fit into the body of the EU legal structure.

Another matter is, that when the original idea materialised with the collapse of the Berlin Wall everyone, especially the EU, was caught by surprise. The grand project of the single market was just underway, the GATT round in Punta del Este had brought about severe pressures to liberalise trade in farm products, services and maritime transport. Thus the EU felt itself under siege. German reunification happened promptly, despite the thinly veiled misgivings of France and Britain, integrating a country of 17mn – the former GDR – into the Community. The costs and the speed of all these, as well as the obvious inability and/or unwillingness to streamline the welfare state, especially labour markets, has pushed the EU on to the defensive. This resulted in a very restrained position against the East. Association agreements could hardly have been finalised without the abortive *coup* in Moscow in August 1991. But these refrained from even abstractly expressing the EC willingness to

integrate these countries. As Wang and Winters (1994, pp 32-53) aptly point out, there was a period of trying to minimise the impact of 1989 on the EC.

### From Association to Accession

Paradoxically, at the very outset it was the perceived extremely dynamic catchup potential of Central and Eastern Europe which produced fears on the EU side. As the calculations of Collins and Rodrik (1991) may exemplify, overcoming the distortions of a planned economy was associated by an automatic and far-reaching growth impetus, which could, in theory, have redrawn the economic map of Europe in favour of the new Eastern tiger economies.

This approach had obviously been quite mechanistic, as it typically neglected those institutional factors and other sources of friction, which made it highly improbable that such an instantaneous adjustment could, indeed, have materialised in mediums other than on paper. As could be forecast at the time (Csaba, 1990), the distortions were so multidimensional, the collapse of old institutions so quick and the emergence of new ones so slow, that even under the best of circumstances, a protracted period of adjustment and recovery was to be expected before the path of sustainable growth could be entered. This crisis of the region was not merely one of external disequilibrium, but it implied the interplay of crises of the growth path, of the social model, of trading patterns as well as of policies and institutions (Kádár, 1990). Both in historic and international terms, successful management of any one of the above-listed challenges is considered as a respectable performance; the cumulation of these tasks made the process even more cumbersome, rendering a fair degree of trial and error inevitable. Therefore any actual policy could only be "suboptimal" against the expectations formulated in the Collins-Rodrik model, and entertained by much of the polity in the region. But these expectations turned out to be unfounded

for the very reasons we summed up above.

Faced with a recession, which proved to be both longer and deeper than visualised by the polity<sup>2</sup> a change of mood took place. In the place of tiger economies the vision of an everlasting recession, (or even "depression") emerged, with no visible way out of the crisis in the foreseeable future. This camp, led by the Economic Commission of Europe, tended to take at face value both the previously reported official output figures and the newly reported (and statistically often inadequate) first results, measured at grossly undervalued market rates of exchange. It also rejected any cautionary note as sheer apologetics. Using regional averages (i.e. by overshadowing the differences in various policies, outcomes and phases of transformation), this approach started to talk about a slump which would exceed the Great Depression.

Reflecting this train of thought the idea of intermediate solutions came to the fore. Begg et. al, (1992) came up with the idea of letting new democracies in through the back door of the EFTA. The idea was further developed by one of the co-authors in a separate monograph (Baldwin, 1994), elaborating the idea of "enlargement on the cheap". This called for a graded membership for countries of the East, excluding them from the areas triggering major transfers, like agriculture and regional policy, allowing them to take part in industrial free trade, but not granting them voting rights, especially over matters of money. This approach included a strong call for Eastern partners to trade more among themselves, and thereby proving their maturity for integration.

Central European countries reacted allergically to the idea. First, they saw it as yet another attempt to banish them into second rank citizens, without even the prospect of getting into the club of equals (or more equals). Second, the Europe Agreements had actually already granted more than free trade, including a series of institution-building measures, law harmonisation etc. Last but not least, by setting up CEFTA, they created not only a forum which made them different from the

rest of postsocialist world, but an area where WTO disciplines actually gradually gained more application than anywhere in the world except the single market itself (Csaba, 1996), i.e. granting each other wider-ranging economic freedoms than a generalised system of Europe Agreements would have resulted.

