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**THE ACCESSION OF CENTRAL EUROPEAN  
COUNTRIES TO THE EUROPEAN UNION:  
THE TRADE AND INVESTMENT EFFECTS ON  
BELARUS, THE RUSSIAN FEDERATION AND  
UKRAINE**

- Elżbieta Kawecka-Wyrzykowska
- Dariusz K. Rosati



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## Abbreviations, acronyms and explanatory notes

ACP	African, Caribbean and Pacific
CE-4	Czech Republic, Hungary, Poland and Slovakia
CEC	central European country
CEFTA	Central European Free Trade Agreement
CIS-3	Belarus, Russian Federation and Ukraine
CN	Combined Nomenclature
EC	European Commission
ECSC	European Coal and Steel Community
EFTA	European Free Trade Association
EU	European Union
FDI	foreign direct investment
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNI	gross national income
GSP	Generalized System of Preferences
hl	hectolitre
IDP	investment development path
kg	kilogram
MFN	most favoured nation
MNC	multinational company
n.e.s.	not elsewhere specified
OJ	Official Journal (of the European Communities)
OLI	ownership, location and internalization
PCA	Partnership and Cooperation Agreements
SSG	special safeguard (of the WTO Agreement on Agriculture)
VAT	value added tax
WTO	World Trade Organization

The following symbols have been used throughout this publication:

..	= not available or not pertinent
–	= nil or negligible

In referring to a combination of years, the use of an oblique stroke (e.g. 1998/99) signifies a 12-month period (say, from 1 July 1999 to 30 June 2000). The use of a hyphen (e.g. 1999-2002) normally signifies either an average of, or a total for, the full period of calendar years covered (including the end-years indicated).

Unless the contrary is stated, the standard unit of weight used throughout is the metric ton. The definition of “billion” used throughout is a thousand million. The definition of “trillion” used throughout is a thousand billion. Minor discrepancies in totals and percentages are due to rounding.

References to dollars (\$) are to United States dollars unless otherwise specified.

## *Abstract*

*The coming enlargement of the European Union will have important economic consequences both for the EU member states (present and prospective) and for their trading partners, especially those at the new borders of the enlarged EU. This paper assesses some of these consequences, focusing on four acceding central European countries (CE-4, that is, the Czech Republic, Hungary, Poland and Slovakia) and three CIS economies bordering the enlarged European Union (CIS-3, namely, Belarus, the Russian Federation and Ukraine). In particular, it seeks to estimate how trade between the CE-4 and the CIS-3 will be affected by enlargement and what will be the likely consequences for the flow of FDI into the latter.*

*The assessment of trade effects is based on some of the standard approaches developed in the economics literature, namely those dealing with the distorting effect of tariffs and other protectionist measures on trade. The partial abolition of trade protection resulting from the expansion of a free trade zone (the case of the EU's eastward enlargement) affects trade both within the trade zone and with the rest of the world, resulting in trade creation and trade diversion. Using this conceptual approach and data about the present and expected levels of trade protection on both sides of the borders of the enlarged EU, estimates are provided of the expected trade creation and trade diversion effects. In addition, the effects of the application of EU technical standards in the new members on trade with third parties such as the CIS-3 are also analysed. The impact of enlargement on inward FDI in the CIS-3 is assessed in the context of the theory of international production, which seeks to explain the main determinants of the cross-border flows of direct investment. Applying this theoretical framework to the available statistical data allows some inferences to be drawn about the expected impact of enlargement on FDI in the CIS-3.*

*One of the main conclusions of the paper is that in the short term the economic impact of EU enlargement on the neighbouring CIS economies will be positive but negligible, both with respect to trade creation, and the diversion of FDI. Another conclusion is that in the longer run, due to positive dynamic effects, EU enlargement is likely to provide significant net benefits to both central Europe and the CIS region through mutual trade creation and the growth of FDI.*

## **Introduction**

The accession of central European countries (CECs) to the EU will affect economic links between them and the third countries, as well as those between the enlarged EU and third countries in a variety of ways. Among the third countries, the European CIS countries – Belarus, the Russian Federation and Ukraine (CIS-3) – are likely to be particularly affected, for several reasons. First, the elimination of remaining trade barriers and the extension of the EU-wide customs union to the CECs will further encourage trade and investment flows between the latter and the EU, probably involving some diversion from traditional partners in the former Soviet Union. Second, the full adoption of the *acquis communautaire* by the CECs will inevitably imply changes in some of the existing rules and practices concerning trade and investment flows between the CIS, the EU and the new members of the EU.

