

# FEMISE RESEARCH PROGRAMME

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***From 15 to 21:***

***The Impact of the Next EU Enlargement  
on Mediterranean non Members Countries***

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**October 2000**

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This text has been drafted with financial assistance from the Commission of the European Communities. The views expressed herein are those of the authors and therefore in no way reflect the official opinion of the Commission

**Not to be quoted**

**FROM 15 TO 21: THE IMPACT OF THE NEXT EU ENLARGEMENT ON  
MEDITERRANEAN NON MEMBER COUNTRIES\***

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**Final Report**

**October 2000**

**\* This report is benefiting from a financial grant from the Commission of the European Communities within the context of the FEMISE program. The views expressed are those of the beneficiary and therefore in no way reflect the official position of the Commission. The authors wish to thank Orly Goldschmidt, Lior Hermann and Hadar Keren for their precious research assistance.**

## CHAPTER I : THE PROBLEMATIQUE

### 1. Organization of the report

Since March 1998, the three so-called Visegrad countries (Hungary, Czech Republic and Poland), Cyprus, Slovenia and Estonia are negotiating their membership into the EU. These are considered to be the first wave countries. Entry is not scheduled to take place before 2003, but most likely entry will be delayed at least until 2005, as indicated by the press at the time of writing (summer 2000).

A second wave of applicants including Slovakia, Romania, Lithuania, Latvia, Malta and Bulgaria have also started negotiations in February 2000 for their entry into the EU, as agreed at the EU's Helsinki Council of December 1999. They are not the focus of this report for different reasons:

- 0) the research proposal of November 1998 approved by the FEMISE Steering Committee referred only to the first wave of applicants.
- 0) as an outcome of the Kosovo crisis of mid-1999, the EU decided under the pressure of events to accelerate quite unexpectedly to open negotiations with a second group of six applicants and accept Turkey as a candidate for accession.
- 0) although the official EU position is that any of the 12 countries conducting negotiations could enter when it would be ready in terms of the adoption of the acquis, the fact that negotiations with the second group has started two years after those with the first group is likely in practice to retard their entry in relation to the first group.
- 0) It is politically inconceivable that countries in the first group be asked to postpone entry until (some) countries of the second group are ready for accession.
- 0) The entry of six countries at the same time is a premiere in the EU's history and is already considered to lead to overload in some member countries; it is unlikely than more than six countries would enter the EU at the same date.

Regarding possible entry dates, most experts do not expect the first wave of accessions to take place before 2005 for different reasons (e.g. Poland's economy will not be ready as it seems until then and an Enlargement without Poland is difficult to envisage).

The basic aim of this research report is to investigate the effects on Mediterranean Non-Member Countries (MNMCS) of applying to the six applicants for full membership into the EU belonging to the first wave the acquis communautaire a) in the domain of the Internal Market and b) in all the remaining domains which are imposed on new EU member countries (such as Home and Justice Affairs or the Common Commercial Policy). A secondary object is to investigate how the shift from a European Union of 15 member states to one with 21 member states could affect countries in the Union's Mediterranean periphery. Not only the size of the EU changes but also its profile and center of gravity. This requires among others to research the foreign economic policies (including trade policy) of the specific candidate countries now applying to enter the EU in the early years of the XXIst century, namely three Central and Eastern European countries, a Baltic country and a Mediterranean country (namely Cyprus).

The report proceeds as follows:

First, it focusses on the a priori implications that for MNMCS has any significant change in the acquis communautaire. The latter is constantly being extended to new domains and embraces an ever-increasing number of countries. MNMCS must keep track of all this, given their economic dependence on the EU. The report briefly reviews chronologically the recent history of relations between the EU and the six applicant countries and then takes stock of the current negotiations between both. The report turns then its attention to a more systematic analysis of the specific effects on MNMCS trade, inward FDI and migrant flows of the elimination of various economic barriers to the movement of goods, services, capital and people between the EU and the six applicant countries. The Single Market is only a part of the acquis. The Enlargement, incorporating six countries with their own policy traditions, will also change

the EU in some respects which must be explored. A very important aspect researched is how the Euro-Mediterranean Partnership might be affected by the next Enlargement.

The outward implications of the next Enlargement of the EU have not been extensively researched until now given the topicality of the subject and the fact that the terms to be offered to applicant countries during the ongoing negotiations are not yet known. This report fills a gap in this respect, concentrating on the implications for Mediterranean Non member Countries.

This report is organized by chapters. The numbering of footnotes starts anew in each chapter. Large tables are included in an Appendix.

## 2. Basic implications for MNMCs of extending the Internal Market for goods, services and factors of production to the new applicants

In fact, looking back for a moment, the economic integration of the new applicants, leaving Cyprus aside, has proceeded by progressive steps since the fall of the Berlin Wall more than a decade ago and has led to a formidable increase in the trade in goods between these countries and the EU as well as in inward FDI (see table A8). Membership will be the last and most important step in the process of historic rapprochement of Eastern Europe to Western Europe. Focussing on trade, for a moment, it is obvious that the deepening in the process of economic integration of the Visegrad countries, Estonia and Cyprus in the EU will continue to lead to an increase in trade between the former and the latter. Depending on the integration stage reached by the applicants at a given point of time (opening of the EU markets without reciprocity, a FTA or a Customs Union) the effects on MNMCs are different. Moreover these effects depend as well on the integration stage reached by the MNMCs with the EU.

In Table 1 a scheme with the different cases have been listed, specifying in each case, the expected trade effects on MNMCs, all other things remaining equal.

Table 1: Trade Effects on MNMCs

	Applicants Unilateral EU opening	FTA	Customs Union with EU
MNMCs			
Unilateral	Trade diversion (Pref. of erosion)	Trade diversion in favour of EU exporters	Increased appl. imports from MNMCs
FTA with EU	Trade diversion (Pref. erosion)	Trade diversion (in favour of EU exporters)	Increased appl. imports from MNMCs
Customs Union	Increased MNMCs imp. from appl.	Increased MNMCs imp. from appl.	Increased appl-MNMC trade

The table must be read across a given line, since the focus of this report is on the effects on MNMCs. In every window are registered the effects which can be expected at different stages of integration of the new applicants with the EU on MNMCs, as a function of the stage the latter are in. For each integration stage of the six applicants in the EU are mentioned the additional effects in relation to the previous stage.

The interpretation of Table 1 is complicated by different factors:

-the interference of multilateral with regional liberalization, e.g. the progressive application of Uruguay Round resolutions both by the EU, the six applicant countries and the MNMCs or of a new Round of multilateral trade negotiations that would have ended successfully before the next EU Enlargement.

-regional integration into the EU by different MNMCs and different applicants is not made according to the same timetables. Most MNMCs are still at a stage indicated in the first line, but not so Israel, which is in the second line in practice since 1989 and Turkey in the third since 1996. In the context of the Euro-Med Partnership, Tunisia, Jordan, the PA and Morocco have already concluded industrial FTA agreements with the EU, while Egypt, Algeria, Syria and the Lebanon have not yet done so. But as can be seen from the table the relative position of MNMCs does not change much when switching from line 1 to line 2. Only a customs union regime (line 3) can lead to different effects. This only concerns Turkey for the moment. But this is precisely an important case, since Turkey is by far, among the MNMCs, the most important trade partner of the largest applicant countries (all in Central Europe).

What is presented above regarding trade in goods can be also applied obviously to services (although the internal regime of the EU in that case resembles more a free trade area rather than a customs union). The concept of diversion can also be applied to capital and labour movements (in other words to investment and to migration). Therefore the scheme in Table 1 can be applied for matters relating to the Internal Market in general.

On terms of methods used, answers to the issues raised above will be tackled by applying economic reasoning and tools used in empirical economic research.

### 3. The EU-21 and the MNMCs: issues of political economy

When dealing with the external profile of the new European Union after the next Enlargement, the following questions come to mind:

- a. Will the change in the geographical center of gravity of the EU affect its economic policies regarding MNMCs?
- b. How will energy dependency change?
- c. What will the likely effect of the Enlargement be on the EU's overseas development assistance policies?
- d. How will the Enlargement affect Home and Justice Affairs, taking into account that by the time of accession, the Schengen Agreement will be part and parcel of the EU's legislation?
- e. Changes in the economic profile and size of the EU and its outward implications
- f. What will be the expected policy input of the new member countries in Mediterranean-related issues?
- g. What are the likely institutional changes brought about by the coming Enlargement and how will this affect relations with MNMCs?

These and other related issues will be addressed either individually or subsumed in Chapter V, using for the analysis comparative statistics and documentation as well as expert opinions collected in in-depth interviews.

### 4. How do the applicants and MNMCs compare? Some basic indicators

It is quite common, e.g. in European Commission documents, to draw statistical comparisons between the EU 15 and the six applicant countries on the one hand; and between the EU and MNMCs on the other. Much less frequent is to draw comparisons between the two peripheral group of countries. In the appendix to this report (see tables A1 to A8) have been included basic economic indicators for the EU 15, the applicant countries and the MNMCs, allowing for this second type of comparison.

Focussing on 1999 GDP data, the aggregate GDP of the six applicants (including Cyprus) reached 293.8 billion \$ in current prices, whereas the corresponding figure for 10 MNMCs (excluding Cyprus

and Malta, but including Turkey) was 560.6 billion \$. This means that the economic size of the latter group is about twice the one of the first wave of applicants. Of course both aggregate figures are dwarfed by the one reflecting the aggregate GDP figure for the EU-15, namely 8494.5 billion \$, since MNMCs represent 6.6 percent of that figure, while applicants barely 3.5 percent. . Noteworthy is that the economic size of Poland is smaller than Turkey's, but larger than Egypt 's and Israel's. The Czech Republic and Hungary can be compared in size to Algeria , but are larger than the other Maghreb economies. Estonia and Cyprus are in the same league as Jordan, and smaller than Lebanon, Syria or Tunisia.

A comparison of GDP growth rates shows that in the last three years (1997-99) the growth record of the six applicants has been sustained at relatively high levels in Hungary, Poland and Slovenia, much less so in the Czech Republic , Estonia and Cyprus, where growth rates have been fluctuating , at times reaching very unsatisfactory levels, quite alike most MNMCs with the exception of Tunisia and Egypt , both of which sustaining growth rates above 5 percent.

GDP per Capita is both an indicator for relative living standards and for development levels. On aggregate a comparison between the applicants and MNMCs shows clearly that the former have higher income levels than the latter. Excluding the odd cases of Cyprus in the first group and Israel in the second, the applicants 1999 GDP per capita range from Poland's 3978 \$ to Slovenia's 10802 \$, while MNMCs 1999 GDP per capita range from 1045\$ in Syria to 5131 \$ in Libya. Noteworthy is that Israel has a higher GDP per capita at current prices than any of the six applicants. To be noted also is that the four Central European candidates and Estonia have been doing a lot of catching-up in the last decade. A comparison of 1990 GDP per capita figures shows that at the time Poland's income level was similar to the one of Algeria and Tunisia and smaller than the one of Turkey. And Estonia was then in the same league as Morocco, Jordan, Syria and Lebanon.

In terms of inflation and monetary stability, MNMCs (with the important exception of Turkey) had reached lower levels of inflation by 1999 than the applicants although both groups , starting from different absolute inflation levels , have been doing quite well in the last five years in terms of reducing inflation.

With the help of WTO trade data it is easy to see that applicant countries have become very open economies. The 1999 export / GDP ratios of Hungary, Estonia and the Czech Republic (about 50% or more) were much higher than those of the most open economies among MNMCs, such as Tunisia (28% ) or Israel (27%). In absolute figures, the Czech Republic or Poland were exporting more than Turkey or Israel, the two leading MNMC traders. A similar record can be observed on the import side. Poland is by far now the leading importer among the countries in the EU's neighbourhood: 44.5 billion \$ in 1999, followed by Turkey with 39.2 billion \$ and Israel with 33.1 billion \$.

The impressive record of openness of the six applicants is confirmed when looking at FDI inflows. On their own, they absorbed billion 10.5 \$ in 1998 (half of it to Poland), twice the amount (5.2 billion \$ ) attracted by the 10 MNMCs considered in the corresponding tables. Summing up, although MNMCs as a group have a larger economic size than the applicant countries of the first wave, both groups are very small when compared to the EU15. The growth record of MNMCs has been less impressive in the last three years than the one of the applicants, particularly in per capita terms. This is partly due to massive FDI inflows into the candidate countries, much less significant in the case of MNMCs. The degree of openness of the new applicants is also larger than the one of the MNMCs. On the other hand, the record of the latter in terms of monetary stability is better overall than the one of the applicants.

##### 5. A survey of EU relations with the non-Mediterranean applicants from 1988 to 1998

Until 1988 the framework for trade relations between the EC and Eastern Europe could be largely summarized as being characterized by a) a lack of a comprehensive bilateral and multilateral legal framework; b) a number of sectorial agreements, relating to sensitive products; c) an impressive number of destructive unilateral EEC trade policy measures governing imports from so-called state-trading countries. Exports of a large number of goods , including so-called "dual-use goods" from the EC to

state-trading countries were subject to strict export controls. By means of a very active anti-dumping policy, the imports from state-trading countries were restricted on a massive scale.

On June 25 1988 a Joint Declaration between the EC and COMECON establishing mutual recognition was signed. It put an end to a situation of de jure non-recognition of the EC by COMECON countries and led to a quick accreditation of missions of those countries to the EC. But the declaration as such lacked substance. Soon after this declaration, a 10-year agreement with Hungary on trade, commercial and economic cooperation was signed by the EC, later on with other CEEC, still under communist governments. The structure of this first generation of agreements (Trade and Cooperation Agreements) was the same. The trade chapter contemplated the gradual elimination of QRs, deadlines being set for 1994 or 1995. It was too little and too late. Very quickly these agreements were superseded (but for the case of the countries of the CIS) by a number of generous unilateral measures taken by the EC within the PHARE programme. Specific (to ex-Comecon countries) and non-specific QRs were eliminated or suspended on the spot. Meanwhile COMECON was dissolved in 1991.

At the Paris Summit of July 1989, the G-7 asked the EC Commission to coordinate the support for the process of political and economic reforms in Eastern Europe. More precisely it was asked to coordinate economic assistance for Hungary and Poland. This programme was called PHARE, originally only aimed at supporting reform in these countries but later extended to Czechoslovakia, Bulgaria, Yugoslavia, East Germany and Romania (Pologne/Hongrie: Actions pour la Reconversion Economique). In December 1989 the first 300 million ECU were allocated for that purpose (to be spent until the end of 1990). The three Baltic states were added to the list in 1991/92. The PHARE programme, now a decade old, has been very successful. It has become the largest financial instrument for know-how transfer to CEECs; its influence on the transition process has been substantial and recognized; it supported areas regarding which other donors did not devote many resources.

As part of the PHARE programme of reforms the EC decided at the end of 1989 to extend GSP benefits to Hungary and Poland as from 1990. The same would apply as from 1991 on for Czechoslovakia and Bulgaria (Romania having received GSP benefits since the 1970s). By 1990, CEECs had been promoted from being considered state-trading countries to being considered GSP countries in the EC's pyramid of privilege. Still, this treatment was less generous than the one received by MNMCs at that time.

In the early 1990s the mood in the EC was one of "wait and see" regarding CEECs. The same applies to the USSR which was in a stage of disintegration. This prudence can also be explained by the economic recession unfolding in much of Western Europe. Moreover many in the EC said that any further enlargement (including the one being studied then to include EFTA countries) would undermine the cohesion within the EC. Others wanted precisely this to happen (e.g. the UK), which led them to back a quick enlargement towards the East. Association was then considered as a short term response to be realized over a medium term period of time. So when the Commission launched in 1990 a proposal to conclude association agreements called Europe agreements as an alternative to accession it did probably not expect that such agreements would gradually evolve toward the main vehicle to prepare for accession. The new association agreements would concern 10 to 11 countries in CEEC but not ex-Soviet Union countries with which the idea was to conclude so-called Partnership and Cooperation Agreements (PCAs). Therefore from then on, a clear differentiation was done between these two groups (with the three Baltic countries being transferred quickly later on from the second to the first group).

The first EAs (Europe Agreements) were negotiated with Poland, Hungary and Czech and Slovak Republics and signed in December 1991. In 1993 EAs were signed with Romania and Bulgaria. These were association agreements according to article 238 which required ratification by all EU member states, the EP and the CEECs concerned themselves. Because that meant a considerable delay in their entry into force, Interim Agreements were signed separately incorporating the EAs trade and trade-related provisions. The EA with Poland and Hungary entered into force only in 1994, while the other four EAs in 1995. Meanwhile EAs were signed that year with the three Baltic States and still later on in 1996 with Slovenia. The agreements contemplated the establishment of industrial free trade in a period of 10 years. The EU endeavoured to free the access to its markets in a period of five years. Therefore the agreements were asymmetric in favour of the CEECs. Specific provisions applied to steel, textiles and clothing, agriculture and fisheries. Movement of persons, establishment, supply of services, payments, capital, competition and approximation were contained in specific chapters. Access to EIB credits was also

contemplated, apart from PHARE. Noteworthy is that anti-dumping and safeguard measures were allowed under the EAs. They were still applied in the early years of association but with decreasing frequency. Still some contingent protection continues to be applied by the EU up to this very day on future EU members from CEEC. Quite significantly as from 1994 the EC considered these countries as market economies for the application of anti-dumping measures.

The CEECs and Baltic countries lost very quickly interest in the EAs and pressed informally for more, namely membership. But accession became a common objective to both these countries and the EU only at the Copenhagen European Council of 21-22 June 1993. There it was accepted that the associated countries or those to become associates (cf. Baltic states) could apply for membership. The EAs contained in their preamble only a sentence saying that accession was the associated country's ultimate objective, not a mutual one shared with the EU. However in the conclusions of the Council the conditions which had to be satisfied by the applicant countries were mentioned, without proposing however a timetable for accession. It was said also that accession would take place as soon as the candidate country could assume the obligations of membership, including stability of institutions guaranteeing democracy, the rule of law, human rights and the respect for and protection of minorities; the existence of a functioning market economy as well as the capacity to cope with competitive pressures and market forces within the Union. The acquis would have to be entirely absorbed with no opt-outs possible. The EU imposed on itself a condition: the capacity to absorb new members, while maintaining the momentum of European integration, an issue which was not addressed in the other enlargement to take place in 1995. The enlargement of the EU to the East would have, it was recognized, important implications for the ECs budget, structural policies and the CAP. The Summit also decided on embarking in a so-called structured relationship with the candidate countries and this in the three pillars of the EU. The "Approximation" of laws became also an important aspect; in practice it meant a process of alignment of EAs countries' legislation with EC rules. De facto candidate countries were supposed to do much of what EEA countries had had to do once in the EEA, only that now it was decided that applicant countries would have to do the approximation well before entry.

In spite of the interim application of the EAs the bilateral trade deficit of CEEC with the EC did tend to increase. The EA agreements came under criticism from various quarters for the degree of EC protectionism they retained and this is why since Copenhagen a supplementary effort was made by the Commission to accelerate trade liberalization and make up for the insufficiencies of the EAs. All duties, QRs were gone by January 1 1995. For steel QRs were immediately lifted while tariffs were phased out by 1996. As to textiles, both tariffs and QRs were eliminated entirely by December 31 1997. Agriculture was left aside. On the other hand, CEEC were allowed under the EAs to raise tariffs for infant industry reasons. It can be said that by 1997 CEECs and Baltic countries were being treated commercially as well as MNMCs and had therefore caught-up with them in the EU's pyramid of privilege in practice and this in spite of the launching of the Euro-Mediterranean Partnership in Barcelona in November 1995. The association agreements to be concluded with each MNMC did not contemplate the possibility of EU membership, something which had been decided regarding CEECs, Baltic countries, Cyprus and Malta already in 1993. Even a formal comparison between the present contractual relations of the EU and its two peripheries shows that the "Europe Agreements" by themselves represent a type of relationship of a slightly deeper nature than the one embodied in the bilateral FTA agreements signed or to be signed with MNMCs in the context of the EMP. For instance the "Europe Agreements" include political conditionality clauses requiring CEECs to buttress democracy, transparency and the rule of law. Both types of agreements have as a final goal industrial free trade and asymmetry in transition periods is a rule. However the latter are shorter in the case of the "Europe Agreements" (10 years instead of 12 years for the EU-MNMCs agreements). Regarding technical harmonization, the "Europe agreements" contemplate the approximation of CEECs laws to the EU acquis over time, while the Euro-Med agreements have rather an open-ended approximation objective. Cumulation of rules of origin among CEECs is also contemplated (and is in place since 1995). Regarding safeguards and anti-dumping duties they can be imposed by the EU only after consultation with the CEECs. There is no such limitation in the case of the Euro-Med agreements. Regarding services, right of establishment, intellectual property rights and the free movement of capital, again the CEECs are supposed to adjust to the acquis communautaire over time. In the case of MNMCs, there are no substantial provisions regarding these items.

