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**Economic Transition in Central and East Europe,
and the Former Soviet Union:
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INTEGRATION OF THE CENTRAL AND EAST EUROPEAN COUNTRIES INTO THE EUROPEAN UNION: IMPLICATIONS FOR THE CEECs

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I. INTRODUCTION

The integration of the Central and East European countries (CEECs) into the European Union poses challenges that, in many ways, are far greater than those posed by the earlier expansions of the European Community. The gap between the income levels of the current members of the EU and the CEECs is greater than that with Spain and Portugal at the time of their accession, for example, while the agricultural sectors of the CEECs will be far more problematic for European agricultural policy than was the case with earlier expansions. In addition, the economic policy reach of the EU is greater than the EC, with consequences for the legal and regulatory environment of prospective new members. For these reasons, the process of accession will force (and in important areas already has forced) substantial change within the CEEC economies. If managed properly, these changes offer important opportunities for the region.

The actual probability and timing of membership for individual candidates depends on the relatively complicated pseudo-calculus of the costs and benefits of eastern enlargement, as understood by the powers-that-be in Brussels. Of course, part (but only part) of this calculus involves the economic consequences for the EU. Other elements include the economic consequences for the East, the political consequences for Europe's emerging post-Cold War policy architecture, the economic consequences for individual sectors (like agriculture and textiles), and the interaction of economic and political consequences outside the EU for labor markets (through migration from the East) and investor confidence (through heightened or reduced political uncertainties). As Baldwin et al (1997) have argued from behind a raft of econometric estimates of budget costs and computable general equilibrium estimates of macroeconomic effects, the direct economic consequences of Eastern enlargement for the current 15 EU Members are likely to be rather slight, at most. Of course, reaching such a conclusion does not require the complexities of a computable general equilibrium model. The CEEC economies amount, together, to roughly 5 percent of the size of the EU, measured in terms of GDP. Hence, even if the EU were to make massive net transfers to the CEECs (say on the order of 10% of annual CEEC GDP), this would still amount to below one half of one cent of GDP.¹ Actual experience suggests that net costs will be much less than this. For the EU, the dominant terms in the decision calculus, therefore, will be political rather than economic.

* This paper draws on joint research on EU eastern expansion, in particular Baldwin, Francois, and Portes (1997), and Francois and Baldwin (1996). All remaining errors are the fault of the author.

¹ Recent experience, including Ireland and Portugal, suggests that for institutional reasons, 5 % of GDP is the effective upper bound for absorption of income transfers from the EU.

While the invitation list and schedule from Brussels to the Eastern enlargement party will depend in large part on political considerations, economic analysis still has an important role left to play. This involves the assessment of the mechanics of EU enlargement. This is true for 2 reasons. The first is that, while enlargement may not loom large in the macroeconomy of Western Europe, it does loom large for individual sectors. In agriculture, for example, the potential scale of CEEC agricultural production (especially under the current regime) renders current agricultural policy in the EU unsustainable. The second reason relates to the CEEC economies themselves. They may be small relative to the economic weight of the EU15. By the same measure, however, membership promises strong pressures to restructure the pattern of production within the CEEC economies.

This paper is concerned with the economics underlying the integration of the CEECs into the EU. As a starting point, emphasis is placed on the economic and policy environment in which such a process is likely to take place. In part, this relates to differences in production and protection structures. These differences point strongly to the issue of timing and the harmonisation of border measures as crucial factors in the adjustment costs to be borne by the CEEC economies. At the same time, the role of the EU as a policy reform anchor is also emphasised. Like the earlier Iberian expansion, the Eastern expansion offers a chance to further anchor market-based economic reforms during a time of political and economic transition, with ramifications for the overall investment climate in the region. The relative importance of market integration (through preferential trade liberalization) and investment effects are examined with reference to applied general equilibrium modeling of the integration process.

II. TRADE

Trade flows

The EU15 sells about \$40 billion to the CEECs and buys slightly less from them. This trade covers a broad range of goods and consists mainly of two-way trade in similar products, as Figure 1 shows. With the exceptions of clothing and light manufactures (where the CEECs are net exporters) and heavy machinery (where the EU is a net exporter) the EU-CEEC trade is approximately balanced product by product. The relative importance of such intra-industry trade has ramifications for the political economy of trade liberalisation. With this sort of trade structure, reciprocal liberalisation can force sectors to expand in both regions due to improved exploitation of scale economies. At the same time, the relatively unbalanced nature of trade in capital goods points to the potential for significant enlargement-related restructuring in the CEECs that is heavily biased against capital goods.