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\* Elzbieta Kawecka-Wyrzykowska, Warsaw School of Economics and Head of the European Integration Division in the Foreign Trade Research Institute in Warsaw. Dariusz K. Rosati, Warsaw School of Economics and member of the Monetary Policy Council of the National Bank of Poland. This paper is also available in a published pamphlet available from the United Nations Bookshop ([unpubli@unog.ch](mailto:unpubli@unog.ch)) as UNECE Occasional Paper No. 2 (2003), Sales No. E.03.II.E.54, ISBN 92-1-116881-3.

The main purpose of this study is to evaluate the economic effects of EU enlargement on the CIS-3. The analysis focuses on two main areas. First, the effects of the adoption by the CECs of EU trade rules, including the common external tariff, on trade between the CECs and the CIS-3 are examined. Second, an evaluation is made of the impact of EU enlargement on the flows of foreign direct investment into the CIS-3. Because of data limitations the analysis is restricted to four central European countries – the Czech Republic, Hungary, Poland and Slovakia (CE-4). All four countries have traditionally had strong economic links with the CIS-3 (they account for more than 60 per cent of exports from the CIS-3 to central and eastern Europe) and all are among the new EU members.

The paper is organized in eight sections. It starts with a short presentation of the theoretical approach to the effects of integration, an approach which is later used to analyse some of the implications of enlargement on CIS trade with the CE-4. In the second section there is a brief discussion of the EU trade regime with respect to third countries, including special arrangements with CIS countries and the main characteristics of the EU common external tariff to be adopted by the CE-4 after accession. The third section compares the current levels of tariff protection in the CE-4 with the common external tariff of the EU on imports from the CIS-3, by individual CE-4 countries and the main products. Section four provides some estimates of the trade creation and trade diversion effects, based on the statistics in the previous section. In section five, the possible impact of other trade measures is discussed, including the implications of CE-4's adjustments to EU technical standards. The possible impact on foreign direct investment in the CIS after the CE-4's accession is examined in the sixth section. Other possible implications of EU enlargement for trade with the CIS-3 are discussed briefly in section seven. Section eight draws some conclusions.

The main finding of the study is that the immediate trade and investment effects of the CE-4's accession to the EU are likely to be very small, almost negligible. The negative implications of the extension of the EU common external tariff to particular imports from the CIS-3 to the CE-4 are likely to be more than offset by gains in many other imports, chiefly because of reduced tariff protection and the extension of the Generalized System of Preferences (GSP) to imports into the CE-4. In the longer run, the dynamic benefits from integration are likely to translate into increased trade with the CIS-3.

Although the analysis is formally restricted to the CIS-3, it is essentially applicable to all members of the CIS because of their similar status within the framework of EU trade policy. Detailed information, however, is presented only with regard to the three main partners in this grouping, i.e. Belarus, Russia and Ukraine. This limitation, while reflecting the relative availability of the necessary statistics for other CIS countries, is primarily justified by the fact that Belarus, Russia and Ukraine largely dominate CIS trade with the CE-4. The CIS-3 accounted for 97 per cent of total CE-4 imports from all CIS countries in 2000 (Russia alone accounting for almost 85 per cent).

Most of the analysis is based on trade and investment data, as well as customs tariffs, available for 2001.

## **I. The theoretical approach to the effects of integration**

The impact of the accession of new member states to the European Union on third countries can be assessed with the standard approach to the analysis of effects of economic integration. In most general terms, these are typically separated into static and dynamic effects. Among the static effects, the two concepts most widely used in the context of trade liberalization are the trade creation and trade diversion effects.<sup>1</sup> Usually these concepts are used to analyse *ex ante* the effects of creating a customs union, i.e. the complete abolition of trade barriers among the union members, accompanied by the implementation of a common customs tariff on imports from countries not belonging to the customs union (the so-called third countries). The trade creation and diversion concepts can also be applied to assess the effects of partial liberalization, i.e. a reduction (not complete elimination) of trade barriers.<sup>2</sup> They focus on the implications for the levels and structure of trade flows of the elimination of trade barriers. Other static effects of trade liberalization include the increase of consumption as a result of lower import prices, the improvement of the terms of trade vis-à-vis third countries and the reduction of transaction costs due to the elimination of customs borders inside the customs union.