Therefore even assuming that CEECs and Baltic countries had not been offered membership by the EU in 1993, EAs would have been placed **slightly** higher up in the EU's pyramid of privilege than the



association agreements to be signed with MNMCs under the EMP<sup>1</sup>. Noteworthy however is that both types of agreements did not contemplate the integration of these two groups of countries in the EU's Internal Market, a marked difference with membership in the European Economic Area, applied to EFTA countries (excluding Switzerland) since 1994.

#### 6. The EU relations with the Republic of Cyprus until 1998 (economic dimension)

The Association Agreement of December 1972 provided for the creation of a customs union in two stages, the first of which was only completed by 1988. In October 1987, the Republic of Cyprus and the EC signed a protocol laying down the conditions and procedures for the implementation of the second stage which was itself divided into two phases. The first phase of 10 years would last until the end of 1997. During this period, Cyprus had to entirely abolish all customs duties for industrial products originating in the EC and adopt the EC's CCT<sup>2</sup>. In fact a Customs Union had only to be in place between the Republic of Cyprus and the EC by the end of the second phase in 2001 or 2002. The two parties had also to eliminate all tariffs on a number of key agricultural products in Cyprus' export basket including new potatoes, citrus fruit and wine, while QRs imposed by the EC on Cyprus would be progressively enlarged. This second phase as foreseen in Article 29 of the 1987 Protocol, would last four or five years (hence the dates of 2001 or 2002), during which both parties would take the necessary steps to complete free trade in agricultural products. Notwithstanding all this, the Republic of Cyprus submitted a formal application for accession to the EC on July 4 1990.

#### 7. Negotiations for accession into the EU of Cyprus and some CEECs and Baltic countries

In July 1997 after agreement on the Treaty of Amsterdam was reached the Commission presented Agenda 2000. It also published its Opinions on the applications on its desk until then. The Agenda basically ignored Turkey. Based on the 1997 Luxembourg European Council decisions and on the strategic background established in the Agenda 2000 official negotiations on accession started in March 1998 with a first batch of four CEECs, one Baltic country and the Republic of Cyprus. Countries were selected on the basis of compliance with the Copenhagen criteria and an assessment of the capacity of candidates to absorb the acquis. Negotiations started with a so-called screening exercise. So, Agenda 2000 was based on differentiation, flexibility and also the need of internal reforms of the EU. In fact, the accession process was open for the 12 applicant countries. The second wave of (6) candidate countries was invited to join Accession Partnerships, which means that all forms of assistance to CEEC, including PHARE would fall within a single framework. Pre-accession financial assistance would be increased. Turkey was not included among the list of candidate countries and would not assist, even if invited, to the London Conference of early 1998. In Agenda 2000 the Commission put the total of 75 bn Euros as the extra cost that the Enlargement was supposed to cost the Union.

Over the years, trade relations have experienced a dramatic geographic reorientation and structural change has resulted in rapidly growing market shares on both sides. The trade impact of the EAs has been important quantitatively. The EA countries already exported some 48% of their exports to the EU in 1992. At that time, their share in extra-EU imports was only 3.3%. Together with Slovenia and the three Baltic states the 1994 share in EU external imports had risen to 5.74%. In agriculture the bilateral trade balance has swung dramatically in the EU's favour. This is due not surprisingly to the fact that EU exports are subsidized, while CEECs exports to the EU are not. FDI involved both in the privatization process and in green field activities has created fundamental pillars for sustainable development, technological upgrading and legal harmonization with the EU.

In passing, from a strict economic viewpoint, acceding nowadays to the EU is not as easy as it used to be in the 1980s for Spain, Portugal and Greece, countries which can be compared for many purposes to the six applicants of the first wave. The accession of third countries to the EC implied then "only": 1) The

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<sup>1</sup> An exception to what is said here is the 1995 EU-Israel agreement which contemplates the conclusion of separate agreements between the two sides, e.g. in R and D leading to the integration of Israel in the EU's scientific space. Certain experts would place because of this the EU-Israel association agreement at par or even above the EA in the EU's pyramid of privilege.

<sup>2</sup> The EC abolished long ago tariffs on Cyprus' industrial exports.

establishment of a customs union between the Community and the new members (relating to trade in goods); 2) the application by one more country of the Common Agricultural Policy and 3) the adoption by the new member of the contractual relationship which the EC had with third countries. Since the ratification of the Single European Act in 1987, which resulted in the creation of the Single Market in 1993, the elimination of all non-tariff barriers on trade in goods and in services between the EC and the new member was then added to the acquis. With the ratification of the Maastricht Treaty (in 1993) the latter was enlarged again in the economic field (steps towards EMU); but also in the foreign policy and security field and in the home and justice affairs. Finally with the ratification of the Amsterdam Treaty, Schengen is now part of the acquis as well. (including a common visa and asylum policy), something which has also economic implications<sup>3</sup>.

Core issues not yet discussed in negotiations of accession of the first wave of countries include agriculture, structural funds, movement of persons and Schengen. These four issues are very sensitive for the EU.

To be noted here that only recently at the Helsinki European Council of December 1999, the EU modified quite radically its Agenda 2000 strategy by announcing it was prepared to open negotiations for accession of the second wave of six countries in the first semester of the year 2000, while Turkey was now included in the list of candidate countries, although no dates for the initiation of negotiations was determined.

#### 8. Present state of the negotiations on the adoption of the acquis by the first wave applicants

Negotiations towards the adoption of the acquis by the the six applicant countries of the first wave are divided into 21 chapters. Not all of them have been opened yet at the time of writing, some of them very important and sensitive such as the one on labour movements. Fortunately for the present research project, key chapters having some bearing on MNMCs have been already been practically closed. Below is a short report.

##### 0) Adoption of the external acquis

The negotiations on this issue have practically been finished. They are not considered problematic.

The basic positions of the parties are as follows:

The EU has said applicants have to apply the Common Customs Tariff and all the bilateral agreements the EU has with third countries at the latest at the time of accession. The applicants will have to denounce any agreement with third countries that is incompatible with the acquis and become a party to all EU external agreements. The EU has said that no transition periods will be granted. Most applicants have requested to maintain their preferential agreements with one or the other of their neighbours that are not becoming members of the EU. None of these neighbours is actually one of the MNMC under focus in this report<sup>4</sup>. But applicants have started to withdraw their requests.

In any case, no applicant has asked for derogations or transition periods regarding the application of the Euro-Med Agreements. In a specific case this has implications for an MNMC, namely Israel, in its relation with Hungary. This country will have to abandon formally its Free Trade Agreement with Israel, which contains important agricultural trade concessions made by Hungary to Israel. In fact nowadays Israel is sometimes better treated by Hungary than the EU, a discrimination which the EU asks to be eliminated forthwith. An example is cut flowers. At present there is a tariff quota open in favour of Israel with zero tariff while on EU-originating imports there is a 2-3% duty. It is obvious that with accession the situation will be reversed, since EU exports will enter Hungary duty- and quota-free, while Israel-originating imports will be traded according to the restrictive regime determined in the 1995 Israel-EU agreement.

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<sup>3</sup> For a detailed explanation of what is required nowadays from applicants with implications for third countries. See Chapter II, section 1.

<sup>4</sup> Strictly speaking Croatia which appears, e.g. in the list of Slovenia is a MNMC, but is not considered by the EU under the EMP, but rather as a potential EU member.

Candidate countries have also been asked by the EU to inform it of any bilateral negotiations the applicants may conduct with third countries. Moreover any new trade agreements which they may conclude between now and accession time should include a provision which enables them to terminate the agreement before accession without need for compensation by the EU to the third partner country.

The Commission has informed the candidates about recent elements entering the “external acquis” in April 2000 such as the EU-South Africa FTA , the EU-Mexico FTA, export credits, the new MEDA Programme and the inclusion in the Barcelona Process of Libya as an observer. Again no objections were raised by any of the six applicants at that occasion (even if in fact the EU was not consulting but rather informing them). Quite important in this respect is that any new acquis adopted from the time of negotiating to actual accession must be incorporated by the applicants (e.g. the agreement between the EU and Egypt to be concluded soon).

The Commission insists that seen from an MNMC perspective, the Enlargement will be a plus since MNMCs will have to confront a single set of rules in 21 European countries and not “only” in 15 . This means a considerable administrative simplification, greater certainty for traders and simplified procedures.

#### 0) Adoption of Single Market rules

Here mention is made of two issues that might have some bearing on the future relative position of MNMCs in terms of competitiveness:

One relates to Poland’s 17 special economic zones, which offer tax relief to producers established there. The EU says they are incompatible with EU competition rules. Poland says that if it has to dismantle them producers established in those zones might locate elsewhere. The EU has however said clearly that no exception will be made regarding state aids or competition rules. Negotiations on this matter are not yet completed. Should the opinion of the EU prevail, as it looks like, some of the industries located in these zones could possibly shift their location to other labour-rich countries, including MNMCs.

The second one relates to Cyprus’ off shore business, developed there initially as an outcome of the Lebanon Civil War, greatly expanded since then and which should be phased out with accession into the EU. In any case, Cyprus will be called to possibly roll back present lax tax rules. The issue has been raised by Cyprus in present accession negotiations since many banking, insurance and shipping management companies will be affected. The EU acquis is not large in these matters. There is an EU code of conduct on harmful business taxation. Cyprus has recently said it will adhere to it. The implications for some MNMCs might be important. For once, Lebanon could possibly recuperate back some of the business lost to Cyprus as a consequence of the Civil War. Israel might benefit too. This unless the menace of sanctions announced quite recently by OECD countries on countries promoting by their practice tax evasion materialises. In shipping, the EU is asking Cyprus to apply the EU’s social and safety standards. This is important because Cyprus has the fifth largest merchant fleet in the world under its flag and is good news for the many MNMC citizens working for Cyprus shipping companies, particularly from the Eastern Mediterranean.

#### 3) Adoption of the Schengen Acquis (Chapter 26)

The EU has said there is no opt-out possibility open to the applicants on this subject. In fact, the EU has obtained the cooperation of Central European countries in controlling asylum seekers and migrants since some time now. This is the so-called Budapest process. Notice must be taken here that the Schengen agreement only entered into force a couple of weeks before the Amsterdam Treaty in April 1999. The EU is helping the applicant countries with technical assistance and money to reinforce their external borders. The direct implication for most MNMCs citizens is obvious. Entering the new member countries legally or illegally will be more difficult than now. Fortress Europe will be enlarged from 15 to 21 countries. For instance as shown in Table 2 below Cyprus will have to eliminate Egypt and Syria of the list of countries for which entry visas are currently issued free at the border and Slovenia will have to impose entry visas on Tunisian and Turkish passport holders. This is in order for these applicants to adjust to the requirements set by the Schengen rules (see Table 17 which spells out which MNMCs visitors must

obtain visas to enter the Schengen area)

Table 2: MNMCs for which entry visa requirements are waived by individual applicant countries

	MNMCs
Cyprus*	Egypt**, Israel** and Syria**
Czech Republic	Israel
Estonia	Israel
Hungary	Israel
Poland	None
Slovenia	Israel, Tunisia and Turkey

**Source:** World Travel Guide, 1999, UK Edition

\* Holders of Turkish Republic of Cyprus refused entry

\*\* Visa issued free provided onward or return tickets and sufficient funds to cover duration of stay

\*\*\* Provided visa for Latvia or Lithuania has been issued by the latter

On the other hand, in the case of Israel, the Enlargement will be liberalising, since Poland, Cyprus and Estonia will have to drop any of the existing visa requirements applied by these three countries in view of the fact that Schengen countries do not require visas from Israeli visitors. Of course should the entry of the Republic of Cyprus be linked to a political arrangement with the Turkish Republic of Cyprus, this would be excellent news for the people of that part of the island, since they would be free to visit without any entry visas not only the other part of the island but also all the other 20 EU member states, a quantum change for them.

#### 4) Adoption of the acquis on labour movements.

Not much can be said for the moment since the chapter is not yet open yet. The only thing that is known is that in this instance the EU will ask for transition periods to delay the application of the acquis and that the applicant countries are likely to accept. Spain, Portugal and Greece had at the time of their own negotiations to enter the EC to accept a seven-year transition period. It is not likely that this time, the transition period will be shorter than that. The implication for MNMCs is then that any knock-on effects on them will take time to materialise.

Finally it should be noted in passing that applicant countries are not asked to adjust their foreign policies (apart from renouncing to an individual trade policy), since these are covered by the second pillar. In other words CFSP is not part of the acquis which means concretely that the new member countries can maintain their own foreign policies regarding conflicts opposing MNMCs among themselves (e.g. the Israeli-Arab conflict; the Turkey-Greece conflict and so on).

## **CHAPTER II: TRADE IMPLICATIONS OF THE COMING ENLARGEMENT FOR MNMCs**

### 1. EC Enlargement viewed from an MNMC's perspective in matters related to trade in goods

The purpose of this chapter<sup>5</sup> is to explore the wider trade implications of the accession of the first wave of six countries into the EU on MNMCs and evaluate some of the possible trade effects. Of course, MNMCs can expect many other effects from the next Enlargement, as explained in Chapters III and IV, such as some investment diversion<sup>6</sup> and substitution in the EU of migrants from the South by migrants from the future member states. As indicated, the terms of the accession agreements being negotiated since March 1998 are not known yet. This is not too important, however, when dealing with trade issues since the trade component of the future Enlargements is already in the making, by the progressive implementation of the Europe Agreements, signed between 1991 and 1995 (the last one with Estonia) and the Customs Union agreement between the EU and Cyprus.

<sup>5</sup> This chapter is a much-extended, revised and up-dated version of the interim paper presented at the FEMISE conference of February 2000 in Marseilles (France). It takes into account remarks made by those attending the presentation of the paper. Helpful comments were also provided by Jakob Kol, of Erasmus University in Rotterdam, on an earlier version of this chapter.

<sup>6</sup> There is some empirical evidence that this has happened already regarding Spain. See Elteto(1995).

Note that this chapter looks into the trade impact of this Enlargement on MNMCs **Turkey included**, since for all purposes the latter is not expected to entry into the EU in the foreseeable future according to all experts consulted.

Viewed from an MNMCs perspective, the accession of third countries to the EC implied until January 1993 several different but all significant steps, deriving from the adoption by new members of the so-called acquis communautaire: 1) The establishment of a customs union between the Community and the new members (relating to trade in goods); 2) the application by one more country of the Common Agricultural Policy and 3) the adoption by the new member of the contractual relationship which the EC had with MNMCs. All these three things were supposed to happen always **after or at the time of accession**. MNMCs had also to consider 4) what new membership meant in terms of the EC's larger economic and political size; 5) how the center of gravity of the Community changed with every incorporation of new members; 6) which institutional changes derived from every Enlargement; 7) which particular input in policy-making the new members brought along.

Since the ratification of the Single European Act in 1987, which resulted in the creation of the Single Market in 1993, MNMCs must also be aware of the possible implications of 8) the elimination of all non-tariff barriers on trade in goods and in services, capital and manpower between the EC and the new member.

With the ratification of the Maastricht and the Amsterdam Treaties, the acquis was enlarged again in the economic field (plans for the creation of a Monetary Union); but also in the in the domain of home and justice affairs (steps towards a common visa, asylum and migration policy; adoption of the Schengen agreement at the EU level). The issue relevant to this chapter is whether the adoption by the new members of this part of the acquis affects MNMCs trade or not as well. It does not seem so as far as Home and Justice Affairs is concerned, which certainly might have a third-country impact on established or potential migrants (see Chapter IV), but not on trade. The adoption of the euro by the six negotiating countries and their entry in the EMU might obviously have trade implications for MNMCs (since the exchange rate is an important non-tariff barrier which is eliminated in any monetary union). But even if the outcome of the on-going accession negotiations are not yet known, it can be assumed quite reasonably that none of the six "first-wave" countries will accede to EMU upon accession but later, if not much later. According to different legal experts<sup>7</sup>, new member countries will have to wait a minimum of two years, even if at the time of entry they comply with all the Maastricht criteria and this in order to check whether the inflation rate over the first two years after accession is in line with what is requested by the criteria. In any case, most of the applicants are far away from complying with at least some of the Maastricht conditions.

Therefore and to sum up basically **the trade impact on MNMCs of the next Enlargement will not be affected by the additions made to the acquis in the 1990s.**

Furthermore, some of the steps specified above may be of little practical consequence depending on the existing relationship between the new member and the MNMC in question. For example, if at the date of joining, e.g. in 2005, the acceding country conducted with the MNMC already industrial free trade, as is likely to happen in the bilateral relationship between Israel or Turkey and Visegrad countries, the adoption by the latter of the 1995 Israel-EU Association Agreement or the Turkey-EC Customs Union is not going to make much of a difference. Israel, indeed, has concluded by now free trade agreements with four of the six first wave candidates (Hungary, Poland, the Czech Republic and Slovenia). Or Cyprus' formal entry into the EU, as is likely by 2005, would not add much as far as MNMCs industrial exports are concerned to the completion of the customs union between Cyprus and the EC scheduled to take place already by 2001<sup>8</sup>, since in that case Cyprus would have to adopt the FTA agreements which the EU has signed with different MNMCs under the EMP **several years before Cyprus actually enters the EU.**

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<sup>7</sup> See, e.g. Wall Street Journal, July 28 2000.

<sup>8</sup> Note, however, that Cyprus has recently asked the EU not to proceed with the establishment of the Customs Union and the EU has agreed, having decided to focus instead on the accession negotiations.

In this respect it is to be noted that trade-wise CEECs, Estonia and Cyprus are being integrated progressively into the EU well before formal accession, the latter actually since the early 1970s when a first association agreement was signed. CEECs and Estonia have started their real trade integration with the EU only in the early and mid 1990s (after being ostracized for many years by the EC, considered as "State Trading Countries", and in the case of Estonia as part of the USSR). Slovenia is a special case since on the one hand it was until 1991 part of Yugoslavia which until then was benefiting from GSP treatment in the EC on its industrial exports (i.e. basically tariff-free quotas), while Hungary, ex-Czechoslovakia and Poland were given ad hoc trade concessions by the EC since 1988, consisting first in the elimination of QRs and the concession of most-favoured nation treatment; then in 1990 they were upgraded to GSP status (Czechoslovakia in 1991) and next in 1991 with the conclusion of the so-called Europe Agreements free trade was to be established between these countries and the EC over a period of 10 years, starting from 1992 (but excluding key industrial sensitive sectors such as steel, steel products, textiles and clothing)<sup>9</sup>. In fact, as a result of, again, ad-hoc decisions in the mid-1990s, CEEC exports to the EU would obtain tariff- and quota-free access into the EU by 1997 or 1998, even for all the sensitive industrial products<sup>10</sup>. As a result and not surprisingly, EU industrial imports from CEECs have increased tremendously in recent years. For instance total imports increased by more than 71% to a total of ECU Bn 26.3 in one single year, 1994 (to be compared with a 11% growth rate of EU imports from MNMCs). CEECs represented already by 1994 5% of extra-EU imports (up from 3% one year before) to be compared to a MNMCs share of 8%, down from 9% in 1991. EU manufactured imports from CEECs and from MNMCs represented then 75% and 51% respectively of total imports (the share of textiles and clothing alone reaching 17.5% and 22.7% respectively)<sup>11</sup>. According to Eurostat, the CEEC are the second most important partner since 1997, ahead of the MNMCs, accounting for 9.7% of extra-EU trade in that year (the US being the first one with 20%). And the EU represented in 1997 71.8% and 55.5% of the CEECs total imports and exports respectively.