Meanwhile, the Western side has also been evolving gradually, but definitely. First, by adopting the Maastricht agreement the EC was transformed into the EU. In other words, the task of "tying Germany in" was accomplished, and a call for wide-ranging liberalisation and monetary restraint was jointly adopted by opting for the plan of a single currency. Second, the drift between the security / strategic interest of the EU and its petty-minded trade policy stance has become unsustainable. This was reflected in the Copenhagen Council decisions of June 1993, making it plain that the EU does share the associated members' objective for accession, and spelling out the criteria for the latter. The same Council called for an accelerated implementation of the trade liberalisation part of the EA, setting the deadline for 1999 instead of the original 2003. Third, the Essen Council of 1994 introduced the instrument of structured dialogue, enabling the associated countries to take part regularly in Community activities (as a kind of training exercise). Fourth, the Madrid Council of 1995 has expressed hope that accession negotiations with the East will start in parallel with those with Malta and Cyprus, i.e. six months after the conclusion of the IGC. It entrusted the Commission to make an *avis*, the latter sent out questionnaires to the applicants, and will decide, on the basis of the *avis*, to launch negotiations in 1998. As it stands now, though talks may start in parallel with 12 countries, the outcome will definitely be differentiated, in both time and substance. In the course of 1994 the top leaders of the Commission already expressed their view, that no more package tours to Brussels will take place.

In formal terms, the EU has gone farther towards Eastern applicants than on any previous occasion. The law harmonisation exercises, the PHARE and other technical

assistance programmes, with a budget of 2.5bn DMark in 1996, have produced a gradual, but more intimate, relationship than trade agreements. Elaboration of the White Book, though controversial in many aspects, still constitutes a guide, a point of orientation over how the single market works, or at least, how is it seen by those operating it. The structured dialogue has allowed for starting cooperation and guided approximation in such sensitive areas as home affairs and environment. The Association Council has wide ranging prerogatives in discussing matters of the trade régime and trade policy in minute detail, which will help to mold a joint philosophy over otherwise contentious issues. The Tempus, Tacis, ACE and other programmes help students and researchers to launch networking and studies in and of the EU.

Finally, a third stage is marked by two important developments. First, the EU expanded Northwards, rendering EFTA and the related option obsolete, by definition. Second, transformational recession has come to an end and recovery has started in the Central European region. As detailed empirical evidence (Fischer, et.al, 1996) indicates, the success of stabilisation, institution building and privatisation policies, i.e. a trio stipulated also by the EU and EA, has brought about results. The outcome of this evidence are directly related to policies, not to factor endowments or history, as the counterposition of Belarus to Estonia clearly indicates.

This also means, that the changing perception of the East is also in the making. If stage two tended to see the region as an object of altruistic activities, stage three is molded by visions of a dynamic new market and one of an investment spot, where both capital and labour are well worth the money spent on them. It is hardly by chance that German analysts (Welfens, 1995) have gone out their way in portraying Central Europe as an ideal place to relocate industries and services. Indeed, this process, which is already well underway, may contribute to increasing competitive pressures on the core-EU, thereby contributing the necessary impetus to a more thorough policy

of readjustment. In the longer run perspective, this "threat" is probably one of the most valuable contributions of the Central European societies to an enlarged Union and its global competitiveness.

Taking all these factors together, the question for 1996 is surely not whether or not there will be an enlargement, but when and how, through which procedures, and in what stages.

In this respect Ludlow (1996, p.67) is right in remarking: "the forthcoming enlargement to the east and south should not be seen as a leap into the unknown, so much as the logical consequence not only of what the Union has promised, but also of what the Union and the states concerned are already engaged in doing together."

As indicated above timetables and procedures already adopted by the EU, such as the IGC, the lack of understanding on the financial directives effective from 1999, the forthcoming WTO mini-round on agriculture starting from 1999, the ongoing farm reform projects, and last but not least, the launching of stage three of the economic and monetary union (emu), taken together make an instantaneous accession, entailing a shock for would-be members highly unlikely. The mere listing of these tasks, each of them extremely comprehensive and time-consuming by their very intricate nature, make the frequently voiced cautioning words against haste sound as sheer hypocrisy. On the contrary, the danger of ending up with an unacceptably longish<sup>3</sup> accession period due to bureaucratic clumsiness, rather than triggered by specific policies or priorities tailored to a peculiar vision of Eastern enlargement, seems to be very grave, indeed. Thus it would be vital not to wait for the ratification of IGC documents by each signatory, and launch the accession talks, not letting the Commission spend an average of two years in preparing the *avis*, but expecting to come up with it as quickly as was the case with the Finns (Kádár, 1996, pp55-7). Such decisions can, and indeed, should be expected, (as the example of the Florence Council, cited above, indicates). Otherwise the