EU15-CEEC7 exports, 1995 (millions of \$US)

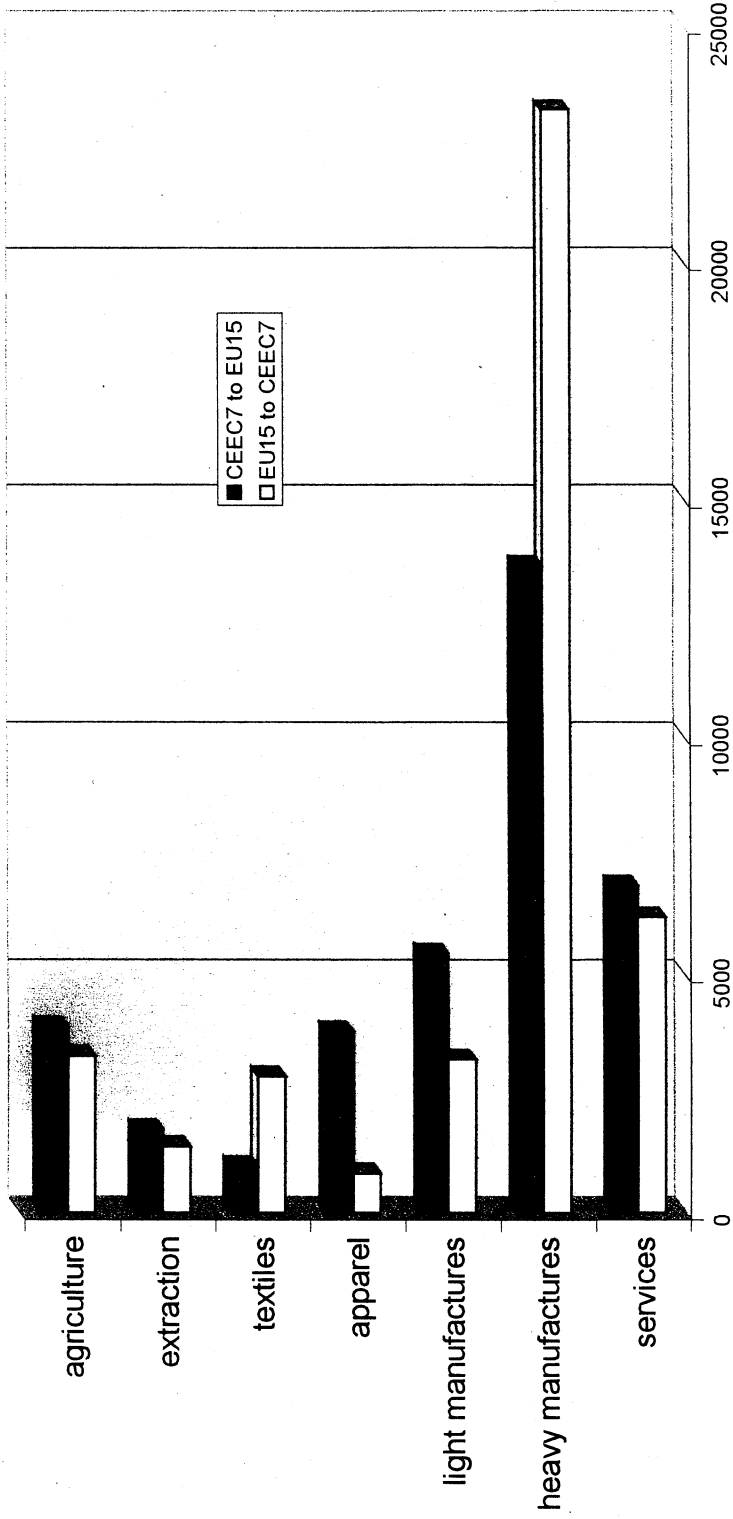
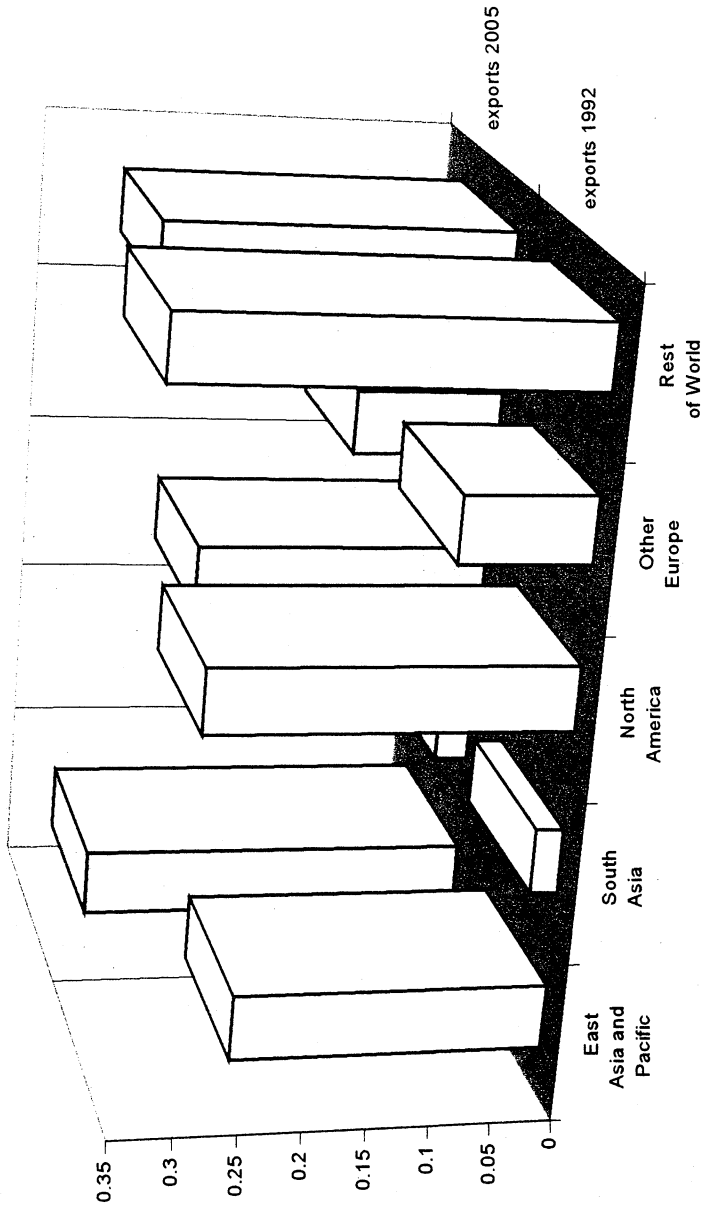


