The Eastward Enlargement Effects on Trade and FDI

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1. Introduction

The fifth enlargement of the European Union (EU) involves deep structural adjustments that will certainly change the competitive position of countries and regions. It is a challenging project that entails opportunities and risks for current as well as new members. It is expected that the Central and Eastern European Countries (CEEC) will experience both the highest risks and the largest benefits, as a result of the singularity of their economic and social structures in relation to EU patterns. Trade and foreign direct investment (FDI) flows have been identified as key elements for economic integration. They have been playing a crucial role in the transition and economic convergence processes and will continue to be paramount for the foreseeable future.

Since the beginning of the transition process, profound economic, political and social changes have occurred in the CEEC. After the collapse of centrally planned economic regimes, and over the past decade, a progressively deeper liberalisation of markets has been taking place. The European Agreements and the Trade and Cooperation Agreements have also contributed to these countries' reforms. Overall, considerable progress in transposing the *acquis communautaire* has been achieved and a high degree of implementation has been accomplished in many areas, such as in the internal market. Considerable tariff reduction has taken place and the main trade barriers have been dismantled. As a consequence, trade liberalisation is already a reality in almost all sectors and countries involved, which coincided with a trade reorientation towards the EU.

FDI has been assuming a key role in the CEEC' catching up process, not only because of its importance in overcoming inefficiencies in the local financial markets, but also because it is a fast way of transferring technology and market-oriented business culture to previously centrally controlled economies. For both reasons, FDI

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contributed to the strategic restructuring of firms and to the transformation of the CEEC' export structures.

In what follows, trade and FDI relations between the EU and the CEEC are analysed, focusing on the major changes that have been occurring in the eve of enlargement. Furthermore, we will try to assess future developments, by identifying the challenges ahead and discussing the policies to be adopted.

2. The Dynamics of EU-CEEC Trade Relations

Following the disintegration of the centrally planned economic regimes, there was a fast and extensive integration of the CEEC into the world markets, with the degree of openness, measured by the ratio of exports plus imports to GDP, increasing from 56% in 1993 to 80% in 2001. Trade relations with the EU have sharply increased, but are more intense with neighbouring countries. In fact, Germany is the CEEC' main trading partner, representing more than 40% of the EU-CEEC trade, followed by Austria and Italy. The progressive reorientation of CEEC' economies towards the EU coincided with a decline in their relationships with the Council for Mutual Economic Assistance members (COMECON). In 2001, the percentage of the CEEC' external trade with the EU was around 65%, comparable to that of most EU members.

The expansion of EU-CEEC trade relations contributed significantly to the deterioration of the CEEC' trade deficits. Indeed, in spite of the efforts to overcome such a trend, these countries still display high structural trade imbalances. Moreover, the catching-up process is expected to induce higher deficits in some cases. This is hardly surprising. During the Southern enlargements the new members' trade deficits also generally worsened after joining the European Community. High levels of investment are necessary to achieve economic modernisation, requiring a higher level of imports, mainly of equipment and capital goods. Furthermore, with the expansion of real incomes, imports of more sophisticated consumption goods will naturally increase. On the other hand, given past developments, an export boom in the Eastern countries is unlikely to occur in the coming years.

Trends in current account deficits vary across the new member states. A significant reduction of such deficits highly depends on the rate of convergence and of industrial restructuring. Therefore, it is expected that those countries that have engaged in more profound reforms of industrial structures, and present a higher convergence in productivity levels, will be in a better position to reduce their deficits.

However, given the relatively small economic dimension of some of these countries, bulky investments may also induce a reduction of deficits. Accordingly, the European Commission (2003) predicts that, by 2006, Estonia and the Slovak Republic will experience sizeable improvements in their current accounts.

Given the increase in EU-CEEC trade relations, one key aspect to assess is whether the trade potential between the EU and the CEEC has already been exhausted. Although the empirical literature has not been unanimous, more recent results seem to suggest that, in the short term and for most countries, trade is either close or even above potential levels (Nielson, 2000; Caetano et al, 2002). However, the results also reveal that exports to the CEEC have converged more quickly than imports from the CEEC. As a consequence, there is still a gap between actual and potential imports from some Eastern countries.

The CEEC' permanent economic transformations makes it difficult to predict with confidence the long run trade potential. Yet, in spite of the great expansion in EU-CEEC trade relations, the volume of trade is expected to continue to rise due to the progress in market reforms and to the increase of real incomes. In addition to accession to the EU, CEEC' adhesion to the Euro-zone will also have positive effects on trade flows.

