OFCE
Observatoire Français des Conjonctures Economiques
69 Quai d'Orsay - 75340 Paris Cedex 07
Tél. : 01 44 18 54 00 - Fax. : 01 45 56 06 15

DESIGNING THE FUTURE EU
MACROECONOMIC PROSPECTS
FOR AN EASTERN ENLARGEMENT

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Sandrine CAZES, Bruno COQUET, Frédéric LERAIS*

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This paper considers macroeconomic effects of an EU[1] enlargement to the six CEECs. Numerous studies have shown partial consequences of such an event with the financial aid required to ease the process of transition to a market economy and the catching-up process. International trade issues also call much attention. This paper refers to these studies to build enlargement scenarios. We use a macroeconometric model of the world-wide economy to appraise the main consequences of the EU enlargement both for western countries and for the CEECs as a group[2].

The paper is organised as follows. We begin with a description of the stakes Europe is facing with the enlargement issue (section 1). The next section sums up recent economic developments in Eastern countries, especially since the beginning of the transition process (section 2). In order to analyse difficulties –mainly financial– that have impeded the transition path, section 3 focuses principally on financial flows observed since the early 90's and sets out an appraisal of financial transfers required to foster transition process context[3]. Section 4 reviews factors that have favoured structural reforms in transition countries: we first describe methods used by others studies to estimate trade flows and the nature of Association Agreements between the EU and the CEECs; we then set out the technical aspect of our work. In the last section we investigate two scenarios characterised by more or less intense financial flows. Macroeconomic outcomes are presented and discussed.

1. The Eastern enlargement of the European Union

1.1 Political stakes and economic issues

The Maastricht Treaty and the integration of three new members have focused the EU's future on two major stakes: the internal organisation of the 15 members and the conditions for accession of Eastern Europe. Political aspects of enlargement imply that the EU first of all answers the following question: should the CEECs get closer to Western Europe or should they remain within the Russian sphere of influence?

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[1] All acronyms used in this paper are detailed in a lexicon, at the end of the document.

[2] For this study we use the CEPII-OFCE new version of the macroeconometric model, MIMOSA, which describes in detail the world economy, through 6 countries and 12 regions (Cf. Mimosa, 1996).

[3] Structural funds and expected effects on the European budget are also detailed in this part.

Indeed, the answer should determine their specific transition path to the market economy.

Even if this political debate seems obvious, market integration tends to neglect it, to focus on overestimated economic constraints. This could weaken the European construction as economic interests are more volatile than political decisions. Indeed, the European project has lost most of his clearness and strength[4]. Thus, it seems necessary to begin the analysis of the Eastern enlargement by raising some questions about the nature and the objectives of European co-operation.

1.2 The enlargement process

Evidence of the two last waves of accessions –Southern-European and EFTA countries– points out the main stakes of the process: memberships of Greece in 1981, of Spain and Portugal in 1986 aimed at political stability. Then, by establishing the *Single Market* , the *Single European Act* has deepened the economic integration and has fostered an increase of structural funds. Those financial transfers can be obtained by the poorest countries to catch up with the average European per-capita income. The recent enlargement to Scandinavian countries and Austria has not raised any controversy, nor specific institutional reforms as these countries seemed to fully agree with the Maastricht Treaty. Furthermore, the high level of development and the small size of these countries have contributed to make this enlargement painless.

Another wave of accessions has yet raised some neglected issues that crop up with the new applicants. First, the enlargement to the 3 EFTA countries has been presented more as an *integration* than an *accession* to the European project. Moreover, Sweden, Austria and Finland were strategic countries of the Cold War and their integration was directly linked to the collapse[5] of the Soviet Union. The CEECs were Warsaw Pact members. Their democratic institutions are still weak and nationality rivalries remain very sensitive. But political implications of their accession appear similar, given that East / West rivalry is still sensitive. Fortunately the process of enlargement relies more today on economic development level than on political antagonisms.

[4] In particular, the initial objective of the European Union of securing peace by prosperity and solidarity.

[5] Mainly, the issue of the compatibility between their neutrality and the External and Security Common Policy has been avoided. For a survey see IFRI, 1995.

Consequently, the *catching-up* process which has been promoted until now by the Treaty of Rome tends to be forsaken in favour of a *convergence process* -mainly because it seems less costly. This evolution promotes political vision which has never been set out but spontaneously sets up because of the vacancy of a negotiated alternative.

1.3 Purposes of Europe and enlargement

The general principle of peace through prosperity and solidarity still provides a guideline for judging the conditions and effectiveness of European convergence. Therefore these criteria seem to be the best ones to set the purposes and logic of an Eastern enlargement.

Even today, the Customs Union Agreement constitutes the main specific feature of Europe and its best achievement. It is therefore not surprising that the path of enlargement mainly revolves around trade issues between Eastern and Western Europe. Nevertheless, trade does not represent an aim in itself. Improvement of European structures and policies should rather be assessed in terms of growth, employment, living standards, social protection and solidarity. This means that the debate of enlargement opportunity has to be oriented towards institutions, sovereignty transfers and solidarity mechanisms.

In the economic context, this is directly linked to nominal convergence criteria, their purpose and relevance. These criteria imply a strong normative idea of economic policy, subsidiarity and European co-operation, widely different from the spirit of Treaty of Rome. It is therefore necessary to define the modalities of involvement in common policies (CAP, Structural Funds, single currency) and to cope with the emerging contradictions between free trade aims (competition, public policies, tax systems, labour laws etc.) and the initial objectives of the EU (fostering growth, employment, price stability, etc.).

Yet the EMU, the Single market and the Association Agreements structure economic action in the EU. But even if they seem to be steps of a sole integration process, those institutions determine different levels of co-operation between countries. Introducing concepts such as 'second-class membership', 'variable geometry', 'hub and spoke bilateralism', 'concentric circles' help conciliating this heterogeneity. Indeed these theories finally design a single European project: a Community where each new membership could come as a piece of a puzzle without any reference to the grounding wishes and principles.

Politically speaking, enlargement raises the opportunity of individual or global accession of Eastern countries[6]. An integration of the CEECs as a group does not guarantee that the new incumbents will share the same view of solidarity in the future. Problems may also arise from economic and social differences between the six countries. Thus, an individual integration appears more suitable, but leaving the possibility open for each country to join.

From an economic point of view, the CEECs can be divided into two groups: Hungary, Poland, the Czech Republic and the Slovak Republic on the one hand, Bulgaria and Romania on the other one. This categorisation mainly comes from their income level and trade specialisation[7]. Furthermore, the first group of countries signed a free trade agreement (CEFTA). This implies different constraints and economic policies in the short run, as well as different accession patterns.

In this paper we explore the effects both of a weak economic commitment by the EU and those of a deeper one (where economic reforms in the CEECs are clearly supported). There is no reference to a common political project in the two scenarios, even if it should be necessary for the EU to have one.

2. Recent economic developments

2.1 Eastern countries: incomplete restructuring

Since the early 90s, the transition economies have experienced a slump of an unexpected intensity. First of all, the impact of the collapse of Eastern bloc and the outcome of structural reforms had widely been underestimated. The fall of CMEA led to tremendous shocks on supply and demand: trade flows, which represented 15 to 35% of GDP in 1990, were almost wiped out the following year. However the reorientation of trade towards Western Europe, in offering new outlets for Eastern countries, has prevented those countries from a deeper collapse[8].