treadmills of bureaucracy and intercountry stalemates may unduly lengthen the preparation time. On the other hand, orchestrating support within the would-be member state can only rest on a foreseeable and clear perspective, not a vague promise of potential membership in the distant future. In other words, the systemic anchoring function of the EU is crucially dependent on its ability to present politically marketable deadlines and conditions against vague promises. The examples of Norway, Switzerland, and Austria to some extent (and possibly also of Malta in the future) may serve as warning signs in this respect.

The Eastern partners have a no less demanding task in molding their systems, priorities and options so as to make them congruous to the emerging new / post-reform emu while providing societal acceptance of these rearrangements. Recent experience in Western Europe pertaining to post-Maastricht reforms necessitated by the emu, like the strikes in France, Italy and Germany, or British-German reluctance to accept the ECB and the 'euro', replacing the respective monetary authorities / currency units, is already indicative of the severity of this problem. While core EU members have to face up to relatively minor rearrangements along the preset and mutually agreed upon path, systems' designers in the East have already agreed in the EAs to adopt an *acquis communautaire*, whose final shape is partly unknown as yet, in part it is still subject to debate, and even opt-outs, by present club members. Moreover, the switch from moderate levels of inflation to low single digit levels is known to entail much larger costs in terms of output and employment than the move from say, Italian-Spanish levels of 6-8 per cent to 1-2 per cent. While the easiest way to avoid the over-extension of the welfare state is restraint in its establishment phase, the obligation to come up to a social Europe, a point repeatedly stressed by the European Parliament, may well go in the opposite direction.

What criteria should be used to evaluate whether a would-be member is on the right track? The Copenhagen Council has

singled out political democracy, a functioning market economy, as well as the ability and willingness of the accessant and the EU to absorb new integration forms, primarily regarding the emu. Ever since that time recurring attempts have been made to try to specify and detail these points. In my view these attempts are partly futile, partly counterproductive. The more one wishes to replace a complex category with a series of indicators, the graver is the danger of ending up with a typical relict of the planned economy, when market assessment was replaced by various partial indicators that were supposed to represent consumer satisfaction or technological progress. At times of fundamental change much of the synthetic indicators of overall economic activity may simply be devoid of content. If one thinks of cases when even the US GDP could be modified by two percentage points, or inflation could move in similar degree, or of the fluctuation of the Italian GDP depending on estimates of the irregular economy, it seems safe to say that any artificial rigour in something that for reasons of structural change is essentially hard to measure, can only end up thwarting the accession process. Competition for the favourable points in the privatisation "beauty contest" has already produced some fairly odd official data, whose precise meaning must be subject to wide interpretation. General government deficit is often not accounted according to standard GFS practices, with various special funds taking over the losses, or the latter simply not being recorded, or passed over to the banking sphere. If such indicators as "ability to implement Community law" were also included, that would already boil down to openly and completely arbitrary decisionmaking, a procedure which is to be eschewed for a number of reasons, in the interests of all concerned.

To my knowledge, it was a paper by Ludlow and Gros (1993) which first came up with the idea of creating a convergence programme for the acceding countries. Since then the EU PHARE programme has already launched a series of studies to realise this end. The idea is obviously based on the

model of Maastricht, while economics has already reached a consensus view of convergence: these criteria are neither necessary, nor sufficient to ensure a single stable currency.

Moreover, meeting the Maastricht criteria is by no means an entry card for Central Europeans. The Copenhagen criteria mean, that by the time of their accession, they will have to arrive at such a position where meeting these criteria does not look far-fetched. In fact, as Fischer, et. al, (1996) document, most Central Europeans fared much better both on the fiscal front and on domestic debt, than the core EU countries, while the long-term interest rate is not a criteria that can or should be interpreted seriously in transforming economies. Furthermore, on previous occasions no development criteria were named, as the Treaty of Rome is clear in rejecting this point. Thus the relevant criteria for their ability to integrate is whether they have already reached Greek-Portuguese-Irish *levels*, which, according to both the above quoted article and other PPP assessments of real GDP / irregular economy included most of them have. In fact, as Begg (1996) and even the tables of Ludlow (1996, pp 55-6) himself indicate, except for Portugal, no major catchup took place in the last fifteen years within the EU, either as an aggregate, even less on the – truly relevant – regional levels. Thus requiring convergence from would-be members is asking for a virtue incumbents were themselves not able to live up to in the period relevant for comparison.