Figure 1

The EU15's trade with the CEECs is distributed in a very disproportionate manner, with Germany alone accounting for 42% of EU15 exports to the CEECs. No other member state accounts for more than 10% of the EU15 total. Austria, Belgium, Finland, Britain, Italy, the Netherlands and France each account for 5% or more of the total. On the other extreme, the exports of Portugal and Ireland to the CEECs account for less than 2% of the EU total. On a sectoral basis, the most important sector is machinery and equipment, in terms of impact on overall EU trade. Even here, however, the current EU export performance in the sector is a direct result of CEEC protection (see below), and hence will not be sustainable after CEEC membership. The last salient point concerns the disparity between the importance of the EU market for CEEC exports and the importance of the CEEC markets for EU exporters.

EU exports (shares), extra-trade



source: Anderson & Francois 1997

Figure 2

CEA exports - - billions of dollars

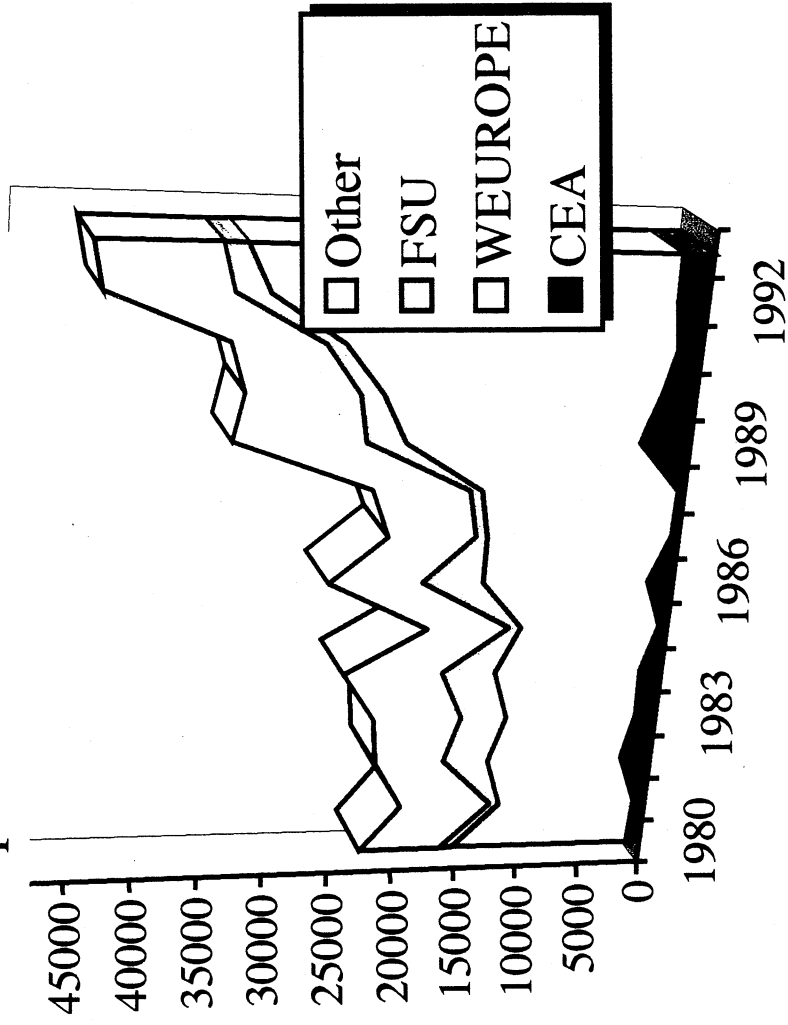


Figure 3

Comparing Figures 2 and 3, we see that the EU market is critical to CEEC exports, amounting to 50-60% of all exports (approximately the importance of the EU market for EU nations themselves). However, the CEEC market is fairly unimportant to the EU exporters. While the welfare gains from trade generally stem from imports rather than exports, national trade policies are typically influenced by mercantilist concerns. It is therefore useful to note that the average EU figure hides a good deal of dispersion. For Germany, Austria, Greece and Finland the figure is at least double average (4% for manufactures, closer to 8% with services), but for Portugal, Ireland, Spain and the UK, the CEEC markets are only half as important as the EU average.

