Survey

Transforming trade and payments in transition economies — the regional dimension

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Abstract

The paper examines the desirability, on economic fundamentals, for the transition economies (TEs) to replace their inherited integration format with another regional compact while awaiting merger into the European Union (EU). Many reasons were invoked to negate this. On economic fundamentals too much faith was placed in the predictability and theoretical strength of the gravity model for predicting normal bilateral trade flows and in the seamless merger of TEs in global trade and financial networks to offset any initial transformational imbalances. Opportunities for regional cooperation have not been seized largely for political and security rather than sound economic reasons. This is a suboptimal policy choice not only in governing the transition but also in governing the processes for eventually playing a constructive role in the EU’s single market. © 2001 Society for Policy Modeling. Published by Elsevier Science Inc.

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Much ink has been spent in recent years on contrasting trends in and the desirability of regional cooperation among transition economies...
(TEs), in preference to their merging quickly into the European Union (EU), with full integration into the global economy, meaning uniform discrimination between resident and all other actors. I shall not enter deeply into this debate. At the very least, the conflict on regionalism as posed is a limited view of the real world: Until some of the TEs can de facto join the EU, the two cannot be mutually exclusive, but could usefully be pursued together. At the very least, gazing at EU integration, even now when some TEs are negotiating for accession and others will do so in the years ahead, while opportunities for regional cooperation, notably within the context of the Baltic Free Trade Agreement (BFTA) and the Central European Free Trade Agreement (CEFTA), are not actively pursued, largely for political and security, rather than sound economic, reasons is paradoxical, especially so when, at the same time, the TE leadership proclaims its steadfast adherence to merging quickly and fully into the global economy. Are all of these aspirations compatible? If not, are economic conflicts looming on the horizon?

To answer these questions, I deem it important to backtrack somewhat to the transition’s inception and reexamine the policy options then available in reorganizing trade and payments, and indeed external cooperation more broadly, and the choices made with their justifications. I focus on three issues of the transformation: (1) the varying views on policy design regarding regional economic cooperation among groups of TEs; (2) forging intimate ‘regional’ ties with the EU that may enhance multilateralism, if only over the longer term; and (3) the TEs’ fuller integration into the global economic framework with minimal discrimination. I do so here with a view toward clarifying the policy options prevailing at this stage, certainly for TEs that have made only minor headway with their structural transformation, but also for those that have booked substantial success and will need many more years to accomplish what the champions of ‘transition’ embarked upon in the early 1990s.

The paper is organized as follows. I first recall the arguments wielded in the early transition debates for and against sustaining economic cooperation and retrace why this path was demonstrably spurned, even as a technical option, by

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2 These comprise the 27 ‘European’ states that used to be, possibly in the context of a now defunct federation, under one-party rule and steered through some form of administrative planning. Most of this paper is devoted to the TEs with a Europe Agreement (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia). Other TEs are Albania, the 12 members of the Commonwealth of Independent States (CIS), and the four remaining successor States of Yugoslavia.

3 Unless there is room for factual error, I use this designation for the efforts to bring about western European economic integration in the postwar period. Formally, of course, the EU came into being only after ratification of the Maastricht Treaty in November 1993.

4 Early-accession negotiations were initiated on 31 March 1998 with the Czech Republic, Estonia, Hungary, Poland, and Slovenia.

5 These two cooperation schemes have been yielding positive results. The links of the member countries with some of the successor States of the Soviet Union, once they regain a measure of stability and growth, deserve to be explored as well, but I do here only incidentally.
nearly all policy makers. Next, I inquire briefly into the aims of the transformation and their bearing on regional cooperation. Then I specify the policy dilemmas in external sectors at this stage in many TEs. Thereafter, I look at the desirability of regional cooperation in the years ahead placed within the perspective of the EU’s eastward enlargement and discuss forecasting the prospective trade opportunities of the TEs. I conclude with notes on the remaking of Europe and the role of cooperation among the TEs therein seen from within the aspiration of global economic integration.

1. The pros and cons of regional cooperation around 1990

At the time of the collapse of the Council for Mutual Economic Assistance (CMEA), most observers deemed it wise not to forestall this outcome, but to nudge this eradication mission along with maximum dispatch. Varying rationales for not bracing intragroup trade were invoked. A truly counterintuitive one was the assertion that, now that political allegiances were fracturing beyond repair, there would prospectively be no room for trade and broader economic collaboration among TEs. Since their economic interactions should prospectively be very small, nothing ought to be done to maintain or encourage closer collaboration; global integration should certainly not be hindered. The ‘normal’ level of interaction among the TEs would be found by simply ‘opening up’ these economies as rapidly and as completely as feasible to global competition for products and factors. Only by traveling this route could decision makers hope to engage correctly in systemwide economic reconstruction. World markets for goods and tradable services — labor was rarely mentioned — would accommodate any trade diversion from CMEA and domestic markets, the primary constraint being the ability to capitalize from the supply side on the opportunities for export-led recovery and modernization. Quick restructuring in response to all-around liberalization was therefore recommended. These claims and assertions need to be parsed carefully.

At the same time, observers championed the view that the TEs could finance just about any current-account deficit incurred by meeting their acute import needs in western capital markets or, in the short run, by official capital inflows. Integral to this stance was a view on the resources required for economic

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6 For representative views, see Kenen (1991), Polak (1991), and Rosati (1991). More emotional justifications, such as fear that these countries would ‘get stuck in a poor man’s club,’ are not unknown, however (Sachs, 1990). For weakly founded empirical evidence, leading to spurious reasons favoring the destruction of intragroup relations and avoiding building new ones, see Lipton and Sachs, 1990. A summary of these positions is presented in Brabant (1995, pp. 386ff.).

7 Recall that under state socialism, trading relations with developed countries had very often been constrained by excess import demand and chronic shortage of foreign exchange. Concerns about foreign-exchange mobilization at the transition’s inception were therefore central.
modernization. These, it was held, would be met by private financial flows perhaps after an initial lubrication with official funds. The latter would primarily emanate from multilateral agencies, be of modest dimensions, and extended over a fairly brief period of time. There might be some friction in engineering this turnaround, but it would be brief and manageable, if only the TE managers were to adhere to ‘appropriate policies.’ Weathering the storms of the transformation and indeed advancing the cause of economic reconstruction were thus held to depend primarily on political will and professional integrity, not really matters of political economy and the hazards of pursuing difficult decisions in an environment with at best emergent markets.

Very few observers (as summarized in Brabant, 1991, 1992) stressed throughout the early transition upheavals the merits of two propositions essential to specifying realistic policy choices in transforming the TEs, including their external sectors, and opting for the ‘better’ alternative. One revolved around the desirability of engineering a much more gradual dissolution of CMEA economic (as distinct from ideological, political, and security) ties while shoring up those that were economically warranted and encouraging new forms of exchange in order to sustain buoyancy in economic activity as well as popular support for painful restructuring. Since markets would remain inchoate and asymmetric for years to come, ‘steering’ these processes, including managing intragroup trade, while utilizing as much as possible even budding market indicators and ‘institutions’ where functioning should not have been ruled out ab ovo. Politics would necessarily play a critical role in the former and unorthodox economics should have to nurse along the economically warranted interchanges; after all, economic policy and politics must be endogenous (Krueger, 1993).

The other argument was simple: There must be room for fruitful economic cooperation among contiguous countries with similar export offers and import needs8 and with a total market of between 65 and 125 million people with some purchasing power in eastern Europe (and 133 million if the Baltic States are included),9 depending on how wide the circle of cooperating TEs one is prepared to draw. Any more or less considered assessment of desirable

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8 One possible indicator is Benelux’s intermeshing. The share of reciprocal trade at its height in the 1950s reached about one fifth. Even with the enormous expansion in trade, EU integration, and very different export offers and import needs now as compared to, say, the early 1950s, reciprocal trade is still very substantial: In 1990–1996, for example, the Netherlands accounted for 13% and 17% of Belgian–Luxemburg exports and imports, respectively, for an average annual total turnover of $39.9 billion; Dutch reports are 13.4% and 12.3% of exports and imports, respectively, for an average annual turnover of $36.4 billion (country pages in IMF, 1997). And that for a market of less than 25 million people, and only 22 million in the early 1950s!