[6] Baldwin, 1992; Martin, 1995; Bofinger, 1995.

[7] Fayolle, 1996; Lemoine, 1995

[8] A review of explanations of the output drop can be found in Rosati, 1994. Rodrik, 1992 imputes almost all the slump in 1991 in Hungary and Czechoslovakia to the collapse of trade with the former Soviet Union.

Table 1. Macroeconomic developments in the CEECs

Countries	Aggregate	1990	1991	1992	1993	1994	1995
Bulgaria	GDP (1)	-9.1	-11.7	-7.3	-2.4	1.8	2.6
	Consumption (2)	na	-8.4	-9.2	-2.5	1.7	na
	Investment (3)	-18.5	-19.9	-23.2	-29.7	na	na
	Prices (4)	26.3	333.5	82.0	73.0	96.3	62.0
	Unemployment (5)	1.5	11.5	15.6	16.4	12.8	10.5
	Budget balance (6)	na	na	-13.0	-10.9	-5.8	-5.7
Hungary	GDP (1)	-3.5	-11.9	-3.1	-0.6	2.9	1.5
	Consumption (2)	-3.6	-5.6	0.0	1.9	-0.2	-4.5
	Investment (3)	-7.1	-10.4	-2.6	2.0	12.5	1.0
	Prices (4)	28.9	35.0	23.0	22.5	18.8	28.2
	Unemployment (5)	1.9	7.5	12.3	12.1	10.4	10.4
	Budget balance (6)	0.4	-2.2	-5.5	-6.8	-8.2	-6.5
Poland	GDP (1)	-11.6	-7.0	2.6	3.8	5.2	7.0
	Consumption (2)	-15.3	6.3	2.3	5.2	4.3	na
	Investment (3)	-10.6	-4.4	2.3	2.9	9.2	19.0
	Prices (4)	585.8	70.3	43.0	35.3	33.2	27.8
	Unemployment (5)	6.1	11.8	13.6	15.7	16.0	14.9
	Budget balance (6)	3.1	-6.5	-6.6	-2.9	-2.0	-3.1
Czech Rep.	GDP (1)	-0.4	-14.2	-6.4	-0.9	2.6	4.8
	Consumption (2)	na	na	15.1	2.9	5.3	6.4
	Investment (3)	na	na	8.9	-7.7	17.3	16.1
	Prices (4)	10.8	56.7	11.1	20.8	10.0	9.1
	Unemployment (5)	0.8	4.1	2.6	3.5	3.2	2.9
	Budget balance (6)	0.1	-2.0	-3.3	0.8	0.9	0.4
Romania	GDP (1)	-5.6	-12.9	-8.8	1.3	3.9	6.9
	Consumption (2)	8.1	-16.2	-9.2	-2.1	5.0	16.9
	Investment (3)	-37.4	-36.7	19.3	-3.7	14.6	na
	Prices (4)	5.1	174.5	210.9	256.1	131.0	32.2
	Unemployment (5)	na	3.0	8.1	10.2	11.0	8.9
	Budget balance (6)	1.2	0.6	-4.6	-0.1	-1.0	-2.8
Slovakia	GDP (1)	-2.5	-14.6	-6.5	-4.1	4.8	7.4
	Consumption (2)	na	-28.2	-2.7	1.2	-5.1	4.1
	Investment (3)	11.7	-25.2	-3.6	-16.0	-4.0	21.5
	Prices (4)	10.8	61.2	10.1	23.2	13.4	9.9
	Unemployment (5)	1.5	11.8	10.3	14.4	14.8	13.1
	Budget balance (6)	0.1	-2.0	-11.9	-7.1	-1.1	3.2

Sources: EBRD; UN/ECE. (1) Real growth rate. (2) Rate of growth of private consumption, when figures are available. (3) Rate of growth of total investment (4) Rate of change in consumption prices. (5) Rate of unemployment (6) Budget balance as a ratio to GDP.

Second, the reforms took place in an environment of European recession, which was deeper than expected and which has dramatically reduced demand addressed to those countries in 1993. Combined with devaluations at the end 1992 in Southern Europe, this has contributed to sluggish exports' growth[9]. The competition of Western products has become more acute. Besides, the real exchange rates, initially very favourable (due to the over-depreciation that followed liberalisation and convertibility of Eastern currencies), have appreciated because of high inflation rates[10]. On labour markets, unemployment appeared and grew. But no one can clearly tell whether it stems directly from the restructuring or from the collapse of demand and output.

The deterioration of Western European countries' economic and social situation has widened EU's public deficits, narrowing their margins –according to the EU– to bring financial resources to transition countries. Meanwhile, the conditionality defined by international organisations, added to a bleak outlook, have brought the goals fixed to transition countries harder to achieve.

If modernisation is on the way in all countries, economic restructuring is far from complete. Yet, countries that have rapidly adopted structural reforms have already benefited from a major shift in supply: prices are mainly determined by market mechanisms, foreign trade is free and intense; currencies are convertible –if only partially. The labour market equilibrium and the path of relative prices constitute undeniable symptoms that reforms go ahead. But were these reforms required, they were not sufficient: a country's recession does not mean necessarily that all the necessary reforms have been undertaken, nor that the current recovery can be attributed to them. Supply-side restructuring to come remains important, as well as that of public interventions. But this could also imply an increasing risk of worsening the social cost of the transition by an intensification of the reforms. Indeed, it augurs a lowering in employment and an increase trend of the unemployment rate and poverty.

The registered growth in 1994 gives encouraging prospects: in countries in which reforms have progressed the most, growth was based on a clear recovery of internal demand. In all countries, except Slovakia and Bulgaria, GDP's growth is supported by the recovery of investment. This is the key point of the recent outlook and the most encouraging one. It reflects favourable demand expectations, indicates that

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[9] Balkanic countries are particularly vulnerable to this competition. See Lemoine, 1995; Faini & Portes, 1995.

[10] See Halpern & Wyplosz, 1995.

firms find out resources and that capacity of production is being renewed. Private consumption has also picked up in all countries, except again Slovakia.

The growth of demand from industrialised countries since 1993, as well as the revival of internal trade, have helped the CEECs to recover[11]. Growth of external demand is a direct and positive counterpart of the international trade opening policy carried out. It highlights the importance of external opening and of strengthening EU's relations', in a transition context. Yet for Western countries, it raises fears, as they regard Eastern countries more as competitors than as potential markets for their products[12].

2.2 Western-European countries: fears to keep away

The importance of financing required to build a market economy and to restructure the firms in the CEECs has rapidly aroused fears of a huge fiscal cost for the donor countries. The prospect of CEECs' integration has reinforced reluctance from the incumbent members, committed to reduce public deficits to meet the criteria of the EMU.

This fear is predicted on the widespread view that saving is not sufficient to finance growth of both Eastern and Western countries. According to this, widening fiscal deficit provokes a rise in interest rates and is detrimental to economic growth[13]. But this view is based on unreasonable assumptions: if one assumes that monetary authorities are inflation averse, the short-term interest rate will be raised only if there are inflationary pressures; now, a public deficit leads to inflation only in case of full-employment of inputs. Given the weakness of the private demand, it is unlikely to be the case now. To avoid excessive debt service, monetary authorities first try to obtain a reduction of fiscal deficits, where they should better lower the interest rate to fight the demand shortfall. Besides, the small amount of financial flows allocated to the Eastern countries can not have effect on Western public deficit, nor on interest rates.