II. PATTERNS OF PROTECTION

Due to the Europe Agreements, the EU has phased out all statutory tariffs on CEEC industrial goods, and the CEECs are in the process of phasing out the same on imports from the EU (Faini and Portes 1995). However, it is important to remember that duty-free treatment of industrial goods is not really preferential treatment in a European context since about 80% of EU imports are accorded such status. In other words, zero statutory tariffs merely level the playing field for Europe's major suppliers. Moreover, zero statutory tariffs do not mean free trade. EU-imposed antidumping duties and price-fixing arrangements meant to avoid such duties greatly restrict CEEC exports in those areas in which they could expand sales most rapidly. The EU has used various measures, including antidumping duties (see Table 1), to limit CEEC exports of iron and steel. The European cement cartel has also succeeded in using the same laws to block potential competition from the East. (Again, see Table 1). The EU also continues to impose quotas on other so-called sensitive industrial goods such as textiles, clothing and footwear. At the same time, restrictions on CEEC exports of non-industrial goods - especially agricultural goods - have been liberalized only slightly by the EU.

Table 1
Products subject to EU anti-dumping actions as of
December 1995

Country	Product
Czech & Slovak CU	Artificial corundum Cement (Portland) Iron or steel sections Pig-iron (hematite)
Hungary	Artificial corundum Iron or steel sections Seamless steel tubes
Poland	Artificial corundum Cement (Portland) Ferro-silicon Pig-iron (hematite) Seamless steel tubes Silicon carbide Urea ammonium nitrate Wooden pallets Zinc (unalloyed, unwrought)
Romania	Cement (Portland) Synthetic textile fibres of polyester Welded tubes of iron or steel
Slovenia	Sheets and plates of iron or steel

note: includes final duties and price undertakings, preliminary actions, and products under investigation.

source: official journals

Table 2
Post-Uruguay Round applied tariff rates, mfn

	European Union	CEECs	Czech & Slovak CU	Hungary	Poland	Romania
agriculture excluding fish and fish	15.7	1.1	-0.3	-1.5	1.3	4.2
petroleum	0.4	1.8	0.5	0	2.9	3
wood and wood	0.3	4.3	4.8	3.3	5.3	8.4
textiles and leather and	8.7	9.5	6.6	8.5	10.4	22.9
metals	4.9	7.1	3.4	6.5	8	20.8
chemicals	1	4.1	1.9	3.9	5.2	7.2
transport	3.8	6.3	4.1	4.2	7.3	15.8
nonelectrical	5.5	13.6	6.9	16.1	10.7	28.3
electrical machinery	1.4	6	3.3	7.5	6.4	15.4
mineral products	5.4	9.7	5.4	8.8	9.5	25.1
other	0.5	2.4	1.8	2.5	2.2	2.9
All industrial	2.9	6.4	3.7	6.7	6.9	11.4
All merchandise	2.8	6.7	3.8	6.8	6.9	11.7

source: World Bank, Finger et al,

Table 2 presents the MFN applied tariff rates for the EU and the CEECs for a range of products. There are three main points to be highlighted. First, the CEECs are on average more protectionist than the EU, although both are quite open when compared to developing countries in Asia, Africa and Latin America. Based on MFN rates, the CEECs' average applied tariff is 6.5% while the EU's is 3%. Second, the CEECs' average of 6.5% consists of somewhat higher-than-EU rates on industrial goods but much lower-than-EU rates on agricultural goods. As a result, the enlargement is likely to lead to an important increase in CEEC agricultural protection against third-country suppliers. The same sort of pattern emerged with the Iberian accession, and in that instance third-countries, notably the US, demanded compensation for the hikes in farm protection. The last point is that the gap between the CEEC and EU rates varies widely among industrial goods. For instance, the gap is more than 10% in transport equipment but less than 2% in textiles and clothing.

This asymmetry of protection rates has important implications for the welfare effects of enlargement. Since the EU is the major trading partner for the CEECs, (See Figure 3), and since this relationship will involve free trade, the ongoing process of joining the EU implies a great deal of tariff cutting in the CEECs, but very little tariff cutting in the EU (especially since imports from the CEECs amount to only 4% of EU15 imports). On the export side, the one sector where the CEECs account for a disproportionate share of EU exports is transport equipment. This is a direct result of CEEC protection in this sector against third markets, and is unlikely to be sustainable after full membership.

With most gains for the smaller partner through own-liberalisation (controlling for possible trade diversion), the initial levels of protection suggest that enlargement will lead to much greater income gains in the CEECs than in the EU. At the same time, like the pattern of trade, the pattern of protection also suggests that negative restructuring in the CEECs will most likely be concentrated in heavy industry. This last point follows, again, from the asymmetry of tariff rates across the EU and CEEC

economies. Given the relative size of the EU15 and CEECS, any tariff harmonisation will be at EU rates. Because EU protection is lower in heavy industry, and CEEC protection is much higher, this implies a second round of structural adjustment following harmonisation.