Reliance on any rigid concept or means of measurement seems all the less legitimate insofar as EU reform is still far from being over. In other words, would-be members need to follow a moving target. Thus any overdose of rigour requiring them to adopt measures, institutions or procedures, the EU is – or at least should be – about to abandon, could only be counterproductive. Especially labour market legislation, farm policies and harmonisation / unification of concrete pieces of legislation, like opening hours or tax rates, may be the areas where the benefit of doubt looks more, rather than less, relevant in the context of accession.

Should sustainingly high rates of growth become a condition for entry? Many analysts suggest so. Meanwhile, such respectable new members, as Finland, and founding members, such as France, have been anything like tiger economies in the last few years. Thus it seems more legitimate to ask for a reconsideration of regional policies, or the priority of equalising development levels / creating cohesion than to ask yet another virtue from candidates what incumbents themselves were not enjoying. Beyond doubt, neoclassical theory would supply a series of arguments establishing a strong catchup potential for countries at a low-medium income level of development. Beyond doubt, joining a big market and opening up their economies to capital inflows can further contribute to such an acceleration. But in this more conservative view catching up is a by-product, rather than a condition, of integrating with more advanced economies. Thus in the traditional wisdom the causation is just the reverse to that in the various convergence programmes, namely high growth being the *reward* rather than the *entry card* for the entire process leading the transforming economies of Central Europe to full EU membership.

#### Accession – But to What Kind of EU?

With the time passing and the strategic logic of accelerated accession there is, and seemingly, there will remain a high degree of uncertainty pertaining to the salient features of the target model transforming countries are to adjust their own internal arrangements. Semiofficial news coming from the IGC foreshadows a policy of muddling through rather than a breakthrough, which was the original idea behind convening this particular forum. Such vital issues as majority voting are unlikely to change, with key members, notably Germany (Seidel, 1996) coming up with strong arguments for preserving, rather than changing, the *status quo*. Even on technical matters, like working languages, more reliance on written communications, or the need to involve national representations

rather than the notorious European Parliament, a minor rather than a larger scale change is in the making. Radical reform plans of Commissioner Fischler have foundered on member-country and farming lobby resistance, thus without the impetus of the WTO no bold decision is to be taken (Maitland, 1996). Convergence among the indicators of member-states is not particularly impressive, whatever we think about the merit of this process. Measures for far-reaching financial liberalisation received insufficient support only (Jack, 1996). And as a recent warning from the Commission made it clear, major members have yet to comply with the basics of the single market, even in banking and taxation (Coleman, 1996) i.e. areas that new members have to comply with before entry. Last but not least, the emergence of the emu is anything but certain. While politicians keep on reiterating the unchanged deadlines, specialists and businessmen sound sceptical, and consider 2002 as the more realistic deadline (e.g. *Neue Zürcher Zeitung*, 15 November, 1995), while others are calling for so lax an interpretation that it would make the arrangement quite formal (*Financial Times*, 5 July, 1996).

The latter is a particularly serious issue. Monetary union, once implemented, is an irrevocable process triggering a series of related measures. Meanwhile, those who join in without coming up to the criteria in reality, face severe feedbacks / punishments by the markets, which may force them to leave the entire Union (Watrin, 1993). Moreover the technical realisation of this arrangement is also burdened with a lot of unresolved problems. But over and above these, it is yet to be decided, whether monetary union should and could be accompanied by more regional transfers, as the vision of social Europe would imply, or conversely, the fiscal criteria will press for a decrease in previously available sums, thus putting the burden of adjustment to wages and national factor market flexibility.

Both in this respect, and in terms of Eastern enlargement, the question of labour mobility arises. Some consider it as a triviality (Tichy, 1996) that under the foreseeable growth of

inequalities among regions, factor mobility should be limited on the labour market. But this would contradict not only to one of the four freedoms, but also to the basics of a monetary union which, in part, is also about triggering labour market adjustment by enforcing flexibility. Without wanting to take a position on the issues debated by and among the incumbents, it should be clear, that the Central Europeans have not only themselves to blame in not being sure about the fundamentals, let alone the particulars, of the target model / *acquis* they are about to converge to. And we have not even touched upon such sensitive / emotional issues as environmental protection, social rights, gender problems, transferability of social security entitlements across the countries or mutual recognition of qualifications.

