Valtion taloudellinen tutkimuskeskus *VATT-muistioita 29*

Europe Agreements:

Trade between the European Union and the Central and East European Countries

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CONTENTS

Introduction

Since the late 1980's and early 90's, fundamental changes have been taking place within Europe's boundaries. The Berlin Wall was brought down in November 1989, and Germany was unified. The Soviet Union saw the detachment of the Baltic States of Estonia, Latvia and Lithuania; and the European Union expanded to encompass Austria, Finland and Sweden - making a total of fifteen countries in the EU.

Perhaps one of the most significant changes - at least in economic terms - was the initiation of the transformation to market economies of the former socialist countries of Central and Eastern Europe. Bulgaria, Czechoslovakia, Hungary, Poland and Romania - together the CEEC (Central and East European Countries) had previously been members of the Council for mutual Economic Assistance (CMEA), which established official relations with the EU in June 1988.

This paper aims to analyse these changes, especially in relation to their effects on trade with Europe. In the beginning of the 1990's bilateral associations of CEEC with the EU were established by the Europe Agreements. The first of these agreements were signed in 1993, but the section of the agreements concerning trade - the Interim Agreements on Trade and Trade-Related Matters (ITA) - were made effective from 1992 and '93. It is this section we will consider here; in order to examine the effects of ITA's on trade between the CEEC and the EU.

1 Background of the European Union

The European Economic Community was established in 1957 with the signature of the Treaties of Rome by Belgium, France, Germany, Italy, Luxembourg and the Netherlands. Since then the Community has expanded to create the European Union of 15 countries and 368 million citizens.

The main constitutional aims of the European Union (EU) are:

- to promote economic and social progress
- to assert its identity on the international scene
- to introduce a citizenship of the Union
- to develop a close cooperation on justice and home affairs

(Treaty on European Union)

There are three main priorities for the EU over the next few years:

- introduction of the single currency
- preparation for new members
- definition of future shape (at the Intergovernmental Conference)

It is the second of these priorities that concerns us in this study.

As the accession of Austria, Finland and Sweden was confirmed in June 1993, the Copenhagen European Council gave notice to the CEEC that *"their accession will be possible as soon as they satisfy the requisite political and economic conditions"*.

In December 1991, the EU recognised that Czechoslovakia, Hungary and Poland had made progress towards pluralist democracy and market economy, by offering them 'Europe Agreements': a significant step towards full trade liberalisation between the CEEC and the EU. In march 1993 Bulgaria signed a similar agreement. At present there are six Europe Agreements in existence with Bulgaria, the Czech Republic, Hungary, Poland, Romania and Slovakia (Czechoslovakia separated in 1993).

2 Portrait of change in the CEEC

Until the dramatic changes of the late 1980's the economies of the CEEC were run under the concept of the 'soft budget constraint' (Kornai 1986). The CEEC were members of the CMEA or COMECON bloc, which was dominated by the Soviet Union, and the Soviet system of economics. Under the central planning system, the goal of individual enterprises was to maximise output, as opposed to maximising profit in a capitalist system. This output maximisation had many consequences which became apparent during the recent reforms.

Financial considerations were secondary to a firms' output maximisation goal. It was therefore not possible to measure allocation efficiency through profit, as prices were not determined by the market, and cost - sales differentials were topped with taxes and subsidies. There was little effective competition, and cost and revenue were determined by administrators, rather than market forces. The absence of financial pressure to use resources efficiently was evidence of the 'soft budget constraint'.

The incentive, then, of enterprises was to maximise resources, with the intention of maximising output. But the lack of financial incentive meant that productivity was poor, product quality was poor, and managers had very little experience of setting prices, marketing, selling and financial control.

Under the central planning philosophy, countries were encouraged to specialise in certain - usually heavy - industries. Due to this specialisation, there was a massive reliance on intra-CMEA trade. More than 40 percent of total exports for Hungary, Poland and Romania; 73 percent for Czechoslovakia, and 80 percent for Bulgaria went to the CMEA group.

International trade was determined by the planning authorities, and so the potential for increased access to the world market, and consequentially increased supply, competition, transfer of technology, and investment, was not fulfilled. The Soviet planners considered the cost of international trade to be far greater than the benefits. World market trade was also hindered by

* inconvertibility of currencies
* nature of exchange rates (determined by authorities, with no relation to true value of currency)
* trade restrictions (tariff and non-tariff barriers)
* poor quality of goods produced

Trade agreements between the EU and CEEC and Soviet Union began in the mid 1960's, with some of the EU countries forming bilateral agreements with individual countries from the CMEA bloc. These, however, expired in 1973, as the EC wanted multilateral agreements between the Union and CMEA countries. At this time Soviet policy was not to recognise the EU as a political entity, and so no trade arrangements were reached.

Soviet policy was attempting to strengthen the role of Comecon, and in 1973, the secretary general of Comecon visited Copenhagen to discuss possible negotiations with

the community. The implications of this were evident to the EU, and not wishing to reinforce Soviet hegemony, the EU refused to trade with Comecon, insisting that the individual countries retain autonomy in their external trade policies, and that Comecon had no formal competence for trade policy.

A dramatic change occurred in the political climate, when, in 1979, Soviet forces intervened in Afghanistan. Talks between the EU and Comecon were abandoned. It would seem that the political obstruction was too great to be overcome in the interest of economic advantage. At this stage Soviet exports to the community were mainly energy and other primary products, which did not face tariffs, and therefore there was little urgency for the Soviets to gain trade agreements with the EU.

The CEEC within Comecon, however, faced a very different situation. A main component of their economies were exports to Western Europe - especially the EC. These exports valued quantitatively at over 10% of Hungary's GDP, and 5-10% of most of the other East Europeans' GDP. Export earnings and hard currencies are essential to their development, therefore trade with the Community was fundamental. Unlike the Soviet exports, though, the CEEC produced goods which fell under the EU's most harsh protection. Also, with the exception of Romania, the CEEC were disadvantaged further for they did not benefit from the Generalised System of Preferences (GSP from GATT), as many of the developing countries did. The CEEC had clear objectives of quota liberalisation and levy reduction.

1985 saw Mikhail Gorbachev become secretary general of the Soviet, Communist Party, and the initiation of the *perestroika* and *glasnost* movements. These were the beginnings of what was to become a whirlwind of change throughout Central and Eastern Europe. Gorbachev suggested that it was 'time to seek a common language' on political matters - in other words recognising the EU as a political entity.

