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European Enlargement:
Structural Change, Outlook, and Chances for Foreign Investment

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European Enlargement: Structural Change, Outlook, and Chances for Foreign Investment

Summary

The EU has become the world's foremost FDI location, and its enlargement causes significant changes not only in the accession countries but also for the "old" member countries and the union's structure as a whole. First, for the accession countries the fast adoption of EU regulations provides a sound basis for further growth, but the dynamics will change considerably between sectors and regions. Second, for the "old" EU increasing political diversity, economic imbalances, and price competition will likely slow or end the union's current phase of harmonization and economic policy integration, or "ever closer union." Third, the enlarged EU will most likely continue to grow – to the East and to the South. Together, these developments should increase the attractiveness of the European market for international investors by pushing it into the direction of a more flexible and competitive common market.

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1. Introduction

The European Union has become the world's foremost Foreign Direct Investment (FDI) location. Most likely, the current European enlargement process, which brought ten high-growth, low-cost Central and Eastern European Countries (CEEC) into the Union on May 1, 2004, will further add to the international interest in Europe's growing economic area. But with the first phase of privatization and transformation in these countries coming to an end and full integration entering its final phase, a Europe-wide rationalization process is now likely to change Europe's economic landscape considerably.

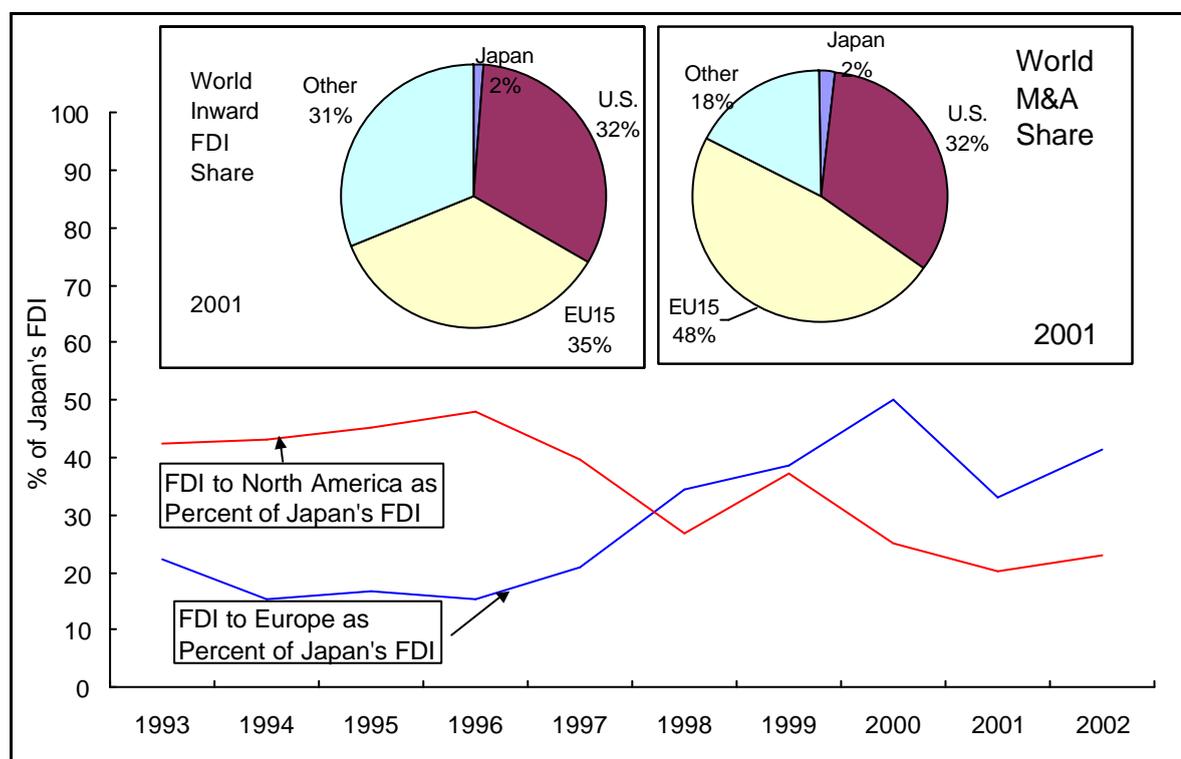
This study focuses on the background of three questions about the European enlargement process that are of particular interest for foreign investors – and especially Japanese foreign investors, who channeled more than 41% of their overall FDI into European markets in 2002. The first question is if the reached level of the CEECs' transformation from socialist to market economies and their fast adoption of EU regulations provides a sound basis for further growth after their accession to the world's largest market. The second, even more important question is about what impact increasing political diversity, economic imbalances, and price competition might have on the European Union as a whole. And finally, the question about the final borders of the growing EU in the East and to the South will have a considerable impact on the future of the union.

Section 2, Foreign Investment in Europe, starts with a review of Japan's particularly high share of FDI directed to Europe, which nevertheless fails to exploit chances in the accession countries. Section 3, Transformation in the CEECs, gives some background about the reached level of transformation in these countries. Section 4, EU Enlargement, analyzes the chances of the CEECs based on the experiences of earlier accession countries and the setup of accession procedures. Section 5, Market Potential and Future Investment in the CEECs, describes the prospects of investments in the CEECs by analyzing the likely rationalization process and future chances for growth. Section 6, Consequences of EU Enlargement for the "Old" EU, summarizes some of the most important changes in the nature of the Europe's political and economic landscape after the enlargement. Section 7 concludes the paper.

2. Foreign Investment in Europe: Japan's FDI

From the late 1990s, the EU has become the region with the world's highest FDI Performance Index.¹ In line with such increasing international FDI flows to Europe, Japan has also started to lift its regional FDI share to particularly high levels. In 2000, the peak year of new foreign investment flows internationally, more than 50% of Japan's FDI was flowing into the EU for the first time. After that, in 2001, Japan still invested more than 33% of its worldwide FDI in Europe, and in 2002 the figure recovered to more than 41% again (see Figure 1).

Figure 1: FDI in Europe



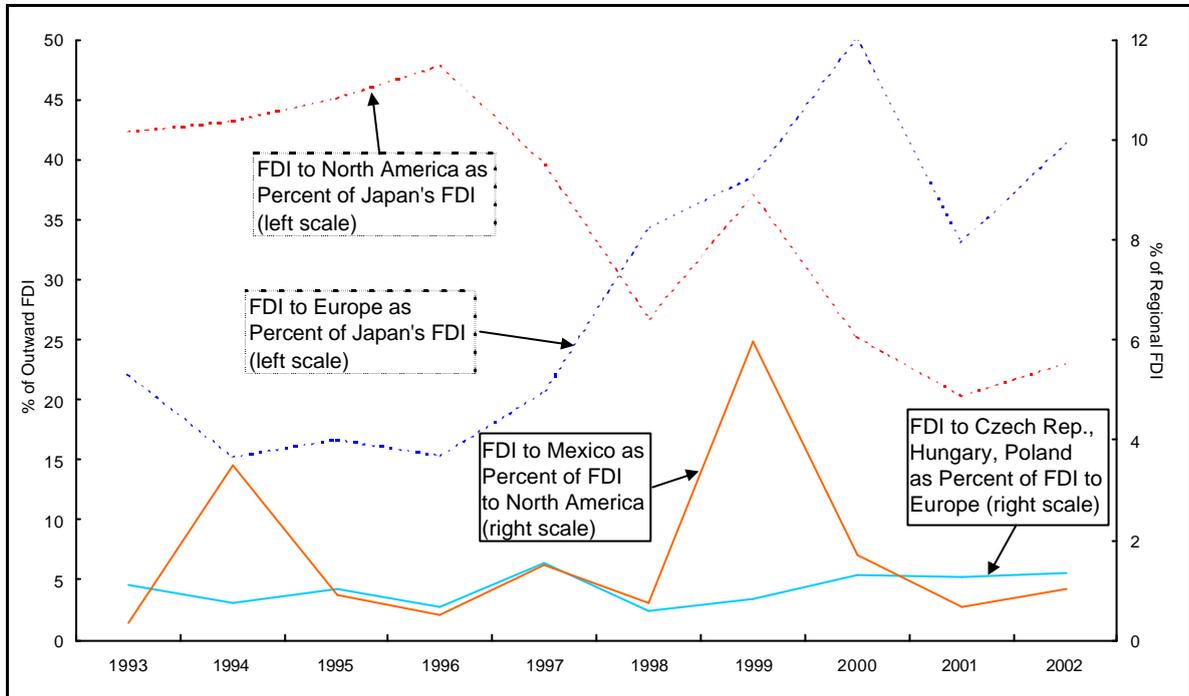
Source: © FRI. Data from MOF (2004): Statistics Monthly, Private Investment Statistics Special Series; UNCTAD (2002): WIR; MOF (2002): WP Int. Trade.

Within Europe, however, Japan's FDI did not flow into some of the most dynamic and fastest developing regions. Particularly the fast growing transformation economies of the CEECs saw hardly any Japanese investment. During the 90s, when major transformation steps in these countries (from socialist to market economies), or breakthroughs in accession negotiations

¹ The UNCTAD's FDI Performance Index is based on a country's share of global FDI to GDP ratio. In 1999-2001 the EU's index value was 1.8, North America had a ratio of 0.78, and other developed countries a ratio of only 0.12 (World Investment Report 2003).

with the EU, caused inflows of FDI from around the world, Japan remained an onlooker only (see Figure 2).²

Figure 2: Japan's Regional FDI

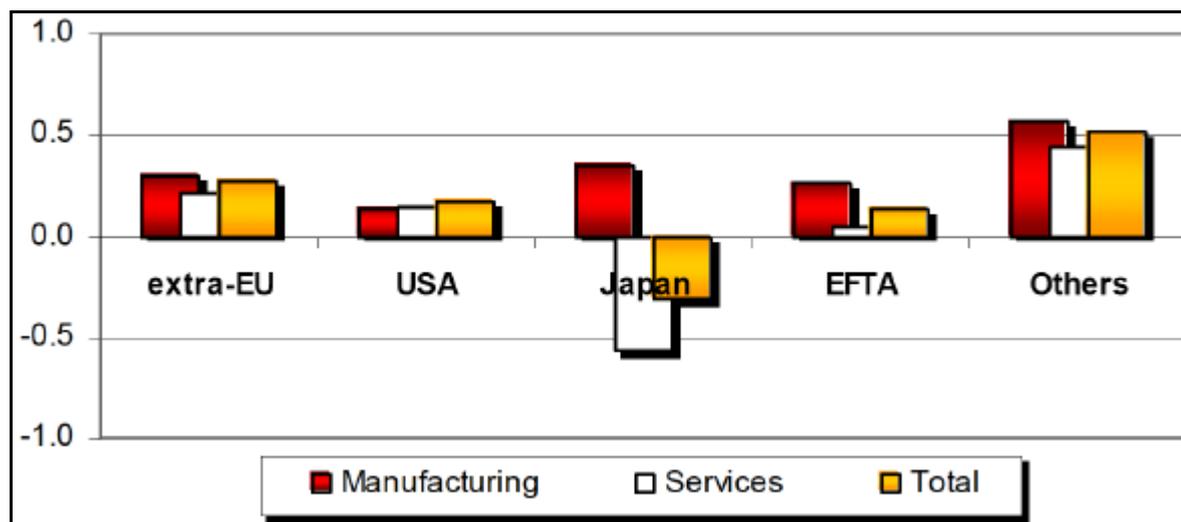


Source: © FRI. Data from MOF (2004): Statistics Monthly, Private Investment Statistics Special Series.

This reluctance to invest in yet untested markets is a general feature of Japan's FDI patterns, which tend to favor green-field investment and follow-up production-network investments in its major export markets for manufacturing products (see Blomstroem ...). In fiscal 2001, for example, Japan's exports to overseas affiliates in the manufacturing industry were ¥17.2 trillion, a 21.6% increase over the previous year. The ratio of exports to Japanese affiliates to total exports of Japan was 37.3%, which was a new record level. Consequently, Europe as well saw huge Japanese investments in its major markets, trade and distributions centers (especially in the UK and the Netherlands), but little interest in rationalization towards low-cost locations in the CEECs or major shifts towards services (see Figure 3).

² For an explanation of the differing investment patterns to the NAFTA area, see the end of this section.

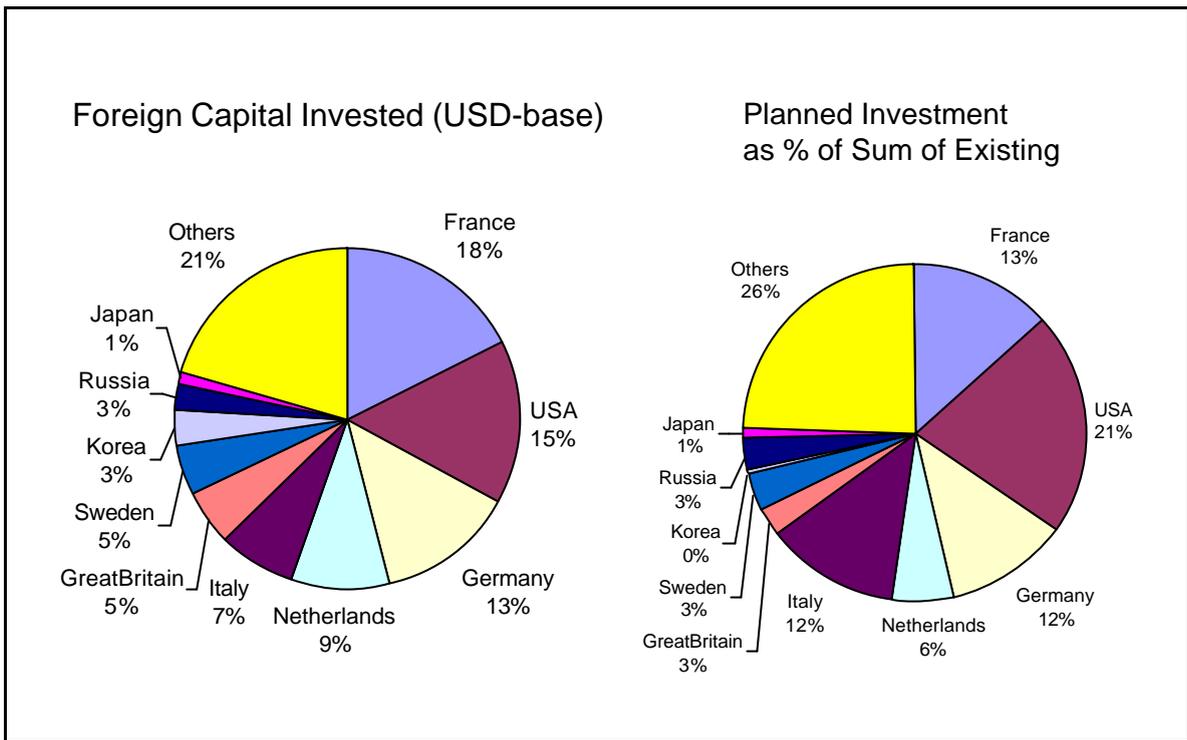
Figure 3: EU 15 Bilateral FDI Net Assets Ratio (2001)



Note: The bilateral FDI net asset ratio is defined as $(\text{Outward stocks} - \text{Inward stocks}) / (\text{Outward stocks} + \text{Inward stocks})$. EU net assets are therefore expressed as a ratio of the level of total FDI stocks involved in the bilateral relationship. The ratio measures the extent to which reciprocal investments are balanced or not. It can go from +1 (with positive outward stocks and zero inward stocks) to -1 in the opposite case. Source: EuroStat (2004): Statistics in Focus: EU-15 FDI in 2002.

The reluctance of Japan's companies to invest in Europe's transformation economies becomes even more pronounced when Japan's FDI in the region is compared with the engagement of the EU countries and the U.S. In Poland, for example, which is the biggest of the CEECs with a share of more than a third of CEEC FDI inflows, only about 1% of all FDI stocks came from Japan (see Figure 4).

Figure 4: International FDI Stocks and Flows to Poland (2001)

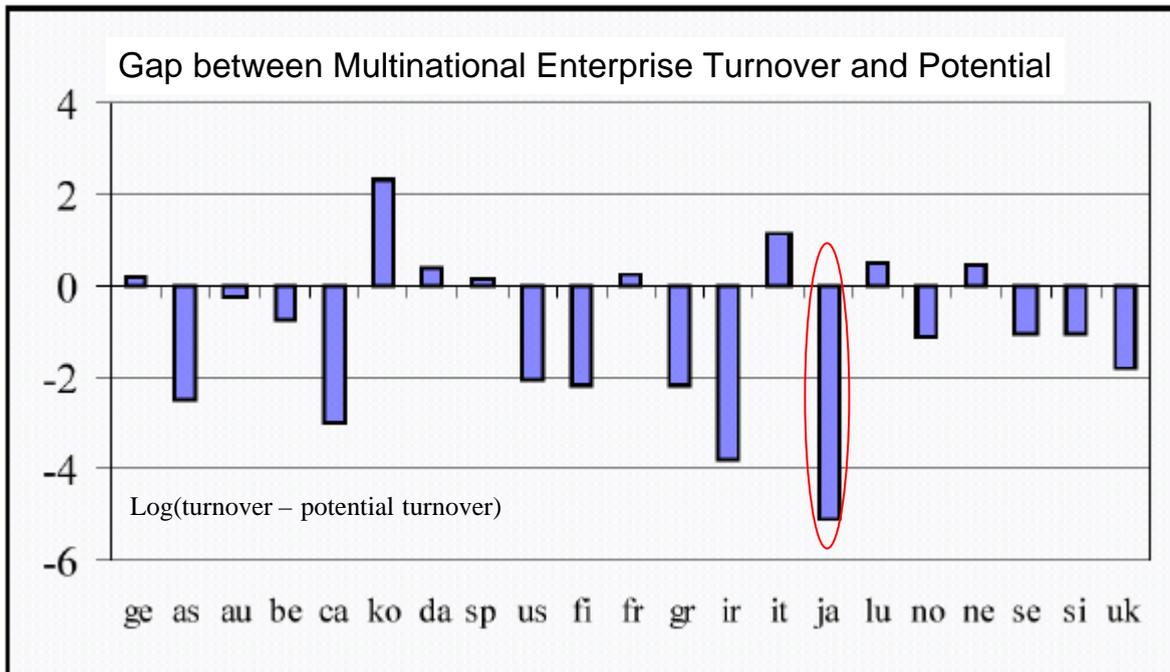


Source: © FRI. Data from MOF (various): Statistics Monthly, Private Investment Statistics Special Series.

Japan's 1% share of foreign capital invested in Poland is not only low compared to major European countries, which are in close vicinity and have a strong interest in the region. It is also low compared to the U.S., which provided 15% of all FDI in 2000, and even low compared to Korea, which provided 3% of Poland's incoming FDI. Furthermore, Japan's investment plans in 2001 remained negligible, while the U.S. planned to provide capital of up to a share of 21% of Poland's FDI after 2001.

Henriot (2002) investigated these pronounced differences further, and estimated the potential turnover of foreign MNC's (Multi National Corporations) in Poland's economy in a gravity model that includes variables for wage differentials and language. As a result, he finds that although most countries have been careful about their investment in Poland, and therefore remained below their potentials, Japan has been by far the country that exploited its potential in Poland the least. Figure 4 demonstrates this result by plotting the logarithmic gap between MNC's turnover in Poland and their estimated potential.

Figure 5: Japan's Potential FDI Gap in Poland (2001)



Note: Potential Turnover estimation is based on a gravity model plus variables for Wage Differential and Language.
 Source: Henriot (2002)

As mentioned above, the very low level of Japanese investment in Poland and the other CEECs is due to the fact that Japanese corporations did not participate in the privatization process of public corporations in these countries. The EBRD (European Bank for Reconstruction and Development), in which Japan holds 15% of the capital, therefore stresses that more recent “green-field investments” by Japanese companies are about to increase while the FDI of other countries that targeted privatizations is gradually decreasing. This observation is in line with the traditional strength of Japanese corporations in manufacturing and the trend for ongoing manufacturing investments in Poland, while other, privatization related, targets of FDI from financial intermediation to transport are stagnating (see Figure 7, page 12).

Furthermore, earlier investment patterns of Japanese corporations into the NAFTA area (see Figure 2) draw a somewhat more encouraging picture for the future of investments into the CEECs. During the 80s, the U.S. had already been established as Japan’s major export market and foreign production location, but only during the 90s did Japanese MNCs become interested in rationalization of production locations throughout the neighboring regional markets. According to Figure 2, for example, Mexico saw major inflows from Japan after NAFTA came into effect in 1994 and after the Mexican crisis cooled and trade with the U.S. boomed in 1999. It also needs to be mentioned, however, that in the past the overall level of

FDI inflows from Japan to Mexico never reached the levels of American or European investments.

It is now likely that Japanese MNCs (Multi National Corporations) will use the enhanced chances for stability and upgraded legal frameworks in the CEECs to expand their activities in the accession countries as well. According to a JETRO survey in 2003, a total of 291 Japanese firms had set up operations in Poland, the Czech Republic, Slovakia and Hungary or had decided to do so by the end of March 2004. This figure is an increase of 50% over the past three years. Of these firms, 123 are manufacturers, mainly from the automotive industry, with Toyota Motor Corp. in the lead, and Suzuki Motor Corp. and Isuzu Motors Ltd. having followed.