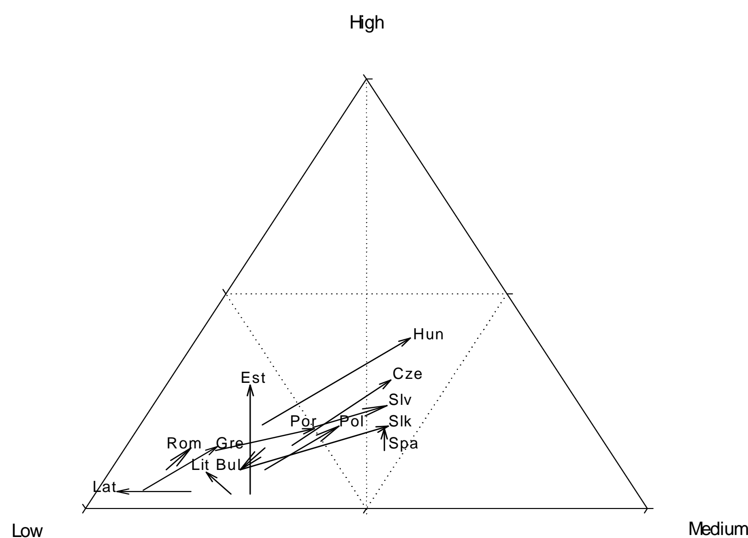
Gains and losses from trade expansion will not be evenly distributed across countries and regions, nor across industrial sectors. Considering the effects of trade creation and trade diversion, empirical evidence suggests that the CEEC that are geographically and economically closer to the EU are the main beneficiaries of trade creation but, simultaneously, are the most affected by trade diversion. The new members sharing a common border with the EU have a pattern of exports that is similar to the one of incumbent members and, therefore, are in a good position to gain market shares from EU countries. Meanwhile, these countries also represent the best markets for EU exports and are very exposed to the competition from European firms. On the other hand, the exports' dimension and structure of the Baltic and Balkan countries will limit their competitiveness in EU markets.

In the EU, the members potentially more affected by CEEC competition are also those which will benefit the most from the integration of Eastern domestic markets into the Single European Market. In contrast, the countries that will benefit the least will also be the less affected by the increasing competition. Portugal is an exceptional case due to its exports profile and geographical location. Indeed, the

country does not have the conditions to gain substantial market shares in the markets of the new members. Furthermore, it may be affected by CEEC' competition in the access to EU markets, resulting in a significant trade diversion.

The liberalisation process in the CEEC changed the economic structures and, consequently, the trade flows and the respective specialisation patterns, reflecting the changes in the relative prices of goods and factors. This process benefited some sectors more than others. Over the last decade, CEEC' exports of natural resources and labour intensive goods have been gradually reduced and replaced by technology and skilled-labour intensive products (see Caetano et al., 2002 and Landesmann, 2003). However, strong heterogeneity at the country level indicates that geographical proximity to the EU core and income convergence stimulates product differentiation and trade of R&D and capital intensive goods. In terms of specialisation patterns, while some countries maintained a traditional specialisation pattern, based on unqualified labour-intensive industries, others registered a progressively higher degree of integration in the European-wide production and trade networks, intensifying their exports of higher technology products (figure 1).

Figure 1: Exports by Technological Levels between 1993-2001

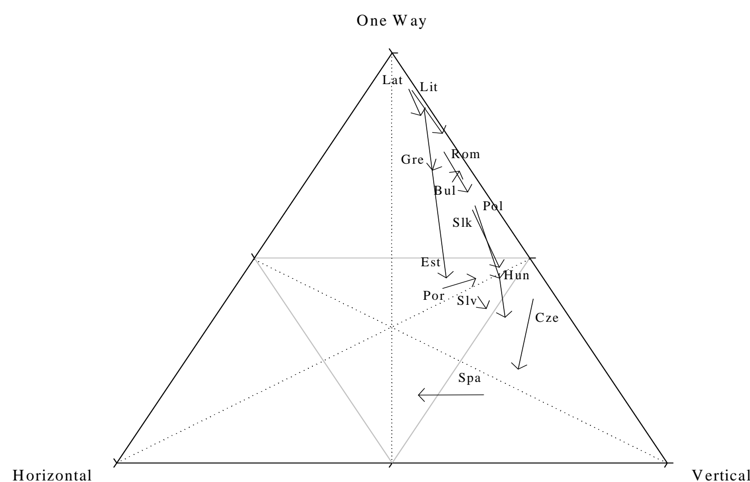


Source: CHELEM – CEPII Database; Own Calculations

Referring to the international segmentation of production processes, there is an increase in the weight of intermediate products (Parts & Components and semi-

finished goods) in the CEEC trade flows and a decline in the weight of the other products (primary, capital and consumption goods). This trend has changed the pattern of comparative advantages, with a decline of comparative advantages in primary and final goods and of comparative disadvantages in intermediate products, resulting in a fall of inter-sectorial trade. The expansion in trade of intermediate goods has coincided with the emergence of a vertical specialisation pattern, which occurs when the comparative advantage pattern suffers an inversion along the production process in each sector (see figure 2). These facts confirm the progressive and rapid entry of the CEEC into the world division of productive processes and add to a better understanding of the changes in the nature and type of trade between them.

Figure 2: IIT Specialisation Pattern between the CEEC and EU (1993/ 2001)



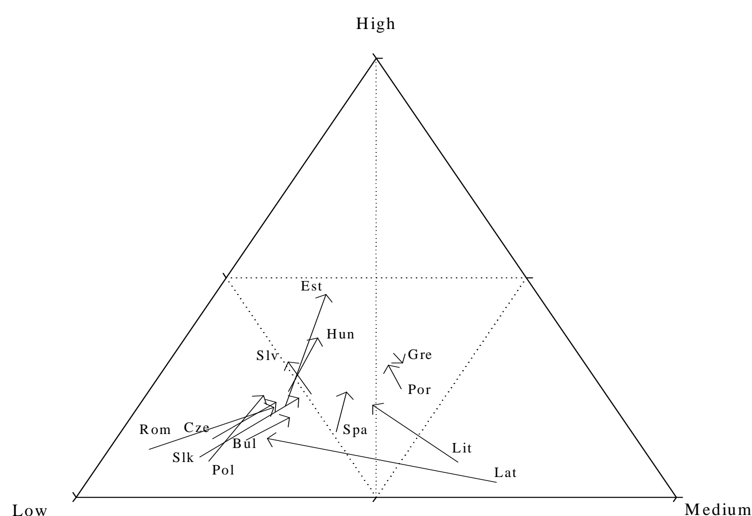
Source: COMEXT – EUROSTAT Database; Own Calculations.

