3

Trade and investment environment in Central Europe

Introduction

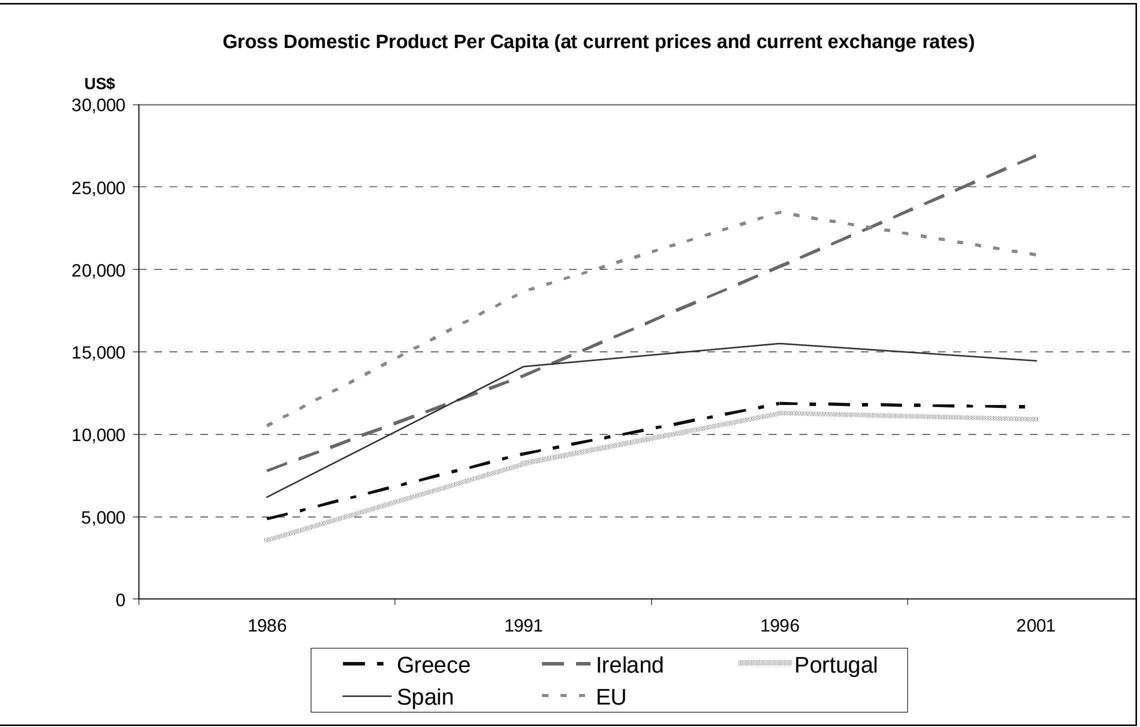
3.1 The addition of just under 75 million Central Europeans to the EU's market of more than 377 million (totalling 452.7 million), will most likely lead to rises in economic activity and living standards throughout the enlarged EU.

3.2 DFAT argues the main effects of the accession of the five acceding countries subject of this inquiry will be manifested through:

- strong market growth, including an emerging middle class
- a steady improvement in the business environment
- the phasing in of the euro in the countries starting in 2004
- the adoption of European standards and institutional mechanisms
- implementation of the Common Agricultural Policy (CAP), with its associated implications for market access

3.3 For a practical indication of what economic effect EU enlargement might have, previous enlargements are instructive. Ireland, Greece, Spain and Portugal's economies grew substantially after their accessions in 1973, 1981, 1986 and 1986 respectively (see Graph 3.1).

Graph 3.1 Economic convergence following previous EU enlargements



Source OECD National Accounts, Main aggregate Volume 1 1960-1993 and OLISNet online

3.4 In that same period of time, trade between Australian and Ireland, Greece, Spain and Portugal has also risen substantially (see Graph 3.2 below).

3.5 The Committee feels that the expansion of acceding countries' economies, and expansion of trade between Australia and those acceding countries, will be repeated with the countries of Central Europe upon their accession.