9 True, in principle, transaction and transportation costs may well outweigh the apparent advantages of short distances and the ‘culture’ wrought by geographic proximity (Messerlin, 1996, pp. 11–12). But is this the case for the TEs and more so for their intragroup trade than in their ties with other trading partners, taking into account the services available in global markets? I return to this in Section 4.
‘regional interdependence,’ perhaps after some adjustment to market forces, should tend to favor ‘trade creation’ over ‘trade diversion,’ to keep matters simple at this stage, especially for countries with similar economic structures and like-minded policy ambitions as concerns radical economic reconstruction anchored to an open environment.

If the presumption of the committed free traders and the neoliberal champions had reflected reality rather than the immanent logic of a confined analytical model, there would, of course, not have been any reason to deviate from the Diktat of properly aligned markets. Otherwise, alternative solutions should have been entertained, including possibly with respect to intragroup relations. The latter would also be justified if, as seemed plausible at the time, sociopolitical consensus on the speed, magnitude, and distribution of the adjustment costs associated with market-driven ‘creative destruction’\textsuperscript{10} might have been difficult to sustain. It is truly paradoxical that Hayek’s view on the fatal conceit of socialism can be transferred lock, stock, and barrel to the extreme views on the creation of markets in TEs. Jeffrey D. Sachs (1993, p. xii), for example, contended for Poland that “markets spring up as soon as central planning bureaucrats vacate the field.” That stance was wrong on at least three counts: central planning of day-to-day economic affairs by 1990 in Poland had largely disappeared; whereas markets for elementary goods and services do emerge rather quickly, this is not the case for most markets of interest in moving toward a catch-up modernization trajectory; and those elementary markets were in any case already essentially in place before the transition’s eruption (Kolodko & Nuti, 1997).

Addressing the question of regionalism vs. multilateralism for TEs here requires not only that one hark back to the theory of free trade, but that one also bear in mind the broader features of the transformation agenda. Only then can policies be drawn up that remain cognizant of the initial conditions, the political realities of the transformation, path dependence, meta-economic aspirations, and the incomplete nature of domestic markets and failures in international trade and factor markets. At the transition’s inception, the public-good nature of effective ‘market institutions’ was not widely recognized. Policy makers were encouraged by advisers and pundits to believe that they could quickly elicit market-based decision making at minimal cost at home and explore fully integrated world markets for goods, services, and capital (but not for labor, although greater flexibility had been anticipated than what the TEs have actually experienced). In consequence, no transitional arrangements were even contemplated to level up somewhat the playing field for established global competitors relative to agents from TEs (see Section 5) and intragroup ties were left to wither; in fact, shrinkage was actively encouraged through policy actions that had at best a dubious rationale.

\textsuperscript{10} Recall that transitologists have often used his notion in a manner that amounts to a travesty of the Schumpeterian concept. Thus, there can be no Schumpeterian creation in the absence of innovation, investment, and competition (see Kolodko & Nuti, 1997, p. 8).
2. Transformation aims and policies

Many aspects of the TE’s transformation can be assessed properly only against the backdrop of the original ambitions cherished early on in the transition. At least in the eastern part of Europe, the aims were political pluralism similar to western Europe’s and dismantling the remains of administrative planning in favor of market-based decision making anchored largely to private property, thus permitting speedy integration into the world economy and especially catch-up with western Europe in terms of productivity, income, wealth, and so on. Overcoming the legacies of administrative planning and of bureaucratic bargaining under state socialism was bound to give rise to vexing problems, especially if policy makers insisted on rapidly opening the economy to global competition through far-reaching trade and foreign-exchange liberalization (devaluation, internal convertibility, low tariffs, no quantitative restrictions, and so on) in combination with the rapid and forcible break-up of regional ties. General shortage of new human and physical capital and pronounced immobility of existing assets in the short to medium run could only exacerbate matters. The latter bottleneck could have been at best partially alleviated through sizable investment inflows and commercial and official transfers from abroad, including from multilateral financial institutions and other aid organizations.

How best to transform the trade and payment regimes during transition has been one of the most widely debated questions in designing comprehensive, speedy, and properly sequenced transformation policies. Integration into the world economy required several basic steps. One was to open up the domestic economy through an orthodox commercial policy. A quite liberal trade regime applicable to all authorized agents with few, if any, nontariff barriers (NTBs); low, preferably uniform, tariffs; and an effective exchange rate would expose the TEs to price-based international competition. Another was to obliterate quickly all vestiges of the CMEA’s trade, pricing, payment, and settlement regimes and all remnants of socialist economic integration. Furthermore, integration into the world economy was from the beginning envisioned to encompass full participation in global economic regimes, including quick membership for TEs not already belonging in the institutions entrusted with safeguarding these regimes. Finally, most TEs coveted membership in what is now the EU at the earliest opportunity. Here I focus on the core of a liberal trade and exchange regimes, which is, of course, only a tiny component of a coherent transformation agenda (see Brabant, 1998a, pp. 101ff.).

The case for trade liberalization has been argued using incontestable credentials rooted in economic theory: It is expected to improve resource allocation in line with social marginal costs and benefits; to facilitate access to more advanced or better-suited technology, inputs, and intermediate goods; to enable a country to achieve economies of scale and scope; to bolster competition in domestic markets; and to provide pro-growth externalities (Krueger, 1997). However, a liberal trade regime in and of itself cannot yield wonders in
countries facing an uphill struggle in successfully catching up with advanced countries: They have to jump into the established trading network at a level of maturity that can be acquired only through endogenous growth, not by exploiting presumptive static comparative advantages. The benefits of full liberalization may not be realized until the environment permits comparatively flexible adjustments to new demand and supply schedules, that is, after erecting a functioning market economy in which domestic and foreign agents can operate on a level playing field.

Early during the transition period, foreign competition may eliminate an inordinate share of domestic production, without the freed-up resources being mobilized for catch-up growth. New competition may also force other competitors out of established markets for reasons that are not necessarily rooted in level playing-field competition. Recall that TEs find themselves more or less in similar straits: The maturity of their agents, whether public or private, in waging effective competition lags several leagues behind that of the principal global actors. Unregulated competition may foster oligopolistic structures. Competitive maturity can be treated as a public good, in the sense that those that possess it have acquired it not solely from working within preset ‘market institution,’ but by steering the latter’s evolution to permit such independent competition to emerge. Until that platform is reached, driving out established competitors through the upheavals of transformation policies in more than one TE may stimulate too much oligopolistic competition, necessarily of a strategic nature. Even with a return to normalcy once the transition is well advanced, catching up to that level of competitive maturity may prove to be as daunting a task as reaching best-practice levels of productivity in the development process (Brabant, 1993, pp. 220ff.).

Though the above hypothetical case seems sensible in its own right, it is wrong for reasons of both theory and actual policy making to presume that inherited economic interdependence must be rapidly destroyed (Fischer, 1992). As a matter of trade theory, it may be desirable to maintain in the short run at least some of the commerce that must prospectively be displaced through changes in the commodity composition or in the geographical orientation of trade once the transition is well under way. There is, of course, no reason to believe that optimal restructuring of trade will obliterate all ties forged over decades. As a matter of political economy, an accelerated compression of trade, hence production, may stop a reform process in its tracks because it undermines the credibility of transformation policies for domestic actors, foreign investors, and assistance-delivering organizations.