Any further enlargement will not only exacerbate the decisionmaking stalemate inherent in the present arrangements, conceived for six (actually only four, with Benelux acting as a unit), but operated by fifteen members. With the joining in of a greater number of small states at least two major problems emerge. One is already being addressed, i.e. the issue of representation, or democratic deficit, which is particularly grave for larger members. This can be overcome by various institutional innovations currently under consideration, like requiring a double majority – i.e. one also by the size of the actual electorate represented – over a broad range of issues. A further step in this direction would be the more direct involvement of national parliaments in elaborating decisions at the Union level.

More importantly, however, new entries will obviously give rise to new types of distributional coalitions, and completely new voting patterns may emerge, which can be modelled through game theory. This is important insofar as the uncertainty in the outcomes of any decision, to be taken at the Union level, is on the increase.

In order to tackle this problem two suggestions have been put forward. One is that of a European Constitution

(Institutions.. pp52-65), proposed mostly by those who wish to set limits to centralisation and arbitrary decisionmaking. As a growing government is burdened with a threat of ever increasing centralisation (both of tasks and financing), adherents to this school apply traditional arguments of constitutional political economy to constrain governmental discretion, and aim at preserving individual freedom from the emerging supra-Leviathan. Adherents to this school (Bernholz, 1996) rightly note that a free society survives only if a given decision needs more justification than the mere existence of a majority favouring it, such as externalities, public purpose, or a commonly agreed aim of redistribution favouring some groups. Meeting these criteria is particularly difficult in a community of 25 members, all the more so, as the contents of national interest not only may, but actually do vary across time. Such phenomena as the French switchover to the policy of *franc fort*, the signing of the World Trade Organisation disciplines, or agreeing to common defence or home affairs objectives, are clear examples of this case. Only if the government – or in our case, joint integrational affairs – are kept reasonably narrow, do we see a chance for affairs of truly common interest to be decided upon in a transparent and efficient manner.

Alternative suggestions (Dewatripont, et.al, 1996) call for a more flexible interpretation of the *acquis*, attempting to single out a type of core *acquis* (adherence to which would be required by any entrant, old or new) and a more optional one. In the latter case, non-participation would also include non-voting over the issue, as already modelled for stage three of the emu. This may, at the end of the day, institutionalise a multispeed Europe. The latter may well have its benefits, however it is hard not to see the political, technical and even more the dynamic problems caused by such an option. From the enlargement perspective all less centralising forms may be seen as advantageous, insofar as they allow for the inevitable diversity that such an extended club would entail.

A further line of thought is the tendency to try to enhance

the technocratic nature of EU organisations, trying to exempt them from the treadmill of daily political compromises. One example is the EMI and the later European Central Bank, which will not be under any governmental control. Similar calls have been made to create a separate EU competition agency and an environmental body, similar to the European Court of Justice. The problem with this line of reasoning is the traditional one, i.e. enhanced technocratic competences may weaken democratic controls, and the split between public perceptions / preferences and technocratic considerations may become unbearable. The more independent these bodies are, the more difficult it may be to turn or change their activities.

Last but not least, competition of systems will surely not come to an end even by the completion of the enlargement process. An enlarged EU will remain in competition with other regions of the globe, as a provider of public services. The poorer the EU performs in this respect, the graver will be the danger of relocation of more competitive personnel, enterprises and activities to areas where the regulatory environment is more favourable to them. A strict interpretation of the Maastricht convergence criteria by relatively weak or short-sighted governments may easily lead to a further increase of the tax burden in Europe and thus to a loss of employment and growth, as Knoester and Kolodziejak (1996) demonstrate. While their suggestion to a Union-wide tax code, compelling the public authorities to cope with fiscal adjustment by means other than tax increases, does not sound entirely convincing, the analytical part of their study clearly evidences the dangers inherent in the most probable scenario of muddling through.

#### **What Countries to Absorb? And How? And When?**

What has been presented above may well suffice to convince the reader: it is not only the Eastern part of the enlargement game which is burdened with uncertainties. But beyond doubt, this – traditionally better explored – area has

also a series of questions to be addressed, and partly even answered, before accession to the EU becomes realistic.