Democratic revolutions and radical political and economic reforms ensued, and the CEEC began marketisation - the process of transformation from a centrally planned system, to an economy reliant on market mechanisms. But the economies of the CEEC were plagued by the consequences of the planning system. Economic crisis became apparent, due to overwhelming state control, declining rates of growth, inefficient use of capital and labour, difficulties with technology gaps, supply side shortages and financial imbalance.

Some figures describing the state of the CEEC economies at the starting phase of the transformation are presented in the following table:

	BU	CZ/SK	HU	PO	RO	OECD
Population (million, 1988)	9.0	15.6	10.6	38.0	23.0	824.8
GDP (billion USD, 1988)	50.7	118.6	68.8	207.2	94.7	12073.
GDP per capita (USD)	5633	7603	6491	5453	4117	14637
Annual growth of GDP (%)						
1981-1985	0.8	1.2	0.7	0.6	-0.1	2.5
1986-1988	1.9	1.5	1.5	1.0	0.1	3.5
Living standards:						
cars / 1000 inhabitants	127	182	153	74	11	385
telephones/1000inhabitants	248	246	152	122	111	542
Share of work force in agriculture (%)	19.5	12.1	18.4	28.2	28.5	8.0
Share of private enterprise in GDP (%)	8.9	3.1	14.6	14.7	2.5	70-80
Workers with secondary education (%)	n.a.	29.4	33.8	28.9	n.a.	61.0
Exports of goods as % of GDP (1988)	23.0	19.7	14.7	6.4	11.2	14.4
Exports of manufactured goods as share of exports to non-socialist countries	59.3	72.4	79.6	63.4	50.6	81.8
Change of share of OECD markets (%, 1979-89)	-18.5	-44.0	-7.8	-32.3	-46.3	-

Source: World Bank

The economic crisis might not have been so grave if the CEEC had not also faced external shocks. Comecon collapsed at the beginning of the 1990's, but the increase in access to western markets was not enough to compensate for the decline in intra-CMEA trade. Another consequence of this collapse was that subsidies ceased to be provided by the Soviet Union. The disruption of trade and rise in oil prices caused by the Gulf War also affected the CEEC, as they are all net importers of oil.

In 1988, a joint declaration was signed for official relations between the community and Comecon. The first trade agreement with Hungary was signed three months later, and by October 1990, all Comecon's European partners had signed similar agreements. This was the starting point for the deepening of relations between the CEEC and the community.

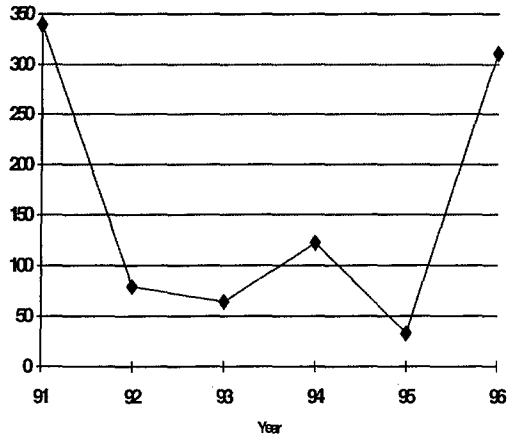
By January 1991 all of the CEEC had been awarded GSP by GATT, and gradual changes began to take place toward liberalisation of trade with the EC.

These gradual changes were overtaken by the signing of Europe Agreements in 1991 with Czechoslovakia, Hungary and Poland, and in 1993 with Bulgaria, the Czech Republic, Romania and Slovakia.

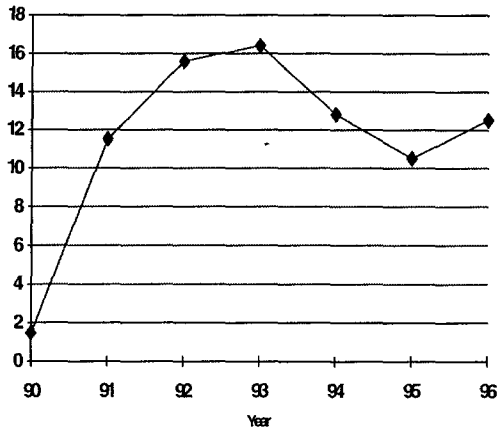
3 Current situation in the CEEC

BULGARIA

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(as % of labour force)



	1990	1991	1992	1993	1994	1995	1996est
Employment in industry*	-6.2	-18.8	-15.1	-11.8	-8.8	-6.8	-4.8
Labour productivity (output per employee)*	-10.4	-11.1	0.2	5.5	14.2	9.0	0.1
Unit labour cost (USD)*	-37.8	-35.1	85.4	21.5	-31.4	17.3	-15.2
Wage in industry (in local currency)*	20.7	167.7	139.5	51.7	53.9	58.1	50.4
Exchange rate (leva per USD)*	116.7	364.1	28.9	18.4	96.3	23.7	77.2
Industrial gross output*	-16.0	-27.8	-15.0	-7.0	4.1	1.6	-4.7
Trade balance (millions USD)	na	404	-212	-885	-17	132	-35
Gross official reserves excluding gold (millions USD)	na	331	935	655	1,002	1,236	518
Gross foreign currency debt (millions USD)	10,000	11,802	12,548	12,946	10,714	9,790	9,600

(* percentage change, year on year) *Source: EBRD*

Bulgaria has experienced a fall in economic activity, due to shortages in raw materials in critical industrial sectors, and many enterprises having poor creditworthiness. The reform process has slowed, and is lagging behind the other transition economies, as a result of economic crisis.

Due to problematic control of the budget deficit, inflation is rising and the exchange rate of the leva is extremely volatile. There is a trade deficit resulting from weakened exports and increases in domestic demand.

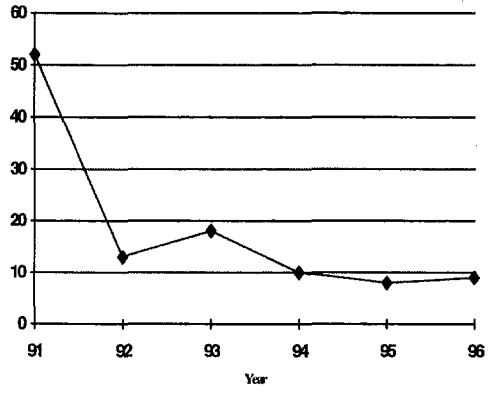
The process of privatisation in Bulgaria has been slower than in the other transition countries, though towards the end of 1996 foreign investment was given potential for improvement, as a stake in the telecoms operator and 26 other companies were offered for sale.