Since the end of 2001, when a joint venture between Toyota and the PSA Peugeot Citroen Group decided to open an assembly plant for subcompacts in the Czech Republic, 13 car parts makers, including Aisin Seiki Co. and Toyoda Machine Works Ltd., have set up operations there. Clearly, with about 60% of all foreign firms in the CEECs operating in the automotive industry, the attraction for these suppliers goes beyond the lead of major Japanese carmakers – the CEECs have become an automotive production center and will continue to attract investment from second tier suppliers.

But the increasing local market size has also attracted many sales units of home electronics makers to the region. Sony Corp. and Matsushita Electric Industrial Co. established a presence in Poland already in the early 1990s, while Ajinomoto Co. and Fujisawa Pharmaceutical Co. recently set up sales arms as well. Victor Co. and NEC Corp. have opened branch offices in Hungary. In the meantime, logistic firms such as Mitsui-Soko Co. and Kintetsu World Express Inc. have moved into the Czech Republic to transport car parts and other items for Japanese firms. The Bank of Tokyo-Mitsubishi has established a unit in Warsaw to extend loans and conduct foreign exchange services for Japanese companies in Poland (Nikkei 2003.8.19).

But before further investigating the chances for foreign investments in the CEECs after the accession to the EU in section 5, the following sections will outline the most important changes in the CEECs during their transformation to market economies and the impact of enlargement on the EU as a whole.

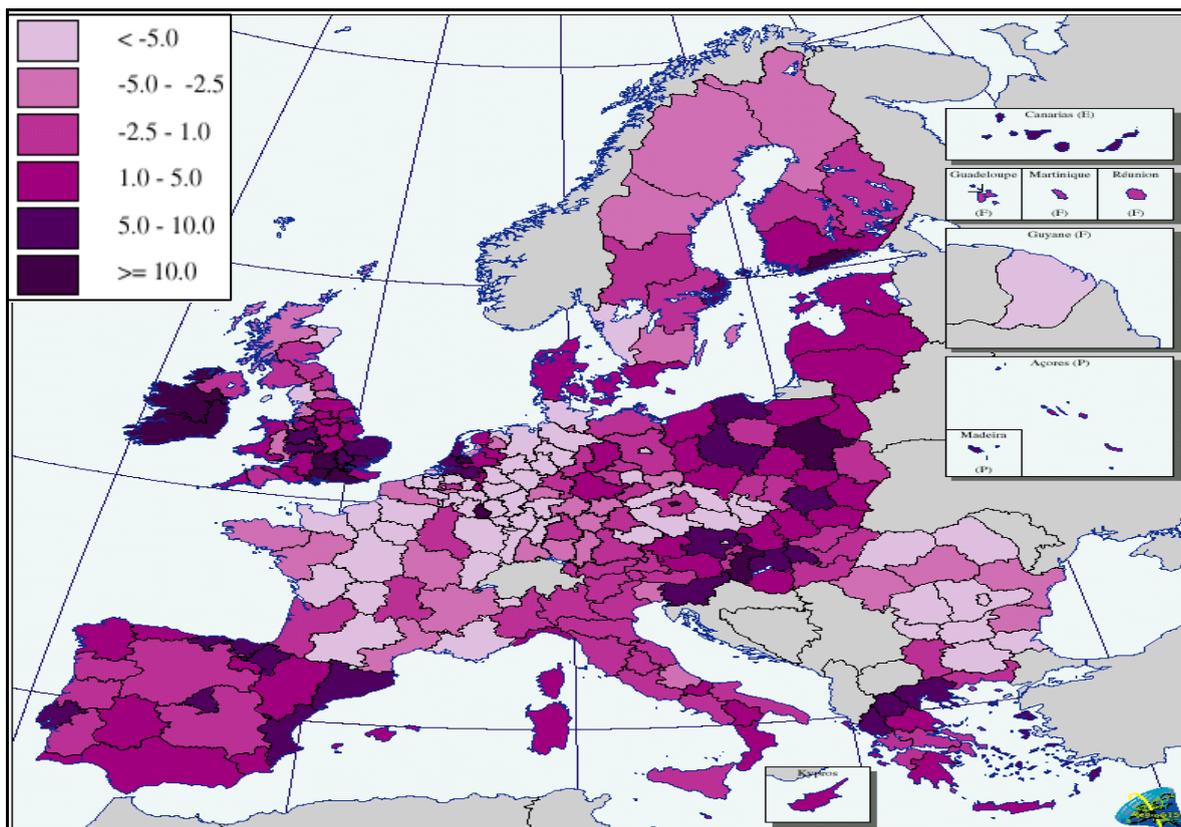
3. Transformation in the CEECs

The transformation of the CEECs from planned to market economies has been an astonishing success. As Figure 6 demonstrates, the high growth rates in the CEECs clearly differentiate the countries from their neighboring Mediterranean or CIS countries. Judging from the already achieved levels and the speed of transformation in the CEECs, Janusz Lewandowski, the former Minister for Privatization of Poland, was probably right when he claimed that the CEECs were not “under-developed” but “wrong-developed” with a much too strong focus on the industrial sector.

Winięcki (1988), for example, found in his comparison of the structure of employment in socialist and market economies at similar levels of per capita income that the former are biased towards industry and against services. After the start of the transformation in the CEECs, Jackman and Pauna (1995) came to similar results in their comparison of the structure of employment in the CEECs to that prevailing in two groups of EU member countries. Relative to either of the two EU benchmarks, CEE economies were found to be characterized by excessive industrial employment and a higher proportion of employment in agriculture.³

³ Döhrn and Heilemann (1996) compare economic structures at similar levels of per capita income but using the structure of production rather than employment. They come to similar results.

Figure 6: Europe's GDP per Capita Change (PPP; 1995-1999)



Remark: EU-27 Index = 100.

Source: Eurostat Inforegio (2002).

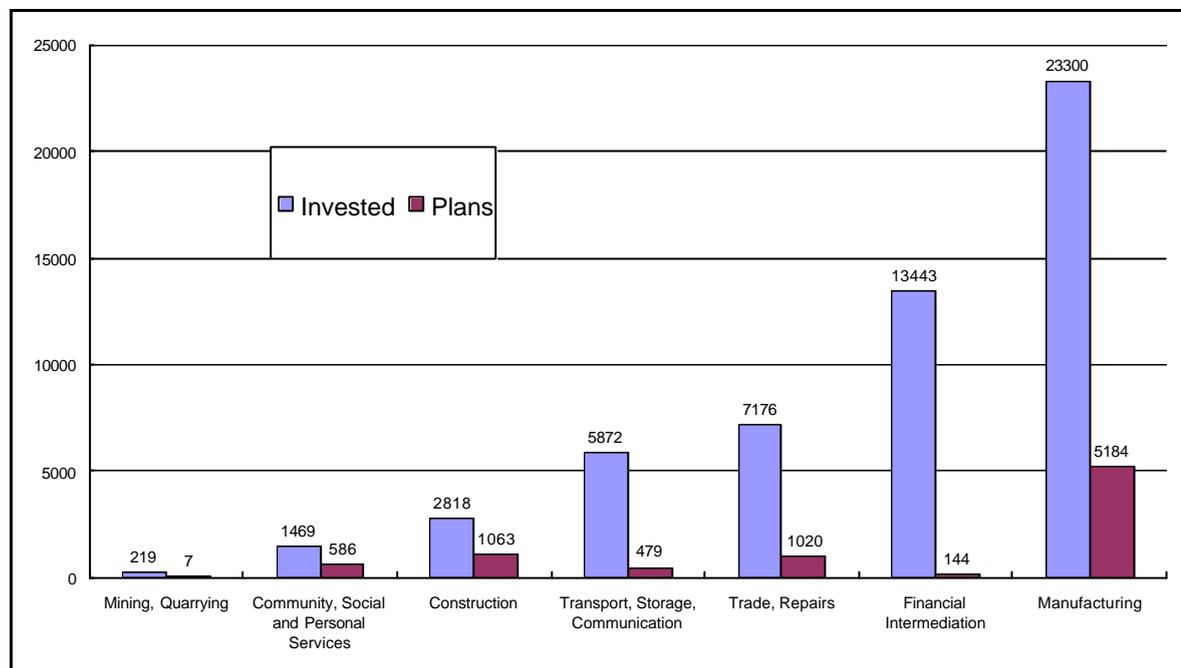
Basically, the most important structural similarities of the CEEC countries were:

1. Based on materialist ideologies, central planners had a strong preference for industry, especially heavy industry, and tended to neglect services. High rates of investment in physical and human capital were therefore concentrated in these sectors.
2. Central planning did not require sophisticated financial systems to allocate savings and investment, and the legal and institutional framework focused more on regulated operations and control than on the legal and jurisdictional underpinnings of a market economy.

Clearly, this “wrong-development” towards over-industrialization in the CEECs is a major element in the explanation of the fast success and high convergence rates in the privatized service sectors, and especially the finance sector, during the early phase of industrialization. Demand for these services and advanced technologies was very high. It also is an important factor for the attractiveness of manufacturing FDI in the CEECs. Foreign investors could take advantage of the necessary process of deindustrialization by setting up “high-tech islands” of corporations with foreign technology and the abundant skilled domestic labor force. As

Figure 7 demonstrates for Poland, for example, FDIs into manufacturing and financial intermediation were by far the most important targets for foreign investment.

Figure 7: FDI in Poland by Sector (2002)

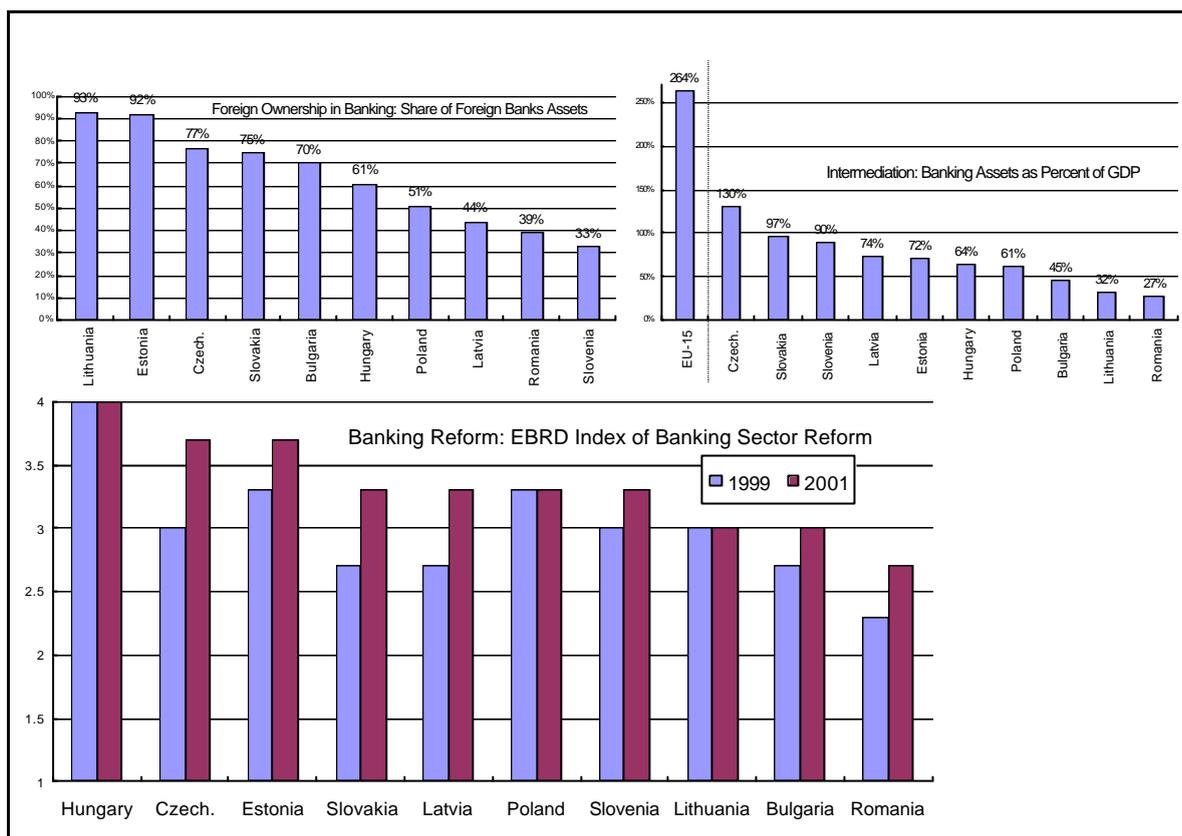


Note: Million USD.

Source: © FRI. Data from Lewandowski (2003).

After a fast start by means of privatizations in the early 90s, however, it was the chance of accession to the EU, with its rigorous accession regimen, that further differentiated the CEECs from other neighboring countries and kept them from falling into the pitfalls of reluctant old bureaucracies, vested interests and unsolved social hardships that slowed the development in the remaining CIS countries of the former Soviet block. The institutional framework in the CEECs, for example, has changed tremendously. In finance, the framework has become stronger than could be expected on the given level of development (Gros, Daniel 2002). The same is true for (foreign) ownership, and for the level of development of institutions – although bureaucratic hurdles and corruption remain to be significant obstacles in Poland, for example. Figure 8 gives an overview of progress for banking sector reform.

Figure 8: Banking Sector Reform (2001)



Remark: see footnote below.

Source: EBRD (2003).

All CEECs show remarkable progress in reform (an indicator value of 1 marks no or little change, 4 the level of an OECD country in accord with BIS standards),⁴ while the countries in the current accession round have already come close to or even surpassed EU levels (as Hungary did already in 1999).

⁴ This indicator provides a ranking of progress in liberalization and institutional reform of the banking sector, on a scale of 1 to 4+. A score of 1 represents little change from a socialist banking system apart from the separation of the central bank and commercial banks, while a score of 2 means that a country has established internal currency convertibility and has liberalized significantly both interest rates and credit allocation. A score of 3 means that a country has achieved substantial progress in developing the capacity for effective prudential regulation and supervision, including procedures for the resolution of bank insolvencies, and in establishing hardened budget constraints on banks by eliminating preferential access to concessionary refinancing from the central bank. A score of 4+ represents a level of reform that approximates the institutional standards and norms of an industrialized market economy, as represented, for example, by the Basle Committee's Core Principles on Effective Banking Supervision and Regulation. The scoring assessments are by EBRD country economists (see EBRD (2000), Chapter 2).

This huge achievement was gained by quickly turning to foreign partners or foreign owners in banking, who now own a majority of banking assets in almost all CEECs (see the upper left chart in Figure 8). This high level of foreign investment and the fast introduction of foreign knowledge in this crucial sector became a key element in the fast transition of the countries. By allowing foreign ownership in the banking sector, the economies not only secured the trust of foreign investors, they also laid the corner stone for the continuous inflow of FDI and future investments after the first wave of privatization was over.

Securing such continuous inflows of foreign capital will remain very important for all CEECs because, as Figure 8 in the upper left corner also shows, the catching up is far from over. With banking assets as a share of GDP well below half of the EU-15 level, the growth potentials in all of these countries remain high even after the initial privatization push. Even after 10 years of transition, and after following the EU's accession program that targeted a far-reaching compliance with the Aquis Communautaire (see below), the socialist heritage therefore still differentiates the CEECs from other developing countries. The countries still share high rates of employment in industry (see Figure 24), they have very extensive physical infrastructures, and a high proportion of their population have passed through secondary and tertiary education (Figure 22).

The transformation is therefore far from over, and the differentiation of economic chances and success between the countries will likely increase after the first common targets of privatization have decreased in importance and impact. Figure 7, for example, demonstrates that the directly privatization related targets of FDI, from financial intermediation to transport and trade, have lost their attraction already. Personal services, construction, and manufacturing, on the other hand, remain strong compared to the levels of investment that have already been undertaken in these sectors because demand and comparative advantages will remain high in these sectors during the course of further growth and transformation – despite the general trend of deindustrialization in the CEECs.

But deindustrialization after the initial phase of privatization also has more problematic implications for the future course of transformation and accession. The empirical analysis of Raiser/Schaffer/Schuchhardt (2003), for example, shows that structural adjustment in industry is far from complete in all the accession candidates. Further downsizing in industry is to be expected in the long run, even though the pace of adjustment in industry shows signs of slowing in a number of countries. This process of deindustrialization with its high numbers of unemployed and high costs for public budgets will therefore continue to be an important

potential source of social and fiscal instability. The same is true for agriculture, although the wealthier and more rapidly reforming accession candidates have continued to reduce the share of their labor forces in agriculture, and have come quite close to levels in many EU member states. Finally, the high share of employment in non-market-oriented services, (bureaucracy) compared to market economies of similar incomes, will continue to be sources of social tension, corruption, and drags on the public finances of these countries.

It is therefore also important to take the major cultural and historical differences of the CEECs, which will certainly continue to influence their chances and strategies within the EU, into account. The CEECs are culturally and structurally a rather diverse group of countries that were historically lumped together by the cold war and referred to as “Eastern Europe” owing to their position between Western Europe and the countries of the former Soviet Union. At the time, the group included on top of the direct neighbors of Western Europe the “Baltic” group of much smaller countries with close relationships with Scandinavia, and a “Balkan” group with Christian Orthodox traditions and strong Muslim minorities that connect them much more strongly to Russia and Turkey. Today, especially the heavy weights of these countries (Poland, the Czech Republic, and Hungary) therefore prefer the name Central Europe, which allows for differentiation from the cold war term and from other Eastern European countries in the north and the south.

Basically, the twelve accession countries can be divided into three regional groups.

1. The Central European group consists of the Czech Republic, Hungary, Poland, Slovakia, and Slovenia. On most accounts, this group does not only include the largest and strongest CEECs, it is also the group that has developed the strongest links to Western Europe. Three of them – Poland, Hungary and the Czech Republic – already joined NATO in 1999. Countries like Hungary and the former Czechoslovakia also retained a rather strong role for their markets under communism. After the “revolutions” of 1989, all have become rather stable democracies with working market economies. Furthermore, the traditions and cultures of these five countries, which earlier had been associated with the Hapsburg Empire, are predominantly Western.
2. The Baltic group consists of the small countries of Estonia, Latvia, and Lithuania, all of which have been under more or less direct control from Russia. These countries swiftly rebuilt their close relationships with the Scandinavian countries, and are getting strong support to rebuild their market economies from this side. They therefore will gain from increasing trade in the Baltic area, including Northern Poland and Western Russia.

3. The Balkan group consists of Romania, Bulgaria, and Cyprus (Malta, the small island in the center of the Mediterranean is a historically and culturally a special case). These countries are the economically least developed of the group, and their history, traditions, and cultures differ significantly from those of most current members. Consequently, the integration of these three developing countries will be the most difficult – and has been shifted to a later date in the case of Romania and Bulgaria. Cyprus has been accepted for accession because of the strong support from Greece (in favor of an associated Republic under the lead of a Greek-Cypriot majority), and because of hopes to bridge the gap with Turkey (which is associated with the internationally not recognized Turkish Republic of Northern Cyprus). As a harbinger of political difficulties with future Balkan accession countries, however, these hopes had a major setback shortly after the acceptance of the Republic of Cyprus for EU accession. Clearly, the integration of these countries depends on the ongoing political support of Greece within the EU, the stabilization of the CIS countries to the East, as well as progress in the countries of the former Yugoslavia in the West. Finally, successful accession of these countries will depend on the progress of membership negotiations with Turkey, which holds the key to stability in the area and would gain from the accession of the Balkan group because of its geographical proximity and large Turkish minorities in this group of future accession countries.

From May 2004, these structural and cultural differences will now affect the success and future course of Europe's enlargement process, as will be analyzed in the following sections.