Most studies emphasise the need for capital transfers to foster the pace of restructuring and to help Eastern countries to catch up with Western standards. In the same way, the fear of developing countries to be disqualified for financing by

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[11] See UN/ECE, 1995.

[12] The Eastern enlargement would represent an opportunity to enter a 100 million inhabitants market.

[13] Some economists have insisted on the fact that Western countries have been hurt by the rise in interest rates because Germany almost reached full capacity of production.

Eastern countries turns out to be false. Actually, Eastern countries have not benefited from considerable capital inflows, such as South-eastern Asia has.

Among the European fears, that of dumping has led to a cautious stance about opening trade. In that way, the European Association Agreements has come along with quotas on 'sensitive products' and with safeguard clauses. In particular, for the agricultural products, trade liberalisation is not effective (cf. later).

Finally, there is also a risk of massive emigration from the CEECs, to find opportunities in Western countries. In fact, these labour flows problems do already exist in the EU-15 and have delayed the implementation of Schengen's Agreements. Nevertheless, the danger of an economic and social crisis in neighbour countries sets political issues and asks for determinate and ambitious economic answers.

3. Financing transition and integration

3.1 Important needs for resources...

In the long run, it was expected that Eastern Countries' opening-up would allow them to catch up with Western level of wealth. But this would require considerable financial flows. The estimated needs of the CEECs ranged, depending on restructuring dynamics, between $ 100 billion and 600 a year[14].

Of course, these resources should have come partly from domestic financing. But the necessity of rapid adjustment, combined with huge needs for reconstruction implied an intense foreign aid. Therefore, external financing seemed crucial quantitatively and qualitatively[15] for the Eastern countries. One difficulty came from the required amount of the flows -much higher than those already experienced. Notably it clearly exceeded the Marshall plan's aid (which roughly represented 1% of GDP of the USA over four years[16]). Another difficulty relied on the starting of the aid process, bounded by narrow scopes in fiscal field.

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[14] Fitoussi & Phelps, 1990; CEPR, 1990; Collins & Rodrik, 1991; Bartolini & Symansky, 1994.

[15] See the debate on the impact of foreign investment on the diffusion of the market rationality.

[16] See Eichengreen & Uzan, 1990; Kirman & Reichlin, 1990; Aglietta & *alii*, 1992; Commisariat Général au plan, 1991.

3.2 ... but low and inadequate flows

Capital flows received by the CEECs turned out to be low and erratic (see table 2). Overall they amounted to roughly 25 billion dollars a year, 12 of which came from private flows. Compared to the 80 billion dollars consented to the former Eastern Germany in 1990[17], those funds seem ridiculously low.

Table 2. Gross capital flows towards the CEECs

Billion dollars

		1990	1991	1992	1993	1994
Private flows (1)		5.0	5.7	6.1	14.4	11.5
of which	FDI	0.6	2.3	3.1	4.5	3.2
Official flows (2)		2.8	7.9	5.4	2.4	5.0
of which	Grants	1.2	1.7	1.2	0.5	0.5
	Credits	0.9	2.5	2.9	1.6	2.6
	IMF	0.7	3.7	1.3	0.3	1.9
New flows (1)+(2)		7.8	13.6	11.5	16.8	16.5
Debt rescheduling (3)		10.4	9.6	7.4	5.9	4.0
Total (1)+(2)+(3)		**18.2**	**23.2**	**18.9**	**22.7**	**20.5**

Source: UN/ECE.

Official inflows first stabilise economy, then initiate recovery. They should have therefore created expectations favouring private capital inflows, which would have taken them over. But the allocation of the funds was imposed by macroeconomic choices and did not constitute a direct aid to restructuring nor to structural reforms. On the one hand, a considerable bulk of those official flows was assigned to debt rescheduling or to macroeconomic stabilisation. On the other one, aids –or loans– were reduced for conditionality reasons. Actually, conditions tend to cumulate and become contradictory: in a slump context. if *ex ante* conditions are not softened, goals are not achieved and funds are not released. This tends of course to worsen the initial situation. Indeed, the lack of co-ordination of the different lenders, as well as the absence of releasing in the allocation criteria, have not helped to step up the restructuring, nor to clarify the private investors' expectations.

Apart from their small amount, these flows are highly concentrated on some countries and sectors. Their composition reflects a classical policy of financing development in a macroeconomic stabilisation framework. Indeed, two trends come

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[17] Or 5% of the West German GDP, and more than 50% of former East German GDP.

out from the structure of resources received by transition countries: financial assistance is low and clearly declines, while private flows increase with official bond issues on the world-wide market.

In fact, the explanation of the rise of external private financing, in 1993-94, lies in borrowing issues on the world capital markets by the CEECs. At the same time, foreign direct investment remains quite low -not to say marginal- except in Hungary and in the Czech Republic. Institutional uncertainty, as well as the general slump in Europe, have discouraged multinational firms from investing as much as they expected at the very start of the transition

In this context, flows towards Eastern countries become more scarce and costly, hindering reform opportunities. Today, there is a risk of financial crisis as private creditors[18] are timorous and versatile: the dynamics of growth in the transition economies could be weaken as soon as creditors would worry. Under these conditions, growth should better rely on exports. Thus, liberalising trade and belonging to a free-market area such as the EU, constitute a crucial stake for the Eastern countries' transition.

3.3 Integration and financing

The integration of the Eastern countries to the EU includes their participation in common policies. Given their level of income, they would be net recipients of structural funds. This would mean for incumbent members an increase of their net contribution. But membership would also favour other kinds of capital inflows; all in all, the total flows received by the CEECs, in case of their integration, would be much higher. Consequently, transition and growth would be much easier for those countries.

3.3.1 An increased European budget

Increasing structural funds will have immediate impacts on the European budget. The cost of enlargement should however not be appraised in absolute terms, but in relative ones. It then becomes very low especially if it is compared to the Marshall plan -roughly 0.3% of the European GDP. Besides, to prevent from perverse macroeconomic effects -bad allocation of resources, pressures on output capacities,

[18] Sgard, 1995.

etc.-, it seems convenient to match these transfers as a share of the recipients' GDP (for example 5 to 6% of their GDP).

This leads us to choose moderate assumptions about fiscal transfers to be implemented. Of course, it is often argued that the rise of public transfers towards the EU's budget could prevent some countries from meeting Maastricht's criteria. But, it is also possible to consider the net contributions to the EU's budget as an explicit and active participation to the European integration process and not as a traditional public spending. This would mean that the European criteria of fiscal deficit would not involve the net financing of the States to the common budget.

3.3.1.1 *Questioning eligibility criteria?*

Several studies attempt to assess the fiscal impacts of Eastern countries' integration (see Table 3). If they all agree on the necessity of helping CEECs' integration with structural funds, they differ on the amounts required, on the levels bearable by the incumbent members and on the absorption capacity of the recipients.

Even if the assessments range from Ecus 11 billion a year to 45 billion, so is less than 0.4% of the current EU's GDP, most authors still fear that integration would be too costly under the current allocation criteria[19]. Their fear is exacerbated by the fact that CEECs compete with South European countries, not only on trade flows[20], but also on structural funds: the latter could receive less money and become net debtors - today they are net contributors- as they would not correspond to the eligibility criteria anymore.

