www.developmentandtransition.net

DEVELOPMENT & TRANSITION

4

JUNE 2006

Albania Armenia Azerbaijan Belarus Bosnia and Herzegovina Bulgaria Croatia Cyprus Czech Republic FYR Macedonia Georgia Hungary Kazakhstan Kosovo (Serbia and Montenegro) Kyrgyzstan Latvia Lithuania Malta Moldova Poland Romania Russian Federation Serbia and Montenegro Slovakia Slovenia Tajikistan Turkey Turkmenistan Ukraine Uzbekistan

Published by the United Nations Development Programme and the London School of Economics and Political Science

EU enlargement and the wider neighbourhood

Two years after its May 2004 enlargement, the 'widening versus deepening' debate remains a perennial feature of the European Union's engagement with the post-communist states. Since then serious doubts among some of the old member states about the viability of future enlargement have been galvanized by the EU's internal divisions over the Constitution for Europe. By choosing 'post-enlargement' as our theme, we aim to address three principal challenges for the region – future enlargement, the European Neighbourhood Policy and European Monetary Union.

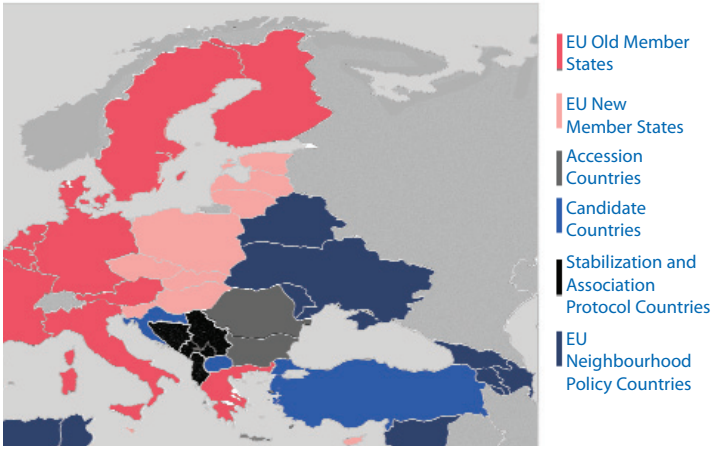
First, we examine the enlargement process. Heather Grabbe argues that the EU's conditionality for enlargement is consistent, and that the door remains open. Several contributions assess the implementation of EU conditionality, both as regards the capacity of the new member states to access and manage the benefits of membership, such as structural funds, and the success of candidates and prospective candidates in meeting political conditions and making structural reforms (Turkey, Serbia). Miroslav Beblavy and Kalman Mizsei highlight one of the key weaknesses of the EU's approach to the region's developmental challenges by demonstrating how its 'risk-of-poverty' measure skews social policy priorities.

Second, we examine the European Neighbourhood Policy, which is intended to be an alternative to accession, for those CIS countries that have made a 'European choice'. Gwendolyn Sasse analyses the inconsistencies in the ENP's development, and argues that the EU's political concerns, notably in Ukraine, have diluted the use of ENP as a barrier to enlargement.

Third, Willem Buiter and Anne Sibert address the prospects for an enlargement of the Eurozone. Whereas Slovenia meets the Maastricht convergence criteria for EMU membership, the prospects of membership for others, such as Estonia and Lithuania, now seem to be fading.

The articles point to a multi-track EU that is characterized by intersecting rather than concentric circles (the Eurozone, the Schengen area, and countries permitting free trans-border labour movements). This heterogeneity is also apparent in the EU's policies vis-à-vis the 'wider neighbourhood'. The unevenness of accession negotiations and prospects call into question the credibility of future enlargement. While some delay allows the EU to maximize its leverage over its neighbours, prolonged delays make the prospect of membership too distant, thus weakening the EU's leverage for reform in the region, and possibly destabilizing the 'wider neighbourhood'.

James Hughes and Ben Slay



The conditionality at the heart of EU enlargement policy

Heather Grabbe

The European Union has been enlarging for over three decades now, but it started elaborating detailed conditionality for new members only from 1993, in response to the desire of the post-communist countries of Central and Eastern Europe to join. For the countries which joined before that, preparations were a much less complicated business. They had to be willing to take on the obligations of membership, but they could negotiate changes with the EU – which was itself much smaller and more flexible – to accommodate their interests. The obligations were also much less demanding, because the Union has itself greatly evolved as it has been enlarged.

Even since setting the accession conditions in 1993, the EU has added new policy areas to its activities, such as justice and home affairs, and the Schengen area of passport-free travel; a common foreign and security policy, with a defence identity; and a common currency. All of these developments add to the requirements that aspirant members have to meet before accession – they have no possibility of negotiating opt-outs like those applying to some member states on Schengen and monetary union. The candidates also have to take on the EU's 'soft law' of non-binding resolutions and recommendations. The EU's conditionality is therefore a moving target for would-be members, and it is a huge external pressure on their domestic reforms.

The conditions for accession

The EU set four conditions for membership at the Copenhagen European Council in 1993:

'Membership requires that the candidate country has achieved stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities, the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union. Membership presupposes the candidate's ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union. The Union's capacity to absorb new members, while maintaining the momentum of European integration, is also an important consideration in the general interest of both the Union and the candidate countries'.

These conditions were designed to minimize the risk of new entrants becoming politically unstable and economically burdensome to the existing EU. They were thus formulated as much to reassure reluctant member states as to guide the candidates, and this dual purpose of the conditionality has continued to play an important role in the politics of accession within the EU. The consideration on 'absorption capacity' at the end reflects the member states' anxieties about the impact that enlargement might have on EU institutions and policies because of the increase in numbers and diversity, apart from the specific problems that particular new members might bring in.

The conditions have been interpreted more and more rigorously over the years since they were set. As the EU has elaborated what constitutes meeting the accession conditions, it has progressively widened the detailed criteria for membership, as new conditions have been added and old ones redefined. For example, the EU added the requirement for the Balkan countries to cooperate with the International Criminal Tribunal for the former Yugoslavia.

Aspirant members have to adopt the EU's rules in certain areas that are viewed as essential to the future functioning of the EU. They cannot negotiate exceptions to regulatory alignment with the single market – which involves the removal of all trade barriers and meeting EU product and process standards – only the length of transition periods before taking on the full EU law and policies.

Ultimately, an applicant is ready to join when member states are convinced that the new member will behave like a good citizen in the EU. A potential member state has to show a certain style of operation – in its public policy-making and state administration – that looks familiar to member states if it is to be acceptable. A country's capacity to implement and enforce EU-inspired legislation effectively is an increasingly important part of meeting the conditions too.

The stages in the accession process

For several years after the entry conditions were first set, it was not clear exactly which elements of the political

and economic conditions had to be fulfilled for an applicant to move on to the next stage. But now there is a very clear progression through eight stages:

1. Privileged trade access and additional aid.

2. Signing and implementation of an enhanced form of association agreement (Europe Agreements for the Central and East European countries, Stabilization and Association Agreements for Southeast European countries).

3. Recognition of candidate status.

4. Opening of accession negotiations, which since 1999 has been explicitly dependent on a candidate's meeting the democracy and human rights conditions.

5. Opening and closing of the 31 chapters in negotiations – each of which can depend on meeting specific benchmarks.

6. Signing of an accession treaty.

7. Ratification of the accession treaty by national parliaments and the European Parliament, and referenda in some countries.

8. Entry as a full member.

The first hurdle for any would-be member state is to have its membership application accepted by the EU. The Union can turn a cold shoulder immediately, as it did to Morocco and initially to Turkey. A would-be candidate needs to be fairly sure of getting a warm reception from the EU, because a premature application can turn member states against the idea of accepting it. It is unwise to apply too early, as that can prejudice the EU against a country which might receive a warmer response if it applied later.

Once the EU has favourably responded to an application, the European Council (comprising the heads of state and government) asks the European Commission to draw up an 'opinion' or *avis* on the country's application. This document sets out the Commission's assessment of the country's suitability as an EU member, and usually recommends whether or not the EU should begin negotiations with the country in the near future. The Commission can also say whether the country should be given candidate status.

The opening of negotiations is usually greeted with celebration in the applicant country. But, in fact, the negotiations are the hardest part of the process to manage politically, because they cause the political realities to sink in. The political classes, the business community and the public begin to realize what EU accession is all about. The conditions for accession may look inoffensive on first reading, but they contain stringent requirements which demand unpopular reform measures.

How will the conditionality evolve in future?

For future aspirants to membership, implementation and enforcement of the *acquis communautaire* will be key. The Union is getting more and more fussy about compliance with its standards, because a 25-member Union is harder to govern than one of 15. In particular, the Commission is keeping a close eye on the functioning of the judicial system – particularly because Bulgaria and Romania took a long time to tackle this area – and on the development of adequate capacity in the state administration.

So far, this application of conditionality has worked well. It had a tremendous transformative effect in Central and Eastern Europe. Some argue that the new members who joined in 2004 have turned out to be better at implementing laws and enforcing regulations than the old ones. But now the conditionality has to prove its power in Turkey and especially the Balkans, where states are weak and societies divided. More and more, the EU is having to develop the capacity to foster development in would-be members.

Heather Grabbe is an adviser to the European Commissioner for Enlargement, Olli Rehn. She writes here in a personal capacity.

Bulgaria and Romania sign the treaty of accession to the EU. A European Commission report has now recommended delaying the decision on full membership until October.

