Economies in transition

Eastern Europe and the former Soviet Union

Regional overview

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The Economist Intelligence Unit

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Symbols for tables

"n/a" means not available; "–" means not applicable

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Contents

Fact sheet[a]

Population
408.2m (2001)

Population growth
-0.2% (average, 1997-2001)

GDP
US$867.0bn (2001, at market exchange rates)
US$2.04trn (2001, at PPP)

GDP growth
3.1% (average, 1997-2001)
4.7% (2001)

GDP per head
US$2,125 (2001, at market exchange rates)
US$5,108 (2001, at PPP)

Inflation
27.3%[b] (average, 1997-2001)
14.6%[b] (average, 2001)

Background
Political developments since 1989 have been dominated by the break-up of the former communist federations and the move to multiparty parliamentary democracy. The economic transition of the east-central European countries (Poland, Hungary, Slovenia, the Czech Republic and Slovakia) has generally proceeded more smoothly than elsewhere in the region. The effects of war in former Yugoslavia and a slower pace of reform have determined developments in south-eastern Europe. Lasting political stabilisation in Russia holds the key to developments in other former Soviet republics.

Political structure
Democratic traditions are weak in most countries in the region. The exceptions, nearly all of them in central Europe, now have systems that approach west European practice. The communist period lasted much longer in the former Soviet Union, and political developments in some parts of the region have been characterised by a drift towards authoritarianism. The end of the cold war has led to open or latent disputes over boundaries and the position of ethnic minorities.

Policy issues
The speed and extent of reform and of institutional change varies widely across the region. Countries with proximity to Western markets and stable political outlooks have proceeded faster and more successfully with stabilisation, liberalisation and privatisation. In the Commonwealth of Independent States (CIS), the number of reform reversals has increased since 1996. Although the post-1989 collapse in output has been halted, the average level of real GDP in the region is still only two-thirds of the 1989 level. The difficult tasks of financial sector reform and institution building represent the second stage of reforms. Institutional weakness, such as the weak rule of law and widespread corruption, continue to plague much of the region.

Foreign trade
The collapse of the Council for Mutual Economic Assistance (CMEA, or Comecon) and the break-up of the Soviet Union disrupted trade and output patterns. Some countries have been successful in reorienting their trade to the West. Attempts to promote trade and integration within the CIS have so far been largely unsuccessful. Total merchandise trade in the region in 2001 amounted to an estimated US$580bn. Because of the continuing large surplus in Russia, the region's total current-account surplus in 2001 was an estimated US$13.6bn.

Exports (2001)	US$ bn	Imports (2001)	US$ bn
East-central Europe	113.7	East-central Europe	133.2
Balkans	25.7	Balkans	40.3
Baltics	10.4	Baltics	13.7
CIS	145.0	CIS	96.8
Eastern Europe excl former Soviet Union	139.4	Eastern Europe excl former Soviet Union	173.5
Eastern Europe incl former Soviet Union	294.8	Eastern Europe incl former Soviet Union	284.0

Taxation
Most countries have carried out sweeping fiscal reforms, including the introduction of value-added tax (VAT) and the overhaul of corporate and personal income-tax systems. Inadequate tax collection by central governments remains a problem in many CIS and Balkan states.

[a] Refers to all 27 economies in transition in eastern Europe, including the former Soviet Union; see page 4 for details. [b] Unweighted average.

Summary

EU funding and east European catch-up growth

Considerable sums will be made available for regional development in the new east European EU members. It is less clear whether this funding will push up growth rates in eastern Europe. The most important ingredients of catch-up growth are a stable macroeconomic framework, supply-side policies that help markets to adjust quickly, and a well-trained, flexible workforce. Only if EU aid is firmly integrated into such a policy framework will it make a positive contribution to growth in the region.

New crises in the Western Balkans?

Recent developments and several new international reports warn of a looming regional crisis in the so-called Western Balkans (Albania, Bosnia and Hercegovina, Croatia, Macedonia, and Serbia and Montenegro). Although the risk of a relapse into large-scale conflict is remote, performance in the region has been disappointing. The recent record of external involvement in the region has been mixed. In any case, the outlook for continued heavy international engagement in the region is highly uncertain as a result of the global economic downturn and competing international concerns. The responsibility for averting crises will thus increasingly fall to local actors.

Political outlook

The crisis over Iraq has caused deep rifts in Europe, both east and west. Despite threats by the French president, Jacques Chirac, the Economist Intelligence Unit does not expect the fall-out from the crisis to derail the timetable for the EU's eastward enlargement. The overall outlook is likely, however, to be characterised by ongoing tensions, rather than reconciliation among the main parties to the present disputes.

Economic forecast

The weak global recovery has had an impact on the transition region. Although real GDP growth in the region has slowed, this has been by less than might have been expected, given most of these countries' high dependence on trade with a weakly performing EU. Domestic demand has been the main driver of growth. Foreign direct investment (FDI) into the region reached a record total, estimated at more than US$34bn in 2002, and is set to climb to US$40bn in 2004.

Business environment rankings

Across the region, most aspects of the business environment are expected to record improvement over the medium term, although at unequal rates. Greater economic stability, more liberal policies towards the private sector, changes in the tax regime and upgrading of infrastructure are expected.

Key indicators

Eastern Europe[a] and CIS[b]	2002	2003	2004	2005	2006	2007
Real GDP growth[c] (%)	3.8	4.0	4.3	4.6	4.4	4.3
Consumer price inflation (av; %)	10.2	10.2	9.0	8.1	6.8	6.1
Current-account balance (% of GDP)	2.0	1.1	-0.3	-1.1	-1.4	-1.8

[a] The Balkan states of Bulgaria and Romania, and the Visegrad countries of Poland, Hungary, the Czech Republic and Slovakia. [b] Russia, Kazakhstan and Ukraine. [c] Weighted averages.

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The subregions

The region comprises 27 countries, following the break-up of the Soviet, Yugoslav and Czechoslovak federations. Based on geographical and associated political criteria, four main subregions can be identified.

East-central Europe: Czech Republic[a], Hungary[a], Poland[a], Slovakia[a], Slovenia

Balkans: Albania, Bosnia and Hercegovina, Bulgaria[a], Croatia, Macedonia, Romania[a], Serbia and Montenegro

Baltics: Estonia, Latvia, Lithuania

Commonwealth of Independent States (CIS): Russia[a], Ukraine[a], Belarus, Moldova, Armenia, Azerbaijan[a], Georgia, Kazakhstan[a], Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan

The articles and the Fact sheet refer to trends throughout the region. The medium-term economic forecast summary relates only to two **Balkan**[a] countries (Bulgaria and Romania), the **Visegrad**[a] group (Poland, Hungary, Czech Republic and Slovakia) and the **CIS**[a] (Russia, Kazakhstan, Ukraine and Azerbaijan)

[a] Covered by individual *Country Forecasts*.

Basic data, 2001

	Population (m)	GDP per head[a]	GDP per head[b]	Real GDP[c]	Growth (av; %)[d]	Inflation (av; %)[d]	Exports[e]	Imports[e]	Current account[e]
East-central Europe	**66.0**	**9,111**	**5,017**	**118.8**	**3.4**	**8.9**	**113.7**	**133.2**	**-12.6**
Czech Republic	10.2	11,712	5,594	105.1	1.0	5.9	33.4	36.5	-2.6
Hungary	10.1	9,460	5,138	111.7	4.5	12.2	28.1	30.1	-1.1
Poland	38.3	8,044	4,779	129.6	4.1	9.9	30.3	42.0	-7.2
Slovakia	5.4	8,934	3,778	109.0	3.3	8.5	12.6	14.8	-1.8
Slovenia	2.0	14,990	9,390	121.5	4.2	7.9	9.3	10.0	0.0
Balkans	**53.9**	**5,021**	**1,790**	**78.4**	**1.0**	**41.2**	**25.7**	**40.3**	**-6.1**
Albania	3.1	3,162	1,420	111.6	4.3	10.7	0.3	1.3	-0.2
Bosnia & Hercegovina	4.1	3,405	1,247	70.6	12.2	4.9	1.0	2.8	-1.1
Bulgaria	7.9	5,621	2,035	83.1	1.9	75.6	5.1	6.7	-0.8
Croatia	4.4	7,397	5,167	86.3	3.0	5.0	4.8	8.7	-0.6
Macedonia	2.0	4,110	1,827	78.5	1.8	0.1	1.2	14.4	-0.3
Romania	21.7	4,958	2,069	87.5	-1.1	63.2	11.4	4.8	-2.3
Serbia and Montenegro	10.7	3,634[f]	1,544[f]	50.0[f]	0.4[f]	48.7[f]	2.0[f]	1.6[f]	-0.6[f]
Baltics	**7.2**	**5,528**	**3,479**	**73.1**	**4.7**	**4.6**	**10.4**	**13.7**	**-1.6**
Estonia	1.4	6,610	4,056	88.6	5.1	6.4	3.3	4.1	-0.3
Latvia	2.4	5,284	3,205	69.2	6.1	4.1	2.2	3.6	-0.7
Lithuania	3.5	5,270	3,439	69.9	3.6	3.3	4.9	6.0	-0.6
CIS	**281.0**	**4,134**	**1,475**	**65.2**	**3.3**	**28.9**	**145.0**	**96.8**	**33.9**
Russia	144.4	5,369	2,146	67.3	3.0	31.9	101.6	53.8	34.9
Ukraine	48.7	2,692	781	45.5	1.9	17.7	17.1	16.9	1.4
Belarus	10.0	5,663	1,222	89.4	6.6	117.1	7.3	8.1	-0.3
Moldova	4.3	1,784	345	36.0	-0.1	19.3	0.6	0.9	-0.1
Armenia	3.5	3,650	613	68.7	5.8	5.0	0.4	0.8	-0.2
Azerbaijan	8.1	1,704	707	57.1	8.8	-0.6	2.1	1.5	-0.1
Georgia	5.4	2,058	577	33.6	4.5	7.6	0.5	1.0	-0.2
Kazakhstan	14.8	4,507	1,511	77.8	5.0	10.9	9.0	7.8	-1.2
Kyrgyz Republic	4.9	2,055	313	71.9	5.2	18.6	0.5	0.4	0.0
Tajikistan	6.5	825	161	51.6	5.8	44.3	0.7	0.8	-0.1
Turkmenistan	5.3	2,252	1,115	91.3	9.1	26.4	2.6	2.3	-0.1
Uzbekistan	25.1	2,359	438	101.5	3.9	30.8	2.8	2.5	0.0
Eastern Europe	**120.0**	**7,102**	**3,566**	**100.2**	**2.7**	**29.3**	**139.4**	**173.5**	**-18.7**
Eastern Europe & the former Soviet Union	**408.2**	**5,105**	**2,125**	**76.5**	**3.1**	**27.3**	**294.8**	**284.0**	**13.6**

[a] US$ at purchasing power parity. [b] US$ at market exchange rates. [c] 1989=100. [d] 1997-2001. [e] US$ bn. [f] Data exclude Kosovo.

Will EU money help eastern Europe to catch up?

By Katinka Barysch, Chief Economist, Centre for European Reform, London

Introduction

On May 1st 2004 ten new members will join the EU, eight of them relatively poor countries from central and eastern Europe. Bulgaria and Romania may join in 2007. Although eastward enlargement will increase the number of people in the EU by one-quarter, the new members together will add no more than 5% to the EU's GDP (perhaps twice that if GDP is measured on the basis of purchasing power parity—PPP—exchange rates). On average, GDP per head at PPP in the new members from eastern Europe will be around 40% of the current EU average according to Eurostat statistics (and only about one-third at alternative PPP estimates, and 20% if GDP is measured at market exchange rates). In short, the new members are generally much poorer than the present members of the EU.

Income gap fuels concerns

The income gap has fuelled concerns in both the existing member states and the accession countries. The existing EU member states fear that they could be swamped by imports from the low-cost accession countries and that firms will relocate to the new member states, where labour is much cheaper and social and environmental standards less demanding. Countries such as Germany and Austria are also concerned that an influx of low-cost workers from the east could increase unemployment and social tensions. For their part, the east Europeans do not want their expensively educated graduates and skilled workers to emigrate in search of better-paid jobs, leaving a pool of unskilled, low-paid workers back home. They also fear that—now that trade barriers between east and west have been removed and transport costs are falling—the west's highly productive industries could simply supply the smaller eastern markets through imports, at the cost of local production. Even if foreign direct investment (FDI) keeps flowing in, they fear that it will finance only low-wage, low value-added industries, with high-technology manufacturing and research and development (R&D) will remain in the west.

Narrowing income gap would smooth integration

Both sides seem to agree that a rapid narrowing in the gap between incomes in east and west could do much to smooth the path of integration. Since it was set up in 1957, the EU has declared that reducing regional differences and, in particular, the backwardness of less developed regions—referred to as cohesion and convergence in Brussels—is one of its main objectives. In 1975, the EU (or European Community, as it was then called) set up its first regional support fund. Since then it has made ever increasing sums available through a growing variety of programmes generally referred to as "structural funds". Once the east European countries join, they too will be eligible for EU regional aid.

This article examines whether there is a case for governments or the EU to become involved in smoothing out regional income differentials. It then looks for evidence of income convergence in the EU and in the accession countries. It details the sums that will be available for regional policies in the new member states and asks how these should best be spent to push up growth rates in eastern Europe. The main conclusion is that the new member states should not

expect EU money to lead to miracles. The most important ingredients of catch-up growth are a stable macroeconomic framework, supply-side policies that help markets to adjust quickly, and a well-trained, flexible workforce. Only if EU aid is firmly integrated into such a policy framework will it make a positive contribution to growth in the region.

The effects of economic integration

Traditional (or "neo-classical") economic theories predict that economic integration between two areas will be unequivocally positive for both sides. It will be especially beneficial if the two regions have large gaps in wealth, or great differences in the supply of capital and labour. Each area will then start to specialise in producing those goods for which it has a comparative advantage. Companies from the richer region will start investing in the poorer one, where returns are higher. Workers in the poorer regions will see their wages rise as productivity grows. The expected result: is that income levels will rise in both regions and the poorer area will start to catch up with the richer region.

Empirical studies yield mixed results

However, empirical studies of the record on global catch-up in income levels yield decidedly mixed results. In some world regions, such as Asia, there is clear evidence of convergence; in others, such as Africa, the gap with the developed world is widening. In addition to the unclear empirical evidence, the so-called new theories of growth have also cast doubt on the predictions of the classical model. According to these, divergence in incomes is in some circumstances just as likely as convergence—if not more likely. Investment can remain concentrated in the richer core regions, with poor regions remaining specialised in low-productivity activities.

This means that neither economic theory nor the global experience give clear guidance for predicting whether and how fast eastern Europe will catch up with EU income levels. Instead, historical evidence from previous episodes of EU integration may give more insight into whether economic integration has benefited poorer countries and the extent to which EU money helped.

The EU's poorer member states

The experience with income convergence in the existing EU is, however, also mixed. There is evidence that the EU's poorer members have grown, on average, faster than the richer countries. But this does not necessarily hold true for individual regions within countries. The following stylised facts seem to hold (Boeri *et al*; Hallet;).

- Income levels in west European countries have been more or less converging since the 1870s. Convergence was particularly strong in the 1960s, when trade barriers came down and trade between European countries increased rapidly. However, convergence ground to a halt during the 1970s and even went into reverse in the early 1980s. The trend towards converging incomes resumed in the 1990s.

- On the whole, the rate of catch-up has been slow, at an annual average of 2% in 1950-90. At this rate, it would take the east European countries around 30 years to halve the present income gap with the existing EU member states.

- Looking at regions in Europe, rather than countries, gives a similar picture. However, the trend towards convergence has been much less pronounced. In

many countries, particularly the poorer peripheral countries, the gap between rich and poor regions has actually widened significantly since the 1980s.

Convergence in the EU15
(GDP per head; EU15=100)

	1975	1985	1995	2001
Greece	62	64	66	65
Spain	82	74	78	84
Ireland	66	69	93	118
Portugal	56	57	70	69

Source: OECD (for 1975 and 1985), Eurostat (for 1995 and 2001)

Looking beyond the aggregates, one finds that individual EU members have gone through very different growth trajectories (Boldrin and Canova, 2001, 2002). Spain and Portugal have narrowed the distance to EU average income levels, and Ireland has overtaken the average in the past decade. Greece, however, has only recently begun to make significant progress in narrowing the gap.

- Spain's GDP per head was around 60% of the EU average in the 1960s. Catch-up growth rates followed trade liberalisation and market-friendly reforms in the 1970s but progress came to a halt in the early 1980s. Since the mid-1980s, Spanish GDP per capita has gradually risen to just under 85% of the EU average. Spain joined the EU in 1986 and subsequently became the largest recipient of structural fund money.

- Ireland started from a similar level in the 1960s. However, unlike Spain, it stagnated for the next two decades, with neither EU accession in 1973 nor the receipt of EU regional aid making much of a difference. By the mid-1980s its per-capita GDP had crept up to around 70% of the EU average. However, after the Irish government fully embraced policies based on free trade, low taxes, low public deficits and stronger competition, growth took off strongly. Now Ireland has a GDP per head that is nearly 20% higher than the EU average—although Irish gross national product (GNP) and living standards are lower than this figure suggests, as foreign firms repatriate much of the profit earned from their Irish operations.

- Like that of Ireland, Greece's economy stagnated for almost 20 years. Its GDP per capita was around two-thirds of the EU average when it joined the union in 1981, and the ratio did not change for a long time. Signs of catch-up growth have appeared only recently, when the government started to consolidate public finances ahead of its entry to the euro zone.

- Portugal has a chequered history of economic reform. It liberalised trade in the 1960s but returned to heavy state intervention after the revolution in 1974. It returned to more market-oriented policies in the 1980s. Economic growth followed a similar pattern: Portuguese GDP per head rose from 45% of the EU average in the 1960s to around 60% in the mid-1970s. It then remained around this level until the late 1980s, but since then has risen to around 70% of the EU average.

Economic policy has played a key role

What explains this mixed picture? Changes in economic policy seem to play an important role. This has certainly been the case in Ireland, where success also

seems, at least to some extent, to have been associated with the EU factor. However, EU accession *per se* may not be the main ingredient, or even have much of an impact on growth. Spain and Greece did most of their catching up before they actually joined the EU. Trade integration and openness to foreign investment often precede EU accession, since countries tend to open up their economies gradually over many years before joining the EU. It also appears that trade integration pushes up GDP growth rates for a while, but that the effect then weakens, leaving the level of GDP permanently higher without providing impetus for further catch-up growth. On the other hand, there are indications that efforts to complete the single market (the liberalisation and deregulation of the markets for goods, services, capital and labour) have had a positive growth effect in most countries of the EU. It is still too early to evaluate whether the most recent milestone for integration—the advent of the single European currency—will have a similar effect.

International and inter-regional income differences

Problems of measurement

Measuring income differentials between countries is not straightforward and it is still more difficult at the regional level. Figures for GDP are often not comparable over time, as classification systems change. The EU itself switched to a new system for presenting key economic data—from European System of Accounts (ESA) 79 to ESA 95—not too long ago. This problem is particularly severe in the central and east European countries, as the official GDP figures for the first years of the transition to a market economy are likely to have been particularly unreliable. In addition, most of these countries have large semi-legal sectors whose activity is not recorded in the official GDP figures. Some observers estimate that official GDP figures undervalue output by as much as one-fifth.