Bulgaria has successfully reoriented its international trade toward developed markets, following the decline in demand from ex-Comecon countries. However, Bulgaria's main trading partner is still Russia, and a positive effect is expected on Bulgarian exports if anticipated recovery in Russia goes ahead.

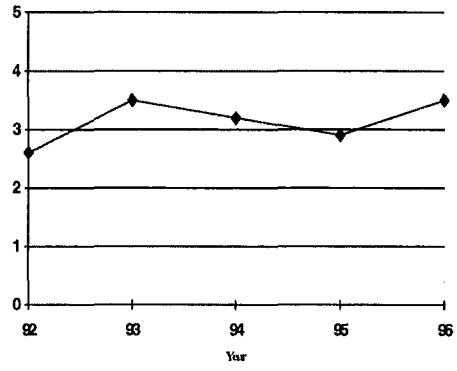
Industry has shown a significant recovery in output during 1992-95, but the need for more high-technology production became apparent after that period and there have been problems with supply of raw materials in certain industries. Leading high-technology enterprises have been establishing operations in Bulgaria; e.g. Philips recently began making colour televisions there.

CZECH REPUBLIC

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(% of labour force)



	1991	1992	1993	1994	1995	1996est
Employment in manufacturing*	-3.1	-11.8	-7.5	-6.6	-3.7	-10.4
Labour productivity (output per employee)*	-0.4	-16.6	-7.6	-3.5	4.0	20.5
Unit labour cost (USD)*	-17.3	-14.8	32.8	25.8	13.2	6.9
Wage in manufacturing* (in local currency)	-1.7	16.8	17.6	25.2	16.3	18.7
Exchange rate* (Czech Crowns per USD)	19.3	64.2	-4.1	3.1	-1.2	-7.8
Manufacturing gross output*	-3.5	-26.4	-14.5	-9.9	0.2	7.9
Trade balance	na	-1.9	-0.3	0.9	-3.7	-6.1
External debt, net of reserves of the banking systems (billions USD)	na	3.5	2.3	1.8	-0.9	1.2

(* percentage change, year on year) *Source: EBRD*

As with the other CEEC, the Czech Republic has seen a change in the territorial structure of its exports over the years since the reforms began. A dramatic shift away from the former Comecon countries, toward the European Union and European Free Trade Agreement countries has been witnessed. Germany is now the Czech Republic's most important trading partner accounting for 32.4% of Czech exports and 26% of imports. Since the split of Czechoslovakia, trade with the former partner has decreased dramatically, and now accounts for 15% of exports and 13% of imports.

In 1996, economic growth was slower than expected, though positive growth was sustained throughout the year. Inflation has been decreasing through fixed exchange rate and limited money supply growth, but inflationary pressures are now emerging. Wages are growing faster than productivity, and the money supply is now expanding due to increases in domestic credit to enterprises.

Foreign investments have been increasing consistently, although they slowed in 1993, while investors waited to see the results of the split from Slovakia. The three main investment partners are now Germany, USA and France. The trade deficit is increasing also, as export growth is trailing import growth.

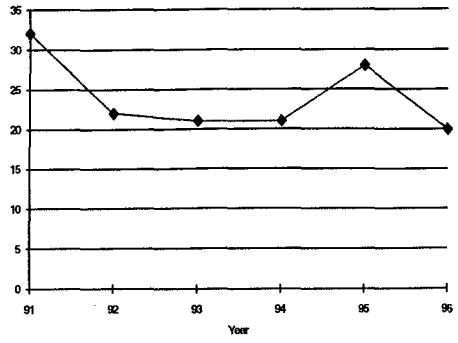
The Czech Republic has a very favourable geographical position for trade, a highly qualified workforce and has many attractions for foreign investors including:

*liberal economic policy
*political stability
*wage controls, enabling maintenance of low production costs
*an exchange rate of the Czech Crown favourable for export

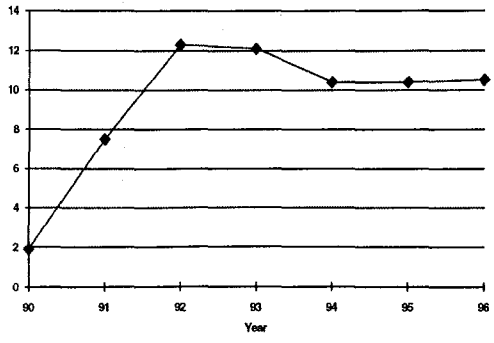
Finally, the export market is also showing a favourable shift toward the OECD markets - the Czech Republic joined the group in December 1995.

HUNGARY

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(as % of labour force)



	1990	1991	1992	1993	1994	1995	1996
Employment in manufacturing*	-10.6	-3.9	-17.1	-12.9	1.9	-5.3	-6.1
Labour productivity (output per employee)*	0.4	-17.9	10.7	18.5	7.3	11.2	8.0
Unit labour cost (USD)*	14.4	29.4	7.6	-9.6	-1.0	-8.7	-7.8
Wage in manufacturing (in local currency)*	14.8	6.2	19.2	7.1	6.3	1.5	-0.4
Exchange rate* (forint per USD)	7.0	18.2	5.7	16.4	14.4	19.6	22.7
Manufacturing gross output*	-10.3	-21.1	-8.2	3.3	9.3	5.3	1.4
Trade balance (billions USD)	0.3	0.2	0.0	-3.2	-3.6	-2.4	-2.7
External debt, net of reserves (bns USD)	20.2	18.7	17.1	17.9	21.8	19.6	17
Foreign direct investment (bns USD)	0.3	1.5	1.5	2.3	1.1	4.5	1.9

(* percentage change, year on year) *Source: EBRD*

Foreign direct investment (per capita) in Hungary is currently the highest of the CEEC, at USD 1500. The total FDI in 1996 was approx. USD 2 billion, and during 1996, 4,088 companies with a foreign stake were established in Hungary. The five greatest investors in Hungary between 1992-96 were Germany, Austria, the Netherlands, France and the United States. For FDI to make significant profit, though, output and export sales must grow, and this is greatly assisted by Hungary's liberalisation of trade with the EU.