The dynamic effects of integration are usually considered to be far more important than the static effects. They include the positive effect of enlarged market size on investment, competitiveness and

growth, economies of scale and the effects of other common policies, such as regional policies. Unfortunately, the dynamic effects are also much more difficult to estimate than the simple static effects.<sup>3</sup>

As the focus of the present study is on the impact of EU enlargement on third countries, not all of the static and dynamic effects are relevant for the analysis: only those that have a bearing on third countries need to be examined. Thus, the effects of enlargement are explored only to the extent that they induce changes in output and trade in the CIS-3. The scope of the analysis is therefore restricted to the impact of replacing the national trade policy regimes in the new member countries by the common trade policy of the EU, including the imposition of the common external tariff. In addition, the possible impact of enlargement on foreign direct investment in the CIS-3 will also be examined.

In a classical customs union approach, the trade creation effect represents the additional imports from the preferred source as a result of a lowering of the import price (due to the elimination of a customs duty). This effect occurs when some domestic production in a country liberalizing its imports is replaced by lower-cost imports from another member of the union. Assuming that all economic resources are fully employed before and after formation of the customs union, this shift in output increases the welfare of all countries concerned because it leads to more specialization in production based on comparative advantage.<sup>4</sup>

The trade diversion effect represents the increase in imports from the preferred source at the expense of the non-preferred, third country suppliers following the abolition of the customs duty on imports from the preferred country of supply (in the customs union). The abolition of duty leads to a lowering of the prices of the preferred source in the market of the preference-giving country (member of the customs union), inducing a switch in imports from the non-preferred to the preferred country. In other words, trade diversion occurs when lower cost imports from outside the customs union are replaced by higher cost imports from a union member. This results from the preferential treatment given to members of the customs union. Trade diversion, by itself, reduces welfare because it shifts production from more efficient producers outside the customs union to less efficient production inside it. Thus, trade diversion worsens the international allocation of resources and moves the structure of production away from one based on comparative advantage.

As a customs union can result in both trade creation and trade diversion, whether it increases or reduces the welfare of union members depends on the relative strength of these two opposing forces. The net result depends on a number of factors. A customs union is more likely to lead to trade creation and increased welfare under the following conditions:<sup>5</sup>

- The higher are the pre-union trade barriers of member countries. There is then a greater probability that formation of the customs union will create more trade among its members than it will divert trade from non-members;
- The greater is the number of countries forming the customs union and the larger their size. Under these circumstances there is a greater probability that low-cost producers fall within the union;
- The more competitive rather than complementary are the economies of member countries. There are then greater opportunities for specialization in production and trade creation after the formation of the customs union. Thus, a customs union is more likely to increase welfare if it is formed by two competitive industrial countries rather than by an industrial and an agricultural (complementary) country;
- The closer geographically are the members of the customs union. Then transportation costs are less of an obstacle to trade creation among members;
- The greater is the pre-union trade and economic relationships among potential members of the customs union. This leads to greater opportunities for significant welfare gains as a result of the formation of the customs union.

Static effects (first of all the creation and diversion effects)<sup>6</sup> are important, but the dynamic effects are crucial. These relate to the numerous ways by which economic integration may accelerate the rate

of growth of GDP of the participating nations. The ways in which it may do this include the following:

- Economies of scale, which are made possible by the increased size of the market for firms and industries operating below optimum capacity before integration occurs;<sup>7</sup>
- Economies external to the firm and industry, which may lower both specific and general cost structures;
- Increased competition that results from the elimination of border barriers inside the customs union. In the absence of a customs union, producers (especially those in monopolistic and oligopolistic markets) are likely to become sluggish and complacent behind trade barriers. The formation of a customs union, i.e. the abolition of protection against products coming from other members of the customs union, means that producers have to become more efficient to meet competition from other producers within the union. If they fail to do so, they will have to go out of business. Increased competition is also likely to stimulate the development and utilization of new technologies. All these efforts will tend to cut costs of production;
- Increased incentives to invest in the bigger market. The formation of a customs union is likely to spur domestic and external investors to undertake production within the customs union and to take advantage of the enlarged market. An additional incentive for outsiders to set up within the union will be to avoid the (discriminatory) trade barriers imposed on non-union products.