Expressing national product figures in a common currency also poses problems. Market exchange rates are volatile and for many of the east European countries were extremely undervalued at the start of the transition to a market economy. Using purchasing power parity (PPP) exchange rates, which attempt to allow for differences in the overall price level between countries, is theoretically more appealing, but constructing PPP exchange rates in practice is difficult, and results are often very sensitive to the assumptions that have to be made about quality differences.

There are additional problems at a regional level. Price levels may vary between regions of the same country, but such differences are not usually covered by official statistics. In regions where there is a large amount of commuting to work in a different region, the level of production in the "home" region may be very different from the level of income available to its residents. This effect tends to artificially boost the measured of GDP of regions which are dominated by, or even identical with large cities. Redistribution between regions by the central government may also lead to a large gap between a region's income and its domestic product. Finally, at a practical level the regional classification used by the EU—called NUTS II—is based on administrative boundaries but makes little economic sense. NUTS II regions differ greatly in terms of size and population, which means that regional data are not really comparable. The population in the EU's current NUTS II regions ranges from 190,000 in Italy's Aosta valley to 18m in Germany's Nordrhein Westfalen. The discrepancies in the new member states are slightly less pronounced: population ranges from 370,000 in Malta to two 5m regions in Poland, with most regions having one or two million inhabitants. However, this size of region is, arguably, too small to function as a measure of income convergence (Boldrin and Canova, 2001).

In addition to trade, FDI has undoubtedly had a strong influence on growth rates, especially in the 1980 and 1990s. Ireland, where FDI inflows amounted to 20% of GDP in the late 1990s, is the best example. In Greece, on the other hand, FDI hardly exceeded 1% of GDP. FDI into Portugal and Spain grew strongly around the time of their EU accession but fell back to lower levels afterwards,

before again picking up in the second half of the 1990s, contributing to an acceleration of growth. However, there is statistical evidence to suggest that—other things being equal—distance from the EU core areas has been a significant barrier to FDI flows for the EU periphery (for example in *World Investment Prospects*, 2003, Economist Intelligence Unit).

FDI has been concentrated in labour-intensive activities

Interestingly, most of the FDI in these countries has gone into labour-intensive manufacturing. This has led to a change in the pattern of regional industrial specialisation in Europe. In the initial trade liberalisation of the 1960s, industrial structures in the countries of western Europe initially became more uniform (Lamers, 2002). Since then, slow-growing, labour-intensive industries have become more heavily concentrated in Europe's low-wage peripheral countries. This does not mean that Portugal, Spain and so on will be stuck with low-value added industries. Some fast-growing, high-tech industries have also spread to the more remote regions. However, for both these types of industry it is the availability of regional resources (low-cost or high-skilled workers, respectively) that is the key factor when searching for the best location. Whether that location happens to be in the middle of the continent or in a more remote location is less important. The same does not hold true for more traditional industries, such as engineering or car manufacture, where a variety of different inputs are needed. Such industries tend to "cluster" in particular locations close to their suppliers and customers.

The experience of the east European accession countries

As with the Mediterranean countries, the central and east European candidates started to open their economies to trade and investment from the EU well before joining the union. In the early to mid-1990s, all central and east European countries signed Association Agreements (the so-called Europe Agreements) with the EU, which foresaw gradual dismantling of trade barriers. By 2002 trade between the EU and the candidates was almost completely liberalised. In proportionate terms (or as a share of total trade), many of the candidate countries now trade with the EU as much as (or more than) the EU members with each other. FDI flows from the EU into eastern Europe have been strong for years, amounting to 5% of GDP or more in the case of the best performing countries. In theory, therefore, the candidate countries should be well advanced in the process of catching up with the richer EU states.

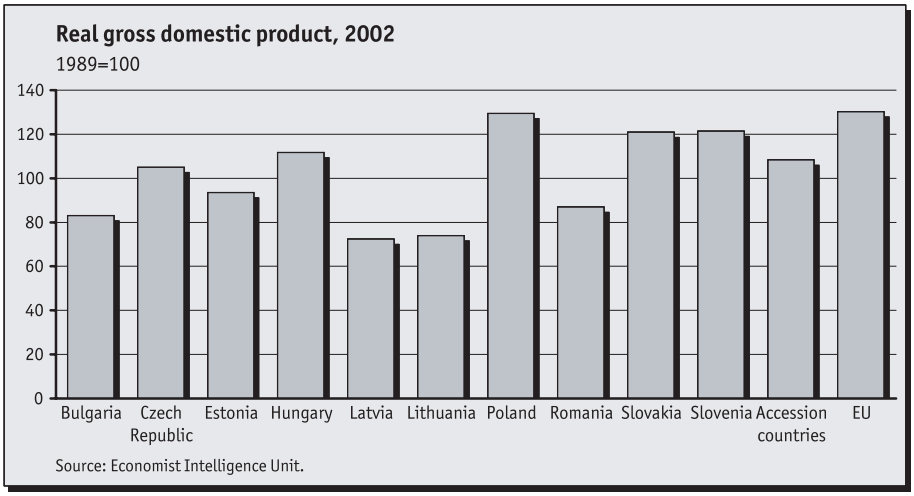
The income gap between the EU and the candidate countries is not closing

In practice, the evidence is not so clear, even for the more recent years, after the end of the transition recession of the early 1990s. According to Eurostat figures, average per-capita GDP in the ten east European candidate countries now stands at around 40% of the EU average (see table below, column 3, which is compatible with Eurostat estimates). Indeed, the gap between average EU income level and that of the candidate countries has widened considerably since 1989. The EU's real GDP grew by 30% between 1989 and 2002, whereas for the ten east European EU accession countries the increase amounted to only 8% over the same period. The widening of the gap is mainly attributable to the sharp fall in GDP in most of the region immediately after the shift from central planning. However, the gap has not diminished appreciably even after the beginning of growth, generally in the mid-1990s—in part because of macroeconomic mismanagement in some countries, slowing structural change in others, and the impact of external shocks, such as the 1998 Russian financial crisis.

GDP per head, 2001
(EU average=100)

	At market exchange rates	At PPP[a]	At PPP[b]
Bulgaria	8.2	22.7	24.3
Czech Republic	26.2	47.5	58.7
Estonia	18.0	26.3	36.2
Hungary	24.5	38.3	50.3
Latvia	15.2	21.6	28.5
Lithuania	15.5	20.4	27.8
Poland	21.7	32.4	39.0
Romania	8.5	19.5	27.7
Slovakia	17.6	36.8	47.3
Slovenia	44.8	60.7	70.4
Accession countries average	**18.4**	**30.9**	**38.9**

[a] Based on 1993 vintage GDP comparisons. [b] Based on post-1996 vintage GDP comparisons.



Regional inequality within the candidate countries is widening

Information about regional inequalities in the candidate countries is even less reliable than in the EU. Four of the ten prospective east European members are so small that they are not divided into regions for administrative and statistical purposes. However, the available evidence suggests quite strongly that the accession countries have followed the pattern of the Mediterranean countries in that recent economic growth has gone hand in hand with a marked widening of regional income differentials. The fastest growth has occurred in the regions centred on capital cities and in those geographically close to the EU. Smaller towns, rural areas and the eastern parts of these countries have generally lagged behind, with poverty, high unemployment and a lack of competitive industries characterising the regions along the EU's future eastern border with Russia, Ukraine and Belarus.

Regional disparities within the candidate countries, 2000
(GDP per head)

Country	EU15=100	Richest region	Own country=100	EU15=100	Poorest region	Own country=100	EU15=100
Bulgaria	26	Yugozapaden (SW)	131	34	Yuzhen Tsentralen (SC)	83	21
Czech Republic	56	Prague	215	121	Stredni Morava	80	45
Estonia	40	-	-	-	-	-	-
Hungary	50	Kozep-Magyarorszag	152	76	Eszak-Alfold	63	32
Latvia	31	-	-	-	-	-	-
Lithuania	36	-	-	-	-	-	-
Poland	39	Mazowieckie	152	59	Podkarpackie	71	28
Romania	23	Bucharest	207	48	Nord-est	70	16
Slovakia	46	Bratislava	213	98	Vychodne Slovensko	77	35
Slovenia	67	-	-	-	-	-	-
For comparison:							
Germany	106	Hamburg	171	182	Dessau	60	64
France[a]	101	Ile de France	157	158	Corsica	75	76
Italy	102	Trentino-Alto Adige	134	136	Calabria	61	62
United Kingdom	100	Inner London	241	241	Cornwall & Isles of Scilly	65	65

[a] France's overseas departments and territories have a lower GDP per head than Corsica.

Source: Eurostat.

Having said this, regional disparities in the east European countries are not that much greater than those prevailing within many existing EU countries. Even though differences in regional unemployment rates can be 10 percentage points or more in Bulgaria, Poland and Slovakia, this is still far below the disparities seen, for example in Italy. Thus unemployment rates are only just over 3% in some northern Italian regions but are as high as 27% in the southern region of Calabria. East European countries are, however, characterised by a striking concentration of economic activity in and around their capital cities, although problems in the treatment of commuting and, perhaps, also in measurement of the cities' populations mean that published statistics may overestimate the capitals' levels of GDP per head.

In the Czech capital, Prague, GDP per capita is twice the national average and wages are one-third higher. In Budapest (Hungary), GDP per capita is three times higher than in the country's most backward region. The city accounts for 40% of the country's total urban population and 35% of service sector employment. Bratislava, the Slovak capital, is the target of around two-thirds of all foreign direct investment (FDI) flowing into the country and is also home to more than 90% of the country's banking and insurance sector employees, and more than 40% of employees in research and development (R&D) and business services. The area around Estonia's capital, Tallinn, has been the target of over 80% of the FDI going into the country and is home to 40% of all registered enterprises. Riga, in Latvia, has 30% of the national population and almost half of the FDI stock.

If current trends continue, regional differences in the east European countries will continue to widen. This divergence in regional economic fortunes fits in well with the industrial specialisation pattern described in the previous section. A reasonably well-developed infrastructure and a better educated workforce has given east European capitals a head start compared with the more remote

regions. FDI has done the rest, crowding into urban areas and western regions while tending to avoid the more remote eastern regions. As a result, the region's capitals have experienced a veritable boom. Prague and Bratislava, for example, now have per-capita income levels that are above the EU average (according to official EU figures), whereas unemployment in eastern regions is still rising, further eroding local income levels. There is therefore a *prima facie* case for the EU to concentrate its regional development efforts on the poorer, eastern regions of the new member states.

Structural funds for the new member states

Under current EU rules, regions with a per-capita GDP of less than 75% of the EU average automatically qualify for EU regional aid under the so-called Objective 1 facility. This means that almost the entire area of all the east European countries will be eligible for EU aid. Boeri *et al* (2002) calculate that if the EU maintained the current degree of redistribution (net payments or receipts as a share of per-capita income differentials) after enlargement, the new members would be due to receive enormous sums. Latvia, for example, would receive transfers amounting to more than 13% of its GDP per year and Poland 8%. However, flows of this magnitude will clearly not be forthcoming, nor would they be easily absorbed. First, the total EU budget is capped at just under 1.3% of total EU GDP (0.46% for the structural funds). Second, the EU has capped structural fund spending in the new member states at 4% of the recipient country's GDP, arguing that the newcomers would simply not be able to deal with any larger inflows (often described as a lack of "absorption capacity").

EU structural funds

Objectives

Ever since its inception, the EU (or EC as it was previously called) has been concerned with uneven economic development among its member states. This concern has grown as the union has enlarged, taking in less well developed countries and regions. However, the objectives of EU regional policy are not clearly defined and its instruments have proliferated to an extent that now only Brussels insiders fully understand how the system works.

Allocation of funds

In the 2000-06 budget, the EU budget allocates some €195bn (US$210bn) for regional aid. Two-thirds of the funds go to the so-called Objective 1 regions, defined as those with a per-capita GDP at purchasing power parity (PPP) exchange rates of less than 75% of the EU average. Another 10-13% each goes to regions that are not necessary poor but suffer from the results of structural change (Objective 2) or regional labour market problems (Objective 3). In addition, the EU funds four so-called community initiatives, such as inter-regional co-operation, urban development and rural development.

Another €18bn is spent through the cohesion funds on transport and environmental projects in countries whose per-capita GDP is less than 90% of the EU average. The cohesion funds are different from other regional support in that they are given to countries rather than regions, and they do not require co-financing out of national budgets.

Procedure

Each EU government draws up a multi-annual development programme as a framework for regional aid. Once this has been accepted by the European Commission, the central government, together with regional and local authorities, identifies projects that they want (co-)financed by the EU in the following areas: (a) infrastructure (transport, energy, telecommunications, environment); (b) support for local companies; (c) training for workers; and (d) research and development (R&D).

Usually, regional governments are responsible for implementing the projects, but the Commission tries to monitor that the money is spent sensibly and efficiently. The EU pays some of the cash "up front", but, once the project has got under way, the local authorities need to present bills to Brussels for reimbursement.

EU regional aid comes in the form of grants, not loans. To make sure that the recipients still have some incentive to spend the money wisely, the EU requires that national or regional budgets co-finance each project. The co-financing requirements depend on the type of project and range from 15% to 40%. Nevertheless, there have been frequent report of waste and even corruption in the use of EU regional aid. The Commission has promised to step up monitoring, which could make the whole process of obtaining funding even more protracted than it is now.

The EU's 1999 Berlin summit set out how much the new members could expect to receive after they joined the union. In the current budget, covering 2000-06, the EU has earmarked a total of €42.6bn (US$45.9bn) for the new members, of which more than half will be paid out through structural funds. Poland will be by far the largest recipient, with more than €11bn, followed by Hungary and the Czech Republic, with €2bn-3bn each. However, the money will be slow to come in. Both regional aid and agricultural payments (the other major spending category in the EU budget) will be phased in gradually after 2004. Moreover, structural fund projects have long lead times and even common agricultural policy (CAP) payments are only reimbursed with a delay. The European Commission expects that in 2004, the year of accession, the new members will receive transfers amounting to only 1% of their combined GDP, rising to 1.5% by 2006. This is much lower than the 3.6% of GDP received by Greece, and the almost 2% of GDP received by Portugal and Spain. In per-capita terms, the new members will get between €200 (US$215) and €600 (US$645) per head at the most in 2004-06, compared with the sums of €1,000-1,500 received in Ireland, Greece and Spain during the last budget period.

EU money for the new members
(€ bn in 1999 prices)

	2004	2005	2006	2004-06
Common agricultural policy	1.9	3.7	4.1	9.8
Regional aid	6.1	6.9	8.8	21.8
Structural funds	3.5	4.8	6.0	14.3
Cohesion funds	2.6	2.2	2.8	7.6
Internal policies & administration	1.9	1.9	2.0	5.8
Other	1.3	1.3	0.9	3.3
Total	**11.1**	**13.8**	**15.8**	**40.7**
Approved in Berlin	11.6	14.2	16.8	42.6

Source: European Commission.

Furthermore, it is not certain whether the new members will actually receive the allocated amounts in full. The east European countries tend to have weak state administrations and little experience with either regional support policies or the handling of large-scale fiscal transfers. The systems for applying for and implementing EU regional support are so complex that even current member states regularly fail to spend the full amounts that they have been allocated. In the new member states, this problem will be much worse. In addition, the new members will have only two years to identify projects and obtain Commission approval for their funding before the current budget period runs out (although the money itself will not need to be spent until the end of the decade).

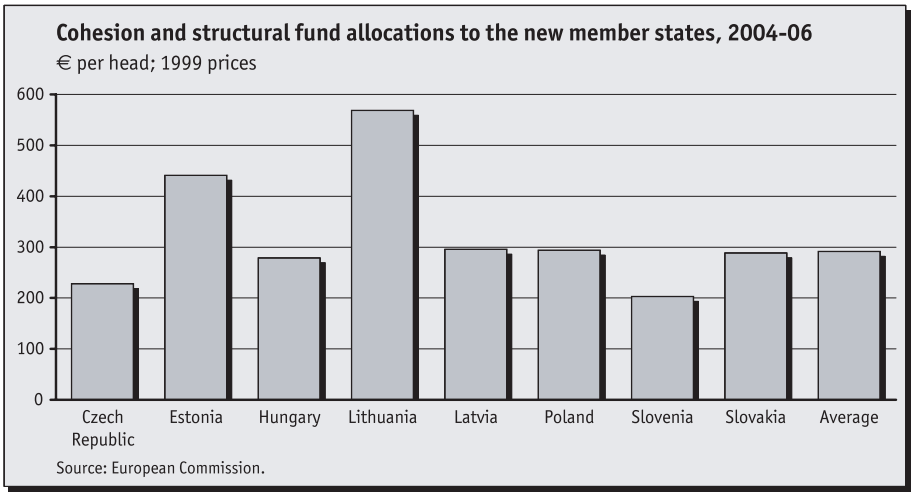
The EU created a pre-accession regional aid facility called Ispa (instrument for structural policies for pre-accession) to help the candidates get used to handling structural funds. Of the €4bn allocated under Ispa, the candidates had managed to spent only €200m by end-2002. One of the problems is that the candidates simply cannot find enough viable projects (the value of each project is supposed to exceed €5m, which is a substantial amount in small transition countries). Another is the requirement that each project has to be met with 25% co-financing out of national or regional budgets. Co-financing requirements under structural fund rules can be lower, at 15-20%, but they will still be an additional burden on stretched government budgets. The Commission has tried to alleviate these problems by paying out a larger share of money through the cohesion funds, which pay for straightforward infrastructure or environmental problems and do not have co-financing requirements. However, it is still safe to assume that EU aid inflows will be a trickle rather than a flood in the first couple of years after accession.

Cohesion and structural fund allocations to the new member states, 2004-06
(€ m in 1999 prices, unless otherwise indicated)

	Cohesion fund	Structural fund	Total	Per capita (€)
Czech Republic	836	1,491	2,327	228
Estonia	276	342	618	441
Hungary	994	1,853	2,847	279
Lithuania	543	823	1,366	569
Latvia	461	575	1,036	296
Poland	3,733	7,635	11,368	294
Slovenia	169	237	406	203
Slovakia	510	1,050	1,530	289
Total	**7,522**	**14,006**	**21,528**	**292**

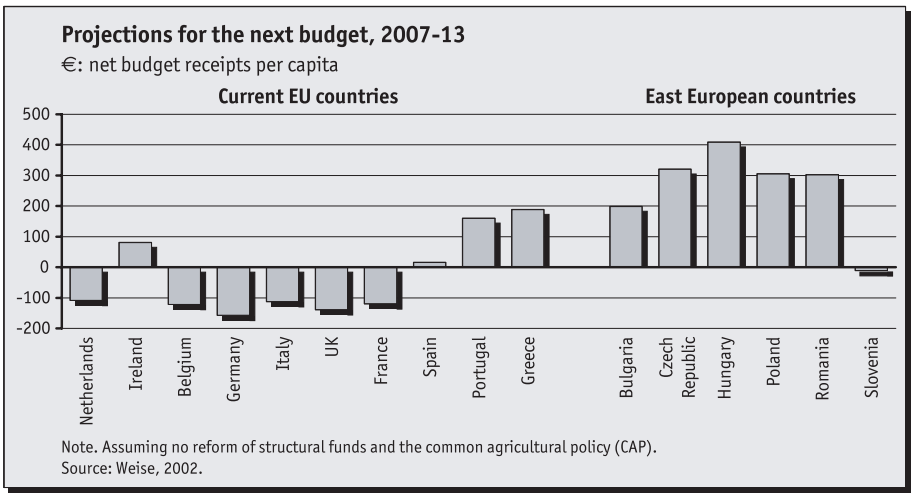
Note. Cohesion fund allocations are author's calculations based on the mid-range of the European Commission's indicative share.