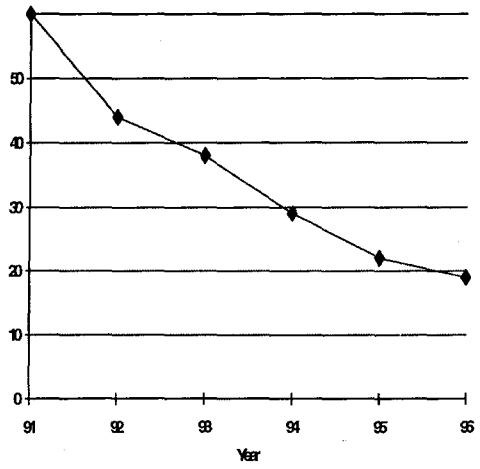
Hungary began to remould the hard core of its economic system in 1996, with institutional reforms in accounting law, prohibition of monetary financing of fiscal deficits, and radical cuts in government spending. Exports remained the only source of growth, as radical tailoring of public outlays implied a contraction of domestic effective demand.

There was an economic slowdown at the beginning of 1996, but the economy has since recovered: inflation is decreasing gradually, the trade deficit is becoming smaller and industrial output is recovering. However, real appreciation of the forint means that trade performance is worsening, and the current account is in deficit.

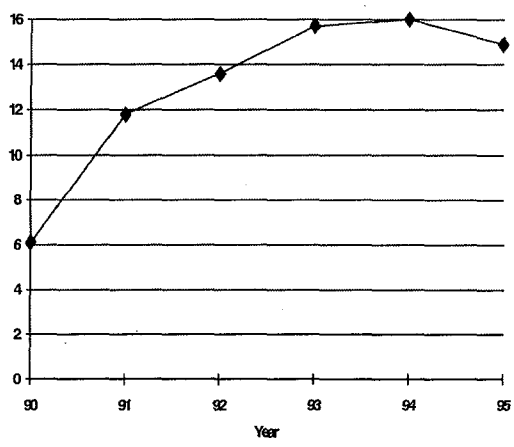
Growth is expected to resume in 1997, encouraged by the growth of imports - in 1996 by 10% in dollar terms - and improvements in corporate profitability- by more than 40% in 1995-96.

POLAND

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(% of labour force)



	1990	1991	1992	1993	1994	1995	1996
Employment in manufacturing*	-3.7	-0.4	-10.5	-2.0	-4.7	1.7	-0.3
Labour productivity (output per employee)*	-21.1	-11.9	17.1	14.5	19.2	9.6	13.4
Unit labour cost (USD)*	-8.9	66.5	-8.7	-8.8	-7.3	15.1	-7.8
Wage in manufacturing (in local currency)*	374.2	63.3	37.7	39.1	38.4	34.6	27.8
Exchange rate* (zloty per USD)	560.2	11.3	28.8	33.1	25.3	6.7	10.1
Manufacturing gross output*	-24.1	-12.3	4.8	12.2	13.7	11.4	13.1
Trade balance (billions USD)	2.2	0.1	0.5	-2.3	-0.8	-1.8	-7.2
External debt, (billions USD)	48.9	48.3	48.2	48.7	40.9	39.4	n.a.
Foreign direct investment (bns USD)	0.0	0.1	0.3	0.6	0.5	1.1	n.a.

(* percentage change, year on year) *Source: EBRD*

A large growth in imports to Poland has caused an increase in the trade deficit to USD 6.2 billion. In 1995 exports were 33% higher than in 1994, while imports were higher by 35%. In the first nine months of 1996 exports grew by only 8.4%, while imports increased by 27.5%. The result is a trade deficit of USD 8.3 billion already in 1997. It has been suggested that the slow down in exports was due to the structure of Polish exports - characterised by a high proportion of low-processed goods.

Despite the liberalisation of trade with the EU and EFTA, and the initial decline of trade with the ex-Comecon countries, the rebuilding of trade links is in effect. Evidence of this is that the CEEC and the former Soviet Union countries have Poland's biggest increase in trade turnover (exports by 29%, imports by 22%).

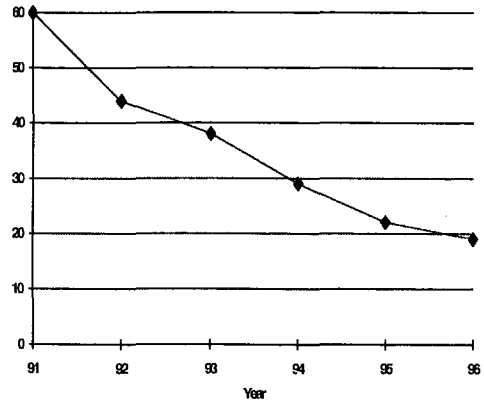
Privatisation of the Polish economy has been progressing smoothly. At the end of 1996, the share of private enterprises in total industrial production exceeded 52%, in

construction over 88%, in retail trade about 93%, in exports 62% and in imports 75%. Over 9 million people (64% of the total labour force) were employed in the private sector.

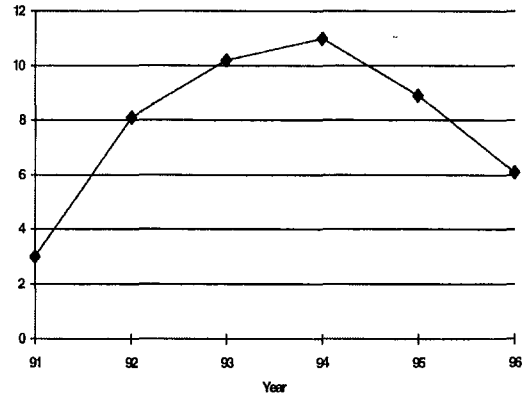
A significant factor in stimulating positive processes of economic growth is an inflow of foreign investments. In 1996, the inflow of foreign capital was greater than USD 5 billion. This can be partly attributed to fast growth of the economy, increasing reserves in foreign currencies and completion of the restructuring process for foreign debt - with these factors Poland became country a more attractive from an economic point of view, and also more secure.

