Executive summary

Chapter 1: From misdirected integration to reintegration

Under central planning, the countries of central and eastern Europe and the former Soviet Union were the victims of misdirected integration. The potential gains from liberalisation were accordingly large. The expansion of the European Union has been central to the process of reintegration into the global economy of many countries of the region. This is clearly the case for the eight transition countries that will become EU members in 2004, as well as for Bulgaria and Romania, which could join the EU as early as 2007.

The accession of some transition countries to the European Union while others remain outside will have a significant impact on the structure of trade and capital flows as well as on the pattern of migration, both legal and illegal. EU expansion is likely to have both trade creating and trade diverting effects. It will also influence investor assessments of the business environment in the transition countries and therefore the pattern of foreign direct investment (FDI) and other cross-border capital flows. Implementation of EU external border controls by the new members will alter the pattern of seasonal and permanent migration among transition countries as well as between transition economies and existing EU member countries.

There is a danger that EU expansion may reinforce the marginalisation of some of the Commonwealth of Independent States (CIS) countries so that they remain on the fringes of the international economy with relatively little foreign investment and little opportunity for legal migration. Further integration of the large CIS countries, particularly Russia but also Kazakhstan and Ukraine, into the international economy is necessary to avoid this outcome. This can be achieved through accession to the World Trade Organization (WTO) along with greater regional cooperation by the smaller CIS countries with their larger neighbours.

Part I: Transition and economic performance

Chapter 2: Progress in transition and the development of democracy

The transition countries have continued to make progress in structural and institutional reform over the past year. The countries of central eastern Europe and the Baltics (CEB) moved further forward from their already advanced position as they finalised the accession negotiations with the European Union. However, EU accession is not the end of the transition process. Reforms in the new member countries will have to continue – especially in the financial sector, public administration and the business environment – if they are to be competitive in the single market.

The prospect of further economic integration has also encouraged reform in other countries with aspirations for closer ties with the EU. Most notably this has been evident in south-eastern Europe (SEE), where the leading reformers continued to catch up in 2002-03. However, countries such as Bosnia and Herzegovina and Serbia and Montenegro are improving from a very low base and their reform achievements are still fragile. Russia has made progress on a number of fronts although the implementation of reforms remains an issue. Elsewhere in the CIS, reform progress has been uneven – with encouraging developments in some countries and virtual stagnation or backtracking in others – and the transition process continues to be held back by poor governance and weak institutions.

These divergent patterns of economic reform are mirrored by political developments. The advanced transition countries are in the process of developing high levels of liberal, constitutional democracy while the countries that lag behind in transition are increasingly characterised by weak constitutional orders and, in some countries, political repression. The evidence suggests that there is a strong link between the depth of democracy and the level of economic reform, particularly with respect to the institutional aspects of transition. While a handful of countries with less liberal political regimes have made significant progress in transition over the past years, this progress has been limited to initial phase reforms – price and trade liberalisation and small-scale privatisation. Only countries that have established high levels of political and civil liberties and the effective rule of law have made significant progress in the more crucial area of institution-building or “second phase” reforms.

Chapter 3: Macroeconomic performance and prospects

Transition countries have remained resilient to the continued sluggishness of the global economy. Growth in the region as a whole could reach as much as 4.7 per cent in 2003. The CEB economies are forecast to grow by 3.3 per cent, spurred by a continued rise in consumption, steady investment and a recent pick-up in exports. Continued restructuring and economic integration underlie the strong performance in the SEE economies, which could grow by around 3.9 per cent this year. The CIS economies continue to benefit from high natural resource prices and are forecast to grow by 6.2 per cent in 2003.

In some parts of CEB, recent growth has been spurred by rapid increases in government consumption, which has led to very high fiscal deficits. However, continued reliance on public consumption is not viable over the medium term, as EU accession will impose additional demands on public expenditure as well as strict criteria for future eurozone accession. Some fiscal tightening may also be desirable to retain the flexibility to respond to macroeconomic shocks.

Further trade and financial integration may help SEE countries to sustain recent high growth rates. However, the countries have to push forward with the institutional reforms needed for increased integration into the enlarged EU market and continue to address macroeconomic imbalances. High fiscal deficits, persistently large current account deficits and substantial debt levels pose risks at a time when foreign assistance to most SEE countries (except Bulgaria and Romania) is being reduced.