The big exception to the liberalization effort made by the EC is of course agriculture. In fact it seems that the EU will not admit the principle of free trade in agriculture with the new member states until at least their formal entry into the EU if not later.

## 2. Trade effects of integrating the six first wave countries in the EU on MNMCs: A taxonomy

Five types of **static effects** must be distinguished:

### A. Trade diversion effects in EU markets (preference erosion)

The general trade regime provided for in the Europe Agreements contemplated full and immediate liberalization for most industrial products, but a lower liberalization for semi-sensitive and sensitive products. No real trade liberalization for agricultural exports is in the offing until well in this decade. Viewed from an MNMCs perspective it means that the erosion in its preferential status is being entirely delayed in agriculture and has been partially delayed until two years ago (1998) for goods for which the MNMCs normally had some comparative advantage (clothing and textiles or steel products); for all the

<sup>9</sup> The agreements were signed only in 1994/1995 but the trade and trade-related provisions were enforced sooner by interim agreements without waiting for the ratification needed for mixed association agreements on the part of the EP, all the EU member states and the associated country's parliaments. Note that only from the entry into force of these Europe Agreements the EC considered the partner as a market economy, not a state-trading economy anymore. This has been important for the application e.g. of anti-dumping measures. Note that since 1992 after the Europe agreements were signed 8 anti-dumping investigations have been opened against Poland (representing 1% of imports from the EU). In the years 1998-99 there were 10 goods subject by the EU to anti-dumping measures (including iron and steel products, zinc, polypropylene and urea ammonium).

<sup>10</sup> A comparison of the trade aspects included in the Europe and the new EMP agreements shows that cumulation of rules of origin among CEECs is contemplated in the former (and is in place since 1998). Regarding safeguards and anti-dumping duties they can be imposed by the EU only after consultation with the CEECs whereas there is no such limitation in the case of the Euro-Med agreements. Regarding services, right of establishment, intellectual property rights and the free movement of capital, the CEECs are supposed to adjust to the acquis communautaire over time. In the case of MNMCs, there are no substantial provisions regarding these items.

<sup>11</sup> All data extracted from European Commission (1995).

other goods the erosion took place long ago at least since the mid 1990s and therefore no supplementary trade diversion against MNMCs should be expected compared to the present situation<sup>12</sup>. In fact for most industrial products it should be possible by now to see what has happened, although not yet for sensitive products at least for a couple of years. The reason is that detailed statistical data by sectors is available now for 1996 and 1997. In any case all what could be said, would relate to the elimination of tariffs and quantitative restrictions. Other non-tariff barriers will be eliminated **only at the time of accession, i.e. in the middle of this decade**. In other words, the completion of a Single Market embracing the EU and the new member countries is not expected to take place before the date of accession (if not later, since some transition periods might be offered by the EU to the applicants, e.g. in the application of EU environmental standards). A typical example, although by no means the most important one, would be rules of origin in the Europe Agreements which will be phased out only then. A fundamental conclusion is that , beyond what has already taken place, **more trade diversion is bound to occur**.

#### B. Trade diversion in the six applicant countries' markets

EAs provide for the creation of industrial FTAs between the EU and the CEECs(including Slovenia) and Estonia over a period of 10 years (ending in 2002). Thus the latter are offering preferences to the EU, generally since 1997 or 1998 and on an increasing basis, which they do not and will not extend to MNMCs until accession at least<sup>13</sup>. This genuine trade diversion effect (in the Vinerian sense) is supposed to be **small**, in some cases negligible, given the low levels of initial trade between CEECs and MNMCs. And most MNMCs producers are not competing in the candidates' markets with EU producers anyway. However much depends on the country one speaks about and the deals the latter cuts with the candidate countries before accession. The case of Israel comes to mind. Not only Israeli exports to Hungary overlap with some European exports in the same market, but Israel benefits from easy access there for all its industrial and some agricultural products because both countries have signed an FTA which entered into force in 1996. The same applies to Slovenia, the Czech Republic and Poland (but not to Estonia and Cyprus). Turkey has tried to do much the same, although not always with the same success as Israel<sup>14</sup>. In sum, Israel and Turkey have tried already to protect themselves from potential trade diversion in Eastern Europe by signing FTA agreements with several CEECs. This is not the case however of other MNMCs, such as Egypt.

#### C. Trade expansion and destruction effects as a result of candidate countries adopting the CCT and the CAP

Generally speaking, candidate countries must **adopt by the time of accession** lower industrial protection levels vis-à-vis third countries than those applied now by adopting, e.g., the present low post Uruguay-Round CCT<sup>15</sup>. **THERE IS AN IMPORTANT EXCEPTION TO THIS RULE: ESTONIA**. The government of Estonia decided to basically adopt unilateral free trade some time ago. It knows that this will have to cease once it enters the EU by adhering to the CCT and the CCP.

For agricultural goods, the Estonia exception becomes the rule for almost all the "first wave" of countries, since levels of agricultural protection are low at present, particularly in Hungary and Poland. Hungary is part or was part until recently of the Cairns group in WTO forums (!). Entry into the EC may impair obviously MNMCs agricultural exports to the four CEECs and Estonia since they will have to adopt the EC's high agricultural tariffs and the CAP's NTBs, still applied on most EU's agricultural imports from

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<sup>12</sup> Strictly speaking, this is not Vinerian trade diversion, since what the EU has done is to end discrimination against CEEC and in favour of MNMCs rather than offering a better treatment to CEECs than to MNMCs. The author of the report wishes to thank S.Hirsch, of Tel Aviv University, for attracting attention to this point.

<sup>13</sup> The reason being that upon accession, but probably after a transition period the candidate countries have to adopt all the EMP agreements providing for industrial free trade; see later. This effect comes on stream later than effect A and increasingly from 1998 until 2002, when all these applicant countries will have eliminated their tariffs and QRs on EU exports(although not yet other NTBs which they will do at the time of accession).

<sup>14</sup> As explained later, Poland , fearing Turkish competition in its own textile market , has refused for the moment to enter into free trade relations with Turkey.

<sup>15</sup> The CCT will cease to apply on MNMCs originating exports once the new member states will have adopted the EU-MNMCs bilateral trade agreements. But this will apply only to exports conforming with origin rules and after a transition period to be decided yet in the current negotiations.

MNMCs. In practice Hungary and Poland have had to adjust some of their agricultural prices up in the process of adjustment to the acquis. Even Cyprus fears that entry in the EU may imply that food prices will go up which explains not surprisingly its request, accepted meanwhile by the EU, to skip the second stage in the implementation of the Customs Union agreement with the EU, which was supposed to enter into force by 2001 and would have implied an early harmonization of its agricultural policies with the CAP and rising m.f.n. tariffs. This would have meant in turn a sharp increase in the price of agricultural inputs imported from third countries.

#### D. Trade diversion effects in favour of MNMCs in the EU markets

The new members countries are asked already since the signature of the Europe agreements to approximate over time their laws to the EU acquis relating to technical, social and environmental harmonization (i.e. high EU standards and norms), while the Euro-Med agreements have rather an open-ended approximation objective. This means that some export-oriented firms which are located nowadays in the candidate countries will lose competitiveness in relation to firms located in MNMCs where production standards must not be approximated to EU levels. That could per se offer to MNMC-based firms new export possibilities.<sup>16</sup>

#### E. Trade creation effects between CEECs/Estonia/Cyprus and MNMCs

Cyprus first (2001 in theory) and then the other five negotiating countries (at the time of accession, say 2003-2005) will integrate the EU's Customs Union, adopting thus in their relations with third countries the EU's external agreements (including the association agreements with MNMCs). This is likely to happen not sooner than 2003 and probably by 2005 for the first wave of entrants. This implies that MNMCs exports complying with origin rules will accede freely into the industrial markets of the six acceding countries in the middle of this decade. It means as well facilitated access for some agricultural products, particularly those not competing with EU products (e.g. tropical fruit, off-season fruit and vegetables<sup>17</sup>). In the reverse direction, MNMCs which have or will have signed by the time of accession of the six applicants into the EU, bilateral free trade agreements in the context of the EMP, will have to dismantle at once or progressively depending on the case their tariffs and QRs on imports originating in new member countries. Observe that generally speaking MNMCs will have to dismantle entirely their barriers on exports from the new members **later (only in 2010 or 2012) than the latter will have to vis-à-vis MNMCs (i.e. upon accession to the EU)**. So there will be some **asymmetry** in the treatment of bilateral trade flows between the new member states and MNMCs (Israel excluded). It is yet too soon to predict the size of this effect. It will vary according to the MNMC one refers to. Of course these trade effects might take place much sooner than just indicated, should MNMCs sign bilateral FTA agreements with the six negotiating countries (as Israel and Turkey will or have already done with the four Visegrad countries).

An interesting case of "extreme" trade creation will occur when as a result of Cyprus acceding to the EU it will have to eliminate all trade barriers on imports from its neighbour, Turkey, from which nothing is imported at present. Therefore this will be an ideal case of a switch from a **no-trade situation** to a **free trade situation**. Given the proximity of the two countries, Turkey could become an important supplier of Cyprus (see later section 8 for empirical evaluations).

Summing up the static effects, in **industry** for MNMCs negative **trade diversion effects** started to take place **several years ago** but will be amplified **right until accession**. **Positive trade effects** in the form of more exports to the new member countries will come on stream **at the time of accession** with the exception of Israel and Turkey which will benefit or are already benefiting from free access into the markets of several new applicants. This contrasts with **agriculture**, where negative trade effects on MNMCs are not to be expected **until the time of accession at the soonest and after the end of transition periods provided for in the six future accession treaties at the latest (2010? 2013?)**. What is said for agriculture applies to **commercial services** as well. Some of them are labour-intensive, such as

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<sup>16</sup> No reference is made here to consumer standards in the EU because these must be respected by anybody selling in the EU market, MNMC producers included.

<sup>17</sup> Jordan Producers in the Jordan Valley are counting in such possibility in view of the high income elasticities for such products in some of the applicant countries.



road haulage. A relevant example will suffice. Turkish firms compete nowadays on a level playing field with EU-based companies for cargo to and from the Central European applicants. Only at the time of accession, they enter the EU's Internal Market for services, implying better treatment for EU-based haulage firms than for Turkey, since the Customs Union the latter has with the EU **does not cover services**.

Turning now to **dynamic effects**, the Enlargement is expected to increase the new member countries' standards of living (through different mechanisms; see Baldwin 1994), which in turn will increase their imports both from members as well as from non member countries, including MNMCs. This is a positive trade effect, which very much will depend on the income elasticities of import demand for the kind of products they import from MNMCs (e.g. citrus fruit, tropical fruit). However if the new member countries decide after accession that they wish to enter the Monetary Union sooner rather than later, they will have to impose upon themselves tough macroeconomic restrictions to comply with Maastricht criteria, something which in turn will keep the rate of growth low.

### 3. Preference erosion in EU markets

Until now the best way that applied economists have to assess the importance of the potential for trade diversion in EU markets as a result of enlargement is by looking at the degree of similarity in the range of products supplied by the new member(e.g. Poland) and the outsider (e.g.Tunisia). In this respect one should not ignore that the Europe Agreements between CEEC and the EU have procured tariff-free access in the latter for sensitive products such as textiles and clothing, and steel products only since a couple of years, but not even that for CAP products (including processed food). This changes with membership. Critical here is that for both the CEECs and MNMCs the principal markets for all these products considered "sensitive" by the EU are by far in the EU itself. Hence the importance of studying export overlap between the two groups. A number of export similarity indexes are mentioned in the economic literature, among which the best known is the Finger-Kreinin index of similarity of export patterns. For two countries (a and b) exporting to a third market(c) the formula is as follows:

$$S = \min(S_{i,ac}, S_{i,bc}) \times 100$$

where  $S_{i,ac}$  and  $S_{i,bc}$  represent the export shares of commodity  $i$  to  $c$  of  $a$  and  $b$  respectively. For each commodity the lower of the two is selected. An index of 100 indicates perfect overlap, while 0 represents no overlap.

This index was used in an earlier paper by one of the authors of this report<sup>18</sup> to assess the degree of overlap of a) agricultural; b) industrial and c) overall Israel's export patterns (to the EC) in 1990 with a candidate to EC membership from the CEEC group(Poland) and one from the Mediterranean(Cyprus).

Data were taken from the U.N. Commodity Trade Statistics, disaggregated at the SITC three-digit level, i.e. a relatively high level of disaggregation. Agricultural and raw material exports were taken as those included under categories SITC 0, 1, 2 and 4, while industrial exports were represented by the remaining SITC categories. Results are reproduced in Table 3.

Table 3: Export similarity indexes Israel-Poland and Israel-Cyprus(1990)

	Agric.exp.	Ind.exp.	Total exp.
Israel - Poland	21.32	25.78	<b>23.31</b>
Israel- Cyprus	37.38	14.74	21.44

SOURCE: U.N. Commodity Trade Statistics 1990

Several important conclusions were then drawn:

- 1) Overall, the Israeli 1990 export patterns to the EC were not very similar to those of Poland and Cyprus.

<sup>18</sup> See Tovias, A.(1995).

2) Focussing then on primary products, as Pomfret and others did in the early 1980s, a decade before that, for all MNMCs, it appeared that Israel export patterns were then more similar to those of Cyprus than to those of Poland.

3) The pattern of Israel's industrial exports to the EC in 1990 was totally dissimilar to the one of Cyprus and also dissimilar to the one of Poland.

Therefore in terms of potential trade diversion against Israeli agricultural products, it seemed a priori that only the entry of Cyprus into the EU would be of some concern for Israel. Hungary may also be mentioned in this context. Although appropriate data for Hungary could not be obtained, it is well known that Israel and Hungary have been competing for some time now in EC markets of goose liver and some fruit. In a new series of tests, based on 1994 data for Hungary's exports to the world by sectors at the SITC 2-digit level has allowed the authors to calculate export similarity indexes between this country and MNMCs. Results are reproduced in Table 4. Data used on exports to the EC disaggregated at the SITC two-digit level were from 1994.

Table 4: Export similarity between Hungary and MNMCs (1994)

Morocco	38.12
Israel	49.12
Egypt	36.30
Turkey	51.63
Jordan	33.07
Algeria	6.56
Tunisia	43.40

SOURCE: U.N. Commodity Trade Statistics 1994; own calculations.

From the table it appears that export overlap is highest in relation to Turkey, Israel and Tunisia. There is less overlap with Morocco, Egypt and Jordan and no overlap with Algeria. This order is not astonishing. The first group is specializing among others in textiles, clothing, food and some types of machinery, as does Hungary. A close look shows that overlap was high in the case of Turkey for SITC 05(vegetables and fruit), 67 (iron and steel), 77 (electrical machinery and parts thereof) and 84(clothing). In the case of Tunisia and Israel also these two last categories can be found with petroleum products also being well represented in the case of Tunisia-Hungary, whereas in the case of Israel-Hungary, overlap is also high for telecommunications equipment.

These figures are not directly comparable with those in Table 5 below, displaying indexes of export similarity between MNMCs and some other CEECs<sup>19</sup>. For the latter, data used are disaggregated at the SITC 3-digit level for 1994, something which caeteris paribus tends to lower the indexes in relation to indexes using data at a less disaggregated level.(For Hungary there was no such data).

Table 5: Export similarity indexes MNMCs-CEECs(1994)

	Romania	Slovenia	Poland	Czech Rep
Israel	20.56	27.49	<b>27.47</b>	27.24
Egypt	27.50	26.10	29.34	23.82
Jordan	17.63	21.70	21.50	18.95
Algeria	12.06	3.03	3.95	4.08
Morocco	29.06	22.67	29.04	19.14
Tunisia	39.94	29.74	33.51	25.50
Turkey	40.67	35.66	46.33	37.47

SOURCE: U.N. Commodity Trade Statistics 1994; own calculations.

<sup>19</sup> There were no data for Bulgaria and Slovakia.

This table tells several things:

First, overall the degree of similarity between the two group of countries is not too high (no index is superior to 50). Among the CEECs selected in the table, the less similar to MNMCs is the Czech Republic. Poland and Romania are on the whole the more similar to MNMCs in their export patterns to the EC among CEECs, while Slovenia is in an intermediary position. It is difficult to place Hungary among CEECs given data limitations.

On the other hand, combining Tables 4 and 5 allows to state that among MNMCs by far the less similar to selected CEECs in terms of its export patterns is Algeria, and then Jordan. Morocco and Egypt come after, because although Israel is in the same category as these last two when it comes to Table 5, the high level of export overlap between Israel and Hungary must be singled out in Table 4. It also appears clearly from the last two tables that, overall, it is Tunisia and even more Turkey which must be concerned by potential trade diversion deriving from the CEECs integration in the EU. For instance, the highest scores in Table 5 (>30) are found for the bilateral indexes of Turkey-Poland, Turkey-Romania, Tunisia-Romania, Turkey-Czech Republic, Turkey-Slovenia and Tunisia-Poland. A close look at the disaggregated data shows that in the case of Turkey, overlap is very high in relation to all CEECs selected for iron and steel bars (SITC 676). In the case of Turkey-Poland there is also high overlap for men and boys clothing and knitted wear (SITC 841) and "other textile and apparel products" (SITC 845); in the case of the Turkey - Czech Republic, ingots of iron and steel (SITC 672) while in the case of Turkey-Romania women and girl clothing and knitted wear (SITC 847). Tunisia and Romania are competing in export markets of fertilizers (SITC 562), men and boys clothing and knitted wear (SITC 841), women girl and clothing and knitted wear (SITC 842) and footwear (SITC 851).

A comparison of Tables 3 and 5 shows that export overlap between Israel and Poland increased from 1990 to 1994 (from 23.31 to 27.47, see figures in bold). This is not astonishing given the industrial transformation of Poland with a marked shift towards specialization in lighter industries than at the beginning of the 1990s. This impression is confirmed later on with data of 1996.

In fact Israel, among other MNMCs (such as Turkey and Tunisia), has already been feeling the pinch since several years, even in the domain of clothing and textiles which initially were officially excluded from the free trade regime provided for in the Europe Agreements. There have been ways to get around it, e.g. outward processing rules. It is well documented that since the end of the 1980s there has been a delocalisation process taking place in Europe whereby textile and clothing firms have been being moved to Eastern Europe, thanks to a special trade regime called OPT (Outward Processing Traffic). This has posed for instance a new problem for Israeli textile firms which had been exporting over the years fiber or cloth to the EC for further processing there, making good use of the duty- and quota-free provisions contained in the old 1975 EC-Israel FTA agreement. This privileged treatment does not apply if the Israeli textile exports are processed in CEECs since in that case textiles and clothing exported from there will not comply with origin rules. Israel tried to extract EU concessions in the context of the negotiations for the 1995 agreement and later on with no success (e.g. accession to the Pan-European cumulation of origin system). As is well known, the OPT regime is slowly being phased out as the concessions offered by the EU in the context of the Europe agreements are being or have already been applied to CEECs textile exports. This new regime however brings no solution to the problem confronted by the Israeli textile industry since OPT was introduced. Therefore, while it cannot be said that the process of EU Enlargement to CEECs is the original cause of the demise of Israel's textile industry, it is certainly a reinforcing factor.

There is also now anecdotal evidence that a process of delocalisation of Italian textile SMEs to Romania is taking place since a number of years to try to reduce unit labour costs. Relevant here is that Italian firms have chosen to locate their workshops in Romania rather than Tunisia which is geographically closer to home<sup>20</sup>.

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<sup>20</sup> Of course other factors than erosion of preferences given to MNMCs might have played a role, such as the better legal environment, the stronger commitment to reform and the better treatment of foreign investment in CEECs. Some experts told to this author that MENA is perceived as a region with intractable problems. And cultural differences may play a certain role in decisions made by investors (e.g. Scandinavians are said to have a worse image of Mediterranean countries than of Mitteleuropa).