ROMANIA

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(% of labour force)



	1990	1991	1992	1993	1994	1995	1996
Employment in industry*	1.2	-5.3	-10.9	-7.0	-7.4	-4.5	-0.5
Labour productivity (output per employee)*	-24.6	-18.5	-12.3	9.0	11.6	15.7	13.1
Unit labour cost (USD)*	3.5	-18.9	-22.6	13.1	-4.7	5.0	-6.3
Wage in industry (in local currency)*	9.4	125.0	173.5	204.2	131.6	49.2	62.4
Exchange rate* (lei per USD)	40.2	240.6	303.1	146.8	117.8	22.8	53.3
Industry gross output*	-23.7	-22.8	-21.9	1.3	3.3	9.4	12.6
Trade balance (billions USD)	-1.8	-1.3	-1.5	-1.2	0.4	-1.2	-0.8
Gross external debt, (billions USD)	0.6	1.4	2.4	3.3	3.4	4.8	7.0

(* percentage change, year on year) *Source: EBRD*

With the exception of agricultural performance, Romania has shown signs of economic recovery. GDP growth in 1996 was positive, and industrial output has grown. At the end of 1996, the share in GDP of the private sector had increased to 55%, from 45% at the end of 1995. However, rising inflation and a budget deficit have resulted from insufficient progress in structural adjustment and loosening of macroeconomic policy.

Increases in private consumption and rising energy and fuel prices have also added to inflationary pressures.

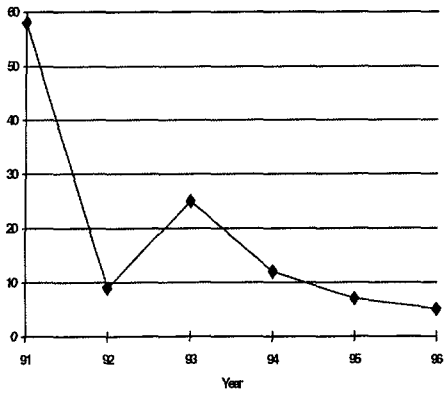
The slow development of Romania's capital markets could be accounted for by a mixture of political and economic factors. One of the greatest obstacles to the capital market was Romania's period of chronic hyperinflation, since no investors would face the risk of investing in a country at a time of such prominent volatility. Until 1994 there were no laws for a stock exchange and regulation over the securities markets began at the end of 1995, which was a further setback to capital market investment.

Exports and imports have weakened despite economic recovery. On the import side this is partly due to low supply of foreign exchange available to finance trade. One of the export side factors is that despite being depreciated in 1996, the leu is still considered over-valued.

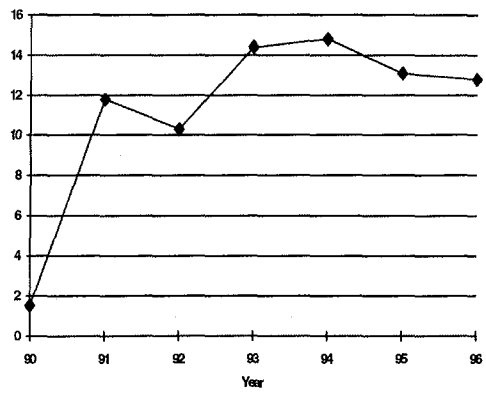
The main trading partners of Romania are on the export side Germany (USD 1,383 million), Italy (USD 1,280 million) and France (USD 431 million); and on the import side Germany (USD 1,705 million), Italy (USD 1,553 million) and Russia (USD 1,259 million).

SLOVAKIA

INFLATION
(Annual change in retail/consumer prices, %)



UNEMPLOYMENT
(% of labour force)



	1992	1993	1994	1995	1996
Employment in industry*	-15.8	-4.3	-2.0	4.1	0.3
Labour productivity (output per employee)*	7.4	0.6	6.8	4.0	2.5
Unit labour cost (USD)*	13.0	12.4	5.9	19.3	11.0
Wage in industry (in local currency)*	16.4	23.1	17.5	15.2	16.3
Exchange rate* (Slovak Crowns per USD)	-4.1	8.8	3.9	-7.1	2.2
Industry gross output*	-9.5	-3.7	4.7	8.3	2.8
Trade balance (billions USD)	-0.7	-0.9	0.1	-0.2	-2.1
Official reserves (billions USD)	na	3.2	2.6	2.4	2.8
External debt, (billions USD)	na	3.2	2.6	2.4	2.8

(* percentage change, year on year) *Source: EBRD*

Rising domestic demand has fuelled economic growth in Slovakia, but has also brought fears of an overheating economy. Exports have been effected by a decrease in demand for steel and iron products from the EU: increasing imports with decreasing exports have led to a negative trade balance and current account.

One of the main principles of Slovakia's foreign trade policy is the further liberalisation of international trade. This principle is realised through the utilisation of market compatible instruments and means to promote export along with temporary protection of domestic market and producers, in accordance with the WTO principles, Europe Agreement with EU, and agreements with EFTA and CEFTA.

The recent tightening of monetary policy has resulted in decreasing inflation, yet expansionary fiscal policy means that inflationary pressures exist.

Slovakia's main domestic industries are chemical, food processing, metallurgy, engineering, energy, paper/wood processing, textiles, electrical engineering, mining and building materials. This means that they are competing with some of the EU's most protected industries.

The main trading partners of Slovakia are the Czech Republic, Germany, Hungary, Russia and Austria. Main export products are consumer goods, machines and machine equipment, industrial products, chemicals, raw materials and foodstuffs.

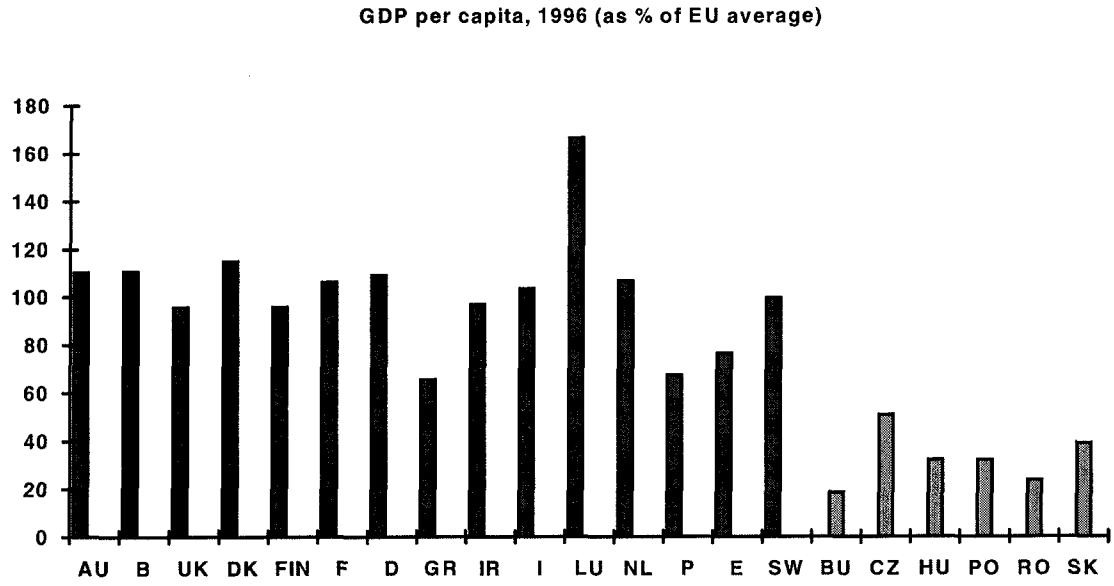
As for foreign investment incentives, Slovakia boasts lower labour costs than Western Europe, well qualified work force, with high proportion of university graduates and a stable macroeconomic environment based on low per capita foreign debt and a stable currency.