Source: European Commission, *Second progress report on economic and social cohesion*; own calculations.



The real impact of the structural funds is therefore likely to come during the next EU budget period, which will run from 2007 to 2013. How much money the new members will receive during that period will be decided in forthcoming budget negotiations. These are likely to be unusually tense because of what Brussels insiders call "the statistical problem". With the accession of the east Europeans, average EU GDP will drop by about 10 percentage points. This means that many of the regions that currently have GDP per head below 75% of the EU average, and so qualify for regional support, will no longer do so. As a result, all Germany's new states, all but two Spanish regions and all but one region in Italy will no longer qualify for Objective 1 funding. In addition, GDP per head in Spain will move above 90% of the EU average, which means that it will no longer qualify for cohesion fund money. Although economic growth means that around one-quarter of the regions now covered by Objective 1 funding would lose their entitlement even if enlargement did not take place, Spain, Italy and others are still likely to fight strongly to retain their entitlements in the EU budget.

Estimates by PNB Paribas, a French bank, show that if current rules were maintained, the costs of Objective 1 support (including pre-accession aid) would go up from €165bn in the 2000-06 period to €251bn in 2007-2013. The amount received by current EU members would fall from €140bn to €93bn, and the sums received by the 12 newcomers would rise from €25bn to €157bn. Only Portugal and Greece would still be eligible for cohesion fund money, and the new members could expect around €26bn from this facility.



Note. Assuming no reform of structural funds and the common agricultural policy (CAP).
Source: Weise, 2002.

The current recipients of EU funds argue that, since the absolute income levels in their poorer regions will not actually change after enlargement, it would be "unfair" to withdraw the money. They will seek a shift in the entitlement barrier, perhaps to 80% of EU average incomes or more. At the very least, they will insist on some kind of transition deal, such as the one that now pays Ireland (which is now richer than the EU average) a "phasing-out" share of structural fund money amounting to 60% of previous entitlements. To calm the current recipients, the Commission has proposed an increase in total structural fund spending to €350bn in the next budget period, but Germany—which

shoulders the largest share of the cost of the EU budget—wants spending capped at the current €270bn. How much the new members will receive in the end will not be known until 2006, but the much more important question is whether EU money is actually worth the fierce fight that the old and new members are gearing up for.

The role of EU regional aid in catch-up growth

There is considerable uncertainty about the impact of structural funding on recipients' growth rates. The sums dispensed through the EU's structural funds budget have grown significantly over the past 20 years. EU regional aid has amounted to 1-3% of Spanish or Portuguese GDP in recent years, financing 5-10% of total investment and increasing the funds available for public spending (net of transfers, health and social insurance payments) by 10-20 percentage points (Boeri *et al*, 2002; Boldrin and Canova, 2002).

Most of the money from the structural funds is spent on physical infrastructure, such as roads or sewage systems, with much of the rest financing education and training. Companies in backward regions often receive direct support (although in some cases this goes against the EU's own rules on competition and industrial subsidies), and there are also special sectoral funds to help farmers or fishermen. The economic rationale behind this allocation of money is that investment in infrastructure and education is supposed to create "externalities"—benefits that go above and beyond the immediate recipient of the money. Building a road to a remote region, for example, will benefit first and foremost those who travel on it, but the improved accessibility may also help to stimulate inward investment and create new jobs. If, as a result, the whole region grows more strongly in the future, everyone benefits, even those who do not use the road. Since private investors do not take into account these externalities, the level of investment in infrastructure and education may well be below its optimal level unless governments step in.

Structural funds boost short-term demand

Since transfers of this size give an immediate boost to domestic demand, they should—other things being equal—increase economic growth in the short term. However, it is much less clear that the funds actually fulfil their stated purpose, which is to create the conditions for higher growth rates in poorer regions in the long term. As pointed out above, in countries such as Spain and Portugal, poor regions have actually fallen further behind the EU average over the past two decades. In Italy, 50 years of income transfers (both national and EU money) have done nothing to help to reduce the gap between the north and south of the country. Germany's eastern states have received large-scale EU aid—complemented by government transfers amounting to more than half of the region's GDP during the 1990s—but have still not managed to achieve self-sustaining growth or to bring down unemployment.

Whereas some economists (for example, Boeri *et al*, 2002) conclude that EU regional aid has "contributed significantly to output growth in at least some of the recipient countries and regions", others (Boldrin and Canova, 2001) find no evidence that "the substantial sums funnelled by the Community to less developed regions are serving any economic purpose other than redistributing income". Some studies even find a negative correlation between EU aid and growth (Ederveen *et al*, 2002).

Impact on growth is uncertain

The European Commission itself has produced mixed evidence of the effectiveness of structural funds (Hallet, 2002a). In one modelling exercise, the Commission found that support for poorer regions since 1989 left Greek and Portuguese GDP in 2000 at 8-10% higher than it would otherwise have been. Irish and Spanish GDP is estimated to have been lifted by around 3%. However, the model makes rather optimistic assumptions about "externalities", and it does not account for the full impact of the transfers on macroeconomic variables. For example, the inflows may push up the exchange rate, thus undermining the competitiveness of domestic industries. Furthermore, higher public investment may "crowd out" private investment and induce households to save more, since they may associate increased public spending with future tax rises. Once these effects are accounted for, the estimated benefits of structural fund spending become much smaller, amounting to 0.5-1.5% of GDP for the four main recipient countries. Since the amounts of EU aid likely to be available to the new member states will be smaller than those dispensed to Greece, Portugal and Spain in the past, the impact on the new member states' GDP is unlikely to be very large.

Some economists suspect that the easy availability of EU money has indirectly contributed to Greece's economic problems by freeing up government money for additional consumption. As a result, the budget deficit and public debt rose sharply and the current-account deficit ballooned. This type of "fungibility" may also be a problem in the new member states, especially as they will channel much regional aid through central rather than regional budgets, thus making it more likely that EU money substitutes for other expenditure items.

The use of EU aid requires new administrative structures

In addition, to administer future aid flows, some of the larger east European countries have had to start building new regional administrative structures—an additional demand on scarce public resources. The European Commission argues that structural funds have led to the establishment of a more decentralised administration and increased interaction between central governments and regional/local administrations. In large, heavily centralised countries such as France, this should probably be seen as beneficial, but in small countries, such as Slovakia, adding an additional layer of bureaucracy risks creating new opportunities for bribery and corruption without adding much in terms of administrative efficiency. Finally, the allocation of structural funds is accompanied by fierce lobbying at the regional, national and EU levels. From an economic point of view, this is a waste of resources and it often leads to an inefficient allocation of funds. Boldrin and Canova (2002) advise the EU to scrap structural funds altogether, since "current policies are ineffective, based on incorrect or at least unsubstantiated economic theory, badly designed, poorly carried out, a source of wrong incentives and, in some cases, corruption".

What really drives growth

Some observers believe that the structural funds' main purpose is to buy the consent of poorer member states to further steps in European integration. Indeed, regional aid instruments have mushroomed every time there has been another round of enlargement or a large step in integration, such as the introduction of the single currency. In so far as this allows for further integration—which can be assumed to be welfare-enhancing—this is not a loss

for the EU as a whole. However, it appears difficult to make a clear economic case for EU regional aid on its own merits.

This is not to say that all structural fund money is wasted. The case of Ireland shows that EU money—if spent wisely as part of a wider national development effort—can contribute to raising growth rates. On the other hand, the Greek example shows that structural funds alone make no positive contribution to growth. These two polar cases may contain valuable lessons for the kind of policies that are needed to make structural funds a success:

- **Macroeconomic stability.** Ireland and Greece both stagnated for about a dozen years after EU accession. Growth only took off when these countries became serious about macroeconomic stabilisation. Ireland turned a deficit of nearly 16% of GDP in 1981 into a surplus by the late 1990s. Greece had a budget deficit of more than 20% of GDP in 1994, before squeezing it below the 3% threshold needed for euro-zone entry in 2000.

- **Supply-side reform.** Ireland has consistently implemented a programme of supply-side reforms, which involved market deregulation, labour market reform, and tax reduction. The resulting boom in FDI continues to dwarf EU subsidies.

- **Institutions.** Economists tend to agree that stable and transparent institutions are an important precondition for growth. Ireland does much better on this score than Greece. Ederveen *et al* (2002) find that structural funds only have a positive impact in countries with the right institutions. Applying their model to the central and east European countries, with their relatively weak institutions, they predict that structural funds may well have a negative impact on growth.

Another critical question is what the new member states should spend their allocations on. Ireland declared education a national priority in the 1970s and consequently invested a much larger share of its structural fund money into education and training than did the other recipient countries, which put more money into infrastructure. Ireland concentrated on providing a good basic education to the majority of its citizens. As a result, new technologies that arrived with foreign investment have spread rapidly through the economy, driving up productivity and wages.

Well-targeted investment in education and training—if combined with measures to improve the functioning of the labour market—can perhaps give a quick boost to productivity growth. The central and east European countries generally score well on educational indicators, such as total years of schooling. However, there are concerns that underfunding has affected the quality of education. Insufficient reform means that education systems in the east often fail to produce the kind of skills needed in a market economy. There is therefore a strong case to be made for channelling a substantial share of EU aid into projects designed to build up human capital.

Payback to infrastructure investment can be substantial

On infrastructure, the picture is less clear. Generally it seems that the payback in terms of productivity is substantial in backward countries, where even basic transport and communication networks are still missing. However, returns fall sharply the more advanced the recipient country or region. Spain, for example, has invested massively in public infrastructure, yet its growth rates have lagged

behind those of Ireland and even some of the more advanced EU countries. Nevertheless, since levels of infrastructure in most accession countries are still far below EU averages, the new members may well benefit from additional funding for building roads, bridges and communication infrastructure.

If spent wisely and accompanied by the right policies, EU money could thus make a positive contribution to growth in the new member states, but it could also exacerbate existing problems, or even possibly have adverse results. For example, if EU money is spent on propping up uncompetitive industries in declining regions, it will serve to perpetuate outdated economic structures, which could be a drag on growth. Although there is a case for making additional money available for investment in infrastructure and education, it is not clear whether this investment should concentrate on poorer regions. For example, building a new road to a remote region can attract investment, but by reducing transport costs it can also make it easier to supply the region with goods from elsewhere. In some cases, EU infrastructure projects have actually added to pressures on local industries in poorer regions. Similarly, training workers in poor regions appears important for attracting investment, but experience shows that better qualified workers are more likely to move to seek jobs elsewhere, leaving the region in question with a deteriorating labour force.

Conclusion

Previous enlargement rounds show that the boost to growth in poorer countries from integration tends to weaken or even peter out after a while. Although many barriers to trade have already been removed, the accession countries still have much work to do to complete their integration into the single market. This, and accession to the euro area, is likely to help to sustain growth rates for some years to come. EU funds may support faster economic growth, but this article has argued that this is only likely to be the case if they are spent on education and infrastructure projects in a sound macroeconomic and institutional environment.

The regional focus of EU aid may be a mixed blessing for the new members. Growth in central and eastern Europe will continue to be based in booming capital cities and fast-changing western regions. It is here, rather than in remote eastern regions and rural areas, that EU-sponsored investment would generate the greatest returns. In fact, eastward enlargement calls into question the whole regional focus of the EU's convergence policies. Most of the new member states are too small to be divided into meaningful regions. Aid efforts in an enlarged EU would therefore have to refocused to help countries, rather than sub-national entities, to catch up.

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The Western Balkans: heading off a looming crisis?

By Laza Kekic, Regional Director, Central and Eastern Europe, Economist Intelligence Unit

Introduction

Recent developments, several new international reports that warn of a looming regional crisis, and a number of high-level meetings in the EU and elsewhere signal a renewed focus on the so-called "Western Balkans"—the term used by the EU to denote the non-EU candidate Balkan countries: Albania, Bosnia and Hercegovina (BiH), Croatia, Macedonia, and Serbia and Montenegro (as Yugoslavia was recently renamed). Greece, which naturally has a special interest in its neighbourhood, currently holds the EU presidency and wants to keep the Balkans near the top of the EU agenda. There appear to be several reasons for the increased attention being paid to the Western Balkans, and for a re-examination of the present and future role of the international community in the region.

There is an increasing realisation that things in the region are not going so well, or certainly not as hoped after the changes in 2000. Any possible achievements are seen as incommensurate with the ambitious goals set in 1999-2000 for Western-backed stabilisation and development efforts. The results of the much-touted Stability Pact for the Balkans and other initiatives have been meagre. The in the main unsatisfactory economic results being achieved may pose a risk of social and political crises. There is a threat of political instability throughout much of the region. The prospects for success of the unwieldy, EU-mediated Serbia-Montenegro state union do not appear promising. Serbia and Montenegro teetered on the brink of political crises after public apathy and insufficient voter turnout led to failed presidential elections in both republics. In Kosovo, despite the formal commitment to the lofty aims of building democracy and a multiethnic society, realistically the best the international community can hope for is to contain the problem. The recent assassination of Serbia's prime minister, Zoran Djindjic, has not only set back Serbia's prospects, but has also affected the entire region by reinforcing external perceptions that the Balkans suffer from endemic violence and criminality.

A glass half-full or half-empty

Optimists still point to the fact that that there has been steady—even if slow and uneven—progress in some areas in recent years. There is no imminent threat of renewed outbreaks of conflict and the region is calmer than at any time since 1990. Even in Serbia—where the assassination of Mr Djindjic appeared to highlight the deep, symbiotic links between criminal and old regime forces—there is little chance of a return to the past or an abandonment of the post-Milosevic course. However, in addition to the socioeconomic malaise, unresolved political and security questions abound in the region, suggesting that the present situation may have more to do with successful containment than a lasting resolution of problems or the establishment of a basis for self-sustained peace. In both Kosovo and Macedonia the peace that holds remains an uneasy one. The October 2002 elections in BiH saw the triumph of nationalist parties, and were thus a serious rebuff to international efforts.

Reports in late 2002 of arms sales to Iraq originating from the region came on top of well-publicised arrests of alleged Middle Eastern terrorist suspects, and

were a reminder of the region's potential to cause ripples well beyond its geographic area. Given war in Iraq, mounting concerns about its impact and aftermath, and continuing post-conflict difficulties in Afghanistan, there has been increasing interest in investigating what lessons the Balkans hold for "nation-building" efforts. Finally, EU and NATO enlargement raise the prospect of intensified marginalisation of the "left out" Western Balkans. There are fears that the region could remain an unstable backwater and perhaps a breeding ground for and exporter of criminality and terrorism.

Are the Western Balkans a region?

One criticism that is frequently heard is that the Western Balkans is an arbitrary, artificial construct by which the EU has lumped together very disparate states for its own administrative convenience (those south-east European states that, unlike Bulgaria and Romania, have been left out of the EU accession process). The appellation carries more than a little irony—given that the term "Western" is generally seen within the region as a byword for prosperity and progress, whereas the region has become a synonym of impoverishment, instability and conflict.

Table 1

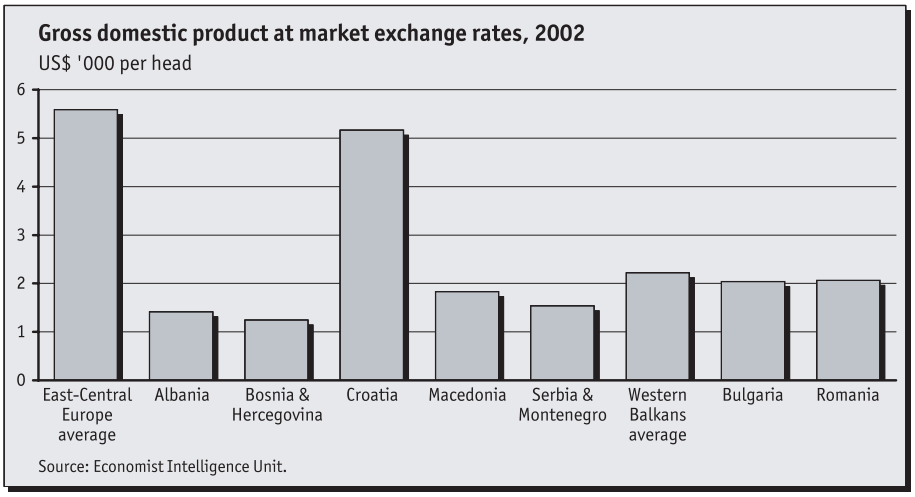
Comparative data, 2002

	GDP per head[a] (US$)	Real GDP (1989=100)	Unemployment rate (%)	Total exports[b] (% of GDP)	Exports to EU[b] (% of total exports)	Exports to EU[b] (% of GDP)
East-central Europe average	**5,590**	**119.0**	**13.2**	**44.4**	**65.6**	**29.0**
Albania	1,420	111.6	14.2	7.6	92.1	7.0
Bosnia and Hercegovina	1,250	70.6	41.0	22.0	51.3	11.3
Croatia	5,170	86.3	20.2	23.5	53.4	12.5
Macedonia	1,830	78.5	30.5	33.5	49.9	16.7
Serbia and Montenegro[c]	1,540	50.0	29.0	18.4	43.3	8.0
Western Balkans average	**2,220**	**78.2**	**27.0**	**21.0**	**58.0**	**11.1**
Bulgaria	2,040	83.1	18.0	37.7	55.2	20.8
Romania	2,070	87.5	8.3	28.7	67.3	19.3

Note. East-central Europe comprises the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

[a] US$ GDP per head is at market exchange rates. [b] Exports refer to merchandise exports. The data, and for associated ratios, are for 2001. [c] Data for Serbia and Montenegro exclude Kosovo.

Sources: Economist Intelligence Unit; IMF; national statistics.



A segmented region

The Western Balkans region is clearly segmented. For example, Croatia's per-capita income is not that far below the central European average, whereas Albania's is closer to that of a developing country. In some parts of the region fundamental questions of political status—which overshadow all other issues—are still contested. At the other end of the spectrum is again Croatia, whose borders now appear settled and secure, and which recently applied for EU membership. Yet Croatia's external relations are also still heavily affected by the legacies of conflict: co-operation, or lack thereof, with the International Criminal Tribunal for former Yugoslavia (ICTY) in The Hague and the question of the future of its largely departed Serb minority). Furthermore, despite the intra-regional differentiation, there are a number of interesting similarities within the region, which set it apart from central Europe, and in some ways even from fellow Balkan states and EU candidates, Bulgaria and Romania.