Make spurious poverty statistics history

Miroslav Beblavy
Kalman Mizsei

Imagine a world where the Britons are, on average, poorer than the Bulgarians and as poor as the Romanians. Imagine a world where even if everyone's real income doubles, a country is no less poor. Imagine a world where each person has less than before, but poverty rates fall.

This is not fiction, but the world according to the European Union's so-called 'risk-of-poverty' flagship poverty statistic. To eliminate poverty by this standard, poorer countries must think twice before they try to spark economic growth or create jobs.

The core poverty statistics produced by the European Commission are based on the concept of relative poverty. The 'risk-of-poverty' indicator looks at how many people in any given country have disposable income smaller than 60 per cent of that country's median. (The median is an imaginary person exactly in the middle of an income distribution, with half of the population earning more money than s/he, and half earning less.) For example, if 21 out of every 100 people in Ireland have income smaller than 60 per cent of their country's median, the European Commission says that the risk-of-poverty rate in Ireland is 21 per cent - regardless of the number of the Irish who are hungry, homeless or cash-strapped.

The Commission labels as a poverty indicator something that is clearly a measurement of income inequality. People certainly compare their own economic status to their neighbour's, but such a comparison skirts the issue of whether they or their neighbour have enough food to eat, or access to basic medical care. Relative poverty (having less than your neighbour) can be an indicator of absolute poverty (not having enough to eat) but it does not tell the whole story. Especially when considering the ethnic dimensions of poverty - as done in *Avoiding the Dependency Trap*, UNDP's report on the Roma of Central and Eastern Europe - measurements of relative poverty fail to address the root causes of deprivation and social exclusion.

The Commission's reliance on the 'risk-of-poverty' indicator causes four conspicuous problems: first, the results of the measurement exercise belie common sense, crippling its explanatory capability. 'Risk-of-poverty' and other relative poverty indicators can't be used for international comparisons unless countries are similar in their level of economic development. Most people are not experts on social statistics, but they know that something must be wrong with a measurement that says the British are poorer than the Bulgarians.

Second, the 'risk-of-poverty' label sends the wrong signal to the public and policy-makers. According to the Commission, Ireland has the highest poverty rate in the European Union and the figure is increasing. Yet Ireland has had a stellar record of growth in jobs and income over the last 15 years. The standard of living for nearly everyone has increased since the early 1990s at a rate unprecedented in recent European history. What's the catch? Income growth has been slightly larger in the upper 80 per cent of the population than it has in the lower 20 per cent. Therefore, according to the Commission's indicator, although hundreds of thousands of people have been lifted out of actual poverty, Ireland is not a success story but a basket case.

Third, the 'risk-of-poverty' logic doesn't lead to effective national policy. The best way to reduce poverty, according to this reasoning, is not to grow and produce, but to redistribute. Unfortunately, in poor countries, no amount of redistribution will make a difference in the lives of poor citizens unless the economy grows quickly for a sustained period of time.

Fourth, the message of this methodology is that within the European Union there should be no cross-country social solidarity. While views on the desirability of harmonizing social policies may differ, everyone should agree that EU data should show the true face of poverty in the Union. The solidarity principle may work well in the EU's various structural and cohesion instruments, but when it comes to assessing poverty, our Union level approach is nothing short of hypocritical.

This is not an academic debate. Use of the wrong poverty indicators can distort policy priorities in the EU's poorest countries, harming poor people instead of helping them. Whereas risk-of-poverty indicators may have useful national informational power, it is high time to apply truly Union-wide indicators of poverty - measured in absolute as well as relative terms.

Miroslav Beblavy is State Secretary, Ministry of Labour, Social Affairs and Family, Slovakia.

Kalman Mizsei is Assistant Administrator and Director, United Nations Development Programme, Regional Bureau for Europe and the CIS.

Structural funds and the new member states: lessons learned

Vasil Marinov
Hachemi Bahloul
Ben Slay

In May 2004 10 countries, eight of which were post-socialist (EU8), joined the European Union (EU). Two additional countries (Romania and Bulgaria) are expected to join in 2007 or 2008. Two more (Croatia and Turkey) have started accession negotiations, while Macedonia has been granted 'candidate' country status. Other countries in the Western Balkans (eg, Serbia and Montenegro) may be granted this status in the coming years.

Almost all regions of the new member states have per-capita GDPs that are below 75 per cent of the EU average. All the new member states therefore qualify for the EU's structural funds, which are intended to help them 'catch up' with their wealthier neighbours. The magnitude of the structural funds is quite significant, representing some 4 per cent of GDP (roughly double the size of pre-accession assistance). If they are well used, the structural funds afford the new member states unparalleled opportunities for economic growth, social cohesion, and human development. However, as Table 1 shows, effective absorption of the structural funds has posed major challenges for the new member states. These challenges reflect both the magnitude of these funds and the strict and often complex requirements for their utilization. In qualitative terms, effective absorption requires inter alia the democratic articulation of stakeholder needs and priorities - national ownership of the structural funds - as well as partnerships among central governments, municipalities, and NGOs, as well as private companies.

Analysis of the new member states' experience can help derive lessons (good and bad) for pre-accession countries and candidate countries. UNDP is finalizing a comparative analysis of structural fund absorption in Ireland, Portugal, the Czech Republic and Poland. Bulgaria has also been included in the study, to enable an analysis of pre-accession preparations. Some of the preliminary results of this study are described below, focusing on critical issues for national policies in accession countries.

Disconnects between pre- and post-accession funding

Pre-transition authoritarian governance structures in the EU8 countries left their mark on the administrative capacity of the EU8 countries. While the new EU member states benefited from a host of pre-accession financial instruments such as PHARE, ISPA and SAPARD[1], it now appears that use of these instruments did not fully translate into post-accession capacity to absorb the structural funds. Differences in the scale of the pre-and post-accession resources to be absorbed, as well as in terms of programming, project development and selection, and weak links with national public finance systems seem to be responsible for this disconnect.

The new member states' experiences show that structural fund absorption requires solid preparation of the central administration, in the form of strong national policy frameworks, inter-ministerial coordination, well designed national programmes, and implementation capacity. Partnerships with regional and local governments, private sector business and non-governmental

Table 1: Structural fund absorption rates (as of March 2005)*

	Paid structural fund monies (per cent of decided funding):	
Recipients	Lowest absorption rates	Highest absorption rates
EU8 countries	10 per cent (Czech Republic, Lithuania, Slovenia)	15 per cent (Hungary)
EU15 countries	30 per cent (Netherlands)	60 per cent (Ireland)

* For EU8 the absorption rates relate to resources allocated for the period 2004-2006. For EU-15 countries they relate to resources allocated for the whole 2000-2006 programming cycle
Source: DG REGIO database Infoview reported in Commission Staff Working Paper, Annex to the 16th Annual Report on the implementation of the Structural Funds 2004, Commission of the European Communities, (2005)

organisations (NGOs) are also essential. In sum, preparation for absorbing the structural funds is often less about market democracy than about modernizing state bureaucracies and helping them to work with local governments and NGOs.

Because pre-accession instruments do not fully prepare countries for structural fund absorption, state budgets must be tapped during the pre-accession period for this - and the earlier the better. Waiting until the eve of accession, or even the early years of membership, can mean that available resources are not absorbed. The development impact of the structural funds can be lessened by their incomplete integration into national public finance systems, particularly in terms of public procurement and public investment finance. Incomplete integration can lead to the appearance of competing programmes that run parallel to initiatives financed by the structural funds. Such competition can reduce the absorption and impact of the structural funds.

It's not only about decentralization . . .

The EU accession process is sometimes accompanied by decentralization which is intended to improve the efficiency of public administration through the application of the principle of subsidiarity. These efforts are often seen as facilitating the management of structural funds which, by definition, have a strong regional focus.

However, the experience of Ireland, Portugal, and at least some of the new member states strongly suggests that decentralization and capacity building to absorb post-accession funding need not go hand in hand. Instead, in countries whose poor regions face severe development challenges and possess limited fiscal resources and administrative capacity, central governments must take a lead role. Centralized structural fund programming and management may be needed to ensure the effective implementation of priority programmes. Decentralization may be necessary - but not for reasons of structural fund absorption. At the same time, the use of centralized approaches should not preclude broad consultative processes for consensus building or programme implementation that reflects local circumstances.

. . . It's also about development partnerships

The partnership principle is at the heart of the design and use of post-accession instruments. It implies close cooperation between the European Commission, central and sub-national governments, NGOs and the private sector, in order to achieve common development objectives. Partnerships can build social capital and attract the co-financing needed to utilize the structural funds. While it often begins as an obligation imposed from Brussels, the partnership principle as applied via the structural funds can gradually influence other sectors and become intrinsic to policy-making. This can help broaden the range of actors and ideas in, and impose better discipline on, policy-making processes. The partnership principle can both facilitate absorption and help democratize and modernize policy processes at the national and sub-national level.

Because efficient partnerships require competent partners, absorption efforts should not overlook strengthening the institutional capacity of other players in the drama. Well-organized NGO sectors are absolutely critical in this respect, since cooperation cannot be imposed 'from above'. In addition to being broadly representative of and accountable to their civil societies, NGOs must be

Development partnerships: the inauguration of an EU funded project to build a wastewater treatment plant in Haskovo, Bulgaria.

sufficiently knowledgeable about the structural funds themselves. Fortunately, the benefits NGOs can receive from the structural funds provide strong incentives for NGO engagement in the partnerships necessary for their absorption. Similar incentives are apparent for municipalities, many of which are too small by themselves to generate the co-financing needed to tap the structural funds. The Portuguese experience in particular demonstrates the important role that associations of municipalities can play in facilitating structural fund absorption.