3.6 This belief underpins the inquiry, this report's analysis and its conclusions.

Overview of Central European economic integration with the EU

3.7 DFAT states that substantial economic integration between the EU and Central Europe has already occurred. The speed and depth of further integration will be a major influence on economic progress and prospects for the countries of Central Europe.[28]

[28] DFAT, Submission No 16, p 49.

3.8 The Europe Agreements established free trade in industrial products over the current transition period. Consequently industrial products from Central Europe have had virtually free access to the EU since the beginning of 1995, with restrictions in only a few sectors, such as agriculture and textiles. In addition, the Agreements contain provisions for liberalisation of the movement of services and capital.[29]

3.9 Approximately 70 per cent of Central European exports go to the EU and 60 per cent of imports come from the EU. Central Europe shows the fastest growth of trade with the EU and now accounts for around 12 per cent of total EU trade, up from 4 per cent in 1992.[30]

3.10 On the financial side, two thirds of net capital flows into Central Europe in the 1990s originated from EU member states. These flows, while important for the recipient countries, represented less than 1 per cent of EU gross fixed investment.[31]

3.11 Total FDI flows into the CEEC-10[32] countries have been nearly 4 per cent of GDP on average. As a result of privatisation, nearly half of the FDI flows have been directed to non-tradeable sectors such as financial institutions and public utilities (telecommunications).

3.12 In the tradeable sector, relatively labour intensive sectors such as textiles, clothing, electrical machinery and the motor vehicles sector have attracted around 20 per cent of FDI flows.[33]

Macroeconomic convergence and the phasing in of the euro

3.13 DFAT believes that EU candidate countries will go through a period of 'macroeconomic convergence' starting in 2004. In this period candidate countries will be required to adopt certain fiscal standards, such as inflation controls, fiscal balances, certain levels of public debt, and exchange rate stability.[34]

3.14 These will eventually flow into full monetary union, participation in the euro area, and full application of economic policy coordination and surveillance procedures.[35]

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[29] DFAT, Submission No 16, p 49.
[30] Figures from DFAT, Submission No 16, p 49.
[31] DFAT, Submission No 16, p 49.
[32] See Glossary for explanation of CEEC-10 and CEEC-8, at the beginning of this report.
[33] DFAT, Submission No 16, p 50.
[34] DFAT, Submission No 16, p 53.
[35] DFAT, Submission No 16, p 53.

3.15 Candidate countries *will not* adopt the euro at the time of accession. They will be required to participate in the Exchange Rate Mechanism (ERM) for at least 2 years which will allow their national currencies to fluctuate within a band around the euro. They will also be required to coordinate economic policies with other member states and adhere to the provisions of the Stability and Growth Pact[36] and the statutes of the European System of Central Banks (ESCB).[37]

3.16 DFAT states in its submission that macroeconomic convergence and the phased introduction of the euro will provide for stability and fiscal certainty.[38] And once the euro is adopted the negative effects on trade of exchange rate fluctuations will be mitigated.

Prospects for economic growth in Central Europe

3.17 As discussed in Chapter 2 and above, prospects for economic growth in Central Europe are very good.

3.18 Over the period 1997 to 2001, most candidate countries achieved rates of economic growth above the EU average of 2.6 per cent. Despite the global slowdown, average real GDP in Central Europe still grew at 4.3 per cent in 2001. GDP per capita measured in purchasing power reached (for the CEEC-10) 39.3 per cent of the EU average in 2001.[39]

3.19 DFAT quotes a European Commission study which found that the average annual growth rate of the CEEC-8 countries could increase by between 1.3 and 2.1 percentage points annually, if reform momentum is maintained.[40]

3.20 There is also an expected modest positive increase to EU-15 GDP of about 0.7 of a percentage point, on a cumulative basis, over the next decade.[41] This will undoubtedly flow through to Central European countries.

