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EASTWARD ENLARGEMENT OF THE EUROPEAN UNION: CAN FAILURE BE AVOIDED?

The start of membership negotiations with five new East European countries is a political gesture made by the European Union. But a number of the countries concerned have not completed their transition to a market economy successfully, or are incapable of respecting the rules of the Single Market. How is it possible to avoid negotiations running into the ground, or, alternatively, to avoid accession occurring before these problems have been solved? European financial aid alone is not enough to help support the renewal of transition. The Union will have to participate in reinforcing the competencies and credibility of national institutions, whose weakness slowed-down or even blocked reform in the 1990s.

In December 1999 in Helsinki, the European Union changed tack in its enlargement strategy, by opening accession negotiations with five, new East European countries: Bulgaria, Latvia, Lithuania, Romania, and Slovakia, to which Cyprus may be added. The future members follow on from the six candidates with whom discussions began in the spring of 1998: Estonia, Hungry, Poland, the Czech Republic, Slovenia and Malta. This switch in strategy has not come in the wake of a sharp reappraisal of the growth outlook for these countries. Nor does it follow from the realisation that integrating these small economies all together will not be very expensive (Table 1). This turnaround is essentially due to political factors. Following the financial crisis in Russia and the Ukraine, in 1988, the Union –strongly encouraged by the US– decided to "anchor" these countries more solidly. Anything was seen as being preferable to the slow, downward drift of Europe's border regions.

As a result, the process of enlargement has taken on a new form. The first wave of 1998 brought together the most dynamic economies, which have experienced sustained growth, sometimes for quite a some time[1]. For them, the opening up of membership negotiations sanctions the success of the transition. In contrast, for countries in the second wave, especially Romania and Bulgaria, it sanctions the failure of reforms over the last ten years. This fundamental difference will have important consequences for the membership process. It will oblige the European Union to take on new responsibilities.

Table 1 - East European and EU countries, economic size and income levels (1999)

	1st Wave	2nd Wave	Ireland	Netherlands	UE
Population (in millions)	61	42	4	16	374
GDP (1998, in USD bn)	257	86	81	378	8 332
GDP per capita (in USD)*	7 210	3 656	20 701	19 810	18 089
Exports of goods and services (in USD bn)	119	36	72	223	2 708

* At constant prices and purchasing power parities, 1990.
Sources: CHELEM-CEPII and IMF.

Avoiding Economic Divergence

In some cases, the divergence in growth is extreme. Of the bigger countries in the region, Hungary and Poland have experienced a 21% and 45% increase in GDP since 1992. By comparison, growth has stagnated in Bulgaria and Romania[2]. The same contrasts emerge for other variables, including investment rates, foreign direct investment, average inflation rates, or bank credit in the private sector (Table 2). In the two East European countries, the second downturn in activity in the mid-

1. See: "Pologne : la transition achéveée ?", *La Lettre du Cepii*, March 1994.
2. The three other candidates have less pressing problems. Not included in this analysis are Malta, Cyprus and Turkey, which each face a series of specific factors.

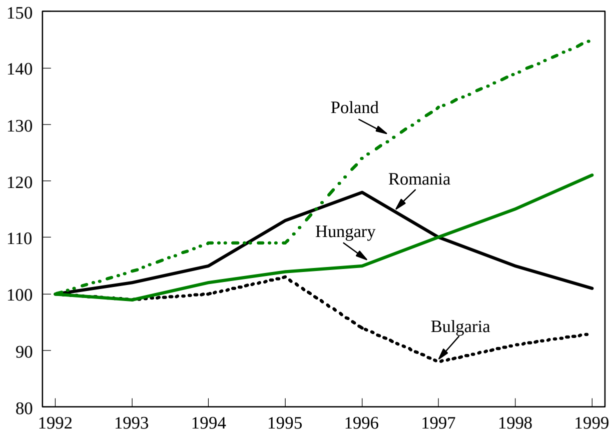
Table 2 - Economic and Social Indicators

	Hungary	Poland	Bulgaria	Romania
Rate of investment (1998)	31.0	26.4	14.7	17.7
Foreign Direct Investment (cumulative total 1995-1999, in USD bn)	10.9	18.5	2.0	4.7
Inflation (average 1995-1999, in %)	18.7	16.3	260.0	66.0
Stock market capitalisation (1998, in USD bn)	14.0	20.0	1.0	1.0
Bank loans to private sector (1999, % of GDP)	22.8	20.6	14.2	12.8
Population below the poverty threshold (1999, in %)	2.0	13.0	33.0	22.0
Internet subscribers (1999, per 10000 of population)	83.0	36.0	9.0	9.0

Sources : ERBD, World Bank, UNDP.