A third series of similarity indexes incorporating more countries have been calculated this time for the year 1996 using only EU **industrial** import data disaggregated at the two-level digit of the **Harmonized System** (categories 25-99)<sup>21</sup>. In fact what is calculated here is the degree of similarity of EU industrial imports from different origins. This time also an overall MNMC index in relation to each candidate country has been calculated as well as an overall CEEC index in relation to each MNMC. All the indexes for the individual countries negotiating now (the six applicants), but also for the four Central European countries and Estonia (called in the table CEEC5) are also calculated, as well as for the CEECs belonging to the second wave of negotiating countries. Finally, indexes relating to all the Central and Eastern European countries considered now for accession (called CEEC10) as a block have been included. No calculations were made for Malta. Results appear in Table A9 in the Appendix.

From the table it appears that the 1996 structure of industrial EU imports from MNMCs was more similar to that of Cyprus (43) than to that of CEECs belonging to the first wave of negotiating countries (33.6). Overall similarity is larger when the CEEC10 (36.5) are considered than when the CEEC5 are the ones under focus.

Looking at the table horizontally it appears rather surprisingly that EU industrial imports originating in the Baltic countries look more alike to the ones from the MNMCs (indexes ranging from 47 to 62.8) than from other candidate countries. Among those two groups must be distinguished: 1) The least similar to MNMCs overall are Hungary, Slovenia, the Czech Republic and the Slovak Republic (with indexes ranging from 27.7 to 29.5); 2) In an intermediary position are Poland, Romania, Bulgaria and Cyprus (indexes ranging from 36.5 to 43). The surprising result regarding the Baltic applicants is due to the importance that crude oil and petrochemicals play in the exports of these three countries. Notice must be taken however that most of these products are simply transiting the three countries. This is why later on a new table is produced excluding this time HS category 27 (see Table A10).

From these overall figures, a first conclusion is that for the MNMCs as a whole and focussing only on industrial products only the accession of the “second wave” of countries will be more problematic for them than the accession of the “first wave”.

Differences in the vulnerability of the various MNMCs analyzed are evident. The degree of similarity of CEEC5 and Israel is the highest among MNMCs (42.9), followed by Turkey (37.6), Tunisia (31.3), Morocco (28.5), Lebanon (26.9), Jordan (23.2), Egypt (22.0), Algeria (9.5), Syria (11.6) and Libya (8.2) in that order. This order does not change much if instead of focussing on the CEEC5 the focus is laid on the CEEC10.

Most alike Cyprus' industrial exports to the EU are those from Turkey (53.3), Morocco (51.8), Tunisia (51.1) followed by Lebanon, Israel and only then Jordan, Egypt, Syria, Algeria and Libya.

Turning now to the individual MNMCs, applicant countries for which the corresponding index is higher than 30 (**in bold higher than 40**) have been indicated:

Turkey: all but for Lithuania and Latvia, being highest for **Cyprus, Bulgaria and Romania**.

Israel : Cyprus, **Bulgaria, the Czech Republic, Hungary**, Lithuania, Poland, **Romania, the Slovak Republic and Slovenia**.

Tunisia: **Cyprus**, Bulgaria, Estonia, **Lithuania**, Poland and Romania.

Morocco: **Cyprus, Bulgaria**, Lithuania and Romania.

Lebanon: Cyprus, **Bulgaria**, Estonia, **Lithuania**, Romania, the Slovak Republic and Slovenia.

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<sup>21</sup> EU import data drawn from Eurostat are used here and later on to calculate indexes instead than export data to the EU as reported by MNMC and acceding countries to the UN used in previous indexes. The assumption is that there are no gaps between bilateral trade flows as reported from exporting countries and as reported by the EU.

Egypt: **Estonia, Latvia**, Lithuania.

Jordan: Bulgaria

Syria : **Latvia**, Estonia.

Algeria and Libya: **Latvia**.

The conclusion is that for Algeria, Syria, Egypt, Jordan and Libya the accession of the six currently negotiating countries does not pose any particular problem when focussing on industrial products (see below for agricultural products). This applies by and large to Lebanon and Morocco as well. Clearly , looking at these indexes, Turkey and Israel should be the most concerned among MNMCs by the coming enlargement of 2003-2005, Tunisia being in an intermediary position.

It is easy to see why by looking the table vertically: The Czech Republic has a quite similar export structure to the one of Israel(42.2) and Turkey (37.8), much less in the case of other MNMC. The same applies for Hungary and Slovenia. The case of Poland is interesting. Overall its export pattern to the EU is less similar to Israel and Turkey than the other three Visegrad countries but then Tunisia has something to worry about (e.g. in the textile and clothing sector) regarding EU imports from Poland.

All these results reinforce what was found for 1990 and 1994, showing as well that over time it appears that the coming Enlargement seems to be more of a problem to Israel than it was a decade ago.

In table A10 similarity indexes of EU industrial imports from different origins have been recalculated excluding this time category HS 27, i.e. crude oil and derivatives, because their inclusion tends to distort the results above, leading to the result that MNMCs are highly similar to Baltic countries in their export patterns to the EU. This is only due to the fact that they serve as transit countries for oil that they do not produce themselves, as indicated before. In the revised table it appears now that Cyprus (59.5%), Bulgaria(50.4%) and Romania (49.1%) are the most similar to MNMCs, Estonia and Lithuania coming only then in the ranking. On the other hand now Latvia is the least similar.

Other conclusions drawn on the basis of the all-inclusive table remain, in particular that for MNMCs the accession of the second wave accessions will be more problematic than the first<sup>22</sup>.

Generally some trade diversion against MNMCs has been and will be inevitable as a result of the long-drawn process of preference erosion which started in 1988. All this has, is and will be taking place independently of whether or when accession of Eastern European countries into the EU will take place.

Some of this trade diversion is in fact “reverse trade diversion” in the sense that the conclusion of trade agreements between the EC and MNMCs in the 1970s did probably led to some trade diversion against some or all of the countries negotiating now accession to the EU.

The main findings of this long section are complementary to recent research published by Brenton of CEPS in 1999. He proves that the assertion heard in the EU whereby it is Spain, Portugal and Greece that should be concerned by competition in EU markets in so-called sensitive products as a result of the entry of Visegrad countries, Cyprus, Slovenia and Estonia in the EU is wrong. He then proves that the countries that should be most concerned by this next Enlargement are those CEECs excluded from the next Enlargement(such as Romania) and Turkey. This report proves that to this list one should add other MNMCs, such as Israel and Tunisia.

Furthermore Brenton himself in another article confirms that as a result of the decision taken at the Luxembourg Summit of 1997 to take first six out of 11 countries into the EU, those left out would suffer not only from trade diversion but from investment diversion as well, because the six to be admitted first

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<sup>22</sup> In this revised table, the index is more than 50% for Cyprus with Turkey, Tunisia and Morocco, Bulgaria-Israel and Lithuania-Lebanon and between 40% to 50% for Cyprus-Egypt, Bulgaria with Morocco and Lebanon; Israel with all Eastern European countries; and Estonia with Turkey.

would be part of the Single Market, not only of the EU's Customs Union. The same applies tel quel to MNMCs<sup>23</sup>.

Further sectorial research done by Stetter (1997) shows that regarding Israel, Revealed Comparative Advantage exists for many categories of goods for which several CEECs have also a high RCA (see below the section devoted in this report to RCA overlaps between the six applicant countries and the MNMCs). Hungary has the most overlaps with Israel (e.g. meat preparations, edible vegetables, preparation of vegetables, oil seeds, fertilizers and some textile articles). Poland follows from close and mostly for the same products. Estonia, Slovenia and the Czech Republic come later in that order. Globally speaking about 15.3% of all Israeli exports to the EU are concerned, according to Stetter.

One more point, which worries Israel and Turkey, and which should worry other MNMCs, is that as from early 1998, CEECs benefit from Pan-European cumulation; e.g. an Hungarian raw material can be exported for processing further into Poland, the Polish semi-manufactured product can be sent then for further processing to the Czech Republic, which can export the good on a duty-free basis to the EU. MNMCs are not included in the system and will not be. The EU is only thinking now in the possibility of cumulation among MNMCs. It does not take much to understand that from an economic viewpoint Israel would be much better off with Pan-European cumulation than with cumulation with other MNMCs because CEECs are more industrialized than the former; therefore intra-industry trade between Israel and CEECs has more potential than with other MNMCs.

Reference should be made now to degree of overlap of EU agricultural import patterns from the applicant countries in relation to those from MNMCs. This is done in Table A11 in the Appendix. The first thing that strikes the observer is that in relation to CEECs, similarity is higher in agriculture than in industry. In particular, Poland's and Cyprus's similarity to MNMCs appears to be relatively high (indexes being 56.4% and 57.5% respectively). This seems important given that Poland is the largest agricultural exporter among the applicants and has a large unused potential and that Cyprus has a comparative advantage in some Mediterranean-type products (e.g. citrus fruit). Similarity between EU imports from Cyprus and those from Egypt, Jordan, Morocco and Israel seem to be pretty high. Fortunately for those countries, Cypriot agricultural exports to the EU are small in absolute numbers. In this respect, in terms of comparative advantage, it is **Morocco** that should be quite concerned by the next Enlargement, not only because of Cyprus but particularly because of Poland's accession to the EU (bilateral similarity index equal to 51.1%), Poland being a large exporter of both fruit and vegetables. It is pretty striking that the share of fruit and vegetables in EU's agricultural imports from Poland reach more than 20 percent, a fact frequently neglected. On the other hand, **neither Turkey nor Tunisia have reasons to be concerned by the coming Enlargement**, which is a quite striking conclusion. In the case of Turkey this is due to its concentration in tobacco exports to the EC; in the Tunisian case, this holds for olive oil.

Finally, although only indirectly related with the issue of trade diversion in EU markets, one should mention here that the six negotiating countries are being helped massively in their pre-accession strategies to be able to cope with EU domestic competition, much more than the other five that were left behind until the Helsinki decision, not to speak of Turkey and other MNMCs. It is calculated that in the first year of membership the six applicants will get on average 170 ECU per capita from the different programs the EU has; the second wave countries will receive by then 23 ECU per capita and MNMCs much less than that: All of them together excluding Israel (which does not get anything) are receiving about 2 bn ECU per year in loans and grants for a population of more than 170 million people; i.e. a little more than 10 ECU per capita).

#### 4. Trends in intra-industry trade between the EU and its two peripheries

The progressive trade integration of CEECs into the EU dates back to the 1990s, particularly after the interim implementation of the Europe Agreements. It has been said that much of the new trade between the two partners is of the intra-industry trade, even of the intra-firm type, **particularly between Germany and the CEECs**, and that there is a process going on leading to the industrial integration of

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<sup>23</sup> Meanwhile as is well known, a decision has been taken at the Helsinki European council of December 1999 to initiate negotiations with the 5 countries of the second wave plus Malta, which obviously takes care of the criticism of Brenton (1999), but not of the criticism made in this report relating to MNMCs.

CEEC into the industrial tissue of Western Europe. The authors of this report have tried to study the issue regarding several CEECs. Suitable data were not available for the Czech Republic. More concretely, using three-digit level trade data from Poland, Romania, Slovenia, Hungary<sup>24</sup> and the EU, Intra-Industry Trade Intensity Indexes have been calculated, which are reproduced in Table 6<sup>25</sup>. The second column reflects the share of intra-industry trade in total trade of the four CEECs selected, while the first one, only intra-industry trade between the latter and the EU.

Table 6: Intra-industry trade indexes for several CEECs (1994)

	EU	World
Poland	0.347262	0.391682
Romania	0.236813	0.279699
Slovenia	0.534313	0.573675
Hungary	0.589230	0.4576

Source: UN Commodity Trade Statistics 1994; own calculations.

It is interesting to note that the share of intra-industry trade in the total trade of three of the four CEECs selected is not larger in trade with the EU than in trade with the world, but rather the contrary. It means that intra-industry trade is more present in trade flows of these three countries with trade partners other than the EU than with the EU itself (eg. with Visegrad countries or the CIS). One cannot find any other satisfactory explanation to these odd results. Observe that Hungary is the real and interesting exception(see more below).

Comparing the four CEECs leads to the non-controversial result that the level of intra-industry trade with the EU is highest nowadays in Hungary and Slovenia and lowest in Romania<sup>26</sup>.

For comparative purposes, similar indexes for different MNMCs have been calculated. It is obviously essential to compare the relative levels of intra-industry specialization of the two EU peripheries, particularly in their relationship with the EU (see table 7).

Table 7 : Intra-industry trade intensity indexes of MNMCs(1994)

	EU	World
Turkey	0.214234	0.283418
Tunisia	0.242365	0.297952
Morocco	0.148978	0.163583
Israel	0.393388	0.56757
Egypt	0.096649	0.146956

Source: UN Commodity Trade Statistics 1994; own calculations.

A country-to-country comparison shows that among MNMCs only Israel has higher general intra-industry trade indexes than Poland and Romania and similar to those of Slovenia or Hungary. It is symptomatic that the level of Israel's intra-industry trade is much lower in trade with the EU than with the world, something reflecting the fact that Israel has attained high levels of intra-industry specialization in trade with the US (in high tech) and not in trade with the EU. Note that exactly the reverse is happening with Hungary which seems already to be "hooked" on the EU.

<sup>24</sup> Data for Hungary were available only at the two-digit level.

<sup>25</sup> The index used is the Grubel-Lloyd Index:

$$GL = \frac{(x + m) - |x - m|}{(x + m)}$$

<sup>26</sup> The comparison between Hungary and the other three CEECs may be biased because of the different levels of data disaggregation available for the former and for the latter.

Intra-industry trade both with the EU and with the world seems unimportant for Morocco and Egypt. Intra-industry trade has the same relative importance for Turkey and Tunisia as for Romania.

The analysis of these indexes leads to the tentative conclusion that Tunisia as Slovenia and Hungary seem to increasingly rely on intra-industry specialization, mainly with the EU. This is not problematic because Tunisia is not specializing in the same industrial segments than Slovenia and Hungary. Israel on the other hand is slowly detaching itself from Europe, industrially speaking. It appears again that it is primarily Turkey among MNMCs which might be concerned should a clear trend towards the industrial integration of Romania, Poland and other CEECs into Western Europe become the order of the day. However this is not evident yet from the indexes collected.

#### 5. The degree of overlap in Revealed Comparative Advantage between the Applicants and MNMCs

A well-known and frequently-used index of Revealed Comparative Advantage (RCA) is given by the following expression:

$$IRCA_{abj} = \frac{X_{bj} - M_{bj}}{X_{bj} + M_{bj}}$$

Where  $IRCA_{aj}$  is the index of revealed comparative advantage of country a in trade with b for sector j in the economy

$X_{bj}$  = exports from country a to country b in sector j as reported by a

$M_{bj}$  = imports of country a from country b in sector j as reported by a

Where  $j = 1, \dots, n$  with n equal the number of sectors in the economy.

The index can take values from 1 to -1. In order to get a sense regarding which sectors country a has a comparative advantage, only those with a quite high index are selected. Of course the index can be criticised for many reasons, e.g. it implicitly assumes that trade barriers are inexistent or that the overall balance of trade of the country is in equilibrium. However the method seems pretty appropriate if the idea is to get a rough indication of the sectors with comparative advantage at a very disaggregated level. Incidentally, the high level of disaggregation chosen is also likely to reduce the amount of intra-industry trade not captured usually by the index.

In what follows RCA indexes have been calculated on the basis of data furnished by the EU COMEXT trade data base at the 4-digit level. Since the raw data obtained are actually exports and imports of the EU to and from, respectively, the six applicant countries as a group and 10 individual MNMCs for the years 1997 and 1998, the RCA index calculated is the following:

$$RCA_{abaj} = \frac{M_{bj} - X_{bj}}{M_{bj} + X_{bj}} \text{ where}$$

$M_{bj}$  = Average 1997-98 EU imports from one of the MNMCs or from the Applicants as a group

And  $X_{bj}$  = Average 1997-98 EU exports to one of the MNMCs or to the Applicants as a group

Where b = one of the MNMCs or the Applicants as a group and a = the EU

Of course the assumption is that  $M_{bj} = X_{bj}$  and that  $X_{bj} = M_{bj}$

Therefore the closer the index calculated ( $RCA_{abaj}$ ) comes to -1 the higher is supposed to be the comparative advantage that one of the 16 countries under focus have in sector j in the EU market. Precaution has been taken not to rely on trade data for only one year, which might be exceptional. An average of 1997 and 1998 data has been systematically taken.

$RCA_{abaj}$  has been calculated for 1236 product groups (i.e.  $n = 1236$ ). Only indexes lying between -0.8 and -1 have been selected. The next step has been to sort out only those sectors where there is overlap between on the one hand the six applicant countries as a group (The Applicants) and each one of the



MNMCs selected. Finally RCA indexes for the MNMCs as a group lying between  $-0.8$  and  $-1$  have been sorted out and compared to the corresponding ones of the Applicants.

Table 7 below reports the number of categories of products for which the RCA index ranges between  $-0.8$  and  $-1$  for all the 16 countries selected.

Table 7: Number of HS categories for which RCA Is below  $-0.8$  (by country)

Czech Republic	91	Morocco	128
Hungary	105	Algeria	45
Poland	110	Tunisia	86
Estonia	71	Libya	26
Slovenia	48	Egypt	95
Cyprus	33	Israel	86
		Jordan	32
		Syria	84
		Lebanon	35
		Turkey	129

Source: See text

The table confirms a familiar argument whereby large countries (in demographic and economic terms) tend to have a larger range of products regarding which they have comparative advantage than smaller ones.

Table 8 lists the number of product category overlaps of RCA indexes ranging from  $-0.8$  and  $-1$  for the 10 Mediterranean countries selected, both individually and collectively, and the Applicants taken as a group. If the number of overlaps is taken as an indication of vulnerability to potential trade diversion as a result of the first wave Enlargement, it appears clearly that Turkey, Morocco, Tunisia , Israel are much more vulnerable than Jordan, Lebanon , Libya, confirming previous findings (see export similarity indexes above in a preceding section of this report). Slightly surprising and somehow at odds with previous findings is that both Egypt, Algeria and Syria appear to be in the same group as Israel and Tunisia and much more vulnerable than Jordan, Lebanon and Libya.

Table 8: Number of overlaps between RCA product categories (ranging from  $-0.8$  and  $-1$ ) of Applicant Countries of the first wave and MNMCs (average 1997-98 data)

All MNMCs	20
Morocco	15
Algeria	12
Tunisia	14
Libya	4
Egypt	13
Israel	13
Jordan	6
Syria	12
Lebanon	6
Turkey	16

Source: See text

On the other hand it is not surprising that the number of RCA overlaps between the MNMCs as a group and the six applicants (20) is larger than for individual MNMCs .

Content-wise, as a group, MNMCs seem to be highly vulnerable to competition by the applicants in EU markets (see Table A12 in the Appendix) for, among others, the following products: live fish (301), fruit and nuts uncooked or preserved (811, 812), animal feed (2308), one inorganic chemical product , i.e. hydrogen peroxide (2847), women clothing not knitted or crocheted (6206), sacks and bags (6305), some articles of natural stone (6801), pig iron (7201) and lead ores and products derived therefrom (2607, 7802).

Looking at individual MNMCs, below are identified some of the products where vulnerability seems highest (see Tables A13 to A22 in the Appendix)<sup>27</sup>:

<b><u>Morocco:</u></b>	Semi-processed fruit and nuts, oil-cake (a kind of animal feed), lead ores, paper and paperboard, wood marquetry, women's clothing (not knitted or crocheted).
<b><u>Algeria:</u></b>	Semi-processed fruit and nuts, lead ores, tar , pig iron.
<b><u>Tunisia:</u></b>	Oil-cake, cement, lead ores, tableware and kitchenware made of wood, women's clothing (not knitted or crocheted), products of natural stone.
<b><u>Libya:</u></b>	Semi-finished products of iron or non-alloy steel.
<b><u>Egypt:</u></b>	Natural honey, some vegetable materials used for plaiting (bamboos, rattan, osier), sub-products of sugar manufacture, limestone, coke.
<b><u>Israel:</u></b>	semi-processed fruit, some types of animal feed, some inorganic chemical compounds (e.g. hydrogen peroxide, carbides).
<b><u>Jordan:</u></b>	<b>products of natural stone.</b>
<b><u>Syria</u></b>	semi-processed fruit and nuts, vegetable materials used for plaiting (bamboos, rattan, osier), oil cake, limestone, women's clothing not knitted or crocheted, felt headgear, products of natural stone.
<b><u>Lebanon:</u></b>	clock and watch cases.
<b><u>Turkey:</u></b>	natural honey, semi-processed fruit and nuts, vegetable materials used for plaiting (bamboos, rattans, osier), sub-products of sugar manufacture, cement, some inorganic chemical compounds as chromium oxides and hydroxides, women's clothing not knitted or crocheted, sacks and bags, products of natural stone, semi-finished products of iron or non-alloy steel.