To avoid problem, several solutions have been proposed, none of which fully adequate:

- Tightening the eligibility criteria would exclude countries such as Spain or Italy from structural funds. This could of course lead them to put their veto on the enlargement.
- Integrating Eastern countries without structural funds is also risky. There is first a risk of fiscal derogation: if some EU countries question structural funds for the CEECs, why not questioning them for Ireland, Portugal, etc.? Besides, giving

[19] Bensainou, 1995; Saint Aubin, 1995; Gual, 1995; Baldwin, 1994.

[20] Gual & Martin, 1995; Lemoine, 1995.

funds to incumbent members and not to new entrants, poorer and far from the EU's productivity standard, appears inconsistent.

- Waiting that the CEECs converge to make their accession less costly is incoherent with the idea that these country belong in the same economic area and shares common objectives and constraints.

Table 3. CEECs' structural funds

Estimates according to different studies

Institute	Year	Cost Ecus Billion	* $ Billion
CEPR	1990	11.5	15.0
EEC [1]	1992	26.0	33.8
Baldwin	1994	26.7	34.7
EEC [2]**	1995	38.0	49.4
Bensainou [1]	1995	12.0	15.6
Bensainou [2]	1995	26.3	34.2
Fayolle	1995	45.0	58.5
Authors' calculus	1995	17.8	23.2

* At the exchange rate of December 1995: 1,3 dollar to 1 Ecu; ** including CAP.

3.3.1.2 Indispensable structural funds

In the context of integration, we have thus assumed that common policies would apply to the CEECs exactly in the same way -and with the same criteria of eligibility- as for the incumbent members.

CAP transfers may not provoke a dramatic increase in the common budget. Actually, since the 1992 reform and the signature of the GATT agreements, agricultural subsidies mainly compensate for price falls in line with world prices. As far as Eastern countries are concerned, convergence towards the EU countries would rather entail increases in agricultural prices. Therefore, we consider that enlargement will only have a marginal impact on this budget item[21].

To assess the transfers, we estimate the structural funds for the Europe-15 according to their GDP per capita and their unemployment rate. Then, we apply this equation to the Eastern countries for the year 1999. Our results fit with those registered for Ireland (roughly Ecus 200 per capita). The flows of structural funds would amount to

[21] Le Cacheux, 1996.

roughly ecus 20 billion a year –0.2% of the EU's GDP. Needless to say that the impact on the *ex-ante* public deficits would be relatively small. By contrast, this amount represents for Eastern countries roughly 5%, on average, of their GDP. But it still remains far below the Marshall plan and the German reunification (see § 3.2).

Our estimates are of course conditioned by GDP per capita assessments that widely differ across institutes; it also depends on the unemployment rate projection. Namely one can consider that employment will pick up with recovery; but one can also argue that restructuring and gains of productivity still remain to come[22].

Table 4. Structural funds and allocation criteria

Estimation of flows towards the CEECs in 1999

	Structural funds (Ecus)			Macroeconomic situation		
Countries	Funds p.c. estimated	Value (millions)	% of GDP	GDP p.c. in Ecus	Unemploy-ment. rate	Population (millions)
Bulgaria	182.4	1550	4.3	4233	13.7	8.5
Hungary.	167.7	1761	3.9	4482	11.1	10.5
Poland	207.6	8013	6.1	3403	16.5	38.6
Czech Rep.	109.8	1153	1.8	6059	3.3	10.5
Romania	198.4	4504	7.7	2573	10.9	22.7
Slovak Rep.	169.7	899	3.2	5229	14.6	5.3
Average	186.3	*17880	4.6	4067	12.5	*96.1

Total amount of structural funds.

Sources: author's calculus with data from World Bank, Planecon, UN/ECE.

3.3.2 Higher foreign direct investment ?

In a scenario of integration, public transfers are more sizeable and less discretionary that in an Association Agreements one. This can have effects on the other capital inflows. In a free-market, the bilateral Association Agreements promote investment in the EU's countries (*the hub*) against other ones (*the spoke*)[23]. Therefore, we have increased the investment in the integration scenario as compared to the Association Agreements one. This can be explained by a trade intensification between each Eastern country and the EU (thus advantaging productions' localisation eastwards) and by domestic investments turned towards wider and more profitable markets. But firms can also invest more on protected markets to bypass trade legislation and

[22] Coquet & Lerais, 1995.

[23] Baldwin, 1994.

to dampen external competition. Yet, Spain and Portugal's experiences suggest that accession implies an increase of foreign direct investment flows.

4. Trade flows and integration

Since 1990, the issues of Eastern countries' opening and of EU's association came together with the necessity of developing world-wide trade, its expected costs and gains. We propose a short survey of empirical and normative analyses, in order to have guidelines for the trade path. This is helpful, in our model, for quantifying trade-diverting and intensification effects [24].

4.1 Prospects for trade patterns

To get an idea of the future European trade patterns, we have estimated the potential trade between the EU and the CEECs[25]. There are no robust theoretical foundations to appraise trade flows following a custom union. Actually, it is very difficult to foresee comparative advantages[26] of *transition* economies. Two kinds of predictive models are generally used: the *gravity model* and estimations based on *historical data.*

4.1.1 A presentation of the models

The gravity model is used for forecasting potential flows between two trade partners. As far as East-West trade is concerned, it is useful to set a *normal* level of trade between the two areas, considered as a potential target for trade between them. The idea underlined in the gravity model is the following: the bigger, the richer and the closer economies will be, the more they will exchange. Therefore, country i trades as more with country j as their GDP are higher, their population less numerous and as they are geographically closer, *ceteris paribus.* Other variables, as *adjacency* or specific relations between the partners, may also have an impact (see box n°1).

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[24] Trade-diverting effect stands for the shift of the market share and intensification, the rise of the overall trade.

[25] Those estimations are within a free-trade context. Actually, it is difficult to accurately assess the effect of custom duties and quotas. Today the ceilings are not reached, so they are not constraining. But, structural reforms improving supply conditions, quotas could constrain foreign trade. Cf. European Commission, 1995b and 1994a; Rollo & Smith, 1993.

[26] Neven, 1995; Halpern, 1995.

BOX 1

THE GRAVITY MODEL

Principles and theoretical foundations of the gravity model

The gravity model consists of a single equation:

$$X_{ij} = b_0 + b_1 \frac{GDP_i}{POP_i} + b_2 GDP_i + b_3 \frac{GDP_j}{POP_j} + b_4 GDP_j + b_5 DIST_{ij}$$

where X_{ij} represents exports from the exporter (country i) to the importer (country *j*); GDP_i and POP_i, income and population of country *i*; DIST, the distance between the two trade partners and b_i parameters to estimate. All variables are in logs.

The gravity model seems to have poor theoretical foundations. Yet some authors have tried to provide formal basis to these models: Bergstrand (1985); Helpman & Krugman (1985); Bergstrand (1989). It is possible, for instance, to derive a gravity equation in the simplest Krugman model of intra-industry (Helpman & Krugman 1985): the point is that the exports of any country expand with its own GDP as do the imports of any country. Clearly, it means that the size and the wealth of *both countries* -the importing and exporting ones- will affect the level of bilateral trade. Bergstrand (1989) introduces transports *costs* in his model.