In recent years, the relative weight of intra-industry trade (IIT) has increased among neighbouring regions, indicating that the international labour division (ILD) is influenced by production cost differentials and by low transport costs. The type of

competition/cooperation between Eastern and Western firms, and the industrial specialisation pattern of each region, will determine the effects of enlargement on trade in the regional context. It is expected that the impact will be stronger in the current EU-CEEC border areas, but dependent on the nature of industrial transformations, the level of development of the region and the type of policies implemented.

Additionally, it is important to refer the strong factor complementarity between the CEEC and the EU. These two groups of countries still export goods of different ranges, with trade in vertically differentiated products having a significant share in CEEC-EU trade flows. In spite of evidence of quality upgrading, CEEC' quality levels still lag behind those of the EU, and trade of low quality products remains a source of comparative advantages for the CEEC (figure 3). This difference in the quality of the exchanged products, corresponding to a significant difference in prices, is due to an increasing specialisation in products of distinct quality, based on the diverse factorial intensities employed in the productive processes. While the technological processes of current members are intensive in physical capital, the CEEC production processes are more labour intensive, requiring large imports of specialised equipment (see Boeri and Brücker, 2000 and Caetano et al, 2002).

Figure 3: Price-Quality Ranges of Exports CEEC-EU between 1993/ 2001



Source: COMEXT – EUROSTAT Database; Own Calculations.

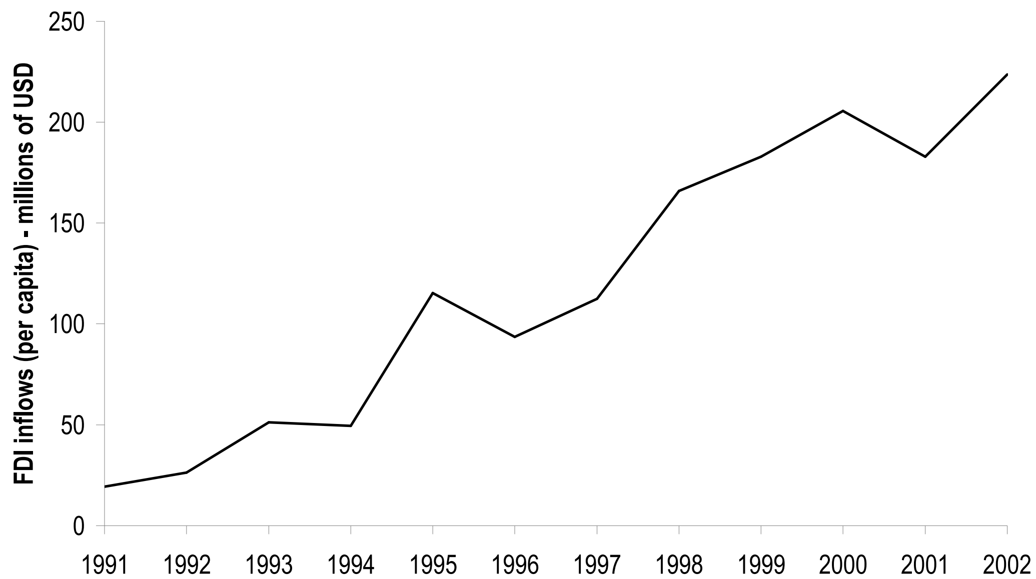
This evolution in the nature and type of trade between countries is highly dependent on the behaviour and strategies of multinational companies, through intra-firm trade and subcontracting of domestic firms, which have stimulated the segmentation of production processes (Kaminski, 2001).

Since trade in vertically differentiated goods has been increasing in EU-CEEC trade relations, a relevant aspect to consider is the effect of foreign exchange rate stability. If trade is horizontally differentiated, with similar prices, firms are not able to accommodate price variations, thus becoming sensitive to foreign exchange volatility. On the contrary, if trade is vertically differentiated, firms have some market power and are therefore better prepared to face foreign exchange volatility. As the empirical evidence suggests, foreign exchange volatility has a more negative impact upon investment in countries with a high degree of openness, a high level of integration in the international processes of production, and a high relative proportion of IIT in similar products (Guérin and Lahréche-Révil, 2001). Accordingly, it is likely that, in those CEEC displaying higher values for these variables, foreign exchange stability will exert favourable effects on investment, trade, and welfare.

3. The Role of FDI in Economic Restructuring

FDI provides funding for projects which would otherwise not find domestic financing. It is recognised as a simple and quick way of transferring business culture and technology to developing regions, performing a pivotal role in the transition process of the former centrally planned economies. In the early nineties, FDI flows to the CEEC were relatively insignificant in global terms. The turning year was 1995 and, since then, FDI growth has been considerable and continuous (figure 4). The CEEC have even been an exception in the worldwide decline of FDI since 2001, continuing to attract increasing volumes of foreign investment (UNCTAD, 2003). Nevertheless, CEEC' FDI stocks, in per capita terms, are still significantly below the EU's average (figure 5), suggesting a continuation of the growth trend in the next few years.