4. EU Enlargement

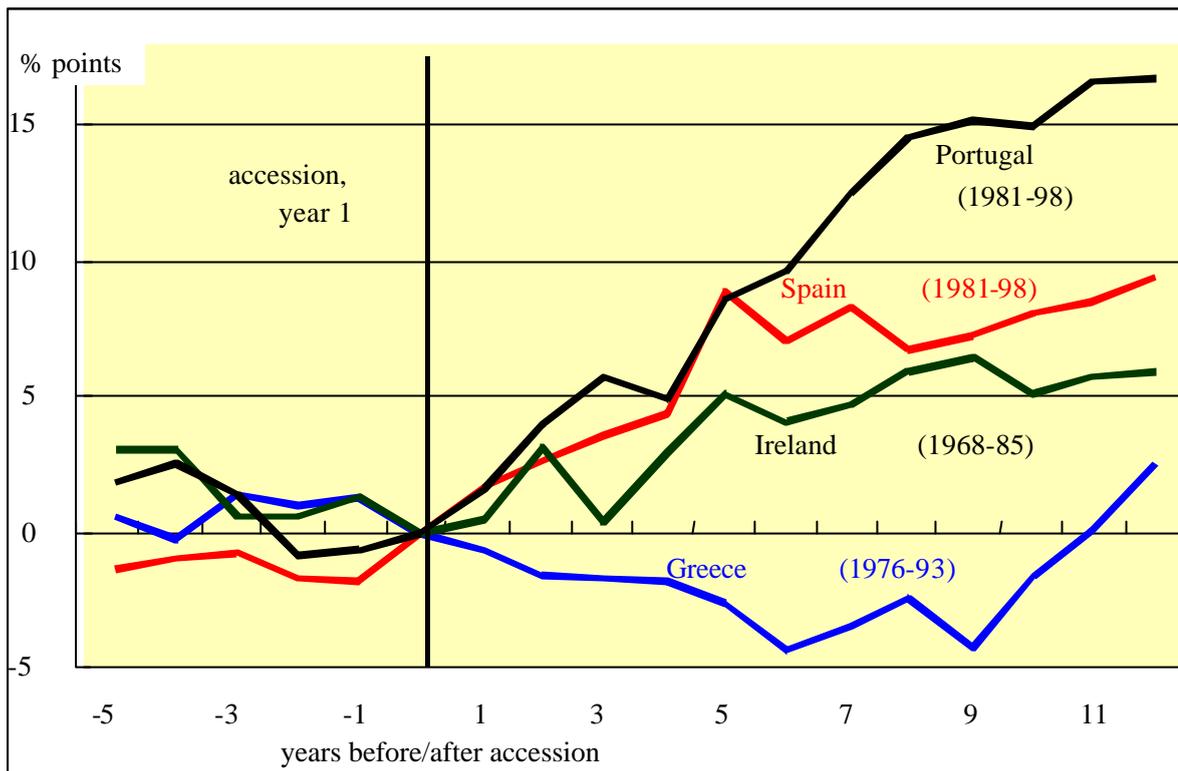
Due to the strong progress in the CEEC accession countries, the EU Copenhagen Summit in December 2002 confirmed the accession of 10 CEECs (Central and Eastern European Countries) for May 1, 2004. Two more countries (Bulgaria and Romania) are negotiating for 2007. Turkey could have the chance to negotiate with the (then) EU-25 from December 2004.

One factor that certainly supported the success of the efforts for economic and political change in the accession countries is the EU's earlier experience with enlargements of its market. At the time of the Treaties' of Paris (1951), which established the European Coal and Steel Community (ECSC), and Rome (1957), which established the European Economic Community (EEC) and EURATOM, the EU had only six founding members (Belgium, France, Germany, Italy, Luxembourg and the Netherlands). Only from 1973, did the EU start to grow in terms of membership – under very different circumstances.

In 1973, Denmark, Ireland and the United Kingdom entered the Union. Of these three countries, however, only Ireland was a country with an income-gap comparable to today's accession countries. A better example for today's situation is therefore the accession of Greece in 1981, and Portugal and Spain in 1986. All three countries had much lower incomes per capita than the earlier members, and their accession led to an increase in the number of low-income earners in the EU (income of less than 30% of the Union's average) from less than 13% to more than 20%. During the last accession round, in 1995, Austria, Finland and Sweden entered the Union. None of these countries had a major negative income-gap with the existing members, of course.

As can be seen in Figure 9, the earlier accession of the less developed European countries has been a success. Ireland, Spain and Portugal started to outperform the other members of the Union almost immediately after their accession. In the figure, Portugal and Spain were doing especially well, while Ireland at least managed to have moderately outperforming growth rates after its accession in 1973. Only Greece failed to grow as fast as the other EU members for the decade after its accession in 1981.

Figure 9: GDP per Capita Change after Accession to the EU



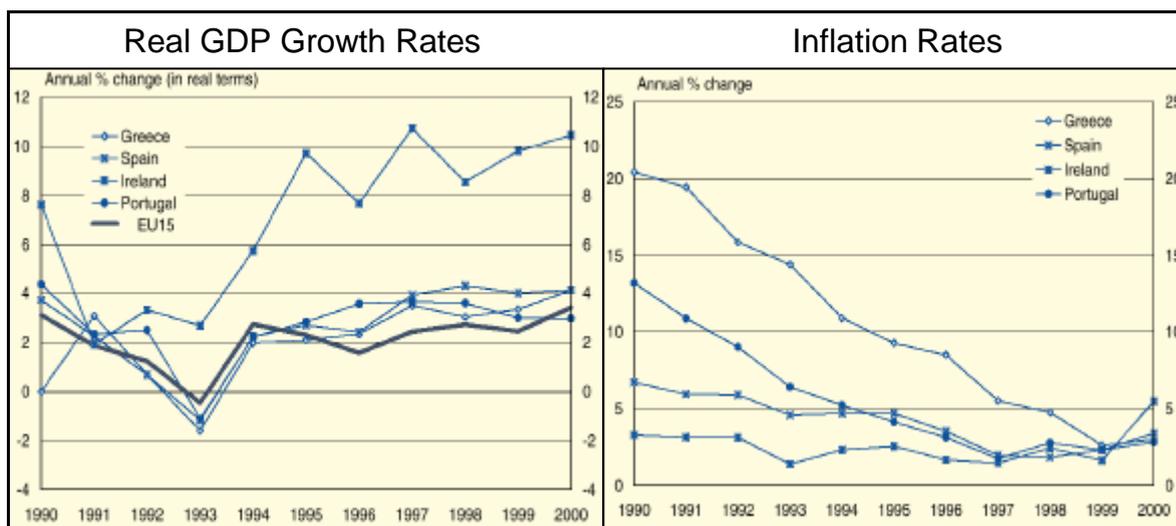
Remark: Growth rates are plotted as PPS per capita as % of the EU15's average. Positive percentage point changes therefore mark strong growth rates because the change is on top of EU-15 growth in real per capita terms.

Source: UN Economic Commission for Europe (2002).

As is known today, however, the two slow-starters of the 70s, Ireland and Greece, became the success story of the 90s. Ireland consistently boasted some of the highest growth rates in the world economy during the 90s, and Greece managed to break with its long-standing depressed growth rates to even become a member of the EMU.⁵ After 1994, (see Figure 10) growth rates in all cohesion countries were consistently higher than in the EU15, although Portugal and Greece had to bring down inflation rates from very high levels during the 90s.

⁵ In Ireland, with an annual growth rate of 6.5 percent over more than 10 years, GDP per capita rose from 64 percent of the Community average in 1988 to 119 percent in 2000. The performance of the other three countries, with a total population of some 60 million people, was much lower, however. Between 1988 and 2000 their GDP per capita rose from 67.8 percent of the Community average to 73.5 percent.

Figure 10: Real GDP Growth and Inflation in Cohesion Countries



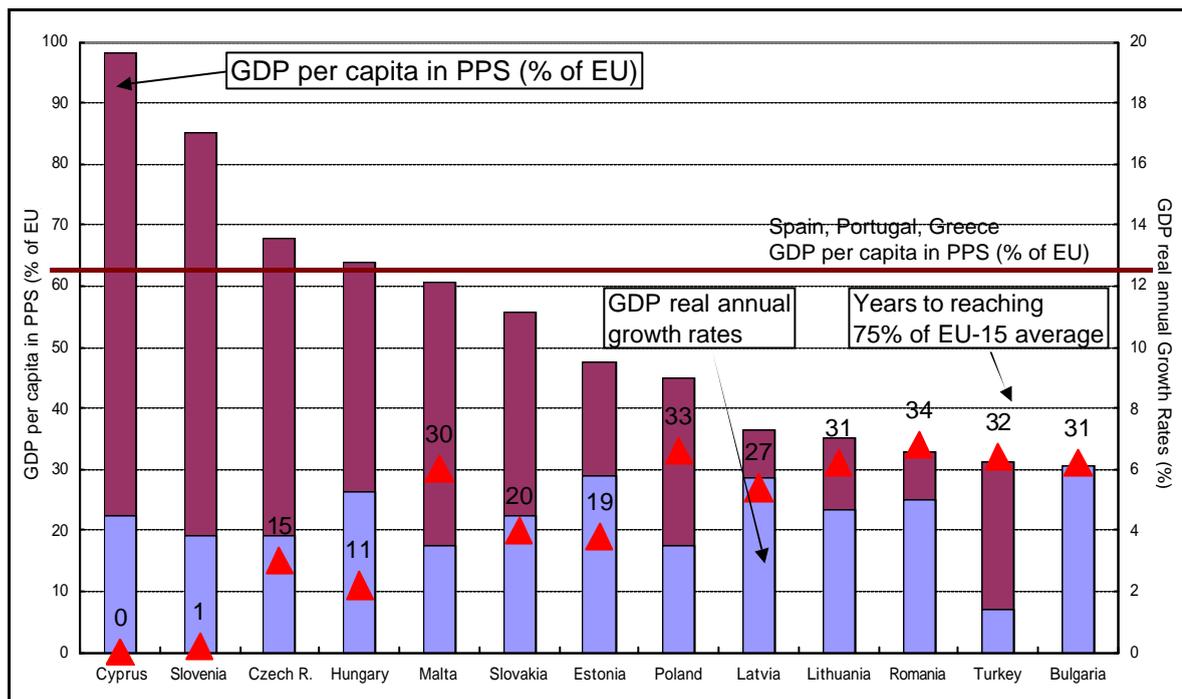
Source: EU Commission (2001): Second report on economic and social cohesion.

All the accession countries seemed to have profited from the significant EU reforms in the late 80s and early 90s. The conclusion of the Single Market, and the monetary stability and low interest rates initiated by the Maastricht treaty and the EURO project, clearly gave a major push to stability and growth in all of these countries.⁶ The early attempts at policy coordination or harmonization, such as the crawling peg European exchange rate system (EMS) or the harmonization of standards for the Single Market during the 70s and 80s, in contrast, did not seem to yield a very strong impact on their growth path.

Judging from these historical experiences and the strong transformation performance of the CEECs during the pre-accession phase, the CEECs' chances for further accelerated growth after accession should therefore be rather good. But the current accession round also faces much larger challenges than these earlier experiences with enlargement. The number of candidates, the increase in area (about 34% of the EU) and population (105 million), and the difference in incomes is much higher than during the earlier enlargements (see also Figure 11).

⁶ The strategies of these countries clearly varied, of course. The success of Ireland, for example, was based on a combination of attractive fiscal policy for foreign direct investment, a social pact that negotiated wage moderation for tax-cuts, and voluntary educational programs aimed at creating a qualified work force. Portugal, on the other hand, used a much more classical mix to improve equipment and infrastructure, with the goal of increasing production capacity in the mid-run.

Figure 11: Real GDP Growth, Income Gaps, and Years to Cohesion



Note: Estimates based on data through 2000. GDP annual growth rates estimated for 2001-2004. Average GDP per capita data for Spain, Portugal and Greece are calculated on basis of their accession years.

Source: ©FRI 2004. Data from European Commission (2001): Real Convergence in the Candidate countries.

The schedule and the obligations for the current accession negotiations have therefore been much stricter than in earlier rounds – and they have also changed their character. The first step for the CEECs was still similar to the earlier accession rounds: they had to negotiate Association Agreements, the so-called Europe Agreements, which were signed between 1993 and 1996. Initially, these Agreements were only upgraded versions of the old Association Agreements that had been signed during the 60s and early 70s by the Mediterranean countries (Turkey 1964; Malta 1970; Cyprus 1972) with only the general intention of preparing for a very gradual convergence. The scope of the agreements therefore covered not only political cooperation, favorable trade relations, and economic activities, but also shared understandings and values as well as cultural cooperation.

The Mediterranean countries in the earlier years of the EU therefore never took these convergence steps too seriously, and remained content with the more specific trade liberalization or FTA elements of the agreements. To them the agreements offered an important key to their most important market because the Europe Agreements provided trade concessions and other benefits normally associated with full membership of the EU, while the associated countries could retain some trade barriers in industrial products over a transition

period.⁷ As a result, the free trade elements of the Association Agreements (the agreement with Turkey even targeted a customs union) have been sufficient for them for decades, and further-reaching commitments, which would target the approximation of their legislation to that of the European Union, for example, were beyond the goals or interests of these association countries.⁸

The CEECs, however, in contrast to the MED before, immediately targeted the approximation and integration aspects of the Europe Agreements because they offered the chance to support their transition into market economies with clear-cut market-based targets and measures of control. Long neglected convergence and oversight instruments of the Europe Agreements, the Association Councils and Committees, and the Joint Parliamentary Councils therefore only gained leverage and real impact with the CEEC Agreements.⁹ Together with their aim of accession to the European Union (most CEECs applied for EU membership during the same year as signing the Europe Agreements), the Europe Agreements became the frameworks within which countries are now preparing for EU membership.

With this new quality of the Agreements and accession procedures, candidate countries now also gained eligibility for major EU Development and Support Programs to support the necessary and often huge adjustments to political and economic institutions. To specifically help the CEECs with their transformation beyond earlier measures, the PHARE program has become the major financial instrument intended to support the objectives of the Europe

⁷ As a result, industrial products from the associated countries have had virtually free access to the EU since the beginning of 1995, with restrictions in only a few sectors, such as agriculture and textiles. They also contain provisions regarding the free movement of services, payments and capital in respect of trade and investments, and the free movement of workers. When establishing and operating in the territory of the other party, enterprises must receive treatment not less favorable than national enterprises.

⁸ This includes applying legislation favoring competition and applying state-aid rulings, or similar levels of protection to intellectual, industrial and commercial property.

⁹ Association Councils are bilateral meetings at ministerial level between the European Union and an associated country, at which all areas of approximation towards the EU is discussed. Association Committees are meetings at senior official level that review in more detail all areas covered by the Europe Agreements. They are complemented by a series of sub-committees, which provide for regular in-depth technical discussions on all areas covered by the Agreements. Joint Parliamentary Committees bring together members of the national parliaments of the associated countries and members of the European Parliament.

Agreements.¹⁰ In 1997 (after the Luxembourg European Council), the PHARE funds started to focus entirely on the pre-accession priorities that had been defined in the “Accession Partnership” documents.¹¹

The programs therefore also went beyond financial support and developed “twinning” projects that seconded civil servants from member states to assist their counterparts in preparing for accession. After initial success with these partnership programs, the management of the programs then became integrated into the CEECs’ governance by creating National Funds and limited numbers of implementing agencies.¹² These institutions will now become the basis for the EU’s structural funds when the countries have become full members in May. Overall, during the period of 2000-2006, PHARE will provide about 11 billion Euro for institution building support through “twinning,” technical assistance, and for investment support.¹³

Interestingly, the extended role of the Europe Agreements through the CEEC negotiations also increased their attractiveness for the Mediterranean countries again. In addition to the ongoing integration of the Single Market and the successful launch of the EURO, the

¹⁰ Originally created to assist Poland and Hungary in 1989, today the Phare program encompasses the 10 CEECs. The other 3 candidates, Cyprus, Malta and Turkey, benefit from separate pre-accession funding. Until 2000 the countries of the Western Balkans (Albania, Bosnia, and Herzegovina and the former Yugoslav Republic of Macedonia) were also beneficiaries of Phare. However, as of 2001 the CARDS program (Community Assistance to Reconstruction, Development and Stability in the Balkans) has provided financial assistance to the Western Balkans. Following the 1993 Copenhagen Council invitation to central European countries to apply for membership, Phare support was reoriented, including a marked expansion in support to infrastructure investment (see EU Commission 2003 – Enlargement Homepage).

¹¹ Specific targets and shortcomings were defined under the following general aims: To strengthen public administrations and institutions to function effectively inside the Union, to promote convergence with the European Community’s extensive legislation, to reduce the need for transition periods, and to promote economic and social cohesion.

¹² Other major funds were introduced in 1999. SAPARD supports agriculture and rural development, while ISPA focuses on transport and environment infrastructure.

¹³ Along with the aid and transformation programs, the accession procedure was based on the actual start of negotiations for accession, which started for the CEECs as well as Cyprus and Malta between 1997 and 1999. Turkey also became an official candidate for accession in 1999, but no clear-cut schedule for starting the negotiations had been agreed. The Accession Negotiations were based on the Criteria of the Copenhagen Summit of 1993, which focused on the progress of stable democratic institutions, a functioning market economy, and the ability to adhere to the aims of Political, Economic, and Monetary Union.

Mediterranean countries started to feel that they would be left behind if they did not start to adapt their markets more closely to EU standards and succeed in stabilizing their economies as well. Turkey therefore officially renewed its interest in accession to the EU after its membership application had been smoldering since 1987, and became an official candidate in 1999. Malta and Cyprus even succeeded in becoming accepted for accession in the first round. Practically, the negotiations were conducted as parallel bilateral government conferences between the individual candidate countries and the EU.¹⁴ On joining the Union, applicants are expected to accept the “Acquis Communautaire”, i.e., the detailed laws and rules adopted on the basis of the EU’s founding treaties, mainly the treaties of Rome, Maastricht and Amsterdam. The table in Figure 12 summarizes the chapters of the Acquis that formed the basis of the accession negotiations as well as the state of play of compliance with these regulations.

¹⁴ The EU Presidency is the negotiator on behalf of the EU, assisted by the Commission. The negotiation sessions were held at the level of ministers or deputies for the Member States, and Ambassadors or chief negotiators for the applicants.

Figure 12: Accession Negotiations: State of Play (Dec. 2002)

CHAPTER	BUL	CYP	EST	LAT	LIT	MAL	POL	ROM	SLOK	SLOV	CZE	HUN
Free movement of goods	*	*	*	*	*	*	*	-	*	*	*	*
Free movement of persons	*	*	*	*	*	*	*	-	*	*	*	*
Free movement of services	*	*	*	*	*	*	*	-	*	*	*	*
Free movement of capital	*	*	*	*	*	*	*	-	*	*	*	*
Company law	*	*	*	*	*	*	*	*	*	*	*	*
Competition policy	-	*	*	*	*	*	*	-	*	*	*	*
Agriculture	-	*	*	*	*	*	*	-	*	*	*	*
Fisheries	*	*	*	*	*	*	*	*	*	*	*	*
Transport policy	-	*	*	*	*	*	*	-	*	*	*	*
Tax legislation	*	*	*	*	*	-	*	-	*	*	*	*
EMU	*	*	*	*	*	*	*	*	*	*	*	*
Statistics	*	*	*	*	*	*	*	*	*	*	*	*
Social and labour market policy	*	*	*	*	*	*	*	*	*	*	*	*
Energy	*	*	*	*	*	*	*	-	*	*	*	*
Industrial policy	*	*	*	*	*	*	*	*	*	*	*	*
Small and medium-sized enterprises	*	*	*	*	*	*	*	*	*	*	*	*
Research and technological development	*	*	*	*	*	*	*	*	*	*	*	*
Education, vocational education and youth	*	*	*	*	*	*	*	*	*	*	*	*
Telecommunications and information technology	*	*	*	*	*	*	*	*	*	*	*	*
Culture and AV policy	*	*	*	*	*	*	*	*	*	*	*	*
Regional policy and coordination of structural instruments	-	*	*	*	*	*	*	-	*	*	*	*
Environment	-	*	*	*	*	*	*	-	*	*	*	*
Public health and consumer protection	*	*	*	*	*	*	*	*	*	*	*	*
Cooperation on justice and home affairs	-	*	*	*	*	*	*	-	*	*	*	*
Customs union	*	*	*	*	*	*	*	*	*	*	*	*
External relations	*	*	*	*	*	*	*	*	*	*	*	*
CFSP	*	*	*	*	*	*	*	*	*	*	*	*
Financial control	*	*	*	*	*	*	*	-	*	*	*	*
Fiscal and budgetary provisions	-	*	*	*	*	*	*	-	*	*	*	*
Institutions	*	*	*	*	*	*	*	*	*	*	*	*
Other												
Provisionally closed, total	23	31	31	31	31	31	31	16	31	31	31	31

Note: (-) means that the chapter is open and under negotiation. (*) means that the chapter has been (provisionally) closed.

Source: EU Commission (2003).

During the negotiations, after agreeable progress on each chapter of the Aquis was recognized, the main focus changed to areas where the candidate countries could not fully comply and therefore would require transitional arrangements. These agreements will be subject to further discussions even after the countries have entered the union. Basically, the negotiations were therefore much less a simple test for compliance with EU regulations, than a very difficult negotiation process about what has been achieved, realistically could have been achieved, and likely would be possible to achieve (after entering the Union).