The dynamic effects are estimated to be about five to six times larger than the static gains.<sup>8</sup> Dynamic effects, however, are extremely difficult to calculate and are inevitably surrounded by large margins of error.

The concepts of static and dynamic effects can be used to calculate the trade implications for the CIS-3 of the CE-4's adjustments to the EU common customs tariff and EU trade preferences. For products where the rates of duty on imports from the CIS-3 will be lowered, an increase of imports can be expected, while in cases where the tariff increases, the opposite is likely to be the case.

Moving now from general analysis to the case of specific commodity categories, the effects will differ for agricultural and non-agricultural trade.

As regards non-agricultural products a free trade area has already been established between the CE-4 and the EU, meaning duties on EU products. Thus, the implications for imports from the CIS derive mainly from the adjustments of the CE-4's most favoured nation (MFN) tariffs to (a) the EU's common customs tariff and (b) to the EU's GSP system. The adoption of the EU common tariff will result exclusively in trade creation (a positive effect for CIS imports as long as the EU common external tariff is lower than the national tariffs of the CE-4, and a negative effect if the opposite is true). No trade diversion will occur, as imports from the EU are already duty-free in the CE-4, i.e. any diversion, as a result of the free trade agreements, had already occurred before enlargement.

The inclusion of the CIS into the GSP system will provide the CIS with improved access to the CE-4 markets and will thus result in trade diversion – to the benefit of imports from the CIS. CE-4 importers may switch from products coming from countries subject to MFN treatment to products coming from the CIS subject to the lower GSP tariffs.

As regards agricultural imports from the CIS-3 – apart from the changes resulting from (a) adoption of EU MFN tariffs and (b) adoption of the GSP – there will also be effects from the elimination of duties and other restrictions on agricultural products coming from within the EU as there is no free trade between the EU and the CE-4 in these products. Elimination of duties on EU products will divert imports from non-preferred (MFN) sources to EU suppliers as the latter's products will become cheaper than those from MFN sources. This will act against supplies from the CIS. Similarly, increases of external tariffs (MFN rates) on some agricultural products will act in

the same direction because some duties are at present lower in the CE-4 than in the EU (e.g. on cereals).

It should be remembered that tariff changes (affecting prices) are not the only factor influencing the direction of trade. Other important factors include: transport costs (especially important in the case of fresh products, and in this respect Belarussian, Ukrainian and some Russian products may have some advantage); the quality of products; the capacity to meet sanitary and veterinary requirements; and so on.

Another way of calculating the effects of liberalization is *ex post* analysis. The main problem with this approach, however, is isolating the effects of integration (liberalization) from the effects of other developments which occur in parallel, e.g. changes of output and demand, changes in prices, fluctuations of exchange rates, etc. The CIS-3 are also in the throes of a much more complex process of transformation from a command to a market economy. Econometric models attempt to address such issues but their results can only be considered as rough approximations, as they are typically based on a number of tenuous assumptions.

## II. The EU trade regime with respect to third countries

### A. EU regulation of trade with the CIS-3: Partnership and Cooperation Agreements

The present trade and economic relations between the EU and most CIS countries are governed by the bilateral Partnership and Cooperation Agreements (PCAs). All these agreements are similar in terms of their structure and content. The first such agreements were concluded with the Republic of Moldova, the Russian Federation and Ukraine in 1994 (see annex table 2.1). They replaced the Agreement on Trade and Economic Cooperation concluded in 1989 with the Soviet Union.