Regarding the foreign-exchange regime, the perplexing multiplicity of exchange rates under state socialism must soonest be replaced by a single rate. Whether it should be fixed or flexible is one of those either-or choices favored by many theoretical economists and inexperienced policy makers. In practice, the question revolves more around the kind of peg to be established and at what intervals the exchange rate should be adjusted to avoid damaging
the currency’s credibility and, by extension, the credibility of transition policies as such. But the initial choice can be crucial, and perhaps nowhere more so than in managing demand and supply of foreign exchange. This must necessarily be made by policy makers rather than by what inchoate markets may indicate. Overdevaluation and in some cases excessive faith in a fixed rate that can hardly be supported have complicated policy making, including in intragroup relations. Only slowly have most TE managers come to realize the anchoring value of a managed nominal exchange rate that is not heavily undervalued but guided from within a proper policy framework. Similar observations apply to measured steps in the direction of currency convertibility, at first preferably equitable access for registered traders, then for current transactions, and only much later on capital account.

Regarding commercial-policy instruments, there is no dispute about the urgent need to transform all NTBs into explicit ad valorem tariffs. Whether the latter should initially remain rather high, possibly at the level implicit in the bewildering variety of trade-inhibiting institutions and instruments under administrative planning, or low to permit effective competition and price transmission, has been a bone of contention. The opposing sides have focused either on forestalling the collapse of large segments of economic activity (especially the so-called value-subtracting or negative value-added firms) early in the transition or on the beneficial effect of market penetration from abroad on domestic competition and price formation. If only for the latter reasons it would be counterproductive to erect formidable trade barriers or to maintain the inherited protective measures in a different guise, provided adequate fiscal revenue can be raised otherwise. Recall that protection within the CMEA context was, if anything, largely implicit; there were virtually no effective tariffs or quantitative restrictions. In moving toward a normal commercial-policy regime with ‘preferences,’ policy makers should have taken this reality into account and designed a ‘new’ protective regime aimed at accomplishing much more than regulating trade and generating fiscal revenue.

Finally, trade liberalization is a necessary but by no means a sufficient condition for achieving greater competitive prowess in domestic markets. However useful, trade and exchange liberalization cannot by itself supply a competitive structure in economies whose geography, size, population, and resource endowments are such that apparently ‘deep’ integration in the short to medium run results only from destroying domestic production. The same applies to countries whose exports and/or imports consist chiefly of goods that national policy makers manage in world trade with the aim of promoting their own agendas. Not only that, direct foreign competition can influence relative prices in the first instance only for traded goods. Even in goods markets, its benefits

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11 Avoiding a sharp cut in real wages and incomes may be attractive if there is presumptive evidence, as in postwar western Europe, that the devaluation necessary to induce structural change may prove too strong, in the interim hampering, and perhaps bankrupting, economic activities that could survive on their own under normal market conditions (Brabant, 1991; Cairncross, 1985).
should not be exaggerated. If import demand collapses because of the sizable devaluation and of the profound economic depression into which the transition plunges the country, import competition provides at best broad indications of how to correct relative prices of traded goods, particularly those whose volume was previously artificially compressed. Relative factor prices are likely to change rather slowly in line with fundamentals, especially during the initial phases of the transition, when foreign competition could do most to promote effective markets. Obstacles to domestic competition and price flexibility must be corrected mainly through domestic policies.

The outcome of the course pursued (as detailed in Brabant, 1998b) is well known and its essentials can be captured in a few observations. First, the TEs’ overall trade plunged, but more so for exports than for imports, leading to the very large trade deficits recorded in a growing number of countries from about 1993 on. Second, this contraction was especially marked for intragroup trade, which has not yet recovered to the levels obtained in the late 1980s even though those levels had been under pressure because of the corrosive course of CMEA cooperation at the time. Third, for the eastern European TEs proper some gains have recently been booked, but intragroup trade shares remain far below what they were in the late 1980s, even for the core transformers in central Europe. Nevertheless, however, one looks at the situation, measured intragroup trade in real terms is still far below the levels observed before the transition’s inception. Even in nominal terms, recovery to the peak of the late 1980s is yet to be achieved (omitting the ‘new trade’). It also tends to be below levels that should be ‘normal’ given the more general pulls and pushes impinging on the buoyancy of trade among neighboring countries with fairly similar production structures and income levels (see Section 4). Fourth, the collapse of intragroup trade, as well as of the TEs’ trade with developing countries, has been offset by the rapid rise in trade with western Europe, the EU in particular. Thus, the share of the TEs in the EU’s imports more than doubled in the first half of the 1990s; that has been the case also for exports, where the 10 privileged TEs in 1995 accounted for 8.4% as compared to 4.1% in 1991 (European Communities, 1997a).

The evolution of the trade of the Baltic States, which were integral to the Soviet Union until 1991, is more difficult to assess for policy and institutional reasons. Among the latter, these countries still maintain substantial transit trade, have less reliable trade data, and were deeply imbedded in the former Soviet economy. They have also adopted less overtly discriminatory policy stances, including lower tariffs, leaving their markets more open to trade with countries other than the EU and eastern Europe with the result that their trade is much less centered on the EU than is that of historical eastern Europe.

It is furthermore worth observing that also the commodity composition of these trade flows has undergone substantial changes. TE exports to the EU have regressed substantially toward more resource- and unskilled-labor-intensive products rather than for high value-added activities (UNECE, 1996, 1997).
Substantial export gains in clothing, footwear, travel goods, and furniture (Hoekman & Djankov, 1996, p. 11) fall in this category. Low-wage goods, the bulk of which is ‘exported’ through outward processing, would also appear to account for the apparently high levels of intra-industry trade in these relations (Hoekman & Djankov, 1996, p. 21; UNECE, 1996). Some gains have been booked with machinery and equipment, but starting from a very low level (European Communities, 1997a; Inotai, 1997a; Plucinski, 1997). One can speculate that the latter gains stem largely from the vertical integration brought about by foreign direct investment (FDI) in the more advanced countries. In fact, even in intragroup trade, market shares of high value-added traded goods, such as cars, have plunged as consumer tastes, policy orientation, and the asymmetric playing field have been favoring Western imports. Finally, although the evidence is not overwhelming in part because documentable trade categories remain rather coarse, ‘new’ products have been entering trading markets, and presumably domestic production, only very slowly. Indeed, the European Commission recently argued that there has been “no major shift in the make-up of the EU’s trade with TEs,” but that there has been a shift from consumption goods to investment goods” (European Communities, 1997b, p. 9), though some changes seem to have been taking place toward more sophisticated manufactured goods in the central European countries in recent years (Aturupane et al., 1997; Hoekman & Djankov, 1996, 1997). These gains have been driven importantly by FDI. Since the integration of these TEs in the global strategies of transnational corporations (TNCs) is overwhelmingly organized with the intragroup market left out, few of those gains have spilled over to date in intragroup trade. Indeed, there is evidence to buttress the proposition that intragroup trade has become even more dramatically dominated by resource-based goods (Inotai, 1997a, pp. 535ff.) and exhibits a far lower degree of intra-industry trade (Plucinski, 1997) than is the case in relations with the EU (Hoekman & Djankov, 1997, pp. 474ff.).

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12 Many of these are ‘sensitive products.’ They account for about half of Hungarian and Polish and about 35% of Czech and Slovak exports to the EU (European Communities, 1997b, p. 9).

13 Problems of sizable trade imbalances, very different levels of development, and still disequilibrium trade conditions are as a rule ignored. They should not (Nilsson, 1997). At the very least, before computing the conventional Grubel–Lloyd indices, or variants thereof, the analyst could usefully sift through the data and allocate them into various categories, including outward processing, screw-driver investment, and ‘normal’ trade. Without this, claims that high intra-industry trade indices provide “evidence of progress from dependence on primary products to a deeper and more mature degree of integration related to technological relationships” (Kolodko & Nuti, 1997, p. 39) ring hollow. The quoted authors cite indices of 0.42 for 1989 and 0.48 for 1995 — hardly compelling evidence for claiming sustainable technological progress for Poland!