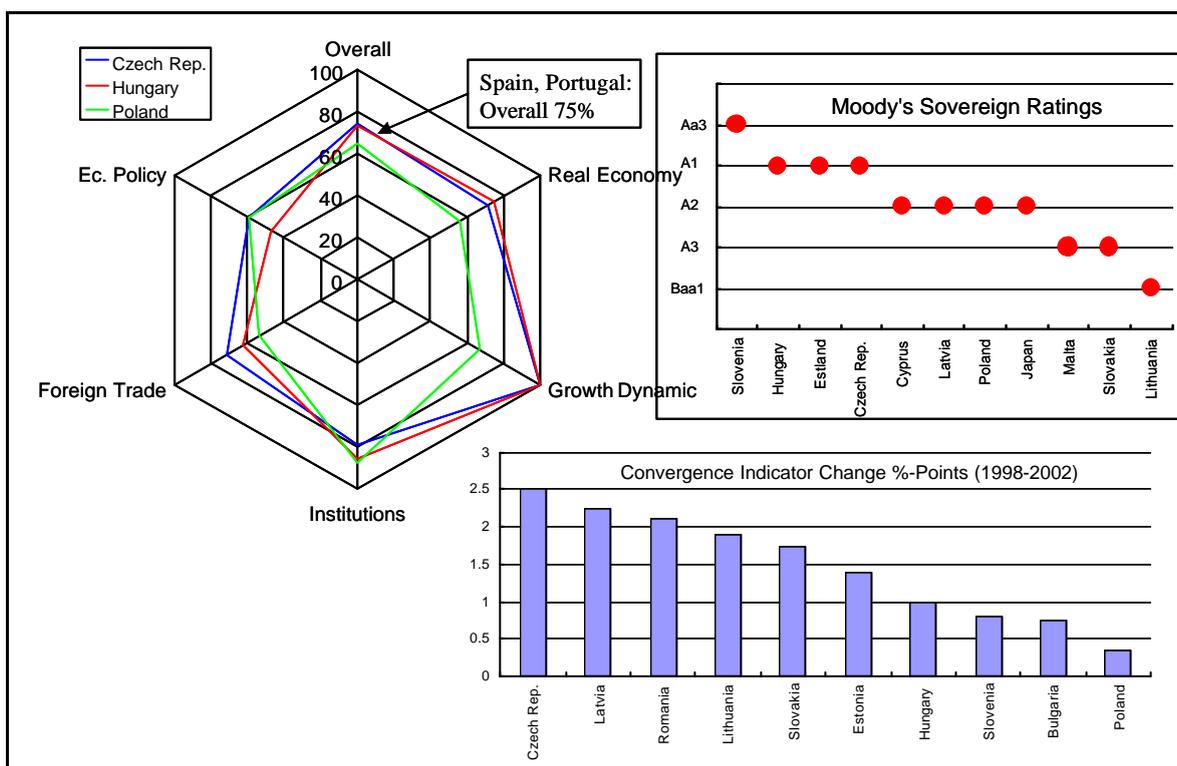
Finally, in October 2002, the EU Commission concluded that ten of the twelve countries that entered accession negotiations had progressed far enough to fulfill all the Copenhagen criteria

and could be ready for accession in 2004. The EU 2002 Copenhagen Summit therefore confirmed the accession of Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic, and Slovenia. Bulgaria and Romania were confirmed to have very good chances of concluding the negotiations and being confirmed for gaining membership by 2007. Turkey is hoped to be able to start negotiations by 2005.

With full membership, the pressure for further transformation and convergence will not stop, however. As part of the Single Market, they still have to solve the remaining problems that have become the subject for provisional exceptions from the Aquis' regulations (which had been negotiated in the Accession Agreements). Certainly, the final implementation of harmonized tax and tariff regulations will remain difficult and costly for the accession countries after May 2004.

But before analyzing the future difficulties for the CEECs further, Figure 13 demonstrates how successful this structured approach to transformation and development has been so far.

Figure 13: CEEC Convergence Indicators (2002)



Note: DB Research Indicator consists of 16 indicators in 5 groups with even weights.

Source: © FRI 2003. Data from Deutsche Bank Research (2002).

The Overall Convergence Indicator of Deutsche Bank Research (2002) shows that two of the big CEEC economies (Czech Republic and Hungary) will have already reached the 75% overall convergence level of Spain and Portugal at the time of their accession to the EU.

Another important indicator shows that their macroeconomic stability reached very high levels as well: Moody's Sovereign Ratings certified international investment grade levels for almost all CEECs, while Slovenia, Hungary, Estonia, and the Czech Rep. even achieved lower sovereign risk levels than Japan. The same is true for improvements in the Convergence Indicator towards EU levels between 1998-2002, although progress in the CEECs' biggest economy, Poland, has clearly deteriorated.

The question therefore arises of whether the accession countries are facing a major backlash after they have entered the Union and if they are likely to give up on strenuous efforts for further convergence, while hoping for increasing inflows of Structural Funds support. Judging on basis of the experience of the earlier accessions countries Ireland, Greece, Portugal and Spain, which has already been analyzed earlier in the section, provides a positive answer: in all of these countries, the conclusion of the Single Market and the chance for joining not only the EU but also the EMU have been major incentives for further progress and development.

The biggest difficulty after accession will therefore likely be the increase of (real) appreciation pressures on their currencies, which can seriously harm the competitiveness of the increasingly trade dependent countries, but cannot easily be dealt with by means of (sound) macroeconomic policy. Economic success, stabilization, and cautious monetary policy do not only provide the basis for higher growth rates, they also attract capital inflows which tend to appreciate the nominal exchange rate, and appreciate the real exchange rate by narrowing the productivity gap to the existing EU countries. This structural problem will become even more difficult after the countries have fixed their exchange rates by joining the upgraded version of the European Exchange Rate Mechanism (ERM), which was established together with the European Monetary Union (EMU).

The ERM-2 is a restrictive fixed exchange rate system (compared to the old ERM of pre-EMU times) for European Union member countries that are not members of the monetary union but intend to join after a membership of at least two years. Currently only Denmark is the single participant in the system.¹⁵ The EU's ECOFIN Council (2000) therefore agreed on

¹⁵ In the ERM-2 the currency of the participating state is linked by a central exchange rate to the euro. The normal fluctuation margin from the central exchange rate is set to a maximum of +/-15% but can be reduced at the request of the participating country (Denmark decided to limit the fluctuation of the Krona to +/- 2.25%). At the margins, ERM-2 intervention is automatic, mutual and in principle unlimited. (Adjustments to central rates are intended to be timely to avoid misalignments, however. Also, the

the compatibility of the system with a broad range of exchange rate arrangements. Excluded are only regimes without a mutually agreed central rate to the euro, crawling peg regimes, and pegs to currencies other than the euro.¹⁶

After entering the EU, and in preparation to the EMU, the CEECs have to fix their exchange rates in the ERM-2, rule out capital controls, and have to sign the stability pact that restricts fiscal policy. Only non-market measures (like direct governmental negotiations with labor unions about wage increases) will therefore remain in their toolkit for dealing with such situations as increasing inflation or strong pressures for nominal appreciation.

Furthermore, real appreciations are almost unavoidable for the CEECs because the productivity in the tradable-goods sectors (especially manufacturing) will tend to rise faster than in the non-tradeable sectors (especially services) while the resulting increases in wages will affect both sectors rather evenly, and therefore produce inflation in the service sector.¹⁷ This Balassa-Samuelson effect has been confirmed for the CEECs in many studies (see Breuss 2003, Halpren/Wyplosz 2001), and will complicate their situation after joining the ERM-2 with its strict exchange rate and inflation rate regime considerably.

Halpren and Wyplosz (2001), for example, estimated in a simple “guesstimate” that the impact of the effect on the average annual rate of real appreciation will be about 3% (for comparison: the actual real appreciation between 1995 and 1999 was 30%).¹⁸ The required

ECB and the involved national central banks are allowed to suspend intervention if price stability is endangered.)

¹⁶ The currency board arrangements of most accession countries have been accepted as a unilateral commitment by the acceding member state, with no further obligations for the ECB (Halpren/Wyplosz 2001).

¹⁷ Since wage increases tend to be more or less the same in all sectors, inflation will be relatively higher in the non-tradeables (service) sector, especially when domestic demand in the growing economy shifts towards services after the first rush for manufactured consumer goods (especially cars) is over. The result is that the strong productivity growth in the tradeables sector, which is the target of foreign investors, will lead not only to a higher inflation rates for non-tradeables but also to a real appreciation of the exchange rate relative to the more developed trading partners that do not have such productivity gains in their tradable sectors (or high inflation rates in their non-tradeable sectors).

¹⁸ They assume a continuation of the average rates of growth of trend productivity in both sectors over the last five years (8.6 percent a year for industry and 1.9 percent for services) and ignore any per-capita-GDP variables that would reinforces the Balassa-Samuelson effect.

stable inflation rate (at par with the EMU members) would therefore lead to a nominal exchange rate appreciation of 3 percentage points each year, or eat up about half of the ERM-2 bandwidth limit of $\pm 15\%$ over the minimum two-year membership period in the ERM-2. Halpren and Wyplocz conclude that if further appreciation pressure from capital inflows¹⁹, etc., were taken into consideration, it would become very likely that the accession countries would run into considerable difficulties with their macroeconomic policies and/or their GDP growth if they decide to remain within the ERM-2 for extended periods (Halpren/Wyplosz 2001).

The consequence from this analysis of the future course of the accession countries after entering the EU is that they most likely would try to enter the EMU as soon as possible, i.e., by January 2007. And indeed are the small accessions countries, Lithuania, Estonia, and Lithuania, Slovenia, Malta, and Zyprus all planning to enter negotiations for joining the EMU almost immediately in May 2004. Most of these countries already fulfill the Maastricht Criteria for monetary union with some (manageable) exceptions for the budget deficit criterion and also have experience with fixed exchange rates to the Euro through currency boards. But the situation looks quite different for the big accession countries, Poland, Czech Republic, Slovakia, and Hungary who are also eager to join the EMU at an early date (see Figure 14).

¹⁹ Henriot (2002) notes: In the EU countries, firms under foreign control account for almost 25% of the manufacturing production. Under the influence of foreign direct investment (FDI), the weight of foreign companies in some CEECs is already relatively high. For instance, the share of foreign affiliates in manufacturing employment reached 46.5% in 1999 in Hungary (the highest rate among OECD countries after Ireland), 18.6% in Poland and 16.2% in the Czech Republic. It is almost certain that the continuing openness of these countries will give multinational firms' the opportunity to locate a larger share of their world production either to supply the domestic, the regional or the global market. This hypothesis is confirmed by the application to the CEEC of the results of a model describing the location of multinational firms among Western economies.

Figure 14: CEEC EMU Convergence: Maastricht Indicators (2003)

EMU convergence*)					
	Inflation**)	Interest rates***)	Budget deficit	Gen. gov. debt	Exchange rate
	% yoy	10Y	% of GDP	% of GDP	vs parity
	2003	latest	2003E	2003E	Max. (2Y)
<i>Reference value</i>	2.7	6.1	-3.0	60.0	+/-15%
Czech Rep.	0.1	4.5	-7.9	25.5	-4.0
Estonia	1.3	2.8	1.9	5.1	-1.6
Hungary	4.7	7.6	-5.7	54.9	-9.1
Latvia	2.9	7.4	-1.8	16.3	-12.4
Lithuania	-1.2	6.4	-1.9	25.3	0.4
Poland	0.7	6.7	-4.8	51.0	-21.2
Slovakia	8.5	5.0	-5.0	45.2	-6.3
Slovenia	5.6	5.5	-1.9	32.1	-4.7

*) Date for budget deficit and public debt from Eurostat (March 2004), for inflation, interest and exchanges rates from DB Research.
 **) Reference value is the average of the three best-performing EU members plus or minus 1.5 percentage points. From May, all 25 countries will be included in the base.
 ***) If not available, shorter maturities.

Note: DB Research Indicator consists of 16 indicators in 5 groups with even weights.

Source: Deutsche Bank Research (2004).

One example for early ambitions to joining the EMU that have been deteriorating during the course of transformation is Hungary. Hungary easily became a favorite among foreign investors when it went on its transformation trail as the earliest of the CEECs and as the country with the most liberal economy from the start. It therefore attracted the highest FDI inflows during the first half of the 1990s, which made up 27% of GDP already in 1995 (see Figure 15). Hungary also went fast ahead with banking sector reform and was found to have reached EU levels as early as 1999 (see Figure 8). In 2002, Moody's sovereign rating grade of Hungary's bonds was A1, investment grade, and only a notch below Slovenia at Aa3 (see Figure 13). Given these early achievements, Hungary planned to join the EMU as the earliest of the CEECs in 2007 as well. But these hopes were shattered when the fast course of transformation ran into domestic resistance and macroeconomic policy mismanagement after the year 2000.

From the late 1990s, Hungary's civil servants demanded higher wages, and finally, by 2002, achieved wage hikes of up to 50%, which soon radiated into the private sector, where real wages increased by 12% in 2003. Unfortunately, these changes in labor market conditions then caused a change in the earlier stability oriented macroeconomic policy as well. The government started to lower its euro exchange rate target to promote the deteriorating export sector, which immediately resulted in undermining foreign investors trust in the independence of the central bank and the general course of Hungarian policy. In June 2003, the forint therefore slid into a currency crisis with severe devaluations, which necessitated a reversal in

policy with an increase in interest rates of up to 12.5% - far higher than rates in the Euro Zone or average rates in the other CEECs.

As Figure 14 shows, Hungary now has to deal with a twin deficit in the current account and the budget, while inflation still is at a rather high level, and general government debt is nearing the 60% of GDP limit. This situation has not only complicated the drafting of credible and much more austere roadmaps for EMU membership for a much later date (most likely after 2010), it also provided a rather poor basis for the difficult post-accession phase with its strong pressures for EU-wide investment rationalization, as section 5 will analyze in further detail.

The final phase of enlargement, between EU accession in May 2004 and entrance into the EMU, which is now not likely to happen earlier than 2010 for the large CEECs, will therefore remain to be another difficult phase. On the one hand side, (especially) the larger CEECs will have to deal with the economic realities of financing further transformation costs within an increasingly restrictive ERM-2 regime when real foreign exchange rates start to appreciate, and with a rationalization processes in EU-wide production and investment networks, which might see FDI flows clustering in a few promising investment locations like Slovakia and Estonia. On the other hand side, the ERM-2 and the run up to entering the Euro Zone provides strong political incentives and control mechanisms to get macroeconomic policies on track, as the history of the EMU after the Treaty of Maastricht has shown before - and it also ensures the ongoing support of the "old" EU member states that face the political necessity to avoid financial crisis and economic failure within its network of member countries. It is therefore likely, that the final step of European enlargement, the entrance of the CEECs into the EMU, can be achieved by 2007-2008 for the smaller countries, Estonia, Lithuania, Latvia, Slovenia (and Cyprus), while Hungary, Poland, the Czech Republic and Slovakia still face major consolidation efforts, especially in their fiscal balances, that will likely last till 2009-2010.

5. Market Potential and Future Investment in the CEECs

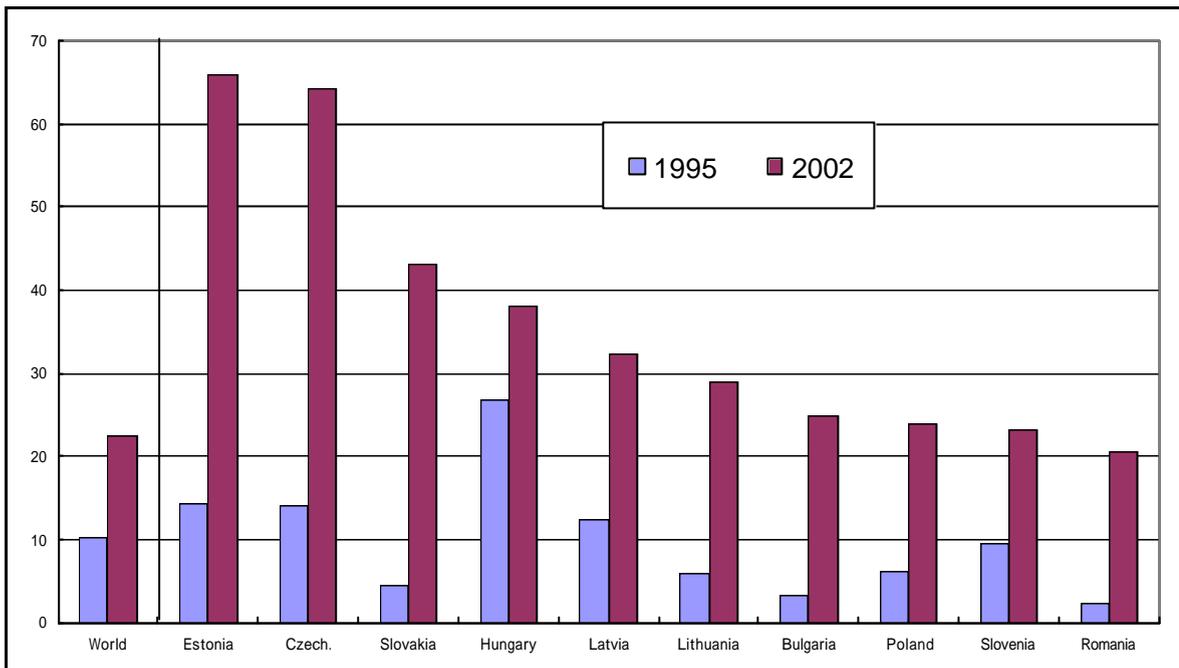
Many regions in the CEECs became major powerhouses of growth during the latter half of the 90s (see Figure 6). Their growth rates have been as high as Ireland's or southern Finland's – and they cover a much larger area. The combination of market potentials with absolute cost advantages from low labor costs have therefore turned the CEECs into major investment locations in Europe.

After the accession, the CEECs will most likely not experience any type of positive or negative “accession shock.” Most barriers to trade between the EU and the new members have already been dismantled during the accession process. The remaining restrictions cover only about 5% of current trade by value, and are mostly related to farm products. Furthermore, prices for many farm products in central Europe have risen close to EU levels while farm productivity remains low and the EU's milk quotas as well as tough health standards for meat will limit exports.

But the overall growth dynamics of the CEECs will change considerably. One of the most important sources of growth, privatization, has already lost its significance. Most companies that could fetch high prices, especially during the stock market boom of the 90s (banks, telecoms and energy), have already been sold. In contrast to these (largely) successful privatizations, sales of the remaining candidates under government control, such as national airlines and steel mills, face strong resistance from labor unions and vested interests in bureaucracy. It is yet unclear if and when these companies would be able to survive without government support.

Unfortunately, not only growth from privatization is fading, the first decade of transition and modernization also made the countries extremely dependent on inflows of FDI in general (see WIR FDI/FCI). This poses a risk to the still fragile market structures especially in the small accession countries because exogenous shocks or (economically non-critical) political infighting in the still unsettled countries have the potential to repel foreign investment and thereby derail the entire business environment (see Figure 15).

Figure 15: CEEC Inward FDI Stock as a percentage of GDP

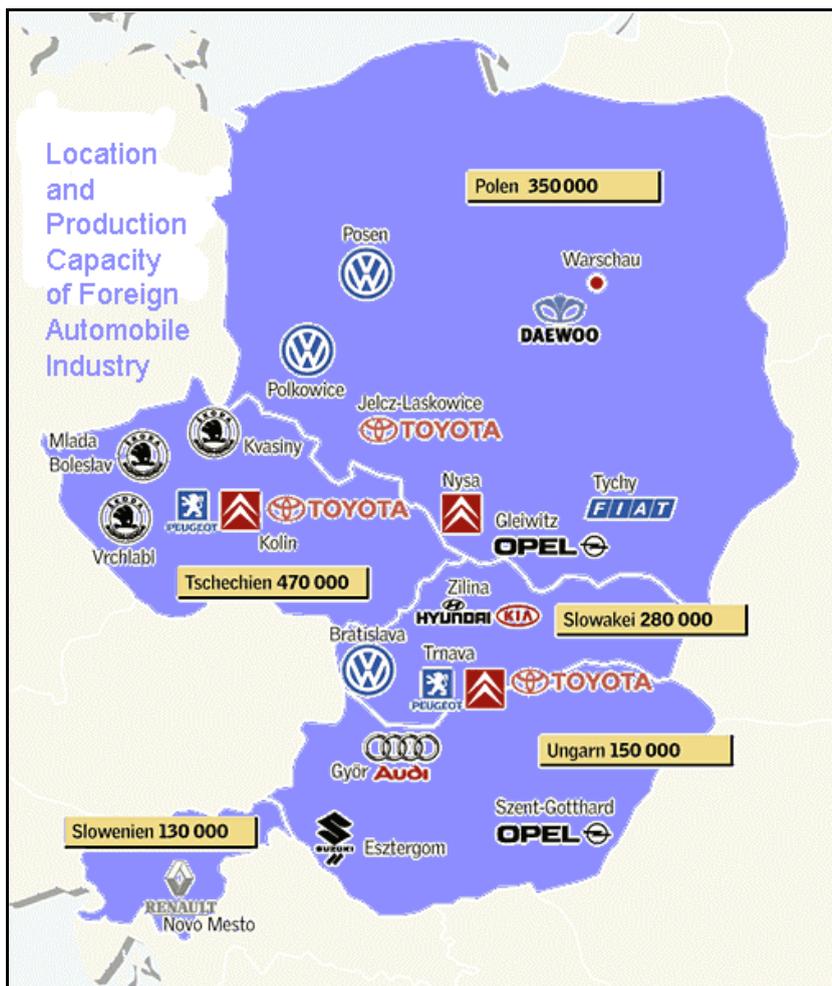


Source: © FRI 2004. Data from UNCTAD FDI Database (2004) Database.