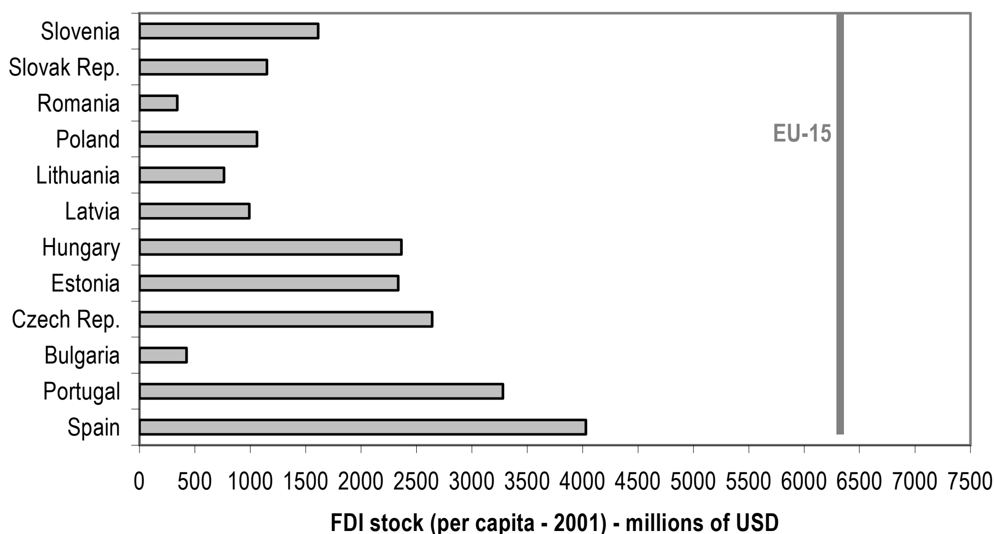
Figure 4: Global FDI inflows per capita in the CEEC (1991 – 2002)



Source: International Financial Statistics, IMF.

FDI projects in the CEEC are very heterogeneous, differing in terms of magnitude, objectives, technology, geographical location, ownership, control structures and geographical origin. The EU is, by far, the main source of FDI in these countries, followed by the United States. More than three quarters of the capital flows entering the region originate in EU member states. Germany is the main partner in terms of FDI flows, followed by the Netherlands and Austria.

Figure 5: CEEC and Southern cohesion countries' FDI stock (2001)



Source: Authors' calculations based on International Financial Statistics (IMF) and UNCTAD (2003).

On the part of the capital suppliers, a variety of motivations influence an entrepreneur's decision to invest abroad, following the optimum management strategies of multinational corporations. The underlying fundamentals behind FDI flows and the reasons for some locations' higher attractiveness have been extensively studied, both theoretically and empirically (see, for instance, Brenton and Di Mauro, 1999, Caetano et al., 2002 and Deichmann et al., 2003). In the process of European integration, the perceived reduction of overall risk in the integrated area has been a key aspect, as FDI increased in the new members after every previous enlargement process.

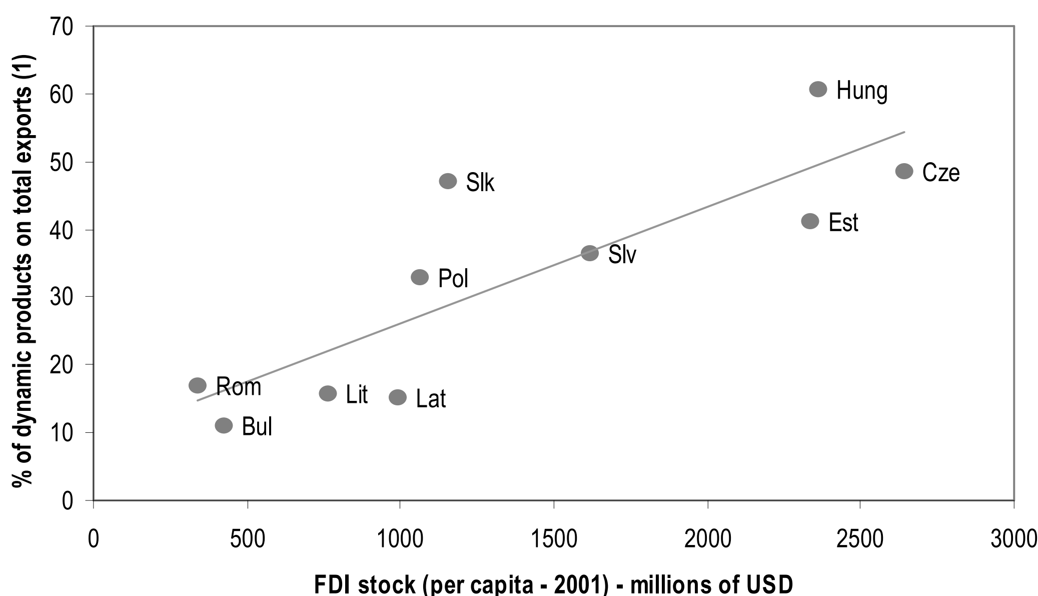
The empirical evidence suggests that spatial proximity and specific economic characteristics attract FDI to Eastern locations (Caetano et al., 2002 and Deichman et al., 2003). Trade and FDI flows concentrate in the bordering countries, with Poland, Hungary, and the Czech Republic, three of the most developed economies, receiving around two thirds of the FDI in the CEEC. Apart from confirming the importance of geographic location, it should also be stressed that these are also the countries that have been more successful in reforming, deregulating, and opening their economies. In addition, host country characteristics, such as its economic dimension, potential demand, openness to world trade, and lower relative labour compensation levels (wages plus supplementary benefits) add up to the list of main FDI determinants.