**By and large, the type of products listed , including clothing, processed food (mostly labour-intensive) and iron and steel products are typically considered yet as “sensitive” in the EU. However there are also some chemicals and construction materials, which are primary resource-intensive.**

In Table A23 in the Appendix the exports in value (average 1997-98) actually done by MNMCs to the EU15 in the categories reported above, in which they are individually or as a group vulnerable because competing with the applicants in the EU, are reported. The main result is that vulnerable exports (as defined here) represent less than 2% of the MNMCs exports to the EU , i.e. 880 Mo.\$, more than half of it originating from Turkey (458 Mo. \$) and Morocco (161 Mo. \$) with higher shares of vulnerable exports (3.64% and 3.24% respectively). At the other extreme this share is less than 1% for Algeria, Libya, Jordan and Syria and quite interestingly Israel (which on the basis of the number of overlaps seemed above to be trade-wise among the MNMCs mostly affected by the Enlargement).

Finally, in Table 9 below the number of bilateral overlaps of RCA categories ranging between 0.8 and 1 (in absolute numbers) have been reported. It appears that in terms of the amount of sectors concerned by the Enlargement, for most MNMC the principal countries in terms of competition are Poland and Hungary, followed by Cyprus and the Czech Republic. This rule does not hold only for Jordan and Lebanon, for which it is the entry of Cyprus into the EU which should be followed with particular interest. For Syria , as well, the number of overlaps with Cyprus is quite high. These results

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<sup>27</sup> Note that waste and scrap of metals, as well as ash and residues or human hair have been disregarded, all being a tiny part of the international trade of MNMCs.

are not surprising in view of the fact all these four countries belong to the same sub-region as Cyprus, namely the Eastern Mediterranean.

Although not as important as the two main competitors (Poland and Hungary), for Egypt and Turkey it appears that Estonia is also a country to watch, whereas for Israel and Morocco that holds for the Czech Republic.

Table 9: Number of bilateral overlaps between RCA product categories (ranging from -0.8 and -1) of Applicant Countries of the first wave and MNMCs (average 1997-98 data)

	Morocco	Algeria	Tunisia	Libya	Egypt	Israel	Jordan	Syria	Lebanon	Turkey
Czech Re.	14	11	15	5	16	15	10	12	11	13
Hungary	24	14	20	10	28	22	10	21	10	26
Poland	27	15	20	6	20	19	8	18	10	30
Estonia	11	13	10	8	16	11	6	12	12	15
Slovenia	7	3	8	2	6	8	4	5	6	9
Cyprus	10	12	13	7	14	16	12	15	15	11

## 6. Trade in services

### A. Trade in financial services

All the applicants are called to apply without transition periods the *acquis communautaire* from the date of accession. This is particularly relevant for the Republic of Cyprus, which has functioned until this very day as an off-shore financial centre. In this connection, and as reported by the press, in April 2000 an informal ECOFIN council in Lisbon decided that the ultimate goal of the EU is to introduce by 2010 an information exchange system between EU tax authorities, signaling the end of banking secrecy, one of the main features of off-shore financial centers. The Feira European Council of June 2000 reached a compromise whereby from 2003 until that date member countries will have a choice between imposing a withholding tax of 20 to 25% on interest earned by non residents and sharing the revenue with the investor's state of residence or exchange information with other EU tax authorities. To be noted is that the six applicants have not the choice between the two systems. They must apply the exchange information system from the date of accession and this of course applies to Cyprus<sup>28</sup>. The EU has drafted a list of non member countries with which it wants to hold discussions to bring them in line with the EU legislation until 2003. Switzerland is among them, but not so any of the MNMCs. Among them, at least two have some characteristics of off-shore financial centers, namely Israel and Lebanon. If no negotiations are conducted by the EU with them until the entry of Cyprus and other applicants, one of the consequences of the first wave Enlargement is that Israel and the Lebanon will attract some of the off shore business in financial services done currently by Cyprus, particularly because partly they address themselves partly to the same clientele from the CIS, Eastern European countries and some Gulf countries. It is of course very difficult to quantify this "reverse trade diversion" effect favouring some MNMCs but it cannot simply be dismissed because of this..

### B. Trade in tourism and air transport services

There are contradicting factors which might affect the relative competitiveness of MNMCs in relation to the applicants in tourism and air transport services after Enlargement takes place. Of course, the six and the 10 do not always compete for the same kind of tourists. But there is certainly some overlap, if only because all 16 countries are in the EU's close neighbourhood, attracting visitors on short-term packages in the spring and in the autumn. Moreover, among the applicants is Cyprus, a Mediterranean country.

<sup>28</sup> Cyprus has in fact agreed to eliminate harmful tax practices by the end of 2005 in order not to appear in the follow-up report presented to the OECD Ministerial Council meeting of June 2000.

a. Factors affecting MNMCs negatively

1) Fifth-freedom rights and cabotage applied to the six applicants imply that the cost of air transport from Western Europe to tourist destinations in the applicant countries will tend to decrease (e.g. any EU-based company will be able to take passengers from Paris to Larnaca; not so from Paris to Tunis).

2) The applicants will adopt the euro before the MNMC do, which will eliminate the need to exchange money in intra-EU travel; ticket prices will be stable because quoted in euro; any remaining exchange controls will have been abolished by the time of accession.

3) Entry in the EU increases the perception of the applicants as totally safe and stable countries.

b. Factors affecting MNMCs positively

1) Food prices will rise after Enlargement, according to all experts, as a result of the adoption of the CAP by the applicants.

2) Wage levels in applicant countries will tend to converge to the EU average, once the enlarged Single Market for goods and manpower is in place.

3) The price of land in some tourist spots is also set to rise with the freedom given to any EU citizen to buy land in the applicant countries (something feared, e.g. in Poland).

4) Tax-free shopping will be eliminated in flights between EU15 member countries and the six applicants.

It is very difficult to quantify these expected effects, but again this is not a reason to neglect them. On balance, the positive factors seem to dominate the negative factors. Among the latter, the price of air transport does play a relatively lesser role because distances are small.

7. The expansion of trade between the six applicants and the MNMCs as a result of the adoption by the former of the external acquis

One of the outcomes of the coming Enlargement is that tariff barriers currently applied by the six applicants will be abolished on industrial products originating in MNMCs at the latest by the time of Accession. In turn tariffs on MNMC industrial imports from Applicant countries will be eliminated at the latest by the time individual MNMC are called to eliminate their tariffs on EU-originating products according to the timetables inscribed in each of the EMP agreements. In some cases these bilateral trade flows are already now exempt from being charged with tariffs (e.g. between Israel and four of the applicants and between the latter and Turkey). The question is then by how much these East-South trade flows will expand?

The methodology used here to estimate the impact of a country's discriminatory tariff liberalization on import trade will be similar to the one used by Cline et al. 1978, Laird and Yeats 1990, Buttelman and Meller 1992 and Karemera and Koo 1994.

In the simulations made later, the simplifying assumption has been made that industrial free trade between the MNMCs and the Applicant countries has been introduced in 1996 (and not in 2008 or 2010, as contemplated in most of the bilateral EMP Agreements)<sup>29</sup>. Therefore when an interpretation of the simulations is made later on, the reader will have to take into account that the results obtained give an

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<sup>29</sup> Free trade has been actually introduced in both directions between Turkey or Israel and most of the applicant countries of the first wave since 1996 or any case had to be introduced following FTAs signed between the parties (Poland being an exception); in any case free trade between Turkey and all of the six applicants should prevail by the end of 2001, since Turkey must complete by then the adoption of the EU's commercial policy with third countries, as explained before.

indication of the "maximum" effect which could derive from the implementation of FTA relationships between the MNMC and the Applicants. The reader will have to take note as well that agriculture is excluded from the simulations.

A first potential effect deriving from the elimination of tariffs by e.g. a MNMC on applicant countries (AC), such as Hungary, is what is called here the value of trade creation (VTCj), i.e., the value of new imports that the MNMC does from the AC. This increase in the MNMC's imports of a given class of products (i.e. an HS category) can be estimated by the following equation:

$$VTCj = VMACjo * Em * tj / (1 + tjo) \quad (1)$$

where

VTCj = Value of trade created in sector j of the MNMC

VMACjo = Initial value of imports which the MNMC does in sector j originating in AC. This value is the product of the quantity imported from AC times the export unit value of the good exported by AC to the MNMC (i.e. the world price augmented, depending on which case one considers, by the tariff imposed by AC).

Em = Price elasticity of the MNMCs import demand in sector j.

tj = Percent change in the tariff applied by the MNMC in sector j as a result of applying the FTA regime to AC.

tjo = Initial level of the tariff applied by the MNMC on imports of sector j originating in AC before implementing the FTA.

Equation (1) assumes that the MNMC is a small importer in world terms, a quite realistic assumption and that any change in its trade policy is not going to affect world prices. From the MNMC's perspective the assumption is simply that the export-supply price-elasticity of the Rest-Of-the-World (ROW) is infinite. The FTA is not going to affect the terms of trade between the MNMC and the ROW.

The second effect produced is what is called here the value of trade diversion (VTDj), i.e. the substitution of external supply sources derived from a change in relative prices caused by the MNMC's discriminatory trade liberalization in favour of the AC. In other words it is the difference between what was imported before the FTA from the ROW and what is imported from it after the FTA is implemented. The quite realistic assumption is made that it is the country benefitting from the preference (here AC) which will export to the preference-donor country (here the MNMC) this difference<sup>30</sup>. This effect can be estimated in three different ways.

When one does not know the elasticity of substitution between different supply sources, one can use two variants. The first is the Baldwin-Murray formula :

$$VTDj = VTCj * VMROWjo / Qjo \quad (2a)$$

where:

VTDj = Value of trade diverted in sector j of the MNMC.

VMROWjo = Value of imports that the MNMC does in sector j from ROW before implementation of the FTA

Qjo = Value of the MNMC's domestic production in sector j

However and given that Qjo is a figure which is frequently unknown, Verdoorn has suggested the following formula, largely accepted among scholars interested in evaluating empirically the trade effects of economic integration:

$$VTDj = VTCj * ( VMACjo / VMACjo + VMROWjo ) \quad (2b)$$

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<sup>30</sup> See Baldwin and Murray 1977, p.33, Sawyer and Sprinkle, 1989, p.64.

When one does have explicit values for the elasticity of substitution between different sources of supply, one can use the formula of Laird-Yeats<sup>31</sup> :

$$VTDJ = \frac{VMAC_{jo} * VMROW_{jo} * Es [- t_j / (1 + t_{jo}) ]}{VMAC_{jo} + VMROW_{jo} + VMAC_{jo} * Es [- t_j / (1 + t_{jo})]} \quad (2c)$$

where

Es = Elasticity of substitution between the MNMC's imports of sector j originating in ROW and those originating in AC

For this report, after an in-depth analysis of pros and cons of each formula<sup>32</sup> in the case studied here (i.e. the creation of FTAs between MNMCs and the six Applicants) and of the available data, the authors have opted for Verdoorn's formula (2b). The World Bank and UNCTAD have in the past profusely applied (2c), using 1.5 as the standard value of the elasticity of substitution of imports (Es) for all sectors and for all countries for lack of something better. Other authors have used a value of 3 and others 2. It must be stressed however that all are guessestimates, not values estimated econometrically, something which seems pretty, if not totally arbitrary. According to some econometricians, all the values usually adopted lead to an overestimation of the value of trade diverted (VTDj). Therefore in this study the authors have disregarded the Laird-Yeats formula and opted openly for (2b), for which data are incidentally available.

The total trade effect for a given sector (i.e. a specific HS category) is given by the sum of VTCj and VTDj and is called the trade expansion effect between the FTA countries (TTEj), i.e.:

$$TTEj = VTCj + VTDj \quad (3)$$

TTEj can be interpreted as the total increase in the value of the MNMC's imports from an AC due to the discriminatory elimination of the former's tariffs on AC. This is the value of the increase in exports by the AC to the MNMC and is composed by two elements: the value of new imports by the MNMC from the AC and the value of the MNMC's imports which have been diverted from the ROW to the benefit of the AC ( the VTDj effect).

What is said until here about potential imports of MNMCs from AC can be applied tel quel in the reverse direction (i.e. future exports of MNMCs to AC)

Data valid for the year 1996 are used to calculate the different formulas and are taken from TRAINS (Trade Analysis and Information System), 1997 edition, a program and data bank produced by UNCTAD, which integrates information on tariffs and NTBs with import data by country and going all the way up to a six-digit level of disaggregation according to the Harmonized Commodity Description and Coding System(HS)<sup>33</sup>. The authors have opted for a two-digit disaggregation level, which means doing all the calculations for a total of 71 industrial sectors. Import demand price-elasticities by sectors have been taken from different country studies, e.g. the one of Boudiaf (1997) with estimates for 11 industrial sectors representing more than 90% of Tunisia's industrial imports.

The main results are reported in Table A24 in the Appendix.

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<sup>31</sup> Laird and Yeats (1991), p.85.

<sup>32</sup> See in particular the discussion by Sawyer and Sprinkle(1989) and Shiells et al.(1986).

<sup>33</sup> UNCTAD. TRAINS CD-Rom, Switzerland, 1997. Tariff data for Israel, not available in TRAINS, were taken directly from the Israel import tariff book.

Regarding future additional exports from the Applicants to MNMCs, only Israel, Morocco, Tunisia and Turkey among them were selected as destination countries, because of data limitations (e.g. Jordan tariffs did not appear in the TRAINS 1997 edition). Focussing on projected additional exports as a result of the Enlargement by the six applicants to the four selected MNMCs (i.e. in the table TTEj), from the table it appears from the table that they are quite limited, since almost none of the bilateral flows are larger than 10 Mo \$. The probable reason for these results is that Morocco and Tunisia are quite small markets in \$ terms, whereas Israel and Turkey have relatively low most-favoured-nation (i.e. GATT) tariffs now.

In the reverse direction, future additional imports of some applicants from the MNMC, namely the Czech Republic, Hungary and Poland have been considered, again for data limitations. It turns out that the additional export potential of Turkey in the direction of the Czech Republic (87 Mo \$), Hungary (72 Mo\$) and Poland (92 Mo \$) is quite remarkable. The same applies for Moroccan and Tunisian exports to Poland (33 Mo.\$ and 30 million \$ respectively). Again the results are not too surprising: the three Eastern European countries have medium-sized economies, actually the largest among the Applicants, and still relatively high m.f.n. tariffs.

Therefore the main result of this exploration is that MNMCs are going to benefit from the Enlargement in terms of the additional industrial exports to the three largest Eastern European economies.

#### 8. Estimation of the trade potential between Turkey and the Republic of Cyprus

The case of Turkey's future trade relations with the Republic of Cyprus deserves particular attention in this report because at present both countries do not trade with each other directly. Although the Republic of Cyprus has officially eliminated not long ago boycott legislation on imports from Turkey, one of the authors of this report has been told by experts that unofficially Cypriot importers are still applying it for fear of the reactions of consumers. The situation is similar regarding Turkey's imports from the Republic of Cyprus. The starting point is therefore one of no-trade. Of course there is no trade neither between the Republic of Cyprus and the Turkey's occupied part of the island.

The situation on the ground is likely to change as a result of the perspective of Cyprus becoming a EU member in the coming years. In fact it should change even should Cyprus' entry into the EU be postponed or suspended and this for the following reason: Both Turkey on the one hand and Cyprus on the other have a Customs Union agreement with the EU. As a result, Turkey has endeavoured to adopt until 2001 all the EU's external trade agreements, including the Customs Union agreement between the Republic of Cyprus and the EU. The same applies symmetrically to the Republic of Cyprus although in this instance it must be noted that both Cyprus and the EU are now in agreement not to proceed with the implementation by Cyprus of the second stage contemplated in the agreement of 1988 reached between the two sides, because that would distract Cyprus from its other obligation to adopt the *acquis* in order to become an EU member. In theory, at least, as from 2001, Cyprus exports to Turkey should get duty-free access to that country, i.e. preferential treatment in relation to other WTO member countries. The same can sensibly be said in the reverse direction.

In fact this is not likely to happen. However if Cyprus becomes a member of the EU, Turkey could not openly discriminate in trade against a part of the EU's territory. That would openly violate the rules of the Turkey-EU agreement and endanger Turkey's status as a candidate for entry into the EU. In reverse the Republic of Cyprus, being now part of the EU's customs territory, could not discriminate against Turkish imports which enter the EU free of any duties or quantitative restriction.

Analytically one must distinguish between two stages in the future improvement of trade relations between the Republic of Cyprus and Turkey. The first phase is tantamount to a normalization of trade relations where the two sides decide to end all formal and informal trade boycotts remaining and treat each other on a most-favoured basis. This could be called the GATT-WTO phase. But there is a further second phase, when both sides apply between themselves the same (free) trade regime as they do apply on imports originating in the other 20 EU member countries.

In order to estimate the un-exploited trade potential between Turkey and Cyprus a simple model based on the one developed in the 1960s by Linnemann (1966) has been used. This model describes the flows from origin country *i* to a destination country *j* in terms of supply factors in the origin

country, demand factors in the destination country and various stimulating or restricting factors relating to a specific bilateral trade flow, such as distance (Brenton et. al, 1998, 4). The idea is to estimate Turkey's trade potential with the Republic of Cyprus on the basis of Turkey's own bilateral trade with 73 countries , including the individual members of the EU. The model used here is as follows:

$$\text{Log(Imports)} = a + b1*\text{log(GDPj)} + b2*\text{log(POPj)} + b3*\text{log(Dist)} + b4*\text{SEA} + b5*\text{CU} + b6*\text{FTA}$$

$$\text{Log(Exports)} = a + b7*\text{log(GDPj)} + b8*\text{log(POPj)} + b9*\text{log(Dist)} + b10*\text{SEA} + b11*\text{CU} + b12*\text{FTA}$$

#### Variables:

**Imports and Exports:** those are the dependent variables. Data is in millions of US \$ and was taken from the “Direct Trade Statistics Quarterly” (December 1999) of the IMF.

**POP:** this variable proxies the physical size of an economy. Larger economies have less need to trade than smaller ones to gain from specialization or scale economies (Hamilton and Winters 1992, p.80) and therefore the coefficient is expected to be negative. Data is in million people and was taken from the “International Financial Statistics” of the IMF (February 2000).

**GDP-** this variable gives us both an indication about the demand for imports of the destination country and supply of exports (referring to variety and size). A larger domestic product means greater total demand and a greater demand of imports of the destination country. At the same time the origin country's size and variety of export supplies depend on its own GDP. Therefore both imports and exports are positively correlated with GDP so that the coefficient is expected to be positive. Data is in \$ billion and was taken from the IMF's “World Economic Outlook” database (April 2000) (www.imf.org).

Note that since Turkey's trade flows with different trade partners in the world are computed for a single year, Turkey's GDP and population (POP) data are constants. Therefore those variables are not included in the estimated equation. If instead Turkey's trade flows over several years would have been examined, there might have been some level of variation in the data and these two variables from the equation should and would not have been omitted.

**Dist:** the variable “Distance” captures transport costs. The assumption is that the higher the distance between two trade partners and the higher are transportation costs and the lower will be the expected volume of bilateral trade.

**SEA:** a dummy variable that receives the value 1 when the trade partner is located on the Mediterranean, Adriatic or Black Sea (short maritime distance to the discussed country).

**CU :** dummy variable that receives the value 1 when a Customs Union exists between Turkey and the partner country (and 0 otherwise). More concretely this refers to the 15 EU member countries with which there is at present a CU trade regime between the latter and Turkey.

**FTA:** dummy variable that receives the value 1 when a FTA relationship exists between Turkey and the partner country (and 0 otherwise). More concretely this refers to 9 Eastern European and Baltic countries, Israel and again the 15 members of the EU.