[36] DFAT, Submission No 16, p 54.
[37] DFAT, Submission No 16, p 54.
[38] DFAT, Submission No 16, p 54.
[39] DFAT, Submission No 16, p 50.
[40] DFAT, Submission No 16, p 50.
[41] DFAT, Submission No 16, p 50.

3.21 More broadly, the World Bank's Global Economic Prospects Report projects that Central Europe's output growth is expected to accelerate from 2.3% in 2002 to 3.1% in 2003 and 4.3% in 2004.[42]

3.22 The report explains that economic activity is expected to be driven by increased import demand from the EU and by intensification of the EU's accession process[43]. In the longer term the World Bank forecasts that Central Europe's second decade of transition will be easier than the first, although their trade dependence on the EU could slacken this economic progress if the EU's recovery is weak.[44]

3.23 Interestingly, the CEEC-10 have made significant economic progress in the last five years but only small gains in convergence with EU living standards. More substantive convergence with the EU on living standards will be a medium to long-term phenomenon. Even under optimistic growth assumptions, it could take the CEEC-8 group of candidate countries over 20 years to achieve 75 per cent of average EU per capita GDP.[45]

3.24 The impending eastward enlargement of the EU is similar to previous enlargements discussed at the beginning of this chapter. One major difference is that Central Europe has a lower starting point than their Mediterranean and Irish predecessors. Accordingly, necessary reform and adjustment within the transition process is much greater. DFAT believes therefore, that continued growth and development is dependent on continued reform.[46]

The business environment and EU accession

Integration issues

3.25 The majority of Central European countries have only just achieved market economy status and are still consolidating many structural reforms[47]. DFAT believes they will continue for some time to be marginally more difficult markets to operate in, compared with more

[42] World Bank, Global Economic Prospects and the Developing Countries, p 18.
[43] World Bank, Global Economic Prospects and the Developing Countries, p 18.
[44] World Bank, Global Economic Prospects and the Developing Countries, p 165.
[45] DFAT, Submission No 16, p 50.
[46] DFAT, Submission No 16, p 50.
[47] DFAT, Submission No 16, p 51.

established market economies. This is especially the case with Bulgaria and Romania.[48]

3.26 The 2002 European Commission report on enlargement[49] assessed the CEEC-8 candidate countries as fully functioning market economies which have reached a high level of alignment with the *acquis communautaire*.[50] This includes having made considerable advances towards ensuring adequate administrative and judicial capacity.

3.27 In a number of areas, such as transport, telecommunications, energy and justice and home affairs, important elements of new EU legislation have or will be adopted shortly. Accordingly they have been assessed as ready for EU accession in 2004. Interestingly the Committee was mid-way through their visit when the 10 acceding countries signed the Accession Treaty in Athens on April 16, 2003.[51]

3.28 Bulgaria and Romania plan to accede to the EU in 2007. In the last year they have made considerable progress towards meeting the Copenhagen criteria[52] for EU membership.

3.29 DFAT explains that one of the EU's priorities is to ensure the integrity of acceding markets. For the Central European countries this will require improvements in the effectiveness of regulatory authorities such as competition authorities, telecommunication, energy and transport regulators and implementation of suitable information technologies.[53]

3.30 There is a corresponding desire in the EU to ensure appropriate environmental; health and safety; and general social service standards are reached in acceding countries.[54]

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[48] DFAT, Submission No 16, p 50.
[49] Towards the Enlarged Union. Strategy Paper and Report of the European Commission on the progress towards accession by each of the candidate countries. Brussels, 9-10-2002. COM(2002)700.
[50] All legislation adopted under the treaties establishing the European Union, including regulations, directives, decisions, recommendations and opinions. Upon accession of a country to the EU, its existing national legislation needs to be harmonised with the acquis communautaire.
[51] European Commission Treaty of Accession information page, http://europa.eu.int/comm/enlargement/negotiations/treaty_of_accession_2003/index.htm
[52] The criteria agreed by the European Council at Copenhagen in June 1993, setting out the political, economic and legal conditions that the EU candidate countries are required to meet before they can join the EU. DFAT, Submission No 16, p xi.
[53] DFAT, Submission No 16, p 52.
[54] DFAT, Submission No 16, p 52.