It is not likely, however, that FDI flows into the CEECs will dry up after May 2004, although the (worldwide) dip in FDI flows in 2003 caused considerable concern about future developments for governments and economic analysts. An important element for continued optimism about investment flows is that most investments in these countries are not fickle “hot money” intended to exploit only short-term privatization or evaluation gains. Most funds are intended to stay and now attract new investor groups that appreciate the added security and transparency of enforceable EU standards.

Especially in the automobile industries, some CEEC production locations have already reached a critical mass that attracts further investments as clusters of production and technology. Of 9,939 million cars produced by German companies worldwide, for example, 44.5% are produced outside of Germany, and already 18% of these are built in Poland, the Czech Republic, Slovakia, and Hungary. This trend is even more pronounced for the automotive suppliers: already 40% of 1,300 German suppliers have production locations in the CEECs. Similarly, PSA Peugeot-Citroën, Toyota, and Hyundai-Kia will soon open the gates at their new production locations in the Czech Republic, Slovakia, and Poland for the production of 800,000 vehicles a year, which adds 20,000 jobs directly and another 50,000 at second tier producers.

Figure 16: CEE Automobile Production Centers (2003)



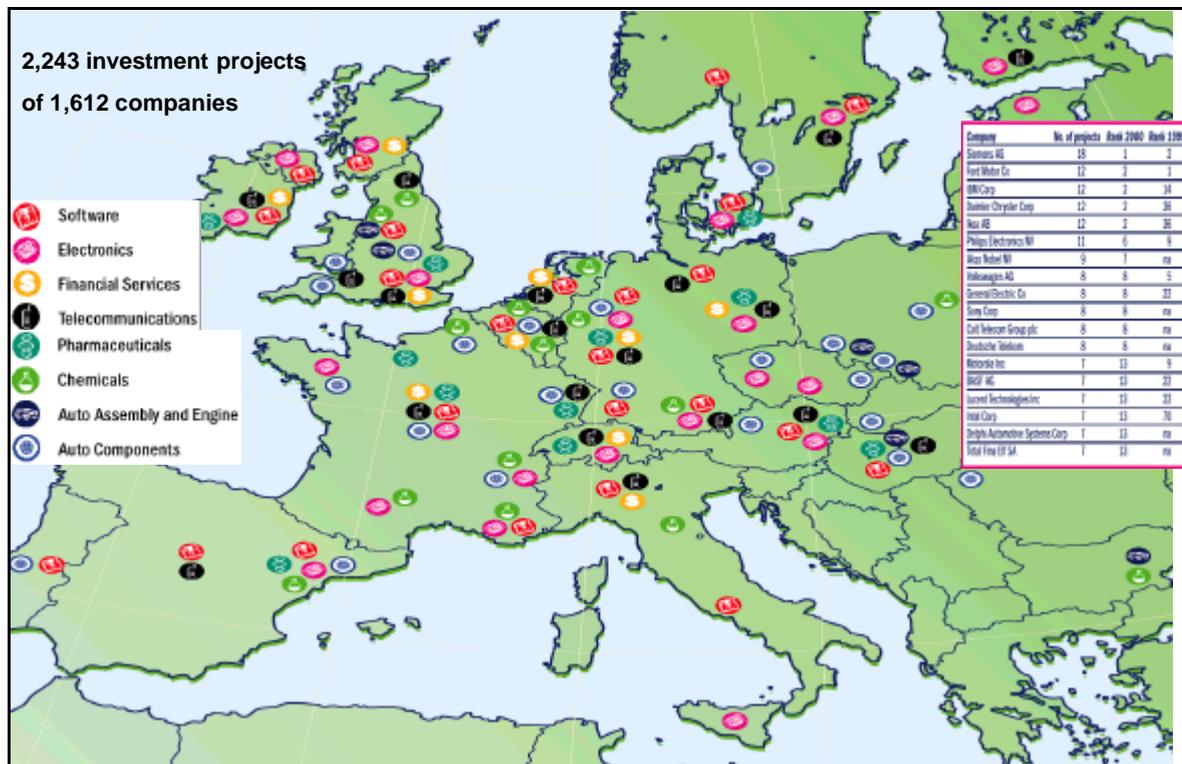
Source: Financial Times Deutschland (2004.04.17).

A study of the Center for Automotive Research (CAR) in Germany estimates that the production capacities in Poland, the Czech Republic, Slovakia, and Hungary will expand to 2.6 million cars by 2006, this is almost half of what has been produced in Germany in 2003 (see DER SPIEGEL ONLINE 2004.4.12). The CAR study claims that the most important driving force for ongoing investments is still the cost differential to the CEECs in the labor-intensive automotive supply industries. Labor costs in manufacturing in 2002, for example, were 28.5 euro per hour in Germany, 16.5 euro in Eastern Germany, 15.4 euro in Spain, 5.4 euro in Poland, 3.3 euro in Slovakia, and 1.7 euro in Rumania.

Manual labor is, however, not the only attraction anymore. FDI inflows into the CEECs have recently become increasingly diversified – away from “extended workbench” investments that target low labor costs (such as automobile parts and textiles) or FDI that are directly related to their transformation (i.e., telecommunication and banking). In the meantime, major corporations have also started to invest in higher-grade automobile, chemical, pharmaceutical,

and software production (see Figure 17). These investments now add to the basis of excellent growth and market potentials, even after the first wave of privatization investments is over.

Figure 17: Europe’s Principal Investment Locations (2000)



Note: The chart marks the principal investment locations of 1,612 internationally investing corporations in Europe
 Source: Ernst & Young European Investment Monitor 2001.

In another study, the KfW banking group surveyed 1,800 larger German SMEs, and, with 233 replies, found that 59% of these German corporations claimed to already employ higher qualified employees in the CEECs. Increasingly, they also see the CEECs as one of their most important markets (66% of the companies). Eighty-eight percent of the corporations therefore replied that securing their market position would be an important investment motive, 83% noted market entry, and only 61% pointed out the wage differential for their investment decisions. Another 43% found less bureaucracy, and 38% lower taxes to be important investment motives.

So even if FDI flows are not expected to deteriorate strongly, they will change depending on the countries’ competitive market development and patterns of specialization. After accession, a strong wave of rationalization of investment patterns is likely to shift economic chances not only between the CEECs, but also between the CEECs and other developing regions in Southern Europe and the East. Due to fading transformation dynamics and increasing costs from real exchange rate appreciations in the CEECs, the foreign-owned subsidiaries of large

Multi-National Companies (MNCs) in particular will reconsider their EU-wide locational strategies, relative factor costs, and prospects for market developments. Basically, these decisions will be determined by the investment strategies the MNCs are following in the transformation countries. For simplicity, three different types of strategies can be differentiated here: resource-, efficiency- and/or market-seeking investment strategies.

The rationalization process in resource-seeking investments will mark the first wave of problematic changes especially for the small CEECs. Nominal and real appreciations will drive resource-seeking investments that target low factor costs with low value-added production beyond the enlarged EU borders, into the CIS and MED countries. Given the limited market sizes of many CEECs, this process is especially problematic because their low attractiveness for market-seeking investments has often induced policy makers in these countries to focus on such (foreign owned) export industries. In many regions within and outside of the EU such prospects of deteriorating FDI inflows and manufacturing capacities therefore resulted in competing subsidies to manufacturing industries, which cemented the positions of the regions as extended workbenches but provided little for their long-run competitiveness. Fortunately, increasing compliance with EU regulations for tax codes and subsidies will prevent most attempts to fight diminishing FDI inflows by means of such industrial policies in the enlarged EU.

The smaller CEECs are therefore competing hard to become the next “Ireland” in terms of attractiveness to international investors and growth rates by limiting the governments’ reach through the introducing of low flat tax regimes and aiming for “small government”. Estonia was first to introduce a flat corporate tax rate in the mid-1990s. Now Slovakia has radically introduced a 19% flat tax for both corporate and personal income, while Poland, Hungary and Latvia have all cut corporation tax to below 20%.

As long as the countries remain able to control their deteriorating fiscal balances, these policies will certainly add to their attractiveness to foreign investors. And in the meantime, it even adds to the pressure of Western neighboring countries to overhaul their outmoded tax structures – as the current discussion in Austria about similar steps, and an initiative in Germany and France to force the opposite for all Europe demonstrates. One important potential result is therefore that the EU’s enlargement would add to the long sought after improvement in the competitiveness of European markets in general.

But such competing “small government” policies will only be successful if additional locational assets, plus rather high levels of efficient market structures and effective

policymakers make them sustainable by yielding early results and securing continued support from the local population. The current star of car manufacturing and low tax regimes, Slovakia, for example, has a population of just 5.4 million with extremely poor minorities (especially gypsies), a budget deficit of 5% of GDP, and a still very limited infrastructure. To finance their extreme tax cuts, they therefore also needed to postpone retirement, cut sickness benefits and tightening eligibility for unemployment benefits. It needs yet to be seen if this effective but costly policy mix will remain acceptable to the population until its returns become clearly visible. In other small countries, like Slovenia and Estonia, on the other hand, their already developed structures and location close to important developed markets to the West (i.e., Italy and Scandinavia) and future markets to the East (the Balkans and Russia) will certainly help to sustain promising growth prospects with less draconian and risky strategies. The bigger CEECs, Poland, the Czech Republic, and Hungary, in contrast, were able to attract and keep a major share of market-seeking investment, which helped during the first stages of transformation much more than in the smaller ones. But even for these countries, the process of industrial rationalization after their accession will bring a major change in business and strategic conditions. Although it is unlikely, at first at least, that their FDI inflows will deteriorate below the already depressed levels of 2003 (which deteriorated internationally from the 2001 peak levels), it will become increasingly difficult for these countries to keep up their earlier investment pace while trying to improve their high budget deficits at the same time.

At first, during 2004-2005, chances are rather good that they might be able to recover high FDI inflows through EU-wide investment relocations because they combine market potential and low factor costs with secure EU standards, which will probably attract many mid-size European investors that have been reluctant to enter these new markets before. They might also further gain from the exit of resource-seeking investors from smaller CEECs (the EBRD even expects a sharp rise from \$6 billion to nearly \$15 billion FDI in 2004). But in general, market-seeking investment in these countries has already lost the initial bonus that came from competition for market share in new markets, the initial markup for the turn-around of acquired companies, and the prospect of awakening consumer demand.

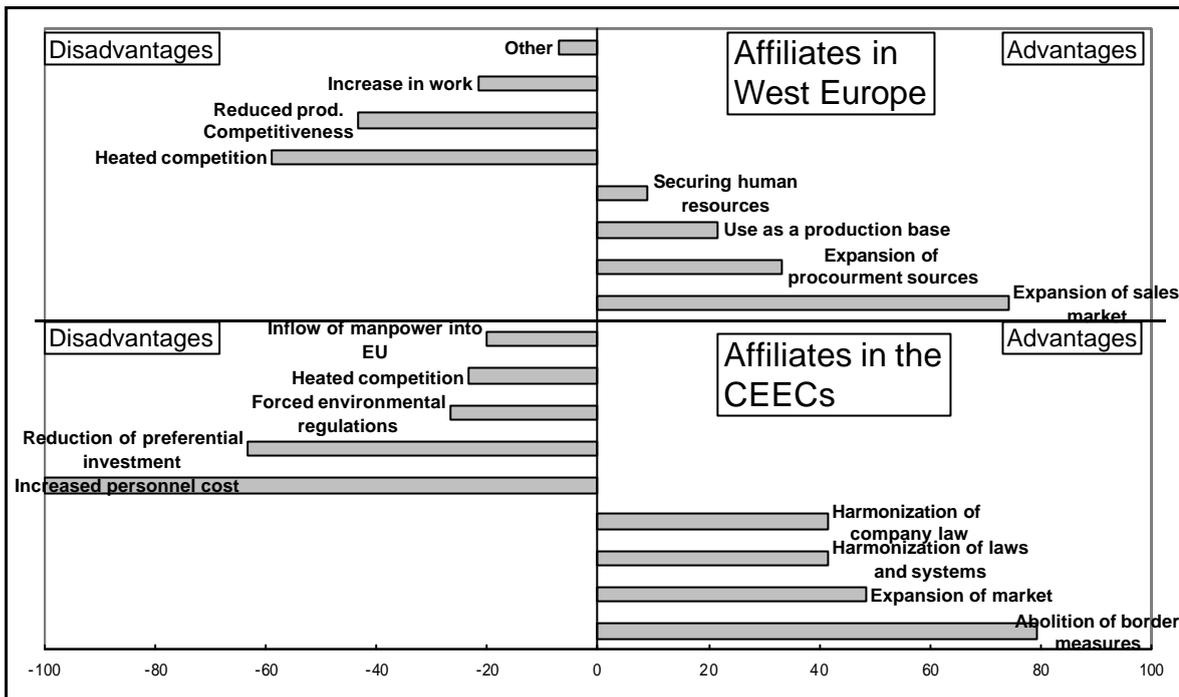
The larger CEECs will therefore soon start to feel the pressure on MNC subsidiaries that have to compete as part of the MNC networks, which discriminate against inadequate quality and differing domestic market standards. The MNCs will also try to cut back the rather wide product lines that served the (earlier) closed markets. Clearly, the CEECs' corporations and

MNC subsidiaries will therefore soon have to specialize, and to comply with the stricter safety, environmental and hygienic standards of the EU - as the companies in Western Europe have painfully done before.

The already existing Japanese manufacturing affiliates in Europe are excellent examples for this development. Since the overwhelming majority of them, 862 out of 986 corporations, still operate in Western Europe only, they regard the advantages of enlargement higher than the disadvantages. Almost half (49.5%) of the West Europe affiliates stated in a 2002 JETRO survey (JETRO 2003) that enlargement has major advantages, while only 13.2% stressed major disadvantages (37.4% expected no impact). For most of these corporations the enlargement presents a clean start that now is being considered on the basis of secure EU-wide rules and regulations. The affiliates that already operate in the CEECs (111 corporations), on the other hand, also stress the disadvantages. Though 51.5% responded that enlargement has major advantages, another 42.4% of the respondents saw major disadvantages in enlargement.

Figure 18 lists the claimed advantages and disadvantages of the manufacturing affiliates in West Europe and the CEECs. In West Europe, the Japanese manufacturers especially fear increased price competition from the East, but see major merits in the expansion of markets, and even plan to use the CEECs as production bases. For the affiliates in the CEECs, on the other hand, the major concerns are increasing personnel costs and the abolition of preferential investment systems (subsidies) that target foreign manufacturers. As major advantages they point out reduced costs from the gradual reduction of border measures, expanding markets for their low-cost products in the West, and the harmonization of EU laws and regulations.

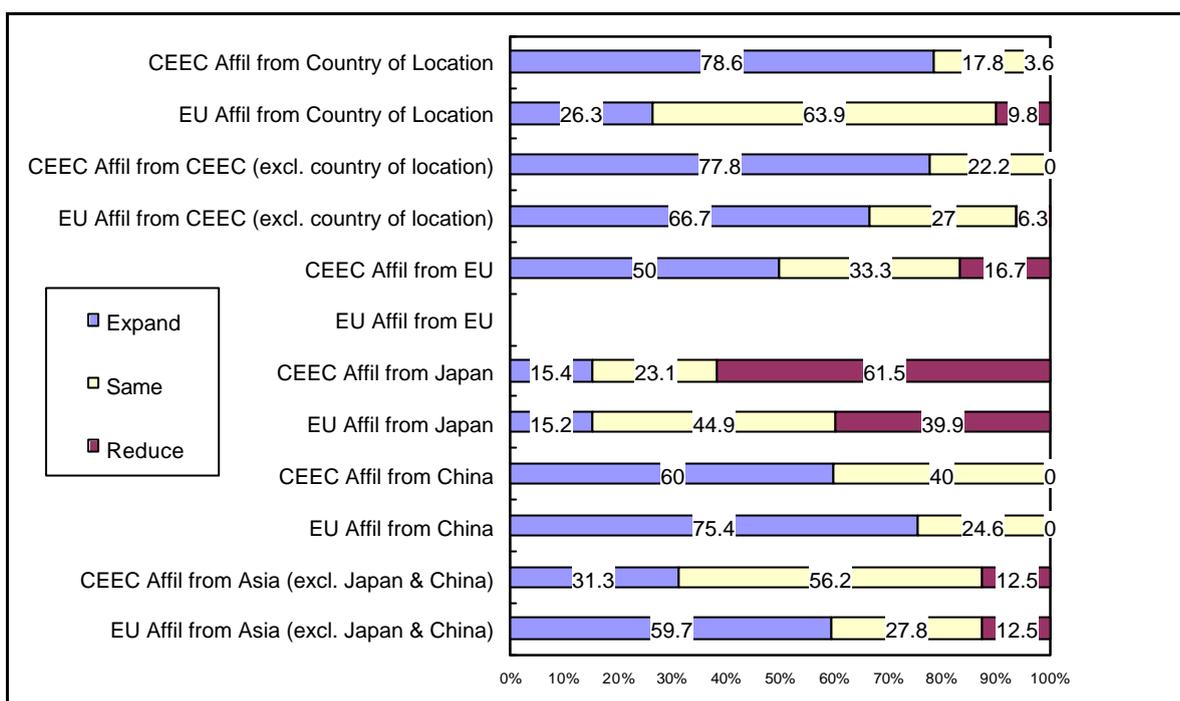
Figure 18: Survey of Japanese Manufacturing Affiliates in Europe: Advantages/Disadvantages of EU Enlargement (2002)



Note: Replies to the left are responses about disadvantages of EU Enlargement. Advantages are listed to the right. The survey covers 862 Affiliates of Japanese Manufacturers in Western Europe and 111 in the CEECs. The response rate was 53.3%.
 Source: JETRO (2003): Survey of Japanese Affiliated Manufacturers in Europe/Turkey.

Due to these changes in Europe’s business environment, the Japanese affiliates are planning to adjust their procurement (Figure 19) and sales (Figure 20) policies. By far most of the Japanese affiliates in the CEECs are planning (according to the latest JETRO survey in 2002) to increase their regional procurement (about 78%), which demonstrates the improving supply situation in the CEECs. Similarly, 66.7% of the Japanese affiliates in the EU are planning to increase their procurement in the CEECs. This increase is only topped by the number of firms that plan to increase procurement from China - and underlines the price competitiveness of the CEECs. Most of these increases in regional procurement plans are at the expense of imports from Japan. More than 60% of the affiliates in the CEECs plan to reduce their imports from Japan by (61.5%), and 39.9% of the EU affiliates are planning to do the same (see Figure 19).

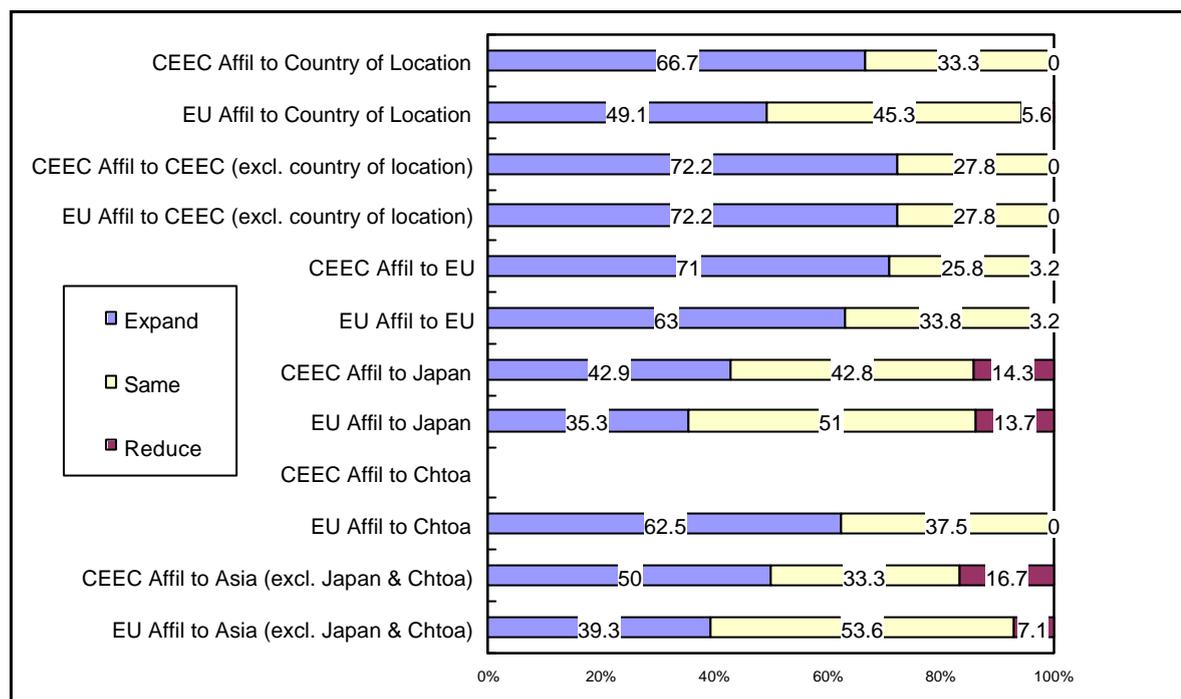
Figure 19: Survey of Japanese Manufacturing Affiliates in Europe: Future Procurement Policy by Region (2002)



Note: Replies to the left are responses about disadvantages of EU Enlargement. Advantages are listed to the right. The survey covers 862 Affiliates of Japanese Manufacturers in Western Europe and 111 in the CEECs. The response rate was 53.3%.
 Source: JETRO (2003): Survey of Japanese Affiliated Manufacturers in Europe/Turkey.