14 In fairness, the report refers explicitly to trade with the Visegrád countries only. But this point applies in all likelihood even more to other TEs.

15 But this is flatly contradicted in Aturupane, Djankov, and Hoekman (1997) and Hoekman and Djankov (1997).
3. Transformation, the external sector, and policy dilemmas at this juncture

The transition policies pursued over nearly a decade have yielded a lot. Even in the more successful TEs, however, the outcome to date falls far short of the envisioned transformation. In reality, reaching fairly mature market institutions and properly aligned microeconomic structures appropriately embedded in global relations requires in some cases several more decades of determined and incisive restructuring. That is, some of the policy dilemmas of the early 1990s linger on. This is partly because of the nature of the transformation, and also because of the policy choices made, including the backdrop against which they were reached.

Apart from the still gingerly drawn admission that something went awry between the cited assumptions for and the observed experience with transition, the profession now also seems to be more willing to acknowledge that extreme forms of liberalization, including destruction of intragroup trade ties inherited from the CMEA past, were ill-advised. In that context, support has been emerging for the proposition that the potential for trade among the TEs was never nil and, albeit with greater circumspection, that it is worthwhile to exploit this room for propping up regional demand on economic grounds (though also for other reasons) for as long as the countries involved do not face trade-diversion conundrums (detailed in Section 5). Perhaps most importantly, and without in any sense intimating economic determinism, many commentators appear to support the notion that buoyant economic interaction among TEs may well be a prerequisite for the health and wealth of these countries. It is certainly required for those bent on joining the EU if they are to play a constructive role in the single market. But it applies even to those largely coveting ‘only’ a close association in some form.

Although the self-inflicted intra-CMEA trade collapse was very severe and has not yet been reversed, not even in nominal terms for the core actors (see Brabant, 1998b), some mutual interdependence lingers in core industrial production. Much of that sector, including machine building, remains in need of thorough restructuring, though some countries (say, Hungary and Poland) have accomplished more in this respect than others (say, the Czech Republic and Slovakia). Nevertheless, meaningful transformation of economic structures at a time when all TEs continue to debate the required, but varying, transformations ahead is not at all an easy task.

Of course, since 1989, new activities have arisen, far more in the service sectors than in manufacturing with the latter primarily driven by FDI and the special EU

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16 True, the exact reasons for the market-access constraints, both in goods and money markets, have been different, at times to a surprising degree, from what those favoring complete opening at record speed underscored and what others contested. For lessons to be learned by all for all, see Brabant (1998a, pp. 379ff.).

17 This is not the place to elaborate the full rationale for whether and how best TEs can best take advantage of the vast EU market (but see Brabant, 1996a, 1996b). I sketch some pertinent lines of thought in Section 5.
market-access provisions. The former caters essentially to domestic demand and at best facilitate trade in more orthodox products, including from the remnants of the CMEA-aligned production specialization. From all the evidence at hand, only slowly has new manufacturing activity penetrated own trading markets.

That said, we should be cognizant of the fact that since 1995 in particular pressures on the external-payment position of most TEs have risen.\textsuperscript{18} For most economies, this situation has come to the fore after a temporary respite due to ‘export pushing,’ including distress disposal. Current payment pressures arise for a good part from the prevailing domestic disarray, in some countries buoyant domestic consumer and investment demand, the stubborn problems of restructuring the export offer toward higher value-added activities, and the as yet quite incomplete market institutions to uphold vigorous economic interdependence among TEs, and to some extent even with western countries. Quite clearly, the current payment situation is unsustainable in the medium run without a substantial improvement in the domestic environment for attracting ‘good’ capital inflows, preferably FDI in modernizing sectors; that is, long-term capital inflows committed to sunk investment projects designed to draw these production activities eventually into the TNCs’ global networks. Indeed, this should complement primarily domestic resource mobilization. That needs to be bolstered in favor of productive activities, especially those that are likely to be carriers of endogenous growth. Only in this manner can factor productivity be lifted, thus enabling the TEs to catch up with levels of productivity, income, wealth, and so on in advanced countries, as discussed in Section 2.

Clearly, imports are required to meet domestic consumer demand and indeed to shore up modernization. If the latter desired imports cannot be financed from abroad, they have to be accommodated through internal savings, export-oriented production exceeding domestic absorption to generate the foreign exchange required to finance imports over the long haul. It is in this context, and recognizing that there may still be spare capacities available, in part remnants of CMEA cooperation, that could be mobilized profitably in the short to medium term\textsuperscript{19} that I deem it important to consider how economic cooperation among the ex-CMEA partners could conceivably be revived, obviously relying on economic fundamentals (see Section 5). In taking this view, I am well aware that exploiting opportunities for intragroup trade cannot provide miracles. But on the margin,

\textsuperscript{18} This has not been the case in all TEs largely because some had to cope with unsustainable imbalances already earlier.

\textsuperscript{19} Capacity utilization in manufacturing in 1996 (more recent data are not available), as measured by OECD experts (UNECE, 1997, p. 96) in the countries with a Europe Agreement for which data are available (the 10 except Romania and Slovenia), ranged from less than half in the Baltic States, Lithuania in particular, to perhaps three-fourths in the case of Hungary. If the estimates are roughly accurate, there would seem to be quite some room for expanding manufacturing output. Even in Poland, in spite of the good growth run since 1994, ample spare capacity in the form of “underutilized capital and infrastructure, and great potential for productivity growth from underutilized technology and know-how” (Kolodko & Nuti, 1997, p. 41) is still reported.
such a prop to regional demand should not be ignored. Capitalizing on it requires political will and determination, but also the institutional wherewithal to respond effectively to such needs. Among these institutions are the array of agents to take care of payments, export insurance, export guarantees, shipping, and so on. True, these services can be easily procured in western markets; but at a price. Yet a considerable volume of intragroup trade continues to be conducted through western, mainly Austrian, German, and Swiss, intermediaries.20 This is undoubtedly costly, especially if resorted to primarily for lack of vision regarding the wherewithal upon which solid trade ties can be erected and nurtured. Offhand, there should be room to compress this transaction cost by internalizing such operations at least for intragroup intercourse.

Is there potential for intragroup economic cooperation after the CMEA’s collapse? This is a question that has engaged many TE managers and commentators. A score have answered it the easy way, focusing on the supposedly almost limitless room for merger into EU markets; hence, the presumed ‘uninteresting nature’ of intragroup trade. Or they have stressed the inability or undesirability of using intragroup cooperation as a vehicle for propping up economic activity and strengthening the pace of restructuring in TEs. Some have, tongue in cheek, suggested that CEFTA cooperation is “an answer in search of a question” (Rollo, 1997, p. 576). On the other hand, others have underlined from the earliest debates that the potential for intragroup exchanges is far from negligible. It certainly is not nil even with the speediest integration into EU markets; the latter may in part be contingent on the former (see Section 5). I am confident that more ‘normal’ market relations and minimal economic restructuring will generate mutually advantageous economic intercourse, perhaps in line with what has been characteristic for small western European countries. This will take time, however. True, many of the former economic and other ties among the TEs have since 1989 been deliberately severed. But that does not corroborate the view of those who argue that it is now in any case too late to benefit from regional economic cooperation beyond what is likely to emerge spontaneously by letting economic agents pursue their own interests. This policy stance is precariously anchored.