4 Approaching membership to the EU

"The trials of fitting 25 members into a club built for six."

All six of the CEEC have applied for membership of the EU, along with Estonia, Latvia, Lithuania, Slovenia and Cyprus. The Europe Agreements with the CEEC are one of the first steps to full membership. The transition to membership, however, may not be as smooth as theory suggests. One of the main concerns is related to the differentials in GDP between the EU countries and CEEC. It took eight years of negotiations before Spain and Portugal joined the EU, and they were more wealthy, and better prepared for the free market than any of the CEEC.

If all six of the CEEC were to join the EU the population would increase by 95.5 million, but average GDP per capita for the CEEC is 32.7% of the EU average. These countries would be a significant drain on EU resources and would endanger the common agricultural policy. The CEEC have a good comparative advantage in agricultural products, as their relatively large agricultural sectors can trade competitively at world market prices.



Source: The Economist: May 31st, 1997

Poland, the Czech Republic, and Hungary are expected to be in the first wave of successful entrance into the EU. Slovakia will be next with the Baltic states, and Romania and Bulgaria will follow. One of the questions with the potential to delay the process of enlargement is "How much will it cost?". The EU expects to be able to cope with the first four or five entrants without raising the present budget ceiling, and recent estimates have been falling: it is expected that the first wave will cost 20 billion ecu.

5 Europe Agreements

The purpose of the Europe Agreements is to:

> *"establish bilateral associations with the European Union based on a political dialogue, progressive economic integration and financial assistance. They are of unlimited duration with transition periods for the removal of economic and commercial barriers of up to 10 years for the associated countries. All Union restrictions on the import of industrial goods will be removed by the end of 1997".*

The main provisions of the Europe Agreements are:

* free trade in industrial goods within 10 years
* the improvement of access for agricultural products, similar to that detailed in the Lome Convention[1]
* commitment to assisting CEEC economic legislation conform to that within the EC
* financial and technical assistance
* potential for transition toward free trade in services.

[1] Santos, S (1997) *Lomé Convention* VATT - Discussion Papers 139. Helsinki, 1997.

6 Logistics of Europe Agreements

The Europe Agreements were signed in 1991 and 1993, but because they include issues beyond the Commission and Council's legislative capability the Agreements had to be ratified by each EC member government. Thus the trade chapters of the agreements were made effective immediately - known as the Interim Agreement on Trade and Trade-Related Matters (ITA). The Europe Agreements go further than a standard GATT- based trade regime.

Europe Agreements:

	signed	in force from	ITA from
Bulgaria	8 March 93	1 Feb 95	31 Dec 93
Czech Rep.	4 Oct 93	1 Feb 95	1 March 92
Hungary	16 Dec 91	1 Feb 94	1 March 92
Poland	16 Dec 91	1 Feb 94	1 March 92
Romania	1 Feb 93	1 Feb 95	I May 93
Slovakia	4 Oct 93	1 Feb 95	1 March 92

Source: European Commission

Each of the Europe Agreements consists of a preface, 122 articles in nine chapters, and annexes detailing lists of goods covered by the Agreements along with protocols and declarations. In the preface the background for political cooperation is established, and indicates that the Europe Agreements are a stepping stone toward membership of the European Union. Title III of the Agreements covers the Free Movement of Goods (ITA) - the area we will concentrate in order to investigate the effects of the agreements on trade. Chapter 1 covers industrial products, excluding agricultural items, chapter 2 covers agriculture, chapter 3 fisheries, and chapter 4 common provisions.

The agreement details both immediate, and gradual reductions on customs duties and quantitative (and similar) restrictions between the Community and CEEC country. The agreements are very similar for each country, and in Title III there are very few differences between countries. Therefore we shall treat the agreements as equal for all countries, and consider their consequences collectively, rather than examining each one individually.

The transition to free trade takes different paths for selected groups of industrial products - there are six agenda for reduction and abolition of customs duties and quantitative restrictions. These are detailed below:

* **the "one-year delayed" free trade group.** Customs duties are reduced to 50 percent on entry into force of the Agreement, and then duties abolished at the beginning of the second year.
* **the "four-year-delayed" free trade group**. Customs duties to be abolished at the beginning of the fifth year, following annual reductions in duties by 20 percent.
* **the "quota/five-year-delayed" free trade group.** Restrictions to trade abolished at the beginning of the sixth year, following a schedule of annual increases in quotas and reductions in customs duties, (customs duties suspended within quota limits).
* **the European Coal & Steel Community (ECSC) group**. Abolition of tariffs on steel by the end of the fifth year. On coal imports to the EU (with the exception of Germany and Spain) abolition of tariffs by the beginning of the second year for Czech Republic, Slovakia and Poland, and by the end of 1995 for the others, imports into Germany and Spain will be tariff free by the end of the fourth year of the ITA's.
* **the MFA group**. The transition to free trade is bound to the Uruguay Round of trade negotiations, but quotas are bilaterally negotiated.
* **the "immediately" free trade group**. This consists of all other products, contained in CN 25-97 which are not included in one of the other schedules above. These products are subject to immediate abolition of tariff and non-tariff barriers immediately on entry into force of the ITA.

Concessions to the Europe Agreements

There were two significant outcomes for the CEEC at the EC summit in Copenhagen in June 1993. Firstly, their aspirations to join the EU were recognised, though no concrete schedule was determined. And secondly, industrial products were accorded further trade concessions, advancing the transition to free trade by one year.