The gravity model and the classical international trade theory

Referring to the Heckscher-Ohlin's model, relative differences in factorial endowment explain international trade; consequently, the size of the economies do not interfere (demand is neutral). This means that *a priori* there is no income variables ; the 'population' variables have different impacts, depending on exports composition (more or less labour/capital-intensive) and on the country's factor endowment. Thus, the relative differences of factorial endowments lead to specialisation and determine trade intensity. Yet, from the Chamberlain-Heckscher-Ohlin's model, Helpman & Krugman (1985) introduce the variables 'size of economies' in the explanatory factors of trade -assuming increasing returns in at least one sector of the economy. Therefore, it is possible, looking at the modern international trade theory, which emphasises increasing returns, on imperfect competition and transportation costs, to conciliate the gravity model with classical theoretical models (see Baldwin, 1994 and Maurel, 1995).

Aggregation and adequacy to Eastern countries

One could ask whether the gravity model is adequate to deal with flows between market economies and formerly planned ones. According to many authors, this model is especially fit for manufactured trade, made up of differentiated products with internal economies of scale, but not to raw-materials trade (Baldwin, 1994). In the first case, *the intra-branche* trade should increase and GDP variables become relevant to assess imports demand and exports supply. Thus, the gravity model seems adequate to appraise EU-CEECs trade, since it is mainly made up of manufactured goods.

Wang & Winters (1991) and Baldwin (1994) estimate a gravity equation to investigate the potential trade of the ex-CMEA countries, once they are fully integrated into

world trade. Calculations are based on Eastern countries' GDPs estimations : Wang & Winters' results use 1985 estimations ; Baldwin calculates a potential trade matrix from data of the 1989's GDPs.

Collins & Rodrik (1991) have an empirical an historical approach. First, they estimate Eastern countries' exports using data from 1988, as if they were Western countries. Then, they estimate the trade share of the CEECs using historical data. They base their predictions of the CEECs ' trade shares on 1928's trade matrixes by applying an updating procedure.

4.1.2 Trade flows below their potential level

All these studies conclude that the CEECs should open-up to trade. Concerning their exports to the EU, the projections differ across the authors (see table 5). The potential of exports strongly varies across countries, reflecting different degrees of opening during the CMEA period. Besides, the intra-area exports, notably those of the CEECs to the former, would experience the sharpest fall (the ratios of potential to actual trade are less than unity)[27]. The trade-diverting effect should mainly be characterised by gains on the EU-15 market: sales to this area should account for a little over 70% of total CEECs' exports.

Table 5. Potential CEECs' exports to the EU

Studies	Wang & Winters 1985		Collins & Rodrik 1988		Baldwin 1989	
Countries	Potential (Billion $)	Potential/ actual	Potential (Billion $)	Potential/ actual	Potential (Billion $)	Potential/ actual
Bulgaria	2.5	6.3	6.7	5.2	2.9	5.2
Hungary	6.5	4.9	5.9	2.5	4.5	1.7
Poland	12.7	5.1	20.1	4.7	8.5	2.1
Romania	5.3	2.1	9.0	4.1	3.0	1.3
Czechoslovakia	15.2	9.9	12.6	3.3	12.5	4.8
Total	42.2	5.1	54.3	3.9	31.4	2.6

Sources: Calculated from the quoted studies.

[27] For the CEECs exports to USSR, results come from Baldwin (1994), as Wang & Winters do not take into account intra-CMEA trade in their work (these studies were prior to the CMEA collapse).

These studies also emphasise the opportunity of a large potential export pattern for West European countries to the Eastern markets[28]. Considering the breakdown by countries[29], the United Kingdom, France and Italy appear to be the 'winners' of an Eastern enlargement, while the four poorer in the EU (Spain, Greece, Ireland and Portugal) should enjoy the strongest exports' growth rates.

4.2 Trade pattern for Eastern Economies

Three main trends characterise the trade pattern for the CEECs since the start of the transition:

- First, those countries have massively reoriented their trade to developed countries, particularly to Western Europe. After the reduction -due to the recession- of trade with industrialised countries, the exports of the Eastern countries have sharply increased in 1994 and in 1995. Those of manufactured goods, for instance, have more than doubled since 1988 . Yet, the share of the CEECs in the total EU's imports remains modest (it has only raised from 2,5% to 4,5%). Reasons for this increase are ambiguous: it is difficult to attribute it exclusively to demand or supply effects. Actually, it can be explained by a rise in the demand to the Eastern economies, but also by competitive gains, by the Association Agreements or by an output surplus (compared to the level of domestic demand)[30]. If one refers to the theoretical explanations, notably those of the gravity model, one can also regard this rise as a trend to a *normal* level.
- Second, the imports (in value terms) from Western countries increased more than the exports to this area. Therefore, the opening of the Eastern countries rather benefited the Western economies. So, the fear that Western products would be crowded out by regional productions at lower price has proved unfounded.
- Finally, since 1994 and for the first time since the start of reforms, the intra-area exports have also increased, mainly in the wake of CEFTA, but also of the recovery of the CIS' exports. These latter are yet very far from the levels registered in the former CMEA.

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[28] Except Finn exports.

[29] See Schumacher, 1996; Baldwin, 1994 and works gathered in Faini & Portes, 1995.

[30] See UN/ECE, *Economic Survey of Europe*, 1995, p.126. In the manufacturing, for instance, production costs have fallen, programmes to foster exports have been introduced and the price-competitiveness have improved thanks to real depreciation.

One of the most significant elements of this pattern is the signing of Association Agreements between the CEECs and the EU. The European Association Agreements (1992 for the four Visegrad countries, 1993 for Romania and Bulgaria) embody a clear commitment by the EU to move (gradually) to free trade in manufacturing within ten years. They include asymmetric trade barriers, advantaging the CEECs. Besides, many EU tariffs and quotas have disappeared since January 1995, except on some 'sensitive' products: iron and steel, textiles, footwear, chemicals, automobile, agriculture and food processing.

Yet these agreements, as they are bilateral, tend to foster heterogeneous relations within Europe and do not favour investment in Eastern countries, nor intra-CEECs trade -two determining factors for economic growth[31]- as much as the Common Market does. So they tend to a kind of 'minimal Europe', satisfying some interests and hopes, without ensuring the CEECs' convergence. Indeed, one should bear in mind the Europe-ACP example: despite of important historical links, favourable trade agreements and massive financial aid within the Lomé Treaty, ACP countries have not really managed their economic take-off[32].

Table 6. Direction of eastern and CIS countries' trade

Growth rate in value (in dollars)

	Exports				Imports			
	1992	**1993**	**1994**	**1995**	**1992**	**1993**	**1994**	**1995**
Eastern countries								
World	-4.0	-0.1	16.4	25.6	3.3	10.4	9.9	33.1
CIS	-31.7	-14.2	8.5	24.5	-3.4	7.9	-6.2	28.1
East	-8.7	-9.7	6.9	29.9	-3.3	-2.3	3.3	36.7
Developed Countries	0.8	1.2	24.5	26.9	10.8	12.9	16.6	34.3
CIS								
World	-16.8	4.5	8.4	30.6	-16.8	-27.5	5.2	19.4
East	-30.6	-5.1	-19.5	44.9	-51.0	-51.1	-16.6	16.7
Developed Countries	-14.6	7.6	21.7	20.3	-10.8	-29.6	20.2	20.4

Sources: UN/ECE

[31] See Baldwin, 1994.

[32] See Colin & *alii*, 1993.

4.3 The gravity model and macroeconomic model

4.3.1 Predictive value of the gravity model

The results of the gravity model are useful to point out the change in international trade. But they keep a normative character: estimating trade potential with a gravity equation implies having an idea *a priori* on the ongoing transition of the Eastern economies and its impact on their GDP growth. Hence, employing such an equation is bounded by two main assumptions: the choice of the countries sample (are the selected countries relevant?) and the choice of the GDP[33](for instance, choosing a high estimation of GDP implies a fast convergence assumption).