The importance of private companies as beneficiaries of the structural funds has recently increased, particularly in light of the March 2000 Lisbon strategy, which committed the EU to become by 2010 'the most dynamic and competitive knowledge-based economy in the world'. Structural funds are increasingly used to support the commercialization of research and development, and to subsidize the introduction of information and communications technologies. Business associations can play an important partnership role in this respect, particularly in terms of helping small- and medium-sized companies to access the structural funds.

Lessons learned

Policy makers in countries now negotiating for EU accession, or who wish to begin these negotiations soon, would do well to remember the following lessons from the EU8 countries' experience with the structural funds:

Don't wait too long to prepare for the structural funds - and don't be stingy. Because pre-accession instruments only partially prepare for structural fund absorption, state budget resources must be tapped during the pre-accession period for this - and the earlier, the better. Waiting until the eve of accession, or even the early years of membership, may be penny-wise but pound-foolish.

Don't forget your development partners - you will need them. A well-prepared state administration is not enough for structural funds absorption - well-prepared partners are also needed. Competent partners mean better policies, quality planning and programming, better projects, and ultimately better absorption. Where public resources cannot support the preparation of development partners, governments should at least send the 'right signals' to encourage them to help themselves.

Integrate the structural funds into national public finance systems. Incomplete integration - particularly with public procurement and public investment systems - can lead to the appearance of wasteful, competing programmes that run parallel to initiatives financed by the structural funds.

Conclusions

The problems of absorbing the structural funds now confronting the new member states reflect the absence of effective national policy frameworks, weak implementation capacities, and inexperience with the principles and practices of development partnerships. This has sometimes led the new member states to adopt approaches to the structural funds that are formalistic and mechanical, rather than truly 'developmental'. The emphasis is on structures and procedures, rather than on partnerships for impact.

In many respects, these problems are not surprising. The structural funds implicitly assume that the new member states do not differ dramatically from the EU-15 countries; the specifics of transition (and, in the case of the Baltic states, the Czech Republic, Slovakia, and Slovenia, new statehood) are assumed away. The development challenges associated with the absolute poverty and social exclusion facing such regions as eastern Slovakia (with its large Roma population), or the Russian-speaking minorities in Estonia and Latvia, can go beyond the problems the structural funds were created to address. They reflect the fact that regional disparities in the new member states are as much about development and transition as they are about European integration.

Vasil Marinov is associate professor at Sofia University.

Hachemi Bahloul is local governance adviser at UNDP's Regional Centre in Bratislava.

Ben Slay is the director of UNDP's Regional Centre in Bratislava.

1. For information on PHARE ISPA and SAPARD see http://ec.europa.eu/comm/enlargement/financial_assistance/index_en.htm.

EU integration and Turkish SMEs

Murat Gursoy

Turkey and the European Union

The European Commission's October 2005 invitation to begin formal accession negotiations marks a milestone in Turkey's relationship with the EU. Turkey's first formal application for membership in the EU (then the European Economic Community) dates back to July 1959, when the EEC offered a roadmap to a customs union, as a prelude to Turkey's eventual membership. This roadmap was formalized by the 1963 Ankara Agreement and its supplemental protocol of 1970, which led to the establishment of the customs union in 1995. The Customs Union between Turkey and the EU was a unique experience in that Turkey was the first (and the only country until 2002) that entered into such integration without being a member of the Union. Moreover, Turkey's agreement with the EU goes well beyond the classical definition of a customs union[1]: Turkey has pledged to harmonize its commercial and competition policies (including intellectual property laws) with those of the EU, as well as extend most of the EU's trade and competition rules to the Turkish economy.

Like other parts of Turkey's business community, Turkish SMEs have already spent 10 years working within the framework of the customs union. This experience suggests some of the possible effects on the SME sector that could result from Turkey's possible accession to, or at least closer integration with, the EU.

Turkish small to medium sized enterprise (SME) export competitiveness and EU integration

SMEs play a critical role in the Turkish economy. According to a recent study, the SME sector accounted in 2000 for 99.8 per cent of total number of enterprises, 77 per cent of total employment, 38 per cent of capital investment, 27 per cent of value added and roughly 10 per cent of exports in Turkey.[2] These estimates may understate SMEs' importance for Turkey's trade balance: legislation encourages SMEs to conduct export-import operations via specialized foreign trade companies, which are not themselves counted as SMEs.[3] With the exception of the financial services and capital-intensive sectors like energy and cement production, SMEs are strongly represented across all sectors. In the 15 years between 1990 and 2005, Turkey's per-capita exports increased from $230 to $1019, while the ratio of exports to GDP rose from less than 9 per cent to over 20 per cent during this time. These improvements reflect Turkey's efforts to liberalize its economy (which began in the 1980s) as well as its growing integration with the EU - both of which were promoted by the EU customs union. At present, roughly half of Turkey's foreign trade is conducted with EU countries.

The supplementary protocol to the 1963 Ankara Agreement foresaw mutual, asymmetric reductions of customs duties on trade in manufactured goods between Turkey and the EEC, so that barriers to Turkish exports on European markets fell faster than barriers to European exports in Turkey. By 1995, the EU had already significantly reduced the protection applied against Turkish imports, so that Turkish exporters had already captured many of the customs union's market access benefits before the customs union was formally established. Turkey's exports to the EU therefore did not jump in 1995; instead, the share of EU exports in total exports actually declined. By assuming the EU's common external tariff regime, Turkey opened its markets not only to EU members, but also to other countries with which the EU had preferential trade agreements.

Significant increases in competitive pressures ensued for Turkish SMEs, most of which at that time were accustomed to competing on price by leveraging on relatively low costs of labour and raw materials and hiding behind trade protectionism. Having lost these protective barriers, Turkish SMEs started to look for new competitive advantages. Turkey's trade data suggest that this search paid off, particularly after 2000. Average annual export growth nearly tripled to 22 per cent during 2001-2005 from 8 per cent during 1990-2000. While many factors contributed to this increasing export competitiveness, Turkey's progress towards EU accession was certainly one of the most important.

EU integration and the labour market

Growing competitive pressures led many SMEs to seek to reduce costs by raising productivity.[4] For the labour-intensive sectors that dominate the Turkish industry, this created incentives for lay-offs, wage cuts, and unfortu-

nately reverting to such illegal means as not providing workers with social security coverage or deploying child labour. However, Turkey's EU integration provided natural brakes on this 'race to the bottom'. Turkey's textile and clothing industries, for example, rely heavily on such European buyers as H&M and Marks and Spencer, whose rules for their suppliers prohibit the employment of children or unregistered workers. Companies in these sectors therefore began to invest in human capital by establishing vocational training schools to improve the quality of blue-collar labour. They also invested in such skill areas as design and innovation, thereby creating new employment opportunities for more skilled workers. Other SMEs responded to these pressures by moving their plants to Turkey's less developed regions where labour costs were lower, thereby creating employment opportunities in Turkey's poorer regions.

Closer integration within the EU could accelerate the brain drain of Turkish specialists, particularly the managers needed to make Turkey's SMEs more competitive. However, movement of labour between Turkey and the EU is not free now, and the restrictions imposed on the new EU member states following their May 2004 accession suggest that such movement would not be immediately and completely liberalized for Turkey. In the interim, Western Europe's needs for imported specialists are likely to be at least partly met by the new member states. Hence, by the time the Turkish labour force acquires the right to move freely in the EU, the EU's demand for skilled labour might be lower than it is today, so brain drain pressures would be weaker as well.

Foreign direct investment in Turkish SMEs

The 10 new EU member states attracted some €80 billion in foreign direct investment (FDI) during 1997-2001[5]. During this time Turkey - with a roughly similar population - was able to attract only some €7 billion. While at the macro level FDI inflows finance external deficits and contribute to economic growth, the short-term impact on SMEs need not be uniformly positive, especially if it means stronger competition from global giants. Competition for skilled labour intensifies, local consumers become more sophisticated and demanding in the face of increased variety and choice, and so on.

So far, however, the impact of FDI linked to European integration has been largely positive, particularly for the automotive sector. The spare parts industry, which is dominated by SMEs, has significantly grown in terms of numbers of companies, employment, and production. In 2005, exports of the automotive and automotive spare parts industries exceeded that of Turkey's textile and clothing industries. This suggests that FDI linked to export-oriented sectors focusing on the EU market is beginning to modernize manufacturing in Turkey - as occurred in the Central European countries, during their run-up to EU accession.

Instead of a conclusion

As a candidate country Turkey might have 'missed the boat' in terms of EU's pre-accession financial assistance. On the other hand, lessons learned from previous accession experiences might be invaluable. In any case, prospects for absorbing EU financial assistance for the SME sector depend more on the capacity of the Turkish authorities to identify, articulate and address the needs of SMEs, and less on the amounts of financial assistance available. Since the EU has to date provided very little pre-accession financial assistance to Turkish SMEs, there is not much evidence to analyse. The opportunities associated with the programmes that have been initiated (focusing among other things on female entrepreneurship and clustering) have yet to be fully exploited by Turkey's SMEs.