III. INVESTMENT

At the moment, Central and Eastern Europe constitute a relatively risky investment climate. The uncertainty stems from microeconomic sources and macroeconomic sources. Since the transitions began, the micro sources have included, *inter alia*, bank failures, privatization, bankruptcies, unpredictable changes in subsidy, trade and indirect tax policies, sudden changes in the legal system, and industrial standards and regulation, and changes in administrative procedures. Nervousness of investors has been further exacerbated by the East Asian and Russian crises. Yet, at least in those CEECs that seem likely to join the EU soon, the prospect of membership has already greatly reduced this riskiness in one very direct way. EU membership gives investors some idea of the direction in which economic policy is heading. Such is not the case for those economies with more distant prospects of joining the EU.

The macro sources of uncertainty include unanticipated changes in inflation rates, interest rates and exchange rates. In many of the CEECs these macro sources of instability are linked to the micro sources. One classic link is that attempts to subsidise sunset industries on a large scale basis lead to large fiscal deficits that are covered by printing money. Also, a large measure of the inflation in these countries stems from initial price shocks that occurred when prices were liberalized and currencies deeply devalued. Finally, given the continued risk of yet more political instability in Russia and the lack of full security guarantees, there remains some small uncertainty about territorial integrity in the region.

Also underlying investor nervousness about current reform is the importance of political economy constraints in the economic reform process. As Williamson (1990) has emphasized, not all stable policy regimes are characterized by good practice. In fact, through most of history, and across most of the world, regimes conducive to stagnation and decline have been remarkably tenacious and even robust. Not surprisingly, given the demonstrated difficulties inherent in pursuing good long-run policies both through painful short- and medium-run adjustments, and through sustained pressures of rent seeking (and rent preservation), an important theme to emerge in some of the recent development literature is the potentially positive role, at least in the economic arena, that can be played by institutional mechanisms that anchor such policies. (Francois, 1997).

Joining the EU should make the CEECs substantially less risky from the point of view of domestic and foreign investors. On the micro side, EU membership greatly constrains arbitrary trade and indirect tax policy changes. It also locks in well-defined property rights and codifies competition policy and state-aids policy. By securing convertibility, open capital markets and rights of establishment, membership assures investors (especially West European investors) that they can put in and take out money. Finally, EU membership guarantees that CEEC-produced products have unparalleled access to the EU15 markets (which account for almost 30% of world income). On the macro side, membership puts the CEECs

on a path toward a more secure relationship with the monetary union, thus providing a solid hedge against inflation spurts. These two aspects of membership are likely to have a related impact on investor confidence and are likely to be mutually reinforcing.

The economics of investment effects

What are the likely investment effects of such a fall in country risk? These relate to dynamic mechanisms, and have been examined in the context of simulation analysis by Kehoe (1994) and Romero (1994) for Mexico and Baldwin et al (1997) for the CEECs. They are illustrated conceptually in Figure 4, where the curve MPK_0 represents the marginal product of capital, and where the line r_0 represents current lending conditions on international capital markets. Conditions for international capital lending will reflect a number of factors, including risk of nationalization, and the security provided by outside obligations (i.e. the Mexican GATT accession in 1986 and the NAFTA, or CEEC obligations as part of their agreements with the EU).