- The social, economic and political legacies of conflict still loom large.
- An unusually high degree of external political dependence and attenuated state sovereignty, with the Kosovo and BiH protectorates representing the extreme examples of a more general trend.
- A weak economic recovery, with real GDP on average still more than one-fifth below its 1989 level.
- A process of de-industrialisation, and of stagnation or even collapse of exports.
- A low degree of international integration, as evidenced by very low shares of merchandise exports in GDP.
- Very high unemployment rates, even though extensive shadow economic activity means that officially reported rates exaggerate the extent of real unemployment.
- Except for Albania, a common former Yugoslav self-management legacy (which outside the sub-region is shared only by Slovenia).
- Unlike in the rest of eastern Europe, and in common with Russia, communism was largely a home-grown affair in both Albania and former Yugoslavia. It was not primarily an external import that came in the baggage of the Red Army, which also means that the legacies of the communist period are somewhat different from elsewhere in eastern Europe.
- Most countries in the region have very large external and fiscal deficits, with a high degree of dependence on foreign official grant financing (see table below). Croatia is the only country in the region with regular access to commercial finance, and its reliance on official aid receipts is now minimal. According to the European Commission, total committed economic aid to the region in 2002 (grants and loans) amounted to some €3.5bn (US$3.7bn), slightly up on the €3.3bn in 2001. Of the 2002 total €1.3bn was from the EU, €500m from other official bilateral sources and €1.7bn from international financial institutions. The aid amounted to 7% of the region's total GDP of some €50bn; the degree of external aid dependence of some countries in the region was considerably above even the high average share.

Table 2

External and fiscal imbalances
(% of GDP)

	Current-account balance[a]	General government budget balance[a]	Foreign financing of budget deficit
Albania	-8.1	-8.0	4.9
Bosnia and Hercegovina	-21.3	-11.6	10.7
Croatia	-5.6	-6.0	3.8
Macedonia	-9.7	-4.5	4.1
Serbia and Montenegro	-11.7	-5.7	4.0
Western Balkans average	**-11.2**	**-4.0**	**5.5**

[a] Before official grants

Sources: IMF; European Commission; National statistics.

All these common features suggest a similar set of problems and a sort of regional identity that goes beyond the dictates of geography and EU political convenience. This is especially true of the former Yugoslav states (given that Slovenia was always very much a special case even in the old Yugoslav federation). There is no lack of possible explanations for the region's present ills—a lack of economic reform; deformed and/or weak institutions; poor macroeconomic management; historic pre-socialist legacies; aid dependence; enduring legacies of conflicts; poor business environments. In statisticians' terms, the causes of the Western Balkans' malaise are over-identified.

Varying explanations

An abundance of possible explanations does not, however, mean that there is a consensus on the solutions to the region's main problems, and in particular on what the role of the outside world should be. Two recent studies illustrate two very differing perspectives on these issues. A US-based think tank, the Council on Foreign Relations, recently released a study calling for an increased role by the US and the EU in the Balkans along present lines—lest unemployment, crime, corruption, and ethnic and religious tensions further destabilise the region (*Balkans 2010: Report of an independent task force sponsored by the Council on Foreign Relations Center for Preventive Action*, 2002).

The report abounds with grim diagnoses of the present situation and some stark warnings. Economic stagnation has generated unemployment and underemployment; hundreds of thousands of refugees still await return or resettlement. Key institutions have resisted reform, which is impeded by corruption and entrenched obstructionist forces (inclusive of organised crime syndicates). Indicted war criminals remain at large. Neglecting these challenges, the study argues, will have severe and destabilising consequences for the region and beyond, in the form of increased poverty and illegal economic activity, trafficking in people and drugs, and a greater likelihood of political extremism, insurgency, and terrorism.

Sticks today, maybe carrots tomorrow

The report is characterised by a strong and undiminished belief in the benefits and necessity of continued and intensified external engagement in the region (albeit "reconfigured and rebalanced"). The study argues that what is required is ample use of "sticks and carrots" to keep Balkan governments on the path of progress and reform. However, the emphasis is primarily on the stick of

conditionality—the linking of international assistance to specific actions and performance goals. Conditionality is effective, it is said, when the international community speaks with one voice, because it puts pressure on local leaders to make difficult and unpopular changes and can give them political cover for doing so. The report also suggests that NATO and the EU can offer the countries of the region the carrot of membership in these organisations in return for sweeping economic and political reforms.

The report is imbued with the nation-building orthodoxy of the 1990s, which appears to be getting a new life lease of life in the context of the aftermath of the Iraq war and ambition to "remake" the Middle East. Arguably, in the Balkans the ideology had never even weakened, in part because of the strong built-up vested interests among scores of international non-governmental organisations (NGOs), bureaucrats and academics. The Council of Foreign Relations report is clearly not unique in this approach. For example, although the language used by the report may be more graphic and dramatic, its approach and recommendations are not dissimilar from those in a British House of Lords report, issued in early 2002, on Western aid to the Balkans.

The Council on Foreign Relations study warns against a "creeping disengagement" from the region by the administration of US president George W Bush, and advocates a yet more forceful role for both the US and the EU in supervising and rebuilding, that is in effect running the region. The report warns that "irredentist, criminal, and antidemocratic forces" will try to exploit people's frustration and that "these elements must be countered through active international engagement". It urges the international community to make clear the benefits of co-operation and reform, but to also be explicit about the penalties—including the withholding of financial aid and international isolation—for "regression and obstructionism".

The report seeks to tie its case to concern about terrorism and to war with Iraq. It argues that renewed conflict and instability in the Balkans would be a policy failure with damaging implications for US relations with the broader Muslim world. It would be an unwelcome diversion from other priorities; would increase the amount of international drug and other trafficking; and would enable terrorists to use the region as a transit hub or a haven. A failure to establish long-term stability in the Balkans would also feed criticism in Europe and throughout the Muslim world that the US is more interested in making war than in keeping the peace.

A crisis in 2004

By contrast, a 2002 report on the Western Balkans by the European Stability Initiative (ESI, a Berlin-based NGO) adopts a different, and somewhat unusual, perspective. The ESI study also provides an alarming diagnosis of present developments, with predictions of an impending "crisis in 2004". However, the study represents a departure from the conventional wisdom by providing a sharp critique of the present international (and EU) efforts in the region, and calling for a new developmental approach. The study appears to have hit a nerve and has been the subject of several high-level meetings, including with the EU's high representative for foreign policy, Javier Solana. It may thus also reflect more widespread doubts and concerns about the region and the present model of external involvement.

The report gives the EU its due for its handling of immediate post-war humanitarian, reconstruction and stabilisation tasks. However, as this period draws to a close, the Western Balkans is facing a crisis of social and economic dislocation. This is now the main danger, not ethnic extremism or military conflict. The crisis is emerging just as external assistance is being scaled down, and as the countries of the region find themselves excluded from the EU enlargement process. Several factors are said to point to a looming "crisis of 2004". These include an imminent fall-off in aid flows to the area; a deepening employment crisis across the region, triggered by a dramatic collapse of socialist industries and only weak response from the new private sector; and a growing disenchantment of citizens with democratic processes that appear unable to reverse social and economic decline.

Vicious circles

In contrast to the prevailing orthodoxy, the report argues that present patterns of international involvement and assistance are contributing to the crisis, by distorting domestic spending priorities and political processes. Strategies of international intervention have limited the room for manoeuvre of representative institutions. Investment priorities are set outside the region. In BiH and Kosovo, almost all reform legislation is drafted by foreigners and imposed by decree. Even the EU's stabilisation and association agreements (SAAs), the outcome of negotiations between governments and the European Commission, reflect external priorities and are largely silent on economic development. There are the makings of a vicious cycle: the weaker the national governments become, the more outside organisations seek to impose their own vision of policy priorities, and the more unresponsive the governments become to their own electorates.

The rhetoric of "Europeanisation" underlies many programmes in the region. However, as it stands, the promise offered by Europe to the region has been "curiously insubstantial". The states of the Western Balkans have no early prospect of opening formal negotiations with the EU on membership and face declining assistance flows. The report calls for radical reform of EU assistance methodologies and instruments; the maintenance of existing levels of funding; reallocation of assistance; and changes in institutional structures that deal with the region. The authors of the report urge the EU to send a strong signal to the countries of the Western Balkans that the promise of Europeanisation is not an illusion.

Structural and cohesion funding as a model

The key new idea in the report is that the EU should include the Western Balkans in its commitment to economic and social cohesion across Europe, and that aid should be delivered in accordance with the development principles that underlie the EU's structural and cohesion funds. The latter imply local co-financing partnerships between the Commission and national and sub-national authorities, and cohesion policies to achieve higher economic growth by increasing investment. A key principle behind structural funds is "additionality": projects must be co-financed from national sources. This ensures that EU funds supplement, rather than substitute for, domestic investment. The model also requires substantive input from local and regional governments in setting development priorities and selecting projects, which can have a positive impact on the development of administrative structures in the recipient states.

Corruption rules

The ESI report steers well clear of the preoccupation with the notion that corruption dominates the area, to the extent of making local actors unfit partners. By contrast, the Council on Foreign Relations study dwells on the problems of corruption in the region—sometimes to the point of caricature. A report by the European Commission from December 2002 ("The Western Balkans in Transition") identifies fighting corruption as the main challenge for the region. The Commission says that corruption robs finance ministries of tax revenue, undermines efforts to speed up privatisation, keeps out foreign direct investment (FDI), and feeds drug and human trafficking. However, on one level, the overwhelming focus on the "rule of law" has become a distraction from more fundamental economic development issues. For example, the results of the latest European Bank for Reconstruction and Development (EBRD) Business and Enterprise survey does not reveal that there is any special Western Balkan "deficit" in this area, compared with other transition economies. Balkan institutions obviously do not function well, but the extent of corruption and institutional dysfunction is often greatly exaggerated.

Table 3

Corruption in the Western Balkans

	% of firms paying bribes frequently	Average bribery payments as % of annual firm revenue
Czech Republic	13.3	0.9
Hungary	22.6	1.0
Poland	18.6	1.2
Slovakia	36.0	1.4
Slovenia	7.1	0.8
East-central Europe average	**19.5**	**1.1**
Albania	36.4	3.3
Bosnia and Hercegovina	22.4	0.9
Croatia	12.9	0.6
Macedonia	22.7	0.8
Serbia and Montenegro	15.9	1.5
Western Balkans average	**22.1**	**1.4**
Bulgaria	32.8	1.9
Romania	36.7	2.6

Note. Data are for 2002.

European Bank for Reconstruction and Development & World Bank, *Business Environment and Enterprise Performance Survey*, 2002.

In all, it can be said that the Council of Foreign Relations and similar reports offer very little that is new. The doctrine of intervention, which reached its high point in the region in the late 1990s, is still very much the guiding principle. Outsiders continue to be needed not only to keep the peace, but to bring stabilisation, reconstruction, development and the rule of law to the region—and to drag it, kicking and screaming if need be, into the European fold. The reaction to unsuccessful intervention is to call for yet more forceful and intrusive intervention. The diagnosis is that internal dynamics and external intervention are not delivering the goods. The response: there is a need for yet more intensive engagement and better application of standard conditionality.

Global aid experience has been poor

Yet the simple fact—that has been borne out by experience—is that there is little reason to expect that traditional patterns of foreign aid, pressure and

conditionality, and far-reaching attempts at external social engineering, should be any more successful in the Balkans than they have been in the developing world. There was never much reason to suppose that the economic results would be better than those observed in other contexts of dependency. The example of BiH stands as a stark warning. The country has received billions of dollars in international assistance and was supposed to be the showcase of the new politically correct pattern of international intervention. Instead it became a prime example of the phenomenon of "aid addiction".

The EU accession model

An awareness of the limits of the traditional model has focused attention on the possibility that the EU accession model may be the mechanism by which the Balkans can be developed. The ESI's suggestion that the EU should extend its tried and tested cohesion policy to the region is one example of this approach. According to one view, the main problem is that the Western Balkans countries do not have a clear promise of eventual EU accession. EU conditionality towards the EU accession countries is unique in that it is "endogenous"—that is, it is a part of the accession process and thus accepted by the applicants because it is a means towards the final destination of membership, and equality of status with the wielder of conditionality. The sort of conditionality imposed on the Western Balkans is, by contrast, "exogenous". The aims of the donor are not necessarily shared by the target of the conditionality. Given the lack of a strong, underlying incentive for the target willingly to comply, conditions are often resented, resisted or simply ignored. Thus, it is argued, the EU needs to transform "exogenous" into "endogenous" conditionality by granting candidate status to all in region.

The cohesion model is not a panacea

The ESI report represents in many ways a departure from the conventional approach. It provides a critique of the existing mode of external involvement in the Balkans—a model that is highly intrusive, crusading, non-economistic. It is largely ineffective and fosters a debilitating dependence among the targets of policy action by external "stakeholders" (as the Council on Foreign Relations calls the outside actors). The ESI makes some innovative suggestions. However, ultimately it also shares the belief in externally driven change. Its belief in the potential of the EU's structural and cohesion funding model is clearly overblown (see the article in this issue on the role of EU assistance in the development of the EU's periphery). The experience in the EU to date shows that EU money has not been the main factor in explaining growth. The most important ingredients of catch-up growth are a stable macroeconomic framework, supply-side policies that help markets to adjust quickly, and a well-trained, flexible workforce.

Conclusions

The outlook for continued heavy external engagement in the region—whether of the traditional type, advocated by the Council on Foreign Relations and others, or along ESI-recommended lines—is highly uncertain. There is little doubt that the outside world will continue to provide for some time whatever military wherewithal is necessary to keep the peace in the region. However, given competing concerns and the global economic downturn, it is unlikely that much more economic aid will be forthcoming. Pleas for the US to stem its gradual trend of disengagement, and not leave the field to the Europeans, are also unlikely to be heeded, especially after the fractures that have been opened by the Iraq crisis.

It is unclear whether extending EU candidate status to the Western Balkans would really provide the elusive magic formula of externally driven change. In any case, the EU's priority of dealing with its first eastward enlargement, preoccupation with its own troubled internal relations, and nervousness about making new commitments, suggest that this is unlikely to happen soon.

Does this mean that crisis in the region is unavoidable? Both the ESI and the Council on Foreign Relations reports contain an element of special pleading by magnifying the risks of a crisis. However, although the risk of renewed large-scale conflict is still remote and the dangers of socioeconomic breakdown are exaggerated, performance in the region has definitely been poor and disappointing. The diminishing role of the external factor suggests that the responsibility for avoiding outright crisis will increasingly fall to internal actors in the region.

Political outlook

Election watch

	Presidential	Parliamentary[a]
East-central Europe		
Czech Republic	-[b]	Jun 2006
Hungary	-[b]	Apr 2006
Poland	2005	2005
Slovakia	2003	2006
Slovenia	2006	2004
Balkans		
Albania	-[b]	2005
Bulgaria	2005	2005
Bosnia & Hercegovina	2006[c]	2004
Croatia	2005	2004
Macedonia	Oct 2004	2006
Romania	Nov 2004	Nov 2004
Serbia and Montenegro	2003[d]	2004
Baltics		
Estonia	2005[b]	2003
Latvia	Jun 2006	2006
Lithuania	2006	2004
CIS		
Russia	Mar 2004	Dec 2003
Ukraine	2004	2006
Belarus	2005	2004
Moldova	2005[b]	2005
Armenia	2007	May 2003
Azerbaijan	Oct 2003	2004
Georgia	Apr 2005	2003
Kazakhstan	2006	2004
Kyrgyz Republic	2005	2004
Tajikistan	2006	2004
Turkmenistan	2008-10[e]	Apr 2003
Uzbekistan	Jan 2004	2004

[a] For lower houses unless otherwise indicated. [b] President chosen by parliament. [c] Collective rotating presidency. [d] Serbia had two failed presidential elections in 2002, because of insufficient voter turnout, and another is expected in 2003; Montenegro had a failed presidential election in February 2003. [e] Latest range given by the president, who in effect sets the election date.

Iraq: effects on eastern Europe

Most regions of the world have been and will be affected by the repercussions of the Iraq crisis. Eastern Europe is no exception. The region's public display of support for the US position on Iraq gave it a prominent place in the international limelight early on, and a more important role than might be normally expected. The willingness of east European governments to ruffle French and German feathers is very unlikely to jeopardise EU and NATO accession. However, eastern Europe can not escape any lasting consequences that the Iraq crisis might have for transatlantic relations and European and international institutions. Against this background, and the present high level of global uncertainty, what is the most likely immediate and longer-term impact on the region?

In late January and early February several east European governments in the region participated in two separate initiatives backing the US position on Iraq. The first involved a letter drafted by a "Group of Eight" that included Poland, Hungary and the Czech Republic alongside the UK, Spain and several other west European signatories. Shortly thereafter, a "Vilnius-10" group consisting entirely of east European governments was formed, and it put out a second, even stronger statement of support for the US position (the ten consisted of the seven countries invited to join NATO at the November 2002 Prague summit and three other aspirants).

"Old" and" new" Europe

These two initiatives elicited warm praise from the US administration (which also apparently applied some pressure to the signatories), as it was seeking to build a "coalition of the willing" to support its stance on Iraq. However, they also provoked a heated response from the French president, Jacques Chirac, who told the east Europeans that they should have remained silent, and even implied that EU membership prospects could be in jeopardy (in particular for Bulgaria and Romania, the two candidates not set to join in 2004). The incidents underlined the existence of growing internal divisions within Europe over the gathering Iraq crisis. They also fuelled the growing rows that followed the earlier statement by the US defence secretary, Donald Rumsfeld, about a divide that allegedly separated a dynamic and market-oriented "new" Europe from an "old" Europe centred on outdated French and German values.

What lay behind the willingness of east European governments to enter the fray in this way? The east Europeans are certainly more likely than most west Europeans to view the US as the only real guarantor of security and stability in the region, and are also more inclined to demonstrate gratitude to the US for its role in opposing the Soviet Union during the cold war. However, the support by east European governments for the US position on Iraq—frequently in the face of strong opposition from their own public opinion—may above all have reflected more immediate concerns, such as the forthcoming vote on NATO enlargement in the US Congress.

In terms of policy preferences, most "new" Europeans of the former Soviet bloc show no greater appetite than "old" Europeans for boosting military spending or for economic liberalism. However, in addition to the greater weight they seem to place on transatlantic ties, they also tend to differ from many west European countries in one other important respect. Most east European countries are fearful of surrendering too much new-found sovereignty, and will thus not regret the blows to closer EU federalism or a common foreign and security policy (CFSP).

A softening of positions

At the same time, most of the governments in the region have sought to defuse the row with France and tended to soften their position in March. In some cases there have been intra-government disagreements within countries on how to proceed. Governments have affirmed their EU aspirations and, prior to the breakdown of diplomacy, they emphasised their continued commitment to the UN process. Most statements from the region since the outbreak of war have also tended to be on the reserved side. Only a few have offered direct, material assistance to the US-led war effort in Iraq.

French pique over eastern Europe's unwelcome assertiveness is unlikely to have serious consequences for the EU and NATO enlargement timetables. Although some other EU leaders sympathised with the sentiments voiced by Mr Chirac, and similarly criticised the Vilnius-10 for fomenting Europe's divisions, this is not being linked to the accession process. The French government is most unlikely to take the extreme step—and thereby risk complete isolation—of punishing the EU candidates by deciding to hold its own referendum on enlargement. French officials have tried to play down Mr Chirac's statements, and a recent meeting between Mr Chirac and the Hungarian prime minister ended with French confirmation of a continued commitment to EU enlargement.

The risk that NATO enlargement might be derailed as a result of differences over Iraq is similarly slim. Most importantly, the Vilnius-10 statement will have helped to keep grateful US lawmakers on board, and French wrath will—as on the EU—not go so far as to try to stop NATO enlargement. The far from smooth build-up to war, and the rows concerning Turkey's role, have added to the already existing doubts about NATO's relevance as a military alliance. This stokes existing east European alarm over the nature of the organisation that they will be joining. However, at the same time, it diminishes the relevance of lingering doubts about enlargement among NATO members, and the possibilities that enlargement may yet stall.