The concessions made were:

* abolition of tariffs on steel products in four, rather than five years
* abolition of duties reduced to two years on the "four-year-delayed" group.
* abolition of duties in five, rather than six years, on the MFA group
* increase in tariff-free quotas/ceilings by an added 10 percent per annum (resulting in 25 percent for Hungary and 30 percent for the other CEEC).
* abolition of duties reduced by two years for the "five-year-delayed" group

Safeguards and "Sensitive Goods"

Once the ITA is in force, there are clauses within the agreement so that neither new duties nor any other equivalent charges can be implemented: with the exception of agricultural products, the same 'standstill principle' is effected to quantitative restrictions. There are allowances within the agreement for the parties involved to

protect themselves against dumping, and it also outlines safeguard measures concerning *"infant industries..., sectors undergoing restructuring or facing serious difficulties, particularly where these difficulties produce important social problems"*.

The benefits of the Europe Agreement are clear as liberalisation of trade, with no requirement for reciprocity and preparation for entrance into the EU bring numerous opportunities and scope for economic development. However, there are also negative aspects of the Agreements.

Firstly, the issue of "sensitive goods". Protection is given by the EU to agricultural, steel, textile and leather products, as the CEEC are particularly competitive in these products. However, as the ultimate goal of the Europe Agreements is absolute liberalisation of trade, the problems of protected 'sensitive' goods will only be for the period of transition.

Secondly, by negotiating bilateral trade agreements with each CEEC, the EU may be intending a 'hub and spoke' approach to trade (Baldwin, 1994). The approach would see the EU as the centre of trade, with each of the CEEC on an individual 'spoke', with bilateral agreements and trade arrangements. This could discourage investment in the CEEC as a whole, and also create bias of competition in favour of the EU. Again this will only be a set-back until membership of the EU is achieved, unless a free trade area is established between the CEEC prior to entry.

Essentially the impact of the Agreements will be that CEEC exports of industrial goods, including steel and textile products will have access to the EU market free of tariff and non-tariff barriers. If the EC goes ahead with plans to reform its Common Agricultural Policy, this could also bring with it improved access for agricultural exports from the CEEC.

7 Potential for trade with CEEC

Winters and Wang (1994) use the gravity model to estimate the effects of liberalisation on trade levels between the EU and CEEC. They achieve this by using a model where the CEEC are fully integrated into the world economy in 1985.

The estimates suggest that Romanian exports to the EC would have been twice their current level, Polish and Hungarian exports five times greater, and Czech exports ten time higher.

In absolute terms this would imply that the opportunities for increasing exports (and imports) are ECU 13 billion per annum for Czechoslovakia, ECU 5 billion for Hungary and ECU 10 billion for Poland. However, this would only be feasible with a total commitment to open markets, stimulation of CEEC economic activity and sustained reform programmes.

The significance of the Europe Agreements will depend on the percentage of exports from the CEEC being imported by the EU. The opportunities presented by the liberalisation of trade are considerable, but they must be fully utilised to gain maximum benefit. When the ITA's were first operative in 1992 (Czechoslovakia, Hungary and Poland) approximately 60 percent of these countries exports of industrial products gained duty-free access to the EU market. The correspondent duty-free export shares for Bulgaria and Romania were 54 and 39 percent, respectively. These percentages rose in accordance with the EA's over the next 5 years.

8 Empirical Analysis

Theoretical Setting

The aim of the empirical analysis was to test the hypothesis (null hypothesis H_0) that the results of the ITA's (Interim Agreement on Trade and Trade-Related Matters) coming into force were an increase in volume of imports to the EU from the CEEC.

Dat

The data was collected from Eurostat, and was comprised of individual levels of imports from the CEEC and also total extra EC trade (into EU). The data was collected by CN code, and three groupings were chosen:

Group 1: CN 01-24 Agricultural products.
Group 2: CN 50-63 Textile products
Group 3: CN 25-49, 64-97. All other products

The time period from which the data was taken was January 1991 to December 1996, the data was monthly over this period.

The trade volume was recorded for imports into the EU12. As Finland, Sweden and Austria joined the EU in 1995, it would have distorted the data if they were included after this date, and would not be accurate to include them before this date (as they were not party to the Europe Agreements at this point). The three countries were included in extra-EC trade imports after 1995, to maintain continuity.

Method

The method chosen was regression by Ordinary Least Squares. Regressions were made for each individual CEEC country, with the exception of the Czech Republic and Slovakia. Given that the two countries were joined until 1993, it was decided to aggregate the two countries data after this date, in order to allow continuity.

Three main regressions were made, the difference being the explanatory variable used. In the Regression 1 it was total EU imports by product group; in Regression 2 it was total EU imports for all products aggregated. In Regression 3 both the explanatory and dependent variables were different: being the first differences of the variables used in Regression 1. In the first two regressions the dependent variable was imports to the EU from a CEEC country by product group, and in all regressions the dummy variable represented the ITA's coming into force.

Regression 1:

The explanatory variable was total imports to the EU from all extra EU countries divided by product group. The dependent variables were EU imports from each CEEC individually, also split as product groups. Originally it was intended to group the

CEEC trade figures together, but because the ITA's came into force on different dates, this was not feasible.

A dummy variable was used to signify the entrance into force of each ITA.

$$Y = \alpha + \beta X + \delta D + u$$

where Y is imports by product group from a CEEC to the EU
X is total imports, (by product group) to the EU from extra EU countries
D is the dummy variable for the start of the ITA
α, β, δ, are parameters to be estimated
u is the error term

Regression 2

The explanatory variable was total EU imports (all products) from all extra-EU countries. Dependent variable was EU imports by product group from the individual CEEC. The intention was to test whether the ITA's were significant to each product group as a part of total trade in all products.

Again a dummy variable was used to signify the beginning of the ITA.

$$Y = \alpha + \beta X + \delta D + u$$

where Y is imports by product group from a CEEC to the EU
X is total imports of all products to the EU from all extra-EU countries
D is the dummy variable for the start of the ITA
α, β, δ are parameters to be estimated
u is the error term

Regression Results

Regression 1

The table below shows the regression results obtained for the dummy variables, and in each case, whether they had a positive (+) or negative (-) effect: those entries marked with * had a significant t statistic.
[t statistic significant when $1.96 < t < -1.96$]

	PRODUCT GROUP		
	X1: CN 01-24	X2: CN 50-63	X3: other
BULGARIA	-	+*	+*
CZECH REP/SLOVAKIA	+	+*	+*
HUNGARY	-*	+*	+*
POLAND	-*	+*	+*
ROMANIA	+*	+*	+*

It would seem that the dummy variable for all countries, and products excepting agricultural, has a significant effect on imports to the EU from the CEEC, as a proportion of all imports in the respective groups. This implies that the imports have increased around the time that the ITA's became effective.