Domestic market for foreign investment

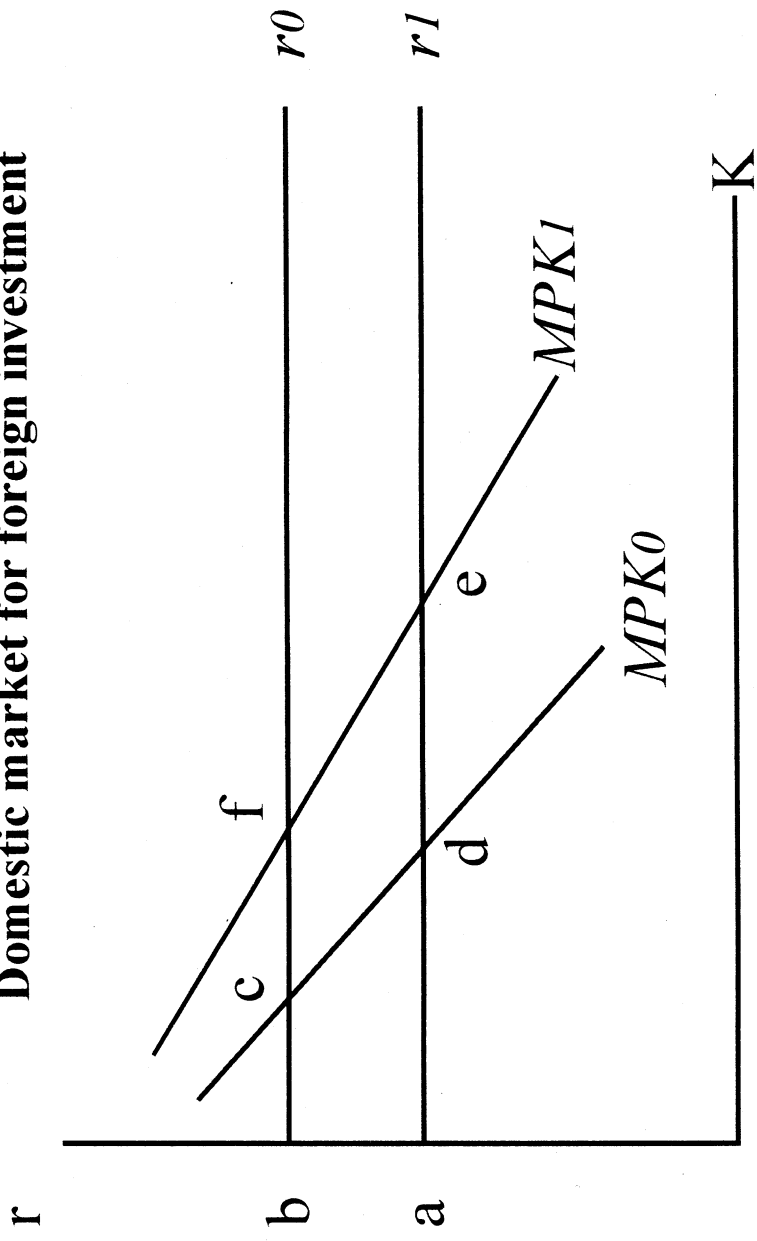


Figure 4

As elements are added to the climate that reduce the underlying risk premium, this is reflected in a shift in r_0 to r_1 . In Figure 4, the national income gain from this reduced risk premium is the area $abcd$. This is related to expanded production and rising labour productivity and wages. Arguably, this effect may be one of the most important medium- to long-run effects of anchoring investment-related external policy reforms.

In addition to reduced risk, there are other effects that will also follow from increased demand for investment capital as the region grows. In terms of the figure, this involves a shift in the marginal demand for capital from MP_{K_0} to MP_{K_1} . The gains from reduced risk would then interact with the economic expansion, yielding the gains $abef$.

Cross-country evidence

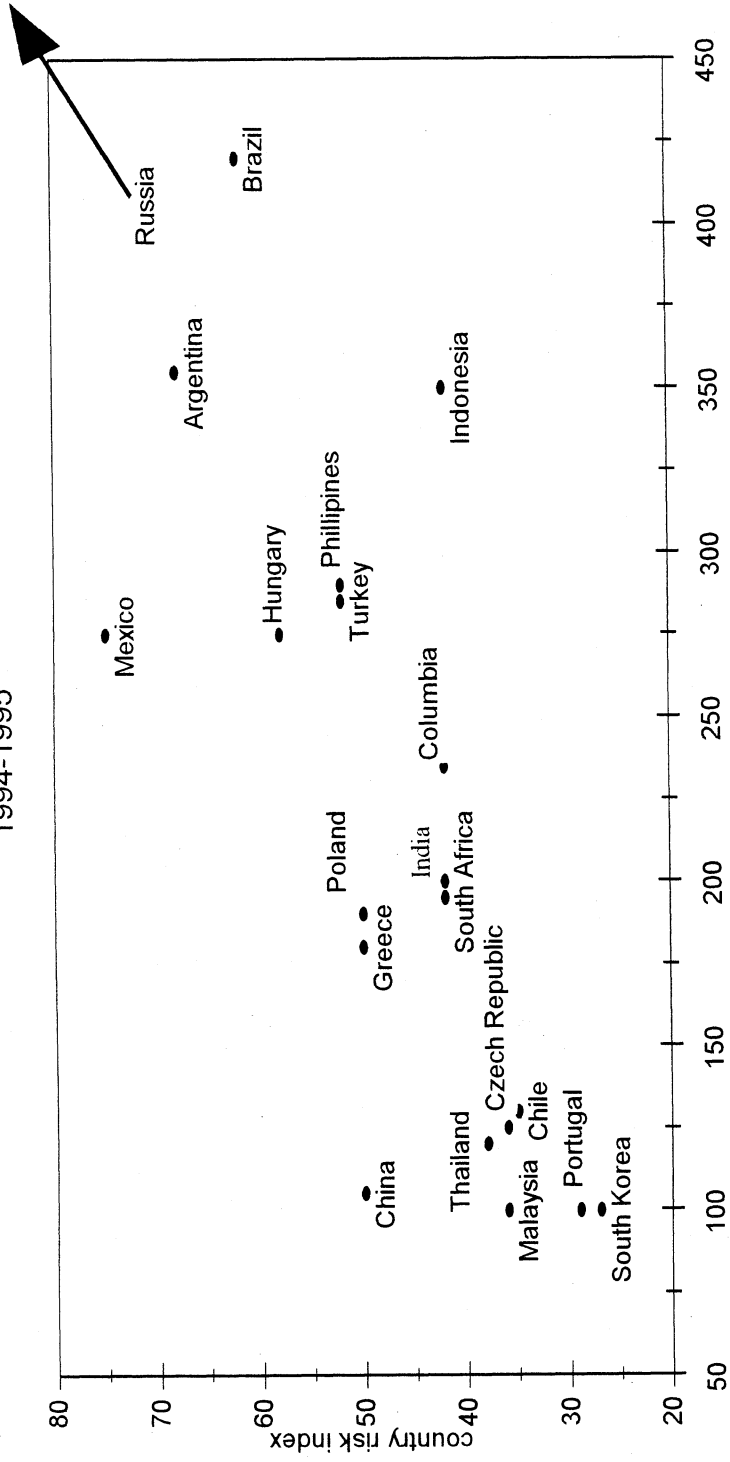
The statement that EU membership will make the CEECs less risky sites for physical investments seems relatively uncontroversial. The hard, and therefore controversial, part is to quantify the impact that enlargement will have on CEEC risk premiums. One approach involves cross-country comparison of investment conditions. Rates of return on capital differ sharply across nations, and these differences are often very persistent.