Political democracy figures first among the Copenhagen criteria of accession. It is relatively easy to establish whether or not the regular peaceful handover of governmental power takes place among competing political forces by way of regular, and internationally supervised, free elections. Later interpretation of the criterion includes observance of human and minority rights, where several would-be members still have a considerable way to go.

A functioning market economy is certainly a vague criterion at first sight. However, similarly to consumer satisfaction or embodied technological progress, its strength lies also in its broadness. This category does allow for a multiplicity of market models as already observed among current members, encompassing versions of the market economy as diverse as those in Greece and Finland. On the other hand it also calls for the successful conclusion of, what is recently termed in Washington as the first generational issues in economic transformations, such as the privatisation of most assets, the setting up of the institutional infrastructure of a market order, liberalisation of all factor markets, the creation of conditions for market clearance by way of proper measures of auditing, bankruptcy legislation and regulatory / supervisory bodies in the financial sphere. Whether or not a country qualifies for OECD membership may well be taken as a benchmark for the progress in this round of transformation.

There is, however, a broader interpretation of transformation which hardly allows for it to be concluded in Western economies in general and in the EU in particular. In this sense the process knows no end. In this broader approach, as argued in detail elsewhere (Csaba, 1995, pp245-267) transition may be seen to be over at a stage, when the quality of reforms to be instituted by the transforming country in question is by and large the same as those in the incumbent countries of the EU. For instance, overcoming the social security crisis, or

finding ways for sustainable financing of health care systems for an ageing population are typically second generational reforms, whose solution can not, and should not, be made a precondition for new entrants, as current EU members also have yet to find ways of solving them.

Between the minimum and maximum points roughly described above, there is a series of areas, where a set of measures can be outlined in order to meet the third Copenhagen criterion; the ability and willingness to cope with the challenge of the emu. First and foremost, fiscal policies can easily get out of control. As long as proper accounting standards and GFS techniques are applied the survival of the welfare state inherited from the socialist period is due to create difficulties. For instance even in a quickly growing economy like Poland, the growth of entitlements, especially in the pension scheme, is shown to be well above the financing capacity of the state determined by the inflow of tax revenue. In the Czech Republic first attempts to privatise important parts of the health care system have created financial bottlenecks already in the first and second quarter of the functioning of this system. In Hungary the pension system, especially early retirement schemes and disability pensions, was misused to fight labour market disequilibria. This has created a situation where 2.4m full time employed have to support over 3m retired, 40 per cent of whom have made no previous contribution and therefore have not created a right to the transfers they receive.

Inflation is still much too high for EU standards in the frontrunner transforming countries. This reflects in part the long period of readjusting prices of energy, housing, public transport, as well as the long road towards a single rate system of VAT. Also, governmental inability to curb spending and raise revenues proportionately leads to a reliance on inflation as a means of balancing public finances, at least *ex post facto*, with all the well-known detrimental consequences. Last but not least, the 1990s have not established a very strong case for tough antiinflationary governmental policies, even in such pioneering

countries as Estonia or Slovenia. Therefore double digit inflationary expectations have become built into the overall perceptions of households and companies alike. International evidence suggests that moderate inflation may indeed be sticky and hard to bring down. The Maastricht criteria play a useful educational role of repeatedly feeding this back to the attention of decisionmakers.

The emu targets also warn decisionmakers in the East of the need to develop a financial and trading system, where reliance on the rate of exchange as an instrument of economic policy can and should be discontinued. This is a fairly tough task for countries, where the exchange rate used to be a mere accounting unit in the socialist period, and activating this instrument was one of the achievements of reform-minded economics. Indeed, against complete governmental discretion and multiple rates the use of a single exchange rate as an across-the-board measure represents an important advance. It also plays the useful role of making the tradeoffs among various policy measures and priorities open, such as export promotion and antiinflationary considerations, or maintaining current account equilibrium and sustaining high levels of domestic activity, or swift structural change. However, the ability and willingness in participating in the emu assumes a much quicker learning ability, than was the case in the core EU. It requires the build-up of a widespread, near-consensus conviction, favouring low inflation and exchange rate stability against other, less abstract, thus more operational policy objectives, such as employment or the protection of domestic producers. In fact, this seems to be a formidable task for the years to come, as it is not only a small circle of policymakers, but wide segments of the population who need to be convinced. In fact, the two tasks are intertwined, as the lower the rate of inflation, the smaller the inflation differential from the EU average, and the easier it may prove to sustain a fixed exchange rate.