The results for agricultural products are less straightforward. For Bulgaria and the Czech Republic and Slovakia there are no significant effects, whereas Hungary and Romania show significant positive effects, and Poland a significant negative effect. Is it feasible that the ITA's could have had little effect for some countries, but opposing effects for others?

Regression 2

The results for Regression 2 were similar to those of Regression 1. The table below shows the regression results for the dummy variable, indicating direction of effect (- or +) and significance (*).

	PRODUCT GROUP		
	X1: CN 01-24	X2: CN 50-63	X3: others
BULGARIA	+*	+*	+*
CZECH REP/SLOVAKIA	-	+*	+*
HUNGARY	-*	+*	+*
POLAND	-*	+*	+*
ROMANIA	+*	+*	+*

As with regression 1, this implies that the ITA's have had a positive effect on volume of textile and 'all other' products, but have had a negligible or even negative effect on agricultural products.

A supplementary regression was run with total agricultural imports to the EU as explanatory variable, and total EU imports of all products as dependent variable, the same dummy was used as in previous regressions. The results were similar to those above, but the t statistics for the dummy variable were noted:

	BU	CZ	HU	PO	RO
t stat value	8.111	2.470	2.471	2.471	4.831
effect	+*	+*	+*	+*	+*

This would seem to imply that with the entry into force of each ITA, the volume of agricultural products being imported into the EU (from all extra-EU countries) has increased. It would be contradictory to say that this implies a positive effect of the ITA, as the previous regressions had not shown this to be such. One explanation for the implied positive effect would be an increase of agricultural imports into the EU from

some country or countries outside the CEEC, at the same time as the ITA came into force.

A second supplementary regression took total imports to the EU as explanatory variable, and the dependent variable was the relative value for agricultural imports from each CEEC (agricultural imports from each CEEC divided by the total agricultural imports to the EU). Dummy variable as before:

	BU	CZ	HU	PO	RO
t stat value	0.074	1.257	-3.516	-4.255	5.024
effect	+	+	-*	-*	+*

With the exception of Romania, this suggest that following the initiation of the ITA, the CEEC's relative share of the EU's imports of agricultural products, either did not change, or suffered a negative effect.

Regression 3

The explanatory variable was the first differences of total EU imports (by product group) from all extra-EU countries, Dependent variable was the first differences of EU imports by product group from the individual CEEC. The intention was try and gain some support for the results gained from regressions 1 and 2, with respect to the 'all other' category of products.

The dummy variable was used to represent the beginning of the ITA.

$$Y = \beta\Delta X + \delta\Delta D + \Delta u$$

Where Y is the first difference of imports by product group from the CEEC to the EU
X is first differences of total imports (by product group) to the EU from all extra-EU countries
D is the dummy variable
β and δ are parameters to be estimated
u is the error term
Δ is the symbol for the first difference

<u>Regression Results</u>

Regression 3

The coefficients of the explanatory variable are noted below, and those values marked with a * had a significant t statistic:

	PRODUCT GROUP		
	X1: CN 01-24	X2: CN 50-63	X3: all other products
BULGARIA	0.004*	0.005*	0.001
CZECH REP/SLOVAKIA	0.009*	0.013*	0.016*
HUNGARY	0.017*	0.014*	0.010*
POLAND	0.020*	0.027*	0.015*
ROMANIA	0.001*	0.014*	0.004*

Again, the dummy variable t statistics were noted by direction (* denotes a significant t statistic):

	PRODUCT GROUP		
	X1: CN 01-24	X2: CN 50-63	X3: all other products
BULGARIA	-	- *	-
CZECH REP/SLOVAKIA	-	+	-
HUNGARY	-	-	-
POLAND	+	-	+
ROMANIA	+	+	-

Regression 3 presents a very different picture to the previous regressions. These results show significantly more variation of positive or negative effect than the original results of Regression 1 and 2. Only one of the dummy variables was significant, and therefore one would have to conclude that more research would be needed to achieve concrete results as to whether the ITA's have had significant effect to trade flows.

Looking at the result in general, one would be sceptical that the ITA's have had a positive effect on trade flows. Though it can be seen in the following charts that the CEEC have increased their share in EU imports in at least some product groups

9 Conclusion

Dramatic transformations have already occurred in the economies of the Central and East European countries. Changes will continue to take place as these countries make there way toward being full market economies. The full trading potential of these countries will not be known until they have 'found their feet' in the world market, and begin to fully utilise the resources available to them.

In general, the CEEC markets are growing, foreign direct investment is increasing and productivity is constantly improving. Manufacturing output is increasing, and economic growth is mostly positive. There is massive potential for investment, especially from abroad.

Politically, the CEEC are now stable, and progressing toward EU membership: the first step being the Europe Agreements. Full membership, however, is still a long way off, and there are many issues to be considered before the present members allow the CEEC entrance. The potential burden of the CEEC is too great not to be given serious consideration.

The positive intent of the ITA's may be slightly soured by the implications of the empirical analysis included in this paper. Taking Regression 3 (variables in differences) into account, one may wonder if the increases in market shares for the CEEC might have been in the supply-side factors, i.e. the collapse of communism.

GLOSSARY

AU	Austria
B	Belgium
bn.	billion - one thousand million
BU	Bulgaria
CAP	Common Agricultural Policy
CEEC	Central and East European Countries
COMECON	Council for Mutual Economic Assistance (also known as CMEA)
CZ	Czech Republic
D	Germany
DK	Denmark
E	Spain
EBRD	European Bank of Reconstruction and Development
EC	European Communities
ECSC	European Coal & Steel Community
ECU	European Currency Unit
EFTA	European Free Trade Association
EU	European Union
F	France
FDI	Foreign Direct Investment
FIN	Finland
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GR	Greece
GSP	General System of Preferences
I	Italy
IR	Ireland
ITA	Interim Agreement on Trade and Trade-Related Matters
LU	Luxembourg
MFA	Multi Fibre Agreement
NL	Netherlands
OECD	Organisation for Economic Co-operation and Development
P	Portugal
PO	Poland
RO	Romania
SK	Slovakia
SW	Sweden
UK	United Kingdom

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