4. The desirability of intragroup economic cooperation

Consider first trade potential. Arguments to the effect that there is no future in intragroup cooperation, not even in the short to medium run, were largely based on sentiment, as discussed in Section 1, and estimates derived from applying the gravity model to ‘predict’ what might be ‘normal’ trade for one or more TEs. Without entering to any depth into the gravity-equation conundrum, one must be clear at least that, inasmuch as the transitions signaled such a strong break of the

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20 I do not possess recent data, but in the early 1990s, one-fifth in Czechoslovak–Hungarian and one third in Hungarian–Polish trade was conducted in this manner (Richter & Tóth, 1993, p. 26).
inherited ‘economic structure,’ predictions could not be based on any formal modeling of the TEs since past evidence would hardly be relevant to the directions likely to be taken. As an alternative, many applied the gravity model to countries that should act as a ‘model’ for TEs and subsequently plugged in relevant variables for the TEs to construct estimates of bilateral trade and their derivatives for total trade, its direction, and its commodity composition. These model estimates of the level, direction, and commodity composition of TE trade leave very much to be desired for theoretical, empirical, and technical reasons dealt with in context elsewhere (Brabant, 1992, pp. 42–44; 1997, Section 6). I find it incomprehensible that otherwise well-informed commentators are still calling for adjudicating the future of regional trade by running yet again a gravity-model specification with current GNP data for “only then will we begin to come to grips with whether intra-CEFTA trade is too low” (Rollo, 1997, p. 577).

The gravity-equation approach, which postulates that bilateral trade depends on the two partners’ ‘wealth’ and ‘size,’ as well as the ‘distance’ that separates them, has an intuitive appeal, if only because the pull of population and push of income or wealth for trade invoke something like a ‘natural’ law, straight out of Newtonian physics. It is regarded by some respectable trade specialists as an entirely appropriate workhorse for “predicting bilateral trade flows” (Frankel, 1997, p. 49). It has been used quite successfully for broad depictions of bilateral trade flows, with identification of several of the ‘newer’ trade determinants, such as geography and preferences. Indeed, it has become something of a cottage industry in formulating variant predictions of trade.

The model itself, its weak theoretical underpinnings, and the way in which it has been applied to forecasting future trade of the TEs, with implications for where these countries should place their preferences, cast serious doubts on its suitability as a predictor of TE trade; it is, hence, not particularly suitable to underpin policy choices in TEs. I challenge in particular those who venture into gravity-model estimates to indulge so ubiquitously in issuing policy advice.21 The recommendations for policy making drawn from such a mechanical exercise may have important implications for some participants in the economic-policy debates on EU accession and assistance of TEs. This is a pity for such analyses broadcast the wrong message. Problems with the evidence on which the recommendations are based are legion (Brabant, 1992). Note that I do not, of course, contest that bilateral trade flows must somehow be related to the two partners’ wealth and size, and the ‘distance’ that separates their markets from each other. I do contest, however, that the gravity model yields accurate forecasts of specific bilateral trade flows either for the countries in the sample from which

21 For one such misguided exercise, see Gros and Gonciarz (1996). Published objections to their findings by Baldwin (1997) and Kellerman (1997) appear only to have hardened their views (Gros & Gonciarz, 1997). For my more detailed critique, see Brabant, 1997. An even less palatable analysis is in Maurer and Cheikbossian (1998). And for a truly preposterous pro-gravity reason, see Drábek, 1997, p. 580.
the parameters were estimated or for other countries for which the data set is held to be the correct anti-monde. Among the many explanations, the following objections are crucial.

First, the theory underlying the gravity model is anything but solid. Engaging in econometrics without the model posited having a solid theoretical foundation is like conjuring up solutions from a black box. Second, the data on which the model is applied leave a lot to be desired, particularly in the case of TEs. Third, to the degree that there is a theory underlying the model it is one based on a general-equilibrium setting, which seems hardly germane to TEs, given their transformation and societal upheaval. Fourth, finding a sample that is ‘representative’ for TEs is by no means straightforward. The counterfactual can be easily posited, but to have a relevant counterfactual poses a great number of conceptual and empirical problems.

Fifth, estimates even for ‘normal’ countries (including western Europe) tend to be ‘unreliable.’ Comparisons between in-sample estimates with actual values vary considerably. Building a fairly reliable confidence interval around estimated values yields a very wide range of plausible ‘normal’ trade levels. Benchmark elasticity estimates even for ‘normal’ countries are not very stable over time, suggesting that the ‘general equilibrium’ is not quite captured by the posited model for the elasticity measures should be reasonably stable. The claim that the coefficients do not vary much over time for ‘normal’ countries, while true, ignores that even a small variation in elasticities, given the model, may generate a significant part of trade.

Sixth, presumably econometric exercises of the class stimulated by the gravity models are intended to ‘predict’ future trade on the evidence presented of ‘normal’ behavior. At the very least, they should be able to forecast the future behavior of in-sample countries that appear to ‘deviate’ from the general line estimated. That is not the case, though. Confidence intervals for time forecasts are much too large to permit even a modestly reliable point estimate. Not only that, comparisons between forecasts of the accepted model with actual outcomes tend to disappoint. This is especially true for small, trade-dependent economies, which evidently have a different functional relationship between trade, on the one hand, and population, GDP, and reciprocal attractiveness, on the other hand, than the ‘normal’ posited.

Finally, especially for small, trade-dependent countries these confidence intervals tend to be very wide indeed. The experiments that I conducted in

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22 Gravity equations estimated with small countries included in the sample (say, of OECD members) can never ‘explain’ such flows. Using such estimates, one would be hard pressed to explain why Finland furnishes 36% of Estonia’s recorded imports and 20% of its recorded exports (East European Markets, 11 April 1997, p. 5), Danish–Swedish trade or the earlier-cited Benelux data.

23 Of course, to the extent the sample includes ‘small’ countries that behave ‘abnormally,’ the behavior of ‘large’ countries should also differ systematically from the ‘normal,’ although the variations from estimates may be smaller by the sheer law of averages.

24 Polak (1996) has found similar objections to obtaining good estimates for countries that are ‘far’ removed from the centers of global trade.
the early 1970s with data for countries such as Benelux, France, and many of the Scandinavian countries, to name only a few of those that I thought might make up a set disclosing pertinent parameters for analyzing future intra-CMEA and east–west trade links, persuaded me to abandon the many alternative gravity-equation experiments I was then exploring.

Even more objectionable is when researchers try to explain away some of the above objections by lapidary reasoning. One such is the Gros–Gonciarz exercise, which recognizes some of the above objections to obtaining reliable absolute estimates of bilateral, regional, and total trade, but then argue that their estimates are nevertheless useful to construct relative magnitudes of trade patterns! This is sheer casuistry: If the absolute values are subject to wide margins of uncertainty, so must be aggregates of bilateral values (although perhaps to a smaller degree) and thus any kind of shares or growth rates upheld as the likely course on the basis of which policy conclusions should be drawn.

In short, I am not particularly persuaded by the ‘technical’ or ‘subjective’ assessments of the limited room for post-CMEA cooperation among the TEs. Other points can be mustered to underpin the reverse. One reason is geographical proximity and the desirability of propping up and building upon the positive markers of postwar collaboration when economically warranted. True, a substantial proportion of the goodwill resulting from long-established trade and business contacts has recently been wasted in the haste of destroying the old without putting anything viable in its stead. However, has in the meantime so much of this economic interdependence been so irreversibly destroyed that there is no longer a cost-effective opportunity to reclaim some of that goodwill by reactivating still idle resources? Given assessed capacity-utilization levels, as cited earlier, assets seem to exist that could be more fully mobilized at low cost, such as to prop up intragroup trade.