Bearing these problems in mind, we have regarded Baldwin (1994) as the most relevant reference for our study. Baldwin considers two scenarios: the first one assumes that Eastern countries become as integrated to European trade as a West-European country -EU or EFTA- in the 1980's. In this case, the trade potential stems from the GDP observed for 1989 in the Eastern countries. In the second scenario, called 'income catch-up', Baldwin computes theoretical trade flows corresponding to GDP levels equal to the currently poorer four ones[34]. The first scenario appears sensible as it assumes moderate growth expectations that allow finally to take the 1990's recession of the CEECs into account. Baldwin takes 1989 as base-year, which is a rather 'high' year, as it is prior to the CEECs' transition and slump. This seems more relevant to implement our macroeconomic simulation, as we foresee the GDPs of the Eastern countries will recover their levels of 1989 in 1997 or 1999, when membership may occur[35].

4.3.2 Market shares pattern

A matrix of potential market-share can be obtained from the trade-matrix computed by Baldwin. In the MIMOSA data bank, we have a comprehensive trade-matrix for the year 1992. It is then possible to compare them: the main results are shown in chart 1. The trade-diverting effect highlights interesting points:

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[33] For more details see Maurel, 1995.

[34] 2010 according to his assumption. Between 1989 and 2010, the CEECs register an economic growth rate of 5% a year, while the EU registers a growth of 2%.

[35] For a world-wide simulation, see MIMOSA, 1995.

- The actual German trade share already outstrips its potential level. German demand to Eastern countries is very high compared to its 'normal' level. Therefore, the export share of the Eastern countries should steadily diminish. Concerning the import share of the Eastern countries *vis-a-vis* Germany, it looks like the opening-up mainly benefited Germany. So, in the medium run, its trade share should slightly decrease.

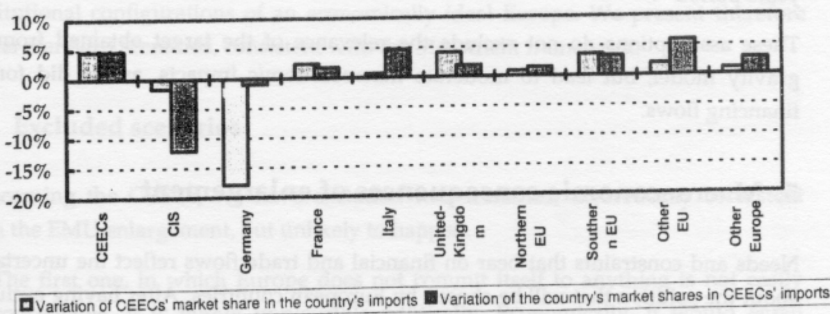
- The registered decrease in the intra-Eastern countries trade proved overshot. Prior to transition, their mutual trade was undoubtedly overweight, but the figures of the gravity model show a potential trade much higher than the actual one. The trade with the CIS remains very high compared to Baldwin's results.

- Some countries should benefit from new net exports: Italy, countries registered as 'other EU', European countries not in the EU, and to a lesser extent countries of Northern Europe.

- France, Southern Europe (Spain, Portugal, Greece), and particularly the United-Kingdom, should register net exports decrease[36]

Finally, Baldwin's results show that the intensification effect of the EU-CEECs trade corresponds to an increasing opening rate of the Western economies up to 0.4 point of GDP.

***Ex ante* Impacts on trade due to Eastern countries integration**



[36] It might be kept in mind that does not take into account increasing Eastern countries' imports. This increase will be included in the dynamics of our model.

4.3.3 Implementation of the gravity model in a macroeconomic model

Implementing the gravity model in a macroeconomic model, such as the MIMOSA model raises several problems:

- Consistence between potential and actual trade flows data.
- Assumptions on *ex ante* trade-diverting effect.
- Difficulties to deal with trade with the rest of the world, for which we lack results.
- Way to modulate the intensification trade, depending on the partners.

In the MIMOSA model, changing the trade share is quite easy: the vectors of addressed demands have to be modified. The trade intensification effect consists in an increase in the import rate. Since, in our model, the Eastern imports are financially constrained, it is necessary to assume extra capital inflows, to simulate an increasing opening rate. For the industrialised countries, this increasing simply comes through a rise of the constant in import equations (see box n°2).

The figures found in Baldwin (1994) are used as targets, which could be reached only in a free-market. Safeguards included in Association Agreements prevent from reaching the calculated potential trade. Actually, imperfections such as rigidities, influence of the exchange rate, economic policies, etc. still remain. Thus, we assume that the effective target represents between one third and two-third of the benchmark, and that it would be gradually achieved only at the end of a 10 or 20 years period[37].

These assumptions do not exclude the relevance of the target obtained from the gravity model, but lead to moderate macroeconomic impacts, as we did for the financing flows.

5. Macroeconomic consequences of enlargement

Needs and constraints that bear on financial and trade flows reflect the uncertainty about the solution that will be chosen by European countries. After having excluded the less likely scenarios, we simulate two polar but sensible ones.

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[37] Indeed, Baldwin provides a potential trade matrix within Europe that differs from actual flow, even for the founders of the Rome Treaty.

5.1 Is Maastricht Treaty adequate to enlargement?

One should first imagine the design of the EU at the time of Eastern countries' integration. To avert institutional difficulties, the framework from the Maastricht Treaty is generally applied to a wider Community. In eluding the chief political questions over Europe, this option is a no-decision one. The Eastern countries have just the same statute as the other countries enjoying Association Agreements, with a comparable financial aid.

The first difficulty, unrelated to enlargement issue, is to imagine how to concretely manage the gaps between insider and outsider countries of the EMU. The systematic EU's deepening, advocated by some countries, and its refusal, by others, have come to a short-run settlement which will prove inaccurate and shaky in the long run. The scope of deepening has been set, but without any institutional framework ensuring its application. In other words *i)* The idea of Europe has lost its consistency: its pacific and co-operative objectives are overshadowed by debate on currency or on economic policies' impact. *ii)* The authority which should represent Europe is hazy: one barely knows its roots, its bounds and the field of its sovereignty.

So, we do not know how the EMU will be concretely ran, institutionally nor even economically. Nobody knows the admission test, nor the number of circles that could be created, nor the connections between them. Rarely have so many economic criteria existed for Europe accession, along with so few answers and solidarity for a rapid and harmonious European construction. Yet, this work is not aimed at testing institutional configurations of an economically ideal Europe. We present therefore rather standard scenarios, consistent with the Maastricht framework.

5.2 Excluded scenarios

Concerning the CEECs, we have excluded two scenarios, theoretically consistent with the EMU enlargement, but unlikely to happen.

- The first one, in which Europe does not commit itself to anything is not easily conceivable. It is highly implausible politically. Economically, it would entail negative effects on Eastern Europe, as their growth is insufficient to reach the

Western's standard level[38]. Furthermore, this scenario would be inconsistent with furthering transition countries' reforms.

- The second scenario relies on a widening of the EMU, or at least an exchange rate mechanism for all European new members. This brings up the problem of managing a Union made up of 21 countries. Besides, it would not be viable for the CEECs. Actually, it would require strengthening stabilisation policies –already very stringent yet – which is inconsistent with restructuring and output growth needs[39]. Moreover, even when some CEECs meet the Maastricht criteria, as the Czech Republic does, their *real* convergence is far from being achieved. In that way, meeting criteria of nominal convergence proves to be devoid of sense.