According to these results, peripheral countries, such as Portugal, may have severe disadvantages in attracting and maintaining foreign investment, not only because of geographical distance, but also due to weak potential demand and low purchasing power. Investors engaged in market-seeking FDI may become less interested in these countries. Efficiency-seeking investors, though, may continue to seek these locations as long as the labour force remains relatively cheap.

The gap in unit labour costs between the new and the incumbent EU members is expected to narrow, thus reducing CEEC' attractiveness from the cost efficiency point of view. Furthermore, all EU members will face the competition of non-member CEEC, who will try to attract efficiency-seeking FDI in the new 'frontier countries'. It should be noted, however, that market potential is expected to increase in the new members, due to GDP growth and the consequent reduction in the economic distance that separates them from the EU average standards. Changes may also be anticipated in the type of FDI directed to the CEEC, as the catching-up process will probably enhance investments by horizontal multinationals and depress investment by vertical multinationals (Carstensen and Toubal, 2003).

The dynamics of FDI flows is expected to promote economic growth in the CEEC, especially due to capital accumulation and the renewal of capital stocks. Besides the positive effects upon restructuring, there are also impacts on the productivity, export performance, product quality and costs. In some successfully restructured sectors, where foreign investors have improved productivity and provided access to foreign markets, cost benefits have been above average and continue to improve (Hunya, 2002, and Havlik, 2003). However, there are concerns that economic growth in some Southern EU countries may be negatively affected, due to a diversion effect or to a crowding-out effect. Though results from previous work do not display evidence of FDI diversion until recent years (Boeri and Brücker, 2000, Buch et al, 2003, and Galego et al., 2004), specific sectors and regions may become affected. Among these are the border regions in Germany and Austria, but also some regions in cohesion countries, highly dependent on the performance of specific sectors (textiles, for example) which will probably be affected by FDI reallocation processes.

Figure 6: CEEC' exports to EU and FDI stock - 2001



(1) dynamic products= products with the highest rate of growth in the EU imports

Source: Authors' calculations based on International Financial Statistics (IMF), UNCTAD (2003) and CHELEM.

Finally, it is important to consider the relationship between FDI and the trade dynamics. Exports structures reflect changes in a country's specialisation pattern and, naturally, the reorientation of exports towards products intensive in technology and qualified labour. The CEEC that have attracted larger amounts of FDI are those that have better adjusted to the dynamics of the EU imports. In fact, as can be seen in figure 6, countries with higher stocks of FDI per capita display a bigger share in their exports of products with the highest rate of growth in the EU imports. Therefore, there appears to be a link between high volumes of FDI and the reshaping of specialisation patterns. These countries have speeded up the process of transformation of trade structures and improved their qualitative competitive position. Moreover, the

structural changes in trade composition were consolidated by increasing shares of IIT in total trade, particularly in the countries receiving the highest amounts of FDI.

4. The Challenges Ahead

The CEEC' accession to the EU will reinforce the integration process. It has already brought increasing opportunities and is expected to keep on generating benefits for economic agents in both new and incumbent member states. Nevertheless, it will also entail several risks. Therefore, it is necessary to prevent the potentially harmful effects, and this will require policies aimed at sustaining past convergence trends of the new member states, or formulating special financial programs, and implementing structural reforms to achieve income convergence between old and new members and strengthen cohesion. Furthermore, it is important to correct possible negative impacts from trade diversion and FDI reallocation, or from the increasing probability of asymmetric shocks.

Before considering particular regions, countries or groups of countries, it is appropriate to focus on the EU's perspective as a whole. The Single Market might be considered the "microeconomic core" of the EU (Brenton, 2002) and the mutual recognition principle is a key issue which depends on mutual confidence among countries. Distortions may arise after the application of the established standards in each country. In addition, negotiations concerning standardisation will also become more difficult when 25 countries instead of 15 are involved. Therefore, administrative and judicial capability is a fundamental element in the application of mutual recognition. Market surveillance and enforcement authorities along with the appropriate means of rectification and sanctions are also important.

The viability of certain firms in the new member states may also be affected by the requirement of complying with the *acquis*, given the substantial investment efforts required. The CEEC must harmonize their regimes with the EU regulations, not only to guarantee full access to the Single Market and to increase competitiveness, but also to benefit the most in terms of investment promotion from the EU regional development funds. Financing the transposition of the *acquis* is exactly one of the areas identified by the European Commission (2003) where specific policies will have to be introduced after enlargement.