1990s bears out fundamental microeconomic and institutional weaknesses of growth (Graph). This has led to highly precarious macro-financial equilibria, due in particular to ineffective banking systems, which are undercapitalised and greatly lack public confidence. Hence, the violent inflationary crisis in Bulgaria in 1996-97 was directly caused by the collapse of the banking system, which had for many years supported the weight of state enterprises that refused to restructure. Since

Graph - GDP trends: 1992 = 100



Sources : EBRD.

then, the currency board regime has ensured a minimum degree of macroeconomic stability, especially with respect to prices and government budgets. But, it has not lead to a dynamic microeconomic adjustment process, nor to a pick up in banking intermediation. Both countries also face major challenges relating to the protection of property rights and credit, bankruptcy laws, entry by new producers, and financial market transparency. Significant progress must be made in these areas if stable growth is to follow[3].

There is no doubt that membership of the European Union in two successive waves will reinforce this divergence among the countries of Eastern Europe. EU budget resources, market integration, foreign direct investment, the development of services will all likely favour the best-placed economies and further crowd out those already stuck in an uncompleted transition[4]. The Helsinki decision seeks to reorient this dangerous divergence. Thus, since last March, twelve sets of negotiations have been going on in parallel, based on the "regatta" principle, which was adopted in 1998 in preference to the "convoy" principle. This means that countries can now move forward at their own speed, negotiating, chapter by chapter, the integration of 80 000 pages of ***acquis communautaire*** into national law. The fastest countries are thus no longer held up by the slower members as in a “convoy” stratery[5]. The risk with this approach lies in weakening the principles on which the strategy for openness has been based so far.

The Uncertainties Surrounding the New Strategy

Before December 1999, the principle of gradual enlargement corresponded clearly to the "Copenhagen criteria", set out in 1993: upon entering the EU, the candidates had to demonstrate that they had adopted democratic rules and also had functioning market economies. This was not very explicit, but at least there was a principle of conditionality. In fact, the Commission had only entered preliminary discussions with those countries that could already show some capacity for respecting the economic criteria of Copenhagen. The economic dynamism of the countries in the first wave, their evident capacity to reform, the consensus among the political and economic elites to push for greater openness to Europe have all been factors providing such assurance[6]. As for the political criteria (relating to democracy and human rights), they led to the exclusion of Slovakia from the negotiations. In December 1999, the European Union abandoned this prudent approach, opening up negotiations to countries

3. See in particular, S. Johnson, J. McMillan & C. Woodruff, "Property Rights, Finance and Entrepreneurship", Stockholm Institute for Transition Economics, Working Paper No 152, June 1999 (http://www.hhs.se/site/Publications/workingpapers.htm).

4. J. Sgard, "L'élargissement de l'Union européenne et la divergence entre les économies en transition", *Revue Française d'Economie*, n°2, 1997, E. Berglöf & G. Roland, "The EU as and 'Outside Anchor' for Transition Reform", SITE, Working Paper 132, June 1999.

5. As a whole, the *acquis* is negotiated within a framework including 31 chapters, covering the main areas of common policy. At the end of June 2000, the Czech Republic was in the lead, with agreement having been reached on 13 chapters. It was followed by Slovenia, Hungary and Poland. However, the most contentious issues have not been broached yet, for example, the free movement of people and capital.

6. Since 1998, the Commission has published annual reports on progress made towards membership. The last summary report stresses that the countries of the former "first wave" are ready to satisfy the economic criteria of Copenhagen (European Commission, *Regular Report from the Commission on Progress towards Accession by each of the candidate countries*, Brussels, October 1999, page 20-21 http://europa.eu.int/comm/enlargement/report_10_99/intro/index.htm).

BOX - THE EU 15 AND EASTWARD ENLARGEMENT

1989 - The PHARE programme is set up to provide economic and political cooperation with Hungary and Poland. It was extended to the rest of the region (excluding the CIS) between 1991 and 1996.

1990 - The European Union extends the System of Generalised Preferences to Poland and Hungary: the goal is free-trade and the principle of EU membership, ultimately. Similar accords are signed with the Czech Republic, Slovakia, Romania, and Bulgaria (CHECK) (1993), and subsequently with the Baltic Republics (1995) and Slovenia (1996).

1993 - The Copenhagen Summit establishes a twofold conditionality for EU membership, based on democracy and the market economy.

1994 - Hungary (March) and Poland (April) apply officially for EU membership: the other countries follow in 1995 and 1996.

1997 - Adoption of the Agenda 2000, which details the institutional and financial framework of enlargement: the principle of enlargement in two waves (December, Luxembourg summit); and the definition of the "reinforced strategy for pre-accession".

1998 - The start of negotiations with the "first wave" countries (March); adoption of the "regatta" principle.

1999 - The decision to open membership negotiations with the six other candidates (Helsinki Council, December).

2000 - The start of negotiations with the "second wave" countries (March).

which are far from having implemented a working market economy and whose capacity for re-launching reform is to be doubted.