Finally, as regards domestic east European opinion, the acrimony over Iraq is unlikely to alter the results of referendums on enlargement. Even though Mr Chirac's statements played into the hands of Eurosceptics in the region, support for EU and NATO membership does not appear to have been affected.

The longer-term consequences

EU and NATO accession may not be in danger, but what sort of organisations will the new members from eastern Europe be joining? These institutions can clearly not remain immune to any lasting international political repercussions from the Iraq crisis, in particular on transatlantic relations and on the institutional framework in Europe. A lasting rift between the US and certain EU member states and intra-EU disunity would pose serious problems for the east European candidate countries. The US may continue to apply pressure on the east Europeans to confirm the existence of a "new" Europe, and countries such as France could apply their own considerable pressure.

Spats, tensions and divisions are nothing new in the history of the EU, but rarely if ever have the divisions been as stark or as deep as over the Iraq war. The EU of 25 members, as it is to become in 2004, is bitterly divided—in effect split down the middle. Recent developments have made a mockery of the idea of a common European foreign and security policy. The efforts of the European convention chaired by former French president Valéry Giscard d'Estaing, whose aim is to draft an EU constitution, have been made much more difficult, if not fatally undermined. The disputes are unlikely to derail EU expansion, but they have soured the overall atmosphere for the EU enlargement process.

Iraq only provided the spark

Iraq, however, was in many ways only the occasion of the crises in the EU and in transatlantic relations, not its fundamental cause. It brought to the fore and highlighted several overlapping, long-running and deep-seated trends. If the

international disputes over Iraq were some kind of accident (borne mainly, as is frequently argued, of diplomatic ineptitude, misjudgement and miscalculation), then they were certainly an accident waiting to happen.

The underlying trends include deep-seated differences over Europe's relations with the US; different visions of the future evolution of the EU; unease about the economic and political impact of enlarging the EU from 15 to 25 member states; and differences over the extent to which economic integration should be extended to the political and security sphere. Above all, the situation also reflects the impact of the long-delayed, and now increasingly probable, demise of the post-second world war international order centred on the UN, which represented the international legal superstructure during the long cold war period. This edifice has been under severe strain since 1989, after its main *raison d'être*—the bipolar struggle between the US and the Soviet Union—was removed, but it had hobbled on, wounded, for more than a decade.

Will the Iraq crisis have a lasting impact on political developments in the enlarged EU and the wider Europe? At the moment confusion and uncertainty reign about likely outcomes, and there is a range of possible scenarios. Will the Franco-German alliance hold and remain the bedrock not only of "old Europe", but the centrepiece of the EU as a whole? Or will France and Germany and a few others attempt to form an inner core EU, an organisation separate from the EU as a whole? Will recent developments turn out to be the catalyst for efforts by the EU to forge an international political identity and security capability, or will they, in fact, hasten the regression of the organisation to something like a free-trade area?

A host of other inter-related problems and potential threats are on the agenda.

- The issues of Turkey's relations with both the US and leading EU countries, its EU membership aspiration, and its role in the failed intercommunal negotiations in Cyprus all simmer on.
- France, Germany and Belgium have arranged a separate meeting on European defence issues. How will that affect efforts to iron out intra-EU differences?
- Anglo-French relations and rivalries lie at the heart of the present disputes. Although both sides can be expected to try to mend fences, relations at present are practically frozen and, should any further tension erupt at this stage, the consequences could be far-reaching.
- Will the French-German-Russian co-operation develop into a fully-fledged alliance changing the geopolitical map of Europe?
- Will the US carry out its recent threat to transfer bases from Germany to countries such as Bulgaria and Romania, which would prove willing hosts?
- There is great uncertainty about what role if any the EU and UN are to have in the administration and reconstruction efforts in Iraq following the removal from power of Saddam Hussein.
- What will be the impact on multilateral trade negotiations? The Doha round of World Trade Organisation (WTO) talks is already in deep trouble; it is practically deadlocked and faces a very tight completion schedule

Three scenarios

In principle, one can identify three broad scenarios on how developments in transatlantic and intra-EU relations could unfold: *breakdown*, *reconciliation*, and *ongoing tensions*.

Breakdown is unlikely

Worst-case scenarios of deepening division, acrimony and ultimately a breakdown of relations both within the EU and between certain EU members and the US are likely to be averted—all sides have an interest in trying to prevent such an outcome. Although the Iraq crisis may leave a legacy of bitterness at the highest political levels, co-operation between EU member states is now so firmly entrenched that this is unlikely to have a lasting impact on the day-to-day functioning of the EU. The economic interests that bind EU countries remain strong, and this should be enough to prevent the EU from fracturing into a "European" core based around France and Germany and an "Atlanticist" periphery comprising the UK, Spain, Portugal and the new east European members. Even the apparently moribund CFSP has some present tasks and will rumble on. The EU is now taking most of the responsibility for the peacekeeping forces in the Balkans and also supplies the majority of international forces in Afghanistan.

The revival of the Franco-German axis may not be durable

An inner EU core is also unlikely because of the potential fragility of the Franco-German axis. The Iraq crisis has reinforced the alliance between France and Germany, which was revived after the surprise agreement reached between the two countries on EU agricultural spending in October 2002, paving the way for a decision on EU enlargement. However, these developments do not necessarily guarantee a durable revival of the previously dominant Franco-German axis. The two countries have very different visions of the future shape of the EU, and Germany could become increasingly assertive in the defence of German interests, even when these conflict with those of France. Despite the October 2002 agreement, Germany may also be determined to lobby for fundamental reforms to the common agricultural policy (CAP), to which France—the largest recipient under the CAP—is opposed. The expansion of the EU to 25 members would, in any case, reduce the effectiveness of a Franco-German axis, even if it is sustained, and would also probably frustrate France's ambition to "build Europe" as a counterweight to the US. Most of the new members from central and east European countries will resist policies that might weaken the security link with the US.

Reconciliation is also unlikely

The EU will carry on and all parties, the US included, will probably soon make some effort to mend fences. This, however, does not guarantee an end to the tensions that have burst out into the open with such vehemence. The most optimistic scenarios can only be based on a view that the international political crisis over Iraq was a one-off, an aberration that was made worse by a litany of diplomatic mistakes and misunderstandings. However, such a view is very far from the truth. True, the nature of the war will have some impact. A brief, relatively bloodless conflict will be much easier to deal with than a long drawn-out war. However, that in itself will not be decisive, given the deeper underlying causes of the present rifts. The "Iraq-centric" view also underpins those expectations that see a disappearance of intra-EU differences once the war is over.

US policy will also influence intra-EU developments

How the EU emerges from its crisis may also depend to a large degree on the attitude and policy of the US. There are several options: the US can basically ignore the EU and concentrate on bilateral ties with European states as the need arises; it may come to the conclusion that it is in its interest actively to undermine the EU, to foment the divisions between "old" and "new" Europe; or it may seek to mend fences with France and Germany, encourage intra-EU reconciliation and pursue a generally benign and co-operative policy towards the EU.

The latter option is probably preferred by most in Europe, on both sides of the present divide, but it is far from certain that the US will decide on such a policy, irrespective of how the war in Iraq goes. It is not just neo-conservatives in Washington who argue that the EU is not really a fit partner for the US—because of its internal weakness, especially in the military sphere; its divergent international interests and focus; and the absence of the cold war glue for the transatlantic alliance. "Shared values" (the existence of which leading US neo-conservatives such as Robert Kagan—and, after Iraq, many Europeans—deny anyway) are an insufficient basis for a true alliance. Even if the US mends fences with France and Germany, this does not mean that the EU will become the US's interlocutor.

There is some risk that the US government may actively try to split the Europeans on other issues, undermining the process of enlargement and further attempts to invest more power in EU institutions. However, such a policy would probably only be likely if present divisions deepened and sharpened further.

US neglect of Europe

A US neglect of the EU is many ways the most likely scenario. Such an orientation was presaged in the presidential election campaign of George W Bush in 2000, when other areas of most direct US interest—such as Asia, Latin America and the Middle East—loomed larger. Essentially, the US would only need to re-examine such a stance when and if the EU becomes a much more unified, stronger and coherent partner. Until then the US may need to deal with the EU only in those areas in which the EU speaks with one voice, such as trade policy—although multilateral trade talks will be derogated in any case, as regional and bilateral trade deals take precedence. In other areas—political, antiterrorism and other security issues—the US will probably continue to build "coalitions of the willing" based primarily on bilateral relations.

Ongoing tensions are the most likely outcome

Even if a further deepening of the present rifts can be avoided, the tensions seen in recent weeks and months are likely to leave lasting effects. This applies even in the best-case scenario of a short war with relatively few civilian casualties. The avoidance by the US of triumphalism in the aftermath of such a war, and conciliatory gestures to opponents over a leading UN role in post-Saddam Iraq would help to ease tensions. The Europeans, in turn, would have little to gain by just sitting back and leaving the US and UK to deal with the aftermath of war on their own, irrespective of how the conflict goes.

However, the Bush administration could view a swift victory in Iraq as vindication of its hawkish stance and confirmation that it should proceed unilaterally with its grand project of reshaping the Middle East, starting with

Iraq. This would increase the risk of further post-war divisions: the EU's commissioner for external relations, Chris Patten, already warned in early March that the EU might see little reason to help with any rebuilding that is not multilaterally driven.

Even assuming that EU states participate in the reconstruction, the wounds left over from the pre-war feud would certainly be re-opened should the US try to extend its "shock and awe" strategy to other states. Progress in fulfilling the suspiciously timed promise to push for a political solution of the Israeli-Palestinian conflict and a "road map" for the creation of an independent Palestinian state is at best likely to be slow. The real commitment of the US to this goal, furthermore, remains suspect. All of this will stoke transatlantic tensions further.

The reluctance of some NATO members to back US calls for defending Turkey, followed by Turkey's refusal to allow access to US forces, will almost certainly have strengthened the hands of unilateralists within the Bush administration. A swift victory in Iraq would only reinforce this, as would the fact that European states are unlikely to heed long-standing calls for greater defence spending.

The demise of the old order

Finally, the main reason why the genie that has been now let out cannot be put back in the bottle is that the recent developments have represented the final nail in the coffin of the post-second world war international order. It is true that, as in the case of Mark Twain, the death of this order, and of the cold war with which it was intimately linked, has been announced many a time prematurely since 1989. Most recently this happened after September 11th. However, never before have so many previously suppressed issues come to a head at the same time, catalysed by the Iraq crisis. Never before has the absence of the key elements that sustained the pre-1989 order been so exposed.

The old order rested on three main pillars (see below), all of them now either destroyed or badly shaken. Once the anti-Communist glue that had held the allies together dissolved, the common institutions and alliance began to be gradually called into question; the concept of state sovereignty was a very early casualty, and eventually the institution of the UN itself—the organisational centrepiece of the old order—was gravely undermined.

The pillars of the old world order

1. The bipolar stand-off between the US and the Soviet Union.

The cold war provided a framework for containing the rivalries between the two superpowers, but also the rivalries between lesser powers that had caused two world wars in less than half a century. The fundamental premise of the cold war was East-versus-West conflict, as opposed to the pattern of the previous era of international relations, which was based on conflict among many powers. The cold war order allowed stability in international relations, it suspended many traditional conflicts. Although many wars were still fought by proxy, none involved the two main powers in a direct clash.

2. US leadership of a more or less united non-communist world.

All the old differences within the Western world were subordinated to the East-West divide. This was also a key mechanism through which the US was able to construct a stable international order under its leadership. The communist threat legitimised US primacy and accorded it the status of the ultimate guarantor of global stability. The system succeeded in creating an unprecedented degree of international co-operation among the main Western nations, but also in certain

respects among the "third world" countries. The institutionalisation of this co-operation through bodies such as the General Agreement on Tariffs and Trade (GATT), the OECD, the IMF, the World Bank, the UN and NATO was a mutually beneficial experience. It was particularly to the advantage of the US, but no participating country was completely excluded from the benefits of co-operation. American are also right to say that this included the EU—it was the US presence that allowed Franco-German rapprochement and all else that followed.

3. The legal superstructure

This was provided by the primacy of the concept of state sovereignty and the associated idea of non-interference in states' internal affairs, commitment in principle to non-violent methods of solving inter-state disputes, and a global security structure centred on the UN Security Council. For the first time in history—in part because of a strong anti-colonialist strain in the US--small states were formally equal to large ones; they could exploit superpower rivalry and the system afforded them a degree of protection. It is not relevant to say that the system did not always function as envisaged. This was the only legal order and certainly had a range of merits and accumulated wisdom; the significance of their absence will only now become plain.

The post-cold war world has been characterised by a confusing mixture of change and continuity, co-operation and conflict. It has taken more than a decade for conflict to vanquish co-operation and for the old international order finally to be laid to rest. The old order lingered on partly through inertia, but also in part because of the peculiarities of the presidency of Bill Clinton in the US—an initial emphasis on the domestic agenda; a long time to find its foreign policy footing; a sensitivity for much of the period to Russian concerns; the personal problems.

The demise of several key precepts of the order have been highlighted during the Iraq crisis: states can be now attacked not in direct self-defence, but on pre-emptive grounds; states with bad regimes do not in any case enjoy sovereign protection; the UN is no longer, even in principle, the ultimate arbiter of international security issues; intra-Western co-operation has cracked; the concept of multilateral decision-making received a heavy blow.

There have been many recent examples of US unilateralism—on the environment, international justice, trade and now military conflict. However, American unilateralism is not necessarily opposed to co-operation in pursuit of American interests. At the WTO meeting in Doha in 2001, the US was in the forefront in pushing for an agreement. The US did also invest energy in organising international support for its campaign in Afghanistan, and did try, although extremely ineptly and not very enthusiastically, to get the UN to underwrite the Iraq venture. The decision to go to the UN on Iraq did not reflect some sudden conversion to the cause of multilateralism. It was a pragmatic move—even if a miscalculation—to increase the political ease and legitimacy of its policy. However, the approach to getting UN assent was made crystal clear—"nice to have, but not essential" to what the US decides to do on the basis of its own interests. US actions have proved that it is willing to deploy its awesome military power by itself and at its own initiative. Thus, as many have expected and predicted, the US would not hesitate to go it alone if it felt that its interests are best served that way, no matter what other governments may think or say.

The EU's contribution

It would be wrong, however, to lay the blame for the demise of the old order only at door of the US. The EU states—both old and new—made a substantial

and perhaps decisive contribution to undermining the post-second world war order and the rise of a new imperialism. They were among the most enthusiastic destroyers of the old order's third pillar, the primacy of and respect for state sovereignty, which was to be superseded by a host of other considerations—as interpreted by the EU and US—from humanitarian concerns to states' perceived softness on terrorism. However, the EU made no serious effort to build up its own capabilities to become a serious actor in international security.

The EU's idea of multilateralism was joint decision-making by a US-EU condominium. There was little room in this "international community" for the rest of the world in Latin America, Asia, Africa, not even major powers such as China or Russia. The EU made no contribution of any kind—much less than the US—in helping to draw a hobbled and potentially very unstable and dangerous Russia into the post-cold war order. The EU's conceit was that it could replace the old US-Russian bipolar world with a new US-EU one, except without Soviet military might. The offer of shared values alone turned out to be a poor substitute for sustaining such an arrangement. Furthermore, it was very late in the day that France suddenly rediscovered many of the traditional UN principles during the Iraq crisis, having happily discarded most of them at in previous years.

There will be no new unipolar order

The old order was imperfect, but much less bad than any other that is likely to replace it. There will be no New Order based on a unipolar US primacy, no matter how devastating the new military technology or ambitious the world-shaping ambitions of some of Mr Bush's foreign policy advisers. *Pax Americana* cannot rest on military might alone. Economically the US is also dominant, but not anywhere nearly as much as in the military dimension. Several of the main economies together easily match the US in this respect. Moreover, although the German and Japanese economies are ailing terribly, the US economy is at present hardly a picture of health, and the boom of the 1990s does not look like returning.

Even in the military sphere it will be a long time before the US erects its defensive nuclear shield, and several countries retain a nuclear deterrent. The hot "war against terror" is not a substitute in terms of mobilising followers for the cold war against the Soviet Union. If hegemony is not voluntarily accepted it will breed resistance. All empires need at least in part also to rest on moral and political authority. Furthermore, all this assumes that the US war in Iraq goes well. Permanent "shock and awe" cannot be the basis of a sustainable world order.

Soon after the events of September 11th 2001, the UK prime minister Tony Blair argued: "This is a moment to seize. The kaleidoscope has been shaken. The pieces are in flux. Soon they will settle again. Before they do, let us re-order this world around us" (speech at Labour Party conference in Brighton on October 2nd 2001). What has happened instead, with no small contribution from Mr Blair himself, is that the pieces lie scattered in all directions, and no one at present knows where even to begin looking for them, let alone how to begin constructing a new order.

The consequences for eastern Europe

So where does this all leave eastern Europe? If the east Europeans want a voice in European and world affairs, they can do so only through the EU, especially after the *de facto* demise of the UN. In economic affairs as well—the region's main concern—the new era is likely to be characterised by a much-increased focus on regionalism, instead of the previous multilateral arrangements. The Iraq crisis has provided another sharp reminder of the growing divergence between US and European capabilities, priorities and methods. This might in turn prove to be a catalyst for institutional changes within the union, to which the east European EU accession countries would now be in a position to contribute. However, even if there were a new will in the EU to try to forge a common foreign and security policy—which is by no means certain—this could not happen quickly.

Neither NATO nor the EU is likely to emerge from the Iraq crisis unscathed. At best, the east Europeans will be joining institutions that are in a state of considerable flux. The east Europeans appear unlikely, therefore, to join the sort of robust organisation they had envisioned in the 1990s. Instead, they will enter into far messier arrangements involving many conflicting pressures and challenges.

Eastern Europe: caught in the middle

Czech Republic

The outgoing Czech president, Vaclav Havel, signed the "Group of Eight" statement of support for the US position on Iraq in late January. The Czech Republic also signed up to the "Vilnius-10" letter that followed in early February. The Czech Republic has nevertheless tempered its generally pro-US stance on the Iraq issue since then, not least because of strong criticism from the French president, Jacques Chirac, in the wake of the Vilnius-10 statement. Mr Havel's recently elected successor, Vaclav Klaus, has expressed strong reservations about a strongly pro-US stance since taking office. The prime minister, Vladimir Spidla, also adopted a less pro-US stance than Mr Havel, and was clearly irritated that Mr Havel had not consulted him prior to signing the Group of Eight letter.

Slovakia

Slovakia signed up to the Vilnius-10 letter and voiced support for the Group of Eight letter. Even more so than the Czech Republic, public support in Slovakia for war in Iraq is decidedly less enthusiastic than is suggested by the government's position. Most Slovaks did not support NATO's bombing of Serbia in 1999 and are less supportive of NATO and military action in general. Although the prime minister, Mikulas Dzurinda, is pro-US and will continue to support the US position on Iraq, domestic opposition and criticism from Mr Chirac have forced him to do so more quietly than at the outset.

Estonia

Estonia is one of the Vilnius-10. Mr Chirac's statements in February were not well received in Tallinn. Nevertheless, the latest row does not seem to be affecting support for the EU, in a country that was already one of the most Eurosceptic of the accession countries. On questions of security Estonia still looks very much to the US for help and support. For the majority of Estonians, the actions of France and Germany in recent months appear only to have confirmed this. Estonians have not come out strongly against their government's position, and anti-war demonstrations have been few and far between.