One common explanation for this is that investors demand a risk premium on funds invested in nations with economic and/or political environments that are perceived as unstable. As figure 5 shows, country risk does correlate with rates of return. The figure plots, on the horizontal axis, World Bank estimates of the basis point spread charged to emerging economies for dollar-denominated fixed rate issues in 1994-95 (World Debt Tables, 1996 Extracts, World Bank 1996). The vertical axis plots country risk indexes (from the Economist Intelligence Unit) for 1995.² The Czech Republic, Poland, and Hungary are arrayed along the middle of the spectrum, with the Czech Republic ranked as the best risk and Hungary as the worst. Poland is ranked as a risk comparable to Greece. Russia is off the charts on both axes, and data for Bulgaria and Romania are unavailable (not a good omen). The unweighed CEEC average for those in the sample (not shown) is located quite close to Poland. In the context of the figure, an important goal of CEEC membership is to move individual countries toward the South West region in the figure.

² A similar pattern (not shown) holds for the spread on the effective dollar yield of domestic debt issues calculated from IMF IFS data for medium-term domestic debt issues adjusted for currency movements.

Risk and return in emerging markets

1994-1995



basis point spread on dollar-denominated fixed-rate issues,
(IMF estimates for comparable maturity issues of benchmark U.S. securities).

Figure 5

Historical evidence

There is also historical evidence suggesting a correlation between investment and membership, at least in poor entrants. A range of case studies for the Iberian countries support the basic notion that EU membership can be good for investment in poor entrants. For Spain, the boost to investment from accession and the effect on the current account are documented by Vinals, 1990; Ortega, et al., 1990). The stimulus to foreign investment is analyzed by Bajo and Sosvilla (1992). For both Portugal and Spain, Braga de Macedo and Torres (1990) specifically demonstrate the decline in country risk premium following accession.

For the six countries that joined the EC during the 1973, 1981 and 1986 enlargements (Denmark, Ireland and UK in 1973, Greece in 1981, and Portugal and Spain in 1986), there was generally an increase in capital. In addition, the Iberian enlargement was accompanied by a stock market boom (while the Greek accession did not produce such a result). Of the 1973 entrants, Ireland is doing much better than the average of the incumbents. This fits in with the general idea that enlargement is likely to have the greatest impact on the countries that are economically the furthest behind the EU incumbents. When it comes to stock market data, Greece is the exception among the poor entrants. The poor performance of Greece is echoed across several financial indicators. Greece hence serves as a reminder that while EU membership provides an opportunity for poor countries to catch up, there is nothing automatic about the benefits. (Baldwin et 1997).

Historically, the closest parallels with the CEECs are in the Iberian peninsula. Until the mid-1970s, Portugal and Spain were under dictatorships that typically ruled the economies with a heavy and sometimes arbitrary hand. Investment in these countries was consequently a risky business for those without close connections to the dictators. The end of Iberian dictatorships and their EU membership bids transformed the investment climate on the Iberian peninsula. This was followed by a catch-up process driven, in part, by investment. On net, the historical evidence provides a *prima facie* case that EU accession can be helpful in encouraging investment in poor entrants (namely Spain, Portugal and Ireland), and support for the assertion that the Iberian investment-led growth in the 1980s was greatly boosted by the prospect of EU membership.

IV. ESTIMATES OF LIKELY EFFECTS

We turn next to estimates of the likely effects of accession. The basis for these estimates is computable general equilibrium simulations of various accession scenarios, as described in Baldwin et al (1997) and Baldwin and Francois (1996). The general equilibrium model is a global model, covering all world trade and production. It allows for scale economies, imperfect competition and endogenous capital stocks. Interested readers are referred to the 50-page technical appendix to Francois, McDonald and Nordstrom (1995) for detailed discussion of the theoretical structure of the model. The data structure and policy experiments for this application are discussed in Baldwin et al (1997). The model is calibrated to social accounting data from the Global Trade Analysis Project (GTAP) version 3 dataset. The GTAP dataset includes information on national and regional input-output structure, bilateral

trade flows, final demand patterns, and government intervention, and is benchmarked to 1992. Protection data are based on World Bank and WTO data on pre- and post-Uruguay Round protection. We work with the post Uruguay-round protection data.