The results of the estimation are as follows:

#### I. Potential exports from Turkey to Cyprus

$$\text{Log(Exports)} = 13.16 + 0.55*\text{log(GDPj)} - 1.35*\text{log(Dist)} + 1.13*\text{CU} - 0.97*\text{FTA}$$

R square: 0.65, No. of observations: 73

The variables Border, SEA and POP were found to be insignificant up to standard level.



The current export potential of Turkey to Cyprus corresponding to what could be described as a sheer “normalization” of trade relations can now be estimated (i.e. assuming there is no free trade regime between both countries and Cyprus is not a member of the EU):

$$\text{Exports} = ((2.718)^{13.15}) * (543^{-1.35}) * (9.11^{0.55}) = 351.67 \text{ Mo.}\$$$

(2.718 is the natural log of the autonomous component in the equation)

When Cyprus would become a member of the EU (CU=1, FTA=1), Turkey’s exports to Cyprus would increase by a further 71 Mo.\$, i.e. by about a further 20% :

$$\text{Exports} = ((2.718)^{13.15}) * (543^{-1.35}) * (9.11^{0.55}) * (2.718^{(-0.97)}) * (2.718^{1.13}) = 422.22 \text{ Mo.}\$$$

## II. Potential imports of Turkey from Cyprus

$$\text{Log(Imports)} = 8.12 + 0.98 * \text{log(GDPj)} - 0.93 * \text{log(Dist)}$$

R square: 0.75, No. of observations: 73

The variables POP, CU, FTA ,SEA and BORDER were found to be insignificant up to standard level.

The import potential of Turkey from Cyprus when normal trade relations are established again between the two countries can now be estimated (i.e. assuming there is no free trade regime between both countries and Cyprus is not a member of the EU):

$$\text{Imports} = ((2.72)^{8.11}) * (9.11^{0.98}) * ((543)^{(-0.93)}) = 83.44 \text{ Mo.}\$$$

(2.72 is the natural log of the autonomous component in the equation)

When Cyprus would become a member of the EU Cyprus’ exports to Turkey would not increase further, since the the dummies CU and FTA were discarded, not being statistically significant.

Given that there was no trade between Turkey and Cyprus in 1998, the year used for data on which these estimations are based, it appears that in \$ terms, “normalization” of trade relations between the two countries would be much more important than the entry of Cyprus in the EU per se. It would rise trade between the two countries from zero to 430 Mo. \$, whereas the entry of Cyprus to the EU would add to that “only” another 70 Mo.\$ to a non negligible total of 0.5 billion \$ . Some experts believe that “normalization” of trade relations and the Enlargement are linked in the sense that Enlargement is inconceivable without “normalization” but the latter is also inconceivable without Enlargement. Cyprus and Greece will not tend to normalize trade relations with Turkey if the perspective and actual entry of Cyprus in the EU is excluded or delayed forever. This is why it can be said that the entire annual estimated potential trade flows of 0.5 Bn \$ between Turkey and Cyprus can be attributed to the prospective inclusion of Cyprus in the EU.

Detailed results for the econometric estimations made follow below:

LS // Dependent Variable is LEXPORT

Date: 08/24/00 Time: 17:37

Sample: 1 77

Included observations: 73

Excluded observations: 4 after adjusting endpoints

Variable	Coefficient	Std. Error	T-Statistic	Prob.
LDIST	-1.34911	0.165733	-8.14028	0
LGDP	0.554686	0.074723	7.42324	0
FTA	-0.973023	0.355135	-2.739869	0.0078
CU	1.133988	0.430733	2.632692	0.0105
C	13.15559	1.25227	10.50539	0
R-squared	0.650512	Mean dependent var		4.645232
Adjusted R-squared	0.629953	S.D. dependent var		1.544491
S.E. of regression	0.939536	Akaike info criterion		-0.0587
Sum squared resid	60.02551	Schwartz criterion		0.098177
Log likelihood	-96.43983	F-statistic		31.64253
Durbin-Watson stat	2.225545	Prob(F-statistic)		0

LS // Dependent Variable is LIMPORTS

Date: 08/24/00 Time: 17:59

Sample: 1 77

Included observations: 73

Excluded observations: 4 after adjusting endpoints

Variable	Coefficient	Std. Error	T-Statistic	Prob.
LGDP	0.981984	0.072524	13.54013	0
LDIST	-0.93138	0.163588	-5.69346	0
C	8.119876	1.224209	6.632752	0
R-squared	0.723842	Mean dependent var		4.869686
Adjusted R-squared	0.715952	S.D. dependent var		2.003175
S.E. of regression	1.067615	Akaike info criterion		0.171083
Sum squared resid	79.78619	Schwartz criterion		0.265211
Log likelihood	-106.827	F-statistic		91.73909
Durbin-Watson stat	1.826663	Prob(F-statistic)		0

### CHAPTER III: The impact of the coming Enlargement on investment flows

#### 1. Introduction

The purpose of this chapter is to examine the influence of the EU enlargement on the MNMCs in respect of the FDI channel. First, the importance of FDI inflows to the receiving countries is examined. The next question addressed is what is the expected influence of the eastward enlargement on the return to capital in the candidate countries and how it should influence the FDI inflows into the MNMCs. In the third part after an analysis of the flow of FDI to the CEECs and to the MNMCs during the 1990's, the chapter examines whether there was a shift of FDI from one periphery to the other. In the last part a forecast of the future investment effects of the Eastward Enlargement is made, relying for that both on a Gravity-type model and on the experience of the 1980s EU enlargements.

## 2. The Importance of FDI

The flow of foreign direct investment (FDI) is critical to the success of liberal and open economies. Investments allow economies of small countries with low capital per worker, and therefore low productivity, to increase production in a relatively short period of time, to a level that was not previously attainable. The flow of foreign direct investments increases per-worker capital. Since increasing the amount of one of the means of production will increase the productivity (in terms of marginal production) of another means of production that participates in the production process, the increase of per-worker capital increases the productivity of workers and is expected to increase their wages.

FDI needs not be analyzed only as a flow of money. The participation of foreign investors has its unique added value and involves indirect contributions, both to the specific enterprise and to all of the receiving economies:

0. **New technologies**- foreign investors bring with them technologies that are unknown in less advanced economies. In many cases the acquisition of new technology by one enterprise paves the way for its use in other factories and industries in the receiving economy. This process of spillover magnifies the effect and increases the importance of FDI.
0. **Management methods**- foreign investors and companies not only introduce capital and technology, but they also bring management skills with them, which may be unknown to the receiving firm and lead to an increase in its efficiency and profits. Just as for technology, a transfer of management skills and standards, not only to the receiving enterprises, but also to other firms and industries, is to be expected.
0. **Access to foreign markets**- in many instances FDI is made by multinational corporations which own their own distribution systems or use their products as intermediary goods in other factories they own in different countries. Local factories can sell their products to consumers and markets to which they have been previously denied access, and therefore increase their sales and profits.
0. **Stimulation of reforms** – in order to attract foreign investors, local governments are obliged to guarantee a favorable business environment by conducting comprehensive structural reforms, exposing the economy to foreign trade and guaranteeing the free movement of capital, etc.

## 3. The effects of the EU's Enlargement of FDI inflows into MNMC in Theory

In order to understand the cross effects of the EU enlargement on the MNMC FDI inflows, one should bear in mind that those two peripheries are competing for the same limited amounts of capital, whether their owners are located in the EU, USA, Japan or any other country. General conclusions can be drawn from the theory of international trade using a simple static model of partial equilibrium in an open economy. This analytical tool is appropriate here since capital can be thought of as a means of production. The model assumes three countries (I, J, K); in each country there is a supply of capital by the households and a demand for capital by the firms. Since there is uncertainty about the success of the investment, the price (=rate of return) in each market is defined in terms of expectations  $\{E(r)\}$ .

The assumption is that free movement of capital prevails; therefore a household invests in the country where the expected rate of return is the highest<sup>34</sup>. The free movement of capital creates a global market in which the level of expected rate of return is  $E(r_w)$  and it is valid in all markets. In the example above, this level is higher than the local level of country I, therefore country I is a net source of FDI in the amount of  $Q_{i1}-Q_{i0}$ . At the same time, the international level of the expected rate of return is lower than the local level in countries J and K, therefore the latter are expected to draw FDI in the amount of  $Q_{j1}-Q_{j0}$  and  $Q_{k1}-Q_{k0}$ , respectively<sup>35</sup>. It should be noted that the parity relates only

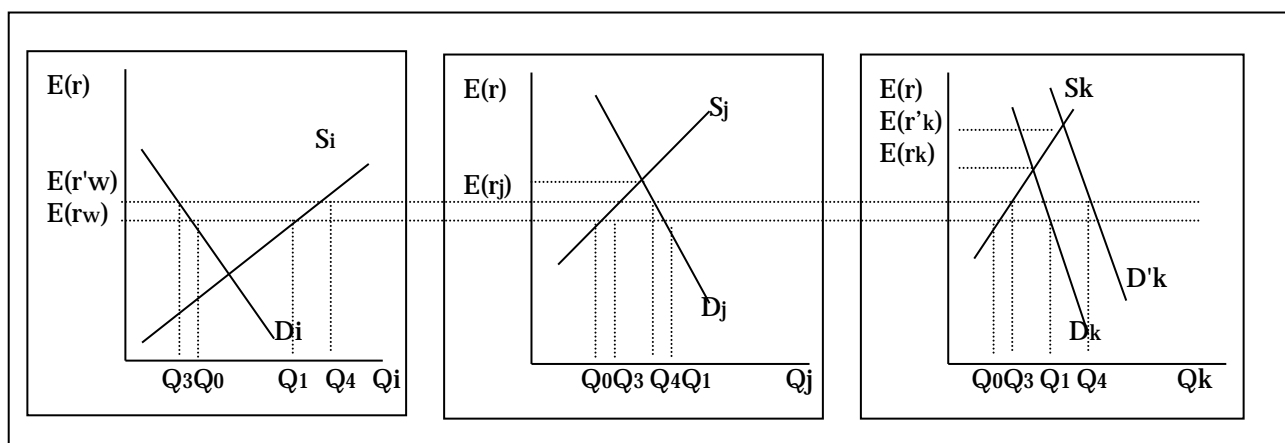
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<sup>34</sup> Symmetric information is assumed, although asymmetric information does not change this conclusion.

<sup>35</sup>  $Q_{i1}-Q_{i0} = (Q_{j1}-Q_{j0}) + (Q_{k1}-Q_{k0})$

to the expected rate of return, therefore, nothing precludes differences in rates of return between various countries. This can be explained by differences in risks related to the various countries.

The accession of country K to the EU will substantially increase its producers' profitability and the return on capital, and therefore the flow of inward FDI. The accession to the EU promises free access for industrial and agricultural goods and free access for services to the affluent markets of Western Europe. This is achieved by abolishing both customs tariffs and non tariff barriers (NTBs), which reduce the per unit cost of K's producers in their export destinations, and make them much more profitable.<sup>36</sup> Since investments are taken here as a means of production, an increase in production leads to an increase in demand for investments in country K (from  $D_k$  to  $D'_k$ ). The local expected rate of return will rise to  $E(r'_k)$ , raising the world expected rate of return to  $E(r'_w)$ . Country J will have to be prepared to pay a higher expected rate of return on imported capital and therefore will receive a smaller inflow of investments.



In addition to the direct influence on local producers' profitability, the accession process forces the candidate countries to make substantial reforms. These include deregulation, adaptation of free market norms, privatization, reduction of government holdings in the economy, and adaptation of international standards related to monetary and fiscal policies, the free movement of capital, etc. These reforms should lead to a favorable business environment and open vast business opportunities for foreign investors, as well as creating large inflows of FDI.

Whereas, many economic activities need time to adjust to changes in the institutional framework, such as membership in the EU, investors operate according to the future and investments tend to take place before the changes actually occur. Therefore, if a specific country is expected to experience a change in the future that will render its producers more profitable, we may expect to see an inflow of FDI prior to this occurrence.

#### 4. The effects of the EU Enlargement on FDI inflows to the MNMC in practice

FDI inflows from the EU to the MNMCs in absolute terms, not only did not decrease during the 1990s, but actually increased dramatically. As one can see in Table 10, EU-originating FDI flows into Magreb and Mashrek countries, together with Israel and Turkey, experienced an 82.1% increase between 1992 and 1996, reaching in that year ECU 812 million. Moreover, the increase in FDI inflows to Magreb countries increased by more than 600% during that period. The reason for this unexpected result is probably a dramatic increase in EU FDI outflows. As one can see in Table xxx, total FDI outflows from the EU increased by 48.8% between 1992 and 1996. Furthermore, extra-FDI outflows from the EU increased by 139.9% during that period. This trend is an expression of a global change in investment habits. In the past, when information facilities were not as efficient as they are today, investment abroad was characterized by high risk. Investors usually operated in their home or neighboring countries, where information was relatively accessible. Today, investment habits have changed dramatically. Due to advanced technology, investors have very accurate and up-to-date information about their investments. Financial investment markets have become global. Although distance still wages costs on real investors

<sup>36</sup> Trade creation is assumed to be larger than trade diversion.

at the present, they are much lower than they were 20 years ago and FDI flows are much higher today than they were in the past.

Table 10: Geographical breakdown of FDI outflows from EU member countries<sup>37</sup>

	1992	1993	1994	1995	1996
Total	67,107	64,361	74,687	99,150	99,833
Extra EU	17,828	24,157	24,129	45,580	42,766
CEEC	2,117	3,238	2,868	5,589	4,829
Magreb Countries	32	152	227	126	225
Mashrek Countries	22	87	145	204	50
Israel	23	36	36	109	178
Turkey	369	280	398	317	359

Source: Eurostat (1999), EU Investment Yearbook 1998 - Data.

There are several other reasons for the sharp increase in the flow of FDI in the 1990s. First, debt rescheduling in a wide range of countries made them more creditworthy. This was quite relevant for countries in Latin America and the CEECs, which were facing huge debt problems in the 1980s. Second, growing productivity as a result of structural reforms and the responsible macroeconomic policy that was taken by the governments after stabilization programs made the countries doing those efforts more attractive to FDI. Third, the decline in world real interest rates at the beginning of the 1990s led investors to be tempted by emerging markets where the expected rate of return was substantially higher (Lopez-Mejia, 1999, 15).

A diversion effect can be detected by examining FDI flows using relative terms - share of FDI to country *j* in the total FDI outflow and in the extra-EU FDI outflow. Table 11 shows a significant increase from 3.2% in 1992 to a peak of 8.3% in 1995 in the share of EU FDI flows to the CEECs as a share of the total EU FDI outflow. Moreover, examining the share of EU FDI outflows to the CEECs in extra-EU FDI outflows (Table 11) a significant diversion effect is detected. During the period 1992-1996 the share of FDI flows to the CEEC increased from 11.9% in 1992 to 27.1% in 1996. One should recall that the increase of country *j*'s share must come at the expense of all other countries. Therefore, just as the partial equilibrium model above has predicted, improving the institutional framework of the CEECs and making them candidates for EU membership, will translate into less FDI flowing into all other countries, all other things equal. Nevertheless, if one examines the share of EU FDI flows to the MNMCs in the total extra-EU FDI outflows, it appears that not only it did not decrease, but the share of the Magreb and Mashrek countries together, with Israel and Turkey, increased to 4.6% in 1996 from 2.5% in 1992. Therefore, one must conclude that even if there was a diversion of FDI flows from the EU to the CEECs, the MNMCs were relatively unaffected by it.

Table 11: Share of FDI outflows to Mediterranean and applicant Countries in total EU FDI outflows

	1992	1993	1994	1995	1996
<i>CEEC</i>	3.2%	4.8%	4.3%	8.3%	7.2%
Magreb Countries	0.0%	0.2%	0.3%	0.2%	0.3%
Mashrek Countries	0.0%	0.1%	0.2%	0.3%	0.1%
Israel	0.0%	0.1%	0.1%	0.2%	0.3%
Turkey	0.5%	0.4%	0.6%	0.5%	0.5%

Source: Eurostat (1999), EU Investment Yearbook 1998 - Data.

<sup>37</sup> Reinvested earnings are excluded.

Table 12: Share of FDI outflows to Mediterranean and applicant Countries in total extra-EU outflows

	1992	1993	1994	1995	1996
<i>CEEC</i>	11.9%	18.2%	16.1%	31.3%	27.1%
Magreb Countries	0.2%	0.9%	1.3%	0.7%	1.3%
Mashrek Countries	0.1%	0.5%	0.8%	1.1%	0.3%
Israel	0.1%	0.2%	0.2%	0.6%	1.0%
Turkey	2.1%	1.6%	2.2%	1.8%	2.0%

Source: Eurostat (1999), EU Investment Yearbook 1998 - Data.

The lack of significant diversion of FDI inflows from the CEEC to the MNMC can be proved using a Gravity-type of model. This model has been frequently used in recent years for empirical studies of foreign trade and later on for empirical studies on FDI flows (Brenton, Di Mauro and Lucke (1998) and Brenton (1999)).

The Gravity model, which was developed in the mid-1960s (Linnemann 1966), describes exports to or FDI stocks of an origin country (i) in a destination country (j) for a given year. As explained in Chapter II, these magnitudes are described as a function of the income and population of the origin country (supply factors), as a function of income and population of the destination country (demand factors) and the distance between the two countries. Beside those basic variables, the model can be completed with dummies, such as the possession of a common border, a common language, membership in the same trade block and so on, variables which might influence bilateral transaction costs.

Specifically, the equation used has the form:

$$\ln X_{ij} = a + b_1 \ln GDP_j + b_2 \ln POP_j + b_3 \ln DIST_{ij} + D_{kij}$$

$X_{ij}$  is the value of FDI stock in \$US million from the EU in country j in 1996<sup>38</sup>. FDI stocks rather than flows are used in the modelling because data on flows can be negative. Since the Gravity model is a dual logarithmic equation, it cannot operate with negative data filling in both for the dependent and independent variables.

$GDP_j$  is country j's gross domestic product in \$US billion in 1996<sup>39</sup>.  $POP_j$  is country j's population in millions in 1996<sup>40</sup>.  $DIST$  is the average distance from all EU members' capitals to country j's capital. Since data are pooled from one origin country in one year,  $GDP_i$  and  $POP_i$  are constants and therefore do not have explicit expression in the equation.

The stock of FDI in country j can be explained by the level of production of that country and its absolute size, which is expressed by the size of its population. FDI stocks are expected to be positively correlated to the country's GDP since the flow of FDI is larger between wealthier nations. FDI stocks are expected to be negatively correlated to the country's size since large countries are expected to be self sufficient in terms of FDI. The relations between FDI stocks and the distance between the two countries is not obvious. On one hand, there are long distance incentives for firms to invest in country j by establishing subsidiaries because distance increases trade costs. On the other hand, the larger the distance between the headquarters and the subsidiary, the higher the operational costs related to management of the latter. Nevertheless, empirical studies show that distance has an overall dampening effect, but to a lesser extent than for trade (Brenton, Di Mauro and Lucke, 1998).

Four dummy variables are added to the equation that represent geographical locations:

0. EU that is equal to 1 if a country is currently a member of the EU and 0 otherwise.
0. CEEC1 that is equal to 1 if a country is one of the candidate countries that are expected to access the EU in the first wave and 0 otherwise.

<sup>38</sup> Source: Eurostat, EU Direct Investment Yearbook – 1998.

<sup>39</sup> Source: IMF, World Economic Outlook database (April 2000).

<sup>40</sup> Source: IMF, World Economic Outlook database (April 2000).

- 0. CEEC2 that is equal to 1 if a country is one of the candidate countries that are expected to access the EU in the second wave and 0 otherwise.
- 0. MMNC that is equal to 1 if a country is one of the Mediterranean non-Member States and 0 otherwise.

Significance of each of the variables means that the FDI inward stock of this specific group of countries is higher (when the coefficient sign is positive) or lower (when the coefficient sign is negative) compared to the "normal" FDI inward stocks from the EU <sup>41</sup>.