Latvia

The Latvian government firmly supports the US on Iraq, whereas the public is largely against the war. Mr Chirac's statements in February were poorly received and fuelled concerns that smaller countries, such as the Baltic states, would not have equal representation in the EU. The spat has confirmed the Latvian government's view that the US will be the guarantor of Latvia's security and stability. However, the latest furore does not seem to have affected public opinion on EU accession.

Hungary

Hungary has allowed the US to use bases and air space in event of war in Iraq, and to train around 1,000 members of the Iraqi opposition at one of Hungary's airbases. Hungary's response is in part a reaction to the pressure it faces as a result of having being singled out as a laggard in NATO. Although the government is doing all it can to placate US concerns, public opposition to a war in Iraq is extremely high and would probably have remained high even had there been a second UN Security Council resolution. In light of this opposition and rising tension with EU member states, some government and opposition officials have criticised the prime minister, Peter Medgyessy, for his stance. Mr Medgyessy sought to smooth relations with France in early March, when he met Mr Chirac and emphasised his support for Iraq's peaceful disarmament.

Bulgaria

The government has expressed strong support for the US and is allowing US forces to use Bulgarian bases, which might serve as a substitute for Turkish bases. Bulgaria was forced to take a public position owing to its seat on the Security Council, and it was one of the four countries that backed a second resolution. The socialist president and opposition have expressed veiled criticism of the government's position, arguing in general terms that it should have adopted a position closer to that of the EU. The government's stance is shaped by the fact that it sees support for the US as key to its bid to join NATO. In addition, the government hopes to receive US help over Iraqi debts owed to Bulgaria.

Romania

Along with other east European states, Romania signed the Vilnius-10 letter supporting the US position on Iraq. Prior to that, Romania was one of the first countries to offer assistance to the US when it started to target Iraq, putting its Black Sea air and maritime space at the disposal of Washington, and welcoming large US troop deployments in the port of Constanta. Romania's parliament has also voted to send non-combatant troops to assist an invasion. Romania is hoping to be rewarded for its loyalty to the US with a stake in post-war reconstruction projects. Loyalty will no doubt guarantee membership of NATO, and Romania may benefit eventually from a shift of US bases in Europe from western to eastern Europe.

Poland

All mainstream politicians have expressed strong support for the US, although public opinion remains less convinced. Mr Chirac's comments condemning the east Europeans did not go down well in Warsaw, and the government faced criticism at home for not respond more strongly to Mr Chirac. Poland hopes that its firm support for the US could lead to US military bases being moved from Germany to Poland. Poland is providing 200 non-combat troops for the war.

Croatia

Although Croatia signed the "Vilnius-10" letter, both the prime minister, Ivica Racan, and the president, Stipe Mesic, have back-pedalled to assure both the public and Croatia's European allies that its signature did not imply unconditional approval of US policy. Under pressure also from the Croatian Democratic Union (HDZ), which strongly support the US position, the government has quietly offered to allow the US the use of its airspace during the war.

Ukraine

A series of damaging scandals—including allegations that the president, Leonid Kuchma, authorised the sale of radar systems to Iraq—have brought ties with both the US and NATO to a low point. Ukraine has therefore supported the US position on Iraq in an effort to shore up these relations. Mr Kuchma has stated that he will ask parliament to authorise stationing a chemical warfare battalion in Kuwait. However, given the time needed to deploy the battalion, the Ukrainian offer of assistance appears largely symbolic. A US-led occupation of Iraq could prove embarrassing for Ukraine if it unearths concrete proof that Ukraine sold radar systems or rocket engines to Iraq.

Lithuania

Lithuania has always been strongly pro-US, regarding the US as a more reliable guarantor of its security than the EU, and popular support for NATO membership has often outweighed that for EU accession. Criticism of the government's pro-US stance has been extremely muted, and there has been little evidence of any popular hostility to the US's policies on Iraq. Despite Mr Chirac's strongly worded criticism of the Vilnius-10, support for EU membership in Lithuania nevertheless remains among the highest of the accession states.

The special case of Russia

The strengthening world hegemony of the US is as unwelcome for Russia as it apparently is for France and Germany. The Russian president, Vladimir Putin, has opposed the war at the risk of inflicting long-term damage to the US-Russian relationship. Russia could be one of the main international losers from war in Iraq—which threatens not only Russian economic interests, but also the UN-based international security order in which Russia has a strong stake. Mr Putin's readiness to jeopardise his relationship with the US may reflect a hope that France will bear the brunt of any US retaliation. Even the most optimistic assessments, however, need to take into account that opposing the US will inevitably have repercussions. Mr Putin is unlikely to suffer any adverse domestic political repercussions for the severe setback that his pro-US course has suffered, especially in view of widespread public support for his policy on Iraq.

The background to Mr Putin's decision to oppose the US in the UN is a series of disappointments with the returns to his pro-US policy. The steady stream of concessions that Russia made since September 2001 was a reflection of Mr Putin's deep-seated commitment to his policy. Mr Putin had been prepared to accept a range of setbacks—such as US withdrawal from the anti-ballistic missile (ABM) treaty, the deployment of US forces in Central Asia, and the enlargement of NATO. He also took in his stride some disappointments over the economic benefits of the US-Russia relationship. Russia was not spared by US steel import restrictions in mid-2002, and the US's commitment to accelerating Russia's WTO entry talks has not extended to a reduction in the main demands made by US negotiators. The war in Iraq has been yet another serious setback for Russia, which also made Mr Putin's balancing act—of appeasing domestic critics while cultivating the US and other Western states—increasingly difficult to sustain.

EU enlargement timetable

The current crisis over Iraq is not expected to delay the timetable for the EU's eastward expansion. As argued above, France is unlikely to carry out its threat to hold a referendum on enlargement. The only referendums to be held will be those in the accession countries themselves. Malta, probably one of the most reluctant candidates, voted by a narrow majority on March 8th to join. Referendums will be held in all eight east European candidate countries, the last referendum being held on September 20th in Latvia. We still expect all the countries to opt for membership, although the results in some of the countries could be closer than present opinion polls suggest.

Dates of referendums on EU membership

Slovenia	Mar 23rd
Hungary	Apr 12th
Lithuania	May 10th-11th
Slovakia	May 16th-17th
Poland	Jun 8th
Czech Republic	Jun 15th-16th
Estonia	Sep 14th
Latvia	Sep 20th

Ten new members will join the EU in 2004

The accession countries are set to join the EU in May 2004, allowing them to participate in the election to the European Parliament in June. It is still unclear

how the current 20-member college of commissioners will reorganise to deal with the influx of new members seven months before its term of office is officially over. The European Commission will step down early, in November 2004, to make way for a new college composed of one commissioner from each member state.

The admission of the new members in 2004 will still leave Bulgaria and Romania outside the EU. They aim to join in 2007 and the European Commission's latest status report appeared to suggest that such a target date is realistic. Croatia applied for EU membership in February, and aims to join Bulgaria and Romania in the next enlargement round, although that would require a rapid positive response from the EU to its application and very rapid pace of negotiations of the chapters of the *acquis communautaire* (the body of EU law).

Economic forecast

The weak global recovery has had an impact on the transition region's economic performance. Average growth in the 27 transition economies in 2002 is estimated at a creditable 4%, down by 0.7 percentage points on the previous year. Although real GDP growth in the region slowed, this was by much less than might have been expected, given most of these countries' high dependence on trade with a weakly performing EU. Growth has remained high compared with most emerging markets, as well as with developed OECD economies. Thus 2002 was on the whole another successful year for eastern Europe, following the strong growth in 2001 and especially 2000. The gains of previous reforms in many countries helped to sustain growth, and foreign direct investment (FDI) into the region reached a new record total estimated at some US$34.5bn in 2002 (the overall FDI total was increased by the inclusion of estimates for reinvested earnings in Hungary, hitherto missing from the data).

Domestic demand has been driving growth

The main reason that the region has weathered the impact of weak global conditions is fairly strong domestic demand growth in most countries, supported by rising household incomes and easing interest rates. Buoyant domestic demand has made up for a declining or negative contribution to GDP growth of the external balance. The latter has been caused in large part by the weakness of EU economies. However, dependence on the EU varies considerably across the subregions. For the east-central European economies, exports to the EU account on average for two-thirds of total merchandise exports, and one-third of GDP. The EU accounts for about 60% of total exports of the Balkan and Baltic economies. In the case of the Baltic states this represents on average just over one-quarter of these countries' GDP; for the less internationally integrated Balkan economies, which tend to have much lower trade/GDP ratios, the average share of EU exports in GDP is only about 14%.

Export dependence, 2001[a]

	Total exports	Exports to EU		Main export destination		
	% of GDP	% of total exports	% of GDP	Country	% of total exports	% of GDP
East-central Europe	**48.4**	**66.9**	**32.1**	**-**	**-**	**-**
Czech Republic	58.9	67.9	40.0	Germany	38.9	22.9
Hungary	54.1	74.4	40.2	Germany	36.0	19.4
Poland	17.2	69.8	12.0	Germany	35.0	6.0
Slovakia	61.7	59.9	37.0	Germany	27.0	16.7
Slovenia	49.9	62.6	31.3	Germany	26.4	13.2
Balkans	**24.5**	**58.9**	**13.7**	**-**	**-**	**-**
Albania	7.6	92.1	7.0	Italy	66.8	5.1
Bosnia and Hercegovina	22.0	51.3	11.3	Italy	22.4	4.9
Bulgaria	37.7	55.2	20.8	Italy	15.1	5.7
Croatia	23.5	53.4	12.5	Italy	23.1	5.4
Macedonia	33.5	49.9	16.7	Serbia and Montenegro	29.3	9.8
Romania	28.7	67.3	19.3	Italy	23.9	6.8
Serbia and Montenegro	18.4	43.3	8.0	Italy	16.4	3.0
Baltics	**43.5**	**60.7**	**27.1**	**-**	**-**	**-**
Estonia	60.3	72.7	43.9	Finland	23.1	14.0
Latvia	29.2	61.6	18.0	Germany	16.9	5.0
Lithuania	40.8	47.8	19.5	UK	13.8	5.6

Export dependence, 2001[a]

	Total exports	Exports to EU		Main export destination		
	% of GDP	% of total exports	% of GDP	Country	% of total exports	% of GDP
CIS	**37.7**	**27.9**	**10.1**	**-**	**-**	**-**
Russia	32.8	38.7	12.7	Germany	9.9	3.2
Ukraine	45.5	20.2	9.2	Russia	23.4	10.7
Belarus	59.6	11.1	6.6	Russia	53.1	31.6
Moldova	38.5	21.4	8.3	Russia	43.7	16.8
Armenia	16.6	21.8	3.6	Russia	17.9	3.0
Azerbaijan	36.4	73.2	26.6	Italy	57.2	20.8
Georgia	15.8	40.5	6.4	Turkey	19.9	3.2
Kazakhstan	40.7	23.9	9.7	Russia	16.6	6.7
Kyrgyz Republic	31.4	26.9	8.5	Germany	23.8	7.5
Tajikistan	63.9	32.9	21.0	Russia	16.1	10.3
Turkmenistan	43.9	10.9	4.8	Ukraine	15.4	6.8
Uzbekistan	26.7	13.6	3.6	Russia	16.7	4.5
Transition economies (av)	**36.9**	**46.8**	**17.0**	**-**	**-**	**-**

[a] Exports refer to merchandise exports. Regional and subregional averages are unweighted means.

Sources: Economist Intelligence Unit; IMF; national statistics.

The negative impact of global conditions has been compounded by the fact that Germany and Italy, the regions' main EU partners, have been among Europe's weakest performing economies. Germany alone accounts for one-third of east-central Europe's merchandise exports and for an average 16% of GDP. Italy is the main trade partner for the Balkans economies, with somewhat lower dependency ratios than the corresponding figures for east-central Europe and Germany.

The adverse impact of the global slowdown has been strongest on east-central Europe, where GDP growth remained weak at 2.1% in 2002, the same as in 2001, making it the slowest growing subregion among the transition economies. This was also in part attributable to the weak performance of the Polish economy, but also to that of the Czech economy. The Czech Republic's performance was affected by the sluggish recovery of international markets, the strong appreciation of the Czech koruna, and the floods that hit the country in August of 2002. The Hungarian economy continued to expand at a relatively healthy pace. Real GDP expanded by 3.3% year on year in the third quarter, as domestic demand growth is being supplemented by some strengthening of exports.

The Baltic states were the fastest growing subregion, with real GDP increasing by 5.5% in 2002. Although growth in the Commonwealth of Independent States (CIS) economies was weaker than a year ago, the average real GDP growth rate was still almost 5%. Real GDP in south-east Europe increased by 4.3%, similar to the growth rate of a year ago.

High oil prices benefit CIS energy producers

The continuation of high oil prices has benefited the oil-exporting CIS countries. Azerbaijan, Kazakhstan, Russia and Turkmenistan experienced robust growth, although average growth slowed from 2001 levels. Increased investment in production capacity in the energy sector has also supported economic activity in these countries. Russia represents a major export market for many of the CIS countries, and continued growth in Russia has also

sustained growth in the subregion. Russia is the leading export market for Ukraine, Belarus, Armenia, Kazakhstan, Moldova, Tajikistan and Uzbekistan. The dependence is highest in the case of Belarus, which sends more than half of its exports to Russia, and for Moldova (44% of total exports). It is also significant for Ukraine—exports to Russia make up one-quarter of Ukraine's total exports and account for about 10% of its GDP. However, the dependence of the other CIS countries—although often significant—is lower than the corresponding dependence of east-central Europe on Germany.

Global outlook

International assumptions

	2002	2003	2004	2005	2006	2007
Real GDP growth (%)						
US	2.4	2.3	3.2	3.1	3.1	3.0
EU	0.9	1.3	2.1	2.3	2.2	2.3
World (market exchange rates)	1.8	2.2	3.0	3.0	3.0	3.0
World (PPP exchange rate)	2.8	3.1	3.8	3.9	3.9	4.0
World trade growth (%)						
Goods	2.9	4.9	6.1	6.3	6.5	6.5
Consumer price inflation (%)						
US	1.6	2.3	2.5	2.9	3.1	3.0
Export price inflation						
Manufactures (US$)	0.4	5.9	0.5	0.5	0.8	1.0
Commodities						
Oil (Brent; US$/b)	25.0	26.6	19.6	17.4	16.4	15.5
Non-oil commodities	8.6	8.7	0.0	7.0	3.6	1.0
Food, feedstuffs and beverages	13.1	11.5	-3.1	4.4	3.9	3.4
Industrial raw materials	2.0	4.0	5.4	11.1	3.0	-2.5
Interest rates (%)						
US$ 3-month commercial paper rate (av)	1.7	1.3	3.1	5.7	6.0	6.0
€ 3-month interbank rate (av)	3.3	2.4	2.9	4.2	4.3	4.3
US 10-year government bond yield (av)	4.6	4.0	6.3	6.5	6.5	6.5
10-year German government bond yield (av)	4.8	3.9	4.6	5.0	5.0	5.0
Exchange rates						
US$:€ (av)	0.95	1.12	1.11	1.08	1.06	1.05
¥:€ (av)	118.6	134.1	134.3	130.1	127.3	125.0
¥:US$ (av)	125.3	120.3	121.5	120.5	119.5	118.5

The global economic recovery remains weak, and there are multiple downside risks to the Economist Intelligence Unit's baseline global forecast. The driving forces behind the initial phase of the 2002 recovery, especially in the US, were strong, but much of the impetus has proved short-lived. Weak and volatile stockmarkets, accounting scandals, accumulated debts, worries about a war in Iraq, and reassessments of long-term profitability have kept investors cautious throughout the world. Global real GDP growth—using purchasing power parity (PPP) exchange rate weights—is estimated at 2.8% in 2002 (1.8% at market exchange rates). Only a moderate pick-up is forecast for 2003—to 3.1% at PPP and 2.2% at market exchange rates.

US growth in 2002 was stronger than in the EU, and is set to remain so this year, largely because of the aggressive US policy response to the downturn in

comparison to that in Europe. Between 2000 and 2002 short-term interest rates were cut by 4.3 percentage points in the US—compared with 1.5 percentage points for the euro zone. In addition, the structural primary budget balance was loosened by 2.8% of GDP in the US, compared with a broadly neutral stance in the euro zone. Nevertheless, the forecast for the US remains modest compared with the 1990s, with real GDP growth of 2.3% in 2003, about the same as the 2.4% rate recorded in 2002.

EU recovery remains weak

The economic recovery in the EU remains very sluggish. EU output started to rise weakly in the first quarter of 2002, but the pace of recovery is not picking up. The impact of euro appreciation on exports will only partly be offset by recent reductions in interest rates. With the economies of Germany and Italy, the transition region's main trade partners, growing especially slowly, the recovery in the EU has been weak: EU real GDP growth (estimated at 0.9% in 2002) is forecast to rise to only 1.3% in 2003.

Export market growth[a]
(%)

	2000	2001	2002	2003
East central Europe	**11.5**	**2.6**	**0.6**	**3.8**
Czech Republic	11.4	2.2	0.1	3.5
Hungary	11.6	2.3	-0.1	3.5
Poland	11.6	3.0	0.7	3.9
Slovakia	11.6	3.4	0.7	4.2
Slovenia	11.4	2.2	1.3	3.8
Balkans	**11.9**	**1.4**	**3.0**	**4.3**
Albania	9.8	0.7	2.7	2.9
Bosnia & Hercegovina	11.0	3.1	3.5	5.0
Bulgaria	14.0	-0.9	4.3	4.6
Croatia	10.5	3.3	2.2	4.1
Macedonia	11.8	3.2	3.4	5.5
Romania	12.7	0.1	2.4	3.7
Serbia and Montenegro	13.4	0.3	2.4	4.4
Baltics	**12.1**	**2.7**	**2.2**	**5.1**
Estonia	12.0	2.5	1.9	5.3
Latvia	12.2	2.8	2.4	4.9
Lithuania	11.3	3.6	2.8	5.2
CIS	**12.5**	**6.2**	**5.7**	**6.1**
Russia	13.7	1.8	3.8	5.7
Ukraine	14.3	4.7	6.6	6.1
Belarus	12.5	12.2	7.7	7.4
Moldova	12.9	7.5	5.2	5.4
Armenia	11.3	7.7	2.6	5.9
Azerbaijan	11.3	9.2	5.9	6.2
Georgia	14.8	0.6	7.7	7.0
Kazakhstan	12.3	7.7	6.3	5.8
Kyrgyz Republic	9.5	4.8	3.9	6.4
Tajikistan	10.2	5.0	4.8	5.6
Turkmenistan	12.7	7.9	6.8	5.5
Uzbekistan	14.2	5.3	7.3	6.5
Transition economies	**12.1**	**3.9**	**3.7**	**5.1**

[a] Based on import demand in 20 leading partner countries. 2000 weights. Regional and subregional growth rates are unweighted averages.

External demand for the transition region's exports is expected to strengthen in 2003. Averaged over all 27 transition countries, average import demand growth in 20 main trading partner countries is projected to rise to 5.1% in 2003, from 3.7% in 2002 and 3.9% in 2001—still far short of the buoyant conditions seen in 2000. The transition countries' average masks some significant inter-country variation. The strengthening in 2003 in external demand, relative to 2002, will be strongest in the externally most dependent subregions, east-central Europe and the Baltics.