If we exclude these scenarios, the logic of the Maastricht Treaty becomes that of concentric circles. We have opted for two contrasted scenarios reflecting two major economic options: convergence or catch-up. In both of them, we assume that the CEECs fix the exchange rates *vis-à-vis* the Ecu, driving a real appreciation of their currency, namely a lost of competitiveness. This appreciation should be *a priori* sustainable, given the productivity and growth gains they should experience. Nevertheless, capital markets expectations may induce speculative crises as in Spain or, more recently, in Mexico. In this way, the two scenarios underline a cautious view.

5.3 Scenario 1: concentric circles and convergence

This first scenario reflects and pursues the current logic and commitments. Concerning the CEECs' integration, it does not imply reshaping institutions and rules, but simply requires to fulfil and apply the mutual commitments[40].

The Association Agreements include two main parts: transfers and trade. Hence, we have considered the Association Agreements' economic impacts as if they were first of all an aid for the transition by external opening-up and we have retained standard and minimal support[41]. We have also assumed a virtuous development, in which these agreements have positive outcomes.

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[38] See MIMOSA, 1995.

[39] See Coquet & Lerais, 1995.

[40] Of course, it does not mean that institutional framework has not to be adapted.

[41] See Section 3.

5.3.1 Financial flows: necessary but insufficient

Concerning financing, this scenario requires that the European Agreements are completely fulfilled and that funds are allocated, as was foreseen. Specially, resources must be allocated regardless of conditionality about the path of reforms or the success of a macroeconomic stabilisation.

In this scenario, the EU's aid to the CEECs corresponds to the PHARE Programme. As already mentioned, it is far below that of the Marshall Plan, and of course, below the necessary amount for a rapid catch-up of these countries. The stabilising effect of PHARE's transfers promotes higher private capital inflows, that we have assessed to 0.2% of Eastern countries' GDP.

5.3.2 Trade flows under scrutiny

Concerning the trade flows, Association Agreements differ from a custom union since they include residual quotas and safeguard clauses permitting a partner to draw back the lift of trade barriers or impose sanctions. In case of competition becoming more acute - the CEECs improving their comparative advantages in sensitive sectors, quotas could be more and more constraining. The EU could also use safeguard clauses to protect itself[42] against new comparative advantages.

Moreover, as the agreements are bilateral, distortions in customs duties can remain between the associated countries. But above all, in this context of partial liberalisation between the CEECs, trade does not reach its potential level.

The Association Agreements do not entail harmonising rules of competition amongst which the legal clauses about government subsidies to firms.

This scenario offers fewer opportunities to the CEECs than to the EU. Actually, CEECs are applicants, at the present, for accession, but this could of course change[43]. In this scenario, transition economies do not gain from raising trade barriers (notably on manufacturing products).

In contrast, trade between the CEECs can follow an opening path as well as a closure one. The first assumption seems the most in line with this scenario (but not the most likely). Finally, the CEECs do not have many tools for their external policy: the

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[42] Neven, 1995.
[43] Bofinger, 1995.

exchange rate[44], custom duties on agricultural goods (since their 'take-off' is based on manufactured goods) or exports subsidies.

BOX 2

IMPACT OF FINANCIAL FLOWS THROUGH A SIMPLE MODEL

To understand the mechanisms of the scenarios, we present some stylised facts through a simple model of the Eastern countries:

If the Eastern countries could import all the goods they need, their total imports (M) would depend on consumption (C) and investment (I):

$$(1)\ M = m_c C + m_i I$$

Yet, we assume they are subject to financial constraints: they can only import up to their exports income (tX), plus the net transfers coming from official or private agents (F_i). Thus, we have the relation:

$$(2)\ M = t X + F_i$$

Equation (2) impedes investment. Therefore, we assume that the causality of equation (1) is altered in the following way:

$$(3)\ I = \frac{M - m_c C}{m_i}$$

The rest of economy stems from this.

Production is supply-constrained: (4) $Y = v I + (1\text{-}d) Y_{-1}$

Exports are assumed to be constrained by export-demand : (5) $X = D_d$

Equation (6) determines the equilibrium: (6) $C = Y + M - X - I$

Employment is obtained by labour productivity: (7) $L = Y/\pi$

where:

C : consumption	t: terms of trade
d: depreciation rate	π : labour productivity
D_d : export demand	v: capital-coefficient
L : employment	X : exports
M : imports	

5.3.3 Results (Association: neutral to West, positive to East)

Concerning the EU, the first scenario shows always positive but very low macroeconomic impacts on growth: they never exceed 0.1% of EU's GDP a year, in the medium run. The unemployment rates, as well as the inflation, remain close to their base-line values (i.e., without Association Agreements). Imports from the

44 Halpern & Wyplosz, 1995.

CEECs' increase, but are offset by a symmetric rise in the EU's exports to this area. Thus, integration would slightly benefit to Southern Europe countries, even if they may be hit by CEECs' competition, according to several studies.

For the CEECs', the output growth -backed by the PHARE programmes- reaches 11.6% by 2002. Compared to the base-line, it means an additional 1% per year.

All in all, results of this simulation are positive. Besides, the cost of this scenario in fiscal and macroeconomic terms is almost null in the medium run. Generally it is positive to world-wide economy. These results also underline that the developing countries' fear of being supplanted by Eastern ones, as far as investment and trade flows are concerned, proves unfounded.

Table 7. Scenario 1-Impacts of association agreements

MIMOSA	2002				
	*GDP	**Current Balance	Prices*	***Unemployment	**Public Balance
United States	0.1	0.0	0.1	-0.1	0.0
Japan	0.0	0.1	0.2	0.0	0.0
Germany	0.0	-0.5	0.1	0.0	0.0
France	0.0	0.0	-0.1	0.0	0.0
Italy	0.3	0.1	0.1	-0.2	0.1
United-Kingdom	0.0	-0.2	0.0	0.0	0.0
North EU	0.1	0.0	0.2	0.0	0.0
South EU	0.1	0.2	0.2	0.0	0.0
EU-15	0.0	0.0	0.1	0.0	0.0
CEECs	11.6	-1.3	na	na	na

Source: MIMOSA Model. * In relative difference from baseline; ** in percentage point of GDP; ***percentage point.

5.4 Scenario 2: solidarity and catch-up

Integration is a far more ambitious alternative than association, since it involves a clear commitment by the EU. It requires to set out, even to change, the aims and tools of Europe.

For the first step, this strategy is the same than the Association Agreements. The main difference with the previous scenario is that aid is turned into budget transfers. This configuration requires eligibility to CAP and Structural funds according to the current criteria. Therefore, it induces a larger European budget. The difficulties raised by the *Paquet Delors II* show that such a decision implies that the fifteen

incumbents change their logic. Namely, it should no longer be a selective enlargement, but a co-operative one, corresponding to the original European ideal. The chief logic here is that of a catch-up integration, and no longer an aid to mere nominal convergence.

We made the assumption that the time necessary to all applicants to ask for a formal accession and the negotiation of the modalities would occur three to five years before the decision. All in all, these delays imply that, between 2000 and 2002, macroeconomic consequences should not sharply differ from those drawn in the first scenario. But, if association induces macroeconomic stabilisation effects, a genuine integration will give them a new impulse.