Furthermore, the TEs share many transformation problems. Claims by one or another of being in a better starting position than its neighbors or of having completed the transition ahead of all others may well be useful public relations, and some may indeed possess advantages (say, Hungary as compared to Poland); the austerity ‘corrections’ introduced in the Czech Republic in response to multiple macro- and microeconomic problems in early 1997 provide a sobering reminder of how truly vacuous such claims are. Indeed, the vast majority of problems associated with the structural transformation of the microeconomic sphere — the core of the needed conversion — are common and pervasive; even those most advanced with their transformation must accomplish much more before they can hope to be on a sustainable catch-up growth trajectory, thus meeting one of the core aspirations of the ‘1989 events.’ I include here the need to revive aggregate demand, such as by remustering for production and trade capacity idled since 1989 that intrinsically is economically sound, at least in the short to medium run, if only because of sunk fixed costs, pending the infusion of new capital structures as economic catch-up takes hold.
Moreover, only some of the TEs’ comparative advantages had been extensively exploited during the CMEA era and all kinds of misallocation resulted from the peculiar specialization biases built into trading patterns forged for the sake of socialist integration. This was nowhere more egregious than for parts and components, as well as for a vast range of durable consumer goods and foodstuffs (Brabant, 1991, 1995, 1996a), which figured very low in CMEA specialization patterns; this apparently continues to be the case (Inotai, 1997a; Plucinski, 1997). All TEs are now in the process of wholesale economic restructuring. The customs-union literature suggests that trade creation results from specialization by actively seeking out trade complementarities while minimizing trade diversification. The protracted transformation should have provided ample opportunity to reallocate resources not just in individual TEs, but at least among those undertaking reasonably in-sync structural modifications.

Furthermore, at present, there is no active support for new or old agents in the TEs to prospect actively for new markets in other TEs. There are political reasons for this state of affairs. Policy makers shun intragroup dependence for security reasons and political apathy. But the infrastructure to support ‘normal’ trading relations is not available or still incomplete. Various foreign-exchange constraints and above-normal transaction costs, including those preventing effective resource mobilization, are inhibiting buoyant intragroup trade. Instruments and institutions other than those customary in world markets, including to facilitate the construction and maturation of such ‘normal’ institutions and instruments, may bring temporary relief.

Perhaps most important, TEs simply cannot ignore markets with a population of between some 65 million and 133 million, as earlier explained (and vastly more when the core CIS economies will be recovering), with some positive purchasing power and a substantial import elasticity of demand. For one thing, even their trade links justified on economic grounds have been ruptured and then a revival hindered for political and institutional obstacles. In addition, these countries have traditionally not tried to reinforce reciprocal trade complementarities by more fully exploiting their present and evolving competitive economic strengths. Economic transformation conceived throughout the area against a broadly shared backdrop should provide lucrative opportunities for building up economically sound complementaries. Furthermore, the TEs focused too much, and often too narrowly, on regaining rapid and sustainable growth of trade with and quick entry into the EU — both rather unlikely events for some time to come. The point is manifestly not that such a market among the TEs could possibly be autarkic or that it should be fashioned through intrusive discriminatory instruments. In fact, governments need to set positive steps to ensure that obstacles presently created by still imperfectly functioning markets be reversed whenever justified on economic grounds (Trybuna, 5 March 1996, pp. 9–10; Zukrowska, 1996). One could even argue beyond that: To restore a level playing field in intragroup trade, as compared to their westward relations, positive but temporary discriminatory measures may be justified under some circumstances.
The reasoning runs quite parallel to and is symmetric with any justification of granting TEs discriminatory arrangements, say, in the EU since 1989. The point is simply that even if eventually intragroup trade should encompass no more than, say, a quarter of the total, but achieved at a high level of economic activity with steady economic expansion, it would amount to many more billions of dollars than recorded at present, and it would count for a nonnegligible part of aggregate demand. For as long as the TEs are not functioning against binding supply constraints, there should be room to accommodate such extra demand at a modest extra cost without slighting EU trade or jeopardizing even the timing of eventual accession.

Do TEs in some combination constitute a ‘region’ or ‘natural partners’ for trade purposes? Messerlin (1996, pp. 11–12) denies this because “[m]odern transport technologies, the crucial importance of transaction costs and adequate regulations do not authorize to infer such notions from the mere existence of small distances and geographical proximity.” Surely, one does not follow from the other. If intermediating services for intragroup trade are costly, they must be high as well for trade with other partners, unless there are special measures that inhibit procuring such services at lower cost in international markets. There may be an important exception in the case of the TEs, given their inherited transportation infrastructure directed at the former USSR and since then the upgrading of the west–east axis with little north–south improvement. For the rest, however, the absence of a regulatory environment affects both extra- and intragroup relations to the same degree, provided no special trade-policy hindrances — additional ‘transaction costs’ — affect the latter. Distances are what they are. The ‘cultures’ of the region, and the lingering effects of postwar CMEA coexistence, simply cannot be conjured away.

In fact, Messerlin (1996, p. 2) provides perhaps the best, albeit partial, explanation of intragroup inhibitions: rather high effective tariffs and a whole range of intransparent NTBs, especially of the contingent-protection variety, many of them built into the ‘spaghetti-bowl of preferences’ associated with the various bilateral preferential arrangements put in place since the early 1990s (Brabant 1998a, pp. 394ff.). Presumably, a case can be made for streamlining these discriminatory trade preferences. Messerlin builds his case on the fact that if the TEs are serious in their quest to join the EU they will sooner or later have to remove reciprocal tariffs against TEs that join the EU and conform remaining trade-policy instruments to the EU’s common external protection regime. One could go for unilateral tariff reductions and removal of NTBs. However, a joint approach to facilitating intragroup cooperation, including by harmonizing commercial policy, would demonstrate the willingness and ability — indeed the maturity — of these countries to cooperate among themselves, and hence in their future relationship with the EU.

The countries under review, in whatever combination, have thus far refused even to consider any new institutional mechanism for propping up regional economic cooperation that would in any conceivable way infringe upon one of
the basic tenets of so-called world conditions or might even remotely interfere with making headway with ‘quick’ de facto membership in the EU. It has evidently not sunk in yet that the very nature of the adjustments these countries face, together with the EU’s (and indeed the broader international community’s) reluctance to share wealth on a broad front, prevents their more buoyant participation. In spite of their obvious aversion to intragroup cooperation, reconfiguring the institutional infrastructure for solidifying intragroup relations, now on standard economic grounds, at least as an interim stimulus to growth in the region, should rank high on national policy agendas. They must prop up intragroup trade while restructuring its geographical pattern and commodity composition as part and parcel of strengthening market-based decision making, including by erecting required institutions. This effort should transcend the more formal, if loose, regional ‘organizations’ presently in place.

5. Does an EU rapprochement inhibit regional cooperation?

The motivation for deserting intragroup relations in the early 1990s had multiple grounds. The economic rationale supposedly derived from a twofold argument. One was the fear that maintaining, rebuilding, or expanding such ties would inhibit EU integration. Related to this was the expectation that such merger into the world economy would occur quickly and at minimal cost. Trade among TEs should therefore emerge as the ‘normal’ outcome of integrating into the world economy; some saw integration with the advanced economies as the sole motor driving the TE’s trade, including among themselves. Some still do (Inotai, 1997a, 1997b). The first argument hinges on the tacit assumption that pursuing commerce with the EU exhausts all capacities for participating in the global economy. That is at best a dubious proposition whose empirical validity has yet to be proved. The second argument revolves around the assumption of a quick and low-cost transformation, hence, reaching expeditiously a sustainable catch-up growth trajectory permitting progress in TEs toward levels of market maturity typical of major participants in global economic affairs. The public-good character of assisting agents in TEs in order to level ever so slightly the playing field for markets in upheaval for all actors has thus far been rejected out of hand.