Corruption

3.31 Various sources indicated corruption remains a problem in the region.[55] The Committee when visiting Central Europe realised quickly that it was a much smaller problem than they had anticipated in most of the countries. The Committee was left with the impression however, that corruption was a more significant problem in Bulgaria and Romania.

3.32 Corruption has declined in most candidate countries through various efforts over recent years. These include measures such as: the establishment of anti-corruption bodies, greater transparency in public procurement procedures and public access to information.[56]

3.33 Transparency International's Corruption Perceptions Index supports the claim that there has been some reduction in the level of perceived corruption in several candidate countries in recent years, including Hungary, Poland, the Czech Republic and Romania (Table 3.1).

Table 3.1 Corruption Perceptions Index[57]

Country	Global Ranking	2000	2001	2002
Slovenia	27	5.5	5.2	6.0
Hungary	33	5.7	5.3	4.9
Poland	45	4.1	4.1	4.0
Bulgaria	45	3.5	3.9	4.0
Croatia	51	3.7	3.9	3.8
Czech Republic	52	4.3	3.9	3.7
Slovak Republic	52	3.5	3.7	3.7
Romania	77	2.9	2.8	2.6

Source Transparency International: Corruptions Perception Index

3.34 Although progress has clearly been made with corruption in Central Europe, Table 3.1 indicates that not all countries have improved.

3.35 The Committee felt that although corruption was an issue of concern, the evidence examined throughout the inquiry suggested that corruption did not diminish the opportunities available.

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55 DFAT, Submission No 16, p 52.
56 DFAT, Submission No 16, p 52.
57 Relates to perceptions of the degree of corruption as seen by business people and risk analysts, and ranges between 10 (highly clean) and 0 (highly corrupt). Source: Transparency International.

3.36 In terms of political and civil freedom Table 3.2 demonstrates clearly the progress and trends in these two freedoms since the early 1990s. Although the Freedom House ranking has no direct link to trade and investment opportunities, free societies are inevitably more inclined towards, and more able to combat corruption. In this indirect sense Central Europe's improving freedom rankings reinforce the Committee's views on the receding risks of corruption.

Table 3.2 Freedom House ranking

Year	Bulgaria	Croatia	Czech Rep.	Hungary	Poland	Romania	Slovakia	Slovenia
1990-91	3,4,PF	-	-	2,2,F	2,2,F	6,5,NF	-	-
1991-92	2,3,F	3,4,PF	-	2,2,F	2,2,F	5,5,PF	-	2,3,F
1992-93	2,3,F	4,4,PF	-	2,2,F	2,2,F	4,4,PF	-	2,2,F
1993-94	2,2,F	4,4,PF	1,2,F	1,2,F	2,2,F	4,4,PF	3,4,PF	1,2,F
1994-95	2,2,F	4,4,PF	1,2,F	1,2,F	2,2,F	4,3,PF	2,3,F	1,2,F
1995-96	2,2,F	4,4,PF	1,2,F	1,2,F	1,2,F	4,3,PF	2,3,F	1,2,F
1996-97	2,3,F	4,4,PF	1,2,F	1,2,F	1,2,F	2,3,F	2,4,PF	1,2,F
1997-98	2,3,F	4,4,PF	1,2,F	1,2,F	1,2,F	2,2,F	2,4,PF	1,2,F
1998-99	2,3,F	4,4,PF	1,2,F	1,2,F	1,2,F	2,2,F	2,2,F	1,2,F
1999-00	2,3,F	4,4,PF	1,2,F	1,2,F	1,2,F	2,2,F	1,2,F	1,2,F
2000-01	2,3,F	2,3,F	1,2,F	1,2,F	1,2,F	2,2,F	1,2,F	1,2,F
2001-02	1,3 F	3,2 F	1,2 F	1,2 F	1,2 F	2,2 F	1,2 F	1,2 F

Source Freedom House country ratings[58] (F=free, PF=partly free, NF=not free)

3.37 DFAT however advises that companies should remain cautious in their entry strategies. Such strategies may involve establishing a working relationship with a reputable distributor or business partner upon entry, to assist in treading delicately through such initial obstacles.[59]

Trade risk

3.38 Another indicator of the business environment in Central Europe in perceived trade risk. Australia's Export Finance and Insurance Corporation (EFIC) provides a country risk analysis on which to base its credit insurance service.