Non-tariff barriers are at the centre of the discussion on the functioning of the Single Market after enlargement. Even though it is expected that such barriers will be eliminated in the process of economic integration, it is also plausible that both old and new members will try to protect a number of vulnerable sectors, arguing with public policy and public security reasons. In fact, different kinds of non-tariff barriers may be an important obstacle to trade. Technical barriers are the main impediment to the trade of goods and result mainly from the execution of regulatory policies (for instance for safety and health reasons) and from voluntary standards adopted by domestic industries. In what relates to trade in services, the key issues relate to differences in regulatory regimes across countries, which seriously limit the ability of firms to effectively operate on a European-wide basis. The EU should therefore take the necessary steps to prevent abusive behaviour of regulatory measures from all its members.

Most assessments of the impact of enlargement on trade and FDI dynamics, for the current and new member states, indicate that the benefits are proportionately much larger for the new members. This conclusion is based on the higher weight of the EU in CEEC exports, when compared to the weight of the CEEC in EU exports, and on the smaller dimension of their economies. Moreover, not only an unequal distribution of the benefits between these two groups of countries is expected, but it is also likely that differences will arise within both groups.

In spite of the profound transformations in the intensity and patterns of trade between CEEC and EU countries during the transition period, adjustments in trade will continue to take place in the medium and long run. First, because of increasing investment and production specialization. Second, because there are still specific sectors where trade liberalisation remains incomplete (automobile, services, agri-food). However, on the part of the EU countries, significant adjustments in trade are not expected and therefore CEEC' complete integration into EU markets of goods/services and labour should not lead to significant competitive tensions in these countries. Indeed, the impact on EU employment and wages will be reduced due to the absence of large-scale competition. The direct effects will be restricted to some border regions and producers of similar goods. As for the CEEC, and following the developments of the transition period, it is expected that enlargement will promote some changes in the production and employment structures, which will affect relative factor costs and the distribution of income. The process of labour reallocation from

the primary sector to services and the transfer from activities based on natural resources to those intensive in labour will promote intense adjustments in labour markets.

Although the major impacts of enlargement will be felt by the CEEC, possible trade diversions affecting both the incumbent members and third countries have to be taken into account. Indeed, empirical results suggest some degree of similarity between EU imports from the CEEC and EU imports from the Southern countries (especially in the case of Portugal). This fact has created some fears of higher competition after enlargement, confirmed by a gradual convergence in export prices between the CEEC and the Southern EU members. This tendency reflects a gradual upgrading of the CEEC in terms of the goods' factor contents and factor relative prices, as well as on productivity levels[1].

From the beginning of the transition process, the CEEC displayed large differentials of factor productivity and product quality when compared to the EU, along with strong heterogeneity between the different industries. Since differences were more pronounced on more technologically developed sectors, the catching-up process has been, and will probably continue to be, more sluggish. It is predictable that convergence will be more difficult to achieve in industries requiring more labour qualification and demanding a drastic progress in organisation and management abilities. Given the current situation in the CEEC, the process of convergence will require high growth rates on factorial productivity and product quality in these countries.

It is important to make a distinction between growth potential and growth feasibility, as economic expansion will depend on the institutional environment and on the behaviour of the agents in each country. Indeed, a wide diversity of patterns of industrial convergence may coexist in the future, implying that the comparative advantages' dynamics of the different countries may present quite distinct patterns, determined by the timing of switchovers of the industries' comparative costs.

Therefore, the CEEC face rather distinct situations in terms of economic convergence with the old EU members. In fact, each country's position depends not only on the quality and extent of the structural transformations achieved so far, but also on the country's position within the intra-European trade networks (Radosevic,

[1] This fact has been confirmed in recent work by Caetano and Costa (2004), which does not corroborate previous conclusions (Boeri and Brucker, 2000).

2003). Subsequently, the catching-up trajectories will reflect each country's ability to undertake the structural adjustments necessary for its integration into the common markets and will determine its participation in the economic structures of the enlarged union.

One other significant aspect to consider is the trade dynamics among the CEEC. As tariff barriers amongst the new member states will be abolished by EU membership, it is likely that changes in intra-CEEC trade dynamics and structures will occur. During the first years of the CEEC' economic transition, there was a remarkable decrease in intra-CEEC trade, together with a redirection of trade towards the EU. However, especially since 1994, there has been evidence of increasing dynamics in intra-CEEC trade, which has been more significant than the one observed in EU-CEEC trade. From a geographical point of view, this has not been a homogeneous process. In fact, according to Boillot et al. (2003), trade flows became particularly intensive inside three sub-regions: the Baltic States (Estonia, Latvia, Lithuania), the countries of Eastern Europe (Romania and Bulgaria) and those of Central Europe (Poland, Czech Republic, Slovakia, Hungary and Slovenia).

This intra-regional trade dynamism is not only driven by geographical proximity and by historical links, but can be seen mostly as a consequence of industrial location strategies of Western companies, which has led to the emergence of flows within sectors, between countries of the same sub-region. Multinational companies try to take advantage of geographic and economic proximity and have established strategic positions in these emergent markets. They also intend to exploit the benefits of agglomeration and of the related scale economies and have structured more competitive clusters which cross CEEC national borders. Accordingly, following the CEEC' effective integration into the EU, a process similar to that which took place when Portugal and Spain became community members is likely to occur. In that case, bilateral trade between these two countries, which was mainly driven by multinational companies' activities, increased at a substantially higher rate than trade with their EU partners (Caetano, 1998). Consequently, it might be expected that the CEEC will keep up the EU tendency to increase intra-regional trade flows, and that intra-CEEC trade will grow faster than that between the EU and the CEEC.