While Turkey's negotiations with the EU are ongoing, Turkish SMEs have been discharging the *de facto* obligations of membership since 1995. This 10-year period has helped change the mindsets in the SME sector and created new ways for them to generate income, employment and value added. As Turkish SMEs have become more competitive during this time, it can be argued that EU integration has made the 'backbone' of the Turkish economy stronger. The biggest challenges, however, lie in improving the innovative capacity of Turkish industry, without which improvements in competitiveness cannot be sustained. Unfortunately, progress in this area has not been satisfactory. Turkey's widening regional disparities pose another set of risks. Many of the positive statements made here are only applicable to SMEs located in Turkey's developed western and central regions: SMEs in the underdeveloped east and southeast are still struggling.

The 10-year experience with the customs union has already generated some important benefits for Turkey's SME sector, in the form of significant FDI inflows into the automotive sector and its local sub-contractors. Equally, a prolonged accession period could help Turkish indus-

try and SMEs to prepare fully for the competitive pressures of the single market. Many of the countries that joined the EU in May 2004 captured many of the benefits of membership years before their formal accession, and Turkey may do likewise.

Murat Gursoy is a project manager in UNDP's Country Office in Turkey.

1. A 'customs union' generally refers to the combined (a) elimination of customs duties and non-tariff barriers to virtually all trade among union members; and (b) introduction of a common external tariff/protection regime for trade with non-member countries.

2. OECD, SME and Entrepreneurship Outlook, 2005. As per EU definitions, SMEs are companies employing fewer than 250 persons and whose annual turnovers or balance sheet totals do not exceed $25 million.

3. For example, the GISAD sectoral foreign trade company, one of Turkey's largest exporters (with $1.8 billion in exports in 2005) was established by SMEs in the textile and clothing industry.

4. The discussion in this section is built on the methodologies and findings presented in 'The Impact of EU enlargement on European SMEs' (European Commission, Enterprise Publications, SME Observatory of European SMEs, 2003/6).

5. European Commission, Enterprise Publications, SME Observatory 2003/6.

EU accession and human development in Serbia

Paola Pagliani
Rastislav Vrbensky

As with other Balkan countries, integration into the European Union (EU) is a declared state goal for Serbia. This will require meeting the EU's political criteria, including the handing over of Ratko Mladic to the Hague, and continuing the cumbersome process of reforming institutions, the socio-economic system, and the rule of law. The successful implementation of the above may require an overarching socio-political consensus. This consensus will emerge only if EU integration is understood not as a goal in itself, but as a means towards achieving progress, freedom and human development.

UNDP's Human Development Index (HDI), which measures human development in terms of life expectancy and education as well as per-capita GDP, has become a particularly important source for measuring human development. According to UNDP's 2005 Human Development Report, all 25 EU member states were among the 50 countries with the highest HDIs (see Table 1). Of the top 20 HDI countries, 12 are EU members.

Human development indicators improved significantly in the eight post-communist countries (EU8) that acceded in May 2004. Slovenia, the best performer, has drawn even with Portugal. The experience of the new member states suggests that accession processes can help to improve economic performance by increasing access to European markets and technologies, and attracting foreign direct investment (FDI). By contrast, transition countries that are not engaged in accession processes are still struggling to regain levels of human development last seen in the 1980s. For instance, Moldova's HDI dropped from 0.739 in 1990 to 0.671 in 2003.

Serbia currently lags behind the new EU member states - including Slovenia, which was a member of the Yugoslav Federation until 1991. Because Serbia's development was slowed by military conflicts that depleted

Bomb damage at a factory in Kragujevac, Eastern Serbia (1999)

Table 1: Human development indices among EU compared with other countries [1]

Country	HDI in 1995	HDI in 2000	HDI in 2003
EU-25	0.875	0.9	0.907
EU-15	0.91	0.93	0.936
EU8	0.804	0.843	0.861
Russian Federation	0.77	n.a.	0.795
Albania	0.702	0.736	0.78
Ukraine	0.747	0.754	0.766
Armenia	0.698	0.735	0.759
Moldova	0.682	0.665	0.671
Tajikistan	0.629	0.63	0.652
Serbia [2]	N.A.	*0.729*	*0.772*

Data in the first three rows are unweighted averages. The EU-15 are the member states before the May 2004 accession; the EU8 are the post-communist new member states (i.e. Cyprus and Malta are not included).

1. HDR 2005 (http://hdr.undp.org/2005/), UNDP, Serbian HDR 2005 (http://www.undp.org.yu/nhdr/index.cfm). Data for Serbia are for 1999 and 2002.

2. Data relative to Serbia in this article refer to Serbia only, excluding the Kosovo province (under UN administration, according the UN Security Council Resolution 1244), and they do not reflect data for Montenegro, the other member of the State Union of Serbia and Montenegro.

its human, economic and social capital, it would be more meaningful to compare Serbia's HDI of today with other transition countries' in 1995, five years after their transition processes began. In 2002 (the most recent available data), Serbia's HDI was 0.772. As Table 2 shows, this is somewhat below the average HDI for the EU8 in 2005, but is roughly comparable to Estonia's and Lithuania's HDIs in 1995 (0.787). This parallel suggests that, with adequate transition policies, Serbia in five years could be among the leading group of human development countries (in 2000, the HDIs for Estonia and Lithuania were 0.833 and 0.828, respectively).

Disaggregating the HDI into its three components shows that Serbia compares favourably with the new member states in terms of life expectancy and the gross primary, secondary and tertiary enrolment ratio (see Table 2). On the other hand, Serbia lags well behind when it comes to economic performance, with per-capita GDP (in purchasing-power-parity terms) around $5,000 - similar to levels of Latvia and Lithuania in 1995. This comparison suggests that the implementation of the ambitious legal and economic reforms required by EU accession, tailored to the Serbian economic structure, together with the consolidation of gains in the health and education spheres, can play an important role in improving living standards in Serbia.

Table 2: Human Development Index components (1995)[3]

Country	HDI	Life expectancy at birth	Adult literacy rate	Combined gross enrolment ratio [4]	GDP per-capita (PPP$)
EU8	0.804	70.6	99.40%	71.40%	8,365
Serbia (2002)	0.772	71.8	96.50%	72%	4,948

3. HDR 1998 (http://hdr.undp.org/reports/global/1998/en/), UNDP, Serbian HDR 2005.
4. For primary, secondary and tertiary schools.

UNDP's 2005 national human development report for Serbia showed that the Gini coefficient for income inequality increased alarmingly, from .283 in 2000 (similar to Germany's) to .341 in 2002 (higher than Poland's). Although some increases in inequality during the transition may be inevitable, such a large increase in only two years could lead to renewed social tensions. Regional disparities also stand out. Whereas the HDI for the city of Belgrade was 0.826 (similar to Latvia's or Bulgaria's HDI) and another four districts (Severno-Backi, Srednje Banatski, Zajecarski and Nisavski) were in the 0.782 – 0.826 range, the Pcinsky district's HDI was only 0.663 - slightly above Tajikistan's, and below the HDIs for Moldova and Kyrgyzstan.

As the data from UNDP's Vulnerable Groups Survey in Table 3 show, the Roma are Serbia's most vulnerable minority. Serbia is also facing challenges of integrating some 139,180 refugees and 208,000 internally displaced

Table 3: Socio-economic vulnerability of Roma in Serbia [5]

Survey respondents	Unemployment rate	Poverty Rate [6]	Average monthly income
Roma	46.10%	61.20%	158 euros
Non-Roma [7]	15.50%	10.30%	372 euros

5. Source: UNDP Vulnerability Survey 2004 (http://vulnerability.undp.sk).

6. In the absence of an official poverty line for Serbia, the income-based internationally comparable poverty line (PPP$ 4.30 for Eastern Europe) has been applied to the Survey Data.

7. In the context of UNDP Vulnerability Survey 2004, 'non-Roma' is interpreted as 'non-Romani' population living in close proximity to Roma.

persons - among whom poverty rates are four times higher than national averages. The rural-urban divide poses additional challenges: poverty rates in rural areas (where some 45 per cent of the country's population resides) are double rates in urban areas (18 per cent versus 9 per cent). Measures to accelerate employment growth, and ensure that social policy is better targeted towards vulnerable socio-economic groups and regions, become particularly important given the UNDP data.

The Yugoslav wars and their consequences cost Serbia a decade in its EU accession process. On the other hand, Serbia now has the benefit of other candidate countries' experiences. While EU accession will help to consolidate Serbia's transition to a market democracy, the human development lens can help devise policies to promote social solidarity and prevent vulnerable groups from being left behind. For many Southeast European countries, EU accession involves reconciling the transposition of the *acquis communautaire* with the unmet development challenges facing countries without fully consolidated European institutions.

Paola Pagliani is policy specialist and Rastislav Vrbensky is deputy resident representative at the UNDP office for Serbia and Montenegro.
paola.pagliani@undp.org rastislav.vrbensky@undp.org

The European Neighbourhood Policy: 'conditionality-lite'?