Enlargement under emu conditions have important implications for official financial transfers. As it seems now

there will hardly be a strong political case for increased spending to be triggered primarily by a new round of enlargements. This is an important difference from times when more spending was taken for granted by the political class and the electorate alike, as e.g. on previous Southern enlargements. In other words, new entrants will have to put up with a much more limited generosity than has previously been the case. Calls for the EU to take up a modernising role in the form of extended financing facilities for pre-accession strategies (Inotai, 1996) seem to miss this fundamental point.

Moreover, as hinted above, enlargement will lead to a redistribution of the available (non-growing) cake among incumbents and newcomers. In other words, a reform of the intra-EU funds is a precondition for enlargement to become feasible. One wonders, for example, whether it will be sustainable to keep entire countries in target zone I, or whether various special arrangements, allowing for some close-to-average regions to receive regional supports under special deals, will or should survive. But if all costs were literally to be avoided, a policy of no change would be seen to be for the best a situation which would, of course, be quite out of the question.

What has been unfolded is the best indication why the traditional EU preference for package tours / deals will be unsustainable and impracticable for Eastern enlargements. The applicants are widely diverging countries, with Slovenia being a potential net contributor, and Romania at the other end, still employing some 35 per cent of its population in the farming sector. Under these circumstances it seems highly likely that the only viable compromise between the strategic need to enlarge, and the financial imperative to keep costs down, will be one of stepwise enlargement. Under this scenario, less problematic countries, such as those with a low share of agriculture, little demand on structural funds, and little or no external conflict potential, will be first to qualify.

On the latter point it is important to be realistic. In a typical argumentation Ludlow (1996, p.43) puts Hungary in the same

category as divided Cyprus in terms of the conflict potential, due to the non-signing of the treaty on good-neighbourly relationship with Romania at the time of the Balladur Pact.<sup>4</sup> In reality, Hungary is neither divided, nor employs the means of conflict management, as one observes in Ulster, Corsica, or the Basque country, not even running into the type of conflicts one can see with Greece and Turkey, or Spain and Britain over Gibraltar. In countries where boundaries and ethnic groupings do not overlap, it is probably inevitable that some tension may exist, as exemplified by Southern Tirol, Alsace or Catalonia. While any effort is worth it to pacify these, and the EU does play an important role to bring this about, one should not, again, fall into the trap of requiring virtues from candidates that incumbents do not live up to. Nor should one mix up ends and means. Joining the EU is possibly one of the best means of attaining the goal of pan-European appeasement along the Catalanian, Tirolean and Lapland models. In this respect one wishes to see the Union's efficiency in finding a solution to the Cyprus problem by making use of its sizeable leverage on Turkey – an instrument Hungary lacks over Yugoslavia (its only neighbour where no basic treaty is yet in force).

Last but not least, the issue of agriculture should be discussed. On the one hand some reform of farm policies will be inevitable, insofar as the 1994 GATT on agriculture has outlawed the use of export subsidies, with a preannounced decreasing scheme in operation until 1999, when further liberalisation measures will be discussed. This means that the entire EU philosophy built on food security, and having led to overproduction, needs to be reassessed, along the lines already circumscribed by the early MacSharry reforms. According to this line of thinking production supports will be discontinued, and regional retraining and ecological, or sheer income support, schemes would take their place. As a consequence, by the time any transforming country can realistically aspire for full membership, the enormous production push effects in the East, that one could have expected under unchanged

conditions, stemming from a combination of higher prices and substantial external transfers, will surely not materialise.

Therefore it is important for the Central Europeans to adopt realistic economic strategies, which do not consider the externally financed modernisation of their farming sector as a core of their overall recovery. The latter approach may become a dangerous illusion leading to misallocation of resources, as well as to the adoption of bargaining stances, which may prove too intransigent and lead to delays in finalising overall deals on actual accession. The stronger a country's farming lobby, the higher the probability will be for this type of deadlock to emerge, especially in such traditionally strong agro-oriented nations as Poland Lithuania and Romania.

But even under the best of circumstances a protracted foot-dragging seems likely, with the farming lobbies on both sides trying to squeeze out the most from the rest of the taxpayers.