**Results:**

Regression of the basic equation using 1996 data has shown high explanatory power (R-square = 0.719) and the equation is highly significant. The regression also shows that the variable DIST<sub>ij</sub> is not significant although the coefficient sign is negative, as expected. This might be explained by the large flows of EU FDI flows to the emerging markets in South America and Asia.

<u>Regression 1</u>				
Dependent variable :		LnFDI		
Included observations:		54		
R-squared:		0.719		
Prob(F-statistic):		0.000		
<u>Variable</u>	<u>Coefficient</u>	<u>Std. Error</u>	<u>T-statistic</u>	<u>Prob.</u>
LnPOP <sub>j</sub>	-0.729	0.140	-5.189	0.000
LnGDP <sub>j</sub>	1.146	0.130	11.196	0.000
LnDIST <sub>ij</sub>	-0.079	0.170	-0.463	0.645
C	8.954	0.142	6.302	0.000

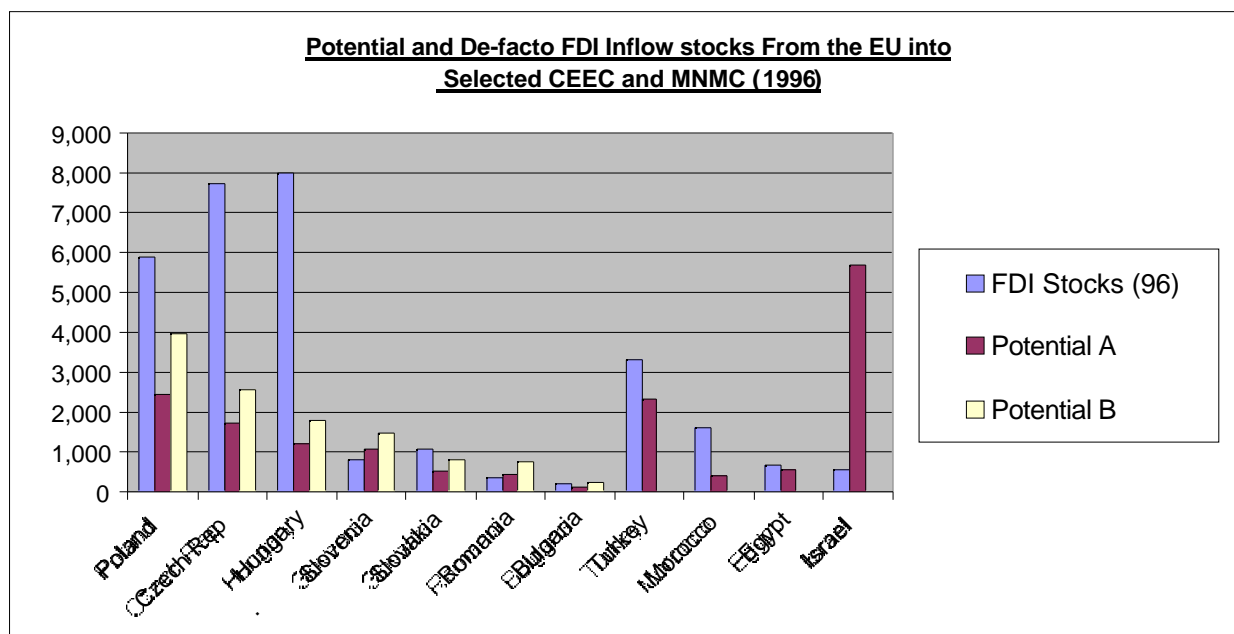
When the EU and the CEEC1 dummy variables are added to the basic equation (without DIST<sub>ij</sub>), the regression results (see regression 2) show a positive, significant coefficient of EU (at 10.8% confidence level) and CEEC1 (at 8.6% confidence level). This means that the EU member countries and the CEECs candidates of the first wave have a higher level of FDI inward stock from the EU than the "normal"<sup>42</sup> level. Moreover, if a country is to become an EU member, its FDI inward stocks are expected to increase in the long run by 91%. This is so given that the EU's dummy coefficient is 0.647 (see regression 2) and since Ln X<sub>ij</sub> is augmented by 0.647, that means that X<sub>ij</sub> is multiplied by 1.909. In a separate exercise the CEEC2 and MNMC dummy variables have been added. It appears that the coefficient of those two dummies are found to be negative but insignificant up to standard level. This means that the amount of FDI inward stocks from the EU in those countries is statistically the same as the "normal" level. The negative sign indicates that there is a tendency for those countries to have lower level of FDI inward stocks than the "normal" level. Regression 2 above omits therefore these two insignificant dummies. The explanatory power of the regression is even higher than regression 1 (R-square = 0.774) which is highly satisfactory statistically speaking.

<u>Regression 2</u>				
Dependent variable :		lnFDI		
Included observations:		55		
R-squared:		0.774		
Prob(F-statistic):		0.000		
<u>Variable</u>	<u>Coefficient</u>	<u>Std. Error</u>	<u>T-statistic</u>	<u>Prob.</u>
LnPOP <sub>j</sub>	-0.632	0.141	-4.344	0.000
LnGDP <sub>j</sub>	1.410	0.140	10.044	0.000
EU	0.647	0.400	1.635	0.108
CEEC1	0.100	0.568	1.753	0.0857
C	7.312	1.146	6.381	0.000

<sup>41</sup> For EU countries EU FDI inward stocks refers to stocks owned by all other countries in the EU.

<sup>42</sup> Taking into account population and gross domestic product of the receiving country.

The graph below shows the (de-facto) FDI inward stocks from the EU to selected CEECs and MNMCs compared to the potential FDI stocks. **Potential A** is the "normal" FDI stock calculated using the basic equation's estimators without the dummy variables. **Potential B** is the FDI stock calculated using the second equation's estimators, assuming CEEC are to become EU members. From this graph it can be seen that the de-facto FDI inward stocks into Hungary, the Czech Republic and Poland are much higher than the "normal" stocks predicted by the gravity model, on the basis of EU FDI stocks in the entire world. The de-facto FDI inward stocks are even higher than the expected stocks assuming those countries are to become EU members (using 1996 population and GDP data).



Nevertheless, the estimated long term equilibrium for these stocks, using as an independent variable a fictitious GDP of the Eastern European applicants calculated on the basis of the 1996 EU average per-capita, is \$18,886 millions for Hungary, \$19,042 millions for the Czech Republic, and \$53,180 millions for Poland. The underlying assumption is that in the long run the applicant's GDP per capita will be similar to the EU's average nowadays. As seen these stocks are far greater than the current ones.

## **CHAPTER IV : LABOUR MIGRATION**

### **1. Introduction**

Foreign workers' remittances are one of the most important sources of foreign currency for the MNMC countries and accounted for 3.8% of their GDP in 1993 (excluding Israel, Lebanon, and Jordan, as seen in table 13). This flow of money is used not only as additional income that increases private consumption, but also as a major source of foreign direct investment (FDI) that increases the production capabilities of the MNMCs economies themselves. Having large numbers of MNMCs citizens working abroad is a result of the income gap between MNMCs and the affluent countries in Europe and the Persian Gulf. This gap can be thought of as procuring a relative advantage in labor services to the MNMCs that would have resulted in a movement of labor from the MNMCs to those wealthy and high-income countries, had there been a free open market for labour. Since the income per capita in the CEEC is relatively low, compared to the prevailing one of EU current member countries, one should expect the accession of the CEECs to the EU to affect the current inflow of remittances from the EU to the MNMC's and affect one of their important sources of foreign currency.



Table 13 :Workers remittances flowing to the MNMCs (1993)

Country	Workers Remittances (\$ billions, 1993)	Percent of GDP
ALGERIA	0.2	0.5%
EGYPT	5.7	12.0%
JORDAN	1.0	18.7%
MOROCCO	2.0	7.3%
SYRIAN ARAB REPUBLIC	0.6	4.3%
TUNISIA	0.6	4.1%
TURKEY	2.9	1.6%
Total	13.0	3.8%

Source: IMF, World Economic Outlook, April 2000; IMF, Balance of Payment Yearbook, 1994

This chapter examines whether the EU enlargement to low income countries could influence the flow of migrant remittances from the EU to the MNMCs. In the first part of the chapter a conventional view is put forward, using economic theory to show how the accession of low-income countries to the EU might affect the labor market of affluent EU countries in general, and specifically, real wages and unemployment. On the basis of this economic analysis political-economic conclusions on the likely impact on the EU migration policies toward the MNMC are drawn. Finally, using these results the chapter focuses on the likely effects on remittances from the EU to the MNMCs and on the MNMCs economies in general. In the second part of this chapter the conventional approach is questioned by raising several issues:

Will enlargement really lead to mass migration from the CEECs to the EU?

Are human resources in the CEECs of the same type as in the MNMCs, so that mass movements of workers from the CEECs to the EU could have a negative incidence on employment and wages levels?

Is the EU's migration policy to the MNMCs so liberal that it might dramatically change as a result of additional supply of the applicant's citizens in the EU labor markets?

Which lesson has been learned from former experiences, especially from the accession of Spain, Portugal and Greece, and from the "Europe 1992" program?

At the end of this chapter a tentative estimation of the overall effect is made, taking into account the conventional approach and the questions raised above.

## 2. Economic analysis of immigration

In order to estimate the effect of the Eastward enlargement on the MNMCs, an examination of the motivation for migration at the individual level should be made. The motivation for migration varies (e.g. it can be grounded on political, ethnic, economic, cultural reasons). In this chapter the focus is on the economic motivation for migration.

From the viewpoint of economic theory, the main motivation for deciding to migrate is the desire of workers to improve their economic conditions. The assumption is that workers are in a constant process of searching for a better job in terms of higher productivity and higher income (Werner, 1999, p.6). The gravity model sums up the economic motivation for migration:

$$V_p = \sum_{n=1}^N \frac{E_2 - E_1}{(1+i)^n} - \sum_{n=1}^N \frac{C}{(1+i)^n} - Z$$

The motivation is expressed by the present value of net benefits ( $V_p$ ) and it is a function of the present value of the increase in earnings ( $E_2 - E_1$ ). Whereas  $E_2$  are the earnings from the new job in year  $n$ ,  $E_1$  are the earnings from an existing job in year  $n$ ,  $N$  is the length that the new job is expected to last,  $i$  is the interest rate,  $n$  is the year in which benefits and costs accrued.  $C$  are the direct or indirect monetary costs resulting from a move in the year  $n$  and  $Z$  is the net psychological cost of a move. Whenever  $V_p$  is positive, the expected earnings are higher than the costs and the person is expected to migrate (McConnell et al., 1995, p.257).

In order to demonstrate the anticipated effect on the labor markets caused by the CEECs accession into the EU, the theory of International Trade can be put into practice. The political-economic discussion often uses of a static partial equilibrium model. The assumption is made that only one kind of profession exists (therefore a unified labor market) and a positively sloped labor supply curve.

There are two markets:

- The EU market in which  $S = SEU = S_0$
- The CEEC market, where wages are given exogenously and the number of workers willing to move to the EU countries (taking into account adjustment costs such as language) is a function of the offered wage in the EU and is given by  $S_{CEEC}$ .

Before enlargement  $S = S_0$ ; therefore the wage is  $W_0$  and the number of employees  $L_0$ .

Enlargement will make the CEECs full members of the EU and will allow free movement of labor. The EU15 labor demand curve will be facing additional supplies of workers ( $S_{CEEC}$ ) that will increase the total supply of labor in the EU15 market to  $S_1$ . The increase in supply will reduce the real wage to  $W_1$  and increase the total number of employed from  $L_0$  to  $L_2$ , whereas the number of local EU15 employed will be reduced from  $L_0$  to only  $L_1$ .

Table 14: Labor costs per worker in manufacturing (\$ per year)

Hungary	2,777	Austria	26,087
Poland	1,257	Belgium	28,735
Slovenia	9,6321	Denmark	35,615
Egypt	1,863	Finland	31,330
Israel	26,635	France	38,900
Jordan	3,125	Germany	63,956
Morocco	3,391	Greece	15,89926,0
Syria	4,338	Italy	35,138
Turkey	7,958	Ireland	25,414
		Netherlands	39,865
		Portugal	7,577
		Spain	20,585
		Sweden	29,043
		United Kingdom	26,045

Source: The World Bank, World Development Indicators 1999

According to this analysis, and in light of the high unemployment EU countries have experienced in the last decade, anti immigration feelings can be expected to develop among the local constituents. Not surprisingly, extreme right-wing or xenophobic parties have gained power or electoral appeal in Europe since the 1980s, especially in districts that were highly exposed to immigration waves. One of the most well known examples is the success of Le Pen's party in the municipal elections in several towns in southern France. Another recent example was the success of Jorg Haider's Freedom Party in Austria in the 1999 elections. Haider's party won 23% of the vote of Austrians as a whole and more significantly 43% of the vote of blue-collar workers who fear(ed) to be hit by a short-term wave of migration from Eastern Europe as a result of Enlargement (Financial Times, June 16 2000).

Besides the direct influence on the receiving economy via the labor market, immigrants impose costs on the receiving economy by increasing the government expenditure in Social Security. As long as immigrants are young healthy men and women, who come on their own, and do not gain citizens

rights, their productivity is relatively high, their medical and social needs are low and they are net contributors to the public sector<sup>43</sup>. But, in reverse, when the immigrants are older, come with their families and receive citizenship, their net productivity is lower. On the other hand, their medical and social needs are greater so that their net contribution to the public sector is lower. Whenever an immigrant is entitled to citizenship and citizenship rights, he is entitled to a larger public services basket and his net contribution is much smaller. This is especially relevant in Welfare State-type of countries, where citizens enjoy varied and high quality services on one hand and are required on the other hand to transfer to the State a large part of their income to finance the public sector.

In those countries xenophobic feelings can be expected, independently of the current economic situation, and surprisingly among the high- income population as well, which carries most of the fiscal burden. This could contribute to explain the success of Jorg Haider's extreme right wing Freedom Party in Austria's 1999 election.

In order to avoid the loss of their voters and their political power, centre- and even left-wing parties may adopt a restrictive migration political platform. Governments headed by these parties may choose to limit the number of immigrants from non-European countries (Mayhew, 1998, p.343). Moreover, they might restrict their rights for social services, deny working permits to foreigners, disallow foreign workers to bring their families, impose restrictions on entry visas required from low-income countries' nationals and on the concession of refugee status to the asylum-seeker. For example, in December 1992 the German coalition parties (Christian Democratic Union and the Christian Social Union) and the opposition party SPD (Social Democratic Party) launched a joint bill for the amendment of the Basic Law regarding those seeking asylum in Germany. Until 1993, persons who sought refuge in Germany requested political asylum under Article 16 (II,2) of the Constitution stating that: "Every politically persecuted individual has a right to asylum." The purpose of the amendment was to prevent "economic refugees" from entering Germany, i.e., those persons who only want to reside in a country where they have better economic prospects than in their country of origin (Cohen-Weisz, 1999, 4).

The adoption of restrictive migration policies should decrease the number of MNMCs workers in EU labour markets and, thus, the flow of remittances to the former's home countries. This will have significant effects not only on local MNMC consumption but on fixed capital formation as well.

One must bear in mind that for this scenario to take place, all of the assumptions on which the present analysis is made should hold simultaneously. But, do all of these assumptions stand up in reality? Will labor markets be freed so that there will be a substantial flow of labor from the applicant countries? Are all workers the same? Are the workers from the CEEC competing with workers from the MNMC in the same labor market(s)?

### 3. Questioning the Conventional Wisdom

#### A. Will Enlargement Lead to mass migration from the first wave applicants to the EU?

Free movement of labor is one of the four freedoms on which the Common Market is based on. First guaranteed by the Treaty of Rome (1957), later in the Maastricht Treaty (1992), every citizen of a member state of the EU is entitled to work in any of the other member countries and compete with local workers for the same jobs on equal terms. EU's eastward enlargement will result in the accession of four CEEC and one Baltic country into the EU as full members, so that citizens from the new member states will be allowed free access to the current EU member labor markets.

As one can see in table 15 below, GDP per capita differences between the first wave candidates and EU current members are huge. In 1999, the EU's per capita average was 4.9 times higher than the first wave candidates' average. Moreover, if one looks at the gap between specific countries, the differences are much higher. For example, Luxembourg's GDP per capita was 12.6 times higher than Estonia's, or Germany's GDP per capita was 6.5 times higher than Poland's, both of whom share a common border. Therefore, the Commission has concluded that there is a strong incentive to East-

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<sup>43</sup> In terms of taxes paid compared to services consumed.

West migration despite high unemployment in Western Europe (EC Commission, Agenda 2000, 1997).

Table 15: GDP per Capita, Current prices (U.S. dollars per person)

Country	1997	1998	1999	2000	2001
TOTAL EU-15	22,251	22,939	22,877	22,554	23,654
First wave candidates	4,331	4,659	4,652	n.a.	n.a.
CYPRUS	13,197	13,872	13,965	n.a.	n.a.
CZECH REPUBLIC	5,166	5,489	5,181	n.a.	n.a.
ESTONIA	3,036	3,392	3,504	3,818	4,202
HUNGARY	4,510	4,659	5,071	5,447	5,869
POLAND	3,698	4,060	3,978	4,244	4,697
SLOVENIA	9,549	10,024	10,802	n.a.	n.a.
LUXEMBOURG	42,096	43,722	44,206	43,263	45,987
DENMARK	31,961	32,903	32,727	32,294	33,606
SWEDEN	26,786	26,819	26,870	27,048	28,440
AUSTRIA	25,616	26,110	25,793	24,959	26,319
GERMANY	25,780	26,233	25,782	24,859	26,238
NETHERLANDS	24,130	24,926	24,988	24,682	26,460
BELGIUM	24,336	24,982	24,760	24,002	25,183
UNITED KINGDOM	22,641	24,097	24,633	25,751	26,216
FRANCE	24,325	24,958	24,594	23,730	24,771
ITALY	20,587	21,050	20,734	20,142	21,239
SPAIN	14,394	14,996	15,369	15,159	16,141

Source: IMF, World Economic Outlook, April 2000

Differences in net economic advantages, especially differences in wages, are the main causes of migration, but the cost of migration, in terms of leaving one's family, friends and culture are very important to consider. Different languages, cultures and traditions make it difficult for immigrants to integrate into the local population, and tend to limit personal decisions to migrate. These considerations are limiting the potential of mass migration in practice (Mayhew, 1998, p. 336). The cost of labor migration seems to remain high even if legal restrictions on international movement of workers are abolished in the area which integrates. Therefore, the assumption easily accepted of a so-called symmetry between capital flows and movement of labor is false (Werner, 1999, p.15). In its assessments of implementation of the "Europe 1992" programme, the EC Commission claims that although there was a steady increase in the number of EU nationals working in other Members States, migration was confined to specific occupations such as managers, professionals or specialized technicians (EC Commission, 1996). Nevertheless, one should bear in mind that the current income gap between the EU15 and the four CEECs plus Estonia is significantly higher than that between the EU9 and Greece, Spain and Portugal on the eve of their accession, or the income gap between EU member states in the mid-1980s at the time they had to complete their Single Market. Therefore, the economic incentives of CEEC's citizens to migrate are considerably higher, compared to former accessions.

A factor that may limit the migration wave is the potential immigrant's expectations regarding the economic future of the region he lives in. If a person believes that his home region is to experience economic growth that will lead to increases in his own economic condition and labour income, he will focus less on the average income gap between his home region and a potential migration destination. The accession to the EU will allow free movement of goods and services. Since wages in the applicant countries are much lower than in the current EU members, theory expects the candidate countries to be specialized in labor-intensive goods and services. According to the Stolper – Samuelson theorem, this will lead to an increase in demand for labor in the candidate countries, and increase in wages that will reduce migration incentives .

A report published by the Commission in May 2000 estimates that only 335,000 people a year will move

from the 10 accession states after enlargement, of whom only one third will seek work (Financial Times, June 16, 2000). These numbers are certainly not the mass migration flows people are so concerned about.