Gwendolyn Sasse

The European Neighbourhood Policy (ENP) evolved out of the final stage of the EU's eastward enlargement, which required the EU to better define its relationship with the new eastern neighbours – the 'outsiders'. Policy discussions in the Commission and the Council intensified from December 2002, when then Commission President Romano Prodi spoke of the enlarged EU's need for a 'ring of friends'. The policy was first outlined in a Commission communication on *The Wider Europe* in March 2003, which included the EU's southern neighbours. ENP has a clear security dimension: the EU is concerned about illegal migration, organized crime, the non-proliferation of weapons of mass destruction and environmental disasters or ethnic conflicts destabilizing or spilling over its borders. In July 2003 a task force under Günter Verheugen, then Commissioner for Enlargement, was set up to develop the strategy and process behind ENP. The European Security Strategy of December 2003 makes a secure neighbourhood one of the EU's strategic objectives. ENP assumed its final form in a strategy paper of May 2004, which extended the policy coverage further to include the countries of the South Caucasus. Thus, 16 countries - six of which belong to the Commonwealth of Independent States (CIS) - were designated as falling within Prodi's notion of the 'ring of friends'.[1]

ENP expresses three related concerns of the EU: the desire for political stability on the EU's borders, the wish to mitigate the real or perceived negative effects of enlargement on neighbouring countries, and an attempt to define an alternative to full EU membership that would be attractive to the neighbours. ENP is located in the fuzzy space between the EU's partnerships and full membership; it has been aptly described as 'politics of the half-open door'. The difficulty for the EU is that some ENP countries, notably Ukraine, have already declared EU membership to be their strategic objective. Furthermore, as the EU's response to Ukraine's 'Orange Revolution' demonstrated, there is uncertainty within the EU itself as to whether ENP is an alternative, or precursor, to full membership.

During the EU's eastward enlargement, the EU applied conditionality to secure compliance from the candidates on a wide range of political, economic and legal matters. The consistency and effectiveness of EU conditionality, however, has remained questionable, and the record of its impact on policy change is mixed across accession countries and policy areas. ENP might at first sight appear to be an alternative form of 'conditionality-lite' for countries that are not seen as future candidates. Paradoxically, the conditionality inherent in ENP is 'hard' rather than 'soft', as compliance is not rewarded with the 'carrot' of full membership.

The inconsistency of ENP is clear from the way the EU has amended its incentive structure. ENP was explicitly built around a country's prospect to participate fully in the EU's four freedoms (movement of goods, services, capital and persons). However, the freedom of movement of persons has proven to be too politically controversial and gradually it has been replaced by references to visa agreements. Moreover, the EU has increasingly stressed that ENP's benefits are bilateral and economic (a free trade area and the offer of a 'stake' in the EU's internal market) rather than political.

A key incentive in ENP is funding. It envisages the streamlining of technical assistance programmes for CIS countries, such as TACIS and Interreg, into a new financial 'ENP Instrument' (ENPI). It was proposed to commit almost €15 billion Euros to ENPI during the 2007-2013 budget period, but the final figure might be closer to €12 billion. In principle, such funding gives the EU leverage in securing reforms to promote 'good governance' and improvements in the trade and investment environment in ways that accord with the EU's own security and economic interests, especially with regard to cross-border initiatives.

The core institutional elements of ENP are the bilateral, tailored 'Action Plans' between the EU and individual countries.[2] This emphasis on bilateralism is hardly consistent with the claim to an overarching 'neighbourhood' policy. Legally, the Action Plans do not overrule the Partnership and Cooperation Agreements (PCAs). Nevertheless, expectations may be raised given that the Action Plans resemble the 'accession partnership documents' with the candidate countries. The Action Plans and the monitoring process surrounding them are reminiscent of the formalism, generalities, and absence of clear benchmarks that characterized the regular reports on the candidate countries during the Eastern enlargement.

ENP's sweep from the CIS to North Africa counterbalanced the interests of the EU's northern and southern member states. Evidently however, the priorities for the eastern and southern dimensions of ENP are not easily reconcilable. A southern neighbour like Morocco has long ago seen its membership application refused on grounds of not being a 'European' country, whereas this argument cannot be applied to the eastern neighbours, such as Ukraine and Moldova. The sweep of ENP has widened the EU's geopolitical concerns: the EU is becoming more directly engaged in managing regional and local crises on its periphery, which may require it to develop a stronger capacity for conflict management, possibly involving a military component. In the case of Eastern Europe and the CIS, such engagement creates tensions in the EU's 'strategic partnership' with the Russian Federation, while, in the case of the Middle East, it causes friction with the United States.

The political inconsistencies of the EU's implementation of ENP are most evident in the case of Ukraine. The EU-Ukraine Action Plan of February 2005 was largely negotiated under the old Kuchma regime. The 'Orange Revolution' of late 2004 and Yushchenko's subsequent push for full membership forced the EU to dilute the logic of ENP and drop the label 'neighbour'. The EU added '*10 points*' to the Action Plan which included a promise to 'respond' if Ukraine implements the Action Plan, and a commitment to increased financial assistance. The core substance of the Action Plan has not changed but the door has been opened a little wider to the prospect of Ukraine's membership of the Union. Ukraine's Partnership and Cooperation Agreement is up for review in 2008, and the Action Plan adds to the momentum for a redefinition of the relationship between the EU and Ukraine at that stage. There seems to be a tacit acceptance in the Commission and the Council that the Action Plan has *de facto* acknowledged Ukraine's membership prospect.

The limitations of ENP are all too apparent. It comprises a large number of diverse countries that are geographically spread out on the EU's periphery, with very different reform challenges, and varying links with the EU or individual member states. In such conditions, the chances for ENP to become a coherent and successful foreign policy instrument for the EU are slim. In its current form ENP will work best in those countries that do not aim for membership, or have almost no prospect of securing it.

We can debate whether ENP evolved as a considered attempt by the EU to provide itself with a vision for the future relationship with its periphery, or was a rushed effort to give itself a breathing space after the 2004 enlargement. The paradox of ENP, however, is that as the ENP countries are adopting EU norms and legislation, and are being socialized into EU networks, the expectations for an 'ENP-plus' grows. Ukraine's Orange Revolution was the first serious test for ENP, and the EU blinked. The EU-Ukrainian relationship is likely to be redefined in a way that supersedes the ENP at the end of the three-year Action Plan. This could then have a knock-on effect on expectations elsewhere.

Gwendolyn Sasse is a Senior Lecturer in Comparative European Politics at the London School of Economics, and a deputy editor of Development and Transition. A fuller version of this piece will be published as 'Conditionality-lite: The European Neighbourhood Policy and the EU's Eastern Neighbours', in: Costanza Musu and Nicola Casarini (eds), *The Road to Convergence: European Foreign Policy in an Evolving International System*, Basingstoke: Palgrave, forthcoming 2006. g.sasse@lse.ac.uk

1. For Wider Europe see http://europa.eu.int/comm/world/enp/pdf/com03_104_en.pdf, and for the Strategy Paper see http://europa.eu.int/comm/world/enp/pdf/strategy/strategy_paper_en.pdf. ENP covers Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Libya, Moldova, Morocco, Palestinian Authority, Syria, Tunisia, Ukraine. While sometimes considered to be part of the 'wider neighbourhood', the Southeast European countries are formally treated as being covered by accession and pre-accession processes per se, and are therefore not covered by the ENP.

2. The first seven ENP Action Plans were agreed in early 2005 with Israel, Jordan, Moldova, Morocco, the Palestinian Authority, Tunisia and Ukraine. The Commission will report on progress in late 2006.

The European Neighbourhood Policy and development: the case of Moldova

Arcadie Barbarosie

Can the European Neighbourhood Policy (ENP) promote a 'Europeanization' process in Moldova? The answer depends in part on the degree to which the ENP can supplement, rather than collide with, other development strategies and instruments, such as Moldova's Economic Growth and Poverty Reduction Strategy (EGPRS) and the Millennium Development Goals of the United Nations. It also depends on whether European integration processes can be robustly applied to a small, post-conflict country like Moldova, that belongs to the Commonwealth of Independent States (CIS). In countries like Moldova European political, economic, and social systems have not yet fully consolidated, and the ENP is presented as a substitute for, rather than as a way station to, eventual EU membership.

The EU-Moldova Action Plan, which was signed in February 2005,[1] is the key tool for ENP implementation in Moldova. Externally, the Action Plan constitutes Moldova's commitment to implementing European democratic values. Internally, the Action Plan has become one of Moldova's most important medium-term development strategies. It sometimes complements, and sometimes competes with, Moldova's other development strategies and programmes.

This article examines some outcomes of the first year of the Action Plan's implementation. It pays special attention to the Action Plan's implications for poverty alleviation, migration and borders, and governance. It concludes by suggesting that, while much was done in the first year, implementation remains uncertain, and depends in part on the evolution of the ENP itself.

The ENP, poverty alleviation, and economic integration

Despite significant declines in poverty rates during the last five years (according to one study, the absolute poverty rate has fallen by two thirds since 1999)[2], Moldova continues to be the poorest country in Europe. The $1510 in per-capita GDP (in purchasing-power-parity terms) reported for Moldova in 2003 was well below the levels recorded in countries like Ghana ($2619) and the Dominican Republic ($6823)[3]. The Economic Growth and Poverty Reduction Strategy (EGPRS), which has been the focus for lending by the International Monetary Fund and World Bank as well as for the coordination of donor activities, has been Moldova's key policy document in this respect.[4]

Despite its title, the EGPRS reads more like a general development strategy for Moldova, rather than a policy document that focuses on poverty reduction as measured by progress towards meeting the Millennium Development Goals. The Action Plan may therefore sharpen the focus on poverty alleviation, and help to build the capacity needed to introduce EU policies that focus on social inclusion. Commonalities between these two documents are apparent in other economic policy areas as well. These include such measures to improve Moldova's business climate as the 'guillotine law', which has significantly simplified the regulatory environment for small- and medium-sized enterprises, and the implementation of the so-called 'one window' system for registering new businesses. On the other hand, the EU's traditional emphasis on relative (rather than absolute) poverty may not be appropriate for a country with Moldova's low per-capita income levels. The potential for institutional collision is also present: whereas the EUMAP is the responsibility of the Ministry of Foreign Affairs and European integration, monitoring EGPRS implementation is the duty of the Ministry of Economy and Commerce.