The immediate consequences have been to render the negotiations formalist, almost industrialised in scale, with progress arising only from the capacity of countries to transcribe the ***acquis*** into national law. The countries of the former first wave should be able to start entering the Union as of 2003, once the conclusions of the Inter-Governmental Conference to reform the institutions and decision-making process of the Union have been ratified by the present EU members. All these countries should be members by 2005. In contrast, the prospects for the former second wave are far less clear. There is a first danger that negotiations may stretch out indefinitely: how Bulgarian agricultural products are to be marketed, for example, could still be subject to negotiation through to 2015. The Helsinki decision would then merely amount to a political gesture. In this case, the efforts made to start the negotiations and begin internal adjustment would not be rewarded by membership within a reasonable period of time. Conversely, it is possible that, in the name of political will, some European summit would sweep aside the reservations put forward by the technicians and lawyers: the economic Copenhagen criteria may be dropped, as issues that would have been settled prior to accession are postponed until after formal accession, even if this means more, extended adjustment schedules and other derogations. Spain and Portugal benefited from such clauses, but if they become too extensive they would strip membership of its content. These considerations have one major consequence. If Helsinki does in fact constitute a real commitment to the countries in the former second wave, especially those which are currenlty failing, then the Union must set itself two objectives. First, it must ensure that the negotiations on the ***acquis*** are completed within credible period of time. Second, the Union has to take part with the candidate countries in defining a strategy for re-launching reform, so that the latter will ultimately be able to establish a dynamic and competitive economy. This is the implicit responsibility which was taken on in December 1999, and which is often forgotten in the discussions relating almost exclusively to the ***acquis***.

Strengthening Key Instiutions

That said, past experience suggests success is not just dependent on reciprocal good will and significant funding. A few percentage points of Communuty GDP, more or less, will not change very much. The political economy of international aid has demonstrated that substantial credits are scarcely effective if strong institutions are lacking or if there is little convergence between legitimatised internal reforms and the expectations of foreign partners[7]. Two examples stand out. The IMF's experience in Russia shows that the billions of dollars which have been disbursed have been largely "instrumentalised" for domestic political ends, by the group of privileged partners who negotiated these programmes. The Greek experience of integration into the Union, when compared to Portugal or Ireland, is another, minor example of the same lesson: massive budgetary transfers only began to have a tangible impact on Greece's economic structures and living standards once they were relayed by domestic changes to economic policy and to public governance.

A founding principle of the Union should at least help guide action. Since 1958, Union membership has been a long term commitment that deeply modifies the internal rules of each Member State, both economically and institutionally. In other words, membership is a political contract and not a multilateral contract, associated with straight-forward conditionality as used by the IMF. This makes the negotiations crucial, but also provides the Union with a strong means of influence. The Union

7. See especially, A. Alesina, "The Political Economy of High and Low Growth," Annual World Bank Conference on *Development Economics 1997*, Washington, World Bank, 1998 and D. Dollar & J. Svenson, *What Explains the Success of Failure or Structural Adjustment Programs?*, World Bank, mimeo, April 1998.

must use these means now in the weakest countries to intervene where reforming governments and international economic organisations have had limited impact since 1990. A priority area of intervention should thus be clearly set out: apart from the vote on and application of the ***acquis***, it is vital to strengthen the competencies and the credibility of strategic institutions which are responsible for reform and the correct implementation of the rules of the Single Market. These institutions relate especially to tax, finance and customs administrations, the control of competition, banking supervision, and commercial law. To be sure, over the last ten years, international aid has had results in these areas which at not negligible, in terms of professional training, the transfer of know-how and technical modernisation. Overall, however, this is insufficient: aid, as defined conventionally, can provide ***resources*** but it cannot easily alter the ***behaviour*** of public and private agents.

For membership and the re-launch of reforms to succeed, the Union must formulate a stronger cooperation strategy, based on the political legitimacy held out by the prospects of enlargement. One possibility would be to establish, in cooperation with the least advanced candidates, some form of ***technical*** supervision by the EU of key institutions. This would be provisional, and occur prior to membership, its objective being not just to provide resources but also to ensure the credibility needed to guarantee that such institutions function correctly. The latter should have the capacity to structure rules of the game domestically which are reasonably stable, equitable and which foster hard financial constraints. Such an arrangement would not involve imposing any transfer of sovereignty, as was the case in the 19th century when French or English investors had direct representatives in the tax administrations of Greece, Bulgaria and Romania. It would mean instead ensuring that Customs Offices or national Treasuries carry out their public service duties, but without the European partners substituting themselves for national legislators. The latter will continue to have the task, among others, of deciding how nationally-collected tax resources are to be used. The goal would be to strengthen the infrastructure of the market economy, without which the market risks degenerating into the law of the jungle, which in turn would undermine the sphere of public action. On the basis of such a ***joint*** strategy, it could thus be possible to integrate full sovereign member states into the Union, and not merely weak governments attracted by windfall benefits. Failing this, the second enlargement and the second transition risk foundering together, as countries may become marginalised on the periphery of the Union or stagnate within the EU. All of Europe would then lose out.

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