Oil prices have risen sharply in recent months, as the markets priced in the risk of an Iraq war and as a result of disruptions to Venezuelan supplies. The beginning of the war and end of uncertainty led to some decline in prices, but these could still, at least temporarily, spike higher. If the conflict is brief and world oil supplies are not seriously disrupted, prices should quickly fall back again. We therefore expect oil prices to average US$26.6/b in 2003. They are expected to fall steadily to under US$20/b over the medium term, as the fundamental oversupply in the market reasserts itself.

We forecast that the US dollar:euro exchange rate will average US$1.12:€1 in 2003. Given sluggish world economic conditions, global interest rates are set to remain low in the short term. The low level of world interest rates will reduce debt-service payments on foreign debt in the region. The strengthening of the euro against the US dollar will also ease the debt burden for most countries in the region, and should help to limit the impact on inflation of a rise in oil prices. However, for many countries—those whose currencies are tied to or track the euro in one way or another—it will also reduce the competitiveness of exports to markets outside the euro zone.

An array of risks

A number of risks mar the global outlook. Most countries in the region would be highly exposed to the impact of a possible prolonged increase in oil prices, triggered by a prolonged war in Iraq, and the effects of a complete stalling of EU recovery. The CIS oil-exporting countries would stand to gain in the short term were there a war-related spike in oil prices. Despite the mitigating effects of buoyant energy prices, the uncertainties surrounding the war in Iraq are also a fundamental source of risk for these economies. Over the longer term continued volatility and uncertainty, and the potentially strong negative impact that a war could have on the global economy—in addition to negative geopolitical repercussions—would tend to offset the short-term price gains. Furthermore, should Iraqi oil production expand significantly following a removal from power of Saddam Hussein, this would depress prices and also hurt the CIS energy exporters.

Another risk to the global forecast is related to the outlook for the US, which accounts for about 30% of world output. Imbalances in the US economy—notably the large current-account deficit and the high level of private-sector debt—could become unsustainable and lead to a sharp slowdown, or even recession. US imports would decline, leading to slower EU growth. There is a related risk that the value of the US dollar could plunge sharply, rather than weaken gradually, as our baseline assumptions anticipate. A sharp drop in the US dollar would trigger a slump in US and then other equity markets. This

would halt the EU's recovery, hitting the transition region's exports and its access to foreign capital.

Growth based on domestic demand is unsustainable

The uncertainties surrounding the global economic outlook and the weak economic performance of western Europe present the main risk to prospects for the transition economies. The latter have so far largely avoided the effects of the global economic weakness, largely owing to the continuing recovery in their domestic demand, which has underpinned the relatively high level of economic activity in 2002. However, these economies could not escape for long the negative effects of a protracted weakness in the global economy. The shift away from export-led growth places the transition economies in a vulnerable position. Most of these economies have large current-account deficits and a weakening of their external balances would pose certain risks.

Short-term growth outlook

Average real GDP growth in 2003 is forecast at 3.9%, similar to 2002. There will be an acceleration in eastern Europe—from 2.7% in 2002 to 3.9% in 2003—given the impact of the expected pick-up in EU demand. Growth is forecast to accelerate in each east-central European country, save Slovakia. In Poland, we project that growth will pick up strongly to 3.5%, after the poor performance in 2001-02, the two weakest years for the economy since the early 1990s. The financial condition of the Polish corporate sector is gradually improving, and this will eventually provide conditions for investment to grow again. Exports are recovering from a period of weakness. In Hungary, growth is forecast to increase to 3.8%, from 3.3% in 2002, on the back of improving export performance. Growth in the Czech Republic and Slovenia should be relatively buoyant in 2003.

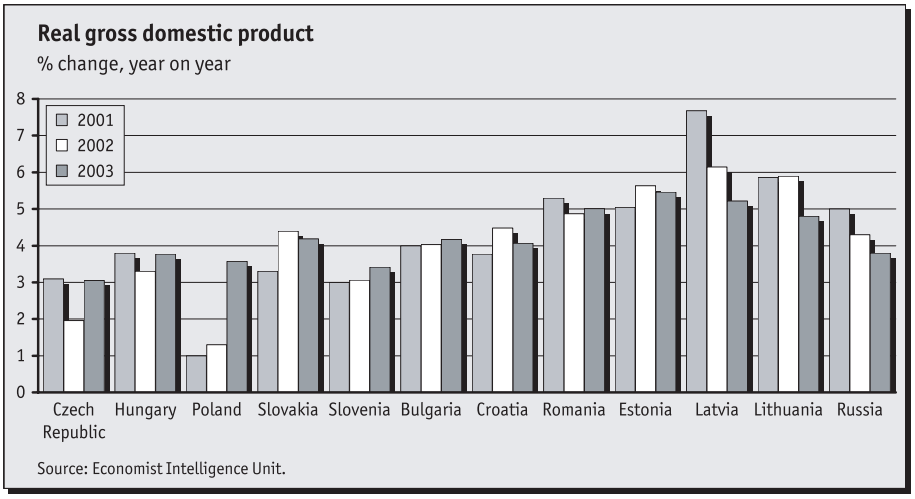
In the Balkans, Bulgaria and Romania are expected to record real GDP growth rates of 4.5-5% in 2003. The main boost to real GDP growth in Romania is expected to come from an acceleration of investment growth, as privatisation gathers pace and inflows of FDI increase. After a poor recent performance some pick-up is expect in both Macedonia and Serbia and Montenegro. The Baltic states will remain the best-performing subregion, although average growth is forecast to decelerate from 5.5% in 2002 to 5.1% in 2003, largely because of an expected slowdown in Lithuania.

Growth is expected to remain relatively high in most of the CIS in the short term. Growth in Russia, although experiencing some slowdown, will continue to be led predominantly by domestic demand (mainly private consumption), but the continued firmness in oil prices in 2003 will also be beneficial for the economy. Rapid economic expansion is expected to continue into 2003 in two of the other oil-exporting countries—Azerbaijan and Kazakhstan. Both countries have benefited from large inflows of FDI in the energy-related sectors of the economy, and these sectors will continue to be the main engines of growth thanks to increased production and export capacities.

Macroeconomic indicators

(%; annual average)

	GDP growth			Inflation		
	2001	2002	2003	2001	2002	2003
East-central Europe	**2.1**	**2.1**	**3.5**	**7.0**	**4.0**	**4.1**
Czech Republic	3.1	2.0	3.0	4.7	1.8	1.6
Hungary	3.8	3.3	3.8	9.2	5.3	5.5
Poland	1.0	1.3	3.6	5.5	1.9	-0.5
Slovakia	3.3	4.4	4.2	7.1	3.3	8.5
Slovenia	3.0	3.1	3.4	8.4	7.5	5.4
Balkans	**4.4**	**4.2**	**4.5**	**20.6**	**8.1**	**5.6**
Albania	6.5	5.0	6.5	3.1	5.1	2.5
Bosnia and Hercegovina	2.3	3.8	4.0	3.9	0.8	0.8
Bulgaria	4.0	4.0	4.2	7.4	5.8	3.9
Croatia	3.8	4.5	4.1	5.2	2.3	2.8
Macedonia	-4.6	0.3	3.0	0.9	0.6	0.7
Romania	5.3	4.9	5.0	34.5	22.5	15.0
Serbia and Montenegro	5.5	3.0	4.0	88.9	19.2	13.7
Baltics	**6.2**	**5.9**	**5.1**	**3.2**	**1.9**	**1.8**
Estonia	5.0	5.6	5.5	5.8	3.6	2.8
Latvia	7.7	6.1	5.2	2.5	1.8	2.1
Lithuania	5.9	5.9	4.8	1.3	0.3	0.4
CIS	**6.1**	**4.9**	**4.0**	**17.2**	**11.1**	**12.2**
Russia	5.0	4.3	3.8	21.6	15.8	14.3
Ukraine	9.1	4.1	3.1	12.0	0.8	6.0
Belarus	4.1	4.2	2.5	61.1	42.8	35.0
Moldova	6.1	7.2	5.0	9.8	5.0	7.5
Armenia	9.6	12.5	7.0	3.1	1.1	5.5
Azerbaijan	9.9	10.6	8.0	1.6	2.7	3.2
Georgia	4.5	4.0	6.5	4.6	5.7	6.0
Kazakhstan	13.2	9.5	6.8	8.4	6.0	6.4
Kyrgyz Republic	5.3	-2.1	1.0	6.9	2.1	3.2
Tajikistan	10.2	9.1	6.0	38.6	12.2	15.5
Turkmenistan	20.5	16.0	8.0	11.6	15.0	20.0
Uzbekistan	4.5	4.2	3.5	27.2	24.0	24.3
Eastern Europe	**2.8**	**2.7**	**3.8**	**14.9**	**6.3**	**5.0**
Eastern Europe and the former Soviet Union	**4.7**	**4.0**	**4.0**	**14.6**	**8.0**	**7.9**



Medium-term growth outlook

The medium-term outlook for the region, on our baseline assumptions, is favourable. EU demand is expected to recover over the medium term, allowing for continued export growth in much of eastern Europe. FDI inflows are likely to remain strong, and productivity growth, although slower than in past years, should continue to outstrip that in the EU. Average growth of 4-5% per year should be sustainable over the medium term, driven by capital goods and technology imports, higher savings rates and improvements in infrastructure. The average contribution to GDP of the private sector in the region now exceeds 60% and will increase further, with a consequent beneficial impact on efficiency.

A limited accession dividend

Our medium-term forecasts do not foresee a massive sudden "accession dividend" for those countries expected to join the EU in 2004. The main integration gains have already occurred from increased trade and FDI, and the scope for significant additional gains in these areas may be limited. However, there should be some further improvement in market access, and eventual membership of European economic and monetary union (EMU) should yield further benefits. In so far as it has not been discounted by investors already, EU membership might also further enhance investors' confidence and positive perceptions of these countries. Structural reforms and the improvement of administrative capacity associated with final preparations for membership should strengthen the efficiency of the economies (although the achievement of EU membership might lead to some relaxation of reform efforts that were driven by the accession preparations). On balance—since the adoption of some aspects of the *acquis communautaire* (the body of EU law) and EU standards will also reduce the flexibility and the vitality of these economies—accession should only marginally improve growth prospects.

Although structural reforms are being pursued in many CIS countries, in general implementation is not as advanced or as widespread as in the EU candidate countries. The recent boom in hydrocarbons prices has provided an impetus to growth, facilitated the introduction of a number of reforms in many of the oil-exporting countries, and contributed to an increase in investment outlays (particularly in the energy sector). However, given the volatility of energy prices, these economies will not be able to sustain higher growth rates until diversification from energy becomes much more broadly based. In Russia, further acceleration of growth much beyond 4% appears unlikely over the medium and long term. Gross fixed investment still only accounts for less than 20% of GDP—too low for the kind of restructuring and modernisation that Russia would require to catch up with the West.

Inflation

In 2002 there was a fall in average inflation in the region, to 8%, a significant deceleration from the rate in 2001. As in 2001, the lower inflation in 2002 was not the result of more moderate domestic cost-push or demand-pull factors, but in general the reflection of good harvests and the real appreciation (in some cases significant) of exchange rates. In 2003 average inflation is expected to be much the same as in 2002. Wage inflation has remained strong and rose much faster than labour productivity in industry, particularly in those countries where the slowdown in industrial output was accentuated by declining foreign

demand. On the demand side, the strong growth in private consumption so far does not appear to have been inflationary.

External financing

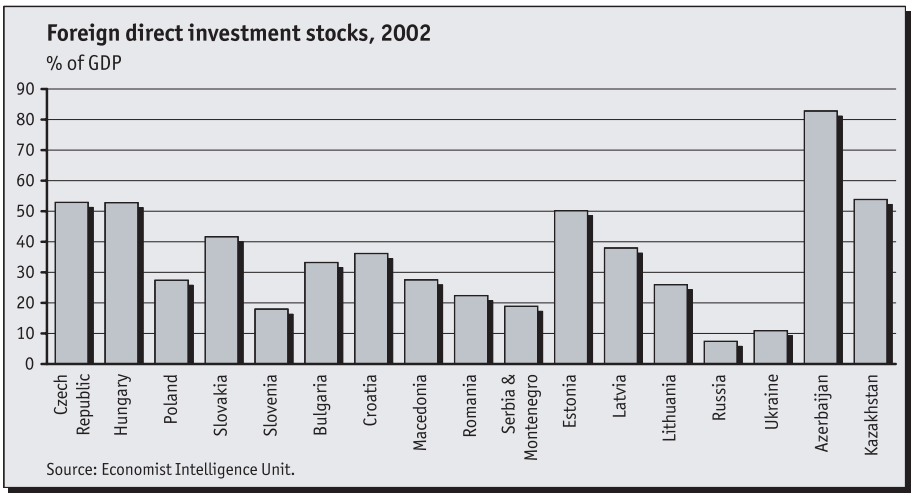
Current-account deficits have continued to be financed fairly easily by foreign capital inflows. Available data indicate a further marked increase in net foreign capital inflows into the transition economies in 2002. Several factors—including continued reform progress, solid external financial positions and approaching EU membership for a large group of candidate countries—have benefited the region by reducing international investors' risk perceptions. However, the situation varies considerably across countries. Some of the advanced reformers and even Russia have been considered as safe havens by investors during periods of market turbulence. Nevertheless, this is still not a region-wide phenomenon, and has affected to a far lesser degree the CIS and Balkan countries.

Capital flows are dominated by FDI

Foreign capital inflows continue to be dominated by FDI flows. Despite the generally unfavourable international climate for FDI, and falling global FDI flows (even into emerging-market areas, where inflows have been more stable in recent years than in the developed world, where—in which FDI has been greatly affected by the collapse in merger and acquisition activity), inflows into the transition region have by contrast increased in 2002, and a further increase is forecast for 2003.

Foreign direct investment

FDI inflows into the transition region in 2002 reached a new record total of US$34.5bn, and thereby bucked the worldwide trend of stagnant or declining FDI. Inflows are forecast to increase further, to some US$40bn, in 2003, and to remain strong over the medium term. The record total in 2002 was achieved despite lower OECD growth and more difficult financing conditions. The effects of the latter were offset by the increased relative attractiveness of the region compared with most other emerging markets; further sales of state assets; and increased cost-cutting pressures on Western companies, which enhanced the attractiveness of relocating operations to eastern Europe. Strong investment growth, rapid structural change and dramatic improvements in competitiveness (driven mainly by FDI) in recent years put most central and east European economies in a strong position to withstand the short-term slump in EU demand.



The dominant transaction during the year involved the €4bn (US$4bn) privatisation of Transgas, the Czech natural gas monopoly. Other large privatisation deals included Slovakia's sales of a 49% stake in gas monopoly SPP for US$2.7bn, and the privatisation of the Slovenian bank Nova Ljubljanska banka (NLB). The overall results for the region were influenced by the large FDI flows into the Czech Republic, which surpassed US$8bn, beating the prior record set in 1999, when FDI inflows reached US$6.3bn. More than half of the total in 2002 came from privatisation, but new investments in established companies were also important.

Foreign direct investment inflows
(US$ m)

	1998	1999	2000	2001	2002	2003
East-central Europe	**13,489**	**17,499**	**19,999**	**16,936**	**22,252**	**17,933**
Czech Republic	3,699	6,313	4,986	4,923	8,350	5,000
Hungary	2,649	3,454	3,483	4,322	2,700	2,862
Poland	6,365	7,270	9,341	5,713	5,400	6,700
Slovakia	561	355	2,053	1,475	4,000	1,900
Slovenia	215	107	136	503	1,802	1,471
Balkans	**3,843**	**3,686**	**3,631**	**4,236**	**3,636**	**4,660**
Albania	45	41	143	207	160	150
Bosnia and Hercegovina	67	177	146	125	256	310
Bulgaria	537	806	1,002	692	520	800
Croatia	932	1,479	1,115	1,447	950	1,000
Macedonia	118	30	176	443	75	150
Romania	2,031	1,041	1,025	1,157	1,200	1,600
Serbia and Montenegro	113	112	25	165	475	650
Baltics	**1,863**	**1,140**	**1,176**	**1,162**	**1,407**	**1,625**
Estonia	581	305	387	539	307	525
Latvia	357	348	410	177	400	450
Lithuania	926	487	379	446	700	650
CIS	**6,782**	**6,867**	**5,443**	**6,881**	**7,175**	**15,330**
Russia	2,764	3,309	2,713	2,468	2,600	10,000
Ukraine	743	496	595	792	850	1,000
Belarus	203	444	119	100	150	150
Moldova	76	41	143	104	70	80
Armenia	221	122	104	70	100	100
Azerbaijan	1,023	510	130	227	1,000	1,400
Georgia	265	82	131	110	100	120
Kazakhstan	1,151	1,587	1,283	2,763	2,000	2,200
Kyrgyz Republic	109	44	-2	5	50	50
Tajikistan	25	21	22	22	25	30
Turkmenistan	62	89	131	150	150	100
Uzbekistan	140	121	75	71	80	100
Eastern Europe	**17,332**	**21,185**	**23,630**	**21,173**	**25,888**	**22,593**
Eastern Europe & the former Soviet Union	**25,978**	**29,191**	**30,249**	**29,216**	**34,470**	**39,548**

Source: National statistics; IMF; Forecast for 2003 Economist Intelligence Unit.

Buoyant medium-term FDI outlook

Although global economic activity is not expected to pick up appreciably until the second half of 2003, FDI inflows into the region are forecast to increase further in 2003 to some US$40bn, which will represent a new record total. Inflows are expected to remain buoyant in 2004-07. Improving business environments will be the main spur to FDI inflows, especially as privatisation

opportunities wind down in the more advanced economies of the region. Productivity growth will tend to offset the negative impact on FDI of rising wage costs.

A large part of the total for the region will continue to go into the traditional leading recipients—the Czech Republic, Hungary and Poland—which will together attract almost 40% of the cumulative forecast total of US$220bn FDI into the transition region over the next five years. Good overall performance will in part be underpinned by existing foreign-owned ventures, and will in turn stimulate further FDI inflows. The composition of FDI is likely to change over the medium term. FDI directed towards gaining access to host-country markets will tend to decline as trade barriers come down further in eastern Europe, making the local market easier to supply through imports rather than local production. Meanwhile, FDI that seeks to relocate production for cost reasons (mainly taking advantage of eastern Europe's well-trained and cheap labour force) is likely to pick up. This type of investment is more likely to bring productivity gains and add to the export potential of the host economy. With privatisation programmes drawing to a close in many applicant countries, they can now expect increasing follow-up investment to make the privatised entities more efficient, and, most probably, a pick-up in greenfield investment projects. This should boost investment rates, speed up the transfer of technology and also create spillover effects as foreign-owned enterprises integrate with local suppliers and downstream enterprises.

Foregone FDI in Russia

Russia has made remarkable progress recently in stabilising its polity and economy. The reform process has been accelerated, with a raft of structural reform legislation adopted over the past two years. However, foreign investment has so far remained a notable absentee from Russia's success story, with inflows at a still paltry US$2.6bn in 2002, equal to the meagre average inflows in 2000-01. However, Russia's total FDI inflows will rise sharply in 2003 because of the recent US$6.75bn investment by BP (UK). Russia, a notable FDI laggard so far, is expected to become the main destination country in the region over the medium term (although as a share of GDP and in per-capita terms inflows will still remain relatively modest). Implementation of reforms will remain a serious problem, but Russia is nevertheless expected to record a substantial improvement in its business environment in the medium term. World Trade Organisation (WTO) membership in a few years and eroding hostility in Russia towards foreign capital will have a positive impact. Inflows into Russia are projected to average about US$10bn per year in 2003-07, almost four times the modest US$2.8bn average recorded in 1998-2002. This is expected to make up more than 20% of the total FDI inflows into the region in 2003-07.