The Action Plan can offer Moldova (as a small, open economy) something that the EGPRS cannot: better access to the EU's single market for Moldovan exports. Under the Action Plan's trade liberalization measures, 88 per cent of Moldovan exports to the EU are to have free access to the EU's single market, the benefits of which are to account for some $20 million annually.[5] On the other hand, this figure only represents about 6 per cent of Moldova's total exports to the EU ($324 million in 2005), or 1.8 per cent of total exports. Moldova's exports of such 'sensitive' goods as foodstuffs and agricultural products will continue to face tariff and non-tariff barriers on EU markets.

Migration and border control

Moldova remains a source of legal and illegal migration to EU and other countries; up to a quarter of Moldova's

economically active population is thought to have emigrated, mainly to EU countries, Russia, and Turkey. Moldova is also a transit country for illegal migrants. The Action Plan calls for improvements in the control of migratory flows, as well as better border management. The main challenges in reforming border control lie in demilitarizing the Border Guard Service (which is a component of Moldova's armed forces), in the implementation of an integrated border management system, and in the conclusion of readmission agreements with EU and other European countries.

While the EU has generally avoided becoming enmeshed in the Transnistrian question, the Action Plan does envisage more extensive EU engagement in this issue. Among other things, the EU has acquired observer status (together with the United States) in the negotiations on Transnistria's future. The EU has fielded a border assistance mission to support both governments' efforts to strengthen their common borders, particularly along the Transnistrian segment. Russia has protested against the introduction of tighter customs procedures, claiming this amounts to an 'economic blockade' of Transnistria. In response Russia has embargoed the import of Moldovan wine production, which constitutes some 80 per cent of total Moldovan wine export, and 24 per cent of the country's GDP.[6] The federalization plan for solving the conflict, entailed in the 'Kozak Memorandum' proposed by Russia, was at first supported and then rejected by Moldova, and was opposed by the EU and United States.

The ENP and good governance

Legislation on the appointment and promotion of judges (intended to increase judicial independence) has been adopted by the parliament, as required by the Action Plan. Human rights measures called for under the Action Plan have already been introduced: Moldova has signed the Optional Protocol of the Convention on the Elimination of All Forms of Discrimination against Women, adopted legislation on equal opportunities for men and women, and introduced punishments for torture. Laws on the electoral code, the audit chamber, and the intelligence and security services have likewise been adopted or amended as stipulated in the Action Plan. Moldova is aligning its higher education system to European standards via the Bologna process. And Moldova has launched (with UNDP assistance) an ambitious set of public administration reforms, aimed at developing transparent, accountable, fair and client-oriented state institutions. The Action Plan's stipulation that local governance reforms should follow the requirements of the European Charter on Local Self-Government and the recommendations of the Congress of Local and Regional Authorities in Europe has led to the creation of the Local Administration Ministry.

On paper, these changes suggest that Moldova is indeed making progress in bringing its political institutions into line with European standards. Further significant improvements in the quality of governance are unlikely in the absence of major support for strengthening the institutional capacity of the new or redesigned state structures. In the new member states, capacity development was supported by extensive outlays from such EU pre-accession funding instruments as PHARE, ISPA, and SAPARD. For Moldova and other ENP countries, such instruments are lacking. Funding under the TACIS programme is now being phased out, and the details of its replacement, the European Neighbourhood Partnership Instrument (ENPI - which is to go into effect in 2007), have yet to be clarified.

Conclusions

The case of Moldova shows that, through its national Action Plans, the ENP can have an impact on policy-making in CIS countries, even over a short period of time. But it also suggests that the ENP's impact significantly lags behind that of the EU accession process *per se*, particularly in terms of trade liberalization. Matters are further complicated by the difficulties of the Transnistria situation, by uncertainties about the amount and type of ENPI assistance that will be available starting next year, and by tensions between the Action Plan and other strategic development documents. Prospects for the Action Plan's successful implementation may hinge on the abilities of other development partners to help strengthen Moldova's institutional capacities for its Europeanization processes.

Arcadie Barbarosie is Executive Director at the Institute for Public Policy, Chisinau, Moldova.

arcadie_barbarosie@ipp.md

1. http://www.mfa.md/En/index.html
2. http://www.scers.md/files/report_for_publication-04.pdf
3. UNDP Human Development Report 2005.
4. http://scers.md/index.php
5. http:// www.moldpres.md, March 13.
6. www.statistica.md

Eurozone entry of new EU member states from Central Europe: Should they? Could they?

Willem H. Buiter
Anne C. Sibert

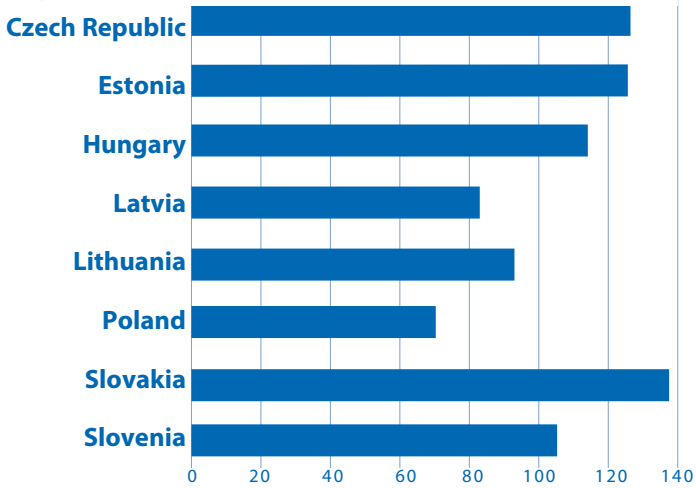
Estonia, Lithuania and Slovenia hope to become members of the Euro area by January 2007; Latvia targets full membership in 2008 and Slovakia hopes to join the Eurozone in 2009. We consider whether or not the eight new members of the European Union from Central and Eastern Europe (EU8) would benefit from joining the Eurozone and whether the Eurozone has any economic grounds for excluding them.[1] We ask whether or not the countries that have set target dates for membership are likely to achieve them.

I. Should the new members join the Eurozone?

The theory of optimal currency areas suggests that it is in the interest of the EU8 to join the Eurozone as soon as possible. They are too small, too open and too vulnerable to speculative attacks against their national currencies to be optimal currency areas. For the smallest ones among them, it is doubtful whether a national currency is a viable option in the medium to long run.

In terms of economic size, as measured by their per centage share of world GDP, the EU8 are tiny. Several are about the size of Luxembourg (0.05 per cent) and collectively (at 1.93 per cent) they are about the same size as Canada (1.84 per cent). The EU8 are also relatively dependent on trade.[2] Their share of trade in GDP, calculated as the percentage of the sum of imports and exports to GDP ranges from about 70 per cent for Poland to nearly 140 per cent for the Slovakia (see fig. 1). This contrasts with the United States, where the share of trade in GDP is about 24 per cent and with France, where it is about 56 per cent. Moreover, their openness is increasing and should become significantly higher. These countries still trade significantly less than would be expected, given their size, per-capita income, distance from trading partners and man-made barriers to trade. The latter impediment is primarily the legacy of misdirected central planning which has still not been completely overcome.

Fig. 1. Share of Trade in GDP

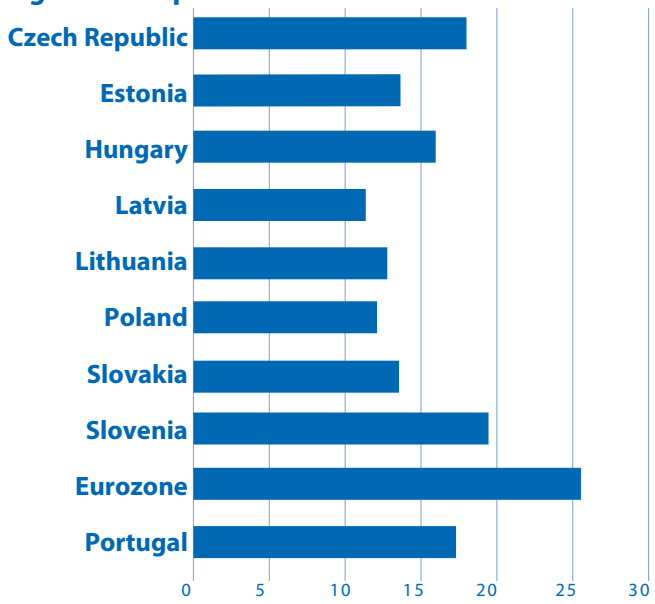


While openness to trade is high, financial openness is nearly complete. As part of the process of qualifying for EU membership, virtually all institutional barriers to financial capital mobility have been lifted. An open financial account has many advantages: it permits nations, such as the EU8, with high economic potential to draw on foreign savings to augment their domestic capital stocks; it permits foreign direct investment, which brings financial resources and transfers skills, knowledge and technology. It increases the efficiency of financial intermediation and permits cross-border risk sharing. However, it exposes countries to whims of international financial markets. Average *daily* turnover in the global foreign exchange market is about $2 trillion and a single large hedge fund may have more financial resources than the monetary authorities of most of the new member states.