A similar change in business strategies evolves for planning in sales, as Figure 20 shows. More than two thirds of Japanese affiliates in the CEECs and the EU are planning to increase their sales in the CEECs. Most of the affiliates in Europe are therefore expecting the CEECs to become their growth market with the highest potential. It is also important to note, however, that 71% of the affiliates in the CEECs are planning increase their sales in the EU, which is further prove to their perception of price competitiveness and certainly adds to the impression of affiliates in the EU about “heating competition.”

Figure 20: Survey of Japanese Manufacturing Affiliates in Europe: Future Sales Destinations by Region (2002)



Note: Replies to the left are responses about disadvantages of EU Enlargement. Advantages are listed to the right. The survey covers 862 Affiliates of Japanese Manufacturers in Western Europe and 111 in the CEECs. The response rate was 53.3%.
 Source: JETRO (2003): Survey of Japanese Affiliated Manufacturers in Europe/Turkey.

On the basis of Japan's current structure of FDI flows to Europe, business chances for Japanese corporations in the enlarged EU are therefore looking rather good. Although only 33% of FDIs in Europe were in the manufacturing sector, another 12% of investments were undertaken in trade, and 7% in non-financial services. For all these investments, the lowering of border controls and growing markets offer major chances for a Europe-wide rationalization process that has only just begun.

As an example, Figure 21 lists some of the chances and key issues for further investments in the bigger CEECs by sector. Even in banking and insurance, where the most important changes have already happened during the privatization process (without much involvement of Japanese corporations), markets in the CEECs are not yet fully saturated in corporate banking (see section 3).

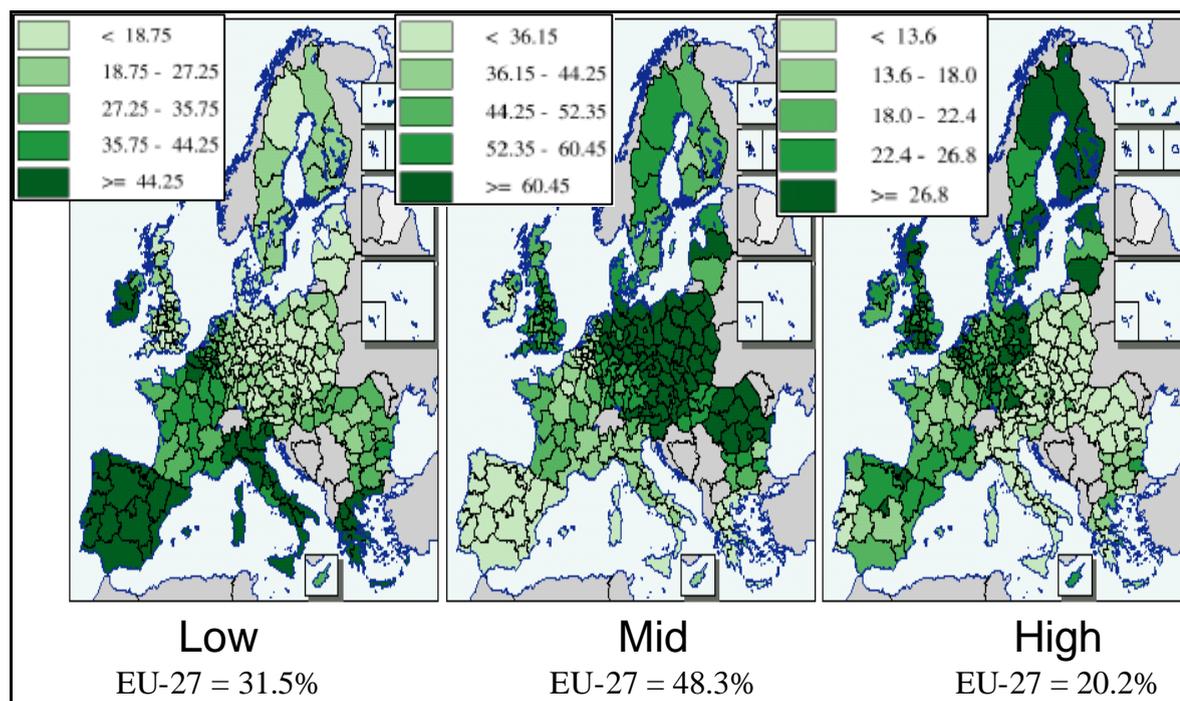
Figure 21: Sectoral Impact and Investment Chances

Sector	Key impacts	Key issues
Industrial	High quality/low cost skilled work force	Limited scope for further investment
Vehicles	Significant acquisitions and greenfield investments	Impact of global consolidation - rationalization of production locations
Consumer goods	International companies looking for long-term returns Rapid market growth in some key sectors	Future rate of growth of consumer incomes Scope for (relatively) low cost production manufacturing or distribution centre?
Tele-communications	Historic lack of investment Rapid growth of mobile communications	Limited by low consumer incomes Catching up Local firms need international partners
Media and entertainment	Low interest from western companies Low impact of technological change on local businesses	Growth of consumer incomes (and advertising revenues) Language limits
Retailing	Market opportunity for customer centric retailers	Further growth opportunities exist E-commerce underdeveloped
Financial services	Now intensively banked Now intensively banked	Pressure for cost cutting and consolidation Scope for corporate banking

Note: Results from a Price Waterhouse Coopers (2001) survey of senior executives from almost 40 international corporations.
Source: Price Waterhouse Coopers (2001).

Beyond such short and mid-term considerations about business strategies after the accession, longer run prospects need to be weighed carefully as well. The most important element of sustainable high growth rates and technology advancements in any country is the level of education of the population. As Figure 22 demonstrates, the CEECs have the highest concentration of young mid-level education workers in Europe. This advantage can hardly be overestimated because these workers do not only provide the basis for current production success but also for further development of their skills to match coming high-level challenges. Furthermore, this situation contrasts also positively to the earlier accession countries of Spain and Greece, where an educated elite in a few regions in combination with a wide base of young low-skill workers throughout the country offered much less chances for fast and sustainable development.

Figure 22: Europe's Education Levels (2000)

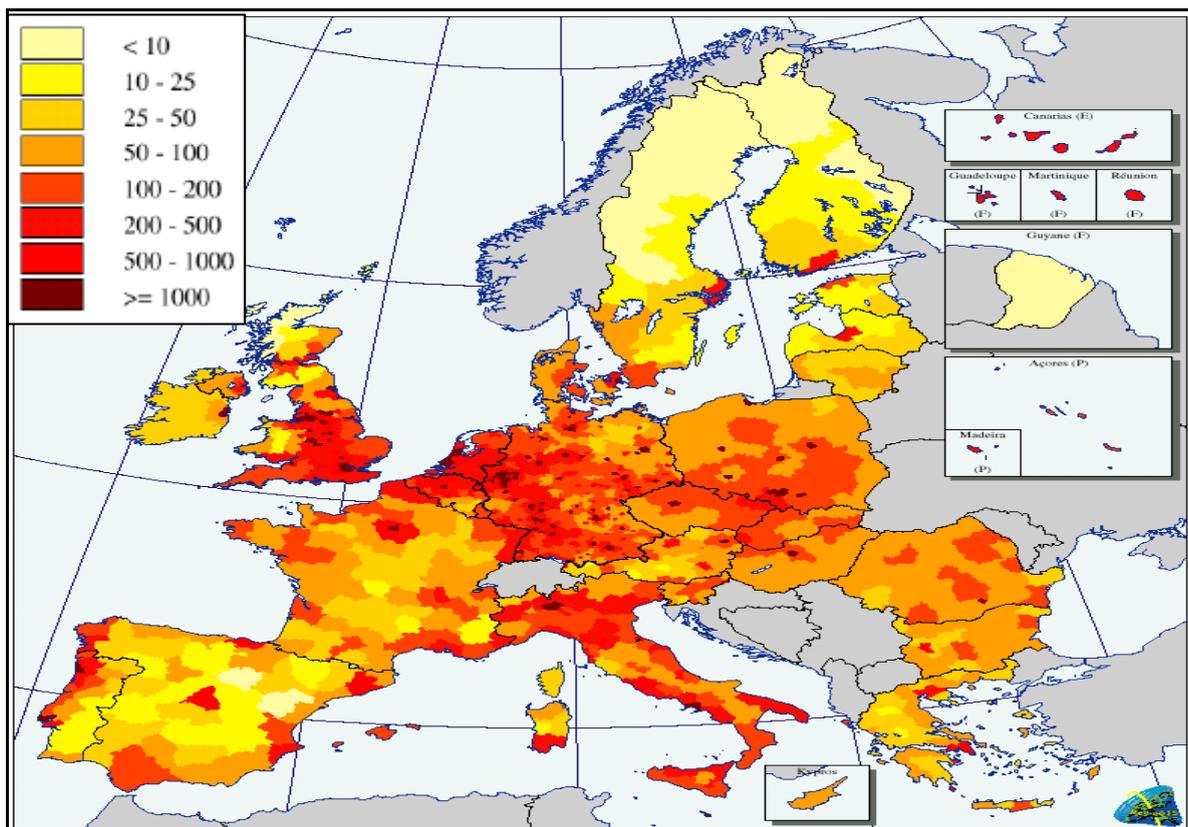


Remark: Percent of population 25-29 years old.

Source: Eurostat Info regio (2002).

Another important determinant of market potentials is high population density. As many studies have shown before (see for example Krugman 1991, Venables 1996, Fujita 1999), high levels of population density and agglomeration centers do not only provide for easily accessible markets but also for high growth rates of consumer demand in the production centers, as well as for the fast introduction and development of new technologies. In such agglomeration centers, the introduction of the technologies and capital often leads to positive cycles of employment expansion, consumer demand, and skill development. Naturally, the small and open economies of the Baltic countries as well as Slovenia have the best chances as focused innovation centers. But Figure 23 also shows that the “big” CEECs, Poland, the Czech Republic, Slovakia, as well as Northern Hungary, have important agglomeration centers that rival the most competitive Western European regions (the regions from Southern England throughout Western Germany to Northern Italy; the “blue Banana”). These centers might be able to further benefit from the spillovers from foreign production technologies that become introduced into the export centers (Brander 1995, Helpman 1989, Ottaviano 2001).

Figure 23: Europe's Population Density (1999)

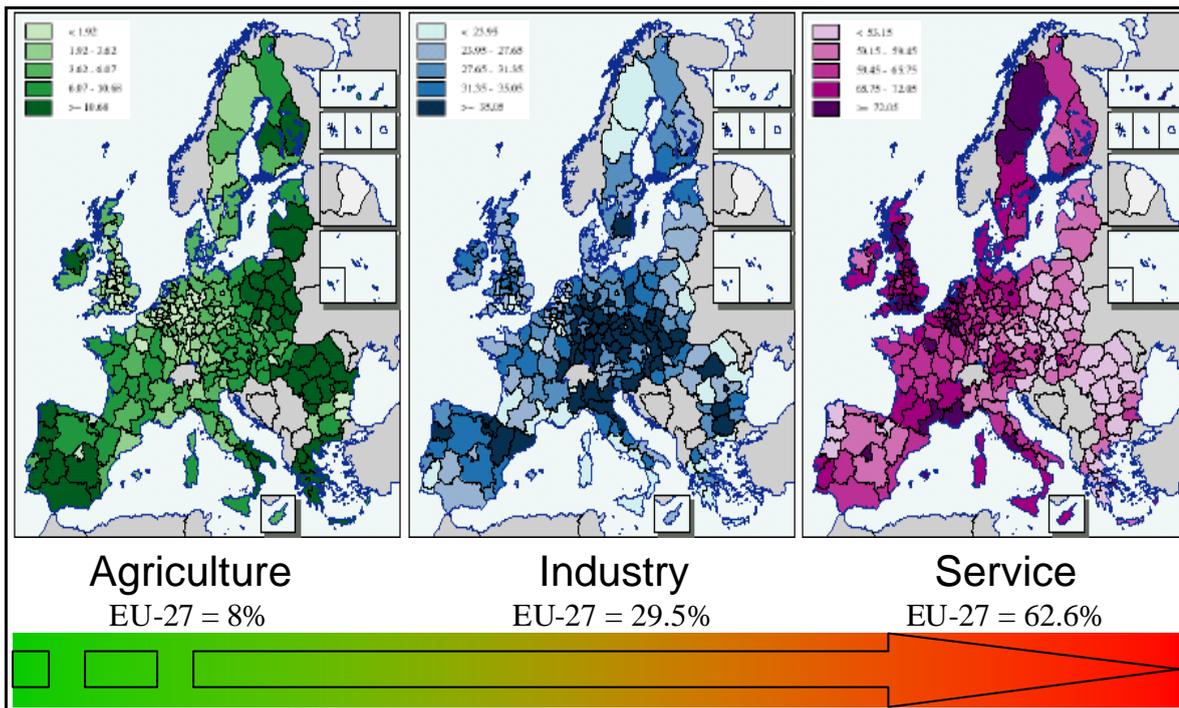


Remark: Population per SqKm.

Source: Eurostat Inforegio (2002).

Finally, a further important element for the market potentials in the CEECs is the developed (even over-developed) industrial base, and the underdeveloped service industry (Figure 24). As explained above, this strong industrial base offered the chance of high growth rates during the CEECs' transformation years through privatization and the introduction of new technology through FDI. For the coming years, however, the chances look quite different. Seventy percent of the CEECs corporations are privatized already, and the decreasing growth rates especially in the "old" transformation countries (Hungary and the Czech Republic) show how difficult the follow up steps of restructuring and rationalization are. Guiding underdeveloped agricultural regions into industrialization and industrial centers to the development of dynamic service industries is a difficult task even in non-transformation economies – although certainly not impossible, as regions in Ireland and Scandinavia have demonstrated.

Figure 24: Europe's Employment by Sector (2000)

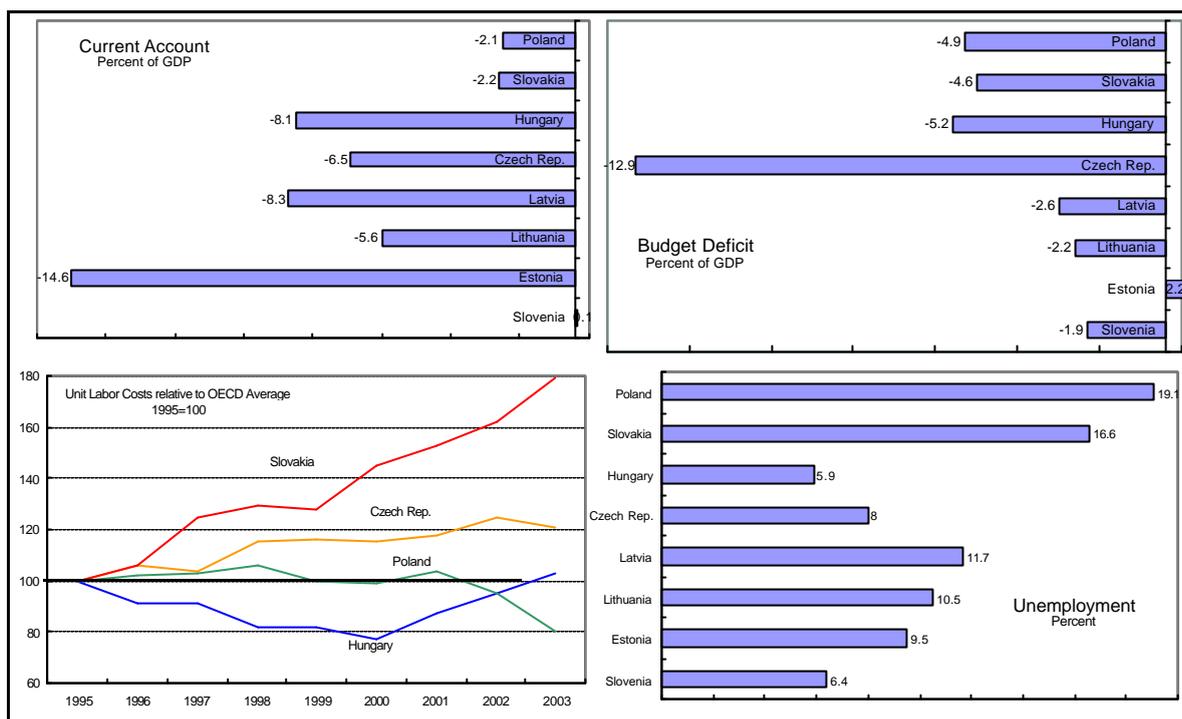


Remark: Percent of sector's of overall employment.

Source: Eurostat Inforegio (2002).

Successful industrial rationalization and the shift to value-added production require high degrees of regional dynamism within the countries and flexible markets throughout the countries. Such structural reforms therefore have a history of stalling in countries that could not mobilize strong political support for the necessary changes. It is therefore too early to differentiate the CEECs or the enlarged European market only by locational assets and remaining differences in regulations. Although one of the most important advantages for countries when joining the EU is increasing economic stability, which is gained by low Europe-wide interest rates, rules for fiscal, monetary and exchange rate discipline (when preparing for EMU membership), and a wide array of common regulations and procedures based on the Aquis Communautaire, this is yet not enough to ignore remaining macroeconomic differences. In case of the CEECs, with the possible exception of Slovenia, all countries are still troubled with unstable governments, high budget deficits, unsettled tax systems, and sometimes staggeringly high unemployment rates (see Figure 25).

Figure 25: CEEC Macro Performance (2003)



Note: Data for unemployment are for January 2004.

Source: © FRI 2004. Data from OECD (ULC), Eurostat (UE), Deka Bank (Budget Deficit and CA).

When looking at the remaining macroeconomic difficulties country by country, Poland, the largest country of the group, sticks out because political support for the implementation of the final steps of the transformation process, for the cleaning up of corruption in the bureaucracy, and for cutting through vested interests in the remaining public corporations, seemed to have almost stalled before the transformation process was complete and the rationalization process that follows EU membership had started. Only recently, and despite a major scandal that toppled the new “pro-reform” government, does Poland seem to be economically back on track again. Today, Poland seems to be moving ahead much faster than before – especially because its export performance has been boosted by falling unit-labor costs and a depreciating zloty. But as the by far biggest country of the group it still faces the biggest difficulties from the necessity of simultaneously upgrading its underdeveloped infrastructure (especially motorways) while keeping its budget deficit (-4.2% in 2003) in check.

The Czech Republic, which has been one of the earliest and most eager adopters of market reforms and premier FDI location, has also already been moving through a full cycle from booming FDI inflows that targeted its low wages and privatization chances to the trough of investor frustration due to its half-hearted actual privatization implementation and political struggles. But after the heavy costs of restructuring the banking sector have been discounted, and fiscal reform plans seem to be in place, the Czech Republic is now ranked as more

competitive than Greece and Portugal. This provides a solid basis for the planned return to sound macroeconomic policies (from a budget deficit of 12.9% in 2003 to a planned deficit of 3% by 2008) that will be required for joining the EMU during this decade. In another sign of a renewed focus on the implementation of realistic domestic targets, the Czech government was the first accession country to shift the possible date for joining the EMU back to the year 2010 as the earliest.

Hungary, on the other hand, as has already been discussed above, is still in the middle of a loss of investor confidence after public sector wages, following an election promise, were doubled, and real wages increased by 12% in 2003. To make matters worse, Hungary's central bank decided in 2003 to preserve the economy's export competitiveness by increasing its inflation target to 4% and announcing a soft exchange rate corridor for the forint. The consequence was an immediate loss of investor confidence and the devaluation of the forint, which necessitated a jump in the key-lending rate to 12.5% and depressed growth prospects for 2004.

Slovakia, the latecomer in terms of market reforms, has become the rising star in manufacturing investment because the government agreed (beyond party lines) to implement an extremely liberal economic policy. Despite the lowering of corporate and income taxes to a flat 19% rate, the government managed to get the budget deficit down to less than 5% with a falling tendency. The same is true for labor-unit costs, which have been rising the fastest in Slovakia, but were driven by productivity gains from foreign investment, and not by lax governmental policy as in the case of Hungary. Given the still high level of unemployment, however, and the still to be digested increases in retirement age and health insurance payments, as well as the partial abolition of the pay-as-you-go pension system and cuts in unemployment payments, it remains to be seen if this policy becomes sustainable in the long run.

In contrast to the large accession countries, the Baltic states have been able to secure continuously high economic growth, broadly balanced budgets, a high dynamic of structural reforms, but high current account deficits. Among these countries Estonia is widely regarded as the best-run economy, although the current account deficit is extremely high (14.6% of GDP). This, however, is due to massive modernization of its economic structure and high machinery imports, and not due to a budget deficit, which was actually a surplus in 2003.

Finally, Slovenia is the economically and politically most stable CEEC. It's currently lower growth rates are due to its strong reliance on its Western trading partners in Germany, Italy

and France, which are still in the midst of a prolonged recession. Slovenia is, on the other hand, still struggling with slow reforms of its remaining monopolistic structures and inflation rate, which was beyond 5% in 2003. Despite these problems Slovenia will most likely be the only accession country that is able to enter the EMU at the earliest possible date (2007).