Recent growth in the CIS was largely based on favourable commodity prices, in particular for oil and gas. Sustainable growth in the CIS countries rich in natural resources will depend on their ability to foster growth outside the core natural resources sector and manage the large and volatile foreign currency flows associated with this sector.

Growth in the non-resource-rich CIS countries is strongly linked to the performance of their resource-rich neighbours, particularly Russia, on which they depend for cheap energy (mainly natural gas) and which act as their chief trading partners. Further trade diversification and deeper regional cooperation would help to improve the medium-term outlook for these countries.

Part II: Integration and regional cooperation

Chapter 4: Trade and integration in transition countries

The process of integration into the world economy has not been uniform across transition countries. Integration has been rapid and deep in the countries of CEB. SEE and CIS countries are far less integrated into the world's product and capital markets for different reasons. In SEE the violent break-up of former Yugoslavia has prevented more rapid integration by its successor states. Slow economic reform during the early 1990s in Bulgaria and Romania has also delayed the process of economic integration with western Europe. CIS trade is limited by obstructive domestic and regional policies and distance from other markets. Moreover, some of the artificial Soviet trade links remain entrenched even after more than a decade of transition.

This chapter proposes a three-pronged solution to the problem of limited international integration in SEE and the CIS. The first issue is to improve market access – in particular, to the region's most important present and future market, the EU. Restrictions to market access remain significant in several sectors compared with those faced by many other countries. Moreover, with the completion of accession, remaining EU trade barriers against the accession countries will be lowered. As a result, trade with the non-accession countries may be reduced unless their market access is improved.

The second area is the link between improved market access and the introduction of structural and institutional reforms. Neither the WTO nor the EU's commercial relations with non-EU members are likely to generate the same depth of domestic reform as EU accession. However, both could indirectly provide a significant boost to reform by providing incentives for more liberal trade policies and better economic governance. This implies that better market access should be granted in parallel to, rather than conditional on, deep institutional reform.

The third area is closer regional cooperation to complement the process of international integration. This is reflected in the EU's Stabilisation and Association Process with the countries of SEE. In the CIS, efforts at regional harmonisation and coordination of policies may be welcome if they provide political momentum for improved cooperation on trade and transit issues, and if they do not delay the simultaneous efforts to complete WTO accession and pursue a general liberalisation of trade policies. Throughout the region, preferential trade arrangements and other forms of closer regional integration need to focus on enhancing, rather than diverting trade, transit and transition.

Chapter 5: Integration through flows of capital and labour

Mobility of capital and labour is an important aspect of integration. While labour mobility has remained quite limited throughout the region, some countries have been able to attract significant capital flows, mainly in the form of FDI. In general, trade and capital flows move together, as the policies that have been conducive to better trade integration have also promoted FDI. As a result, most FDI has been received by the advanced reformers of CEB where trade integration has proceeded furthest. FDI has also been increasing in those countries of the CIS that are rich in natural resources. However, most other transition countries have failed to benefit to any notable degree from capital inflows and FDI, in particular. This is due not simply to deficiencies in economic policy – although these have been important – but also to location and lack of resources. There are a number of ways in which such deficiencies can be addressed, including steps towards greater regional integration, which not only improve the flow of goods but may also have a positive influence on inward investment.

With regard to labour flows – contrary to many expectations – the movement of labour westwards from the transition countries has been quite limited and may well remain that way, even after EU accession. This is partly due to the presence of immigration barriers but also to the lack of effective integration of domestic labour markets.

As transition has proceeded, not only have unemployment rates tended to rise but the regional variation in unemployment has also grown. Policies designed to improve the flow of information, to promote the functioning and affordability of the rental housing market and to eliminate benefits that reduce labour mobility will be essential to address these problems. In short, gains from greater integration will require far more progress in the integration of domestic labour markets. However, an uncritical acceptance that cross-border mobility will necessarily be good for the transition countries is unwarranted. Particularly in the context of low domestic mobility, the types of workers who are likely to move will be young, skilled and relatively affluent. The obvious danger is that their migration will result in a "brain drain". Using temporary contracts for skilled workers may mitigate this risk but raises major problems of enforcement as well as ethical issues.