Beyond the Association Agreements, Eastern countries go towards the 'Single market', but excluding, in a 'transition phase', factor mobility (labour and capital). This convergence is characterised by:

- Phasing-out of Eastern firms' subsidies.
- Trade levels going more rapidly towards their potential.
- An extension of common policies to new members.

This scenario is consistent with the current institutions. It would however largely benefit from a renewal of the institutional framework, to set out a clear position – at least a fiscal one.

5.4.1 Determining financing flows

Applying common policies to Eastern countries means that new members must receive aid according the EU current rules. This could have endogenous effects on the paths of GDPs, hence of structural funds. We use an econometric equation to model transfers. The received amounts depend on the GDP per capita and on the unemployment rate (see section 3).

The advantage of structural funds, compared to current loans financing, is that they back productive projects and not only macroeconomic balance goals[45].

The breakdown of financial flows remains the same as in the first scenario. By contrast, the level should be much higher. Two effects should play: first, best economic growth prospects should raise the yield of loans (hence their volume);

[45] Sgard, 1995.

second, credibility gains should narrow the risk premium applied to these countries (hence the cost of financing).

Besides, foreign direct investments are more encouraged in this scenario than in the previous one. In the short run, there actually are no trade barriers and the differences in the factors unit cost are still large; while in the long run, impediment on capital flows would be gradually suppressed. All in all, private flows (loans and foreign direct investments) could increase over 1 percentage point of GDP.

5.4.2 Fostered trade

In this case, the thorniest problem is to assess the impact of European rules (competition, social security etc.) on trade and growth. Nevertheless, the economic restructuring necessary in a transition framework should lead to a lower growth.

In this scenario, trade agreements become multilateral ('Single market's' context). Compared to the previous scenario, trade would no longer be hindered by particular retorting threats. So, this would be equivalent to gradually introducing in our model the total of trade flows estimated in the gravity model.

5.4.3 Results (*Integration favours convergence*)

As the CEECs' are financially constrained, structural funds provided by the EU turn out to be critical: the Eastern countries' GDP is 29% higher than in the baseline in 2012 (despite restructuring), i.e. an additional 1.5% a year for twenty years. Structural funds help to finance productive investment, that entails imports from Western Europe.

Western European countries also benefit from the situation as structural funds to the CEECs drive a rise in CEECs' imports. Exports to Eastern countries boost economic growth of industrialised countries and induce a slight decrease in unemployment, in public deficit and in external deficit.

The *ex-ante* cost amounts to ecus 20 billion a year, i.e. 0.2% of EU's GDP. This gross cost is hence negligible; but it brings favourable macroeconomic impacts to the beneficiaries and neutral ones to the contributor ones. It is essential to point out that the impact on public balances is null thanks to positive effects on government revenues.

Table 8. Scenario 2- Impacts of CEECs' integration

MIMOSA	2012				
	*GDP	**Current Balance	Prices *	***Unemployment	**Public Balance
United States	0.4	-0.2	0.7	-0.2	0.1
Japan	0.0	0.7	1.3	0.0	0.0
Germany	0.4	-2.0	1.5	-0.2	0.1
France	0.5	0.0	0.8	-0.2	0.0
Italy	0.9	0.1	1.6	-0.6	0.1
United-Kingdom	0.1	-1.6	0.7	0.0	-0.1
North EU	0.4	1.1	1.6	-0.2	-0.1
South EU	0.3	2.1	1.3	-0.1	0.0
EU-15	0.4	0.0	1.4	-0.2	0.0
CEECs	29.4	-4.5	na	na	na

Source: MIMOSA Model. * In relative difference from baseline; ** in percentage point of GDP; ***percentage point

5.4.4 The 'sensitive' sectors

Overall, the effects on EU's employment and growth are weak, but positive. Nevertheless, these global macroeconomic results can hide more contrasting results at a *sector* level, both for the EU and the Eastern countries.

Concerning the EU's countries, some 'traditional' sectors, still protected, are undoubtedly more exposed than others. The adjustment in those sectors may be more costly in terms of employment, as they are highly concentrated in some regions. Besides, workers of those sectors, situated most of the time in declining areas, are less mobile.

These sectors represent a large share of the EU's economies, but depending on the regions (the most exposed ones are in France, Germany and Southern Italy; indeed, it is more generally the case that the less favoured regions are the most dependant on 'sensitive' products). But the CEECs' import penetration in these sectors is currently low: the ratio of imports to gross production rarely rises above 1%. Yet, these ratios are in value and can be much higher in terms of physical quantities of goods[46].

These sectors are also important in the CEECs, since they represent over a third of value-added and employment in manufacturing and over 40% of manufacturing

46 Mathieu & Sterdyniak, 1994.

output at the beginning of the transition. They account for 25% (in Poland) to 40% (in Hungary) of their total exports and roughly a third of the overall exports to the EU.

But 'sensitive' exports have increased less rapidly that the rest of trade. Besides, according to Hughes & Hare (1992), 'sensitive' products are in general not among the most competitive sectors. This could be explained by a lack of restructuring according to the comparative advantages of these countries[47]

6. Conclusion

The stakes of the EU's Eastern enlargement outstrip the narrow scope of economic interest. The integration pattern remains liable to uncertainty and governed by political considerations.

Despite these uncertainties, this work shows that in two much debated economic fields -trade and budget- macroeconomic implications do not preclude integration. In a context of weak co-ordination - the Association Agreements- or of tight co-operation -the integration-, macroeconomic consequences of eastwards enlargement turn out to be positive. Difficulties arise from a sectoral analysis. Besides, the positive outcomes of integration on the Eastern countries[48] can be dampened by the way catching-up and convergence policies will be implemented.

We point out that the second scenario is clearly more favourable to Eastern countries, without being too costly to the EU. Political integration, social and legal rules could represent a positive point. Nevertheless, large public transfers are required from European countries to generate higher and confident private flows, and efficient free trade. These official transfers constitute the keystone of a successful transition.

Enlargement highlights the necessity to bring a massive economic and financial assistance to Eastern countries. In a first time, this necessity can be considered apart from the political enlargement of the EU: on the one hand because it would be a key point of the Union; on the other, because a massive durable support would help the CEECs to access to political union. Actually, the less economic obstacles will be relevant, the more the stakes of political union will be clearly analysed and discussed. Indeed, political accession requires to share a strong will of commitment, by both incumbent and applicant countries.

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[47] CEPR, 1990; Collins & Rodrik, 1991; Hamilton & Winters, 1992; Rollo & Smith, 1993.

[48] See Fayolle, 1996.

7. Abbreviations

ACP: Africa, Caribbean & Pacific.

CAP: Common Agricultural Policy.

CEEC: Central and Eastern Europe Countries.

CEFTA: Central European Free Trade Agreement.

CIS: Commonwealth of Independent States.

CMEA: Council for Mutual Economic Assistance.

EBRD: European Bank for Reconstruction and Development.

ECE: Economic Commission for Europe.

ECU: European Currency Unit.

EFTA: European Free Trade Agreement.

EMU: Economic and Monetary Union.

EU: European Union.

FDI: Foreign Direct Investment.

GATT: General Agreement on Tariffs and Trade.

GDP: Gross Domestic Production.

IMF: International Monetary Fund.

NA: Non available.

OECD: Organisation for Economic Co-operation and Development.

PHARE: Poland and Hungary : aid for Economic Restructuring.

UN: United Nations.

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