The PCAs provide for the parties to grant each other most favoured nation treatment and national treatment, subject to exceptions for regional trade agreements and preferences to developing countries. A party may not apply quantitative restrictions on imports from the other party, although special provisions are made for separate agreements on “sensitive” products (textiles and clothing, and iron and steel products). The other provisions are the following:

- CIS partners agree to apply the rules of the WTO in relations and trade with the EU;
- Any protective measure may be introduced only after prior consultation and only 30 days after the consultation;
- There are provisions for establishment of foreign enterprises on the respective territories;
- There are no restrictions on foreign direct investments;
- Rules for competition and the protection of property and intellectual rights have been introduced;
- Economic cooperation for mutual acknowledgement of standards should be developed;
- The EU has confirmed its commitment to financial assistance to the CIS through TACIS.<sup>9</sup>

Apart from issues of trade and economic cooperation, which are very important for the partners, the PCAs also regulate other areas of cooperation. They provide for:

- A political dialogue, i.e. summits at presidential level at least twice a year (between, for example, the Russian President and the President of the Commission);
- A Cooperation Council at a ministerial level, to meet at least once a year;
- A Cooperation Committee at an expert level with joint consultations;
- A Parliamentary Committee which assures dialogue between the respective CIS parliaments and the European Parliament.

The time-frame of these agreements is 10 years, after which they should be renegotiated. The term “transitional economy” was chosen rather than “market economy” or “state-planned economy” to describe the status of the CIS. The basis for changing this status is described in the agreements. Such a change would allow the elimination of the remaining discriminatory elements in trade (e.g. anti-dumping procedures) and generally create better conditions for trade.

PCAs are not association agreements and the question of a possible entry of any CIS country into the EU was never a part of them. Neither are PCAs preferential agreements, i.e. they do not provide for a reduction of customs duties. They do provide, however, the so-called evolutionary<sup>10</sup> clause, which offers the possibility of further negotiations on free trade areas.<sup>11</sup> Moreover, they have created greater predictability in the mutual relations of the partners.

The provisions of the PCAs will apply to trade with the CE-4 as they are part of the EU external trade policy and have to be adopted by new members as part of the *acquis communautaire* (unless, of course, the agreements are changed or replaced by other rules, such as for example, those of the WTO by the time of the CE-4’s accession to the EU). They will refer mainly to exports from the CE-4 to the CIS-3 since imports from the CIS to the CE-4 will be regulated by EU rules – see below). They have no practical importance, however, because the provisions of these agreements – as already mentioned – are non-preferential and will not change the present, non-preferential status of products exported by the CE-4 to CIS markets.<sup>12</sup>

## **B. The EU common customs tariff to be adopted by the CE-4**

### ***1. The level of EU import tariffs***

At present, customs duties in the EU are not high. The simple average tariff for non-agricultural products (excluding petroleum) in 2001 was 4.1 per cent.<sup>13</sup> However, tariffs on sensitive products such as textiles and clothing are higher.

Agricultural products are generally subject to higher tariffs than non-agricultural products. In 2001 the simple average tariff on agricultural products was estimated at 16.7 per cent, although tariff quotas provided somewhat better access for high-tariff items.<sup>14</sup>

The simple average applied rate of duty on all products in 2001 is estimated at 6.4 per cent (see also annex table 2.2).

There are tariff peaks (triple the simple average or more) for meat, dairy products and cereals, and for textiles and clothing. One third of dutiable products are subject to low tariffs (up to 3 per cent), implying a low protective effect. The range of applied tariffs, in terms of the minimum and maximum rates, is also larger for agricultural products (from 0 per cent to 236.4 per cent) than for non-agricultural products (from 0 to 26 per cent).<sup>15</sup>

Since the EU maintains numerous preferential trade agreements and arrangements with many groups of countries, exclusively MFN treatment applies only to imports from a few countries and territories: Australia, Canada, Hong Kong Special Administrative Region of China, Japan, the Republic of Korea, New Zealand, Singapore, Taiwan Province of China and the United States. Although their number is small, the share of these partners in external EU trade is significant: in 2001 they accounted for 38 per cent of total imports into the EU.

Apart from the countries subject to MFN treatment, other trading partners are eligible for various preferential regimes.

The most beneficial treatment is granted to least developed and African, Caribbean and Pacific (ACP) countries (95 per cent of lines are duty free), followed by regional trade agreements (80 per cent), GSP beneficiaries (54 per cent) and countries subject only to MFN (20 per cent of product lines).<sup>16</sup>

























































