Given that both the intra-CEEC trade and the EU-CEEC trade are expected to rise, the flows with third parties may become affected. In fact, some incoming nations have specific trade interests with non-member countries that will require special

authorisation from the EU in order to maintain previously established trade agreements. Although the EU will probably reject such requests, it will be under pressure to improve trade and economic relations with the former COMECON countries. Specific cases will have to be assessed. The EU must adjust its interests in trade negotiations to those of the new members, following what occurred in previous enlargements. In the current case, such behaviour on the part of the EU may also simplify the process of future membership for some of the new members' trading partners. The adoption of the Common External Tariff (CET) by new members may create additional competitiveness problems, as for most industrial goods the CET is lower than these countries' tariffs towards third countries. In order to overcome the challenges of a more competitive environment, domestic firms must correctly identify their weaknesses and be supported in their upgrading efforts. This requires a quick development of new members' financial systems and support infrastructures.

In terms of FDI, even though most empirical assessments find no evidence of FDI diversion from the EU periphery to the CEEC, such conclusion is probably due to the fact that the work published so far is based on data sets that end before 2001. However, a closer analysis of the determinants of FDI in Eastern locations (geographical proximity to the EU core, low labour costs and high potential demand) and a careful examination of FDI stocks' figures in the last two years suggests that the hypothesis of FDI diversion is plausible, particularly when individual regions and specific sectors are considered, instead of countries. Since services are mainly locally supplied, FDI reallocation is more likely in the manufacturing sector, which is the main FDI receiver sector in the CEEC.

It is reasonable to anticipate that the positive expectations related to the CEEC' long-run catch-up trend, the future abolition of foreign exchange-rate uncertainty within the EU, or the lower institutional and political risks will foster both intra-industry trade and FDI in the newly integrated area. FDI will probably be the more positively influenced, as the perceived more secure economic environment will be translated into lower risk premia demanded by foreign investors. In addition, even though there is the need for FDI regimes to comply with EU regulations, and therefore to give up some existent special incentives to attract foreign investors, several CEEC might improve international competitiveness by lowering corporate taxes below the EU average (UNCTAD, 2003). The case of Ireland is interesting in this respect, as the country became a strong attractor of FDI and displays corporate

taxes that are below the EU and CEEC averages (Frasquilho, 2002). However, in the CEEC, tax competition may become incompatible with the need to improve infrastructures, especially in the context of the fiscal discipline imposed by EMU.

A particular feature of the EU enlargement is the redirection of the Structural and Cohesion Funds away from the incumbents to the new members, mainly at the expense of Ireland and Portugal. The aim is to promote the catching-up process in the CEEC, allowing the development of infrastructures which may make the CEEC more attractive to foreign investors. Simulations in Breuss et al. (2003), based on the Agenda 2000, show that the reallocation of funds could divert FDI by five to seven percentage points from current to new EU members in the short-term, or even more after the accession of Romania and Bulgaria.

In spite of the trend that is currently observable, there are reasons to believe that sustaining the current levels of FDI inflows to the CEEC might not be possible in the future. First, the adoption of the *acquis communautaire* enforces stricter labour and environmental regulations, probably increasing production costs. In addition, EU competition policy does not generally allow public subsidies or tax relief favouring foreign investors (Dauderstädt, 2003). Second, the tendency toward price convergence and the Balassa-Samuelson effect will contribute to an increase in new members' wages and other production costs. However, this effect could at least be partially offset by productivity and by income growth. Third, a real appreciation of domestic currencies may occur following large capital inflows and higher inflation. Fourth, the gradual exhaustion of privatisation processes, a major FDI attractor, will require more greenfield investments in order to compensate for such a downward pressure. Finally, FDI stocks in these countries are reaching the EU average, suggesting that some equilibrium level may soon be achieved, reversing the current trend and repeating the course of events in all previous EU enlargement processes.

Overall, considering all the above mentioned factors, it may be anticipated that, although in the short run high volumes of FDI may continue to flow to the CEEC, eventually diverted from the old Southern EU members, a reversal is expected in the near future. The main immediate beneficiaries from such phenomenon may be the new Eastern EU neighbours, now already offering lower wages and similar education levels. Among the new competitors is the group that is expected to join the EU in the next enlargement - Bulgaria and Romania - but also other Eastern countries such as Ukraine. In the manufacturing sector, for example, wages in Poland are

already five to six times above those in Ukraine, an incentive for firms to move across the border and further East.

Under these circumstances, there is a need for specific policies to attract FDI in the more vulnerable new and incumbent members, which are likely to suffer idiosyncratic shocks. More selective promotion strategies should be implemented, favouring high technology and export-oriented activities. Efforts should be made to implement structural reforms capable of generating the necessary conditions to attract market-seeking FDI and upgrade the demand for efficiency-seeking projects. National policies should be conceived to exploit positive externalities produced by FDI flows, namely in productivity, employment, technology transfers and human capital development. On the one hand, negotiations with social partners will be essential to achieve a sustainable development. On the other hand, current technology gaps have to be identified. If such gaps are very pronounced, the technology transfer process between local and multinational companies will be compromised and situations of oligopoly, or even monopoly, may occur. There is still space for further restructuring of domestic firms, despite the structural changes already promoted by FDI. Furthermore, policy makers should promote the development of local innovative firms' clusters and of other alternative ways of generating local synergies. Investment in R&D-driven activities and in innovation is a strategy that should attract FDI with high technological content, which is precisely the more desirable from the host country point of view.