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[58] The characters representing scores for each year are, from left to right, political rights, civil liberties, and 'freedom' status. Each of the first two is measured on a one-to-seven scale, with one representing the highest degree of freedom; "F," "PF," and "NF" respectively stand for "free," "partly free," and "not free." http://www.freedomhouse.org/ratings/index.htm

[59] DFAT, Submission No 16, p 53.

3.39 Table 3.3 details the 'trade risk' EFIC has deemed each Central European country to carry based on three criteria: credit worthiness, progress in transition from command to market economies and progress towards EU accession.

Table 3.3 EFIC country risk ratings

	Risk Rating (1-low, 6-high)	**Transition scores** (% complete)
Bulgaria	4	72.3
Croatia	4	72.7
Czech Republic	2	82.6
Hungary	2	87.5
Poland	2	83.4
Romania	5	69.2
Slovakia	3	76.9
Slovenia	2	77.1

Source EFIC, Submission No 1, p 4.

3.40 On the measure listed above the Czech Republic, Hungary, Poland and Slovenia are the best performers. Slovakia scored a 3 rating. Bulgaria and Croatia scored a 4 rating, and Romania was deemed to carry the highest risk.

Tariffs and trade barriers

3.41 DFAT and USTR[60] detail a range of barriers to trade with Central Europe. Although some of the barriers are substantial for different sectors in different countries, the Committee believes again that opportunities outweigh the costs. They are still clearly important and worthy of consideration.

The Common Agricultural Policy

3.42 The Common Agricultural Policy (CAP) provides EU primary producers a mix of production subsidies, guaranteed prices, and export subsidies that significantly increase their returns.[61]

3.43 In 2001-02, Australia exported A$116.3 million in agricultural products to the Central European countries. As these countries

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60 Office of the United States Trade Representative (http://www.ustr.gov/reports/nte/2002).
61 DFAT, Submission No 16, p 54.

become members of the EU, they will integrate their tariff structures with the EU's and participate in the CAP.[62]

3.44 Australia is seeking improvements in market access in agricultural negotiations in the WTO Doha Round which constitutes an external pressure on CAP reform.[63]

3.45 EU enlargement is also adding to internal pressures to reform the CAP. The cost of EU agricultural support was 35 per cent of the value of total EU agricultural production in 2001 (compared to 21 per cent for the United States and 4 per cent for Australia).[64]

3.46 CAP programs also account for 90 per cent of the amount spent on direct export subsidies in world agricultural trade. The amount spent on the CAP was EURO 40.5 billion in 2000, accounting for around 43.9 per cent of EU expenditure.[65]

3.47 DFAT believes the agricultural protection provided under the CAP will serve to inhibit growth prospects in some agricultural exports to these markets as well as distorting our agricultural trade with third countries.[66]

Industrial products

3.48 For industrial products, DFAT believes there will be a reduction in average applied tariffs in most of the acceding countries following accession. This will provide a range of benefits to Australian exporters in seeking to enter these markets.[67] They will include: further savings in exporting to those countries because of the potential for greater economies of scale in shipments, simplification of official dealings and lower transaction costs in dealing with the EU.[68]

3.49 However, exporters will still be at a disadvantage relative to EU countries because of the EU's common external tariff.[69]

[62] DFAT, Submission No 16, p 54.
[63] DFAT, Submission No 16, p 54.
[64] DFAT, Submission No 16, p 54.
[65] DFAT, Submission No 16, p 55.
[66] DFAT, Submission No 16, p 55.
[67] DFAT, Submission No 16, p 58.
[68] DFAT, Submission No 16, p 58.
[69] DFAT, Submission No 16, p 58.