Their small size and financial openness and vulnerability imply that for the EU8, a national currency is a liability. If they peg their exchange rates, then sooner or later they will almost certainly undergo a sudden and costly disruption to their financial sectors. The disastrous experiences of East Asia, Russia and Latin America in the late 1990s and 2002 serve as a warning that, for small open economies with mobile financial capital, pegged or heavily managed exchange rates lead to turmoil and output loss. The current situation of Iceland and New Zealand illustrates the problem with the alternative floating exchange rate regime. Swings in capital flows brought about by external events can force central banks to have to choose between cutting off growth with high interest rates or allowing precipitous declines in the value of their currency.

Wolfgang Munchau of the *Financial Times*, argues that Estonia and Lithuania are too poor to join the Eurozone.[3]

Fig. 2. Per-capita GDP in thousands of euros



Indeed, Estonia and Lithuania are poor relative to most of the other new member states and the new member states are poor relative to the Eurozone (see Fig. 2). But, the gap is narrowing and the Czech Republic and Slovenia are wealthier than the Eurozone member Portugal. Moreover, if poverty implies that sharing a common currency with wealthier neighbours is undesirable, perhaps Tower Hamlets should leave the sterling area.[4] Fortunately, having similar levels of per-capita income is not an Optimal Currency Area criterion.

The smallness and openness of the member states implies that the exchange rate is not an effective instrument or buffer, allowing them to achieve the necessary changes in international relative costs and prices with small transitional costs of excessive inflation and unemployment. Instead, the foreign exchange market itself is a source of excess volatility, instability and, at times, persistent misalignment.

A cost of joining a common currency is losing an independent monetary policy to stabilize country-specific shocks. However, because of an incentive to use monetary policy opportunistically and because, even when the policy makers are competent and credible, monetary policy in a small open economy with unrestricted capital mobility and a floating exchange rate is a poor stabilization instrument, giving up the monetary stabilization instrument is no great loss for the EU8.

A factor which might mitigate any cost associated with losing a stabilization role for the central bank is the surprisingly high degree of cross-country labour mobility between the EU8 and the few EU member countries that have allowed labour immigration from the new member states since May 2004. Labour mobility can serve as a substitute for conventional stabilization policy in coping with country-specific shocks.

The cost of a common monetary policy to countries such as Estonia and Lithuania would not necessarily be greater than the cost to the existing Eurozone members. In the 14 years since their independence, Estonia and Latvia have been remarkably successful in transforming themselves into flexible and resilient market economies. The World Bank publishes an index measuring the ease of doing business in different countries. The index depends on such factors as business regulations, property rights and labour market rigidities. On this index, Lithuania and Estonia rank 15th and 16th in the world, ahead of Germany (19th place) and France (44th place).[5]

II. What are the prospects for Estonia, Lithuania, Latvia, Slovakia and Slovenia to satisfy the Maatstricht convergence criteria?

There are four Maastricht criteria for full membership in EMU. The first is a pair of fiscal conditions that government deficits be less than three percent of GDP and government debt less than sixty percent of (annual) GDP. The second is an interest rate criterion: long-term nominal interest rates on government debt are to be within two percent of the average in the three EU member countries with the best inflation record. The third is an inflation criterion that specifies that the annual inflation rate cannot exceed the average of the three best performing EU member countries by more than 1.5 per cent during the year prior to the candidate's formal assessment. Finally, there is an exchange rate criterion: the exchange rate has to remain within the normal fluctuation margins (15 per cent around a fixed parity with the euro) without severe tensions for at least the last two years before the formal assessment. This two-year ERM 'waiting room' or purgatory has been characterized as an investment without return: a country that demonstrates it is capable of managing its exchange rate in this way is rewarded with membership in the monetary union and thus the permanent loss of its ability to manage its exchange rate.[6]

In terms of the theory of optimal currency areas, only the fiscal criteria are rationalizable and even these are questionable: the Maastricht fiscal criteria are neither necessary nor sufficient for fiscal sustainability. Note that the candidate countries are required to achieve

Fig. 3. Government debt as a percentage of GDP

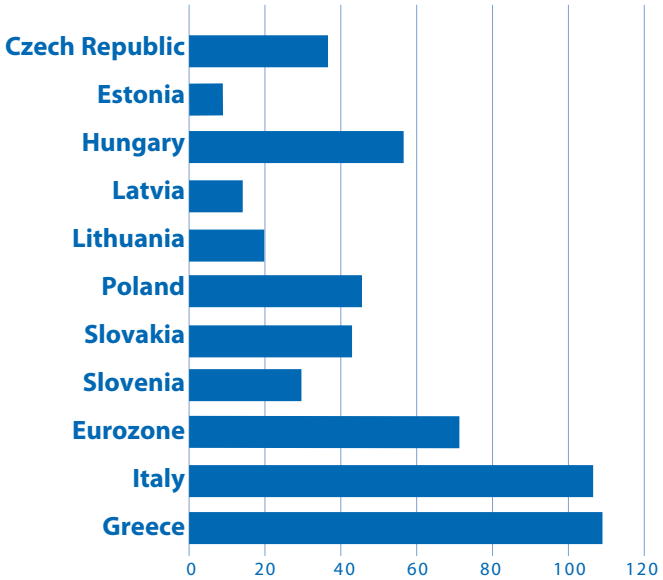
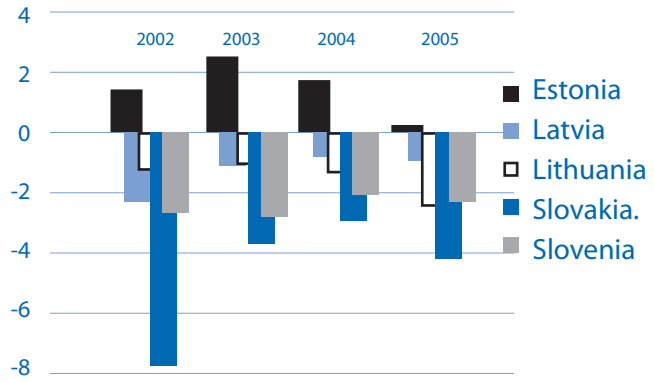


Fig. 4. Goverment surplus as a percentage of GDP



three nominal targets simultaneously - inflation, interest rate and exchange rate. Most central banks have trouble targeting even one.

An unsustainable fiscal policy in a candidate Eurozone member can be viewed as a potential cost of their membership to the existing members: an actual or threatened insolvency might jeopardize the entire Eurozone financial system or destabilize the common currency by forcing the European Central Bank into a bail-out. Establishing whether or not a country is following a sustainable fiscal policy is not a straightforward matter, but government insolvency and debt default is a threat whenever the outstanding stock of debt is high relative to the ability and willingness of present and future governments to generate primary budget surpluses, that is surpluses before interest payments.

Figure 3 shows that the existing debt-to-GDP ratios of the EU8 are well below the average of the Eurozone and much lower than the levels of Greece and Italy.[7] As is clear from Figure 4, however, Poland, Hungary and the Czech Republic have persistently run larger conventional budget deficits than the Eurozone. They also show no evidence of being capable and willing to generate primary surpluses. Fundamental doubts about fiscal sustainability, rather than a failure to meet the wholly arbitrary Maastricht numerical deficit criterion, justify the claim that Poland, Hungary and the Czech Republic are not ready for Eurozone membership.

The three Baltic countries and Slovenia, and possibly even Slovakia, have run surpluses or small deficits and are ready for Eurozone membership now (see Figure 2); indeed they are more *ready* than Italy, Greece, and quite possibly also France and Germany, none of which can be confidently stated to have sustainable fiscal programmes.

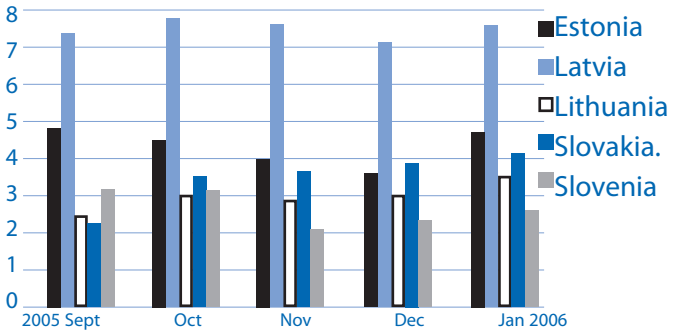
The five candidate countries should easily meet the long-term interest rate criterion and appear likely to meet the exchange rate criterion. Bond yields within the Eurozone have converged and rates in the EU8 are not much higher. Estonia, Lithuania and Slovenia joined ERM in June 2004. Estonia and Lithuania have successfully maintained a currency board arrangement that keeps their currencies at the central parity rate; Slovenia's monetary policy is aimed at stabilizing its exchange rate and its currency has traded close to its central parity rate since entry. Latvia joined the ERM in May 2005 and its currency has also remained well within its target zone of plus or minus 1 per cent around the central parity. After Slovakia entered the ERM in Nov 2005, its currency appreciated, but has since stabilized between 1 and 2 per cent above the central rate.