The claims of quick EU accession that might be hindered with more active intragroup cooperation among the TEs were never solid in theory. In addition, from the point of view of pragmatic policy making, given the transition’s circumstances, they rested on shaky grounds. Let me point out a few in addition to those marshaled earlier to buttress the proposition that the potential for intragroup cooperation after the CMEA’s collapse was never negligible. First, because domestic economic agents do not yet possess the institutional infrastructure of markets and can at best procure a substitute in world markets at a significant direct cost, they are not well placed to compete with established competitors. As a result, in the short to medium run early in the transformation,
the comparative advantage of TEs tends to regress to levels at which the gap in relative costs becomes substantial; hence one of the reasons for the ‘new’ specialization of the TEs in labor-intensive low-wage and, in some cases, resource-intensive goods. The TEs’ long-term dynamic comparative advantage, which must be carved out if catch-up is to occur, is unlikely to be located in such goods. The impact of large transaction costs is more pronounced in intragroup trade, an asymmetry that should warrant at least an in-depth examination of whether anything sensible can be undertaken through other than market channels to redress the situation somewhat.

Second, the TEs have experienced a deep economic depression from which only some have been emerging comparatively slowly; only Poland in 1996 and Slovenia in 1997 appear to have overcome the setbacks that antedated the collapse of state socialism! To the extent that the lost output had no ‘market,’ the erosion must be deemed salutary since the freed-up resources could have been used for productive endeavors with a market outlet. At least for some years of the transition, however, those freed-up resources were left idle for lack of aggregate demand; some still are or remain underutilized. Even brisk trade relations with the EU would not have precluded vigorous restructuring of commercial relations among the TEs had their traders been able to compete on an equal footing with established western agents.

Third, integration into EU markets is constructive only if TEs can jump the hurdles of effective participation in the core of the single market. That is, unambiguously intra-industry trade for comparatively high value-added manufactures. Specialization in resource-based or in low labor-cost goods is not really desirable, given the EU’s framework. Reliance on substantial outward-processing trade or footloose foreign investment fares not much better. Without the ability to compete effectively in the EU’s single market, neither the present 15 nor the acceding TEs stand to reap the potential benefits of a large market (as opposed to budgetary transfers or temporary rents accruing from the EU). This cannot possibly be as trivial a matter as it tends to be handled by those claiming that TE accession is hindered because the EU is not ready (Kiss, 1997). Faith that FDI will necessarily launch the TEs eligible for accession into the virtuous circle of intra-industry competition is just that. FDI can only complement domestic capital formation in ever more complex and durable production activities (Brabant, 1998a, pp. 459ff.).

Fourth, one of the requirements for lodging a credible request for EU accession and for running constructive negotiations is ‘good neighborly relations.’ Although this is a fuzzy concept, a state of war, civil unrest, territorial claims, ethnic strife, and so on cannot be considered good neighborly relations.25

25 One should not take this too literally as the long-festering conflicts in the EU (such as northern Ireland, Basque claims in Spain, and the Cyprus problem for Greece) demonstrate. But it would be inconceivable to usher into the EU, say, the Baltic States without the question of sizable, mainly Russian, minorities and of territorial inviolability having been given more than cursory attention.
Furthermore, members must be able and willing to explore the room available for regional cooperation. This includes building upon the comparative advantages inherited from the postwar period when warranted by the presently prevailing economic success criteria. Various regional initiatives, including BFTA and CEFTA, have been launched in response to this challenge. But there has not been much by way of concrete policy measures, if only because some policy makers adamantly reject any ‘counseled’ form of regional cooperation other than what spontaneously arises from market forces, poorly developed as they necessarily are and will remain for some time to come. Nevertheless, the applicant for EU accession must accept the modi operandi of a free-minded, rule-governed European economic space, and that necessarily implies the space presently occupied by the TEs in some constructive configuration. The regression of this reciprocal trade (Inotai, 1997a, 1997b; Plucinski, 1997) toward less ‘sophisticated’ products is worrisome.

Fifth, regardless of how generously the EU will facilitate TE accessions, the adjustment of the candidates to the core of the acquis over a fairly compressed period of time is likely to be traumatic and quite costly. If only for that reason, pleas for quick accession because the trade gains for the EU may offset the incremental transfers to the eastern beneficiaries are not particularly compelling. Although it is difficult to prepare a solid estimate of the ‘other’ costs, it is not useful to ignore the burden of adjusting to and of having new entrants unable or unwilling to live up to the acquis, thus ‘harming’ present members.26 The true dimensions of the costs involved in assimilating and applying the acquis (such as in labor regulations, environmental standards, health inspections, and so on) are only slowly coming to the fore (Inotai, 1997a, 1997b). The effects of the full blast of EU competition are as yet unknown because the liberalization of markets for manufactures for EU competitors started only in 1996. Some TEs have already encountered problems in adhering to their EU commitments (such as Poland with its iron and steel). Not only that, many trade inhibitions, including aspects of the prevailing instabilities in the economic, political, and social environment, must prospectively be removed. At the very least, efforts could have been made to resolve some of the hard common problems, perhaps even by making a joint démarche for assistance and consideration in Brussels. As recently confirmed by Inotai (1997a, 1997b), who is one of the core insiders in these matters, such a cooperative approach has yet to be launched.

In other words, rather than intragroup cooperation diverting attention from a rapprochement with the EU, at least in the medium to long run, exactly the opposite would seem to be the case: Intragroup collaboration can be considered a prerequisite for facilitating EU accession for technical, as well

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26 The Economist, 12 April 1997, p. 77 makes the first point, relying on Baldwin, Francois, and Portes (1997). That paper uses, however, a highly contestable methodology to arrive at very partial and wild estimates that overstate the benefits and understate the costs (Rodrik, 1997 touches upon some of the problems afflicting their assessment).
as subjective, reasons. Most of these regional undertakings have remained very weak and fragile. One should best look at them as potentially affording interim forms of economic and related cooperation that may or may not survive evolving events. Most probably will not as stronger ties are woven over time with core cooperation partners. Unlike others (see Baldwin, 1994), I do not see much purpose in promoting new institutional–organizational forms of either intragroup or east–west cooperation. Exceptions for intragroup trade are to level the playing field, and here proposals have ranged from streamlining and expanding CEFTA to emulating the Asian–Pacific Economic Cooperation initiative (Messerlin, 1996). In relations with the EU I would favor streamlining the Association Councils and indeed the newly inaugurated European Conference into the operative institutional platform for developing, monitoring, assessing, and fine-tuning the pre-accession strategies to facilitate the EU’s eastward expansion; but some format to safeguard the EU’s interests vis à vis all TEs deserves attention too (Brabant, 1996a, pp. 213ff.), if only to ensure that differentiation among the TEs will not disadvantage slow-track privileged TEs and indeed other TEs as well.

Whether regional economic cooperation should preferably be based on voluntary efforts rather than on agreements backed up with a minimal institutional infrastructure has been a controversial issue in TE trade-policy negotiations. I have the impression that adamant refusal to back up CEFTA with even a minimal constitutional framework and a secretariat has been a major source of friction among the members and one core explanation of the comparatively meager results attained so far. Anyway, BFTA and CEFTA embody a free trade agreement (FTA) based on poorly coordinated bilateral FTAs with many safeguards and exceptions that over time may become better coordinated into a single FTA, at least for manufactured goods. Seeking EU accession when FTA members are unable, possibly unwilling, to accord each other effective free-trade status leads to an anomaly: Intragroup trade is far more constrained than relations with the core EU members. True, BFTA and CEFTA has improved over time, but the slow process of harmonizing the various bilateral duty lists and the costs of staving off trade deflection not just from the outside but for now also among themselves, due to the absence of a common external tariff and effective customs regulations, continue to be high.

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27 His proposal aims in particular at generating convergence in tariffs and other commercial-policy instruments among TEs and in time, even before EU accession negotiations are well advanced, to the EU’s external tariff.