Non tariff barriers

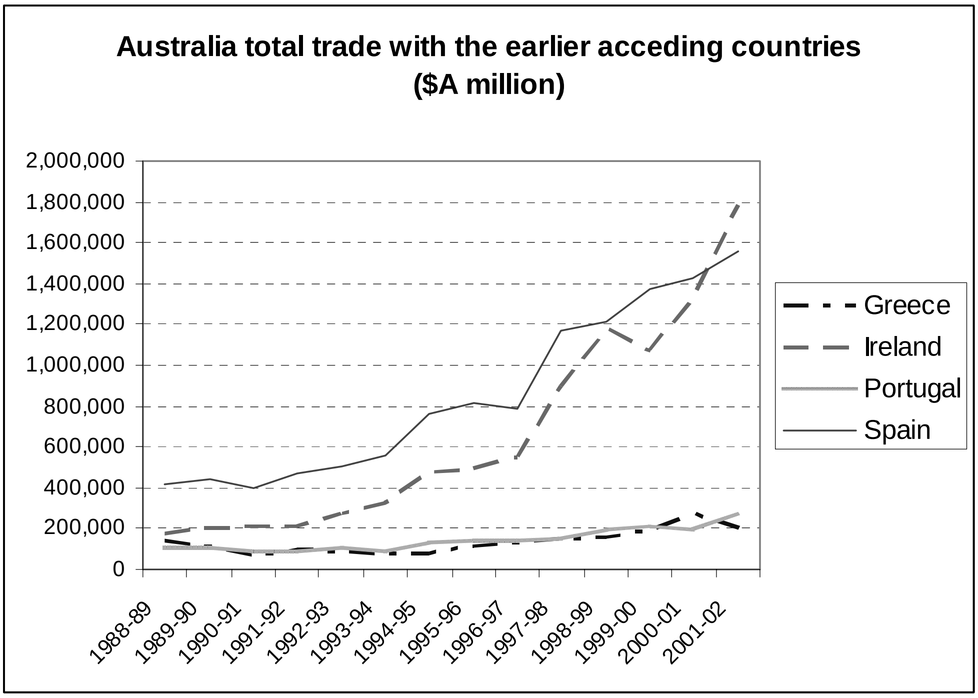
3.50 There are also trade challenges in the areas of standards, testing, labelling and certification. While harmonizing standards with the EU is an objective of all of the accession countries, some US exporters have complained about the lack of transparency and complexity surrounding standards and certification issues.[70] These concerns apply equally to Australia.

Trade creation or diversion

3.51 A key issue in any changing economic situations for Australia, is whether enlargement, leading to a single market approaching 453 million people, will lead to improved trading opportunities (trade creation) or loss of trading opportunities (trade diversion).

3.52 Although this is a common debate revolving around trading agreements involving preferential trade, such as the proposed Australia-US free trade agreement, the Committee is certain that further Central European integration with the EU with create trade as it did with earlier accessions to the EU. See Table 3.2.

Graph 3.2 Australian trade with Greece, Ireland, Portugal and Spain



Source Australian Bureau of Statistics

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70 DFAT, Submission No 16, p 62.

Getting a 'foot in the door' pre-accession

3.53 During the Committee's visit to Central Europe, officials and business people in a number of countries stressed that Australian companies wishing to invest or trade should establish themselves in the region *before* accession. Several people believed that entering the markets in certain sectors post-accession might be more difficult (see section on agribusiness opportunities in Chapter 4).

3.54 While time might already be too short for those countries acceding in 2004, Croatia, Romania and Bulgaria - who will not join the EU until at least 2007 – still do provide opportunities in this regard.

3.55 The Committee believes the negotiation process surrounding this aspect of accession may provide Australia opportunities. This is discussed further below.