<i>Number of residents from Eastern Europe in the EU</i>			
	1998	2010*	2030*
Austria	103,000	351,013	469,931
Belgium	10,773	36,713	49,151
Denmark	8,863	30,204	40,437
Finland	11,985	40,844	54,681
France	22,000	74,974	100,374
Germany	554,869	1,890,933	2,531,556
Greece	20,131	68,604	91,846
Ireland	200	682	912
Italy	34,490	117,538	157,359
Luxembourg	700	2,386	3,194
Netherlands	9,606	32,736	43,827
Portugal	781	2,662	3,563
Spain	10,539	35,916	48,084
Sweden	26,191	89,256	119,495
UK	39,000	132,908	177,935
Total	853,128	2,907	3,892,345

\*projection

Source: DIW-Berlin and IGIER-Bocconi report for European Commission.

Moreover, the population of the successful European economies is aging, thereby creating a need for foreign workers, in order to maintain the share of the working age population. It is estimated that by 2050 the EU, as a whole, will have to import 1.6 million workers per year (Germany 487,000 ; France 109,000). Seen from another slight different perspective, it appears that in order just to keep the ratio of workers per pensioners steady, the EU would need to import 13.5 million immigrants a year (Economist, May 6th, 2000). Thus, even if a substantial amount of CEECs' migrants would actually flow to the EU , the member states' economies would be able to absorb them in the medium and long term without undue difficulty.

B. Are human resources in the CEECs actually of the same kind as those of the MNMC, so that mass movements of workers from the CEECs to the EU may have a negative effect on MNMCs migrants' employment and wages levels?

Mass migration from the CEECs and Estonia does not necessarily directly imply a decrease in migrant remittance flows from the EU to the MNMCs. This will happen only if the human resources in the CEECs are actually similar to that of the MNMC, so that both CEEC's and MNMC's workers are competing in the same labor market. Furthermore, if one disaggregates the EU's labor market functionally, he may also discover that the human resources in the CEECs are not the same as in current EU members. Therefore, the effects predicted at the beginning of this chapter on wages and unemployment in the EU members might not be relevant at all.

One may think of several indicators to estimate similarity in labour patterns of the two peripheries. One indicator that may be useful for the purposes of this chapter is the distribution of the labour force among major sectors in the economy. The accession of a "similar" country in terms of this distribution is expected to affect third countries more significantly than the one of a "dissimilar" country. One can see in table 16 the high share of employed in the agriculture sector in many of the CEECs and the MNMCs. There are substantially high shares of employed in the agricultural sector in Poland, Egypt, Morocco and Turkey. On the other hand, comparing the corresponding shares in the

industrial and the service sectors, one can see that in CEECs, the share of the service sector as an employer is substantially higher than in MNMCs and the one of the industrial sector substantially lower than in MNMCs.

Table 16: Distribution of the labor force

	Male			Female		
	Agriculture	Industry	Services	Agriculture	Industry	Services
Czech Rep.	13%	9%	54%	36%	33%	55%
Estonia	18%	11%	48%	34%	34%	55%
Hungary	19%	11%	42%	32%	39%	57%
Poland	27%	28%	45%	25%	28%	48%
Slovenia	5%	6%	52%	39%	43%	54%
Algeria	18%	57%	38%	7%	45%	36%
Egypt	29%	32%	22%	7%	39%	37%
Israel	4%	2%	37%	15%	55%	77%
Jordan	10%	41%	28%	4%	63%	55%
Lebanon	6%	10%	34%	22%	60%	68%
Libya	7%	28%	27%	5%	66%	68%
Morocco	35%	63%	28%	19%	37%	18%
Syria	22%	69%	30%	6%	49%	25%
Tunisia	23%	42%	33%	32%	44%	27%
Turkey	29%	59%	27%	12%	38%	19%

Source: The World Bank, World Development Indicators – 1999.

On the other hand, if one examines the literacy rate among the adult population (over 15 years old), one can see a substantial difference between the two peripheries. Whereas the CEEC's rate is almost 100%, most MNMC's countries do not exceed 87%. Furthermore, the literacy rate in Algeria, Morocco and Egypt, all of them highly populated and who are highly dependent on remittances, does not exceed 62%.

Table 17 :Rate of Literate in Adult Population in MNMCs and CEECs

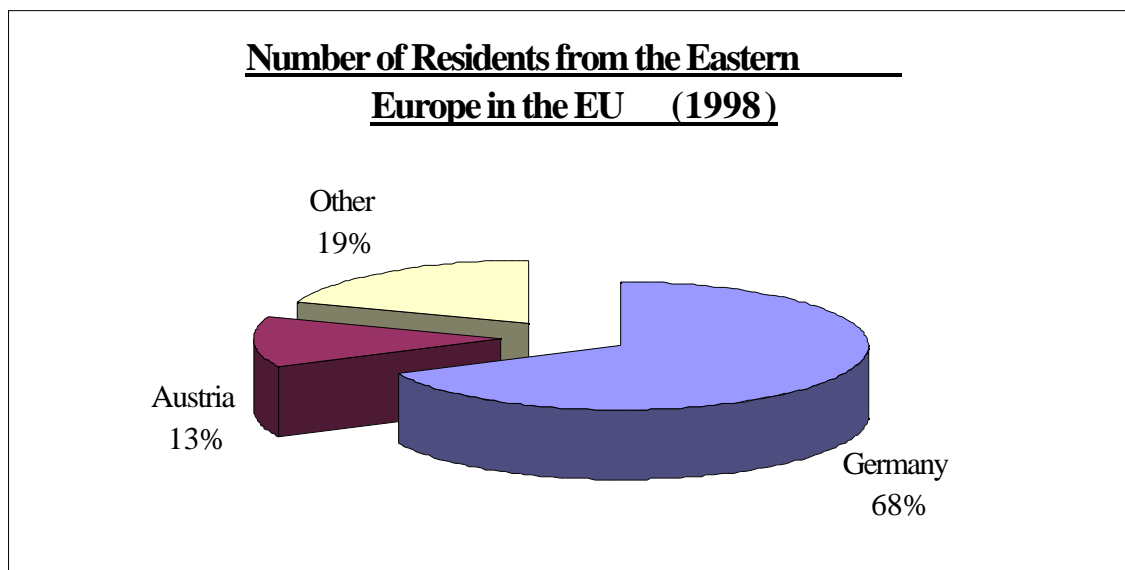
Country	Literate	Country	Literate
Algeria	61.6%	Czech Rep.	99.9%
Egypt	51.4%	Estonia	100.0%
Israel	95%	Hungary	99.0%
Jordan	86.6%	Poland	99.0%
Lebanon	86.4%	Slovenia	99.0%
Libya	76.2%		
Morocco	43.7%		
Syria	70.8%		
Tunisia	66.7%		
Turkey	82.3%		

Source: CIA, Factsbook, 2000

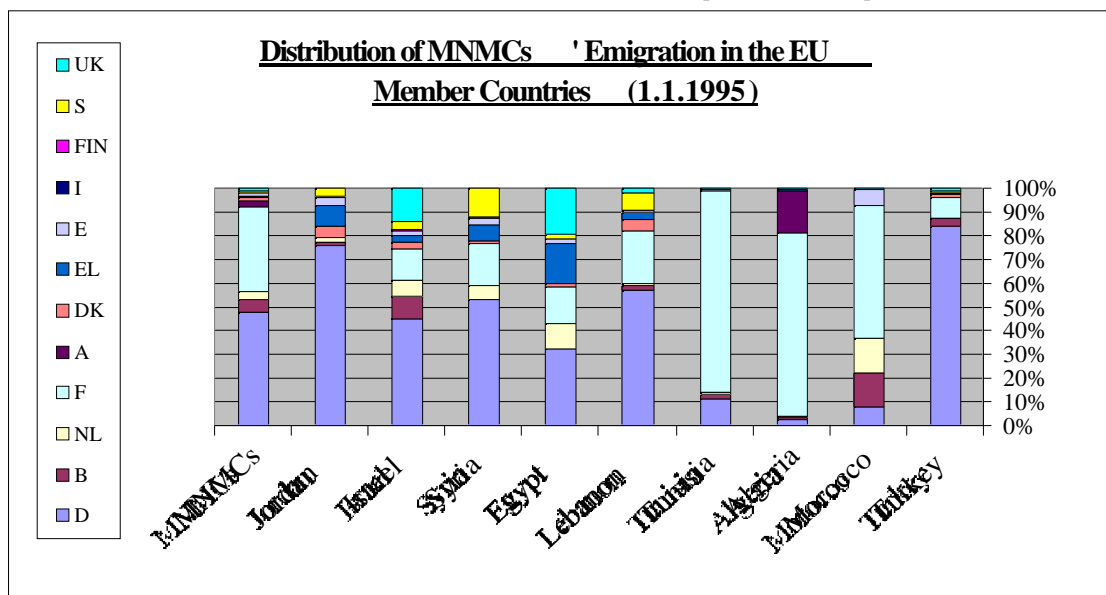
Besides 'objective variables' such as education and professional training, the human resources of the two peripheries differ in terms of their linguistic, geographical and cultural "proximity" to the EU, as well as in terms of the existence of former migrant communities in the various EU member states. As already mentioned, when discussing the Gravity model, those variables determine the cost faced by the potential migrant. Not surprisingly the final destination of migrants of these two peripheries are by

and large different, so that the effect of new flows of CEECs migrants into the EU15 on the MNMCs originating migrants should be quite limited.

Because of geographical, ethnic and linguistic “proximity”, most migrants of CEECs origin are settling in the northern and eastern parts of the EU, especially Germany and Austria. The diagram below shows that in 1998 87% of the Eastern European citizens living in EU countries were based in Austria and Germany. Immigration from the MNMCs is much more dispersed.



Source: Financial Times based on the DIW-Berlin and IGIER-Bocconi report for the European Commission



Source:EUROSTAT.Statistics in Focus-Population and social conditions 1998(3)

From the two diagrams above, one can easily infer that the major destination of migrants from the former French colonies is France itself. Therefore there would not be a substantial geographical overlap of Maghreb-originating migrants and CEEC migrants, even in the event of mass migration to the EU from the CEECs . On the other hand, for all other MNMC migrants, Germany is a major destination. This is especially true for Turkey where 80% of its emigrants settle. When one examines the MNMCs as a whole, Germany ends up as the new home country for 50% of the migrants from MNMCs. Therefore, if patterns of migration stay the same in the future, mass migration from the CEECs might affect the MNMCs in general, and especially the countries of the Eastern Mediterranean and Middle East.

C. Would the EU's migration policy toward MNMC dramatically change as a result of a possible arrival of additional labour supplies from the applicant countries into EU labor markets?

Even if all previous assumptions are held, resulting in EU's members' governments adopting a restrictive policy toward MNMC immigration, remittance flows from the EU to the MNMCs would be reduced only if one assumes that the current policy is somewhat liberal. However, if, on the contrary, it can be proven that in fact the EU members' policy is already restrictive, the number of MNMCs citizens working in EU member countries is already abnormally small and one cannot expect easily a further decrease in the MNMCs migrant residents in the EU.

Under the original EEC Treaty, the Community had no power to prescribe rules for entry of third nationals into the territory of Member States and the migration policy was thought to be an exclusive concern of member states. This view was challenged in the European Court of Justice (Demirel case) and is at odds with the long-term intention to enable third-country nationals to move around freely within the Union (Hailbronner, 1994, p.969). Moreover, the Amsterdam Treaty has integrated the Schengen 'Acquis' into the framework of the European Union. The Schengen 'acquis' consists of rules in various areas from visa policy and travel from third countries to requests for asylum, extradition, and so on, as well as of the Schengen information system.

Up until the 1970s, most European countries pursued a formal liberal policy toward labour migration. The import of cheap labor by the rich European economies was essential to their fast growth over the three decades following the World War II. The economic crisis of 1973 and the outbreak of violence against immigrants has changed this liberal attitude and made migration policy heavily restricted and preferential. The EC member states' policy was not intended to attain zero immigration, but immigration control was and has been directed at countries with a high emigration potential. The main feature of the present EC members immigration policies is that while meeting international obligations with respect to refugee migrations, the general posture of the EU countries towards immigration is a negative one. EU member countries firmly discourage further immigration into Western Europe from the South and the East and prefer to foster economic (mainly trade and investment) relations with their neighboring countries to substitute for migration.

Since "overstaying" is a major source of illegal immigration, entry visa policies are an expression of the overall immigration policy. Entry visa regulations are expected to be highly restrictive in countries which are facing major immigration problems, and especially toward citizens of countries which are a potential source of major immigration. Table 17 shows entry visa requirements of the EU Members toward the MNMCs and toward the first wave applicant countries (including the Republic of Cyprus). As is apparent, none of the MNMCs' citizens, except for Israelis, Maltese and the permanent Turkish residents of a Schengen country, is allowed free access to EU countries without visa. At the same time, the applicant countries' citizens, except for Estonia, are allowed access without entry visas, something quite striking since the incentive for most of them of staying illegally in EU member countries is almost the same, considering the relative income gaps between the two peripheries and the EU15.



**Table 17: Applicant countries and/or MNMCs for which entry visa requirements are waived by individual EU member states**

	Applicant Countries	MNMCs
Austria	All but Estonia*	Israel, Malta
Belgium	All but Estonia	Israel, Malta, Turkey**
Denmark	All	Israel, Malta
Finland	All	Israel, Malta
France	All but Estonia	Israel, Malta
Germany***	All but Estonia	Israel, Malta
Greece	All but Estonia	Israel, Malta
Ireland	All	Israel, Malta
Italy	All but Estonia	Israel, Malta
Luxemburg	All but Estonia	Israel, Malta
Netherlands	All but Estonia	Israel, Malta
Portugal	All but Estonia	Israel, Malta
Spain	All but Estonia	Israel, Malta
Sweden	All	Israel, Malta
United Kingdom	All	Israel, Malta

Source: World Travel Guide, 1999, UK Edition.

\* Nationals of Czech Rep. For Stays up to 30 days.

\*\* Nationals of Turkey provided they reside permanently in a Schengen country.

\*\*\* Germany does not recognize passports issued by Palastinian government.

To sum up, using a Neo Classical partial equilibrium model with (only) one unified labor market leads to dire forecasts of rising unemployment and wage reduction among some European-based economists. That analysis is based mainly on the assumption that the free movement of labor in the enlarged EU will lead to mass migration flows from East to West. Another concern is that immigration of socially weak segments of the population will put a further burden on the generous social security systems and will in all likelihood increase dramatically the Government's budget deficit. From former experience, growing unemployment can be followed by the rise of right wing radical parties, whose electoral platform is based on promoting aliens' hate, or the adoption of a (even) more restrictive policy toward immigration by the center parties that fear losing their political clout. Since a large share of the MNMCs' foreign currency earnings and domestic investments are based on the remittance of income by foreign workers, this might severely harm their economies. In this chapter it was shown that this analysis and its conclusions regarding the MNMCs should not prevail since its assumptions are flawed and do not seem to fit the reality on the field. First, from the experience of previous EU enlargements, it appears that labor movements in Europe are limited mainly by linguistic, cultural and psychological barriers. Second, the type of labor service which will be offered by CEEC potential migrants is not necessarily the same as the type offered by MNMC migrants already in the EU and therefore CEECs' migrants do not necessarily compete with MNMC migrants. As shown, the labor distribution in the CEECs and the MNMCs is not the same although the share of employed in agricultural activities is high in both areas. Moreover, the rate of literacy in the CEECs is substantively higher than in the MNMCs, which might point to different education levels and therefore to totally different job profiles filled by migrants of the two peripheries in EU labour markets. Finally it was shown that the EU countries' official policies toward immigration have been restrictive since the 1970s. Therefore, it is unlikely that it can worsen much further as a result of economic conditions on the ground.

## CHAPTER V: MAIN CONCLUSIONS

In this short chapter, a summing up of the main conclusions of this report follows.

The basic assumption is that the six applicants belonging to the first wave (namely Poland, Hungary, the Czech Republic, Slovenia, Estonia and the Republic of Cyprus) will enter the EU by 2005. This will happen probably only after a political arrangement of some sort between the two parts of the island of Cyprus is reached.

But in the area of trade in goods, trade diversion against MNMCs has already taken place since the mid-1990s as a result of the progressive trade integration of the six applicants into the EU's Single Market. As an illustration of what was found, the demise of the Israeli textile and clothing industry since a number of years is due partly to this phenomena. The research shows that the coming Enlargement is of particular relevance for industries in Israel, Turkey and Tunisia. Egypt and Morocco will be more affected by the inclusion in the EU of the "second wave" of applicants. Taken as a group, for MNMC the accession of these "second wave" countries (which would include countries such as Romania and Bulgaria) will be more problematic than the first. Regarding this coming Enlargement, first, the levels attained of intra-industry trade between Tunisia and the EU do not seem to be affected until now. Second, on the basis of overlap in RCA indexes, it appears that only a small amount of inter-industry trade between the MNMCs and the EU will be vulnerable (about 2 percent of the MNMCs exports to the EU), although reaching between 3 to 4 percent in the cases of Turkey and Morocco (while at the other extreme Algeria, Jordan, Syria and Lybia will be not at all affected by trade diversion). The principal countries in terms of competition are Poland and Hungary, followed by Cyprus and the Czech Republic. For Eastern Mediterranean countries the entry of Cyprus is the most relevant in terms of potential trade diversion. Not surprisingly the report shows that competition is important for processed fruit and nuts, some types of clothing, sacks and bags, pig iron and some articles of natural stone.

In financial services, some off-shore type of activities operated by Lebanon and Israel could gain from the obligatory withdrawal imposed by the EU on Cyprus (as a condition for EU entry) in off-shore financial operations considered harmful by the EU (and other OECD countries). The MNMCs tourism sector could also gain from the fact that competing countries among the applicants will see their food and land prices, as well as wages rise, something which will not be compensated by the cheapening of intra-EU air transport.

The trade potential between the MNMCs and the six applicants after the Enlargement is not large in absolute numbers, but MNMCs exports to the six will increase by more than the imports of the former from the latter. Morocco and Tunisia are likely to find that Poland will become one important export destination for them. There is one important exception to what is said here. Turkish exports to the Republic of Cyprus should expand from essentially zero nowadays to about 500 Mo. \$ per year, a non negligible sum. In turn the Republic of Cyprus' exports to Turkey could reach about 80 Mo.\$ per year.

Turning now to investments, the report concludes that, while there has been a significant expansion of FDI flowing into Central Europe since a decade, until now the feared diversion of FDI from MNMCs to the six applicants has not taken place. This is proved by using a Gravity model and also comparing statistics.

In the domain of migration, MNMCs should be concerned by the reinforcement of the EU's external border, embracing in the future 21 European countries, not 15 as in the past and also by the extension of the EU member countries restrictive migration policies to the new applicants. On the other hand, for established MNMCs migrants in Germany and the Benelux, new competition by Eastern European workers emigrating freely to those countries after the Enlargement is a daunting perspective. There is less of a potential problem for Maghrebian workers established mainly in Southern Europe (including France). More generally, the impact will be limited by the fact that many of the potential Eastern European migrants carry with them skills which are different than the ones held by MNMCs migrants. In other words MNMCs migrant remittances do not seem to be at risk.

Among other effects of the Enlargement relevant to MNMCs are that:

- 1) Negotiations for the right to fish in Cyprus exclusive economic zone will have to be conducted by MNMCs with Brussels, not with Nicosia anymore.
- 2) On balance, Turkey's prospective entry into the EU could be impaired, since some of the applicants are wary to it for different reasons.
- 3) Although in terms of population and geographical area, the enlarged EU will expand by almost a fifth, MNMCs trade dependence on the enlarged trade block will only rise by 1 percentage point.
- 4) The EU 21 will be more energy-dependent on the ex-CIS and logically will try to diversify this geographic dependence, something which may favour some energy-rich MNMCs (e.g. Algeria, Egypt).
- 5) The Barcelona Process will lose steam, all other things being equal. This is for different reasons. The institutional reform to be approved at the end of 2000 is likely to be slightly detrimental to future EU policies regarding the MNMCs. Apart from Cyprus, the new members will be more interested in developing the EU relations with their own neighbours in Northern, Eastern (including Russia and the Ukraine) and South-Eastern Europe. Bilateral relations between the EU21 and individual MNMCs will not be under the focus of the EU as now but for the exception of relations with Israel and Turkey.
- 6) On balance the Enlargement is likely to result in a further liberalisation of the CAP for the kind of goods for which MNMCs have a comparative advantage.

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