28 Whereas one may be skeptical about CEFTA’s future, given its setup (see Brabant, 1995, pp. 554ff.), it is important to recognize that there is room for deepening and widening cooperation among CEFTA members, as well as other TEs. In averring this, I still fail to grasp why some observers view CEFTA as constituted as a salutary development and the core of what potential economic cooperation among the TEs can prospectively be all about (Inotai, 1997a, 1997b; Plucinski, 1997; Richter, 1996; Richter and Tóth, 1993, 1996). CEFTA does not even meet the minimum conditions to bring about a status similar to a real FTA. For BFTA, see Sorsa, 1997.
Whether or not the EU in its rapprochement toward the TEs should seek to facilitate the latter’s reciprocal dialogue and cooperation has admittedly been a highly controversial issue. In my view, exerting subtle pressure on TEs to shore up their mutual cooperation, not only in trade, is definitely worth exploring prior to more fuller integration into the EU. I find the reverse claim that worrying about these issues before adhesion diverts attention from the current priority of securing EU membership (Inotai, 1997a, 1997b) not especially persuasive. It is hard to imagine eastward expansion of the EU while mutual ties among the acceding TEs remain fragile. In fact, a case can be made for nurturing close cooperation among the TEs while some await admission simply to avoid infusing undesirable centrifugal forces into their tactical stances, including with respect to accession negotiations (Martin, 1995). Accession will in any case require time (Brabant, 1996a, 1996b). Meanwhile these economies need to sustain their economic recovery into catch-up growth at the most rapid pace feasible. Given the severity of the TEs’ recession in the early 1990, and the still tepid pace at which they have been emerging from that trough, there must remain room for mutually supportive policies to shore up aggregate demand. To do so in activities that will enable TEs to participate constructively in the core of single-market competition would be very valuable indeed.

As argued earlier, transaction costs in trade among the TEs remain unusually high. The infrastructure for mediating and supporting commercial links continues to be poorly developed (Trybuna, 5 March 1996, pp. 9–10), and often western intermediaries are mobilized for what could largely be taken care of by a regional institution (as for effecting payments). Greater credibility and targeted institutional supports, including to defuse irrational fears that political and strategic entanglements might divert attention from moving into the world economy, could be provided at a sensible cost. With this as beacon, the most desirable ways and means of assisting the TEs in reentering the global economy through international cooperation could usefully be explored. That, rather than rehashing what could have been, or was, should be the principal guideline for exploring regional cooperation in greater depth.

The paramount motivation for action at this juncture should be the search for how best to exploit the current and prospective room for rebuilding commercial ties on economically warranted principles. It may well be true that firms in one TE or another continue to have only a weak interest in importing from their TE neighbors. However, that can only be a transitory aberration. Once the profitability of expanding intragroup trade becomes clear, the penchant for favoring one market over another with spare capacities, or resources available to expand such capacities, will disappear as arbitrage in functioning markets discloses profitable opportunities forgone. Likewise, I do not see any justification for

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29 Even independent researchers have weird ideas about what that might connote. For telling examples, see Pawel Bozyk, who is director of the Institute for International Economic Relations of Poland, no less, in Rynki Zagraniczne, 27 January 1996, p. III; and Richter and Tóth, 1993, 1996.
assuming that current and prospective commercial ties ought to consist solely of technologically sophisticated manufactures (Richter & Tóth, 1993, p. 17). There is simply nothing intrinsically wrong with world trade as such! Legacies of the technological snobbery so prevalent in state-socialist posturing continue to cloud the decision-making horizon and current thinking about economic, political, and social transformations much more than need be. The point that in intragroup trade ‘price–quality’ relationships are disadvantageous (Richter, 1996; Richter & Tóth, 1993, 1996) is also unconvincing. For if it were true, but not in EU trade, how could other TEs find themselves in the same situation? Moreover, how could EU trade be sustained?

Any of the above arguments, and certainly when all are taken together, could justify EU support for policies to improve the specialization of the TEs, individually and collectively, thus mitigating some of the obstacles to the EU’s eventual eastward expansion. This applies especially to weak intermediation in general, shaky financial markets, and the crisis in the banking system in many TEs. EU assistance in strengthening the banking and financial systems could be very important in enabling the TEs to participate effectively in the single market. However, there are other areas where EU involvement would be important.

The core of western Europe constitutes a natural center for exerting ‘subtle’ pressures on the TEs to the extent these countries can be persuaded at all of the usefulness of such a course, perhaps in exchange for obtaining a commitment to broad assistance from and collaboration with the EU. This could most fruitfully be formulated to shore up and impart an impetus to intragroup cooperation, and smooth whatever rough edges there are for now, linked directly to the integration of the TEs into the global community in general and into ‘Europe’ in particular. This should be an integral element in the strategy for strengthening democracy and market-based decision making in the eastern part of Europe and preparing these countries for moving eventually more fully into the global economy in general and the EU in particular for economic security.30

6. Conclusions

I have argued here the merits of several propositions concerning the choices policy makers made early on in the transition regarding in particular the restructuring of external sectors when policy makers were strongly averse to explore voluntarily opportunities for reviving intragroup economic cooperation. Liberalization was the right choice, but the intensity initially chosen with geographical biases was not because demand for TE products is not infinite

30 No conceivable assistance package, including its domestic prerequisites, can be foisted upon any TE. But intransigence on the latter’s part should, then, diminish the claim for assistance to the level of perceived ‘national security’ that western Europe may wish to safeguard.
and financial resources from abroad and scarce and costly. To infuse greater confidence into any such action, I have also argued that outside support, such as from the EU, might be very constructive at least in releveling somewhat the playing field for all economic actors. In fact, most of the intragroup cooperation resorted to so far has been either in a purely defensive mode, such as security concerns about political developments to their east, or because the EU has insisted that TEs knit closer ties among themselves. The substantial volume of idle resources, including labor, could be reabsorbed into production at comparatively low cost for intragroup trade, hence, prop up aggregate demand.

The institutional as well as transportation infrastructure for encouraging trade and economic cooperation among the TEs continues to be particularly weak. Efforts to support interim solutions for the presently missing market institutions crucial for the smooth conduct of trade and payments make sense only when prevailing opportunities for beneficial economic intercourse are not being seized for ‘institutional’ reasons in the broad sense, including ideological aversion to restoring ‘antiquated’ trade patterns; foreign-policy motivations around falling back into economically, politically, and strategically undesirable levels of dependence at a time that these countries seek to foster strong links with the west; and the simple fact that the institutions for the smooth conduct of trade and payments are not yet in place.

Some of these weaknesses could be overcome through concerted policy action. A common approach toward eliminating the artificial trade restrictions imposed since 1989–1990, for example, would cater to political interests and commitments, which are intrinsically shared. It would also shore up efforts to reach the twin basic goals of transformation. True, the degree of overt commonality remains rather shallow. There is simply too much distrust and apprehension that regional cooperation may delay the TEs’ accession to the EU in particular. Strengthening economic ties would bolster confidence and trust among the TEs, quite apart from mitigating some of the asymmetries of the dislocated ‘playing field.’ If such could be achieved with outside support linked directly to the political dynamic of integrating into the EU in particular, the cooperative benefits would accrue not solely from direct trade gains. It should also catalyze structural transformation, strengthen markets in and among the TEs, and prepare the TEs for more complete integration into the EU through a positive, purposively forward-looking, pro-active strategy.

Whereas advocacy of greater ‘regional integration’ would as a rule undermine efforts to multilateralize the global trading framework, in the TEs’ case one can muster support for the view that there is congruence of interest, at least up to some degree. Once the TEs become sucked into EU policies that are truly inimical to globalization, and are not necessarily in the interest of the TEs at least until they will have jumped onto a sustainable growth path to lift themselves by the bootstraps onto the convergence path, the conflicts between regionalism and multilateralism will once again become more pronounced,
however. Reaching that point by pursuing for now regionalism among themselves and with the EU would be salutary provided the policies embraced can be justified on economic grounds. Rounding off the foundations for a maturing market economy remains a prime task.

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