Regional bias in trade

3.56 The pattern of trade for Central European countries has a strong bias towards regional free trade partners. The main reason for this is efforts towards regional integration and EU-integration in the early 1990s by Poland, the Czech Republic, Slovakia and Hungary, a grouping otherwise known as the Visegrad Four.[71]

3.57 Australian companies also face higher tariff barriers in exporting to Central European candidate countries than the EU itself. See average applied MFN tariffs in Table 3.4.

Table 3.4 Average applied MFN tariffs in the EU and selected accession countries

Country	Date of Trade Policy Report	Average applied tariff on agricultural products	Average applied tariff on non-agricultural products	Simple average applied rate
		(%)	(%)	(%)
European Union	Jun 2002	16.1	4.1	6.4
Slovenia	Apr 2002	16.0	9.5	10.8
Slovakia	Oct 2001	13.2	4.3	6.1
Czech Republic	Sep 2001	13.4	4.3	6.1
Poland	Jun 2000	34.2	11.1	15.9
Romania	Sep 1999	33.9	16.2	19.8
Hungary	Jun 1998	na	Na	11.6

Source DFAT, Submission No 16, p 59.

[71] The Visegrad Four agreed to establish the Central European Free Trade Agreement (CEFTA) in 1992, with Bulgaria, Slovenia and Romania joining in 1998. As a result of CEFTA and the Association (or Europe) Agreements signed with the EU, there is now a strong bias in the region's trade towards each other and the EU.

3.58 And although Central European countries' external tariffs will be harmonised with the EU common tariff after accession, countries outside the EU will still be at a disadvantage in the expanded EU, due to the newly functioning free trade arrangements within the EU.

WTO and compensatory market access

3.59 When Central European countries accede to the EU, Article XXIV:6 of the GATT will require the EU to compensate Australia for its losses as a result of those countries adopting the 'common external tariff'.[72]

3.60 This point is particularly important because it gives Australia an opportunity to build up agricultural trade in pre-accession Central European countries such as Bulgaria, Croatia and Romania (see Chapter 4 for relevant sectoral opportunities).

3.61 A similar compensation process will take place in services trade under the terms of Article V:5 of the GATS.[73] DFAT states it will be important that Australia is involved closely in this process to protect its access to European markets and to lobby against the expansion of agricultural subsidies.

3.62 DFAT expects that preceding accession, the EU will initiate a WTO related process with its trading partners to discuss the implications of enlargement on their trading interests. This process should begin in 2004.[74]

3.63 The Committee believes that strong diplomatic efforts are warranted during the course of negotiations between the EU and acceding Central European countries. The Committee also suggests that these efforts be focused on ensuring agricultural subsidies are not enlarged, and generally maintaining Australia's agricultural market access to the EU and Central Europe.

Other reform issues

Privatisation

3.64 Privatisation of parts of the CEEC-10 economies has been widespread since 1997. Privatisation strategies are currently focused in sectors

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72 DFAT, Submission No 16, p 59.
73 DFAT, Submission No 16, p 60.
74 DFAT, Submission No 16, p 60.

such as the utilities, transport, tourism, education and energy, and are accompanied by efforts to restructure these industries.[75]

Land reform

3.65 Land reform and the creation of functioning, modern property markets are prominent outstanding issues in many CEEC-10.[76] This is hindering land and housing market development. It could also limit the ability of candidate countries to benefit fully from support systems under the Common Agricultural Policy and the EU's various structural and regional support funds.[77]

Banking

3.66 While most CEEC-10 countries now have a more efficient and stable banking sectors, capital markets and private equity markets are relatively underdeveloped.[78] The financial sector contributes little to the financing of investment in what should be a growing private sector.[79]

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[75] DFAT, Submission No 16, p 53.
[76] DFAT, Submission No 16, p 53.
[77] DFAT, Submission No 16, p 53.
[78] DFAT, Submission No 16, p 53.
[79] DFAT, Submission No 16, p 53.