At the same time, there is the need for an efficient system of financial intermediation. Flexible and quick ways to find funds for entrepreneurial activities and easily available risk capital are important to strengthen the entrepreneurial environment. In spite of the remarkable progress already achieved with the privatisation of the large state banks and the entry into the financial sector of EU and USA strategic investors, further reforms towards the restructuring of the financial system and its regulatory environment should not be neglected. This is particularly important given the urgent need to address the problem of the escalating current account deficits in most CEEC, reflecting the convergence process. This entails non-negligible risks for these countries' financial stability, as the Asian experience demonstrates, given the possibility of sudden reversals of capital inflows. Current accounts have been largely financed by FDI, which is considered to be less harmful than short-term capital. However, given its expected reversal in the near future, as

noted above, the relative importance of FDI inflows may be replaced by riskier portfolio investments, as external investors gain confidence with EU accession and try to explore short-term gains. It is therefore prudent to maintain current account deficits within sound limits, to prevent the risks of sudden capital reversals.

One remaining question is related to the timing of the euro adoption on the part of new members. From the commercial point of view, there appears to be no need for an immediate entry into EMU. However, given the rapid structural changes in trade patterns that occurred during the transition period and the growing importance of foreign investment, the adoption of the common currency seems to be inevitable. In fact, the euro may contribute to strengthening the credibility of the ongoing industrial restructuring processes, and may have positive effects upon the new division of labour on the European scale. Notwithstanding this, the integration into EMU will bring additional challenges for new member states, in terms of economic growth and employment, which inevitably will affect trade and FDI. In this respect, the difficulties in complying with the Stability and Growth Pact currently felt by some members are a hint of what the future may entail for new members.

5. Final Remarks

EU membership will promote a broader market liberalisation and a higher level of economic and monetary stability in the CEEC. The new competitive environment will reinforce the role of the market as a mechanism of economic adjustment and promote a more efficient allocation of resources. Therefore, the current processes of industrial and entrepreneurial restructuring, and the geographical reorientation of trade patterns, in the countries involved, will be reinforced. In such a context, the dynamics of trade flows and of foreign investments, along with the strengthening of other forms of entrepreneurial cooperation, are the most visible channels of economic and technological integration of the two European areas. Nevertheless, the empirical studies developed so far suggest that the resulting economic benefits have not been evenly distributed at the geographical or at the sectoral levels.

During the transition process, the dynamics of trade and FDI flows were crucial for the restructuring and modernisation of new members' economies, thus contributing to sustain growth and convergence in the incoming CEEC. Concerning trade, profound changes in terms of the intensity, composition and nature of flows

have been taking place. However, the liberalisation of product and factor movements may maintain the structural asymmetries and therefore the heterogeneous distribution of benefits and costs. From the mid nineties, an increasing flow of FDI into the CEEC has generated positive impacts on industrial restructuring. In fact, transfers of technology and new methods of management have improved competitiveness and the access to international markets. CEEC' technological progress and economic openness have contributed to a new international labour division, via production and distribution networks that involve Eastern and Western European firms.

In the context of enlargement, the greater risks are related to the fact that such dynamics, upon which the internationalisation of the Eastern emergent economies was based, may not be sustainable in the long run. Regarding external investment, it is recognised that foreign firms, stimulated by the privatisation processes and by the prospects of EU enlargement, gradually took positions in CEEC' markets, substituting in a way for the scarcity of domestic funds. FDI flows were also a compensation for the increasing current account deficits. In some countries, however, the inflow of FDI has already slowed down and, in cases such as that of Poland, has declined, thus raising concerns about future developments.

The dynamics of CEEC exports in the last decade, which in real terms grew more than 10% per year, was one of the main sources of economic growth in these countries. Exports' competitiveness was based, among other factors, on low labour costs and on a skilled labour force, on favourable exchange rates and on the re-discovery of the near and large EU markets. FDI played an important role in this process, as shown by the participation of foreign firms in CEEC' trade structures and also by the geographical and sectoral reorientation of exports. The institutional environment promoted by the European Agreements and by the Outward Processing Trade regimes also supported such dynamics. However, there are already signs that the rate of growth of exports to the EU is decreasing.

Summing up, in the future, the greatest risk is related to the mounting signs of partial exhaustion of this growth model. Furthermore, given the evident differences in terms of economic performance and in the degree of internationalisation of domestic and foreign firms in the CEEC, social tensions and regional asymmetries are increasing. Probably the enlargement in itself will not alter recent trends in a significant way, so that growth sustainability in the near future should rely on the dynamics of domestic economies and on processes of economic adjustment. The

incentives to increase domestic saving and to modernise and internationalise domestic firms are the most important challenges to the success of enlargement, since they determine both the rhythm of convergence towards the EU and the balance of current accounts. Appropriate economic policies and EU financial support for the modernisation of infrastructures will undoubtedly help to achieve those goals.

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