In sum, due to the delays in the internal reforms of the EU the, *absorption capacity of the Union* does not seem to be on the sufficient increase. Therefore the politically most opportune timing of the first round of accession by the year 2000 seems to have been missed. It is next to impossible to visualise any scenario, short of a catastrophic derailment in Russia, which could accelerate the accession talks, upsetting and redrawing the intricate internal balances within the Union, to come to an end early enough, so that national parliaments could ratify all the relevant pieces of legislation by that time. Instead, 2002 seems to be the first realistic target date by which the countries in the first round may accede. But this first round is likely to be followed by second and third rounds, extending over yet another decade.

Most observers find the sequencing of candidates politically embarrassing. However, an enlargement in a single step would definitely be financially unsustainable. Moreover, even in pure political terms, it might be equally embarrassing to get in a larger number of unknowns, or to change the geographical equilibrium within the Union too conspicuously

and too quickly. A step by step enlargement, by contrast, can play a useful role of trial and error, assisting the more problematic countries to adjust themselves to the same standards. And conversely, this may be the only way to maintain the necessary political momentum for more distant entries.

### Concluding Remarks

The Eastward enlargement of the Union will be an act of high politics, just as much as was the case on previous occasions. However, it does not mean that there will not be an equally weighty economic component. The latter will substantially differ from the enlargement to the South, not only because of the single market, but because of the foreseeable and inescapable budgetary consequences of the emu, as well as of further reforms that will have been finished before enlargement takes place.

As it seems today, just because of the foreseeable limited generosity of the EU, money may well not be the main thing hindering a potential enlargement. Official money is bound to play a subordinate role anyway. What seems to be a more serious issue, is the change in voting patterns and in potential distributory coalitions. The less the EU manages to come up with a rule-based and efficient decision making structure, the greater is the threat of becoming more of a UN-type of discussion forum. The decision over emu stage three may forestall such an outcome, however at the cost of creating several categories among members. The latter may make accession at the first run easier, but it may postpone the moment of fully-fledged membership to a distant point in the future.

Those countries which have concluded the first round of transformation have entered a period of sustained growth. These countries may have a lot to offer for the international competitiveness of the EU. On the other hand, the EU will not

be able to shrug off the trouble with those countries, who will not become members, not even in the distant future. For the latter, strategies on par with the Mediterranean strategy, i.e. implying more official transfers but less institutional generosity, may be a serious option to be considered. All the more so, as both the threat of migration and the security challenge is coming *primarily* from the latter group, not from the would-be members.

### Notes

- 1 The author is senior economist at Kopint-Datorg Institute and Professor of international economics at the College of Foreign Trade, both based in Budapest.
- 2 Kornai (1993) calls this transformational recession, as distinct from cyclical slumps, adjustment recessions and the Great Depression alike.
- 3 Even that would not be as long as the recent suggestion of Baldwin (1996) on starting negotiating free trade from 2003.
- 4 The Hungarian-Romanian Grundvertrag was signed in September, 1996 and was ratified by the Romanian legislation next month. Hungarian ratification is due in the first quarter of 1997.

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## Is Russia Getting into the International Financial Market?: An Analysis of the Balance of Payments Statistics

Akira Uegaki

### Introduction

In February 1992, the balance of payments statistics of the USSR and the RSFSR for the years 1990 and 1991 were released after a 56 year interruption of the publication of such data. In March 1993, the Russian Official Statistical Office (Goskomstat) published the balance of payments related to the transactions between the Russian Federation and so-called "Distant Foreign Countries (hereafter DFCs)" for the first nine months of 1992. After that, the balance of payments statistics of the Russian Federation have been available every three months, though they are only related to DFCs<sup>1</sup>. Since the balance of payments represents the flows of goods, service and capital of a country within a certain period, it shows the country's economic status in the international arena. Therefore, we now have a strong method for constructing an exact picture of the Russian economy from the international point of view.

### Reliability of the Statistics

#### (1) From 1990 to 1992

Despite their availability some of the published statistics are not reliable for use in scientific analysis. The RSFSR's balance of payments for 1990 and 1991 are only figures estimated by researchers based on the assumption that Russia's exports are 78% of that of the USSR and that 67% of the mined gold in the USSR belongs to Russia and so on<sup>2</sup>. Moreover, the RSFSR's