Other CIS energy producers will continue to attract significant FDI over the medium term. The investment plans of a group of large and well-established investors in the oil and gas sector mean steady inflows of up to US$2bn per year in Kazakhstan in 2003-07. In Azerbaijan, additional pipeline capacity will be an important consideration for new investment.

Business environment rankings

East European business environments are expected to improve at a fairly rapid pace over the medium term. Despite a slowdown in 2001-02, growth of 4-5% per year in 2003-06 will be driven by the expected results of earlier reforms, the effect on productivity of rising imports of capital goods and technology imports, higher savings rates, and improvements in infrastructure. Macroeconomic orthodoxy is likely to be adhered to in most of the region, suggesting that average inflation will continue to decline, despite a temporary upturn in 2003. Rising domestic and foreign investor confidence should help policymakers to maintain fiscal and monetary prudence.

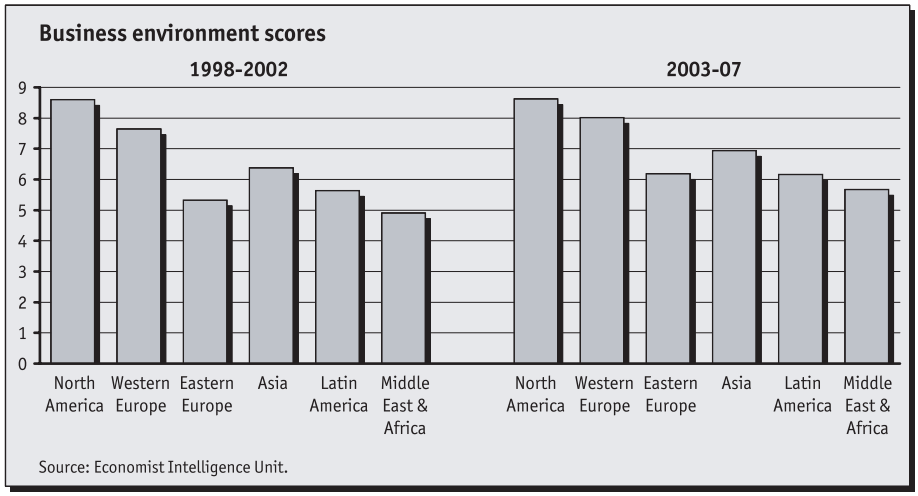
Across the region, most aspects of the business environment are expected to improve in 2003-07. More liberal policies towards the private sector, changes in tax regimes, further liberalisation of foreign trade and exchange regimes, and infrastructure development imply an average business environment in 2002-06 that will be significantly better than in the 1990s—although it will still lag considerably behind western Europe and leading emerging markets.

Business environment scores and ranks

	1998-2002 Total score [a]	1998-2002 Global rank [b]	2003-07 Total score [a]	2003-07 Global rank [b]	Change in total score	Change in rank	Grade 1998-2002	Grade 2003-07
Azerbaijan	4.37	55	5.30	52	0.93	3	very poor	poor
Bulgaria	5.42	41	6.24	40	0.82	1	poor	moderate
Czech Republic	6.55	27	7.40	26	0.85	1	good	good
Hungary	6.72	25	7.24	27	0.52	-2	good	good
Kazakhstan	4.81	50	5.22	54	0.41	-4	very poor	poor
Poland	6.37	32	7.14	29	0.76	3	moderate	good
Romania	4.67	51	5.69	48	1.02	3	very poor	moderate
Russia	4.54	53	5.97	46	1.42	7	very poor	moderate
Slovakia	5.78	34	6.54	34	0.76	0	moderate	good
Ukraine	4.06	58	5.23	53	1.16	5	very poor	poor
World average	**6.37**	**–**	**6.93**	**–**	**0.56**	**–**	**moderate**	**good**

Note. Qualitative grades are assigned according to the following scale: very good, score more than 8; good, 6.5-8; moderate, 5.5-6.4; poor, 5-5.4; very poor, less than 5.

[a] Out of 10. [b] Out of 60 countries.



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Data summary

	2001	2002	2003	2004	2005	2006	2007
Population (million)							
Balkans	29.6	29.5	29.4	29.4	29.3	29.2	29.2
Visegrad	64.0	64.1	64.0	64.0	64.0	63.9	63.9
CIS	216.0	214.8	213.8	213.1	212.4	211.8	211.2
East Europe (excl CIS)	93.6	93.6	93.5	93.3	93.2	93.2	93.1
East Europe (incl CIS)	309.6	308.4	307.3	306.4	305.6	304.9	304.3
GDP growth rates (%)							
Balkans	4.9	4.8	4.9	5.0	4.8	4.6	4.6
Visegrad	2.1	2.0	3.5	3.9	4.1	4.2	4.0
CIS	6.1	4.7	4.1	4.3	4.9	4.5	4.4
East Europe (excl CIS)	2.7	2.6	3.8	4.1	4.3	4.3	4.1
East Europe (incl CIS)	4.6	3.8	4.0	4.3	4.6	4.4	4.3
GDP (US$ bn) at nominal exchange rates							
Balkans	53.3	60.8	73.0	78.8	85.3	91.4	99.3
Visegrad	292.2	322.3	382.2	408.5	434.7	464.4	498.6
CIS	376.1	426.9	479.8	527.8	585.0	645.7	712.2
East Europe (excl CIS)	345.4	383.1	455.2	487.3	520.0	555.8	597.9
East Europe (incl CIS)	721.5	810.1	935.0	1,015.1	1,105.0	1,201.5	1,310.1
GDP per head (US$) at nominal exchange rates							
Balkans	1,799.6	2,060.3	2,479.3	2,684.0	2,911.6	3,129.2	3,407.2
Visegrad	4,562.0	5,032.3	5,970.1	6,383.7	6,797.2	7,263.7	7,800.3
CIS	1,741.4	1,987.4	2,244.0	2,477.5	2,754.4	3,049.1	3,372.3
East Europe (excl CIS)	3,688.8	4,094.8	4,870.7	5,220.2	5,576.8	5,966.8	6,424.1
East Europe (incl CIS)	2,330.4	2,626.8	3,042.9	3,313.0	3,615.5	3,940.5	4,305.8
GDP (US$ bn) at purchasing power parities							
Balkans	152.0	161.1	171.4	183.7	192.5	201.4	210.7
Visegrad	571.8	590.0	620.0	657.4	684.4	713.3	741.6
CIS	986.8	1,045.1	1,104.1	1,175.6	1,213.2	1,267.5	1,322.4
East Europe (excl CIS)	723.8	751.1	791.5	841.1	876.9	914.7	952.3
East Europe (incl CIS)	1,710.6	1,796.2	1,895.5	2,016.7	2,090.1	2,182.2	2,274.7
GDP per head (US$) at purchasing power parities							
Balkans	5,134.7	5,458.1	5,824.9	6,256.4	6,574.3	6,890.9	7,226.4
Visegrad	8,928.0	9,212.0	9,684.5	10,274.2	10,700.9	11,158.0	11,602.1
CIS	4,569.5	4,865.1	5,163.9	5,517.8	5,712.4	5,985.9	6,262.1
East Europe (excl CIS)	7,728.9	8,027.9	8,468.9	9,010.6	9,404.8	9,819.4	10,231.4
East Europe (incl CIS)	5,525.1	5,824.7	6,169.1	6,581.9	6,838.9	7,157.1	7,476.3
Consumer price inflation (%)							
Balkans	26.6	17.7	11.8	10.2	8.8	7.9	7.3
Visegrad	9.3	3.3	5.6	4.9	4.7	4.3	3.7
CIS	19.1	12.9	12.5	11.1	9.8	8.1	7.2
East Europe (excl CIS)	12.9	6.4	6.9	6.1	5.6	5.1	4.5
East Europe (incl CIS)	16.5	10.2	10.2	9.0	8.1	6.8	6.1
Merchandise exports (US$ bn)							
Balkans	16.5	19.4	22.7	23.6	25.4	27.4	29.6
Visegrad	104.4	116.3	142.5	156.0	168.3	182.4	197.0
CIS	129.8	137.4	146.3	142.3	148.2	155.8	162.1
East Europe (excl CIS)	120.9	135.7	165.2	179.6	193.7	209.8	226.6
East Europe (incl CIS)	250.7	273.2	311.4	321.9	342.0	365.6	388.7

	2001	2002	2003	2004	2005	2006	2007
Merchandise imports (US$ bn)							
Balkans	-21.0	-23.7	-28.1	-29.1	-31.3	-33.5	-36.1
Visegrad	-123.3	-133.3	-161.9	-176.7	-191.0	-207.6	-225.7
CIS	-80.0	-88.8	-99.3	-106.2	-116.4	-128.4	-139.5
East Europe (excl CIS)	-144.3	-157.0	-190.0	-205.8	-222.3	-241.1	-261.8
East Europe (incl CIS)	-224.3	-245.8	-289.3	-312.0	-338.8	-369.5	-401.3
Trade balance (US$ bn)							
Balkans	-4.5	-4.2	-5.4	-5.5	-5.9	-6.1	-6.5
Visegrad	-18.9	-17.0	-19.4	-20.7	-22.7	-25.2	-28.7
CIS	49.8	48.6	47.0	36.1	31.8	27.4	22.6
East Europe (excl CIS)	-23.5	-21.2	-24.8	-26.2	-28.6	-31.3	-35.2
East Europe (incl CIS)	26.4	27.4	22.1	9.9	3.2	-3.9	-12.6
Current-account balance (US$ bn)							
Balkans	-3.2	-2.4	-3.4	-3.4	-3.9	-4.0	-4.3
Visegrad	-12.6	-15.5	-18.3	-19.7	-21.0	-21.7	-23.1
CIS	35.0	34.3	31.6	19.5	13.2	8.6	3.3
East Europe (excl CIS)	-15.8	-17.9	-21.8	-23.1	-24.9	-25.6	-27.3
East Europe (incl CIS)	19.2	16.3	9.8	-3.5	-11.7	-17.0	-24.0
Exports (% of GDP)							
Balkans	31.0	32.0	31.1	30.0	29.8	30.0	29.8
Visegrad	35.7	36.1	37.3	38.2	38.7	39.3	39.5
CIS	34.5	32.2	30.5	27.0	25.3	24.1	22.8
East Europe (excl CIS)	35.0	35.4	36.3	36.9	37.3	37.7	37.9
East Europe (incl CIS)	34.7	33.7	33.3	31.7	31.0	30.4	29.7
Current-account balance (% of GDP)							
Balkans	-5.9	-3.9	-4.7	-4.3	-4.6	-4.3	-4.3
Visegrad	-4.3	-4.8	-4.8	-4.8	-4.8	-4.7	-4.6
CIS	9.3	8.0	6.6	3.7	2.3	1.3	0.5
East Europe (excl CIS)	-4.6	-4.7	-4.8	-4.7	-4.8	-4.6	-4.6
East Europe (incl CIS)	2.7	2.0	1.1	-0.3	-1.1	-1.4	-1.8
External debt (US$ bn)							
Balkans	22.2	24.7	27.3	28.2	29.2	30.8	32.5
Visegrad	125.4	132.4	153.8	161.5	169.3	177.6	185.7
CIS	171.6	170.7	168.4	169.0	167.9	167.6	170.3
East Europe (excl CIS)	147.6	157.2	181.0	189.7	198.5	208.4	218.3
East Europe (incl CIS)	319.2	327.9	349.5	358.7	366.4	376.0	388.5
External debt (% of GDP)							
Balkans	41.6	40.7	37.4	35.8	34.3	33.7	32.8
Visegrad	42.9	41.1	40.2	39.5	39.0	38.2	37.3
CIS	45.6	40.0	35.1	32.0	28.7	26.0	23.9
East Europe (excl CIS)	42.7	41.0	39.8	38.9	38.2	37.5	36.5
East Europe (incl CIS)	44.2	40.5	37.4	35.3	33.2	31.3	29.7
External debt (% of exports)							
Balkans	134.3	127.2	120.3	119.5	115.0	112.3	110.0
Visegrad	120.2	113.9	107.9	103.5	100.6	97.4	94.3
CIS	132.2	124.2	115.2	118.8	113.2	107.6	105.0
East Europe (excl CIS)	122.1	115.8	109.6	105.6	102.5	99.3	96.3
East Europe (incl CIS)	127.3	120.0	112.2	111.4	107.1	102.8	100.0

Guide to the business rankings model

Outline of the model

The business rankings model measures the quality or attractiveness of the business environment in the 60 countries covered by *Country Forecasts* using a standard analytical framework. It is designed to reflect the main criteria used by companies to formulate their global business strategies, and is based not only on historical conditions but also on expectations about conditions prevailing over the next five years. This allows the Economist Intelligence Unit to utilise the regularity, depth and detail of its forecasting work to generate a unique set of forward-looking business environment rankings on a regional and global basis.

The business rankings model examines ten separate criteria or categories, covering the political environment, the macroeconomic environment, market opportunities, policy towards free enterprise and competition, policy towards foreign investment, foreign trade and exchange controls, taxes, financing, the labour market and infrastructure. Each category contains a number of indicators that are assessed by the Economist Intelligence Unit for the last five years and the next five years. The number of indicators in each category varies from four (foreign trade and exchange regimes) to 11 (the political environment), and there are 70 indicators in total.

Almost half of the indicators are based on quantitative data (eg, GDP growth), and are mostly drawn from national and international statistical sources for the historical period (1997-2001) and from Economist Intelligence Unit forecasts for the forecast period (2002-06). The other indicators are qualitative in nature (eg, quality of the financial regulatory system), and are drawn from a range of data sources and business surveys adjusted by the Economist Intelligence Unit, for 1997-2001. All forecasts for the qualitative indicators covering 2002-06 are based on Economist Intelligence Unit assessments.

The main sources used in the business rankings model include CIA, *World Factbook*; Economist Intelligence Unit, *Country Risk Service*, *Country Finance*, *Country Commerce*; Freedom House, *Annual Survey of Political Rights and Civil Liberties*; Heritage Foundation, *Index of Economic Freedom*; IMF, *Annual Report on Foreign Exchange Restrictions*; International Institute for Management Development, *World Competitiveness Yearbook*; International Labour Organisation, *International Labour Statistics Yearbook*; UN, *Human Development Report*; US Social Security Administration, *Social Security Programs Throughout the World*; World Bank, *World Development Report*; World Development Indicators; World Economic Forum, *Global Competitiveness Report*.

Calculating the rankings

The rankings are calculated in several stages. First, each of the 70 indicators is scored on a scale from 1 (very bad for business) to 5 (very good for business). The aggregate category scores are derived on the basis of simple or weighted averages of the indicator scores within a given category. These are then adjusted, on the basis of a linear transformation, to produce index values on a 1-10 scale. An arithmetic average of the ten category index values is then calculated to yield the aggregate business environment score for each country, again on a 1-10 scale.

The use of equal weights for the categories to derive the overall score reflects in part the theoretical uncertainty about the relative importance of the primary determinants of investment. Surveys of foreign direct investors' intentions yield widely differing results on the relative importance of different factors. Weighted scores for individual categories based on correlation coefficients of recent foreign direct investment inflows do not in any case produce overall results that are significantly different to those derived from a system based on equal weights.

For most quantitative indicators the data are arrayed in ascending or descending order and split into five bands (quintiles). The countries falling in the first quintile are assigned scores of 5, those falling in the second quintile score 4 and so on. The cut-off points between bands are based on the average of the raw indicator values for the top and bottom countries in adjacent quintiles. The 1997-2001 ranges are then used to derive 2002-06 scores. This allows for intertemporal as well as cross-country comparisons of the indicator and category scores.

Measurement and grading issues

The indices and rankings attempt to measure the average quality of the business environment over the entire historical or forecast period, not simply at the start or at the end of the period. Thus in the forecast we assign an average grade to elements of the business environment over 2002-06, not to the likely situation in 2006 only.

The scores based on quantitative data are usually calculated on the basis of the numeric average for an indicator over the period. In some cases, the "average" is represented, as an approximation, by the recorded value at the mid-point of the period (1999 or 2004). In only a few cases is the relevant variable appropriately measured by the value at the start of the period (eg, educational attainments). For one indicator (the natural resources endowment), the score remains constant for both the historical and forecast periods.

List of indicators in the business rankings model

Political environment

1. Risk of armed conflict
2. Risk of social unrest
3. Constitutional mechanisms for the orderly transfer of power
4. Threat of politically motivated violence
5. International disputes or tensions
6. Government policy towards business
7. Effectiveness of political system in policy formulation and execution
8. Quality of the bureaucracy
9. Transparency and fairness of political system
10. Corruption
11. Impact of crime

Macroeconomic environment

*1. Inflation
*2. Budget balance as % of GDP
*3. Government debt as % of GDP
*4. Exchange-rate volatility
*5. Current-account balance as % of GDP

Market opportunities

*1. GDP, US$ bn at PPP
*2. GDP per head, US$ at PPP
*3. Real GDP growth
*4. Share of world merchandise trade
*5. Average annual rate of growth of exports
*6. Average annual rate of growth of imports
*7. The natural resource endowment
*8. Profitability

Policy towards private enterprise and competition

1. Degree to which private property rights are protected
2. Government regulation on setting up new private businesses
3. Freedom of existing businesses to compete
4. Promotion of competition
5. Protection of intellectual property
6. Price controls
7. Distortions arising from lobbying by special interest groups
8. Distortions arising from state ownership/control

Policy towards foreign investment

1. Government policy towards foreign capital
2. Openness of national culture to foreign influences
3. Risk of expropriation of foreign assets
4. Availability of investment protection schemes

Foreign trade and exchange controls

1. Capital-account liberalisation
**2. Tariff and non-tariff protection
*3. Openness of trade
4. Restrictions on the current account

Taxes

**1. The corporate tax burden
*2. The top marginal personal income tax
*3. Value-added tax
*4. Employers' social security contributions
5. Degree to which fiscal regime encourages new investment
6. Consistency and fairness of the tax system

Financing

1. Openness of banking sector
2. Stockmarket capitalisation
**3. Distortions in financial markets
4. Quality of the financial regulatory system
5. Access of foreigners to local capital market
6. Access to medium-term finance for investment

The labour market

**1. Incidence of strikes
*2. Labour costs adjusted for productivity
*3. Availability of skilled labour
4. Quality of workforce
5. Restrictiveness of labour laws
6. Extent of wage regulation
7. Hiring of foreign nationals
*8. Cost of living

Infrastructure

*1. Telephone density
**2. Reliability of telecoms network
**3. Extent and quality of road network
*4. Production of electricity per head
**5. The infrastructure for retail and wholesale distribution
**6. Extent and quality of the rail network
7. Quality of ports infrastructure
*8. Stock of personal computers
*9. R&D expenditure as % of GDP
*10. Rents of office space

Note. A single asterisk (*) denotes a purely quantitative indicator. Indicators with a double asterisk (**) are partly based on data. All other indicators are qualitative in nature.