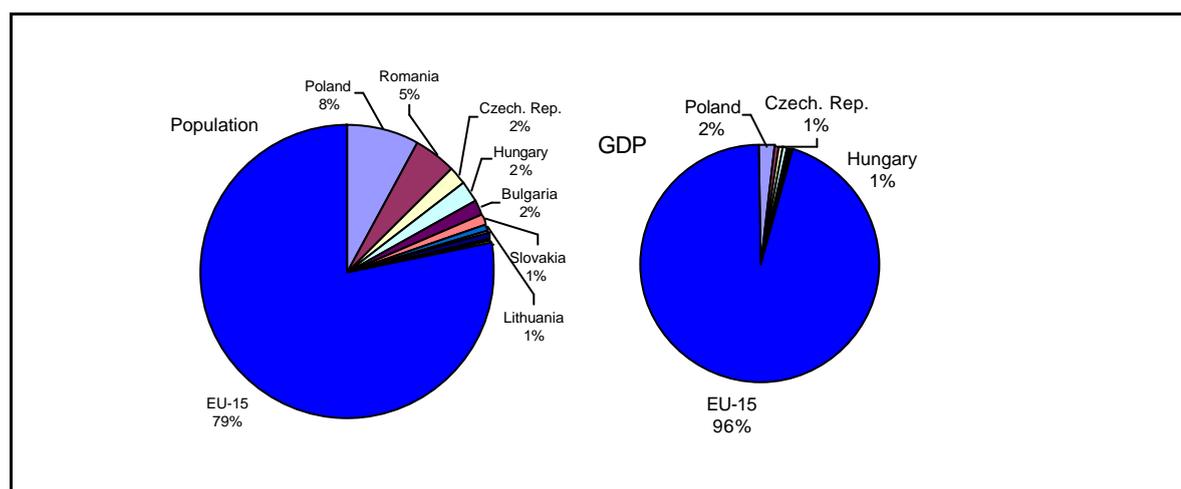
Because of the differences in locational assets, economic structures and policies the post-accession phase will most likely further differentiate winners and losers on a regional basis. The larger CEECs need to focus on overcoming the burdens of (real) exchange rate appreciation and the challenges of EU-wide competition by developing their domestic markets fast. The smaller countries, on the other hand, need to develop their specialization patterns fast enough to thrive as regional centers. Given their current progress in most of these areas, the analyzed countries are offering an excellent mix of relatively stable market frameworks, strong fundamentals with still low factor costs, and excellent long-term perspectives in an European Union that most likely has not yet seen its final step of enlargement to the east and to the south.

6. Consequences of EU Enlargement for the “Old” EU

The direct economic impact of EU enlargement on the current members will be limited.

Figure 26 shows that the accession countries represent only about 5% of the EU’s GDP. Even if the countries would develop high inflation rates or budget deficits after their accession, the direct effect on the EU’s inflation rates or the Euro’s exchange rate stability would not be strong. Lommatzsch and Tober (2002), for example, estimate that a 1.5% higher inflation rate in all accession countries than in the Euro Area would only add 0.08% percentage points to the Euro-wide inflation rate. The same is true for changes in trade flows, which have almost entirely been liberalized for imports into the EU during the accession process.²⁰ Unfortunately, of course, any positive impact of continuing strong growth in the CEECs on Europe’s GDP would be limited as well.

Figure 26: CEEC’s European Population and GDP Shares (2001)



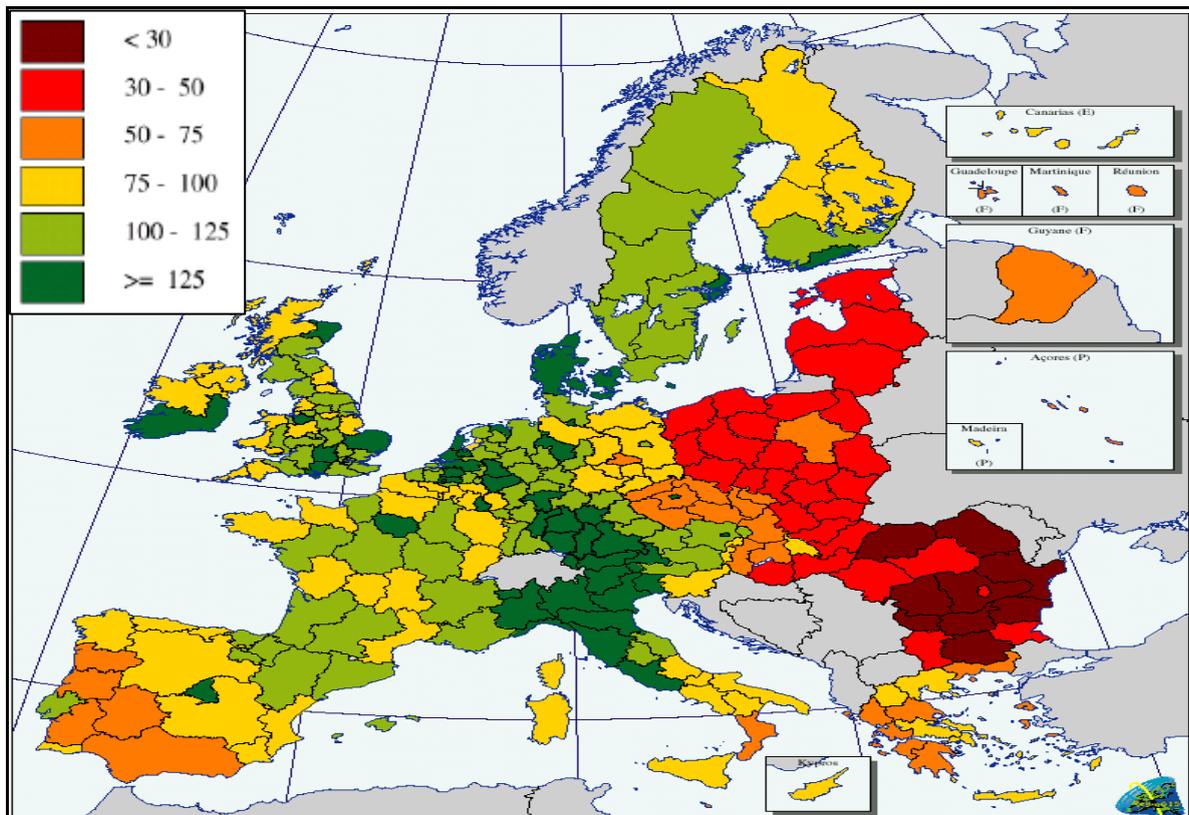
Source: © FRI 2002. Data from Eurostat (2001).

The more significant economic impact of the enlargement will therefore come from the increase in a relatively poor population (income per capita based on PPP in the CEECs is only 45% of the EU level). Among the problems from this growth in population, the possibly strong East-West migration has been discussed most anxiously, especially in the easternmost Western European countries. They fear a major wave of economic immigrants into their

²⁰ These last restrictions cover about 5% of current trade by value, mostly farm products. Furthermore, prices for many farm products in the CEECs have risen close to EU levels, and farm productivity remains low. Additionally, the region's big dairy industry will be held back by EU milk quotas, and the EU's strict health standards will limit meat exports.

communities beyond the impact of immigration they already experienced during the 90s. Between 1989 and 1998, gross flows of immigrants into Europe swelled from a very low level to the size of those into America (relative to population size).²¹ Due to this increase in immigration, Greece, for example, which has been one of the world's least immigrant-dense countries, has become nearly as immigrant-dense as the United States. Frankfurt in Germany, as another example, has now a foreign-born population of 34%, which rivals old immigration cities like New York (36%). (Economist 2003.10.31).

Figure 27: Europe's GDP per Capita Gaps (PPP; 1995-1999)



Remark: EU-27 Index = 100.

Source: Eurostat Inforegio (2002).

The EU therefore forcefully negotiated interim regulations against its own principles (and to the embarrassment of the CEECs) that restrict the freedom of movement of CEEC citizens for up to seven years on application. Germany, for example, is already entitled to restrict employment and immigration from the CEECs for two years after May 2004.

²¹ About 1 million people a year enter America legally, and some 500,000 illegally; about 1.2 million a year enter the EU legally, and perhaps 500,000 illegally.

But even without these safeguard measures the immigration problem appears to be greatly exaggerated. On the basis of estimations of the German Institute for Economic Research, the emigration from the CEECs to Germany, for example, would only reach 2 to 2.8 million after 20 years from today's 600,000 persons (see Brücker 2004). The impact of such low numbers would be rather limited, and since about half of these immigrants would be workers, the inflow would have an additional positive effect on Germany's social security systems. Although Europe will surely only reluctantly move into the direction of the U.S. as an immigration region, the development would positively contribute to the EU's growth rates, as it has done in the U.S., and, even more importantly, it would also have the potential to buffer the fast progress of ageing in the Western European countries.

So far, the migration experience of the EU in general seems to support the case for rather unproblematic migration flows in unions with countries of economic disparity but political stability and freedom. In Europe, at least, net labor migration usually ends long before wages equalize in emigration and immigration countries. Brücker (2000), in a study for the European Commission, estimates that initially 335,000 people from the new members might move west each year, but that after ten years the flow would drop below 150,000 as incomes converge and the most footloose would have gone. Martin (1991), in a study of migration patterns in southern Europe in the 1980s, even estimates that the turning point of "hump-shaped" emigration is reached when wages in neighboring countries start to fall to just under \$4,000 per head, which will be reached by most CEECs earlier than the earlier migration studies anticipated (see also Venturini 2004). It is therefore most likely that the EU's immigration problem will rather remain to be a politically sensible problem with the politically instable neighboring countries in Central Asia, the Middle East, and Northern Africa, than within the enlarged EU.

The more important changes to the future course of the EU therefore seem to be of a political nature at first: the EU needs to adapt its regulations and institutions to become fit for a much larger, and much less historically grown union:

1. One important issue is the currently discussed constitution for the EU. During its development, the EU's flexible approach to rules and constitutional changes became based on the collection of treaties and agreements in the *Aquis Communautaire*. This ad-hoc approach worked quite well and the *Aquis* even became a useful guide for the transformation and accession of the new members. But after growing to 25 member states, and advancing to an integration level where already about 50% of all new national laws

and regulations become initiated in Brussels, this approach does not seem to be sufficient anymore. Especially since the national constitutional courts have become entangled in a growing interdependence with the European Court, the earlier ad-hoc approach would surely gain from a clearer structure as a basis for future developments and clarity to outsiders (especially when EU policies will further extend into criminal and immigration law).²² A draft for a future constitution of the EU has therefore already been compiled, and a revised draft is under intense discussion. Unfortunately, however, this second draft still seems to be far from covering the common ground of what has been achieved or, more importantly, of what should be the agreed upon for the future shape of the union. But fortunately it is already also sure that the new constitutional treaty will not push the union into endless struggles by laying the foundations of a European (super) state. Necessary elements for such a task, like the ability to raise taxes, or commanding a (military) force will remain off limits.²³

2. Along the same lines, a single EU presidency would be an important issue to integrate the political powers of an increasingly diverse union, to better integrate the growing European bureaucracy, and to increase its accountability as well as to simplify complaints against its actions.²⁴ Current drafts, however, are in favor of splitting the European presidency into (at least) two parts. One president for the Commission, and another one for the nations, i.e., the Council of the EU.²⁵ By doing so, the problem of a rather inefficient triangle

²² The Acquis covers 80,000 pages in the English edition, and constitutes a constitutional development “*sui generis*,” although most of the regulations and agreements refer to the common agricultural policy of the EU.

²³ At first, the same is true for the planned Charter of Fundamental Rights which might include paragraphs of social rights, like the right to strike, the right to a job, or the right of workers to be informed and consulted. All these provisions will not easily become EU wide law because they will only apply to European law, not domestic law, as especially the UK insisted. European law is extending its scope gradually, however, and struggles on these important issues are sure to continue in an constitutional union.

²⁴ Already Henry Kissinger has complained: “Europe has no telephone number.” After May 1, 2004, the situation will get even more difficult. Each new member state will be represented by one commissioner with voting rights but no portfolio. In the new Commission of 25, after November 2004, the large members will waive having a second commissioner and the portfolios will be redefined for a college of 25.

²⁵ The votes of the Council of Ministers will be weighted during a transition period until November 2004 as at present. Then, the new weighting rules of the Treaty of Nice will come into force, with the votes per country ranging between 3 and 29. The qualified majority threshold will also be raised. A decision taken by qualified majority in the

between the European Commission, which is the driving force of the integration process but has only limited powers within the nation states, the European Council, which controls and decides about the integration process but is suspicious of being dominated by the bigger European states who try to enforce their own interests, and a weak European Parliament, which has not yet developed into an accepted forum for European policy, would become worse, not better.²⁶

3. A new governance structure for the European Central Bank is necessary. Based on the contract of Maastricht, the ECB has become a truly independent agency with clear-cut objectives. The ECB also is, however, governed by a rather large board of directors from all member states. The governors of the acceding countries' central banks will attend meetings of the General Council of the ECB as observers after May 2004. But they will not join the main decision-making body – the Governing Council – until they adopt the euro. To accomplish the integration of all central bank presidents from the new member states, the ECB ventured into a governance reform that anxiously tries to protect its independency by constructing a multi-layered decision making board that would not allow for dominating powers of single country board members while trying to convince the member states that they will retain sufficient democratic control over the future course of the ECB's development. Unfortunately, the resulting complicated rotation scheme might

EU-25 will then require 232 of a total of 321 votes (72.3%). Under this voting regimen smaller countries would have considerably more votes per capita than bigger ones. Spain and Poland, for example would be only one vote short of the much bigger Germany. It is therefore not very likely that these Nice weighting would last very long – even if attempts for a EU constitution with new regulations would be shelved.

- ²⁶ The underlying fears of an overly integrationist stance in such a diverse area of nation states, where already more than 50% of all legal and regulatory initiatives start in Brussels, certainly have a very sound foundation and should not be taken lightly. But the important, accepted, and difficult work of the European Commission to integrate and de- or re-regulate key markets, like the financial and capital markets, has not been finished in time and the current powers of the Commission do not seem to be sufficient to steer the negotiations efficiently. Furthermore, the increasing powers of the European council by establishing a second presidency for the representation of the nation states does not support a growing role for the directly elected European Parliament. It would most likely further undermine its future role by producing incentives for the (smaller) states, which might feel poorly represented in the European Council, to use the Parliament as a veto-machine for reforms that might be unpopular in their home-countries.

rather result in technical inefficiency or even structural paralysis than in securing the necessary decisiveness for the monetary steering of this major economy.²⁷

4. The current (Fiscal) Stability and Growth Pact needs to be set up in a more flexible way. As the case of Ireland has already demonstrated, the fast-growing (developing) economies are in need of the chance of temporarily higher budget deficits if they want to equilibrate their economies when nominal exchange rates are fixed and monetary policy becomes determined from the outside. The high and persistent budget deficits of the major economies of Germany and France, however, prevent such flexibility because any reform runs the risk of allowing fiscal discipline to deteriorate further.
5. The EU traditionally attached strong importance to the process of “harmonization” because the removal of differing technical standards, which might pose technical barriers to trade, is thought to be a core element for the functioning of the internal market. Already in the early 80s it became clear, however, that the prevailing detailed case-by-case approach to harmonization was too time consuming and inefficient. After 1985, the process of harmonization therefore became expedited with a “new approach” that focused only on “essential requirements” that would become EU directives for the Single Market.²⁸ But still, the procedure time for a EU Standard is 8 years (in 1999),²⁹ and

²⁷ The rotation system operates on a two-group (from 16 EMU countries) or three-group basis (from 22 countries). The six members of the Executive Board retain a full voting right in both cases. For the rotation of the voting rights of the national central bank governors in the Council, the EMU member states are divided into groups according to their shares in aggregate GDP of the euro area and the relative size of their financial systems, measured against the total aggregated balance sheet of the financial institutions in EMU. The weights are 5/6 for the economy and 1/6 for the financial system. The rotation system reflects the principle of “one member, one vote” and ensures that all national central bank governors can give the public in their home countries first-hand information on the ECB’s monetary policy. In the two-group model, the first group – consisting of the large countries – is assigned four voting rights and the other countries have a total of 11. The composition of the groups must be such that the governors in the first group are entitled to vote at least as often as those in the second group. But the fine adjustment of the groups depends on the exact number and size of the new EMU members Deutsche Bank Research (2004).

²⁸ Before 1985, technical harmonization was based on a case-by-case approach and contained very detailed specifications with type-approval procedures, which were difficult to implement. Under the “new approach,” community legislation became restricted to establishing the essential requirements that products must meet. These requirements fix thresholds or levels of protection for the whole of the Community in the area of health and safety.

therefore too long for an efficient integration of the enlarged market. The enlarged Union requires a more flexible approach along the lines of simple international “mutual recognition” procedures. “Mutual recognition” procedures (of product regulations), which have become the most important tool of technical harmonization worldwide, on the other hand, have already proven to be more flexible and efficient.³⁰ In Europe, for example, a “mutual recognition infringement” process averages only 15.5 months to completion.

It is unfortunately not likely that meaningful progress on these issues would change obstacles in the current structure of the EU anytime soon. The immediate shift of the political power balance of the EU after accession is therefore often feared to have a negative impact on the EU and its prospects for growth. Seen as a block, the CEECs would indeed outweigh the currently most powerful members in terms of voting rights. After years of painful structural reforms, and as main receivers of European aid and structural funds they might therefore be inclined to rather exploit the Union by focusing on increasing transfers than to support its structural reform agendas. Another fear, especially of the Western member states, is that a Central European “power block” will evolve because most of the new member countries culturally and politically gravitate mainly toward Austria and Germany. Such a shift would easily have the potential to wreck the entire European Union project in the longer run – especially in its political integration dimensions.

But both developments are not likely to happen because the CEECs are a much too diverse group (see section 3) to agree on common “CEEC” positions, or to become unified under the lead of a much stronger Germany. Quite the opposite is likely to happen in economic terms. The CEECs are already engaged in strong economic competition for foreign capital and

²⁹ The EU Commission reports that it takes between 24 and 75 months to draft a standard (EU Commission 1998: Technical Harmonization. <http://europa.eu.int/scadplus/leg/en/s06011.htm>).

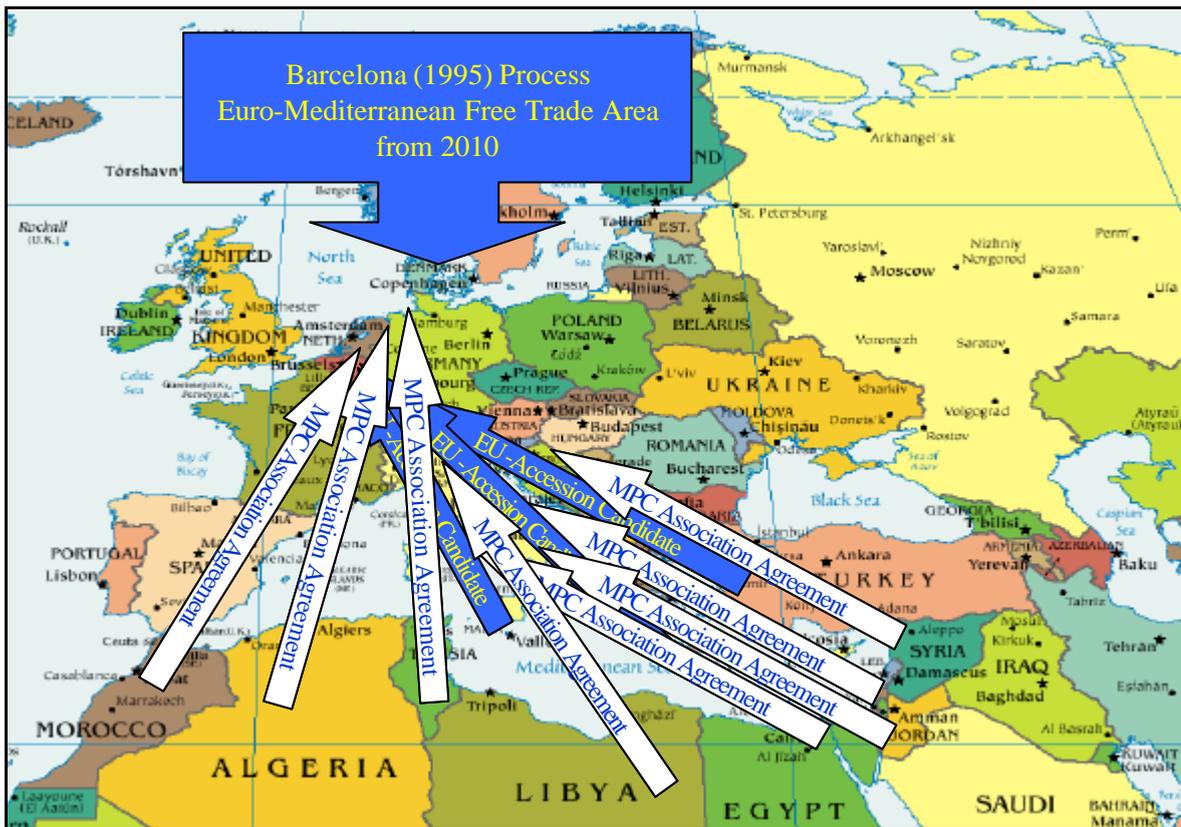
³⁰ Basically, the two procedures work in different directions. While “harmonization” is implemented top-down to set standards for the national conformity assessment bodies, “mutual recognition” works bottom-up by having the domestic bodies implement standards that might be acceptable to others. Both procedures rely on mutual trust on the reliability of national conformity assessment procedures in all participating countries. The EU Commission recognizes this in its “new trade barrier transparency procedure” of 1997 by stating: “in other words, in those areas which are not subject to EU-level harmonisation measures (...), mutual recognition must be the rule, and harmonisation must be exceptional.”

technologies (see section 5), and the old member states have already started to feel the increased pressure for economic reforms in their labor markets and tax regimes. Even politically, the accession effect is not likely to derail the union by causing the development of disruptive blocks. Poland, for example, as one of the “big” member states, has a very different economy from Germany in the West and the much smaller Baltic countries in the East. It will therefore rather try to develop its own “European Agenda,” which might focus on close links to Scandinavia, which has remained at the fringes of the EU before. Together with the Baltic group (Estonia, Latvia, and Lithuania), who will certainly pursue close relationships with the Scandinavian countries, this impact of enlargement would therefore rather strengthen the Union by integrating the Scandinavian countries more closely.