The EU8's inflation, measured as the change from the same month of the previous year, is shown in Figure 5.[8] We calculate that the benchmark average of the three lowest inflation rates in the EU plus 1.5 per cent was about 2.5 per cent in early 2006. Thus, Slovenia appears to have a good chance of satisfying the inflation criterion. It is clear that Latvia is far from being able to satisfy the inflation target; it appears unlikely that Estonia, Lithuania and Slovakia will satisfy it. Given their success in maintaining their exchange rates against the euro, the inflation rates in Figure 5 are no surprise. In the face of external shocks, either a small open economy's exchange rate fluctuates or its inflation rate varies. It is not possible to achieve both an inflation target and an exchange rate target simultaneously, except by chance. Since June 2004 Estonia has maintained an unchanged exchange rate in the ERM. However, mainly as a result of oil price rises, its inflation rose to 4.1 per cent in 2004. As

a consequence, Estonia will not meet the Maastricht inflation criterion by June 2006; it is unlikely to meet it in 2007.

Even without an energy price shock, we should expect that as the accession countries' productivity levels catch up with Euro area countries, their real exchange rates will appreciate. This is because productivity catch-up to the level of the EU15 is faster in the traded goods sector than in the non-traded goods sector. The relative price of non-traded goods to traded goods will therefore be rising faster in the EU8 than in the EU15 – the real exchange rates of the EU8 countries will appreciate. This phenomenon is called the Balassa-Samuelson effect. If their nominal exchange rates are stable against the euro, then their inflation rates will be higher than in the Eurozone. Current estimates of the magnitude of the Balassa-Samuelson effect are in the range of 1.5 - 2.5 per cent per year.[9]

Fig. 5. Inflation



As the Maastricht Treaty only allows for inflation to be 1.5 per cent above the best-performing members of the EU, this creates a serious problem for Estonia and Lithuania. They can, with a fixed exchange rate, simultaneously satisfy the inflation and the exchange rate criteria only by luck. There are just two other macro-economic policy options to meet the inflation criterion. Either they abandon their highly successful currency boards and adopt a more flexible exchange rate system: the 15 per cent exchange rate bands may permit more leeway than the 1.5 per cent band in the inflation target. Or, they can use fiscal policy to create a recession which reduces inflation to the point where both criteria can be met. Neither choice seems particularly appealing.

The most bizarre feature of the Maastricht inflation criterion is that its benchmark is based on the three lowest inflation rates among the 25 EU members, and not just on the inflation performance of the 12-member Eurozone. Indeed, in recent months, two of the three lowest inflation rates were for countries that are in the EU but not in EMU - Poland and Sweden. It would make as much economic sense to base the decision on admitting the candidate Eurozone members on the inflation performance of Sub-Saharan Africa as on that of EU members that are not in the Eurozone. Indeed, even requiring convergence to the level of inflation of existing members is not essential: membership in the Eurozone itself will assure inflation convergence.

Conclusion: what to do when 'the law is a ass'

Of the five candidate Eurozone members - Estonia, Latvia, Lithuania, Slovakia and Slovenia - only Slovakia is not yet a convincing candidate for immediate Eurozone membership. All that stands between the four countries and a Eurozone membership that would benefit both them and the existing EU members is the likelihood of the rigid application of an arbitrary inflation criterion.

This raises the problem of what to do when 'the law is a ass'. Failure to enforce a treaty-based rule weakens the institutions of the European Union, as does enforcing a rule that makes no sense and inflicts unnecessary harm. Fortunately, in the case of the numerical Maastricht criteria for inflation, debt and deficit, interest rate and exchange rate - none of which make any sense at all - this dilemma has already been resolved: the criteria have been violated both in spirit and in the letter so frequently that little or no further damage will be done by a flexible interpretation of the inflation criterion. Italy, Greece and Germany joined EMU despite not meeting the debt criterion; Finland, Italy and Greece joined without satisfying the exchange rate criterion; Estonia, Latvia, Lithuania and Slovenia should be allowed to join as well.

Willem H. Buiter is Professor of European Political Economy, European Institute, London School of Economics and Political Science, Universiteit van Amsterdam, Centre for Economic Policy Research (CEPR) and National Bureau of Economic Research.

Anne C. Sibert is Professor of Economics, Birkbeck College, University of London and CEPR.

1. The Eurozone has 12 members. The UK, Sweden and Denmark, as well as the 10 new EU members that joined the EU on 1 May 2004, are not members of the Eurozone.
2.World Bank Development Indicators, 2004.
3. 'Monetary union is not for the poor', 30 Jan 2006.
4. Tower Hamlets is among the poorest boroughs of London, although it contains Canary Wharf, London's new financial centre.4. Eurostat, OECD.
5. World Bank, Doing Business in 2006, overview. The first three countries are New Zealand, Singapore and the United States, respectively.
6. See Willem H. Buiter *To Purgatory and Beyond: When and How should the Accession Countries from Central Europe Become Full Members of the EMU*, 2004; http://www.nber.org/~wbuiter/vienna.pdf
7.Source: Eurostat, OECD
8. Source: Eurostat
9. See Willem Buiter (2004) op. cit.

FORTHCOMING CONFERENCES

'Responsible Investing' 19-20 June 2006 - The international forum, organized jointly by the United Nations Development Programme, the Austrian Development Agency and the United Nations Industrial Development Organization 'Responsible Investing' – is a forum to promote corporate social responsibility and facilitate multi-stakeholder partnerships in Southeast Europe, the new EU member states and the Commonwealth of Independent States. It will be held at the Vienna International Centre in Austria.

www.vienna-csrforum.com.

"At Risk: Roma and the Displaced in Southeast Europe" 26-27 June 2006 – UNDP's Dimensions of Vulnerability Report will be launched in Brussels. The main objective of the publication is to provide an in-depth assessment of the determinants of vulnerability affecting Roma and displaced persons in Southeast Europe. It is based on the data derived from a comprehensive integrated household survey conducted in eight countries of Southeast Europe and the UN-administered province of Kosovo. For more information, please contact Andrey Ivanov, andrey.ivanov@undp.org or Susanne Milcher, susanne.milcher@undp.org. Data on Roma and other vulnerable groups can be found at:
http://www.undp.org/europeandcis/vulnerability.

Regional Meeting on Environment and Security Programme for the Fergana Valley 6-7 July 2006. The meeting will bring together the representatives of the Ministries of Environment and provincial environmental authorities from Kyrgyzstan and Tajikistan to discuss the environmental risks to human security and areas for stronger environmental cooperation in the border areas of the Fergana Valley countries. For more information, please contact Inkar Kadyrzhanova, Energy and Environment Programme Specialist, UNDP.
inkar.kadyrzhanova@undp.org.

Summer course on Human Development and the MDGs, 3-14 July, Central European University, Budapest
This summer course will be a policy and practice-based course for approximately 15-20 civil servants/decision makers as well as graduate students from Central and Eastern Europe, the Caucasus, and Central Asia, as well as interested graduate students from other regions. The aims of the course are to customize the Millennium Development Goals to the target regions and develop policy proposals for realizing them.

http://www.ceu.hu/sun/SUN_2006/Downloads/Detailed/Sustainable.doc

European Consortium for Political Research - Standing Group on the European Union Third Pan-European Conference on EU Politics. 21-23 September 2006, Bilgi University, Istanbul, Turkey. The Standing Group's Pan-European Conferences are the largest academic conferences on the European Union in Europe and bring together scholars from all over the world. The Conference has the following sections covering major fields of current research on the EU as well as an open section for cross-cutting and interdisciplinary themes. Theories of European Integration; EU Institutions and Politics; Political Economy of the European Union; EU Law and Policies; Equality, Diversity, and European Integration; EU Enlargement and Neighbourhood Policy; Foreign Policy and External Relations; and Migration and European Integration.

http://www.jhubc.it/ecpr-istanbul/index.cfm

Fourth International Water Forum 'AQUA UKRAINE - 2006' 3-6 October 2006 International Exhibition Centre, Levoberezhna subway station, 15 Brovarsky Ave., Kyiv, Ukraine. The meeting will focus on water preparation, water supply, water removal, sewage treatment, local water treatment devices, pumping and armature equipment, engineering networks.

http://www.tech-expo.com.ua/index_e.htm

To have your event listed here please send an email to developmentandtransition@lse.ac.uk

Forthcoming issues of Development and Transition will focus on:

- Poverty and inequality
- Conflict and post-conflict societies

The editors welcome contributions. If you wish to submit an article please follow the guidelines on-line at www.developmentandtransition.net

Development & Transition is published by the United Nations Development Programme and the London School of Economics and Political Science
www.developmentandtransition.net

UNDP Bratislava Regional Centre
Grosslingova 35
Bratislava 81109
Slovakia

Tel: +421 2 59337 111
Fax: +421 2 59337 450
www.undp.org/europeandcis

Editor: James Hughes: j.hughes@lse.ac.uk **Executive Editor**: Ben Slay **Deputy Editor** Gwendolyn Sasse, **Managing Editor** Horatio Mortimer **Advisory Board** : Nick Barr, Willem Buiter (chair), Stanislaw Gomulka, Mary Kaldor, Dominic Lieven, Margot Light, Kate Mortimer

Houghton Street, London WC2A 2AE, UK
www.lse.ac.uk