Table 3
Macroeconomic effects of EU enlargement,
changes in GNP in billion ECU and percent

	conservative estimates		less conservative estimates	
CEEC7	2.5 b ECU	(1.5 %)	30.1 b ECU	(18.8 %)
EU15	9.8 b ECU	(0.2 %)	11.2 b ECU	(0.2 %)
EFTA3	0.2 b ECU	(0.1 %)	0.1 b ECU	(0.1 %)
Ex-USSR	1.1 b ECU	(0.3 %)	2.1 b ECU	(0.6 %)

note: conservative case involves no foreign investment.
less conservative case involves induced foreign investment.

source: Baldwin, Francois, and Portes (1997).

Table 4

Sectoral output effects for CEECs, percent	long run effects, with foreign investment
agriculture, forestry, fisheries	16.40
primary mining and fuels	20.98
processed foods	20.69
textiles	140.23
apparel	87.62
non-ferrous metals	-22.22
iron and steel	9.23
chemicals, rubber, and plastics	59.86
fabricated metal products	-9.81
transport equipment	-87.59
other machinery and equipment	-39.72
other manufactures	14.26
services	25.26
Standard deviation of output*	57.40
Mean change in output	18.09

Sectoral output effects for EU15, percent	long run effects, with foreign investment
agriculture, forestry, fisheries	0.00
primary mining and fuels	0.13
processed foods	-0.01
textiles	-11.53
apparel	-2.48
non-ferrous metals	0.85
iron and steel	-0.66
chemicals, rubber, and plastics	-1.47
fabricated metal products	0.92
transport equipment	1.65
other machinery and equipment	1.40
other manufactures	0.28
services	0.19
standard deviation of output*	3.38
Mean change in output	-0.83

*defined as $SD = \sqrt{\frac{\sum(qo^{**2})}{n}}$, where n is the number of sectors and qo is the normalized (i.e. percent) deviation in sectoral output.

Tables 3 and 4 present estimates of the impact of accession on the CEEC economies. Table 3 presents estimates of the impact on regional GNP. The first set of estimates involves only the static effects of trade liberalisation, without induced foreign investment. Even in this base case, it is clear that the impact on the CEECs is much greater, in relative terms, than the impact on the EU. The second set of estimates includes induced investment effects. Based on a "best guess" of the fall in cost of capital for the CEEC economies (see discussion in Baldwin et al), these estimates are far greater than those from trade liberalisation alone. While the individual estimates are crude at best, the point they highlight is striking. The important economic impact of accession is going to follow from increased investment, and not from increased trade. In terms of gains related directly to improved market access, these gains are almost secondary. They are likely to be swamped by induced investment effects, *if* membership has an effect comparable to the one that followed the Iberian accession.

Table 4 presents estimates of sectoral adjustment. Like the macroeconomic estimates, it is best to view these sectoral effects with extreme scepticism. They reflect the necessity of sometimes Herculean assumptions about social accounting data (i.e. the benchmark structure of production) in a region undergoing dramatic transition. Even so, the basic pattern of CEEC effects, viewed alongside those for the EU, is striking. Clearly, most of the sectoral adjustment, at least in relative terms, is likely to be felt by the CEEC economies. The concerns raised earlier, with regard to the pattern of protection, are manifested in the relative collapse of the heavy machinery sector in the CEEC economies. Of course, such effects will be influenced by government subsidies, contingent protection, and related measures. Still, the results suggest that the process of harmonisation of CEEC tariffs with those of the EU will place considerable pressure on their heavy industrial sectors. This

may be manifested in actual changes in output, or otherwise in a political solution involving the machinery of EU economic policy and support mechanisms. Whatever the outcome, it is clear that to keep the accession process (and implicitly the reform process) viable, attention must be paid to the adjustment process undergone in the CEEC economies.

V. FINAL RUMINATIONS

This paper has been concerned with the process of integrating the CEEC economies into the European Union. Recent estimates (Baldwin et al) indicate that the costs and benefits for the EU will be relatively small, at least in economic terms. The decision made by Member governments regarding membership will, therefore, be determined in the end by political considerations, which should dominate the small contribution made to the total decision calculus by economic factors.

The same does not hold true for the CEEC economies. Given the relative size of the two regions, the long-term economic benefits of membership for the CEEC economies are indeed very important. At the same time, these benefits are likely to involve significant pressures for restructuring. Since political factors appear to dominate the decision calculus for the CEEC governments as well, the economics of the process forces the question of the appropriate structure of the accession process. In this regard, one important point relates to the divergent nature of EU and CEEC tariff rates. It will be important that, to the extent possible within GATT/WTO obligations, CEEC rates of protection be harmonised toward EU rates before actual accession. At the same time, industrial assistance (like investment subsidies) to sectors that will lose protection should be phased out as part of this same process. Otherwise, membership will be followed by appeals to Brussels from these same sectors for protection.

Also, it is important to keep in mind that investment effects dominate the direct trade effects of EU accession. This means that the cost of a failed membership bid, or signals of prevarication by Brussels, may go well beyond the direct benefits of secure access to EU markets. The prospect of EU membership has already gone a long way toward easing capital costs down in the leading CEEC economies. By 1995, for example, the Czech Republic had almost graduated to the point of borrowing on the same terms as some of its fellow OECD members. Loss of investor confidence in the process, or even signals that the probability of a failed membership bid is nontrivial, could begin the reversal of this process.

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