Instead of making the European project of economic integration less interesting for outsiders by adding to its problems, enlargement will rather increase its attractiveness by building more outside links. Each of the three Baltic countries, for example, has strong historical ties with Russia, especially through their extensive Russian minorities. Similarly, Poland will become an important trade link between the EU and Russia because of its close proximity. These new member states will therefore shift European outside relations and interests eastward into the direction of Russia. The same process works to the South. Slovenia, a Central European country with a small population of two million people, links Austria and Italy with the Balkans, especially the former Yugoslavia. Cyprus, and the second-wave accession countries Romania and Bulgaria, have very different cultural traditions from the “old” EU countries, but close links to Turkey as well as a religious proximity to Greece because of their Christian Orthodox traditions. The “new” EU will therefore encompass the entire Balkans, strengthen Greece’ role in the Southeast of the Union, and develop even closer links with Turkey and Russia (see ...).

It is therefore unlikely that the process of European enlargement of the “new” EU will stop at its currently projected borders. As Figure 28 shows, quite a few more countries, which are interested in close relations with the EU, will become direct neighboring countries. Turkey has already applied for accession to the EU, Belarus and the Ukraine are interested, and Russia is developing a strong interest in an extended FTA with the EU.

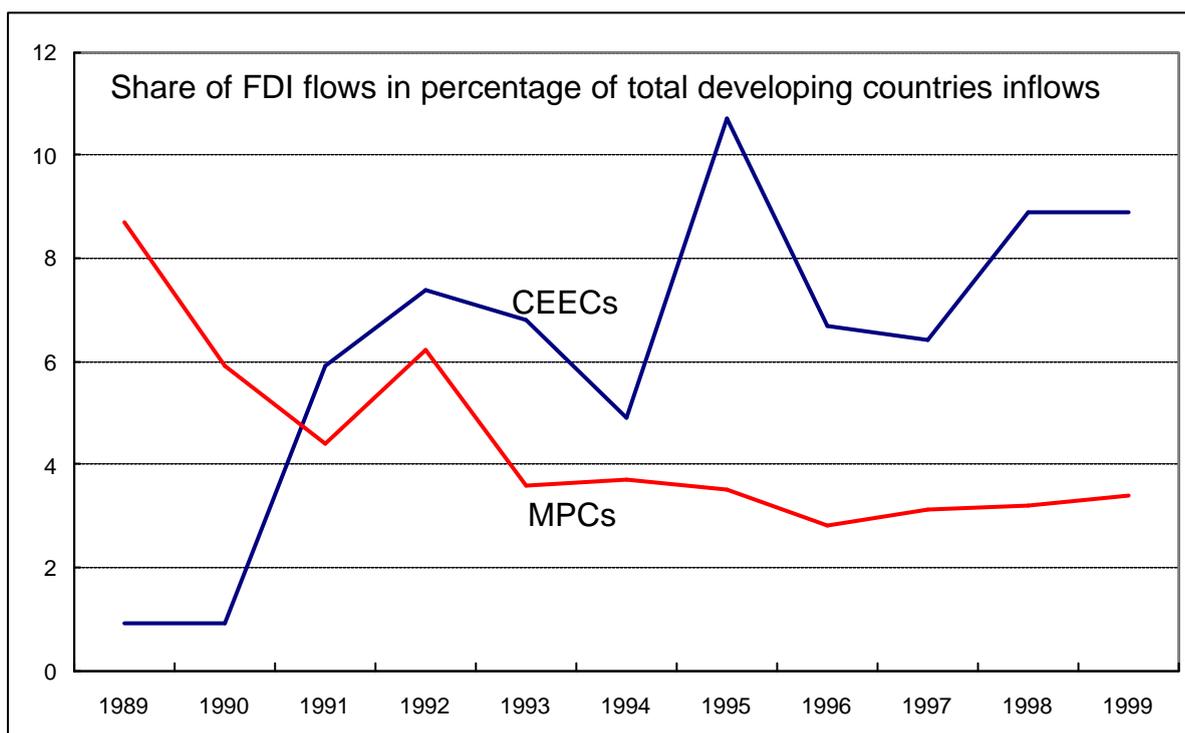
Figure 28: Europe's Southern Enlargement (2003)



Source: © FRI 2003. Map from CIA (2002).

The same attraction (see also Section 4) works on the neighboring countries to the South, the Mediterranean countries in North Africa. The Mediterranean partner countries (MPC; these countries basically are the North African countries plus Turkey) now feel a strong gravity from the EU not only because of its sheer market size and growing political influence, but also because enlargement has diverted FDI and trade flows towards the CEECs. As see Figure 29 shows, were the MED countries the clear losers in terms of FDI inflows during the booming 1990s. The economies of the CEECs, on the other hand, with their transformation and accession chances seemed to have soaked up most planned FDI's flows into developing European and Mediterranean countries that might otherwise have been dispersed more widely.

Figure 29: Share of FDI Inflows to CEECs and MPCs



Note: DB Research Indicator consists of 16 indicators in 5 groups with even weights.

Source: © FRI 2003. Data from Deutsche Bank Research (2002).

Clearly, the political and military instability in the Middle East had reduced any early hopes for a fast process of much closer association between many of the MED countries and the EU. It is also important to note, however, that the process of cooperation between the EU and the southern Mediterranean countries on the basis of Cooperation Agreements, which has been in existence since the 1970s, never completely broke down. From November 1995, the EU and 12 Mediterranean Foreign Ministers therefore (re)ignited a new phase of Mediterranean Association Agreements at a conference in Barcelona – the so-called “Barcelona Process.”³¹ Most of the MED countries have already signed the Association Agreements to become members of a European FTA (see Figure 30).

³¹ The original group of Mediterranean (MED) countries included Cyprus, Malta, and Turkey in addition to the table below. These countries gained a different status by becoming accession candidates.

Figure 30: Europe's Mediterranean Association Agreements (2003)

Country	Association Agreement
Algeria	Concluded 2001.
Egypt	Concluded 1999. Signed 2001
Israel	Ratified, 1995
Jordan	Signed, 1997. Under ratification
Lebanon	Concluded 2001.
PNA	Ratified, 1997
Morocco	Ratified, 1996
Syria	In negotiation
Tunisia	Ratified, 1995

The new phase of regional dialogue extended three broad pillars: political and security partnership; economic and financial partnership; and social, cultural and human partnership. To add some impact to such extensive bilateral agreements, the European Commission established the MEDA program and several other regional budget lines together with around 1 billion euro in new commitments each year as its second biggest external relations program. Among the different pillars, the economically most important ones are the support for free trade among the Mediterranean partners (“horizontal” or South-South integration), and the clear focus on the gradual implementation of bilateral free trade with the EU. The new generation of Euro-Mediterranean Association Agreements therefore aims at dismantling customs duties, making substantial reforms to the fiscal, economic and industrial sectors within the MED group, and supporting Association wide free trade in manufactured goods and progressive liberalization of trade in agricultural products. The agreed goal is the establishment of a Euro-Mediterranean Free-Trade Area by the year 2010. This free-trade area is supposed to link together the 25 EU Member States and the 9 Mediterranean Partners. Together with EFTA this zone would include some 40 States and 600-800 million consumers.

The most important consequence of enlargement for the “old” EU members is, however, that the union’s current phase of economic policy integration, or “ever closer union,” will likely end. This is because the club of 25 has now grown beyond the limits of an effective working of unanimous decision-making, the union’s main decision-making instrument.

For a major part of its history, especially during the 70s and 80s, EU policy focused on trade, agriculture, and the harmonization of common standards. Already during this rather successful time in technical terms, however, European citizens developed a rather frustrated general view of their Union. They considered it to be slow, loaded with economic costs, and steered by remote, wrongly focused (especially in the case of the Common Agricultural

Policy), and poorly controlled institutions. With the Treaty of Maastricht (1992) the EU therefore turned its approach to trade and market harmonization – but economic policy diversity – upside down. The Treaty enforced harmonization in economic policy (“Maastricht Criteria”), but allowed more competition and diversity in regulatory and market reform (“Subsidiarity Principle”). Since this approach to policy coordination has proven to be extremely successful in terms of economic (policy) stability and attractiveness to foreign partners, the future course of the EU seemed to have become identified with concepts of an “ever closer union” or even integrationist plans for full integration into some kind of federal European state. But after having become a club of 25, and soon to become a group of even more members, there is little chance of agreeing on such comparatively far-reaching integration goals anymore. As a consequence, the EU will have to refocus on the effective implementation of basic economic market reforms to secure its bureaucratic legitimacy and its role as a driving force among the governments of Europe.

This development is, on the other hand, certainly no step backward for the development of the union as a whole, especially because many of the earlier policy agreements are still awaiting their effective implementation. One of the most important ones, for example, the EMU’s growth and stability pact of fiscal restrictions is just about to fall apart through negligence by the large member states. It is also no step backward for the development of agreeable solutions to the problem of different EU “circles” or “clubs” around specific problems or policies. Already in the EU of 15, for example, some members have been members of the monetary union, others not. Some members joined the Schengen frontier-free zone, while others stayed out. Some members are part of NATO, others are neutral, and some members plan to put up a joint European force. In contrast, such a Europe of different speeds, cores and peripheries, or structured co-operation (in Euro speak) has proven to be a source of progress and integration solutions. And this situation will not change with the entrance of the new members who will surely add some more perspectives to the common market development.

In practical terms, it is most likely that the new member states will add to the liberal voices within the union – the CEECs’ despised history under socialist and soviet regimes and their strong urge to catch up with the old members led most of the countries to a fundamentally liberal policy stance. They will probably support movements for more competition vs. harmonization when deciding about economic issues - as could recently be seen when many CEECs deliberately, and beyond party lines, chose very restrictive tax regimes. They will probably also support long-term movements towards democratic reforms in favor of the

European Parliament, and against more centralist movements that support the power play of the large European countries in the European Council of Ministers or the European Commission. The current process of enlargement will therefore have positive consequences for major parts of the EU's reform agenda: structural reforms, freedom of movement, and economic competitiveness will likely increase, and not deteriorate as was often feared before the enlargement of the union.

7. Conclusion

The EU's enlargement will have a major impact on the future development of the union. Four developments of special interest to foreign investors have been discussed in this article: the transformation of the central and eastern accession countries to market economies, their chances in the enlarged union, the likely structural changes in the enlarged union, and the prospects for further enlargement.

A major part of the successful transformation of the CEECs is due to the fact that they have been much less "under-developed" than "wrong-developed" with a strong bias towards industry and heavy infrastructure, and weak or under-developed services from finance to communication and distribution. This did not only open up chances for foreign investors and fast turnaround successes through privatization in labor intensive industries, and especially the labor intensive automobile sector, it also produced high demand for advanced services. By quickly turning to FDI for industrial development and foreign capital in banking, the CEECs therefore did not only secure the trust of foreign investors, they also laid the cornerstone for the continuous inflow of FDI after the first wave of privatization was over. Unfortunately, this successful phase of high growth progressed with the strong support of investors from the EU and the U.S., but almost no involvement of otherwise active Japanese investors, who still focused on building up networks for their manufacturing exports to West Europe.

After accession, FDI flows are not expected to deteriorate strongly, but they will change depending on the countries' competitive market development and patterns of specialization. A strong wave of rationalization of investment patterns is likely to shift economic chances not only between the CEECs, but also between the CEECs and other developing regions in Southern Europe and the East. Especially the larger CEECs will soon start to feel the pressure on MNC subsidiaries that have to compete as part of the (Europe- or world-wide) MNC networks, which discriminate against inadequate quality and differing domestic market standards. The MNCs will also try to cut back the rather wide product lines that served the (earlier) closed markets. Clearly, the CEECs' corporations and MNC subsidiaries will therefore soon have to specialize, and to comply with the stricter safety, environmental and hygiene standards of the EU - as the companies in Western Europe have painfully done before. It is therefore a positive and important signal for the next phase of development after accession that FDI inflows into the CEECs are already changing from directly transformation related (i.e., telecommunication and banking) and "extended workbench" investments that

target low labor costs (such as automobile parts and textiles) to higher-grade automobile, chemical, pharmaceutical, and software production. Especially already existing regional production centers, as in the automobile industry, a sector in which about 60% of all foreign firms in the CEECs operate, seemed to have reached a critical mass that now attracts new investor groups that appreciate the added security and transparency of enforceable EU standards. Together with these countries high proportion of secondary and tertiary education graduates such regional centers in Hungary, the Czech Republic, Poland and Slovakia now have the chance to develop into clusters of production and technology through further investments from second and third tier suppliers.

The already existing Japanese manufacturing affiliates in Europe have proven to be excellent examples for this development. Since the overwhelming majority of them still operate in Western Europe only, they regard the advantages of enlargement higher than the disadvantages. For most of these corporations the enlargement presents a clean start into the new markets on the basis of secure EU-wide rules and regulations. The affiliates that already operate in the CEECs, on the other hand, also stress the disadvantages. Though half of the respondents to a survey said that enlargement has major advantages, more than 40% also saw major disadvantages in enlargement.

Furthermore, with full EU membership, the pressure for further transformation and convergence will not stop, which offers chances but also major difficulties for the CEECs. As part of the Single Market, they still have to solve the remaining problems that have become the subject for provisional exceptions from the Aquis' regulations (which had been negotiated in the Accession Agreements). Certainly, the final implementation of harmonized tax and tariff regulations will remain difficult and costly. Furthermore, the final phase of enlargement, between EU accession in May 2004 and entrance into the EMU, with the smaller CEECs aiming for the earliest possible date (2007) but the larger CEECS probably having to wait until 2010, will remain to be a difficult phase. Especially the larger CEECs will have to deal with the economic realities of financing further transformation costs within an increasingly restrictive ERM-2 regime when real foreign exchange rates start to appreciate and harm their competitiveness (Balassa-Samuelson effect).

Because of the differences in locational assets, economic structures and policies the post-accession phase will most likely further differentiate winners and losers on a regional basis. The larger CEECs need to focus on overcoming the burdens of (real) exchange rate appreciation and the challenges of EU-wide competition by developing their domestic

markets fast. This will prove to be a very difficult task for countries with wide regional differences as in the case of Poland, even if consistent economic policies are finally on track. The smaller countries, on the other hand, need to develop their specialization patterns fast enough to thrive as regional centers. In general, however, given the CEECs current progress in most of these areas, the countries are offering an excellent overall mix of relatively stable market frameworks, strong fundamentals with still low factor costs, and excellent long-term perspectives in a European Union that most likely has not yet seen its final step of enlargement to the east or to the south.

One important element for such optimism is that the run up to entering the Euro Zone provides strong political incentives and control mechanisms to get macroeconomic policies on track, as the history of the EMU after the Treaty of Maastricht has shown before. Additionally, this adjustment phase will also ensure the ongoing support of the “old” EU member states that face the political necessity of avoiding financial crises and economic failure within the network of member countries.

Stable economic development in the CEECs, which now make up 34% of the EU’s area and are home to 105 million of its citizens, will indeed become an important requirement for the successful development of the EU as a whole. This is not only because an impoverished South and East of the union (current income per capita based on PPP in the CEECs is only 45% of the EU level) might become a source of disrupting emigration flows. The non-convergent countries might also become inclined to block current decision-making procedures in the union that requires unanimity for most important regulations and treatise amendments, and they might try take the union’s other members as hostages for public bailouts of deteriorating finances and increasing transfers.

None of these problems are likely to get out of control in the enlarged union, however. The possibility of strong East-West migration has been anticipated most anxiously, especially in the easternmost Western European countries. But current research seems to agree that migration flows will remain unproblematic, as long as positive growth rates provide to the countries development and the political regimes remain stable – even if real convergence might be decades away. The same is true for the direct economic impact of EU enlargement on the current members. The accession countries represent only about 5% of the EU’s GDP. Even if the countries would develop high inflation rates or budget deficits for an extended period after their accession, the direct effect on the EU’s inflation rates or the Euro’s exchange rate stability would not be strong. Not even major burdens from structural fund

transfers are to be expected because the current transfers for transformation support will not easily be topped by future assistance, and transfers within the framework of the Common Agricultural Policy have been frozen at current levels.

The new member states are, on the contrary, even more likely to become driving forces for structural change and economic development in the EU. The CEECs' negative view of their history under socialist and soviet regimes and their strong urge to catch up with the old members led most of the countries to a fundamentally liberal policy stance. They will therefore probably support movements for more competition vs. harmonization when deciding about economic issues - as could recently be seen when many CEECs deliberately, and beyond party lines, chose very restricted tax regimes (even tax-dumping regimes from the viewpoint of many of the old member states). They will probably also support long-term movements towards democratic reforms in favor of the European Parliament, and against more centralist movements that support the power play of the large European countries in the European Council of Ministers or the European Commission. The current process of enlargement will therefore have positive consequences for major parts of the EU's reform agenda: structural reforms, freedom of movement, and economic competitiveness will likely increase – and not deteriorate as was often feared before the enlargement of the union.

The flipside of the coin is, however, that the union's current phase of economic policy integration, or "ever closer union," will likely slow. This is because the club of 25, which will soon become a group of even more members, has now grown beyond the limits of being able to effectively use a unanimous decision-making process, which will remain necessary for agreements of far-reaching integration goals like jurisdictional integration and a broadening of the EU Commission's tax base. As a consequence, the EU will have to refocus on the effective implementation of basic economic market reforms to secure its bureaucratic legitimacy and its role as a driving force among the governments of Europe.

The same mechanisms work against the EU's traditionally strong focus on a detailed case-by-case approach to "harmonization," which targeted the removal of differing technical standards that might pose technical barriers to trade, but already proved to be often inefficient by being too time consuming and inflexible. The enlarged Union will therefore require a more flexible approach along the lines of simple international "mutual recognition" procedures that allow for much wider "non-integrated" differences and margins for competing standards.

But this development is not necessarily a step backward for the development of the union as a whole, especially because many of the earlier policy agreements are still awaiting their

effective implementation. In contrast, such a Europe of different speeds, cores and peripheries, or structured co-operation (in Euro speak) has proven to be a source of progress and integration solutions in the unions past.

The importance of enlargement of the EU therefore goes far beyond the development of the CEECs. But instead of making the European project of economic integration less interesting for foreign investors by adding to its problems, enlargement will rather increase its attractiveness by building more outside links. Each of the three Baltic countries, for example, has strong historical ties with Russia, especially through their extensive Russian minorities. Similarly, Poland will become an important trade link between the EU and Russia because of its close proximity. These new member states will therefore shift European outside relations and interests eastward into the direction of Russia. The same process works to the South. Slovenia, a Central European country with a small population of two million people, links Austria and Italy with the Balkans, especially the former Yugoslavia. Cyprus, and the second-wave accession countries of Romania and Bulgaria, have very different cultural traditions from the “old” EU countries, but close links to Turkey as well as a religious proximity to Greece because of their Christian Orthodox traditions. The “new” EU will therefore encompass the entire Balkans, strengthen Greece’s role in the Southeast of the Union, and develop even closer links with Turkey and Russia.

It is therefore unlikely that the process of European enlargement of the “new” EU will stop at its currently projected borders because the same attraction works on the neighboring countries to the South, the Mediterranean countries in North Africa. The Mediterranean partner countries (MPC; these countries basically are the North African countries plus Turkey) now feel a strong gravitational pull from the EU not only because of its sheer market size and growing political influence, but also because enlargement has diverted FDI and trade flows towards the CEECs. This, however, further adds to the likeliness that a future, much bigger EU would become a Union that resembles more a well-regulated common market, with a common currency for some members, than a truly integrated economic and currency union (“Euroland”) or politically unified “United States of Europe.”

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